

## ERGO

*Analysing developments impacting business*

### CORPORATE GOVERNANCE: SEBI'S GO AHEAD TO KOTAK COMMITTEE RECOMMENDATIONS

2 April 2018

#### Introduction

SEBI, in its board meeting on 28 March 2018 considered the Kotak Committee report (Report) on corporate governance. The Kotak Committee (Committee) had submitted the Report proposing amendments to the SEBI (Listing Obligation and Disclosure Requirements) Regulations, 2015 (LODR) with the objective of enhancing fairness and transparency in the corporate governance landscape in India.

Our earlier update on the Report can be accessed [here](#).

#### SEBI's views on the Report

SEBI has accepted several reforms suggested by the Committee both with and without modifications. Certain recommendations (such as internal financial controls, roles of ICAI, adoption of IND-AS etc.) of the Committee have been referred to various governmental agencies/professional bodies for further deliberations.

The press release issued by SEBI only sets out an indicative list; one should wait for the fine print for a complete picture of changes to the LODR.

#### Recommendations without any modifications

- Independent director (ID) appointments (From 1 April 2018): Individuals from the promoter group or appointed pursuant to a 'board inter-lock' arrangement (i.e., cross directorship arrangements) cannot be appointed as IDs. Board to certify that each individual appointed as ID fulfils eligibility criteria mentioned in the LODR. Similarly, IDs are required to provide declaration to this effect.

**Comment:** *This suggestion appears to be a reaction to a few instances of board interlocks. This may create unnecessary difficulties in cases where there is an unintended interlock. For cases where such interlock was intended, they will continue to treat ID appointments as a 'tick the box' exercise. Merely expanding eligibility qualifications and providing certification may not achieve desired results.*

- Expertise / skills of directors (Initial disclosure without names by 31 March 2019, and detailed disclosure by 31 March 2020): The annual report is required to contain a matrix setting out the competencies / expertise that the board believes its directors

should possess. Subsequently, a list of skills of each of the individuals on the board is also required to be disclosed.

**Comment:** Disclosure of directors' skills may probably provide more credibility to the board, and hopefully this will form the broad basis for board evaluation. In the short run, this may help companies weed out directors who do not possess the requisite qualifications or credentials for managing listed companies.

Greater awareness and training of the promoters and directors about the benefits of governance to all the stakeholders is critical to the success of these measures. The change of mindset is key to the success of corporate governance than some of the optical measures accepted by SEBI.

- Enhanced role of certain board committees (From 1 April 2018): Audit committee is required to scrutinise end use of funds raised from primary issuances. Nomination and remuneration committee is required to recommend payments of senior management employees (one level below the board). Risk management committee is required to consider cyber security threats.

**Comment:** The regulator's message is loud and clear – meaningful participation by the Independent Directors in the affairs of the companies, and to bring accountability for their actions and omissions.

- Reduction in the maximum number of listed entity directorships: Reduction in the limit of maximum number of directorships (including alternate directorships) to 8 listed companies (of which independent directorships shall not exceed 7) by 1 April 2019 and no more than 7 listed companies by 1 April 2020.

**Comment:** With the increased responsibilities as directors, limiting the number will help ensure sufficient time is devoted by directors.

- Permission to related parties to vote against RPTs: The blanket restriction on related parties from voting on any and all related party transactions has been removed. Related parties can now cast a negative vote on transactions on RPT matters.

**Comment:** The intent appears to align the voting requirements with company law. It appears that the intent is reflected in the language, and the differences in compliance requirements for RPTs are done away with.

- Increase in disclosures:

DISCLOSURE	COMPLIANCE DATE
Details of utilisation of capital raised through preferential issues/QIPs in annual report	From 1 April 2018
Half yearly disclosures of RPTs on consolidated basis (similar to annual disclosure)	
Details of transactions with any person (including promoter group) which holds 10% or more shares in annual report	
Details of credentials, basis of recommendation and fees payable to auditors in notice seeking auditors' appointment	

Mandatory disclosure of consolidated quarterly results

From FY 2019-20

**Comment:** Increase in disclosures will bring in more transparency from a shareholders' perspective – however, more compliance costs for companies. The disclosures regarding related party transactions and end use would bring in a lot of cheer with shareholder activist groups, who have been mooting for stricter governance norms for related party transactions.

- Unlisted 'material' subsidiaries and Secretarial Audit: Material subsidiary to now include subsidiaries who account for 10% of the consolidated income or net worth of the listed company. Further, the listed company is required to appoint at least one ID as a director on the board of its off-shore material subsidiaries. In the latter case, the earlier threshold of 20% of the consolidated income or net worth continues to apply. Further, secretarial audit has been made mandatory for listed companies and their unlisted Indian material subsidiaries from 1 April 2018.

**Comment:** The increase in compliance requirements for unlisted material subsidiaries is positive from a governance perspective. Having said that, this will mean companies having to factor in larger budgets and manpower for compliance.

### Recommendations with Modifications

- Separation of key positions: Kotak Committee recommended that all listed companies with more than 40% public shareholding are required to have different individuals appointed as chairperson and managing director/CEO by 1 April 2020. SEBI has limited applicability to the Top 500 listed companies by market capitalisation, meeting the public shareholding criteria.

**Comment:** This is a bold good governance measure – it helps avoiding concentration of power in one individual. It also forces promoter driven companies to focus on succession planning.

- Woman ID: Kotak Committee recommended appointment of at least one independent woman director for all listed companies by 1 October 2018. SEBI has provided for a staggered applicability of this requirement – top 500 listed companies (by market cap) to comply by 1 April 2019 and top 1000 listed companies (by market cap) to comply by 1 April 2020.

**Comment:** The existing requirement of at least one-woman director was meant to bring in gender diversity in the board room. To achieve the true intent of the law, perhaps, this amendment is necessary. Coupled with the recommendations for disclosure of directors' expertise, skills and qualifications, it is hoped that a large section of competent human resources that remained hitherto untapped will now rightfully occupy the director positions.

- Royalty/brand payments to related parties: Kotak Committee recommended that payments made by listed companies to related parties with respect to brands usage / royalty which exceeds 5% of annual consolidated turnover, requires a prior approval from the shareholders on a "majority of minority" basis by 1 October 2018. SEBI while accepting this has taken a stricter approach and reduced the threshold from 5% to 2%.

**Comment:** The stricter approach by SEBI will be welcomed by shareholder activist groups. Interestingly, this has been limited only to "royalty and brand" payments and not to other payments to related parties.

➤ Procedural changes on board and shareholder meetings:

RECOMMENDATION	KOTAK COMMITTEE	SEBI
<b>Board of Directors</b> <u>Quorum:</u> Higher of 3 or 1/3 of total strength <u>Board size:</u> At least 6 directors	All listed companies to comply by 1 October 2018	Top 1,000 listed companies to comply by 1 April 2019; and Top 2,000 listed companies to comply by 1 April 2020
<b>Annual General Meetings (AGMs)</b> For the top 100 listed companies, (i) AGMs to be held within 5 months as opposed to 6 months currently (ii) one-way <u>live webcast</u> of the meeting proceedings	(i) from FY 2018-19, i.e., applicable from 31 August 2018 (ii) 1 April 2018 for all shareholder meetings	(i) after the end of FY 2018-19, i.e., by 31 August 2019 (ii) from FY 2018-19 for AGMs

**Comment:** SEBI has taken a more flexible approach by limiting it to top companies to avoid unnecessary compliance burden for mid-sized and smaller listed companies.

## Way forward

SEBI, by accepting most of the Kotak Committee recommendations has shown its willingness to undertake strong and bold measures to improve the corporate governance environment in India. India Inc needs to be well prepared to embrace the overhaul changes in corporate governance regime – soon this may be a reality! As mentioned, one will have to wait for the details, which are expected in the coming weeks.

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