Mandatory Board Governance in India – Lessons from new regulatory regimes

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Executive Summary

- The applicability of corporate governance provisions based on market capitalization is made uniform in the recent amendment as these will continue to apply even if the firm falls below the threshold. On the other hand, different thresholds of market capitalization like top 500, 1000, and 2000 are specified for the applicability of various provisions. This should be simplified by adopting a single threshold.
- An increase in the minimum board size is not aligned with the global standards. However, given the mandatory requirement of at least four committees for top 1000 firms, a board size of six may help duties to be allocated effectively across directors by avoiding conflicting memberships across committees.
- The amended regulation mandates the Chair of the Board to be non-executive and not related to the MD/CEO.
- The new regulation on the separation of Chairperson and CEO/MD, though voluntary in nature, will reduce the board independence requirements to 33 percent which is lower than the global standards.
- Mandatory Risk Management Committee for top 1000 firms. In total, these firms will be required to compose four mandatory board committees – Audit, Nomination & Remuneration, Stakeholder Relationship, and Risk Management
- Director obligations are increased under the new regulation as there is a quorum required for board meetings as well as committee meetings. The quorum for board meetings is different in SEBI LODR from that required as per the Companies Act 2013. The regulations also contradict for the minimum board size.
- Lastly, both Corporate Law and Securities Regulation should be aligned to ensure effective, uniform, and sustainable corporate governance practices in the country.

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I. Introduction

Through the introduction of Clause 49 in the Listing Agreement, SEBI enforced the listing regulations and disclosure requirements for listed companies paving the way for corporate governance reforms in the country. These regulations were further strengthened by the enactment of the Companies Act 2013, which provides a formal structure for the corporate governance rules and guidelines. More recently, SEBI enforced the new regulation Listing Obligations and Disclosure Requirements (LODR) 2015 replacing Clause 49. Further, to harmonize the SEBI regulations with the Companies Act 2013, and to strengthen the existing corporate governance norms and reduce the burden of compliance, a Committee on Corporate Governance chaired by Shri Uday Kotak was constituted by the SEBI. Some of the recommendations of the Kotak Committee were incorporated through a Circular on May 10th, 2018. These amendments include changes in the context of board structure, composition, and activities of the board of directors. This *Quarterly Briefing* reviews the revised corporate governance structure to present the comparison with global standards in the following aspects:

- Applicability of provisions
- Board structure and composition
- Board independence
- Board activities and policy

II. Applicability of provisions

Earlier regulations required companies crossing the thresholds based on equity capital, net worth, and market capitalization to comply with the corporate governance provisions. Therefore, once the companies fall below these thresholds, they cease to practice the acceptable norms. To address this, the recent amendments mandated the corporate governance provisions based on market capitalization to be applicable even if the market capitalization falls below the threshold. With respect to the equity capital and net worth, once the regulations become applicable, they shall remain applicable unless the equity capital or net worth remains below the threshold for three consecutive years. This amendment aligns the applicability of corporate governance provisions with the global standards where the trigger of the applicability is not subject to change once enforced.

III. Board structure, composition, and independence

Board size: In the recent amendments, the SEBI increased the minimum board size to six directors for the largest 2000 companies according to their market capitalization. This is above the requirements of 3-5 directors in most jurisdictions around the world. In addition, this is a significant departure from the minimum board size of three directors in the Companies Act 2013. As audit and nomination and remuneration committees with a minimum of three directors are mandatory for all the listed entities, a board size of six would mean that no director needs to be on more than one of those two committees. With respect to the maximum board size, both the Law and the Regulation require listed companies to have a board of directors with a maximum of 15 directors. As shown the Table 1, among the selected jurisdictions following Tier-1 board structure, India is an exception to impose the maximum number of directorships which is usually the practice among countries with Tier-II board structure (e.g. Germany).

Board composition: SEBI (LODR) 2015 requires at least fifty percent of the board members to be non-executive for all listed companies and the Companies Act 2013 mandates the appointment of one woman-director on the boards of public companies based on thresholds of equity capital and net worth. Following the recommendations of the Kotak Committee, LODR 2015 is amended that top 1000 companies are required to appoint at least one independent woman director. In addition, the LODR imposes a maximum age limit of seventy-five on the non-executive directors to be appointed or continuing to serve on the board. A special resolution will be needed to be passed for such appointments. On the other hand, the Companies Act 2013 has a maximum age limit of seventy years for the executive directors on the board. Taken together, there is a gap in both the Law and the regulation in their specifications of age limit to the type of the director. In most of the jurisdictions across the world, the Corporate Law leaves it to the company's charter to specify their requirements of the maximum age of the directors. Table 1 compares the mandatory regulations on board composition in India with selected countries.

Table 1: Comparison of Board Structures

	Board Size (Minimum & Maximum)	Gender Diversity	Shareholder Director	Tenure for IDs (Minimum number of Years before re-appointment)	Maximum number of other directorships
Companies Act 2013 (India)	Minimum: 3; Maximum: 15	>1	1[1]	5	Total companies : 20; Listed companies: 10
SEBI LODR 2015 (India)	Minimum: 6; Maximum: 15[2]	> 1 and an ID for the top 1000.[3]	-	3	Listed companies: 7
USA	Minimum: 3; Maximum: nil	-	-	3	-
UK	Minimum: 2; Maximum nil	-	At least 1 required for premium listed companies with controlling shareholders	1[C]	Total companies : 20; Public companies: 10[C]
Brazil	Minimum: 3; Maximum: nil	-	-	3	-
Germany	Minimum: 3; Maximum: 21	-	At least 1 required in the Supervisory Board of large companies	5	-
Hong Kong	Minimum: 3[4]; Maximum: nil	-		3[C]	-

Source: Compiled by Author from OECD (2021), SEBI (LODR) 2015, and Companies Act 2013.
Notes: USA, UK, Hong Kong follow a one-tier system of the board of directors. Germany follows a two-tier system. Brazil provides an option between one a and two-tier systems. For Brazil, the statistics reported in this table are for the one-tier system. C= Corporate Governance recommendation made under country's Corporate Governance Code of Best Practices and Principles.

Board independence: Following the recommendations of the Kotak Committee, the LODR (2015) is amended to specify conditions of separation of the Chair of the board from the Managing Director or Chief Executive Officer in the top 500 listed companies. According to the revised regulation, the Chairperson should be non-executive and should not be related to the Managing Director or the Chief Executive Officer. This requirement is made applicable on a "voluntary basis" on 15 February 2022 due to an unsatisfactory level of compliance. In principle, this separation requirement addresses the issue of type II CEO duality in a country where most of the firms are promoter-controlled or the Chair of the board is related to the promoter or belongs to the promoter group. The companies with no promoter shareholdings are exempted from this Clause. By explicitly accounting for the relationship between the Chair of the Board and the MD/CEO, India leads the corporate governance practices by recognizing the type of Chair-CEO duality that extends beyond the two being the same person. Such type II duality can be a norm in most companies even after having two separate individuals for the two roles. Such separation requirement combined with the mandatory disclosure on the relation with the controlling shareholders is a leading step in corporate governance best practices.

Table 2 presents the comparison of requirements of the status of the Chair of the board and board independence across selected countries. As shown in the table most of the countries require the Chair of the board to be non-executive. The voluntary recommendation of the separation of roles of the Chair of the Board from the top executive management will eventually align the requirements of board independence with the Companies Act 2013 for the top 500 companies. For other listed companies the discrepancy on the requirement of board independence continues to remain. On the other hand, if listed companies comply with this separation, the legislative requirement of board independence falls below the global standards.

[1] Section 151 of Companies Act 2013 specifies that "small shareholders" means a shareholder holding shares of nominal value of not more than twenty thousand rupees or such other sum as may be prescribed.
[2] Section 17(1) (c) of SEBI (LODR) 2015
[3] Section 17(1)(a) of SEBI (LODR) 2015
[4] In Hong Kong (China), the Main Board Listing Rules do not contain any requirements for minimum board size but they require at least three independent non-executive directors and they must represent at least one-third of the board OECD(2021).

Table 2: Comparison of Board Independence

	Number or proportion of Independent directors	Separation of Chair of the board and CEO/MD	Maximum tenure of Independent directors before re-appointment (years)
Companies Act 2013 (India)	>33%	Recommended	5
SEBI LODR 2015 (India)	>33% if Chair is non-executive and non-promoter. > 50% if Chair is executive or promoter	Recommended for top 500[5]	5
USA	>50% Recommended	-	-
UK	50% Recommended	Recommended	9
Brazil	20-25%	Mandatory	-
Germany	-	-	-
Hong Kong	2-3 / 33% Recommended	Recommended	8-10

Source: Compiled by Author from OECD (2021), SEBI (LODR) 2015, and Companies Act 2013.

IV. Mandatory board committees

Many of the regulations on corporate governance practices recommend the formation of two committees – the Audit Committee and the Nomination and Remuneration Committee. Nearly all jurisdictions under OECD study in 2014 reported requiring a mandatory audit committee (OECD, 2021). While the nomination and remuneration committees are not mandatory, a majority of the countries recommend these committees to be established through the listing rules or codes of best practices.

In India, both Law and Regulation on listed companies require two additional board committees – Stakeholder Relationship Committee (SRC) and Risk Management Committee (RMC). While most jurisdictions surveyed by OECD in 2014 have requirements regarding the board's responsibilities concerning risk management as an inclusion of a separate section of the board's policy along with explicitly including the risk management role of the audit committee, India leads the legislative recognition of relationship with financial stakeholders and risk management as part of board obligations. As per the OECD report on the corporate governance framework and practices relating to corporate risk management in 2014, apart from India, only Germany highlighted special provisions for major risks threatening the existence of the company and enforced the requirement of a separate committee on Risk Management. Table 3 compares the establishment of these board committees across selected countries.

[5]17(1B) With effect from April 1, 2022, the top 500 listed entities the top 500 listed entities 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 Managing Director or the Chief Executive Officer as per the definition of the term "relative" defined under the Companies Act, 2013
This separation requirement is changed from mandatory to *voluntary* by the regulator following the recent board meeting on 15 February 2022.

Table 3: Requirements of Board Committees across countries

Jurisdiction	Audit Committee	Remuneration Committee	Nomination Committee	Stakeholder Committee	Risk Management Committee
India (Companies Act 2013 (India)[IN]	Legislative	Legislative	Legislative	Legislative for the companies with more than one thousand shareholders, debenture-holders, deposit-holders, and any other security holders at any time during a financial year	-
SEBI LODR 2015 (India) [IN]	Legislative	Legislative	Legislative	Legislative for the companies with more than one thousand shareholders, debenture-holders, deposit-holders, and any other security holders at any time during a financial year	Legislative for the top 1000 listed entities by market capitalization.
USA	Legislative	Legislative	Listing requirement	-	-
UK	Recommended by Code	Recommended by Code	Recommended by Code	-	-
Germany	Legislative	-	Recommended by Code	-	-
Hong Kong	Legislative	Legislative	Recommended by Code		-
Brazil	Optional	Recommended by Code	-	-	-

Source: Compiled by Author from OECD (2021), SEBI (LODR) 2015, and Companies Act 2013.
Notes: USA, UK, Hong Kong follow a one-tier system of the board of directors. Germany follows a two-tier system. Brazil provides an option between one a and two-tier systems. For Brazil, the statistics reported in this table are for the one-tier system. C= Corporate Governance recommendation made under country's Corporate Governance Code of Best Practices and Principles.

In the recent amendments in SEBI (LODR), the mandatory requirement of a separate Risk management committee (RMC) is increased from top 100 to top 1000 companies based on their market capitalization. In addition, the details of RMC are also required to be included in the corporate governance report in the same format as the audit committee, NRC, and SRC respectively. Following the recommendation of the Kotak Committee on Corporate Governance, the regulation is further amended to implement the following changes:

1. Increase the proportion of IDs on the NRC from fifty percent to two-thirds of the board.
2. Expansion in the roles of Stakeholder Relationship Committee (SRC) and requirement of compulsory attendance of the Chair of the committee in the meetings.
3. Specify the quorum of board committee meetings

Table 4 presents the composition and obligations of the mandatory board-level committees for listed companies in India.

Table 4: Mandatory Board Committees in India – Composition, and Obligations

Board Committee requirements under Companies Act 2013 (L) SEBI (LODR) (R)	Requirements	Minimum Size & Composition	Committee Chairperson	Number/Ratio of independent directors	No of Meetings per year	Quorum of the board committee meetings[R]
Audit Committee	L: Required for all listed companies R: Required for all listed companies	L: 3 R: 3	L: None R: ID	L: > 50% R: > 66%	L: - R: >4	Maximum of 2 or 1/3 of the committee including 2 IDs
Nomination and Remuneration Committee (NRC)	L: Required for all listed companies R: Required for all listed companies	L: 3; NEDs R: 3; NEDs	L: None R: Different from Board Chair	L: >=50% R: >=50%	L: - R: >=1	Maximum of 2 or 1/3 of the committee including at least one ID; Chair of the committee is required to be present
Stakeholder Relationship Committee (SRC)	L: >1000[CA] R: All listed companies	L:- R: 3	L:NED R: NED	L: - R: >=1	L:- R:>=1	Chair should be present
Risk Management Committee (RMC)	L:- R: Top 1000	L:- R: 3; >50% board members	L:- R: Chair should be a board member	L:- R:>=1	L:- R:>=2	Maximum of 2 or 1/3 of the committee including at least one Board Member

Source: Author's compilation from SEBI (LODR) and Companies Act (2013).

Notes: NED = Non-executive directors; ID= Independent Directors; CA= Threshold on a number of shareholders, debenture-holders, deposit-holders, and any other security holders; R= Applicable only through SEBI (LODR) and not applicable in the Companies Act 2013.

V. Way forward

Recent amendments require a minimum board size of six directors for the top 2000 companies. This is in contrast with the Companies Act 2013 which mandates at least three directors. This is not only a significant departure from the existing regulations and codes across the world but the first in itself. The academic literature advances our understanding that the optimal board size is an outcome of optimal allocation of duties of the directors across various board functions. At the same time, the number of directors on the board also depends on the complexity of the firm. If the firm operates in multiple businesses, it is likely to appoint a larger board compared to a firm that operates in a single segment business. Therefore, while such a requirement ensures less committee membership for the directors, the subsequent regulations on the quorum of a board meeting are contradicted.

The quorum requires the board meetings to have a maximum of at least one-third or three directors including at least one independent director. This is in contrast with the Companies Act which requires a maximum of one-third or two directors and does not mandate the attendance of the independent director. For the top 2000 companies with minimum board size, the quorum enforces minimum attendance in the board meetings to three directors including one independent director. The absence of a majority of independent directors in the board meetings could be a cause of concern especially if there is voting on any important issues. For the larger boards, such minimum requirement in the number of independent directors could be a concern as the proportion of independent directors will fall further. In such scenarios, the independent directors would be voted out easily. Instead of specifying the numbers or proportions, a simple quorum of majority of the independent directors can be implemented to enforce the board obligations in spirit.

Next, it is widely recognized that directors are not able to carry out their duties effectively due to a lack of time. This forms the regulators' rationale to limit the maximum number of committee membership and chairmanships of the board of directors across all the listed entities in which the directorship is being held. While the amended LODR specifies the orientation and operation of the additional board committees it mandates for listed companies –NRC for all listed companies and RMC for top 1000, the determination of a maximum number of committee membership is done incompletely. In particular, SEBI considers the membership of only two committees – Audit Committee and SRC – to determine the maximum number of committee memberships of the directors. It was recommended by the Kotak

Committee that NRC should be treated at par with the two committees in determining the maximum number of committee memberships and chairmanship. This regulation is inconsistent with the mandate of enforcing four mandatory committees for the top companies and not accounting for the obligations of the directors fairly across these committees.

In addition, the corporate governance provisions, currently, apply to firms based on different thresholds of market capitalization like the top 500, 1000, and 2000. This can be simplified by adopting a single threshold and ensuring that the regulation is enforced uniformly across the companies.

Finally, the regulation has taken a significant departure from the best practices in the board independence as the top companies will be required to appoint only 33 percent of the directors as IDs, which is below most jurisdictions globally. This is because of the current requirement of the board independence is subject to the status of the chairperson. While the regulation explicitly recognizes the requirement to separate the roles of the Chair of the board from the MD/CEO, this would also mean that these companies can reduce the proportion of IDs to 33percent. It might be worth revisiting the board independence requirement of having at least 50% the board as IDs as recommended by the Kotak Committee.

References

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