

# INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

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Volume 6 | Issue 6

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2023

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# Corporate Governance for Unlisted Companies

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## ABSTRACT

*This article examines the landscape of corporate governance in India, specifically focusing on both listed and unlisted companies. Governed by the Companies Act, 1956, and overseen by regulatory bodies like SEBI, listed entities adhere to stringent compliance standards. In contrast, unlisted companies face distinct challenges due to the absence of dedicated regulatory oversight.*

*Influenced by the Anglo-Saxon model, the corporate governance framework in India witnessed regulatory changes in 2015 through the Listing Obligations and Disclosure Requirements (LODR). Unlisted companies, ranging from startups to state-owned enterprises, present unique challenges for regulation. While the Companies Act provides a common framework, differences in ownership structures, regulatory focus, and the private nature of these entities necessitate nuanced governance approaches.*

*Challenges in regulating unlisted companies arise from factors like concentrated ownership, regulatory focus on public markets, and the private nature of these entities. The article outlines reasons for a more lenient regulatory approach, including flexibility for innovation, voluntary compliance, and resource constraints faced by regulatory bodies.*

*Recent developments indicate discussions within the Company Law Committee to subject larger unlisted firms to a more stringent regulatory environment. Issues at Byju's underscore the importance of enhanced scrutiny, prompting considerations such as mandatory quarterly financial reporting for unlisted companies.*

*The article suggests voluntary practices that unlisted companies may adopt to ensure corporate governance, including training programs, whistleblower mechanisms, board committees, ethical guidelines, and transparent financial reporting. The absence of a fixed regulatory authority allows flexibility for unlisted companies to tailor governance measures based on their unique circumstances.*

*In conclusion, the article emphasizes the need for a balanced regulatory approach, considering the diversity of unlisted companies. Recent developments and discussions indicate a proactive stance toward addressing governance concerns. The voluntary adoption of best practices and periodic governance audits are seen as crucial steps toward building stakeholder trust.*

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## I. INTRODUCTION

The need for and importance of corporate governance had seen a significant spurt in popularity and application all over the world in the last decade or so.<sup>2</sup> In India, the Companies Act, 1956 provides the legal framework for companies & is one of the main instruments for Corporate Governance. The Ministry of Corporate Affairs is the authority that regulates listed companies through the stock exchanges. Securities and Exchange Board of India (SEBI) acts as a regulatory body to ensure compliance of the prescribed corporate governance practices and standards. Additionally, statutory institutions like Institute of Chartered Accountants and Institute of Company Secretaries perform the role of promoting better corporate governance and practice.<sup>3</sup>

### **Corporate Governance Model in India**

The corporate governance model in India adopts a hybrid of the Anglo-Saxon model<sup>4</sup>, the UK model or the insider model.<sup>5</sup> SEBI, in 2015, introduced a new set of regulations concerning Listing Obligations and Disclosure Requirements (LODR). This regulation was designed to make the disclosure standards more stringent, encourage increased involvement of public shareholders, and promote proactive engagement for companies listed on the stock exchange.

On the other hand, there is no such exclusive dedicated regulatory body authorized for unlisted companies, often resulting in gaps when it comes to enforcing, monitoring, and ensuring corporate governance practices in unlisted companies.<sup>6</sup>

However, having a body or authority to uniformly regulate corporate governance in all the unlisted companies is not a practical idea as well. The domain of non-listed companies may vary from a small-scale startup business to a huge company owned by the state itself or a reputed joint venture company. Therefore, the 'one-size-fits-all' approach cannot be applied to ensure corporate governance compliance in unlisted companies,<sup>7</sup> thereby deeming it necessary for

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<sup>2</sup> Demirag, I., S. Sudarsanam and M. Wright, 2000, 'Corporate Governance: Overview and Research Agenda', *British Accounting Review* 32, 341-354.; Keasey, K., S. Thompson and M. Wright, 2005, *Corporate Governance: Accountability, Enterprise and International Comparisons*, London: Wiley.

<sup>3</sup> *Corporate Governance for Non-listed Companies*, ISBN-92-64-03573-7 © OECD 2005

<sup>4</sup> Aguilera, Ruth & Cuervo-Cazurra, Alvaro. (2011). *Codes of Good Governance*. *Corporate Governance: An International Review*. 17. 10.2139/ssrn.1773090.; Fernando, A.C. (2012) *Corporate Governance: Principles, Policies and Practices*. Pearson Education India, Bengaluru.

<sup>5</sup> Sarkar, J., & Sarkar, S. (2000). Large shareholder activism in corporate governance in developing countries: Evidence from India. *International Review of Finance*, 1, 161-194. <http://dx.doi.org/10.1111/1468-2443.00010>; Varottil, Umakanth, Evolution and Effectiveness of Independent Directors in Indian Corporate Governance (February 6, 2010). *Hastings Business Law Journal*, Vol. 6, No. 2, p. 281, 2010, Available at SSRN: <https://ssrn.com/abstract=1548786>

<sup>6</sup> Cf OECD 2004.

<sup>7</sup> Arcot, Sridhar and Bruno, Valentina Giulia, *In Letter But Not in Spirit: An Analysis of Corporate Governance in the UK* (May 2006).

different rules to exist for application in the real sense.<sup>8</sup>

Up to an extent, the Companies Act regulates both listed and unlisted companies commonly, for instance, Section 188 of the Act<sup>9</sup> emphasizes on the importance of shareholders' participation and approval with respect to related party transactions. This provision expects compliance by both listed as well as unlisted companies.

## II. CHALLENGES IN REGULATING UNLISTED COMPANIES

Despite all the differences, there are still some principles with respect to controlling, governing, and monitoring, that are similar at the ground level for both listed as well as unlisted companies.<sup>10</sup>

However, the fact that several aspects such as the organizational structure of the unlisted companies, be it the composition powers of board of directors<sup>11</sup> or provisions with respect to related party transactions,<sup>12</sup> varies substantially when compared to that of listed companies, cannot be overseen.

Therefore, corporate governance framework that deviates from the social and economic needs of unlisted companies will develop flaws over time and fail to realize the legal strategies aimed at minimizing transaction costs.<sup>13</sup>

Regulating corporate governance in unlisted companies is not as comprehensive as it is in listed companies due to various reasons:

- 1) **Ownership Structure:** Unlisted companies often exhibit a more concentrated model when it comes to ownership. They have fewer owners which further results in streamlined communication and decision-making, potentially minimizing the perceived requirement for external regulatory intervention.
- 2) **Regulatory Focus on Public Markets:** Regulatory entities such as the Securities and Exchange Board of India (SEBI) or analogous bodies in other jurisdictions commonly concentrate their regulatory efforts on entities engaged in public markets. Given that unlisted companies operate in a more secluded domain, regulators may allocate their resources with a priority towards overseeing publicly traded entities.

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<sup>8</sup> Corporate Governance for Non-listed Companies, Oxford University Press, J.A. McCahery and E.P.M. Vermeulen, 2008

<sup>9</sup> Companies Act, 2013

<sup>10</sup> <https://www.linkedin.com/pulse/role-corporate-governance-management-unlisted-rahul-khatuwala/>

<sup>11</sup> Section 179

<sup>12</sup> Section 188

<sup>13</sup> Corporate Governance for Non-listed Companies, Oxford University Press, J.A. McCahery and E.P.M. Vermeulen, 2008

- 3) **Private Nature:** Unlisted companies, inherently privately owned and excluded from public stock exchanges, typically refrain from raising capital through public markets. This absence of public financing may lead regulators to perceive a diminished necessity for extensive oversight in comparison to publicly traded counterparts.
- 4) **Flexibility for Innovation:** It has been argued that a more lenient regulatory approach provides the necessary flexibility for innovation and adaptation to their distinctive circumstances. The perception is that excessive regulation could be interpreted as inhibiting creativity and adaptability, particularly in these smaller and more agile organizations.
- 5) **Voluntary Compliance:** Across various jurisdictions, the adherence to corporate governance principles by unlisted companies is often encouraged but not obligatory. Regulators may favour a reliance on voluntary commitment to best practices, industry standards, and codes of conduct, permitting companies to tailor governance measures according to their specific needs.<sup>14</sup>
- 6) **Risk Assessment:** Regulators may evaluate that the risks associated with non-compliance to certain governance standards in unlisted companies are comparatively lower than the potential risks linked to publicly traded companies. This risk assessment becomes a determining factor in shaping the level of regulatory scrutiny applied to different types of entities.
- 7) **Resource Constraints:** Regulatory bodies frequently contend with limited resources, leading to a strategic prioritization of oversight for larger, publicly traded companies where governance issues may exert a more substantial impact. Unlisted companies, being of smaller scale, might consequently not undergo the same level of regulatory scrutiny.
- 8) **Recognition of Governance Importance:** While formal regulation for corporate governance in unlisted companies may be less stringent, there is a growing acknowledgment of the significance of good governance practices across diverse businesses. Various industry associations and professional bodies offer guidelines and best practices, encouraging unlisted companies to voluntarily embrace these

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<sup>14</sup> Arcot, Sridhar and Bruno, Valentina Giulia, In Letter But Not in Spirit: An Analysis of Corporate Governance in the UK (May 2006).

standards to fortify their governance frameworks and promote sustainable business practices.

- 9) **Contractual Nature:** The nature of corporate governance framework for unlisted companies is predominantly contractual i.e., by formulating their agreements, business parties have the flexibility to select from various sources of corporate governance mechanisms and techniques.<sup>15</sup>

### III. RECENT DEVELOPMENTS

So far, an Indian company not listed on the stock exchange can only make its presence on an international market by opting for depository receipts or financial instruments such as masala bonds, foreign currency convertible bonds (FCCBs), and foreign currency exchangeable bonds (FCEBs). On the contrary, foreign companies can be listed in India by utilizing the Indian Depository Receipts framework.<sup>16</sup>

The Company Law Committee (CLC) is currently engaged in discussions aimed at establishing a comprehensive framework to subject larger unlisted firms, including mature startups, to a more stringent regulatory environment. Among the regulations proposed by the committee, aspects such as heightened scrutiny on financial reporting, including the mandatory submission of quarterly financial statements for these entities were considered.

In India, the practice of quarterly financial reporting involves disclosing information about a company's financials, is standard for all listed companies. This standard is required to be complied with by all the listed companies and is highly crucial for stakeholders to promptly address any lapses or issues in a company's financials or reporting. With the expanding startup ecosystem and the substantial growth of unlisted companies comparable to their listed counterparts, the Ministry is exploring regulatory parity.

The backdrop of these developments includes corporate governance concerns at the ed-tech giant Byju's, where auditors and three board members resigned over differences with founder Byju Raveendran on key operational issues. Deloitte cited the company's non-compliance with allowing the commencement of a delayed audit as a violation of company norms, leading to its resignation as the auditor for Byju's.<sup>17</sup>

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<sup>15</sup> Corporate Governance for Non-listed Companies, Oxford University Press, J.A. McCahery and E.P.M. Vermeulen, 2008

<sup>16</sup> Special Correspondent, 'Allow Unlisted Firms to List Abroad,' THE HINDU, Dec. 4, 2018, <https://www.thehindu.com/business/allow-unlisted-firms-to-list-abroad/article25665360.ece> (last visited Dec 16, 2023).

<sup>17</sup> Big unlisted companies may come under tighter regulatory norms, <https://www.businessinsider.in/business/corporates/news/big-unlisted-companies-may-come-under-tighter->

Currently, listed entities adhere to comprehensive disclosure requirements, but such obligations do not extend to unlisted companies. The former chief of the Securities and Exchange Board of India (SEBI), Ajay Tyagi, has advocated for a review of corporate governance compliance in mature startups. SEBI, in its annual report, has emphasized the necessity of regulations to identify, monitor, and manage risks introduced by unlisted companies within a conglomerate alongside a complex network of listed and unlisted associates.

The tenure of the Company Law Committee, formed by the Ministry of Corporate Affairs (MCA) in 2019, has been extended by a year to address various issues, including the regulation of larger unlisted companies. Discussions have reportedly taken place at an inter-ministerial level to amend the Companies Act and impose stricter rules on large unlisted firms.

Sources suggest that one of the contemplated measures is the mandatory submission of quarterly financial statements by unlisted companies, including major startups. This step aims to facilitate closer scrutiny of their financial positions and prevent malpractices. The Company Law Committee, established by the Ministry of Corporate Affairs, is at the forefront of addressing these regulatory considerations.<sup>18</sup>

#### **IV. PRACTICES THAT UNLISTED COMPANIES MAY ADOPT**

The absence of a fixed regulatory authority paves way to its own advantages. Due to the absence of need to strictly adhere to uniform and stringent regulations, the unlisted companies may make use of the freedom and flexibility and ensure the prevalence of corporate governance based on their position, structure, and suitability.

Following are some of the ways in which unlisted companies may voluntarily ensure the compliance of Corporate Governance:

- 1) **Regular Training and Awareness Programs:** Conducting periodic training sessions for employees on corporate governance principles and ethical practices fosters a culture of compliance and accountability. Awareness programs contribute to employees' understanding of their role in upholding governance standards.
- 2) **Whistleblower Mechanism:** The establishment of a whistleblower mechanism enables employees and stakeholders to report instances of unethical behaviour or governance

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regulatory-norms/articleshow/103935168.cms (last visited Dec 16, 2023).

<sup>18</sup> Exclusive | Stricter regulations for “bigger” unlisted companies, mature start-ups on cards, CNBCTV18 (2023), <https://www.cnbctv18.com/business/companies/ministry-of-corporate-affairs-mca-clc-stricter-regulations-for-bigger-unlisted-companies-sebi-17875811.htm> (last visited Dec 16, 2023).

concerns without fear of reprisal. This mechanism, often anonymized, encourages the disclosure of potential issues.<sup>19</sup>

- 3) **Board Committees:** While not obligatory for unlisted companies, the formation of board committees such as an Audit Committee, Nomination and Remuneration Committee, and Risk Management Committee can significantly contribute to effective governance. These committees enhance oversight and bring specialized expertise to crucial areas.
- 4) **Ethical Guidelines and Code of Conduct:** It is imperative for unlisted firms to formulate and implement transparent ethical guidelines and a robust code of conduct. These documents articulate the company's values, outline acceptable behaviour, and establish a framework for ethical decision-making across all organizational levels.
- 5) **Transparent Financial Reporting:** Prioritizing transparent and comprehensive financial reporting is crucial for unlisted companies. Despite not facing identical reporting requirements as listed counterparts, providing stakeholders with clear and accurate financial information establishes trust and credibility.
- 6) **Independent Directors:** While not mandated by regulatory bodies for unlisted companies, the inclusion of independent directors in the board can provide an external viewpoint. Independent directors serve as a check on decision-making processes and offer valuable insights, ultimately bolstering the overall governance structure.<sup>20</sup>
- 7) **Adoption of Best Practices:** Unlisted entities can strategically compare their practices against recognized corporate governance benchmarks, even if not legally obligated to adhere to specific standards. This proactive approach contributes to enhancing their standing and attractiveness to potential investors.
- 8) **Regular Board and Stakeholder Meetings:** Conducting regular board meetings and actively engaging with stakeholders through periodic updates and meetings facilitates open communication. This practice ensures that all relevant parties are well-informed about the company's performance, strategy, and governance practices.<sup>21</sup>

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<sup>19</sup> Inyang, U. (2020). Whistleblowing as a Corporate Governance Mechanism: A Comparative Analysis of Employee-Whistleblower Protection in the United Kingdom and Nigeria. SSRN Electronic Journal. <https://doi.org/10.2139/ssrn.3547899>

<sup>20</sup> Kallamu, B. S. (2016, January 1). Ownership structure, independent directors and firm performance. *E3 Journal of Business Management and Economics*, 7(1), 019–028. [https://doi.org/10.18685/ejbme\(7\)1\\_ejbme-15-012](https://doi.org/10.18685/ejbme(7)1_ejbme-15-012)

<sup>21</sup> Corporate Governance for Non-listed Companies, Oxford University Press, J.A. McCahery and E.P.M. Vermeulen, 2008



- 9) **Internal Controls and Risk Management:** Developing robust internal controls and risk management systems stands as a pivotal necessity for unlisted companies. This encompasses the implementation of effective audit processes, the formation of internal audit committees, and the establishment of mechanisms for evaluating and mitigating risks.
- 10) **Adoption of Technology:** Leveraging technology for governance-related processes, such as board communication, document management, and compliance tracking, can boost efficiency and transparency. Implementing secure digital platforms for communication and reporting simultaneously improves data security.
- 11) **Engagement with Stakeholders:** Proactively involving stakeholders, encompassing shareholders, employees, and suppliers, can empower unlisted businesses to cultivate openness and responsibility. Consistent communication channels and feedback mechanisms are instrumental in establishing trust.
- 12) **Environmental, Social, and Governance (ESG) Considerations:** The integration of ESG considerations into business practices showcases a commitment to sustainability and responsible conduct. Unlisted companies should assess and disclose their impact on the environment, society, and governance issues pertinent to their operations.
- 13) **Voluntary Codes of Conduct:** Unlisted enterprises have the flexibility to embrace voluntary codes of conduct and governance guidelines. Industry-specific associations often offer such codes for companies to voluntarily adopt, showcasing a dedication to upholding elevated governance standards.
- 14) **Periodic Governance Audits:** Conducting periodic governance audits, whether internally or through external agencies, aids unlisted companies in identifying areas for improvement. These audits assess compliance with governance practices and propose adjustments to enhance overall effectiveness.<sup>22</sup>

## V. CONCLUSION

In conclusion, while challenges persist in aligning governance practices for both listed and unlisted entities, recent developments indicate a growing recognition of the need for enhanced oversight in unlisted companies.

However, the lack of a dedicated authority to monitor the regulatory framework for unlisted

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<sup>22</sup> Duguay, R. (2022). The Effect of Financial Audits on Governance Practices: Evidence from the Nonprofit Sector. SSRN Electronic Journal. <https://doi.org/10.2139/ssrn.3273502>

companies gives an opportunity for the company to adopt highly customised and suitable measures, thereby leading to a more flexible environment. As the regulatory landscape evolves, striking a balance between promoting innovation and ensuring accountability remains crucial.

The voluntary adoption of best practices by unlisted companies, along with periodic governance audits, can contribute to building trust among stakeholders. The extension of the Company Law Committee's tenure and discussions at an inter-ministerial level signify a proactive approach to address the specific challenges associated with governing unlisted companies.

In essence, while a one-size-fits-all regulatory approach may not be practical for unlisted companies given their diverse nature, a strategic blend of voluntary adherence to best practices and targeted regulatory interventions can pave the way for robust corporate governance in this sector.

The journey toward comprehensive governance in unlisted companies requires a collaborative effort involving industry stakeholders, regulatory bodies, and the companies themselves, ensuring a dynamic and adaptive framework that aligns with the evolving corporate landscape.

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