



August 21, 2017

Committee on Corporate Governance  
Securities and Exchange Board of India  
SEBI Bhavan  
Plot no. C-4A  
'G' Block Bandra Kurla Complex  
Bandra East, Mumbai 400051  
Maharashtra, India

By post and email:

### **ACGA Submission on Corporate Governance**

Dear Sir,

The Asian Corporate Governance Association (ACGA) is an independent, not-for-profit association chartered under the laws of Hong Kong. The Association is dedicated to assisting companies and markets across Asia in their efforts to improve corporate governance practices. Our research encompasses 12 markets in Asia-Pacific including Australia. In our educational outreach, we are guided by a practical, long-term approach. ACGA's operations are supported by a membership base of institutional investors, such as public pension funds and fund managers, as well as listed Asian companies, international accounting firms, business associations and universities. ACGA now has more than 110 organisations as members, two-thirds of which are institutional investors with more than US\$26 trillion in assets under management globally. They are also significant investors in the India market.

We appreciate the opportunity to provide input to the Committee on Corporate Governance on its deliberations for improving the regulation and practice of corporate governance in India. We commend the Securities and Exchange Board of India (SEBI) for undertaking this latest review of the corporate governance arena, especially after the many changes that have taken place in the last few years. We understand the tight timeframe the committee is working under and hope our comments will help its efforts.

#### **General comments**

Our overall view of the topics under review is positive and we appreciate, in particular, the following:

- Ensuring the independence in spirit of independent directors and their active participation in the functioning of boards;
- Improving safeguards and disclosures pertaining to related-party transactions;
- Improving the effectiveness of board evaluation practices; and
- Disclosure and transparency related issues.

Notwithstanding our positive view on the issues being discussed, there is one area where we have a long-standing concern. This relates to the flexibility permitted public-sector undertakings (PSUs) regarding non-compliance with sections of the listing rules, the lack of independent directors on boards and failing to achieve the 25% public float. We believe this reflects badly on the market and is an area requiring immediate attention.

Our specific comments for the Committee follow.

## **INDEPENDENT DIRECTORS**

While a definition of an independent director is already provided in the Listing Obligations and Disclosure Requirements (LODR) (*Chapter IV, 16 (b)*) and in the Companies Act 2013 (*Chapter XI, Section 149 (6)*), the decision by the Committee to address independence in spirit is a timely one. We believe this could be strengthened further by focussing on a few key areas:

- More guidance on statutory fiduciary duties;
- The duties of skill, care and diligence; and
- Financial literacy, a subset of skill, care and diligence.

### **1. Guidance on fiduciary duties**

With the passing of the Companies Act, 2013, directors in India now have statutory guidance on their fiduciary duties and liabilities. The duties have been codified as follows (see *Section 166, Companies Act 2013*):

- To act in accordance with the articles of the company;
- To act in good faith to promote the objects of the company, and in the best interests of the company and its stakeholders as well as for the protection of the environment;
- To exercise reasonable care, skill and due diligence and independent judgement;
- To avoid conflicts of interest, or potential conflicts of interest;
- To not accept benefits from third parties;
- To not assign his office.

It is beneficial for directors that their duties have been clarified and that they understand the penalties for breaching them. The Act further elucidated the duties of independent directors in Schedule IV and stated that they were expected to “safeguard the interests of all stakeholders” (*Schedule IV, II (5), Companies Act 2013*).

In 2015, the securities regulator published the Listing Obligations and Disclosure Requirements (LODR) 2015, aligning director requirements in the listing regulations with the Act (*Chapter II, 4 (2)(f), LODR*). While fiduciary duties have been further clarified, recent cases involving related-party transactions or relating to severance packages have shown either a lack of understanding or a disregard for these duties by some boards and/or audit committees.

### **Our recommendation**

We suggest that SEBI provides more detailed guidance on what fiduciary duties entail for a board and its mandatory committees. Such notes should not be prescriptive, but rather a practical statement as to how directors could better use their judgement in carrying out their duties. There seems to be confusion in some boards as to how to respond to changing market expectations and what is expected of directors. Such guidance could also help allay the fears of people who might consider becoming independent directors, but are apprehensive about liability. We also recommend training and mentorship programmes for directors.

## 2. Focus on skill, care and diligence

Notwithstanding the confusion described above, across much of the region the duties of loyalty, good faith and the need to act in the interests of all stakeholders appear to be better understood by many directors today than the duties of skill, care and diligence—a relatively newer area of focus. What objective level of skill should each individual director have as a director (in addition to any particular area of expertise that they possess)? Are there minimum levels of knowledge and expertise that all directors should have? What do “care” and “diligence” mean in the context of decisions made by the board or its committees? As the pressure on boards increases, and as companies and capital markets become more complex and international, the issue of director skill will likely increase in importance in the coming years.

Is it sufficient for a board to say that it has a collection of diverse skills among its directors and, therefore, its composition is adequate in general terms? Or do boards need to take a more structured approach to ensure that the skills of each individual director support the company’s current and future business strategy, and that there is a proper balance of skill and knowledge among the directors?

### Our recommendation

We suggest SEBI encourages companies and directors to focus greater attention on the skills and expertise required by individual directors, both executive and non-executive, in fulfilment of their duties both on the board and specific committees. These skills should be aligned with a company’s long-term strategy and any material environmental, social and governance risks they face. For example, how many boards can say they are truly competent to respond to climate change? Or more prosaically, how many boards are ready to engage in depth with their shareholders under the new “investor stewardship” rubric? A useful tool adopted by leading companies in developed markets is the “skills matrix”, which measures the collective and individual expertise on a board, as well as geographic and market knowledge, gender balance and other key metrics.

## 3. Financial literacy

Under the new Companies Act, financial literacy is specifically mentioned in relation to audit committees: the law states that the “majority of members of the Audit Committee including its Chairperson shall be persons with ability to read and understand, the financial statement” (*Part II, 177 (2), Companies Act 2013*). The listing regulations go further and require all audit committee members to be financially literate, with at least one member having accounting or related financial management expertise (*Chapter IV, audit committee, section 18 (c), LODR*); additional notes have been provided explaining what “financially literate” and “accounting or related financial management expertise” entails.

While we agree that audit committee members require sufficient knowledge of accounting and finance, our view is that all board members should, at a minimum, be able to read and understand financial statements. As boards collectively approve audited accounts and major transactions, it is difficult to see how this can be done with integrity if some directors are financially illiterate. Indeed, there have been cases recently where audit committees have come up short in meeting their responsibilities.

### **Our recommendation**

We suggest that SEBI could offer new guidance on helping audit committees and all directors fulfil their roles. It could also raise the bar by creating a regulatory expectation that all directors share responsibility for the content of corporate reporting as part of their stewardship function. The Financial Reporting Council in the UK did this in 2012 with the publication of a guidance manual called “Effective Company Stewardship: Enhancing Corporate Reporting and Audit”.<sup>1</sup> In Australia, the Australian Securities & Investments Commission (ASIC) promotes financial literacy among all directors. In a strikingly clear description on its website relating to Directors and Financial Reporting, ASIC says: “Each director has a duty of skill, competence and diligence in the understanding of the financial report that is to be disclosed to the public.”<sup>2</sup>

### **COMPENSATION**

The Companies Act 2013 restructured how independent directors are paid: They are no longer eligible for stock options, instead remuneration consists of sitting fees, capped at Rs100,000 for participation in board and other meetings, as well as a profit-related “commission”, which must be approved by shareholders (*Chapter XI, Section 149 (9), Companies Act 2013; Chapter IV, 17 (6) (b), LODR*). We understand the need for companies to compensate independent directors commensurate with their experience and responsibilities, but capping fees and offering performance-based elements such as profit-based commissions creates potential conflicts of interest and distorted incentives. The question arises: How independent can a director be when his or her remuneration is linked to profit? How can shareholders be confident that independent directors are not compromised when they participate in decisions that affect a company’s bottom line?

### **Our recommendation**

We believe the issue of independent director compensation should be rethought, with the capping of fees removed and companies themselves deciding how much to pay directors (subject to shareholder approval or, better still, minority shareholder approval). As directors would then be fairly paid for their services, commissions would no longer be needed.

### **DISCLOSURE**

#### **1. Appointment of directors**

SEBI regulations dictate that in the case of the appointment of a new independent director or re-appointment of a director, companies need to disclose a brief resume, relationships between directors, his or her expertise in specific areas, and on which other boards and sub-committees he or she sits (*Chapter IV, 36 (3), LODR*). The Companies Act, meanwhile, requires companies to provide a statement that in the opinion of the board the independent director fulfils the criteria under the Act for the appointment (*Section 152 (5), Companies Act 2013*). By today’s standards, this level of disclosure is quite minimal.

---

<sup>1</sup> Financial Reporting Council, UK, 2012: <https://www.frc.org.uk/Our-Work/Publications/FRC-Board/Effective-Company-Stewardship-Enhancing-Corporate-File.pdf>

<sup>2</sup> ASIC website: <http://asic.gov.au/regulatory-resources/financial-reporting-and-audit/directors-and-financial-reporting/>

**Our recommendation**

Companies should provide more information on a director than simply a resume, which we note in many cases can be extremely brief. The nomination and remuneration committee should inform shareholders of its reasons for choosing a candidate, the value this person will add to the board, how his or her expertise will balance that of other directors and so on. In some markets, companies invite new directors to make a statement as to how they intend to contribute to the company's governance.

**2. Compensation of executives**

A matter of concern for investors is the lack of full disclosure regarding executive pay packages: how pay packages are structured; what performance metrics the companies used; and what performance targets have been set for key executives. There is a failure by companies to meet investors' needs as recent cases have illustrated. Even though SEBI rules (*Schedule VC (5) (c), LODR*) require disclosure of all elements of a remuneration package, including details of the fixed component as well as performance-linked incentives and performance criteria, companies consistently fail to provide depth to their remuneration disclosure for executives.

**Our recommendation**

Companies be further encouraged to disclose the criteria used in reaching executive compensation decisions and the relationship between its compensation policies and corporate performance.

We would be pleased to discuss any of the above points in further detail.

Yours truly,



Jamie Allen  
Secretary General