FINSEC Law Advisors

Securities and Investment Regulations

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A Silver Bullet for Corporate Mis-governance?

SEBI, through its circular dated 17 April, 2014, revisited Clauses 49 and 35B of the Listing Agreement with a view to align it with the Companies Act, 2013, thereby adopting the best practices on corporate governance to increase its efficacy. The changes, along the lines of the "Consultative Paper on Corporate Governance norms in India" (4 January, 2013), are set to take effect from 1 October, 2014, requiring the stock exchanges to amend their listing agreements. While a number of these norms have already been incorporated within the Companies Act, 2013, SEBI has chosen to lay down more stringent norms in certain respects.

Responsibilities of Board

- Disclosure by directors regarding material interests in any transactions
- Key functions of board include reviewing corporate strategy, ensuring transparency of board nomination process, managing potential conflicts of interest, ensuring integrity of accounting and financial reporting.
- Other responsibilities include encouragement of high ethical standards and continuing director's training

Board of Directors in General

The second part of the revised Clause 49 discusses issues relating to board of directors including aspects such as composition of the board, remuneration, independent directors, and code of conduct. While succession planning was a hot topic of discussion in the consultation paper, the revised clause merely obligates the board to satisfy itself that a succession plan is in place. Neither the proposed requirement to disclose the plan or the requirement to disclose the existence of a plan has been retained in the revised clause.

A whistle-blower policy wherein directors and employees may report unethical behaviour, actual or suspected fraud or any violation of the company's code of conduct, has been mandated. While the revised Clause does not provide any specifics regarding the nature of the policy, it stipulates provision of adequate safeguards against victimization.

Independent Directors

SEBI has taken steps for ensuring independence and effectiveness of independent directors. While qualifications specified in the Companies Act, 2013, which are applicable to independent directors, including the new provision that excludes nominee directors from the list of independent directors within a company remain the same, some key additions are:

Evaluation

The entire board, apart from the director being evaluated, will conduct the performance evaluation of every independent director and this may act as a basis for determining whether the said director deserves to continue in his position.

Separate Meetings

To ensure that impartial judgement of independent directors is not over-run by dominant board members, separate meetings in the absence of non-independent directors have been mandated. In these meetings, performance evaluation of the remaining directors, of the board can be carried out.

No ESOPS for IDs

The revised clause does away with the provision that allowed granting of ESOPs to independent directors. This is with a view to restrict any conflict of interest that may arise due to their shareholding in the company. SEBI's wisdom behind such a move may be questionable, given the permissive nature of the Companies Act in this regard.

No. of Directorships

No person can hold more than 7 independent directorships and no more than 3 if he also is a whole-time director in any company.

Tenure

An independent director can occupy such a position for a maximum of two terms of 5 consecutive years. The second term requires shareholder approval by special resolution.

Liability of Independent Directors

Within the provision requiring the creation of a code of conduct for board members, the extent of liability of independent directors has been outlined. In relation to any violation of any provision within the listing agreement by a company, an independent director of the company can 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.

Related Party Transactions (RPT)

The revised clause deals extensively with related party transactions. The scope of transactions falling within this has been expanded by giving a wide definition to the term 'related party'. It is stated that parties are considered related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and/or operating decisions. The creation of a deeming provision provides greater clarity regarding which transactions constitute RPTs and is especially important considering how RPTs now require approval from the audit committee. If these transactions can be categorised as material RPTs, they will also require the approval of shareholders through a special resolution. The materiality of the transaction in question depends on an RPT Policy that every company is expected to frame. While the move is certainly well-intentioned, the provisions may create roadblocks to some legitimate RPTs.

Divestment of material subsidiaries

While every company is required to formulate a policy to aid in determining which subsidiaries would be considered material, the revised Clause provides a minimum standard to determine materiality by stating that *"a subsidiary shall be considered as material if the investment of the company in the subsidiary exceeds twenty per cent of its consolidated net worth as per the audited balance sheet of the previous financial year or if the subsidiary has generated twenty per cent of the consolidated income of the company during the previous financial year."* Special restrictions will be attracted when the holding company attempts to divest shares or assets of such a material subsidiary. A special resolution in a general meeting of shareholders is mandated where a company intends to reduce its shareholding in a material subsidiary to less than 50% or cease exercise of control over it and in circumstances where the company intends to sell, dispose or lease assets exceeding 25% of the material subsidiary's assets.

Merchant Banker's Liability for Misstatements in the Offer Documents

On 21 March, 2014, SEBI passed an order against Almondz Global Securities Limited (Almondz), along with its CEO and Managing Director and the authorised signatory of due-diligence certificate issued for PG Electroplast Limited's (PGEL) IPO. The order prevents the named entity and the persons from taking up any assignment or involvement in new issues of capital, buy-back of securities, open offers and delisting of securities for a period of 5 years, due to a number of non-disclosures and misstatements in the prospectus and red herring prospectus (RHP). The primary grounds were:

1) Non-disclosure that the funds raised by PGEL through ICDs were in the nature of a bridge loan: Almondz relied on the comfort letter issued by PGEL's statutory auditor. SEBI held that a comfort letter was a qualified and limited opinion, which was itself based on the information provided by PGEL, and the merchant banker could not be ignorant that funds raised by PGEL through ICDs were in the nature of a bridge loan.

2) Non-disclosure about the existence of loan committee and the decision of the board of PGEL to invest in ICDs of the other companies: SEBI held that though the ICDR Regulations and Listing agreement did not prescribe details of the disclosures of these, names of the committees taking material decisions of the company were required to be disclosed in the offer documents as material information according to Regulation 57(1) of ICDR Regulations. The merchant banker was obligated to pore through and scrutinise the complete minutes of the board meetings and that non-disclosures could have been avoided if reasonable due diligence was undertaken.

SEBI elaborated on a merchant banker's role in an IPO, stating that while it was obligated to the company to manage the IPO, it had an equal commitment towards the investor to present the company's information unambiguously in the offer documents. Further, SEBI emphasized the importance of the merchant banker's due diligence as not merely passively reporting client-provided information, but examining all relevant details to provide a true account in the prospectus and making an active effort to examine material developments, since investors make their investment decisions on the faith that due-diligence is done properly.

Supreme Court bars Withdrawal of Voluntary Open Offer

The Supreme Court in the matter of *SEBI v. M/s. Akshya Infrastructure Private Limited* has considered the question of whether an open offer for purchase of shares of the target company, voluntarily made through a public announcement, can be permitted to be withdrawn if such an open offer has become uneconomical.

The acquirer, M/s Akshya Infrastructure Private Limited, is a part of the promoter group of the target company, MARG Limited. It had made several acquisitions, between 2006-2010, in excess of the 5% creeping acquisition limit under the SEBI (SAST) Regulations, 1997. Though in breach, the acquirer made a voluntary open offer in October, 2011, scheduling the tendering period to commence from December, 2011. Due to certain reasons, the acquirer expressed its desire on 29 March, 2012 to withdraw the open offer. SEBI's comments on the draft letter of offer were received by the acquirer on 30 November, 2012, after a delay of 13 months from filing, without any reference to the acquirer's request to withdraw the open offer. SEBI's comments, in effect, mandated that the open offer fructify after incorporating its suggestions on the same. Appealing against SEBI's directions, primarily on the ground that the delay rendered the open offer unviable and academic, the acquirer obtained a favourable ruling from SAT on the issue. In appeal from SAT's decision, SEBI placed before the Supreme Court various arguments hinging on various provisions of the SEBI (SAST) Regulations, 1997 and an earlier Supreme Court decision in *Nirma Industries & Anr. v. SEBI* to state that no special dispensation was accorded to voluntary open offers, under the law, in respect to their withdrawal.

Taking cognisance of various arguments, some interpretative, the Supreme Court rapped SEBI on the knuckles for its delay of 13 months in giving its comments on the draft letter of offer, but declined to make the delay, or economic unviability of the open offer, a valid ground for relief to the acquirer. In the absence of such a ground in the exempting provision of the SEBI (SAST) Regulations, 1997, the Supreme Court ordered the setting aside of SAT's decision and the implementation of SEBI's directions to make the offer.

While the Supreme Court and SEBI played by the book in this case, regulatory propriety dictates that SEBI not consider this ruling as permissive, in relation to its responsibilities to market participants. As a regulator, SEBI owes a significant duty of care to foster a compliant, yet conducive business environment.

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