THE ECONOMIC CONSEQUENCES OF 'SEBI' REGULATION ON CORPORATE GOVERNANCE' ON INDIAN STOCK MARKET

Thesis Abstract

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Abstract: The issue of corporate governance has attracted considerable attention from the early 1980's. Subsequently, many countries implemented a code on corporate governance to enhance investor protection. Cadbury Committee is the foremost to propose a Code on corporate governance; this Code is applicable to the listed companies in the United Kingdom. The long lasting East-Asian crisis, Enron and Worldcom debacles has required regulators of different countries to strengthen their corporate governance practices. In India, Securities and Exchange Board of India has implemented a Code (regulation) on corporate governance in the year 2000, upon the recommendations of Kumar Mangalam Birla Committee, to improve transparency and accountability and other corporate governance practices of publicly traded companies. These recommendations are applicable as clause 49 of the listing agreement. The main objective of this Regulation is shareholder wealth maximization through appropriate governance mechanisms and by reduction of information asymmetry between the managers and the investors.

Prior to the Regulation, there was limited regulatory emphasis on financial disclosures and corporate governance mechanisms. Disclosures were regulated by the Companies Act, 1956, listing agreement and Accounting standards formulated by the ICAI. The mandatory disclosures required under these statutes were limited when compared to disclosures required in advanced countries. Also, very few companies' voluntary disclosed information necessary for the shareholders to accurately value the company. Keeping all these limitations in mind, the Regulation is indeed an important measure taken by SEBI to enhance investor protection and strengthen the capital markets in India.

The objective of our empirical study is two fold; to understand the economic implications of this Regulation on stock market variables and to understand the role of various corporate governance structures on agency costs of publicly traded companies.

We conduct a quasi-experimental research study with two time periods, pre-regulation time period and post-regulation time period. For the purpose of this study, we consider pre-regulation time period from 1st June 1998 to 31st May 1999 and the post-regulation time period from 1st June 2001 to 31st May 2002. We classify all the companies, whose data is available on Prowess database, into experimental group, quasi-experimental group and control group. We hypothesize

that the Regulation will be effective in reducing the cost of equity and increasing the trading volume of companies belonging to experimental group. We use beta, volatility and actual returns as surrogates for cost of equity.

To understand the effect of governance structures on agency costs, we segregate the companies based on their affiliation to business groups. Since, family-owned business groups control majority of the companies in the private sector; understanding the role of corporate governance in reducing the agency costs, with reference to these business groups, will strengthen our research. To calculate the agency costs, we use 6 proxies i.e., asset turnover ratio, operating expense ratio, market-to-book value, incremental economic value added, return on investment and percentage change in capital investment.

From our empirical results, we observe that the beta of the experimental group of companies has reduced subsequent to the Regulation. However, no conclusive results can be drawn from the volume, volatility and actual returns. We can argue that beta is a stationery variable, at least for a period of 6-12 months, and is affected by radical changes in corporate or economic environment. On the other hand, volatility, volume and returns may be affected by minor changes in the company or external environment. We can argue that beta is the appropriate surrogate for cost of equity. Since, beta is an important determinant of cost of equity capital, the results of beta supports our hypothesis that the Regulation has been effective in reducing the cost of equity of experimental group of companies. With respect to agency costs, we observe that FII shareholding is effective in reducing the agency costs of companies. The result that FII's are good monitors corroborates the results obtained by Sarkar and Sarkar (2000), where they prove that higher FII shareholding increases the firm value. For companies affiliated to business group with CEO duality, we observe that promoter ownership has a positive impact on asset turnover ratio (alignment effect). We also observe that board size below 10 members is effective in reducing the agency costs; on the other hand, a board size greater than 10 members increases the agency costs. This result supports the argument put forth by Jensen (1993) that higher board size leads to coordination and communication problems, thereby, reducing the profitability of such companies. Our results prove that institutional investors are not effective in reducing agency costs of the companies. This result is consistent with those obtained by Sarkar and Sarkar (2000), where they prove that institutional investors are passive monitors and have limited role in the functioning of a company. Similarly, we also observe that independent directors do not have any effect on the agency costs of companies. This result is contrary to the expectations of Kumar Mangalam Birla Committee that independent directors will help in improving the performance of the companies.

Thus, our results provide evidence that the Regulation has been effective in reducing the beta of the experimental group of companies and that FII and promoter ownership are effective in reducing the agency costs. These results, to a limited extent, prove that Regulation has been effective in addressing the 'information asymmetry problem' and the 'agency problem'. Understanding the effect of this Regulation on stock market efficiency and on voluntary disclosures made by publicly traded companies can be an extension of our study.