SEBI decision regarding Kotak Committee recommendations

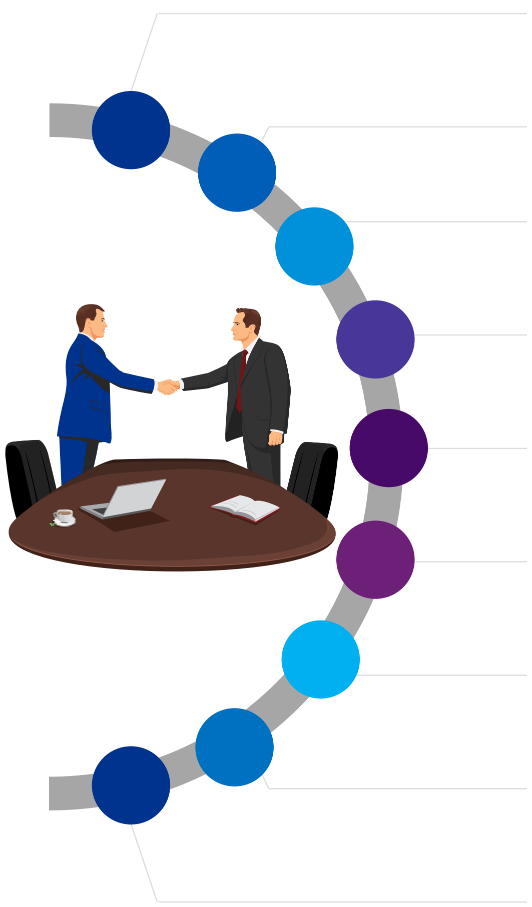
Board Leadership Center

Background

On 28 March 2018, the Securities and Exchange Board of India (SEBI) considered the recommendations of the Kotak Committee on Corporate Governance (the Committee) and the public comments thereon. Accordingly, they accepted certain recommendations without modifications, few with modifications and referred certain recommendations to various agencies (i.e. government, other regulators, professional bodies, etc.) since the matters involved those agencies.

In this documents, we have categorised the decisions on the basis of their applicability dates.

The decisions that are expected to be applicable from 1 April 2018 and have been accepted without modifications are as follows:



1. Eligibility criteria for independent directors
2. Role of an audit committee
3. Role of nomination and remuneration committee
4. Role of risk management committee
5. Auditor related disclosures
6. Secretarial audit
7. Related party transactions
8. Obligations on the board with respect to subsidiaries
9. Utilisation of proceeds of preferential issue and QIP

SEBI decisions expected to be applicable (without modifications) from 1 April 2018

1 Eligibility criteria for independent directors

Eligibility criteria for a director to be an independent director has been revised and would be as follows:

- Specifically exclude persons who constitute the 'promoter group' of a listed entity
- Require an undertaking from an independent director that he/she is not aware of any circumstance or situation, which exists or may be reasonably anticipated, that could impair or impact his/her ability to discharge his/her duties with objective independent judgements and without any external influence
- The board of the listed entity to take on record the above undertaking after due assessment of the veracity of such undertaking.
- Exclude 'board inter-locks' arising due to common non-independent directors on boards of listed entities (i.e. a non-independent director of a company on the board of which any non-independent director of the listed entity is an independent director, cannot be an independent director on the board of the listed entity).

  For example, if Mr. A is an executive director on the board of entity A (being a listed entity) and is also an independent director on the board of entity B, then no non-independent director of entity B can be an independent director on the board of entity A.

Additionally, board of directors as a part of the board evaluation process may be required to certify every year that each of its independent directors fulfils the conditions specified in the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) and is independent of the management.

2 Role of an audit committee

The audit committee members would need to also review the utilisation of loans and/or advances from/investment by the holding company in the subsidiary exceeding INR100 crore or 10 per cent of the asset size of the subsidiary, whichever is lower.

3 Role of nomination and remuneration committee

Nomination and remuneration committee members are required to identify and recommend persons who can be appointed in senior management. Accordingly, the persons in senior management should include all members of management one level below the chief executive officer/managing director/whole-time director/manager (including chief executive officer/manager, in case chief executive officer/manager is not part of the board) and should specifically include the company secretary and the Chief Financial Officer (CFO). Administrative staff would not be included in senior management.

Also the nomination and remuneration committee members would need to recommend the remuneration payable to the senior management to the board of the listed entity.

4 Role of risk management committee

The board of directors would need to include cyber security and related risks while specifying the role and responsibility of risk management committee.

Additionally, the requirement for constitution of a risk management committee should be applicable to top 500 listed entities determined on the basis of market capitalisation, as at the end of the immediate previous financial year.

5 Auditor related disclosures

The explanatory statement to the notice that is sent to shareholders for an Annual General Meeting (AGM) in relation to the item on appointment/re-appointment of auditor(s), would include the following disclosures (in addition to any other disclosures that the board of directors may deem fit):

a) Basis of recommendation for appointment including the details in relation to and credentials of the auditor(s) proposed to be appointed and

b) Proposed fees payable to the statutory auditor(s) along with the terms of appointment. In case of a new auditor, any material change in the fee payable to such an auditor from that paid to the outgoing auditor and the rationale for such change.

c) Detailed reasons for resignation of an auditor as given by the said auditor.

6 Secretarial audit

Secretarial audit has been made compulsory for all listed entities under the Listing Regulations in line with the provisions of the Companies Act, 2013. Secretarial audit has also been extended to all material unlisted Indian subsidiaries.

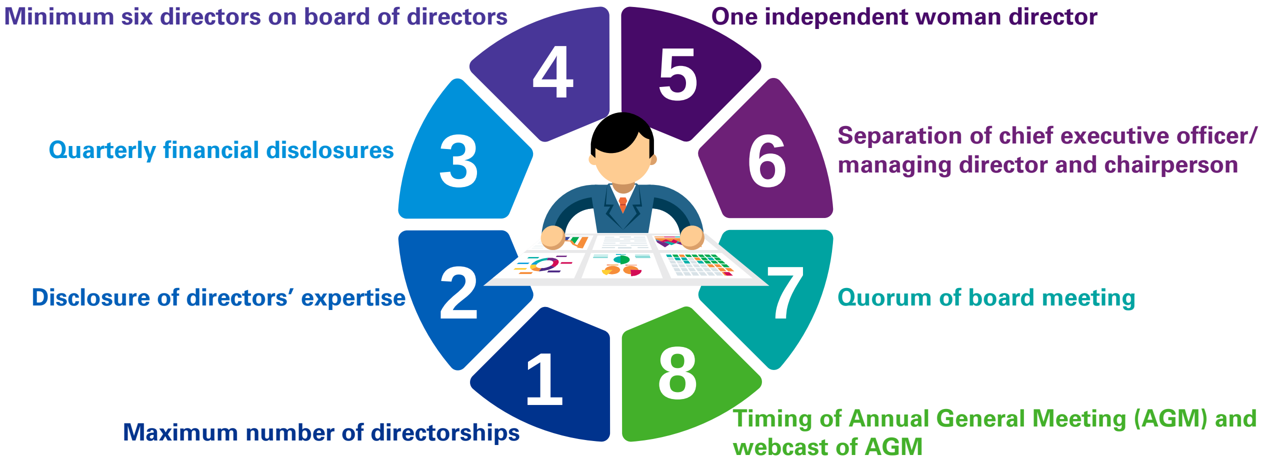
SEBI decisions expected to be applicable (without modifications) from 1 April 2018

7	**Related Party Transactions (RPTs)**	In order to strengthen transparency on RPTs, the listed entities would need to take action on the following requirements: • A person or an entity belonging to the promoter or promoter group of the listed entity and holds 20 per cent or more of shareholding in the entity would be considered as a related party. • Half yearly disclosure of RPTs on a consolidated basis, in the disclosure format required for RPT in the annual accounts as per the accounting standards, on the website of the listed entity within 30 days of publication of the half-yearly financial results. Copy of the same also has to be submitted to the stock exchanges. • Disclosure of transactions with promoters/promoter group entities holding 10 per cent or more shareholding be made annually and on a half-yearly basis (even if not classified as related parties). • Strict penalties may be imposed by SEBI for failing to make requisite disclosures of RPTs. The Listing Regulations would be amended to allow related parties to cast a negative vote as such voting cannot be considered to be in conflict of interest. Therefore, all material RPTs would require approval of the shareholders through resolution and no related party would vote to approve such a resolution whether the entity is a related party to the particular transaction or not.
8	**Obligations on the board with respect to subsidiaries**	The board of listed companies would need to take actions regarding following: • *Definition of material subsidiary:* The definition of a material subsidiary has been revised to mean a subsidiary whose income or net worth exceeds 10 per cent (from the current 20 per cent) of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year. For the requirement of appointment of independent directors on the board of material subsidiaries, the threshold of 20 per cent would continue. • *Appointment of an independent director:* At least one independent director on the board of directors of the listed entity should be a director on the board of directors of an unlisted material subsidiary, including unlisted foreign material subsidiary. • *Significant transaction or arrangement:* The management of the unlisted subsidiary should periodically bring to the notice of the board of directors of the listed entity, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary (currently the disclosure is required for material subsidiary).
9	**Utilisation of proceeds of preferential issue and Qualified Institutional Placement (QIP)**	A disclosure regarding utilisation of funds raised through preferential allotment and QIPs undertaken in the relevant financial year, until such funds are fully utilised would be required. This disclosure will be included in 'other disclosures' section of the Corporate Governance Report.

The decision that is expected to be applicable from 1 April 2018 but has been accepted with a modification is as follows:

1	**Royalty/brand payments to related parties**	The payments made by listed entities with respect to brands usage/royalty amounting to more than two per cent of consolidated turnover of the listed entity would require prior approval from the shareholders on a 'majority of minority' basis.

The decisions that are expected to be applicable from 1 April 2019 or 1 April 2020



1	**Maximum number of directorships**	The maximum number of listed entity directorships held by a person has been brought down from 10 to eight (for an independent director it should not exceed seven) with effect from 1 April 2019. From 1 April 2020, the number of directorships would be reduced to seven listed entities. Any person who is serving as a whole-time director/managing director in any listed entity would serve as an independent director in not more than three listed entities.
2	**Disclosure of directors' expertise**	The corporate governance report would disclose competencies of its board members against every identified competency/expertise without disclosing names in the annual report for financial year ending 31 March 2019. However, detailed disclosures of competencies of every board member, along with their names, would be required with effect from 31 March 2020.
3	**Quarterly financial disclosures**	Consolidated financial results have been made mandatory for all listed entities on a quarterly basis with effect from financial year 2019-20. The stand-alone financial results would continue to be published.
4	**Minimum six directors on board of directors**	The composition of board of directors of the listed entity would comprise of not less than six directors. This requirement is expected to be applicable to top 1,000 listed entities from 1 April 2019 and to top 2,000 listed entities from 1 April 2020.
5	**One independent woman director**	The board of directors would be required to appoint at least one independent woman director. This requirement is expected to be applicable to top 500 listed entities from 1 April 2019 and to top 1,000 listed entities from 1 April 2020.
6	**Separation of chief executive officer/managing director and chairperson**	Top 500 listed entities would be required to separate the roles of chairperson and chief executive officer/managing director from 1 April 2020. While the Kotak Committee had recommended that all listed entities with more than 40 per cent of public shareholding should separate the roles of the chairperson and chief executive officer/managing director with effect from 1 April 2020, with the chairperson being a non-executive director, SEBI has decided to modify the recommendation to make it applicable to the top 500 listed entities. However, it is unclear if the modification is meant to restrict the applicability to the top 500 listed companies with public shareholding of more than 40 per cent or instead extend the applicability to all of the top 500 listed entities irrespective of the level of public shareholding.
7	**Quorum for board meetings**	The quorum for every meeting of the board of directors of the listed entity would be one-third of its total strength or three directors, whichever is higher, including at least one independent director. This requirement is subject to the requirements of the Companies Act, 2013 and the participation of the directors by video conferencing or by other audio visual means would also be counted for the purposes of such quorum. This requirement is expected to be applicable to top 1,000 listed entities from 1 April 2019 and to top 2,000 listed entities from 1 April 2020.

The decisions that are expected to be applicable from 1 April 2019 or 1 April 2020 (cont.)

8	**Timing of AGM and webcast of AGM**	The top 100 listed entities would need to hold AGMs within five months after the end of financial year 2018-19 i.e. by 31 August 2019 and also provide webcast of AGMs from financial year 2018-19.

Our comments

The SEBI decisions are a welcome step and are expected to help India Inc ensure robust corporate governance. Following are our detailed observations:

- **Eligibility criteria of independent directors:** The role of independent directors is critical for a robust corporate governance. Therefore, additional eligibility criteria have been defined. There is also a requirement for a continuous assessment of the independence criteria.
- **Role of audit committee:** The role of audit committee has been enhanced and would be required to review the utilisation of funds of the listed entity infused into unlisted subsidiaries including foreign subsidiaries. To avoid an onerous obligation, scrutiny would be for loans and/or advances from/investment by the holding company in the subsidiary that exceed INR100 crore or 10 per cent of the asset size of the subsidiary, whichever is lower.
- **Role of nomination and remuneration committee:** The definition of senior management has been elaborated and it specifies that all members of management one level below the chief executive officer/managing director/whole time director/manager (including chief executive officer/manager, in case chief executive officer/manager not part of the board) and include company secretary and chief financial officer. All payments made to senior management, in whatever form, would need to be recommended by the nomination and remuneration committee to the board of the listed entity. This process would be followed for any payment to be made to the senior management, irrespective of existing contracts, unless the same has been approved earlier through this process.
- **Auditor related disclosures**: The enhanced disclosures regarding credentials and terms of appointment of auditors would help shareholders take informed decisions on the appointment of auditors of listed entities. Disclosure of proposed fees paid to a new auditor as compared to current fees is expected to improve transparency.
- **Related party transactions:** The enhanced disclosures are expected to bring greater transparency in relation to transactions with parties that are related to the promoters/promoter group entities, and within the ambit of disclosures mandated by SEBI regulations as the Committee observed that certain promoters/promoter group entities were not getting categorised as related parties as they did not strictly fall under the extant definition of related parties.
- **Obligations on the board with respect to subsidiaries**: The SEBI expects to bring global subsidiaries at par with Indian subsidiaries in the context of corporate governance. This is due to the fact that an appropriate level of review and oversight is required by the board of the listed entity over its unlisted entities for protection of interests of public shareholders.
- **Royalty/brand payments to related parties**: Currently, there is no specific provision in SEBI regulations pertaining to payments made regarding brand/royalty arrangements to related parties. Therefore, to help shareholders comprehend the terms and conditions of such payouts, all companies are encouraged to make better disclosures on the value a company derives from a brand or technology for which it has agreed to pay royalty, brand, or technical fees to the parent company/promoters and in addition, SEBI regulations would require approval of shareholders on 'majority of minority' basis for payments that exceed two per cent of the consolidated revenues. However, it is not clear from the Kotak committee recommendation whether this approval requirement would apply to payments under existing arrangements that have previously been approved by the shareholders.
- **Maximum number of directorships:** In order to help directors to allocate sufficient time to a particular entity, the maximum number of directorships would be reduced in a staggered manner i.e. eight directorships from 1 April 2019 and seven from 1 April 2020. Additionally, any person who is serving as a whole-time director/managing director in any listed entity would serve as an independent director in not more than three listed entities.
- **Separation of chief executive officer/managing director and chairperson:** Currently, the Companies Act, 2013 states that an individual should not be appointed/reappointed as the chairperson of a company as well as its managing director/chief executive officer at the same time. However, such appointment is possible when the articles of such company provide otherwise or the company does not undertake multiple businesses. The SEBI regulations did not mandate a separation of the posts of chairperson and chief executive officer of the listed entity but allow listed entities to use their discretion.

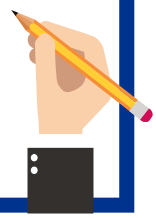
  The committee felt that the separation of powers of the chairperson and chief executive officer/managing director would provide a better and more balanced governance structure to a listed entity. Therefore, the committee had recommended that listed entities with more than 40 per cent of public shareholding should separate the roles of the chairperson and chief executive officer/managing director with effect from 1 April 2020, with the chairperson being a non-executive director. However, SEBI has accepted this recommendation with a modification and as mentioned earlier it is unclear from the SEBI decisions whether they have modified the recommendation to apply it to all top 500 listed entities irrespective of the level of public shareholding or whether the separation of roles would be required only by those top 500 listed entities that have more than 40 per cent of public shareholding.

Our comments (cont.)

- **One independent woman director:** In order to improve gender diversity on corporate boards, the SEBI has accepted the decision that every listed entity should have at least one independent woman director on its board of directors.
- **Increase in the number of minimum directors:** The board of directors play an important role in an entity's governance and performance. Therefore, SEBI has accepted the decision to mandate minimum six directors with diverse backgrounds and skill sets so that the boards of listed entities are able to fulfil their functions and obligations.
- **Webcast of AGMs:** As per SEBI decision, the top 100 listed entities would need to provide a webcast of AGMs from financial year 2018-19. It appears that this requirement would be for the AGMs that pertain to the financial year 2018-19 and not for the AGMs for the financial year 2017-18. For companies, following calendar year as their financial year, it appears that the webcast would be required for AGMs in the year 2020. The SEBI should clarify the applicability date for the webcast of AGMs to avoid any confusion.

The bottom line

The SEBI has accepted many of the recommendations of the Kotak Committee and demonstrated its commitment to raise the governance standards for Indian corporates. It is now important for companies to gear up to embrace these changes keeping in mind the spirit of the requirements, rather than just the letter of the law.



About KPMG's Board Leadership Center

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