SEBI tightens reigns on corporate governance yet again

1. Introduction

Securities Exchange Board of India ("**SEBI**"), caretaker of investors' interest, introduced some amendments in the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**Regulations**"). It notified Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2018 ("**Amendments**") through notification dated May 9, 2018. The Amendments focus on increasing transparency in governance of listed companies' affairs to enable investors to track their performance as well as participate in decision making. On June 2, 2017, SEBI constituted Kotak Committee under Mr. Uday Kotak and assigned it with the task to produce a report highlighting methods to improve corporate governance in listed companies so that the spirit of the Regulations is implemented fully. The committee issued its report on October 5, 2017 and while SEBI adopted 42 out of the total 81 recommendations, as of now, only 14 have made their way in the Amendments. While most of the amendments will come into force on April 1, 2019, the Amendments provide for a phased timeline of October 1, 2018 to April 1, 2020 for the remaining. The period of 18 months will enable companies to adjust to new governance requirements as well as overcome any implementation challenges.

This newsletter analyzes selective changes that the Amendments will introduce in governance of listed companies.

2. Related party

Companies Act, 2013 ("**Act**") defines "related parties" under section 2 (76) to include directors, key managerial personnel, their relatives and persons on whose advice directors are accustomed to act. Section 188 of the Act restrains companies from executing contracts with related parties without the consent of board and shareholders. One of the conditions here is that the shareholders cannot cast their vote on resolutions for approval of transactions where they are related parties. So, if a shareholder is not a related party, then the company can execute an agreement with him and such shareholder can also vote on resolutions for approval of such transactions. Regulation 3(a) of the Amendments widens the scope of the definition of related parties to include promoters or promoter group holding 20% or more shares. Once this amendment comes into force on April 1, 2019, listed companies can execute contracts with shareholders holding 20% or more shares, but with board's and other shareholders' approval and the contracting shareholder cannot participate in voting. Currently, listed companies can execute contracts with promoters if they are unrelated parties and such promoters can also vote to approve any transaction with them or their relatives. It appears that the underlying intent to bring promoters within the definition of related party is to check situations where promoters having a sizeable shareholding, are not related parties but act as service providers for the company for their personal benefits.

Further, at present, the Act[1] and the Regulations[2] only require companies to disclose related party transactions executed in a financial year in the annual board report. In order to

[1] Section 188 (2) of the Act
[2] Regulation 2(1) (zc) of the Regulations

introduce greater transparency and enable shareholders to constantly monitor that board and majority shareholders are not involved in self enrichment, the Amendments mandate that from April 1, 2019 onwards, all listed companies will have to make half yearly disclosure of related party transactions on their website within 30 days of publication of their half yearly financial results.

3. Board composition

The Amendments introduce major changes in board composition of listed companies. Different timelines are prescribed for these amendments to become effective, as described below:

3.1 Number of directors

The Amendments propose to increase the minimum number of board members to six as against three under the Act.[3] While this will ensure that a listed company has sufficient number of directors to carry out multiple functions in a more effective manner, it would have been better to mandate that all the directors must be from diverse skill sets viz. finance, strategy and planning, marketing, so that the board is professionally competent to fulfil different duties, as intended. In many listed companies, the board positions are mostly held by family or friends who may not possess the expertise and skills to manage the relevant departments under them. Although the board can seek external expert advice on various matters, given the need for the board to make informed business judgements, having a board comprising multiple skill sets would have proved to be a step in the right direction although this will add to the costs. In addition, an even number composition may create deadlock situations.

The amendment will come into effect from April 1, 2019 for top[4] 1,000 listed entities and from April 1, 2020 for top 2,000 listed entities.

3.2 Women directors

The Act[5] and the Regulations[6] provide for at least one woman director on the board of listed entities who may be either an independent or a non-independent director. The Amendments provide for appointment of one independent woman director in addition to a woman executive or non executive director. This is a positive step towards gender diversity. Kotak Committee's report stated that corporate India had responded positively on one woman on every board and women representation on the boards of NIFTY 500 companies, which was at 5% as on March 31, 2012 had increased to 13% by March 31, 2017.

As per the Amendments, a listed company must have at least one independent woman director on the board of the top 500 listed entities by April 1, 2019 and for the top 1000 listed entities by April 1, 2020.

[3] Section 149 (1) of the Act
[4] As per Regulation 3(d) of the Regulations, "top" entities will be determined based on market capitalization at the end of the immediate preceding financial year
[5] Proviso to section 149(1) of the Act
[6] Regulation 17 of the Regulations

3.3 Separation of roles of chairperson and managing director

The Regulations permit listed companies to appoint two or more persons for the position of chairperson (to preside over meetings) and managing director. So far, that has not been mandatory. The Amendments now make it mandatory to have a chairperson who is a non-executive director and who is not a relative[7] of managing director. The idea here is to ensure that excessive power is not concentrated in the hands of the managing director who can focus solely on the operational activity.

This amendment will be effective from April 1, 2020 and will be applicable to only top 500 listed companies.

3.4 Independent directors

The independent directors play a critical role of watchdog of a company, its shareholders' and employees' interests. As per schedule IV of the Act, independent directors are obligated to raise concerns about the functioning of a company and ensure that the concerns are recorded in board meeting minutes. Given this, the Kotak Committee made several recommendations to increase the role of independent directors and ensure that they are truly independent.

Section 149 of the Act and Regulation 16(1)(b) of the Regulations lay an exhaustive criteria with respect to their qualifications. The Amendments supplement the criteria with an additional requirement that a listed company cannot have an independent director on its board who is non-independent director of another company. Simply put, if A is an executive director of listed company A and an independent director on the board of company B, then no non-independent director of company B can be an independent director on the board of company A. The Kotak Committee has termed this as avoidance of "board inter-locks" to cure "structural vulnerability of *quid-pro-quo"*. This amendment has widened the net of exclusions under the Regulations so as to make independent directors independent in a true sense. The amendment has already come into force on October 1, 2018.

In addition, in the interest of minority shareholders, in every board meeting at least one independent director is now required to be present. There was no such requirement under the Act or in the Regulations. As noted above, independent directors are expected to safeguard the interests of stakeholders, particularly the minority shareholders and the amendment further substantiates that duty. For top 1,000 listed entities the amendment shall come into effect from April 1, 2019 and for top 2,000 listed entities, it shall come into effect from April 1, 2020.

The Act permits appointment of alternate directors for all directors including independent ones subject to fulfilment of statutory qualifications for an independent director.[8] There is no specific provision pertaining to alternate directors in the Regulations though. The Amendments now prohibit appointment of alternates for independent directors. This is a step in the right direction as independent directors are appointed based on their skills and experience and unless there is a mandate to ensure that the alternate director must also have similar set of skills to

[7] Under section 2(77), the Act defines relatives to mean spouses, father, mother, son, daughter, son's wife, sister, brother and members of hindu undivided family

[8] Section 161(2) of the Act

perform their job, replacement with another head negates the purpose of having an independent director.

4. Investor participation

Increased participation by shareholders in general meetings enhances governance as it promotes accountability of board and management towards the company and shareholders. In order to ensure maximum shareholder participation in annual general meeting ("**AGM**"), the Amendments have made it mandatory for top 100 listed companies to provide live one-way webcasts from April 1, 2019 onwards. For greater shareholders' participation, it would have been better if the provision were applicable to all shareholders' meetings as against only AGMs.

Further, under the Act, it is mandatory for a listed entity to provide e-voting facility to shareholders. Such e-voting is permitted until one day prior to the AGM and up to 5 p.m. [9] Kotak Committee had recommended that the e-voting should be kept open till midnight on the day of the meeting so that e-voters could cast their vote based on the discussions witnessed at the webcast. The webcast provision will meet the objective of maximum shareholders' participation if the shareholders are able to cast vote at the time of or after the webcast. As of now, SEBI and the Ministry of Corporate Affairs have put this recommendation under consideration.

As per the Kotak Committee's report, in many countries such as South Korea, Thailand, Italy, Singapore, Japan, etc. timeline for holding AGM is shorter than the timeline of six months provided in India. Under the Act, listed Indian entities are required to hold AGM within six months from the end of the financial year. This causes bunching of meetings in August and September which can result in lower shareholder participation. The Amendments now mandate holding AGM by August i.e. within five months from the end of the financial year. However, this amendment will be applicable to top 100 companies only. While the amendment may encourage higher shareholder participation, it would have been better if the Regulations had obligated other listed companies to convene their AGMs during August as well so as to avoid any probability of bunching of meetings.

5. Conclusion

The Amendments aim to provide a higher degree of transparency in the affairs of a listed company. The foregoing provisions are positive steps towards better governance. Needless to state, the Amendments are the tip of the iceberg and it is unclear why only 14 provisions have been included versus the 42 adopted ones. Further, there appears no rationale behind excluding extra ordinary general meetings from the webcast provision and retaining the e-voting timeline to one day prior to the AGM.

Nonetheless, the initiative is a laudable one and the expectation will be that all stakeholders shall be propelled to participate and engage more with the corporations they are a part of.

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[9] Section 108 of the Act read with rule 20 of Companies (Management and Administration) Rules, 2014