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Sebi accepts Kotak Committee recommendations: Getting closer to global best practices

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In light of various developments in the realm of corporate governance across the globe and in continuation of its role as a proactive regulator, the Securities and Exchange Board of India (SEBI) constituted a committee under the chairmanship of Uday Kotak in June 2017 to suggest suitable policy and regulatory changes required to be carried out in order to enhance the efficiency of corporate governance norms for Indian listed entities (Kotak Committee).

The Kotak Committee, submitted its report (Report or Kotak Committee Report) on October 5, 2017 after careful and detailed deliberation with various experts and stakeholders. The Report contained best recommendations pertaining to a plethora of regulatory changes to align Indian corporate governance norms with global best practices, while being premised on local business realities unique to India, such as the prevalence of large, concentrated shareholding blocks (as opposed to a dispersed shareholding pattern observed in few developed markets such as the United States of America), family run businesses and 'promoter-raj'.

News reports suggested that the recommendations of the Kotak Committee were to be considered and implemented in a phased manner. In its board meeting on March 27, 2018, SEBI, after detailed consideration and due deliberation, accepted several recommendations of the Kotak Committee without any modifications and accepted a few other recommendations with certain modifications as to timelines for implementation, applicability thresholds among others.

SEBI also decided to refer certain recommendations, which were criticized by market participants as being an example of "jurisdictional over-reach", to various agencies (i.e. government, other regulators, professional bodies, etc.), considering that the matters involved related to them.

Key Recommendations of the Kotak Committee approved by SEBI

Increasing Transparency -Enhanced Disclosure Requirements

Corporate governance norms are aimed at reduction of agency costs for residual owners of a corporation (its shareholders) incurred by them in monitoring and ensuring effective functioning of a corporation as per its objectives (by the management). Effective disclosures, thus, are fundamental to corporate governance. The Kotak Committee, had made various recommendations pertaining to enhancing disclosure requirements of listed entities. Some recommendations of the Kotak Committee, which have been approved by SEBI pertain to the following-

Disclosure of Utilization of Funds from Qualified Institutional Placement (QIP) /Preferential Issues-Full disclosure of utilization of funds raised through Preferential Allotment and QIPs undertaken in the relevant financial year have to be made in the Annual Report of the listed company until such funds are fully utilized.

Disclosures of Auditor Credentials, Audit Fee, Reasons for Resignation of Auditors-A listed entity will now be required to disclose in its Annual Report, the details of all fees paid by the listed entity and its subsidiaries (on a consolidated basis) to the statutory auditor and to all other entities in the network firm/network entity of which the auditor is a part. Further, the notice being sent to shareholders for an Annual General Meeting (AGM) where the statutory auditor(s) is/are proposed to be appointed/re-appointed will have to include the following disclosures as a part of the explanatory statement to the notice:-

- (i) Proposed fees payable to the statutory auditor(s) along with terms of appointment and in case of a new auditor, any material change in the fee payable to such auditor from that paid to the outgoing auditor along with the rationale for such change;
- (ii) Basis of recommendation for appointment, including the details in relation to and credentials of the statutory auditor(s) proposed to be appointed.

Apart from the above, detailed reasons for resignation of an auditor as given by the said auditor has to now be disclosed to the stock exchanges.

Disclosure of Expertise/Skills of Directors-The listed entity is required to disclose a chart or a matrix setting out the skills/expertise/competence of the board of directors in its Annual Report containing a list of core skills/expertise/competencies identified by the board of directors as required in the context of its business(es) and sector(s) for it to function effectively, and those actually available with the board in the Financial Year -2018-2019.

Further, detailed disclosures of competencies of every board member, along with their names have to be disclosed in the Annual Report for the Financial Year 2019-2020.

Enhanced Disclosure of Related Party Transactions (RPT)-A listed entity has to submit within 30 days of publication of its standalone and consolidated financial results for the half year, disclosures of RPTs on a consolidated basis, in the format prescribed in the relevant accounting standards for annual results, to the stock exchanges and to publish the same on its website. Further, listed entities will now have to include disclosures of transactions of the listed entity with any person or entity belonging to the promoter/promoter group which hold(s) 10 per cent or more shareholding in the listed entity, in the format prescribed in the relevant accounting standards for annual results in its Annual Report.

Mandatory Disclosure of Consolidated Quarterly Results with effect from Financial Year 2019-2020-A listed entity has to mandatorily disclose consolidated quarterly results with effect from Financial Year 2019-2020.

Reshaping the Institution of the Board of Directors and Enhancing the Role of Committees of the Board

The board of directors of a company, being entrusted to keep a check on the management, is its primary governance body. The board of directors owe a fiduciary duty to a company as a whole, and have the function of protecting the interests of various stakeholders. Therefore, institutionalizing a board of directors is of primal importance to effective corporate governance. The Kotak Committee had recommended various measures to strengthen the institution of the board of directors, some of which have been approved by SEBI. The approved changes pertain to:

Separation of the office of the chairperson (i.e. the leader of the board) and CEO/MD (i.e. the leader of the management) - The top 500 listed entities (by market capitalization) having a public shareholding of 40 per cent or more, have to separate the office of CEO/MD and Chairperson with effect from April 1, 2020.

Augmenting board strength and diversity- The top 1000 listed entities (by market capitalization), and the top 2000 listed entities, have to mandatorily have a minimum of six directors on their boards by April 1, 2019 and April 1, 2020 respectively. The top 500 listed entities (by market capitalization) and the top 1000 listed entities have to have a minimum of one woman independent director by April 1, 2019 and April 1, 2020 respectively.

Enhanced Quorum-Quorum of the board of directors will be one-third of the total strength of the board of directors or three directors, whichever being higher, from April 1, 2019 for the top 1000 listed entities (by market capitalization) and from April 1, 2020 for the top 2000 listed entities.

Capping the Maximum Number of Directorshipsâ€“No person will be allowed to hold the office of director in more than eight listed entities at the same time (of which independent directorships are capped at seven) with effect from April 1, 2019. Further, with effect from April 1, 2020, such number will be capped at seven.

Expanded Eligibility Criteria for Independent Directorsâ€“No person who is a part of the promoter group can be appointed as an Independent Director. Further, to avoid the problem of "board interlocks"™, a person who is a non-independent director of another company on the board of which any non-independent director of the listed entity is an independent director, will not be eligible to be an independent director in the listed entity.

Enhanced Role of committeesâ€“

(i)**Audit Committee** - The Audit Committee will have to review the utilization of loans and/or advances from/investment by the holding company in the subsidiary exceeding Rs 100 crore or 10 percent of the asset size of the subsidiary, whichever is lower.

(ii)**Nomination and Remuneration Committee**â€“ The Nomination and Remuneration Committee, which is currently mandated by the LODR Regulations to recommend to the board of directors the appointment and removal of the senior management of a listed entity, shall now have to identify and recommend to the board, the appointment and removal of persons for the positions/offices 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 a part of the board), specifically including the position of the company secretary and the chief financial officer: Such positions/offices will now be considered to be a part of the "senior management"™. Further, it shall now be the duty of the Nomination and Remuneration Committee specifically to recommend to the board, all remuneration, in whatever form, payable to members of the senior management.

(iii)**Risk Management Committee** - The functions of the Risk Management Committee shall now specifically cover cyber security.

Down-streaming Corporate Governance

In light of the increasingly complex corporate structures being used by businesses, which function through a web of subsidiaries incorporated in India/abroad, governance practices at subsidiary level is of increased importance to the shareholders of a listed entity. SEBI, in recognition thereof, has approved the following recommendations of the Kotak Committee:

Enhanced Obligations on Listed Entities with Respect to Subsidiaries â€“ One independent director from the board of directors of a listed entity should also be a director on the board of directors of its unlisted foreign material subsidiary (as opposed to the extant requirement pertaining to an unlisted material subsidiary incorporated in India). Additionally, the board of all listed entities will now have to be apprised of significant transactions involving all unlisted subsidiaries (as opposed to the extant requirement of significant transactions of only unlisted material subsidiaries). A material subsidiary is defined as a subsidiary, whose income or net worth exceeds 10 percent (as opposed to 20 percent) of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year.

Secretarial Audit to be Mandatory for Listed Entities and their Material Unlisted Subsidiariesâ€“All listed companies and their material subsidiaries incorporated in India will have to undertake secretarial audit and annex a secretarial audit report given by a practicing company secretary with their Annual Reports.

Shareholder Participation and Involvement

It is widely considered and acknowledged that a key connection between decision-making and accountability, is the effective engagement between shareholders and the board of directors of a company. Further, shareholders, being owners of a company, are stakeholders for the primary benefit of whom corporate governance norms are envisaged. In light of the same, SEBI has approved the following recommendations of the Kotak Committee to increase shareholder participation and engagement in the affairs of a listed company:

The top 100 listed entities by market capitalization have to hold their AGM within five months from the date of closing of the Financial Year 2018-2019 i.e. by August 31, 2019.

Mandatory webcast of AGMs has been mandated for top 100 entities by market capitalization with effect from Financial Year 2018-19.

Requirement of shareholder approval being majority of minority for royalty/brand payments to a related party exceeding 2% of consolidated turnover (instead of the proposed 5%).

Conclusion

The approved changes to corporate governance norms is aimed towards aligning corporate governance standards to global best practices. Most of the approved recommendations, are firmly rooted in local business realities, where most listed entities are promoter-led as opposed to being professionally managed, thus increasing risks of promoter-raj at the cost of minority shareholders.

Some of the approved recommendations, such as the enhanced disclosure requirements, will have the effect of reducing information asymmetry between the managers of a company and its shareholders. To conclude, while there may exist certain issues and glitches, such as the fact that various recommendations of the Kotak Committee which have been approved have been made applicable to top companies in terms of market capitalization, precluding smaller listed entities from such compliance requirements even though it is usually some of the smaller listed entities wherein corporate governance standards are found to be wanting, the approved recommendations are indeed welcome and are expected to extol corporate India to a leadership position with regards to corporate governance.

Some argue that added compliance requirements are de factor abdication of the regulators role and will have the effect of increasing regulatory burden on listed companies, and consequently increase transaction costs/agency costs; in terms of cost benefit analysis for the Indian securities markets at large, it is clearly a move forward. Enhanced monitoring and disclosures arising out of structural modifications will benefit all shareholder, especially the smallest. Needless to add, a robust governance will enhance the credibility of the entire public markets and attract more investors in the long term.

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