RAISING THE BAR ON CORPORATE GOVERNANCE IN INDIA

Suggestions on implementing the recommendations of the Kotak Committee on Corporate Governance

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The CFO Board is India's pre-eminent body of financial leaders and includes foremost CFOs in the country as members. The CFO Board debated the key issues impacting corporate governance in Indian companies, including the recommendations of the Uday Kotak led SEBI Committee on Corporate Governance, and its implications from corporate India’s perspective with support from KPMG in India.

This whitepaper is meant to serve as a high level analysis of some of the key issues that are relevant for policy makers and regulators to consider before implementing any changes to the corporate governance requirements in India.

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Introduction

Corporate governance is an ever evolving subject, and an area where the regulations in India have seen significant change, particularly over the past decade. In many aspects, India's corporate governance standards are now on par with the best in the world, and yet there is room for improvement in many areas. The recent report of the SEBI Committee on Corporate Governance led by Mr. Uday Kotak ('Kotak Committee'), is an attempt to further raise the bar on corporate governance in India, with an eye on getting corporate India to move the needle from adopting the standards in letter to adoption in spirit. It also seeks to focus on the need for better governance for long term value creation and for protection of stakeholder interests.

The Kotak Committee report has generated considerable discussion in various forums.

On the one hand, the report has been widely acknowledged as being bold and innovative and an honest attempt in bringing corporate governance in line with changing business realities. The proposed reforms will strengthen India's corporate governance standards and increase the attractiveness of Indian corporates for international investors. On the other hand the report has been criticized as being a regulatory overkill which will increase compliance requirements, including extensive disclosures, not all of which are seen as relevant, and also an attempt to micro-manage the board. It has been critiqued for laying down recommendations which are in the ambit of the other agencies like Ministry of Corporate Affairs ('MCA') and Institute of Chartered Accountants of India ('ICAI').

The CFO Board, in consultation with its various members, engaged with various stakeholders including industry associations, CFOs of other large companies, as well as some of the large accounting and consulting firms to seek their feedback on the recommendations of the Kotak Committee report. Based on these inputs, the CFO Board has certain observations and suggestions, which are discussed in this whitepaper. This document also does not cover all the recommendations of the Kotak Committee, and therefore is not meant to be an exhaustive analysis, but has instead focused on some of the key recommendations.

Observations on matters covered by the Kotak Committee Report

The CFO Board welcomes the recommendations of the Kotak Committee and believe that these are steps in the right direction. The CFO Board has also deliberated the practical implementation challenges associated with these recommendations, and have certain observations and suggestions, which are discussed below:

Role and composition of the Board

Board size: Considering the number of committees that a listed company is required to have together with the wider duties and responsibilities that each director has, it is appropriate to increase the minimum number of directors on the board.

Women independent directors: While many boards currently have relatives of promoters playing the role of a woman director, as mandated under law, the recommendation of having an independent woman director is certainly welcome, as it would add to the diversity in the boardroom. Studies have shown that having one or more women in the board improves the boardroom dynamics.

Separation of chairman and CEO roles: The role of the board will further be strengthened as the chairman and CEO roles are separated; a non-executive chairman should be able to act as a facilitator to optimise the role of the board and help create a culture of open and honest debate in the boardroom, thereby encouraging much more open discussions, questions, challenges and criticism, in particular from the independent directors. This recommendation will also help in avoiding 'concentration of power' in one individual.

> ***Specific recommendation of the CFO Board:*** SEBI, while implementing this change, should specify that a company should not be allowed to have both an executive chairman and CEO, as that would lead to multiple power centres within the organization, which may not be in the best interests of the company. Therefore, wherever the role of chairman and CEO are required to be separated, the chairman of the Board should be a non-executive director, as suggested by the Kotak Committee.

Matrix reporting structure: Currently the Nomination and Remuneration Committees (NRC) of the boards of many companies, in particular in the case of MNCs and promoter run groups, do not have visibility on appointment of senior management. Further, in the management of the company, this continues to be challenge, where the KMPs and other business heads in the company report to their functional counterparts in the regional or global HQs rather than to the CEO and the Board. This potentially makes the board and NRC of the company redundant. The recommendation of the Kotak Committee will make the boards and NRC of the listed companies more cognisant of their duties and responsibilities and help ensure that they are duly discharging such duties and responsibilities and make an annual representation to that effect.

Agenda of board and committees: The Kotak Committee has recommended that the board focus on a number of areas, in addition to regular financial reporting and compliance matters. Two key areas that should form part of the board agenda are strategy and succession planning, as rightly highlighted by the Kotak committee. Further, while expanding the coverage of companies required to constitute a risk management committee, the Kotak Committee has referred to the importance of cyber security, we recognize the importance of other risks as well and recommend that risk management be looked at a broader level.

Institution of independent directors

Proportion of independent directors and their role: The increased proportion of independent directors on the board, together with the recommendations on the introduction of a lead independent director, stricter independence criteria, mandatory trainings and exclusive meetings of independent directors will certainly empower independent directors to function more effectively and make their voice heard in the governance process.

> ***Specific recommendation of the CFO Board:*** While it is good to have a higher proportion of independent directors, considering the current shortage of people who are willing to take on this role, and till the time a good pool of directors is not available, SEBI may consider making the recommendation of increasing the proportion of independent directors in all listed to at least 50% of the board as a 'recommendatory' provision, rather than a 'mandatory' provision, and instead continue with the current requirement of mandating at least 50% independent directors to those situations where the company has an executive chairman.

Minimum compensation and D&O cover: There is a need to increase the pool of high quality independent directors with the right incentives and also manage the risks associated with their role. The committee has recommended mandatory D&O policies as well as minimum compensation levels with a view to help in attracting more independent directors. This is certain a welcome move.

> ***Specific recommendation of the CFO Board:*** The CFO Board additionally recommends that the remuneration of directors, especially independent directors be linked to both the 'participation' and 'contribution', so that the Board can recognize due contribution of each of its members in an appropriate and judicious manner.

Monitoring of group companies and related party transactions

Oversight of group companies: With the growth in the economy and globalisation, Indian companies have expanded their operations significantly, with business of the group today being carried out through a large number of subsidiaries, both Indian and foreign. The recommendations of the committee to enhance the oversight on all material subsidiaries, while reducing the materiality threshold from 20 per cent to 10 per cent of the consolidated income or net worth, would significantly enhance the coverage of operations that are subject to oversight by the listed entity's board. The establishment of a group governance policy will also provide a structured approach towards the oversight functions.

Audit committee oversight on utilization of funds by group companies: The Kotak Committee has recommended that the audit committee members should 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.

> ***Specific recommendation of the CFO Board:*** The CFO Board believes that this may be too onerous on the Audit Committee of the listed company, which may not have the wherewithal to carry out this oversight function in addition to its other responsibilities. Therefore, the CFO Board recommends that this be made a 'recommended' practice rather than a 'mandatory' provision, and instead augment

this with a mandatory certification by the CEO and CFO of the listed company on the utilisation of loans and/or advances from/ investment by the holding company in the subsidiary. Further, the end-use of funds for any related party transactions outside the group (i.e., listed company and its subsidiaries) can also be subject to approval by the Audit Committee of the listed company.

Promoters and related party transactions

Framework for information access: The recommendation on developing a framework under which information can be shared with promoters and other shareholders with nominee directors under an 'Access to Information Agreement' is a welcome move, and something that maybe fairly unique in the Indian context considering the numerous promoter controlled entities in the Indian market. This would also be relevant in the context of listed Indian subsidiaries of multi-national companies. The CFO Board supports the need for a special agreements which enable management to share sensitive information on a 'need to know' basis with 'designated persons'.

Reclassification of promoters: The recommendations on reclassification of the entire promoter group or specific promoters, together with the proposed thresholds, will also help in easing the process of reclassification and better reflect economic realities.

Enhanced disclosures of related party transactions: The disclosure of related party transactions and other transactions with promoter owned entities, will also bring greater transparency on the group's operations.

Disclosure, transparency and investor participation

Enhanced disclosures: The recommendations of the Committee in this area are aimed at ensuring that more relevant information is made available to investors in a timely manner and also to encourage more active participation by investors. Disclosures relating to changes in key financial indicators or those relating to long term and medium term strategy of the company are expected to provide more insight to investors on the company's functioning and its future direction.

Stewardship code: The recommendations relating to the development of a stewardship code, and requiring webcast of shareholder's meeting together with e-voting, are likely to help enhance the level of engagement of key shareholders in decision making.

Other recommendations: Many of the other recommendations are likely to also help in improving the timing and/or quality of disclosures on various matters including changes in credit ratings, valuation reports, websites, use of funds, and so on, which would help in reducing the information asymmetry.

Accounting and audit related matters

Quality and rigour of corporate reporting: The Committee has also recommended that SEBI institute appropriate mechanisms to enhance its oversight on the financial and other reporting done by companies on a periodic basis. Currently, SEBI carries out detailed reviews of filings done at the time of initial public offerings and follow-on offerings, whereas reviews of periodic filings by listed companies are rather limited. The Committee has recommended that SEBI set up a separate unit to carry out detailed reviews of all periodic filings, including annual reports, made by companies. This in turn is likely to bring in much more rigour to the disclosures and filings made by companies, and also enable SEBI to intervene at an appropriate time, where required, and take corrective action.

Auditor oversight: The Committee has also emphasised the need for an independent auditor oversight mechanism for listed companies, and recommended strengthening of the Quality Review Board to effectively carry out this mandate. These measures would help enhance investor protection by improving the quality and consistency of reporting by companies as well as audit quality.

Governance in PSEs

The Committee's recommendation on full compliance by PSEs with the LODR requirements and its enforcement by SEBI is welcome as it would demonstrate to the investor community that PSEs ultimately adhere to the same or higher standards as compared to their private sector peers. Further, their compliance with all corporate governance norms, together with complete clarity on their mandate and objectives, is likely to allow investors to make a fair assessment of value, as they look to make investment decisions relating to PSEs. The ultimate move towards a holding company structure, with independence from the administrative ministry, will also pave the way for the government to unlock the true value of these national assets.

Building regulatory capacity for enhancing governance of listed entities

Any regulation is only as good as its monitoring and enforcement. It's in this context that the Committee has recommended that SEBI build significant capacity to take on these functions, commensurate with the needs of India's capital markets.

Specifically, the Committee has referred to the need for bridging the human resources gap, use of data science and risk prediction and greater collaboration between SEBI and other agencies. The human resource gap is particularly evident in the comparison between the US SEC and SEBI, where for overseeing a similar list of companies, US SEC has over five times the number of employees as compared to SEBI, and in the Corporate Finance department, US SEC has over 15 times the number of resources as compared to SEBI.

Therefore, enhancing SEBI's monitoring and enforcement mechanisms can potentially make a big difference in enhancing the standards of corporate governance.

Other matters not covered by the Kotak Committee Report

The CFO Board also deliberated on a few other topics on related matters, which have not been specifically covered in the Kotak Committee report. Some of the key recommendations emanating in these areas are discussed below:

Removal of Independent Directors

The CFO Board fully supports the role that independent directors are expected to play on corporate boards. However, there may be situations when there is a need to bring a change to the composition of the board, in the best interests of the company and its stakeholders.

In order to strike a balance between situations where independent directors who are 'disruptive' or create a 'hostile board environment' are sought to be removed, vis-à-vis, situations where promoters want to remove independent directors who are not only truly independent but also competent and committed to speak their mind, the CFO Board recommends that a proposal to remove an independent director should require approval with 75% majority votes, while also permitting promoters to vote on such resolutions.

Independent directors – additional exclusions to be considered

There are situations where relatives of politicians and bureaucrats are appointed as directors on boards of companies. Considering the potential conflicts of interests that may exist in such situations, SEBI should expand the definition of independent director in Regulation 16(b) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 to preclude any relatives of politicians or bureaucrats who hold public office from being considered as independent directors in listed companies.

Nominee directors

Many listed companies have nominee directors who are appointed by either financial institutions, including lenders or other government bodies.

SEBI should consider a change to the regulations to require nominee directors who are appointed by financial institutions or government bodies, to meet the test of independence as applicable to independent directors.

Adoption of technology and related record keeping

The committee's recommendation on the adoption of technology for shareholder meetings through a one-way webcast of the proceedings, will certainly enhance the shareholder's engagement in general meetings. Further, in the current age of technology, board meetings and committee meetings can also be done by video conference, which helps reduce time and costs.

However such electronic data relating to shareholder, board and committee meetings should be considered a record maintained in electronic form under the 'Companies (Meetings of Board and its Powers) Rules, 2014' and 'Companies (Management and Administration) Rules, 2014' formulated under the Companies Act, 2013, and the Company Secretary should be responsible and accountable for the maintenance of such electronic records and the company should establish adequate disaster recovery arrangements to ensure the safety of such records.

Adoption of technology – alignment with tax requirements

While the adoption of technology for better governance and effective participation in shareholder, board and committee meetings is either required or permitted, under the SEBI regulations and Companies Act, there is a need to also take into account the tax laws relating to 'place of effective management' or 'POEM', which may drive corporate behaviour in a particular direction. Therefore, in order to meet the objectives of more effective governance, while minimizing any risks arising on tax from the applicable of POEM, we suggest that SEBI, MCA and tax authorities work together to align these requirements to the extent possible.

Adoption of corporate governance maturity model

Currently, listed companies are required to provide a report on compliance with the corporate governance requirements. However, the maturity of governance practices vary across companies, ranging from mere compliance with the letter of the law to adoption of best practices in line with the spirit of the requirements.

Considering this diversity in practice, the CFO Board strongly recommends the development of a corporate governance maturity model, which can be adopted by companies using a self-assessment framework, to assess the maturity of their practices. Large unlisted companies may be allowed to follow this model.

Conclusion and way ahead

The recommendations of the Kotak Committee, once implemented, would significantly help in enhancing the level of corporate governance in Indian companies. As one goes through the numerous recommendations, it is also evident that many of these recommendations complement each other and it's the combination of these measures that will help enhance the governance standards, and each of these recommendations may not be as effective if implemented in isolation. Therefore, SEBI must attempt to try and implement as many of these as are possible, in a manner that's least disruptive to business, while raising the bar on governance.

It is important that SEBI works closely with other bodies such as MCA and ICAI to make sure that the recommendations are finally implemented in the manner intended by the Kotak Committee, and has support of all key regulatory and policy making stakeholders.

This report has been prepared by the CFO Board, under the guidance of Mr. PK Ghose, and Ms. Neeta Revankar, members of the CFO Board along with other CFO Board members, with support from Mritunjay Kapur of KPMG in India.

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