Study of Company Act and The key changes brought about by the Amendment Act in 2017

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Introduction

Company Law, an ever evolving subject, has undergone major transformation in the last decade. The impetus for such transformation germinated partially from the worldwide move for market oriented polices and partially by disquieting features of globalization, resulting into focused attention on need for Good Corporate Governance. The advancements in information technology and influence of faster means of communications over corporate operations have also provided impetus for such transformation. In other words, the paradigm shift witnessed in the global economy and corporate sector the worldover, have cumulatively presented various issues that have triggered debate and become important factors for initiating changes in Company Law in our country and abroad.

The post reforms corporate India has witnessed tremendous growth and expansion as a result of deregulation and procedural simplification of Company Law. The corporate India experienced multifaceted growth in terms of number, size, volume and extraterritorial reach. This growth can be gauged from the fact that there were 5,84,184 companies limited by shares with an estimated aggregate paid up capital of Rs. 3,39,801.6 cores. Today, the Indian corporate sector has spread its wings in other parts of the world also and even resorted to acquisitions abroad. The catalyst behind this growth has been Government's commitment to provide growth oriented policy and regulatory framework for corporates. However, this corporate growth has been punctuated by incidences of corporate failures, securities scams, vanishing companies, mismanagement, growing shareholders dissatisfaction and unethical business practices. The Enron debacle and meltdown of certain once mighty US corporations have further aggravated the situation and raised various issues of Good Corporate Governance and attracted worldwide focus.

The Companies Act, 2013 (Act) was the legislative outcome of a process that had begun a decade earlier. Desiring a simplified and compact law with flexible rule making powers for 'ever changing business models', the Central Government constituted the JJ Irani Expert Committee on Company Law (Irani Committee). Unfortunately, the process from committee report to enactment resulted in a rather voluminous statute with reams of rules, riddled with drafting ambiguities and regulatory overlap.

Consequently, numerous stakeholders reported challenges in implementing the provisions of the Act. Despite an initial amendment and a flurry of clarifications, orders and rules, the Central Government set up another committee, the Companies Law Committee[1] (CLC) in 2016 to see where 'the shoe pinches'.

Based on the CLC report, an amendment to the Act (Amendment Act) was passed by the Lok Sabha last year, and thereafter by the Rajya Sabha on 19 December 2017. The Amendment Act received presidential assent yesterday and will come into force pursuant to notifications in the official gazette.

The key changes brought about by the Amendment Act are highlighted below:

Aligning Listing Agreement with the Companies Act 2013

Companies Act requirements on issuing a formal letter of appointment, performance evaluation, and conducting at least one separate meeting of the independent directors each year and providing suitable training to them are now included in the revised norms of SEBI. Independent directors are not entitled to any stock option, and companies must establish a whistle-blower mechanism and disclose them on their websites.

Restricting Number of Independent Directorships

Per Clause 49, the maximum number of boards a person can serve as independent director is seven, and three in case of individuals also serving as a full-time director in any listed company. The Companies Act sets the maximum number of directorships at 20, of which not more than 10 can be public companies. There are no specific limits prescribed for independent directors in the Companies Act.

Although SEBI reforms seem to be moving in the right direction, these limits may initially pose challenges in sourcing qualified independent directors for listed companies.

Maximum Tenure of Independent Directors

Based on the Companies Act as well as the new Equity Listing Agreement, an independent director can serve a maximum of two consecutive terms of five years each (aggregate tenure of 10 years). These directors are eligible for reappointment after a cooling-off period of three years.

Can a director who has served two five-year terms be considered independent after a cooling period of three years? CFA Institute recommends that board members limit their length of service on a specific company board to no more than 15 years to ensure new board members with fresh insights and ideas are elected.

Board-Mix Criteria Redefined

Per Clause 49 of the Equity Listing Agreement, 50% of the board should be made up of independent directors if the board chair is an executive director. Otherwise, one-third of the board should consist of independent directors. Additionally, the board of directors of a listed company should have at least one female director.

CFA advocates that diversity should be embraced from all angles, such as diversity of backgrounds, expertise, and perspectives, including an increased investor focus to improve the likelihood that the board will act independently and in the best interest of shareholders.

Role of Audit Committee Enhanced

The SEBI reforms call for two-thirds of the members of audit committee to be independent directors, with an independent director serving as the committee's chairman. While the Companies Act requires the audit committee to be formed with a majority of independent directors, SEBI has gone a step further to improve the independence of the audit committee.

The role of the audit committee also has evolved to incorporate additional themes from the Companies Act, such as reviewing and monitoring auditor independence, approval of related-party transactions (RPTs), scrutiny of inter-corporate loans, valuations, and evaluations of internal financial controls and risk management systems.

More Stringent Rules for Related-Party Transactions

The scope of the definition of RPTs has been broadened to include elements of the Companies Act and accounting standards:

All RPTs require prior approval of the audit committee.

All material RPTs must require shareholder approval through special resolution, with related parties abstaining from voting.

The threshold for determining materiality has been defined as any transaction with a related party that exceeds 5% of the annual turnover or 20% of the net worth of the company based on the last audited financial statement of the company, whichever is higher.

Since SEBI Clause 49 requires shareholder approval for all material RPTs, with no exception for transactions in ordinary course of business or at arms-length, companies feel that this will result in practical difficulties (i.e., compliances costs and delays), particularly for those that regularly transact business with subsidiaries.

The ultimate effectiveness of such legislation will depend upon the degree and quality of enforcement, or the monitoring capabilities of the regulator.

Improved Disclosure Norms

In certain areas, SEBI resorts to disclosure as an enforcement tool. Listed companies are now required to disclose in their annual report granular details on director compensation (including stock options), directors' performance evaluation metrics, and directors' training. Independent directors' formal letter of appointment / resignation, with their detailed profiles and the code of conduct of all board members, must now be disclosed on companies' websites and to stock exchanges.

E-voting Mandatory for All Listed Companies

Until now, resolutions at shareholder meetings in listed Indian companies were usually passed by a show of hands (except for those that required postal ballot). This means votes were counted based on the physical presence of shareholders. SEBI also has changed Clause 35B of its Equity Listing Agreement to provide e-voting facility for all shareholder resolutions.

We think this is a pertinent change as it will allow minority shareholders to express their voices at shareholder meetings without having a physical presence. CFA Institute has advocated for company rules that ensure each share has one vote.

Enforcement

SEBI is setting up the infrastructure to assess compliance with Clause 49 to ensure effective enforcement. Companies need to buckle up and assess the impact of these reforms and step up compliance.

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