

## M&A Hotline

April 17, 2018

### SEBI CORPORATE GOVERNANCE NORMS: WILL CHANGE BE THE PROMISING CONSTANT?

Considering the infamous standards of corporate governance witnessed lately, the Securities and Exchange Board of India ("SEBI") constituted a committee on corporate governance as on June 2, 2017 under the chairmanship of Shri Uday Kotak to implement measures to ameliorate the standards of corporate governance for listed companies in India. A report was presented to SEBI by the committee ("Report") and subsequently released to the public for comments.

The Report proposed a gamut of changes to the listing and disclosure requirements prescribed for listed companies under the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("SEBI LODR"). Based on the comments received from the public including various stakeholders and industry experts, SEBI in its recent board meeting<sup>1</sup>, has decided to accept quite a few important changes proposed in the Report which will have a significant impact on listed companies in India.

SEBI has decided to accept several recommendations without any modifications and certain recommendations with modifications.

### RECOMMENDATIONS WITHOUT MODIFICATIONS:

#### *Reduction in the maximum number of listed entity directorships*

SEBI has decided to reduce the maximum number of listed entity directorships held by an individual from 10 to 8 by April 01, 2019 and to 7 by April 1, 2020. SEBI LODR prohibits a person from serving as an independent director in more than seven listed entities and if the director is a whole time director in any one listed entity, then she / he can be an independent director in only 3 listed entities<sup>2</sup>.

While the rationale for reduction of directorships held by one individual may be to enhance the ability to play an effective role while advising the board of a company, it is questionable as to whether the reduction to a maximum of 8 directorships changes much and this may still seem like an ineffective attempt to manage the expectations of several dynamic entities and deliver per their specific requirements. 5 or less than 5 directorships may have been a more reasonable number to ensure adequate and perhaps undivided attention is provided to each such company as a board member.

#### *Expanding the eligibility criteria for independent directors*

The Report recommends adoption of the following criteria for appointment of independent directors (ID) in listed companies:

- Specific exclusion of persons who constitute 'promoter group' of a listed entity for appointment as an ID;
- Undertaking from IDs of any conflicting situations to their knowledge that could impair their ability to discharge their respective duties towards the listed entity, and subsequent acceptance by the board of the same after due assessment of the veracity of such undertaking;
- Exclusion of situations of 'board inter-locks';
- Continuous assessment of the IDs by the board, and
- Certification by the board every year that the IDs fulfil the conditions specified under SEBI LODR.

While the above mentioned has been prescribed to improve the process of selection and appointment of IDs, SEBI must also prescribe the objective criteria for the continuous assessment of IDs by the board of a listed entity.

#### *Disclosure of expertise / skill of directors*

Going forward, every listed company will be required to disclose and list down the core competencies / skills / expertise of its board of directors as is required in the context of business and sectors to enable the company to function effectively. Names of directors who have such skills / expertise / competence will also need to be disclosed from the financial year ended March 31, 2020.

It is only fair to assume that the disclosure intends to improve the quality of directors appointed to manage the expectations of the business(es) in a better manner. We hope that this requirement does not result in a parade of individual performance and accomplishments and a compare and contrast between directors, forcing the interests of the company to take a backseat.

#### *Permission for related parties to vote against related party transactions (RPTs)*

SEBI LODR provides a blanket restriction on related parties voting on any resolution pertaining to a material RPT<sup>3</sup>. In

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order to align the voting requirements for RPTs under the Companies Act, 2013 with the requirements under SEBI LODR, the recommendation is to permit related parties to cast a negative vote on any material RPTs. This would avoid any voting that can be considered to be in conflict.

#### ***Enhanced obligations in relation to subsidiaries***

- The definition of the term 'material subsidiary' shall be revised to include a subsidiary whose income or net worth exceeds 10% (from the current 20%) of the consolidated income or net worth of the listed entities and its subsidiaries in the immediately preceding accounting year.
- SEBI LODR requires at least one independent director on the board of a listed company to be appointed on the board of an unlisted material subsidiary. This requirement shall also extend to unlisted foreign subsidiaries. However, for this purpose a material subsidiary shall have the earlier threshold of 20% (rather than the revised threshold of 10%).
- The requirement to submit significant 'material' transactions or arrangements entered into by an unlisted subsidiary to its listed parent, has been deleted and limited to submission of significant transactions.
- With effect from April 1, 2018, secretarial audit to be mandatory for listed entities and their unlisted subsidiaries.

#### ***Enhanced role of audit committee (AC), nomination and remuneration committee (NRC) and risk management committee (RMC)***

- With effect from April 1, 2018, ACs in listed entities will be required to review the end utilisation of funds of the listed entities infused into the unlisted subsidiaries (including foreign subsidiaries) where the total amount of loans / advances / investments exceeds INR 100 crores (Indian Rupees Hundred Crore) or 10% of the asset size of the subsidiary, whichever is lower.
- With effect from April 1, 2018, the scope of NRCs in listed entities will extend to recommendations in relation to appointments and payments made to senior management employees (on level below the CEO / CFO / MD / whole time director / company secretary).
- With effect from April 1, 2018, the role of RMCs will specifically cover management of cyber security and related threats.

#### ***Increase in disclosure requirements***

With effect from April 1, 2018, for better transparency, the following additional disclosures will be required to be made by a listed company:

- Utilization of funds raised through preferential allotment or qualified institutional placements undertaken in the relevant financial year, until such funds are fully utilized.
- Half yearly disclosure on RPTs required to be made on consolidated basis.
- Disclosure of details of transactions entered into with any person which holds 10% or more shares as per the annual report.
- Disclosure of details of auditor credentials, audit fee and reasons for resignation of auditors.

Further, listed companies will also be required to disclose its consolidated quarterly results with effect from financial year 2019 -2020.

#### **RECOMMENDATIONS WITH MODIFICATIONS:**

##### ***Separation of MD / CEO and Chairperson***

With effect from April 1, 2020, the top 500 listed entities (by market capitalization) having a public shareholding of 40% or more at the beginning of the financial year shall ensure separate individuals are appointed for the roles of CEO / MD and Chairperson.

Many listed companies will be hit by this change, including those in the big league such as Reliance, Wipro, Future Retail. The change is to avoid concentration of power in the hands of one individual and divide the powers and responsibility between the CEO / MD and the Chairperson in relation to day to day operations and long term growth, respectively. This will further ensure better accountability and independence for decisions taken by the company and not hold the same individual accountable for major decisions implemented.

##### ***At least one woman independent director***

By April 1, 2019, the top 500 listed entities (by market capitalization) and by April 1, 2020, the top 1000 listed entities (by market capitalization) are required to appoint at least one woman independent director.

Currently, women representation on the boards of NIFTY 500 companies, which was at 5% as on March 31, 2012, increased to 13% as on March 31, 2017<sup>4</sup>. This requirement will improve the gender diversity on the board of listed companies.

##### ***Royalty / brand payments to related parties***

SEBI LODR does not currently provide for royalties paid to related parties in relation to usage of brands under the ambit of 'material related party transactions'. SEBI has now considered to include payments made to a related party with respect to brand usage or royalty as 'material related party transactions' if such transactions (individually or taken together with previous years' transactions) exceeds 2% of the annual consolidated turnover of the listed entity as per the entity's last audited financial statements. Such payments shall require the prior approval of the shareholders of the listed entity on a majority of minority basis.

The reduction of materiality threshold for related party transactions from 10% to 2% in relation to royalty payments for brand usage will ensure the entity does not make excessive payments to its controlling shareholders or bleed out before it arranges to pay dividend to its shareholders.

##### ***Other procedural changes***

- By April 1, 2019, the top 1000 listed entities (by market capitalization) and by April 1, 2020, the top 2000 listed entities (by market capitalization) are required to have a minimum number of 6 directors on its board. While this is a

welcome reform, the rationale for the change is unclear considering, it is an even number and this may lead to situations of dead lock amidst the board members. Further, it remains to be seen whether this would impact the governance standards of a listed entity directly.

- By April 1, 2019, the top 1000 listed entities (by market capitalization) and by April 1, 2020, the top 2000 listed entities (by market capitalization) are required to maintain a quorum requirement of 1/3<sup>rd</sup> of the size of the board of the listed entity or 3 members, whichever is higher.
- Top 100 listed entities will be required to hold annual general meetings within 5 months after the end of financial year 2018-19 by August 31, 2019.
- With effect from financial year 2018-19, the top 100 listed entities (by market capitalization) will be mandatorily required to provide a webcast of their annual general meetings.

SEBI also decided to refer certain recommendations such as strengthening the role of the ICAI, internal financial controls, adoption of Ind-AS, treasury stock, etc. to various governing agencies that are involved in managing such functions.

## CONCLUSION

The recent incidents in the industry have formed a compelling case to redefine the standards of corporate governance and the committee formed under the chairmanship of Shri Uday Kotak has attempted to propose changes to improve the situation. While *prima facie* these changes seem promising, the real test lies in the implementation of these changes and its after effects remains to be seen. For the time being however, 'good corporate governance' continues to remain subjective.

— Poonam Pal Sharma & Simone Reis

You can direct your queries or comments to the authors

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<sup>1</sup> Press Release for SEBI board meeting held on March 28, 2018, available at: [www.sebi.gov.in/media/press-releases/mar-2018/sebi-board-meeting\\_38473.html](http://www.sebi.gov.in/media/press-releases/mar-2018/sebi-board-meeting_38473.html)

<sup>2</sup> Regulation 25, SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

<sup>3</sup> Regulation 23 (4), SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.

<sup>4</sup> Report of the Committee on Corporate Governance, October 5, 2017.

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