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ANALYSIS OF KOTAK COMMITTEE RECOMMENDATIONS ON CORPORATE GOVERNANCE

Introduction:

Corporate governance is the system of rules, practices and processes by which a company is appropriately managed and controlled. Corporate governance essentially balances the rules relating to the power relations between members, employees and the stakeholders as well as the public at large are formulated.

The SEBI Committee on corporate governance was formed on June 02, 2017 under the Chairmanship of Mr. Uday Kotak (the executive vice chairman and managing director of Kotak Mahindra Bank) along with different stakeholders from the Government, industry, stock exchanges, academicians, proxy advisors, professional bodies, lawyers etc., with the aim of improving standards of corporate governance of listed companies in India. The Committee comprised of twenty five members in total and was requested to submit its report to SEBI within four months.

The Committee was requested to provide its recommendations with the aim of improving standards of Corporate Governance of listed companies in India on the following issues:

1. Ensuring independence in spirit of Independent Directors and their active participation in functioning of the company;
2. Improving safeguards and disclosures pertaining to Related Party Transactions;
3. Issues in accounting and auditing practices by listed companies;
4. Improving effectiveness of Board Evaluation practices;
5. Addressing issues faced by investors on voting and participation in general meetings;
6. Disclosure and transparency related issues, if any;
7. Any other matter, as the Committee deems fit pertaining to corporate governance in India.

The Committee had twelve meetings over a period of four months with the first meeting held on June 14, 2017 and the last on September 29, 2017 after which the Committee submitted its report detailing several recommendations on October 05, 2017. The Report suggests certain amendments to the existing provisions and certain new provisions that may be required to implement the recommendations. The Committee received letters from Ministry of Corporate Affairs (“MCA”) and Ministry of Finance (“MoF”) dated October 03, 2017 with certain comments on the recommendations. The report was not favourably received by MCA¹, especially in relation to extending the jurisdiction to unlisted companies and proposing amendments to other core company law principles. Similar comments were also provided by the MoF². Subsequently, the Report along with the comments and observations of

¹ Page 105 of Kotak Committee Report

² Page 111 of Kotak Committee Report

MCA and MoF was placed before SEBI for its consideration.

Report of the Committee was placed on the SEBI website for public comments to be submitted latest by November 4, 2017. Comments were received from a variety of stakeholders including industry, government, global associations, institutional investors, lawyers etc. Based on the analysis of the public comments received and the consultation with the Ministries as stated above, SEBI considered the recommendations of the Committee.

In its meeting held on March 28, 2018, out of a total of 81 recommendations made by the Committee, SEBI accepted 40 proposals without modifications, 15 with modifications, rejected 18 and referred 8 to other regulatory bodies.

SEBI followed this by amendments to the SEBI (Listing Obligation and Disclosure Requirements) Regulations, 2015 (“SEBI LODR Regulations”) on May 09, 2018 and through issuance of a circular SEBI/HO/CFD/CMD/CIR/P/2018/79 on May 10, 2018 (“May 10 Circular”). The amendments to the SEBI LODR Regulations, unless specified otherwise, are to come into force with effect from April 1, 2019.

This Article discusses some of the important recommendations of the Committee, the acceptance or rejection thereof by SEBI and its impact on Corporate Governance of listed companies in India.

I. Composition and Role of the Board of Directors

The Committee was of the view that the board of directors as a whole is responsible to all stakeholders for meeting the requisite standards of corporate governance in a company. Accordingly, the Committee sought to address the issues *inter alia* relating to strength of the board, its diversity, issues pertaining to independent directors and disclosure of skills / expertise of the board members.

³ Proviso to Regulation 17(1)(a), as amended by the LODR amendments of May 09, 2018.

1. Minimum and Maximum Number of Directors on a Board

As per the Companies Act, 2013 (“Act”) and the relevant rules, a minimum of 3 directors are required on the board of a public limited company whereas the SEBI LODR Regulations stipulates no such requirement. Keeping in view the need of sufficient number of directors with diverse backgrounds and skill sets on the boards of listed entities to fulfil their functions and obligations, a minimum of 6 (six) directors on the board was recommended by the Committee.

This recommendation was accepted by SEBI with modifications and a new clause (c) has been inserted in sub-regulation (1) of Regulation 17 which requires **the top 1000 listed entities by market capitalization (with effect from April 01, 2019) and the top 2000 listed entities (with effect from April 1, 2020) to have a minimum number of 6 (six) directors.**

SEBI’s decision to limit the minimum number of 6 directors to larger companies based on market capitalization is a relief for mid-sized and smaller listed companies which would have otherwise been burdened with unnecessary compliance.

2. Gender Diversity on the Board

The Act and the SEBI (LODR) Regulations require at least one woman director on the board of directors of every listed entity. It was recommended by the Committee to have at least one independent woman director on the board of directors of every listed company. SEBI decided to accept the recommendation in a phased manner, i.e. **at least one independent woman director in the top 500 listed entities by the market capitalization by April 01, 2019 and in the top 1000 listed entities, by April 1, 2020.**³

The existing requirement of at least one woman director was to bring about gender diversity on the board. It is expected that with the aforesaid

amendments, corporate India will witness women playing a more active role.

3. Quorum

Currently, the Act requires a quorum of one-third of the total strength of the board of directors or two directors, whichever is higher, for every board meeting. SEBI LODR Regulations do not prescribe any quorum for meetings of board of directors. The Committee was of the view that given the increased obligations of the boards of listed entities, they should be subject to a higher quorum requirement. Further, the Committee was also of the view that for minority rights protection, presence of one independent director as a mandatory quorum requirement was necessary.

May 09, 2018 amendments to the SEBI LODR Regulations inserted a new sub-regulation (2A) to Regulation 17, whereby, **the quorum for every meeting of the board of directors of the top 1000 listed entities by market capitalization (with effect from April 1, 2019) and of the top 2000 listed entities (with effect from April 1, 2020) shall be 1/3rd of the size of the board or 3 members, whichever is higher, including at least one independent director.**

Limiting the aforesaid quorum requirements to larger listed companies shall save the smaller and mid-sized listed companies from unnecessary compliance burden.

4. Separation of Key Positions

The Act currently provides that an individual shall not be appointed / reappointed as the chairperson of a company as well as its Managing Director (“MD”) / Chief Executive Officer (“CEO”) at the same time unless the articles of such company provide otherwise or the company does not undertake multiple businesses. SEBI LODR Regulations do not mandate a separation of posts of chairperson and CEO of a listed entity but is stated as a discretionary requirement.

The Committee recommended that all listed companies with more than 40% public shareholding should separate the roles of chairperson and MD/CEO with effect from April 1, 2020 and subsequent to the aforesaid date, SEBI may examine extending the requirement to all listed entities with effect from April 1, 2022.

SEBI accepted the aforesaid recommendation with a minor modification in as much as under the newly inserted sub-regulation (1B) of Regulation 17, the SEBI LODR Regulations provide that **with effect from April 1, 2020, the top 500 listed entities by market capitalization shall ensure that the chairperson of the board of such listed entity shall – (a) be a non – executive director; (b) not be related to the MD or the CEO as per the definition of the term “relative” under the Act.**

In relation to composition and role of board of directions, several recommendations of the Committee were accepted by SEBI without any modifications, inter alia including:

- reduction in the maximum number of listed entity directorships from 10 to 8 by April 01, 2019 and to 07 by April 1, 2020;
- expanding the eligibility criteria for independent directors (*discussed in paragraph II below*);
- disclosure of expertise / skills of directors in the annual reports of the listed entities (initial disclosure without names by March 31, 2019 and detailed disclosure by March 31, 2020).

II. Institution of Independent Directors

The institution of independent directors is essential to a good corporate governance framework as they are expected to bring objectivity into the functioning of the board and

improve its effectiveness.⁴ Section 149(6) of the Act states that an independent director means a director other than a managing director or a whole-time director or a nominee director, who, in the opinion of the board is a person of integrity and possesses relevant expertise and experience and is or was not related to promoters or directors in the company, its holding, subsidiary or associate company. Independent directors are essential for minority rights protection, balancing the conflicting interest of various stakeholders and bringing an objective view to the evaluation of the performance of the board and management.

One of the most significant recommendations of the Committee vis-à-vis independent directors was in relation to the expansion of their eligibility criteria. The Act and SEBI LODR Regulations stipulate certain objective criteria for determination of independence of a director⁵. Every Independent director is required to provide a declaration that he/ she meets the legal criteria of independence, at the first meeting of the relevant board in which he or she participates as a director and thereafter at the first meeting of the board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director⁶.

The Committee was of the view that the evaluation of “independence” of an independent director should entail both objective and subjective assessments and such assessment should be both continuing as well as genuine.⁷ Following are the eligibility criteria as recommended by the Committee to be included in the existing provisions:

1. Specifically exclude persons who constitute the ‘promoter group’ of a listed entity;

⁴ Page 24 of the Kotak Committee Report

⁵ Section 149(6) of the Companies Act, 2013 and Regulation 16(1)(b) of SEBI LODR Regulations

⁶ Section 149(6) of the Companies Act, 2013

⁷ Page 25 of the Kotak Committee Report

⁸ Section 1.2 of SEBI Board Meeting dated March 28, 2018, PR No. 09/2018 followed by the May 09, 2018 amendments to

2. Requirement of an undertaking from the independent director that such a director 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.
3. The board of the listed entity taking on record the above undertaking after due assessment of the veracity of such undertaking.
4. 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).

The recommendations of the Committee with respect to expanding the eligibility criteria for independent directors have been accepted by SEBI without any modifications.⁸

III. Board Committees

Delegation of responsibilities to committees of the board is necessary for the effective governance of listed entities given the broad range of roles and responsibilities of the board. Committee’s recommendations addressed issues pertaining to representations in the board committees, setting minimum number of meetings and quorum for each such committee and increase in the number and nature of board committees.

1. Minimum Number of Committee Meetings

the SEBI LODR Regulations, specifically in Regulation 16(1)(b)(ii), insertion of new sub-clause (viii) to Regulation 16(1)(b) and insertions of sub-regulations (8) and (9) to Regulation 25.

SEBI LODR Regulations require at least four meetings of the Audit Committee every year whereas it does not prescribe the minimum number of meetings for other committees.⁹ In order to allow audit committees the time and opportunity to address matters beyond the quarterly reporting, it was recommended by the Committee that the minimum number of Audit Committee meetings be increased to five every year. In addition, the Committee also recommended all other mandatory board committees necessarily meet at least once in a year.

While SEBI did not accept the recommendation with respect to increase in the minimum number of meetings of the Audit Committee, it accepted the recommendations of the Committee vis-à-vis minimum number of meetings of the Nomination and Remuneration Committee (“NRC”), the Stakeholders Relationship Committee and the Risk Management Committee without any modifications. Regulations 19, 20 and 21 have been accordingly amended to prescribe that each of the Nomination and Remuneration Committee, the Stakeholders Relationship Committee and the Risk Management Committee shall meet at least once in a year.

2. Enhanced Role of the Audit Committee, Nomination and Remuneration Committee, Stakeholders Relationship Committee and Risk Management Committee

The Committee was of the view that the audit committee should also review the utilization of funds of the holding company infused into subsidiaries where the total amount of the loan and / or advances from / investment by the holding company in the subsidiary exceeds INR 100 crore or 10% of the asset size of the subsidiary, whichever is lower. This suggestion was accepted with a minor modification by SEBI by way of amendment inserting new sub-clause (21) in Schedule II, Part C, Clause A in

the SEBI LODR Regulations. SEBI’s amendments included existing loans / advances / investments existing as on the date of coming into force of this provision.

The Committee noted that the role of the Nomination and Remuneration Committee includes identifying persons who may be appointed in senior management in accordance with the criteria laid down, and recommending their appointment and / or removal to the board of directors. The Committee was of the view that the definition of senior management in Regulation 16(1)(d) be amended from the present definition of “senior management shall mean officers/personnel of the listed entity who are members of its core management team excluding board of directors and normally this shall comprise all members of management one level below the executive directors, including all functional heads”, to state:

“senior management” shall mean officers/personnel of the listed entity who are members of its core management team excluding board of directors and normally this shall comprise 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 shall specifically include company secretary and chief financial officer:

Provided that administrative staff shall not be included.”

The aforementioned recommendation was accepted without inclusion of the proviso stated in the recommendation above.

The Committee further noted that in the absence of specific provisions in SEBI LODR Regulations, compensation paid to certain Key Managerial Personnels were not being recommended by the NRC in some companies.

⁹ Regulation 18 of the SEBI LODR Regulations

The recommendation of the Committee was accepted by way of inclusion of a new sub-clause (6) in clause A of Schedule II, Part D to state the following: “(6) *recommend to the board, all remuneration, in whatever form, payable to senior management.*”

The role of the Stakeholders Relationship Committee was significantly amended and clause (B) of Schedule II, Part D was revised as follows:

“The role of committee shall, inter alia, include the following:

- (1) Resolving the grievances of the security holders of the listed entity including complaints related to transfer / transmission of shares, non – receipt of annual report, non – receipt of declared dividends, issue of new / duplicate certificates, general meetings, etc.*
- (2) Review of measures taken for effective exercise of voting rights by shareholders.*
- (3) Review of adherence to the service standards adopted by the listed entity in respect of various services being rendered by the Registrar & Share Transfer Agent.*
- (4) Review of the various measures and initiatives taken by the listed entity for reducing the quantum of unclaimed dividends and ensuring timely receipt of dividends warrants / annual reports / statutory notices by the shareholders of the company.”*

The role of the Risk Management Committee was enhanced to specifically cover cyber security.¹⁰

3. Composition of NRC and Stakeholders Relationship Committee

The Committee recommended that at least 2/3rd members of the NRC should be independent directors, however, this recommendation has not been accepted by SEBI and only 50% of the

members need to be independent directors as per Regulation 19(1). The recommendation with respect to quorum requirements of the NRC has been accepted and a new sub-regulation (2A) has been inserted in Regulation 19 which requires that the *quorum for a meeting of the nomination and remuneration committee shall be either two members or one third of the members of the committee, whichever is greater, including at least one independent director in attendance.*

With respect to the Stakeholders Relationship Committee, a new sub-regulation (2A) has been inserted in Regulation 20 to state that *at least three directors, with at least one being an independent director, shall be members of the Committee.*

The recommendations of the Committee with respect to Board Committees have been largely accepted by SEBI. One of the most significant takeaways from the amendments brought about in the SEBI LODR Regulations is regarding the increased and meaningful participation of independent directors in the affairs of listed entities.

IV. Enhanced Monitoring of Group Entities

1. Obligation on the Board of the Listed Entity with Respect to Subsidiaries

Unlike the Act, SEBI LODR Regulations, 2015 imposes certain specific obligations on the board of the listed entity with respect to its subsidiaries¹¹. In the age of globalization with many Indian companies operating through their overseas subsidiaries, the Committee was of the view that such overseas subsidiaries should be treated at par with a company’s Indian subsidiaries. The Committee also observed that an appropriate level of review and oversight is required of the board of the listed entity over its unlisted subsidiaries for protection of interests

¹⁰ Amendment to Regulation 21(4) of the SEBI LODR Regulations on May 09, 2018.

¹¹ Regulation 24 of the SEBI (LODR) Regulations, 2015

of public shareholders. Accordingly, it made certain recommendations in relation to obligation of the board of a listed entity with respect to its subsidiaries which were accepted by SEBI without making any modifications. Following are the key changes brought in vide SEBI Board Meeting dated March 28, 2018:

- (i) The definition of material subsidiary in Regulation 16(1)(c) has been amended to include within its scope subsidiaries whose income or net worth exceeds ten percent (as opposed to the previous limit of twenty percent) of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year;
- (ii) Regulation 24(1) of the SEBI LODR Regulations was amended to provide for the appointment of at least one independent director of the holding listed entity to be a director on the board of an unlisted material subsidiary, whether Indian or overseas. *Provided however*, for the purposes of Regulation 24(1), the term “material subsidiary” shall mean a subsidiary whose income or net worth exceeds 20% of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year.

1. Secretarial Audit

Secretarial Audit was recommended as mandatory for listed entities and their material unlisted subsidiaries. Accordingly, Regulation 24A has been inserted in the SEBI LODR Regulations which requires every listed entity and its material unlisted subsidiaries to undertake secretarial audit and annex with its auditors report, a secretarial audit report, given by a company

secretary in practice, in the prescribed form with effect from year ended March 31, 2019.

V. Related Party Transaction

“Related Party” has been defined under SEBI LODR Regulations as a related party as defined under Section 2(76) of the Act, *provided that* this definition shall not be applicable for the units issued by mutual funds which are listed on a recognised stock exchange(s).¹²

As per the recommendations of the Committee, Regulation 2(1)(zb) of the SEBI LODR Regulations were amended and a proviso was inserted after the definition and before the aforementioned existing proviso as “*Provided that* any person or entity belonging to the promoter or promoter group of the listed entity and holding 20% or more of the shareholding in the listed entity shall be deemed to be a related party.”

In order to strengthen transparency on related party transactions, the Committee recommended by way of insertion of new sub-regulation (9) in Regulation 23 of the SEBI LODR Regulations, half yearly disclosure of related party transactions (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 to also be submitted to the stock exchanges. This amendment is to come into force with effect from the half year ending March 31, 2019.

The Committee discussed upon the discrepancy between the Act and SEBI LODR Regulations viz., the former allowed related parties to vote on (albeit not in favour of) a related party transaction while the latter required such parties to abstain from voting. The Committee recommended that the SEBI LODR Regulations be streamlined to the Act. Accordingly, Regulations 23(4) and 23(7) were

¹² Regulation 2(1)(zb) of the SEBI LODR Regulations

amended to allow related parties to vote against material related party transactions. This amendment makes it easier for listed entities to comply with the requirements under the Act and the SEBI LODR Regulations.

SEBI also rejected the proposal of removing voting rights on treasury stock. The market regulator also refrained from taking any decisions vis-à-vis governance aspects of public sector enterprises (PSEs). Key recommendations in this regard were independence of PSEs from administrative ministries, consolidation of government holdings etc.

VI. Investor Participation in Meetings of Listed Entities

The Committee was of the view that increased and better participation by investors will enhance good governance. It supported the idea of removing the boundaries of physical meetings and adopting the use of technology.

A new sub-regulation (5) was inserted in Regulation 44 which required the top 100 listed entities by market capitalization (determined as on March 31st of every financial year) hold their annual general meetings (“AGMs”) within a period of 5 months from the date of closing of the financial year, i.e. by August 31st every year.

In addition to the above, a new sub-regulation (6) was inserted in Regulation 44 which requires the top 100 listed entities to provide one-way live webcast of the proceedings of the AGMs. The top 100 listed entities shall be determined on the basis of market capitalization, as at the end of the immediate previous financial year.

VII. Referrals to Other Agencies:

Some recommendations of the Committee were rejected or referred to other agencies as the suggested changes infringed on jurisdiction of other regulators. For instance, the proposal strengthening the role of Institute of Chartered Accountants of India (ICAI), a body that regulates auditors was referred to the Central Government. The Kotak Committee had recommended that greater powers be given to ICAI to enhance the governance of listed entities, inter alia including powers to penalize members by up to INR 10 million and audit firms by up to INR 50 million etc.

VIII. Conclusion:

The Kotak Committee recommendations addressed certain core issues in relation to corporate governance. These recommendations are in line with the global practices and amendments made to the SEBI LODR Regulations are a step forward in terms of achieving transparency and credibility in the corporate environment altogether.