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**SEBI accepts Kotak Committee's recommendations – Mandates transfer in DEMAT form****GAURAV N. PINGLE**

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*In its recent board meeting, the SEBI Board deliberated upon quite a few significant issues directly affecting the India Inc., securities market and securities market intermediaries. Some of the significant decisions include amendments to Corporate Governance norms, strengthening of the framework of equity derivatives market, revising framework for non-compliance of the Listing Regulations, mandating transfer in securities only in demat form, etc. This article is an analysis and compilation of the decisions taken by the SEBI Board at its meeting and its impact on the securities market*

**Introduction**

1. In its last board meeting of the financial year 2017-2018, the SEBI Board deliberated upon a few significant issues directly affecting the India Inc., securities market and securities market intermediaries. Some of the significant decisions include amendments to Corporate Governance norms, strengthening the framework of equity derivatives market, revising framework for non-compliance of the Listing Regulations, mandating transfer in securities only in demat form, etc. The SEBI Board has resolved to lay down the framework for compliance with SEBI Regulations by listed entities subject to Corporate Insolvency Resolution Process under Insolvency and Bankruptcy Code. SEBI proposes to review Regulations relating to Buy Back of securities and Takeover Code, 2011.

This article is an analysis and compilation of the decisions taken by the SEBI Board at its meeting and its impact on the securities market.

**Corporate Governance Norms**

2. In June 2017, SEBI had constituted a Committee under the Chairmanship of Shri. Uday Kotak to make recommendations to SEBI for improving standards of corporate governance of listed entities in India. The Committee was represented by different stakeholders including the Government, industry, stock exchanges, academicians, proxy advisors, professional bodies, lawyers, etc. The Committee submitted its report detailing several recommendations on October 5, 2017. SEBI received feedback and comments from a variety of stakeholders.

SEBI Board accepted several recommendations of the Kotak Committee without any modifications. The Board decided to accept several recommendations with modifications. SEBI Board decided to refer certain recommendations to various agencies (i.e., Government, other regulators, professional bodies), considering

that the matters involved related to them. Such recommendations, *inter-alia*, include strengthening the role of ICAI, internal financial controls, adoption of Ind-AS, treasury stock, governance aspects of PSEs, etc.

**3. The SEBI Board accepted the following recommendations of Kotak Committee without any modifications:**

- (i) Reduction in the maximum number of listed entity directorships to 8 (from 10) by April 1, 2019 and to 7 by April 1, 2020,
- (ii) Expanding the eligibility criteria of independent directors,
- (iii) Enhanced role of the Audit Committee, Nomination and Remuneration Committee and Risk Management Committee,
- (iv) Disclosure of utilization of funds from QIP/preferential issue,
- (v) Disclosures of auditor credentials, audit fee, reasons for resignation of auditors, etc.
- (vi) Disclosure of expertise/skills of directors,
- (vii) Enhanced disclosure of related party transactions and related parties to be permitted to vote against RPTs,
- (viii) Mandatory disclosure of consolidated quarterly results with effect from FY 2019-20,
- (ix) Enhanced obligations of the listed entities with respect to subsidiary companies,
- (x) Secretarial Audit to be mandatory for listed entities and their material unlisted subsidiaries under SEBI's Listing Regulations.

With respect to the increase in the eligibility criteria of independent directors, Kotak Committee has recommended: (i) Specific exclusion of persons who constitute the 'promoter group' of a listed entity, (ii) Requirement of an undertaking from an independent director that he/she is not aware of any circumstance or situation, which exists or may be reasonably anticipated, that could impair or impact his/her ability to discharge his/her duties with objective independent judgements, (iii) Board of the listed entity taking on record such declaration given by Independent director, (iv) Exclude 'board inter-locks' arising due to common non-independent directors on boards of listed entities. The introduction of a declaration from an independent director he/she is not aware of a particular circumstance or situation, intends to protect the interest and independence of independent director. The concept of 'board inter-locks' is a new concept for India Inc. It will be interesting to see the compliance level of the same. Interestingly, the SEBI Board has not approved of the proposal of minimum compensation to independent directors and disclosures on resignation of independent directors. In its Report, Kotak Committee had stated that the resignation of Independent Directors can be construed as a worrisome sign for external stakeholders, in order to provide greater clarity and reassurance to the stakeholder community, it is considered a good practice for companies to provide full disclosure on the reasons for an Independent Director's resignation. Kotak Committee's recommendation about the enhanced role of the Audit Committee has been accepted by the SEBI Board without any modification. Accordingly, the Audit Committee should be required to scrutinize the end utilization of funds where the total amount of loans/advances/investment from the holding company to the subsidiary exceeds Rs. 100 crore or 10% of the asset size of the subsidiary, whichever is lower. The SEBI Board has enhanced disclosure of related party transactions, which includes: (i) Half yearly disclosure of RPTs on a consolidated basis, in the disclosure format required for related party transactions in the annual accounts as per the accounting standards, (ii) Strict penalties may be imposed by SEBI for failing to make requisite disclosures of RPTs. Other than enhancing disclosures, there is no significant change in compliance for RPTs. With an objective to bring in more transparency and accountability, the SEBI Board has accepted Kotak Committee's recommendation of making appropriate disclosures w.r.t. utilisation of proceeds of preferential issues and Qualified Institutional Placements (QIPs) till the time such proceeds are utilised. However, the recommendation does not specifically mention whether the disclosure has to be quarterly, half-yearly or annually. The mandatory Secretarial Audit for listed entities and its material unlisted subsidiaries (under SEBI's Listing Regulations) is in line with the theme of strengthening group

oversight and improving compliance at a group level. SEBI, along with ICSI, will now define the scope of the Secretarial Audit.

#### **4. The SEBI Board accepted the following recommendations of Kotak Committee with modifications:**

- (i) Minimum 6 directors in the top 1000 listed entities by market capitalization by April 1, 2019 and in the top 2000 listed entities, by April 1, 2020,
- (ii) At least one woman independent director in the top 500 listed entities by market capitalization by April 1, 2019 and in the top 1000 listed entities, by April 1, 2020,
- (iii) Separation of CEO/MD and Chairperson (to be initially made applicable to the top 500 listed entities by market capitalization w.e.f. April 1, 2020),
- (iv) Quorum for Board meetings (1/3rd of the size of the Board or 3 members, whichever is higher) in the top 1000 listed entities by market capitalization by April 1, 2019 and in the top 2000 listed entities, by April 1, 2020,
- (v) Top 100 entities to hold AGMs within 5 months after the end of FY 2018-19, i.e., by August 31, 2019,
- (vi) Webcast of AGMs will be compulsory for top 100 entities by market capitalization w.e.f. FY 2018-19,
- (vii) Shareholder approval (majority of minority) for Royalty/brand payments to related party exceeding 2% of consolidated turnover (instead of the proposed 5%).

In view of the additional functions and obligations of the board of a listed entity, relative to unlisted entities, it is crucial that a sufficient number of directors with diverse backgrounds and skill sets are available on the boards of listed entities to fulfill these functions and obligations. Based on this background, Kotak Committee recommended minimum of 6 directors on board of listed entity. One of the most significant recommendations accepted by the SEBI Board is separation of CEO/MD and Chairperson. It is proposed that such amendment is to be initially made applicable to the top 500 listed entities by market capitalization w.e.f. April 1, 2020. The decision will have a significant impact on the promoter-driven companies in India. Holding Annual General Meetings within 5 months after the end of FY 2018-19, i.e., by August 31, 2019 (applicable for Top 100 entities) and compulsory webcast of the Annual General Meetings (applicable for Top 100 entities by market capitalization w.e.f. FY 2018-19) will have positive impact on the shareholder's participation in the general meeting, however, the cost of compliance (w.r.t. the webcast) will increase for these companies.

#### **Measures for Strengthening Algorithmic Trading Framework**

**5.** With an objective to strengthen algorithmic trading framework, the SEBI Board approved of the following proposals:

- (i) Stock Exchanges to introduce shared co-location services;
- (ii) Stock Exchanges to provide Tick-by-Tick Data feed to all the trading members, free of charge, subject to trading members creating the necessary infrastructure for receiving and processing it;
- (iii) Under the penalty framework for Order to Trade Ratio (OTR), penalty would be levied on Algo orders placed beyond  $\pm 0.75\%$  of Last Traded price (LTP) from the current level of  $\pm 1\%$  of LTP. Further, the OTR framework would also be extended to orders placed in the equity cash segment and orders placed under the Liquidity enhancement Scheme;
- (iv) Stock Exchanges to allot a unique identifier to each algorithm approved and each order generated by the algorithm to carry the unique identifier with it, in order to establish an audit trail and to ensure better surveillance of Algo trading;
- (v) Stock Exchanges to provide a simulated market environment for testing of software including algorithms. The stock exchanges to provide such facility over and beyond the current framework

of mock trading.

With an objective to strengthen algorithmic trading framework and reduce the cost of trading for the members who wish to operate from co-location facility, SEBI Board has approved of the above measures. Algo trading includes automated rule-based trading where decision-making is delegated to a computer model, while High Frequency Trading is a type of also which is latency sensitive and is characterised by high daily portfolio turnover and high OTR. SEBI Chairman, Ajay Tyagi said that "*The regulator's board has decided to review trading requirement for algo software for strengthening algorithmic trading framework by mandating stock exchanges to provide a simulated market environment for testing of software used for such high-frequency trades.*" The decisions taken by the SEBI Board are expected to address the concerns relating to market quality, market integrity and fairness on account of usage of algo trading and co-location. Co-location is a facility provided by exchanges to trading members and data vendors whereby their trading or data systems are allowed to be located within or at close proximity to the premises of the bourses. The facility enables the co-located entities to access the trade/order related data before other non-co-located entities. It also enables co-located members to minimise the time for sending orders to the trading system of the exchange.

### **Rationalizing and strengthening of the framework of Equity Derivatives Market**

6. SEBI Board approved of the following proposals to rationalize and strengthen the framework of the equity derivatives market, *inter-alia*, which includes the following:

- (i) To facilitate greater alignment of the cash and derivative market, physical settlement for all stock derivatives shall be carried out in a phased and calibrated manner;
- (ii) To update and strengthen the existing entry criteria for introduction of stocks into the derivative segment in line with the increase in market capitalization since the last revision of the criteria in 2012. Accordingly, existing criteria (like market wide position limit and median quarter-sigma order size) shall be revised upward's from current level of INR 300 crore and INR 10 lakh, respectively, to INR 500 crore and INR 25 lakh respectively;
- (iii) The stocks which are currently in derivatives but fail to meet any of the enhanced criteria, would be physically settled. Such stocks would exit the derivative segment if they fail to meet any of the enhanced criteria within a period of 1 year from the specified date or fail to meet any of the current existing criteria for a continuous period of 3 months;
- (iv) Stocks which are currently in derivatives and meet the enhanced criteria shall be cash settled;
- (v) To reflect global initiatives on product suitability, a framework has been approved. Individual investors may freely take exposure in the market(cash and derivatives) upto a computed exposure based on their disclosed income as per their Income Tax Returnover a period of time. For exposure beyond the computed exposure, the intermediary would be required to undertake rigorous due diligence and take appropriate documentation from the investor.

Physical settlement in derivatives means settling of a trade by giving and taking of shares rather than cash. Even though SEBI Board has announced physical settlement, it may not be implemented on all the stocks in the derivative segment. The decision is taken to reduce the high level of speculation in the derivative market. SEBI Board has enhanced the threshold, i.e., existing criteria (like market wide position limit and median quarter-sigma order size) from current level of INR 300 crore and INR 10 lakh, respectively, to INR 500 crore and INR 25 lakh respectively. As per the criteria, very few stocks could be available for physical settlement. Most of the widely traded stocks will be out of the purview. The decision taken by the SEBI Board would be implemented in a phased manner. On the decision, SEBI Chairman, Mr. Ajay Tyagi said "*Around 26% of the volumes in the equity derivative segment is accounted by retail investors. Moving to physical settlement would reduce speculation in the derivative market and facilitate greater alignment of price with the cash market.*"

### **Go Green initiative in Mutual Funds**

7. With electronic mode of communication being the preferred mode of communication besides being environment friendly, the SEBI Board approved of certain proposals, *inter-alia*, to dispense with the requirement of publication of daily NAV, sale, repurchase prices in newspapers and of sending (i) Physical copies of scheme annual reports or abridged summary to all the investors whose email addresses are not available, and (ii) Statement of scheme portfolios to unit holders on half-yearly basis. Instead, the aforesaid details will be placed on the websites of AMFI and Mutual Funds. SEBI Board resolved that the Mutual Funds shall publish an advertisement informing about hosting of the annual report and statement of scheme portfolios on the websites and shall provide the relevant information to investors upon request.

The decision taken by the SEBI Board of initiating electronic mode of communication will definitely reduce the administrative cost of the mutual funds which would ultimately provide surplus funds for further investments or declaration of dividend. Considering the fact that the investors are from different age groups and are spread across the country, electronic communication shall not be mandatory for all investors. The decision taken by the SEBI Board would require an amendment to the SEBI (Mutual Fund) Regulations and certain Circulars issued by SEBI would then be rescinded.

### **Amendments to SEBI (Alternative Investment Funds) Regulations, 2012 regarding Angel Funds**

8. Based on the recommendations of the working group, the SEBI Board has approved of following amendments to SEBI (Alternative Investment Funds) Regulations, 2012 with respect to 'Angel Funds':

- (i) Increase in maximum investment amount in venture capital undertakings by an angel fund in any venture capital undertaking from Rs. 5 crore to Rs. 10 crore,
- (ii) The requirement of minimum corpus of an angel fund reduced from Rs. 10 crore to Rs. 5 crore,
- (iii) Increase in maximum period for accepting funds from angel investors from 3 years to 5 years,
- (iv) The requirement of filing of scheme of memorandum to SEBI by angel funds replaced with the requirement of filing term sheet containing material information (as specified by SEBI) within 10 days of launching scheme,
- (v) The provisions of the Companies Act, 2013 shall apply to the Angel fund, if it is formed as a company.

With an objective to provide an impetus to early-stage start-ups, SEBI Board resolved to double the investment limit by angel funds in venture capital undertakings to Rs10 crore. The decision taken by the SEBI Board to increase the maximum period for accepting funds from angel investors from 3 years to 5 years, will provide angel funds more time to identify opportunities and invest in venture capital firms. SEBI Board has also clarified that the provisions of the Companies Act, 2013 shall apply to the Angel fund, if it is formed as a company. The provisions relating to private placement of shares, statutory limits for loans, guarantees and securities will be the crucial provisions in relation to the angel funds.

### **Revised Framework for non-compliance of the Listing Regulations**

9. SEBI Board resolved to revise the existing enforcement framework for non-compliance of the listing regulations by listed companies. The revised framework has the following distinct features:

- (i) It is more comprehensive and covers a wide gamut of listing regulations such as the requirements pertaining to composition of the listed company's Board and its committees, submission of Corporate Governance Compliance Report, financial results and voting results, etc. Non-compliance of these regulations will lead to imposition of fines by stock exchanges;
- (ii) It also empowers the stock exchanges to freeze the shareholding of the promoter and promoter group in such non-compliant entity as well as their shareholding in other securities. If non-compliance persists it will lead to suspension.

As per the Press Release of SEBI, the revised framework is expected to promote a better compliance culture apart from putting in place an appropriate system for effective enforcement of continuous compliance of requirements by listed companies and their promoter/promoter group. Based on the directions of SEBI, per day penalty can be imposed on the listed entity by stock exchanges for non-compliance of the provisions. The penalties are in addition to the provisions of Section 24 of the Securities Contracts (Regulation) Act, 1956 ('SCRA'). Section 24 states that where a contravention of any of the provisions of SCRA or any rule, regulation, direction or order made thereunder has been committed by a company, every person who, at the time when the contravention was committed, was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the contravention, and shall be liable to be proceeded against and punished accordingly.

### **Distribution of cash benefits by listed companies through Depositories**

**10.** The SEBI Board decided to include the option of distribution of cash benefits like dividends through Depositories, in addition to the present system of distribution directly by the listed companies or through their Registrar to an issue and/or Share Transfer Agents. As per the SEBI Press Release, the option will widen the choice for investors with its benefits such as shorter turnaround time for receiving benefits, ability to get consolidated statements of all such benefits and to receive alerts (SMS/E-mails), etc.

### **Amendment to Regulation 40 of the SEBI (LODR) Regulations, 2015 for mandating transfer of securities only in demat form**

**11.** SEBI Board revised the provisions relating to transfer of listed securities and decided that requests for effecting transfer of listed securities shall not be processed unless the securities are held in the dematerialized form with a depository. As per the SEBI Press Release, the measure is aimed at curbing fraud and manipulation risk in physical transfer of securities by unscrupulous entities. It also states that the transfer of securities only in demat form will improve ease, convenience and safety of transactions for investors.

Mandating transfer of securities only in demat form will not have a very significant impact on the investor's sentiments. In case of listed companies, the securities which are not in dematerialized form are mostly the cases relating to transmission. Based on the experience of half-yearly audits, the transfer of shares in physical form is quite rare. Most of the cases relate to transmission or nomination of shares. To curb fraud and manipulation risk in physical transfer of securities, there are adequate checks and balances in Regulation 40 of the SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015.

### **Proposed Framework of compliance with SEBI Regulations by listed entities subject to Corporate Insolvency Resolution Process under IBC**

**12.** The SEBI Board, on the basis of the discussion paper placed before it, approved of the proposal of undertaking a public consultation process as a part of reviewing the requirements of compliance with various SEBI Regulations by listed entities which are subject to Corporate Insolvency Resolution Process under the Insolvency and Bankruptcy Code, 2016. Various issues have been flagged in the discussion paper, which include aspects relating to disclosures, trading in stock exchanges, material related party transactions, re-classification of promoters, compliance with minimum public shareholding requirement and delisting pursuant to resolution plan/liquidation.

### **Proposal to review Regulations relating to buy-back of securities and Takeover Code, 2011:**

**13.** SEBI Board approved of the proposal of undertaking a public consultation process for reviewing the SEBI (Buy-back of Securities) Regulations, 1998 and the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 2011. As per the press release, the objective of such public consultation is to simplify the language, remove redundant provisions and inconsistencies, update the references to the Companies Act, 2013/other new SEBI Regulations, and incorporate the relevant circulars, FAQs, informal

guidance in the regulations, wherever possible. The press release states that an important amendment proposed to Takeover Code is granting of additional time for upward revision of open offer price.

## **Conclusion**

**14.** The SEBI Board has taken some significant decisions in its recent meeting-One of the most significant decisions being acceptance of certain recommendations of Uday Kotak Committee on Corporate Governance. The SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015 will undergo a round of amendments. Taking into account the on-going litigation, SEBI Board's decision of proposing a framework of compliance with SEBI Regulations by listed entities subject to Corporate Insolvency Resolution Process under Insolvency and Bankruptcy Code is also a significant and important decision. However, the SEBI Board has not deliberated on the proposed provisions relating to disclosure by listed companies in case of default in repayment of bank loans or interest.

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