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Handbook on Corporate Governance in India

Legal Standards and Board Practices

2021 Edition

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Handbook on Corporate Governance in India

Legal Standards and Board Practices

2021 EDITION

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Foreword

Governance is an ever-evolving topic—boards are faced with myriad issues and priorities, but ensuring compliance with the laws, regulations, and rules is a paramount priority. We decided to partner with The Conference Board to replace the very popular 2015 Handbook, as much has changed in the Indian governance ecosystem in the last few years. We hope this publication will be found useful by board members, legal professionals, company secretaries, and associated entities in fostering greater compliance with the laws and assimilating the true spirit of corporate governance in business. Over and above these basics, we believe what will drive effective governance is the ability of boards to ensure that the company's purpose and operations meet societal expectations.

Sanjay Kapoor
Managing Director, RRA India

While regulatory interventions played a major part initially in shaping the corporate governance landscape in India, the more recent influences have been through the broader governance ecosystem (such as the role of rating agencies, proxy advisory firms, auditors etc.) and regulators' response to the cases which went bad. Therefore, the 2021 edition of the *Handbook on Corporate Governance in India* not only offers an overview of the regulatory regime in India, but also analyzes several important recent case studies in corporate governance. Accordingly, through this Handbook, we encourage readers to explore and discuss open issues that currently or in the future may pose challenges to good governance.

Pankaj Arora
Managing Director, RRA India

The previous edition of our *Handbook on Corporate Governance in India* (2015) was released in early 2016. Since then, India has witnessed several regulatory changes, commencing with the SEBI Listing Regulations and the amendments to it, as well as several changes in the Companies Act, 2013 and its rules. Very recently, the CSR framework in India has also undergone a massive overhaul. This Handbook, in its introductory chapters, provides a brief overview of the history of corporate governance in India and then delves into the extant laws, offering readers insights on the key regulatory changes. The Handbook presents an up-to-date commentary on Indian laws on corporate governance.

Matteo Tonello
Managing Director, ESG Research
The Conference Board, Inc.

Executive Summary

The Handbook on Corporate Governance in India: 2021 Edition provides a comprehensive study of corporate governance laws in India. This edition of the Handbook is divided into 12 chapters that review the current Indian legal framework for corporate governance with a specific focus on listed companies. The Handbook takes a broad perspective on corporate governance, addressing interactions between boards and shareholders, as well as minority and controlling shareholders. The Handbook covers legal duties and their enforcement, as well as ethics and risk management issues. Given the growing focus on corporate social responsibility and sustainability, the Handbook tackles the key regulatory changes and debates in India. Furthermore, this edition includes recent case studies of corporate governance challenges faced by Indian firms. The case studies provide key insights for companies, boards, legal practitioners, company secretaries, and other corporate governance professionals.

The introductory chapters trace the development of India's corporate governance regime and examine the nature of ownership and control at Indian companies. The Handbook addresses the duties and responsibilities of Indian boards and explains director liabilities under various Indian laws. Several chapters address the current legal framework related to board committees—the nomination and remuneration committee, the audit committee, and the corporate social responsibility committee, with a detailed review of sustainability and the extant responsible business practice norms in India. Other chapters review the laws and best practices in relation to related party transactions, risk management, and business ethics. Given the rise of institutional and other non-controlling shareholders, the Handbook provides an analysis of shareholder participation, activism, and rights under Indian law. The Handbook's final chapter includes an analysis of the institutional framework and mechanisms for enforcement of corporate governance norms in India. Each chapter ends with a summary of key takeaways and invites the reader to consider certain issues that remain open. A brief outline of the topics covered in the Handbook is as follows.

OVERVIEW OF THE REGULATORY FRAMEWORK

In the late 1990s, the Indian government began to undertake a significant overhaul of the country's corporate governance system. In 2000, the Securities and Exchange Board of India (SEBI) introduced the first set of comprehensive corporate governance reforms via Clause 49 of the listing agreement of stock exchanges. Over the next decade, after much debate, voluntary guidelines, and lessons learned through the Satyam scandal in 2009, the Companies Act, 1956 was repealed and replaced by a new set of laws under the Companies Act, 2013 (Companies Act, or Act). The passage of the Companies Act was followed by new rules thereunder as well as the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (SEBI Listing Regulations). Furthermore, there has been a continuous refinement of standards of corporate governance in India. In October 2017, the SEBI formed the Kotak Committee (i.e., the Committee on Corporate Governance headed by Uday Kotak), undertook a comprehensive review of extant corporate governance norms in India, and invited public comments on its recommendations. The committee considered several aspects of corporate governance, including corporate purpose and stakeholder interests, and focused on the business realities of Indian corporations, including the impact of promoter dominance. Several of the recommendations of the Kotak Committee were incorporated into the SEBI Listing Regulations. Corporate governance norms have undergone and will continue undergoing changes to adapt to and fulfill the needs of the dynamic capital markets.

OWNERSHIP, CONTROL, AND BOARD COMPOSITION

Concentrated ownership, often referred to as promoter control, is widespread in corporate India. While concentrated ownership may benefit the corporation and its stakeholders by providing, inter alia, commitment to the performance and growth of the company, it may also lead to exploitation of power. This edition of the Handbook discusses at length the recent challenges faced by Infosys Ltd. and Tata Sons Ltd. by analyzing the various aspects of ownership and control. Public sector units (PSUs) face unique corporate governance challenges because the state is the controlling shareholder. As state-owned enterprises, PSUs have had difficulty meeting some of SEBI's governance rules. Based on the typical nature of holding and control in Indian listed companies, under

the Act and the SEBI Listing Regulations, there is greater emphasis on board composition. Both the Act and the SEBI Listing Regulations provide for appointment of independent directors and women directors. Further, the Act now codifies, for the first time, the fiduciary duties of directors of companies. The SEBI Listing Regulations, as amended after the Kotak Committee recommendations, seek to enhance governance structures and policies at listed companies. The revised regulations, inter alia, address CEO duality, independence of directors, and director evaluation and remuneration. Additionally, the new Act and the SEBI Listing Regulations also seek to address and regulate transactions between related parties (RPTs). Concentrated ownership of Indian companies and the use of complex group company structures create the potential for abusive RPTs that erode value for minority shareholders. With several amendments over a period of time, India's substantive legal framework for regulating RPTs has now slowly converged toward international standards. Indian law now mandates audit committee approval as well as approval by disinterested shareholders for certain RPTs.

BOARD COMMITTEES

The SEBI Listing Regulations mandate listed companies to form certain committees at the board level, each assigned a specific function. All listed companies are required to form a board committee on nomination and remuneration (NRC), two-thirds of which should comprise independent directors. The NRC's many responsibilities include framing criteria for director qualifications and independent directors' performance evaluation, and recommending managerial remuneration to the board. The Audit Committee's roles and responsibilities have made it crucial for enhancing corporate governance practices and protecting the interests of stakeholders. The Audit Committee is endowed with certain powers, including seeking information, under the SEBI Listing Regulations and plays an important part in reviewing and consenting to RPTs. The Act also mandates a board-level Corporate Social Responsibility (CSR) Committee to regulate the CSR programs of the company, approve its CSR policy, and ensure reporting of CSR activities. In addition to the CSR requirements under the Companies Act, the regulatory framework also includes the National Guidelines on Responsible Business Conduct (NGRBC) and the SEBI Business Responsibility Reporting.

ETHICS AND DIRECTOR LIABILITY

Recent amendments to the Prevention of Corruption Act, 1988 and the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, and the introduction of the NGRBC are major steps India has taken toward strengthening the statutory framework governing ethics. A code of conduct and ethics, as well as whistleblowing systems, is necessary for establishing a framework for regulating ethical conduct at companies, not only at the board level but also throughout the enterprise as a whole. The challenges faced by ICICI Bank are examined at length in this context in this edition of the Handbook. Effective corporate governance requires action against directors who are engaged in unethical practices and acting in contravention of the law and their fiduciary duties. Accordingly, the liabilities of directors are set out under the Act, as well as under other Indian statutes. When determining whether to hold a director liable for a particular act or omission, the court is required to consider a variety of factors, including but not limited to the nature of the directorship, the nature of the offense, the intention of the director, and the knowledge and the sanction of the board of directors. Further, the Act provides certain safe harbor provisions for liabilities that independent directors may encounter.

RISK MANAGEMENT

Effective corporate governance includes a robust framework for risk management. Boards need to be more involved in fostering a risk culture and setting a good balance of risk and return. While the Act sets forth a limited risk management framework, the SEBI Listing Regulations have a stricter risk management mandate for listed companies. Accordingly, a company may put in place a detailed Enterprise Risk Management (ERM) framework for identification, analysis, and evaluation of risk, but it must also address cognitive biases in the corporate culture to ensure that behaviors are not contrary to the ERM process. A chief risk officer and ERM team can enable boards and senior officers to communicate openly about risks, arrive at common priorities, and collaborate in mitigating them. Long-term strategic insights on risk can only be acquired via an integrated risk system. The shortcomings of ineffective risk management systems are discussed in a case study of the IL&FS Ltd. crisis.

ENFORCEMENT OF SHAREHOLDERS' RIGHTS

The Act and the SEBI Listing Regulations provide several mechanisms by which shareholders may monitor companies as well as enforce their rights. Activism by institutional investors also plays an important role in developing corporate governance standards. Regulatory measures such as the introduction of proxy advisers, facilities for e-voting, and the introduction of class actions can enable nonpromoter shareholders to assert their rights. Stewardship codes can encourage institutional investors to perform their fiduciary duty by focusing on the company's long-term goals and by actively monitoring the public company on material matters. Collectively under the Companies Act, the SEBI Listing Regulations, and the Insolvency and Bankruptcy Code, several regulatory bodies have been entrusted with the functions of overseeing the enforcement of corporate governance norms in India. Class action suits, newly introduced under the Act, confer upon the National Company Law Tribunal wide powers to grant relief to aggrieved shareholders.

CHAPTER ONE

Corporate Governance Reforms in India

A Brief Overview

Since the late 1990s there has been a sea change in corporate governance in India. The needs of India's expanding economy, including access to foreign direct investment, the increased presence of institutional investors (both domestic and foreign), and the growing desire of Indian companies to access global capital markets, have spurred a vast array of corporate governance laws. India's corporate governance reforms were initially spearheaded by corporate India and quickly became an important component of the work of the country's primary capital markets regulatory authority, the Securities Exchange Board of India (SEBI), and the Ministry of Corporate Affairs (MCA), as well as of the stock exchanges.

Beginning in the late 1990s, the Indian government began to undertake a significant overhaul of the country's corporate governance system.[1] After lobbying by large firms and leading industry groups, SEBI in 2000 introduced unprecedented corporate governance reforms via Clause 49 of the listing agreement of stock exchanges (Listing Agreement) (Clause 49).[2] Clause 49, a seminal event in Indian corporate governance, established a number of governance requirements for listed companies, with a focus on the role and structure of corporate boards, internal controls, and disclosure to shareholders. India's corporate governance reform efforts did not cease after adoption of Clause 49. In fact, the adoption of Clause 49 was just the beginning of vast changes in corporate governance in India.

Like corporate governance reforms in other jurisdictions, corporate governance reforms in India were further adopted in response to scandals. In January 2009, the Indian corporate community was rocked by a massive accounting scandal involving Satyam Computer Services Ltd. (Satyam), one of India's largest information technology companies.[3] (See "The Satyam Scandal," p. 16.) The Satyam scandal prompted quick action by the Indian government, including the arrest of several Satyam insiders and auditors, investigations by the MCA and SEBI, and substitution of the company's directors with government nominees.[4] As a result of the scandal, Indian regulators and industry groups advocated for a number of corporate governance reforms to address some of the concerns raised by the Satyam scandal. Some of these responses moved forward, primarily through the introduction of voluntary guidelines by both public and private institutions.

Even more significant changes in the corporate governance space occurred in the new decade. After many years of debate, significant corporate governance measures through comprehensive revision of the Companies Act, 1956[5] were enacted in 2013 and 2014 through passage of the Companies Act, 2013 (Companies Act, or Act) and the rules thereunder.[6] Unlike the Companies Act, 1956, the Companies Act of 2013 includes substantial corporate governance provisions and outlines the duties and responsibilities of directors, with a focus on independent directors.

Since the passage of the Companies Act, the MCA has adopted numerous rules to operationalize the legislation. The MCA has continued to release various notifications and clarifications regarding the rules adopted pursuant to the Act, which itself stands updated through various amendment acts.

The Companies Act was not the only recent significant development in corporate governance for Indian companies. In January 2013, SEBI issued a Consultative Paper on Review of Corporate Governance Norms in

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1 For a detailed history of developments in Indian corporate governance, see Afra Afsharipour, "Corporate Governance Convergence: Lessons from the Indian Experience," *Northwestern Journal of International Law & Business* 29, no. 2 (2009): 335; Rajesh Chakrabarti, "Corporate Governance in India—Evolution and Challenges" (working paper, OP Jindal Global University, Sonipat, 2005), 20.

2 CIRCULAR NO. SMDRP/POLICY/CIR-42/2000, AMENDMENTS TO CLAUSE 49 OF THE LISTING AGREEMENT, SEC. & EXCH. BD. OF INDIA (2000); CIRCULAR NO. SEBI/MRD/SE/31/2003/26/08, CORPORATE GOVERNANCE IN LISTED COMPANIES—CLAUSE 49 OF THE LISTING AGREEMENT, SEC. & EXCH. BD. OF INDIA (2003) [hereinafter Clause 49 (2003)].

3 James Fontanella-Khan, "Timeline: The Satyam Scandal," *Financial Times*, January 7, 2009; "India's Enron," *Economist*, January 8, 2009.

4 "Satyam Fraud: Raju Sent to Central Prison; CFO Vadlamani Arrested," *Economic Times*, January 10, 2009; "Satyam's Raju Brothers Arrested by AP Police," *Economic Times*, January 9, 2009; Jackie Range, "Pricewaterhouse Partners Arrested in Satyam Probe," *Wall Street Journal Asia*, January 25, 2009; Mukesh Jagota and Romit Guha, "India Names New Satyam Board," *Wall Street Journal*, January 12, 2009.

5 The Companies Act, 1956, No. 1, Acts of Parliament, 1956 (as amended).

6 The Companies Act, 2013, No. 18, Acts of Parliament, 2013; NO. 2/19/2011-CL-V, PRESS RELEASE, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA (2013).

India.[7] SEBI's consultative paper discussed the possibility of additional changes to Clause 49, both to reconcile the Companies Bill with Clause 49 and to consider even more stringent corporate governance standards than adopted in the Act. Following a public comment period, on April 17, 2014, SEBI issued its amended rules for Clause 49, which became effective on October 1, 2014.[8] SEBI further amended Clause 49 in September 2014 to address concerns raised by listed companies and to bring certain provisions in line with the rules under the Companies Act.

Subsequently, in 2015, SEBI issued the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (SEBI Listing Regulations), effectively codifying all existing corporate governance provisions under the framework of regulations, thus replacing Clause 49.

This chapter briefly outlines the process undertaken to reform India's corporate governance laws.

Overall, India's corporate governance reform efforts reflect the following:

- Significant industry involvement in assisting the government with crafting corporate governance measures;
- Substantial focus on improving the function and structure of company boards, including (1) emphasis on the independence of the board of directors; and (2) an increased role for board committees such as the audit committee and the nomination and remuneration committee; and
- Noteworthy increase in disclosure and rights to public shareholders.

The First Phase of India's Corporate Governance Reforms: 1996–2008

India's corporate governance reform efforts were initiated by corporate industry groups, many of which were instrumental in advocating for and drafting corporate governance guidelines. Following vigorous advocacy by industry groups, SEBI proceeded to adopt considerable corporate governance reforms. The first phase of India's corporate governance reforms was aimed at "making boards and audit committees more independent, powerful, and focused monitors of management" as well as aiding shareholders, including institutional and foreign investors, in monitoring management.[9] These reform efforts were channeled through a number of different paths, with both SEBI and the MCA playing important roles.

The role of industry. India's first major corporate governance reform proposal was launched by the Confederation of Indian Industry (CII), India's largest industry and business association. In 1996, the CII formed a task force to develop a corporate governance code for Indian companies. Desirable Corporate Governance: A Code (CII Code) for listed companies was proposed by the CII in April 1998.[10] The CII Code contained detailed governance provisions related to listed companies, although it was voluntarily adopted by only a few companies and did not result in a broad overhaul of governance norms and practices by Indian companies.[11]

SEBI-appointed committees and the adoption of Clause 49. Shortly after introduction of the CII Code, SEBI appointed the Committee on Corporate Governance under the chairmanship of Kumar Mangalam Birla (the Birla Committee). In 1999, the Birla Committee submitted a report to SEBI "to promote and raise the standard of Corporate Governance" for listed companies.[12] The Birla Committee's recommendations were primarily focused on two fundamental goals: improving the function and structure of company boards and increasing disclosure to shareholders. With respect to company boards, the committee made specific recommendations regarding board representation and independence that have persisted to date in the Companies Act and the SEBI

7 CONSULTATIVE PAPER ON REVIEW OF CORPORATE GOVERNANCE NORMS IN INDIA, Securities and Exchange Board of India (2013).

8 CIRCULAR NO. CIR/CFD/POLICY CELL/2/2014, CORPORATE GOVERNANCE IN LISTED ENTITIES – AMENDMENTS TO CLAUSE 36B AND 49 OF THE EQUITY LISTING AGREEMENT, Securities and Exchange Board of India (2014).

9 Dhammika Dharmapala and Vikramaditya S. Khanna, "Corporate Governance, Enforcement, and Firm Value: Evidence from India" (Olin Working Paper No. 08-005, University of Michigan Law School, November 2011), 7.

10 DESIRABLE CORPORATE GOVERNANCE: A CODE, CONFEDERATION OF INDIAN INDUS. (1998) [hereinafter CII Code].

11 CORPORATE GOVERNANCE IN INDIA: THEORY AND PRACTICE, NAT'L FOUND. FOR CORP. GOVERNANCE 7 (2004) [hereinafter NATIONAL FOUNDATION].

12 Kumar Mangalam Birla et al., *Report of the Kumar Mangalam Birla Committee on Corporate Governance*, Securities and Exchange Board of India, 1999 [hereinafter Birla Report].

Listing Regulations.[13] The committee also recognized the importance of audit committees and made many specific recommendations regarding the function and constitution of board audit committees.[14] The Birla Committee also made several recommendations regarding disclosure and transparency issues, in particular with respect to information provided to shareholders. Among other recommendations, the Birla Committee stated that a company's annual report to shareholders should contain a Management Discussion and Analysis (MD&A) section, and that companies should transmit certain information, such as quarterly reports and analyst presentations, to shareholders.[15]

SEBI implemented the Birla Committee's proposals less than five months later, in February 2000. At that time, SEBI revised its Listing Agreement to incorporate the recommendations of the country's new code on corporate governance. These rules—contained in Clause 49, a new section of the Listing Agreement—took effect in phases between 2000 and 2003. The reforms applied first to newly listed and large companies, then to smaller companies, and eventually to the vast majority of listed companies.

In the wake of the Enron scandal and the adoption of the Sarbanes-Oxley Act in the United States, SEBI formed the Committee under the chairmanship of Narayana Murthy (Murthy Committee) to evaluate the adequacy of the then-existing Clause 49, to further enhance the transparency and integrity of India's stock markets and to "ensure compliance with corporate governance codes, in substance and not merely in form."[16] The Murthy Committee stated that recent corporate governance failures, particularly in the United States, combined with the observations of India's stock exchanges that compliance with Clause 49 up to that point had been uneven, compelled the committee to recommend further reform.[17]

Like the Birla Committee, the Murthy Committee examined a range of corporate governance issues relating to boards and audit committees, as well as to disclosure to shareholders. The committee focused heavily on the role and structure of corporate boards and strengthened the director independence definition in the then-existing Clause 49, particularly to address the role of insiders.[18] For example, while the new definition actually encompassed the old, it also indicated, among other things, that the director cannot be: related to promoters or management at the board level, or one below the board; an executive of the company in the preceding three years; a supplier, service provider, or customer of the company; or a shareholder owning 2 percent or more of the company.[19] The Murthy Committee also recommended that nominee directors (i.e., directors nominated by institutions, particularly financial institutions, with relationships with the company) be excluded from the definition of independent director and be subject to the same responsibilities and liabilities applicable to any other director.[20] In order to improve the function of boards, the Murthy Committee recommended that board members should also receive training in the company's business model[21] and quarterly reports on business risk and risk management strategies.[22]

The Murthy Committee paid particular attention to the role and responsibilities of audit committees. It recommended that audit committees be composed of "financially literate" members,[23] provided a greater role for the audit

13 Birla Report, §§ 6.5, 6.9. The Committee recommended that at least half the members should be independent (or one-third if the chairman of the board is an independent director), and defined an independent director as one who has no "material pecuniary relationship [, other than remuneration,] or transaction with the company [et al.] . . . which in the judgment of the board may affect [the director's] independence of judgment." To ensure that directors give companies due attention, the Committee also recommended that directors be limited to holding a maximum of ten directorships and five chairmanships. Birla Report, § 11.2.

14 Birla Report, § 9.6. The Committee recommended that the audit committee be composed of at least three directors, all nonexecutive directors, a majority of independent directors, and at least one director with financial and accounting knowledge. The chair of the audit committee should be independent. In addition, the Committee recommended that the audit committee should meet at least three times a year. Birla Report, § 9.7.

15 Birla Report, §§ 13.4, 14.7.

16 N.R. Narayana Murthy et al., *Report of the SEBI Committee on Corporate Governance*, Securities and Exchange Board of India, February 2003, § 1.6 [hereinafter Murthy Report].

17 Murthy Report, §§ 1.5.4, 1.5.5.

18 Murthy Report, § 3.10.14.

19 Murthy Report, § 3.10.14.

20 Murthy Report, §§ 3.8.1.1, 3.8.1.2.

21 Murthy Report, § 3.5.2.4.

22 Murthy Report, § 3.5.1.7.

23 Murthy Report, § 3.2.2.3.

committee,[24] and stated that whistleblowers should have access to the audit committee without first having to inform their supervisors. Further, the committee required that companies should annually affirm that they have not denied access to the audit committee or generally treated whistleblowers unfairly.[25]

In 2004, SEBI further amended Clause 49 in response to the Murthy Committee's recommendations.[26] However, implementation of these changes was delayed until January 1, 2006, due primarily to industry resistance and lack of preparedness to accept such wide-ranging reforms.[27] While there were many changes to Clause 49 as a result of the report of the Murthy Committee, governance requirements with respect to corporate boards, audit committees, shareholder disclosure, and Chief Executive Officer (CEO)/Chief Financial Officer (CFO) certification of internal controls constituted the largest transformation of the governance and disclosure standards of Indian companies.

Clause 49 included the following key requirements:

- **Board Independence.** Boards of directors of listed companies must have a minimum number of independent directors. Where the chairman is an executive or a promoter or related to a promoter or a senior official, then at least one-half the board should comprise independent directors; in other cases, independent directors should constitute at least one-third of the board size.
- **Audit Committees.** Listed companies must have audit committees of the board with a minimum of three directors, two-thirds of whom must be independent, including the chair of the audit committee; in addition, the roles and responsibilities of the audit committee are specified in detail.
- **Disclosure.** Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency.
- **CEO/CFO Certification of Internal Controls.** The CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal controls.
- **Annual Reports.** Annual reports of listed companies must carry status reports about compliance with corporate governance norms.

24 Murthy Report, § 3.4.1.5.

25 Murthy Report, §§ 3.11.1.3, 3.11.2.4.

26 PR No.303/2003, PRESS RELEASE, RECOMMENDATIONS OF THE NARAYANA MURTHY COMMITTEE ON THE REVISED CLAUSE 49, Securities and Exchange Board of India (2003).

27 For an overview of implementation and enforcement issues with respect to Clause 49, see Afsharipour, "Corporate Governance Convergence: Lessons from the Indian Experience"; Umakanth Varottil, "A Cautionary Tale of the Transplant Effect on Indian Corporate Governance," *National Law School of India Review* 21, no. 1 (2009); Bala N. Balasubramanian, Bernard S. Black, and Vikramaditya S. Khanna, "Firm-Level Corporate Governance in Emerging Markets: A Case Study of India" (ECGI - Law Working Paper 119/2009; 2nd Annual Conference on Empirical Legal Studies Paper; U of Michigan Law & Economics, Olin Working Paper 08-011; U of Texas Law, Law and Econ Research Paper No. 87; Northwestern Law & Econ Research Paper No. 09-14; July 2, 2008).

MCA-appointed committees and proposed amendments to the Companies Act. In addition to SEBI's corporate governance reforms that were only applicable to listed companies, the MCA undertook efforts in the early 2000s to reform the Companies Act to reflect more rigorous corporate governance provisions for all Indian companies. By 2005, the MCA had commissioned two separate committees to examine the Companies Act with respect to corporate governance provisions.

In August 2002, the MCA formed the Committee chaired by Naresh Chandra, a former Cabinet secretary (Naresh Chandra Committee). The Naresh Chandra Committee was charged with undertaking a wide-ranging examination of corporate auditing and independent directors, although its report focused primarily on auditing and disclosure matters.[28] The Naresh Chandra Committee made a series of recommendations regarding, among other matters, the grounds for disqualifying auditors from assignments, the type of nonaudit services that auditors should be prohibited from performing, and the need for compulsory rotation of audit partners.[29] While the recommendations of the Chandra Committee did not result in legislative changes, certain of its recommendations were incorporated in the report put forth by the Murthy Committee.[30]

28 NATIONAL FOUNDATION, 8.

29 NATIONAL FOUNDATION, 8.

30 Murthy Report, § 4.

In December 2004, the MCA convened a committee, led by J.J. Irani, a director of Tata Sons, Ltd. (Irani Committee).[31] The Irani Committee was charged with evaluating the Companies Act, with a focus on combining internationally accepted best practices in corporate governance, with attention to the particular needs of the growing Indian economy. Many of the committee's recommendations were incorporated into proposed amendments to the Companies Act. These changes would apply to all Indian firms and not just those listed on the stock exchanges, and thus would introduce an entirely new corporate governance framework for many Indian firms. For example, the concept of "independent director" was introduced in the Companies Act for the first time.[32] Companies that have a prescribed minimum share capital are required to have a board with at least one-third independent directors.

The Irani Committee recognized that requirements of special or small companies be accounted for through a series of exemptions, so that smaller businesses would not be burdened with the same level of compliance costs as larger, established corporations. In keeping with this theme, the Irani Committee recommended a wider set of classifications for companies than just the public or private labels because the committee believed that the binary system of classification was too narrow to account for the varying needs of companies of different sizes and with different resources.[33] The committee's goal was to expand the system of classifications and exemptions to tailor compliance costs to needs while maintaining sufficient regulatory stringency for large listed companies that access public capital.[34]

While there are many similarities between the corporate governance provisions of Clause 49 and the recommendations of the Irani Committee, there were some significant differences with respect to the board of directors, in particular as related to independent directors. As discussed below, these differences are largely reflected in the Companies Act.

31 Jamshed J. Irani et al., *Report on Company Law*, Expert Committee on Company Law, May 2005, p. 3 [hereinafter Irani Report].

32 Irani Report, 23.

33 Irani Report, 10–11.

34 Irani Report, 11–12.

The Second Phase of Reform: Corporate Governance after Satyam

India's corporate community experienced a significant shock in January 2009, with damaging revelations about board failure and colossal fraud in Satyam's financials. The Satyam scandal also served as a catalyst for the Indian government to rethink the corporate governance, disclosure, accountability, and enforcement mechanisms in place.[35] As described below, Indian regulators and industry groups advocated for a number of corporate governance reforms to address some of the concerns raised by the Satyam scandal.

Industry response. Shortly after news of the scandal broke, the CII began examining the corporate governance issues arising out of the Satyam scandal.[36] Other industry groups also formed corporate governance and ethics committees to study the impact and lessons of the scandal.[37]

In late 2009, a CII task force put forth corporate governance reform recommendations.[38] In its report, the CII emphasized the unique nature of the Satyam scandal, noting that "Satyam is a one-off incident…The overwhelming majority of corporate India is well run, well regulated and does business in a sound and legal manner."[39]

In addition to the CII, the National Association of Software and Services Companies (NASSCOM, the trade body for India's IT industry)[40] also formed a Corporate Governance and Ethics Committee, chaired by N. R. Narayana Murthy, one of the founders of Infosys and a leading figure in Indian corporate governance reforms.[41] The committee

35 Omkar Goswami, "Aftermath of Satyam," *BusinessWorld* (India), Jan. 23, 2009; Prashant K. Sahu, Sapna Dogra, and Aditi Phadnis, "Satyam Scam Prompts Clause 49 Review," *Business Standard*, January 14, 2009.

36 "CII Sets Up Task Force on Corporate Governance," *Business Standard*, January 12, 2009.

37 "NASSCOM Announces Formation of Corporate Governance and Ethics Committee," *Business Standard*, February 11, 2009.

38 Naresh Chandra et al., *Report of the CII Task Force on Corporate Governance*, CII Task Force on Corporate Governance, November 2009 [hereinafter CII 2009 Report].

39 CII 2009 Report, 1.

40 "About Us," NASSCOM.

41 Afra Afsharipour, "The Promise and Challenges of India's Corporate Governance Reforms," *Indian Journal of Law & Economics* 1, no. 1 (2010): 50.

The Satyam Scandal

Satyam Computer Services Ltd. (Satyam) was a publicly traded company listed on the Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) in India, and cross-listed on the New York Stock Exchange (NYSE) in the United States. While Satyam's promoters, represented by Mr. Ramalinga Raju and his family, held 8 percent of the shares in the company at the end of 2008, the company had a majority independent board of directors that comprised several Indian luminaries. Described as a "gold-plated group," Satyam's independent directors included a Harvard Business School professor, the then-dean of the Indian School of Business, and a former Indian cabinet secretary in India.[a] Moreover, Satyam received the Golden Peacock award for excellence in corporate governance.

In early 2009, Satyam experienced two related scandals: the first an aborted related-party transaction involving the company's promoters, the second the uncovering of colossal fraud in the company's financial statements.

The Maytas transaction. On December 16, 2008, Satyam's board convened a meeting to consider the proposed acquisition of Maytas Infra Limited and Maytas Properties Limited, companies focused on real estate and infrastructure development.[b] Two major issues in the proposed transaction surfaced. First, the Maytas companies were focused on two industries unrelated to Satyam's core information technology business.[c] Second, the Raju family owned approximately 30 percent of the Maytas companies. If effected, this related-party transaction "would have resulted in a significant amount of cash flowing from Satyam…to its individual promoters, the Raju family."[d] While several of Satyam's independent directors questioned the proposed transaction, the board eventually adopted a resolution unanimously to proceed with the proposed acquisition. Satyam notified the stock exchanges of the board approval as required under the Listing Agreement.[e] The market reacted badly to the news, and the company quickly withdrew the Maytas proposal.[f]

Financial fraud. On January 7, 2009, shortly after the failed Maytas transaction, Raju confessed to falsifying the financial statements of the company, including balance sheet errors showing fictitious cash assets of over USD 1 billion.[g] The confession further revealed that the proposed Maytas acquisition involved "just illusory transactions intended to manipulate the balance sheet of Satyam and to wipe out inconsistencies therein."[h] As a result of this information, Satyam's stock price dropped another 70 percent, essentially obliterating the wealth of the Satyam shareholders.

a Vikramaditya Khanna and Shaun J. Mathew, "The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence," *National Law School of India Review* 22 (2010): 41.

b Omkar Goswami, "Satyam: The Tasks Ahead," *Business Standard*, January 21, 2009.

c Umakanth Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," *Hastings Business Law Journal* 6, no. 2 (2010), 334.

d Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance."

e Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," 335; N. Balasubramanian, "Is Corporate Governance Mere Lip Service?" *The Economic Times*, December 23, 2008; "Satyam Independent Directors Watching Situation," *The Hindu*, December 27, 2008.

f Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," 335; Somasekhar Sundaresan, "Year of Al-Pervasive Poor Governance," *Business Standard*, December 29, 2008; S. Nagesh Kumar, "Independent Directors Put Tough Questions, But Gave Blank Cheque," *The Hindu*, January 14, 2009.

g "It Was Like Riding a Tiger, Not Knowing How to Get Off Without Being Eaten," *Financial Express*, January 8, 2009; Mandar Nimkar, "How Much Is Satyam's Stock Actually Worth?" *The Economic Times*, January 8, 2009; Heather Timmon and Jeremy Kahn, "Indian Company in a Fight to Survive," *New York Times,* January 9, 2009.

h Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," 337.

The Satyam Scandal *continued*

The aftermath. As a result of the scandal, the MCA, the Government of India, and SEBI initiated investigations.[i] The police arrested Raju, Satyam's managing director, and the company's CFO within a few days of the confession.[j] Two partners from Lovelock & Lewis, an Indian affiliate of PricewaterhouseCoopers and Satyam's auditor, were also arrested.[k] Further, the Government nominated and replaced remaining Satyam board members with candidates of its choice.[l] Under the new leadership, Satyam was able to make a remarkable turnaround and the company was purchased by Tech Mahindra in April 2009.[m]

In April 2015, Ramalinga Raju and his brother, Rama Raju, Satyam's former managing director, were found guilty of criminal conspiracy, cheating, and breach of trust for manipulating Satyam's financial statements for several years.[n] Both Ramalinga Raju and his brother were sentenced to seven years in prison and fined INR 5 crore.[o] In addition, six other employees and two former PricewaterhouseCoopers workers were found guilty of criminal conspiracy and cheating.[p] They were each sentenced to seven years in prison and fined INR 25 lakh.[q] In May 2015, the accused filed appeals challenging their convictions.[r]

The concerns raised by the Satyam scandal reverberated in corporate India more broadly. For example, in a study of independent directors, the authors found evidence of mass resignations of independent directors of Indian firms following Satyam, with "at least 620 independent directors" resigning in 2009 alone, "a figure that is…by far without precedent globally."[s]

i Oomen A. Ninan, "Satyam Episode: SEBI Enquiries Will Focus on Three Areas," *The Hindu Business Line*, January 16, 2009; Souvik Sanyal, "Government Refers Satyam Case to Serious Frauds Investigation Office," *The Economic Times*, January 13, 2009.

j "Satyam Fraud: Raju Sent to Central Prison; CFO Vadlamani Arrested," *The Economic Times*, January 10, 2009; "Satyam's Raju Brothers Arrested by AP Police," *The Economic Times*, January 9, 2009.

k Jackie Range, "Pricewaterhouse Partners Arrested in Satyam Probe," *Wall Street Journal Asia*, January 25, 2009.

l Mukesh Jagota and Romit Guha, "India Names New Satyam Board," *Wall Street Journal*, January 12, 2009.

m Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," 338.

n "Court Convicts Ex-Satyam Chief of Fraud in 'India's Enron' Case," *Business Insider*, April 9, 2015.

o "Satyam Verdict: Raju Gets 7 Years in Jail, Slapped Rs 5 Cr Fine for Corporate Fraud," *The Economic Times*, April 10, 2015.

p "Court Convicts Ex-Satyam Chief of Fraud in 'India's Enron' Case," *Business Insider*.

q "Satyam Verdict: Raju Gets 7 Years in Jail, Slapped Rs 5 Cr Fine for Corporate Fraud," *The Economic Times*.

r "Satyam Scam: Court Order on Ramalinga Raju's Appeal for Sentence Suspension to Be Pronounced Tomorrow," *The Economic Times*, May 13, 2015.

s Khanna and Mathew, "The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence," 36; Rajesh Chakrabarti, Krishnamurthy Subramanian, and Frederick Tung, "Independent Directors and Firm Value: Evidence from an Emerging Market," June 28, 2010, p. 2 (detailing exodus of independent directors following the Satyam scandal).

issued its recommendations in mid-2010, focusing on stakeholders in the company. The report emphasized recommendations related to the audit committee and a whistleblower policy. The report also addressed improving shareholder rights. Similarly, the Institute of Company Secretaries of India (ICSI) put forth a series of corporate governance recommendations.[42]

Government response. Satyam prompted quick action by both SEBI and the MCA.

SEBI ACTIONS

In September 2009, the SEBI Committee on Disclosure and Accounting Standards issued a discussion paper that considered proposals for:

- appointment of the chief financial officer (CFO) by the audit committee after assessing the qualifications, experience, and background of the candidate;
- rotation of audit partners every five years;
- voluntary adoption of International Financial Reporting Standards (IFRS);
- interim disclosure of balance sheets (audited figures of major heads) on a half-yearly basis; and
- streamlining of timelines for submission of various financial statements by listed entities as required under the Listing Agreement.[43]

In early 2010, SEBI amended the Listing Agreement to add provisions related to the appointment of the CFO by the audit committee and other matters related to financial disclosures.[44] However, other proposals such as rotation of audit partners were not included in the amendment of the Listing Agreement.[45]

MCA ACTIONS

Inspired by industry recommendations, including the influential CII recommendations, in late 2009 the MCA released a set of voluntary guidelines for corporate governance.[46] The voluntary guidelines addressed myriad corporate governance matters, including

- independence of the boards of directors;
- responsibilities of the board, the audit committee, auditors, and secretarial audits; and
- mechanisms to encourage and protect whistleblowing.[47]

Important provisions included[48]

1. Issuance of a formal appointment letter to directors
2. Separation of the office of chairman and the CEO
3. Institution of a nomination committee for selection of directors
4. Limiting the number of companies in which an individual can become a director
5. Tenure and remuneration of directors
6. Training of directors
7. Performance evaluation of directors
8. Additional provisions for statutory auditors

In discussing the voluntary nature of the guidelines, then-Corporate Affairs Secretary R. Bandyopadhyay stated that the MCA did not want to enact a rigid, mandatory law.[49] However, the MCA also indicated that the guidelines are a first step and that the option remains open to perhaps moving to something more mandatory.

42 ICSI RECOMMENDATIONS TO STRENGTHEN CORPORATE GOVERNANCE FRAMEWORK, INST. OF CO. SEC'YS OF INDIA (2009).

43 DISCUSSION PAPER ON PROPOSALS RELATING TO AMENDMENTS TO THE LISTING AGREEMENT, SEBI COMM. ON DISCLOSURES & ACCOUNTING STANDARDS (2009).

44 These measures have been introduced through an amendment to the Listing Agreement. See CIRCULAR NO. CIR/CFD/DIL/1/2010, LISTING CONDITIONS—AMENDMENTS TO THE EQUITY LISTING AGREEMENT, SEC. & EXCH. BD. OF INDIA (2010).

45 LISTING CONDITIONS—AMENDMENTS TO THE EQUITY LISTING AGREEMENT, Securities and Exchange Board of India; Umakanth Varottil, "India's Corporate Governance Voluntary Guidelines 2009: Rhetoric or Reality?" *National Law School of India Law Review* 22, no. 2 (2010), 13.

46 CORPORATE GOVERNANCE VOLUNTARY GUIDELINES 2009, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA, (2009) [hereinafter the VOLUNTARY GUIDELINES]. For detailed evaluation of the substance of the voluntary guidelines and whether a voluntary approach is the correct approach, see Varottil, "Rhetoric or Reality."

47 VOLUNTARY GUIDELINES.

48 VOLUNTARY GUIDELINES.

49 "Corporate Affairs Secretary R. Bandyopadhyay: 'CSR is not Charity—It's a Win-Win Situation,'" *Knowledge@Wharton*, June 17, 2020.

2012 GODREJ COMMITTEE'S "GUIDING PRINCIPLES OF CORPORATE GOVERNANCE"

In furtherance of its corporate governance goals, the MCA created a committee to formulate a comprehensive policy framework with practical suggestions to strengthen corporate governance.[50] Formed in March 2012, the committee, headed by Adi Godrej, chairman of Godrej Industries Limited, consisted of a group of high-level executives of Indian companies, along with SEBI Executive Director Ravindran and Dr. Bhaskar Chatterjee, director general of the Indian Institute of Corporate Affairs (Godrej Committee).[51] Together, they transformed a checklist of requirements into an actual road map of 17 general principles to guide corporate governance.[52]

The final report enumerated a set of recommendations that aimed to strengthen "the actual performance of Indian corporate governance within the existing legal framework."[53] The committee emphasized transparency, equitable shareholder treatment, strategic planning, and board composition and diversity. The Godrej Committee Guiding Principles on Corporate Governance, together with the OECD Principles of Corporate Governance, formed the foundation of the SEBI review of corporate governance norms for listed companies, parts of which were then incorporated into the Companies Act and eventually into the new corporate governance norms by SEBI (2014).[54]

For example, the committee report addresses the issue of India's high familiarity quotient—high familiarity between board members.[55] The committee noted that when new board positions are filled with people already connected to current members, the chances of shared values and mutual respect increases; nevertheless, the high level of familiarity may have adverse impacts on board productivity. A high level of familiarity increases the risk that board decisions are quickly negotiated, sometimes without necessary deliberations. Existing power hierarchies also affect the voices present in the room. Thus, the committee suggested the periodic introduction of independent directors to ensure the exchange of fresh opinions and ideas. A required number of independent directors was adopted by the Companies Act and reinforced in SEBI's revision of Clause 49 of the Listing Agreement in February 2014.

The Third Phase of Reform: 2013–2015

THE COMPANIES ACT, 2013

On August 5, 2009, the Companies Bill, 2009 was introduced in the Lok Sabha, the directly elected lower house of the Indian Parliament, in the same form in which it had been presented in 2008.[56] However, passage of the bill was deferred, and the bill was withdrawn and amended as a result of an August 2010 report by the Standing Committee on Finance of Parliament, which examined the 2009 bill in great detail.[57] The resulting bill included substantial changes related to corporate governance matters.

Following these significant revisions, the Companies Bill, 2011 was introduced in the Lok Sabha on December 14, 2011. Less than two weeks later, the government withdrew the bill and referred it for further reconsideration by the Standing Committee on Finance.[58] After further revisions resulting from yet another report by the Standing Committee on Finance, the Companies Bill, 2012 was approved by the Lok Sabha in December 2012. The bill was finally considered and passed by the Rajya Sabha on August 8, 2013. The bill received the necessary assent of the president of India on August 29, 2013, and became the Companies Act of 2013. Following passage of the Act, the MCA set about adopting rules to operationalize the Act.

Pursuant to Section 1(3) of the Companies Act, the Central Government, through the MCA, was charged with notifying the date(s) on which various provisions of the Act would

50 Adi Godrej et al., *Report of the Committee Constituted by MCA to Formulate a Policy Document on Corporate Governance*, Ministry of Corporate Affairs, Government of India, September 2012 [hereinafter Godrej Report].

51 Godrej Report, 48-49.

52 Godrej Report, 1.

53 Godrej Report, 1.

54 CONSULTATIVE PAPER ON REVIEW OF CORPORATE GOVERNANCE NORMS IN INDIA, Securities and Exchange Board of India (2013); "Govt Considering Godrej Panel Suggestions on Corporate Governance," *The Economic Times*, March 14, 2013.

55 Godrej Report, 5-6.

56 Chakshu Roy and Avinash Celestine, *Legislative Brief: The Companies Bill, 2009*, PRS Legislative Research, August 2009.

57 *The Companies Bill, 2009, Twenty-First Report*, STANDING COMMITTEE ON FINANCE (2009-2010), Fifteenth Lok Sabha (Aug. 2010).

58 *The Companies Bill, 2011, Fifty-Seventh Report*, STANDING COMMITTEE ON FINANCE (2011-2012), Fifteenth Lok Sabha (June 2012).

come into force.[59] Through the adoption of various rules, the MCA has notified and operationalized the Companies Act.

The Companies Act substantially changed the role of boards, bringing about the concept of board independence in company law and significantly enhancing the roles and responsibilities of board members. For example, for the first time, the Act defined the specific duties of directors. It also sets forth professional qualifications for directors serving on the audit committee, stating that a majority of the members of the audit committee, including its chairperson, must have the ability to read and understand financial statements. In addition to audit committee qualifications, the Act includes an extensive definition of independent directors and a detailed code in Schedule IV of the Act, with a guide to professional conduct for independent directors. The Act also sets forth significant measures to address the problems of related-party transactions. (See Chapter Eight: Related Party Transactions, p.143.) As clear from the provisions included in the Companies Act and the rules thereunder, a substantial part of the law is in the form of rules that are adopted by the MCA.

SEBI'S CORPORATE GOVERNANCE REFORM EFFORTS IN LIGHT OF THE COMPANIES ACT, 2013

SEBI quickly responded to passage of the Companies Bill, 2012 by the Lok Sabha. In early January 2013, SEBI issued a detailed consultative paper that reviews corporate governance norms in India. The consultative paper sought to both harmonize the corporate governance provisions of Clause 49 with those included in the Companies Bill, 2012 (most of which were incorporated into the Companies Act) and recommend additional measures to impose a more stringent regime for listed companies.[60]

On April 17, 2014, SEBI issued its amended rules for Clause 49.[61] SEBI amended Clause 49 of the Listing Agreement in February 2014, with the revised requirements being effective as of October 1, 2014. The revised Clause 49 included many provisions meant to align the listing requirements for listed companies with the requirements of the Companies Act. For example, like the Companies Act, SEBI also required that boards include at least one woman director. SEBI also aligned the definition and requirements of independent directors to that of the Companies Act. In September 2014, SEBI made further amendments to Clause 49.[62]

In the face of criticism from various market participants that SEBI's revised Clause 49 was significantly more onerous to companies than the Companies Act, in September 2014, SEBI made some important modifications to the initial changes announced in early 2014. For example, under the original Clause 49, an independent director excluded anyone with any pecuniary relationship with the company or other related parties, while the revised Clause 49 provides that independent directors must not have any *material* pecuniary relationship. Similarly, the tenure for independent directors was relaxed to be aligned with the Companies Act so that independent directors may hold their directorships for 10 years. Other major changes to Clause 49 pertained to related party transactions.

The Fourth Phase of Reform: 2015—SEBI Listing Regulations

SEBI also took additional steps to ensure the enforceability of the listing requirements, including Clause 49. In November 2014, SEBI introduced the conversion of the Listing Agreement into the SEBI (Listing Obligations and Disclosure Requirements) Regulations.[63] The SEBI Listing Regulations that came into effect in 2015 provided for a comprehensive framework governing listed securities and were intended "to consolidate and streamline the provisions of existing Listing Agreements, thereby ensuring better enforceability."[64] The SEBI Listing Regulations are categorized into three subdivisions: (1) the substantive provisions of the regulations; (2) schedules to the regulations that provide procedural requirements; and (3) circulars by SEBI that prescribe the forms of disclosure. Overall, the replacement of Listing

59 The Companies Act, 2013, § 1(3).

60 CONSULTATIVE PAPER ON REVIEW OF CORPORATE GOVERNANCE NORMS IN INDIA, Securities and Exchange Board of India.

61 CIRCULAR NO. CIR/CFD/POLICY CELL/2/2014, CORPORATE GOVERNANCE IN LISTED ENTITIES—AMENDMENTS TO CLAUSE 36B AND 49 OF THE EQUITY LISTING AGREEMENT, Securities and Exchange Board of India (2014) [hereinafter Clause 49 (2014)].

62 CIRCULAR NO. CIR/CFD/POLICY CELL/7/2014, CORPORATE GOVERNANCE IN LISTED ENTITIES—AMENDMENTS TO CLAUSE 49 OF THE EQUITY LISTING AGREEMENT, Securities and Exchange Board of India (2014).

63 PR NO. 130/2014, SEBI BOARD MEETING, Securities and Exchange Board of India (2014).

64 SEBI BOARD MEETING, Securities and Exchange Board of India.

Agreements with regulations was aimed at "consolidating and streamlining the listing requirements and…clarifying their legal nature so as to obviate any issues as to their enforceability" but did not introduce any new substantive legal requirements.[65]

The Fifth Phase of Reform: The Kotak Committee

In 2017, SEBI set up a committee chaired by Uday Kotak, the executive vice chairman and managing director of Kotak Mahindra Bank, to undertake a comprehensive review of the SEBI Listing Regulations to further strengthen the existing corporate governance regime (Kotak Committee). The committee's members represented a wide range of stakeholders, including the government, industry, stock exchanges, academics, proxy advisors, professional bodies, lawyers, and so forth.[66]

SEBI charged the Kotak Committee with addressing the following issues: (1) improving the role, composition, and effectiveness of the board and its committees, including evaluation practices; (2) ensuring independence in the spirit of independent directors and their active participation in the functioning of the company; (3) improving safeguards and disclosures pertaining to related party transactions; (4) improving transparency in accounting and auditing practices by the listed companies; (5) addressing issues faced by investors on voting and participation in general meetings; (6) enhanced monitoring of group entities; and (7) disclosure- and transparency-related issues, if any.[67]

On October 5, 2017, the Kotak Committee released its recommendations for public comment.[68] The Kotak Committee stated that its recommendations were intended to focus on long-term solutions to corporate governance challenges while maintaining and protecting shareholder interests.[69] This framework allowed the committee to develop recommendations that promoted reliability and asymmetric information, addressed conflicts of interest, and created regulatory schemes to scrutinize and optimize corporate governance.[70]

The Kotak Committee's most significant recommendations are summarized below.

- **Increasing transparency.** To ensure that corporations are run cost-efficiently and effectively, many of the Kotak Committee's recommendations were aimed at promoting appropriate disclosures. These recommendations included (1) disclosure of auditor credentials, audit fees, auditors' reasons for resignation in the company's annual report; (2) disclosure of the expertise/skills of directors in the company's annual report; (3) enhanced disclosure of related party transactions submitted to the stock exchanges and published on their website; (4) disclosure of consolidated quarterly results; and (5) all listed companies and their material subsidiaries incorporated in India must undertake secretarial audit and annex a secretarial audit report given by a practicing company secretary with their annual reports.
- **Reshaping the management of the company.** To ensure that the directors fulfill their fiduciary duties to both the company and its stakeholders, the Kotak Committee set forth several important recommendations with respect to the board of directors of a company; these included the following recommendations, which were accepted by SEBI:
  - The top 500, listed entities (by market capitalization) with a public shareholding of 40 percent or more must separate the office of CEO and Chairperson beginning April 1, 2022.
  - The top 1,000 listed entities (by market capitalization) and the top 2,000 listed entities must have a minimum of six directors by April 1, 2019, and April 1, 2020, respectively.
  - The top 500 listed entities and the top 1,000 listed entities must have a minimum of one independent woman director on their boards by April 1, 2019, and April 1, 2020, respectively.

65 Umakanth Varottil, "SEBI Reforms—Part 3: From Listing Agreement to Listing Regulations," *IndiaCorpLaw Blog*, November 25, 2014.

66 Divyarajsinh Zala, "A Study of Kotak Committee Report on Corporate Governance," *Abhinav National Monthly Refereed Journal of Research in Commerce & Management* 7, no. 4 (2018), 86.

67 *SEBI Listing Obligations and Disclosure Requirements (Amendment) Regulations, 2018*, Ernst & Young Associates LLP, June 2018.

68 *SEBI Listing Obligations and Disclosure Requirements (Amendment) Regulations, 2018*, Ernst & Young Associates LLP.

69 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86.

70 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86.

- No person may hold directorships in more than eight listed entities at the same time (of which independent directorships are capped at seven), beginning April 1, 2019. Beginning April 1, 2020, the maximum number will be lowered to seven.
- No person who is a part of the promoter group can be appointed as an independent director.
- To avoid the problem of "board interlocks," a person who is a nonindependent director of another company on the board of which any nonindependent director of the listed entity is an independent director will not be eligible to be an independent director in the listed entity.

- **Enhancing the role of board committees.** Several Kotak Committee recommendations were aimed at enhancing the role of committees of the board of directors. The recommendations included:
  - Audit Committee review of the utilization of loans and/or advances from or investment by the holding company in the subsidiary exceeding INR 100 crore or 10 percent of the asset size of the subsidiary (whichever is lower).
  - The Nomination and Remuneration Committee 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 the chief executive officer/manager is not a part of the board), including the position of the company secretary and the chief financial officer.
  - The Nomination and Remuneration Committee be charged with recommending to the board all remuneration, in whatever form, payable to members of the senior management. In addition, the quorum for a Nomination and Remuneration Committee must be either two members or one-third of the members of the committee, whichever is greater, including at least one independent director in attendance. The Nomination and Remuneration Committees must meet at least once a year.
  - The Risk Management Committee must specifically address cybersecurity. The board of directors must include this and any related risks when covering roles and responsibilities of this committee. Additionally, the requirement for constituting a Risk Management Committee should be applicable to the top 500 listed entities determined based on market capitalization at the end of the previous financial year. The Risk Management Committees must meet at least once a year.
- **Board and shareholder meetings.** Several recommendations were aimed at enhancing board and shareholder meetings, including (1) a quorum of the board of directors must be one-third of the total strength of the board of directors, or three directors (whichever is higher); (2) the top 100 entities must hold annual general meetings within five months of the end of financial year 2018–19, i.e., by August 31, 2019; (3) the top 100 entities must hold a webcast of annual general meetings; and (4) shareholder approval (majority of minority) for royalty/brand payments to related party must exceed 2 percent of consolidated turnover (instead of the proposed 6 percent).[71] In addition, the Committee recommended that shareholder approval be required when the annual remuneration payable to a single nonexecutive director exceeds 50 percent of the total remuneration payable to all nonexecutive directors.

At its board meeting in March 2018, SEBI considered the recommendations and accepted 40 of them; 15 of these were accepted with modifications. Approximately 18 recommendations that were viewed as too onerous were rejected, including recommendations on sharing information with promoters and significant shareholders, an increase in the number of independent directors on boards, minimum compensation to independent directors, and more board meetings.

The Kotak Committee's recommendations were developed in response to deep-seated local business realities, where most listed entities are promoter-led rather than professionally managed. The amendments instituted by SEBI are expected to elevate India's corporate governance standards and in turn, methods across the board.[72]

71 *SEBI Listing Obligations and Disclosure Requirements (Amendment) Regulations*, 2018, Ernst & Young Associates LLP; Uday Kotak et al., Report of the Committee on Corporate Governance, Securities and Exchange Board of India, October 2017.

72 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86, 92.

Corporate Governance in the Age of a Pandemic

By Umakanth Varottil

Experience from past crises suggests that companies with robust corporate governance systems and practices are able to weather a storm better than others. Similarly, it is reasonable to hypothesize that, even amid the throes of a crisis such as the COVID-19 pandemic, referred to in corporate speak as an "unknown unknown" that has sparked a systemic risk, well governed companies can more optimally address the interests of various corporate stakeholders.

The Board's Duties

Situated at the core of governance dynamic is the board of directors of a company. Its role, actions, reactions, and omissions are bound to be subjected to microscopic scrutiny in this time of pronounced uncertainty, as compared to normal circumstances. Exacerbating the situation is the fact that social distancing norms limit the ability of directors to meet physically, who must therefore rely on unconventional means of engagement.

Conscious of these limitations, regulators the world over have relaxed various governance measures. For instance, the Ministry of Corporate Affairs in India has temporarily allowed boards to meet virtually to decide all matters of business, and also permitted virtual shareholders' meetings. The Securities and Exchange Board of India has taken the sting out of stringent filing and reporting requirements by extending several deadlines. As much as such a move could allure boards to be drawn into a state of complacency, the regulatory motivation is far from the truth. These rulings dispense with formal and administrative requirements, but they do not relieve corporate boards of their obligations as fiduciaries. Directors continue to bear the burden of various duties imposed on them under corporate law. They would be hard-pressed to shake off directors' duties in a crisis, which will instead operate with greater vigor.

This gives rise to a key question. How should boards tread in this unchartered territory when they face constraining factors such as social distancing, and nevertheless discharge their fiduciary obligations? If there is a single strategy that boards must devolve their attention towards during this crisis, it is: communicate, communicate, and communicate. The board's engagement operates at different levels depending upon the constituencies involved. They can be internal to the company, in the form of discussions essentially with management. They can be external, in the form of timely disclosures to shareholders, employees, creditors, customers, and the government.

Communication with Management

The far-reaching impact of COVID-19 on the corporate sector demands greater focus on the part of directors, especially non-executive directors. At the outset, and notwithstanding various regulatory dispensations, it would be prudent for boards of affected companies to meet more regularly to communicate with management. Given that non-executive directors too are subject to fiduciary duties and responsibilities under company law, it is incumbent upon them to place a stronger oversight on the affairs of the company. They must not only constantly ask questions and seek information to their reasonable satisfaction from management, but they are also required to get to the bottom of issues raised as red flags. The discharge of such duties by the board will require the establishment of open channels of communication and information flow between the board, especially non-executive directors, and the management. Given that board and committee meetings are likely to be held virtually, governance practices such as advance notice of meetings, sharing of agenda and board papers, and the faithful depiction of the proceedings (including objections from specific directors) in the minutes gain utmost importance.

Corporate Governance in the Age of a Pandemic *continued*

Corporate governance pundits have also debated about the possibility that companies may establish a crisis management committee to help the company steer through the vagaries presented by COVID-19. While the utility of such a committee is understandable, individual companies may embark on such an effort depending on the specifics of their situation. Ultimately, whether or not such a committee is constituted, the board of directors as a whole bears the legal responsibility for decisions taken.

A few specific risks have come to the forefront that boards must consider in their decision-making. The first relates to internal controls, where traditional means are palpably inadequate because employees, including those handling the financial affairs of the company, are working remotely. Companies will have to swiftly implement emergency measures to address financial oversight under the supervision of the audit committee. Failing this, companies could suffer from significant risks, as a crisis tends to create a perfect storm setting for financial chicanery. The second relates to cybersecurity, which is understandable as several corporate functions, including board interactions, are taking place using technology. Cyber threats and vulnerabilities have magnified in the wake of COVID-19, which requires companies that are not yet in a state of preparedness to put in place appropriate measures speedily. Third, during a pandemic the risk that one or more of the key managerial personnel may fall ill cannot be overstated, as is the importance of succession planning.

Stakeholder Engagement

Directors of Indian companies bear a duty, enshrined in section 166 of the Companies Act, to act in the interests of the company, its shareholders, employees, and the community. They must also act with "due and reasonable care, skill and diligence and shall exercise independent judgment." As the saying goes, "sunshine is the best disinfectant." A vigorous communications strategy will compel boards to identify and address existing and impending risks that the company and its stakeholders encounter.

To begin with, shareholders bear the financial brunt in crisis settings. As Chairman Jay Clayton and Director William H. Hinman of the US Securities and Exchange Commission noted, shareholders "are thirsting to know where companies stand today and, importantly, how they have adjusted, and expect to adjust in the future, their operational and financial affairs to most effectively work through the COVID-19 health crisis." This makes constant communication and engagement with shareholders crucial. Here, historical information mandated by legal rules and accounting standards can go only so far. Shareholders would be keen to know the board's assessment of the risks the current situation presents and, more importantly, the steps it has put in place to address those risks. Directors' duties tend to operate across time horizons. Corporate law generally expects directors to adopt a long-term perspective, but existential scenarios such as an imminent insolvency may necessitate a response steeped in the immediacy. Flexibility, adaptability and dynamism are the need of the hour.

While SEBI is yet to mandate specific COVID-19 disclosures, companies would be well-advised to make them regardless in the spirit of disclosures pertaining to material events. Board oversight to ensure the accuracy of these disclosure is ever more critical in these circumstances. Similarly, the board's engagement with large institutional investors too would be meaningful, subject of course to insider trading considerations. Companies with limited or no promoter control, whose shares suffer from undervaluation, could be susceptible to influence from activist investors, or even hostile takeovers, which their boards need to be cognizant of.

Corporate Governance in the Age of a Pandemic *continued*

As Indian corporate law adopts a stakeholder-oriented tone, the interests of non-shareholder constituencies cannot be ignored. Remote working and the associated physical isolation create insecurities among employees. In order to assuage their concerns and their health and safety, boards would do well to go above and beyond their established roles and reach out to motivate employees by "setting the tone at the top." Communication with creditors becomes paramount in companies facing severe financial strain. Complete transparency with key suppliers and customers regarding the company's strategy to mitigate the risks they may face will enable the continued maintenance of these crucial relationships.

Conclusion

In all, despite several regulatory relaxations, directors continue to be bound by their fiduciary obligations owed to their companies to address the interests of various stakeholders. Apart from discharging these duties in the most uncertain of economic circumstances the world has witnessed in recent times, their task has been made more daunting by limitations to human interaction. The lessons from prolonged social distancing might even call for companies to begin establishing or strengthening "board continuity plans" to safeguard enduring and effective corporate leadership in times of a crisis.

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As experts noted, the amendments adopted pursuant to the Kotak Committee's recommendations "limit promoter governance" with respect to related-party transactions by mandating that no related party may vote to approve any related party transactions whether the entity is a related party to the particular transaction or not, and that the board both create a policy for dealing with material related party transactions and make biannual disclosures of related party transactions to the stock exchanges.[73]

Although the Kotak Committee's recommendations were generally well received, there were some concerns and criticisms.[74] The approved recommendations and subsequent amendments have only been made applicable to companies that lead in terms of market capitalization, excluding smaller listed entities from compliance requirements.[75] Critics noted, however, that some of the smaller listed entities are the ones most in need of such regulations. Some have also argued that the added compliance requirements ultimately increase the regulatory burden on listed companies and their transaction costs.[76] However, others argued that the committee's recommendations and SEBI's amendments to the listing regulations were steps in the right direction for the Indian securities markets at large because increased transparency, accountability, and regulatory oversight benefit all shareholders, regardless of size.[77]

The following chapters discuss at greater length the various facets of the corporate governance regime in India as it stands today. Even after the amendments to the SEBI Listing Regulations subsequent to the Kotak Committee recommendations, SEBI continues to review the regulations on an ongoing basis. Similarly, the MCA has continued refining the rules adopted pursuant to the Companies Act. With the changing landscape of the

73 Vijay Parthasarathi and Rohit Tiwari, "April 2019 – Dawn of a New Era in India Corporate Governance?," *India Corporate Law Blog*, Cyril Amarchand Mangaldas, March 14, 2019.

74 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86, 92.

75 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86, 92.

76 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86, 92.

77 Zala, "A Study of Kotak Committee Report on Corporate Governance," 86, 92.

securities markets, corporate governance norms need to be suitably amended to safeguard the interests of all stakeholders.

Key Takeaways

- As evidenced by the passage of the Companies Act, 2013 and the major amendments to the SEBI Listing Regulations, there is a continuous refinement of standards of corporate governance in India.
- The Kotak Committee considered several aspects of corporate governance, including corporate purpose and stakeholder interests, and focused on the business realities of Indian corporations, including the impact of promoter dominance.
- Corporate governance norms will continue undergoing changes to adapt to and fulfill the needs of the dynamic securities markets.

CHAPTER TWO

Concentrated Ownership and Control in India

Origins, Trends, and Directions

Concentrated ownership with operational control of the corporation is the generally prevalent model of ownership around the world, including in India.[1] The two notable exceptions are the United States and the United Kingdom, where a majority of public companies are widely held and where institutional investors play a powerful role.[2]

Concentrated ownership, including by business families, has the benefits of entrepreneurial drive and long-term commitment to the corporation. However, it may also bring enormous opportunities for self-dealing and other forms of tunneling in favor of the controlling shareholders, to the detriment of minority shareholders. The regulatory challenge, therefore, is how to balance the positives and negatives in ways that can capture market confidence, approbation, and reward.

This chapter traces the origins and the current state of concentrated ownership and control in India and outlines some of its major benefits and key challenges.

How Did We Get Here?

Concentrated ownership, often referred to as promoter control, is quite widespread in India.[3] The following is a brief discussion of some of the key contributing factors to this phenomenon.[4]

THE LEGACY FACTOR

Several structural changes in the late 18th to early 19th centuries laid the foundations for the proliferation and entrenchment of concentrated ownership in India. English agency houses were licensed by the company to engage in independent trade and other business activities. This gave rise to the system of managing agencies, arguably unique to India. Initially British owned but later Indian owned as well, managing agencies were the prime drivers for promoting, operating, and controlling business enterprises.[5] In consequence, the concept of group control in business operations and management proliferated, with the potential for amassing private benefits of control while requiring very little equity investment.

For more than a hundred years, the managing agency system was the dominant form of business enterprise in India, covering a significant range of companies, industries, and locations. However, by the second and third generations of controlling families, the system was corrupted due to interlocking ownership and directorates, intercorporate investments and loans, siphoning of funds through commissions, and other undesirable practices.[6] This led to stringent legislative control and the managing agencies' eventual demise, as initiated by the Companies Act, 1956.

The transition from the managing agencies era to a domestic, ethnocentric, conglomerate culture was quite smooth. British managing agencies had long developed close working relationships with many Indian business families.[7] After the transition, a large majority of companies previously controlled by managing agencies continued to remain closely clustered and controlled

1 This chapter is adapted from the contribution of Professor Bala N. Balasubramanian in the first edition of the *Handbook on Corporate Governance in India*. We honor Professor Balasubramanian, a leading scholar of corporate governance in India, and mourn his loss.

2 Even in the United States, however, some very large companies, such as Facebook, have controlling shareholders. Zohar Goshen and Assaf Hamdani, "Corporate Control and Idiosyncratic Vision," *Yale Law Journal* 125, no. 3 (2016): 560.

3 Bala N. Balasubramanian and Anand Ramaswamy, "Ownership Trends in Corporate India 2001-2011: Evidence and Implications," IIM Bangalore Research Paper No. 419, July 30, 2013; Tarun Khanna and Krishna Palepu, "The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry," in *The History of Corporate Governance Around the World: Family Business Groups to Professional Managers*, ed. Randall Morck (Chicago: University of Chicago Press, 2005), 284-303.

4 For a detailed history of this legacy, see N. Balasubramanian, *Corporate Governance and Stewardship* (Noida: Tata McGraw-Hill Education Private Limited, 2010), 328-31, 359-66; Dwijendra Tripathi, *The Oxford History of Indian Business* (New York: Oxford University Press, 2004), 44-58; Kamala Gollakota and Vipin Gupta, "History, Ownership Forms and Corporate Governance in India," *Journal of Management History* 12, no. 2 (2006): 185-92.

5 For a detailed discussion of the history of managing agencies in India, see Blair B. Kling, "The Origin of the Managing Agency System in India," *The Journal of Asian Studies* 26, no. 1 (November 1996): 37; Balasubramanian, *Corporate Governance and Stewardship*, 328-31, 359-66.

6 Balasubramanian, *Corporate Governance and Stewardship*, 329.

7 For example, the financial muscle and local knowledge and contacts of the Marwaris, especially in Calcutta, became indispensable to the British managing agency houses that were seriously strapped for funds after the depression years, and looked to the Marwari community for financial support. Over a period, many British managing agencies and their managed companies had to accommodate Marwari businessmen on their boards as directors. Gijsbert Oonk, "Industrialisation in India, 1850-1947: Three Variations in the Emergence of Indigenous Industrialists" (research paper, Erasmus University Rotterdam, 2004), traces these developments in Calcutta (Marwaris), Bombay (Parsis), and Ahmedabad (Gujaratis). Omkar Goswami, "Then Came the Marwaris, Some Aspects of the Changes in the Pattern of Industrial Control in Eastern India," *The Indian Economic and Social History Review* 22, no. 3 (September 1985); Omkar Goswami, "Sahibs, Babus, and Banias: Changes in Industrial Control in Eastern India, 1918-50," *The Journal of Asian Studies* 48, no. 2 (May 1989); Maria Misra, *Business, Race, and Politics in British India, c. 1850-1960* (New York: Clarendon Press Oxford University, 1999).

by a single family or other tight-knit concentrated ownership groups. During the second half of the twentieth century, the permissive financing environment and the government's no-destabilization-of-incumbent managements policy further consolidated the families' and groups' controlling positions.[8] Furthermore, due to perceived uncertainties following independence, several British managing agencies chose to exit the country, and their businesses were available to Indian entrepreneurs. Most of these agency houses had already developed decades-long close contacts with Indian business houses, and therefore passing on their entire stakes seemed to be an easy and efficient option. In the case of the Indian managing agency houses, the transition was even smoother.

THE PATRONAGE FACTOR

Many Indian businessmen, among them Ghanshyam Das Birla, Jamnalal Bajaj, and Ambalal Sarabhai, had been close to Mahatma Gandhi and the political leadership during India's struggle for independence from British rule. When the same individuals (except Gandhi, who never took any office of state power) became national leaders post-independence, the previously formed relationships played an important role in shaping India's industrial and developmental policies. As a result, networking with politicians and bureaucrats became a core competence to ensure commercial success, which in turn made such business families attractive partners for foreign corporations looking to enter the Indian market.

Of course, patronage was not an entirely new phenomenon post-independence. The Tatas had previously enjoyed benefits from their patronage of the British, who favored the anglicized Parsi community with government contracts and support.[9] The fine art of patronage and networking was developed and used to great advantage in the 1970s and 1980s by the Ambani group.[10] The game continues to be played to devastating effect even in the current millennium.

THE COMPETENCIES FACTOR

Significant expansions of business activities in some of the dominant ownership groups can be attributed to their expertise and entrepreneurial drive rather than to legacy factors. Some family-owned groups, like the Tatas and Bajaj, adapted to the new environment and continued to succeed even after liberalization. The Tata experience deserves particular mention because, despite their loss of government patronage during the socialist Nehru era, the Tatas nevertheless significantly expanded their businesses.[11] Most of the other promoter groups suffered post-economic liberalization: in 1991, 22 of the top 50 firms were controlled by families that increased their power during the License Raj.[12] By 2000, only four out of the top 50 were run by the older business families, and, of the top 50, 35 were professionally managed, 14 of which were first-generation businesses.[13]

The Birlas were the other group that prospered despite criticism that they were squatting on licenses and preempting others' entry into their businesses. Scholars Khanna and Palepu, referring to the fallout of what was seen by the Birlas as unfair allegations, document the group's expansion plans to overseas locations.[14] Between 1970 and 1995, the Birlas established plants in Egypt, Indonesia, Malaysia, the Philippines, and Thailand, with overseas activity accounting for a third of their overall business. Furthermore, the Birlas' world-leading position in viscose staple fiber, palm oil, and insulators, and their world sixth-largest position in the manufacture of carbon black, can be primarily attributed to the group's entrepreneurial capabilities.[15]

THE INSTITUTIONAL FACTOR

It has also been suggested that India's lack of venture capital institutions and developed capital markets significantly contributed to the growth and sustenance

8 Balasubramanian, *Corporate Governance and Stewardship*, 330.

9 Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 296.

10 Hamish McDonald, *The Polyester Prince: The Rise of Dhirubhai Ambani* (Crows Nest: Allen & Unwin Pty., Limited, 1999).

11 Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 284-303, 289.

12 Omkar Goswami, "The Tide Rises, Gradually: Corporate Governance in India," 10, (paper, OECD Development Centre Informal Workshop on Corporate Governance in Developing Countries and Emerging Economies, Paris, France, April 3-4, 2000).

13 Goswami, "The Tide Rises, Gradually: Corporate Governance in India."

14 Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 297.

15 Gurcharan Das, *India Unbound: From Independence to The Global Information Age* (Penguin Books India, 2000), 176.

of concentrated ownership of Indian firms. One example is the Tata group's forays into various new business ventures. During the period from 1870 to 2001, the group entered textiles (1874), the hospitality industry (1902), steel (1907), power (1910), cement (1912), soaps and toiletries (1917), printing and publishing (1931), aviation (1932), chemicals (1939), consumer electronics (1940), commercial vehicles and locomotives (1945), cosmetics (1952), air conditioning (1954), pharmaceuticals (1958), tea and coffee (1962), information technology (1968), watches and financial services (1984), auto components (1993), telecom services (1994), passenger cars (1998), retail (1999), and insurance (2001).[16] Despite the remarkable diversity of these businesses, the group has maintained a leading position in most of the businesses it entered. In virtually every one of these unrelated expansions, group companies with funding potential have contributed to the expansion.

In addition to stepping into intermediary roles during times of institutional instability, dominant families and groups arguably helped support entrepreneurial aspirations of their own kith and kin by providing them with financial, moral, and business backing. Many of the latter-day business empires owe their origin and growth to such initial support from dominant families and groups.

Entrenching Dominant Ownership

Certain policies also unexpectedly contributed to concentrated ownership in India. Several well-meaning policy and regulatory measures, aimed at rapid industrialization and development, in practice had the collateral effect of promoting and preserving concentrated ownership and control. The following discussion addresses three such policy areas in the decades following political independence in 1947: (1) capital market development and control; (2) corporate protectionism; and (3) development finance.

Capital market development and control. The enormous expansion of the Indian stock markets was a major development of the 1970s Indian capital market landscape. The Foreign Exchange Regulation Act, 1973 (FERA), which essentially required all foreign-owned and -controlled businesses to incorporate themselves as corporate entities under Indian company law, was the significant driver of this expansion.[17]

One significant regulatory change of the FERA was that noncore businesses (which included most foreign businesses) could not have foreign ownership of more than 40 percent of the equity capital of their companies.[18] If their foreign ownership was higher, they had to reduce it to 40 percent or less within an agreed time frame set by the Reserve Bank of India, or close down their business operations.[19] This dilution of ownership was to be achieved by issue of new capital or by offering for sale their "excess" shareholdings to local Indian investors, at valuations decided upon by the Controller of Capital Issues, a Union Ministry of Finance authority.[20]

To broaden the base of the Indian stock markets, one of the conditions for such offers of dilution was that there should be at least 20 investors for every INR 1,000 of face value of the equity offered. The inevitable result was a wide dispersal of shareholdings among thousands of shareholders, each with very small shareholdings. This was an unmitigated advantage to controlling shareholders. It effectively disenfranchised substantial proportions of the voting rights within the company, because it was unviable for minority shareholders to participate in the affairs of their companies. Thus, controlling shareholders only had to manage their block shareholders, usually state-owned or -controlled development financial institutions and investment corporations. Similar to the post-Independence period, this was best done by cultivating strong networking relationships with the appropriate political and bureaucratic powers.

A second initiative that facilitated concentrated ownership was the government's approach to joint ventures and partnerships involving multinational entities. As foreign ownership generally could not exceed 40 percent, and

16 Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 298.

17 Foreign Exchange Regulation Act (1973).

18 Balasubramanian, *Corporate Governance and Stewardship*, 330.

19 IBM and Coca-Cola were the two high-profile businesses that shut down and exited the country at this time, not willing to bring down their ownership to 40 percent or less. Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 305.

20 The valuations were often the subject of protracted negotiation between the companies and the government and more often than not were beaten down to levels substantially below their real worth, a factor that made the equity offerings most attractive to Indian investors.

yet participation as a minority shareholder with the Indian partner holding the majority 60 percent was not always an acceptable alternative, a compromise formula was born. This formula ensured an at least equal shareholding to the Indian (40 percent) and foreign partners (40 percent), while the remaining 20 percent was held by external minority shareholders through a public offering.[21] Given the apathy of this group of minority shareholders, there was little fear of any interference or dissonance from them.

In order ostensibly to protect Indian businesses from predatory foreign investors, a further impetus for the proliferation of concentrated ownership structures was developed. If a foreign partner in a joint venture were to set up its own entities with full ownership (or higher shareholding than in the joint venture), the foreign investor had to obtain a no-objection letter from the Indian partner (but not from the other minority shareholders).[22]

Corporate protectionism. Another policy initiative of the government, which had the unstated goal of protecting incumbent Indian management—especially those close to the political powers of the time—from potential takeovers by foreign investors, further strengthened the institution of concentrated ownership. This was usually achieved through voting support by the government-owned financial institutions that held block shares in such corporations. These government-owned institutions acted in concert with each other, even holding regular inter-institutional meetings to decide investments and other matters such as voting on important resolutions at company meetings, in order to help incumbent or other desired managements to retain or acquire control of their assisted corporations. The following excerpt illustrates the manner in which incumbent management entrenchment was tacitly encouraged and supported by the state.

> In 1984, long before the liberalization of the Indian economy or the promulgation of the Takeover Code, British businessman [now Lord] Swaraj Paul attempted to unilaterally take control of two Indian corporations, Escorts Limited and DCM. Although he accumulated more than the promoters of each corporation (roughly 7.5 percent and 13 percent stakes in Escorts and DCM, respectively), the two companies resisted his takeover attempts and each blocked the transactions by refusing to register Paul's newly purchased shares. The promoters used their political clout against Paul, despite his personal ties to Prime Minister Indira Gandhi. Paul was also opposed by The Life Insurance Corporation of India, a state-owned financial institution that held a minority stake in the companies. Paul finally retracted his bid. Although unsuccessful, Paul's hostile threat sent shockwaves through the otherwise complacent Indian business world.[23]

Development finance. Post-independence, India's banks played an important developmental role, with the high availability of debt capital for investment opportunities. As discussed above, the FERA in 1973 forced foreign investors to dilute their holdings in many cases to less than 40 percent. As an alternative, foreign investors partnered with established business houses as well as with institutional shareholders. A regime of licenses and permits that thrived on political patronage and discretionary power further added to the entrenchment of well-connected families and groups taking control of a large number of businesses, often with a relatively small equity holding.[24] Development banks and investment institutions, owned or influenced by the government, became block holders in a multitude of corporations, partly by investing in the equity and often by exercising their option to convert part of their debt offerings into the borrowers' equity. Subsequent policy initiatives to generally not destabilize incumbent managements foreclosed any possibilities of a market for capital control and contestability.

21 Balasubramanian, *Corporate Governance and Stewardship*, 351.

22 Popularly known then as Press Note No. 18, this provision aimed to protect the incumbent joint venture's interests but in practice it was interpreted to require a no-objection letter from the Indian company. This effectively meant that the Indian partner (but not the other minority shareholders) came to enjoy valuable veto rights. This was strongly resented by foreign investors and led to modifications in recent years. Balasubramanian, *Corporate Governance and Stewardship*, 352. This requirement has now been fully removed.

23 Shaun J. Mathew, "Hostile Takeovers in India: New Prospects, Challenges and Regulatory Opportunities," *Columbia Business Law Review 2007*, no. 3 (2007): 811-12. Current Indian law highly constrains the ability of a target company to refuse to register shares. Companies now may not refuse to register shares unless the transfers are adjudged in violation of law and their voting rights are suspended by the Company Law Board.

24 Debt: Equity ratios of two to one were the order of the day, irrespective of the riskiness of the business; in fact, the riskier the business, the higher the permitted financial leverage on the grounds of encouraging capital-intensive, high-risk projects to foster industrial development.

The legal system was weak, and suffered enormous delays in the administration of justice. Investor protection measures were not fully implemented, and shareholder democracy was more of a concept than a practice. All these enabling factors contributed to the propagation, entrenchment, and continuance of the institution of concentrated ownership in India.

Increasingly, in the post-deregulation years since 1991, political and public policy attitudes appear to have softened considerably on matters like concentration of economic power. Family-controlled corporate groups appear assured of undisturbed continuance and growth. Recent studies show that more than half of the 32 firms that were listed in the NSE NIFTY Index in 2006 and also in 2013 showed shareholder patterns where insiders continued to own a majority of the shares.[25] Between 2006 and 2013, almost two-thirds of these 32 NIFTY firms (81 percent of which were promoter controlled rather than government controlled) saw increases in promoter concentration levels over this time period.[26] And in fact, almost four out of five NIFTY firms have inside ownership levels greater than 30 percent, which likely conveys effective control over the company, given the challenge of coordinating governance activity among dispersed minority investors.[27] Moreover, societal acceptability and political encouragement seem to have turned back in their favor as they are seen to contribute to a globally competitive and international-sized India Inc.

The Pros and Cons of Promoter Control

Concentrated ownership and control is often seen as detrimental to the interests of other noncontrolling shareholders, with controlling stockholders seen as "opportunistic actors who seek to reap private benefits at the expense of minority shareholders."[28] However, concentrated ownership has persisted around the world because it also creates value for both controlling and other shareholders.[29] Furthermore, concentrated ownership can create advantages not just for other minority shareholders but also for the government. The government has been seen to use the mechanism to promote policy objectives of development and growth and as an instrument of rent extraction for party and political purposes.

ARGUMENTS IN SUPPORT OF CONCENTRATED OR PROMOTER CONTROL

Improved focus on corporate performance. An individual businessperson or a managing owner or partner is likely to be more rigorous and committed in running operations to maximize profits, since he or she directly benefits from improved performance and is equally affected by poor performance. This kind of entrepreneurial drive leads to meticulous attention to detail and strict surveillance over potential unacceptable wastages and leakages, in contrast to professionally managed enterprises, where the direct adverse impact on the managers cannot be personally felt or experienced. In the context of the global financial meltdown of 2007–08, firms with large shareholders did not experience worse stock returns compared to those with institutional block holdings. This illustrates how firms with large shareholders (in other words, with concentrated ownership) handled high-risk businesses with caution and care, in stark contrast to the behavior of firms with diversified ownership and consequent dependence on executive management.[30]

There is a sizable body of research that suggests a favorable correlation, internationally, between concentrated ownership and corporate performance. And some research finds that family-owned businesses "may outperform nonfamily businesses" at least until succession to the next generation of family ownership.[31] Promoter ownership tends to translate into tighter control on costs and improvement in revenues and overall profitability. The potential downside, of course, is that such control offers opportunities for tunneling and other private benefits of control. However, the probability of limiting the extent of such diversion improves with increasing promoter equity holding, since that leads to a mitigation of the gap between their cash flow rights

25 George S. Geis, "Shareholder Power in India," in *Research Handbook on Shareholder Power*, ed. Jennifer G. Hill and Randall S. Thomas (Cheltenham: Edward Elgar Publishing, 2015), 592, 598.

26 Geis, "Shareholder Power in India," 592, 599, 609.

27 Geis, "Shareholder Power in India," 592, 598.

28 Goshen and Hamdani, "Corporate Control and Idiosyncratic Vision," 560.

29 Goshen and Hamdani, "Corporate Control and Idiosyncratic Vision," 560.

30 David Erkens, Mingyi Hung, and Pedro Matos, "Corporate Governance in the 2007-2008 Financial Crisis: Evidence from Financial Institutions Worldwide," *Journal of Corporate Finance* 18, (April 2012): 318-411.

31 Benjamin Means, "The Value of Insider Control," *William & Mary Law Review* 60, no. 3 (February 2019): 894.

and control rights. The Indian experience is no different: there is some evidence that "higher Indian promoters' ownership leads to higher corporate performance."[32]

More stable and longer-term commitment to performance and growth. A major concern often highlighted in corporate performance is that managers tend to emphasize short-term, quarter-on-quarter growth metrics, which are almost invariably driven by market expectation and peer performance pressures on the one hand, and their close connectivity to managerial compensation and performance bonuses on the other hand. Firms controlled and run by professional executives tend to be more vulnerable to undesirable initiatives that prioritize short-term strategies over long-term company growth than those controlled and run by promoter shareholders. Promoter shareholders are generally in business for the long haul and aim to bequeath their businesses to succeeding generations of family members. Theoretically, much of the same logic should apply to nonfamily promoter groups, like multinational corporations (MNCs) and the government in the case of state-owned enterprises (SOEs) as well, but in practice, changes in personnel in the case of MNCs, and of political formations and bureaucracies in the case of SOEs, may well impair the longer-term survival or growth of the corporations.[33] (See "Public Sector Units and Central Public Center Enterprises," p. 41.)

Looked at from a different standpoint, promoter holdings in companies in business groups may also signal stability of the companies, as well as their promoters. Khanna and Palepu have argued that stability was doubtful, as indicated by the churn in the top 50 groups between 1966 and 1997, with 43 in the former dropping out of the latter listing.[34] On this basis, they also concluded that the potential for entrenchment in India was not great. This view has since been contradicted, with corrected evidence suggesting that 43 out of the original 50 groups were still operational in 1997, although in many cases, splits within the family have led to different subdivisions of the same original group.[35] This latter view seems to be justified intuitively as well, considering the continuing entrenchment and further growth of family groups in the country.

Reputational support for innovative and risky businesses. Concentrated ownership also benefits from the positive reputation of developing in-house venture capitalism and incubatory support that has successfully spawned new and often risky business ventures that developed into viable entities in the course of time. It has been credited with filling the void in the system due to the absence of specialist financial intermediaries to address such needs.[36] Promoter control provides both a reputational platform and the wherewithal in terms of financial, managerial, and risk-tolerance capabilities that would be difficult to match by stand-alone entrepreneurs. The expansion and diversification of home-grown business groups (illustratively, the Tatas, Birlas, Ambanis, Murugappas, Mallyas, Adanis, Ruias, Jindals) in India over the last century and a half can, for the most part, be attributed to the parenting advantage provided by the promoters.

Financial support for incubation and nurturing of group businesses by the promoter entities is substantially achieved through underwritten borrowings and intercorporate investments, and not necessarily by equity holdings alone.[37] Empirical evidence suggests that promoter individuals and families usually finance only a small percentage of their large companies, and these continue to get smaller as the companies get larger. Intercorporate loans from group companies, guarantees, and "comfort" letters for group company borrowings are the usual routes to finance subsidiaries and affiliates that cannot fund themselves on their own. Although such mechanisms (often frowned upon and also controlled by corporate legislation) do not offer enhanced cash flow

32 Parmjit Kaur and Suveera Gill, *The Effects of Ownership Structure on Corporate Governance and Performance: An Empirical Assessment in India*, National Foundation for Corporate Governance, 2009.

33 In overseas operations through subsidiaries and joint ventures, the host country firms prosper so long as their champions at headquarters continue, but a change of guard, not unusual in such corporations, may alter the fortunes of the subsidiary or affiliate. Similarly, a change in the political party in power or even a reshuffle of ministers or key bureaucrats may bring about realignment of priorities and recalibration of policies that might unfairly impact the corporation.

34 Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 289-94.

35 Surajit Mazumdar, "The Analysis of Business Groups: Some Observations with Reference to India," Institute for Studies in Industrial Development Working Paper No: 2008/11, December 2008, pp. 18-20.

36 Khanna and Palepu, "The Evolution of Concentrated Ownership in India," 298-302.

37 Mazumdar, "The Analysis of Business Groups: Some Observations with Reference to India," 9-13.

rights to the promoters, these nontraditional finance mechanisms do give the promoters disproportionate control rights over group assets and related private benefits. Nevertheless, such entrepreneurial initiatives are also positive aspects of promoter-controlled businesses and tend to command a reputational premium as well.

THE CONS OF CONCENTRATED OR PROMOTER CONTROL

The benefits of concentrated ownership must also grapple with the several negatives that it entails: greater opportunity for tunneling through related party transactions, exploitation of private benefits of control, and expropriation of corporate opportunities, to name a few. The potential for such initiatives can potentially be contained (but not wholly eliminated) with higher levels of investor protection regimes. Although in recent years investor protection measures have been strengthened in India, more still needs to be done. In the meantime, as in other emerging economies, Indian investors continue to be vulnerable to exploitation by the less-than-scrupulous elements in the corporate sector.

Corporate opportunities. One of the several benefits of business group promoters is the often unfettered freedom to usurp attractive corporate opportunities from one of their group entities and relocate them to another, where their cash flow rights are more favorable. This can also work in the reverse direction, where unsuccessful ventures are relocated in entities with lower promoter cash flow rights. When directors sit on several boards of companies that compete with each other, most of their judgements would presumably be tilted in favor of the entities that provide them higher cash flow rights. Often categorized as a "parenting advantage" in a business and strategic policy context, such decisions offer the promoters the temptation to transfer potential business profits from where they rightfully belong to where they most benefit the promoters. It has also been observed that many business groups have promoted a clutch of unlisted satellite subsidiaries or affiliates to facilitate intragroup maximization of cash flow and control rights to the promoters. This generally happens within the framework of legal provisions but often without offering any disclosures or inviting unsolicited attention by outsiders.[38]

Tunneling. There is substantial research support to indicate widespread prevalence of tunneling among business groups in India.[39] Given the opaque nature of the activity, hard evidence is difficult to come by, and most research efforts tend to read between the lines of publicly available information. Bertrand et al. tracked the effect of shocks on different entities within the group and found greater impact on entities where promoter holdings are lower than in other entities, many of them higher in the hierarchy from the top where the holdings were larger.[40] Mazumdar makes the point that the extent of tunneling must be much larger than what Bertrand et al. found because much of such diversions would also be routed through unlisted private entities, which were not included in their research sample that covered only listed corporations.[41]

In a later study covering data of 4,517 unique firms from 22 countries across Europe and Asia, Gopalan and Jayaraman confirm high instances of tunneling activities in insider-controlled corporations.[42] Their study reports that such companies operating in low-investor-protection countries are associated with more earnings management than their noninsider-controlled counterparts. In addition, the study found that in such countries, insider-controlled firms with greater divergence between cash flow rights and control rights are associated with more earnings management.

The issue, therefore, is not whether such tunneling potential exists, but rather to what extent and with what degree of success it is exploited and how it may

38 Rao and K.S. Chalapati, *Indian Private Corporate Sector: Some Characteristics and Trends, Company News and Notes*, Ministry of Law Justice and Company Affairs, Government of India, 2007.

39 Mazumdar, "The Analysis of Business Groups: Some Observations with Reference to India," 17-18; Marianne Bertrand, Paras P. Mehta, and Sendhil Mullainathan, "Ferreting Out Tunneling: An Application to Indian Business Groups," Massachusetts Institute of Technology, Department of Economics Working Paper 00-28, September 2000.

40 Bertrand et al., "Ferreting Out Tunneling: An Application to Indian Business Groups."

41 Mazumdar, "The Analysis of Business Groups: Some Observations with Reference to India," 18.

42 Radhakrishnan Gopalan and Sudarshan Jayaraman, "Private Control Benefits and Earnings Management: Evidence from Insider Controlled Firms," *Journal of Accounting Research* 50, no. 1 (March 2012): 117-57.

be contained. The fact that only a minuscule number of tunneling cases ever get exposed in India, and even then the offending parties get away with insignificant fines and settlements, often in a frustratingly delayed time frame, is indicative of the high success rates of indulging in such unlawful and unethical practices. Regrettably, these efforts are often aided and abetted by compliant directors and even independent auditors, either through active collusion or by convenient indifference (as seems to have happened in the infamous Satyam Computers case).[43]

Containing tunneling activities engaged in by promoters under the circumstances is indeed a big task. Legislation and regulation, when skillfully drafted and rigorously enforced, may help to control unbridled tunneling. Transparency and disclosure accompanied by timely and purposeful regulatory surveillance are helpful building blocks to control unbridled tunneling. To be effective, the respective boards and their independent directors must critically explore such disclosures and ensure that such transactions, when approved, would not adversely affect their companies' and their minority shareholders' interests. In fact, a recently conducted study on corporate governance in emerging markets found that a combination of a well-functioning board and strong disclosure policies can reduce agency conflicts between minority shareholders and insiders and can improve firm decision-making.[44] This study found some evidence that investors react positively to enhanced disclosure.

Institutional block holders and corporate tunneling. While much of the research and investigative interest has been focused on tunneling by promoter groups, institutional and block investors have also played a notable role, both in acquiescence and participation (albeit more as conduits for pass-through benefits to their own controlling shareholders). In the Indian context, major institutional block holders (individually and also collectively) are government owned and/or controlled development banks and investment institutions. There is little transparency in the internal processes that determine their voting positions on key issues at board and members' meeting of their investee companies. Given the nexus between and among leading business houses, the political establishment, and the bureaucracy, promoter groups may often find it more efficient to lobby for support on key issues coming up for voting and have those decisions communicated to the financial institutions for necessary implementation. That leaves the boards, directors, and executive management of such institutions open to criticism for not considering the larger interests of the respective companies, as well as the interests of key stakeholders, such as bank customers, insurance policy holders, mutual fund unit holders, and so on. To this extent, it appears that the institutional investors tacitly collude with promoters on their tunneling initiatives for the benefit of their own shareholders, which in this case is the state and its political and administrative functionaries.

Private benefits of control are extracted in numerous ways, but among the most unique mechanisms is the manipulation of nonoperating cash flows of group entities. In this respect, there does not appear to be any distinguishable difference between the private sector business groups and the government in respect to state-owned enterprises. The buyback of capital using corporate funds, even when promoters are not participating in the scheme, and thus passively enhancing their holding percentages without any matching cash investments; using company funds to acquire shares in other group entities to facilitate controlling shareholders' financial needs;[45] price preferences in purchasing from group entities; and administered prices mandated

(*continued on p. 44*)

43 For a detailed case study, see N. Balasubramanian, *A Case Book on Corporate Governance and Stewardship* (New Delhi: Tata McGraw-Hill Education Private Limited, 2011), ch. 4.

44 Bernard Black, Antonio Gledson De Carvalho, Vikramaditya Khanna, Woochan Kim, and Burcin Yurtoglu, "Which Aspects of Corporate Governance Do and Do Not Matter in Emerging Markets," European Corporate Governance Institute Working Paper No. 566/2018, November 2019, p. 3.

45 A classic example was the cross-buying of equity shares held by the government in three public sector corporations in the oil industry in 1998 to 1999. ONGC and IOC bought 10 percent of each other's equity being held by the Government; ONGC and IOC each bought 5 percent of Government equity in GAIL; and GAIL bought 2.5 percent in ONGC. Transactions were at market prices with no premium. The objective was to help out government finances by partially augmenting disinvestment receipts, which were languishing at that time. Despite being listed companies, no shareholder approvals for this strategy of cross-holdings were deemed necessary. *Merger and Acquisition of Oil and Gas Companies, Forty-Second Report*, STANDING COMMITTEE ON PETROLEUM AND CHEMICALS (2003), Thirteenth Lok Sabha (May 2003).

Corporate Governance Challenges of the Tata Group

The Tata Group's corporate governance challenges came to light when Tata Sons Limited, the holding company of the Tata group of companies, released a statement in October 2016 indicating that the board had replaced Cyrus Mistry as chairman after his four-year tenure.[a] In this statement, the board also indicated that the previous chairman of Tata Sons, Ratan Tata, would be taking over in the interim "in the interest of stability and continuity so that there is no vacuum."[b] Ratan Tata is the chairman of Tata Trusts, the charitable groups that own roughly two-thirds of Tata Sons.

At the time of Mistry's removal, little was known as to the reasoning behind this decision. However, it became clear that Tata Trusts was the driving force, as principal shareholders lost confidence in Mistry because they believed that Mistry had departed from "the culture and ethos of the group."[c] Although this explanation is ambiguous, certain factors related to Mistry's performance point to the potential motives behind his removal. Tata Power, one of the group's companies, acquired Welspun Renewables Energy in June 2016, revealing to the board that Mistry made decisions on his own rather than collectively.[d] Mistry also requested that the Tata group of companies no longer engage with the Shapoorji Pallonji group of companies to "avoid any perception of a potential conflict of interest," which became an additional point of contention between Mistry and Tata.[e] Furthermore, principal shareholders with Tata Trusts felt that Mistry's strategic plan lacked any sort of concrete direction, making it difficult to maintain faith in his leadership.

In response to being ousted, Mistry wrote a letter to both Tata Sons and Tata Trusts expressing his disbelief over their decision. His letter highlighted corporate governance issues at the firm and suggested that an accurate valuation of some businesses could result in a write-down of INR 1.18 lakh crore.[f] Mistry defended his term throughout the letter, claiming that he had inherited many of the issues the company was facing, and had made the decisions he had to in the moment.

When Mistry was appointed chairman of Tata Sons, he was simultaneously appointed to the board of numerous Tata Group companies. Following his removal, Ratan Tata appealed to his shareholders to remove Mistry from the boards of these companies, contending that Mistry's presence would be significantly disruptive and ineffective.[g] Mistry initially refused to step down from the boards of these companies, creating an even greater rift.[h] However, in December 2016, Mistry gave up his board positions at Tata Motors, Tata Steel, Indian Hotels Co., Tata Chemicals, and Tata Power.[i] These companies all had forthcoming shareholder meetings scheduled to discuss Ratan Tata's call to remove Mistry.[j]

a Aveek Datta, "Tata vs. Mistry: The Inside Story," *Forbes India*, November 7, 2016.

b Datta, "Tata vs. Mistry: The Inside Story."

c Datta, "Tata vs. Mistry: The Inside Story."

d Oommen A. Ninan, "Conflict of Interest Led to Cyrus Mistry Removal: Ratan Tata," *Hindu*, June 4, 2017.

e Ninan, "Conflict of Interest Led to Cyrus Mistry Removal: Ratan Tata."

f Datta, "Tata vs. Mistry: The Inside Story."

g Megha Mandavia, "Cyrus Mistry's Presence in Tata Group Boards is Disruptive: Ratan Tata," *Economic Times*, December 8, 2016.

h Mandavia, "Cyrus Mistry's Presence in Tata Group Boards is Disruptive: Ratan Tata."

Corporate Governance Challenges of the Tata Group *continued*

Shortly after Mistry's removal, the independent directors of Tata Chemicals, including Nusli Wadia, issued a statement supporting Cyrus Mistry.[k] Tata Sons immediately moved to oust Wadia from the boards of Tata Chemicals, Tata Steel, and Tata Motors in response.[l] Wadia's service on these boards was somewhat of a reciprocal arrangement, as Ratan Tata had served on the board of a Wadia Group company for 33 years.[m] Tata Sons' decision to seek Wadia's removal fueled the rumors that such decisions were made based on personal rather than on professional matters.

Following Mistry's resignation, Mistry family firms Cyrus Investments and Sterling Investment filed suit against Tata Sons at the National Company Law Tribunal (NCLT), alleging mismanagement and oppression of minority shareholder interests at Tata Sons.[n] The filed suit called for proportionate representation for Shapoorji Pallonji Group directors on the Tata Sons board.[o] Given that the Shapoorji Pallonji Group was the largest shareholder in Tata Sons and owned by Mistry's family, Mistry sought to prevent interference by trustees of Tata Trusts in the affairs of Tata Sons. Furthermore, the suit called for stopping the conversion of Tata Sons into a private company to avert the restriction of free share transfer.[p]

In July 2018, the NCLT dismissed Mistry's suit against Tata Sons, claiming that the NCLT found no merit in Mistry's accusations that Ratan Tata and trustee N. Soonawala inappropriately interfered with affairs of the group.[q] The two-member bench further stated that they felt that the board was competent to make the decision to remove Mistry, and could not prevent Tata Sons from converting to a private company.[r] Mistry filed an appeal with the National Company Law Appellate Tribunal (NCLAT), which was admitted and set to be heard in front of a two-judge bench.[s]

On December 18, 2019, the NCLAT announced its ruling, in which they held that Mistry's October 2016 removal was illegal and ordered his reinstatement as executive chairman of Tata Sons.[t] The NCLAT also ordered restoration of his directorships in the holding company as well as in three group companies.[u] The NCLAT set aside the NCLT's previous findings that there was no oppression in the conduct of the board and majority shareholders of the company, and directed that the unsupported and negative comments about Mistry and others be expunged.[v] The NCLAT also deemed illegal the actions taken by Tata Sons in the interim, including the appointment of a new executive chairman.[w] However, in

i Gabriele Parussini, "Cyrus Mistry Resigns from Five Tata Company Boards," *Wall Street Journal*, December 19, 2016.

j Parussini, "Cyrus Mistry Resigns from Five Tata Company Boards."

k *Removal of Independent Directors: A Sword of Damocles*, Institutional Investor Advisory Services India Limited, November 15, 2016.

l *Removal of Independent Directors: A Sword of Damocles*, Institutional Investor Advisory Services India Limited.

m *Removal of Independent Directors: A Sword of Damocles*, Institutional Investor Advisory Services India Limited.

n Mandavia, "NCLT Dismisses Cyrus Mistry's Plea Against Tata Sons," *Economic Times*, July 10, 2018.

o Mandavia, "NCLT Dismisses Cyrus Mistry's Plea Against Tata Sons."

p Mandavia, "NCLT Dismisses Cyrus Mistry's Plea Against Tata Sons," *Economic Times*; National Company Law Appellate Tribunal (Bench, New Delhi), Cyrus Investments Pvt. Ltd. v. Tata Sons Ltd. (July 9, 2018).

q Mandavia, "NCLT Dismisses Cyrus Mistry's Plea Against Tata Sons."

r Mandavia, "NCLT Dismisses Cyrus Mistry's Plea Against Tata Sons."

s Komal Gupta, "NCLAT Admits Mistry Plea, Issues Notice to Tata Sons," *Livemint*, August 29, 2018.

t Umakanth Varottil, "Some Comments on NCLAT's Ruling in the Tata-Mistry Case," *IndiaCorpLaw Blog*, December 23, 2019.

u Samanwaya Rautray, "Tata vs. Mistry: Supreme Court Stays NCLAT Order Favouring Cyrus Mistry," *Economic Times*, January 11, 2020.

Corporate Governance Challenges of the Tata Group *continued*

order to make the transition from the illegally appointed executive chairman back to Mistry seamless, the NCLAT suspended its order to reinstate Mistry for four weeks.[x] The NCLAT order also set aside Tata Sons' decision to convert itself into a private company.[y]

On January 2, 2020, Tata Sons challenged the NCLAT's order on six grounds and sought a stay of the verdict from the Supreme Court.[z] In its petition, Tata Sons stated that the ruling was both baseless and unsustainable.[aa] The company also expressed concerns that the NCLAT order undercut corporate democracy and the rights of current board members, since restoring his directorship was directly contrary to the shareholder vote.[ab] Tata Sons stated that this would set a "dangerous precedent."[ac] The company further cited the fact that Mistry stated that he did not seek reinstatement as executive chairman before the NCLT, because his term had expired in March 2017.[ad]

On January 11, 2020, the Supreme Court stayed the NCLAT's order reinstating Mistry as executive chairman, citing "basic errors" in the NCLAT's observations.[ae] Finally, in September 2020, Mistry announced that the Shapoorji Pallonji Group would be selling its stake in Tata Sons[af] since its separation from the Tata Group was necessary.[ag] In December 2020, the Supreme Court commenced the final hearings for the matter.[ah]

v Suresh Seshadri, "NCLAT's Tata-Mistry Ruling," *Hindu*, December 22, 2019.

w Varottil, "Some Comments on NCLAT's Ruling in the Tata-Mistry Case."

x Seshadri, "NCLAT's Tata-Mistry Ruling."

y Rautray, "Tata v. Mistry: Supreme Court Stays NCLAT Order Favouring Cyrus Mistry."

z "Tata Sons vs. Cyrus Mistry: Boardroom Battle Goes to Supreme Court, What Next," *India Today*, January 2, 2020.

aa "Tata Sons Moves SC Against NCLAT Order on Cyrus Mistry," *National Herald*, January 2, 2020.

ab Prathma Sharma, "Relief for Tata as SC Stays NCLAT Order Reinstating Mistry," *Livemint*, January 11, 2020.

ac "Tata Sons vs. Cyrus Mistry: Boardroom Battle Goes to Supreme Court, What Next," *India Today*.

ad "Tata Sons vs. Cyrus Mistry: Boardroom Battle Goes to Supreme Court, What Next," *India Today*.

ae Sharma, "Relief for Tata as SC Stays NCLAT Order Reinstating Mistry."

af Amritesh Malhan, "Six Degrees of Separation: From Starry-Eyed Start to Messy Finish, the Anatomy of Tata-Mistry Divorce," *Economic Times*, September 25, 2020.

ag George Mathew and Sandeep Singh, "SP Group's Exit from Tata Group: Who Can Buy Its Stake, and How," *Indian Express*, September 24, 2020.

ah FE Bureau, "Final Hearing in Tata-Mistry Feud Begins in Supreme Court," *Financial Express*, December 9, 2020.

Corporate Governance Challenges at Infosys

Infosys CEO Vishal Sikka resigned on August 16, 2017.[a] In his resignation letter, Sikka cited a consistent stream of "distractions and negativity" brought on by those he expected to support him.[b] He further mentioned the structural challenges at Infosys, claiming that they prevented him from spearheading the transformations that were seemingly expected from him.[c] However, a deeper look into these issues reveals corporate governance challenges arising from the relationship between the board and the Infosys founders that had been building for some time.[d]

In February 2015, Infosys acquired Panaya, an Israeli company, for approximately $200 million.[e] Shortly thereafter, an anonymous whistleblower alleged misconduct in the acquisition, claiming that a high severance payment was made to former Infosys CFO Rajiv Bansal, who had not been in favor of the acquisition.[f] This transfer of money apparently served to silence Bansal's views on the acquisition. Additionally, Infosys founder and shareholder (holding 0.39 percent of the company) Narayana Murthy had also outwardly expressed his disapproval of certain board decisions, such as the severance pay to Bansal, the high salary paid to Sikka, and Sikka's spending.[g] The allegations gained enough traction to cause Infosys board–appointed Gibson, Dunn & Crutcher to investigate.[h]

In April 2015, Infosys named Ravi Venkatesan co-chairman of the company and subsequently appointed a three-person panel to "support and advise" Sikka in strategy development and execution.[i] This decision was not well received by Sikka because it symbolized distrust in the company's leadership. However, Sikka received good news in June 2017, when Gibson Dunn submitted their findings of no evidence of misconduct with regard to the acquisition of Panaya.[j]

Less than one month later, Murthy wrote a letter to the board demanding they release the investigation report to the public.[k] This illuminated the preexisting rift between the board and the shareholders. Murthy raised numerous concerns in his letter, expressing concerns that the accused company independently hired a firm to conduct an investigation, highlighting a clear lack of transparency.[l] Murthy suggested that such an internal review ultimately failed to address the whistleblower's concerns in the public eye. Sikka viewed Murthy's call to action as a personal and direct attack on him.[m]

Tensions worsened as Venkatesan, the newly appointed co-chairman, spoke up on corporate governance issues at the company that seemed to paint Sikka in a negative light.[n] A culmination of these events led to Sikka's decision to resign, which he first disclosed to

a "Five Reasons Why CEO Vishal Sikka Had to Leave Infosys," *Economic Times*, August 18, 2017.

b "Why Vishal Sikka Quit as Infosys MD: Full Text of His Resignation Letter," *Economic Times*, August 18, 2017.

c "Why Vishal Sikka Quit as Infosys MD: Full Text of His Resignation Letter," *Economic Times*.

d "Five Reasons Why CEO Vishal Sikka Had to Leave Infosys," *Economic Times*.

e "Panaya: "How One Infosys Acquisition Kicked Off the Big Storm," *Economic Times*, August 18, 2017.

f "Infosys Rules Out Irregularities in Panaya Deal, Severance Pay to Bansal," *Business Standard*, October 24, 2017.

g "Infosys Rules Out Irregularities in Panaya Deal, Severance Pay to Bansal," *Business Standard*.

h "Infosys Rules Out Irregularities in Panaya Deal, Severance Pay to Bansal," *Business Standard*.

i Anirban Sen and Varun Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation," *Livemint*, August 21, 2017.

j Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

k "Panaya: How One Infosys Acquisition Kicked Off the Big Storm," *Economic Times*.

l "Panaya: How One Infosys Acquisition Kicked Off the Big Storm," *Economic Times*.

m Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

n Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

Corporate Governance Challenges at Infosys *continued*

nonexecutive chairman Ramaswami Seshasayee.[o] On the same day, Murthy wrote an email indicating that three executives at the company, including Venkatesan, expressed their opinion that Sikka was not fit to serve as CEO but rather as chief technology officer (CTO) of Infosys.[p] A few days later, Murthy sent a remarkably similar email that notably excluded the information about the executives' statements on the matter.[q] When Sikka formally exited the company, the Infosys board vehemently rejected Murthy's letters and continuous attacks on Sikka.[r] However, the damage had been done, as Infosys's first nonfounding CEO had resigned.

The conflict that led to Sikka's departure from Infosys highlights the importance of striking a balance between the involvement of promoters and the board's independence.[s] On the one hand, industry giants such as Infosys cannot retain their independence if promoters continue to assert their dominance in major decision-making.[t] On the other hand, promoters' status as shareholders entitles them to some level of involvement to ensure that their interests are protected.[u] It is clear that there is a need for a middle ground that prevents over-interference from promoters while also protecting their rights as shareholders.[v]

o Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

p Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

q Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

r Sen and Sood, "The Backstory to Infosys CEO Vishal Sikka's Resignation."

s "Promoter Over-Reach in Corporate Governance—Murthy v. The Board," *The CBCL Blog*, Centre for Business and Commercial Laws, November 19, 2018.

t "Promoter Over-Reach in Corporate Governance—Murthy v. The Board," Centre for Business and Commercial Laws.

u The (Ambiguous) Position of Chairman Emeritus in Corporate Governance," *IndiaCorpLaw* Blog, December 27, 2018.

v "Promoter Over-Reach in Corporate Governance—Murthy v. The Board," Centre for Business and Commercial Laws.

Public Sector Units and Central Public Sector Enterprises

In India, a PSU, also referred to as a public sector enterprise (PSE), is a state-owned business entity. Unlike in some developed markets such as the United States, the United Kingdom, and Canada, PSUs in India maintain an active role in running commercial businesses[a] and are among the largest business entities in India.[b]

Size of the SOE Sector

- Overall, there are 348 central public sector enterprises (CPSEs), of which 249 are operational. Among the operational PSUs, 178 are profitable and 70 operate at a loss.
- Apart from these, there are several state-level PSEs.
- As of March 31, 2019, there were 56 listed and traded CPSEs on the Bombay Stock Exchange (BSE).
- As of March 31, 2019, the market capitalization of CPSEs on the BSE was INR 13,71,116.34 crore, comprising 9.08 percent of the market capitalization of the BSE.

Source: Public Enterprises Survey 2018-2019.

a *Corporate Governance in the Public Sector—The Road Ahead,* KPMG, 2010.

b *Public Enterprises Survey 2018-19: Volume-1,* Ministry of Heavy Industries and Public Enterprises, Government of India, February 2020.

Ideally, PSUs should lead India's corporate governance norms by establishing new policies for accountability and transparency rather than by following the private sector.[c] However, PSUs and especially unlisted PSUs trail the private sector in terms of quickly adopting transparent corporate governance practices.[d]

According to a survey by the Confederation of Indian Industry (CII) and the Institutional Investor Advisory Services (IiAS), corporate governance is "very important" to institutional investors in deciding whether to invest in a target company.[e] In the same survey, PSUs were perceived as having the lowest corporate governance standards when compared with MNCs, promoter-managed companies, and professional companies. While corporate governance for CPSEs is gradually improving, the successful implementation of appropriate corporate governance norms remains a concern. The following section identifies these concerns.

Multiple Interests in State Ownership

PSUs face unique corporate governance issues because the state is the controlling shareholder.[f] Although the state is generally considered a single owner, it does not function as a single unit. For example, while the Government of India is controlling shareholder of the Oil and Natural Gas Corporation, its day-to-day affairs are heavily influenced by the Ministry of Petroleum and Natural Gas.[g]

c Pankaj Sinha and Anushree Singhal, *A Note on Corporate Governance in Public Sector Undertakings in India*, Munich Personal RePEc Archive, August 2012, p. 18.

d *Corporate Governance in the Public Sector—The Road Ahead*, KPMG, 2010.

e *Institutional Investors—Driving Force for Good Governance, A Survey,* National Foundation for Corporate Governance.

f Varottil, *Corporate Governance in State-Owned Enterprises,* NSE Centre for Excellence in Corporate Governance Quarterly Briefing, April 2015, p. 3.

g Varottil, *Corporate Governance in State-Owned Enterprises.*

Public Sector Units and Central Public Sector Enterprises *continued*

The existence of multiple ministries and departments that co-govern each PSU gives rise to considerable dilution of power and also increases the likelihood of competing interests due to the potentially contradictory objectives of the multiple government entities, which in turn may lead to excessive state intervention.[h] For example, PSUs have sold coal or oil below market value to benefit consumers and subsidize public utilities.[i] While subsidized natural resources may benefit the public, the practice of satisfying the government's socio-political aims comes at the expense of minority shareholders' potential financial profits,[j] as seen in the famous case of the TCI investment firm suing Coal India for this exact scenario.[k] As a result, traditional notions of board independence and independent directors do not operate in the same manner for SOEs as they do for private firms, because the board and independent directors must also monitor for the state's political goals and similar interests, which may be less clear-cut than a related party transaction in a privately controlled firm.[l]

h *OECD Guidelines on Corporate Governance of State-Owned Enterprises,* Organisation for Economic Co-operation and Development [OECD], 23 (2015) [hereinafter *OECD Guidelines on Corporate Governance of State-Owned Enterprises]*. The OECD has also issued a draft revision of the guidelines, which is available at *OECD Guidelines on Corporate Governance of State-Owned Enterprises, Draft for Public Comment—May 2014*, Organisation for Economic Co-operation and Development [OECD], (2014).

i Varottil, *Corporate Governance in State-Owned Enterprises,* 3.

j Vikramaditya Khanna and Umakanth Varottil, "Board Independence in India: From Form to Function," in *Independent Directors in Asia: A Historical, Contextual, and Comparative Approach*, ed. Dan W. Puchniak (Cambridge: Cambridge University Press, 2017).

k Varottil, *Corporate Governance in State-Owned Enterprises,* 5; Umakanth Varottil and Richa Naujoks, "Corporate Governance," in *India*: *The Business Opportunity*, ed. Linda Spedding (Lucknow: Eastern Book Company, 2016), 51-53.

l Khanna and Varottil, "Board Independence in India: From Form to Function."

Autonomy and the Board of Directors

"The Government plays the role of regulator, majority shareholder, and manager in PSUs."[m] PSUs can exercise a certain level of autonomy, but only if they have the requisite number of nonexecutive directors on their board.[n] Due to the difficulties in filling nonexecutive director positions, which can be attributable to the government, many PSU executives are unable to meet this condition. Consequently, the government retains extensive formal control of PSUs, which often limits the managements' autonomy in decision-making and subjects them to the influence of political and bureaucratic pressures.[o]

This government control can impede PSUs' attempts to comply with SEBI regulations. For example, listed companies are required to appoint a specific number of independent directors to their executive board.[p] However, the board often does not have a "say in CEO selection, appointment of other directors, and key strategic decisions—instead the concerned Ministry takes the decision."[q] Initially, because of bureaucratic delays involved in the appointment of directors by government entities, many PSUs were not able to meet the SEBI deadline for appointing independent directors.[r]

m Jayanta Mallick, "FIIs Express Reservations over Governance Practices in PSUs," *Hindu Business Line*, March 27, 2012.

n *Corporate Governance in the Public Sector—The Road Ahead,* KPMG.

o Sinha and Singhal, *A Note on Corporate Governance in Public Sector Undertakings in India,* 18.

p CIRCULAR NO. SEBI/CFD/DIL/CG/1/2004/12/10, CORPORATE GOVERNANCE IN LISTED COMPANIES—CLAUSE 49 OF THE LISTING Agreement (2004), cl. 49(II)(A)(1).

q *Corporate Governance in the Public Sector—The Road Ahead,* KPMG.

r Varottil, *Corporate Governance in State-Owned Enterprises,* 4.

Public Sector Units and Central Public Sector Enterprises *continued*

As this was not a deliberate mistake, SEBI dropped actions against these PSUs. Since then, the stock exchanges have levied fines on several PSUs for lack of sufficient appointment of independent directors, which the PSUs have refused to pay.[s]

Recent increased activism by institutional investors (such as TCI's lawsuit against Coal India, and subsequent exit from investment)[t] may push PSUs to comply with international corporate governance standards, even in the absence of strict regulation.[u] Filling up this regulatory lacuna and requiring PSUs to comply with good governance norms together with fulfilling their social obligations will benefit the stakeholders at large.[v]

However, studies reveal the poor performance of India's PSUs and stress the need to open them up to a greater degree of autonomy.[w] Some experts argue that privatization of certain Indian PSUs would facilitate the improvement of public infrastructure and lead to better use of resources.[x] In certain cases, such as that of Air India, in view of mounting debt the only viable option other than shutting down the business of the carrier may be to privatize it.[y]

In early 2020, the Government of India announced broad objectives of a new PSE policy being formulated primarily for privatizing certain PSUs in the following sectors: coal, minerals, defense production, aviation, power distribution in Union territories, space, and atomic energy.[z] The Union Cabinet is expected to consider this policy, which will define the strategic sectors wherein the government intends to retain only four PSUs, while privatizing the remaining entities, as a part of the Atmanirbhar Bharat Abhiyan package.[aa] The Ministry of Power, Government of India, has recently taken steps toward privatizing power distribution activities by issuing draft standard bidding documents.[ab]

However, since privatization alters the basic ownership structure of a corporation, a different analysis may be necessary for each sector. For example, in the banking sector, where public money and liquidity are directly at stake, it may be beneficial to consider feasible alternatives.[ac] Given the variety of issues to be dealt with while privatizing state-run enterprises, the processes involved are manifold, complex, and time consuming.[ad]

s Pavan Burugula, "PSUs Unhappy with Fines Over Corporate Governance Violations," *Economic Times*, October 18, 2019.

t Varottil and Naujoks, "Corporate Governance," in *India: The Business Opportunity,* 51-53.

u Jayanta Mallick, "FIIs Express Reservations over Governance Practices in PSUs."

v Vijay Kumar Singh, "Reforming SOEs in Asia: Lessons from Competition Law and Policy in India," ADBI Working Paper No. 1056, December 2019.

w Kunmin Kim and N. Panchanatham, "Reform and Privatization of State-Owned Enterprises in India," ADBI Working Paper No. 1057, December 2019.

x Ajay Chhibber and Swati Gupta, "Public Sector Undertakings—Bharat's Other Ratnas," NIPFP Working Paper No. 186, January 2017.

y Rhik Kundu, "Govt Can Privatize AI or Shut It Down: Puri," *Livemint*, September 15, 2020.

z "Govt Unleashes Major Privatisation Reforms for Coal, Defence, Power Distribution and Space," *India TV*, May 17, 2020.

aa "Cabinet Said to Consider New Public Sector Enterprises Policy Soon," *BloombergQuint*, October 13, 2020.

ab "Privatisation of Discoms to Unlock a Market Bigger Than Telecom: Vinayak Chatterjee," *Economic Times*, September 24, 2020.

ac Shekar Swamy, "PSB Privatisation: Beware the 'Foreign Hand,'" *Hindu Business Line*, October 13, 2020.

ad Nidhi Verma, "Govt Moving 'Cautiously' on Privatisation of Bharat Petroleum: Dharmendra Pradhan," *Livemint*, October 13, 2020.

by law[46] are some examples of the benefits that controlling shareholders enjoy at the expense of minority shareholders, often without their formal concurrence or support for such actions. In most of these cases, company boards tend to be passive instruments of de jure approvals without much freedom to objectively evaluate the value of such decisions to absentee shareholders. Collaterally, such practices also bring into question the relative primacy of company boards and their shareholders in decision making on matters in the usual course of their companies' business.

Is "Best of Both Worlds" a Feasible Proposition?

Promoter ownership and control without its maleficent downsides can greatly benefit minority shareholders. While it is virtually impossible to eliminate the inherent agency potential for expropriation entirely, it may be worthwhile to attempt, through legislation and regulation, a regime of control and disclosure that would discourage expropriation by promoter shareholders and insiders controlling the company's operations.

Two broad categories of legislation—empowering independent directors on boards and disenfranchising interested shareholders at members' meetings—may be helpful in achieving this objective.[47] Both of these suggestions are incorporated into the Companies Act, 2013 (Companies Act, or Act), which introduces comprehensive compliance requirements with respect to certain related party transactions. (See Chapter Eight: Related Party Transactions, p. 143.)

The Companies Act also helped further cement India's corporate law approach toward being stakeholder oriented.[48] The Act included the codification of directors' duties to act in good faith to promote the interests of shareholders and other stakeholders; independent directors' duties to safeguard the interests of all stakeholders, particularly minority shareholders; and a new requirement for companies to participate in corporate social responsibility.[49]

Key Takeaways

- Concentrated ownership, often referred to as promoter control, is widespread in India. While concentrated ownership may benefit the corporation and its stakeholders by providing, inter alia, commitment to the performance and growth of the company, it may also lead to exploitation of power.
- Public sector units/undertakings (PSUs) face unique corporate governance challenges because the state is the controlling shareholder. As state-owned enterprises, PSUs have had difficulty meeting some of SEBI's governance rules. Several of India's PSUs are expected to be privatized under the Atmanirbhar Bharat Abhiyan.

46 Both public-sector and private-sector companies formally or informally exercise such preferences for transactions within the groups. Strictly, these related party transactions may not pass muster if independently evaluated by respective company boards and their audit committees, but they seem to be glossed over in general, partly encouraged perhaps by the disclosure exemption provided to intragroup transactions (Para 8, AS 18 issued by the Institute of Chartered Accountants of India and notified under the Companies Act, 1956). In the case of state-owned enterprises, the related party transaction rules (Para 9, AS 18) specifically exempted disclosure requirement relating to transactions between state-controlled enterprises.

47 Bala N. Balasubramanian, "Addressing Some Inherent Challenges to Good Corporate Governance," *The Indian Journal of Industrial Relations* 44 (April 2009).

48 Varottil, "The Stakeholder Approach to Corporate Law: A Historical Perspective from India," in *Research Handbook on the History of Corporate and Company Law*, ed. Harwell Wells (Cheltenham: Edward Elgar Publishing, 2018), 15.

49 Varottil, "The Stakeholder Approach to Corporate Law: A Historical Perspective from India," 16.

CHAPTER THREE

Directors' Duties and Board Practices

The Companies Act, 2013 (Companies Act, or Act) codifies and consolidates the law relating to companies in India.[1] Over the past decade the Companies Act has undergone a significant transformation in its approach to the composition, practices, and duties of the Board of Directors (board). The Companies Act, 1956 did not include many provisions regarding board composition, and did not require boards to have independent directors. The concept of independent directors was first introduced through securities regulations imposed on listed companies. (See Chapter One: Corporate Governance Reforms in India, p. 10.) Unlike the 1956 Act, the Companies Act of 2013 includes sweeping provisions regarding the composition, function, and duties of the board of directors. Chapter VII of the Companies Act, which relates to director duties and board practices, became effective in 2014.[2] Further, in 2014 the Ministry of Corporate Affairs (MCA) issued rules for Chapter VII of the Companies Act. Since 2014, several important amendments, discussed herein, have been introduced to streamline the requirements of the Act.

In addition to compliance with the Companies Act, publicly listed companies in India must comply with securities regulations promulgated by the Securities Exchange Board of India (SEBI). The Securities Contracts (Regulation) Act, 1956, together with the rules and regulations made thereunder, required that every company seeking to list its shares on a recognized Indian stock exchange execute a listing agreement (Listing Agreement).[3] In 2015, SEBI replaced the Listing Agreement with the SEBI (Listing Obligations and Disclosure Requirements) Regulations (SEBI Listing Regulations), which incorporate the Listing

Overview of Companies Act, 2013 Requirements for Boards of Directors

- Criteria for independence of directors
- Accountability to stakeholders beyond only shareholders
- Extensive disclosure and reporting requirements
- Liability on class action suits
- Significant penalties on insider trading and restatements
- Significant involvement in corporate social responsibility
- Significant responsibility for managing related party transactions
- Rollout of whistleblower vigil mechanism
- Mandate on board gender diversity

Overview of the SEBI Listing Regulations Requirements for Boards of Directors

- Mandate on board composition—executive versus nonexecutive, independent directors, age of directors, gender diversity
- Criteria for independence of directors
- Separation of chair and CEO posts
- Board committees
- Director remuneration
- Extensive disclosure and reporting requirements
- Penalties for noncompliance

1 For a detailed history of the development of the Indian Companies Act, see Umakanth Varottil, "The Evolution of Corporate Law in Post-Colonial India: From Transplant to Autochthony," *American University International Law Review* 31 (2016): 253-325.

2 The Companies Act, 2013 §§ 91, 100, 102-06, 107, 111-14, 116, No. 18, Acts of Parliament, 2013 (Aug. 29, 2013); CIRCULAR NO. 16/2013, CLARIFICATION ON THE NOTIFICATION DATED 12.8.2013, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA (2013) (explaining that the notified sections of the Companies Act, 2013 replace the corresponding sections of the Companies Act, 1956).

3 Securities Contracts (Regulation) Act, 1956 § 21, No. 42, Acts of Parliament, 1956.

Agreement and other listing norms in India. The SEBI Listing Regulations codify previously uncodified principles of corporate governance in India.[4]

Board Composition

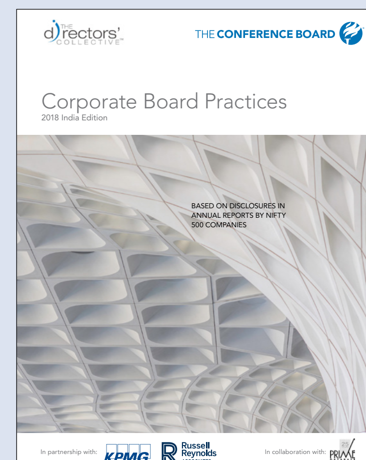
Companies Act. The board of directors is a single collective body responsible for all duties, functions, management, and administration of a company.[5] The Companies Act defines "director" as a "director appointed to the Board of a company."[6] Indian law also mandates that every company must have a board of directors consisting of individuals as directors.[7] Thus, a person who has been validly appointed or elected to the board of the company, and on whose behalf the relevant form has been filed with the concerned authorities, is considered to occupy the position of a director.

The Companies Act requires that the administration and management of companies should be conducted in a fair and transparent manner. The Act prescribes a minimum number of directors (two for a private company, three for a public company, and one for a one-person company) and a maximum number of directors (15; but a company may appoint more upon approval of a special resolution passed by shareholders).[8] Further, the Act requires appointment of at least one woman director on the board for prescribed classes of companies.[9]

SEBI Listing Regulations. Similar to the Companies Act, the SEBI Listing Regulations provide for the following categories of directors: executive directors, nonexecutive directors, women directors, and independent directors.

Corporate Board Practices: 2018 India Edition found that on average, for companies with annual revenue between INR 1,000 crore and INR 5,000 crore, the board comprised nine directors (see Figure 3.1). Companies with annual revenue greater than INR 5,000 crore reported an average board size of 10 directors. This finding underscores a

The Directors' Collective (a research and educational initiative composed of The Conference Board, KPMG India, and Russell Reynolds Associates) and the PRIME Database Group analyzed board practices at companies in the NIFTY 500 index in its study titled *Corporate Board Practices: 2018 India Edition*. The NIFTY 500 index comprises the largest 500 companies, by capitalization, listed on the National Stock Exchange of India (NSE). According to the most recently released NSE statistics, the NIFTY 500 index represents about 95.2 percent of the free float market capitalization of the stocks listed on the NSE. The study reviews public disclosures of board composition, governance practices, and granted executive remuneration made by publicly traded Indian companies in the NIFTY 500 index. Unless specifically noted, the report examines the data compiled by PRIME Database Group and drawn from public disclosures (annual reports) as of January 5, 2018. In total, the study reviews data for a set of 4,746 corporate board members.



4 Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 ch. II (Sept. 2, 2015) [hereinafter SEBI Listing Regulations].

5 The Companies Act, 2013 § 2(10).

6 The Companies Act, 2013 § 2(34).

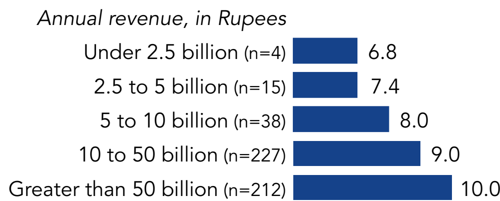
7 The Companies Act, 2013 § 149.

8 The Companies Act, 2013 § 149.

9 The Companies Act, 2013 § 149.

direct correlation between company size and board size, which is likely due to the expanding responsibilities and workload of directors in larger organizations.

Figure 3.1
Board Size, by Company Size
Number of board seats



Note: The range of annual revenue is not known for 4 companies (37 directors). Accordingly, out of 4,746 directors, the data are presented for 4,709 directors.

Source: The Directors' Collective/PRIME Database Group, 2018

Further, following SEBI's acceptance of the Kotak Committee's recommendation on board size, the SEBI Listing Regulations now mandate that the board of the top 1,000 listed entities, as of April 1, 2019, and in the top 2,000 listed entities, effective April 1, 2020, must have a minimum of no fewer than six directors.[10]

Independent director. The Companies Act provides the criteria for director independence.[11] The Companies (Appointment and Qualifications of Directors) Rules, 2014 (Companies Rules) and the SEBI Listing Regulations supplement this definition by introducing additional criteria and strengthening the existing provisions (see Table 3.1). In addition, the 2017 Amendment Act[12] introduced certain amendments to the definition of an independent director. Most significantly, these amendments permit an independent director to have limited pecuniary relationships with the company without compromising director independence, such as receiving

Overview of Criteria for Appointing Independent Directors

- Directors nominated by investors or lending institutions cannot be construed as independent directors
- The board is responsible for verifying the integrity, expertise, and skills of independent directors
- Present or past promoters of any group company are not allowed
- Independent directors must have no significant pecuniary relationship with promoters or directors of the company or group
- Relatives of independent directors must have no pecuniary relationship with the group
- Independent directors must have no key managerial positions
- Independent directors must have no voting rights (other than less than 2 percent of total voting power)
- Independent directors must not be CEOs or directors of any NGO receiving 25 percent or more of its receipts from the company or promoter group
- Independent directors must have appropriate qualifications, knowledge, and skills

10 SEBI Listing Regulations, pt. III sec. 4 no. 17(1)(c).

11 The Companies Act, 2013 § 149(6).

12 The Companies (Amendment) Bill, 2016 was introduced by the Union Minister of Corporate Affairs in the Lok Sabha on March 16, 2016, and was referred to the Standing Committee on Finance for examination and for submitting a report thereon. The Standing Committee on Finance (2016-2017) submitted its 37th Report on December 1, 2016, to the Lok Sabha. As of the date of this report, the Companies (Amendment) Bill, 2016 (as amended by the suggestions of the Standing Committee on Finance) has been enacted as The Companies (Amendment) Act, 2017.

remuneration as an independent director and having transactions with the company not exceeding 10 percent of the director's total income.

Independent directors must possess appropriate skills, experience, and knowledge in one or more of the following fields: finance, law, management, sales, marketing, administration, research, corporate governance, technical operations, or other disciplines related to the company's business.[13] In addition, the Act includes an extensive code of conduct for independent directors. The Code broadly contains the following:

- Guidelines of professional conduct
- Role and functions
- Duties
- Manner of appointment
- Reappointment
- Resignation or removal
- Separate meetings
- Evaluation mechanisms

With a view to streamlining the process of appointment of independent directors on boards, the Indian Institute of Corporate Affairs was, in late 2019, mandated to create and maintain a data bank of persons who are eligible and willing to be appointed independent directors.[14] In accordance with these rules, independent directors currently serving on boards and persons seeking appointment as independent directors must apply for the inclusion of their names in the data bank.[15] With the exception of certain categories of persons enlisted under the Companies Rules, all other persons who have enrolled themselves are required to pass an online proficiency test with an aggregate of 50 percent in order to ensure that their names are retained in the data bank.[16]

Under Section 149(4) of the Act, every listed company must have at least one-third of the total number of directors as independent directors. In addition, the Act provides that the MCA may prescribe the minimum number of independent directors for unlisted public companies.[17] The Companies Rules provide that public companies that have (1) paid-up share capital[18] of at least INR 10 crore; (2) turnover of at least INR 100 crore; or (3) in aggregate, outstanding loans, debentures, and deposits exceeding INR 50 crore, must have at least two directors as independent directors.[19] A private company subsidiary of a public company would be considered a public company, and thus would need to have independent

13 The Companies (Appointment and Qualifications of Directors) Rules, 2014, *Gazette of India*, pt. II sec 3(i) ch. XI sec. 5 (Mar. 31, 2014).

14 The Companies (Creation and Maintenance of databank of Independent Directors) Rules, 2019, *Gazette of India*, pt. II sec 3(i) (Oct. 22, 2019).

15 The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI sec. 6.

16 Under the amended Companies (Appointment and Qualifications of Directors) Rules, 2014, an individual shall not be required to pass the online proficiency self-assessment test when he has served for a total period of not less than three years as on the date of inclusion of his name in the data bank (A) as a director or key managerial personnel, as on the date of inclusion of his name in the data bank, in one or more of the following, namely—a listed public company, an unlisted public company having a paid-up share capital of INR 10 crore or more; or a body corporate listed on any recognized stock exchange or in a country which is a member State of the Financial Action Task Force on Money Laundering and the regulator of the securities market in such member State is a member of the International Organization of Securities Commissions, bodies corporate incorporated outside India having a paid-up share capital of USD 2 million or more, statutory corporations set up under an Act of Parliament or any State Legislature carrying on commercial activities, or (B) in the pay scale of Director or above in the MCA or the Ministry of Finance or Ministry of Commerce and Industry or the Ministry of Heavy Industries and Public Enterprises and having experience in handling the matters relating to corporate laws or securities laws or economic laws, or (C) in the pay scale of Chief General Manager or above in SEBI, RBI, IRDA or PFRDA and having experience in handling the matters relating to corporate laws or securities laws or economic laws. For the purpose of calculation of the period of three years, any period during which an individual was acting as a director or as a key managerial personnel in two or more companies or bodies corporate or statutory corporations at the same time shall be counted only once.

17 "Public company" means a company which (a) is not a private company; (b) has a minimum paid-up share capital of INR 5 lakh or such higher paid-up capital as may be prescribed; provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be a public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles. The Companies Act, 2013 § 2(71).

18 Under Section 2(64) of the Companies Act, 2013, "paid-up share capital" or "share capital paid-up" means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called.

19 The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI sec. 4.

Table 3.1 **Definition of Independent Director under the Companies Act, 2013 (as amended), The Companies (Appointment and Qualifications of Directors) Rules, 2014 and the SEBI Listing Regulations**

Section 149(6) of the Act (as amended), together with the rules promulgated thereunder, read with the SEBI Listing Regulations, define an independent director as follows:

Conditions	Companies Act, 2013 (as amended) read with The Companies (Appointment and Qualifications of Directors) Rules, 2014	SEBI Listing Regulations
Type of Director	Director other than a managing director or a whole-time director or a nominee director	Nonexecutive director, other than a nominee director of the company
Expertise and Experience	In the opinion of the board, such a director must be a person of integrity and possess relevant expertise and experience	Same as the Companies Act, 2013
Skills and Knowledge	Should possess appropriate skills, experience, and knowledge in one or more fields of finance, law, management, sales, marketing, administration, research, corporate governance, technical operations, or other disciplines related to the company's business	
Promoter Status	Should not be a promoter of the company or its holding, subsidiary, or associate company	In addition to the Companies Act requirement, he should also not be a member of the promoter group of the listed entity
Relationship with the Promoters or Directors	Should not be related to promoters or directors in the company, its holding, subsidiary, or associate company	Same as the Companies Act
Pecuniary Relationships	No pecuniary relationship, other than remuneration as such director or having transactions not exceeding 10 percent of his total income or such amount as may be prescribed, with the company, its holding, subsidiary, or associate company, or their promoters or directors, during the two immediately preceding financial years or during the current financial year	Apart from receiving director's remuneration, no material pecuniary relationship with the company, its holding, subsidiary, or associate company, or their promoters or directors, during the two immediately preceding financial years or during the current financial year
Restrictions on Relatives	No relative of the director (1) should hold any security of or interest in the company, its holding, subsidiary, or associate company during the two immediately preceding financial years or during the current financial year: Provided that the relative may hold security or interest in the company of face value not exceeding INR 50 lakh or 2 percent of the paid-up capital of the company, its holding, subsidiary, or associate company or such higher sum as may be prescribed; (2) should be indebted to the company, its holding, subsidiary, or associate company or their promoters, or directors, in excess of INR 50 lakh during the two immediately preceding financial years or during the current financial year;	No relatives of the director should have or should have had a pecuniary relationship or transaction with the listed entity, its holding, subsidiary, or associate company, or their promoters or directors, amounting to 2 percent or more of its gross turnover or total income or INR 50 lakh or such higher amount as may be prescribed from time to time, whichever is lower, during the two immediately preceding financial years or during the current financial year

Conditions	Companies Act, 2013 (as amended) read with The Companies (Appointment and Qualifications of Directors) Rules, 2014	SEBI Listing Regulations
Restrictions on Relatives *Continued*	(3) should not have given a guarantee or provided any security in connection with the indebtedness of any third person to the company, its holding, subsidiary, or associate company or their promoters, or directors of such holding company, for INR 50 lakh during the two immediately preceding financial years or during the current financial year; or (4) should not have any other pecuniary transaction or relationship with the company, or its subsidiary, or its holding or associate company amounting to 2 percent or more of its gross turnover or total income singly or in combination with the transactions referred to in (1), (2), or (3) above.	
Restrictions on Employment	The director himself or any of his relatives (1) should not hold or should not have held the position of a key managerial personnel or employee of the company or its holding, subsidiary, or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed In the case of a relative who is an employee, the above restriction shall not apply for his employment during the preceding three financial years (2) should not be or should not have been an employee or proprietor or a partner in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of (a) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary, or associate company, or (b) any legal or consulting firm that has or had any transaction with the company, its holding, subsidiary, or associate company amounting to 10 percent or more of the gross turnover of such firm; (3) should not hold together with his relatives 2 percent or more of the total voting power of the company; or (4) should not be a chief executive or director, by whatever name called, of any nonprofit organization that receives 25 percent or more of its receipts from the company, any of its promoters or directors or its holding, subsidiary, or associate company, or that holds 2 percent or more of the total voting power of the company	Same as the Companies Act with the following addition: Should not be a material supplier, service provider, or customer or a lessor or lessee of the company

Conditions	Companies Act, 2013 (as amended) read with The Companies (Appointment and Qualifications of Directors) Rules, 2014	SEBI Listing Regulations
Other Qualifications	Other qualifications as may be prescribed	
Minimum Age Requirement		21 years of age
Other Directorships		Should not be a nonindependent director of another company on the board of which any nonindependent director of the company is an independent director

directors, if it meets the aforementioned thresholds. The following classes of unlisted public companies are exempt from the above requirement: (1) joint ventures; (2) wholly owned subsidiaries; and (3) dormant companies as defined under Section 455 of the Companies Act.[20] If a company is required to appoint a higher number of independent directors due to the composition of its audit committee, such higher number of independent directors are applicable to this requirement. Further, any intermittent vacancy of an independent director must be filled by the board at the earliest opportunity, but not later than the immediate next board meeting or three months from the date of such vacancy (whichever is later). If a company ceases to be the type of company under this rule for three consecutive years, it is not required to comply with this provision. Further, if a company belongs to a class of companies that require a higher number of independent directors specified by the law, it must comply with that law.

For listed companies, the SEBI Listing Regulations prescribe that the board of directors must have an optimum combination of executive and nonexecutive directors with at least one woman director, and no less than 50 percent of the board of directors must comprise nonexecutive directors. Further, for listed companies in which the chair of the board is nonexecutive, at least one-third of the board must comprise independent directors. In cases where the listed company does not have a regular nonexecutive board chair, at least half of the board must comprise independent directors. Where the regular nonexecutive chair is a promoter of the listed company or is related to any promoter or person occupying management positions at the board level or one level below, at least half of the board of directors of the listed entity must consist of independent directors. SEBI has clarified that for the purpose of determining whether the board chair is related to any promoter, the following rules apply: (1) if the promoter is a listed company, its directors other than the independent directors, its employees, or its nominees will be deemed to be related to it; (2) if the promoter is an unlisted company, its directors, its employees, or its nominees will be deemed to be related to it.[21]

The institution of independent directors has been further strengthened by new provisions introduced by SEBI in the SEBI Listing Regulations. The quorum for every meeting of the board of directors of the top 1,000 listed companies (effective April 1, 2019) and of the top 2,000 listed companies (effective April 1, 2020) must be one-third of

20 The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI sec. 4.

21 SEBI Listing Regulations, pt. III sec.4 no. 17. In terms of Regulation 15 of the SEBI Listing Regulations, Regulation 17 requirements are not applicable to listed companies having paid-up equity share capital not exceeding INR 10 crore and net worth not exceeding INR 25 crore, as of the last day of the previous financial year. Where the provisions of the Regulation 17 become applicable to a listed company at a later date, such listed company is required to comply with the requirements within six months from such date. Further, Regulation 17 also does not apply to a listed entity that has listed its specified securities on the SME Exchange. For other listed entities that are not companies but bodies corporate, or that are subject to regulations under other statutes, the corporate governance provisions as specified in Regulation 17 shall apply to the extent that it does not violate their respective statutes and guidelines or directives issued by the relevant authorities.

Table 3.2 **Appointment and Tenure of Independent Directors under the Companies Act, 2013**

Appointment for 5-year tenure	An Independent Director shall be appointed for a term of up to 5 consecutive years at a general meeting of the Company. Justification for such appointment shall form part of the explanatory statement to the notice of general meeting (Sec 149(10))
Reappointment	An Independent Director is eligible for reappointment for another term of up to 5 years subject to compliance with conditions including performance evaluation by the board of directors and approval by members through special resolution (Sec 149 (11)) On completion of two consecutive terms of office, the Independent Director will be eligible for appointment only after 3 years, provided he/she is not associated with the company in any other capacity during the 3-year period, either directly or indirectly (Sec 149 (11))
Data bank for Independent directors	An Independent Director may be selected from a data bank maintained by notified institutes or associations (Sec 150 (1))
Vacancies	Any vacancy of an Independent Director shall be filled in by the Company at the immediate next Board Meeting or within 3 months from the date of such vacancy, whichever is later
Alternate directors also subject to same eligibility/qualifications as independent director	No person shall be appointed as an alternate director for an independent director unless he/she is qualified to be appointed as an independent director under the provisions of the Act (Sec 161(2))
Declaration from Independent Director on eligibility and qualification	Every independent director shall give a declaration that he meets the criteria of independence at the first meeting in which he participates as a Director and subsequently at the first meeting of every financial year or whenever there is any change in circumstances that may affect his status as an independent director (Sec 149(7))
Compensation only via sitting fees and profit-related commission—no stock options	Independent Directors are not entitled to any stock option, but are eligible for sitting fees, reimbursement of expenses for participating in meetings and profit-related commission as may be approved by the members of the company (Sec 149(9)) If an Independent Director contracts with the company (e.g., professional services) and such contract is in the ordinary course of business and at arms' length, it would not be considered to be a pecuniary interest impacting the independence of such director.

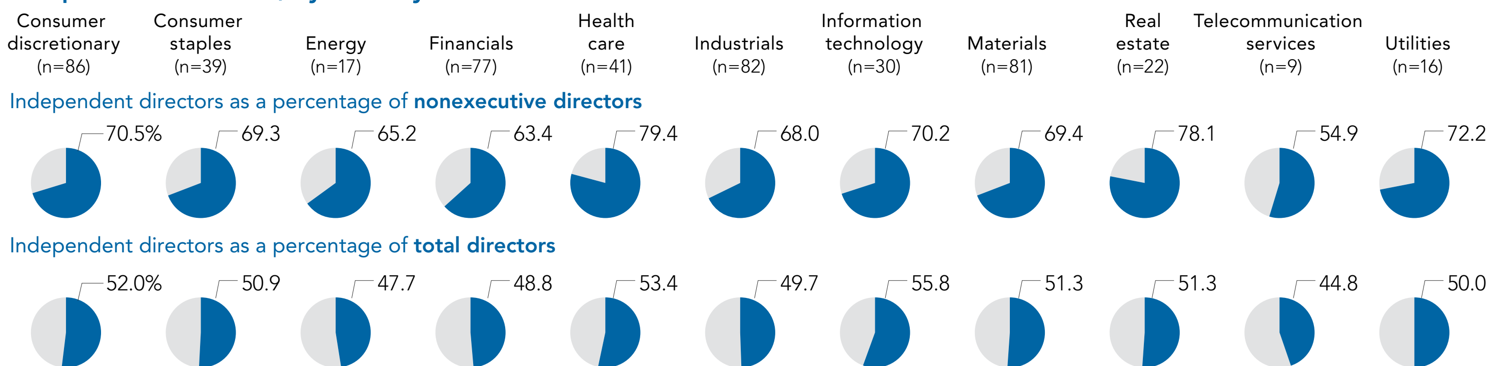
the total board size of the company or three directors (whichever is higher), and must include at least one independent director.[22]

Appointment and tenure of independent directors. Like other directors, the appointment of an independent director must be approved in a general meeting but is not subject to annual retirement rotation rules. For an independent director, the explanatory statement needs to indicate the justification for choosing the person as an independent director, and a statement by the board that they fulfill the conditions for appointment (see Table 3.2). The independent director, once appointed, must give a declaration that they meet the criteria for independence in the first board meeting they attend, and thereafter at the first board meeting of every year. The MCA has clarified that in view of the provisions of Schedule IV, appointment of independent directors under the Act must be formalized through a letter of appointment. The rules require maintaining a data bank of persons eligible and willing to be appointed as independent directors by institutions so authorized by the Central Government. This list is placed on the MCA website so that the data bank is publicly

22 Inserted as Regulation 17(2A) of the SEBI Listing Regulations by the SEBI Listing Amendment Regulations 2018. Securities and Exchange Board of India (Listing Obligations and Disclosure Requirement) (Amendment) Regulations, 2018, *Gazette of India*, pt. III sec. 4 (May 9, 2018) [hereinafter SEBI (Listing Amendment) Regulations].

Figure 3.2

Independent Directors, by Industry



Note: For 16 directors, information as to their independent status was not available, and hence these directors are not included in the analysis.

Source: The Directors' Collective/PRIME Database Group, 2018

available.[23] In March 2021, SEBI published a consultation paper for a review of certain regulatory provisions related to independent directors.[24] The paper invites public comments on revision of provisions governing approval and appointment of independent directors, disclosures by and composition of the NRC and remuneration for independent directors. The consultation paper discusses a dual approval for appointment of independent directors; i.e., approval by shareholders at large and a separate approval by a simple majority of the shareholders excluding the promoter and promoter group. The consultation paper also puts forth the proposal that two-thirds of NRC members should be independent. Lastly, it solicits public views on whether there is a need to review the remuneration structure for independent directors, and if so, whether ESOPs could be used as a component in the overall remuneration of independent directors.

In *Corporate Board Practices: 2018 India Edition*, a study by The Directors' Collective, it was noted that up to 53 to 55 percent of the board is independent for companies in the healthcare and information technology sector (see Figure 3.2). The telecommunication services sector holds the lowest percentage of independent directors at under 45 percent. The healthcare sector has reported the highest percentage of independent directors from among the total nonexecutive directors at 79 percent. Companies in the telecommunication services sector have the lowest average percentage of independent directors out of the total nonexecutive directors; in these companies, less than 55 percent of the nonexecutive directors are independent.

The study also found that the proportion of independent directors vis-à-vis total board size and nonexecutive directors also varies. For NIFTY 500 companies with annual revenue of less than INR 250 crore and more than INR 5,000 crore, independent directors make up less than 50 percent of the total board size (48 and 49 percent, respectively; see Figure 3.3). For all other NIFTY 500 companies, 51 percent of directors are independent for companies with annual revenue between INR 250 crore and INR 1,000 crore, and 52 percent of directors are independent for companies with annual revenue between INR 1,000 crore and INR 5,000 crore.

Resident director. Under the Companies Act, as amended by the 2017 Amendment Act, every company must have at least one director who has been a resident

23 The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI sec. 6. The Institute of Chartered Accountants of India, The Institute of Company Secretaries of India, and The Institute of Cost Accountants of India, under the active encouragement of the Ministry of Corporate Affairs, Government of India, have developed an independent directors' repository to facilitate eligible persons to register themselves and for companies to obtain information about such persons to consider their appointment as independent directors. "Centre for Independent Directors: About Independent Directors Databank," Indian Institute of Corporate Affairs (web page); "Independent Director's Databank," Indian Institute of Corporate Affairs.

24 SEBI Consultation Paper on Review of Regulatory Provisions related to Independent Directors, March 1, 2021, www.sebi.gov.in

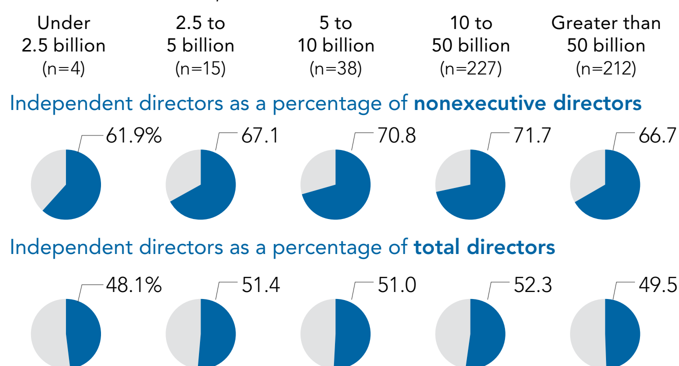
of India for at least 182 days during a financial year.[25] The amendment to this provision was pursuant to the February 2016 report of the Companies Law Committee.[26] The committee expressed a concern that because of the residency requirement, it was imperative for a new subsidiary of a company incorporated outside India to appoint a person entirely unconnected with the company as a director in India. Accordingly, as per the amendment, for newly incorporated companies, the requirement of a appointing a resident director applies proportionately at the end of the financial year in which such companies are incorporated.

Woman director. Section 149 of the Act provides that every company must have a board of directors and that "such class or classes of companies as may be prescribed, shall have at least one woman director."[27] The Act thus left it to the MCA to develop rules pursuant to Section 149. Under the rules finalized by the MCA in 2014, the Section 149 "one woman director" requirement became applicable to all listed companies, and any public company with (1) a minimum paid-up share capital of INR 100 crore or (2) an annual turnover of at least INR 300 crore.[28] Further, any intermittent vacancy of a woman director must be refilled by the board at the earliest opportunity, but no later than the immediate next board meeting or three months from the date of such vacancy (whichever is later).

Figure 3.3

Independent Directors, by Company Size

Annual revenue, in Rupees



Note: For 16 directors, information as to their independent status was not available, and hence these directors are not included in the analysis.

Source: The Directors' Collective/PRIME Database Group, 2018

Overview of Companies Act, 2013 Responsibilities of Independent Directors

- Oversee the implementation of best corporate governance practices;
- Safeguard the interests of all stakeholders;
- Ensure an adequate and functional whistleblower vigil mechanism;
- Determine appropriate levels of remuneration for executive directors, key managerial personnel, and senior management;
- Ensure compliance on related party transactions;
- Prime accountability on CSR compliance; and
- Liability on class action suits.

25 The Companies Act, 2013 § 149(3).

26 The Companies Law Committee was set up on June 4, 2015, to make recommendations to the Government of India in relation to the issues arising from the implementation of the Companies Act, 2013. This committee consisted of 10 members. In addition to providing its own views, the committee had to take into consideration recommendations received from the Bankruptcy Law Reforms Committee, the High Level Committee on CSR, the Law Commission and other agencies. The Companies Law Committee submitted its report to the then Hon'ble Union Minister of Finance, Corporate Affairs, and Information & Broadcasting on February 1, 2016. Tapan Ray et al., *Report of the Companies Law Committee*, Ministry of Corporate Affairs, Government of India, February 1, 2016.

27 The Companies Act, 2013 § 149(3); The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI sec. 3.

28 The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI sec. 3. For the purposes of this rule, the MCA has clarified that the paid-up share capital or turnover as of the latest audited financial statements shall be taken into account. Newly incorporated companies must have one woman director within six months from the date of incorporation.

The SEBI Listing Regulations have imposed more stringent rules regarding board diversity for publicly listed companies, providing that

(1) a board of directors must have an optimum combination of executive and nonexecutive directors with at least one woman director, and no less than 50 percent of the board of directors shall consist of nonexecutive directors;[29] and

(2) a board of directors of the top 500 listed entities must have at least one independent woman director by April 1, 2019, and the board of directors of the top 1,000 listed entities must have at least one independent woman director by April 1, 2020.[30]

The woman director mandate was introduced primarily with the objective of increasing women's participation in decision-making at the board level across corporations.[31] However, neither the Act nor the rules include specific penalty provisions for companies that fail to comply with the requirement.[32] Moreover, neither the Companies Act nor the SEBI Listing Regulations provide guidance on how a woman director should be appointed.

The purpose of advocating for gender diversity is to work toward populating Indian firms with experienced and competent women who could meaningfully contribute to board processes and decision-making. Nevertheless, reports indicate that, at least initially, many of the women directors appointed to company boards were family members of the promoters or nonindependent directors.

In *Corporate Board Practices: 2018 India Edition*, The Directors' Collective noted that NIFTY 500 companies had, on average, one woman director on their board.

In a report on women directorships in NIFTY 500 companies, published in May 2020,[a] IiAS noted that as of March 30, 2020, out of the total 4,657 directorship positions at the NIFTY 500 companies, 777 were held by women. The study notes that the regulatory mandates have pushed companies to ensure gender diversity in their boards, with 93 percent of the NIFTY 500 companies that have reported at least one independent woman director on their boards as of March 30, 2020. The study also cites certain noteworthy examples of companies that have two or more women directors on their boards: the boards of Apollo Hospitals Limited, Godrej Agrovet Limited, Godrej Consumer Products Limited, and India Cements Limited have five women each, and another seven boards have four women on their board. Such companies, forming almost 44 percent of NIFTY 500 companies, have opted to create a more gender-diverse board instead of appointing only a single independent woman director, which is the minimum regulatory requirement. The study reveals that in NIFTY 500 companies, women have a higher board representation in healthcare, consumer staples sectors, and realty. On the other hand, the study notes that PSUs need to be more forthcoming in establishing gender diversity at the board level. Additionally, only 18 companies out of 491 NIFTY 500 companies have women as chairs, demonstrating that women's participation in board leadership continues to be very limited.

a *Corporate India: Women on Boards*, Women on Corporate Boards Mentorship Program, Institutional Investor Advisory Services India Limited and SBI Mutual Fund, May 2020.

29 SEBI Listing Regulations, pt. III sec. 4 no. 17(1)(a).

30 SEBI Listing Regulations, pt. III sec. 4 no. 17.

31 For an analysis of the provisions for women directors, see Afra Afsharipour, *Handbook on Corporate Governance in India: Legal Standards and Board Practices*, The Conference Board, January 2016.

32 Section 172 of the Companies Act, 2013 includes a minor penalty provision for noncompliance with the sections of Chapter XI of the Act which do not include a penalty provision. The Companies Act, 2013 § 172. Under this penalty provision, a noncompliant company and every officer of the company who is in default would need to pay a fine of at least INR 50,000 and in case of continuing failure, a further penalty of INR 500 for each day during which such failure continues, subject to a maximum of INR 3 lakh in case of a company and INR 1 lakh in case of an officer who is in default.

Small Shareholder Directors under the Companies (Appointment and Qualifications of Directors) Rules, 2014

Nomination Process

- The small shareholders intending to propose a person as a candidate for the post of small shareholder director must leave a notice of their intention with the company at least 14 days before the meeting under their signatures specifying the name, address, shares held, and folio number of the person whose name is being proposed for the post of director and of the small shareholders who are proposing such person for the office of director.
- The notice for appointment of a person as small shareholders' director must be signed by at least 1,000 small shareholders.

Appointment and Tenure of Small Shareholder Director

- Small shareholders' director will be considered an independent director subject to meeting the independence requirements under the Act and related Rules and giving a declaration of his or her independence in accordance with Section 149 of the Act.
- The appointment of small shareholder director will be subject to the provisions regarding the appointment of directors under Section 152 except that
  - such director will not be liable to retire by rotation;
  - such director's tenure as small shareholder director must not exceed three consecutive years; and
  - on the expiry of the tenure, such director will not be eligible for reappointment.
- A small shareholders' director must meet the director qualification requirements set out in Section 164 of the Act.
- A person appointed as small shareholder director must vacate the office if
  - the director incurs any of the disqualifications specified in Section 164;
  - the office of the director becomes vacant in pursuance of Section 167; or
  - the director ceases to meet the criteria of independence as provided in subsection (6) of Section 149.
- No person can hold the position of small shareholder director in more than two companies at the same time. The second company in which the director has been appointed must not be in a business that is competing or is in conflict with the business of the first company.
- A small shareholder director must not, for a period of three years from the date on which he or she ceases to hold office as a small shareholder director in a company, be appointed in or be associated with such company in any other capacity, either directly or indirectly.

Small shareholder director. The Act also recognizes the need for representation of small shareholders,[33] and contemplates that a listed company may appoint a director elected by small shareholder vote subject to the terms and conditions prescribed in the Companies Rules.[34] The Companies Rules provide that a listed company may elect a small shareholders' director upon notice of at least 1,000 small shareholders, or one-tenth of the total of such shareholders (whichever is lower).[35] The Companies Rules outline specific details regarding the qualifications and tenure of a small shareholders' director.

In what has been viewed as the first attempt to exercise rights under Section 151 of the Act, Unifi Capital Private Limited proposed Murali Rajagopalachari as a candidate for a small shareholder director in Alembic Limited. However, the board of Alembic Limited rejected the proposal of such an appointment on the grounds of conflict of interest between the proposed small shareholder director and the company.[36] Despite the laudatory provision, minority shareholders, in several instances, have not been able successfully to secure board representation.[37] In 2017, minority shareholders of Florintree Advisors Private Limited sought the appointment of a small shareholder director to the board of PTC India Limited, but could not secure the requisite majority votes.[38] Similarly, India Horizon Fund failed in their attempt to appoint a director under section 151 of the Act on the board of Religare Enterprises.[39]

Executive and nonexecutive directors. A company may choose to appoint executive (also referred to as "whole-time") directors and nonexecutive directors to serve on the board. The Act contemplates that some directors may be managing directors. Under the Act, a managing director means "a director who, by virtue of the articles of a company or an agreement with the company or a resolution passed in its general meeting, or by its Board of Directors, is entrusted with substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called."[40] An executive director is a director who is employed full time by the company.[41] Executive directors generally devote all of their time to the company and are generally paid employees of the company with functional responsibilities. Neither managing nor executive directors are considered independent directors under the Act. The Act contemplates that some members of the board may be nonexecutive directors. The Act does not define the term "nonexecutive director," although it is understood that nonexecutive directors do not undertake to devote their full working time to the company and usually receive a smaller compensation. Nonexecutive directors are usually well-known business people, reputable professionals, or persons of eminence whose names are brought to light as a matter of pride and credibility for the company.

Promoter directors. Public companies in India display concentrated shareholding in the hands of a controlling shareholder (or promoter) who is either a business family or the state.[42] The term "promoter" has wide import under the Act. A promoter may be any person who has been named as such in a prospectus or is identified by the company in the annual return or any person who has control[43] over the affairs of the company, directly or indirectly, whether as a shareholder, a director, or otherwise. Further, the term "promoter" also includes any person in accordance with whose advice, directions, or instructions the board of directors of the company is accustomed to act, although this does not extend to

33 The Act defines a small shareholder as "a shareholder holding shares of nominal value of not more than INR 20,000 or such other sum as may be prescribed." The Companies Act, 2013 § 151.

34 The Companies Act, 2013 § 2(54).

35 The Companies (Appointment and Qualifications of Directors) Rules, 2014, pt. II sec 3(i) ch. XI. sec. 7.

36 "Board Seat: Alembic Junks Small Shareholder Plea," *Economic Times*, July 29, 2017.

37 Sachin P. Mampatta, "Five Years on, Sec 151 on Small-Shareholder Directors Makes Little Headway," *Business Standard*, June 29, 2019.

38 "Shareholder Activism in India – Has It Been Successful?," *ETCFO*, April 11, 2018.

39 Mampatta, "Five Years on, Sec 151 on Small-Shareholder Directors Makes Little Headway."

40 The Companies Act, 2013 § 2(54).

41 The Companies Act, 2013 § 2(94); The Companies (Specification of Definitions Details) Rules, 2014, pt. II sec 3(i) ch. I (Mar. 31, 2014).

42 The concept of "promoter" has specific legal significance in the Indian context. Promoters in India are typically controlling shareholders, but they can also be those instrumental in a public offering or those named in the prospectus as promoters.

43 Section 2(27) of the Companies Act, 2013 defines control as "the right to appoint majority of the directors or to control the management or policy decisions exercisable by a person or persons acting individually or in concert, directly or indirectly, including by virtue of their shareholding or management rights or shareholders agreements or voting agreements or in any other manner." The Companies Act, 2013 § 2(27).

people acting merely in a professional capacity.[44] Given that corporate ownership in India is still concentrated and promoter-dominated, board independence is encouraged to ensure protection of the interests of minority shareholders from possible exploitation by the promoter or controlling shareholder.[45] While some Indian companies have evolved toward management by professionals, the board often remains in the control of the promoters.[46] In certain cases, even promoter-controlled companies are likely to have an individual who has grown professionally as a business manager as CEO.

Nominee directors. Investors or other stakeholders routinely participate in the governance of an investee entity through nominees, often appointing a nominee as a director to safeguard their interests. The Companies Act recognizes the appointment of such nominee directors. The Act provides that subject to the Articles of Association of a company, the board of directors may appoint any person as a director nominated by any institution in pursuance of the provisions of any law for the time being in force of any agreement or by the Central Government or the State Government by virtue of its shareholding in a Government company.[47] Provisions relating to independent directors clarify the position that a nominee director would not be considered independent.[48]

Additional directors. The Articles of Association of a company may confer on its board of directors the power to appoint any person (except for a person who has failed to be appointed as a director in a general meeting), as an additional director at any time. Under the Act, an additional director will hold office up to the date of the next annual general meeting or the last date on which the annual general meeting should have been held (whichever is earlier).[49]

44 The Companies Act, 2013 § 2(69).

45 Bala N. Balasubramanian, *Issues in Board and Director Independence*, NSE Centre for Excellence in Corporate Governance Quarterly Briefing, October 2016.

46 Afra Afsharipour and Manali Paranjpe, *Director Notes India: The Role of the Nomination Committee in Board Independence and Composition in Indian Companies*, The Conference Board, March 2017.

47 The Companies Act, 2013 § 161(3).

48 The Companies Act, 2013 § 149(6).

49 The Companies Act, 2013 § 161(1).

Alternate directors. The board of directors of a company may, if so authorized by the company's Articles of Association or by a resolution passed in a general meeting, appoint a person, not being a person holding any *alternate directorship for any other director in the company* (emphasis added), to act as an alternate director for a director during his absence from India for a period of not less than three months.[50] The Companies Law Committee noted that the text of the above provision leaves potential for ambiguous interpretation by not specifically prohibiting an existing director of a company from acting as an alternate director for another director in the same company.[51] This may lead to one person attending a board meeting in dual capacities—personally as a director and as an alternate director—which the Companies Law Committee opined could lead to conflicts of interest and increase ambiguity in the calculation of quorum. Accordingly, the 2017 Amendment extends the disqualification to those directors who hold a directorship in the same company. Further, an alternate director appointed as an independent director must fulfill all the prerequisites of an independent director. The alternate director's term of office can only extend to the length of the term of the director whose place the alternate director has taken. Once the independent director has returned to India, the alternate director is required to vacate the office. The Act also considers a scenario in which the original independent director's term expires prior to his return to India. In this case, any provision for the automatic reappointment of retiring directors, in default of another appointment, applies to the original director and not to the alternate director.[52]

According to the Kotak Committee, since independent directors are elected to the board for their skills, experience, acumen, network, and objectivity, it is not appropriate to replace them with an alternate director. Although the alternative director may satisfy the criteria for independence, these qualities are specific to the person appointed as the independent director. Also, since the Act and the rules made thereunder allow a director to attend a meeting from any place by electronic means, the Kotak Committee has maintained that such appointment

50 The Companies Act, 2013 § 161(2).

51 Tapan Ray et al., *Report of the Companies Law Committee*.

52 The Companies Act, 2013 § 161(2).

of an alternate director for an independent director ought not to be permitted.[53] SEBI has accepted this recommendation and effective October 1, 2018, no person may be appointed or continue as an alternate director for an independent director of a listed entity.[54]

Lead independent directors. A "lead independent director" is an independent director who is typically in charge of functions including, inter alia, overseeing the functioning of independent directors, convening their meetings, and generally acting as the independent directors' representative in discussions between the independent and nonindependent board members. In terms of global best practices, the duties and functions of a lead independent director include acting as an independent chief among all board members who takes a proactive role in board decisions and responds to issues raised by shareholders or members of the company that have not been satisfactorily dealt with by the board chair or management.[55] While the appointment of a lead independent director formed part of the SEBI Consultative Paper on Review of Corporate Governance Norms in India,[56] it is not mandated by the Act or any other corporate governance norms currently in force. Such a position may assume importance in companies where the chair of the board is executive or nonindependent or would not strictly meet the criteria for independence.

However, certain companies in India do incorporate the concept of lead independent director into their corporate governance policies. For instance, as per the annual report filed by Wipro Limited for the year 2016–2017,[57] the company has designated one of its independent directors as the lead independent director. Reliance Industries Limited also has had a lead independent director on its board, since October 2015, and the company has outlined the role and duties of a lead independent director in its annual report of 2019–20 as follows: (1) to preside over all meetings of independent directors; (2) to ensure there is an adequate and timely flow of information to independent directors; (3) to liaise between the board chair and the managing director, the management, and the independent directors; and (4) to preside over meetings of the board and shareholders when neither the board chair nor the managing director is present or where he or she is an interested party to perform such other duties as may be delegated to him by the board and/or the independent directors.

In the opinion of the Kotak Committee, all listed entities (which have a nonindependent chair) must be mandated to designate one independent director as the lead independent director, who in addition to being a member of the NRC, shall, inter alia, preside over the meetings of the board at which the chairperson or vice-chairperson is not present, serve as a liaison between the chair of the board and the independent directors, and be available for consultation and direct communication, if requested by significant shareholders.[58] This recommendation, however, has not been accepted by SEBI.

CEO duality. "CEO duality" means that the chief executive officer of the company is also the chair of the board of directors. Best practice standards advocate the separation of these two roles given that the former relates to execution (looking after the day-to-day affairs of the company) while the latter emphasizes monitoring (the supervision exercised by the board over the management).[59] CEO duality has been a widely debated topic, and its impact on firm performance has been widely studied and analyzed. Different perspectives arise from agency theory, which argues in favor of separation of these roles between different persons to ensure that the operational and supervisory functions are carried out

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53 Uday Kotak et al., *Report of the Committee on Corporate Governance*, Securities and Exchange Board of India, October 2017, ch. II, para. 7. The MCA has opined that the provision pertaining to the appointment of alternate directors cannot be done away with since it would conflict with the provisions of the Act.

54 SEBI Listing Regulations § 25(1) (as substituted by SEBI (Listing Amendment) Regulations).

55 *A Short Note on Lead Independent Director*, InGovern Research Services.

56 Issued for public comments by SEBI in 2013. CONSULTATIVE PAPER ON REVIEW OF CORPORATE GOVERNANCE NORMS IN INDIA, SEC. & EXCH. BD. OF INDIA (2013).

57 "Annual Reports," Wipro Limited.

58 Uday Kotak et al., *Report of the Committee on Corporate Governance*, ch. II, para 8. The MCA has no comments on this issue.

59 "Bala" N. Balasubramaninan, "Strengthening Corporate Governance in India," Indian Institute of Management, Ahmedabad, India Working Paper No. 2014-01-03, January 2014.

CEO Duality—History of SEBI Changes to Regulation 17(1B) of the SEBI Listing Regulations

In October 2017, the Kotak Committee recommended that the chair of the board for public companies should be a nonexecutive director.[a] There are several explanations for why the Kotak Committee recommended companies should separate the chair and CEO roles. The report points to the distinct roles of the chair and the CEO to argue that greater clarity in these roles can allow the CEO to concentrate more on strategy and the board to prioritize its own tasks.[b] Additionally, the recommendation reduces the concentration of authority in a single individual.[c] Separation of powers could make the board more independent, which promotes a more balanced governance structure, effective supervision of management,[d] and fairer executive compensation.[e] Finally, a voluntary recommendation for the separateness of the chair and the CEO follows international precedents from countries such as the United Kingdom and the United States.[f]

In May 2018, SEBI responded to the report by amending Regulation 17(1B) of the SEBI Listing Regulations to state that by April 1, 2020, the top 500 listed entities with an identifiable promoter shall ensure the chair of the board is a nonexecutive director.[g] The rule mandates a clear split between the roles and includes an additional provision requiring the chair and the CEO to be unrelated.

a Akila Agrawal, "Chairman or Managing Director?—Eenie Meenie Miney Mo," *Mondaq*, January 17, 2020.

b *The Elephant in the Boardroom*, Institutional Investor Advisory Services India Limited, December 2019.

c *The Elephant in the Boardroom*, Institutional Investor Advisory Services India Limited.

d Agrawal, "Chairman or Managing Director?—Eenie Meenie Miney Mo."

e *The Elephant in the Boardroom*, Institutional Investor Advisory Services India Limited.

f Gurbir Singh, "New Push Back on SEBI's Edict to Split Top Corporate Posts," *New Indian Express*, January 12, 2020; THE UK CORPORATE GOVERNANCE CODE: JULY 2018, FIN. REPORTING Council (2018).

g Agrawal, "Chairman or Managing Director?—Eenie Meenie Miney Mo."

On January 10, 2020, SEBI amended Regulation 17(1B) to become effective on April 1, 2022. By the beginning of 2020, almost two years after SEBI announced its changes to Regulation 17(1B), of India's top 500 companies, 161 companies had the same person in the role of chair and CEO, and the chair and CEO were related in 79 companies.[h] Several affected companies stated they were ill-prepared for the move with too short of a timeline to properly enact a succession plan.[i] To rush such a decision to meet the 2020 deadline, they argued, would be counterproductive for their business.[j]

While there was some support for SEBI's underlying goal of board independence, India Inc. was critical of Regulation 17(1B)'s potential efficacy and fairness. Public comments on the Kotak Committee's report suggest a wide range of alternatives to the dual-authority mandate. These comments include extending the rule to private companies and providing an option for other checks on concentration of power, such as requiring two-thirds of the board to be independent and reforming audit committees and board evaluations.[k] Those skeptical of whether Regulation 17(1B) would provide real corporate governance reform or merely compliance on paper offered suggestions to bolster SEBI's efforts. For example, SEBI could focus more on visible and harsh punishment for noncompliance, coordinate with other regulators, and work with companies to demonstrate how dual-authority generates value.[l] Prominent industry associations largely advocated for a voluntary policy.

h Reena Zachariah and Rajesh Mascarenhas, "Over 200 Big Companies Yet to Split Chairman, MD Roles," *Economic Times*, January 6, 2020.

i Jayshree P. Upadhyay, "India Inc Breathes Easy, Gets Two Years to Split CMD Position," *Livemint*, January 13, 2020.

j Upadhyay, "India Inc Breathes Easy, Gets Two Years to Split CMD Position."

k BOARD MEMORANDUM, VIEW ON THE RECOMMENDATIONS OF KOTAK COMMITTEE ON CORPORATE GOVERNANCE, SEC. & EXCH BD. OF INDIA 54-57 (2018).

l "If No CEO Gets to Chair a Board Meeting," *Livemint*, November 5, 2019.

CEO Duality—History of SEBI Changes to Regulation 17(1B) of the SEBI Listing Regulations *continued*

The Confederation of Indian Industry (CII) opposed a blanket requirement irrespective of a company's unique business requirements. The CII argued that the board is in the best position to determine a company's need for an independent chair.[m] Similarly, The Federation of Indian Chambers of Commerce and Industry (FICCI) said this decision should be left to the shareholders.[n] The Institutional Investor Advisory Services India (IiAS) did see merit in having separate posts but stated they found no evidence that such companies perform better, and thus compliance should not be mandatory.[o]

Indian companies assert that the dual-authority approach popularized in Western countries is unsuitable to the shareholder dynamics in India, where some view maintaining control within the family as the best way to provide continuity in their corporate strategy.[p] Venu Srinivasan, Chair of TVS Group, argued that SEBI should align its regulations with emerging economies instead of the United States or the United Kingdom to ensure its regulations are easier for Indian corporations to follow.[q]

FICCI echoed these sentiments in a letter to the Finance Minister arguing that India's governance structure is an essential characteristic of domestic businesses. FICCI cited stronger top-line growth of family-run businesses and lack of support showing that separation of the chair and CEO roles leads to better financial performance as reasons to allow companies to make such decisions for themselves.[r]

Despite pushback, the majority of top companies had complied with Regulation 17(1B) when SEBI announced the delay in 2020. The delay seemed to be a factor in some companies' plans to separate the chair and CEO roles. After deciding to step into a nonexecutive role in 2019, Mahindra and Mahindra Group's board chair deferred his move after SEBI postponed the deadline to 2022.[s] Additionally, speculation around Reliance Industries' appointing its first non-executive chair in company history has since been quelled following the announcement from SEBI.[t]

m Lijee Philip and Kala Vijayaraghavan, "Sebi's Cut-Off for Separate Chairman and MD is Here. Are Family-Run Businesses Ready?," *Economic Times*, December 27, 2019.

n Rishabh Schroff, "A Welcome Reprieve for India Inc. on Splitting Top Roles," *Livemint*, January 16, 2020.

o Philip and Vijayaraghavan, "Sebi's Cut-Off for Separate Chairman and MD is Here."

p "If No CEO Gets to Chair a Board Meeting," *Livemint*.

q Philip and Vijayaraghavan, "Sebi's Cut-Off for Separate Chairman and MD is Here."

r *The Elephant in the Boardroom*, Institutional Investor Advisory Services India Limited.

s Nehal Chaliawala, "Anand Mahindra to Remain M&M Exec Chairman Till Nov 2021," *Economic Times*, February 8, 2020.

t "Reliance Industries May Get a Non-Ambani MD for the First Time," *Livemint*, January 13, 2020.

effectively,[60] and organization and stewardship theories, which support CEO duality for establishing robust and unambiguous leadership.[61]

The recently amended SEBI Listing Regulations mandate the top-500 listed entities to ensure that the chair of the board of such listed entity is a nonexecutive director and further, is not related to the managing director or the CEO as per the definition of the term "relative" under the Act.[62] However, the above requirement is not applicable to listed companies that do not have any identifiable promoters as per the shareholding pattern filed by such companies with the stock exchanges.[63]

Historically, under the Companies Act, 1956 regime, the Corporate Governance Voluntary Guidelines, 2009, issued by the Ministry of Corporate Affairs, India, had recommended the separation and clear demarcation of the offices, roles, and responsibilities of the board chair and the CEO, as far as possible, "to promote balance of power and to prevent unfettered decision making power with a single individual."[64] This was prior to the enactment of the Companies Act. The Act does not seek to do away with CEO duality completely. Although the Act stipulates that no person shall be appointed or reappointed as the chairperson of the company (in pursuance of the Articles of Association of the company) and the managing director or the CEO of the company at the same time, it paves the way for CEO duality by enabling the making of such an appointment in a dual capacity if the Articles of Association of the company provide for it or if the company is not involved in multiple businesses.[65]

Subsequently, in 2017, the Kotak Committee was of the view that separating the roles of CEO and chair reduces the concentration of authority in the hands of one person and provides for a better and more balanced governance structure and that the time was right in India to introduce the concept of separation of the roles in listed companies.

Director Qualifications and Appointment

General qualifications. Notwithstanding the specific qualifications for residential directors, woman directors, and independent directors, the Companies Act also prescribes general qualifications for all directors.

Under Section 164(1) of the Act, a person is ineligible for appointment as a director if

(a) He is of unsound mind and stands so declared by a competent court;

(b) he is an undischarged insolvent;

(c) he has applied to be adjudicated as an insolvent and his application is pending;

(d) he has been convicted by a court of any offense, whether involving moral turpitude or otherwise, and sentenced in respect thereof to imprisonment for not less than six months and a period of five years has not elapsed from the date of expiry of the sentence; provided that if a person has been convicted of any offense and sentenced in respect thereof to imprisonment for a period of seven years or more, he shall not be eligible to be appointed as a director in any company;

(e) an order disqualifying him for appointment as a director has been passed by a court or tribunal and the order is in force;

(f) he has not paid any calls in respect of any shares of the company held by him, whether alone or jointly with others, and six months have elapsed from the last day fixed for the payment of the call;

60 Dendi Ramdani and Arjen van Witteloostuijn, "The Impact of Board Independence and CEO Duality on Firm Performance: A Quantile Regression Analysis for Indonesia, Malaysia, South Korea and Thailand," *British Journal of Management* 21, no. 3 (September 2010): 607-26.

61 Sydney Finkelstein and Richard A. D'Aveni, "CEO Duality as a Double-Edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command," *Academy of Management Journal* 37, no. 5 (1994): 1079-1108.

62 The requirement that the CEO and chairperson of the board ought not to be relatives was not included in the recommendations of the Committee on Corporate Governance but has been included in the amended SEBI Listing Regulations, presumably to avoid family arrangements that would be tantamount to defeating the spirit of the regulations. The Confederation of Indian Industry has requested that SEBI review the norm requiring the board chair and CEO to be unrelated, stating that such a requirement is onerous on companies and not necessary given the checks and balances in place. K. R. Srivats, "Relook listed firm norm requiring chairman, MD/CEO to be unrelated, CII tells SEBI," *Hindu BusinessLine*, November 13, 2018.

63 SEBI Listing Regulations § 17(1B) (inserted by SEBI (Listing Amendment) Regulations).

64 Paragraph A.2: Separation of Offices of Chairman & Chief Executive Officer, Corporate Governance Voluntary Guidelines, 2009, issued by the Ministry of Corporate Affairs, India.

65 The Companies Act, 2013 § 203(1) (proviso).

(g) he has been convicted of the offense dealing with related party transactions under Section 188 at any time during the preceding five years;

(h) he has not received a director identification number under Section 154; or

(i) he already holds office as a director in the maximum prescribed number of companies.

The Act also provides that a person will not be eligible for appointment as a director of any company for a period of five years from the date on which the public company, in which he or she is a director, has failed to file annual accounts and annual returns (in cases where such failure to file has been for any continuous period of three financial years), or has failed to repay its deposits or interest thereon or redeem its debentures on the due date or pay dividends declared (in cases where such failure to pay or redeem has been continuing for one year or more).[66]

Qualifications for a managing or executive director. The Companies Act provides for detailed conditions that must be fulfilled for eligibility as a managing or executive director.[67]

Under Schedule V of the Act, a person will not be eligible for appointment as a manager, a managing director, or an executive director if he or she fails to satisfy the following conditions:

1. He or she may not have been sentenced to imprisonment for any period, or a fine imposed under any of the following statutes, namely,
   - The Indian Stamp Act, 1899;
   - The Central Excise Act, 1944;
   - The Industries (Development and Regulation) Act, 1951;
   - The Prevention of Food Adulteration Act, 1954;
   - The Essential Commodities Act, 1955;
   - The Companies Act, 2013, or any previous company law;
   - The Securities Contracts (Regulation) Act, 1956;
   - The Wealth Tax Act, 1957;
   - The Income Tax Act, 1961;
   - The Customs Act, 1962;
   - The Monopolies and Restrictive Trade Practices Act, 1969 (now the Competition Act, 2002);
   - The Foreign Exchange Regulation Act, 1973 (now the Foreign Exchange Management Act, 1999);
   - The Sick Industrial Companies (Special Provisions) Act, 1985;
   - The Securities and Exchange Board of India Act, 1992;
   - The Foreign Trade (Development and Regulation) Act, 1973;
   - The Prevention of Money-Laundering Act, 2002;
   - The Insolvency and Bankruptcy Code, 2016;
   - The Goods and Services Tax Act, 2017; and/or
   - The Fugitive Economic Offenders Act, 2018.
2. He or she may not have been detained or convicted for any period under the Conservation of Foreign Exchange and Prevention of Smuggling Activities Act, 1974.
3. He or she must be between 21 and 70 years of age. The upper age limit, however, is not applicable if the appointment is approved by a special resolution passed by the company in a general meeting or the approval of the Central Government is obtained.[68]
4. He or she must be a resident of India.

Number of directorships. The Companies Act prevents a director from serving as a director in more than 20 companies simultaneously.[69] Directorships in private companies that are either holding or subsidiary companies of a public company are included in this limit. Further, a

66 The Companies Act, 2013 § 164.

67 The Companies Act, 2013 §§ 196-197.

68 The RBI, in its Discussion Paper on Governance in Commercial Banks in India published in June 2020, has proposed that in order to improve corporate governance standards in the banking sector, the age limit for CEOs and whole-time directors of banks be capped at 70 years. It also proposes a maximum tenure of 10 years for directors belonging to the promoter group. DISCUSSION PAPER ON GOVERNANCE IN COMMERCIAL BANKS IN INDIA, DEP'T OF REGULATION, RESERVE BANK OF INDIA, June 2020.

69 The Companies Act, 2013 § 165.

person cannot be appointed as a director in more than 10 public companies. While the Act does not provide for any lower limits for independent directors, under the SEBI Listing Regulations, a person may be an independent director in only seven listed companies. If a person is an executive or managing director in a listed company, the SEBI Listing Regulations provide that said person can only be an independent director in three companies.[70] SEBI has mandated that a person may hold director positions in no more than eight listed companies, effective April 1, 2019. This maximum limit shall decrease to seven listed companies, effective April 1, 2020. This applies to alternate directorships that can be held by directors at any point of time.

In *Corporate Board Practices: 2018 India Edition*, The Directors' Collective noted that the average number of directorships held by one person for companies in the NIFTY 500, across both industries and company sizes, was two.

Role of the Board

The directors of a company can do all such acts and exercise all such powers that the company is entitled to do and exercise, subject to restrictions imposed by law[71] and the charter documents—the Memorandum of Association and/or the Articles of Association (together the Charter Documents)—of the company. The Act vests in the board of directors, as the governing body and the supreme managerial organ of a company, the general powers of management of the company. The management of the affairs of the company is vested in the board, and all powers, excepting those that are specifically reserved for the shareholders meeting by the Act or the Charter Documents or otherwise, must be done by the board.

Nonexecutive directors have largely the same duties as executive directors, except those relating to functional areas managed by the executive directors. All fiduciary duties are applicable to nonexecutive directors to the same extent as they are to executive directors. The view is that nonexecutive directors bring an independent judgment to the board's deliberations, thereby ensuring that the board acts in the interest of the company and not in the interest of a particular shareholder or member of the board. Nonexecutive directors are essentially appointed with the purpose of keeping the board in check while bringing the benefit of their experience to the company. Most companies in India have nonexecutive directors appointed to the board.

The Changing Role of Directors

Historically, directors were expected to focus essentially on "value creation" for stakeholders. In recent times, that outlook has changed, and directors have to play a more proactive role in "value protection, preservation, and enhancement" as well as in "value management."

Under a corporate governance framework, the board is also expected to

- strengthen the strategic guidance of the company;
- effectively monitor the operating management by the board; and
- be accountable to the company and all its stakeholders.

With the above broad intent, the directors are expected to jointly and severally assume the following responsibilities:[72]

- Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and all its stakeholders.
- Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.
- The board should apply high ethical standards. It should take into account the interests of all stakeholders.
- The board should fulfill certain key functions, including
    - Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets, and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions, and divestitures.

70 SEBI Listing Regulations § 17A (as inserted by SEBI (Listing Amendment) Regulations).

71 The Companies Act, 2013 § 179.

72 *Concept Paper on National Corporate Governance Policy*, Institute of Company Secretaries of India, 2012, p. 21.

Duties of Directors under the Companies Act, 2013

Section 166 of the Companies Act includes a broad sweeping provision codifying the duties of directors. According to the Act, a director of a company must

- Act in accordance with the articles of the company, subject to the provisions of the Act;
- Act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, and the community, and for the protection of the environment;
- Exercise his duties with due and reasonable care, skill, and diligence and exercise independent judgment;
- Not become involved in a situation in which he may have a direct or indirect interest that conflicts, or possibly may conflict, with the interest of the company;
- Not achieve or attempt to achieve any undue gain or advantage either to himself or to his relatives, partners, or associates, and if such director is found guilty of making any undue gain, he shall be liable to pay an amount equal to that gain to the company; and
- Not assign his office; any assignment so made shall be void.

If a director commits a breach of the duties outlined, such director can be fined a minimum of INR 1 lakh and a maximum of INR 5 lakh.

Mandatory Secretarial Standards (SS-1 and SS-2) Governing BOD and General Meetings[a]

Effective July 1, 2015, the Institute of Company Secretaries of India (ICSI) adopted a uniform framework of secretarial practices involved in the execution of board meetings and general meetings. These mandatory standards are intended to ensure compliance with the Companies Act and facilitate effective corporate governance systems. The Secretarial Standards (1), governing the board of directors' meetings, set out various requirements, including information on convening a meeting, frequency, quorum, attendance, obligations, passing a resolution, minutes, and preservation of records. The Secretarial Standards (2), governing general meetings, cover requirements related to assembling the meeting, frequency, quorum, attendance, obligations, minutes, and preservation of records, as well as information on proxies, voting, and resolutions. These provisions must be followed by all companies governed under the Companies Act, except for one-person companies (where there is only one director on the board).

a SS-1 SECRETARIAL STANDARD ON MEETINGS OF THE BOARD OF DIRECTORS, THE INST. OF CO. SEC'YS OF INDIA (2015) (revised version effective from October 2017); SS-2 SECRETARIAL STANDARD ON GENERAL MEETINGS, THE INST. OF CO. SEC'YS OF INDIA, (2015) (revised version effective from October 2017); Delep Goswami and Anirrud Goswami, "A Broad Overview of Secretarial Standards for Company Board Meetings," *Chartered Secretary: The Journal for Corporate Professionals* 45, no. 5 (May 2015).

The Board's Report under the Companies Act, 2013

Section 134 of the Companies Act provides that the board of directors of a listed company must adopt the financial statements for each financial year and get the auditor's report on the accounts. The board must prepare its own report to the shareholders every year and submit such report to the shareholders at the annual general meeting along with the financial statements and auditor's report.

The board's report must include a significant amount of information, including

- the web address, if any, where the annual return has been placed;
- the number of meetings of the board;
- a Directors' Responsibility Statement as set forth in Section 134(5);
- details in respect of frauds reported by auditors under Section 143(12) other than those that are reportable to the Central Government;
- a statement on independence declaration given by independent directors;
- particulars of loans, guarantees, investments, contracts, or other arrangements with related parties;
- financial summary or highlights;
- a description of material changes and commitments, if any, affecting the financial position of the company that have occurred between the end of the financial year of the company to which the financial statements relate, and the date of the report;
- a statement indicating development and implementation of a risk management policy for the company, including a discussion of any element of risk that in the board's opinion may threaten the existence of the company;
- details of the policy developed and implemented on corporate social responsibility; and
- for listed companies and other large public companies, a statement indicating the manner in which formal annual evaluation of the performance of the board, of its committees, and of individual directors has been made.

The report must also be prepared based on the company's stand-alone financial statements.[a] The report must contain a separate section highlighting the performance of subsidiaries, associates, and joint venture companies and their contribution to the overall performance of the company during the period under report.[b] Further, the report must detail the company's impact on the conservation of energy, efforts made toward technology absorption, and foreign exchange earnings and outgo.[c]

a The Companies (Accounts) Rules, 2014, *Gazette of India*, pt. II sec 3(i) ch. IX sec. 8 (March 31, 2014).

b The Companies (Accounts) Rules, 2014, pt. II sec 3(i) ch. IX sec. 8.

c The Companies (Accounts) Rules, 2014, pt. II sec 3(i) ch. IX sec. 8.

- Monitoring the effectiveness of the company's governance practices and making changes as needed.
- Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.
- Aligning key executive and board remuneration with the long-term interests of the company and its shareholders.
- Ensuring a formal and transparent board nomination and election process.
- Monitoring and managing potential conflicts of interest of management, board members, and shareholders, including misuse of corporate assets and abuse in related party transactions.
- Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.
- Overseeing the process of disclosure and communications.

- The board should be able to exercise objective independent judgment on corporate affairs.
- The mandate, composition, and working procedures of committees of the board should be well defined and disclosed by the board.
- Board members should commit themselves effectively to their responsibilities.

In order to fulfill their responsibilities, board members should have access to accurate, relevant, and timely information.

Officer in default. Various provisions of the Act refer to an "officer who is in default" in order to ascribe responsibility and potential liability for certain directors, including managing and executive directors of a company.[73] Under the Act, an "officer in default" is liable for acts

73 The Companies Act, 2013 §2(60).

TCI's Actions against Coal India

The fiduciary duties of directors came under significant debate when The Children's Investment Fund (TCI) decided to initiate legal action against Coal India Limited (a public sector undertaking/government company) and its directors.[a] In 2012, TCI alleged that the conduct of Coal India and its management related to fuel supply agreements with power companies at prices below international market prices constituted serious breaches of key provisions of Indian Corporate Law. Specifically, TCI contended that this was a breach of fiduciary duties, and that Coal India's affairs were being run in a manner that was both prejudicial to the public interest and oppressive to shareholders.[b] This move came after the government stated that it may invoke a presidential directive to force Coal India's Board to sign fuel supply agreements (FSAs) with power companies. TCI argued that a number of government directives are not in public benefit and should not be followed by Coal India because they destroy the profitability and value of the people of India's stock in Coal India.

a Vikas Bajaj, "The Children's Investment Fund Wages Battle with Coal India," *New York Times*, April 19, 2012.

b "TCI to Launch Legal Action Against Coal India," Press Statement, The Children's Investment Fund Management UK LLP, April 1, 2012.

or omissions of the company for purposes of various penal provisions. However, independent directors and nonexecutive directors who are not promoters or key managerial personnel of the company are only liable for acts or omissions of the company that occurred with their knowledge, attributable through board processes, and with their consent, connivance, or where they had not acted diligently.[74] Officers of the company who have been charged with an offense and have proceedings initiated against them may be punished if they are found to be officers in default. The concept of officer in default is thus relevant for those penal provisions of the Act that seek to penalize a company's officers, including directors. (See Chapter Four: Director Liability in India, p. 74.)

Fiduciary Duties

Directors are in the position of trustees as well as agents of the company. Accordingly, the powers of management given to directors collectively must be exercised in a fiduciary capacity bona fide in the interest of and for the benefit of the company as a whole. Directors are required to exercise due care and skill while performing their duties, act honestly, and diligently attend to the affairs of the company.

Directors cannot have implied powers aside from those that are incidental to or properly to be inferred from the powers expressed in the Charter Documents. On the other hand, unless the Charter Documents specifically authorize them to do so, directors cannot transfer to others, duties imposed on them that involve the exercise of judgment and discretion.

Directors may not delegate any additional powers conferred on them by the shareholders.

When a director is appointed as the nominee of another company, he or she cannot ignore his or her duties toward the company on the grounds that he or she is entitled to take care only of the interests of the company nominating him or her.

74 The Companies Act, 2013 §149(12).

Duty of good faith. Directors who are empowered by the articles to allot shares at their discretion ought to have exercised their power with utmost good faith for the benefit and interest of the company.[75]

Duty of care. The Supreme Court of India held[76] that

1. in discharging the duties of his position, a director must act honestly, but he must also exercise some degree of both skill and diligence;
2. so long as a director acts honestly, he cannot be made responsible in damages unless guilty of gross or culpable negligence in a business sense;
3. a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience;
4. If directors act within their powers, if they act with such care as is reasonably to be expected from them, having regard to their knowledge and experience, and if they act honestly for the benefit of the company they represent, they discharge both their equitable and their legal duty to the company;
5. in respect of all duties that, having regard to the exigencies of business, and the articles of association, may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly; and
6. In the event the director is alleged to be liable for misfeasance, if is sufficient to see whether he acted honestly and with due diligence.

Furthermore, a director has the duty to not exercise his powers for a collateral purpose. For example, in connection with the issue of further capital, it has been held by courts that additional shares must be issued for a proper purpose, such as expanding the business of the company. This power cannot be exercised merely to dilute the shareholding of a minority group or take over control of the company.

75 Goldmark Enter. Ltd. v. Pondy Metal & Rolling Mills, (2007) 136 Comp. Cas. 598 CLB.

76 Official Liquidator, Supreme Bank Ltd. v. P.A. Tendolkar (Dead) by Lrs. and Ors., AIR 1973 SC 1104.

Duty to the shareholders of the company. Ordinarily, directors are not the agents or trustees of individual shareholders and do not owe fiduciary duties to shareholders. However, under certain circumstances, a fiduciary relationship may initiate as a result of any responsibility assumed by the directors to the shareholders pursuant to a special arrangement, contract, special facts, or specific legislation.

In *Sangramsinh P. Gaekwad and Ors. v. Shantadevi P. Gaekwad (Dead) thr. Lrs. and Ors*., the Supreme Court of India held that "[d]irectors owe no fiduciary or other duties to individual members of their company in directing and managing the company's affairs, acquiring or disposing of assets on the company's behalf, entering into transactions on its behalf, or in recommending the adoption by members of proposals made to them collectively. If directors mismanage the company's affairs, they incur liability to pay damages or compensation to the company or to make restitution to it, but individual members cannot recover compensation for the loss they have respectively suffered by the consequential fall in value of their shares, and they cannot achieve this indirectly by suing the directors for conspiracy to breach the duties they owed the company. However, there may be certain situations where directors do owe a fiduciary duty and a duty to exercise reasonable skill and care in advising members in connection with a transaction or situation that involves the company or its business undertaking and also the individual holdings of its members."[77] The Court also referred to *Peskin and Anr. v. Anderson and Ors.*, which held "the directors had no fiduciary duty to the shareholders in the facts and circumstances obtaining therein. However, observations were made therein that such duties may arise in special circumstances demonstrating the salient features and well-established categories of fiduciary relationship such as agency which involves duties of trust, confidence and loyalty."[78]

Duty to take responsibility. In the case of *Govind Narayan Kakade v. Rangnath Gopal Rajopadhye*, the Bombay High Court held that directors still have duties to perform. If they fail to perform these duties, they must take the financial and other consequences of their negligence.[79]

Loyalty to the company. In the case of *Kishore Kundan Sippy and Anr. v. Samrat Shipping and Transport Systems P. Ltd*., the court held that one of the main elements of fiduciary duties of a director is loyalty to the company.[80] More specifically,

- A director must not knowingly put himself in a position where his interest would conflict with the interest of the company. He must act in good faith and make full disclosures to the company if he has any interests that conflict with those of the company.
- A director is under an obligation to act in the interests of the company while dealing with the assets of the company. He should not use the assets of the company for any purpose other than fulfilling the objects of the company. He must also act in good faith while disposing of or selling the assets of the company.
- A director has a duty to not make secret profits as a result of his position as a director. For example, if a director receives information with respect to a potential business opportunity in his capacity as a director of the company, he must not use that opportunity for his own purpose.

Confidentiality. Directors owe a duty of confidentiality to the company. Directors should not disclose or make use of confidential information relating to the company for any purposes, except for the benefit of the company.

Director Obligations under the Companies Act

Directors generally. Section 166 of the Companies Act codifies the duties of directors. (See "Duties of Directors under the Companies Act, 2013," p. 66.) The duties listed in Section 166 are essentially a codification of the existing equitable and common law principles of the fiduciary

77 Sangramsinh P. Gaekwad & Ors. v. Shantadevi P. Gaekwad (Dead) thr. Lrs. & Ors., (2005) 11 SCC 314.

78 Peskin & Anr. v. Anderson & Ors., (2001) 1 BCLC 372.

79 Govind Narayan Kakade v. Rangnath Gopal Rajopadhye, AIR 1930 Bom 572.

80 Kishore Kundan Sippy & Anr. v. Samrat Shipping & Transport Systems P. Ltd, (2004) 120 Comp. Cas. 681 (Bom).

duties of directors. These duties have already been laid down by the courts in several of their judgments under the Companies Act, 1956.

In addition to directors' duties under Section 166, the Act obligates the board of directors to

1. call an extraordinary general meeting of the company on requisition from the members of the company (Section 100);
2. give assistance and produce books of accounts and other books and papers of the company, etc., in their custody or control, to the Registrar of Companies (the Registrar), authorized person of the Central Government or officers of SEBI making the inspection for the same (Section 207);
3. put forth the company's financial statements for the financial year at every annual meeting (Section 129);
4. approve the balance sheet and profit and loss account before they are submitted to the auditors for their report, and authenticate the same (Section 134);
5. attach a report to every balance sheet laid before the company at the general meeting (board's report) and take all reasonable steps and provide full information and explanation for the preparation of the board's report (Section 134);
6. regularly attend the meetings of the board. If a director is absent from all the meetings of the board of directors held during a period of 12 months with or without seeking leave of absence of the board, he will be deemed to have vacated his office (Section 167);
7. disclose the nature of their concern or interest to the board if they are directly or indirectly concerned or interested in a contract, arrangement, or proposed contract, or arrangement entered into or to be entered into by the company. The disclosure must be made at the board meeting where the arrangement is first taken into consideration or after they have become aware of such an interest (Section 184); and
8. disclose their concern or interest in any company or companies or bodies corporate, firms, or other association of individuals, which shall include the shareholding, in such manner as may be prescribed.[81] The disclosure must be made at the first meeting of the board in which they participate as a director and thereafter at the first meeting of the board in every financial year or whenever there is any change in the disclosures already made (Section 184).

Independent directors. Independent directors are also subject to the code for independent directors under Schedule IV of the Companies Act. This code delineates the guidelines of professional conduct, role and functions, duties, manner of appointment, reappointment, resignation or removal, separate meetings, and evaluation mechanisms for independent directors. Under the Act, independent directors must meet at least once in a financial year without the presence of the nonindependent directors and members of the management. In such meetings, the independent directors are required to review the performance of the nonindependent directors, the board as a whole, and the chair of the company, as well as to assess the quality, quantity, and timeliness of information flow to the board to enable effective performance of its duties.

According to the Code, independent directors must

1. undertake appropriate induction, and regularly update and refresh their skills, knowledge, and familiarity with the company;
2. seek appropriate clarification or amplification of information and, where necessary, take and follow the appropriate professional advice and opinions of outside experts at the expense of the company;

81 The Companies (Appointment and Qualifications of Directors), Rules, 2014 proscribe that every director must disclose his concern or interest in any company by giving a notice in writing in Form MBP 1. It shall be his duty to disclose it at the meeting held immediately after the date of the notice. Further, all notices must be kept at the registered office and such notices shall be preserved for a period of eight years from the end of the financial year to which it relates. They shall also be kept in the custody of the company secretary or any other person authorized by the Board for the purpose. The Companies (Meetings of Board and Its Powers) Rules, 2014, *Gazette of India*, pt. II sec. 3 ch. XII sec. 9 (Mar. 31, 2014).

3. strive to attend all meetings of the board of directors and of the board committees of which they are a member;
4. participate constructively and actively in the committees of the board in which they are chairs or members;
5. strive to attend the general meetings of the company;
6. where they have concerns about the running of the company or a proposed action, ensure that these are addressed by the board and, to the extent that they are not resolved, insist that their concerns be recorded in the minutes of the board meeting;
7. keep themselves well informed about the company and the external environment in which it operates;
8. not unfairly obstruct the functioning of an otherwise proper board or committee of the board;
9. pay sufficient attention, ensure that adequate deliberations are held before approving related party transactions, and assure themselves that the same are in the interest of the company;
10. ascertain and ensure that the company has an adequate and functional vigil mechanism, and that the interests of a person who uses such mechanism are not prejudicially affected on account of such use;
11. report concerns about unethical behavior, actual or suspected fraud, or violation of the company's code of conduct or ethics policy;
12. acting within their authority, assist in protecting the legitimate interests of the company, its shareholders, and its employees; and
13. not disclose confidential information, including commercial secrets, technologies, advertising and sales promotion plans, unpublished price-sensitive information, unless such disclosure is expressly approved by the board or required by law.

The SEBI Listing Regulations also mandate the board of directors to establish a code of conduct for all members of the board of directors and senior management of the listed entity, suitably incorporating the duties of independent directors as articulated in the Act.[82]

All members of the board of directors and senior management personnel are required to affirm compliance with such code of conduct of board of directors and senior management on an annual basis.[83]

Overall, the Act imposes significant duties on independent directors. When directors fail to perform such duties, the Act gives recourse to members and depositors to file class action suits against them. However, the Act also grants reasonable immunity to an independent director or a nonexecutive director who is not a promoter or key managerial personnel, such that a director will be held liable only with respect to acts of omission or commission by a company that occur with his or her knowledge, attributable through board processes, and with his or her consent, connivance, or where he or she had not acted diligently. For a detailed discussion on liabilities of directors, please see Chapter Four: Director Liability in India, p. 74.

82 SEBI Listing Regulations, pt. III sec. 4 no. 17(5).

83 SEBI Listing Regulations, pt. III sec. 4 no. 26(3).

Key Takeaways

- Under the Act and the SEBI Listing Regulations, there is greater emphasis on board composition by providing for appointment of independent directors and women directors.
- Under section 166, the Act now codifies the fiduciary duties of directors of companies.
- The SEBI Listing Regulations, as amended after the Kotak Committee recommendations, seek to promote better governance structures and policies at listed companies.

Open Questions

- Under Indian law, the provisions of the Act and the SEBI Listing Regulations do not give any substantive powers to the chair except conducting and chairing meetings and casting a tie-breaking vote. With the newly mandated split in the chair and CEO posts, does the law need to specify in greater detail the role of the chair?
- Does the lack of clarity on the liability of directors or independent directors block more qualified personnel from pursuing board positions in listed companies?
- Can the board or the NRC, in the exercise of its discretionary powers under the Act, reject a proposed appointment of a small shareholder director? If yes, what safeguards are necessary to secure the true spirit of the enabling provision for small shareholders under section 151 to have board representation?

CHAPTER FOUR

Director Liability in India

Introduction

The role of independent directors has been highlighted in India after "lax oversight has led to crises at large listed companies."[1] For example, the massive 2009 accounting scandal involving Satyam Computer Services Ltd. (Satyam), one of India's largest information technology companies, involved the resignation of independent directors and highlighted the pressing need to review their role.[2] (See "The Satyam Scandal," p. 16). Furthermore, the Satyam scandal "exposed the growing need to ascertain precisely the standard for determining the liability of independent directors for prevention and detection of fraud, in view of the limited roles performed by them in the company."[3]

Directors of publicly listed companies are primarily governed by the Companies Act, 2013 (Companies Act, or Act) and the SEBI Listing Regulations. Independent director liability in India arises mainly under the Act. However, liability can also arise from other statutes, such as under the Negotiable Instruments Act, the Income Tax Act of 1961, foreign exchange regulations, securities regulations, the Shops and Establishments Act, and money-laundering regulations. The liability imposed on directors in different statutes typically imposes liability "in primarily two ways: (1) vicarious liability on those officers who are in charge of and responsible to the company for the conduct of its business; and (2) vicarious liability on those officers who have contributed to the contravention or the offence by consenting, conniving or not acting diligently, thereby allowing the offence to take place."[4] As described by Umakanth Varottil, "the question of liability of independent directors is a sensitive one given such directors carry substantial risk without having an influence in the day-to-day management of the company."[5] Although the perception of risk for independent directors is very high, it is not actually clear how frequently independent directors in India are actually subject to liability, as there is no empirical data.

This chapter summarizes the liabilities of directors under the Act. The chapter then sets out the liabilities of directors for acts of or offenses by the company (1) in relation to the criminal liability of the company; (2) under the Negotiable Instruments Act, 1881, as amended (the Negotiable Instruments Act);[6] (3) under the Indian Contract Act, 1872, as amended (the Contract Act)[7] and the law of torts; and (4) under other Indian laws, including taxation laws and labor regulations. The chapter also discusses the concepts involved in attributing liability to independent directors specifically. Further, it explains the indemnification of directors and concludes by outlining the challenges in the extant legal regime vis-à-vis independent directors' liability.

Statutory Liability of Directors

I. THE COMPANIES ACT

Breach of fiduciary duties. The Act contemplates a general grant of powers to the board of directors of a company. In exercising such powers, a director has a duty to act bona fide in the best interests of the company and to prefer the interests of the company over his own. (For a discussion of the fiduciary duties of directors, see Chapter Three, Directors' Duties and Board Practices, p. 45.)

1 Venkatesh Vijayaraghavan and Akshaya Iyer, "Independent Directors: Staying Mindful of Liabilities," *India Business Law Journal*, March 20, 2019. "A critical failure of Indian corporate law was further highlighted during various corporate and financial scams, such as the Harshad Mehta episode or the Satyam fiasco." Vyapak Desai and Ashish Kabra, "Director and Officer Liability in India, *Litigation* 41, no. 4 (Summer 2015): 18.

2 James Fontanella-Khan, "Timeline: The Satyam Scandal," *Financial Times*, January 7, 2009; "India's Enron," *Economist*, January 8, 2009.

3 Shinoj Koshy, S. Preetha, and V. Vandana, "New Directions: The Responsibilities, Rewards and Liabilities of Independent Directors Will Be Transformed by the New Companies Act," *India Business Law Journal* 7, no. 6 (December 2013–January 2014), p. 28; Vikramaditya Khanna and Umakanth Varottil, "Board Independence in India: From Form to Function?" in *Independent Directors in Asia: A Historical, Contextual and Comparative Approach*, ed. Dan W. Puchniak, Harald Baum, and Luke Nottage (Cambridge: Cambridge University Press, 2017), pp. 352, 372; Debanshu Mukherjee and Astha Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, Vidhi Centre for Legal Policy, September 2019, p. 6. Khanna and Varottil describe the "greater sense of urgency" for corporate law reform in India after the Satyam scandal. Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 372. Mukherjee and Pandey state that the Satyam scandal "caused the government and the securities markets regulator to introduce stringent corporate governance standards coupled with a strict liability regime for directors." Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 6.

4 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, pp. 21–22.

5 Varottil, "Actions Against Independent Directors for Dishonour of Cheques," *IndiaCorpLaw Blog*, February 16, 2019.

6 The Negotiable Instruments Act, 1881, No. 26, Acts of Parliament, 1881.

7 The Indian Contract Act, 1872, No. 9, Acts of Parliament, 1872 (hereafter the Contract Act, 1872).

For a breach of fiduciary duties, a director may be held liable for civil consequences such as breach of trust. English case law (which has persuasive value in India) has established that any profits made by a director in breach of his fiduciary duties make the director liable for such profits to the company.[8] In addition, a director shall be personally liable for breach of trust and any contracts or agreements entered into by him on behalf of the company, which is ultra vires his authority.

In a 1984 ruling, the Delhi High Court held that if any profit is made by a director or any damage is caused to the company by a director, the director will be liable to make good such loss or damage to the company.[9] The Supreme Court of India has held that the directors of a company are liable for breach of trust and guilty of misfeasance when it was established that they had misappropriated funds of the company and the directors were held accountable to the company for the amount misappropriated.[10] In one case, an agreement was entered into by a company following the disclosure of the directors' interest in the agreement. The court was of the view that, notwithstanding the disclosure, the directors were in breach of their fiduciary duties because the agreement was detrimental to the interests of the company. The court also held that the agreement was void and that the company was entitled to ask for its rescission.[11]

Certain Indian courts have relied upon the test formulated in the case of In re Denham & Co.[12] to determine the liability of a director in relation to the issuance of false and fraudulent reports and balance sheets in relation to a company. In this case, the court held that it was sufficient if the directors appointed a person of good repute, competence, and skill to audit the accounts and that the directors were not bound to examine entries in any of the company's books. It was further held that a director was entitled to trust the auditors and, since there was nothing that could have aroused the suspicion that the auditors were not doing their duties, the director was not guilty of gross and willful negligence and therefore not liable.[13]

Breach of statutory duties. The Act prescribes civil and criminal penalties for default of certain provisions of the Act applicable to the company and every "officer who is in default."[14] Under the Act, directors may also be liable for frauds, and may incur personal liability in certain cases.

A variety of provisions under the Act pose potential liability risk for directors. For example, Section 99 of the Act prescribes a certain fine that the defaulting company and every officer who is in default is liable to pay in the event that certain provisions relating to the annual general meeting have not been complied with.

In addition, other provisions in the Act impose penalties specifically on directors. Under Section 128(6) of the Act (which relates to the maintenance of books of account of a company), a managing director, a whole-time director, the CFO, or any other person charged by the board with compliance obligations may be fined if he defaults in complying with the provisions of this section. Under Section 129(7) of the Act (which relates to the financial statements of a company and its presentation to a company's members at an annual general meeting), the managing director, the whole-time director in charge of finance, the CFO, or any other person charged by the board with the duty of complying with the requirements of this section and in the absence of any of the officers mentioned above, all the directors are punishable with imprisonment for up to one year or a fine of not less than INR 50,000 up to INR 5 lakh or both for failing to take all reasonable steps to comply with the provisions of this section.

Section 166 of the Act codifies certain duties of directors. (For a discussion of the fiduciary duties of directors, see Chapter Three, Directors' Duties and Board Practices,

8 *Regal Hastings Ltd.* v. *Gulliver* (1942) 1 All ER 378.

9 *Globe Motors Ltd.* v. *Mehta Teja Singh & Co.* (1984), 55 Comp. Cas. 455 (Delhi).

10 *Official Liquidator, Supreme Bank Ltd.* v. *P.A. Tendolkar* (deceased) by LRs, AIR 1973 SC 1104.

11 *Globe Motors Ltd.* v. *Mehta Teja Singh* & *Co.* (1984), 55 Comp. Cas. 455 (Delhi).

12 *In re Denham & Co.* (1884), 25 Ch.D, p. 752.

13 Relied upon in *In re Tri-sure India Ltd.* v. *Registrar of Companies, Maharashtra* (1983), 54 Comp. Cas. 197 (Bom).

14 Section 2(60) of the Companies Act, 2013 defines the term "officer who is in default," and an executive director is deemed to be an "officer who is in default." The Companies Act, 2013, Section 2(60), No. 18, Acts of Parliament, 2013 (August 29, 2013). See Section I.C below in relation to "officers in default" under the Companies Act.

p. 45.) In the event a director contravenes such duties, such director is punishable with a fine ranging from INR 1 lakh to INR 5 lakh.[15]

The operative Section 448 of the Act imposes a penalty on any person for any statement made in any return, report, certificate, balance sheet, prospectus, statement, or other document required for the purposes of any of the provisions of the Act, that is false in any material aspect, knowing it to be false, or that omits any material fact, knowing it to be material. Under Section 447, this penalty includes the provision that "if the fraud involves an amount of at least INR 10 lakh or one percent of the turnover of the company, whichever is lower, imprisonment for a term which shall not be less than six months but which may extend to 10 years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud; provided that where the fraud in question involves public interest, the term of imprisonment shall not be less than three years. Where the fraud involves an amount less than INR 10 lakh or one percent of the turnover of the company, whichever is lower, and does not involve public interest, any person guilty of such fraud shall be punishable with imprisonment for a term which may extend to five years or with fine which may extend to INR 50 lakh or with both."

15 The Companies Act, 2013, Section 166(7).

Officers in default under the act. Section 2(60) of the Act[16] defines the term "officer who is in default." A managing director,[17] or whole-time director,[18] of a company is deemed to be an "officer who is in default." In addition, any director formally given the responsibility to ensure the company's compliance with provisions of the Act will be an "officer in default." If the company does not have a managing director, whole-time director, or manager, and if no director has been specified by the board of directors as the officer in default, all directors may be liable on behalf of the company for certain violations of the Act.[19]

Under the Act, the term "officer who is in default" has been used in several provisions while stipulating the consequences of violation of those provisions and may result in personal liability or imprisonment for certain persons who may be construed to fall within this definition. The principle is that in addition to the offending company itself, the "officers who are in default" are

16 Section 2(60) of the Companies Act, 2013 provides that for the purpose of any provision in the Companies Act that stipulates that an officer of the company who is in default shall be liable to any punishment or penalty, whether by way of imprisonment, fine, or otherwise, the expression "officer who is in default" means all the following officers of the company: the whole-time director; key managerial personnel; where there is no key managerial personnel, such director or directors as specified by the board in this behalf and who has or have given his or their consent in writing to the Board to such specification, or all directors, if no director is specified; any person who, under the immediate authority of the board or any key managerial personnel, is charged with any responsibility including maintenance, filing, or distribution of accounts or records, authorizes, actively participates in, knowingly permits, or knowingly fails to take active steps to prevent, any default; any person in accordance with whose advice, directions, or instructions the board of directors of the company is accustomed to act, other than a person who gives advice to the board in a professional capacity; every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance; in respect of the issue of transfer of any shares of a company, the share transfer agents, registrars, and merchant bankers to the issue or transfer. The Companies Act, 2013, Section 2(60).

17 Section 2(54) of the Companies Act defines "managing director" as "a director who, by virtue of a company or an agreement with the company or a resolution passed in its general meeting, or by its Board of Directors, is entrusted with the substantial powers of management of the affairs of the company and includes a director occupying the position of managing director, by whatever name called." The Companies Act, 2013, Section 2(54).

18 The explanation to Section 2(94) of the Companies Act, 2013 states that a "whole-time director" means a director in the whole-time employment of the company. The Companies Act, 2013, Section 2(94).

19 The Companies Act, 2013, Section 2(60)(iii).

also held responsible for the offense committed by the company. These officers of the company are the persons who are in charge of the management of the company or who have been charged with the responsibility of complying with the provisions of the Act. Thus, the managing director(s), the whole-time director(s), the manager, the secretary, and any person in accordance with whose instructions the board of directors is accustomed to act, are all included within the definition of "officer who is in default." In addition, any person charged by the board with the responsibility of complying with a particular provision (provided such person has consented to the same) is also deemed to be an "officer who is in default" in relation to the violation of such provision.

Courts have generally held that unless a director has been specifically charged by the company with ensuring compliance with a particular legal obligation under the Act, he becomes liable for a breach of the obligation as an officer in default only if the company has not appointed any other individual to occupy the offices of managing director, whole-time director, or manager.[20] The Ministry of Corporate Affairs clarified its stand on the point via Master Circular no. 1/2011.[21] Further, while the Companies Act does not specifically link references to the "officer who is in default" to the time when the offense was committed, it would appear that this would be the case, and hence persons who come to hold the position of managing director, whole-time director, or the other officers mentioned in the definition of "officer who is in default" in the Companies Act, subsequent to the time when the offense was committed, may not be held liable as an "officer who is in default" in relation to such offense.

Further, the Act provides that if in any proceeding against an officer of the company (including a director) for negligence, default, breach of duty, misfeasance, or breach of trust, it appears to the court hearing the case that he is or may be liable in respect of the negligence, default, breach of duty, misfeasance, or breach of trust, but that he has acted honestly and reasonably and that, having regard to all the circumstances of the case, including those connected with his appointment, he ought fairly to be excused, the court may relieve him, either wholly or partly, from his liability on such terms as it may think fit.[22]

The concerned officer in default is liable for the respective penalties imposed under a majority of the provisions of the Act. As such, it may not be possible to enumerate all the instances of liability of an officer in default under the Act.

Nonexecutive directors. As a practical matter, a complaint alleging liability against a company and its directors may name all the directors of the company, with the onus then being on the relevant director(s) to establish that the offense in question was committed without his knowledge or that he had exercised diligence to prevent the commission of such offense. This has created difficulties for directors not connected with the day-to-day management of companies.

To address this situation, in July 2011 the Ministry of Corporate Affairs issued a Master Circular on Prosecution of Directors[23] (the Master Circular) to discourage the practice of naming all directors of a company in criminal complaints. The Master Circular states that greater caution must be exercised in cases where criminal actions are initiated against directors not charged with relevant responsibilities, including directors nominated as independent directors of listed companies and nonexecutive directors, as appropriate. The MCA Circular also emphasizes that *nonexecutive directors, officers and employees not connected with responsibility* in relation to certain provisions of the Companies Act relating to

20 *Ravindra Narayan* v. *Registrar of Companies* (1994), 14 CLA 323 (Raj.), where a criminal complaint was filed by the Registrar of Companies against three directors and the managing director of the company for default in compliance with section 220(1) and (2). The High Court held that the definition of "officer in default" as per Section 5 of the Companies Act makes it clear that a director or directors of the company fall within the said definition if the company does not have any of the officers specified in sections (a)–(c). In the instant case, since the company already had a managing director, the other three directors were held not to be "officers in default" and the court quashed the proceedings against the three directors.

21 CIRCULAR NO. 6/94, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (June 24, 1994); MASTER CIRCULAR NO. 1/2011 (NO.3/57/2011/CL-II), MASTER CIRCULAR ON PROSECUTION OF DIRECTORS—REGARDING, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (July 29, 2011).

22 The Companies Act, 2013, Section 463. An important limitation on the powers of the court under this provision is that in criminal proceedings the court has no power to grant relief from any civil liability that may attach to the officer in respect of such negligence, default, breach of duty, misfeasance, or breach of trust.

23 MASTER CIRCULAR NO. 1/2011 (NO.3/57/2011/CL-II), MASTER CIRCULAR ON PROSECUTION OF DIRECTORS—REGARDING, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2011).

maintenance and preparation of accounts[24] should not be considered in default for noncompliance with such provisions by a company. Further, the Master Circular states that no such directors shall be held liable for any act of omission or commission by the company or by any officer of the company that constitutes a breach or violation of any provision of the Companies Act unless

1. such director did not act diligently in the board process (including any meeting of a committee of the board of directors); or
2. such breach occurred (a) with such director's knowledge (including knowledge attributable through board processes—for instance, information that a director was authorized to receive); and (b) with such director's consent or connivance.

Further, in 2020, the MCA issued a clarification on prosecutions filed and internal adjudication proceedings initiated against independent directors, nonpromoter and non-key managerial personnel (KMP), and nonexecutive directors (2020 Circular).[25] The 2020 Circular, inter alia, clarified that the nature of the default is crucial for holding any officer of the company liable for any default committed under the Act. For example, not all filings of information with the registrar of companies (ROC) or maintenance of statutory registers are the responsibility of independent directors or nonexecutive directors unless any specific requirement is provided in the Act or in any court of tribunal order. The 2020 Circular also emphasizes that care must be taken to ensure that civil or criminal proceedings are not unnecessarily initiated against independent directors or nonexecutive directors unless sufficient evidence exists to warrant the issue of process against them. The circular urges that the records available with the ROC be examined to ascertain if the concerned director or KMP had been serving in the company as of the date of default.

Individual liability. Under the Act, directors may be liable in certain cases in their individual capacity. Such personal liability typically arises in cases where the director acts in breach of his fiduciary duties or acts beyond the limits prescribed by the Memorandum of Association (MoA) Articles of Association (AoA) of the company. Failure to exercise reasonable care, skill, and diligence may also lead to the director being held guilty of negligence. Misconduct and willful misuse of powers can also lead to individual liability. For example, under Sections 21 and 22 of the Act directors may be individually liable for entering into contracts and other transactions in their own names without disclosing that they are acting on behalf of the company, and under Section 26 directors may be liable for false or misleading statements in a prospectus issued or signed by them.

II. THE SEBI LISTING REGULATIONS

Directors of listed companies are required to comply with the provisions of the SEBI Listing Regulations. While the regulations do not stipulate specific instances of liabilities and the corresponding penalties for noncompliance with the regulations, such directors are nonetheless governed by the Act. As discussed below, similar to the Act, the SEBI Listing Regulations also provide safe harbor provisions for independent directors.

III. OTHER STATUTES

Directors may be liable under a variety of Indian regulations containing penal provisions that extend the responsibility and liability for company offenses to such directors and officers of the company who at the time of the commission of the offense were in charge of, and responsible to, the company for the conduct of the business of the company. In general, where a statute specifically provides for vicarious liability of directors and officers of a company, it is generally understood that the role of a director in a company is a question of fact that could vary from case to case, and there is no universal rule that a director of a company is in charge of and responsible to the company for conduct of its business. The position of a managing director may be different since the designation of such person suggests that he is in charge of the company and is responsible for the conduct

24 These provisions are (1) Sections 209(5) and 209(6) of the Companies Act relating to nonmaintenance of proper books of account; (2) Section 211 of the Companies Act relating to proper preparation of the balance sheet and the profit and loss account of the company; and (3) Section 212 of the Companies Act relating to inclusion of certain particulars of subsidiaries in the balance sheet of holding companies. The Companies Act, 2013, Sections 209(5), 209(6), pp. 211, 212.

25 GENERAL CIRCULAR NO. 1/2020 (F. No. 16/1/2020—Legal), CLARIFICATION ON PROSECUTIONS FILED OR INTERNAL ADJUDICATION PROCEEDINGS INITIATED AGAINST INDEPENDENT DIRECTORS, NON-PROMOTERS AND NON-KMP NON-EXECUTIVE DIRECTORS—REG., MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2020).

of the business of the company. However, directors who do not associate themselves with the management of the day-to-day affairs of the company will not ordinarily be considered responsible for conduct of the business of the company.[26]

The Indian Penal Code, 1860, as amended (the Indian Penal Code). In 2010, the Supreme Court of India held[27] that a criminal complaint for cheating and criminal conspiracy under the Indian Penal Code could lie against a company in respect of misleading statements in a private placement memorandum. In its judgment, the Supreme Court did not decide the question of whether criminal liability existed on the facts of the case. However, the decision indicates that Indian courts may be willing to consider whether statements or omissions in a prospectus amount to cheating and other offenses under the Indian Penal Code. The penalty for the offense of cheating under the Indian Penal Code is imprisonment or a fine or both. Accordingly, a company, and possibly its directors, could be held liable under the provisions of the Indian Penal Code, including where the penalty prescribed is mandatory imprisonment.

The Negotiable Instruments Act. Section 138 of the Negotiable Instruments Act states that “where any cheque drawn by a person is returned unpaid by the bank, then the drawer of such cheque is deemed to have committed an offense and shall be punishable with up to two years’ imprisonment or with a fine which may extend to twice the amount of the cheque, or with both.” Section 141 of the Negotiable Instruments Act extends criminal liability for the dishonor of a check by a company to any director, manager, secretary, or any other officer of such company, provided that such person was in charge of the company at the time the offense was committed.[28]

Courts in India have typically held that in circumstances where the company is the principal accused, criminal liability will attach to the directors of the company only if it is proved that such persons were responsible for the conduct of the company. However, as a practical matter, nonexecutive directors have in the past been named in complaints for dishonored checks, although the Master Circular and the 2020 Circular may help rectify this issue.

The Indian Contract Act and the law of torts. In general, a director is not liable for any contract entered into by the company or a breach thereof, unless expressly provided for, or fraud or misrepresentation on the part of such director can be established.

The term “fraud” is defined under Section 17 of the Contract Act to include any of the following acts committed by a party to a contract, or with his connivance, or by his agents, with the intent to deceive another party thereto or his agent, or to induce him to enter into the contract:

- the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
- the active concealment of a fact by one having knowledge or belief of the fact;
- a promise made without any intention of performing it;
- any other act fitted to deceive; and
- any such act or omission as the law specially declares to be fraudulent.

The term “misrepresentation” is defined under Section 18 of the Contract Act to include

- the positive assertion, in a manner not warranted by the information of the person making it, of that which is not true, though he believes it to be true;
- any breach of duty that, without an intent to deceive, gains an advantage for the person committing it, or any one claiming under him, by misleading another to his prejudice, or to the prejudice of any one claiming under him; and
- causing, however innocently, a party to an agreement to make a mistake as to the substance of the thing that is the subject of the agreement.

The remedy available to the defrauded party or the party to whom the misrepresentation is made is that the contract is voidable at such party’s option,[29] or a claim for

26 *S.M.S. Pharmaceuticals Ltd.* v. *Neeta Bhalla*, AIR 2005 SC 3512.

27 *Iridium India Telecom Ltd.* v. *Motorola* (2011), 1 SCC 74.

28 *K.K. Ahuja* v. *V.K. Vora*, (2009) 10 SCC 48; *Aneeta Hada* v. *Godfather Travels & Tours Private Ltd.* (2008), SCC 838 (2012); S.M.S. *Pharmaceuticals Limited* v. *Neeta Bhalla*, AIR 2005 SC 3512.

29 The Contract Act, 1872, Section 19.

damages may lie, or both.[30] In the event that a director of a company makes a misrepresentation to a third party, or fraudulently induces a third party to enter into a contract with the company, such director may be liable to compensate the third party for damages under the law of torts.

Other Indian laws and regulations. Directors may also be liable for offenses under other legislation, such as (1) the Indian taxation laws including the Income Tax Act, 1961, as amended;[31] and the Central Excise Act, 1944,[32] as amended; and (2) various labor regulations including the Employees' Provident Funds and Miscellaneous Provisions Act, 1952, as amended,[33] the Employee State Insurance Act, 1948, as amended,[34] the Equal Remuneration Act, 1976, as amended,[35] the Payment of Bonus Act, 1965, as amended,[36] the Minimum Wages Act, 1948, as amended,[37] and the Contract Labour (Regulation and Abolition) Act, 1970, as amended,[38] which provide for the liability of directors and officers of a company in respect of offenses committed by companies in largely identical terms. In addition, the Industrial Disputes Act, 1947, as amended (the IDA) contains a provision that states that in the event a company commits an offense under the IDA, every director of such company will be deemed to be guilty of such offense unless such person proves that the offense was committed without such person's knowledge or consent.[39] This chapter does not cover all legislation that attaches liability to a director of an Indian company.

30 Pollock and Mulla, *Indian Contract and Specific Relief Acts*, 12th ed. (LexisNexis Butterworths, 2001), 553.

31 The Income Tax Act, 1961, No. 43, Acts of Parliament, 1962 (as amended).

32 The Central Excise Tax, 1944, No. 1, Acts of Parliament, 1944 (as amended).

33 The Employees' Provident Funds and Miscellaneous Provisions Act, 1952, No. 19, Acts of Parliament, 1952 (as amended).

34 The Employee State Insurance Act, 1948, No. 34, Acts of Parliament, 1948 (as amended).

35 The Equal Remuneration Act, 1976, No. 25, Acts of Parliament, 1976 (as amended).

36 The Payment of Bonus Act, 1965, No. 21, Acts of Parliament, 1965 (as amended).

37 The Minimum Wages Act, 1948, No. 11, Acts of Parliament, 1948 (as amended).

38 The Contract Labour (Regulation and Abolition) Act, 1970, No. 37, Acts of Parliament, 1970 (as amended).

39 The Industrial Disputes Act, 1947, Section 32, No. 14, Acts of Parliament, 1947.

Liability of a Company

There is certain legislation where criminal liability is imposed on the company itself. In 2005, the Supreme Court of India in *Standard Chartered Bank* v. *Directorate of Enforcement*[40] held that the criminal intent of the persons responsible for the affairs of the company could be attributed to a corporation. The Supreme Court of India also held that in cases where the offense is the contravention of the provisions of a statute (in this case, the now-repealed Foreign Exchange Regulation Act, 1973) and the consequences of such offense include penalty as well as prosecution, the interpretation of the relevant provisions of the statute should not be confined to the imposition of only one of the two. Further, a penalty that is capable of being recovered from the company itself may also be recovered from the officers in charge of the company or from those who were instrumental in the contravention of the provisions of the statute in question. The question of who "the persons responsible for the affairs of the company" are is a question of fact to be determined at trial.

The Supreme Court of India upheld the above in the case of *Iridium India Telecom Limited* v. *Motorola and Others*[41] in 2010. Citing decisions of the U.S. Supreme Court and the House of Lords, the Supreme Court held that companies and corporations cannot claim immunity from criminal prosecution on the grounds that they are incapable of possessing the necessary mens rea for the commission of criminal offenses. The criminal intent of the company or body corporate would be imputed to the person or group of persons that guide the business of the company, such as its directors or managers.

40 *Standard Chartered Bank* v. *Directorate of Enforcement* (2005), 4 SCC 530. This judgment overruled Assistant Commissioner, Assessment-II, Bangalore v. Velliappa Textiles Ltd., AIR 2004, SC 86.

41 *Iridium India Telecom Ltd.* v. *Motorola* (2011), 1 SCC 74. Securities Appellate Tribunal (Mumbai Bench, Mumbai), BPL Ltd. v. Securities & Exchange Board of India (June 20, 2002); *Sushila Devi* v. *Securities & Exchange Board of India* (2008), 83 SCL 62 (Delhi); *Ankur Forest & Project Development India Ltd.* v. *Securities & Exchange Board of India* (2011), 106 SCL 578 (Delhi).

Sunil Bharti Mittal Case

On March 19, 2013, a special court summoned Sunil Bharti Mittal and Ravi Ruia, who had been accused in a corruption case related to telecommunication licenses that were illegally granted in 2002.[a] At the time, Mittal was chair-cum-managing director of Bharti Cellular Limited and Ruia was director of Sterling Cellular Limited. While the companies were named parties in the corruption case, the officers were not. However, the court issued summons to Mittal and Ruia because they were "the directing mind and will of each company" and the "acts of the companies could be attributed and imputed to them."[b] The two officers challenged the summons before the Supreme Court.

The Supreme Court held that the acts of the company are not attributable and may not be imputed to the acts of the directors and senior officers.[c] While the criminal intent of a director or a senior officer may be imputed to the company, the reverse is not true, because it would impose vicarious liability upon the directors and senior officers. The court noted that while an individual who has perpetrated a criminal act on behalf of the company may be accused, sufficient evidence of the individual's active role and criminal intent is required. The court also noted that vicarious liability does not automatically exist unless a statute specifically provides for it. Having found that the special court issued its order on an erroneous presumption in law, the court quashed the order.[d] However, the court noted that the special court could issue an order if it later found that enough incriminating material existed to proceed against Mittal and Ruia.

a Sunil Bharti Mittal v. Cent. Bureau of Investigation, (2015) 2015 SCC, pp. 11–12.

b Sunil Bharti Mittal, (2015) 2015 SCC 12.

c Sunil Bharti Mittal, (2015) 2015 SCC 41-42.

d Sunil Bharti Mittal (2015), 2015 SCC 55.

Liability of Independent Directors

Under the Companies Act, 2013, independent directors are subject to both civil and criminal liability.[42] Civil liability can result in independent directors having "to make payments to the victims or the state" and criminal liability can result in "fines or imprisonment."[43] Previously under the Companies Act, 1956, liability was only attributable to "officers in default."[44] Independent directors were not considered "officers in default," and thus did not carry any liability for board actions.[45] The Companies Act, 2013 not

42 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381. "Directors may face both civil and criminal liability, under various laws which govern a broad spectrum of issues, and make the person in charge of and responsible at the time of commission of the offence, as well as other officers liable for that offence." Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 19.

43 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381.

44 Shinoj Koshy and S. Preetha, "Much Ado About Independent Directors," *Hindu Business Line*, December 4, 2013.

45 Koshy and Preetha, "Much Ado About Independent Directors"; "Companies Act 2013: Greater Emphasis on Governance Through the Board Processes," Nishith Desai Associates, June 4, 2014; Koshy et al., "New Directions: The Responsibilities, Rewards and Liabilities of Independent Directors Will Be Transformed by the New Companies Act," p. 28.

only expanded the role of independent directors[46] but also expanded the liability of independent directors to board actions.[47] The expanded role independent directors are expected to fill now comes with steeper penalties for not fulfilling their duties.[48]

Generally, an executive director is subject to greater liability than a nonexecutive director, since such a director is considered to be discharging his functions as an ordinary director of the company as well as a person who devotes his whole time to the day-to-day management and affairs of the company.

In the context of independent directors, certain courts in India have held that in determining whether directors should be granted relief from liability arising out of a breach or default by a company, it is necessary to make a distinction between directors who are on the board of a company purely by virtue of their technical skill or because they represent certain special interests, and those who are in effective control of the management and affairs of the company. Generally, such judgments have considered it unreasonable to impose liability for a breach or default of a company on nominee directors and directors appointed by virtue of their special skills or expertise. Some courts have held that it would be appropriate in such cases not to impose liability on such directors unless they are directly involved in the acts or omissions complained of, or have otherwise failed to act honestly or reasonably.

Section 149 of the Act includes some limitations on independent director liability, thus creating a "specific safe harbor provision."[49] Section 149 states that independent directors "shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently."[50] The term "connivance" has been distinguished from consent by the courts "in that connivance does not require the parties to be of one mind."[51] The term "with his knowledge, attributable through Board processes" opens the door for a director to be "deemed to have knowledge of all matters that have been taken up at the board level."[52] The term "where he had not acted diligently" suggests that "directors can no longer ignore developments within the company, fail to attend board meetings with a sense of regularity or omit to raise the right questions."[53] Nevertheless, the purpose of Section 149 was "to balance the extensive nature of the duties and liabilities imposed on independent directors" by "insulat[ing] potential liability for independent directors for acts of the company for no fault of their own."[54]

Section 149 is not a perfect solution to easing the risk for independent directors. Although Section 149 affords independent directors some protection from liability, "it does not provide any safeguards at the summoning stage."[55] Most investigating authorities and courts summon all directors, including independent directors.[56] This exposes independent directors to possible

46 "The New Companies Act sought to achieve four things. First, it identified independent directors as the key driver in respect of governance and regulatory compliance in a company. Second, it tasked the independent directors to be the protectors of minority shareholder interest. Third, it asked independent directors to have an independent voice. . . . Finally, as laid down in Schedule IV of the Companies Act, 2013 independent directors were required to hold separate meetings in the "absence of non-independent directors and members of management" and "review the performance of non-independent directors and the Board as a whole" as well as "review the performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors." Santosh Pande, "Independent Directors and Well Performing Boards—Some Pointers for Indian Companies" (unpublished manuscript, February 5, 2018), p. 7.

47 Koshy and Preetha, "Much Ado About Independent Directors."

48 Pande, "Independent Directors and Well Performing Boards—Some Pointers for Indian Companies," p. 7.

49 Varottil, "Director Liability Under the New Regime," *IndiaCorpLaw Blog*, June 16, 2014; Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 382; Varottil, "Actions Against Independent Directors for Dishonour of Cheques"; Devaditya Chakravarti and Varun Chablani, "Responsibilities of Independent Director—A Magic Bullet or Unnecessary Appendage?" Lakshmikumaran & Sridharan, Attorneys, October 20, 2014.

50 The Companies Act, 2013, Section 149(12).

51 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

52 Varottil, "Director Liability Under the New Regime."

53 Varottil, "Director Liability Under the New Regime."

54 Varottil, "Director Liability Under the New Regime."

55 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 7.

56 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 7.

reputational harm and "protracted legal proceedings."[57] Furthermore, independent directors can still be held liable for "passive negligence," including their failure to record any concerns or objections.[58] The application of this provision would depend upon the manner in which the courts interpret it, based on the specific facts and circumstances of each case.

Additionally, under the Companies Act, 2013, an officer in default includes "every director, in respect of a contravention of any of the provisions of this Act, who is aware of such contravention by virtue of the receipt by him of any proceedings of the Board or participation in such proceedings without objecting to the same, or where such contravention had taken place with his consent or connivance."[59] This provision in particular is thought to have led to independent directors often being advised "to record any objections or reservations to any action by the company which they are against, for the purpose of insulating themselves from any punitive action."[60] However, it is unclear whether independent directors actually take this advice.

Other Avenues of Independent Director Liability

Class actions. Liability for independent directors can also arise from "claims made against the directors by either the company or the shareholders for breaches of directors' duties."[61] Such claims are typically not successful, due to "docket explosion before the Indian courts, the ability of shareholders or the company to bring a suit, and . . . to enforce a successful claim against directors."[62] However, Section 245 of the Companies Act, 2013 established a class action mechanism "[i]n order to obviate the difficulties" of bringing a claim against directors by allowing a group of shareholders "to bring an action on behalf of all affected parties."[63] This mechanism exposes all directors to class actions.[64] The 2013 Act also allows such actions to be brought before the National Company Law Tribunal (NCLT) instead of the regular court system, which is intended to be "faster, more efficient and less costly."[65] The threshold required for a class action was only recently notified in May of 2019 by the Ministry of Corporate Affairs (MCA).[66] The notified threshold for an application for a class action is at least a member or members representing 5 percent of the total members of the company or at least 100 members, whichever is less.[67] Additionally, the MCA is also working on a "scheme to provide financial assistance to minority investors filing class actions under the companies law."[68] It appears that no class actions have been brought to date.[69]

SEBI Listing Regulations. Under the SEBI Listing Regulations,[70] independent directors are required to "exercise reasonable care, diligence, and skill to ensure" that financial statements are correct.[71] Failure to do so is equivalent "to facilitating false and misleading disclosures" and thus "may involve liabilities" under the Regulations.[72] Other requirements on independent directors from SEBI include declaring that they meet

57 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 7.

58 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 7.

59 The Companies Act, 2013, Section 2(6)(vi).

60 Amitabh Robin Singh, "Minimizing the Liability of Directors: SEBI's Order in the Zylog Case," *IndiaCorpLaw Blog*, June 28, 2017.

61 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381.

62 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381.

63 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381–82.

64 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381 n.116.

65 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 381–82.

66 Ashima Obhan and Vrinda Patodia, "Class Action Suits in India: Government Notifies Thresholds For Filing Class Action Suits," *Corporate Law Blog*, Obhan & Associates.

67 "Government Notifies Thresholds for Filing Class Action Lawsuits," *Economic Times*, May 9, 2019.

68 "Government Notifies Thresholds for Filing Class Action Lawsuits," *Economic Times*.

69 Clifford Alvares and Harsha Jethmalani, "Why Threat of India's First Class Action Suit Against ADAG May Be a Pipe Dream," *LiveMint*, October 4, 2019.

70 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

71 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

72 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

the criteria to be considered independent and reporting any changes of their independence, and reviewing board performance and information flow to the board.[73]

Currently, under the SEBI Listing Regulations, an independent director may be held liable only in respect of such acts of omission or commission by the listed company that had occurred with his knowledge, attributable through processes of the board of directors, and with his consent or connivance or where he had not acted diligently with respect to the provisions of the SEBI Listing Regulations.[74] In an order issued in March 2011,[75] SEBI held that an independent director is bound to discharge his duty of care toward the company with the exercise of independent judgment and with reasonable care, diligence, and skill. In this case, it was alleged that the financial statements of a company contained inflated revenue and profit figures, thereby misleading the public. SEBI held that the independent directors ignored certain aberrations in financial figures that "would alert any person of ordinary prudence,"[76] particularly since such directors were also members of the audit committee of the company's board of directors. SEBI considered that such directors had failed to ask the right questions and had consequently failed in their duty of care as independent directors. SEBI ordered that the directors be restrained from acting as independent directors on the board of any listed company for a period of two years.

Other statutes. As mentioned previously, liability can also arise from other statutes, such as under the Negotiable Instruments Act, the Income Tax Act of 1961, foreign exchange regulations, securities regulations, the Shops and Establishments Act, and money-laundering regulations.[77] However, the liability imposed on directors in different statutes typically imposes liability "in primarily two ways: (1) vicarious liability on those officers who are in charge of and responsible to the company for the conduct of its business; and (2) vicarious liability on those officers who have contributed to the contravention or the offence by consenting, conniving or not acting diligently, thereby allowing the offence to take place."[78] The Supreme Court of India has held that in order for directors to be held liable for an offense by the company, the director must have had an active role with criminal intent and the statute must stipulate the liability of directors.[79]

The Negotiable Instruments Act is an "illustrative example of the inordinate liability risk faced by independent and non-executive directors."[80] Earlier in 2019, in two different cases "[n]on-executive and independent directors of a company challenged the criminal actions initiated against them under the Negotiable Instruments Act and approached the High Court to quash such actions."[81] In the first case, *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.*, a nonexecutive nominee director had been summoned "to answer the accusations of offense under Section 138 of the Negotiable Instruments Act, 1881" after no payment was made by the company despite a notice of demand after "dishonor of certain cheques."[82] The petitioner argued that he was a nonexecutive nominee director at the relevant time and had no control over the day-to-day affairs or the business of the company.[83] The Court held that in order for a director to be prosecuted under the Negotiable Instruments Act, he must be in charge of day-to-day activities and be responsible for the conduct of the business.[84] The Court relied on the 2014 Supreme Court case of *Pooja Ravinder Devidasani* v. *State of Maharashtra & Anr.*, which held that a director cannot be held liable under the Negotiable Instruments

73 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

74 Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 no. 25(5) (Sept. 2, 2015), hereafter SEBI Listing Regulations.

75 Securities Appellate Tribunal (Mumbai Bench, Mumbai), In re Pyramid Saimira Theatre Ltd. (March 11, 2011).

76 Securities Appellate Tribunal (Mumbai Bench, Mumbai), In re Pyramid Saimira Theatre Ltd. (March 11, 2011).

77 Desai and Kabra, "Director and Officer Liability in India," p. 19.

78 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, pp. 21–22.

79 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 22.

80 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 24.

81 Varottil, "Actions Against Independent Directors for Dishonour of Cheques."

82 *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.* (2019), 2019 DEL p. 746.

83 *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.* (2019), 2019 DEL p. 746.

84 *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd*. (2019), 2019 DEL p. 746; Varottil, "Actions Against Independent Directors for Dishonour of Cheques"; Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 25.

Act simply because he is a director.[85] The Supreme Court explained that a nonexecutive director is a custodian of the governance of the company but is typically not involved in the day-to-day affairs.[86] The Supreme Court further stated that "A [d]irector, who was not in charge of and was not responsible for the conduct of the business of the Company at the relevant time, will not be liable for an offence under Section 141 of the [Negotiable Instruments Act]."[87] The Court thus quashed the action against the nonexecutive nominee director for a check the company had issued.[88]

In the separate case of *Sh Somendra Khosla and Others* v. *State & Anr.*, the petitioners were directors summoned as accused under Section 138 of the Negotiable Instruments Act.[89] The petitioners sought to have the complaints quashed "on the grounds that petitioners are independent directors and are not in charge of day to day business of the [company]."[90] However, in this case there were allegations that the petitioners were actually responsible for day-to-day affairs.[91] The Court stated that the Supreme Court permits summoning of directors who were in charge of day-to-day affairs.[92] The Court thus refused to quash the action because the complaint alleged that the independent directors were responsible for day-to-day activities.[93] Professor Umakanth Varottil believes that the Court in this case "entirely overlooks the position of an independent director" and arrived at their conclusion without considering the position of an independent director.[94] Others posit that "the contrasting outcomes in the cases discussed above highlight that the effectiveness of insulating potential liability for such directors is heavily dependent on the manner in which courts interpret it, based on the specific facts and circumstances of individual cases."[95]

Indemnities and Insurance

A company may indemnify its directors and may include such indemnity in its articles of association.[96] In the 1956 Act, companies were not permitted to indemnify directors for negligence, default, breach of duty, and the like.[97] The current Act, however, does not contain such a provision, which means that directors may have greater flexibility in obtaining indemnification from the company, especially in cases where the director's conduct is not at issue.[98] The 2013 Act implicitly recognizes the right of the company to obtain directors' and officers' (D&O) insurance policies by paying a premium.[99] Any indemnity by a company in favor of a director or an officer of the company is subject to the provisions of Section 197 and Section 463 of the Companies Act, 2013.

Section 197 of the Companies Act states that when a company takes insurance on behalf of, among other personnel, its managing director or whole-time director to indemnify them against liability in respect to any negligence, default, misfeasance, breach of duty, or breach of trust of which they may be guilty, the premium paid on such insurance shall not be treated as part of the remuneration payable to such personnel. However, if such person is proven guilty, the premium on such insurance shall be treated as part of the remuneration.

Section 463 of the Act states that if in any proceeding for negligence, default, breach of duty, misfeasance, or breach of trust brought against an officer of the company, it appears to the court hearing the case that he is or may

85 *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.* (2019), 2019 DEL p. 746.

86 *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.* (2019), 2019 DEL p. 746.

87 *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.* (2019), 2019 DEL p. 746.

88 Varottil, "Actions Against Independent Directors for Dishonour of Cheques"; *Bhardwaj Thirvenkata Venkatavaraghavan* v. *PVR Ltd.,* (2019) 2019 DEL p. 746.

89 *Sh Somendra Khosla* v. *State* (2019) 2019, DEL p. 797.

90 *Sh Somendra Khosla* v. *State* (2019) 2019, DEL p. 797.

91 *Sh Somendra Khosla* v. *State* (2019) 2019, DEL p. 797.

92 *Sh Somendra Khosla* v. *State* (2019) 2019, DEL p. 797.

93 *Sh Somendra Khosla* v. *State* (2019) 2019, DEL p. 797; Varottil, "Actions Against Independent Directors for Dishonour of Cheques."

94 Varottil, "Actions Against Independent Directors for Dishonour of Cheques."

95 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 26.

96 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 382–83.

97 Khanna and Varottil, "Board Independence in India: From Form to Function," pp. 352, 382–83.

98 Varottil, *Directors' Duties and Liabilities in the New Era*, NSE Centre for Excellence in Corporate Governance Quarterly Briefing, April 2014.

99 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 382–83; Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 19.

be liable in respect of the negligence, default, breach of duty, misfeasance, or breach of trust, but that he has acted honestly and reasonably, the court may, taking into consideration all the circumstances of the case, including those connected with his appointment, hold that he ought fairly to be excused, and relieve the officer, either wholly or partly, from his liability, on such terms as the court may deem fit. However, in a criminal proceeding, the court has no power to grant relief from any civil liability that may attach to an officer in respect of such negligence, default, breach of duty, misfeasance, or breach of trust.

D&O insurance "has already become prevalent in Indian companies" and is only expected to increase.[100] However, even when a company has D&O insurance and director indemnification, this does not eliminate all risk for independent directors since it is common for insurance and indemnities to "not provide protection against liability arising out of fraudulent or criminal conduct."[101] Independent insurance experts suggest that independent directors negotiate indemnity provisions in their letters of appointment and insist on a "good D&O liability insurance policy with [an] adequate limit and comprehensive coverage."[102]

Challenges in the Legal Regime

Independent director liability risk in India appears to be greater than in other jurisdictions. In the United States, independent directors are largely protected by the business judgment rule when they have exercised due diligence and acted in an informed manner.[103] In the United Kingdom, independent directors have similar duties but have a lower culpability standard than in the United States.[104]

Recent developments and crises in India have put "enormous pressure on independent directors."[105] Not only are they now expected to play a larger role, but they can also be "subject to legal proceedings" if they fail to fulfill their role adequately.[106] Thus, independent directors in India are often advised to "be aware of and mitigate potential liabilities."[107] The suggestion to independent directors facing this heavier burden is to "seek and securely maintain updated records of board and committee proceedings and other matters."[108] Independent directors should also ensure that any dissent or objection they have on a resolution is recorded, and should engage their own counsel.[109] Lastly, it is suggested that independent directors should "understand the company's business model, operations and systems, especially financial controls, and seek expert input where warranted."[110]

Many have expressed concerns about the impact of the increased possible liability imposed on independent directors. Former SEBI chair M. Damodaran shared his concern that the expansion of liability for independent directors may cause "good people" to leave board positions and thus actually undermine the system that was meant to "bring balance to the boardroom."[111] He further stated that independent directors suffer from "information asymmetry" and that therefore, if independent directors were treated as "persons who have connived, conspired or colluded," it would be "grossly unfair" when they were negligent at best.[112] Other experts agree that while the Act clarifies independent directors' roles and liability, it

100 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 383.

101 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 30.

102 Umesh Pratapa, "Independent Directors in India: Risk Exposures, Safeguards, and Insurance Protection," *D&O Diary*, May 11, 2016.

103 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, pp. 12–13.

104 Mukherjee and Pandey, *The Liability Regime for Non-Executive Independent Directors in India: A Case for Reform*, p. 14.

105 Kalpana Unadkat, "Independent Directors—Over Expectation or Under Achievement?" *Asian Legal Business*, June 11, 2019.

106 Unadkat, "Independent Directors—Over Expectation or Under Achievement?"

107 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

108 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

109 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities"; Koshy and Preetha, "Much Ado About Independent Directors," stating that the most effective tool independent directors have is "to record a dissent."

110 Vijayaraghavan and Iyer, "Independent Directors: Staying Mindful of Liabilities."

111 Vijayaraghavan, Maulik Vyas, and Rica Bhattachayya, "More Independent Directors Take the Exit Fearing Legal Scrutiny," *Economic Times*, June 21, 2019.

112 Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny."

may prove to be a disincentive for individuals to accept independent directors positions and may actually be "counter-productive."[113]

Khanna and Varottil also posited in 2017 that the "higher obligations under the new legal regime might hinder competent individuals from taking up independent directorships on corporate boards."[114] They further explained, "For instance, the regime makes the duties and liabilities of independent directors fairly significant" and that "[t]he duties and liabilities may operate as a disincentive to highly skilled people."[115] However, some do acknowledge that the Act is a positive step in the right direction for the integrity and independence of independent directors, but also voice concerns that the Act simply fails to recognize that independent directors actually have very limited impact on the board.[116]

There is data suggesting that more independent directors are now resigning their positions and exiting without adequate reasons, with the number growing year after year.[117] Others are not willing to accept a position as an independent director.[118] This increase in resignations and unwillingness to accept positions has been speculated to be a result of the "heavy personal liability" that independent directors carry.[119] However, this may change, since more independent directors are now asking for appropriate D&O insurance coverage to join boards.[120]

According to NSE Infobase,[121] companies listed on the NIFTY 500 had a total of 316 independent directors exit in financial year 2019, a 31.7 percent increase from the preceding year.[122] The reasons for exits varied from personal reasons to 50 independent directors "quit[ing] without giving any reason."[123] Some former directors have anonymously said that they are refusing independent directorship offers because of fears about liabilities and being held accountable for the actions of promoters and management.[124] Some have explicitly cited corporate governance as a reason for stepping down.[125] Experts believe that independent directors are resigning as soon as they realize that "all is not well with the company" and that this may have to do with the fact that an independent director is now personally liable "for any acts of omission or commission by a company, with his knowledge or consent, or connivance, or in cases where he had not acted diligently."[126]

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113 Koshy et al., "New Directions: The Responsibilities, Rewards and Liabilities of Independent Directors Will Be Transformed by the New Companies Act," p. 28.

114 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 384.

115 Khanna and Varottil, "Board Independence in India: From Form to Function?" pp. 352, 384.

116 Koshy and Preetha, "Much Ado About Independent Directors."

117 Jayshree P. Upadhyay, "Why Independent Directors are Rushing for the Exit Door," *LiveMint*, December 19, 2018; Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny"; "Independent Directors Quitting over Governance Issues Should State It Clearly: SEBI," *Financial Express*, October 22, 2020.

118 "Former executives, ex-bureaucrats and others are increasingly quitting or declining to accept jobs as independent directors." Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny."

119 It has been speculated that independent directors are quitting due to "heavy personal liability." Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny."

120 Shilpy Sinha, "Companies Buying More and More Insurance For Directors & Officers Amid Rising Bankruptcy, Fraud Cases," *Economic Times*, January 28, 2019.

121 "NSE Infobase," National Stock Exchange of India Ltd. The NSE Infobase provides "unmatched quality and accurate information on listed companies."

122 Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny."

123 Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny"; Vijayaraghavan, Vyas, and Lijee Philip, "Why are Independent Directors Resigning in Droves," *Economic Times*, September 7, 2020.

124 Vijayaraghavan et al., "More Independent Directors Take the Exit Fearing Legal Scrutiny."

125 Upadhyay, "Why Independent Directors are Rushing for the Exit Door."

126 Upadhyay, "Why Independent Directors are Rushing for the Exit Door."

Key Takeaways

- The liabilities of directors are set out under the Companies Act, 2013, as well as under other Indian statutes.
- While holding a director liable for a particular act or omission, the court is required to consider a variety of factors, including but not limited to the nature of the directorship, the nature of the offense, the intention of the director, and the knowledge and sanction of the board of directors.
- The Companies Act, 2013 provides certain safe harbor provisions for liabilities that independent directors may incur.

Open Questions

- Does the Indian legal framework cast an unduly heavy burden on independent directors? Which of the specific provisions imputing liability on corporate directors need to be adjusted to ensure that directors can continue performing their duties effectively?
- Would certain clarifications on the liability of directors contribute to increasing the ease of doing business in India?

CHAPTER FIVE

The Nomination and Remuneration Committee

The Companies Act, 2013 (Companies Act, or Act) and the SEBI Listing Regulations both require that all listed companies must have a nomination and remuneration committee (NRC). In addition, in accordance with the rules under the Act, certain other large public companies must have an NRC.

In most other leading jurisdictions, securities laws or listing regulations require two separate committees—one focused on nomination and one focused on remuneration. However, as the concept has developed in India, boards of Indian companies are required to form only one committee.

This chapter explores the development of the NRC concept in India and explains the current rules for the committee under both the Act and the SEBI Listing Regulations.

Development of the Nomination and Remuneration Committee Concept

Development of the nomination committee. Historically, Clause 49 of the Listing Agreement did not require boards of Indian companies to constitute nomination committees. Because directors (including independent directors) were voted for individually at a shareholders' meeting by way of a separate resolution, a majority of the shareholders could determine the composition of the entire board. Controlling shareholders could therefore wield significant influence in the nomination and appointment of directors.

Despite the lack of a formal requirement, several leading companies nevertheless constituted nomination committees as a matter of good practice. These included companies that were cross-listed on foreign stock exchanges such as the NYSE and the NASDAQ that mandate a nomination committee. However, at the time, a substantial number of Indian listed companies chose not to constitute a nomination committee.[1]

Due to the influence of controlling shareholders in the nomination and appointment of directors, the concept of nomination committees was formally recognized in India for the first time under the Ministry of Corporate Affairs' Corporate Governance Voluntary Guidelines, 2009 (Voluntary Guidelines), but the requirement was not made mandatory.[2] Under the Voluntary Guidelines, companies had the option to establish a nomination committee composed of a majority of a company's independent directors, including its chair.

To be effective, the nomination committee should

- consider proposals for searching, evaluating, and recommending appropriate independent directors and nonexecutive directors based on objective and transparent guidelines;
- evaluate nominations against criteria such as qualifications, positive attributes, independence, and availability of the individual; and
- determine the process for evaluating the skill, knowledge, and experience of individual directors and the entire board.

Moreover, the nomination committee's role extends to ensuring that the board has an appropriate balance of executive and nonexecutive directors. The annual reports of companies are required to elaborate on the nomination committee's guidelines, as well as the role the committee has performed over the course of the year to guarantee adequate disclosures. This disclosure is intended to provide greater transparency into the functioning of the committee.

The Voluntary Guidelines did not significantly change the director nomination process. Directors (both executive and independent) continued to be nominated by either existing directors or controlling shareholders.[3] Although the nomination committee plays a significant role in other countries in increasing minority shareholders' faith in the director selection process, it did not achieve a similar effect on Indian corporate governance. Thus, experts suggested that the nomination committee requirement should be mandatory.[4]

1 According to one survey, 56 percent of the respondents did not constitute a nomination committee. *CG Review 2009: India 101-500*, FICCI and Grant Thornton, March 2009.

2 CORPORATE GOVERNANCE VOLUNTARY GUIDELINES 2009, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA (2009) (hereinafter VOLUNTARY GUIDELINES).

3 One survey indicates that 55 percent of directors are nominated by existing directors. Corporate Governance Review of the Mid-market Listed Companies in India: 2010-11, FICCI and Grant Thornton (2011).

4 Vikramaditya S. Khanna and Shaun J. Mathew, "*The Role of Independent Directors in Controlled Firms in India: Preliminary Interview Evidence*," *National Law School of India Review* 22 (2010): 35-66; Umakanth Varottil, "Beyond Satyam: Analyzing Corporate Governance in India," *IndiaCorpLaw Blog*, February 12, 2009.

Development of the remuneration committee. Initially, Clause 49 gave companies the discretion to form a remuneration (compensation) committee. There were four provisions in Clause 49 regarding compensation committees:

1. A company's board of directors could set up a compensation committee to determine its policy on compensation packages for executives and directors.
2. The chair of the committee could be an independent director, and the committee could have at least three directors, all of whom were to be nonexecutives. This would ideally avoid conflicts of interest.
3. All members of the committee could be present at meetings.
4. The chair of the committee could be present at the company's annual meeting to answer shareholder questions.

These nonmandatory provisions on compensation committees differed from requirements in other jurisdictions, such as the United States. In the United States, all NYSE and NASDAQ listed companies must have a compensation committee composed entirely of independent directors.[5]

Before compensation committees became mandatory, many large companies had already chosen to create them.[6] Professors Jayati Sarkar and Subrata Sarkar of the Indira Gandhi Institute conducted research on compensation committees for the top 500 listed companies in India.[7] Their research indicated that about 74 percent of the top 500 listed companies had compensation committees in 2008.[8] The study also looked into the size of the compensation committees at these top 500 listed companies. In 2008, over 47 percent of the companies had committees of three directors, and approximately 17 percent had compensation committees of four directors.[9] Interestingly, the professors' research revealed that companies with compensation committees pay directors more than companies without them.[10] Moreover, they found that director compensation increases at a faster rate in companies with compensation committees.[11] The research also indicated that many companies in India had an executive on the compensation committee. Such companies tend to pay their executives and directors more in fixed salaries and long-term benefits and less in variable bonuses and commissions—a compensation structure with lower risks.[12]

The institutional culture of Indian companies also emphasizes the importance of compensation committees. Many Indian companies are owned by families or promoters. Many promoters tend to be CEOs, high-level executives, or directors.[13] Research indicates that executives from founding families or those related to them receive higher compensation compared to those with no relation.[14] More recently, the issue of CEO compensation has become increasingly significant as research indicates that "median CEO pay of BSE 500 companies has outpaced corporate performance" in the five years leading up to financial year 2018.[15]

Toward a Mandatory Nomination and Remuneration Committee

The Act provides that every listed public company and any other specified company is required to have an NRC.[16] The MCA has specified that in addition to listed companies,

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5 "NYSE Listed Company Manual," New York Stock Exchange, last amended January 11, 2013, § 303A.05; "NASDAQ Listing Rules," Nasdaq, Inc., last amended January 11, 2013, rule 5605(d).

6 Jayati Sarkar and Subrata Sarkar, *Corporate Governance in India*, ed. Vivek Mehra (SAGE Publications, 2012), 346.

7 The research and resulting calculations are based on compensation data available in the SANSCO database. Sarkar and Sarkar, *Corporate Governance in India*, 347.

8 Sarkar and Sarkar, *Corporate Governance in India*, 347.

9 Sarkar and Sarkar, *Corporate Governance in India*, 348.

10 Sarkar and Sarkar, *Corporate Governance in India*, 350.

11 Sarkar and Sarkar, *Corporate Governance in India*, 350. As the authors explained, there are two possible reasons for these findings: (1) companies with compensation committees are more skilled in setting compensation levels to appropriately incentivize directors, or (2) companies hire compensation consultants and may be subjected to the "ratchet effect" as they try to top average compensation levels in the industry.

12 Sarkar and Sarkar, *Corporate Governance in India*, 350.

13 Sarkar and Sarkar, *Corporate Governance in India*, 360.

14 *Executive Remuneration: Time to Rein in the Rewards*, Institutional Investor Advisory Services India Limited, May 8, 2013.

15 "CEO Remuneration: Competition to Pay More," *Institutional EYE Blog*, Institutional Investor Advisory Services India Limited, April 8, 2019.

16 The Companies Act, 2013 § 178, No. 18, Acts of Parliament, 2013 (Aug. 29, 2013).

public companies that have (1) paid-up share capital[17] of at least INR 10 crore, (2) turnover of at least INR 100 crore, or (3) in aggregate, outstanding loans, debentures, and deposits exceeding INR 50 crore, must have an NRC.[18] Under Section 178 of the Act, the NRC may consist of three or more nonexecutive directors, a majority of which must be independent directors. In addition, the chair of the company can be on the NRC but may not serve as its chair.

The NRC must identify suitable persons for directorship and senior managerial positions in the company and recommend their appointment to the board. The committee is also required to evaluate the performance of board members and recommend removal, if required. The committee should establish criteria for determining the qualifications, positive attributes, and independence of a director. The committee should also specify a method for effectively evaluating the performance of the board, its committees, and its individual directors.[19] More specifically, the NRC is charged with formulating the criteria for evaluating the performance of independent directors, and with devising the policy on board diversity. This criterion for performance evaluations must be disclosed in the company's annual report.

Commentators argue that although the NRC committee is mandatory, its effect in India likely will not be the same as that experienced in other countries such as the United States.[20] This is because the concentrated shareholding in Indian companies would provide controlling shareholders with significant influence (through exercise of their voting power) to determine whether the candidate nominated by the committee should be appointed or not. Hence, the nomination committee might be compelled to function in the shadow of an ultimate shareholder decision (with controlling shareholder influence). The solution to this problem lies in altering the nomination and voting process for election of directors such that minority shareholders obtain a greater direct say in the process. Cumulative voting or decision-making by a majority of the minority are possible alternatives to alleviate this concern. The Companies Act provides for a voluntary cumulative voting scheme under Section 163, which states that "the articles of a company may provide for the appointment of not less than two-thirds of the total number of the directors of a company in accordance with the principle of proportional representation, whether by the single transferable vote or by a system of cumulative voting or otherwise and such appointments may be made once in every three years and casual vacancies of such directors shall be filled as provided in subsection (4) of section 161."

The SEBI Listing Regulations require NRCs to be subject to the same requirements as the Companies Act.[21] Additionally, under the SEBI Listing Regulations, the NRC must comprise solely nonexecutive directors, with independent directors serving as half the membership and as the committee chair. For listed entities with outstanding superior voting rights equity shares (SR Equity Shares), two-thirds of the NRC must comprise independent directors. The chair of the company may be appointed as a member of the committee but cannot chair the committee. The quorum for a meeting of the NRC shall be either two members or one-third of the members of the committee (whichever is greater), as long as at least one independent director is in attendance. While the SEBI Listing Regulations mandate minimum meetings for the Audit Committee, the NRC previously did not have a similar requirement. SEBI has now accepted the Kotak Committee's recommendation[22] that the NRC must meet at least once every year.[23]

In *Corporate Board Practices: 2018 India Edition*, it was noted that across all industry categories, nonexecutive directors make up more than 90 percent of the

17 Under section 2(64) of the Companies Act, 2013, "paid-up share capital" or "share capital paid-up" means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid up in respect of shares issued and also includes any amount credited as paid up in respect of shares of the company, but does not include any other amount received in respect of such shares, by whatever name called.

18 The Companies (Meetings of Board and its Powers) Rules, 2014, *Gazette of India*, pt. II sec. 3 ch. XII sec. 6, 2014 (Mar. 31, 2014).

19 The Companies Act, 2013 § 178.

20 Umakanth Varottil, "Evolution and Effectiveness of Independent Directors in Indian Corporate Governance," *Hastings Business Law Journal* 6, no. 2 (2010): 281

21 SEBI Listing Regulations, pt. III sec. 4 no. 19(1).

22 Uday Kotak et al., *Report of the Committee on Corporate Governance*, Securities and Exchange Board of India, October 2017, ch. III, para. 1. The MCA has not provided any views on this recommendation.

23 Inserted as Regulation 19(3A) of the SEBI Listing Regulations by the SEBI Listing Regulations Amendment Regulations 2018. Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2018, *Gazette of India*, pt. III sec. 4 (May 9, 2018).

Board Evaluations by the NRC

The Companies Act was enacted to align Indian corporate governance standards with global best practices in response to a growing need for transparency and accountability within Indian boards.[a] Board evaluations became one of the critical elements of these heightened standards. Although the Kotak Committee had recommended board evaluations for listed companies in 2003, the Act advanced the recommendation to a requirement.[b]

Current framework. In conjunction with the SEBI Listing Regulations, the Act sets forth the requirement that listed companies evaluate their boards and committees.[c] Section 134 of the Act requires the board of directors of listed companies to include a statement outlining their method of formal evaluation.[d] Furthermore, section 178(2) of the Act gives the NRC full discretion over the methods of evaluation, performing the evaluation, and determinations on whether to continue or extend the directors' term based on the evaluation.[e] The SEBI Listing Regulations similarly charge the NRC with formulating the criteria for the evaluation of independent directors and the board as a whole.[f] Additionally, independent directors must also review the performance of non-independent directors, the board as a whole, and the chair of the listed entity. Independent directors are also required to holistically assess the flow of information between management and the board of directors to determine if it is adequate for the board's performance.[g]

Studies reveal that although listed companies were technically in compliance with these requirements, they failed to actively and effectively evaluate boards in a way that improved their performance. A 2015 study of the board evaluation practices of the top 100 companies in India identified challenges and best practices for evaluations. This study found that when rated on a scale of 1 to 5 based on board evaluation practices, no company scored higher than 3.[h] Additionally, no company had disclosed areas for improvement that were identified through the evaluation process.[i] Although this disclosure is not mandated, it is considered a best practice globally.[j]

The study also suggested that a comprehensive evaluation requires the use of individual questionnaires, web-based questionnaires, personal interviews, and group discussions.[k] Additionally, evaluation criteria for the board should include "its role and participation in strategy formulation, succession planning, review of board composition, business oversight and governance

a *The India Board Report 2015 – 16*, AZB & Partners, Hunt Partners, and PricewaterhouseCoopers Pvt. Ltd., (2017).

b *Board Evaluation Practices in India: A Study of Top 100 Companies in 2015*, CimplyFive and InGovern, May 2016.

c Shashwat Sharma, Prithvi Vardhan, and Simone Reis, "Evaluation of the Board of Directors of the Listed Company: The Need of the Hour?" Nishith Desai Associates, January 24, 2017.

d The Companies Act, 2013 § 134; "Board Evaluation: A Gateway to Stakeholders' Trust," Deloitte, *Forbes India*, January 19, 2017.

e The Companies Act, 2013 § 178(2).

f Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 no. 19 (Sept. 2, 2015) [hereinafter SEBI Listing Regulations].

g The Companies Act, 2013 § 178(2); SEBI Listing Regulations, pt. III sec. 4 sched. II pt. D.

h *Board Evaluation Practices in India: A Study of Top 100 Companies in 2015*, CimplyFive and InGovern.

i *Board Evaluation Practices in India: A Study of Top 100 Companies in 2015*, CimplyFive and InGovern.

j Arundhati Ramanathan, "Indian Board Evaluation Practices Fail to Match Global Standards," *LiveMint*, May 31, 2016.

k *Board Evaluation Practices in India: A Study of Top 100 Companies in 2015*, CimplyFive and InGovern.

Board Evaluations by the NRC *continued*

process."[l] Evaluation of individual directors covered personal attributes like knowledge, experience, ethical standards, communication, and persuasion skills with application tested through attendance, participation, and contribution in board discussions."[m] The study further suggested that communicating an actionable plan for improvement, after disclosing areas for improvement, was critical to the overall success of the board evaluation.

Deloitte also conducted a similar study to assess trends in the disclosures of board evaluation practices. Deloitte sampled companies from the BSE Sensex, NIFTY 50, S&P BSE 100, and S&P BSE 200 for their study, and found that only 7 percent of the companies had hired an external agency to conduct the evaluation of the board.[n] Although not required, many experts suggest that board assessments be conducted independently.[o] Additionally, of the sampled companies, only 37 percent disclosed their methodology and/or criteria for board evaluations, and only 33 percent disclosed the results (quantitatively or qualitatively) of the board evaluations.[p]

The National Stock Exchange (NSE) and IiAS conducted three separate studies on board evaluation disclosures and practices in India.[q] In their most recent study, they focused on 2016 to 2017 annual disclosures.[r] This study found that companies had improved their board evaluation practices and disclosures related to the evaluation process over the last three years.[s] However, the study noted a need to enhance practices and disclosures related to board evaluation outcomes in addition to the processes.[t] It also emphasized the need for boards to base salary decisions on board evaluations.[u]

SEBI Guidance Note. On January 5, 2017, SEBI released a guidance note to provide more direction to listed entities regarding the board evaluation process.[v] The guidance note reorganizes the board evaluation process by dividing it into the pre-evaluation process, evaluation process, and post-evaluation process, and providing clarity on best practices.[w] Specifically, the guidance note highlights the need for precise parameters that evaluate the structure of the board and its individual members, while underscoring the need for external evaluations, as mere internal evaluations had given rise to issues following the Act.[x] However, the guidance note simultaneously emphasizes the importance of selecting an external agency that is not a related party subject to a conflict of interest.[y] The note further suggests using

l *Board Evaluation Practices in India: A Study of Top 100 Companies in 2015*, CimplyFive and InGovern.

m *Board Evaluation Practices in India: A Study of Top 100 Companies in 2015*, CimplyFive and InGovern.

n "Board Evaluation: A Gateway to Stakeholders' Trust," Deloitte.

o "Board Evaluation: A Gateway to Stakeholders' Trust," Deloitte.

p "Board Evaluation: A Gateway to Stakeholders' Trust," Deloitte.

q "Board Evaluation: Disclosures and Practices—2016-17," *Institutional EYE Blog*, Institutional Investor Advisory Services India Limited, February 26, 2018.

r "Board Evaluation: Disclosures and Practices—2016-17," Institutional Investor Advisory Services India Limited.

s "Board Evaluation: Disclosures and Practices—2016-17," Institutional Investor Advisory Services India Limited.

t "Board Evaluation: Disclosures and Practices—2016-17," Institutional Investor Advisory Services India Limited.

u "Board Evaluation: Disclosures and Practices—2016-17," Institutional Investor Advisory Services India Limited.

v CIRCULAR NO. SEBI/HO/CFD/CMD/CIR/P/2017/004, GUIDANCE NOTE ON BOARD EVALUATION, SEC. & EXCH. BD. OF INDIA (2017).

w GUIDANCE NOTE ON BOARD EVALUATION, SEC. & EXCH. BD. OF INDIA.

x GUIDANCE NOTE ON BOARD EVALUATION, SEC. & EXCH. BD. OF INDIA.

y GUIDANCE NOTE ON BOARD EVALUATION, SEC. & EXCH. BD. OF INDIA.

Board Evaluations by the NRC *continued*

technology to conduct the board evaluation process to ensure efficiency of external evaluations.[z] The Guidance Note also reiterates the aforementioned importance of disclosing the methodology employed by boards for evaluation. It suggests taking additional steps beyond this disclosure to share results, action plans, and current status to various stakeholders in an effort to increase transparency.[aa]

Conclusion. India has significantly shifted its approach to improving corporate governance in recent years. This is especially evidenced by the shift from merely establishing procedures toward developing a corporate culture that truly emphasizes transparency and accountability. Although the SEBI Guidance Note is not mandatory, it puts pressure on companies to incorporate its elements to develop a long-term strategy of improving board evaluations, and thus, corporate governance in India.

z GUIDANCE NOTE ON BOARD EVALUATION, SEC. & EXCH. BD. OF INDIA.

aa GUIDANCE NOTE ON BOARD EVALUATION, SEC. & EXCH. BD. OF INDIA.

directors serving on NRCs (see Figure 5.1a). In the telecommunications sector, 100 percent of members of the NRCs are nonexecutive directors. In terms of company size, for companies with annual revenue up to INR 250 crores, all members of the NRCs are nonexecutive directors. For all other companies, over 90 percent of the directors on the NRC are nonexecutive directors (see Figure 5.1b).

Corporate Board Practices: 2018 India Edition, also noted that the telecommunications sector has the lowest percentage of independent directors serving on NRCs at 57 percent (see Figure 5.2a). The real estate sector has the highest percentage of independent directors in NRCs at 87 percent. In terms of company size, on average, 80 percent of NRC directors are independent (see Figure 5.2b). Companies with annual revenue between INR 500 crores and INR 1,000 crores reported having the most independent directors serving on NRCs at 82 percent.

Corporate Board Practices: 2018 India Edition found that across industries, with the exception of financials and materials, 100 percent of NIFTY 500 companies have an independent NRC chairperson (see Figure 5.3a). Noncompliance (when the NRC chair does not meet the independence standard) is observed at a rate of 5 percent for financials and 1 percent for materials. In terms of companies classified by annual revenue, NIFTY 500 companies, except those with annual revenue above INR 5,000 crores, have complied with the requirement of the SEBI Listing Regulations (see Figure 5.3b). For companies with annual revenue above INR 5,000 crores, 2 percent of the NRC chairs are not independent.

International corporate governance standards regard independent board members playing a key role in the NRC as good practice.[24] When questions arise at NRC meetings, they are determined by a majority vote of present members. When the resulting votes are equal on both sides, the chair of the NRC is given a second or casting vote.[25] Given this procedure, the composition of the NRC needs to be carefully considered in order to promote good

24 G20/OECD Principles of Corporate Governance, Organisation for Economic Co-operation and Development [OECD] (2015).

25 The Companies Act, 2013, sched. I tbl.F.

Figure 5.1a

Executive and Nonexecutive Directors on NRC, by Industry

Percent of total directors

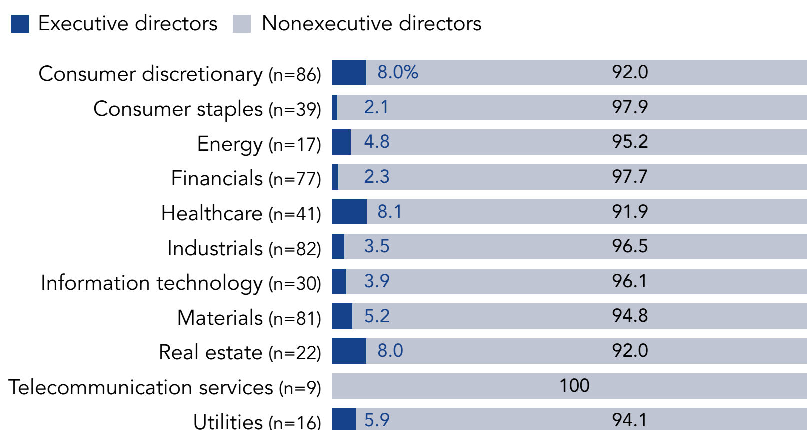
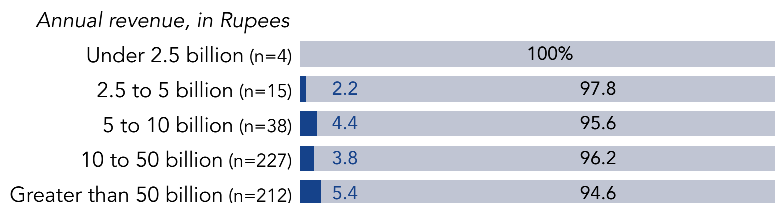


Figure 5.1b

Executive and Nonexecutive Directors on NRC, by Company Size

Percent of total directors



Note: For Figure 5.1b, out of 1,722 directors, the range of annual revenue is not known for four companies. Accordingly, 14 directors have not been included in the above analysis.

Percentages may not add up to 100 due to rounding.

Source: The Directors' Collective/PRIME Database Group, 2018

Nomination and Remuneration Committee (Companies Act, 2013 Section 178(1)-(4))

Composition

- Three or more nonexecutive directors with a majority of independent directors
  - The chair of the company may be appointed as a member of the committee, but must not chair the committee

Role

- Identify persons qualified to become directors or senior management in accordance with the criteria laid down, and recommend their appointment or removal to the board
- Carry out evaluation of every director's performance
- Specify the method for effectively evaluating the performance of the board, its committees, and its individual directors to be carried out by the board, by the committee itself, or by an independent external agency and review its implementation and compliance
- Formulate the criteria for determining the qualifications, positive attributes, and independence of a director
- Recommend a remuneration policy for directors, key managerial personnel,[a] and other employees
  - Ensure that the level and composition of remuneration is reasonable and sufficient to attain, retain, and motivate directors of the quality required to run the company successfully
  - Ensure that the relationship of remuneration to performance is clear and meets appropriate performance benchmarks
  - Ensure that the remuneration to directors, key managerial personnel, and senior management involves a balance between fixed and incentive pay reflecting short-term and long-term performance objectives appropriate to the working of the company and its goals

Such policy is to be placed on the website of the company, and the salient features of the policy, changes therein, and the web address of the policy are to be disclosed in the board's report.

Applicability

- Every listed public company
- Public companies with (1) a paid-up share capital of at least INR 10 crore; (2) a turnover of at least INR 100 crore; or (3) in aggregate, outstanding loans, debentures, and deposits exceeding INR 50 crore

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a The Companies Act, 2013 defines key managerial personnel in relation to a company as the following: the chief executive officer, managing director, or manager; the company secretary; the whole-time director; the chief financial officer; such other officer, not more than one level below the directors, who is in whole-time employment, designated as key managerial personnel by the board; and such other officer as may be prescribed.

governance. Members of the NRC are appointed by the board, or by the NRC chair. As with any other board committee, the NRC should be constituted bearing in mind factors such as the director's knowledge, skills, expertise, and capacity to honor time commitments. Members of the NRC should also be able to outline the goals of the committee and be led by a capable chair.[26] However, scholars have argued that allowing the CEO to propose and shortlist names for the NRC can result in a greater "familiarity quotient" between the board and the CEO, potentially weakening governance. One possible remedy to the issue of familiarity is to introduce outsiders to the board or a committee of independent directors, and charge them with nominating the next independent director.[27]

Disclosures by the Nomination and Remuneration Committee

The Companies Act requires that the company's annual report and the board's report include disclosure regarding the committee's remuneration policy, as well as significant information on the remuneration of directors and key managerial personnel. The SEBI Listing Regulations require that the annual report disclose a brief description of the terms of reference of the NRC, the composition thereof, the names of the members and chair, details of meetings, and attendance during the year.[28]

Remuneration caps and disclosure regarding median remuneration. Under Section 92 of the Act, a company's annual report must include the details of remuneration paid to directors and key managerial personnel. Section 197 of the Act provides for remuneration caps for public companies. For example, for public companies, the Act provides a maximum limit of 11 percent of net profits for managerial remuneration.

Composition of the NRC under the SEBI Listing Regulations

- Committee to have at least three directors
- All NRC members to be nonexecutive directors
- At least 50 percent of directors to be independent directors
- Chair to be an independent director

Role of the NRC under the SEBI Listing Regulations

- Formulate the criteria for determining the qualifications, positive attributes, and independence of a director and recommend to the board a policy relating to the remuneration of the directors, key managerial personnel, and other employees.
- Formulate criteria for evaluating the performance of the independent directors and the board.
- Devise a policy on board diversity.
- Identify persons who are qualified to become directors or senior management in accordance with the criteria prescribed and recommend to the board their appointment or removal.
- Recommend to the board all remuneration, in whatever form, payable to senior management.

In addition, the continuance of independent directors is decided based on evaluation results.

26 BOARD COMMITTEES: A HAND BOOK, THE COMPANIES ACT, 2013 SERIES, INST. OF CO. SEC'YS OF INDIA (2014).

27 Adi Godrej et al., *Report of the Committee Constituted by MCA to Formulate a Policy Document on Corporate Governance*, Ministry of Corporate Affairs, Government of India, September 2012.

28 SEBI Listing Regulations, pt. III sec. 4 sched. V.

Figure 5.2a

Independent Directors on NRC, by Industry

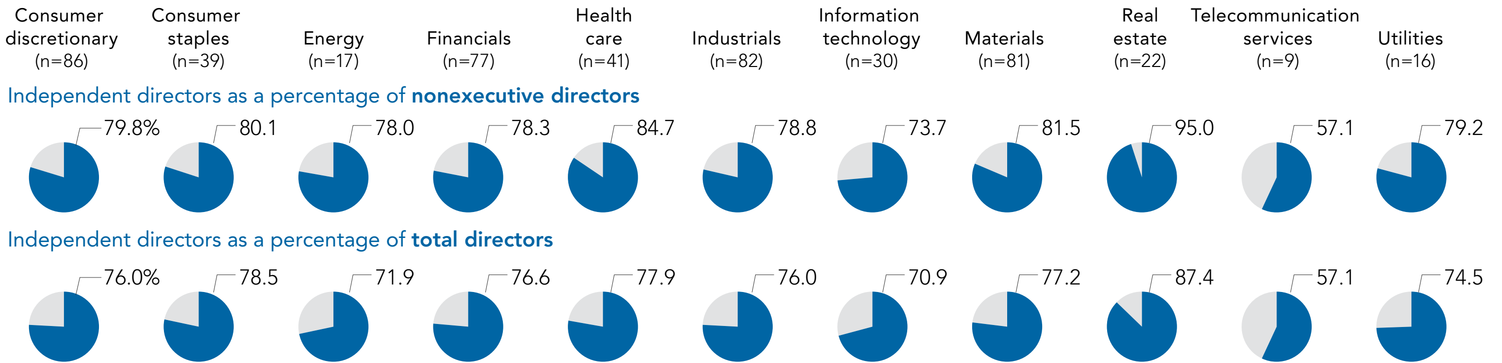
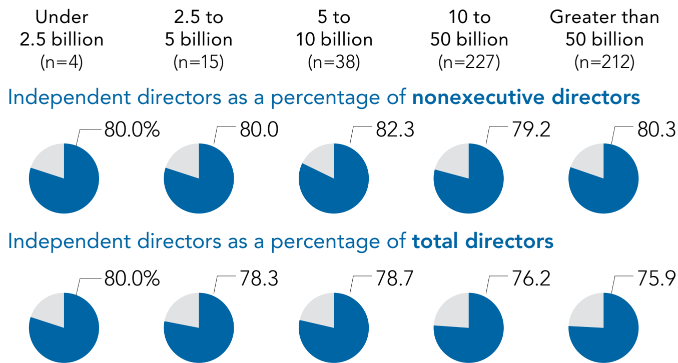


Figure 5.2b

Independent Directors on NRC, by Company Size

Annual revenue, in Rupees



Note: In Figures 5.2a and 5.2b, out of 1,722 directors serving on nomination and remuneration committees, it was not known for one director whether that director was independent or not, and hence that director has not been included in this analysis.

Source: The Directors' Collective/PRIME Database Group, 2018

Figure 5.3a

Independent NRC Chairperson, by Industry

Percent of total

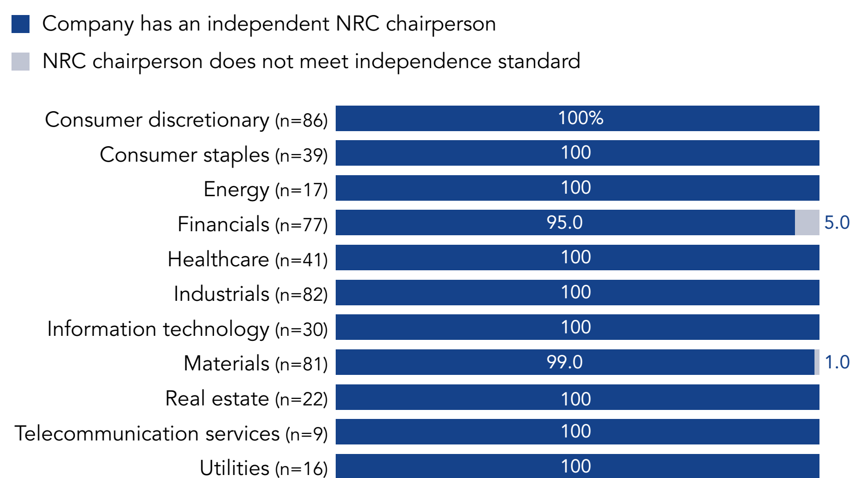


Figure 5.3b

Independent NRC Chairperson, by Company Size

Percent of total

Source: The Directors' Collective/PRIME Database Group, 2018

Recovery of Remuneration under the Companies Act, 2013

The Act contains stringent provisions for cases in which a company is required to restate its financial statements pursuant to fraud or noncompliance with any requirement under the Act and the rules made thereunder. Section 199 of the Act states that a company must recover the excess remuneration paid (including stock options) from any past or present managing director, executive director, manager, or chief executive officer who, during the period for which the financial statements have been restated, has acted in such capacity.

Section 197 of the Companies Act requires listed companies to disclose in the board's report the ratio of the remuneration of each director to the median employee's remuneration, and such other details as may be prescribed. The Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, clarify the additional disclosures that must be made by listed companies.[29] Under Rule 5, every listed company must disclose in the board's report

- the ratio of the remuneration of each director to the median remuneration of the employees of the company for the financial year;
- the percentage increase in remuneration of each director, chief financial officer, chief executive officer, company secretary, or manager, if any, in the financial year;
- the percentage increase in the median remuneration of employees in the financial year;
- the number of permanent employees on the rolls of the company;
- the average percentile increase already made in the salaries of employees other than the managerial personnel in the last financial year compared with the percentile increase in the managerial remuneration and justification thereof, pointing out if there are any exceptional circumstances for increase in the managerial remuneration; and
- an affirmation that the remuneration is as per the remuneration policy of the company.

SEBI Listing Regulations: Remuneration disclosure requirements. The SEBI Listing Regulations also require disclosure regarding the remuneration of directors in the section on corporate governance in a company's annual report. All listed companies must publicly disclose their criteria for making payments to nonexecutive directors, as well as all pecuniary relationships or transactions of the nonexecutive directors vis-à-vis the listed entity. Alternatively, this may be disseminated on the listed entity's website and referenced in the annual report. In addition to the disclosures required under the Act, the company must also disclose with respect to all directors[30]

- all elements of the remuneration package of individual directors summarized under major groups, such as salary, benefits, bonuses, stock options, pension, etc.;
- details of fixed-component and performance-linked incentives, along with the performance criteria;
- service contracts, notice period, and severance fees; and
- stock option details, if any, and whether issued at a discount, as well as the period over which accrued and exercisable.

29 The Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014, *Gazette of India*, pt. II sec 3(i) ch. XIII (Mar. 31, 2014).

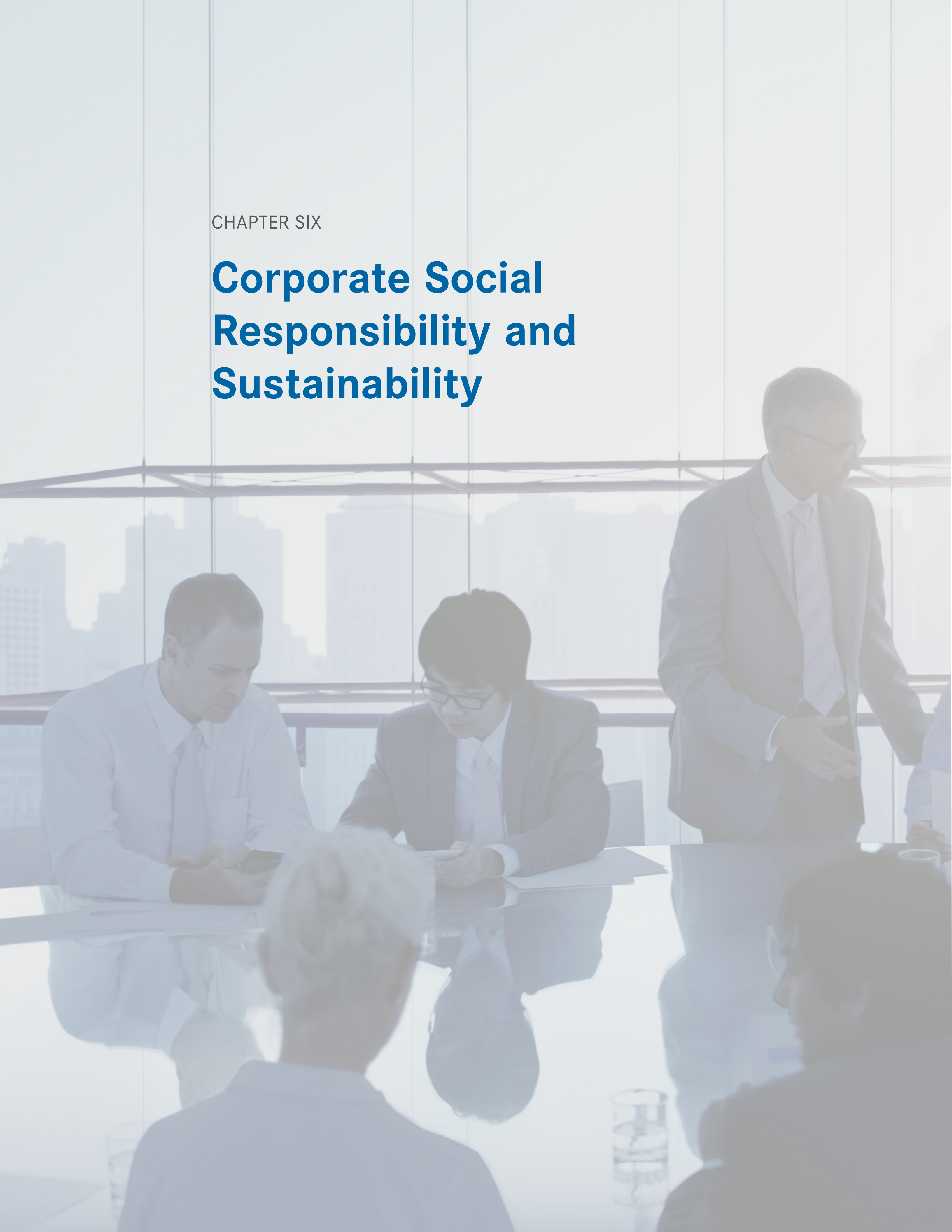
30 SEBI Listing Regulations, pt. III sec. 4 sched. V.

Key Takeaways

- For listed companies, two-thirds of the NRC should comprise independent directors.
- Every NRC must meet at least once a year.
- The NRC, inter alia, frames criteria for director qualifications and independent directors' performance evaluation, and recommends managerial remuneration to the board.

Open Questions

- Should the NRC be replaced by two separate committees—a nomination committee and a remuneration committee—in line with international practices?
- Should the NRC be more independent than the regulations currently require it to be, or should it be entirely composed of independent directors?
- Since the NRC has such a vast role to play, should it be mandated to hold meetings at least once every quarter?
- Does the NRC require a more detailed and binding regulatory mandate for board evaluation?



CHAPTER SIX

Corporate Social Responsibility and Sustainability

Introduction

Corporate social responsibility (CSR) has received significant attention from businesses, civil society, and governments around the world. It is widely observed that corporations must not only behave ethically, but also "contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large."[1] For decades, CSR was viewed as a set of voluntary practices, articulated in various codes of conduct and principles, to encourage companies to operate in a responsible manner. More recently, the global CSR movement has changed from voluntary good citizenship practices into a sustainability concept under which companies integrate the potential social and environmental impact of their business activities into the core of their decision-making. As noted by the Corporate Social Responsibility Initiative at Harvard's Kennedy School of Government: "Corporate social responsibility encompasses not only what companies do with their profits, but also how they make them. It goes beyond philanthropy and compliance and addresses how companies manage their economic, social, and environmental impacts, as well as their relationships in all key spheres of influence: the workplace, the marketplace, the supply chain, the community, and the public policy realm."[2] The increased emphasis on sustainability comes from many sides, particularly from large institutional investors.[3]

Since the late 2000s, the Indian government has repeatedly sought to infuse CSR into the corporate governance of Indian businesses. This initiative was initially proposed by the Ministry of Corporate Affairs (MCA) in the 2009 Voluntary CSR Guidelines and is a key feature of the Companies Act, 2013 (Companies Act, or Act).[4] Section 166 of the Companies Act provides that directors must "act in good faith in order to promote the objects of the company for the benefit of its members as a whole, and in the best interests of the company, its employees, the shareholders, and the community and for the protection of environment."[5] This broad vision of directors' duties to stakeholders is reiterated in the Code for Independent Directors, which provides that independent directors must "safeguard the interests of all stakeholders… [and] balance the conflicting interest of the stakeholders."[6] In short, the law requires that Indian boards consider the interests of various stakeholders and the trade-offs involved before making balanced decisions.

With the Companies Act and other legislation, India is now at the forefront of efforts to impose CSR requirements, mandating extensive CSR policies, spending, and disclosures. The securities laws require extensive disclosures for large, listed companies, including disclosure of their environmental, social, and governance initiatives in their annual business responsibility reporting. SEBI has also introduced voluntary integrated reporting that requires disclosure of the six capitals (financial, manufactured, intellectual, human, social and relationship, and natural) to enable informed investment decision-making. In addition, in March 2019, the MCA issued the National Guidelines on Responsible Business Conduct (NGRBC). The NGRBC are designed to encourage and assist businesses in contributing to wider development goals while seeking to maximize profits.

As the concepts of CSR and sustainability have developed both in India and globally, India's efforts have been aimed at transforming CSR from charitable giving into a sustainability model. Charitable giving has long been a priority for many Indian firms. Even prior to the Companies Act, many of India's largest conglomerates had separate active philanthropic funds and welfare programs or initiatives. This was not because of legal requirements but rather as a form of charity meant to indicate the virtues of the company or the organization.[7] In connection with changes in legal requirements, studies have found that some of the largest Indian companies "now apply the same rigour to causes as diverse as hunger, poverty, healthcare,

1 World Business Council for Sustainable Development (1999), p. 3.

2 Beth Kytle and John Gerard Ruggie, "Corporate Social Responsibility as Risk Management: A Model for Multinationals," Corporate Social Responsibility Initiative Working Paper No. 10, March 2005.

3 Vikramaditya S. Khanna, *Global Asset Managers and the Rise of Long Term Sustainable Value*, NSE Centre for Excellence in Corporate Governance Quarterly Briefing, October 2018.

4 Corporate Social Responsibility Voluntary Guidelines, Ministry of Corporate Affairs, Government of India; The Companies Act, 2013, Section 35, No. 18, Acts of Parliament, 2013 (Aug. 29, 2013).

5 The Companies Act, 2013, Section 166.

6 The Companies Act, 2013, sched. IV, II(5)–II(6).

7 Meera Mitra, *It's Only Business! India's Corporate Social Responsiveness in a Globalized World* (Oxford: Oxford University Press, 2007), 34–36; Bala N. Balasubramanian, "Governing the Socially Responsible Corporation—A Gandhian Perspective," in *Ethics, Business and Society: Managing Responsibly*, ed. Ananda Das Gupta (New Delhi: SAGE Publications Pvt. Ltd., 2010), 10.

education, cleanliness, environmental sustainability, and rural development, as they bring to their business."[8] Furthermore, with the imposition of greater regulatory requirements, many large Indian companies have enhanced their disclosure and reporting on sustainability matters.[9]

India's Changing CSR Concept

Since the late 2000s, the Indian government has attempted to transform CSR activities from a collection of philanthropic activities undertaken by only the largest business houses to a way of doing business that involves the right combination of enhancing long-term shareholder value and protecting the interests of various other stakeholders (employees, creditors, consumers, and society at large).[10] Thus, in addition to the mandatory frameworks instilled in the Act, their accompanying rules, and the SEBI Listing Regulations, the government has issued a series of voluntary guidelines. These guidelines not only helped develop the CSR concept in India, but more recently have helped propel the conversation toward a sustainability framework.

CORPORATE SOCIAL RESPONSIBILITY VOLUNTARY GUIDELINES (2009)

In late 2009, the MCA proposed groundbreaking CSR Guidelines in what has been deemed the first concrete attempt to recognize CSR from a regulatory standpoint.[11] The guidelines attempt to frame CSR as part of Indian history and culture, stating that "Indian entrepreneurs and business enterprises have a long tradition of working within the values that have defined our nation's character for millennia. India's ancient wisdom, which is still relevant today, inspires people to work for the larger objective of the well-being of all stakeholders."[12]

The fundamental principle of the CSR Guidelines is that

> [e]ach business entity should formulate a CSR policy to guide its strategic planning and provide a roadmap for its CSR initiatives, and that this should be an integral part of overall business policy and aligned with a company's business goals. The policy should be framed with the participation of various level executives and should be approved and overseen by the Board.[13]

According to the CSR Guidelines, the CSR Policy should cover the following core elements:

- care for all stakeholders, including shareholders, employees, customers, suppliers, project-affected people, society at large, etc.;
- ethical functioning, transparency, and accountability;
- respect for workers' rights and welfare;
- respect for human rights;
- respect for the environment; and
- activities for social and inclusive development.[14]

ENVIRONMENTAL, SOCIAL, AND CORPORATE GOVERNANCE (ESG) GUIDELINES—JULY 2011

In July 2011, the MCA issued the National Voluntary Guidelines on Social, Environmental & Economic Responsibilities of Business (NVG).[15] The NVG established concrete, voluntary measures for companies to adopt in order to address the interests of various stakeholders such as employees, customers, and the environment. They supersede the 2009 CSR Guidelines and revolve around the following nine core principles:

1. Businesses should conduct and govern themselves with ethics, transparency, and accountability.
2. Businesses should provide goods and services that are safe and contribute to sustainability throughout their life cycle.

8 "Corporate Social Responsibility: A Lot More Than Feel-Good," *Institutional EYE Blog*, Institutional Investor Advisory Services India Limited, March 2019.

9 Umakanth Varottil, *Environmental and Social Reporting by Indian Companies*, NSE Centre for Excellence in Corporate Governance Quarterly Briefing, January 2019.

10 For a detailed review of India's CSR Reform efforts, see Afra Afsharipour and Shruti Rana, "The Emergence of New Corporate Social Responsibility Regimes in China and India," *UC Davis Business Law Journal* 14, no. 2 (2014), pp. 175–230.

11 Varottil, "Voluntary Guidelines on Governance and Social Responsibility," *IndiaCorpLaw Blog*, December 31, 2009.

12 Corporate Social Responsibility Voluntary Guidelines, Ministry of Corporate Affairs, Government of India, 2009.

13 Corporate Social Responsibility Voluntary Guidelines, Ministry of Corporate Affairs, Government of India, p. 11.

14 Corporate Social Responsibility Voluntary Guidelines, Ministry of Corporate Affairs, Government of India, pp.11–12.

15 National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, Ministry of Corporate Affairs, Government of India, 2011.

3. Businesses should promote the well-being of all employees.
4. Businesses should respect the interests of, and be responsive toward, all stakeholders, especially those who are disadvantaged, vulnerable, and marginalized.
5. Businesses should respect and promote human rights.
6. Businesses should respect, protect, and make efforts to restore the environment.
7. Businesses, when engaged in influencing public and regulatory policy, should do so in a responsible manner.
8. Businesses should support inclusive growth and equitable development.
9. Businesses should engage with and provide value to their customers and consumers in a responsible manner.

The NVG further elaborated on each of these core principles. Similar to the 2009 Guidelines, the ideals set forth in the NVG are lofty:

> The Guidelines emphasize that businesses have to endeavor to become responsible actors in society, so that their every action leads to sustainable growth and economic development. Accordingly, the Guidelines use the term "Responsible Business" instead of "Corporate Social Responsibility" (CSR) because the term "Responsible Business" encompasses the limited scope and understanding of the term CSR.
>
> The Guidelines take into account the learnings from various international and national good practices, norms and frameworks, and provide a distinctively "Indian" approach, which will enable businesses to balance and work through the many unique requirements of our land. By virtue of these Guidelines being derived out of the unique challenges of the Indian economy and the Indian nation, they take cognizance of the fact that all agencies need to collaborate together, to ensure that businesses flourish, even as they contribute to the wholesome and inclusive development of the country. The Guidelines emphasize that responsible businesses alone will be able to help India meet its ambitious goal of inclusive and sustainable all round development, while becoming a powerful global economy by 2020.

Indian businesses showed little indication of widespread adoption of the NVG.

NATIONAL GUIDELINES ON RESPONSIBLE BUSINESS CONDUCT

In March 2019, the MCA issued the NGRBC, a set of guidelines designed to encourage and assist businesses in contributing to wider development goals while seeking to maximize profits.[16]

Many factors contributed to the NGRBC's release and to the MCA's articulation of a more comprehensive guide to help businesses of all sizes implement the principles espoused in the NVG.[17] Ever since the NVG was issued in 2011, national and international developments such as India's Companies Act of 2013 and the United Nations Guiding Principles on Business and Human Rights (UNGP)[18] have demonstrated a need for India to modernize its guidelines. The NGRBC can be viewed as a signal of India's visible implementation of the UNGP and of its commitment to other sustainable development goals.[19] Furthermore, developing more robust CSR guidelines could enable India to attract more long-term strategic investment. Some investors consider a company's inability to consider ESG-related challenges in their decision-making a risk, and that can be an impediment to attracting sustainable investment in Indian companies.[20]

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16 NATIONAL GUIDELINES ON RESPONSIBLE BUSINESS CONDUCT, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2018).

17 NATIONAL GUIDELINES ON THE ECONOMIC, SOCIAL AND ENVIRONMENTAL RESPONSIBILITIES OF BUSINESS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2018).

18 NATIONAL GUIDELINES ON RESPONSIBLE BUSINESS CONDUCT, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA; *Business & Human Rights Ambitions and Actions in India: A Primer for WBCSD Members Doing Business in India,* World Business Council for Sustainable Development, Confederation of Indian Industry, and CII-ITC Centre of Excellence for Sustainable Development, August 2019; "MCA Releases National Guidelines on Responsible Business Conduct," *News Chrome*, March 2019.

19 "MCA Releases National Guidelines on Responsible Business Conduct," *News Chrome*.

20 *Transformational Shift or Incremental Change? A Comparative Analysis of the Draft National Guidelines on Social Environmental and Economic Responsibilities of Business, and Its Corresponding Business Responsibility Framework*, Oxfam India and cKinetics (2018).

The NGRBC is organized into nine principles accompanied by core elements, which are suggested actions for operationalizing each of the broad principles. These principles substantially mirror those found in the NVG:

1. Businesses should conduct and govern themselves with integrity, and in a manner that is ethical, transparent, and accountable.
2. Businesses should provide goods and services in a manner that is sustainable and safe.
3. Businesses should respect and promote the well-being of all employees, including those in their value chains.
4. Businesses should respect the interests of and be responsive to all their stakeholders.
5. Businesses should respect and promote human rights.
6. Businesses should respect and make efforts to protect and restore the environment.
7. Businesses, when engaging in influencing public and regulatory policy, should do so in a manner that is responsible and transparent.
8. Businesses should promote inclusive growth and equitable development.
9. Businesses should engage with and provide value to their consumers in a responsible manner.

The NGRBC builds on the NVG's governance structure by identifying particular aspects of each of these principles to correspond to a particular duty owed by the highest governance structure of the business.[21] While the NGRBC is depicted as the more robust successor to the NVG, the guidelines remain specific suggestions rather than requirements, aimed at providing businesses of all sizes with flexibility in interpreting and implementing the guidelines. However, although the NGRBC is technically voluntary, some suggest that large multinational companies are expected to follow them.[22]

There are numerous differences between the NVG and the NGRBC. The NVG defines broad responsibilities for businesses, whereas the NGRBC asks companies to identify specific governance structures to oversee the adoption, implementation, and monitoring of each principle.[23] For example, the NVG outlined the need for transparent disclosure, while the NGRBC merely suggests businesses have a governance structure to assign responsibility for transparent disclosure.[24] Additionally, the NGRBC includes several new core elements. For example, the NGRBC core element in Principle Three explicates the kinds of stakeholders businesses should consider, such as employees and suppliers, whereas the NVG outlined a broad policy of considering stakeholder interests. Principle Six includes a core element asking businesses to monitor their impact on several environmental factors proactively.[25] Principle Seven's core principles promote fair competition and transparency in influencing public and regulatory policy.

The NGRBC also presents several notable changes related to suggested reporting and provides an annex with a business responsibility reporting framework to "serve as an internal tool for businesses wishing to align themselves with the NGRBC."[26] This reporting framework introduces detailed questions related to leadership indicators; governance data such as company policies on ethics, bribery, and corruption; environmental risks and mitigation efforts; and the company's top three investments. Implementing the NGRBC often demands more from companies than the current laws or regulations require.[27] The reporting scheme under the NGRBC involves very detailed questions for companies to elucidate each element of the principles.

In general, the NGRBC has been well received. Several groups and business leaders in the CSR space view the NGRBC as an instrument of positive change for

21 NATIONAL GUIDELINES ON THE ECONOMIC, SOCIAL AND ENVIRONMENTAL RESPONSIBILITIES OF BUSINESS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

22 *Business & Human Rights Ambitions and Actions in India*, World Business Council for Sustainable Development et al.

23 *Transformational Shift or Incremental Change?* Oxfam India and cKinetics.

24 *Transformational Shift or Incremental Change?* Oxfam India and cKinetics.

25 *Transformational Shift or Incremental Change?* Oxfam India and cKinetics.

26 NATIONAL GUIDELINES ON THE ECONOMIC, SOCIAL AND ENVIRONMENTAL RESPONSIBILITIES OF BUSINESS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

27 *Business & Human Rights Ambitions and Actions in India*, World Business Council for Sustainable Development et al.

Indian businesses. Experts have noted that the NGRBC framework provides an opportunity for Indian companies to boost their credibility, reduce risk, and attract talent.[28] The India CSR Network applauded the MCA for promoting business responsibility instead of philanthropy, as delineated by the Act, in the NGRBC.[29] The U.N. working group of business and human rights welcomed the NGRBC as a pledge to promote corporate respect for human rights, and recognized India as the first South Asian country to prepare a plan in line with UNGP.[30] Nevertheless, the self-compliance and nonmandatory nature of the NGRBC has caused some commentators to question its potential impact, especially outside the cohort of the largest companies.[31]

India's Regulatory Framework for CSR and Related Disclosure

SEBI Business Responsibility Reports. In August 2012, SEBI issued a circular mandating that the top 100 listed companies based on market capitalization submit Business Responsibility Reports (BRR) in order to increase transparency and encourage adoption of the NVG.[32] The BRRs must be submitted as part of a company's annual report, and their format was designed to include disclosures regarding adherence to the nine principles set out in the NVG. SEBI has explained that the "key principles that are required to be reported by the entities pertain to areas such as environment, governance, stakeholder's relationships, etc."[33] Failure to comply with the BRR requirement will be construed as noncompliance with Clause 55 of the Equity Listing Agreement.

Initially, SEBI encouraged other listed companies to disclose information voluntarily on their ESG performance in the BRR format. However, the regulatory framework was quickly transformed into a mandatory one for the largest listed companies. In 2015, pursuant to Regulation 34(2)(f) of the SEBI Listing Regulations, the BRR requirements were expanded to the top 500 listed companies by market capitalization. In early 2020, SEBI extended this reporting requirement to the top 1,000 listed companies.

In 2017, to further develop the disclosure regime, SEBI announced that the top 500 listed companies may voluntarily adopt integrated reporting. As SEBI explained, "an integrated report aims to provide concise communication about how an organisation's strategy, governance, performance and prospects create value over time" and provides shareholders and interested stakeholders with relevant "financial and non-financial information" useful for making well-informed investment decisions.[34]

There has been a considerable increase in the incidence and quality of the BRRs issued by Indian companies. In 2017, only 60 percent of companies reporting BR data adopted policies for all NVG Principles.[35] Companies are beginning to transform their disclosures pursuant to the NGRBC. Reliance Industries Limited (RIL), the largest company in India, considers itself a pioneer in adopting the NGRBC guidelines.[36] In their 2019 BRR, RIL disclosed that they have policies in place corresponding to all nine NVG principles, as well as giving specific examples of programs and products RIL has introduced that are aligned with the principles. Apollo Hospitals, a Fortune 500 company in India, also reported implementing policies for all nine principles in its BRR.[37]

Certain industries in India, such as the financial and automotive industries, have been identified as lacking either transparent disclosures or robust internal policies

28 Jyotsna Belliappa, "Leaders Now Understand the Importance of Responsible Business, Says Jyotsna Belliappa of BlueSky," *Blue Sky CSR Company Blog*, December 27, 2019.

29 "NGRBC 2018: A Boon for CSR," *India CSR Network*, November 18, 2019.

30 "UN Expert Group Welcomes India's Plan to Promote Corporate Respect for Human Rights," United Nations Human Rights Office of the High Commissioner, March 22, 2019.

31 Vikrant Wankhede, "New Business Guidelines: A Moral Voice, Not an Execution Tool," *DownToEarth*, July 5, 2018.

32 BUSINESS RESPONSIBILITY REPORTS—FREQUENTLY ASKED QUESTIONS (FAQS), SECURITIES & EXCHANGE BOARD OF INDIA (2013) [hereafter SEBI, BRR FAQs]; Rajib Kumar Debnath, Tejas Saolapurkar, and Avinaw Prasad, "Corporates Set to Plant the Seed of Sustainable Reporting," *Hindu Business Line*, August 4, 2013.

33 CIRCULAR NO. SEBI/HO/CFD/CMD/CIR/P/2017/10, INTEGRATED REPORTING BY LISTED ENTITIES, SECURITIES & EXCHANGE BOARD OF INDIA (2017), para. 1.

34 INTEGRATED REPORTING BY LISTED ENTITIES, SECURITIES & EXCHANGE BOARD OF INDIA, para. 2.

35 *Business Responsibility Reporting: An Analysis of Top 100 BSE and NSE Listed Companies*, KPMG, July 2017.

36 *Business Responsibility Report, Integrated Annual Report 201819*, Reliance Industries Limited, 2019.

37 *Business Responsibility Report 2018–2019*, Apollo Hospitals Enterprise Limited, 2019.

to protect various stakeholders.[38] A sampling of such companies on India's 2019 Fortune 500 list suggests that some companies are addressing NGRBC Principles more directly, despite perceived industry challenges. Indian Oil Corporation and Tata Motors reported having policies in place for all nine principles in their 2018–2019 annual reports.[39] In the banking industry, the State Bank of India also reports policies for all NGRBC principles.[40] ICICI Bank reported that they either have their own policies consistent with the NGRBC, comply with other state guidelines in lieu of specific NGRBC principles, or claim that the core elements are not applicable to their business.[41]

In 2018, the MCA constituted a committee to review the BRR framework, and the committee presented its findings and proposals in its report dated May 8, 2020.[42] The committee, inter alia, laid emphasis on the concept of sustainability. In order to enhance clearer and accurate disclosures under the BRR framework, it proposed simplifying certain questions in the reporting format and provided guidance notes to aid disclosure. To encourage a spectrum of companies wider than those to which the BRR framework applies, the committee recommended a shorter Business Responsibility and Sustainability Report (BRSR) Lite format for reporting. On August 18, 2020, SEBI released a consultation paper inviting comments from the public on the adoption of the BRSR format as recommended by the MCA committee.[43]

38 "Most Indian Banks Fail on Policies of Climate Change and Human Rights," *Oxfam India*, September 30, 2019; Rhythma Kaul, "Poor Safety Mechanism, Work Pressure Maims Thousands in Auto Sector: Report," *Hindustan Times*, August 12, 2019; Supriya Sharma, "Can India Build Cars and Bikes Without Workers Losing Fingers? Yes, If Auto Firms Act on This Report," *Scrol.in*, August 28, 2019.

39 *74th Annual Report (Integrated) 2018–19*, Tata Motors, 2019; *60th Annual Report 2018–19, 2nd Integrated Annual Report*, Indian Oil Corporation Limited, 2019.

40 *Sustainability Report 2018–19: Spearheading Digital India*, State Bank of India, 2019.

41 *Business Responsibility Report, Annual Report 2017–2018*, ICICI Bank, 2019.

42 Gyaneshwar Kumar Singh et al., *Report of the Committee on Business Responsibility Reporting*, Ministry of Corporate Affairs, Government of India, 2020.

43 CONSULTATION PAPER ON THE FORMAT FOR BUSINESS RESPONSIBILITY AND SUSTAINABILITY REPORTING, SECURITIES & EXCHANGE BOARD OF INDIA (2020).

CSR UNDER THE COMPANIES ACT, 2013

In 2010, the MCA moved toward incorporating a more mandatory version of CSR into the Act. Over the next several years, the MCA fluctuated between imposing mandatory CSR requirements into the Companies Act and adopting CSR recommendations with a comply-or-explain (CorEx) approach.[44]

In line with the thorough examination of the 2009–2012 versions of the Companies Bill by the Standing Committee of Parliament on Finance, which included a review of the extent of CSR being undertaken by corporations and the need for a comprehensive CSR policy, the MCA indicated that it would introduce mandatory CSR requirements into the Companies Bill (2012).[45] The Companies Bill (2012) received presidential assent on August 29, 2013 and became the Companies Act, 2013.

Section 135 of the Act sets out the contours of India's new CSR requirements, which became applicable in the 2014–2015 fiscal period.[46] The reach of the CSR clause was expected to be vast. The Indian Institute of Corporate Affairs estimated that at least 6,000 Indian companies would be required to comply with the CSR provisions of the Act.[47] This turned out to be a modest estimation. For FY2014–2015, the MCA reported that 15,548 companies fell within the requirements for the CSR provisions.[48]

44 *The Companies Bill, 2011, Fifty-Seventh Report*, STANDING COMMITTEE ON FINANCE (2011–2012), Fifteenth Lok Sabha (June 2012), pp. 14–15.

45 PRESS RELEASE, RECOMMENDATION TO MAKE FORMULATION OF A CSR POLICY MANDATORY FOR BIG COMPANIES, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2010); Varottil, "Movement Towards Mandatory CSR," *IndiaCorpLaw Blog*, September 11, 2010.

46 PROPOSED DRAFT CORPORATE SOCIAL RESPONSIBILITY RULES UNDER SECTION 135 OF THE COMPANIES ACT, 2013: GUIDING PRINCIPLE, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA [hereafter "Draft CSR Rules"]. The final CSR rules issued by the MCA clarify that for companies that otherwise do not need to appoint independent directors (for example, some unlisted firms), the requirement to have an independent director on the CSR committee will not apply. The Companies (Corporate Social Responsibility Policy) Rules, 2014, *Gazette of India*, pt. II sec 3(i) sec. 5(1) (Feb. 27, 2014) [hereafter MCA, CSR Rules].

47 *Handbook on Corporate Social Responsibility in India*, Confederation of Indian Industry and PricewaterhouseCoopers Private Limited; *Understanding Companies Bill 2012*, Ernst & Young Global Limited, February 21, 2013, p. 30. Other reports indicate that given the low profitability threshold in the Act, the CSR requirements may apply to about 8,000 companies in India. "CSR to Make Available 50,000 More Jobs in the Sector: Experts," *Business Standard*, October 13, 2013.

48 "National CSR Data Portal," Ministry of Corporate Affairs.

Under the Act, and the subsequent 2017 amendments, CSR is considered to be board-level activity. Every company with (1) a net worth of INR 500 crore or more, (2) a turnover of INR 1,000 crore or more, or (3) a net profit of INR 5 crore or more during the immediately preceding financial year must constitute a CSR committee of the board consisting of three or more directors, of which at least one must be independent.[49] Under the 2017 amendments, if a company is not required to have an independent director under Section 149, it is only required to have a CSR committee consisting of two or more directors.[50] The Act empowers the CSR Committee with (1) formulating and recommending a CSR policy to the board that indicates the activities the company shall undertake; (2) recommending the amount of CSR expenditure to be incurred on such activities; and (3) regularly monitoring the CSR initiatives of the company.[51] The board must take the committee's recommendations into account and approve the company's CSR policy.[52] Where the amount to be spent by a company toward CSR as specified above does not exceed INR 50 lakh, the company need not constitute a a separate CSR committee, but the functions of such committee would need to be discharged by the board of directors.[53]

Under the Act, the board must "ensure that the company spends, in every financial year, at least two per cent of the average net profits of the company made during the three immediately preceding financial years, in pursuance of its Corporate Social Responsibility Policy."[54] If a company does not have adequate profits, or is not in a position to spend the prescribed amount on CSR, the regulation requires the directors to provide disclosures and give suitable reasons in their annual report to check for noncompliance.

Failure to explain is punishable by a fine on the company of INR 3,00,000.[55] Officers who default on the reporting provision may be subject to a fine of INR 50,000.[56] To date, the MCA has provided "no guidance as to what constitutes a sufficient or statutorily valid explanation for failure to spend in the board report."[57] However, registry offices have sent show-cause notices to companies for not meeting the CSR spending requirements "disregarding the so-called reason given in the [company's] board report."[58]

The Companies Act includes a detailed schedule of CSR activities (Schedule VII) that companies "may" undertake,[59] and Section 135 states that CSR should preferably be spent in local areas where the company operates.[60] This scheduled list of activities was further updated and amended by the MCA several times in early 2014, 2019, and in 2020 considering the COVID-19 pandemic.

CSR DEVELOPMENTS SINCE THE COMPANIES ACT, 2013

Since passage of the Companies Act, the MCA has set up multiple committees to address CSR.[61] In 2018, the MCA formed its High Level Committee on Corporate Social Responsibility "to review the existing framework and guide and formulate a coherent policy on Corporate

49 The Companies Act, 2013, Section 135(2). The MCA has clarified that "any financial year" implies "any of the three preceding financial years," meaning that any activity that fulfilled the eligibility criteria within the preceding financial years would apply. CIRCULAR NO. 05/01/2014—CSR, CLARIFICATIONS WITH REGARD TO PROVISIONS OF CORPORATE SOCIAL RESPONSIBILITY UNDER SECTION 135 OF THE COMPANIES ACT, 2013, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2014).

50 The Companies (Amendment) Act, 2017, Section 37, No. 1, Acts of Parliament, 2018 (January 3, 2018).

51 The Companies Act, 2013, Section 135(3).

52 The Companies Act, 2013, Section 135(4).

53 The Companies Act, 2013, Section 135(9) as introduced by the Companies (Amendment) Act, 2020, with effect from January 22, 2021.

54 MCA, CSR Rules. Net profit is defined as the net profit of a company per its financial statement, excluding profits arising from branches outside India and any dividend received from other companies in India.

55 The Companies Act, 2013, Section 134.

56 The Companies Act, 2013, Section 134.

57 *The 2% CSR Clause: New Requirements for Companies in India*, Kordant Philanthropy Advisors, 2013.

58 Vinod Kothari, "Highlights of Companies (Amendment) Bill, 2019," *IndiaCorpLaw Blog*, July 27, 2019.

59 The Companies Act, 2013, Section 135, sched. VII.

60 The Companies Act, 2013, Section 135, stating that a company must "give preference to the local area and areas around it where it operates, for spending the amount earmarked for Corporate Social Responsibility activities."

61 Vasani et al., "Corporate Social Responsibility – Less Carrot More Stick"; Injeti Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*, Ministry of Corporate Affairs, Government of India, August 2019; INVITATION FOR PUBLIC COMMENTS FOR HIGH LEVEL COMMITTEE ON CORPORATE SOCIAL RESPONSIBILITY-2018, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2018).

Corporate Social Responsibility under the Companies Act, 2013 (Section 135)

Board-level CSR Committee

- Consists of three or more directors with at least one independent director.
- Consists of two or more directors if the company is not required to have an independent director under Section 149.
- Composition is to be disclosed in the annual board of directors' report.

Responsibilities of the CSR Committee

- Formulate and recommend a CSR Policy and the amount of CSR expenditure.
- Monitor the CSR initiatives regularly.

Annual spending on CSR by companies

- Every financial year, at least 2 percent of the average net profits made during the three preceding financial years may be spent.
- Schedule VII indicates activities that can be undertaken by a company.
- CSR should preferably be spent in local areas where the company operates.

Responsibilities of the company's board

- Approve and disclose a CSR policy in the annual directors' report and on the company website.
- Ensure implementation of CSR activities as per the policy.
- The directors' report is to specify reasons if the specified amount is not spent.

Applicable to all companies that have any of the following in any financial year

- Net worth of INR 500 crore or more.
- Turnover of INR 1,000 crore or more.
- Net profit of INR 5 crore or more.

CSR spending is already mandatory for PSUs

SCHEDULE VII

Activities that may be included by companies in their corporate social responsibility policies should relate to

- eradicating hunger, poverty, and malnutrition;
- promoting health care including preventive health care, and sanitation, including contribution to the Swachh Bharat Kosh set up by the Central Government to promote sanitation and increase the availability of safe drinking water;
- promoting education, including special education, livelihood-enhancement projects, and employment-enhancing vocational skills, especially among children, women, the elderly, and the differently abled;
- promoting gender equality; empowering women; setting up homes and hostels for women and orphans; setting up old-age homes, day care centers, and other facilities for senior citizens; and taking measures to reduce inequalities faced by socially and economically backward groups;

Corporate Social Responsibility under the Companies Act, 2013 (Section 135) *continued*

- ensuring environmental sustainability, ecological balance, the protection of flora and fauna, animal welfare, agroforestry, the conservation of natural resources, and the maintenance of the quality of soil, air, and water, including contribution to the Clean Ganga Fund set up by the Central Government to rejuvenate the river Ganga;
- protecting the national heritage, art, and culture, including restoration of buildings and sites of historical importance and works of art; setting up public libraries; promoting and developing traditional arts and handicrafts;
- instituting measures for the benefit of armed forces veterans, war widows and their dependents, the Central Armed Police Forces (CAPF) and the Central Para Military Forces (CPMF) veterans and their dependents, including widows;
- training to promote rural sports, nationally recognized sports, Paralympic sports, and Olympic sports;
- contributions to the Prime Minister's National Relief Fund (PMNRF), the Prime Minister's Citizen Assistance and Relief in Emergency Situations Fund (PM CARES Fund), or any other fund set up by the Central Government for the socioeconomic development, relief, and welfare of the Scheduled Castes, Scheduled Tribes, other backward classes, minorities, and women;
- contributions to incubators or research and development projects in the fields of science, technology, engineering, and medicine funded by the Central or State Government, public sector undertaking, or any agency of the central government or state government; contributions to publicly funded universities, the Indian Institute of Technology (IIT), national laboratories and autonomous bodies established under the Department of Atomic Energy (DAE); the Department of Biotechnology (DBT); the Department of Science and Technology (DST); the Department of Pharmaceuticals; the Ministry of Ayurveda, Yoga and Naturopathy, Unani, Siddha and Homeopathy (AYUSH); the Ministry of Electronics and Information Technology; and other bodies, namely the Defense Research and Development Organisation (DRDO); the Indian Council of Agricultural Research (ICAR); the Indian Council of Medical Research (ICMR); and the Council of Scientific and Industrial Research (CSIR), engaged in conducting research in science, technology, engineering, and medicine aimed at promoting the sustainable development goals (SDGs);
- rural development projects;
- slum area development; and
- disaster management, including relief, rehabilitation and reconstruction activities.

SCHEDULE III: PART II STATEMENT OF PROFIT AND LOSS

General Instructions for Preparing the Statement of Profit and Loss

- A company shall disclose additional information regarding aggregate expenditure and income on, among other items, CSR activities if the company is covered under Section 135.

Social Responsibility."[62] The Committee released its report in August 2019 after the passage of the Companies (Amendment) Act, 2019.[63] One of the recommendations made by the Committee required that unspent CSR funds be transferred to a designated special account, and if not spent within three to five years, transferred to a fund specified by the Central Government.[64] This recommendation was reflected in the Companies (Amendment) Act, 2019. Additionally, the committee recommended that violations be decriminalized and subject only to civil liability.[65] The MCA reviewed the amendments of Section 135 in light of outcry from corporations and the High Level Committee on Corporate Social Responsibility's recommendations.[66] Many corporations expressed unhappiness with the new mandatory framework for CSR and liken it to a tax, since any unspent CSR funds must be transferred into a government fund.[67]

The amendments regarding Section 135 under the Companies (Amendment) Act, 2019 were met with considerable opposition, and the government initially refrained from notifying the amendments to the controversial CSR provision. However, more recently, the Companies (Amendment) Act, 2019 and the Companies (Amendment) Act, 2020 have incorporated these amendments into section 135 and the Companies (Corporate Social Responsibility Policy) Rules, 2014 (CSR Rules) with effect from January 22, 2021.

While there was much debate over whether the CSR spending provision ought to be mandatory or if the spending should be through a CorEx framework, the 2021 amendment of Section 135 has moved away from the CorEx framework for CSR spending by making it mandatory. Companies are now required to transfer any unspent CSR funds to one of the funds set forth in Schedule VII within six months of the end of the financial year, unless the unspent amount is related to an ongoing project.[68] Funds stated in Schedule VII include funds such as the Prime Minister's National Relief Fund, as well as any other funds set up by the Central Government or State Governments for socioeconomic development and relief.[69] Unspent CSR funds pursuant to an ongoing project must be transferred to a special account opened by the company, known as the Unspent Corporate Social Responsibility Account, within 30 days of the end of the financial year.[70] If the company fails to spend the funds in the account within three financial years of the date of transfer, the funds must be transferred to one of the funds specified in Schedule VII within 30 days of the end of the third financial year.[71] In August 2019, Union Minister of Finance and Corporate Affairs Nirmala Sitharaman stated that violations will be treated only as a civil liability and not as a criminal offense.[72] Accordingly, if a company is in default in complying with the above provisions that mandate such transfer of funds, the company would be liable to a penalty of twice the amount required to be transferred by the company to the Fund specified in Schedule VII or the Unspent Corporate Social Responsibility Account, as the case may be, or INR 1 crore, whichever is less. Further, for every officer of the company who is in default in such a case would be liable to a penalty of one-tenth of such the amount due to be transferred by the company or INR 2 lakh, whichever is less.[73] The Central Government is also authorized to give any general or special necessary directions to companies

62 INVITATION FOR PUBLIC COMMENTS FOR HIGH LEVEL COMMITTEE ON CORPORATE SOCIAL RESPONSIBILITY-2018, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA.

63 Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*.

64 Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*, p. 68.

65 Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*, p. 63.

66 Rabindra Jhunjuhunwala and Parag Bhide, "Companies (Amendment) Act, 2019—CSR Provisions Not Implemented!" Khaitan & Co., August 21, 2019; Kumar and Gopal, "Decriminalising Companies Act Offences—Striking a Balance Between Ease of Doing Business and Corporate Governance."

67 Vasani et al., "Corporate Social Responsibility—Less Carrot More Stick."

68 The Companies (Amendment) Act, 2019 Section 21 (amendment of section 135).

69 The Companies Act, 2013, sched. VII.

70 The Companies (Amendment) Act, 2019 Section 21 (amendment of section 135).

71 The Companies (Amendment) Act, 2019 Section 21 (amendment of section 135).

72 Manisha Kumar and Kunal Gopal, "Decriminalising Companies Act Offences – Striking a Balance Between Ease of Doing Business and Corporate Governance," *India Corporate Law Blog*, Cyril Amarchand Mangaldas, September 23, 2019.

73 Section 135(7) of the Companies Act, 2013, introduced by the Companies (Amendment) Act, 2020 with effect from January 22, 2021.

to ensure compliance.[74] On the other hand however, if the company spends an amount in excess of the requirements provided, such company may set off such excess amount against the requirement to spend under section 135 for such number of succeeding financial years and in such manner, as may be prescribed.[75] Any surplus arising out of the CSR activities must not form part of the business profit of a company and must be ploughed back into the same project or transferred to the Unspent CSR Account and spent in pursuance of CSR policy and annual action plan of the company or transfer such surplus amount to a Fund specified in Schedule VII, within a period of six months of the expiry of the financial year.[76]

THE MCA'S RULES

In September 2013, the MCA released draft rules that provided important additions and clarifications to Section 135 of the Companies Act. After a period for comments from various stakeholders, the MCA amended and updated the draft rules. The rules were finalized on February 27, 2014, when the MCA notified Section 135 of the Companies Act and the Companies (Corporate Social Responsibility Policy) Rules, 2014 ("CSR Rules").[77] The final rules went into effect on April 1, 2014. The MCA made small amendments to the Rules in 2015 and 2016.[78] Further amendments were also made to the Rules in 2020 in light of the COVID-19 pandemic.[79] The CSR Rules were further amended by the Companies (Corporate Social Responsibility Policy) (Amendment) Rules, 2021, with effect from January 22, 2021. The CSR Rules are broadly prescriptive and provide clarifications to Section 135 of the Act, while arguably imposing additional requirements. A summary of the key provisions of the CSR regime imposed by the final CSR Rules appears below.

Applicability of the CSR requirements. As noted above, the Act's CSR provision is applicable to companies with (1) an annual turnover of INR 1,000 crore or more; (2) a net worth of INR 500 crore or more; or (3) a net profit of INR 5 crore or more during any financial year. Companies that trigger any of these conditions must spend at least 2 percent of their average net profits made during the three immediately preceding financial years on CSR activities, and/or report the reason for spending or nonexpenditure. The final rules mandate that the CSR requirements are applicable to every qualifying company as well as to their holding or subsidiary companies.[80] More importantly, the final rules expand the coverage of the Act's CSR requirements to foreign companies with branches or project offices in India to ensure that foreign companies with Indian businesses will be subject to the Act's mandatory CSR provisions.[81]

The scope of CSR activities. The final rules define CSR to mean projects and programs including, but not limited to, those that relate to activities specified in the schedule, or to activities undertaken by the board in pursuance of recommendations of the CSR committee per the declared CSR policy, subject to the condition that such policy covers subjects enumerated in the schedule.[82] The final rules provide important limitations on what counts as CSR and which CSR activities and expenditures are not included.[83]

In addition to defining CSR, the MCA issued a new Schedule VII that expands the scope of CSR activities included in the Companies Act and adds several new activities under the rubric of CSR. Later in 2014, the MCA again amended Schedule VII to provide further activities and clarification. The MCA has explained that the activities covered in Schedule VII are to be

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74 The Companies (Amendment) Act, 2019 § 21 (amendment of section 135).

75 Proviso to section 135(5) of the Companies Act, 2013, introduced by the Companies (Amendment) Act, 2020 with effect from January 22, 2021.

76 CSR Rules.

77 MCA, CSR Rules.

78 The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2015, *Gazette of India*, pt. II sec 3(i) (Jan. 19, 2015); The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2016, *Gazette of India*, pt. II sec 3(i) (May 23, 2016).

79 The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2020, *Gazette of India*, pt. II sec 3(i) (Aug. 24, 2020).

80 MCA, CSR Rules.

81 MCA, CSR Rules. Commentators have noted that the MCA exceeded its legislative mandate by applying the CSR rules to foreign companies, since under the Companies Act, Section 135 is only applicable to companies incorporated under Indian law. Rahul Rishi, Ankita Srivastava, and Milind Antani, "New Rules for Corporate Social Responsibility Announced," Nishith Desai Associates, March 12, 2014; Harinderjit Singh, "CSR Rules: The Ambit of the Act Enlarged," *Firm*, March 25, 2014.

82 MCA, CSR Rules. Some experts have noted that it appears that activities outside Schedule VII would not be considered as permitted CSR activities. "Political Funding Kept Out of CSR Ambit," *Hindu Business Line*, February 27, 2014.

83 CSR Rules.

From Comply or Explain to Mandatory CSR

The 2021 amendments to Section 135, and rules pursuant thereto, have moved India's CSR framework from a comply or explain approach to a mandatory regime.

- Mandatory CSR spends
  - Unspent amount relating to an ongoing project must be transferred to Unspent CSR Account and used within immediate succeeding three FYs in pursuance to CSR policy
  - Amount transferred to Unspent CSR Account remaining unspent at the end of immediate succeeding three FYs must be transferred to Government funds notified in Schedule VII
  - Unspent amount not relating to ongoing projects must be transferred to Government funds notified in Schedule VII
- Ongoing project defined as multi-year project not exceeding three years, excluding the FY in which it was commenced. Board may extend duration of a project to make it an ongoing project.
- Board to monitor implementation of ongoing projects and shall be competent to make modifications, if required
- On Board's approval, excess CSR spending allowed to be carried forward for succeeding three FYs
- Ownership of capital assets created out of CSR fund to be held by
  - A section 8 Company, or a Registered Public Trust, or Registered Society, having charitable objects and a CSR Registration Number; or
  - Collectives of beneficiaries; or
  - Public authority

interpreted liberally and are intended to cover a wide range of activities.[84] The 2017 amendments codified this clarification by changing the language from "as specified in Schedule VII" to "in areas or subjects specified in Schedule VII."[85] In 2019, the MCA amended Schedule VII twice.[86] Most recently, Schedule VII(ix) was expanded to encourage more funding of research and development, an area where India is lagging.[87] Previously, CSR funds could only go to technology incubators at government-approved academic institutions.[88] However, under the recent amendment, CSR funds can be spent on incubators funded by central or state governments, any agency or public sector undertaking of central or state governments, public universities, the Indian Institute of Technology, or any national laboratories and autonomous bodies engaged in research in science, technology, engineering, or medicine aimed at promoting sustainable development goals.[89] This expansion of Schedule VII is moving further from the purpose of CSR. Under the new Schedule VII, a

84 CIRCULAR NO. 05/01/2014—CSR, CLARIFICATIONS WITH REGARD TO PROVISIONS OF CORPORATE SOCIAL RESPONSIBILITY UNDER SECTION 135 OF THE COMPANIES ACT, 2013, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

85 The Companies (Amendment) Act, 2017, Section 37.

86 *F. No. 05/01/2019-CSR, Notification*, Ministry of Corporate Affairs, Government of India, *Gazette of India* (May 30, 2019), amendments to Schedule VII of the Companies Act, 2013; *F. No. 13/18/2019–CSR, Notification*, Ministry of Corporate Affairs, Government of India, *Gazette of India* (Oct. 11, 2019), amendments to Schedule VII of the Companies Act, 2013), hereafter MCA, Amendments to Schedule VII of the Companies Act, 2013, Oct. 11, 2019.

87 MCA, Amendments to Schedule VII of the Companies Act, 2013, Oct. 11, 2019; Shreya Nandi, "Govt Expands Scope of CSR Spending," *LiveMint*, September 20, 2019; "Now, India Inc Can Deploy CSR Funds on Research," *Hindu*, September 20, 2019.

88 Nandi, "Govt Expands Scope of CSR Spending."

89 MCA, Amendments to Schedule VII of the Companies Act, 2013, Oct. 11, 2019.

Definition of CSR

The rules define CSR as activities undertaken by a Company in pursuance of its statutory obligation laid down in section 135 of the Act in accordance with the provisions contained in the Companies (Corporate Social Responsibility Policy) Rules, 2014 (CSR Rules).

Exclusions from Definition of CSR

CSR activities must NOT include the following:

- activities undertaken in pursuance of the normal course of business of the company
  - Provided that any company engaged in research and development activity of a new vaccine, drugs and medical devices in their normal course of business may undertake research and development activity of a new vaccine, drugs and medical devices related to COVID-19 for financial years 2020-21, 2021-22, and 2022-23 subject to the conditions that (a) such research and development activities must be carried out in collaboration with any of the institutes or organizations mentioned in item (ix) of Schedule VII to the Act; and b) the details of such activity must be disclosed separately in the annual report on CSR included in the board's report.
- any activity undertaken by the company outside India
  - except for training of Indian sports personnel representing any State or Union territory at a national level or India at an international level
- contribution of any amount directly or indirectly to any political party under section 182 of the Act
- activities benefiting employees of the company as defined in clause (k) of section 2 of the Code on Wages, 2019
- activities supported by the company on a sponsorship basis for deriving marketing benefits for its products or services
- activities carried out for fulfillment of any other statutory obligations under any law in force in India

private pharmaceutical company would be able to conduct research for their own benefit with a publicly funded institution using CSR funds.[90] Further amendments were also made to Schedule VII in 2020.[91] The current list of permitted CSR activities is included under Schedule VII (as amended). See "Corporate Social Responsibility under the Companies Act, 2013 (Section 135)," p. 112.

Methods for undertaking CSR activities. The CSR Rules provide several different acceptable methods through which companies can undertake CSR activities, in addition to the company undertaking such activities through itself:[92]

- *Conducting CSR through a third party:* CSR activities may be undertaken through a registered society or registered public trust, or a Section 8 Company (i.e., a nonprofit company) under the Companies Act established (i) by the company, either singly or along with any other company; or (ii) by the Central or State Government. CSR activities may also be undertaken through a Section 8 company or a registered public trust or a registered society having an established track record of at least three years in undertaking similar activities.

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90 "Now, India Inc Can Deploy CSR Funds on Research," *Hindu*.

91 *E-F. No. CSR-07/2/2020-CSR-MCA, Notification*, Ministry of Corporate Affairs, Government of India, *Gazette of India* (Aug. 24, 2020) (amendments to Schedule VII of the Companies Act, 2013); *F. No. 13/18/2019-CSR, Notification*, Ministry of Corporate Affairs, Government of India, *Gazette of India* (June 23, 2020), amendments to Schedule VII of the Companies Act, 2013; *F. No. 13/18/2019-CSR, Notification*, Ministry of Corporate Affairs, Government of India, *Gazette of India* (May 26, 2020), amendments to Schedule VII of the Companies Act, 2013.

92 MCA, CSR Rules.

CSR and COVID-19

In August 2020, the MCA amended the CSR Rules in response to the COVID-19 pandemic.[a] Under the revised rules, companies engaged in research and development activities related to new vaccines, drugs, and medical devices in their normal course of business can use CSR funds to undertake such research and development activities related to COVID-19 for the 2020–2021, 2021–2022, and 2022–2023 financial years. To avail themselves of this provision, such research and development activities must happen in collaboration with any of the institutes or organizations mentioned in item ix of Schedule VII of the Act. Further, the details of such activities must be separately disclosed in the Annual Report on CSR, included in the board's report. Further, in early 2021 the MCA clarified that carrying out awareness campaigns/programs or public outreach campaigns on COVID-19 vaccination programs is an eligible CSR activity under Schedule VII of the Act.[b]

a The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2020.

b MCA, General Circular No. 01/2021, January 13, 2021.

- *Conducting CSR through state entities:* Companies may also carry out their CSR activities through any entity established under an Act of Parliament or a State legislature.
- *Collaborating or pooling resources:* Companies may also collaborate with other companies in undertaking CSR projects or programs so long as the collaborating companies are in a position to report separately as per the reporting requirements under the Companies Act.
- With effect from April 1, 2021, all entities that intend to undertake any CSR activity need to register themselves with the Central Government by filing the e-form CSR-1 with the ROC.
- A company may engage international organizations for designing, monitoring, and evaluation of the CSR projects or programs as per its CSR policy as well as for capacity building of their own personnel for CSR.
- The board of a company should satisfy itself that the funds so disbursed have been utilized for the purposes and in the manner as approved by it and the Chief Financial Officer, or the person responsible for financial management must certify to that effect.
- In case of an ongoing project, the board of a company needs to monitor the implementation of the project with reference to the approved timelines and year-wise allocation and must be competent to make modifications, if any, for smooth implementation of the project within the overall permissible time period.

Constitution of a CSR committee. Upon passage of the Companies Act, there was significant confusion over the constitution of CSR committees for companies that otherwise do not need to appoint independent directors.[93] The CSR Rules have dispensed with the requirement of appointing an independent director to the CSR committee of the board of an unlisted or private company that does not otherwise need independent directors on its board. Further, the CSR Rules have relaxed the requirement regarding the presence of three or more directors on the CSR committee. For a private company with only two directors on the board, the CSR committee may consist of these two directors. For a foreign company required to comply with the CSR Rules, the CSR committee must consist of at least two persons, with one being a resident of India and the other nominated by the foreign company.[94] These clarifications to the CSR Rules were incorporated in the 2017 amendment of the Companies Act,[95] which added the provision that if a company is not required to have an

93 Rishi, Srivastava, and Antani, "New Rules for Corporate Social Responsibility Announced."

94 MCA, CSR Rules.

95 The Companies (Amendment) Act, 2017, Section 37.

independent director under Section 149 of the Companies Act, it is only required to have a CSR committee consisting of two or more directors. Compliance with this provision is alarmingly low, with the majority of companies failing to report on the establishment of a CSR committee for the last four financial years.[96]

Calculation of net profits. Every company must report its stand-alone net profits during a financial year for the purpose of determining whether it triggers the threshold criteria as prescribed under Section 135(1) of the Companies Act. For an Indian company, the final rules have clarified that in determining the net profit, dividend income received from another Indian company or profits made by the company from its overseas branches are excluded. Moreover, the 2 percent spent on CSR is computed as 2 percent of the average net profits made by the company during the three preceding financial years.

The CSR Rules prescribe that the CSR requirements are applicable to a foreign company with a branch or a project office in India. The CSR Rules further prescribe that the balance sheet and profit and loss account of a foreign company will be prepared in accordance with Section 381(1)(a). Net profits are calculated per Section 198 of the Companies Act. The rules do not clarify how to compute net worth or turnover for a branch or project office of a foreign company.

Reporting and disclosure. One important aspect of the CSR provisions in the Companies Act is the move toward additional disclosure.[97] The Companies Act requires that the board, after taking into account the recommendations of the CSR committee, approve the company's CSR policy, disclose its contents in its report, and publish the details on the company's website.[98] In addition, if the company fails to spend the prescribed amount, the board must specify the reasons in its report.[99]

Under the CSR Amendment Rules, the board's report of a company pertaining to any financial year must include an annual report on CSR.[100] Balance sheets filed by foreign companies must also contain an annual report on CSR. Further, every company with an average CSR obligation of INR 10 crore or more in the three immediately preceding financial years must undertake an impact assessment, through an independent agency, of its CSR projects having outlays of INR 1 crore or more, and which have been completed not less than one year before undertaking the impact study. Impact assessment reports must be placed before the board and must be disclosed in the annual report on CSR.[101]

Many Indian companies fail to disclose their CSR policies fully,[102] so additional disclosure could be a tool for nongovernmental organization (NGO) advocates and lawyers to pressure companies to comply with their CSR policies.[103] A 2010 study of CSR reporting by India's top 500 companies found that nearly half reported on CSR, but most do not mention the amount spent.[104] Another report found that CSR reporting is "qualitative rather than quantitative in nature," and that most listed Indian companies do not have stand-alone CSR reports.[105] There is also a larger focus on CSR outputs compared with CSR

96 Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*, p. 32.

97 *Corporate Social Responsibility: Review of Current Policies, Practices and Disclosures*, Institutional Investor Advisory Services India Limited, March 2014, p. 3.

98 The Companies Act, 2013, Section 135(3).

99 The rules do not clarify "what constitutes a valid reason for not carrying out CSR activities in a given financial year." *Corporate Social Responsibility*, Institutional Investor Advisory Services India Limited, p. 13.

100 Annexure I and II of the CSR Rules.

101 Expenses incurred in carrying out such impact assessment may be booked toward Corporate Social Responsibility for that financial year, which shall not exceed 5 percent of the total CSR expenditure for that financial year or INR 50 lakh, whichever is less. CSR Rules

102 *Corporate Social Responsibility*, Institutional Investor Advisory Services India Limited, pp. 4–5.

103 Christoph Lattemann et al., "CSR Communication Intensity in Chinese and Indian Multinational Companies," *Corporate Governance: An International Review 17*, no. 4 (July 2009): 429; Seema G. Sharma, "Corporate Social Responsibility in India: An Overview," *The International Lawyer* 43, no. 4 (2009), p. 1521. Among Brazil, Russia, India, and China (BRIC countries), Indian firms rank third in CSR communications intensity. Shaomin Li et al., "Corporate Social Responsibility in Emerging Markets: The Importance of the Governance Environment," *Management International Review: Journal of International Business* 50, no. 5 (October 2010), pp. 646, 648.

104 Richa Gautam and Anju Singh, "Corporate Social Responsibility Practices in India: A Study of Top 500 Companies," *Global Business and Management Research: An International Journal* 2, no. 1 (2010), p. 49.

105 C.V. Baxi and Rupamanjari S. Ray, "Corporate Social & Environmental Disclosure & Reporting," *Indian Journal of Industrial Relations* 44, no. 3 (January 2009), pp. 356, 357.

Treatment of CSR Expenditures

- The board must ensure that administrative overheads not exceed 5 percent of the total CSR expenditure of the company for the financial year.
- Where a company spends an amount in excess of the requirement provided under 135(5), such excess amount may be set off against the requirement to spend under section 135(5) up to the immediate succeeding three financial years, subject to the conditions that the excess amount available for set off must not include the surplus arising out of the CSR activities, if any, in pursuance of Rule 7(2) of the CSR Rules, and the board of the company must pass a resolution to that effect.
- The CSR amount may be spent by a company for the creation or acquisition of a capital asset, which must be held by (a) a section 8 company, or a Registered Public Trust or Registered Society, having charitable objects and a CSR Registration Number under rule 4(2); or (b) beneficiaries of the said CSR project, in the form of self-help groups, collectives, or entities; or (c) a public authority. Any capital asset created by a company prior to January 22, 2021, must within a period of 180 days therefrom comply with the requirement of this rule, which may be extended by a further period of not more than 90 days with the approval of the board based on reasonable justification.

outcomes.[106] Even for information technology companies, CSR reporting on the internet is reported as "strikingly low."[107]

Indian firms may not see the benefits of CSR reporting clearly. A 2007 study of Indian companies found that, when asked if there was a business case for CSR reporting, respondents were unsure whether the benefits accrued from CSR were from CSR reporting or from actual CSR activities.[108] Respondents were unsure of the extent to which CSR reporting impacted employee morale, and they doubted the efficacy of CSR reporting on certain employees.[109] They also did not think CSR reporting improved customer relations.[110] Other companies saw value in CSR reporting, stating that they believed that institutional investors cared about it.

Even after the Companies Act was implemented, a large number of companies that are subject to Section 135 and required to report on CSR fail to do so. In the last four financial years, the number of companies failing to report on CSR ranged from 5,335 to 9,753.[111] The 2017–2018 financial year saw a failure to report from 46 percent of companies that fell within the reach of Section 135.[112]

SHORTCOMINGS OF THE EMERGING CSR MODEL

Several important concerns have been raised about the Indian government's approach to CSR.[113] First, the mandatory spending provision is indicative of a philanthropic model of CSR rather than a broad stakeholder model. Instead of a holistic approach to CSR activities, the Companies Act provides a limited scope for CSR activities and arguably reduces CSR to an ineffective 2 percent spending provision.[114] Second, the Act has

106 Baxi and Ray, "Corporate Social & Environmental Disclosure & Reporting," p. 360.

107 Vidhi Chaudhri and Jian Wang, "Communicating Corporate Social Responsibility on the Internet: A Case Study of the Top 100 Information Technology Companies in India," *Management Communication Quarterly* 21, no. 2 (November 2007), pp. 232, 242.

108 Adam J. Sulkowski, S.P. Parashar, and Lu Wei, "Corporate Responsibility Reporting in China, India, Japan, and the West: One Mantra Does Not Fit All," *New England Law Review* 42, no. 4 (2008), pp. 787, 805.

109 Sulkowski et al., "Corporate Responsibility Reporting in China, India, Japan, and the West," pp. 803–04.

110 Sulkowski et al., "Corporate Responsibility Reporting in China, India, Japan, and the West," p. 804.

111 Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*, p. 22.

112 Srinivas et al., *Report of the High Level Committee on Corporate Social Responsibility 2018*, p. 25.

113 In addition to the criticisms discussed in this section, critics have also lamented the lack of clarification regarding the tax treatment of the CSR provisions. Singh, "CSR Rules: The Ambit of the Act Enlarged."

114 The Companies Act, 2013, Section 135(5); Aneel Karnani, "India Makes CSR Mandatory: A Really Bad Idea," *European Financial Review*, October 29, 2013.

Impact Assessment

The 2021 amendments to the CSR Rules increase a company's focus on impact assessment.

- Companies with an average CSR obligation of INR 10 crore or more in the immediate three preceding FYs must undertake an impact assessment through an independent agency
- Impact assessments to be undertaken for CSR projects with outlays of INR 1 crore or more
- Impact assessments to be undertaken for projects completed not less than one year before undertaking the impact study
- Impact assessments reports to be placed before the board
- Details and reports of impact assessments undertaken, and amounts spent on the same, to be disclosed in the annual report on CSR

been criticized as an attempt by the government to force companies to conduct activities that should be the state's job, such as providing education.[115] Third, the government appears to capitalize on the cultural values of Indian firms while largely placing responsibility for CSR activities with the board, the same approach it has used—with mixed success—with respect to corporate governance reforms.

The vision of CSR espoused in the Act and the final CSR Rules certainly falls short of an expansive stakeholder view of CSR. Experts have questioned whether the Act's requirements render CSR a mere check-the-box obligation and detract from the broader vision of CSR.[116] While Indian corporate law experts described the exclusion of "activities undertaken in pursuance of the normal course of business of the company" as "somewhat paradoxical,"[117] such activities are no longer excluded from the scope of CSR per amendments made to the CSR Rules in August 2020.[118] Nevertheless, certain other exclusions from the list of approved CSR activities, such as the exclusion of activities for the benefit of employees or their families, "undermines the general principle that employees are a key stakeholder in the entire scheme of things."[119]

Critics have noted that the 2 percent spending provision is fruitless and will not render a business socially responsible.[120] For example, given the vagueness in the definition of CSR under the Companies Act and the scope of CSR activities in the MCA's final rules, a corporation in a line of business that causes significant detrimental environmental impact could spend the mandatory funds on building a school in an unaffected rural area rather than focusing on mitigating its adverse environmental impact. Additionally, there is a large discrepancy as to where CSR funds are being spent. Maharashtra receives the largest amount of CSR funds by far.[121] During FY2017–2018, INR 2,527 crore of CSR funds were spent in Maharashtra.[122] Karnataka received only INR 951 crore of CSR funds, which was the second largest amount but still less than half of what was spent in Maharashtra.[123] The states seeing the least amount of CSR funds were Uttar Pradesh, Telangana, West Bengal, and Andhra Pradesh, with only INR 298 crore, INR 291 crore, INR 280 crore, and INR 269 crore, respectively, spent in each state during FY2017–2018.[124] The 2 percent spending provision has also caused some firms to decrease their CSR spending. Large firms

115 "Corporate Social Responsibility in India: No Clear Definition, but Plenty of Debate," *Knowledge@Wharton*, August 2, 2011.

116 Satvik Varma, "Legislating CSR," *IndiaCorpLaw Blog*, February 19, 2011.

117 Varottil, "Draft Rules Under the Companies Act; CSR," *IndiaCorpLaw Blog*, September 10, 2013.

118 The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2020.

119 The Companies (Corporate Social Responsibility Policy) Amendment Rules, 2020.

120 Somasekhar Sundaresan, "Govt's Approach to CSR Gives Scope for Corruption," *Business Standard*, September 13, 2010; "Corporate Social Responsibility in India: No Clear Definition, but Plenty of Debate," *Knowledge@Wharton*, stating that "India's philanthropic community is also against compulsory CSR". But see Surya Deva, "Socially Responsible Business in India: Has the Elephant Finally Woken Up to the Tunes of International Trends?" *Common Law World Review* 41, no. 4 (June 2012), p. 314.

121 "National CSR Data Portal," Ministry of Corporate Affairs.

122 "National CSR Data Portal," Ministry of Corporate Affairs.

123 "National CSR Data Portal," Ministry of Corporate Affairs.

124 "National CSR Data Portal," Ministry of Corporate Affairs.

that were spending more than 2 percent on CSR prior to the Act actually reduced their spending after the Act went into effect.[125]

Critics have also lamented that such CSR activities are essentially a privatization of the state's role and responsibility in many areas.[126] Noted Indian philanthropist Rohini Nilekani has called the provision an "outsourcing of governance" that is "taking the failure of the state and the corporates and trying to create a model out of it."[127] Critics have argued that "[i]t is dysfunctional for steel or aluminum companies to run schools or hospitals...mandatory CSR over and above taxation, forces companies to do the government's job. And trying to outsource the state's primary job is a bad idea."[128] In other words, businesses cannot substitute for the state in solving India's massive social problems.[129]

The corporate governance framework for implementing CSR activities has also come under attack. The CSR requirements of the Companies Act place the onus on the board of directors to supervise and provide public reports on CSR policies, including the amount of profits spent on CSR efforts. Doing so could potentially exacerbate weaknesses in the country's corporate governance model (i.e., the domination of promoters and majority shareholders) without taking advantage of a broader vision for CSR.[130] Indian companies in general have dominant controlling shareholders, many of whom are old-money business families with significant political connections.[131] Since board members of Indian companies still see themselves as strategic advisors to these promoters, there is a risk that CSR policies will essentially serve to further the interests and power of promoters and their views about social reality and values.[132] Accordingly, experts have noted that investors and analysts should examine whether a company's CSR program unduly benefits promoters or other related parties.[133]

Given India's primary corporate governance problem, its proposed CSR guidelines may exacerbate some of the problems that exist with respect to majority–minority agency costs. Controlling stockholders could use the CSR funds on projects that may benefit themselves at the expense of the company as a whole. Commentators have argued that the CSR spending provisions could potentially lead to greater promoter abuse of corporate funds and essentially provide "greater scope for corruption and scams."[134]

Lessons and Implications for the Future

Given India's global influence, there is much potential for the country's vision of CSR and sustainability to spread to the rest of the world. India's moves can be tied to the massive transformation in its economy and some of the resulting unrest related to economic disparities and corporate governance failures. Its CSR efforts have also been an important but often overlooked part of its larger corporate governance reform efforts. Because other regions of the world, such as Latin America and Africa, are experiencing a similar economic transformation, the development of the Indian CSR model may provide important lessons as countries around the world embark on corporate governance reforms. However, questions remain about whether India's legal changes will translate into actual changes on the ground. Institutional

(*continued on p. 125*)

125 Dhammika Dharmapala and Vikramaditya Khanna, "The Impact of Mandated Corporate Social Responsibility: Evidence from India's Companies Act of 2013," CESifo Working Paper No. 6200, November 2016.

126 Kounteya Sinha, "Govt Wants to Further Privatize Healthcare," *Times of India*, December 27, 2012.

127 Sharma, "Corporate Social Responsibility in India."

128 Akanksha Jain, "The Mandatory CSR in India: A Boon or Bane," *Indian Journal of Applied Research* 4, no. 1 (January 2014), pp. 301, 302; Kumkum Sen, "Is CSR a Sustainable Business Model?" *Business Standard*, February 2, 2014.

129 Manish Sabharwal, "We Do Have Mandatory CSR: Taxation Will Not Create Better Corporate Citizens," *Economic Times*, February 11, 2013. But see *Corporate Social Responsibility & Social Business Models in India,* Nishith Desai Associates, 1, positing that the "private sector in India is uniquely positioned to venture into the social sector and expand its consumer base by using its innovation and market expertise to create a sustainable future".

130 Afra Afsharipour, "Directors as Trustees of the Nation? India's Corporate Governance and Corporate Social Responsibility Reform Efforts," *Seattle University Law Review* 34, no. 4 (2011), pp. 999-1001 (hereafter cited as Afsharipour, "Directors as Trustees").

131 Afsharipour, "Directors as Trustees," pp. 394–95.

132 Afsharipour, "Directors as Trustees," p. 1003.

133 Krishnan Neelakantan, *Mandatory Corporate Social Responsibility: How Should Shareholders Think About It While Evaluating Companies?* Institutional Investors Advisory Services India Limited, December 2013.

134 Afsharipour, "Directors as Trustees," 1021.

IiAS Reports on CSR in India

In January 2018, the IiAS released a report that examined the CSR spending of S&P BSE 100 companies for FY17.[a] Companies had increased their CSR spending by 7.8 percent from FY16.[b] S&P BSE 100 companies spent 1.9 percent of their three-year average profits on CSR—an increase from only 1.7 percent in FY16—but still failed to reach the 2 percent mark.[c] Fifty-nine companies met the required 2 percent CSR spending, an increase from 46 companies meeting the 2 percent requirement in FY16.[d] Companies primarily spent their CSR funds on areas such as hunger, poverty, healthcare, education, rural development, and environmental sustainability.[e] Ninety-seven companies disclosed CSR committee compositions in their FY17 annual report, while only three failed to disclose CSR committee details.[f] In sum, companies need to increase their CSR spending to meet the 2 percent requirement.

Most recently, the IiAS examined the CSR spending of BSE 100 companies for FY18. Overall, companies increased their CSR spending by 5.8 percent from FY17.[g] The amount the companies spent of their three-year average profits on CSR remained the same at 1.9 percent, still falling short of 2 percent.[h] More companies met the CSR spending requirement in FY18 compared to FY17, with 68 companies meeting the 2 percent threshold for CSR spending in FY18.[i] Companies primarily spent their CSR funds in the same areas as they did in FY17.[j] Although there was an increase in overall spending on CSR, the unspent amount of CSR funds increased from INR 140 crore in FY17 to INR 520 crore in FY18.[k]

a *Corporate India Commits to Its Social Responsibilities*, Institutional Investor Advisory Services India Limited, January 2018.

b *Corporate India Commits to Its Social Responsibilities*, Institutional Investor Advisory Services India Limited.

c *Corporate India Commits to Its Social Responsibilities*, Institutional Investor Advisory Services India Limited.

d *Corporate India Commits to Its Social Responsibilities*, Institutional Investor Advisory Services India Limited.

e *Corporate India Commits to Its Social Responsibilities,* Institutional Investor Advisory Services India Limited.

f *Corporate India Commits to Its Social Responsibilities,* Institutional Investor Advisory Services India Limited.

g *Corporate Social Responsibility: A Lot More Than Feel-Good*, Institutional Investor Advisory Services India Limited, March 2019.

h *Corporate Social Responsibility: A Lot More Than Feel-Good*, Institutional Investor Advisory Services India Limited.

i *Corporate Social Responsibility: A Lot More Than Feel-Good*, Institutional Investor Advisory Services India Limited.

j *Corporate Social Responsibility: A Lot More Than Feel-Good*, Institutional Investor Advisory Services India Limited.

k *Corporate Social Responsibility: A Lot More Than Feel-Good*, Institutional Investor Advisory Services India Limited.

National Action Plan on Business and Human Rights

In addition to CSR and sustainability plans, India has begun to develop a National Action Plan on Business and Human Rights (NAP). As of February 2020, the NAP was in phase two, whereby the MCA solicits public comments and consultations. The obligation to draft a NAP stems from India's endorsement of the UNGPs.[a] The objective of the UNGPs is to enhance standards and practices concerning business and human rights and contribute to socially sustainable globalization.[b] In endorsing the UNGPs and creating a NAP, India joins more than 45 other countries in modernizing its human rights and corporate policies in line with international standards.

India's economic growth in the past decades has spurred the government's focus on corporate respect for human rights.[c] Increased national and international business activity can exacerbate societal issues such as inequality, environmental degradation, and low wages, and bring them to light on a global stage. Thus, there exists a need for increased public accountability in India's business activities. India's MCA views the NAP as a way to build on its CSR regulatory progress. For example, human rights are a key element of India's SDGs,[d] and in 2018 the MCA released its second draft of the NGRBCs in addition to the zero draft of the NAP.[e] The NAP is another opportunity for the government to review the implementation of these existing business and human rights frameworks and to identify gaps and necessary changes.[f]

In addition, the NAP is a way to bolster India's commitments to protect a broader range of corporate stakeholders. The shift from a shareholder model of corporate governance to a stakeholder-focused model is exemplified in the Companies Act, which requires directors to safeguard the interests of all stakeholders.[g] This commitment becomes more relevant as the NAP's development and release coincides with the COVID-19 pandemic, which has exposed systemic weaknesses in business operations and is seen as a litmus test for stakeholder capitalism.[h]

NAP Goals

The UNGP's three pillars provide India's overall structure and goals for the NAP.[i] The first pillar is the state's duty to protect human rights. The NAP aims to increase transparency around the government's legal duty to protect individuals against business-related human rights impacts.[j] The NAP must also be context-specific and address the country's actual and potential business-related human rights abuses.[k] The second pillar, the

a INDIA'S NATIONAL ACTION PLAN ON BUSINESS & HUMAN RIGHTS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2019).

b *Guiding Principles on Business and Human Rights*, United Nations Human Rights Office of the High Commissioner (2011).

c *Business & Human Rights Ambitions and Actions in India*, World Business Council for Sustainable Development et al.

d *Business & Human Rights Ambitions and Actions in India*, World Business Council for Sustainable Development et al.

e INDIA'S NATIONAL ACTION PLAN ON BUSINESS & HUMAN RIGHTS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

f *Voices from the Margins: Community Consultation Report on National Action Plan (NAP) on Business and Human Rights*, Partners in Change (2019).

g NATIONAL ACTION PLAN ON BUSINESS AND HUMAN RIGHTS: ZERO DRAFT, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA (2018).

h Namit Agarwal, "India's Business & Human Rights National Action Plan," Institute for Human Rights and Business, April 14, 2020.

i "UN Expert Group Welcomes India's Plan to Promote Corporate Respect for Human Rights," United Nations Human Rights Office of the High Commissioner, March 22, 2019.

j INDIA'S NATIONAL ACTION PLAN ON BUSINESS & HUMAN RIGHTS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

k INDIA'S NATIONAL ACTION PLAN ON BUSINESS & HUMAN RIGHTS, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

National Action Plan on Business and Human Rights *continued*

corporate responsibility to respect human rights, aims to involve the private sector as a critical partner in reducing human rights abuses.[l] The third pillar holds both the state and businesses accountable by providing victims with access to remedies for business-related abuses.[m]

Adopting the NAP could also promote investments in India by clarifying the responsibilities of the state and businesses. For example, human rights conflicts over land in India affect millions of people and billions of investment dollars.[n] The NAP has the potential to enable companies to calculate risk more effectively in their potential investments by increasing certainty around what businesses owe to various stakeholders.

Finally, the NAP offers a new opportunity for national discourse around meaningful reform on business and human rights.[o] Because India has bolstered its commitment to CSR over the past decade, many Indian businesses have developed internal policies related to human rights. Critics warn that these corporate practices may tend to "sanitize" the notion of human rights in the business context as a box-checking exercise.[p] The NAP development process allows companies to publicly highlight their successes or to review their business practices before the plan goes into effect.

l Vishal Gulati, "National Action Plan on Business, Human Rights Beneficial to India," *Business Standard*, November 26, 2018.

m NATIONAL ACTION PLAN ON BUSINESS AND HUMAN RIGHTS: ZERO DRAFT, MINISTRY OF CORPORATE AFFAIRS, GOVERNMENT OF INDIA.

n Ranjan Kumar Ghosh and Pranab R. Choudhury, "The Draft National Action Plan on Business & Human Rights (NAP-BHR)," *BW Education, April 10, 2020.*

o *Status of Corporate Responsibility in India, 2019: Is Human Rights in Business Limited to Rhetoric?* Corporate Responsibility Watch, October 2019.

p *Status of Corporate Responsibility in India, 2018: Do Businesses Respect Human Rights?* Corporate Responsibility Watch, October 2018.

enforcement weaknesses, a lack of transparency, and corruption remain significant problems. Unless they are addressed, the full potential of India's CSR efforts will go unrealized.

At the same time, India's progress in the realm of CSR should not go unrecognized. In an attempt to develop a CSR regime with its own national characteristics, India has rejected the notion that CSR is solely a Western import. The country also rejects the idea that CSR is purely voluntary. These developments may enable India to develop a CSR model with greater cultural adaptability or acceptability and organically develop a model of CSR and corporate governance that presents viable alternatives to those developed under different circumstances and pressures in the West. India is increasingly privatizing its economy, creating a space for corporate action in a realm previously dominated by the state, and appears to be seizing the opportunities that CSR presents to improve economic growth and address public concerns.

Key Takeaways

The Companies Act empowers a board-level CSR committee to regulate the CSR programs of the company, approve its CSR policy, and ensure reporting of CSR activities.

Every financial year, CSR spending for a company must be at least 2 percent of the average net profits made during the three preceding financial years. Schedule VII of the Companies Act indicates the activities that can be undertaken by a company.

In addition to the CSR requirements under the Companies Act, the regulatory framework in India in the CSR space also includes the NGRBC and the SEBI BRR.

Open Questions

What may be the implications of removing the exclusion of activities undertaken in the normal course of a company's business from CSR expenses?

How can the issues hampering effective CSR and business responsibility reporting be resolved?

Would the 2021 amendments be effective in achieving more transparent disclosures and more effective CSR projects?

CHAPTER SEVEN

Audit Committee

The Development of the Audit Committee

Influenced by corporate governance reforms in the United States and the United Kingdom, SEBI implemented audit committees through Clause 49 of the Listing Agreement.[1] "SEBI formed the Murthy Committee in the wake of the Enron scandal in the United States in order to evaluate the adequacy of the existing Clause 49, to further enhance the transparency and integrity of India's stock markets and to 'ensure compliance with corporate governance codes, in substance and not merely in form.'"[2] The Murthy Committee's 2003 report focused on the audit committee as an important institution to improve corporate governance.

Since the implementation of Clause 49, the audit committee concept has been further developed and strengthened. In 2009, the MCA released its Corporate Governance Voluntary Guidelines, which delineated the role and composition of audit committees and a company's use of auditors.[3] The MCA largely tracked the Voluntary Guidelines in the Companies Act, 2013 (Companies Act, or Act) and made several of the provisions in the Voluntary Guidelines mandatory. In response, SEBI also amended Clause 49 of the Listing Agreement to adhere to the Companies Act. These provisions were further strengthened and incorporated in the SEBI Listing Regulations.[4]

Audit Committees under the SEBI Listing Regulations

Composition of the audit committee. The SEBI Listing Regulations (see Table 7.1) state that

1. The audit committee must comprise a minimum of three directors.

   Corporate Board Practices: 2018 India Edition, a study conducted by The Directors' Collective, found that on average, NIFTY 500 companies across industries have audit committees composed of four directors. In terms of annual revenue, NIFTY 500 companies with revenue above INR 500 crore have audit committees of four directors; those with annual revenue below INR 500 crore reported an average audit committee size of three directors.

2. Two-thirds of the directors must be independent directors.

   Corporate Board Practices: 2018 India Edition reported that all NIFTY 500 companies complied with this requirement.

3. The chair of the audit committee must also be an independent director.

   Corporate Board Practices: 2018 India Edition noted that NIFTY 500 companies in all sectors, except the financials sector, reported that the chairs of their respective audit committees were independent directors. Firms in the financials sector reported that 92 percent of their respective audit committee chairs were independent (see Figure 7.1a). In terms of company size, for companies with annual revenue greater than INR 5,000 crores, approximately 97 percent had independent audit committee chairs. In all other revenue groups, 100 percent of companies reported audit committees with independent directors as chairs (see Figure 7.1b).

The SEBI Listing Regulations also require that every member of the audit committee be financially literate. Financial literacy is defined as "the ability to read and understand basic financial statements, i.e., balance sheet, profit and loss account, and statement of cash flows."[5] Moreover, at least one member of the audit committee must have "accounting or related financial management expertise."[6] Under the SEBI Listing Regulations, "related financial management expertise" includes experience in finance, accounting, requisite professional certification in accounting, "or any other comparable experience or background which results in the individual's financial

1 Afra Afsharipour, "Corporate Governance Convergence: Lessons from the Indian Experience," *Northwestern Journal of International Law & Business* 29, no. 2 (2009): 340.

2 Afsharipour, "Corporate Governance Convergence," 371.

3 CORPORATE GOVERNANCE VOLUNTARY GUIDELINES 2009, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA (2009).

4 Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 no. 18 (Sept. 2, 2015) [hereinafter SEBI Listing Regulations].

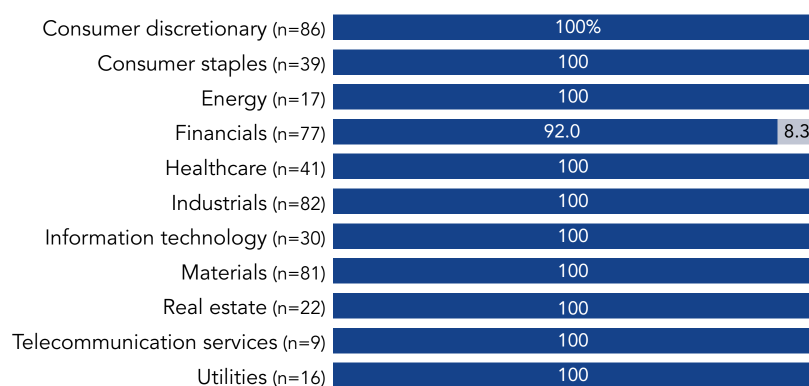
5 SEBI Listing Regulations, pt. III sec. 4 no. 18.

6 SEBI Listing Regulations, pt. III sec. 4 no. 18.

Figure 7.1a

Independent Audit Committee Chairperson, by Industry

Percent of total

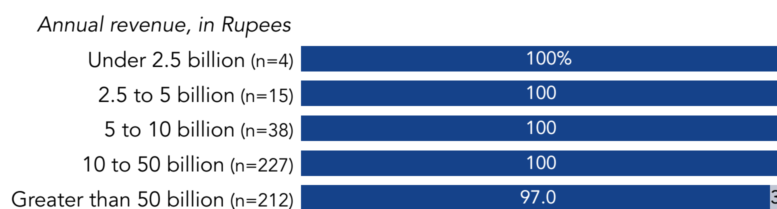


Percentages do not add up to 100 due to rounding.

Figure 7.1b

Independent Audit Committee Chairperson, by Company Size

Percent of total



Source: The Directors' Collective/PRIME Database Group, 2018

Note: For Figure 7.1b, the data is available for 3,074 directors in all. Out of these, the range of annual revenue is not known for four companies. Accordingly, 28 directors out of the 3,074 directors have not been included in this analysis.

sophistication," including experience as a CEO, CFO, or other senior management position with financial oversight responsibilities.[7]

Role of the audit committee. The SEBI Listing Regulations reflect the role of the audit committee in enhancing corporate governance practices and safeguarding the interests of minority shareholders. Under the SEBI Listing Regulations the audit committee must be responsible for[8]

- overseeing the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient, and credible;
- recommending to the board the appointment, remuneration, and terms of appointment of auditors of the company;
- approving payment to statutory auditors for any other services rendered by the statutory auditors;
- reviewing, with the management, the annual financial statements and auditor's report before submission to the board for approval, with particular reference to
  - matters required to be included in the Director's Responsibility Statement to be included in the board's report in terms of Section 134(3)(c) of the Act;
  - changes, if any, in accounting policies and practices and reasons for the same;
  - major accounting entries involving estimates based on the exercise of judgment by management;
  - significant adjustments made in the financial statements arising out of audit findings;
  - compliance with listing and other legal requirements relating to financial statements;
  - disclosure of any related party transactions; and
  - modified opinion(s) in the draft audit report.
- reviewing, with the management, the quarterly financial statements before submission to the board for approval;
- reviewing, with the management, the statement of uses and application of funds raised through an issue (public issue, rights issue, preferential issue, etc.); the statement of funds utilized for purposes other than those stated in the offer document, prospectus, or notice; and the report submitted by the monitoring agency examining the utilization of the proceeds of a public or rights issue, and making appropriate recommendations to the board to take steps in this matter;
- reviewing and monitoring the auditor's independence and performance, and the effectiveness of the audit process;
- approving or subsequently modifying transactions of the company with related parties;
- scrutinizing intercorporate loans and investments;
- valuing undertakings or assets of the listed entity wherever necessary;
- evaluating internal financial controls and risk management systems;
- reviewing, with the management, the performance of statutory and internal auditors and the adequacy of the internal control systems;
- reviewing the adequacy of the internal audit function, if any, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage, and frequency of internal audit;
- discussing any significant findings with internal auditors;
- reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature, and reporting the matter to the board;
- discussing the nature and scope of the audit with statutory auditors before the audit commences, as well as having a post-audit discussion to ascertain any area of concern;
- looking into the reasons for substantial defaults in the payment to the depositors, debenture holders,

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7 SEBI Listing Regulations, pt. III sec. 4 no. 18.

8 SEBI Listing Regulations, pt. III sec. 4 sched. II pt. C.

shareholders (in case of nonpayment of declared dividends), and creditors;

- reviewing the functioning of the whistleblower mechanism;
- approving the appointment of the chief financial officer after assessing the qualifications, experience, and background of the candidate;
- carrying out any other function as mentioned in the terms of reference of the audit committee;
- reviewing the utilization of loans and/or advances from or investment by the holding company in the subsidiary exceeding INR 100 crore or 10 percent of the asset size of the subsidiary, whichever is lower, including existing loans, advances, or investments existing as of the date of this provision coming into force; and
- holding meetings four times per year, with no more than 120 days between meetings. The quorum for a meeting is two members or one-third of the members of the audit committee, whichever is greater; at least two independent directors should be present.

The audit committee is also charged with mandatorily reviewing[9]

- management discussion and analysis of financial condition and results of operations;
- statement of significant related party transactions (as defined by the audit committee), submitted by management;[10]
- management letters and letters of internal control weaknesses issued by the statutory auditors;
- internal audit reports relating to internal control weaknesses;
- the appointment, removal, and terms of remuneration of the chief internal auditor; and
- the statement of deviations:
  - a quarterly statement of deviation(s) including report of monitoring agency, if applicable, submitted to stock exchange(s) in terms of Regulation 32(1) of the SEBI Listing Regulations
  - b annual statement of funds utilized for purposes other than those stated in the offer document, prospectus, or notice in terms of Regulation 32(7) of the SEBI Listing Regulations

In order to be effective, the audit committee has the following powers mandated by the SEBI Listing Regulations:[11]

- to investigate any activity within its terms of reference;
- to seek information from any employee;
- to obtain outside legal or other professional advice; and
- to secure attendance of outsiders with relevant expertise, if deemed necessary.

Audit Committees under the Companies Act, 2013

Audit committee role and composition. The Act addresses in detail both the role and the composition of the audit committee.[12] All listed public companies[13] and all public companies with a paid-up capital of at least INR 10 crore, all public companies having turnover of at least INR 100 crore, and all public companies having, in the aggregate, outstanding loans, borrowings, debentures, or deposits exceeding INR 50 crore must establish an audit committee.[14] The Act also provides specific provisions to help strengthen the independent auditor. For example, the Act requires that an auditing firm's tenure at a company should not exceed 10 years.[15] In addition, to reduce conflicts of interest between the auditors and the company, Section 144 of the Act provides that statutory auditors should not provide nonaudit services to a company that their firm is auditing.

9 SEBI Listing Regulations, pt. III sec. 4 sched. II pt. C.

10 Chapter Eight provides greater detail regarding related party transactions.

11 SEBI Listing Regulations, pt. III sec. 4 no. 18(2)(c).

12 The Companies Act, 2013 § 177, No. 18, Acts of Parliament, 2013 (Aug. 29, 2013); The Companies Act, 2013 ch. X.

13 The Companies Act, 2013 § 177(1).

14 The Companies (Meetings of Board and its Powers) Rules, 2014, *Gazette of India*, pt. II sec. 3 ch. XII sec. 6, 2014 (Mar. 31, 2014).

15 The Companies Act, 2013 § 139(2).

AUDIT COMMITTEE (SECTION 177)

Composition

- Three or more directors with a majority of independent directors (see Table 7.1)
  - A majority of committee members, including its chair, must be able to read and understand the financial statements

Role

- The audit committee must act in accordance with the terms of reference specified in writing by the board, which must include
  - recommending the appointment, remuneration, and terms of appointment of auditors of the company;
  - reviewing and monitoring the auditor's independence and performance and the effectiveness of the audit process;
  - examining the financial statement and the auditors' report thereon;
  - approving or subsequently modifying transactions of the company with related parties;
    - The audit committee may make omnibus approval for related party transactions subject to such conditions as may be prescribed.
    - In case of transactions other than those referred to in Section 188 and where the audit committee does not approve the transaction, it shall make its recommendations to the board.
    - In case any transaction involving any amount not exceeding INR 1 crore is entered into by a director or officer of the company without obtaining the approval of the audit committee, and it is not ratified by the audit committee within three months from the date of the transaction, such transaction shall be voidable at the option of the audit committee; and if the transaction is with the related party to any director or is authorized by any other director, the director concerned shall indemnify the company against any loss incurred by it. The provisions of this clause shall not apply to a transaction, other than a transaction referred to in Section 188, between a holding company and its wholly owned subsidiary company.
  - scrutinizing intercorporate loans and investments;
  - valuating undertakings or assets of the company wherever necessary;
  - evaluating internal financial controls and risk management systems; and
  - monitoring the end use of funds raised through public offers and related matters.
- The audit committee may investigate any matter in relation to the items specified in the previous provision or referred to it by the board, and for this purpose, may
  - obtain professional advice from external sources; and
  - have full access to information contained in the records of the company.
- The audit committee may call for the auditors' comments about internal control systems and the scope of the audit, including the observations of the auditors and a review of the financial statement before their submission to the board.
- The audit committee may discuss any related issues with the internal and statutory auditors and the management of the company.

Applicability

- Every listed public company
- Such other class or class of companies, as may be prescribed

Audits and Auditors under the Companies Act, 2013

Some of the most significant governance-related provisions in the Act relate to audits and auditors. These provisions aim to enhance audit effectiveness and auditor accountability. The Act focuses on auditor independence, imposing new rules regarding auditor qualification, rotation, and resignation, along with significant oversight of auditors to be done by the audit committee. The Act addresses several important matters related to audits and auditors, including

Table 7.1 **Differences between Companies Act and SEBI Listing Regulations Audit Committee Requirements**

Companies Act, 2013	SEBI Listing Regulations
An audit committee must be composed of a minimum of three directors, with independent directors forming a majority.	An audit committee must be composed of a minimum of three directors, with two-thirds of members being independent directors.
A majority of the audit committee's members, including its chair, must have an ability to read and understand financial statements.	All members of the audit committee must be financially literate, and at least one member must have accounting or related financial management expertise.
The chair of the audit committee need not be an independent director.	The chair of the audit committee must be an independent director. Chair must also attend the annual general meeting to answer shareholder questions.

- auditor appointment and qualification
- mandatory auditor rotation
- nonaudit services
- auditing standards
- secretarial audit for bigger companies
- secretarial standards
- internal audit

AUDITOR APPOINTMENT AND QUALIFICATIONS

Under Section 139(1) of the Companies Act, the auditor is appointed for a period of five years, with a requirement to ratify such an appointment at each annual general meeting. For companies that are required to have an audit committee, the committee is charged with considering the qualifications and experience of the individual or the firm proposed for appointment as auditor, and whether such qualifications and experience are commensurate with the size and requirements of the company.[16] The audit committee must then recommend the auditor to the board of directors, who must recommend the appointment of the auditor to the shareholders at an annual general meeting.

Section 141 of the Act sets forth auditor qualifications and disqualifications. Under Section 141(1), only chartered accountants may serve as auditors. The Act provides that with respect to appointment of a firm as the auditor of a company, the firm must be a limited liability partnership registered under the Limited Liability Partnership Act, 2008. Under Section 141, when a firm is appointed as an auditor of a company, only those partners who are chartered accountants are authorized to act and sign on behalf of the firm. Section 141 further prescribes an additional list of disqualifications and extends certain disqualification to include relatives[17] and partners. The Act, together with The Companies (Audit and Auditors) Rules, 2014 disqualifies the following persons from being auditors:[18]

- a person (including such person's relative or partner) who is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company of face value exceeding INR 1,000 (INR 1 lakh with respect to a relative);
- a person (including such person's relative or partner) who is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of INR 5 lakh;
- a person (including such person's relative or partner) who has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for INR 1 lakh;

16 The Companies (Audit and Auditors) Rules, 2014, *Gazette of India*, pt. II sec. 3 ch. X (Mar. 31, 2014).

17 Relative with reference to any person means (a) members of a Hindu Undivided Family, (b) husband and wife, (c) father (including stepfather), mother (including stepmother), son (including stepson), son's wife, daughter, daughter's husband, brother (including stepbrother), sister (including stepsister). The Companies Act, 2013 § 2(77); The Companies (Specification of Definitions Details) Rules, 2014, *Gazette of India*, pt. II sec. 3 r. 4 (Mar. 31, 2014).

18 The Companies (Audit and Auditors) Rules, 2014, pt. II sec. 3 ch. X.

- a person or a firm who, whether directly or indirectly, has a business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company, except
  - commercial transactions that are in the nature of professional services permitted to be rendered by an auditor or audit firm;
  - commercial transactions that are in the ordinary course of business of the company at arm's length price-like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels, and such other similar businesses;
- a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;
- a person or a partner of a firm who holds appointment as an auditor in more than 20 companies as well as a person who is in full-time employment elsewhere;
- a person who has been convicted by a court of an offense involving fraud and a period of 10 years has not elapsed from the date of such conviction;
- any person who is engaged as of the date of appointment in consulting and specialized services, whether directly or indirectly, to the company, or its holding company or subsidiary company; such prohibited services include
  - accounting and bookkeeping services;
  - internal audit;
  - design and implementation of any financial information system;
  - actuarial services;
  - investment advisory services;
  - investment banking services;
  - rendering of outsourced financial services;
  - management services; and
  - any other kind of services as may be prescribed.

Auditor rotation. The Voluntary Guidelines introduced the first set of significant provisions with respect to rotation of auditors. The Act largely followed these provisions by prescribing rotations for auditors. Under the Act, no listed company, and no unlisted public company having paid-up share capital of INR 10 crore or more, private limited company having paid-up share capital of INR 50 crore or more, or company having paid-up share capital having public borrowings from financial institutions, banks, or public deposits of INR 50 crore or more shall appoint or reappoint

(a) an individual as auditor for more than one term of five consecutive years, and

(b) an audit firm as auditor for more than two terms of five consecutive years.[19]

Further, an individual auditor who has completed his term under clause (a) will not be eligible for reappointment as an auditor in the same company for five years from the completion of his term. Likewise, an audit firm that has completed its term under clause (b) will not be eligible for reappointment as an auditor in the same company for five years from the completion of such term.[20]

IMPORTANCE OF AUDITOR INDEPENDENCE[21]

Because of the nature of their work, it is imperative that auditors are considered independent. An independent auditor is typically used to avoid conflicts of interest and to ensure the integrity of the auditing process. When an audit is performed, it is the auditor's responsibility to ensure that records are examined in an honest and forthright manner. Accordingly, auditors must actually be independent and also perceived to be independent.

Auditors must have independence of mind so that they can make informed, objective, and reasoned decisions without being affected by factors like conflicting interests, loyalty, or incentives, which would compromise their integrity and lead to professional skepticism. Auditors must also appear to be independent, so that third parties and the public can conclude from circumstances that integrity, objectivity, and professionalism were not compromised.

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19 The Companies Act, 2013 § 139; The Companies (Audit and Auditors) Rules, 2014, pt. II sec. 3 ch. X sec. 5.

20 The Companies Act, 2013 § 139.

21 *Report on State of Auditor and Audit Committee Functioning in India*, National Stock Exchange of India Ltd., June 2013.

Auditors (Chapter X of the Companies Act, 2013)

Appointment

- Must be a chartered accountant
- Persons not eligible for appointment:
  - corporate bodies other than an LLP under the Limited Liability Partnership Act, 2008
  - officers, partners, or employees of the company
  - persons who are indebted to, have a business relationship with, or hold securities in the company
  - persons whose relative is a director or key managerial personnel of the company
  - persons with at least 20 other audit assignments
  - persons who have been convicted of fraud within the past 10 years of appointment
  - persons providing nonaudit services

Tenures and Auditor Rotation

- auditor rotation required for listed companies
  - One five-year term for an individual
  - Two five-year terms for audit firms
- mandatory five-year cooling-off period
- three-year period to comply with the provisions

Auditor Removal

- a special resolution is required to remove an auditor before expiry of terms
- an auditor resigning before his term is required to file with the Registrar a statement explaining the reasons for his resignation

Responsibilities

- provide a detailed auditor's report on the company's financial statements to the shareholder of the company
- report fraud to the central government or to the audit committee
- report whether the company has adequate and effective internal financial controls

True and perceived independence can also be compromised when auditors have previously been involved in the company. For example, if someone on the audit team was recently a key player for the client, he would be less inclined to detect errors that he himself may have committed, known as the "self-review" threat. Similarly, auditors that have existing relationships and ties to the client company may again find themselves partial either to key personnel or ideas, compromising the objectivity of their review.

Nonaudit services and audit clients. The Act includes several restrictions on nonaudit services aimed at achieving auditor independence. The Act states that any service to be rendered by the auditor must be approved by the board of directors or the audit committee. Additionally, the auditor is restricted from providing specific services, including

- accounting and bookkeeping services
- internal audit
- design and implementation of any financial information system
- actuarial services
- investment advisory services
- investment banking services
- rendering of outsourced financial services
- management services, and any other service which may be prescribed

Further, the Act provides that such services cannot be rendered by the audit firm either directly or indirectly through itself or any of its partners, its parent or subsidiary, or through any other entity whatsoever, in which the firm or any other partner in the firm has

significant influence or control or whose name or trademark or brand is being used by the firm or any of its partners.

Auditor liability. The scope and extent of the auditor's liability has been substantially enhanced under the Act. Under the Act, an auditor is subject to oversight by multiple regulators, including the Institute of Chartered Accountants of India, and the National Financial Reporting Authority, which is authorized to investigate matters involving professional or other misconduct of the auditors. The Act also includes penalty provisions and other repercussions that an auditor may face, including monetary penalties, imprisonment, debarring of the auditor and the firm, and in case of fraud, even class-action suits.

Additional responsibilities of the auditor. Section 143 of the Act, and corresponding rules, provide detailed requirements regarding an auditors' report. These include the following:

- the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- any qualification, reservation, or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- whether the company has adequate internal financial controls with reference to financial statements in place and the operating effectiveness of such controls;
- whether the company has disclosed the impact, if any, of pending litigations on its financial position in its financial statement;
- whether the company has made provision, as required under any law or accounting standards, for material foreseeable losses, if any, on long-term contracts, including derivative contracts;
- whether there has been any delay in transferring amounts, required to be transferred, to the Investor Education and Protection Fund by the company;
- whether the company had provided requisite disclosures in its financial statements as to holdings as well as dealings in Specified Bank Notes during the period from November 8, 2016, to December 13, 2016, and if so, whether these are in accordance with the books of accounts maintained by the company.

Initially, Section 143 and the rules adopted pursuant to this section[22] required an auditor to report within 60 days from the date of his knowledge to the central government if he or she has any reasons to believe that any offense involving fraud is being committed or has been committed against the company by its officers or employees. The rules adopted by the MCA set forth the process an auditor must go through to make any such report, including forwarding the report to the board or the audit committee and seeking their reply. An auditor may be fined for failure to make any such report. The Companies (Amendment) Act, 2015 relaxed these requirements, requiring an auditor to report fraud to the Central Government only if it exceeds a certain threshold amount to be prescribed by the MCA.[23] Otherwise, an auditor is required to report fraud to the company's audit committee. The company must also disclose the details about such fraud in the board's report.

SECRETARIAL AUDIT

In addition to accounting audits, Section 204 of the Act requires all listed companies and every public company with a paid-up share capital of INR 50 crore or more or a turnover of INR 250 crore or more or outstanding loans or borrowings from banks or public financial institutions of INR 100 crore or more to also conduct annual secretarial audits. Under the SEBI Listing Regulations now, an annual secretarial audit has been made mandatory for every listed entity and its material unlisted subsidiaries incorporated in India. The secretarial audit report issued by a company secretary in practice is to be annexed with the annual report.

The secretarial audit is intended to check the company's compliance under a host of laws, including the Companies Act.[24] Rule 8 of the Companies (Meetings of Board and its powers) Rules, 2014[25] require that the secretarial auditor be appointed by the board. Rules 9 and 10 of the

22 The Companies (Audit and Auditors) Rules, 2014, pt. II sec. 3 ch. X.

23 The Companies (Amendment) Act, 2015 § 13, No. 21, Acts of Parliament, 2015.

24 "Frequently Asked Questions on Secretarial Audit," The Institute of Company Secretaries of India.

25 The Companies (Meetings of Board and its Powers) Rules, 2014, pt. II sec. 3 ch. XII.

Companies (Appointment and Remuneration of Managerial Remuneration) Rules, 2014 clarify the scope of the secretarial audit. The secretarial auditor must examine, check, and report compliances by the company under the following laws and rules during the period under review:

- The Companies Act, 2013 and the rules made thereunder;
- The Securities Contracts (Regulation) Act, 1956 (SCRA) and the rules made thereunder;
- The Depositories Act, 1996 and the regulations and bylaws framed thereunder;
- The Foreign Exchange Management Act, 1999 and the rules and regulations made thereunder to the extent of foreign direct investment, overseas direct investment, and external commercial borrowings;
- The following regulations and guidelines prescribed under the Securities and Exchange Board of India Act, 1992:
  - The Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011;
  - The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015;
  - The Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009;
  - The Securities and Exchange Board of India (Employee Stock Option Scheme and Employee Stock Purchase Scheme) Guidelines, 1999;
  - The Securities and Exchange Board of India (Issue and Listing of Debt Securities) Regulations, 2008;
  - The Securities and Exchange Board of India (Registrars to an Issue and Share Transfer Agents) Regulations, 1993 regarding the Companies Act and dealing with client;
  - The Securities and Exchange Board of India (Delisting of Equity Shares) Regulations, 2009; and
  - The Securities and Exchange Board of India (Buyback of Securities) Regulations, 1998.
- Secretarial Standards issued by The Institute of Company Secretaries of India;
- The Listing Agreements entered into by the company with stock exchange(s), if applicable;
- Other laws that are specifically applicable to the company.

The Institute of Company Secretaries of India (ICSI) issued an FAQ on Secretarial Audit and has clarified that "other laws" involve[26]

- reporting on compliance of "other laws as may be applicable specifically to the company," including all the laws that are applicable to a specific industry; for example, for banks, all laws applicable to the banking industry, or for insurance companies, all laws applicable to the insurance industry; and
- examining and reporting whether adequate systems and processes are in place to monitor and ensure compliance with general laws like labor laws, competition laws, environmental laws, etc.

INTERNAL AUDIT

The Companies Act mandates an internal audit process for certain classes of companies. The internal auditor must be either a chartered accountant or a cost accountant, or another professional decided by the board to conduct an internal audit of the functions and activities of the company. The audit committee of the company or the board must, in consultation with the internal auditor, formulate the scope, functioning, periodicity, and methodology for conducting the internal audit. Under Rule 13 of the Companies (Accounts) Rules, 2014, the class or classes of companies that are required to appoint an internal auditor are[27]

- every listed company
- unlisted public companies meeting any one of the following criteria:

(*continued on p. 141*)

26 "Frequently Asked Questions on Secretarial Audit," The Institute of Company Secretaries of India.

27 The Companies (Accounts) Rules, 2014, *Gazette of India*, pt. II sec. 3 ch. IX (Mar. 31, 2014).

Challenges at CG Power

CG Power and Industrial Solutions Limited provides various solutions to utilities, industries, and consumers for the management and application of electrical energy in India, as well as internationally.[a]

CG Power was once controlled by Gautam Thapar, who also controls the Avantha Group. Although Thapar was a founder promoter of CG power, he lost nearly all of his shares after lenders (YES Bank and Vistra) invoked pledged shares.[b] This led Avantha Group's shareholding in the company to drop to less than 1 percent, with Thapar possessing 8,574 shares out of the 62.6 crore (626,000,000) shares of the company.[c]

Background. Lapses in the financial statements of CG Power first came to light in March 2019 when an operations committee was set up under the chairmanship of one of the independent directors of the company that sought to refinance certain facilities.[d] K. N. Neelkant, CEO and managing director, was placed on leave on May 10 by the board to allow proper investigation into these financial irregularities.[e]

On August 19, 2019, CG Power released an exchange filing stating that its board and its risk and audit committee (RAC) had discussed the status of the annual financial statements.[f] After 13 hours of review of the findings that would have implications for the financial position of the company, the board determined that there had been certain unauthorized transactions executed by "certain employees" that might have led to a potential understatement of the company's total liabilities, as well as of the advances to related and unrelated parties of the company and the group.[g] The filing began by disclosing that the liabilities of the company and the Avantha Group might have been understated by approximately INR 1,054 crore and INR 1,608 crore, respectively, on March 31, 2018. Additionally, advances to related and unrelated parties and the Avantha Group may have been understated by over INR 4,796 crore.

The board stated that certain assets of the company were supposedly provided as collateral without authorization from the board, and that CG Power was made a coborrower and/or guarantor for enabling apparently unrelated third parties to obtain loans without appropriate authorization.[h] Specifically, the RAC viewed that "funds diverted from CG Power were fraudulently transferred to its promoter company Avantha Holdings and entities related/connected with the company,

a "CG Power and Industrial Solutions Limited," Wallmine (web page).

b "CG Power Investors, Lenders Seek Tycoon Gautam Thapar's Removal As Chairman," *Business Standard*, August 25, 2019.

c "CG Power Investors, Lenders Seek Tycoon Gautam Thapar's Removal As Chairman," *Business Standard*.

d "CG Power Share Nosedives 20% on Reports of Fraud Transactions; YES Bank Tanks 8%," *Business Today*, August 20, 2019.

e "Axe on CG Power CFO," *The Telegraph*, September 1, 2019.

f "CG Power Discloses Serious Financial Irregularities As Probe Reveals Fraudulent Related-Party Transactions," *Business Today*, August 21, 2019; "Outcome of the Board Meeting dated August 19, 2019," CG Power and Industrial Solutions Limited, August 19, 2019.

g Amit Mudgill, "'Suspect' Transactions Detected at Gautam Thapar's CG Power; Stock Tanks 20%. YES Bank Suffers Collateral Damage," *Economic Times*, August 20, 2019.

h Swaraj Singh Dhanjal, "Lights Out For CG Power As Serious Lapses Are Revealed," *Live Mint*, August 21, 2019.

Challenges at CG Power *continued*

Avantha International, Acton Global Private Limited, Ballarpur International, Mirabelle and Solaris Industrial Chemicals Limited, without knowledge of the company and without any approval from its board."[i]

The filing went on to state that the suspicious transactions were purportedly carried out by former and current company personnel, and might have impacted financial outcomes for FY17, FY18, and FY19.[j] These suspicious transactions included CG Power selling its land and factory in Nashik to shell companies (2016), CG Power selling land to shell companies without board or RAC approval (2017), unauthorized and diverted loans that resulted in "round tripping" (2017), and untraceable trade transactions (2018).[k] The probe was ultimately initiated when a check issued by CG Power to YES Bank bounced.

On August 20, 2019, one day after the regulatory filing, CG Power's share price plummeted by a maximum of 20 percent.[l] This led investors and lenders to call for the removal of Thapar as chairman of CG Power.[m] Although the regulatory filing did not name specific individuals involved in the dubious transactions, the general sentiment surrounding the filing was that the company's management had played a large role in the scam.[n]

CG Power immediately launched a full investigation into any wrongdoings, and simultaneously developed a revival plan to reform and remedy the company's governance and finances.[o] This plan incorporated INR 500 crores of equity-based fundraising, seeking lender support for any interim liquidity mismatch, as well as the sale of noncore assets.[p]

Removal and further investigation of chair Gautam Thapar and CFO V. R. Venkatesh. On August 29, 2019, the CG Power board announced the immediate removal of Gautam Thapar as chairman of the company.[q] Thapar responded with a press statement that same day, vehemently refuting the allegations.[r] He stated that the initial reports finding dubious financial transactions were not factual, and "no promoter or promoter entity [had] derived any undue benefit."[s] Thapar went on to state that he was unable to play a role in the investigation, and reaffirmed that transactions were properly sanctioned and funds had not been misappropriated.[t] Advisors did not necessarily view this removal as a step in the right direction for CG Power, given the fact that Thapar would remain on the board until shareholders approved his removal.[u]

i Ruchika Chitravanshi, "CG Power Case: Look Out Circular Issued Against Ex-Chairman Gautam Thapar," *Business Standard*, September 18, 2019.

j "CG Power Discloses Serious Financial Irregularities As Probe Reveals Fraudulent Related-Party Transactions," *Business Today*.

k Rachita Prasad, "Irregular Deals By Brass May Have Led to Rs 3000 Crore Loss for CG Power: Report," *Economic Times*, September 17, 2019.

l Dhanjal, "Lights Out For CG Power As Serious Lapses Are Revealed."

m "CG Power Investors, Lenders Seek Tycoon Gautam Thapar's Removal As Chairman," *Business Standard*.

n "CG Power Investors, Lenders Seek Tycoon Gautam Thapar's Removal As Chairman," *Business Standard*.

o Amritha Pillay, "CG Power May Raise Funds Through Equity Route, Sell Non-Core Assets," *Business Standard*, August 27, 2019.

p Pillay, "CG Power May Raise Funds Through Equity Route, Sell Non-Core Assets."

q Amritha Pillay, "CG Power Board Removes Gautam Thapar As Chairman with Immediate Effect," *Business Standard*, August 30, 2019; "Chairman of the Board of Directors," CG Power and Industrial Solutions Limited, August 29, 2019.

r Pillay, "CG Power Board Removes Gautam Thapar As Chairman with Immediate Effect."

s Pillay, "CG Power Board Removes Gautam Thapar As Chairman with Immediate Effect."

t Pillay, "CG Power Board Removes Gautam Thapar As Chairman with Immediate Effect."

u Pillay, "CG Power Board Removes Gautam Thapar As Chairman with Immediate Effect."

Challenges at CG Power *continued*

On August 30, 2019, one day after the removal of Thapar as chair, the board of CG Power announced their decision to remove CFO V. R. Venkatesh, citing his alleged "misconduct" and breach of trust regarding actions that were damaging to the interests of the company and its stakeholders.[v]

Almost two weeks after his removal, Thapar (represented by Shardul Amarchand Mangaldas & Co.) took legal action against the company's board (represented by Cyril Amarchand Mangaldas).[w] Thapar's legal team requested documents related to and video recordings of the board meeting held on August 30, along with clarification on whether the company's board had recorded Thapar's categorical rejection of the allegations against him.[x]

After removing Gautam Thapar from the chair position, CG Power also moved to declassify him as a promoter.[y] On October 18, 2019, CG Power filed an application with SEBI to reclassify Thapar's Avantha Holdings and others from promoter shareholders to public shareholders, stating that any association with Thapar would be harmful to the interests of CG Power.[z]

MCA & SEBI investigations. Following their removal from CG Power, the MCA began probes of both Thapar and Venkatesh. The MCA issued a look-out circular against Venkatash in September 2019 while they probed the alleged irregularities, thus preventing Venkatash from leaving India.[aa] The MCA also issued a look-out circular against Gautam Thapar as a preemptive measure while they inspected inconsistencies in the company's financial statements.[ab] If the MCA's findings suggest fraud or massive inconsistencies, officials have stated that the case could be referred to the Serious Fraud Investigation Office (SFIO).[ac]

SEBI also began actions. On September 13, 2019, SEBI barred Thapar, Venkatesh, and two directors of CG Power from accessing the capital market as a result of their alleged misconduct.[ad] SEBI restricted three entities belonging to the Avantha Group from diverting money or disposing of their assets. SEBI also requested that the BSE appoint forensic auditors to audit CG Power's books from financial year 2015–2016 onwards to examine the manipulation of books and accounts, misrepresentations related to financial and business operations, and illegitimate diversions of company funds.[ae] The audit firm has six months from the date of the order to submit its report to SEBI.[af] This report is still pending. Further, in

v "After Thapar, Fraud-Hit CG Power Sacks CFO Venkatesh for Alleged Misconduct," *Business Standard*, September 1, 2019; "Removal of Chief Financial Officer of the Company," CG Power and Industrial Solutions Limited, August 30, 2019.

w Kala Vijayraghavan and Rashmi Rajput, "Gautam Thapar Takes Legal Action Against CG Power Board," *Economic Times*, September 9, 2019.

x Venkatesh Ganesh, "CG Power Fraud: Gautam Thapar Initiates Legal Action Against His Sacking," *The Hindu BusinessLine*, September 11, 2019.

y "After Sacking Gautam Thapar As Chairman, CG Power Seeks to Remove Him As Promoter," *Economic Times*, November 24, 2019.

z "Intimation of 82nd Annual General Meeting of the Company and Annual Report for the Financial Year 2018-19," CG Power and Industrial Solutions Limited, November 20, 2019.

aa Rashmi Rajput, "Former CFO of CG Power VR Venkatesh Prevented from Travelling Abroad," *Economic Times*, September 7, 2019.

ab Chitravanshi, "CG Power Case: Look Out Circular Issued Against Ex-Chairman Gautam Thapar."

ac Chitravanshi, "CG Power Case: Look Out Circular Issued Against Ex-Chairman Gautam Thapar."

ad Chitravanshi, "CG Power Case: Look Out Circular Issued Against Ex-Chairman Gautam Thapar."

ae Reena Zachariah, "CG Power Case: Sebi Bans Gautam Thapar, 3 Others from Market; Orders Forensic Audit," *Economic Times*, September 18, 2019.

af Zachariah, "CG Power Case: Sebi Bans Gautam Thapar, 3 Others from Market; Orders Forensic Audit."

Challenges at CG Power *continued*

its confirmatory order dated March 11, 2020, SEBI also called for the examination of certain persons including the statutory auditor of CG Power and the RAC.[ag]

ag CONFIRMATORY ORDER IN THE MATTER OF CG POWER AND INDUSTRIAL SOLUTIONS LIMITED, SEC. & EXCH. BD. OF INDIA (2020).

- paid-up share capital of INR 50 or more
- turnover during the preceding financial year of INR 200 or more
- outstanding deposits at any time during the preceding financial year of INR 25 crore or more
- outstanding loans or borrowings from banks or public financial institutions at any time during the preceding financial year of INR 100 crore or more

- private companies meeting either of the following criteria:
  - outstanding loans or borrowings from banks or public financial institutions at any time during the preceding financial year of INR 100 crore or more
  - turnover during the preceding financial year of INR 200 crore or more

In a 2019 report, The Centre for Economic and Policy Research noted that there is a need to clearly demarcate the responsibilities of the audit committee and the auditors and to improve the role of the audit committee so that the overall approach shifts from post facto analyses to finding loopholes in advance and averting crises.[28]
In a survey of Indian investors by IiAS in April 2020, a surprising 57 percent opined that they are willing to move beyond the big four audit firms,[29] shedding light on the way Indian corporates today perceive auditors, the audit process, and the liabilities associated with it. In the wake of the recent failures at top corporates in India, it has become necessary to strengthen the audit process not only at the committee and auditor level, but also at the regulatory level by increasing the powers of the NFRA.

28 *Auditors for New India*, The Centre for Economic and Policy Research, November 2019.

29 *A Short Investor Survey*, Institutional Investor Advisory Services, May 2020.

Key Takeaways

- The audit committee is crucial for enhancing corporate governance practices and protecting the interests of stakeholders, given the many roles that it plays. Accordingly, it is endowed with certain powers, including seeking information, under the SEBI Listing Regulations.
- Auditor independence is vital for the audit process to be effective.
- Since auditors play an important supervisory role over corporations, auditors themselves are also subject to regulatory scrutiny and have certain responsibilities and liabilities.

Open Questions

- What measures need to be undertaken to strengthen the entire audit process, internally and externally?
- Do excessive qualifications in audit reports undermine the strength, reliability, and conclusiveness of the audit process, as evidenced in recent cases?

CHAPTER EIGHT

Related Party Transactions

Introduction

Related party transactions (RPTs) are defined as those transactions between a company, its subsidiaries, employees, its controlling shareholders, management or members of their immediate family, and affiliates.[1] RPTs may occur in the form of transfer pricing, asset stripping, intercompany loans and guarantees, sale of receivables to a special purpose vehicle, leasing and licensing arrangements between a parent and a subsidiary, and the like.[2] While RPTs can be beneficial to companies, they also have the potential to be abusive—unduly benefiting controlling shareholders while adversely affecting the interests of minority shareholders.[3]

Regulation of RPTs is crucial when the corporate landscape is characterized by groups of companies that are owned either by business families or by the state. Controlled companies are predominant in the Asian context,[4] and India is no different. Public companies in India display concentrated shareholding in the hands of a controlling shareholder (or promoter) that is either a business family or the state. While promoter holdings in NSE-listed companies peaked at about 64 percent in 2009, this has fallen to approximately 54 percent in 2020.[5] Apart from absolute shareholding in Indian public companies, promoter control is emboldened through other mechanisms such as cross-holding, pyramiding, and tunneling.[6] Such shareholding structures allow promoters to extract greater value through transactions with group companies (in which they have a substantial interest), potentially to the detriment of minority shareholders. "Abusive RPTs oppress small and retail investors, undermining confidence in the financial market and thereby adversely affecting the mobilization of investment."[7]

Corporate governance scholars argue that a robust regulatory regime on RPTs may minimize abusive and value-reducing transactions. However, they also caution that the "general assumption that RPTs per se are evidence of defective corporate governance and that stricter regulation of RPTs consequently equates to 'good law' is erroneous."[8] Experts further argue that in addition to law on the books, other factors such as public enforcement, corporate norms and culture, and rule of law norms matter significantly for managing RPTs. For example, in India, the Company Act's Code of Conduct for independent directors requires them to be informed of and to ensure that adequate deliberations are held before approving RPTs and assure themselves that the transactions are in the interests of the company. But "the mere requirement of approval of independent directors fails to constitute a failsafe mechanism against controlling shareholder opportunism through RPTs. Ultimately, it boils down to the question of how effective independent directors are in the context of companies with concentrated shareholding that epitomize" countries like India.[9] In India, for example, there are questions about the actual independence of independent directors because promoters exercise significant influence in the nomination and election of directors.

Prior to passage of the Companies Act, 2013 (Companies Act, or the Act), much of Indian law relating to RPTs focused on disclosure requirements, but imposed little in terms of approval requirements such as approval by independent directors or disinterested shareholders.[10] This detailed disclosure-based regulatory regime provided only weak safeguards for minority shareholders.[11]

1 Guide on Fighting Abusive Related Party Transactions in Asia, Organization for Economic Co-operation and Development [OECD], 16-19 (September 2009) (hereafter OECD Guide).

2 OECD Guide, 11.

3 Tarun Khanna and Yishay Yafeh, "Business Groups in Emerging Markets: Paragons or Parasites?" *Journal of Economic Literature* 45, no. 2 (June 2007): 331-72; Dan W. Puchniak and Umakanth Varottil, "Related Party Transactions in Commonwealth Asia: Complicating the Comparative Paradigm" in *The Law and Finance of Related Party Transactions*, ed. Luca Enriques and Tobias Tröger (Cambridge: Cambridge University Press, 2019), 327-60.

4 OECD Guide, 9-10.

5 "What Increased Investor Ownership Means," *Institutional Eye Blog*, Institutional Investor Advisory Services India Limited, February 17, 2020.

6 Marianne Bertrand, Paras Mehta, and Sendhil Mullainathan, "Ferreting Out Tunneling: An Application to Indian Business Groups," *Quarterly Journal of Economics* 117, no. 1 (February 2002): 126.

7 *Improving Corporate Governance in India: Related Party Transactions and Minority Shareholder Protection*, Organization for Economic Co-operation and Development [OECD] (2014) PP (hereafter OECD RPTs Report).

8 Puchniak and Varottil, "Related Party Transactions in Commonwealth Asia," 7.

9 Puchniak and Varottil, "Related Party Transactions in Commonwealth Asia," 20.

10 OCED RPTs Report, 19-24.

11 *ACGA White Paper on Corporate Governance in India,* Asian Corporate Governance Association, January 2010, p. 22 (hereafter *ACGA White Paper*).

Satyam-Maytas

Satyam Computer Services Limited (since taken over and renamed) was a leading information technology services company in India, with its shares listed on Indian stock exchanges as well as the NYSE. Its promoter was Ramalinga Raju, who was also the chair. The company was lauded for having robust corporate governance practices, including reputed independent directors on its board.[a]

On December 16, 2008, Satyam convened a board meeting to consider the possible acquisition of two other companies, Maytas Infra Limited and Maytas Properties Limited.[b] The Maytas companies were predominantly owned by Mr. Raju and his family, thus making this a related party transaction. The transaction was also significant in size, as the consideration was set at approximately $1.6 billion USD,[c] and it pertained to the acquisition of an entirely unrelated business, because the Maytas companies were involved in real estate. The transaction structure would permit an enormous amount of cash to flow from Satyam indirectly into the hands of its promoters. Despite various concerns raised at the board meeting, the transaction was nevertheless approved unanimously by the board of directors.[d] The minutes of the board meeting indicate that although some directors expressed concern regarding the merits of the transaction, none of them vetoed it.

The then-prevailing legal regime on related-party transactions failed to rein in an acquisition that was otherwise unduly in favor of the promoters and to the detriment of minority shareholders. Although the transaction was approved by the board, it was not implemented, because shareholders reacted adversely to the news. The consequent drop in the price of Satyam's stock compelled the management to withdraw the proposal.[e] The Maytas transaction was followed by Raju's confession to falsifying the accounts of Satyam to the extent of over $1 billion USD.[f] (For more details, see "The Satyam Scandal," p. 16.)

a "Satyam Receives Golden Peacock Award for Excellence in Corporate Governance," *Financial Express*, September 23, 2008.

b "Minutes of the Meeting of the Board of Directors," Satyam Computer Services Limited (December 16, 2008), 2 (hereafter Board Minutes).

c Satyam Board Minutes, 4.

d Satyam Board Minutes, 8-10.

e Somasekhar Sundaresan, "Year of All-Pervasive Poor Governance," *Business Standard*, December 29, 2008.

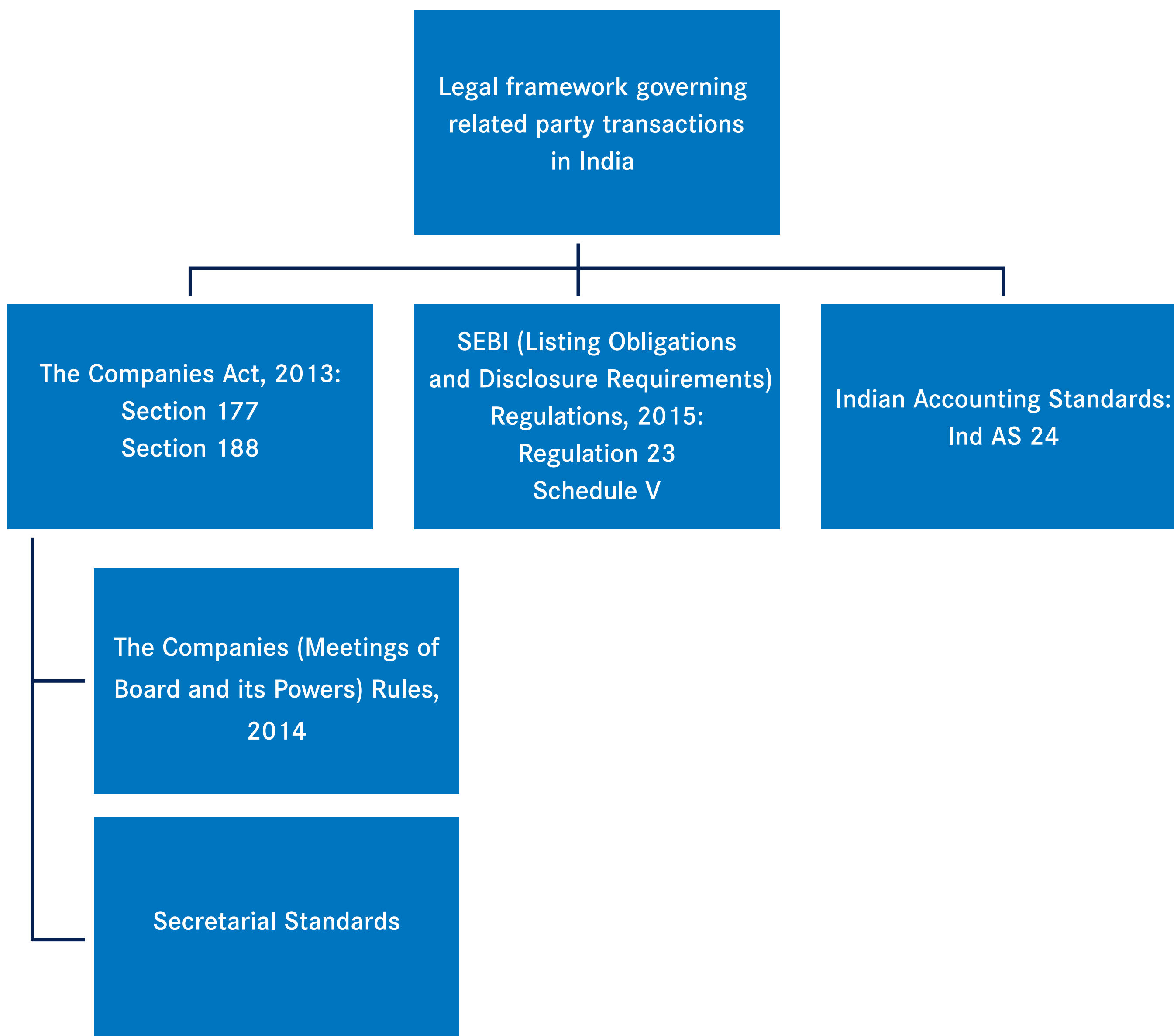
f B. Ramalinga Raju, Chairman, Satyam Computer Services Ltd., letter to the Board of Directors, Satyam Computer Services Ltd., January 7, 2009.

Legal Framework

The law in India that regulates related party transactions is somewhat fragmented. The legal framework can be extracted from several different sources, including

- certain provisions of the Companies Act;[12]
- The Companies (Meetings of Board and its Powers) Rules, 2014;
- SS-1: Secretarial Standard on Meetings of the Board of Directors;
- SEBI Listing Regulations; and
- Indian Accounting Standards issued under the Companies (Indian Accounting Standards) Rules, 2015.

In all these laws, several different approaches have been adopted to address RPTs, including disclosure, board oversight and approval, and disinterested shareholder approval. Minority shareholders can benefit from greater protection if they are able to vote (independent of the promoters) on related party transactions.



12 The Companies Act, 2013 § 184, No. 18, Acts of Parliament, 2013.

SEBI Working Group on Related Party Transactions

In November 2019, SEBI constituted a Working Group to review the policy space pertaining to RPTs under the chairmanship of Ramesh Srinivasan, managing director and CEO, Kotak Mahindra Capital Company Limited (the RPT Working Group). The Working Group was charged with making recommendations to SEBI on the following issues:

1. the definition of the terms "related party" and "related party transactions";
2. the thresholds for classification of "related party transactions," as material;
3. the process followed by the audit committee for approval of related party transactions;
4. review of the provisions relating to related party transactions in the SEBI Listing Regulations vis-à-vis the Indian Accounting Standards and the Companies Act;
5. the format for periodic disclosure of RPTs by listed entities; and
6. recommendations for strengthening the monitoring and enforcement of regulatory norms related to RPTs.

The RPT Working Group submitted its report on January 22, 2020.

This chapter provides a brief overview of the recommendations of the RPT Working Group.

SCOPE OF RELATED PARTY TRANSACTIONS

To examine the concept of "related party transactions," it is imperative to consider how the term "related party" has been defined under the legal framework. Under the SEBI Listing Regulations, a "related party" means a related party as defined under section 2(76) of the Act or under the applicable accounting standards, provided that this definition is not applicable for the units issued by mutual funds that are listed on recognized stock exchanges.[13] Further, any person or entity belonging to the promoter or promoter group of the listed entity and holding 20 percent or more of shareholding in the listed entity is deemed to be a related party.

Accordingly, in the context of listed companies, in assessing what qualifies as a "related party," the definitions under the Act and the accounting standards must be examined together. Table 8.1 outlines the definition of related party under the Act and the Indian Accounting Standard (Ind AS) 24.

DEFINITION OF RELATED PARTY TRANSACTION

The Act does not set out a definition of "related party transaction" per se. The SEBI Listing Regulations on the other hand specifically define the term as a transfer of resources, services, or obligations between a listed entity and a related party, regardless of whether a price is charged, and a "transaction" with a related party shall be construed to include a single transaction or a group of transactions in a contract. The SEBI Listing Regulations further stipulate that this definition is not applicable for the units issued by mutual funds which are listed on a recognized stock exchange(s).[14]

CONSENT REQUIREMENTS

Audit Committee consent. In addition to board approval, under Section 177(4) (iv) of the Act, the Audit Committee is charged with "approval or any subsequent modification of transactions of the company with related parties." (See Table 8.2.) The Companies (Meetings of Board and its

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13 Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 no. 2(1)(zb) (Sept. 2, 2015) [hereinafter SEBI Listing Regulations].

14 SEBI Listing Regulations, pt. III sec. 4 no. 2(zc).

Table 8.1 **Definition of "Related Party"**

The Companies Act, 2013	Ind AS 24
2(76) "related party," with reference to a company, means (1) a director or his relative; (2) a key managerial personnel or his relative; (3) a firm in which a director, manager, or his relative is a partner; (4) a private company in which a director or manager or his relative is a member or director; (5) a public company in which a director or manager is a director and holds, along with his relatives, more than 2 percent of its paid-up share capital; (6) any body corporate whose board of directors, managing director, or manager is accustomed to act in accordance with the advice, directions, or instructions of a director or manager; (7) any person on whose advice, directions, or instructions a director or manager is accustomed to act: Provided that nothing in (6) and (7) above shall apply to the advice, directions, or instructions given in a professional capacity; (8) any body corporate that is (a) a holding, subsidiary, or associate company of such company; (b) a subsidiary of a holding company to which it is also a subsidiary; or (c) an investing company or the venturer of the company. Explanation: For the purpose of this clause, "the investing company or the venturer of a company" means a body corporate whose investment in the company would result in the company becoming an associate company of the body corporate. (9) such other person as may be prescribed.	A *related party* is a person or entity that is related to the entity that is preparing its financial statements (referred to in this Standard as the "reporting entity"). (A) A person or a close member of that person's family is related to a reporting entity if that person (1) has control or joint control of the reporting entity; (2) has significant influence over the reporting entity; or (3) is a member of the key management personnel of the reporting entity or of a parent of the reporting entity. (B) An entity is related to a reporting entity if any of the following conditions applies: (1) The entity and the reporting entity are members of the same group (which means that each parent, subsidiary, and fellow subsidiary is related to the others). (2) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member). (3) Both entities are joint ventures of the same third party. (4) One entity is a joint venture of a third entity and the other entity is an associate of the third entity. (5) The entity is a postemployment benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity. If the reporting entity is itself such a plan, the sponsoring employers are also related to the reporting entity. (6) The entity is controlled or jointly controlled by a person identified in A. (7) A person identified in A1 has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity). (8) The entity, or any member of a group of which it is a part, provides key management personnel services to the reporting entity or to the parent of the reporting entity. A *related party transaction* is a transfer of resources, services, or obligations between a reporting entity and a related party, regardless of whether a price is charged. Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity, including

Table 8.1 **Definition of "Related Party"** *continued*

The Companies Act, 2013	Ind AS 24
	(1) that person's children, spouse or domestic partner, brother, sister, father, and mother; (2) children of that person's spouse or domestic partner; and (3) dependents of that person or that person's spouse or domestic partner. The terms "joint control" and "significant influence" have been defined under Ind AS 28 as follows: *Joint control* is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control. *Significant influence* is the power to participate in the financial and operating policy decisions of the investee, but is not control or joint control of those policies.

Powers) Rules, 2014[15] provide that while all RPTs must be approved by the audit committee, the audit committee may make omnibus approval for RPTs proposed to be entered into by the company subject to certain conditions described below.

The audit committee must, after obtaining approval of the board, specify the criteria for making the omnibus approval, which must include the following:

- the maximum value of the transactions, in aggregate, that can be allowed under the omnibus route in a year;
- the maximum value per transaction that can be allowed;
- the extent and manner of disclosures to be made to the audit committee at the time of seeking omnibus approval;
- review, at such intervals as the audit committee may deem fit, of the RPT(s) entered into by the company pursuant to each omnibus approval made; and
- transactions that cannot be subject to the omnibus approval by the audit committee.

The audit committee is required to consider the repetitiveness of the transactions (in the past or in the future) and the justification for the need for omnibus approval, while specifying the criteria for making such omnibus approval. The audit committee must be satisfied with the need for omnibus approval for transactions of a repetitive nature and determine that such approval is in the interest of the company.

The omnibus approval is required to contain or indicate the following:

- the name of the related parties;
- the nature and duration of the transaction;
- the maximum amount of the transaction that can be entered into;
- the indicative base price or current contracted price and the formula for variation in the price, if any; and
- any other information relevant or important for the audit committee to take a decision on the proposed transaction.

The Companies (Meetings of Board and its Powers) Rules, 2014 further provide that where the need for a future RPT cannot be foreseen and the above details are not available,

15 The Companies (Meetings of Board and its Powers) Rules, 2014, *Gazette of India*, pt. II sec. 3 ch. XII sec. 6A, 2014 (March 31, 2014).

Definition of Related Party—RPT Working Group Recommendations

The RPT Working Group made the following recommendations regarding the definition of a related party.

Recommendation: All persons or entities belonging to the “promoter” or “promoter group,” irrespective of their shareholding in the listed entity, should be deemed to be related parties.

Rationale: The RPT Working Group reasoned that in terms of the definition of promoter under the SEBI Listing Regulations, a promoter may be a person exercising control over a company irrespective of the extent of shareholding. Further, the subjectivity of the Ind AS definition of related party may lead to certain promoters or promoter group entities with less than 20 percent shareholding in the listed entity not getting categorized as related parties and therefore, transactions with such persons may not get categorized as RPTs under the SEBI Listing Regulations. Further, noting that a significant percentage of Indian businesses are structured as intrinsically linked group entities that operate as a single economic unit, with the promoters exercising influence over the entire group, the RPT Working Group recommended that promoter group members may also be included under the definition of a related party, irrespective of their shareholding.

Recommendation: Shareholders who are not part of the promoter or promoter group but hold above 20 percent in a company should also be classified as a related party. The RPT Working Group further recommended that a deeming provision be created for aggregation of direct and indirect shareholding of individual shareholders and their relatives, as defined under the Act, for the purposes of calculating the 20 percent threshold.

Rationale: In terms of the Act and the Ind AS, a shareholding of 20 percent is considered sufficient to confer a shareholder with significant influence over the company.

the audit committee may make omnibus approval for such transactions subject to their value not exceeding INR 1 crore per transaction.

Under these rules, omnibus approval is only valid for up to one financial year and new approvals are necessary after expiration of such financial year. Omnibus approvals cannot be made for transactions involving selling or disposing of any undertaking of the company.

In case of transactions other than transactions referred to in section 188, the audit committee is required to make its recommendations to the board where it does not approve the transaction.

If any transaction involving any amount not exceeding INR 1 crore is entered into by a director or officer of the company without obtaining the approval of the audit committee and it is not ratified by the audit committee within three months from the date of the transaction, such transaction shall be voidable at the option of the audit committee; and if the transaction is with the related party to any director or is authorized by any other director, the director concerned shall indemnify the company against any loss incurred by it.

This shall not apply to a transaction, other than a transaction referred to in section 188, between a holding company and its wholly owned subsidiary company.

In terms of the Secretarial Standard on Meetings of the Board of Directors (SS-1), the audit committee should discuss related party transactions that are not in the ordinary course of business or that are not on an arm’s-length basis at meetings and not through circulation.

Definition of Related Party Transaction—RPT Working Group Recommendations

The RPT Working Group proposed certain amendments in the definition of RPTs under the SEBI Listing Regulations.

To clarify the nature of the parties to such transactions, the Working Group proposed that RPTs be defined as follows:

“related party transaction” means a transaction involving a transfer of resources, services, or obligations between

(1) the listed entity or any of its subsidiaries on the one hand and a related party of the listed entity or any of its subsidiaries on the other hand; or

(2) the listed entity or any of its subsidiaries on the one hand, and any other person or entity on the other hand, the purpose and effect of which is to benefit a related party of the listed entity or any of its subsidiaries, regardless of whether a price is charged or not.

Such transaction shall be construed to include a single transaction or a group of transactions.

Provided further that this definition shall not be applicable for the units issued by mutual funds that are listed on a recognized stock exchange(s).

The RPT Working Group further proposed that a list of transactions that are not to be construed as RPTs should be included in the above definition. The Working Group set forth the following proposed list of excluded transactions:

1. the issue of specified securities on a preferential basis, subject to requirements under the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018 being complied with; and
2. the following corporate actions by the listed entity that are uniformly applicable and offered to all shareholders in proportion to their shareholding:
   a. payment of dividend;
   b. subdivision or consolidation of securities;
   c. issuance of securities by way of a rights issue or a bonus issue; and
   d. buy-back of securities.

However, there is no bar on omnibus approval of limits being passed by a circular resolution by the audit committee.[16]

In addition to the above provisions, the RPT Working Group has recommended that SEBI Listing Regulations explicitly provide that, with respect to approval of an RPT, the audit committee must review the following information as provided by the management of the listed entity:

1. the type, material terms, and particulars of the proposed transaction;
2. the name of the related party and its relationship with the listed entity or its subsidiary, including the nature of its concern or interest (financial or otherwise);
3. the tenure of the proposed transaction (the transaction should have a particular tenure or term and should not be indefinite or open-ended);
4. the value of the proposed transaction (an upper limit should be provided, and in case of a recurring or continuous transaction, the aggregate value and the period within which such limit will be exhausted);

(*continued on p. 155*)

16 GUIDANCE NOTE ON RELATED PARTY TRANSACTIONS, INST. OF CO. SEC’YS OF India (2019); SS-1, SECRETARIAL STANDARD ON MEETINGS OF THE BOARD OF DIRECTORS, INST. OF CO. SEC’YS OF INDIA, para. 1.3.8, annexure A (2017).

Table 8.2 **Party Transactions—Consents Required by Listed Companies**

Particulars	Board consent	Audit Committee consent	Shareholders' consent
Nature of transactions	(a) sale, purchase or supply of any goods or materials; (b) selling or otherwise disposing of, or buying, property of any kind; (c) leasing of property of any kind; (d) availing or rendering of any services; (e) appointment of any agent for purchase or sale of goods, materials, services or property; (f) such related party's appointment to any office or place of profit in the company, its subsidiary company or associate company; and (g) underwriting the subscription of any securities or derivatives thereof, of the company [CA - Sec. 188(1)]	Prior approval for all RPTs [LODR – Reg. 23(2)] [SEBI RPT Working Group recommendations: 1. Prior approval for subsequent material modifications of any RPT as well 2. The regulations shall specify that this shall be the audit committee of the listed entity. 3. Prior approval of the audit committee of the listed company for RPTs to which the subsidiary of a listed entity is a party but the listed entity is not a party, if the value of such transaction (whether entered into individually or taken together with previous transactions during a financial year) exceeds 10 percent of the annual total revenues, total assets or net worth of the subsidiary, on a standalone basis, for the immediately preceding financial year, whichever is lower, provided that the criterion relating to net worth shall not be applicable if the net worth of the subsidiary is negative.	Approval through resolution for all material RPTs [LODR – Reg. 23(4)] **"Material" RPTs** Transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds the annual consolidated turnover of the listed entity as per the last audited financial statements of the listed entity • By 5 percent, for transactions involving payments made to a related party with respect to brand usage or royalty [LODR – Reg. 23(1A)] • By 10 percent, for all other transactions [LODR – Explanation to Reg. 23(1)] Prior approval by members' resolution for the following RPTs: (i) sale, purchase or supply of any goods or material, directly or through appointment of agent, amounting to 10 percent or more of the turnover of the company (ii) selling or otherwise disposing of or buying property of any kind, directly or through appointment of agent, amounting to 10 percent or more of net worth of the company (iii) leasing of property any kind amounting to 10 percent or more of the turnover of the company (iv) availing or rendering of any services, directly or through appointment of agent, amounting to 10 percent or more of the turnover of the company These apply for transaction or transactions to be entered into either individually or taken together with the previous transactions during a financial year. (v) appointment to any office or place of profit in the company, its subsidiary company or associate company at a monthly remuneration exceeding INR 2.5 lakhs

Table 8.2 **Party Transactions—Consents Required by Listed Companies** *continued*

Particulars	Board consent	Audit Committee consent	Shareholders' consent
		4. Prior approval of the audit committee of the listed entity shall not be required for a related party transaction to which the listed subsidiary is a party but the listed entity is not a party, if such listed subsidiary is not exempt from regulation 23 and the other corporate governance provisions of the SEBI Listing Regulations specified in regulation 15(2). 5. For related party transactions of unlisted subsidiaries of a listed subsidiary specified above, the prior approval of the audit committee of the listed subsidiary would suffice.]	(vi) remuneration for underwriting the subscription of any securities or derivatives thereof, of the company exceeding 1 percent of the net worth [CA – First Proviso to Sec. 188(1) read with the Companies (Meeting of Board and its Powers) Rules, 2014 – Rule 15(3)] [SEBI RPT Working Group recommendation: 1. Such approval by shareholders must be "prior" approval. 2. Such prior approval shall be for subsequent material modifications of any material RPT as well. 3. Prior approval of the shareholders of a listed entity shall not be required for a related party transaction to which the listed subsidiary is a party but the listed entity is not a party, if such listed subsidiary is not exempt from regulation 23 and the other corporate governance provisions of the SEBI Listing Regulations specified in regulation 15(2). 4. For RPTs of unlisted subsidiaries of a listed subsidiary specified above, the prior approval of the shareholders of the listed subsidiary would suffice. 5. Materiality – A transaction with a related party transaction shall be considered material if the transaction(s) to be entered into individually or taken together with previous transactions during a financial year, exceeds 10 Rs.1,000 crore or 5 percent of the annual consolidated turnover total revenues, total assets or net worth of the listed entity on a consolidated basis as per the last audited financial statements of the listed entity, whichever is lower, provided that the criterion relating to net worth shall not be applicable if the net worth of the listed entity is negative.]

Table 8.2 **Party Transactions—Consents Required by Listed Companies** *continued*

Particulars	Board consent	Audit Committee consent	Shareholders' consent
Exemptions from consent requirements	Transactions in the ordinary course of business and on arm's length basis [CA – Fourth Proviso to Sec. 188(1)] "Arm's length" transaction is defined as "a transaction between two related parties that is conducted as if they were unrelated, so that there is no conflict of interest." While the Act does not prohibit a company from entering into a RPT that is not arm's length, the board is required to give justification for entering into any such transaction to the shareholders in its report.	Transactions entered into between two government companies [LODR – Reg. 23(5)] Transactions entered into between a holding company and its WOS whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval. [LODR – Reg. 23(5)]	Transactions entered into between two government companies [LODR – Reg. 23(5)] Transactions entered into between a holding company and its wholly owned subsidiary whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval. [LODR – Reg. 23(5) and CA – Fifth Proviso to Sec. 188(1)] Resolution plan approved under section 31 of the Insolvency Code, subject to stock exchange disclosures within one day of approval [LODR – Proviso to Reg. 23(4)] [SEBI RPT Working Group recommendation: Transactions entered into between two wholly-owned subsidiaries of the listed holding company, whose accounts are consolidated with such holding company and placed before the shareholders at the general meeting for approval.]
Who cannot vote	Where any director is interested in any contract or arrangement with a related party, such director shall not be present at the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement. The concerned interested director shall leave the meeting during discussions on the subject matter of the resolution relating to such contract or arrangement. [Rule 15(2) of the Companies (Meetings of Board and its Powers) Rules, 2014 and Paragraph 3.2 of SS-1, Secretarial Standard on Meetings of the Board of Directors]	All persons being related parties to the company, irrespective of them being or not being related party to the concerned transaction [LODR – Reg. 23(7)]	Shareholders being related parties to the company, irrespective of them being or not being related party to the concerned transaction [LODR – Reg. 23(4) and CA - Second Proviso to Sec. 188(1)] Pursuant to the recommendations of the Kotak Committee, the Listing Regulations now provide that related parties of the listed entity may cast a negative vote on resolutions seeking approval of RPTs. Hence shareholders who are related parties can not approve an RPT but can oppose a resolution seeking such approval.

the percentage of the listed entity's annual total revenues, total assets, and net worth, on a consolidated basis, for the immediately preceding financial year, that is represented by the value of the proposed transaction, provided that, for a related party transaction involving a subsidiary, the value of the proposed transaction as a percentage of the subsidiary's annual total revenues on a standalone basis should additionally be provided;

5. if the transaction relates to any loans, intercorporate deposits, advances, or investments made or given by the listed entity or its subsidiary;
   a. details of the source of funds in connection with the proposed related party transaction;
   b. where any financial indebtedness is incurred to make or give loans, intercorporate deposits, advances, or investments (the nature of the indebtedness, cost of funds, and tenure);
   c. applicable terms, including covenants, tenure, interest rate, and repayment schedule, whether secured or unsecured, and if secured, the nature of security; and
   d. the purpose for which the funds will be utilized by the ultimate beneficiary of such funds pursuant to the related party transaction;
6. justification as to why the related party transaction is in the interest of the listed entity;
7. a copy of the valuation or other external report, if any such report has been relied upon;
8. the percentage of the counterparty's annual total revenues, total assets, and net worth, that is represented by the value of the proposed related party transaction, provided that the information mentioned in this subclause may be placed before the audit committee on a voluntary basis; and
9. any other information that may be relevant.

In addition to the above consent requirements, the Code of Conduct for independent directors requires them to be informed of and to ensure that adequate deliberations are held before approving related party transactions and assure themselves that the transactions are in the interest of the company.[17]

BLANKET PROHIBITION

In extreme cases, certain RPTs are prohibited altogether. Section 185 of the Act imposes strict restrictions on certain types of transactions. Thus, a company cannot, directly or even indirectly, provide a loan, security, or guarantee in favor of (a) a director of the company or of a company that is its holding company or any partner or relative of any such director; or (b) any firm in which any such director or relative is a partner, subject to certain conditions.[18] A company may advance any loan, or give any guarantee, or provide any security in connection with any loan taken by any person in whom any of the director of the company is interested, subject to the conditions that a special resolution is passed by the company in a general meeting, with the explanatory statement to the notice disclosing the full particulars of the loan, guarantee, or security, its end use and all other relevant facts, and that the proceeds are used by the borrowing company for its principal business activities.

Loans made by, guarantees given, or security provided by a holding company to its wholly owned subsidiaries for its principal business activities are exempt from the requirements of section 185. Further, guarantees given or security provided by a holding company to a bank or financial institution for the purpose of a loan taken by any subsidiary for its principal business activities is also exempt. The prohibition also does not apply to giving loans to MDs or whole-time directors as a part of the service conditions extended by the company to all its employees or pursuant to any scheme approved by members by a special resolution. A company which in the ordinary course of its business provides loans or gives guarantees or securities for the due repayment of any loan, and in respect of such loans an interest is charged at a rate not less than the rate of the prevailing yield of one year, three years, five years, or 10 years, the Government security closest to the tenor of the loan is also exempt.

17 The Companies Act, 2013, sched. IV Code of Conduct for Independent Directors.

18 The Companies Act, 2013 § 185(1).

DISCLOSURES

Disclosure of interest by directors. Section 184 of the Act requires every director who is either directly or indirectly interested in a contract or arrangement of the company to disclose the nature of the interest at a board meeting. Some experts argue that the disclosure requirements under the Act do not account for the complexity in shareholding structures adopted by Indian promoters, and that they are also subject to several exceptions.[19] For example, one exception states that the disclosure requirements do not apply if a director (or all directors together) of a company hold(s) no more than 2 percent of the shareholding of another body corporate (with which the contract or arrangement is proposed to be entered into).[20]

Disclosures in agenda for board meeting. The Companies (Meetings of Board and its Powers) Rules, 2014 provide that the agenda of the board meeting at which the resolution is proposed to be moved must disclose the following information:[21]

- the name of the related party and the nature of the relationship;
- the nature, duration of the contract, and particulars of the contract or arrangement;
- the material terms of the contract or arrangement, including the value, if any;
- any advance paid or received for the contract or arrangement, if any;
- the manner of determining the pricing and other commercial terms, both included as part of the contract and not considered as a part of the contract;
- whether all factors relevant to the contract have been considered; if not, the details of the factors not considered, with the rationale for not considering those factors; and
- any other information relevant or important for the board to take a decision on the proposed transaction.

Disclosures in the explanatory statement for general meeting. With respect to RPTs for which shareholder approval is being sought, the explanatory statement to be annexed to the notice of a general meeting is required to contain the following details:[22]

- the name of the related party;
- the name of the director or key managerial personnel who is related, if any;
- the nature of the relationship;
- the nature, material terms, monetary value, and particulars of the contract or arrangement; and
- any other information relevant or important for the members to take a decision on the proposed resolution.

Disclosure on the website of the company. Under the SEBI Listing Regulations, listed entities are required to formulate a policy on materiality of RPTs and on dealing with such RPTs.[23] Listed entities are required to maintain a functional website containing basic information about them and required to publish on their respective websites their policy on dealing with RPTs.[24]

Disclosures in annual reports. The annual report of a listed entity is required to contain disclosures as specified in the Act along with the other related party disclosures mandated by the SEBI Listing Regulations,[25] including, inter alia, information in respect of materially significant RPTs that may have potential conflicts with the interests of the listed entity at large. The board of directors of listed entities is responsible for monitoring and managing potential conflicts of interest of management, members of the board, and shareholders, including misuse of corporate assets and abuse in RPTs. All of the above disclosure requirements are aimed at ensuring that shareholders can make informed voting decisions.

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19 "Related Party Transactions: SEBI Must Not Budge," *Institutional Eye Blog*, Institutional Investor Advisory Services India Limited, July 9, 2015.

20 The Companies Act, 2013 § 184(2)(a).

21 The Companies (Meetings of Board and its Powers) Rules, 2014, pt. II sec. 3 ch. XII sec. 15.

22 The Companies (Meetings of Board and its Powers) Rules, 2014, pt. II sec. 3 ch. XII sec. 15.

23 SEBI Listing Regulations, pt. III sec. 4 no. 23.

24 SEBI Listing Regulations, pt. III sec. 4 no. 46.

25 SEBI Listing Regulations, pt. III sec. 4 no. 53, pt. III sec. 4 sched. V para. A.

Information for Shareholders—RPT Working Group Recommendations

The RPT Working Group noted the need to increase informed shareholder participation in India given that a majority vote is required by nonrelated shareholders for approval of RPTs. Accordingly, the RPT Working Group has proposed that the SEBI Listing Regulations mandate that the notice being sent to shareholders seeking approval for any proposed related party transaction must, in addition to the requirements under the Act, include the following information as a part of the explanatory statement:

- a summary of the information provided by the management of the listed entity to the audit committee pursuant to paragraph B (2) of Part C of Schedule II;
- the recommendation of the audit committee in respect of the proposed transaction, specifying justification for why the transaction is in the interest of the listed entity;
- where the transaction relates to any loans, intercorporate deposits, advances, or investments made or given by the listed entity or its subsidiary, the details specified under paragraph B (2) (f) of Part C of Schedule II;
- whether the approval of the related party transaction by the audit committee was unanimous;
- a statement that the valuation or other external report, if any, relied upon by the listed entity in relation to the proposed transaction will be available for inspection at the registered office of the listed entity;
- the percentage of the counterparty's annual total revenues, total assets, and net worth, that is represented by the value of the proposed related party transaction, provided that the information mentioned in this subclause may be placed in the notice sent to shareholders on a voluntary basis; and
- any other information that may be relevant.

Ind AS 24 disclosures. With the expanded definition of related parties under the Ind AS 24, companies need to reassess the individuals and entities considered to be related, since disclosure of their names and the nature of their relationship are still required, irrespective of whether transactions have occurred.[26] Ind AS 24 requires disclosures of key management personnel compensation in total and on other various bases, including short-term and postemployment benefits.[27] Ind AS 24 also clarifies that items of a similar nature may be disclosed in aggregate, except when separate disclosure is necessary to understand the impact of a RPT on the financial statements and status of the entity.[28]

Significant beneficial ownership disclosures. Section 90 of the Act introduced the vital concept of "significant beneficial owner" in the Indian corporate law framework and requires every company to maintain a register of and file returns of significant beneficial owners of the company and changes therein with the ROC as prescribed under the Companies (Significant Beneficial Owners) Rules, 2018. Companies are required to take the required steps to identify significant beneficial owners in relation to the company and ensure compliance with the provisions of the Act and the rules in this regard by requiring such persons to furnish the requisite information of their beneficial ownership. If a person does not give the required information or does not tender satisfactory information, the company may even apply to the NCLT for an order directing that the shares in question be subject to restrictions with regard to transfer of interest, suspension

26 INDIAN ACCOUNTING STANDARD (IND AS) 24, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA, para. 13 (2015) [hereinafter IND AS 24].

27 IND AS 24, para. 17.

28 IND AS 24, para. 24.

Material RPTs—RPT Working Group Recommendations

The RPT Working Group deliberated on the existing materiality thresholds under the SEBI Listing Agreement and has proposed that for an RPT to be considered material, such transaction(s) to be entered into individually or taken together with previous transactions during a financial year should exceed INR 1,000 crores or 5 percent of the annual total revenues, total assets, or net worth of the listed entity on a consolidated basis as per the last audited financial statements of the listed entity, whichever is lower, provided that the criterion relating to net worth shall not be applicable if the net worth of the listed entity is negative.

of all rights attached to the shares, and such other matters as may be prescribed. The Act provides for penalties for contravention of this section.

The above provisions would contribute to more detailed disclosures of the beneficial owners of companies, revealing the identities of the ultimate persons behind it. This will aid shareholders in determining who is actually going to benefit from certain specific transactions.

PENALTIES FOR NONCOMPLIANCE

Under the Act, RPTs that are entered into without the requisite board and shareholder consent, and are not ratified by the board or the shareholders within a period of three months of entering into such contract or arrangement, are voidable at the option of the board or of the shareholders, as the case may be.[29] Furthermore, the Act introduces the following penal consequences in case of noncompliance:

- liability of the directors concerned, to indemnify the company against loss arising, if any, in case of a contract or arrangement with a related party vis-à-vis any director or one who is authorized by any other director;
- right conferred upon the company to take legal measures for recovery of loss against any director or employee involved in contravention;
- for any director or employee involved in contravention, provisions entailing a fine of INR 25 lakh in the case of a listed company and a fine of INR 5 lakh in the case of others; and
- disqualification of the person from being appointed as a director of a company, if he or she has been convicted of the offense dealing with related party transactions at any time during the preceding five years.

In case any transaction involving any amount up to INR 1 crore is entered into by a director or officer of the company without obtaining the approval of the audit committee, and it is not ratified by the audit committee within three months from the date of the transaction, such transaction shall be voidable at the option of the audit committee, and if the transaction is with the related party to any director or is authorized by any other director, the director concerned shall indemnify the company against any loss incurred by it.[30]

REMEDIES FOR MINORITY SHAREHOLDERS

Because RPTs may have a significant adverse impact on minority shareholders, minority shareholders need to have access to appropriate remedies in case there is a breach of the substantive regulations either by the board of directors of the company or the promoters. While the amendments in the Act and the replacement of the Clause 49 listing agreement regime with the SEBI Listing Regulations address some of the shortcomings in India’s legal framework with respect to RPTs, scholars argue that there is more that can be done on the enforcement front. The robustness of the legal framework is determined by the extent to which it is properly enforced. Enforcement remedies in India tend to be somewhat limited. For example, company law does not impose duties (such as fiduciary duties) on controlling shareholders.[31] Thus, controlling shareholders can exercise their voting powers

29 The Companies Act, 2013 § 188(3).

30 New proviso to section 177(4). This clause shall not apply to a transaction, other than a transaction referred to in section 188, between a holding company and its wholly owned subsidiary company.

31 OECD RPTs Report, 29. Contrast this with directors, who owe fiduciary duties to the company. *Rolta India Ltd. v. Venire Indus. Ltd.* (2000) 100 Comp. Cas. 19.

Significant Beneficial Ownership under the Companies Act

"Significant Beneficial Owner" under the Companies (Significant Beneficial Owners) Rules, 2018:

- Any individual, who acting alone or together, or through one or more persons or trust, possesses one or more of the following rights or entitlements in a reporting company, namely

  (1) holds indirectly, or together with any direct holdings, not less than 10 percent of the shares;

  (2) holds indirectly, or together with any direct holdings, not less than 10 percent of the voting rights in the shares;

  (3) has the right to receive or participate in not less than 10 percent of the total distributable dividend, or any other distribution, in a financial year through indirect holdings alone, or together with any direct holdings; or

  (4) has the right to exercise, or actually exercises, significant influence or control, in any manner other than through direct holdings alone

  is considered as a significant beneficial owner in relation to such company.

- Direct right or entitlement

  An individual shall be considered to hold a right or entitlement directly in the reporting company, if he or she holds shares in the reporting company in his or her name or if he or she holds or acquires a beneficial interest in the share of the reporting company under section 89(2) of the Act and has made a declaration in this regard to the reporting company.

- Indirect right or entitlement

  An individual is considered to hold a right or entitlement indirectly in the reporting company, if he or she satisfies any of the following criteria (see following Table), in respect of a member of the reporting company.

  If any individual, or individuals acting through any person or trust, act with a common intent or purpose of exercising any rights or entitlements, or exercising control or significant influence, over a reporting company, pursuant to an agreement or understanding, formal or informal, such individual, or individuals, acting through any person or trust, as the case may be, shall be deemed to be "acting together." The instruments in the form of global depository receipts, compulsorily convertible preference shares, or compulsorily convertible debentures shall be treated as "shares."

Significant Beneficial Ownership under the Companies Act *continued*

Nature of member of reporting company	Relationship of the concerned individual with such member
Body corporate (whether incorporated or registered in India or abroad), other than a limited liability partnership	Holds a majority stake in such body corporate or in the ultimate holding company (whether incorporated or registered in India or abroad) of that member
HUF	Karta of the HUF
Partnership firm	Partner of the firm or holds a majority stake in the body corporate that is a partner of the partnership or holds a majority stake in the ultimate holding company of the body corporate that is a partner of the partnership
Trust	Trustee of a discretionary trust or charitable trust or beneficiary of a specific trust or author or settlor of a revocable trust
Pooled investment vehicle or an entity controlled by the pooled investment vehicle based in FATF member state and the regulator of the securities market in such member state is an IOSCO member	General partner of the pooled vehicle or investment manager of the pooled vehicle or CEO, where the investment manager of such pooled vehicle is a body corporate or a partnership entity
Pooled investment vehicle or an entity controlled by the pooled investment vehicle not fulfilling the above requirements	The above provisions mentioned for bodies corporate, HUFs, partnership firms, and trusts shall apply as the case may be.

in their own interests rather than in the interest of the company, because they do not act in any fiduciary capacity.

Since there are no remedies exclusively designed to deal with RPTs, it is necessary to rely upon general remedies of shareholders under corporate and securities laws. While there are several remedies available, depending on the nature of the harm caused either to the company or to the minority shareholder, many of them are based on conventional principles of law and procedure. Many of the remedies such as derivative actions are to be initiated in the normal civil courts in India, which are known for their severe delays (due to excessive backlogs) and prohibitive costs. Other remedies, such as those for oppression and mismanagement, may be initiated before the National Company Law Tribunal (NCLT),[32] while regulatory actions are usually initiated by SEBI. One newer remedy under the Act is Section 245, which allows class action proceedings to be instituted by members or depositors of any company before the NCLT. Such class action may be brought about by members, inter alia, to restrain the company from doing any act which is contrary to the provisions of the Act or any other law for the time being in force or even to restrain the company from taking any action contrary to any resolution passed by the members. It remains to be seen whether the new class action remedy will be used in any significant way by minority shareholders. Other remedies for breach of the SEBI Listing Regulations continue to be accessible since SEBI has wide powers to investigate breaches and impose penalties,[33] order disgorgement of profits or damages, restraining persons from accessing the securities market and even delisting (although the minority shareholders will suffer in such a case). Please refer to Chapter Eleven (Shareholder Participation and Activism by Nonpromoter Shareholders) and Chapter Twelve (The Enforcement of Corporate Governance in India) for further discussion on shareholder remedies.

Key Takeaways

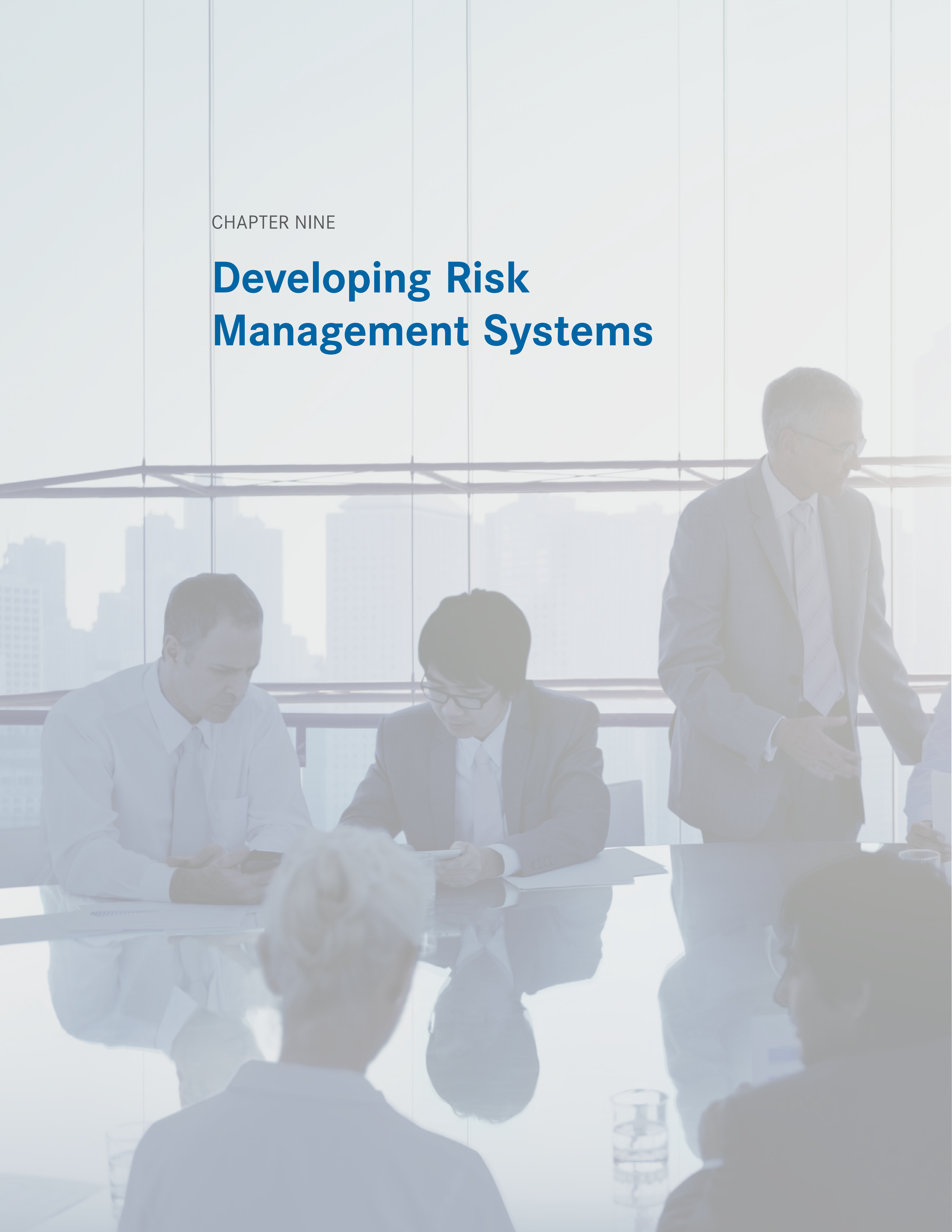
- Concentrated ownership of Indian companies and the use of complex group company structures create the potential for abusive RPTs that erode value for minority shareholders.
- India's substantive legal framework for regulating RPTs has slowly converged toward international standards, including audit committee approval as well as approval by disinterested shareholders for certain RPTs.

Open Questions

- Should the legal framework governing RPTs introduce the concept of "interested parties" within the definition of related parties?
- Is the 10 percent threshold for shareholder approval appropriate?
- Should the law define the term "ordinary course of business"?

32 The Companies Act, 2013 § 241.

33 Securities Contracts (Regulation) Act, 1956 § 23E No. 42, Acts of Parliament, 1956.



CHAPTER NINE

Developing Risk Management Systems

A key factor in the 2008 global financial crisis was the lack of effective risk management systems at major companies and financial institutions. While India did not experience the massive losses experienced in the United States and other developed economies, the global financial crisis emphasized the importance of risk management and placed the issue at the forefront of the corporate governance conversation.

In addition to the potentially disastrous effects of not having effective risk management systems in place, Indian companies have other incentives to discuss and develop these systems into their corporate cultures. These incentives include competitive advantage, satisfying listing requirements across geographies, attracting foreign investment, improved communication internally and with external stakeholders, and more favorable credit ratings.

Nevertheless, studies and surveys suggest that risk management has yet to become a priority for boards at Indian companies. One survey found that even as recently as in 2018, 39 percent of companies surveyed did not have a chief risk officer in their executive structure.[1] Recent problems with leading Indian firms, such as the collapse of Infrastructure Leasing and Financial Services (IL&FS), highlight the issue of the lack of effective risk management.[2] Indian companies need to adopt better risk management systems to grow sustainably.

This chapter will first provide an overview of a holistic approach to risk management, commonly known as Enterprise Risk Management (ERM). ERM has come to the forefront of risk oversight since the global financial crisis, and has been implemented at many companies in the United States and other developed economies. It will further discuss the risk management regulations currently in place in India. The section will conclude by identifying issues with the current framework of risk management for Indian companies, where there may be scope for further improvement.

1 *Risk Survey 2018*, Deloitte Touche Tohmatsu India LLP, 2018, p. 11.

2 George Mathew, IL&FS Mess Got Deeper but Its Top Risk Committee Never Met In Last Two Years, *Indian Express*, October 3, 2018.

Enterprise Risk Management

ERM is a holistic approach for firms to address their operational, strategic, and financial risks.[3] It focuses on identifying, evaluating, and reacting to risk events. ERM focuses on identifying risks, developing and monitoring a risk management system, and reacting to risk events when they occur. Because ERM is a firmwide effort to manage all the firm's risks, involvement by the company's board of directors and senior management is imperative.

EVOLUTION OF AN ERM FRAMEWORK

Beginning in the mid-1980s, the Committee of Sponsoring Organizations of the Treadway Commission (COSO), initially formed in part to study fraudulent financial reporting, began to articulate a risk management framework.[4] In 2004, following several corporate governance scandals around the world, COSO issued a detailed report defining ERM as "… a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives."[5] The COSO approach presents eight interrelated components of ERM:

1. internal environment (the tone of the organization);
2. setting objectives;
3. event identification;
4. risk assessment;
5. risk response;
6. control activities;
7. information and communications; and
8. monitoring.

3 Michelle M. Harner, "Barriers to Effective Risk Management," *Seton Hall Law Review* 40, no. 4 (2010): 1332.

4 COSO is a joint initiative of five private-sector organizations that provides thought leadership through the development of frameworks and guidance on critical aspects of organizational governance, including enterprise risk management. "About Us," Committee of Sponsoring Organizations of the Treadway Commission.

5 *COSO Releases Enterprise Risk Management–Integrated Framework*, Committee of Sponsoring Organizations of the Treadway Commission, September 2004.

THE IMPORTANCE OF EFFECTIVE RISK MANAGEMENT

The significance of ERM can be seen in the value it creates when effectively implemented and the value it destroys when there are shortcomings in leadership and implementation. Studies suggest that ERM provides more timely information to directors and upper level management, which in turn enables a quicker response and preservation of significant value.[6]

Value creation. ERM is a critical component of value creation. To create value successfully, ERM must play a central role in every substantive business decision. Effective ERM can enable a company to manage potential future events that create uncertainty, and respond to uncertainty in a manner that reduces the likelihood of downside surprises. ERM can also help a company improve the quality of risk taking and thereby give the company a competitive advantage.

Avoiding value destruction. A company cannot preserve its value if its ERM is below standard. This role of preserving corporate value is far more visible when ERM fails than when it succeeds. Failures in risk management have contributed to some of the most significant scandals and losses suffered by companies. Recent global failures include environmental disasters (e.g., BP), financial fraud (e.g., Enron, WorldCom, Satyam), foreign bribery (e.g., Siemens) and massive trading losses (e.g., JPMorgan). According to the OECD, these risk management failures were often "facilitated by corporate governance failures, where boards did not fully appreciate the risks that the companies were taking (if they were not engaging in reckless risk-taking themselves), and/or deficient risk management systems."[7]

IMPLEMENTING AN EFFECTIVE ERM FRAMEWORK

For ERM to be implemented, boards and top management need to create a culture that values assessing and discussing risk events. The board and management must also set risk appetite and monitor the ERM process. Scholars indicate that the core elements of ERM "revolve around efficient and effective communication channels and active monitoring of the firm's risks against its risk portfolio and risk appetite."[8] This means that risk managers need direct access to the board to increase the exchange of ideas and information and to reduce the likelihood that risk reports are not reviewed.

In addition to the culture and process required to successfully foster ERM, a shift in corporate structure is necessary. The following list is a structure proposed by an industry-leading consultant.[9]

- ***Board of directors:*** Responsible for ensuring that the ERM framework achieves its business objectives and enhances shareholder value.
- ***Enterprise risk management committee (ERMC):*** Holistically reviews the company's risk management activities and guides the Enterprise risk management team (ERMT).
- ***Chief risk officer (CRO):*** Facilitates the execution of the ERM process and infrastructure. More generally, leads the ERM effort.
- ***ERM team:*** Makes decisions relating to risk management activities in consultation with the CRO and the ERMC.
- ***Risk and mitigation plan owners (RMO):*** Implements risk mitigation plans.
- ***Internal audit (IA) team:*** Responsible for review of the risk management process. It develops an IA calendar as a part of its annual audit plan and submits its review to management.

Moreover, the CRO, together with the ERM team, should define the company's principles of risk management and guidelines for the undertaking of transactions. The team should also emphasize incorporating quantitative and qualitative data into the decision-making process.[10]

Experts note that "a well implemented ERM framework will guide an organization in mitigating and managing risks, which otherwise can materially affect the organization's

6 Harner, "Barriers to Effective Risk Management," 1335-36.

7 *Risk Management and Corporate Governance*, Organization for Economic Co-operation and Development [OECD] (2014).

8 Harner, "Barriers to Effective Risk Management," 1334.

9 *Embedding Enterprise Risk Management: A Process of Evolution*, Ernst & Young, July-October 2011.

10 *Embedding Enterprise Risk Management: A Process of Evolution*, Ernst & Young.

ability to achieve its stated objectives."[11] According to a leading consulting firm, some of the most important factors in developing a successful ERM framework include[12]

- board sponsorship of ERM;
- involvement of all key stakeholders—business heads, operations, support functions, etc.;
- embedding identification and evaluation of risk in the culture of the organization;
- establishing a transparent culture that encourages identification and deliberation on risks;
- periodically reviewing the risk profile for timely course correction;
- focusing and prioritizing key risks (avoid developing a laundry list of risks);
- focusing on both external and internal risks; and
- identifying a focus group to drive the framework rather than to identify risks.

In the United States, postrecession studies indicate that a lack of ERM integration and communication is the most significant risk management problem that US firms face.[13] Yet studies also indicate that corporate boards find the ERM process too cumbersome, or resist forms of mandated risk management.[14]

Studies indicate that this resistance and the presence of cognitive biases within senior management are significant barriers to implementing ERM. The first of these barriers is confirmation bias, a tendency to assign too much merit to evidence that confirms a particular view or strategy and to ignore evidence that contradicts that view.[15] This tendency leads executives to seek out information that supports their position. The second cognitive bias is overconfidence. Many studies indicate that corporate CEOs tend to overestimate their skills and abilities, which leads them to invest the company's resources into faulty beliefs of their abilities and intuition.[16] The third cognitive bias that can act as a barrier to effective implementation of ERM is framing, the tendency to view problems differently by altering the perspective from which the problem is viewed.[17] These cognitive biases can overlap and effect a transaction from beginning to end. The designers of an ERM program must consider the presence of these biases.

India's Approach to Risk Management

Like international standards, India's regulatory framework recognizes the board's central role in ERM. Experts in India have addressed this role since the early 2000s. For example, the 2003 report of the Narayana Murthy Committee included an extensive discussion of risk management, stating that "it is important for corporate Boards to be fully aware of the risks facing the business" and that shareholders must "know about the process by which companies manage their business risks."[18] More recently, the regulatory structure has also attended to the board's role in risk management.

RISK MANAGEMENT UNDER THE COMPANIES ACT

The Companies Bill, 2012 made no mention of risk management prior to the 2011 version's proposed revisions. The Companies Act, 2013 (Companies Act, or Act) moves forward by acknowledging the need for risk management, yet arguably the Act does not go far enough. The Act does not specifically require a separate risk management committee, nor does it include guidance to boards about how to develop effective risk management systems.

The first mention of risk management is in Section 134 (3) (n), which deals with the board's report. The section specifically states that companies should issue "a statement indicating development and implementation of a risk management policy for the company including identification therein of elements of risk, if any, which

11 *Governance Observer: The Changing Face of Corporate Boardrooms, Volume 2*, Grant Thornton India LLP, 2014, p. 94.

12 *Governance Observer: The Changing Face of Corporate Boardrooms, Volume 2*, Grant Thornton India LLP.

13 Harner, "Barriers to Effective Risk Management," 1335.

14 Harner, "Barriers to Effective Risk Management," 1333.

15 Harner, "Barriers to Effective Risk Management," 1352-53.

16 Harner, "Barriers to Effective Risk Management," 1354, 1354 n. 158 (citing studies).

17 Harner, "Barriers to Effective Risk Management," 1355 (citing Ian Weinstein, "Don't Believe Everything You Think: Cognitive Bias in Legal Decision Making," *Clinical Law Review* 8, (2002): 797).

18 N.R. Narayana Murthy et al., *Report of the SEBI Committee on Corporate Governance*, Securities and Exchange Board of India, February 2003 (hereafter Murthy Report).

in the opinion of the Board may threaten the existence of the company."[19] Looking at the entirety of Section 134, however, it is clear that the board's report is an attachment to the company's financials that are presented at a general shareholder meeting, and the statement on risk management is one of many pieces of information to be included in the report. Moreover, the emphasis on elements of risk that threaten the company's existence arguably neglects a holistic approach to evaluating risks that could present strategic opportunities as well as reducing potential setbacks.

More broadly, the Act does not address the kinds of risk management policies that companies should consider in the implementation process. For example, Section 177 discusses the requirements of audit committees, and section (4) (vii) of the Section states that "[a]udit committees will evaluate internal financial controls and risk management systems."[20] However, there is little information on how to develop risk management systems. Similarly, Schedule IV to the Act (Code for Independent Directors) mentions risk management twice. Schedule IV addresses the role of independent directors in risk management, namely, to "[bring] independent judgment to bear on the Board's deliberations especially on issues of strategy, performance, risk management"… and "satisfy themselves …that financial controls and the systems of risk management are robust and defensible."[21] Similar to the Section on audit committees, the Act prescribes that independent directors keep an eye on risk management.

The obvious omission in the Act is prescribing a system of risk management and its implementation process. The proposed revisions to the Act do little to guide companies that are looking to build up their risk management systems.

19 The Companies Act, 2013 § 134, No. 18, Acts of Parliament, 2013 (August 29, 2013).

20 The Companies Act, 2013 § 177(4)(vii).

21 The Companies Act, 2013, sched. IV.

RISK MANAGEMENT UNDER THE SEBI LISTING REGULATIONS

The SEBI Listing Regulations make the board of directors responsible for framing, implementing, and monitoring the risk management plan for the listed entity.[22] The listed entity is required to lay down procedures to inform the board about risk assessment and minimization procedures[23] and for the top 500[24] listed entities (determined on the basis of market capitalization at the end of the immediate previous financial year),[25] the board of directors are mandated to constitute a risk management committee.

THE RISK MANAGEMENT COMMITTEE

- *Composition.* The majority of members of a risk management committee are to be directors serving on the board of the company.[26] The committee is to be chaired by a board member. Senior executives of the listed entity may be members of the committee.

22 Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 no. 17(9)(b) (September 2, 2015) (hereafter SEBI Listing Regulations).

23 SEBI Listing Regulations pt. III sec. 4 no. 17(9)(a).

24 Previously this requirement applied only to the top 100 listed companies. This expansion was recommended by the Kotak Committee and accepted by SEBI. The Committee's rationale was as follows: "Given the dynamic business environment, an active risk management committee is imperative for identification, mitigation and resolution of risks. These risks that are being managed operationally on a daily basis call for a more formal structure, especially for the next set of high-growth companies. Hence, it is recommended to extend the requirement of a Risk Management Committee to the top 500 listed entities by market capitalization as against current applicability to top 100 listed entities. In addition, the Committee recommends that, in view of the increasing relevance of cyber security, and related risks, the role of risk management committee specifically cover this aspect." Uday Kotak et al., *Report Submitted by the Committee on Corporate Governance*, Securities and Exchange Board of India, October 2017, p. 42.

25 SEBI Listing Regulations pt. III sec. 4 no. 21.

26 In case of a listed entity having outstanding SR equity shares, at least two-thirds of the Risk Management Committee shall comprise independent directors. SEBI Listing Regulations pt. III sec. 4 no. 21(2) (as amended by the Securities and Exchange Board of India, Listing Obligations and Disclosure Requirements, Fourth Amendment Regulations, 2019). *Gazette of India*, pt. III sec. 4 (July 29, 2019).

- *Meetings.* The risk management committee needs to meet at least once a year.[27]
- *Role and responsibility of the risk management committee.* The board is mandated to define the role and responsibility of the risk management committee and may delegate monitoring and reviewing of the risk management plan to the committee and such other functions as it may deem fit. One such function should specifically cover cybersecurity.[28]

SEBI has envisioned further changes to the risk management committee. Recognizing the need to extend the risk management requirements to a larger number of companies, SEBI has proposed that boards of the top 1,000 listed companies be mandated to form a risk management committee.[29] A November 2020 SEBI Consultation Paper has proposed the specification of the role and responsibility of the risk management committee.[30] While the role of the risk management committee has not to date been specified under the SEBI Listing Regulations, the Consultation Paper proposes that the committee must be required to do the following: (a) formulate a detailed risk management policy to include a framework for identification of internal and external risks specifically faced by the company, in particular including financial, operational, sectoral, sustainability (specifically ESG-related risks and impact), information and cybersecurity risks, measures for mitigation of such risks, systems for internal controls and business contingency plan; (b) monitor and oversee implementation of the risk management policy, including evaluating the adequacy of risk management and internal control systems; (c) ensure that appropriate methodology, processes, and systems are in place to monitor and evaluate business risks; (d) review the risk management policy annually; (e) inform the board about the nature and content of its discussions, recommendations, and actions to be taken; and (f) review jointly with the Nomination and Remuneration Committee, the appointment, removal and terms of remuneration of the Chief Risk Officer (if any). Further, the risk management committee is expected to coordinate its activities with the audit committee in instances where there is any overlap in its functions with audit actions.

In order to strengthen the resources of the risk management committee, the Consultation Paper also envisions empowering the committee to seek information from any employee, obtain outside legal or other professional advice, and secure attendance of outsiders with relevant expertise. Recognizing the significant need to allocate sufficient time to risk oversight, the paper proposes that the committee should meet at least twice a year. The Consultation Paper also proposes that at least one board member should be present at all risk management committee meetings.

ROLE OF THE BOARD IN RISK MANAGEMENT

One of the key functions of the board of directors includes reviewing and guiding the risk policy for the company and ensuring the integrity of the listed entity's accounting and financial reporting systems, including the independent audit. The board is also charged with ensuring that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.[31]

Under the SEBI Listing Regulations, other responsibilities of the board of directors include encouraging positive thinking, while ensuring that it does not result in overoptimism that leads either to ignoring significant risks or to exposing the listed entity to excessive risk.[32] The board is required to have the ability to step back to assist executive management by challenging the assumptions underlying strategy, strategic initiatives (such as acquisitions), risk appetite, exposures, and the key areas of the company's focus.[33]

27 This was recommended by the Kotak Committee and was accepted by SEBI. SEBI Listing Regulations pt. III sec. 4 no. 21(3A); Securities and Exchange Board of India (Listing Obligations and Disclosure Requirement, Amendment Regulations, 2018. *Gazette of India*, pt. III sec. 4 (May 9, 2018) (hereafter SEBI (Listing Amendment) Regulations).

28 This was recommended by the Kotak Committee and was accepted by SEBI. SEBI Listing Regulations pt. III sec. 4 no. 21(4) (as amended by SEBI [Listing Amendment] Regulations).

29 Securities and Exchange Board of India (SEBI), *Consultation Paper on the Applicability and Role of the Risk Management Committee*, November 10, 2020, https://www.sebi.gov.in/reports-and-statistics/reports/nov-2020/consultation-paper-on-the-applicability-and-role-of-the-risk-management-committee_48142.html

30 Securities and Exchange Board of India (SEBI), *Consultation Paper on the Applicability and Role of the Risk Management Committee.*

31 SEBI Listing Regulations pt. III sec. 4 no. 4(2)(f)(ii)(7).

32 SEBI Listing Regulations pt. III sec. 4 no. 4(2)(f)(iii)(9).

33 SEBI Listing Regulations pt. III sec. 4 no. 4(2)(f)(iii)(10).

The SEBI Listing Regulations mandate the company to lay down procedures to inform members of the board of directors about risk assessment and minimization procedures. The board is responsible for framing, implementing, and monitoring the risk management plan for the listed entity.[34] Further, the SEBI Listing Regulations also mandate the audit committee to evaluate internal financial controls and risk management systems.[35] The management discussion and analysis section of the annual report also requires that the discussion on risk and concerns and internal control systems and their adequacy be included.[36]

Challenges for Boards of Directors in Developing ERM

Over the past several years, corporate India has become much more engaged with and sensitized to ERM. Leading companies have formed risk management and compliance teams that are integrated within the firm and that provide valuable information to the board. Nevertheless, there is room for improvement.

Indian boards face significant challenges in designing and implementing an effective ERM system, including:

- *Effectively linking risk and strategy*: Integrating risk management into the overall corporate strategy is a challenge for many India firms. The challenge is to have an ERM system that encompasses a process capable of being applied in strategy setting across the enterprise. "Effective risk management is not about eliminating risk taking, which is a fundamental driving force in business and entrepreneurship."[37] In other words, taking appropriate risk needs to be at the heart of corporate strategy. For this to happen, the board must understand and guide the company's appetite and ability to take risk, and communicate the same to the company's risk management team. Operationally, what does "tying risk with strategy" mean for management? It means that risk managers must be integrated in implementing the company's strategy and must not be separated from the board and management, so that actual risk taken is tied to the company's risk appetite and ability. Moreover, the ERM programs must be developed with input from various functions in the organization, such as finance, sales, legal, and so forth.
- *Implementing cost-effective risk management for small and medium-sized enterprises*: While the costs of risk management failures can be high, designing and implementing efficient ERM can also be quite costly, especially for small and medium-sized firms. For example, hiring consultants or the necessary staff to develop stress-testing and early warning systems to alert the board regarding significant risks can be difficult to do in smaller companies. In addition, while large firms can establish a chief risk officer function with direct report to the board, doing so is much harder for smaller companies.
- *Addressing all major areas of risk*: ERM requires a firm to take a portfolio view of risk; boards must consider how various risks interrelate, rather than treating each business and risk individually. This is a significant challenge for many boards.
- *Mitigating new risks*: In India, many complex areas of risks have emerged in the last decade or so, which has made risk management particularly challenging. For example, some traditional areas of risk, such as political instability and strikes and unrest, appear to have subsided while others, such as information and cybersecurity as well as terrorism and insurgency, have increased in prominence. Companies in a wide variety of industries have experienced the theft of data and sensitive information. For companies in major cities, the threat of terror attacks has become a growing cause for concern, which can be hard to manage by the company itself.

34 SEBI Listing Regulations pt. III sec. 4 no. 17. Further, effective October 1, 2018, the top 500 listed entities by market capitalization calculated as of March 31 of the preceding financial year, are required to undertake directors and officers insurance ("D and O insurance") for all their independent directors of such quantum and for such risks as may be determined by its board of directors. SEBI Listing Regulations pt. III sec. 4 no. 25.

35 SEBI Listing Regulations pt. III sec. 4 sched. II, Part C.

36 SEBI Listing Regulations sched. V.

37 *Risk Management and Corporate Governance*, OECD.

ERM in India: Suggestions for Effective Risk Management

While the corporate governance regime in India seeks to ensure various levels of risk scrutiny, it is up to firms to follow the true spirit of the regulations.[38] India is certainly taking steps to implement risk management into its corporate culture. The question is whether more needs to be done by boards to keep pace with its growing economy and increasing globalization.

There are important steps that boards can take to enhance the risk management system of a firm and the board's own role in risk oversight. A COSO 2009 ERM release recommends that board members must

- understand the company's risk philosophy and concur with its risk appetite;
- review the company's risk portfolio against that appetite;
- know the extent to which management has established effective ERM; and
- be apprised of the most significant risks and whether management is responding appropriately.

To accomplish all these, certain review mechanisms are necessary on the part of the board, which are detailed in COSO's 2010 progress report; they include

- reviewing with management the company's procedures for identifying when risks arise and the actions to be taken if material risks arise;
- reviewing the quality and types of risk-related information provided to the board;
- reviewing management's implementation of the company's risk policies and procedures, to assess whether they are being communicated across the firm, are followed, and are effective;
- reviewing the company's risk management functions, including the qualifications and backgrounds of risk management personnel and policies applicable to risk management personnel, to assess whether they are appropriate, given the company's size and scope of operations;
- reviewing reports from internal and external experts, such as auditors, legal counsel, and analysts, to ensure that appropriate risks are being considered; and
- reviewing whether the board members primarily tasked with risk oversight have the necessary experience, knowledge, and expertise to oversee the company's risk management matters, and provide director risk education as necessary.

The above recommendations must of course be tailored for each company, and must balance the cost and value of each step. Nevertheless, the growing number of corporate resolution processes for insolvency in India leads us to consider whether the requirement of constituting a risk management committee must be extended to all listed companies. Further, the IL&FS crisis has demonstrated that ERM not only is a risk management committee issue but encompasses auditor powers as well.[39]

38 For example, the Risk Management Committee of the IL&FS met only once between 2015 and 2018. Surya Sarathi Ray, "IL&FS Risk: Leverage Rose to 13, but Risk Panel Met Just Once in 4 Years," *Financial Express*, October 3, 2018.

39 Jayshree P. Upadhyay, "Inside the Audit Lapses That Led to IL&FS Crisis," *Livemint*, May 21, 2019.

The IL&FS Crisis

Infrastructure Leasing & Finance Services (IL&FS Ltd.), an infrastructure lending nonbanking financial company (NBFC), was formed as an RBI Registered Core Investment Company by the Central Bank of India, Housing Development Finance Corporation (HDFC), and Unit Trust of India (UTI) to finance various infrastructure projects.[a] IL&FS serves as the holding company of the IL&FS Group, and has several group companies in various business sectors. As an NBFC, IL&FS issues debt instruments to potential lenders. In return, it pays an interest rate and repays the principal to lenders on a predetermined due date. IL&FS has collected over INR 91,000 crore in debt instruments.[b]

As of March 31, 2017, the largest shareholders of IL&FS were the Life Insurance Corporation of India (25.34 percent), the ORIX Corporation Japan (23.54 percent), the IL&FS Employees Welfare Trust (12 percent), the Abu Dhabi Investment Authority (12.56 percent), HDFC (9.02 percent), the Central Bank of India (7.67 percent), and the State Bank of India (6.42 percent).[c]

The Crisis

Between July and September 2018, two subsidiaries of IL&FS defaulted on loan payments (including interest), intercorporate deposits, and term and short-term deposits to other lenders.[d] The company also failed to meet the commercial paper redemption obligations due on September 14, 2018.[e] These lapses indicated that IL&FS was experiencing a liquidity crunch, with insufficient cash to meet its operating needs.

In response to these defaults, credit rating agencies such as ICRA and CARE rapidly downgraded IL&FS from a high-grade investment rating of AA to “junk” status.[f]

a “IL&FS Crisis Explained,” Stocksbaazigar, October 23, 2018.

b “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*, October 3, 2018.

c Shashank Pandey, “Explainer: The IL&FS Insolvency Case,” *Bar and Bench*, July 21, 2019.

d “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*.

e “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*.

f “IL&FS Crisis Explained,” Stocksbaazigar.

The investment downgrade put investors, banks, and mutual funds associated with IL&FS at severe risk, and incited panic among investors.[g]

By mid-September, IL&FS and IL&FS Financial Services had collectively accrued INR 27,000 crores in debt.[h] Additionally, six other group companies had suffered similar downgrades, resulting in another potential INR 12,000 crores in debt.[i]

Cause of IL&FS Defaults

As an infrastructure lending company, the primary source of IL&FS revenue is the income from its infrastructure projects.[j] When infrastructure was on the rise, IL&FS took advantage and simultaneously built up a debt-to-equity ratio of 18.7 among 24 direct subsidiaries, 135 indirect subsidiaries, six joint ventures, and four associate companies.[k] However, infrastructure in India began to face severe challenges related to land acquisition, lengthy judicial processes, cost escalation, corruption, and so forth.[l] These barriers to infrastructure resulted in reduced revenue, and the rising market interest rates further burdened IL&FS.[m]

Legal Aftermath of IL&FS Defaults

On October 1, 2018, the central government moved an application under Sections 241 and 242 of the Companies Act before the NCLT.[n] The application stated that the affairs of IL&FS were being conducted in a manner prejudicial to public interest, and thus sought

g “IL&FS Crisis Explained,” Stocksbaazigar.

h “Explained: What is IL&FS Crisis and How Bad It Is?” *Week Magazine*, September 25, 2018.

i “Explained: What is IL&FS Crisis and How Bad It Is?” *Week Magazine.*

j “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*.

k “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*.

l “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*.

m “IL&FS: The Crisis That Has India in Panic Mode,” *Economic Times*.

n PRESS RELEASE, MINISTRY OF CORP. AFFAIRS, GOV’T of India (2018) (dated October 1, 2018).

The IL&FS Crisis *continued*

immediate suspension of IL&FS's board of directors and appointment of new directors on the grounds that IL&FS had severely mismanaged their finances.[o] The NCLT invoked its powers to suspend the existing board and institute the new, specified board.[p] The new board consisted of Uday Kotak, MD & CEO of Kotak Mahindra Bank, as nonexecutive chair; Vineet Nayyar, IAS; G. N. Bajpai, former Chairman of SEBI; G. C. Chaturvedi, nonexecutive chair of ICICI Bank; Dr. Malini Shankar, IAS; and Nand Kishore, IA&AS.[q] The NCLT granted immunity to the new board members, such that they would not be liable for any past actions of the suspended directors or officers of IL&FS.[r]

To maintain stability during the resolution process, IL&FS sought a moratorium against specific creditor actions.[s] IL&FS maintained that it did not have the legal framework in place to handle these actions and the concurrent financial crisis. While the NCLT denied the moratorium,[t] on appeal, it was granted by the NCLAT.[u]

Several other agencies also sprang into action. On November 30, 2018, the Serious Fraud Investigation Office submitted an interim report.[v] This served as the basis of the central government's decision to implead more individuals in the original petition.[w] A total of 318 respondents were named in the petition before the NCLT.[x] Furthermore, the Disciplinary Directorate of the Institute of Chartered Accountants of India (ICAI) also sought to consider the performance of the statutory auditors of the companies in question following the impact IL&FS had on the market as a whole.[y] The ICAI found major lapses and manipulations in the financial statements created by the statutory auditors.[z] As a result, the ICAI held the statutory auditors guilty prima facie of professional misconduct. This has raised questions as to which agencies are responsible for the probe into the role of the auditing firms.[aa] The National Financial Reporting Authority ultimately initiated an investigation.[ab]

In response to these findings, the central government filed a petition before the NCLT under Section 130 of the Companies Act, seeking to reopen IL&FS's and its group companies' books for the past five financial years.[ac] The NCLT granted this petition.[ad] On May 30, 2019, the SFIO submitted a list of 30 parties, including two auditor firms, that would be charged for concealing information by not flagging the alleged criminal conspiracy and misreporting the financial statements of the IL&FS firms.[ae] The MCA moved against the auditors, Deloitte Haskins & Sells and BSR & Associates LLP, as well as their former auditors, under Section 140(5) of the Companies Act for their role in perpetuating the fraud.[af]

On June 4, 2019, the Supreme Court granted the SFIO permission to reopen and recast the accounts of IL&FS and two of its subsidiaries for the past five financial years.[ag]

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o PRESS RELEASE, MINISTRY OF CORP. AFFAIRS, GOV'T OF INDIA.

p Pandey, "Explainer: The IL&FS Insolvency Case."

q Pandey, "Explainer: The IL&FS Insolvency Case."

r Pandey, "Explainer: The IL&FS Insolvency Case."

s Pandey, "Explainer: The IL&FS Insolvency Case."

t National Company Law Tribunal (Mumbai Bench, Mumbai), Union of India, *Ministry of Corp. Affairs v. Infrastructure Leasing & Fin. Servs. Ltd.* (Jan. 1, 2019).

u Pandey, "Explainer: The IL&FS Insolvency Case."

v Pandey, "Explainer: The IL&FS Insolvency Case."

w Pandey, "Explainer: The IL&FS Insolvency Case."

x Pandey, "Explainer: The IL&FS Insolvency Case."

y Pandey, "Explainer: The IL&FS Insolvency Case."

z Pandey, "Explainer: The IL&FS Insolvency Case."

aa Pandey, "Explainer: The IL&FS Insolvency Case."

ab Sachin Dave, "IL&FS Case: NFRA, ICAI Spar over Probe into Auditors' Role," *Economic Times*, April 27, 2019.

ac Pandey, "Explainer: The IL&FS Insolvency Case."

ad National Company Law Tribunal (Mumbai Bench, Mumbai), Union of India, *Ministry of Corp. Affairs v. Infrastructure Leasing & Fin. Servs. Ltd.* (Jan. 1, 2019).

ae Pandey, "Explainer: The IL&FS Insolvency Case."

af Pandey, "Explainer: The IL&FS Insolvency Case."

ag Pandey, "Explainer: The IL&FS Insolvency Case."

The IL&FS Crisis *continued*

On July 12, 2019, the NCLAT asked IL&FS and the Ministry of Corporate Affairs about the classification of IL&FS Group Companies on the basis of solvency:[ah] those that would be able to repay all financial debt obligations;[ai] those that were not able to meet ***all*** obligations, but were able to meet operational and senior secured financial debt obligations;[aj] and those that cannot repay any debt obligations.[ak]

The Ministry of Corporate Affairs initiated prosecution against the aforementioned auditors of IL&FS for their failure to detect and report the misreporting that took place within IL&FS and its entities.[al] The NCLT accepted the Ministry of Corporate Affairs' request on this prosecution on July 18, 2019.[am]

A Lesson in Risk Management

The IL&FS crisis has raised unique governance issues specific to financial institutions.[an] Experts in the field have analyzed India's corporate governance framework, and have suggested that the current structure is ill equipped to deal with financial institutions.[ao] Experts argue that while the current governance framework seeks to balance the interests of shareholders and managements, for financial institutions, creditors become a third party whose interests must be factored into the equation.[ap] Arguably, the current framework, which does not consider creditors, encourages management to take extreme risks to the detriment of creditors. Furthermore, standard governance issues exist within the corporation.[aq] When governance issues arise in financial institutions, it can have a massive impact on the financial markets and the economy. Finally, financial institutions rely on government bailouts when taking excessive risks because there is a common interest in preventing an economic downturn. These factors ultimately result in financial institutions taking excessive risks.[ar]

Ultimately, scholars in the field believe that the financial sector should be held to a higher standard of risk management via risk management committees.[as] Risk management is integral to the board's function and must be a shared objective of the financial institution.[at] While this level of commitment can be difficult to achieve, it is critical to ensure that other financial institutions do not experience a crisis similar to IL&FS.

ah National Company Law Tribunal (New Delhi Bench, New Delhi), Union of India, *Ministry of Corp. Affairs v. Infrastructure Leasing & Fin. Servs. Ltd.* (July 12, 2019).

ai Pandey, "Explainer: The IL&FS Insolvency Case."

aj Pandey, "Explainer: The IL&FS Insolvency Case."

ak Pandey, "Explainer: The IL&FS Insolvency Case."

al Pandey, "Explainer: The IL&FS Insolvency Case."

am Pandey, "Explainer: The IL&FS Insolvency Case."

an Umakanth Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift," *Bloomberg Quint*, October 8, 2018.

ao Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift."

ap Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift."

aq Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift."

ar Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift."

as Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift."

at Varottil, "Governance of Financial Institutions: Call for a Paradigm Shift."

Key Takeaways

- In addition to a robust regulatory framework for risk management, boards need to be more involved in fostering a risk culture and setting a good balance of risk and return. A company may put in place a detailed ERM framework for identification, analysis, and evaluation of risk, but it must also address cognitive biases in the corporate culture to ensure that behaviors are not contrary to the ERM process.
- A chief risk officer and ERM team can enable boards and senior officers to communicate openly about risks, arrive at common priorities, and collaborate in mitigating them. This team can allocate resources in line with risk priorities in an efficient manner.
- Risk management activities must be embedded into individual goals and performance measures to balance focus on risk and reward. Long-term strategic insights on risk can only be acquired via an integrated risk system.

Open Questions

- What loopholes in the regulatory framework governing risk management in India need to be plugged to avoid another IL&FS-like crisis?
- Do different sectors need industry-specific risk management norms, or is a blanket approach to risk management more effective?
- Should the formation of the risk management committee be mandated even for unlisted companies having capital or revenue above a certain threshold?

CHAPTER TEN

Ethics and Compliance Oversight Practices in India

Introduction

Business ethics relates to the responsibilities of a company and its relationship with investors, customers, employees, franchisees, trading partners, the local community, and even society at large. As noted by the Secretary General of the OECD, "Business ethics derive from transparency, objectivity, reliability, honesty and prudence. These values allow the financial sector to generate the key asset to conduct business and discharge its fiduciary responsibility: trust. Trust is the basic element for the well functioning of markets and societies."[1]

With respect to ethics and compliance oversight practice, the Indian business environment has undergone significant change.[2] Financial scandals like Satyam (see "The Satyam Scandal," p. 193) and Everonn (see "The Everonn Episode," p. 192) and high-profile corruption cases involving business leaders have shown that there are significant costs when there is a failure to adhere to ethical standards. Besides legal sanctions, recent scandals remind us that there are other costs attached to unethical behavior. For instance, the marketplace may punish unethical behavior by driving away customers and employees.

Corporate India is moving from strict letter-of-the-law compliance to an increasing focus on internal prevention and self-reporting. This shift is evident from the adoption and implementation of corporate codes of ethics by a growing number of Indian companies, as well as from investments by firms in building an anti-fraud ecosystem.[3] It is also reflected in the National Guidelines on Responsible Business Conduct (NGRBC) issued by the Indian Ministry of Corporate Affairs (MCA) in 2019. Nevertheless, corruption remains a significant challenge in India. Transparency International's Corruption Perception Index (CPI) ranked India at 78 (out of 180 countries) in 2018, with a CPI score of 41 based on an overall potential score of 100 (100 being the least corrupt).[4]

This chapter examines ethics and compliance in the Indian context by analyzing the external and internal drivers for ethical conduct. The chapter also includes case studies on scandals in corporate India that have raised significant ethics concerns.

Understanding the Architecture of Ethics

Government and industry bodies have increasingly become sensitive to the need for implementation of an effective corporate governance system. Many committees have been appointed to suggest models for corporate governance. While several government-appointed committees have assessed corporate governance issues in the Indian context, none of the committees examined the ethical perspective in detail.

Nevertheless, due to several external and internal factors, business ethics and compliance practices have come to occupy a critical role in the Indian business milieu. These external factors include the statutory and regulatory frameworks, decisions, and orders of government departments and voluntary guidelines and reports. The internal factors governing the ethical conduct of a company are self-regulated processes, mainly contained in the code of ethics and conduct and the whistleblowing policy formulated by a company.

STATUTORY FRAMEWORK

Regulation of corruption. The Indian Penal Code, 1860 (IPC),[5] the Prevention of Corruption Act, 1988 (PCA),[6] and the Prevention of Money Laundering Act, 2002 (PMLA)[7] are some relevant legislation. The IPC is the primary criminal code and provides for penal remedies and enforcement through penal courts. The PCA is the primary legislation intended to tackle corruption among public servants and in their dealings with the private sector, while the PMLA seeks to prevent and control activities concerning money laundering and also provides for the confiscation of property derived from money-laundering

1 Angel Gurria, OECD Secretary General, "Business Ethics and OECD Principles: What Can Be Done to Avoid Another Crisis?" remarks, European Business Ethics Forum (EBEF), Paris, January 22, 2009.

2 Ben DiPietro, "GE's Take on the State of Compliance and Ethics in India," *Wall Street Journal*, September 5, 2017.

3 *India Corporate Fraud Perception Survey 2018*, Deloitte, 2018.

4 "Corruption Perceptions Index," Transparency International, 2018.

5 The Indian Penal Code Act, No. 45 of 1860, PEN. CODE [hereafter IPC].

6 The Prevention of Corruption Act, 1988, No. 49, Acts of Parliament, 1988 [hereafter PCA].

7 The Prevention of Money-Laundering Act, 2002, No. 15, Acts of Parliament, 2003 [hereafter PMLA].

activities. While the IPC deals with the conduct of both individuals and public officials, the PCA and the PMLA primarily cover the conduct of public officials.

The IPC classifies several acts as offenses, including Section 120B (criminal conspiracy), Section 420 (cheating), Section 409 (criminal breach of trust), Section 468 (forgery), and Section 471 (falsification of records). The punishment for these offenses ranges from two years' rigorous imprisonment to life imprisonment, along with fines in case of certain offenses. For example, in the infamous Satyam Scandal, the promoter, Ramalinga Raju, was charged under several of the abovementioned provisions and was sentenced to prison for his crimes.

Under the PMLA, the offense of money laundering is defined as directly or indirectly attempting to indulge or be actually involved in any process or activity connected with the proceeds of crime and projecting such proceeds as untainted property.[8] Proceeds of crime means any property derived or obtained, whether directly or indirectly, by any person as a result of any criminal activity related to certain offenses set out in the relevant schedule of the PMLA.

The PCA and the 2018 amendments. The PCA is the primary Indian legislation tackling corruption and bribery in India. Unlike the Foreign Corrupt Practices Act in the United States, which focuses on the bribe giver, the primary focus of the PCA was originally on the bribe taker (the recipient). The PCA states that *any person* who either accepts or agrees to accept any gratification as a motive or reward f*or inducing by corrupt means or by exercising his personal influence* any public servant to do or forbear doing any official act, or to show favor or disfavor to any person, commits an offense.[9]

Prior to amendments in 2018, the PCA covered the supply side of bribery only indirectly. The PCA included provisions regarding abetment of offenses,[10] whereby any person who abets the principal offenses mentioned under the PCA, whether or not the offense is committed in consequence of the abetment, is also liable. For instance, in the Everonn Episode, the case was registered against the tax official (i.e., a public servant) for taking gratification other than legal remuneration in respect of an official act,[11] and criminal misconduct for obtaining a pecuniary advantage while holding office as a public official,[12] and against the managing director of Everonn for offering the bribe.[13] (For a detailed discussion on this topic, see "The Everonn Episode," p. 192.)

In 2018, the PCA was amended to bring about several significant changes, including direct liability for commercial organizations involved in bribery in India. The 2018 Amendment overhauled the charging sections of the PCA and included a distinct offense dealing with the bribe giver. Section 8 of the amended PCA prohibits giving or promising to give an undue advantage (which includes any kind of gratification) other than legal remuneration to a public servant with the intention of inducing or rewarding a public servant for the improper performance of any public function. Whether the offer or promise is ultimately accepted by the public servant is immaterial. Punishment for the offense may include imprisonment for a period not exceeding seven years and/or a fine.

Critically, the concept of the term "public servant" has undergone significant change under the PCA. The general understanding was that the term referred to employees of the different branches of the state (executive, legislature, judiciary) or employees of public sector undertakings and institutions. As a result of the broad manner in which the term is now defined in the PCA, however, it is not only persons associated with an Indian governmental institution who come under PCA purview. For example, because the PCA's definition of the term includes any person who discharges a duty in "which the State, the public or the community at large has an interest," the Supreme Court of India ruled in 2016 that the term also includes employees of private banks.[14]

8 PMLA, Section 2.

9 PCA, Sections 8 and 9.

10 IPC, Section 107.

11 PCA, Section 7; "CBI Arrests an Additional Commissioner of Income Tax and Two Others in a Bribery Case of Rs. 50 Lakh," Central Bureau of Investigation, August 30, 2011.

12 PCA, Section 13(1)(d); "CBI Arrests an Additional Commissioner of Income Tax and Two Others in a Bribery Case of Rs. 50 Lakh," Central Bureau of Investigation.

13 PCA, Section 12; "CBI Arrests an Additional Commissioner of Income Tax and Two Others in a Bribery Case of Rs. 50 Lakh," Central Bureau of Investigation.

14 PCA Section 2(c)(viii). See Central Bureau of Investigation v. Ramesh Gelli and others, Criminal Appeal Nos. 1077-1081 of 2013 and Writ Petition (Crl.) No. 167 of 2015. The Supreme Court of India came to include private bankers within the definition of a public servant also as a result of provisions of the [Indian] Banking Regulation Act, 1949.

The removal of immunity for bribe givers also indicates a significant shift in approach. Initially, Section 24 of the PCA would provide bribe givers immunity from prosecution if they reported the acceptance of a bribe by a public servant or became a witness in the prosecution of a bribery offense. The 2018 Amendment significantly limits this protection for bribe givers, and instead increases the burden on them to report the occurrence of an offense. Those seeking immunity must now prove that they were "compelled" to provide an undue advantage (such as a bribe) to a public servant, and must report the provision of the undue advantage to Indian enforcement or investigating agencies within a period of seven days.

Most significantly for corporate India, the PCA's 2018 Amendment introduced various provisions intended to improve integrity levels within the Indian business community. These provisions will also significantly increase the compliance burden for companies doing business in India.

Under Section 9 of the amended PCA, a commercial organization can be held liable "if any person associated with the commercial organisation gives or promises to give any undue advantage to a public servant" with an intent to obtain or retain business or any advantage for that commercial organization. This provision covers all types of entities doing business in India, excluding charitable organizations. Commercial organizations operating in India will therefore be vicariously liable for any bribes provided to public servants by persons associated with such organizations.

In order to cast a wide net on intermediaries who provide bribes on behalf of commercial organizations, the 2018 Amendment considers anyone "who performs services for or on behalf of the commercial organisation" to be a person associated with such organization. Thus, commercial organizations can be held liable for the actions of their employees, agents, service providers, and professional advisers. Further, a parent company (including a foreign parent company) can be held liable under the PCA for the actions of its Indian subsidiary. Commercial organizations can avoid liability for a bribe provided by a person associated with them by demonstrating that the bribe was provided to the public servant despite the organization having put in place "adequate procedures designed to prevent" it. The requirement to install adequate safeguards is the latest in a legislative trend mandating robust compliance programs.

The Companies Act, 2013. The Companies Act, 2013 (Companies Act, or Act) covers whistleblowers in some private sector companies. Section 177 of the Act provides that

- Every listed company or such class or classes of companies, as may be prescribed,[15] shall establish a vigil mechanism for directors and employees to report genuine concerns in such manner as may be prescribed;[16]
- Such vigil mechanism must "provide for adequate safeguards against victimisation of persons who use such mechanism and make provision for direct access to the chairperson of the audit committee in appropriate or exceptional cases";[17] and
- Companies disclose the details of the establishment of such mechanism on their website, if any, and in the board's report.[18]

The rules under the Companies Act prescribe that companies that are required to constitute an audit committee must oversee the vigil mechanism through the committee and that if any of the members have a conflict of interest in a given case, they should recuse themselves.[19] If the company does not have an audit committee, the board must nominate a director to play the role of the audit committee for purposes of the vigil mechanism. The rules also explain that the vigil mechanism must provide for adequate safeguards against victimization of employees and directors who avail themselves of the vigil mechanism and also provide for direct access to the chair of the audit committee

15 The Companies Act Rules prescribe that the following companies must also establish vigil mechanisms: companies that accept deposits from the public and companies that have borrowed money from banks and public financial institutions in excess of INR 50 crore. The Companies (Meetings of Board and its Powers) Rules, 2014, *Gazette of India*, pt. II sec. 3. ch. XII sec. 7(1), 2014 (Mar. 31, 2014).

16 The Companies Act, 2013, Section 177(9), No. 18, Acts of Parliament, 2013 (Aug. 29, 2013).

17 The Companies Act, 2013, Section 177(10).

18 The Companies Act, 2013, Section 177.

19 The Companies (Meetings of Board and its Powers) Rules, 2014, pt. II sec. 3 ch. XII sec. 7.

or the director nominated to play the role of the audit committee in exceptional cases. It also prescribes that in case of repeated frivolous complaints by a director or an employee, the audit committee or the director nominated to play the role of the committee may take suitable action against the concerned director or employee, including reprimand.

Further, the Code of Conduct under Schedule IV of the Companies Act requires independent directors to uphold ethical standards of integrity and probity and report concerns about unethical behavior, actual or suspected fraud, or violation of the company's code of conduct or ethics policy. The code also prescribes that the letter of appointment of an independent director shall set out, inter alia, the Code of Business Ethics that the company expects its directors and employees to follow.

In addition to the Companies Act, the government introduced the Whistle Blowers Protection Act in 2014. The law seeks to protect whistleblowers, facilitate the disclosure of information, and uncover corruption and deceptive practices that exist in government. It provides adequate safeguards against victimization of the whistleblower while retaining the provision of punishment for false or frivolous complaints, striving to balance an interest in protecting whistleblowers against the unnecessary harassment of public officials.[20] The law, however, is confined to action against government officials and does not extend to whistleblowers in the private sector. In addition, there is no provision for rewarding whistleblowers, and actions on anonymous complaints have not been included in the ambit of the law.

SEBI Listing Regulations. Regulation 17 of the SEBI Listing Regulations mandates a publicly listed company to adopt a code of conduct for its board members and senior management and requires them to affirm compliance with the code of conduct on an annual basis.

A mechanism for whistleblowing is an important element in creating an ethical organization because it encourages honest individuals within an organization to take the right decisions. From a regulatory perspective, SEBI requires a mandatory whistleblowing policy rather than an optional one. Regulation 4 of the SEBI Listing Regulations provides that companies "should devise an effective whistle blower mechanism enabling stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal or unethical practices." It also requires the board to "maintain high ethical standards" and to consider the interests of all stakeholders. Regulation 22 requires the following for all listed companies:

- The company must establish a vigil mechanism for directors and employees to report genuine concerns.
- This mechanism should also provide for adequate safeguards against victimization of director(s)/employee(s) who avail themselves of the mechanism, and should also provide for direct access to the chairman of the audit committee in appropriate or exceptional cases.
- The details of establishment of such mechanism must be disclosed by the company on its website and in the board's report.

In addition, the audit committee is charged with reviewing the functioning of the whistleblower mechanism.

The Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015. Effective as of December 26, 2019, SEBI has amended the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations) by introducing a new regulatory mechanism encouraging whistleblowing reporting on suspected violations of insider trading laws. While whistleblower complaints of alleged violations of insider trading laws would lie with SEBI's Office of Informant Protection, to be made in accordance with the prescribed forms, these provisions also stipulate that the identity of informants be kept confidential with a view to protecting them from retaliation. The new framework also provides for rewarding informants in certain cases as deemed fit by SEBI. It is to be noted, however, that this regime restricts itself to bringing to light insider trading offenses.

Company policy. Because neither the SEBI Listing Regulations nor even the PIT Regulations specify a process to be followed by companies, whistleblower complaints are dealt with in accordance with the internal policy of the recipient company. Such policies therefore vary from company to company. While this may be helpful so that

(*continued on p. 184*)

20 Christine Liu, "India's Whistleblower Protection Act—An Important Step, But Not Enough," *Edmond J. Safra Center for Ethics Blog*, Harvard University, June 5, 2014.

The Infosys Whistleblower Matter

Infosys is an NYSE-listed global IT consulting firm headquartered in Bangalore, India. The company offers business, technology, and software consulting services, product engineering, customized software development, maintenance of information systems, and outsourcing services to corporations in India and overseas. Vishal Sikka took over as Infosys CEO and MD in 2014 from one of Infosys's founders. However, his tenure was short-lived; he resigned in 2016 because of corporate governance issues. Pravin Rao took over as CEO in August 2017, and Salil Parekh filled the position in December 2017.

Whistleblower Complaints

On September 20, 2019, an anonymous group of whistleblowers referring to themselves as "ethical employees" of Infosys made allegations that the CEO, Salil Parekh, and the CFO, Nilanjan Roy, engaged in "disturbing unethical practices" to represent higher revenue and profit numbers.[a] The whistleblowers submitted their complaint in the form of a letter to both the Infosys board and the U.S. Securities and Exchange Commission (SEC).[b]

In the first complaint, the whistleblowers alleged that within the last quarter some employees were instructed not to fully recognize expenses like visa costs, in an effort to boost profits.[c] Additionally, the complaint stated that some employees were pressured not to recognize the reversal of a $50 million up-front payment in a contract.[d] The employees asserted that this was inconsistent with standard accounting practices because it was an attempt to prevent reduced profits and stock prices for Infosys.[e] The allegations further stated that vital information was withheld from the board and the auditors, and revenue recognition in larger contracts was forced.[f]

The letter also alleged that the CEO, Parekh, bypassed approval processes in large deals and instructed the sales team to make incorrect assumptions in order to represent inflated profit margins.[g] The whistleblowers further claimed that Parekh and the CFO, Roy, dismissed their concerns and prevented them from presenting data on large deals and financial measures at board meetings and from making key disclosures.[h] The whistleblowers claimed that the CEO and the CFO asked them to make changes to policies that would show short-term profits, and to refrain from making key disclosures in Form 20-F and in annual reports.[i] Finally, the complaint alleged that Parekh's personal travel expenses were paid for by the company and that he used his travel expenses to the United States as a green card holder to avoid taxes.[j]

Several weeks after the first set of allegations, Infosys received a second, undated, whistleblower complaint accusing Parekh of engaging in misdemeanors and urging the board to take action against him.[k] The complaint began by addressing the fact that, following

a Megha Bahree, "Indian Tech Giant Infosys Shaken by Whistleblower Complaints," *Forbes*, October 25, 2019.

b Shilpa Phadnis, "Anonymous Employees Allege Infosys is Dressing Up Its Books," *Times of India*, October 21, 2019.

c Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

d Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

e Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

f Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

g Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

h Bahree, "Indian Tech Giant Infosys Shaken by Whistleblower Complaints."

i Bahree, "Indian Tech Giant Infosys Shaken by Whistleblower Complaints."

j Phadnis, "Anonymous Employees Allege Infosys is Dressing Up Its Books."

k "Infosys Faces Another Whistleblower Complaint, CEO Accused of Misdeeds," *Economic Times*, November 12, 2019.

The Infosys Whistleblower Matter *continued*

Sikka's departure, Infosys explicitly required that the next CEO be based in Bengaluru, India.[l] The complaint went on to allege that Parekh was living in Mumbai, India, which resulted in significant travel costs to and from Bengaluru being expensed to the company.[m] The complaint also alleged that Parekh rented an apartment in Bengaluru with the intent to mislead the company about his residency, that he had made numerous personal investments in small companies in Mumbai, and that he continues to reside in Mumbai to oversee these investments.[n] The complaint suggested that Parekh visits the United States at least once a month solely in order to retain his green card status and does not interact with any Infosys clients or offices during his visits.[o] The complaint further alleged that Parekh used his status as CEO to essentially bribe several prestigious U.S. universities to admit his children as students.[p] The complaint ultimately stated that Parekh's actions were eroding the value systems of the company and warranted his termination.[q]

Infosys Initial Response to the Whistleblower Statements

On October 22, 2019, the company issued a public statement that the board had received two anonymous whistleblower complaints as of September 30, 2019.[r] Both complaints were placed before the audit committee on October 10, 2019, and before the nonexecutive members of the board on October 11, 2019.[s] The audit committee commissioned independent legal counsel, Shardul Amarchand Mangaldas & Co., and the PricewaterhouseCoopers investigation team to lead the investigations.[t] Parekh and Roy were both recused from the investigations.

Regulatory Investigations Following Whistleblower Complaints

Regulators in both India and the United States responded quickly to the whistleblower allegations. Shortly after the October 22, 2019 company statement, the SEC initiated an investigation.[u] Infosys publicly stated that it would cooperate with the SEC investigation.[v] Indian regulatory authorities also looked into the matter. The Securities and Exchange Board of India (SEBI),[w] India National Stock Exchange (NSE), Bombay Stock Exchange (BSE), National Financial Reporting Authority (NFRA), and the Registrar of Companies, Karnataka, each opened investigations or sought further information about the alleged unethical practices.[x] The company stated in a press release that they would provide information and cooperate with these authorities.[y]

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l "Infosys Faces Another Whistleblower Complaint, CEO Accused of Misdeeds," *Economic Times*.

m Ayushman Baruah, "Infosys CEO Hit by More Charges in Second Whistleblower Letter," *LiveMint*, November 12, 2019.

n Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

o Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

p Phadnis, "Anonymous Employees Allege Infosys Is Dressing Up Its Books."

q "Infosys Faces Another Whistleblower Complaint, CEO Accused of Misdeeds," *Economic Times*.

r "Company Statement," Infosys Limited, October 22, 2019.

s "Company Statement," Infosys Limited.

t "Infosys Audit Committee Finds No Evidence of Financial Impropriety of Executive Misconduct," Infosys Limited, January 10, 2020.

u "Update on Whistleblower Complaints," Infosys Limited, October 24, 2019.

v "Update on Whistleblower Complaints," Infosys Limited, October 24, 2019.

w Bahree, "Indian Tech Giant Infosys Shaken by Whistleblower Complaints."

x "NFRA, RoC Seek Information on Whistleblower Complaints: Infosys," *Economic Times*, November 6, 2019.

y "Update on Whistleblower Complaints," Infosys Limited, October 24, 2019.

The Infosys Whistleblower Matter *continued*

Infosys Internal Investigations Report

On January 10, 2020, Infosys published a detailed press release about the findings of its internal investigations.[z] D. Sundaram, chair of the audit committee, stated, "The Audit Committee commissioned a thorough investigation with the assistance of independent legal counsel. The Audit Committee determined that there was no evidence of any financial impropriety or executive misconduct."[aa] The press release detailed the methodology of the investigations, the amount and types of data reviewed, and the interviews with relevant company personnel.[ab] The press release stated that no limitations or restrictions were placed on the investigation team's access to information, and that the company, its directors, and its employees fully cooperated.[ac] The extensive investigation included 128 interviews with 77 persons, and a review of more than 210,000 electronic or imaged documents, with over 8 terabytes of electronic data processed.[ad] Non-executive chairman Nandan Nilekani stated that the investigation was done in complete transparency, with its results largely open to the public for review.

The January 10, 2020 press release addressed each allegation in the whistleblower complaints:

- Regarding the improper visa cost expensing, revenue recognition accounting, and lack of approval for large deals allegations, the press release stated they were unsubstantiated.[ae] The company strictly complied with its treasury policy, without any interference or pressure from either the CEO or the CFO.[af] Further, the company stated that large deals under the investigation team's review were approved by the necessary stakeholders, including approval by the board and the audit committee.[ag]
- The particulars of each irregular accounting allegation were addressed. The company stated that it appropriately used a percentage-of-completion cost accounting method for one particularly large transaction at issue, in accordance with prescribed accounting standards and consistent with the company's accounting policy.[ah] The percentage-of-completion accounting method is indeed included as part of the Company's accounting policy in its consolidated financial statements.[ai] The press release noted that disclosure regarding using this method was neither required nor necessary, as it was not material.[aj]

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z "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited, January 10, 2020.

aa "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ab "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ac "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ad "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ae "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

af "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ag "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ah "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ai *Infosys Limited Condensed Standalone Financial Statements under Indian Accounting Standards (Ind AS) for the Three and Nine Months Ended December 31, 2019*, Infosys Limited, December 31, 2019, p. 28.

aj "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

The Infosys Whistleblower Matter *continued*

- Regarding an improper accounting of the obligation with respect to a service credit allegation, the investigation team determined that the reversal or nonaccounting of provisions were neither qualitatively nor quantitatively material.[ak] The reversal would not have made any impact on its revenue and operating margin parameters.[al] The press release also dismissed the visa costs, nonrecognition of reversal of up-front payment, finance team exits, and nondisclosure of key information allegations as unsubstantiated, but did not go into further detail on these issues.[am]
- Regarding the CEO misconduct allegations, the investigation team found that the CEO relocated to and operates from the Bengaluru office. The CEO travels to the Mumbai office, and within India and abroad, for business purposes.[an]
- The investigation confirmed that the CEO's bonus was computed in accordance with applicable company policies and his employment contract and was paid after approval from the Nomination and Remuneration Committee.[ao] The press release provided further detail into this issue, stating that a revision of the vesting period of the annual performance bonus was made upon the recommendation of the Nomination and Remuneration Committee and the subsequent approval of company shareholders. Shareholder approval of the revision was not required but was sought regardless, as a measure of good corporate governance.[ap]
- The other allegations against the CEO for not attending committee and board meetings, use of company funds for personal matters, seeking admission for his children to foreign universities, and the CEO's personal investments into small companies in Mumbai were addressed, with additional facts to show how the investigations team decided the claims were unsubstantiated.[aq]

SEC Concludes Investigation

In March 2020, the SEC concluded its investigation and stated it did not anticipate any further action.[ar] On March 24, 2020, Infosys confirmed it had cooperated with the SEC and that it has responded to all inquiries received from Indian regulatory authorities.[as] As of September 2020, there had been no further company update on

ak "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

al "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

am "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

an "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ao "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ap "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

aq "Infosys Audit Committee Finds No Evidence of Financial Impropriety or Executive Misconduct," Infosys Limited.

ar "Infosys Gets Clean Chit from SEC in Whistleblower Complaint Case," *LiveMint*, March 24, 2020.

as "Company Statement," Infosys Limited, March 24, 2020.

whether the Indian regulatory authorities had concluded or were continuing their inquiries,[at] and there has been no order passed by SEBI.

Shareholder Class Action Lawsuits

Two class action lawsuits were filed, in October 2019 and in December 2019,[au] to recover losses suffered by investors in the wake of the whistleblowers' complaints.[av] On May 22, 2020, Infosys announced that the October 2019 lawsuit was voluntarily dismissed by the plaintiff without prejudice.[aw]

Revisions of Infosys Policies and Charters

On April 20, 2020, the Infosys Board amended the following policies and charters:[ax]

- Related Party Transaction Policy
- Dividend Distribution Policy
- Policy for Determining Materiality for Disclosures
- Nomination and Remuneration Policy
- Corporate Social Responsibility
- Corporate Policy on Investor Relations
- Audit Committee Charter

The April 20, 2020 Related Party Transaction Policy was updated to state that omnibus approvals of certain repetitive RPTs, under SEBI Regulation 23(3), were not applicable to transactions entered into between a holding company and its wholly owned subsidiary whose accounts were consolidated with such holding company and placed before the shareholders at the general meeting for approval.[ay] It also broadened certain reporting requirements from "details of all material transactions" to "details of all transactions."[az]

The updated Policy for Determining Materiality for Disclosures made some changes to who has the authority to make the determination of materiality. It also removed the language that the general counsel and chief compliance officer shall consult with the CEO and CFO in these determinations.[ba]

The April 20, 2020 Audit Committee Charter added requirements that, in the event an auditor resigns before completing their term, the committee must examine all concerns by the auditor regarding nonavailability of information, noncooperation by management, and any other apprehensions, and then discuss these concerns at the next immediate meeting.[bb] Further, these concerns of the resigning auditor must be disclosed to the stock exchanges.[bc]

at "Financials & Filings," Infosys Limited (web page), last visited September 25, 2020.

au Megha Mandavia, "Class Action Lawsuit Dismissed Against Infosys," *Economic Times*, May 22, 2020; "Infosys Down 2.50% as US Law Firm Files Suit," *The Hindu Business Line*, December 12, 2019.

av "Infosys Faces Another Lawsuit in US," *Economic Times*, December 12, 2019.

aw "Class Action Lawsuit Dismissed," Infosys Limited, May 22, 2020.

ax "Form 6-K," Infosys Ltd., SEC filing for quarter ended March 31, 2020, filed April 20, 2020.

ay "Related Party Transaction Policy," Infosys Limited, April 20, 2020 (hereafter cited as Infosys 2020 Related Party Transaction Policy); "Related Party Transaction Policy," Infosys Limited, April 12, 2019 (hereafter cited as Infosys 2019 Related Party Transaction Policy).

az Infosys 2020 Related Party Transaction Policy; Infosys 2019 Related Party Transaction Policy.

ba Policy For Determining Materiality for Disclosures," Infosys Limited, April 20, 2020; "Policy for Determining Materiality For Disclosures," Infosys Limited, January 13, 2017.

bb "Audit Committee Charter," Infosys Limited, April 20, 2020 (hereafter cited as Infosys 2020 Audit Committee Charter); "Audit Committee Charter" (hereafter cited as Infosys 2019 Audit Committee Charter).

bc Infosys 2020 Audit Committee Charter; Infosys 2019 Audit Committee Charter.

The Infosys Whistleblower Matter *continued*

Notably, the whistleblower policy remained unchanged from its April 1, 2019 version.[bd] In the January 10, 2020 press conference, Nilekani had underscored the company's desire to protect whistleblowers, as they may expose genuine fraud.[be]

Conclusion

It appears that Infosys was able to answer the regulatory authorities' investigations appropriately and to defend against the whistleblowers' allegations of inappropriate accounting methods and executive misconduct. The board also took additional steps to prevent fraud and strengthen disclosure mechanisms by swiftly reviewing and revising applicable policies.

bd "Whistleblower Policy," Infosys Limited, April 1, 2019.

be "Transcripts of the Press Conference and Earnings Call Conducted after the Meeting of Board of Directors on January 10, 2020," Infosys Limited, January 10, 2020.

each company has a dynamic policy to suit its business environment, there is still no standard across all industries and sectors.

Decisions and orders of Government departments. Various government and regulatory bodies have deliberated on the issue of ethics and compliance practices. For instance, in October 2011, the Department of Public Enterprises, Government of India issued a Code of Ethics and Business Conduct for Central Public Sector Employees (CEB) for the employees of public sector enterprises.[21] The committee formulating the CEB noted that, while in the context of personal ethics the choice between right and wrong may be relatively easy, it is not so in the business context.[22] Nevertheless, the CEB attempted to define the general expectations of ethical conduct as follows: "[t]he underlying values, principles and norms for such ethical conduct include, among others, honesty, integrity, professionalism, fairness, accountability, credibility, diligence, respect for others, a sense of responsibility to the job, loyalty to the company, primacy of company's interests over personal interests, respect for the law, staying above the temptation to utilize official position or knowledge for personal gain, and a strong personal sense of right and wrong."[23]

Further, in 2019, the MCA issued National Guidelines on Responsible Business Conduct (NGRBC), to replace the then-existing National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business, 2011.[24] The NGRBC are designed to be applicable to and used by all businesses, regardless of their ownership, size, sector, structure, or location, and it is expected that all businesses investing or operating in India, including foreign multinational corporations (MNCs) will follow these guidelines. The NGRBC set out nine principles to be followed by businesses. The principles are interdependent, interrelated, and indivisible, and businesses are urged to address them holistically. The first of these principles states that "businesses should conduct and govern themselves with integrity, and in a manner that is ethical, transparent and accountable." As the NGRBC recognizes, "ethical behavior, in all operations, functions and processes, is the cornerstone of businesses guiding

21 "Code of Ethics and Business Conduct for Central Public Sector Employees," Hindustan Prefab Limited, 4.

22 "Code of Ethics and Business Conduct for Central Public Sector Employees," Hindustan Prefab Limited.

23 "Code of Ethics and Business Conduct for Central Public Sector Employees," Hindustan Prefab Limited.

24 National Guidelines on Responsible Business Conduct, Ministry of Corp Affairs, Government of India (2018).

Ranbaxy Laboratories Whistleblower

The United States also provides for whistleblower protections. In 2002, Dinesh Thakur began his employment for Ranbaxy Laboratories, an Indian multinational pharmaceutical company.[a] During his employment, he discovered that Ranbaxy had falsified and fabricated pharmaceutical data that it submitted to U.S. regulators. In 2004, Thakur reported his findings to his superior, Rajinder Kumar. Kumar reported the matter to senior management and the board and, according to Thakur, was asked to destroy the evidence of fraud. In 2005, Kumar and Thakur resigned. Thakur then reported his findings to the U.S. Food and Drug Administration (FDA) and filed a complaint in the U.S. District Court under the False Claims Act (FCA).[b] The FCA imposes liability on companies for knowingly submitting fraudulent information to the government. Under the FCA, private individuals who have information on the company's fraudulent actions may file claims on behalf of the government and may receive a portion of any recovered damages. In May 2013, a U.S. district court imposed a $150 million criminal penalty and a $350 million civil settlement on Ranbaxy for falsifying data and violating manufacturing norms.[c] Thakur received approximately $48.6 million from the federal share of the $350 million settlement.[d]

A whistleblower in Thakur's position would not have been able to file a claim successfully under Indian law. As discussed above, the Whistle Blowers Protection Act, 2014 only applies to public corruption and does not address corruption in the private sector. Further, there are no provisions for a reward for the whistleblower. Accordingly, under Indian law, a whistleblower in Thakur's position would have to pursue other measures to expose corporate wrongdoing and to safeguard his interests adequately.

a "Ranbaxy's Top Bosses Wanted to Destroy Proof: Dinesh Thakur," *Economic Times*, May 15, 2013.

b "Generic Drug Manufacturer Ranbaxy Pleads Guilty and Agrees to Pay $500 million to Resolve False Claims Allegations, cGMP Violations and False Statements to the FDA," U.S. Department of Justice, May 13, 2013.

c "Drug Manufacturer Ranbaxy Pleads Guilty," US Department of Justice.

d "Drug Manufacturer Ranbaxy Pleads Guilty," US Department of Justice.

their governance of economic, social and environmental responsibilities." For further discussion of the NGRBC, see Chapter Six: Corporate Social Responsibility and Sustainability.

Voluntary guidelines and reports. In addition to the statutory framework and the decisions and orders of the government departments, various voluntary guidelines and reports have been issued by prominent industry bodies in India that play their part in setting the tone for ethics and compliance practices. For instance, in 2011, the CII developed and recommended a Code of Business Ethics to be followed by its members on a voluntary basis.[25] More recently, the CII's 2020 Guidelines on Integrity and Transparency in Governance and Responsible Code of Conduct emphasize ethics and integrity.[26]

Implementing Ethical Practices

Code of ethics and conduct. A clearly spelled-out and communicated code of ethics and conduct is an important step toward creating an ethical environment in organizations. General guidance is available from industry bodies and government on the essential components of a code of ethics and conduct.[27] Some of the essential components of a code of ethics and conduct are set out below.

- zero tolerance of corruption and bribery;
- procedures and mechanism to prevent and detect violations;
- comprehensive whistleblower policy;
- reasonable efforts to avoid hiring employees, agents, and suppliers with a history of illegal or unethical behavior;
- education of employees about the company's ethics and compliance program;
- suppliers and vendors selected through a transparent process;
- implementation of disciplinary measures and enforcement mechanisms for employees who violate the code of ethics and conduct or fail to comply with the law; and
- tools to monitor and periodically evaluate the code's effectiveness.

Such essential components have been incorporated by leading Indian companies in their respective codes. For instance, the codes of business ethics of Tata[28] and Infosys[29] mandate maintaining correct financial records, giving equal opportunities to all, preventing any instances of bribery and corruption, establishing a mechanism for whistleblowing, and so forth. They also provide that third parties, such as distributors and suppliers engaged in dealings with the company, must adhere to the same code as that of the employees. Significantly, these codes are more comprehensive than the requirements mandated by the SEBI Listing Regulations because they apply to all employees of the company rather than only to the board of directors and senior management, as provided for in the SEBI Listing Regulations.

A code of ethics and conduct is a necessary but not sufficient condition for the enforcement of business ethics. A clearly articulated code of ethics and conduct must be accompanied by oversight and enforcement. Satyam is a classic example of the impact of the failure of effective enforcement of the code of ethics and conduct. (For details, see "The Satyam Scandal," p. 193.)

An important step in the successful oversight and enforcement of a code of ethics and conduct is the involvement of senior management. Senior management must, through words and deeds, convey to other employees that ethics and compliance are vital to the continued success of the business. The company must also encourage effective communication of standards and procedures as well as offer periodic training for all levels of the organization, including the board, management, employees, and agents. Further, the company must also have a dedicated ethics compliance officer reporting to the board. The board must be kept informed on ethics and

25 CODE OF BUSINESS ETHICS, CONFEDERATION OF INDIAN INDUS. (2011).

26 GUIDELINES ON INTEGRITY AND TRANSPARENCY IN GOVERNANCE AND RESPONSIBLE CODE OF CONDUCT, CONFEDERATION OF INDIAN INDUS. (2020) (hereafter CII GUIDELINES).

27 *Preparing a Code of Conduct—Concept Note*, Ernst & Young and FICCI, 2014.

28 *Tata Code of Conduct*, Tata Sons Ltd., 2015.

29 *Code of Conduct and Ethics*, Infosys Limited.

compliance issues as well as the actions taken to address them. The code must be reviewed periodically to ensure that the code remains relevant.

Ethics committees. Certain companies opt to form ethics committees in addition to audit committees. Neither the Companies Act nor the SEBI Listing Regulations make it mandatory to constitute a committee of directors to look into issues pertaining to ethics. Notable examples of companies that have chosen to do so are GAIL India[30] and Sun Pharmaceuticals,[31] to name a few.

Whistleblowing systems. The three most common programs adopted by corporations for an effective whistleblowing policy are (1) telephone hotlines, which are toll-free numbers whereby the employees can report wrongdoing by calling in at any time of the day; (2) ethics post office boxes, which are usually anonymous; and (3) corporate ombudsmen, who ensure an independent line of communication with any employee of the company on ethical matters besides carrying out a number of other functions.[32]

Once a complaint has been lodged, the companies must have the necessary mechanisms in place to deal with the situation. They must monitor the situation adequately and document any follow-up action. Those who call hotlines should be given a reference number for follow-up calls. The ombudsman should not keep a formal record of any whistleblower who consults him in person. The board should request regular reports from the internal audit department to ensure that the system is working properly and promptly.

To implement the whistleblowing system effectively, the company must take some measures to maintain confidentiality and impartiality. It takes great courage for employees to report improper professional behavior about their colleagues. Companies must therefore ensure that employees reporting unethical goings-on at the company are protected from retaliation and are not victimized. It is advisable that the management of the company, especially where the promoters or their affiliates constitute the management, is not involved in the whistleblowing system because they may be biased. Furthermore, as the identity of the whistleblowers must never be disclosed, companies must safeguard the anonymity of the whistleblower at every step of the process.

30 "GAIL India to Set Up Ethics Committee," *Hindustan Times*, January 29, 2009.

31 Divya Rajagopal and Mohit Bhalla, "Sun Pharmaceuticals to Set Up an Ethics Committee to Oversee Corporate Governance-Related Matters," *Economic Times*, May 6, 2019.

32 For a sample, see Whistleblower Policy, Tata Motors Limited.

Challenges at ICICI Bank

ICICI Bank is an Indian multinational banking and financial services company. After a long tenure at the bank, in 2009 Chanda Kochhar became the CEO and managing director (MD) of ICICI Bank.[a] Kochhar was instrumental in the growth of ICICI. Under her leadership, the bank experienced significant growth and expansion and ultimately rose to its title as the second-largest bank in India in terms of assets and market capitalization. Kochhar was celebrated as one of the most powerful businesswomen in the world, winning numerous accolades and awards in India and beyond. Kochhar's leadership, however, ended in 2018 when she stepped down from her position in connection with allegations of corruption with respect to loans made by ICICI to businesses tied to her family.

The corporate governance challenges at ICICI Bank first came to light in 2016 amid concerns about loan irregularities and conflicts of interest at ICICI.[b] Arvind Gupta, a shareholder in both ICICI Bank and Videocon Industries, alleged that ICICI Bank CEO Chanda Kochhar induced a quid pro quo arrangement between Videocon and her immediate family members.[c] In his complaint addressed to Prime Minister Narendra Modi, Gupta specifically pointed to the relationship between Videocon founder, chairman, and managing director Venugopal Dhoot, and Kochhar's husband, Deepak Kochhar.[d] Gupta had also shared his complaint with the Indian press, but the press initially ignored it.

a Arvind Gupta, appeal for investigation to Narendra Modi, Prime Minister of India, March 15, 2016.

b "Here's a Timeline of the ICICI Bank-Videocon Loan Case," *Moneycontrol*, January 31, 2019.

c "Here's a Timeline of the ICICI Bank-Videocon Loan Case," *Moneycontrol*.

d Gupta, appeal for investigation to Narendra Modi, Prime Minister of India.

At the heart of Gupta's complaint were allegations that Dhoot had provided crores of rupees to a firm promoted by Deepak Kochhar and two relatives six months after Videocon received a loan of INR 3,250 crore from ICICI Bank in 2012.[e] Gupta asserted that these transactions constituted corruption within ICICI Bank at the hands of Chanda Kochhar, and called for the Prime Minister, the governor of the Reserve Bank of India, and multiple other authorities to investigate these claims.[f] However, his complaint garnered little attention and ICICI Bank was able to avoid a probe.

In March 2018, Gupta's complaint resurfaced in the public domain on a blog, and began to gain momentum as multiple agencies, including the Central Bureau of Investigation (CBI), the Enforcement Directorate (ED), and the Serious Fraud Investigation Office (SFIO) launched probes into Kochhar's actions.[g] ICICI Bank's board preemptively released a statement denying the veracity of any such claims.[h] The press release cited the "adequate checks and balances in loan appraisal" and stated that the claims of any sort of quid pro quo, nepotism, or conflict of interest were unsubstantiated.[i] But this blanket assertion was not accompanied by any sort of report and therefore raised eyebrows because it was an internal, self-proclaimed review.[j] The lack of

e Gupta, appeal for investigation to Narendra Modi, Prime Minister of India; "Who is Deepak Kochhar, the Man at the Centre of the ICICI-Videocon Controversy?" *Business Today*, April 2, 2018.

f "Here's a Timeline of the ICICI Bank-Videocon Loan Case," *Moneycontrol*.

g "Here's a Timeline of the ICICI Bank-Videocon Loan Case," *Moneycontrol*.

h "Could Chanda Kochhar Have Kept Her Job at ICICI Bank?" *Institutional EYE Blog*, Institutional Investor Advisory Services India Limited, October 25, 2018.

i "ICICI Bank Statement on Findings in the Enquiry Report of Hon'ble Mr. Justice (Retd.) B.N. Srikrishna," ICICI Bank Limited, January 30, 2019.

j "Could Chanda Kochhar Have Kept Her Job at ICICI Bank?" Institutional Investor Advisory Services India Limited.

Challenges at ICICI Bank *continued*

disclosure on the part of the board allowed the media to control the narrative, further contributing to the demise of Chanda Kochhar's reputation.[k]

The CBI's initial inquiry was into the supposed nexus between Deepak Kochhar and Dhoot, and the legitimacy of the claims of any sort of quid pro quo deal.[l] The CBI originally decided to close the preliminary inquiry per the initial recommendation made by the investigating officer for lack of evidence after questioning Deepak Kochhar and Chanda Kochhar's brother-in-law.[m] The acting director rejected this advice, however, and registered a First Information Report (FIR) on the situation in January 2019.[n] In the FIR, Chanda Kochhar is accused of receiving "illegal gratification through her husband (Deepak Kochhar) from Videocon MD VN Dhoot for sanctioning a term loan of INR 300 crores to Videocon International Electronics Ltd."[o] According to the FIR, one day after a rupee term loan of INR 300 crores was paid by ICICI Bank to Videocon, Dhoot allegedly transferred 64 crores to NuPower Renewables (owned by Deepak Kochhar) via Supreme Energy, another entity controlled by Dhoot.[p] The FIR further indicates that senior bank officials who participated in the decision to sanction the loan may also be probed.[q]

In June 2018, ICICI Bank's board initiated an independent probe, and appointed retired Supreme Court Justice B.N. Srikrishna to head the investigating panel.[r] Although this eased the minds of investors, some experts expressed concern that the investigative process had moved relatively slowly.[s] At ICICI Bank's October board meeting, the board announced that Chanda Kochhar would be resigning as CEO of the bank after accepting her request for early retirement.[t]

In January 2019, Justice Srikrishna's report was released, which asserts that Chanda Kochhar was in violation of the ICICI Bank Code of Conduct and acted in "conflict of interest."[u] Upon the release of the report, the board stated that they were treating Chanda Kochhar's separation from ICICI Bank as termination for cause under the bank's internal policies.[v]

k "Could Chanda Kochhar Have Kept Her Job at ICICI Bank?" Institutional Investor Advisory Services India Limited.

l "Chanda Kochhar: Here's Why the Star Banker Decided to Quit," *Economic Times*, October 4, 2018.

m Rashmi Rajput and Raghav Ohri, "ICICI Probe: CBI Had Almost Closed Preliminary Enquiry Against Kochhar," *Economic Times*, January 28, 2019.

n Rajput and Ohri, "ICICI Probe: CBI Had Almost Closed Preliminary Enquiry Against Kochhar."

o Rajput and Ohri, "ICICI Probe: CBI Had Almost Closed Preliminary Enquiry Against Kochhar."

p Rajput and Ohri, "ICICI Probe: CBI Had Almost Closed Preliminary Enquiry Against Kochhar."

q Rajput and Ohri, "ICICI Probe: CBI Had Almost Closed Preliminary Enquiry Against Kochhar."

r "Here's a Timeline of the ICICI Bank-Videocon Loan Case," *Moneycontrol*.

s "Could Chanda Kochhar Have Kept Her Job at ICICI Bank?" Institutional Investor Advisory Services India Limited.

t Sahil Joshi, "Srikrishna Panel Finds Chanda Kochhar Violated Norms; Ex-ICICI CEO 'Deeply Shocked' over Board's Decision," *Business Today*, January 30, 2019; "Full Text: ICICI Bank Statement on Srikrishna Enquiry Report on Chanda Kochhar," *BloombergQuint*, January 30, 2019.

u Joshi, "Srikrishna Panel Finds Chanda Kochhar Violated Norms; Ex-ICICI CEO 'Deeply Shocked' over Board's Decision."

v Joshi, "Srikrishna Panel Finds Chanda Kochhar Violated Norms; Ex-ICICI CEO 'Deeply Shocked' over Board's Decision."

Challenges at ICICI Bank *continued*

In February 2019, following the registration of the FIR and Justice Srikrishna's findings, the ED registered a criminal case against Chanda Kochhar, Deepak Kochhar, Dhoot, and others under the PMLA.[w] ED officials launched several raids to obtain evidence on the case and continued questioning related parties.[x] Chanda Kochhar, Deepak Kochhar, and Rajiv Kochhar (Chanda Kochhar's brother-in-law) were summoned by the ED for questioning.[y] However, Chanda Kochhar had failed to attend the three ED summonses in June 2019, citing health reasons.[z] By the end of June 2019, the ED had questioned Chanda Kochhar and her husband as a part of its probe and started analyzing details of the Kochhars' assets.[aa]

In November 2019, Chanda Kochhar filed a petition against ICICI Bank in the Bombay High Court (HC) for terminating her employment after having accepted her request for early retirement.[ab] She challenged the ICICI Bank's denial of her remuneration and claw back of bonuses and stock options between April 2009 and March 2018.[ac] The former bank CEO and MD contended that her termination was "illegal, untenable, and unsustainable in law."[ad] ICICI Bank objected the maintainability of Chanda Kochhar's petition.[ae] Darius Khambata, counsel for ICICI Bank, argued that the termination was a contractual dispute and that ICICI Bank is a private bank against which a writ petition is not maintainable.[af] Kochhar's counsel, Vikram Nankani, then sought to amend Chanda Kochhar's petition to include the Reserve Bank of India (RBI) as a party.[ag] The HC permitted Nankani's amendment to the petition, forcing the RBI to reply to Chanda Kochhar's plea.[ah] The RBI responded to the writ petition by defending its approval of Chanda Kochhar's termination as a fair and not arbitrary decision that did not violate any of the former bank CEO and MD's fundamental rights.[ai]

In early January 2020, the ED moved to attach properties belonging to Chanda Kochhar and her husband to the money laundering case.[aj] After reviewing the parties' pleas, the HC dismissed Chanda Kochhar's petition on March 5, 2020.[ak] Justices Nitin Jamdar and Makarand Karnik of the bench agreed with ICICI Bank's contention

w Rashmi Rajput, "ED Quizzes Chanda Kochhar for 3rd day in Moneylaundering Case," *Economic Times*, March 4, 2019.

x Rajput, "ED Quizzes Chanda Kochhar for 3rd day in Moneylaundering Case."

y "ICICI-Videocon Loan Case: Chanda Kochhar, Husband Appear Before ED," *Economic Times*, May 13, 2019.

z Munish Pandey, "Chanda Kochhar Skips ED Summons for Third Time, Probe Expanded," *India Today*, June 14, 2019.

aa "Videocon Loan Case: ED Questions Chanda & Deepak Kochhar, Dhoot," *Indian Express*, June 29, 2019.

ab Vidya, "Now ICICI Bank Files Suit Against Chanda Kochhar Seeking Recovery of Funds," *India Today*, January 13, 2020.

ac Maulik Vyas and Reena Zachariah, "Chanda Kochhar Moves High Court Against ICICI Bank over Termination," *Economic Times*, December 1, 2019; "ICICI Bank-Videocon Loan Case: Bombay High Court Dismisses Chanda Kochhar's Plea Against Termination of Employment," *Firstpost*, March 5, 2020.

ad Vyas and Zachariah, "Chanda Kochhar Moves High Court Against ICICI Bank over Termination"; "ICICI Bank-Videocon Loan Case: Bombay High Court Dismisses Chanda Kochhar's Plea Against Termination of Employment," *Firstpost*.

ae Swati Deshpande, "Bombay HC Allows Chanda Kochhar to Amend Plea Against Her Termination," *Times India*, December 3, 2019.

af Deshpande, "Bombay HC Allows Chanda Kochhar to Amend Plea Against Her Termination."

ag Deshpande, "Bombay HC Allows Chanda Kochhar to Amend Plea Against Her Termination."

ah Deshpande, "Bombay HC Allows Chanda Kochhar to Amend Plea Against Her Termination."

ai "Chanda Kochhar's Writ Petition Shouldn't Be Entertained, RBI Pleads in Court," *Financial Express*, December 19, 2019.

aj "Chanda Kochhar Steps Down as Chairperson of Vadodara IIIT," *Economic Times*, January 24, 2020.

ak "ICICI Bank-Videocon Loan Case: Bombay High Court Dismisses Chanda Kochhar's Plea Against Termination of Employment," *Firstpost*.

Challenges at ICICI Bank *continued*

that the writ petition was not maintainable since the dispute was contractual and concerned a private body.[al] The court said, "[t]he termination of the petitioner is in the realm of contractual relationship," and "[c]ourts cannot exercise their writ jurisdiction when employment in a private entity is regulated by contracts."[am] Chanda Kochhar appealed before the Supreme Court against the above rejection by the Bombay High Court. The Supreme Court refused to interfere with the order of the Bombay High Court in early December 2020. The three-judge bench of the Supreme Court opined that the only issue in question pertained to the resignation by Kochhar and the termination of her services by the bank, which was purely a contractual issue between Kochhar and the bank, thereby rejecting Kochhar's appeal.[an] In early September 2020, the ED arrested Deepak Kochhar in the money laundering case during the investigation of certain new evidence pertaining to money trails being probed in the matter.[ao]

Possibly in light of the controversy surrounding Chanda Kochhar, in June 2020 the RBI proposed to restrict promoters from holding a CEO position for more than 10 years and to cap the tenure of a nonpromoter CEO at 15 years.[ap] If the proposal is converted into regulation, it would have significant implications for promoter-led banks such as Kotak Mahindra Bank and Bandhan Bank.[aq]

al Deshpande, "Chanda Kochhar's Writ Petition Against Termination of Service Not Maintainable: HC," *Times India*, March 6, 2020.

am "ICICI Bank-Videocon Loan Case: Bombay High Court Dismisses Chanda Kochhar's Plea Against Termination of Employment," *Firstpost*.

an Chandra Deepak Kochhar v. ICICI Bank Ltd., 2020 SCC OnLine SC 969.

ao Rashmi Rajput, "Chanda Kochhar's Husband Deepak Kochhar Arrested by ED in Money Laundering Case," *Economic Times*, September 8, 2020.

ap "Reserve Bank of India Moots 10 Years Cap on Promoters' CEO Term," *New Indian Express*, June 12, 2020; "RBI Moves in to Strengthen Governance in Commercial Banks," *Hindu Business Line*, June 12, 2020; "RBI Plans to Overhaul Corporate Governance Structure of Banks," *Economic Times*, June 13, 2020.

aq "Reserve Bank of India Moots 10 Years Cap on Promoters' CEO Term," *New Indian Express*.

The Everonn Episode

A pioneer in achieving a breakthrough in the sphere of education, Everonn Education Limited (Everonn) was established in 1987. The company provided computer education services at schools. In due time, it was listed on both the BSE and the NSE in 2007, with its stocks being oversubscribed 145 times. Everonn pioneered satellite-based education in India, and became the first Indian education company to provide education through mobile phones in 2009. In the same year, Everonn launched its business academy, Global School of Business, in Chennai.

The Everonn Debacle

Everonn's MD, P. Kishore, owned a 8.52 percent stake in the company. Addressing the shareholders on August 15, 2011, Kishore said that the company's profit after tax was INR 9.67 crore, and cash in hand in Q1 FY2012 stood at INR 158.31 crore. On August 30, 2011, Kishore was reported to have been apprehended by the CBI for his attempt to bribe income tax officials for hiding taxable income worth INR 116 crore. He was reported to have offered the tax official INR 50 lakh.

Market Reaction to the Debacle

The trust and goodwill of a company are its foundations in the market. With the arrest of the MD, Everonn's shares nosedived 20 percent on the BSE. This was followed by the resignation of the chairman of Everonn's board, J.J. Irani. Dr. Irani headed the committee set up by the MCA in 2004 that investigated various company law issues, including corporate governance.

Everonn had a code of conduct for its top-level employees. The code for directors, however, was different from that for senior management personnel. Senior management personnel included all employees from one level below the board of directors up to the general manager. The code of conduct for directors as well as for senior management employees prescribed the general responsibilities in terms of secrecy, disclosure of interest, and gifts and benefits, along with honest and ethical conduct. The code of conduct laid down by Everonn was substantially along the lines of Clause 49 of the listing agreement. The code had even prescribed a committee to investigate the actions of the directors. The code empowered this committee to remove a director from the board for noncompliance with the code. Despite having a strong internal framework for ensuring the ethical behavior of its employees and directors, Everonn had to face the heat from the markets because of the alleged illegal and unethical behavior of its MD. The Everonn episode is a recent one in which unethical behavior by the company and its directors and senior management was severely punished by shareholders.

The immediate repercussion of the Everonn episode was the heavy offloading of shares by two major FIIs, Morgan Stanley Mauritius Company Limited and JF Eastern Smaller Companies Fund.

Aggressive tactics and strategies were employed by Everonn to regain the confidence of investors before any permanent damage was done. The management decided to alter and modify the top hierarchy by inducting SKIL Infrastructure's Group chairman and promoter, Nikhil Gandhi, onto the board of Everonn.

The Satyam Scandal

Background

Established with 20 employees in the year 1987 by B. Ramalinga Raju and his brother B. Rama Raju, Satyam Computer Services Limited was listed on the BSE, the NSE, and the NYSE. Satyam was required by all the stock exchanges on which it was listed to formulate a code of conduct and ethics. Satyam implemented a formidable code of conduct and ethics for its employees as well as its management. In fact, the corporate governance practices adopted by Satyam were bestowed a Golden Peacock Award for corporate governance at the beginning of 2008 by the World Council for Corporate Governance.

The Maytas-Satyam Saga

As described in more detail in "The Satyam Scandal," p. 16, on December 16, 2008, Satyam offered to acquire Maytas Infra and Maytas Properties for approximately USD 1.6 billion. The deal raised eyebrows across the corporate world. Analysts were of the view that Satyam had overvalued the target companies. Importantly, the Raju brothers had a 31 percent stake in Maytas Infra, and Maytas Properties represented the Raju family's old construction and property business. Pursuant to the deal, a lot of cash would be moved from Satyam to the Raju family. Satyam had to abort the deal on account of the market reaction.

Soon thereafter, the corporate world was hit by another significant development. On January 7, 2009, B. Ramalinga Raju resigned from the board of directors of Satyam and confessed that the company funds, worth USD 1.5 billion, were nonexistent, and that the company had been falsifying its accounts for several years. The NYSE halted trading in Satyam stocks on the same day, and India's NSE announced the removal of Satyam from its S&P CNX Nifty 50-share index on January 12, 2009. The Raju brothers were subsequently arrested on various criminal charges.

The Satyam debacle proves the point that while short-term profit maximization can be achieved by adopting unethical practices, for a business to achieve long-term profitability it needs not only ethical internal rules but also effective enforcement of such rules. Satyam had a Code of Conduct and Ethics for Director and Associates, as mandated by the various stock exchanges on which it was listed. The conduct of its directors, both executive and nonexecutive, along with other associates of the company, was regulated by the code. The code not only expected "legal, honest, and ethical conduct" from its associates, but also facilitated whistleblower policies and mandated that any noncompliance with the code was to be reported to the human resources department or the compliance officer. The code had unambiguously put a lot of emphasis on the ethical practices being adopted by its employees and the management. However, its own internal rules were flouted by the highest level of management, leaving the stakeholders amid a severe crisis.

Key Takeaways

- While ethical business conduct by a company is largely self-regulatory, the recent amendments to the PCA and SEBI PIT Regulations and the introduction of the NGRBC are major steps India has taken toward strengthening the statutory framework.
- A code of conduct and ethics as well as putting in place whistleblowing systems are necessary for establishing a framework for regulating ethical conduct at companies.

Open Questions

- Should the law mandate the formation of an ethics committee for listed companies?
- In the absence of a regulatory mandate, should larger corporations be encouraged to appoint ethics officers?
- In the Indian context, would factors such as a lack of effective enforcement machinery and political will, coupled with cultural and social tolerance toward unethical practices such as bribery and corruption, continue to remain the major roadblocks to shaping ethical and compliance practices?

CHAPTER ELEVEN

Shareholder Participation and Activism by Nonpromoter Shareholders

As noted by the Kotak Committee, “a majority of Indian listed entities continue to be promoter-driven entities with significant shareholding being held by the promoter or promoter group. Therefore, protection of the interests of minority shareholders, especially those of retail shareholders, assumes even more importance.”[1] While promoter ownership of Indian firms has remained largely stable, over the last decade there has been a “steady growth in the size and influence of institutional investors in Indian capital markets.”[2] Minority shareholders, including retail and institutional investors (both domestic and foreign), have shown concern over corporate governance issues in India, especially in promoter-dominated firms. Historically, outside shareholders, whether retail or institutional, have been passive shareholders, with little participation in shareholders’ meetings. More recently, however, both regulatory changes and market forces have led to increased activism by nonpromoter shareholders in Indian firms.[3]

This chapter focuses on the role of nonpromoter shareholders, particularly institutional investors, in the development of corporate governance standards in India. It also discusses the emergence of proxy advisory firms in India as facilitators of greater shareholder involvement.

Corporate governance trends from 2014 to 2019 show that 105 proposed resolutions were defeated by nonpromoter shareholders. In 2018–2019 alone, 155 resolutions had more than 20 percent of the investors voting against them.[4] Recent increased instances of investor activism demonstrate the role that institutional investors can play in the corporate governance of an Indian company, and how institutional investors can help the evolution of a company’s corporate governance practices and standards.

Foreign Investors in India

Ownership structure in India. Concentrated ownership has been a hallmark of the Indian corporate landscape. (For a more in-depth discussion of the prevalence of concentrated ownership in India, see Chapter Two: Corporate Ownership and Control, p. 27.) Due to India’s early socialist inclination soon after its independence, the government envisioned a planned economy, with a focus on agriculture and fundamental industries such as steel and power. The government had the exclusive right to allocate resources and to issue licenses and permits to use such resources.[5] This permit, or License Raj, era resulted in suboptimal utilization of resources. The barriers to entry in the form of government permissions (and regulations) made the system inefficient, uncompetitive,[6] and prone to corruption. With capital markets not as evolved as they are today, and participation in equity markets limited, promoters retained tight control of their firms.[7] This continued the historical trend from early India, where promoters were in complete control of their firms. As scholars Khanna and Palepu have pointed out, concentrated ownership is a result of institutional voids or a lack of sophisticated intermediaries in the capital markets.

Corporate governance in India has been influenced by a variety of factors and combines elements of the shareholder-centric Anglo-Saxon system and the stakeholder-centric Continental system, along with influences from India’s social values. While a majority of Indian companies are still controlled by promoters, there has been an increasing trend to have more dispersed ownership with professional management (and outside investors). Government policy has encouraged this trend through progressive regulatory norms. Certain measures, such as the increased minimum public float from 10 percent to 25 percent for all listed companies, have

1 Uday Kotak et al., *Report of the Committee on Corporate Governance*, Securities and Exchange Board of India, October 2017, p. 7.

2 *Ownership Structure of Listed Companies in India*, Organisation for Economic Co-operation and Development [OECD], 2020.

3 For a more detailed account of shareholder activism in India, see Umakanth Varottil, “The Advent of Shareholder Activism in India,” *Journal on Governance* 1, no. 6 (2012).

4 *The Corporate Governance Landscape in India*, Institutional Investor Advisory Services India Limited, August 2019, pp. 5–6.

5 For further discussion, please refer to Vikramaditya Khanna, “Law Enforcement and Stock Market Development: Evidence from India,” Center on Democracy, Development and the Rule of Law Working Paper No. 97, January 2009.

6 Khanna, “Law Enforcement and Stock Market Development: Evidence from India.”

7 Tarun Khanna and Krishna Palepu, “The Evolution of Concentrated Ownership in India: Broad Patterns and a History of the Indian Software Industry,” in *The History of Corporate Governance around the World: Family Business Groups to Professional Managers*, ed. Randall K. Morck (Chicago: University of Chicago Press, 2005), 284-303.

In the past decade, there have been several high-profile instances of nonpromoter shareholder activism in India, including the following:

- Minority shareholders of Cadbury India Limited succeeded in obtaining an order from the Bombay High Court directing the company to pay INR 2,014.50 per share to buy back its shares. This amount was 50 percent higher than the previous offer made by the company to its minority shareholders in 2009.[a]
- The majority of the institutional investors of Raymond Limited voted against a proposal to sell a prime property of the company to the chairman of the company and his relatives at a price lower than one-tenth of the market value of the property.[b] A more detailed case study can be found on page 205.
- Although the proposal was rejected, approximately 1,000 small shareholders of Alembic Limited sought the appointment of a small shareholder director.[c] A more detailed case study can be found on page 201.
- The remuneration proposed by Tata Motors Limited for certain executive directors was not approved by its public shareholders.[d]
- Proposals made by United Spirits Limited to enter into related party transactions were rejected by its shareholders.[e]

a Khushboo Narayan, "The Advent of Shareholder Activism in India," *Livemint*, November 27, 2014.

b Hima Bindu Kota, "Advent of Shareholder Activism," *The Pioneer*, January 17, 2018.

c Kota, "Advent of Shareholder Activism."

d Umakanth Varottil, "Case-Study Evidence of Shareholder Activism," *IndiaCorpLaw Blog*, February 24, 2016; "Shareholder Activism in India Highest in Asia, Says Report," *Business Standard*, September 23, 2014.

e "Shareholder Activism in India," *Law Times Journal*, August 6, 2017.

resulted in more diverse ownership and made the markets more liquid.[8] Such measures also allowed for an oversight mechanism of management decisions by making their actions discernible by a larger audience.

Corporate governance and foreign investments in Indian companies. The process of economic liberalization, which included the introduction of market reforms and the gradual shift of the Indian economy from a planned economy to a market-oriented economy, started in the early 1990s. This process led to a dramatic increase in foreign investment. Foreign direct investment (FDI) plus foreign portfolio investment (FPI) rose from a mere $103 million in 1991 to $30.09 billion in 2019.[9] The increase has led to a corresponding increase in FPI shareholding in Indian companies, which stands at an average of 26.27 percent in the top 30 listed companies; i.e., the index of the Bombay Stock Exchange (BSE), the SENSEX (see Table 11.1, p. 198). The total nonpromoter institutional shareholdings in these companies stand at an average of 44.45 percent (see Table 11.1, p. 198).

Foreign investors demanded management best practices as well as active shareholder oversight, which was almost nonexistent prior to economic liberalization. Management teams began to realize that their performance would be scrutinized and questioned, and began to adapt with this in mind, not only to survive but also to flourish in the longer term. Given the limited availability of domestic capital, the need for foreign capital for the survival of the company underscored and accelerated the changes in Indian corporate governance. (For a more in-depth discussion of

8 F.NO.5/35/2006-CM, PRESS RELEASE, AMENDMENT TO PUBLIC SHAREHOLDING REQUIREMENT, MINISTRY OF FIN. (2010).

9 *Handbook of Statistics on the Indian Economy*, Reserve Bank of India, 2018-2019.

Table 11.1 **Market Capitalization and Institutional Holdings in Top 30 Index Companies of the Bombay Stock Exchange (2020)**

Company	Market cap full (INR crore)	Market cap free float (INR crore)	FPI %	Total nonpromoter institutional investors %
Asian Paints Ltd	2,30,423.29	1,08,298.95	21.13	28.15
Axis Bank Ltd	2,30,829.91	1,91,588.83	51.02	74.55
Bajaj Auto Ltd	1,12,850.24	50,782.61	13.06	22.19
Bajaj Finance Ltd	3,34,131.67	1,47,017.93	23.89	32.96
Bajaj Finserv Ltd	1,65,293.68	62,811.60	8.78	14.85
Bharti Airtel Ltd	2,98,009.82	1,31,124.32	17.75	39.53
Dr Reddy's Laboratories Ltd	74,843.26	54,635.58	29.13	43.86
HCL Technologies Ltd	2,61,827.98	1,04,731.19	24.92	35.17
HDFC Bank Ltd	8,74,263.90	6,90,668.48	39.35	60.82
Hindustan Unilever Ltd	5,15,516.14	1,95,896.13	14.92	25.64
Housing Development Finance Corp	4,78,308.97	4,78,308.97	71.95	89.07
ICICI Bank Ltd	4,36,802.05	4,36,802.05	47.43	89.92
IndusInd Bank Ltd	83,316.05	61,653.88	54.93	71.13
Infosys Ltd	5,72,358.55	4,97,951.94	32.26	56.01
ITC Ltd	2,58,289.54	1,80,802.68	13.31	56.25
Kotak Mahindra Bank Ltd	3,76,130.45	2,78,336.53	45.09	58.01
Larsen & Toubro Ltd	2,10,201.81	1,82,875.57	21.11	54.41
Mahindra & Mahindra Ltd	1,05,944.87	81,577.55	37.9	66.14
Maruti Suzuki India Ltd	2,15,210.90	94,692.79	23.09	38.75
Nestle India Ltd	1,60,964.59	59,556.90	12.84	20.59
NTPC Ltd	1,09,184.46	53,500.39	12.32	45.77
Oil & Natural Gas Corp Ltd	1,43,352.28	41,572.16	7.67	25.38
Power Grid Corp of India Ltd	1,18,992.51	58,306.33	26.74	42.27
Reliance Industries Ltd	13,95,532.78	6,97,766.39	25.16	38.08
State Bank of India	3,61,491.39	1,55,441.30	9.82	34.7
Sun Pharmaceutical Industries Ltd	1,49,750.79	68,885.36	12.19	33.03
Tata Consultancy Services Ltd	11,31,410.35	3,16,794.90	15.88	23.59
Tech Mahindra Ltd	94,457.22	60,452.62	39.04	52.59
Titan Co Ltd	1,30,890.75	61,518.65	18.59	29.45
UltraTech Cement Ltd	1,87,599.95	75,039.98	16.8	30.9

Table 11.1 shows the institutional shareholding in the top 30 constituent companies of the Bombay Stock Exchange's Index, the SENSEX. The average nonpromoter institutional holding (domestic plus foreign) in these index companies is 44.45 percent.

the development of corporate governance standards in India, see Chapter One: Corporate Governance Reforms in India, p. 10.)

Around the same time, the government began to introduce a fundamental regulatory framework and structure in an effort to codify the need for strong corporate governance standards. The government instituted the Securities and Exchange Board of India (SEBI) under the SEBI Act, 1992, as a primary regulator of the securities market in India.[10] The development of a regulatory institutional framework, as well as market realities, have encouraged the development of corporate governance best practices among Indian corporations, particularly in listed public companies.

The last two decades of significant economic reforms have sent a strong signal to prospective foreign investors about India's entry on the scene of modern economic development. Over time, various steps were taken to open up the economy and align the domestic markets to the new world economy while at the same time preserving the integrity of the Indian markets. The attractive potential for growth has made India emerge as one of the top destinations for foreign investments.

Investment routes to invest into India. The need for capital in an expanding economy led Indian companies to seek foreign investment. Subsequent to the Industrial Policy of 1991, exchange control norms were relaxed and the domestic economy was gradually opened up for foreign investment. The resulting influx of foreign investment contributed to India's strong economic growth. There are several routes through which foreign investors invest in India: foreign direct investment (FDI), foreign venture capital investment (FVCI), foreign portfolio investment (FPI), external commercial borrowing (ECB), nonresident Indian portfolio investment scheme under NRI-PIS, and alternative investment funds (AIFs).

Institutional Investors in India

Institutional investors in India can be broadly categorized as development finance institutions (DFIs), insurance companies, banks, mutual funds, AIFs and FPIs. In addition to the regulatory restrictions, each of these categories has a different investment strategy and investment objective. Therefore, the type and magnitude of governance concern for each will vary. Further, depending on the ownership structure of the portfolio company and the stakes involved, the role of the institutional investor in monitoring and performance will be different.

Foreign portfolio investors include government agencies, sovereign wealth funds, banks, private equity funds, hedge funds, insurance companies, and foreign corporations. Some foreign investors have taken board seats in their target companies and have been active shareholders and diligent in their oversight.[11] The very nature of their investment strategies and objectives incentivizes foreign investors to seek investments primarily in companies with good corporate governance practices. FPIs may be the first ones to exit when any corporate governance issue arises with a company.

Indian domestic institutional investors (DIIs) have traditionally been dormant investors. Prior to India's economic liberalization, no dynamic participation of such institutional investors was observed. Traditional DIIs include insurance companies, such as the Life Insurance Corporation of India, public-sector lending institutions, and mutual funds.

Historically, mutual fund houses, in spite of being some of the dominant DIIs in India, used their voting powers sparingly. When they did vote, they mostly voted in line with promoters. Data regarding mutual fund voting from 2011, released by Institutional Investor Advisory Services (IiAS), shows that Indian mutual funds abstained from 69 percent of the voting resolutions, voted 38 percent of the times in favor of the voting resolutions, and voted against the voting resolutions only 1 percent of the time.[12] This data indicates a lack of interest on the part of mutual funds in active oversight of management decisions.

To address these problems, SEBI implemented increased disclosure obligations. SEBI directed mutual funds to disclose their general policies and procedures with respect to voting on shares held by them on their website

10 Securities and Exchange Board of India Act, No. 15, Acts of Parliament, 1992 [hereinafter SEBI Act].

11 Afra Afsharipour, "Corporate Governance and the Indian Private Equity Model," *National Law School of India Review* 27, no.1 (2016): 18.

12 *2010-11: Mutual Fund Voting Data*: *A Small Beginning*, Institutional Investors Advisory Services India Limited, January 2012.

as well as in their annual report.[13] In 2011, SEBI also required mutual funds to disclose how they voted on shareholder resolutions. In 2014, SEBI required that mutual funds publish their rationale for voting decisions and also increased the frequency of reporting these disclosures from once a year to once per quarter.

In the 2013 proxy season, Indian mutual funds voted on 61 percent of the 30,124 resolutions presented to shareholders.[14] This marked a 7 percent increase from mutual fund voting in the 2011 proxy season.[15] Armed with new rules and regulations, investors were even more active and engaged in the 2014 proxy season. The IiAS report chronicled several examples of the impact of increased investor engagement, such as the following:

- Maruti Suzuki was compelled to change the terms of its agreement with Suzuki Motor Company (Japan) on setting up its Gujarat plant following strong opposition from institutional investors.
- Tata Motors' resolutions against retrieving the remuneration for three of its executives was defeated: almost 30 percent of votes were cast *against* the pay hike. To pass, the resolution needed a 75 percent *for* vote.
- Twenty-three percent of Havells India's shareholders who voted cast their vote *against* the payment of royalty and trademark charges to promoter-owned companies for the use of the brand "Havells." The resolution came very close to being defeated.
- In Panacea Biotec, the resolution regarding related party transactions with Panera Biotec was defeated, with more than 94 percent of the nonpromoter shareholders voting *against*.
- In PTL Enterprises, shareholders got a court injunction to stop the company from presenting a resolution that would allow the company to sell its largest business to a promoter-controlled entity at a price that favored the buyer.[16]

Subsequently, SEBI, the Insurance Regulatory and Development Authority of India (IRDA), and the Pension Fund Regulatory and Development Authority (PFRDA) considered a proposal for the adoption of stewardship principles in India, which was approved by a subcommittee of the Financial Stability and Development Council (FSDC-SC). In March 2017, the IRDA formally adopted the Stewardship Guidelines for Insurers, and the PFRDA formally adopted the Common Stewardship Code in May 2018.[17] In December 2019, SEBI put in place a stewardship code for mutual funds and AIFs. The stewardship code was to come into effect on April 1, 2020, but was extended to July 1, 2020, to account for the COVID crisis.[18]

PROXY ADVISORY FIRMS

Institutional investors are increasingly turning to proxy advisory firms for recommendations on new proposals. While the proxy advisory industry has been well established internationally, it was not until 2010 that institutional investors in India embraced proxy advisory firms.[19] Three proxy advisory firms (IiAS, InGovern, and SES) have experienced considerable success; as a result, India has witnessed an increase in analytical and well-organized shareholder activism that is bolstered by the advice of proxy advisory firms. Typically hired by institutional investors, proxy advisory firms analyze corporate proposals and provide voting recommendations to their clients. Proxy advisory firms also release public reports with recommendations and an analysis of corporate governance trends. These recommendations often cover major transactions such as mergers and acquisitions and the appointment of directors and auditors. Because these recommendations are often discussed in the public domain, proxy advisory firms may encourage companies to improve their standards of governance and protect the interests of minority shareholders.[20]

(*continued on p. 204*)

13 CIRCULAR NO. SEBI/IMD/CIR NO 18/198647/2010, CIRCULAR FOR MUTUAL FUNDS, SEC. & EXCH. BD. OF India (2010).

14 "The New Shareholder: Active, Engaged and Online," Institutional Investor Advisory Services India Limited, October 29, 2014.

15 "The New Shareholder: Active, Engaged and Online," Institutional Investor Advisory Services India Limited.

16 "The New Shareholder: Active, Engaged and Online," Institutional Investor Advisory Services India Limited.

17 *One India, One Stewardship*, Institutional Investor Advisory Services India Limited, February 24, 2020, p. 1.

18 CIRCULAR NO. CIR/CFD/CMD1/168/2019, STEWARDSHIP CODE FOR ALL MUTUAL FUNDS AND ALL CATEGORIES OF AIFS, IN RELATION TO THEIR INVESTMENT IN LISTED EQUITIES, SEC. & EXCH. BD. OF India (2019); "Coronavirus: Sebi Extends Implementation of Stewardship Code Till July 1," *Financial Express*, March 30, 2020.

19 Umakanth Varottil, "The Advent of Shareholder Activism in India," *Journal on Governance* 1, no. 6 (2012): 602.

20 Varottil, "The Advent of Shareholder Activism in India," 603-604.

India’s Path to a Stewardship Code

Stewardship has been defined as “the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society.”[a] As described by Blackrock, one of the world’s leading institutional investors, stewardship can promote corporate governance practices that encourage long-term value creation for a public company’s shareholders.[b] Stewardship codes promote the idea that institutional investors’ fiduciary duties include focusing on the company’s long-term goals[c] by requiring the investors to actively monitor and engage with the public company on material matters.[d]

In 2010, the UK Financial Reporting Council rolled out its seven stewardship principles. These UK principles have been adopted almost entirely by many countries, including India.[e] Since the UK’s adoption of its stewardship principles, various countries have adopted stewardship codes, including South Africa, Japan, Singapore, Hong Kong, Taiwan, Brazil, and now India.

The regulators’ imposition of stewardship responsibilities upon institutional investors was driven by increasing institutional holdings in Indian firms. While in 2009 promoter-controlled companies owned 64 percent of companies listed on the India National Stock Exchange (NSE), they now hold about 54 percent.[f] In 2009, institutional investors controlled 24 percent of NSE-listed companies; in 2020, they controlled 35 percent of the market.[g]

Several codes have been adopted in India, including the IRDA Stewardship Guidelines for Insurers, adopted in March 2017, and the Common Stewardship Code, adopted by the PFRDA in May 2018.[h] Most recently, SEBI mandated that all mutual funds and all categories of AIFs create and implement a stewardship code by July 1, 2020.[i]

While most other countries have adopted a comply-or-explain (CorEx) approach to stewardship,[j] both the PFRDA and SEBI implemented mandatory stewardship codes, while the IRDA code is CorEx.[k] Experts have

a *Building a Regulatory Framework for Effective Stewardship, Discussion Paper DP19/*1, Financial Conduct Authority and Financial Reporting Council, January 2019, p. 11.

b *One India, One Stewardship,* Institutional Investor Advisory Services India Limited, 1.

c *One India, One Stewardship,* Institutional Investor Advisory Services India Limited, 1.

d “Responsible Shareholder Engagement: The Case for an Indian Stewardship Code,” *Institutional EYE Blog*, Institutional Investor Advisory Services India Limited, January 2, 2017.

e *One India, One Stewardship*, Institutional Investor Advisory Services India Limited, 1.

f *Five Trends That Will Shape the Governance Landscape* in the 2020’s, Institutional Investor Advisory Services India Limited, January 17, 2020, pp. 1–2.

g *Five Trends That Will Shape the Governance Landscape in the 2020’s*, Institutional Investor Advisory Services India Limited, pp. 1–2.

h *One India, One Stewardship*, Institutional Investor Advisory Services India Limited, 1.

i “Coronavirus: Sebi Extends Implementation of Stewardship Code till July 1,” *Financial Express*.

j Pammy Jaiswal, “SEBI’s Stewardship Code for Institutional Investors,” *IndiaCorpLaw Blog*, February 11, 2020.

k Umakanth Varottil, “Shareholder Stewardship in India: The Desiderata,” National University of Singapore Law Working Paper No. 2020/005, February 2020, p. 23.

India's Path to a Stewardship Code *continued*

commented that the mandatory approach is more appropriate for India, due to several issues that prevent successful implementation of CorEx.[l] For example, the general lack of desire among company directors to improve governance standards shows little concern for the interests of stakeholders who do not have a voice in the board room.[m] Other factors include a lack of clear disclosure on company corporate governance policies, and low shareholder activism.[n]

The Principles of India's Stewardship Codes

SEBI, IRDA, and PFRDA each published regulations that required institutional investors of mutual funds, AIFs, insurers, and pension funds, respectively, to adopt stewardship codes that meet the following six principles. These six principles are almost identical to the principles laid out in the UK stewardship code.[o]

- *Principle 1: Formulate a policy on the discharge of stewardship responsibilities and publicly disclose that policy.*[p] Institutional investors must create and implement a comprehensive policy that contains a framework for investors, as stewards, to monitor and engage with the investee company on matters such as performance, strategy, risk structure, governance, and capital structure. The policy must provide the mechanisms that will ensure compliance with stewardship responsibilities. This policy must be publicly disclosed on the company's website and be reviewed periodically.[q]
- *Principle 2: Have a clear and detailed policy to manage conflict of interest.*[r] Institutional investors must identify areas where conflicts of interest may arise.[s] The policy must also provide a plan to mitigate or resolve potential conflicts of interest such as a blanket ban on certain investments that may present a conflict,[t] a conflicts of interest committee, the recusal of interested persons in any potentially problematic transactions,[u] and the maintenance of records and minutes of decisions undertaken to manage such conflicts.[v]
- *Principle 3: Monitor the business of the investee company.*[w] Institutional investors must codify how they will monitor their investee companies for performance and compliance with regulations. The company's operational and financial performance, corporate governance of the board and related party transactions, shareholders' rights and grievances, and risks including environmental, social, and governance (ESG) risk are all potential areas to be monitored.[x]
- *Principle 4: Establish clear policies on when and how the investors will intervene as stewards in the companies, as well as how to act collaboratively with other institutional investors.*[y] Potential reasons to intervene include the company's poor financial performance, corporate governance–related practices, remuneration strategy, ESG

l Nawshir Mirza and Nirmal Mohanty, *Comply or Explain—An Alternate Approach to Corporate Governance*, NSE Centre for Excellence in Corporate Governance Quarterly Briefing, January 2014, p. 3.

m Mirza and Mohanty, *Comply or Explain—An Alternate Approach to Corporate Governance*, 4–5.

n Mirza and Mohanty, *Comply or Explain—An Alternate Approach to Corporate Governance*, 4–5.

o *One India, One Stewardship*, Institutional Investor Advisory Services India Limited, 1.

p Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

q Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

r Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

s Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

t Rohan Banerjee, "Being Responsible Corporate Citizens—How Mutual Funds and Alternative Investment Funds Will Rise Up to the Stewardship Code," *India Corporate Law Blog*, Cyril Amarchand Mangaldas, January 13, 2020.

u Banerjee, "Being Responsible Corporate Citizens."

v Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

w Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

x Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

y Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

India's Path to a Stewardship Code *continued*

risk, leadership issues, and litigation. The code must also include clear provisions that allow for collaboration with other institutional investors, when necessary, to meet or fulfill the interests of all investors of the company.[z]

- *Principle 5: Establish a clear policy on voting and public disclosure of those voting rights.*[aa] The investors' voting policies should disclose voting rights and activities, including the mechanisms to be used for voting (such as e-voting, physical attendance, and/or proxy voting), guidelines on how to vote, and factors that must be considered while voting on proposals. The details of votes cast should be disclosed on a quarterly basis.[ab]

- *Principle 6: Periodic reporting on the implementation of the above stewardship principles.*[ac] Institutions must periodically update the other investors and stakeholders in the company on how they have fulfilled their stewardship obligations by implementing the above five principles.[ad] These periodic reports are to be published publicly on the company's website.[ae]

Examining the Indian Approach to Stewardship

Scholars and experts have just begun to explore the ramifications of India's stewardship approach. For instance, as India already imposes considerable stakeholder responsibilities on boards, stewardship codes have the potential to effectively supplement the stakeholder approach of Indian corporate law.[af]

z Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

aa Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

ab Banerjee, "Being Responsible Corporate Citizens."

ac Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

ad Banerjee, "Being Responsible Corporate Citizens."

ae Jaiswal, "SEBI's Stewardship Code for Institutional Investors."

af Varottil, "Shareholder Stewardship in India: The Desiderata," 3–4.

Several other points have arisen that deserve additional attention. Experts argue that India suffers from "fragmented stewardship" among the three different codes imposed on the insurance, pension fund, mutual funds, and AIF sectors.[ag] The IiAS, for example, recommends that regulators work together and develop one stewardship code for India, because investors would welcome a more cohesive approach.[ah]
Another common criticism of India's stakeholder approach to corporate governance is that it is unclear whether the nonshareholder constituencies have any direct enforcement remedies in the case of a breach of directors' duties to not take into account stakeholder interests.[ai] Umakanth Varottil, for example, suggests that a stewardship regime may enable shareholders to use existing remedies (such as shareholder derivatives or class action lawsuits) to protect broader stakeholder interests.[aj] However, enforcement actions brought by institutional investors may not be an immediate cure to this problem, due to the notorious delays of the Indian legal system.[ak]

ag *One India, One Stewardship*, Institutional Investor Advisory Services India Limited, 1.

ah *One India, One Stewardship*, Institutional Investor Advisory Services India Limited, 1.

ai Varottil, "Shareholder Stewardship in India: The Desiderata," 21

aj Varottil, "Shareholder Stewardship in India: The Desiderata," 21

ak Afra Afsharipour, "Redefining Corporate Purpose: An International Perspective," *Seattle University Law Journal* 40 (2017): 465, 491, discussing the problem of delayed regulatory and judicial enforcement in India's legal system.

The SEBI (Research Analysts) Regulations, 2014 provide for the oversight and regulation of proxy advisors.[21] All persons who provide advice, through any means, to institutional investors or shareholders of a company, in relation to exercise of their rights in the company, including recommendations on public offer or voting recommendations on agenda items, fall under the ambit of proxy advisors that must be registered with SEBI. The regulations, inter alia, require proxy advisors to maintain an arms-length relationship between their research and other business activities, and to also have policies in place that ensure no research report or analysis is used to manipulate the market.

The Corporate Governance Role of Nonpromoter Shareholders

Why is this important? Experts contend that corporate governance results in enhanced corporate performance and can lead to increased economic growth.[22] Corporate governance affects the development and functioning of capital markets and exerts a strong influence on resource allocation.[23] The Birla Committee[24] emphasized that, due to their collective stakes, institutional shareholders can sufficiently influence the policies of the company such that the company they have invested in complies with the corporate governance code, which in turn can maximize shareholder value. According to the Birla Committee report, a good corporate framework is one that provides adequate avenues to the shareholders for effective contribution to the governance of the company while insisting on a high standard of corporate behavior that does not interfere with the day-to-day functioning of the company.

Learning from past experiences. Post-liberalization, institutional investors have had a traceable influence on the corporate governance practice of Indian companies. The advent of foreign institutional investors (FIIs) and private sector mutual funds has transformed the institutional investor landscape. FIIs tend to exercise their shareholder rights more actively than domestic mutual funds and insurance companies do.

There is strong evidence that companies with good corporate governance practices have attracted institutional investors. However, there have been some outliers. For example, Satyam was listed in India and had its American Depository Receipts (ADRs) listed on the New York Stock Exchange (NYSE). It had many large institutional holders, such as Aberdeen Asset Management, Fidelity, ICICI Prudential, Lazard Asset Management LIC, JP Morgan AMC Europe, Government of Singapore, Morgan Stanley Mauritius, Citigroup Global Markets Mauritius, and Swiss Finance, among others.[25]

In a 2019 study by IiAS, an increase in investor engagement levels was noted in BSE 100 companies. The study further notes that, in one instance, the promoter's resignation was not accepted by the lenders so as to ensure that the promoter would continue to bear the responsibility.[26]

Laws Relating to the Rights of Minority Shareholders

The primary law that governs corporate governance for incorporated entities is the Companies Act. Apart from the Companies Act, another important law from a corporate governance perspective is the SEBI (Prohibition of Insider Trading) Regulation, 2015.[27]

The Companies Act provides certain protections to minority investors. Broadly, there are three situations under which minority shareholders (any shareholder holding less than 50 percent of the paid-up capital of a company) can approach the National Company Law Tribunal (NCLT):

21 Securities and Exchange Board of India (Research Analysts) Regulations, 2014, *Gazette of India*, pt. III sec. 4 (Sept. 1, 2014), hereafter SEBI (Research Analysts) Regulations.

22 Maria Maher and Thomas Andersson, *Corporate Governance: Effects on Firm Performance and Economic Growth*, Organization for Economic Co-operation and Development [OECD] (1999).

23 Maher and Andersson, *Corporate Governance: Effects on Firm Performance and Economic Growth*, para. 6.

24 Kumar Mangalam Birla et al., *Report of the Kumar Mangalam Birla Committee on Corporate Governance*, Securities and Exchange Board of India, 1999 [hereinafter Birla Report].

25 As of September 30, 2009, according to the shareholding pattern on the BSE.

26 *Corporate Governance Scores 2019: Stability Despite Headwinds*, International Finance Corporation, Bombay Stock Exchange, and Institutional Investor Advisory Services India Limited, December 2019; Hetal Dalal, "Policy: Will 2020 Mark a Positive Shift In India's Corporate Governance?" *Moneycontrol*, May 11, 2020.

27 Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, *Gazette of India*, pt. III sec. 4 (Jan. 15, 2015) [hereinafter SEBI (Prohibition of Insider Trading) Regulations].

Institutional Shareholder Activism: Some Highlights

The year 2017 marked a significant shift in shareholder activism trends in India. The number of cases in which shareholders dissented from their board and management was unprecedentedly high, as compared with previous years.[a] Until 2017, most shareholder activist campaigns in India were driven by individuals. However, in 2017, a majority of the campaigns were brought by institutional investors.[b] Below are a few highlighted cases of institutional shareholder activism.

Raymond Limited—Shareholder voting. In 2017, Raymond Limited proposed a related party transaction (RPT) to sell one of the company's prime properties to its chair and his relatives at a price below 10 percent of its market value. Even though the company acknowledged that this transaction would result in a loss for the company, the board and the audit committee approved the transaction.[c] In response, 50 percent of Raymond Limited's institutional shareholders exercised their voting rights. Of this 50 percent who decided to vote, 99.61 percent voted against the proposal; 92.35 percent of noninstitutional shareholders voted against the proposal as well. Promoters were not allowed to vote because it was an RPT. The proposal failed to pass, with a total of 97.67 percent of shareholder (both institutional and noninstitutional) votes cast against the resolution.[d]

a "2017 Becomes Tipping Point of Shareholder Activism in India," *Moneylife*, November 28, 2017.

b "2017 Becomes Tipping Point of Shareholder Activism in India," *Moneylife*.

c "2017 Becomes Tipping Point of Shareholder Activism in India," *Moneylife*.

d "2017 Becomes Tipping Point of Shareholder Activism in India," *Moneylife*.

Alembic Pharmaceuticals Ltd—Independent director appointment. In August 2017, Alembic Pharmaceuticals received a proposal from Unifi Capital Pvt. Ltd., a portfolio fund manager, to appoint an independent director to represent small shareholders to the board. Unifi Capital held about 3 percent of the shares in the company and gathered the support of almost 1,000 small shareholders for this proposal. The Companies Act, 2013 (Companies Act, or Act) provides for the appointment of a director representing the interests of small shareholders.[e] However, the company retains discretion on whether to appoint a small shareholder director.[f]

The Alembic Pharmaceuticals board rejected the proposal, stating a conflict of interest since the proposed director was the vice president of Unifi Capital[g] and a director in various Unifi group entities,[h] and because Unifi Capital and its group companies were linked to larger shareholders of Alembic.[i] In addition, the 914 shareholders who submitted the proposal were also Unifi clients.[j] However, InGovern Research Services and IiAS, two prominent proxy advisory firms, stated that the Alembic board had no meaningful reason for rejecting this proposal.[k] The Companies Act does not specify where the small shareholders must come from or what kind of association they must have.[l]

e Sajeet Manghat, "Beware India Inc., a Portfolio Fund Manager Has Turned Shareholder Activist," *BloombergQuint*, July 25, 2017.

f P.B. Jayakumar, "A Board Seat," *Business Today*, September 10, 2017.

g Jayakumar, "A Board Seat."

h Sohini Das and Aneesh Phadnis, "Shareholder Activism at Alembic Pharma: Issue Unlikely to Die in a Hurry," *Business Standard*, July 30, 2017.

i Das and Phadnis, "Shareholder Activism at Alembic Pharma: Issue Unlikely to Die in a Hurry."

j Das and Phadnis, "Shareholder Activism at Alembic Pharma: Issue Unlikely to Die in a Hurry."

k Das and Phadnis, "Shareholder Activism at Alembic Pharma: Issue Unlikely to Die in a Hurry."

l Das and Phadnis, "Shareholder Activism at Alembic Pharma: Issue Unlikely to Die in a Hurry."

Institutional Shareholder Activism: Some Highlights *continued*

Unifi Capital's proposal to appoint a director to represent small shareholders was a seminal case because it was the first time a set of sophisticated domestic investors took a firm stance to challenge the board.[m] This case was an example of active shareholder engagement that went beyond simply exercising their voting rights.[n] While Unifi Capital's proposal was ultimately unsuccessful, experts agree that it set a positive precedent for the possibility of small shareholders to appoint a small shareholder director to the board in the future.[o]

HDFC—Director reappointment and shareholder voting. In 2018, Deepak Parekh was up for reappointment as the nonexecutive chairman of the Housing Development Finance Corporation (HDFC), India's largest mortgage lender.[p] Parekh had served in leadership positions of HDFC for almost 30 years.[q] However, several U.S. proxy advisory firms advised shareholders to vote against the reappointment of Parekh to the HDFC board because he also served as a director of eight other companies.[r] The concern was that the time constraints of serving on too many boards would prevent Parekh from effectively fulfilling his fiduciary responsibilities to HDFC.[s] Foreign institutional investors own more than 72 percent of shares in HDFC.[t] Parekh's reappointment as nonexecutive chairman was just barely approved, with 77.36 percent of shareholders voting in favor. A 75 percent approval was required for the reappointment, and nearly 23 percent of the shareholders voted against his continuation.

m Deepali Gupta, "Small Investors Look to Raise Concerns about Undervalued Holding Companies," *Economic Times*, September 6, 2017.

n Varottil, "Shareholder Stewardship in India: The Desiderata," 21.

o "2017 Becomes Tipping Point of Shareholder Activism in India," *Moneylife*; Jayakumar, "A Board Seat."

p "Deepak Parekh Reappointed HDFC Director Even as 22.64% Shareholders Voted Against," *Livemint*, July 31, 2018.

q Shilpy Sinha, "Being on Boards of Eight Other Companies Went Against Deepak Parekh at HDFC Vote," *Economic Times*, August 1, 2018.

r "Deepak Parekh Re-Appointed as Non-Executive Director on the Board of HDFC," *Business Standard*, August 1, 2018.

s Sinha, "Being on Boards of Eight Other Companies Went Against Deepak Parekh at HDFC Vote."

t Sinha, "Being on Boards of Eight Other Companies Went Against Deepak Parekh at HDFC Vote."

1. oppression and mismanagement;[28]
2. variation in shareholders' rights;[29] and
3. derivative rights of shareholders.[30]

Remedies against oppression and mismanagement can be availed of by filing an application under Section 241 of the Companies Act to the NCLT for relief. On the occurrence of a variation of rights attached to any class of shares, minority shareholders may seek this remedy. The Act also allows shareholders to bring a derivative action, which allows shareholders to sue on behalf of the company. Under a derivative action, any member of the company may pursue a claim on behalf of the company against any director(s) who breach their fiduciary duty toward the company. The company joins in as a codefendant, is the beneficiary of the suit, and is entitled to enforce the judgment. Further, Section 245 of the Companies Act empowers shareholders and members and depositors to bring class actions, which are discussed at greater length in this chapter.

While there are many potential benefits to the use of private enforcement of corporate governance by minority shareholders, there are also significant limitations in the enforcement regime in India.[31] While some of these limitations are limitations of the laws in effect, others are due to the ownership structure of Indian firms. As Khanna notes, "[t]he importance of business families, founders and powerful bureaucrats running most major firms in India may create an atmosphere of reticence in challenging these controllers in open court and a preference for less visible challenges or for resolutions that keep disputes out of the public view."[32]

28 The Companies Act, 2013, Sections 241–46, No. 18, Acts of Parliament, 2013 (Aug. 29, 2013).

29 The Companies Act, 2013, Section 48.

30 The Companies Act, 2013.

31 Vikramaditya Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" in *Enforcement of Corporate and Securities Law*: *China and the World*, ed. Robin Hui Huang and Nicholas Calcina Howson (Cambridge: Cambridge University Press, 2017), 333–58.

32 Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" pp. 333–58.

Oppression and mismanagement. The Companies Act provides mechanisms for redress to minority shareholders when their rights and interests have been violated.[33] Minority shareholders have rights under Sections 241 to 244 to apply to the NCLT for relief in cases of oppression and mismanagement.[34] The minimum preconditions for making the application are the following:

- at least 100 members of the company or at least one-tenth of the total number of its members, whichever is less; or
- any member or members holding not less than one-tenth of the issued share capital of the company, provided that all calls and other sums due on their shares have been paid; and
- in the case of a company not having a share capital, not less than one-fifth of the total number of its members.

The application by members to the NCLT may be on these grounds:

- that the company's affairs are being conducted in a manner (1) prejudicial to public interest, or (2) prejudicial or oppressive to any member or members, or (3) prejudicial to the interests of the company;
- that a material change has taken place in the management or control of the company, whether by an alteration in the board of directors, or of the manager, or in the ownership of the company's shares or its membership, as the case may be, or in any other manner, and that due to such a change it is likely that the affairs of the company will be conducted in a manner prejudicial to its interests or its members or any class of members. It is to be noted that such a change should not be a change brought about by, or in the interests of, any creditors, including debenture holders or any class of shareholders of the company.

Under the Companies Act, the NCLT has the discretion to waive any of the above requirements to enable aggrieved members to apply for relief. Since the Act has introduced the element of prejudice caused to shareholders, which did not exist under the Companies Act, 1956,

33 Oppression and mismanagement actions previously could be brought under Sections 397 to 399 of the Companies Act, 1956. The Companies Act, 2013, Sections 397–99.

34 The Companies Act, 2013, Sections 241–46.

Derivative Suits in India

While derivative suits are available in India, few derivative cases have been brought.[a] In their 2012 study, Khanna and Varottil find that, over a 60-year period, only 10 derivative suits reached the High Courts or the Supreme Court in India. Of these 10 cases, only three were permitted to move forward. Khanna and Varottil attribute the lack of derivative actions in India to several factors, including (1) the limitations of the common law standard that holds that if a majority of shareholders approve a particular activity, the suit becomes ineffective, a significant hurdle in a regime where controlling stockholders can often ratify a particular action; (2) lack of fiduciary duties for controlling stockholders; and (3) a paucity of case law explicating the fiduciary duties of directors.[b]

a Vikramaditya S. Khanna and Umakanth Varottil, "The Rarity of Derivative Actions in India: Reasons and Consequences" in *Derivative Actions in Major Asian Economies: Legislative Design and Legal Practice*, ed. Harald Baum, Michael Ewing-Chow, and Dan W. Puchniak (Cambridge: Cambridge University Press, 2012).

b Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" pp. 333–58.

the Act widens the scope of challenge by a petitioning shareholder by reducing the standard of conduct that needs to be fulfilled to access this remedy. However, the Act continues to require the petitioning shareholder also to show grounds for a just and equitable winding up of the company. Whether this two-pronged requirement makes this remedy truly effective or rather renders it cumbersome needs to be tested.[35]

In a recent dispute, the Mumbai Bench of the NCLT dealt with a rare case of promoter directors being majority shareholders of a company seeking remedies under Sections 241 to 244 of the Act. The petitioning majority shareholders, holding around 60 percent stake in the company (the petitioners) approached the NCLT, seeking to restrain investors holding around 40 percent stake in the company (the respondents), from deliberately obstructing the promoter directors from carrying out certain functions fundamental to the existence of the company, such as approving the renewal and extension of credit facilities to the company by banks. The petitioners also alleged misconduct on the part of the respondents by averring that the respondents did not cooperate in conducting board meetings and passing the requisite resolutions, and carried out correspondence with the concerned banks in breach of their obligations, and in doing so jeopardized the very existence of the company by hindering the bank finance arrangements. While the main proceedings are pending before the NCLT, the NCLT has, in July 2020, granted interim reliefs to the petitioners, by injuncting the respondents from, inter alia, preventing any ongoing credit facility extended to the company by its banks or any extension thereof.[36]

(*continued on p. 213*)

35 Umakanth Varottil, "Unpacking the Scope of Oppression, Prejudice and Mismanagement Under Company Law in India," NUS Law Working Paper No. 2020/020, July 2020.

36 National Company Law Tribunal (Mumbai Bench, Mumbai), Jasdanwalla v. New Consolidated Constr. Co. Ltd. (July 29, 2020).

Principles and Technical Requirements for Sustaining an Action for Oppression and Mismanagement

Prior to the passage of the Companies Act, oppression and mismanagement claims could be brought under Sections 397 to 399 of the Companies Act, 1956. As experts have noted, such claims were not viewed as particularly significant "because the most common remedy available was an injunction."[a] While oppression cases under Section 397 of the Companies Act, 1956 were the bulk of shareholder remedies in India, the remedy was interpreted narrowly by the courts.[b] Moreover, the Company Law Board (the precursor to the NCLT), could protect directors from liability under Section 633 of the Companies Act, 1956 if it was shown that directors acted honestly and reasonably. As with litigation in India more generally, oppression and mismanagement claims experienced "lengthy delays so that any recovery probably has a substantially reduced real value to a litigant."[c] To date, few cases have been brought under Sections 241 to 244 of the Companies Act.

Conditions to Be Satisfied for Invoking Section 397 of the Companies Act, 1956

V.S. Krishnan v. Westfort Hi-Tech Hospital Ltd. [2008] 83 SCL 44/142 Comp. Cas. 235 (SC)

The judgment specifies situations in which a case of oppression can be brought and confirms the principle that mere unfairness does not constitute oppression.[d] From several judgments of the Supreme Court, it is clear that oppression would be brought

1. where the conduct is harsh, burdensome, and wrong;
2. where the conduct is mala fide and is for a collateral purpose, where although the ultimate objective may be in the interest of the company, the immediate purpose would result in an advantage for some shareholders vis-à-vis others;
3. where the action is against probity and good conduct;
4. where the oppressive act complained of may be fully permissible under law, yet may be oppressive and, therefore, the test as to whether an action is oppressive or not is not based on whether it is legally permissible or not (where an action is legally permissible, but it is otherwise against probity or good conduct or is burdensome, harsh, or wrong, or is mala fide, or for a collateral purpose, it would amount to oppression under Sections 397 and 398 of the Companies Act, 1956); or
5. where conduct is found to be oppressive under Sections 397 and 398, in which case the discretionary power given to the Company Law Board (CLB) under Section 402 of the Companies Act, 1956 to set right remedy or put an end to such oppression was very wide.

What facts would give rise to or constitute oppression is basically a question of fact and, therefore, whether an act is oppressive or not is fundamentally a question of fact.

a Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" 333–58.

b Varottil, "Unpacking the Scope of Oppression, Prejudice and Mismanagement Under Company Law in India."

c Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" 333–58.

d Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" 11.

Principles and Technical Requirements for Sustaining an Action for Oppression and Mismanagement *continued*

Principles Governing Section 397

Elder v. Elder & Watson Ltd. [1952] SC 49/George Meyer v. Scottish Cooperative Wholesale Society Ltd. [1954] SC 381/Scottish Co-operative Wholesale Society Ltd. v. Meyer [1958] 3 All ER 66

The court held that when a parent company is engaged in the same business as one of its subsidiaries, and the subsidiary has a minority of independent shareholders, the parent company must conduct its affairs in a way that is fair to the subsidiary.[e] Thus, if the controlling shareholders act with intent to destroy the subsidiary's business, and the minority shareholders suffer a loss, a case of oppression can be made under Section 210/ Section 397.[f]

The court noted that the following principles govern section 210 of the English Companies Act, Section 397 of the Companies Act, 1956:

1 The oppression of which a petitioner complains must relate to the manner in which the affairs of the company concerned are being conducted, and the conduct complained of must be such as to oppress a minority of the members (including the petitioners) *qua* shareholders.

2 It follows that the oppression complained of must be shown to be brought about by a majority of members exercising as shareholders a predominant voting power in the conduct of the company's affairs.

3 Although the fact relied on by the petitioner may appear to furnish grounds for the making of a winding up order under the 'just and equitable' rule, those facts must be relevant to disclose also that the making of a winding up order would unfairly prejudice the minority members *qua* shareholders.

4 Although the word 'oppressive' is not defined, it is possible, by way of illustration, to figure a situation in which majority shareholders, by an abuse of their predominant voting power, are 'treating the company and its affairs as if they were their own property' to the prejudice of the minority shareholders and in which just and equitable grounds would exist for the making of a winding up order … but in which the 'alternative remedy' provided by Section 210 by way of an appropriate order might well be open to the minority shareholders with a view to bringing to an end the oppressive conduct of the majority.

5 The power conferred on the court to grant a remedy in an appropriate case appears to envisage a reasonably wide discretion vested in the court in relation to the order sought by a complainant as the appropriate equitable alternative to a winding up order:

It is not enough if it is established that the company's affairs have been conducted unwisely or inefficiently or carelessly:

K.P. Chackochan v. Federal Bank [1989] 66 comp. Cas. 953 (Ker.)

In issuing the opinion, the court held that while the misuse of official machinery in the present case may have been oppressive, it was an isolated act, and not an ongoing or continued oppression required for a valid

e *Scottish Co-operative Wholesale Soc'y Ltd. v. Meyer* [1958] 3 All ER 66.

f *Scottish Co-operative Wholesale Soc'y Ltd. v. Meyer* [1958] 3 All ER 66.

Principles and Technical Requirements for Sustaining an Action for Oppression and Mismanagement *continued*

Section 397 claim.[g] The court noted that in order to grant relief under Section 397, a petitioner must show three things:

1. The facts pleaded justify the making up of a winding up order on the 'just and equitable' ground, but the winding up would unfairly prejudice the shareholders, including the petitioners who support the petition, but an order passed under Section 402 would grant them appropriate relief.
2. The affairs of the company are being conducted in a manner oppressive to some part of the members/shareholders, including the petitioners. It is to be noted here that the section does not require that the oppressed members should be the majority. 'Shareholders with a minority beneficial interest may, by having voting control, be able to oppress those with the majority beneficial interest.' The oppression complained of must be suffered by the shareholders in their capacity as shareholders and not in their character as directors. The expression employed in the section 'the affairs of the company that are being conducted' indicates, not isolated acts of oppression, 'but a continuing process, and one continuing down to the date of the petition.' It is pertinent to note that it is not enough if it is established that the company's affairs have been conducted unwisely or inefficiently or carelessly. Under such circumstance also, a shareholder can contend that he has lost confidence in the manner in which the affairs of the company are conducted. That is not sufficient. That is not oppression; nor is resentment at being outvoted a ground for relief under this section.
3. To wind up the company would unfairly prejudice the oppressed members.

Principles for the Application of Section 397

V.M. Rao v. Rajeswari Ramakrishnan [1987] 61 Comp. Cas. 20 (Mad.)

The court found that the following principles must be kept in view when considering a claim of oppression:[h]

1. The oppression complained of must affect a person in his capacity or character as a member of the company; harsh or unfair treatment in any other capacity, e.g., as a director or a creditor, is outside the purview of the section.
2. There must be continuous acts constituting oppression up to the date of the petition.
3. The events have to be considered not in isolation but as a part of a continuous story.
4. It must be shown as preliminary to the application of section 397 that there is just and equitable ground for winding up the company.
5. The conduct complained of can be said to be "oppression" only when it could be said that it is burdensome, harsh, and wrongful; oppression involves at least an element of lack of probity and fair dealing to a member in matters of his proprietary right as a shareholder.

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g *K.P. Chackochan v. Federal Bank*, (1989) 66 Comp. Cas. 953, at 14.

h *V.M. Rao v. Rajeswari Ramakrishnan*, (1987) 61 Comp. Cas. 20 (Mad.).

Principles and Technical Requirements for Sustaining an Action for Oppression and Mismanagement *continued*

The Meaning of "Oppression"

Palghat Exports Private Ltd. v. T.V. Chandran [1994] 79 Comp. Cas. 213 (Ker.)

In Section 397 claims, the question in each case is whether the conduct of the affairs of a company by the majority shareholders was oppressive to the minority shareholders.[i] The term "oppression" in Section 397 is not defined by the legislature, and thus the court must interpret and clarify its meaning.[j] The opinion evaluates case law on this topic to determine what exactly needs to be shown to prove oppression.[k]

> It is not enough to show that there is just and equitable cause for winding up the company, though that must be shown as preliminary to the application of Section 397. It must further be shown that the conduct of the majority shareholders was oppressive to the minority as members and this requires that events have to be considered not in isolation but as a part of a consecutive story. There must be continuous acts on the part of the majority shareholders, continuing up to the date of petition, showing that the affairs of the company were being conducted in a manner oppressive to some part of the members. The conduct must be burdensome, harsh, and wrongful and mere lack of confidence between the majority shareholders and the minority shareholders would not be enough unless the lack of confidence springs from oppression of a minority by a majority in the management of the company's affairs, and such oppression must involve at least an element of lack of probity or fair dealing to a member in the matter of his proprietary rights as a shareholder.[l]
>
> It is clear from these various decisions that on a true construction of Section 397, an unwise, inefficient or careless conduct of a director in the performance of his duties cannot give rise to a claim for relief under that section. The person complaining of oppression must show that he has been constrained to submit to a conduct which lacks in probity, conduct which is unfair to him and which causes prejudice to him in the exercise of his legal and proprietary rights as a shareholder.
>
> *Needle Industries (India) Ltd. v. Needle Industries Newey (India) Holding Ltd.* [1981] 51 Comp. Cas. 743 wherein the Supreme Court observed, after reviewing the English as well as Indian authorities, thus (at p. 782).[m]

The court notes that in every case under Section 397, it is obligatory on the part of the complainant to establish "persistent and persisting course of unjust conduct." A survey of judicial decisions, though not exhaustive, would indicate the following acts of the controlling shareholders to be oppressive to minority shareholders:

1 The power exercised by the controlling shareholders is directed to destroy the company's business.

2 Usurping the power and obtaining the entire power and exercising it against the wishes of the shareholders who are in a minority with regard to voting power.

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i *Palghat Exps. Private Ltd. v. T.V. Chandran*, (1994) 79 Comp. Cas. 213 (Ker.), at 6.

j *Palghat Exps. Private Ltd. v. T.V. Chandran*, (1994) 79 Comp. Cas. 213.

k *Palghat Exps. Private Ltd. v. T.V. Chandran*, (1994) 79 Comp. Cas. 213.

l *Palghat Exps. Private Ltd. v. T.V. Chandran*, (1994) 79 Comp. Cas. 213.

m *Palghat Exps. Private Ltd. v. T.V. Chandran*, (1994) 79 Comp. Cas. 213, at 8.

Principles and Technical Requirements for Sustaining an Action for Oppression and Mismanagement *continued*

3. Denying voting rights to the shareholders.
4. The directors refuse to distribute compensation money obtained on nationalization of the company.
5. The company undertakes business other than those mentioned in the objects' clause without calling a general meeting or passing a resolution.
6. The company exercises the power by majority to expel members.
7. Deadlock is created in carrying out the affairs of the company due to lack of faith between two factions of the family.
8. The directors and managing directors are consistently not functioning in their office.
9. The directors are not taking an interest in the affairs of the company and are always quarrelling, so as to cause loss to the company.
10. In a company where there are only two shareholders who are directors and one director, who has got majority shares, refuses to cooperate with the affairs of the company and exhibits mutual lack of confidence not to be settled otherwise than by taking it to court, by mutual domestic policy.
11. The directors refuse to register shares in the name of the complaining petitioners with the object of retaining control over the affairs of the company.

CLASS ACTION UNDER THE COMPANIES ACT

Section 245 of the Companies Act empowers members, depositors, or any class of them to approach the NCLT on behalf of members or depositors, as the case may be, if in their view the company's affairs are being conducted in a manner prejudicial to the interests of the company, the members, or the depositors. Experts doubt whether the availability of class actions will be successful in addressing corporate governance concerns in India. For example, Khanna notes that "class actions are likely to be of limited value because of (1) the glacial speed of the Indian courts, (2) the lack of contingency fees, (3) the limited availability of monetary remedies under the class action provision, and (4) the interaction between ownership structure in India—virtually all firms are controlled—and the absence of fiduciary duties owed by controllers to minority shareholders."[37] In fact, without any fiduciary duties imposed on controlling stockholders, the class action may simply be "a procedural device that is only weakly tethered to an underlying duty."[38]

In such an action brought by the members or depositors, the following reliefs may be sought from the NCLT:

- restraining the company from committing acts which are ultra vires the articles or memorandum of the company, or any acts in violation of the Act or any other law;
- restraining the company from breaching any provisions of its memorandum or articles;
- declaring that a resolution altering the memorandum or articles of the company is void, since it had been passed by suppression of material facts or obtained by misstatement to the members or depositors;
- restraining the company and its directors from acting on such a resolution;

37 Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" 333–58.

38 Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" 333–58.

- restraining the company from acting contrary to any resolution passed by the members;
- seeking damages or compensation or any other suitable action from or against
  - the company or its directors—for any fraudulent, unlawful, or wrongful act or omission or conduct or any likely act or omission or conduct on its or their part;
  - the auditor including the audit firm of the company—for any improper or misleading statement of particulars made in the audit report or for any fraudulent, unlawful, or wrongful act or conduct; or
  - any expert or advisor or consultant or any other person—for any incorrect or misleading statement made to the company, or for any fraudulent, unlawful, or wrongful act or conduct or any likely act or conduct on his part;
- or any other remedy as the NCLT may deem fit.

To bring about class action proceedings before the NCLT under these provisions, a minimum of one-fifth of the members of the company or a minimum of 100 shareholders of the company (for companies having a share capital) is required, provided that all calls and dues on the shares have been paid in full, or a minimum of 100 depositors.

The NCLT must take into account a few factors in considering such an application made before it. It assesses good faith on the part of the applicant and whether there are alternate remedies available that the member or depositor could utilize instead of an order under this section. The NCLT also considers evidence before it as to the involvement of any person other than directors or officers of the company and the views of the members or depositors of the company who have no personal interest, direct or indirect, in the matter proceeding under this section. Lastly, it also considers whether an act or omission being the cause of action would be authorized or ratified by the company.

Two class action applications for the same cause of action are not permitted. The order passed by the NCLT in such class action proceedings is binding on the company and all its members, depositors, auditors (including audit firms, experts, and consultants), advisors, and all persons associated with the company. Failure to comply with the NCLT order in such proceedings is punishable with a fine of INR 5 lakhs, which may extend to INR 25 lakhs. Every officer who is in default shall be punishable with imprisonment for a term that may extend to three years and with a fine of INR 25,000, which may extend to INR 1 lakh. Frivolous or vexatious applications are rejected, the reasons for which are recorded in writing by the NCLT, and such applicant is required to pay costs up to INR 1 lakh to the opposite party.

As experts have noted, "Section 245 is largely concerned with restraining the behaviour of the firm and its members rather than compensating shareholders."[39] Furthermore, to date, class actions have not been a remedy used in India, and experts doubt their efficacy "given the absence of fiduciary duties owed" by controlling stockholders and given the lack of a provision that permits contingency fees.[40]

OTHER PROVISIONS FOR SAFEGUARDING SHAREHOLDER INTERESTS

E-voting. The Companies Act and the SEBI Listing Regulations also encourage shareholder participation through e-voting. Additionally, the Companies (Management and Administration) Rules, 2014 lay down further norms for executing e-voting processes.

Previously, votes in a shareholder meeting were counted by a show of hands, which meant that physical presence was required in order to vote. Thus, if shareholders were unable to attend a shareholder meeting, they would be unable to vote. This process perpetuated a pattern of low shareholder voter turnout, because of the inconveniences associated with traveling to the meeting or posting the ballot.[41] Additionally, at one vote per hand, smaller

39 Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" pp. 333–58.

40 Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" pp. 333–58. Contingency fees are generally not permitted in India; therefore plaintiffs must pay attorneys directly. "In addition to the certainty of paying court fees, if the plaintiff loses he may have to pay some part of the defendant's legal costs (India follows the English rule on legal costs—'loser pays')," which could amount to substantial out-of-pocket costs for small shareholders. Khanna, "Enforcement of Corporate and Securities Laws in India: The Arrival of the Class Action?" pp. 333–58.

41 Priya Nair, "E-Voting Will Democratize Shareholder Participation," *Business Standard*, July 6, 2014.

shareholders could undermine the interests of larger shareholders, especially if the larger shareholders were absent from a meeting.

However, with the e-voting requirements, companies have to offer a platform to which shareholders can log on to see the proposed resolution and to vote. Now all resolutions must be polled electronically, even those that are presented only at shareholder meetings. E-voting gives even the smallest of shareholders an opportunity to participate in voting on these resolutions.

The e-voting resolution was passed to enhance the participation of minority shareholders. Furthermore, e-voting counts one vote per share held, meaning that the representation of each shareholder's interest is proportional to the number of shares they hold. Thus, larger shareholders have a more representative voice, regardless of their ability to attend shareholder meetings.

Under SEBI guidelines and some provisions of the Companies Act, promoters and controlling shareholders may not vote on transactions in which they have an interest. This includes related party transactions (except transactions with wholly owned subsidiaries or between two government entities), mergers and acquisitions with promoter-owned or promoter-controlled entities, and delisting resolutions. Consequently, public shareholders have a greater role in approving or rejecting certain transactions in which promoters and controlling shareholders may not vote. The adoption of e-voting practices allows these interested minority shareholders to have their voices heard, even if they may not be able to attend a meeting.

It is important to note, however, that with the benefit of increasing minority shareholder participation that comes with e-voting, companies must continue to provide as much knowledge and data as possible to ensure that their shareholders are fully informed and educated. In their role of supporting the company, shareholders must consider decisions that encourage long-term growth, even when their own short-term objectives may not be met.[42]

42 Nair, "E-Voting Will Democratize Shareholder Participation."

INSIDER TRADING REGULATIONS

Effective May 15, 2015, SEBI revised India's 1992 insider trading regulations by introducing the SEBI (Prohibition of Insider Trading) Regulations, 2015 (PIT Regulations).[43] The PIT Regulations, as amended from time to time, tighten the rules on insiders and are largely in line with global approaches to insider trading.

The PIT Regulations redefine key terms, including the definition of an insider, and require companies to implement a code of fair disclosure and conduct for regulating, monitoring, and reporting trading by employees or connected persons, and for fair disclosure of material information.[44] Under the regulations, every listed company, market intermediary, and other persons formulating a code must designate a compliance officer to administer the code and other requirements.[45]

The compliance officer will also monitor trading by employees and connected persons.[46] For example, the compliance officer will review trading plans proposed by insiders.[47] An insider may formulate a trading plan and present it to the compliance officer for approval and public disclosure in accordance with the trading plan. Trading plans are subject to various restrictions, however.[48] For example, the trading plan must be disclosed to the public, and a person cannot trade within six months of the public disclosure. Further, a person subject to a trading plan may not deviate from the plan.

Not only do these regulations prohibit trading in securities when in possession of insider information, they also prohibit the communication or procuration of insider information, except in furtherance of legitimate purposes, performance of duties, or discharge of legal obligation.[49] Additionally, SEBI has recently introduced a whistleblowing mechanism under the PIT Regulations. For further details, please see Chapter Ten: Ethics and Compliance Oversight Practices in India.

43 SEBI (Prohibition of Insider Trading) Regulations.

44 SEBI (Prohibition of Insider Trading) Regulations, Sections 8–9.

45 SEBI (Prohibition of Insider Trading) Regulations, Section 9(3).

46 SEBI (Prohibition of Insider Trading) Regulations, Section 2(1)(c).

47 SEBI (Prohibition of Insider Trading) Regulations, Section 5.

48 SEBI (Prohibition of Insider Trading) Regulations, Section 5(2).

49 SEBI (Prohibition of Insider Trading) Regulations, Section 3(2).

The stakeholder relationship committee. In addition to the provisions for safeguarding shareholders' interests, the Act requires that certain companies have a stakeholder relationship committee. The board of directors of a company having more than 1,000 shareholders, debenture holders, deposit holders, or any other security holders at any time during a financial year is mandated to constitute a stakeholder relationship committee (SRC).[a] Under the SEBI Listing Regulations, this requirement of constituting an SRC to look specifically into various aspects of interest of shareholders, debenture holders, and other security holders applies to all listed companies.[b]

In Corporate Board Practices: 2018 India Edition, a study by The Directors' Collective, it was noted that for NIFTY 500 companies operating in all industries, SRC strength has been recorded as three directors on average (see Figure 11.1).

While, under the Act, the composition of the SRC may be at the discretion of the board, the chair of the SRC is required to be a nonexecutive director.[c] *The Corporate Board Practices: 2018 India Edition* found all NIFTY 500 companies, with a single exception, compliant with this requirement. For listed companies, the SEBI Listing Regulations also require the SRC chair to be a nonexecutive director.[d] In light of the recommendations of the Kotak Committee that were accepted by SEBI, the SEBI Listing Regulations now require the SRC to be composed of at least three directors, with at least one being an independent director and, in the case of a listed entity having outstanding SR equity shares, at least two-thirds of the SRC members are required to be independent directors.[e]

The chair of the SRC shall be required to remain present at annual general meetings of the company to answer queries of the security holders.[f]

The SRC is primarily constituted to resolve the grievances of the security holders of the company and specifically to look into the various aspects of the interests of shareholders, debenture holders, and other security holders. This is outlined in Part D of Schedule II of the SEBI Listing Regulations. In keeping with the opinion of the Kotak Committee, SEBI has now mandated a minimum of one meeting of the SRC every year.[g]

a The Companies Act, Section 178(5).

b Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, *Gazette of India*, pt. III sec. 4 no. 20(1) [hereinafter SEBI Listing Regulations].

c The Companies Act, 2013, Section 178(5).

d SEBI Listing Regulations, pt. III sec. 4 no. 20(2).

e SEBI Listing Regulations, pt. III sec. 4 no. 20(2A).

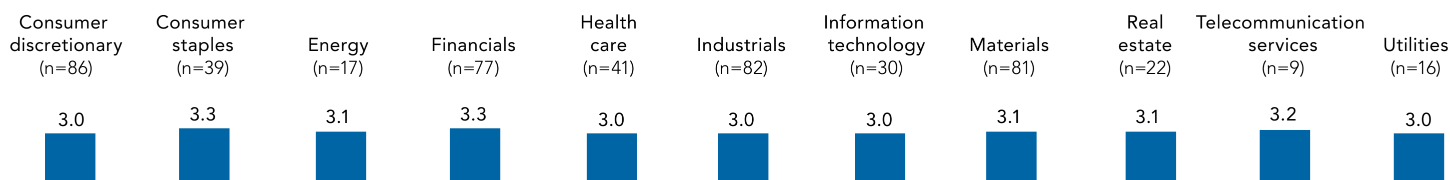
f SEBI Listing Regulations, pt. III sec. 4 no. 20(3).

g SEBI Listing Regulations, pt. III sec. 4 no. 20(3A).

Figure 11.1

SRC Size, by Industry

Number of SRC seats



The Tata Group—Oppression and Mismanagement Issues

The Tata Group's corporate governance challenges came to light when Tata Sons Limited, the holding company of the Tata Group of companies, released a statement in October 2016 indicating that the board had replaced Cyrus Mistry as chairman after his four-year tenure. In this statement, the board also stated that the previous chairman of Tata Sons, Ratan Tata, would be taking over in the interim "in the interest of stability and continuity so that there is no vacuum." Ratan Tata is the chairman of Tata Trusts, the charitable groups that own roughly two-thirds of Tata Sons.

At the time of Mistry's removal, little was known as to the reasoning behind this decision. However, it became clear that Tata Trusts, as principal shareholders, lost confidence in Mistry due to their assessment of his "repeated departures from the culture and ethos of the group." Although this explanation is ambiguous, certain factors related to Mistry's performance point to the potential motives behind his removal. Tata Power, one of the group's companies, acquired Welspun Renewables Energy in June 2016, revealing to the board that Mistry had made decisions on his own, rather than collectively. Mistry also requested that the Tata group of companies no longer engage with the Shapoorji Pallonji group of companies in order to "avoid any perception of a potential conflict of interest," which became an additional point of contention between Mistry and Tata. Furthermore, principal shareholders with Tata Trusts felt that Mistry's strategic plan lacked any sort of concrete direction, making it difficult to maintain faith in his leadership.

In response to being ousted, Mistry wrote a letter to both Tata Sons and Tata Trusts expressing his disbelief over their decision. His letter further highlighted corporate governance issues at the firm and suggested that an accurate valuation of some businesses could result in a write-down of INR 1.18 lakh crore. Mistry defended his term throughout the letter, claiming that he had inherited many of the issues the company was facing and had made the decisions he had to in the moment.

When Mistry was appointed chairman of Tata Sons, he was simultaneously appointed to the board of numerous Tata group companies. Following his removal, Ratan Tata appealed to his shareholders to remove Mistry from the boards of these companies, contending that Mistry's presence would be significantly disruptive and ineffective. Mistry initially refused to step down from the boards of these companies, creating an even greater rift. However, in December 2016, Mistry gave up his board positions at Tata Motors, Tata Steel, Indian Hotels Company, Tata Chemicals, and Tata Power. These companies all had forthcoming shareholder meetings scheduled to discuss Ratan Tata's call to remove Mistry.

Shortly after Mistry's removal, the independent directors of Tata Chemicals, including Nusli Wadia, issued a statement supporting Mistry. Tata Sons immediately moved to oust Wadia from the boards of Tata Chemicals, Tata Steel, and Tata Motors in response. Nusli Wadia's service on these boards was somewhat of a reciprocal arrangement, as Ratan Tata had served on the board of a Wadia group company for 33 years. Tata Sons' decision to seek Wadia's removal fueled the rumors that such decisions were made based on personal matters rather than on professional ones.

One day after Mistry's resignation, Mistry family firms Cyrus Investments and Sterling Investment filed suit against Tata Sons at the National Company Law Tribunal (NCLT), alleging mismanagement and oppression of minority shareholder interests at Tata Sons. The filed suit called for proportionate representation for Shapoorji Pallonji Group directors on the Tata Sons board. Given that the Shapoorji Pallonji Group is the largest shareholder in Tata Sons and owned by Mistry's family, Mistry sought to prevent interference by trustees of Tata

The Tata Group—Oppression and Mismanagement Issues *continued*

Trusts in the affairs of Tata Sons. Furthermore, the suit called to stop the conversion of Tata Sons into a private company to avert the restriction of free share transfer.

In July 2018, the NCLT dismissed Mistry's suit against Tata Sons, claiming that the NCLT found no merit in Mistry's accusations that Ratan Tata and trustee N. Soonawala inappropriately interfered with affairs of the group. The two-member bench further stated that they felt that the board was competent to make the decision to remove Mistry and could not prevent Tata Sons from converting to a private company. Mistry filed an appeal with the National Company Law Appellate Tribunal (NCLAT).

On December 18, 2019, the NCLAT announced its ruling, in which they held that Mistry's October 2016 removal was illegal and ordered his reinstatement as executive chairman of Tata Sons. The NCLAT also ordered restoration of his directorships in the holding company as well as in three group companies. The NCLAT set aside the NCLT's previous findings that there was no oppression in the conduct of the board and the majority shareholders of the company and directed that the unsupported and negative comments about Mistry and others be expunged. The NCLAT also deemed the actions taken by Tata Sons in the interim, including the appointment of a new executive chairman, illegal. However, in order to make the transition from the illegally appointed executive chairman back to Mistry seamless, the NCLAT suspended its order to reinstate Mistry for four weeks. The NCLAT order also set aside Tata Sons' decision to convert itself to a private company.

Critics of the NCLAT's ruling immediately considered its impact and the likelihood of its being challenged. In considering whether there was a case of oppression, the NCLAT did not discuss the law of oppression but rather cited extraneous considerations and informal communications between the parties. This appeared to treat Tata Sons as a quasi-partnership without probing the implications of this. Furthermore, legal experts viewed the order as an oversimplified conclusion to a complex matter because it did not consider the procedures surrounding the removal of Mistry or the new executive chairman's qualifications.

On January 2, 2020, Tata Sons challenged the NCLAT's order on six grounds and sought a stay of the verdict from the Supreme Court. In its petition, Tata Sons stated that the ruling was both baseless and unsustainable. The company also expressed concerns that the NCLAT order undercut corporate democracy and the rights of current board members, since restoring his directorship was directly contrary to the shareholder vote. Tata Sons stated that this would set a "dangerous precedent." The company further cited the fact that Mistry had not sought reinstatement as executive chairman before the NCLT because his term had expired in March 2017.

On January 5, 2020, Mistry issued a statement claiming that, while he would not seek reinstatement as executive chairman, he planned to vigorously pursue his seat on the board to improve its governance standards. The minority shareholders of Tata Sons expressed support for the NCLAT's ruling, maintaining that Tata Sons' conversion to a private corporation drastically affected their rights.

On January 11, 2020, the Supreme Court stayed the NCLAT's order reinstating Mistry as executive chairman, citing "basic errors" in the NCLAT's observations. The Supreme Court stated that the tribunal could not order consequential relief that was not sought in the first place. Finally, in September 2020, Mistry announced that the Shapoorji Pallonji group would exit Tata Sons by selling its stake.

Key Takeaways

- Activism by institutional investors plays an important role in developing corporate governance standards.
- Regulatory measures such as the introduction of proxy advisers, facilities for e-voting, and the introduction of class actions can enable nonpromoter shareholders to assert their rights.
- Stewardship codes can encourage institutional investors to perform their fiduciary duty by focusing on the company's long-term goals by actively monitoring the public company on material matters.

Open Questions

- Given the promoter culture in Indian corporations, has the law been successful in effectively empowering nonpromoter shareholders?
- Does the legal framework need to plug certain loopholes to ensure that there is no nuisance caused to the companies under the guise of shareholder activism?
- Do we need the threefold distinction among oppression, prejudice, and mismanagement for providing relief to adversely affected shareholders of a company? Does the law need to further clarify the specific requirements that a shareholder needs to prove for a plea to be maintainable?

CHAPTER TWELVE

The Enforcement of Corporate Governance in India

Indian companies have historically been owned, controlled, and managed either by families or by the state. After 1991, the liberalization of the Indian economy augmented the inflow of foreign capital into Indian companies (listed as well as unlisted) and led to an increase in the professionalization of management. With the development of robust capital markets in India, the common stock of Indian companies is increasingly owned by members of the public and by institutional investors. While this is a sign of a robust financial market, deepening its reach for raising capital, it also raises a red flag as to how the interests of minority shareholders, such as ordinary shareholders and foreign investors, will be handled by controlling shareholders (promoters) in India.

Corporate governance in India has changed significantly since the early 2000s. The Companies Act, 2013 (the Companies Act, or the Act), along with other relevant laws, has set forth strict provisions on governance. Non-compliance with the provisions of the Companies Act can result in monetary fines, imprisonment, or both. As a result of this enhanced liability, many companies, particularly large listed companies, have taken numerous measures to create robust compliance systems.

In addition to the Companies Act, the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (SEBI Listing Regulations) specify the corporate governance obligations of listed entities; that is, entities that have listed their equity shares or other instruments. Any failure on the part of a listed company to comply with the SEBI Listing Regulations may lead, among other things, to one or more of the following consequences: the imposition of fines, the suspension of trading, the freezing of promoter or promoter group holding of equity shares, and other actions initiated by SEBI, depending on who violated the provisions of the SEBI Listing Regulations. Appropriate action can also be taken by SEBI against a listed company under the provisions of the SEBI Act for contravention of the provisions of the SEBI Listing Regulations.

Indian regulators have taken a slew of measures to tighten corporate governance of Indian listed companies to ensure transparency, fairness, and accountability. Nevertheless, systemic risks still remain uncontrollable—and this became dramatically apparent in early 2008 with the Satyam scandal. (See “The Satyam Scandal,” p. 16.) Such corporate governance risks have continued to arise since the Satyam scandal, with several major Indian companies hit by scandal in the past decade. (See “The Infosys Whistleblower Matter,” p. 179, “Challenges at ICICI Bank,” p. 188, and “The IL&FS Crisis,” p. 170.) As experts have noted, “while the substantive law on corporate governance has evolved at a rapid pace, the legal enforcement of these norms has fallen short of the intended goals.”[1]

To address key issues of corporate governance enforcement in India, this chapter is divided into three parts: (1) the regulatory model for corporate governance in India, (2) the jurisdiction of key regulators, and (3) remedies and enforcement actions.

The Regulatory Model

To understand the regulatory model, it is essential to understand the structure of business organizations in India. Under the operative sections of the Companies Act, 2013, there are different types of companies that can be incorporated to conduct business. Every listed company and every other company having a paid-up capital of at least INR 5 crore must appoint a whole-time company secretary. Further, under the rules, every listed company and every other company having a paid-up share capital of at least INR 10 crore must have whole-time key managerial personnel.[2]

PRIVATE VS. PUBLIC COMPANIES

Private companies. A private company is required to have a maximum of 200 shareholders under the Companies Act, 2013 and a minimum paid-up share capital as may be prescribed. All shareholders’ liability is limited to their subscription of fully paid-up equity shares. The private company’s board must have at least two directors. There must be restrictions on the transfers of shares. A private company is not permitted to accept deposits from the public. There is no restriction on the total managerial remuneration of a private company. More importantly, a private company has minimum regulatory compliance and

1 Umakanth Varottil, “Board Failures: The Travails of Corporate Governance Without Enforcement,” *Bloomberg Quint*, November 29, 2018.

2 The Companies (Appointment and Remuneration of Managerial Personnel) Rules, 2014 *Gazette of India*, pt. II sec 3(i) ch. XIII sec. 8 (Mar. 31, 2014).

Companies Act, 2013: Business Organizations

The Companies Act, 2013 defines the following business organizations:[a]

Listed Company[b]

- A listed company is one that has any of its securities listed on any recognized stock exchange.

Private Company[c]

- A private company is one that has a minimum paid-up share capital as may be prescribed, and that, by its articles
  - restricts the right to transfer its shares;
  - limits the number of its members to 200, except in cases of a One Person Company; and
  - prohibits any invitation to the public to subscribe for any securities of the company.

Public Company[d]

- A public company is one that is not private; and
- has a minimum paid-up share capital as may be prescribed;
- except that a company that is a subsidiary of a company, not being a private company, shall be deemed to be a public company for the purposes of the Act, even where such subsidiary company continues to be a private company in its articles.

a The Companies Act, 2013, Section 2, No. 18, Acts of Parliament, 2013 (August 29, 2013).

b The Companies Act, 2013, Section 2(52).

c The Companies Act, 2013, Section 2(68).

d The Companies Act, 2013, Section 2(71).

disclosure norms. Typically, an Indian promoter chooses to form a private company if he wants to keep a tight control on business, shareholders, and regulatory disclosures.

Public companies. A public company is not a private company, and it has a minimum paid-up share capital as may be prescribed. A public company must be formed by seven or more persons.[3] Liability of all shareholders is limited to their respective subscription of fully paid-up shares. However, there cannot be any restriction on the transfer of shares.[4] Further, a public company is free to accept deposits from the public.[5] The rules, however, impose a limitation on deposit-accepting companies, which are not allowed to accept or renew deposits if the amount of such deposits together with the amount of other deposits outstanding exceeds 35 percent of the aggregate of the company's paid-up share capital, free reserves, and securities premium account.[6] A public company's total managerial remuneration cannot exceed 11 percent of the net profit, except in certain cases as prescribed.[7]

The concept of a public company therefore does not necessarily imply that the equity shares of the company are listed for trading on a stock exchange. However, under the Companies Act, 2013, the public company has more reporting and compliance obligations than a private limited company.

Public listed companies. Under current regulations, a listed company is required to be a public limited company. Prior to listing of its equity shares on any stock exchange in India, the private limited company must convert into a public limited company. Once it is listed on the stock exchange, the listed company will have more reporting and compliance obligations (under the regulations prescribed by SEBI) than an unlisted public company.

3 The Companies Act, 2013, Section 3(4).

4 The Companies Act, 2013, Section 58.

5 The Companies Act, 2013, Section 76.

6 The Companies (Acceptance of Deposits) Rules, 2014, *Gazette of India*, pt. II sec 3(i) ch. V sec. 3 (Mar. 31, 2014).

7 The Companies Act, 2013, Section 197.

RESPONSIBLE ENTITIES

From a regulatory perspective, there are three primary regulatory bodies responsible for making and enforcing corporate governance rules: (1) the MCA, (2) SEBI, and (3) the stock exchanges in India.

A number of other entities are also responsible for enforcing corporate governance issues, including

- The National Company Law Tribunal (NCLT) under the Companies Act, having quasi-judicial powers to decide certain matters under the Companies Act, including the protection of minority shareholders from oppression by majority shareholders and mismanagement, and its appellate authority, the National Company Law Appellate Tribunal (NCLAT).
- The Registrar of Companies (ROC), which generally has a presence in every Indian state, and primarily ensures compliance by a company in relation to filings and disclosures under the Companies Act.
- The Regional Director (RD), to which certain powers of the central government have been delegated. There are seven RDs in India, each with their own territorial jurisdiction, in which they, inter alia, supervise the working of the relevant ROCs.
- The Competition Commission of India (CCI), created under the aegis of the Competition Act, 2002, which regulates antitrust issues where a company's action may have an adverse effect on competition in the relevant Indian market.

Every industry/sector also has its own regulators; for example, insurance, air transport services, banking, information and broadcasting, telecommunication. In addition, the consequences of director liability under various penal statutes such as labor and environmental legislation, the Insolvency and Bankruptcy Code, 2016 and the Prevention of Money Laundering Act, 2002, also drive corporate governance practices of companies.

At times, the jurisdiction of each regulator is not clearly defined, which results in confusion as to which regulator should initiate the necessary enforcement action. There is a need to develop a mechanism to resolve any conflict between the regulators to ensure prompt and effective action.

Government Enforcement Actions

Central Government Enforcement Actions. Under Section 210 of the Companies Act, 2013, the Central Government of India is empowered to initiate investigation into the affairs of a company to detect any noncompliance with the laws and irregularities in conducting the business if it is in the public interest, upon report of the ROC or upon intimation of a special resolution passed by shareholders. Experts have noted that while the MCA has broad authority to investigate under the Companies Act, its cases "have been subject to significant delays leading to MCA's having a substantially weakened ability to play an important and timely enforcement role."[8]

The Securities Exchange Board of India. SEBI has wide powers under the Securities and Exchange Board of India Act, 1992 to investigate the affairs of the public listed company. Further, SEBI's powers are supplemented by the Securities Contracts (Regulation) Act, 1956 and the Depositories Act, 1996.[9] In a nutshell, the Securities Contracts (Regulation) Act, 1956 provides for a basic framework for contracts of securities, and the Depositories Act, 1996 lays down the mechanism for dematerialization of securities of Indian companies.

While SEBI's role as the primary regulator of the Indian capital markets has been recognized, there have been concerns about SEBI's effectiveness. Experts have noted that "SEBI is understaffed given the vast nature of India's capital market and its players. The enforcement of securities regulation continues to be a challenge due to the inadequacy of resources within the regulator."[10] In fact, the Kotak committee recommended enhancing SEBI's staffing to strengthen its monitoring and enforcement capabilities.[11] Nevertheless, recent strong enforcement

8 Vikramaditya Khanna, "Enforcement of Corporate and Securities Law in India: The Arrival of the Class Action," in *Enforcement of Corporate and Securities Laws*, ed. Robin Hui Huang and Nicholas Calcina Howson (Cambridge: Cambridge University Press, 2017), p. 340.

9 Securities Contracts (Regulation) Act, 1956, No. 42, Acts of Parliament, 1956; The Depositories Act, 1996, No. 22, Acts of Parliament, 1996.

10 Umakanth Varottil, "The Protection of Minority Investors and the Compensation of Their Losses: A Case Study of India," NUS Law Working Paper No. 2014/001, February 11, 2014, p. 18.

11 Uday Kotak et al., *Report of the Committee on Corporate Governance*, Securities and Exchange Board of India, October 2017, chapter 11.

Noncompliance with the Erstwhile Clause 49

Initially, when SEBI introduced Clause 49, companies could suffer delisting only for noncompliance. Recognizing the urgent need to create significant deterrence for compliance with the listing agreement, Section 23 of the Securities Contracts (Regulation) Act, 1956 was amended in 2004 to include a penalty of INR 25 crores and imprisonment up to 10 years for a single violation by the concerned officer or employee of the company. The offense is cognizable and nonbailable under the Criminal Procedure Code. Under the Criminal Procedure Code, the police can also arrest, without a warrant, an offender of the provisions and can search and raid his official and residential premises.

After seven and a half years of Clause 49, in 2007 SEBI brought enforcement actions against certain companies, including government-owned companies—public sector undertakings (PSUs)—for noncompliance with Clause 49.[a] Previously, SEBI had acknowledged that there was a low level of compliance with Clause 49, yet there had been no action.[b]

a “SEBI Kicks Off Probe Against 20 Cos,” *Times of India*, September 12, 2007; “SEBI Pulls Up 20 Clause 49 Violators,” *Economic Times*, September 12, 2007.

b “SEBI Wants SEs to Act Against Firms Defying Clause 49,” *Financial Express*, August 31, 2006; Bijith R., “57% of BSE Listed Cos Yet to Comply with Clause 49,” *Indian Express*, January 3, 2007.

For the first time, in May 2010, the National Stock Exchange suspended trading of Pyramid Saimira Theatre Ltd. for failure to file its quarterly compliance governance report,[c] but SEBI initiated no action under the Securities Contracts (Regulation) Act, 1956.

It is also notable that there was no private enforcement of Clause 49; it could only be enforced by SEBI.

c “NSE Bans Pyramid Saimira from Trading from June 1,” Business Standard, May 26, 2010.

actions by SEBI have made Indian companies focused on ensuring compliance and formulating stricter governance norms.[12]

Stock Exchange—SEBI Listing Regulations. In the scheme of corporate governance, stock exchanges have a pivotal role to play in improving the corporate governance of listed public companies. The courts in India have recognized that the stock exchange performs important public functions, and therefore constitutes state authority under the Constitution of India.[13]

As a precondition to the listing on any stock exchange, every company has to enter into a standard listing agreement with the stock exchange, under the aegis of the SEBI Listing Regulations. The SEBI Listing Regulations mandate regular reporting of compliance with its requirements by listed companies, and the stock exchange is under obligation to report any noncompliance to SEBI.

By introducing the SEBI Listing Regulations, in 2015, SEBI replaced the existing Listing Agreement and provided for a comprehensive framework governing listed securities. The SEBI Listing Regulations enhance the enforceability of the regulatory provisions contained in the Listing Agreement by providing statutory recognition of the listing norms in India. The SEBI Listing Regulations are categorized into three subdivisions: (1) the substantive provisions of the regulations; (2) schedules to the regulations, which provide procedural requirements; and (3) circulars by SEBI, which prescribe the forms of disclosure. While most of the provisions are aligned with the provisions of the Companies Act, 2013 and the rules thereunder, the SEBI Listing Regulations are amended from time to time as necessary.

Private Enforcement: Minority Shareholders' Remedies

Oppression and mismanagement. Under the Companies Act, any shareholder (or together with other shareholders) having at least a 10 percent share capital of a company could approach a company law board (specialized tribunal) on the grounds that the majority or controlling shareholders are oppressing the minority shareholders and mismanaging the company.[14] To illustrate, the courts have recognized the following actions of majority shareholders to constitute actions of oppression of minority shareholders or mismanagement of the company:

- siphoning of funds;
- related party transactions;
- initiating a new line of business unrelated to the main business of the company;
- interested directors' transactions;
- noncompliance with the Companies Act: regulatory filings, appointment of statutory auditors, access to books and accounts, and so forth.

Generally, in a listed public company, retail investors own a fraction of the total share capital, and they accordingly find it difficult to tie up the support of 10 percent of minority shareholders. This requirement of a minimum 10 percent of shareholders impairs any effective enforcement by minority shareholders in a timely fashion.

Under Section 244 of the Companies Act, 2013, aggrieved shareholders may approach the NCLT for redress of their grievances on the grounds of oppression and mismanagement. The NCLT may, on an application made to it in this behalf, waive all or any of the specific requirements of percentage of holding or number of aggrieved shareholders so as to enable the members to apply and seek relief under these provisions. The Companies Act, 2013 has produced greater shareholder democracy and stricter corporate governance norms. For example, in 2017, the NCLAT held that the petition for waiver made by Cyrus Mistry before the NCLT was a fit case for waiver and remitted the petition filed by him that challenged, inter alia, his ouster as chair of Tata Sons, to the NCLT for consideration on merits. (For more details on the Cyrus Mistry–Tata Sons issue, please see p. 217.) Nevertheless, experts have noted that in general "it is hard for minority shareholders to obtain a successful outcome in such actions, as they need to discharge a high burden of proving the requisite standard of wrongful conduct."[15]

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12 Kiran Kabtta Somvanshi, "Probes by SEBI Treble in Four Years, But Closure Rate Falters," *Economic Times*, January 1, 2020.

13 *K.C. Sharma* v. *Delhi Stock Exchange and Others*, AIR 2005 SC 2884.

14 The Companies Act, 2013, Sections 241–246.

15 Varottil, "Board Failures: The Travails of Corporate Governance Without Enforcement."

Derivative suits. The stockholder derivative suit is a mainstay of corporate governance enforcement by private actors in jurisdictions like the United States. Derivative actions involve shareholders, acting on behalf of the company, bringing suit against directors, controlling shareholders, and other parties when persons who are at the helm of affairs of the corporation fail to take appropriate action and perform their fiduciary duties. Pursuant to common law principles, derivative suits are available in India, yet are rarely brought due to a variety of complex substantive law and procedural barriers.[16] These barriers include limitations related to the ownership structure of India firms, where controlling stockholders often ratify corporate actions, and a paucity of case law on director fiduciary duties. Furthermore, scholars also argue that local business norms in India, including "a pragmatic business culture of not challenging directors with powerful bureaucratic connections," play an important role in limiting derivative litigation.[17]

Class actions. The Act has also introduced for the first time in India the concept of class action suits, empowering investors to sue a company for "oppression and mismanagement" and claim damages. Like other actions by shareholders, however, the class action mechanism is uncertain in its effectiveness, and the jurisprudence around class actions has yet to develop in India.[18] Experts note that while the class action mechanism "is wide in nature and confers considerable discretion to the National Company Law Tribunal to grant different types of remedies, the novelty of the provision leaves it with considerable uncertainty. There does not appear to be evidence of its successful use in any corporate governance lapses or other corporate wrongdoing."[19] Scholars do not expect the class action remedy as currently provided to be of significant value in the future for several reasons, including "(1) the glacial speed of the Indian courts, (2) the lack of contingency fees, (3) the limited availability of monetary remedies under the class action provision, and (4) the interaction between ownership structure in India—virtually all firms are controlled—and the absence of fiduciary duties owed by controllers to minority shareholders."[20]

Class Actions under the Companies Act, 2013

Section 245 of the Companies Act, 2013 introduces the concept of class action suits in India. Under Section 245, any shareholder or class of shareholders may file an application before the NCLT on behalf of all shareholders if they are of the opinion that the manner of management or conduct of affairs of the company is prejudicial to the interests of the company or its shareholders. The number of shareholders or depositors required for filing such suits is specified to be the lower of 100 or such percentage of total shareholders or depositors as may be prescribed. The provisions enable shareholders or depositors to seek compensation not only from the company but also from the directors, auditors, and expert advisors for any unlawful or wrong conduct.

Under the MCA's rules, a class is defined as being the lesser of 2 percent of the issued share capital, 100 shareholders, or 5 percent of the total number of shareholders.

Amid the corruption and corporate scandals, there is an immediate need to intensify India's corporate governance enforcement framework. While regulators generally have broad enforcement powers, outside of a few prominent cases, their exercise of these powers has been somewhat lackluster. Furthermore, while there are many options for

16 Vikramaditya S. Khanna and Umakanth Varottil, "The Rarity of Derivative Actions in India: Reasons and Consequences," in *The Derivative Action in Asia: A Comparative and Functional Approach*, ed. Harald Bum, Michael Ewing-Chow, and Dan W. Puchniak (Cambridge: Cambridge University Press, 2012).

17 Dan W. Puchniak, "The Derivative Action in Asia: A Complex Reality," *Berkeley Business Law Journal* 9, (2012), p. 1.

18 Khanna, "Enforcement of Corporate and Securities Law in India: The Arrival of the Class Action."

19 Varottil, "Board Failures: The Travails of Corporate Governance Without Enforcement."

20 Khanna, "Enforcement of Corporate and Securities Law in India: The Arrival of the Class Action."

private enforcement, these options have yet to be explored in any significant way by shareholders because of “delays in the judicial process and unclear bases for liability.”[21]

Key Takeaways

- Collectively under the Companies Act, the SEBI Listing Regulations, and the Insolvency and Bankruptcy Code, several regulatory bodies have been entrusted with the functions of overseeing the enforcement of corporate governance norms in India.
- Class action suits, newly introduced under the Companies Act, confer upon the NCLT wide powers to grant relief to aggrieved shareholders.

Open Questions

- Is the corporate governance enforcement framework in India effective for protecting minority shareholders?
- Has tribunalization contributed positively to strengthening India’s enforcement processes?

21 Khanna, “Enforcement of Corporate and Securities Law in India: The Arrival of the Class Action,” p. 341.

Index of Abbreviations

Act or Companies Act	The Companies Act, 2013, as amended from time to time
ADR	American Depository Receipts
AIFs	alternative investment funds
AoA	Articles of Association
Birla Committee	SEBI Committee on Corporate Governance under the Chairmanship of Kumar Mangalam Birla
board	Board of Directors
BSE	Bombay Stock Exchange
CBI	Central Bureau of Investigation
CCI	The Competition Commission of India
CEB	Code of Ethics and Business Conduct for Central Public Sector Employees issued by the Department of Public Enterprises, Government of India
CEO	Chief Executive Officer
CFO	Chief Financial Officer
Charter Documents	Memorandum of Association and Articles of Association collectively
CII	Confederation of Indian Industry
CII Code	Desirable Corporate Governance: A Code issued by the CII in 1998
Clause 49	Clause 49 of the listing agreement of stock exchanges (Listing Agreement)
Contract Act	The Indian Contract Act, 1872
CorEx	comply-or-explain
COSO	The Committee of Sponsoring Organizations of the Treadway Commission
CPI	Transparency International's Corruption Perception Index
CPSE	Central public sector enterprise
CRO	Chief Risk Officer
CSR	Corporate Social Responsibility
CSR Amendment Rules	Companies (Corporate Social Responsibility Policy) (Amendment) Rules, 2021
CSR Rules	Companies (Corporate Social Responsibility Policy) Rules, 2014
CTO	Chief Technology Officer
DFIs	development finance institutions

Index of Abbreviations *continued*

DIIs	domestic institutional investors
ECB	external commercial borrowing
ERM	enterprise risk management
ERMC	enterprise risk management committee
ERMT	enterprise risk management team
ESG	environmental, social, and governance
FCA	False Claims Act
FDA	U.S. Food and Drug Administration
FDI	foreign direct investment
FERA	The Foreign Exchange Regulation Act, 1973
FICCI	Federation of Indian Chambers of Commerce and Industry
FII	foreign institutional investors
FIR	First Information Report
FPI	foreign portfolio investment
FSDC-SC	Financial Stability and Development Council
FVCI	foreign venture capital investment
Godrej Committee	Committee formed by the MCA chaired by Adi Godrej
HC	Bombay High Court
IA	internal audit
ICAI	Institute of Chartered Accountants of India
ICSI	Institute of Company Secretaries of India
IDA	The Industrial Disputes Act, 1947
IFRS	International Financial Reporting Standards
IiAS	Institutional Investor Advisory Services India Limited
Ind AS	Indian Accounting Standards
Indian Penal Code/IPC	Indian Penal Code, 1860
Irani Committee	Committee formed by the MCA chaired by J. J. Irani
IRDA	Insurance Regulatory and Development Authority of India
Kotak Committee	SEBI Committee on Corporate Governance under the Chairmanship of Uday Kotak

Index of Abbreviations *continued*

Listing Agreement	Listing agreement of stock exchanges
MCA	The Ministry of Corporate Affairs, Government of India
MNC	multinational corporation
MoA	Memorandum of Association
Murthy Committee	SEBI Committee on Corporate Governance under the Chairmanship of Narayana Murthy
Naresh Chandra Committee	Committee formed by the MCA chaired by Naresh Chandra
NASSCOM	National Association of Software and Services Companies
NCLAT	National Company Law Appellate Tribunal
NCLT	National Company Law Tribunal
Negotiable Instruments Act	The Negotiable Instruments Act, 1881
NFRA	National Financial Reporting Authority
NGRBC	National Guidelines on Responsible Business Conduct
NRC	Nomination and Remuneration Committee
NRI-PIS	nonresident Indian portfolio investment scheme
NSE	National Stock Exchange
NYSE	New York Stock Exchange
PCA	Prevention of Corruption Act, 1988
PFRDA	Pension Fund Regulatory and Development Authority
PI	portfolio investment
PIT Regulations	Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015
PMLA	Prevention of Money Laundering Act, 2002
PSE	public sector enterprise
PSU	public sector undertaking
RAC	Risk and Audit Committee
RBI	Reserve Bank of India
RD	Regional Director
RMO	risk and mitigation plan owners
RoC / ROC	The Registrar of Companies

Index of Abbreviations *continued*

RPT	related party transaction
RPT Working Group	SEBI-constituted Working Group to review the policy space pertaining to RPTs under the chairmanship of Ramesh Srinivasan, managing director and CEO, Kotak Mahindra Capital Company Limited
Satyam	Satyam Computer Services Ltd.
SEBI	The Securities and Exchange Board of India
SEBI Act	The Securities and Exchange Board of India Act, 1992, as amended from time to time
SEBI Listing Regulations	The Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, as amended from time to time
SEC	U.S. Securities and Exchange Commission
SFIO	Serious Fraud Investigation Office
SOE	state-owned enterprise
SRC	stakeholder relationship committee
Voluntary Guidelines	Ministry of Corporate Affairs' Corporate Governance Voluntary Guidelines, 2009

INR–USD Conversion

1 USD = 73.2948 INR

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Source: www.fbil.org.in

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Prior to joining the UC Davis faculty, Professor Afsharipour was an attorney with the corporate department of Davis Polk & Wardwell in both New York, NY and Menlo Park, CA. There she advised clients on domestic and cross-border mergers and acquisitions, public and private securities offerings, and corporate governance and compliance matters. She also served as a law clerk to the Honorable Rosemary Barkett of the Eleventh Circuit Court of Appeals. She holds a B.A. (*magna cum laude*) from Cornell University and a J.D. from Columbia Law School (Harlan Fisk Stone Scholar), where she was an articles editor of the *Columbia Law Review* and a submissions editor of the *Columbia Journal of Gender and Law*.

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