ARTICLE

Digitizing Corporate Governance – Innovative use of Blockchain Technology

Change is the only constant in every sphere of life. Similarly, a change is needed to bring about effective Corporate Governance. One of the newest technologies - Blockchain has made a lot of headlines all over the world mainly, due to it being a birthplace for thousands of crypto currencies. However, the unique features of this technology if adopted in the right manner can completely transform both the concept and the impact of Corporate Governance.

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INTRODUCTION

Corporate Governance is a phrase which has been oft-repeated with a lot of vigor and enthusiasm since the past more than two decades. When one talks about Corporate Governance then concepts like ethics, transparency, disclosures, compliances, investor protection, integrity and values come to mind. Over the years we have seen the law and policy evolving to keep pace with the changing times. The reforms have been brought in primarily by two of the regulators being Ministry of Corporate Affairs (MCA) and the Securities and Exchange Board of India (SEBI). The cornerstone of Corporate Governance is Transparency. Recent years have seen the advent of a new technology that has been introduced to the world called "Blockchain", the functioning of which is centered around 'transparency' and 'trust'. There appears to be a fundamental synergy between the two concepts of Corporate Governance and Blockchain and this article attempts to take this discussion forward by professing the use of Blockchain technology as a tool for effective Corporate Governance.

EVOLUTION OF CORPORATE GOVERNANCE IN INDIA

In the year 2000, we saw for the first time, new provisions being inserted into our laws with respect to Corporate Governance. The Companies Act, 1956 was amended and a new Section 292A was inserted which mandated certain types of public companies to constitute an Audit Committee and which also defined the broad terms of reference for the Audit Committee. Similarly, Clause 49 was inserted into the Listing Agreement which mandated several measures to be followed by listed companies based on the recommendations of the Kumar Mangalam Birla Committee Report.

Then we had the Satyam scandal in the year 2009, which changed the entire course of discussion on Corporate Governance. Satyam was a beacon of Corporate Governance with its elaborate Annual Reports year after year. Little did we know the reality which unraveled so spectacularly before all of us. The scandal revealed unethical conduct, board failure, ineffective independent directors and a huge financial fraud despite the company appearing to have been in compliance with the requirements of Corporate Governance. Consequently, there was a fresh look at the laws relating to Corporate Governance. Both the MCA and SEBI got into action and introduced a slew of changes in the laws relating to Corporate Governance which focused on transparency and accountability.

The Companies Act, 2013 introduced several provisions to ensure better Corporate Governance such as stricter regulations for Independent Directors, restricted norms for related party transactions and empowering minority shareholders to protect their interests. Also, a greater onus has now been put on the Directors of a company. At the same time, SEBI has also done its bit by introducing stricter provisions in the Listing Obligations and Disclosure Requirements (LODR) such as a compulsory whistleblower policy, mandatory rotation of auditors, broadening the role of the Audit Committee in cases of fraud or suspected irregularity and has provided stringent guidelines for reporting and disclosures.

Unfortunately, despite stricter norms and the need for greater transparency, we are still seeing Corporate Governance failures continuing to plague the system. There is a need to restructure Corporate Governance and one of the ways it can be done is by making use of the latest available technology. Since the last few years, the Distributed ledger technology (DLT) and now also popularly known as Blockchain, has emerged as a ray of hope for those who want to ensure transparency in transactions.

WHAT IS DLT / BLOCKCHAIN

It is a method of recording and sharing data across a network. The way the DLT system works is that it comprises of three elements:

i) A ledger

ii) Sharing of the database

iii) Network of computers

So there is a digital database called a ledger which is shared/distributed with a network of computers called nodes. The ledger contains the record of all the data and each node contains a copy of the same data. Consequently, whenever any data is added to the ledger, simultaneously, all the nodes get updated. The distinguishing feature that separates the DLT system from other kinds of shared databases is that it is not possible to unilaterally add data on to the ledger. All the nodes which are in the network must give their consensus for data to be added. This consensus mechanism has been designed to make it extremely difficult to change or amend any data once it has been added to the ledger.

USING DLT / BLOCKCHAIN FOR CORPORATE GOVERNANCE

Although, we have come to associate Blockchain technology with cryptocurrencies, a deeper understanding reveals that it is a state of the art technology which can provide smart solutions for the inadequacies of Corporate Governance. It can be an effective tool for various stakeholders involved.

Blockchain technology generally provides two important elements:

a) *Transparency* due to its verifiable system of recording data and transactions; and

b) *Trust* since the data is immutable or incorruptible.

These two elements are extremely relevant to Corporate Governance.

Some of the ways in which Blockchain can support Corporate Governance is as under:

1. Transparency of Ownership

In the case of several companies, sometimes it is a struggle to find out who the actual owners are due to the way their shareholding is structured. There may be layers and layers to be unearthed before one can arrive at the actual beneficial owners. Companies indulge in complicated ownership structures for various reasons as they deem fit or are advised.

If the Blockchain technology is used to record the data of the shareholders of a company, then in that case all shareholders and other interested parties would be able to view the arrangement of ownership at any point of time and identify changes instantly as they occurred. Also, it will be verifiable and foolproof historical data and useful for investors at large as well as the regulators.

2. Deterrent for Insider Trading

Insider Trading has been one of the scourges of Corporate Governance. People who have been entrusted with unpublished price-sensitive information have taken advantage of their prior knowledge and indulged in buying/ selling of securities of their company, thereby, making opportunistic profits. This is a serious breach of fiduciary duty by the insider who in law is duty-bound not to indulge in insider trading. At times, the insider believes that no one will come to know about his transactions or he is hand in glove with some intermediaries who manipulate the affairs to facilitate the insider trading.

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This is one of the areas where the Blockchain technology can come in handy. Firstly, by its very nature of existence, there is no need for intermediaries in the process and secondly, once it records a transaction, that can neither be modified nor can it be erased. So if a company devised a mechanism which uses Blockchain, all the network users can see the trading done by the various Insiders. Since even the historical data will be stored and it is almost incorruptible, this can be a strong and effective tool to deter insider trading. Manipulation of the data will be next to impossible and this can be a key component in the fight for transparency of transactions.

3. Annual General Meeting (AGM)

Theoretically, the AGM is one of the most important tools available to shareholders and it serves three purposes for them:

i) Information sharing

The AGM is the annual meeting where a shareholder is given detailed information and data about the financial health of the company and its business.

ii) Meeting and Discussion

It is the annual opportunity for shareholders to meet face to face with the management and also with fellow shareholders to exchange their thoughts and ideas.

iii) Decision making

There are several acts which the company cannot do without shareholder approval whether by simple majority or by special majority. So shareholders play a key part in the decision-making process as well.

However, the importance of the AGM as a value addition for shareholders has greatly reduced over the years. The information is already disseminated beforehand due to the strict disclosure norms in place. Further, with the postal ballot and e-voting system also taking place beforehand, there is little scope either to discuss anything of substance at the AGM and it becomes more of a cosmetic annual exercise.

One way in which Blockchain technology can address some of the above concerns is by creating a Blockchain based discussion platform for board members and shareholders. For example, all questions from shareholders can be included in the blockchain and thus become transparent. Similarly, all the answers (or lack thereof) to those questions by the management also should be included. A historical data gets created and it will ensure greater vigilance and transparency at the end of both the Board and the Shareholders. Moreover, shareholders need not be limited to the traditional duration of the AGM, but can be enabled to ask questions during a longer period, e.g. from the record date onwards till the conclusion of the AGM.

4. Real-Time Accounting

This would entail adopting the use of Blockchain technology for bookkeeping and accounting. Every entry is made in real-time and is time-stamped. By being made in real-time, there is an immediate updation which takes place and one will have access to real time data. Further, since every entry will be permanently time stamped, it prevents any alteration or adjustment once the data has been posted. The company's entire ledger would then be visible immediately to any shareholder, customer, lender, trade creditor, or other interested party. Real-time accounting will also enable observers to instantly spot suspicious transactions and also transactions which reveal conflict of interest.

5. Smart Contracts

A smart contract is a computer program that automatically executes/enforce predefined terms of a contract which has been made using the Blockchain technology. The terms and conditions agreed to between the parties are directly converted into the code of the computer program. Consequently, these are contracts which cannot be amended or renegotiated and there is a certainty of the performance of parties to such contracts. Smart contracts can overcome moral hazard problems, strategic defaults and they can dramatically reduce costs of verification and enforcement.

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Some examples in which smart contracts may be useful from the angle of Corporate Governance are cases where preference shareholders have not been paid dividends for two consecutive years and they acquire voting rights, transmission of shares in case of death of shareholder to the nominee. Some other ways in which smart contracts can be used which may not directly impact Corporate Governance could be in the mechanical exercise of options embedded in derivative securities, the instant transfer of collateral in the event of default and the payment of employee compensation if performance goals are achieved. The possibilities are endless for using smart contracts.

The willingness of a Company to enter into a smart contract could represent a pre-commitment to behave with integrity and ethically and not to behave opportunistically in the future which could also make it an attractive proposition for investors and other stakeholders.

CONCLUSION

Blockchain technology is an evolving technology and disruptive in its use. The benefits of adopting this technology are growing multifold. If used with the right intention and spirit, Blockchain technology can transform Corporate Governance by making transactions transparent, reduce the risk of frauds, effectively manage the interests of the shareholders, and bring about efficient administration of an organisation. Shareholders, in general, have to rely on the board of directors for information, but with blockchains, verified and secure information will be readily available for the shareholders to draw their own conclusions. However, it is reiterated that the technology is still in a nascent stage and is constantly developing with many benefits still to be discovered. Although, it appears that there are a lot of advantages of adopting the Blockchain technology, it will take some time to gain wide acceptance as the kind of transparency and accountability it brings may not be practical for any and every situation. In any case, the technology is at our doorstep and is being adopted in several companies and it has already begun being a subject of discussion in India as well. Eventually, time will tell us if we are able to embrace all the facets offered by the Blockchain technology and bolster Corporate Governance. CS