Business Law for Managers
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Module-2: Corporate Governance

Lecture – 8
Major Structural Issues

Good evening, we are on lecture 8 major structural issues on corporate governance.

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Now, governance in India has gone through changes and changes have been quite drastic in nature though it took time, but it has in the last 10 years picked up speed momentum and genuinely concerned about the level of corporate governance that India is deciding and that signal also has gone to the community outside India, the international community, the foreign institutional investors, FDIs, the big investment giants; they also appreciate the journey of corporate governance and the spread, the momentum, the speed has been appreciated.

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The framework is quite robust. It started all with a board committee namely audit committee comprising mainly of a new nomenclature of directors which was conceived and introduced by the Securities and Exchange Board of India first time called independent directors, as if the directors in the board were primarily required to be independent, still required to be told that you gentlemen are independent directors.

If we see the definition of directors, you would find that directors are primarily required to be independent whether representative of majority shareholders or not that is not the criteria. He is basically a director who has to look into the interests of all the shareholders, not one shareholder, one, later on, all the stakeholders not shareholders only. Still, the need was that we need a class of gentlemen in the board to be declared to the outside world as independent directors.

Earlier, we are only 2 types of directors, executive directors and non-executive directors. Easy to understand directors who are in the employment of the company or executed directors like managing director or executive director per se, if the finance head CFO becomes a director if the legal head becomes a director, if the marketing head becomes a director, he becomes an executive director. All other directors are non-executive directors.

Now, within non-executive directors, SEBI created a separate block called independent non-executive directors. So, non-executive directors can be both independent and non-independent, but executed directors by their whole definition are always non-independent.

They can never be independent because they are paid employees; they are salaried employees. So, they cannot be independent of the management.

So, all executive directors are non-independent directors but all non-executive directors are not non-independent directors or independent directors, they are bifurcated into non-independent and independent. Now, in that independent lot, maximum number is taken and formed a committee called audit committee. So, an audit committee is constituted with the majority independent directors and chairman independent.

So, if 4-member committee is there, 3 will be non-independent and the chairman also will be non-independent. Therefore, only one person will remain who sorry, will be independent audit committee would be consisting of majority independent directors with chairman independent. So, supposing there are 4-member audit committee, 3 would be independent, chairman independent, only one person who will be non-independent that is a creation of SEBI.

Now, that is one part of it, a committee has been formed. So, what does this show? That this committee will be governed by independent directors largely. An independent directors will take the decision because decision of audit committee is always majority and majority being independent. So, decision of the audit committee will always be independent of the board, not be influenced by the majority shareholders in any way or by the board even.

They will be independent of the board. This was one part of it. But if you look at the powers of the audit committee, what the audit committee is going to do? We will be seeing that the practically the entire power that is there of the board as regards the financial part is concerned, including appointments and reappointments of CFOs, statutory auditors, internal auditors are all to be pre-approved by the audit committee, pre-approved.

Unless they approve, it will not go to the board. If they approve and it goes to the board, board can reject. But board cannot take on its own if they reject and it goes to the board, board takes it up on its own and approves it, then it has to be disclosed in the stock exchange. A very, very devastating disclosure, it should be that the board of directors has disregarded the view of the audit committee and appointed somebody which will be a blow for the corporate governance of the organisation to the outside world.

Huge power is given to the audit committee. So, that is one strong message that has gone to the corporate Indian corporate that the audit committee is primarily consisting of independent directors and all decisions, strategic decisions, important decisions are taken by the audit committee before it goes to the board.

Then there are other committees like nomination and remuneration committee will discuss in the next following slides, which we will call system independent directors only, only, which will consider the remuneration of the managing director, the key managerial personnel, any person who will be appointed as an independent director or a board has to be recommended by the nomination and remuneration committee consisting only of independent directors, then stakeholders' relationship committee.

How we are maintaining the relationship with the institutional shareholders and other stakeholders? Very important. What kind of complaints are coming from them? What kind of questions are raised by them? The committee has to see. Then perhaps a very important committee now, one of the most important committees of the board, risk management committee.

Every business community has multiple risks starting from operational risk, technology risk, cyber risk, financial risk, pandemic risk, pose major incident risk, technology risk, disruption risk. So many risks are there that sometimes one gets that how does the business perform which so many risk, procurement risk, foreign exchange validity risk. All these risks, political risks, you are doing business in a country where there is huge political risks.

So, your entire business is dependent or you are sourcing material from a country which has got huge political risk. Your main customer is located in a country which has got a huge political risk. So, various kinds of risk management committee risk management committees' job is to see the various kinds of risk and that continuous mitigation measures. Risk cannot be indicted. Business has to live with risk, but what are the mitigation measures and of course, the corporate social responsibility committee.

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So, section 149 of the Companies Act and SEBI LODR, listing, obligations, disclosure, regulations, very important is table LODR which I think is more important even than section 149 which guides the independent directors and their provisioning. Special resolution is required to increase the number of directors beyond 15.

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This is exactly the composition of a board. As I say, it can be basically executive and non-executive. Non-executive can further break down into independent and non-independent. This independent director is actually a break, breakaway group of the non-executive directors. And now comes one more provision, at least one women director. This is another very good introduction by SEBI, again by SEBI Security Exchange Board of India requirement that at least one women director should be there in the board.

It is important not only from diversity angle. It is also important for the quality of discussion that happens in a board. A woman director brings in a lot of in perspectives, which are perhaps missed out and mostly, I have seen from my personal experience, societal and governance, discussions and improvisations, focus is strengthened by the presence of a woman director.

Basically, what happens is discretion many times centered around business primarily. And at times environment of course, because that has something to do with the sustainability part of it, largely sustainably part of it. As for business, operational sustainability is required. But many times, A’s and G gets little more or less importance in the discretion of the board. The induction on the women director has been rightly done to bring that focus into it.

The societal aspect, the aspect of the governance, the aspect of the larger good, the aspect of the inclusive growth. The number is to go up from 1 to 2, to 3. And already we are seeing in many corporates, the number is 2, not 1, the number is 2. And SEBI has mandated now. One independent of women director, which was earlier only women, now it has been mandated one independent women director which is another very good move.

If the wife of a promoter is in the board, then it complies with the women director, but does it comply the very purpose? In later, it is complied, but is it complying in spirit? So, to comply in spirit, you require an independent woman director or a relation of majority shareholder is a lady and she occupies the post, most welcome to occupy. But, is it compliance in spirit? It is in law, of course.

But in the spirit, it was meant for women director. SEBI did not initially mandate it. The very nice move of SEBI, SEBI gives the blows gradually. Because the regulatory also needs to be given time to improve, you cannot bring a regulation on a fine morning and just put it on the regulatory. The regulator and the regulatory both have to survive. So, the regulatory is given time that look, I have come out with a one provision of a women director, better make it an independent woman director.

I will give 2 more years to make it independent woman director that exactly has happened. Now, it is an independent woman director, 50% of the board, non-executive directors and specific code of conduct has been given by the independent director; specific code of conduct. What you need to do? Very important. What you need to do your guidelines? Even to the extent of power has been given to independent directors to seek expert opinion, if he is not comfortable with something.

If he is not comfortable with the presentation of the CFO on the matter in which he does not have the expertise, he can say, I need to check with an expert in this. I will find out whatever you stated. I will get it reverted by the export and then only will pass this in the next board meeting. That power is also given to him. All the expenses of that consultant has to be borne by the company. Independent director has only to raise his voice saying that I need a riveting by such and such person whom he thinks is an expert in that.

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Another important prohibition has come in in this aspect is independent directors now have been told not to randomly accept assignments as independent directors because they also need to give time. So, a cap has been given maximum 7 listed companies, they can be independent so, on one individual independent director can be in the board of maximum 7 listed companies, not beyond that.

So, that he could do justice to all the requirements of an independent director. That is another very positive move. These are the constitution of an audit committee; very interesting. The audit committee should consider minimum 3 directors as member, 2 thirds of the members of audit committee shall be independent directors' majority; at least one member shall have accounted related financial expertise.

So, one member should have financial expertise. Why? Because finance is a subject which not everybody's cup of tea. It requires some specialised knowledge. He maybe a chartered accountant, maybe a finance; he maybe a CFAs. He may be anything but he must be considered or have the acumen knowledge to understand financial results. Because financial results are prepared by financial chartered accountants audited by statutory auditors, many times reading between the lines becomes a challenge.

I myself as a chartered accountant; I am a company secretary also; I also feel sometimes the results which have been published by the listed companies, which we go through perhaps the institutional investors, even the retail investors would not be able to get the full picture unless an analysis of this result is done. There is a gap in the presentation. There is always a gap in the presentation.

What is stated? What is perceived is a different. What is actual is again different. So, actual statement, perception, all are different. Now, is it done deliberately? No one can answer because legally absolutely correct. But interpretation is something which is something which is debatable, how it can be interpreted. Therefore, for that reason, he is stitching on the pant that one member should be financially literate.

Now, what is the definition of financial literate? It has been beyond be given whether it will be MBA finance from any premium management institute or he will be a finance-chartered accountant that has not been defined; it will leave open. However, it has been said that if he has been the managing director of a company, then he will be presuming that he will have financial literate.

But I have question mark even on that whether all managing directors of companies are financially literate is a question mark, because they are exceptionally good professionals in their own subject. But as the finance goes, other than seeing the bottom line, the top line, the various notes that come in interpreting that notes really, really becomes challenging. Independent directors shall be the chairperson of the audit committee and she shall be also present in the AGM to answer share's query.

So, shareholders will take him to task; shareholders have been given the power to take him to task in the only meeting that they have with the directors which is the annual general meeting. The shareholders meet them only once religiously that is in the annual general meeting. So, there, he can take the chairman of the audit committee with an independent director to task that how you are approved these results.

What is your answer to these results? Because this result must have been approved by you. Because any results, financial results has as I told, earlier said, stated has to be pre-approved by the audit committee. Then the shareholders will ask how is that these results have been approved by you; you are the chairman of the audit committee; you are an independent director; you are a financial literate.

Or you have in your stable financial literate directors; you may not be financially literate but at least one should be financial literate. So, how is that you have positive results? We do not accept this result. So, you will be taken to task.

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The company secretary, of course, is the secretary to the audit committee. Finance director, head of finance shall be invited. This is another important thing. The audit committee can invite the CFO, the head of internal audit, anyone under the sun, he wants to be present in the audit committee to question him, even to use the what, Coast Marshal him, even the factory head if there is an incident of fire, there is an incident of any damage, accident.

He has the all authority the audit committee to call each and every employee to present grilled, answered and desktop, what is happening because a large responsibility is given to the audit committee members to do their due diligence.

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Now, we come to another important committee, which is called the nomination and remuneration committee. The name suggests who nominating whom and remunerating whom. The committee actually nominates and remunerates all the independent directors, the directors, as well as the key managerial personnel. Who are the key managerial personnel in the company?

The only 3 persons who are defined as the key managerial personnel, key managerial personnel. They are the managing director, the company secretary and the Chief Financial Officer. These are the 3 key KMPs in an organisation. All 3s remuneration are to be screened and pre-approved by the nomination and remuneration committee. All directors of the company shall be non-executive directors.

50% of directors shall be independent directors and the chairperson shall be the nomination remuneration committee.

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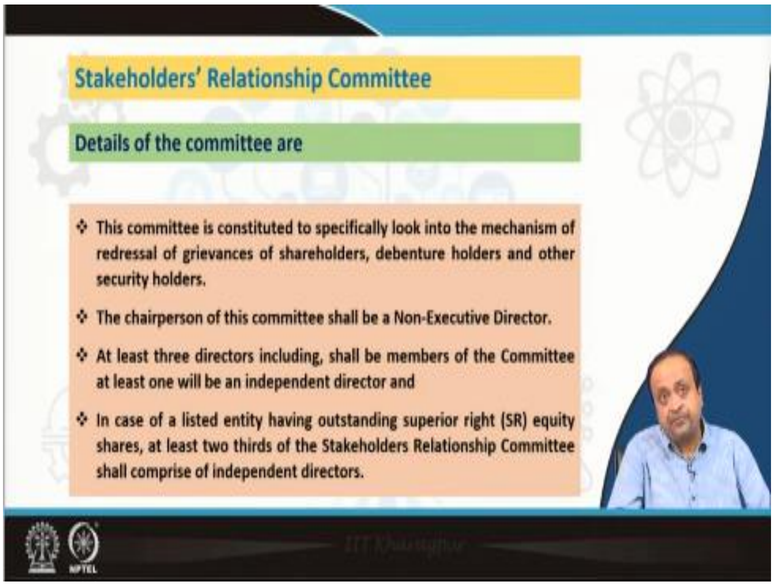

At least 3 directors shall be members of the committee; at least one will be an independent director; same thing in case of listed entity also your superior equity shares at least 2 thirds of shareholders relationship committee.

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Now, we are coming to another committee, but before that, this nomination remuneration committee will also be important in the respect that he is recommending somebody as an independent director, then the nomination remuneration committee actually has to take the owners, he is truly independent. If an independent director is not truly independent, the whole entity will fall. Then that question of corporate governance will not come.

It will not deliver the results. So, it is important prerogative for the nomination remuneration committee to recommend the right person as an independent director. And the chairperson of the nomination remuneration committee being an independent director would be in a better position to ensure the proper independent director is inducted in the board.

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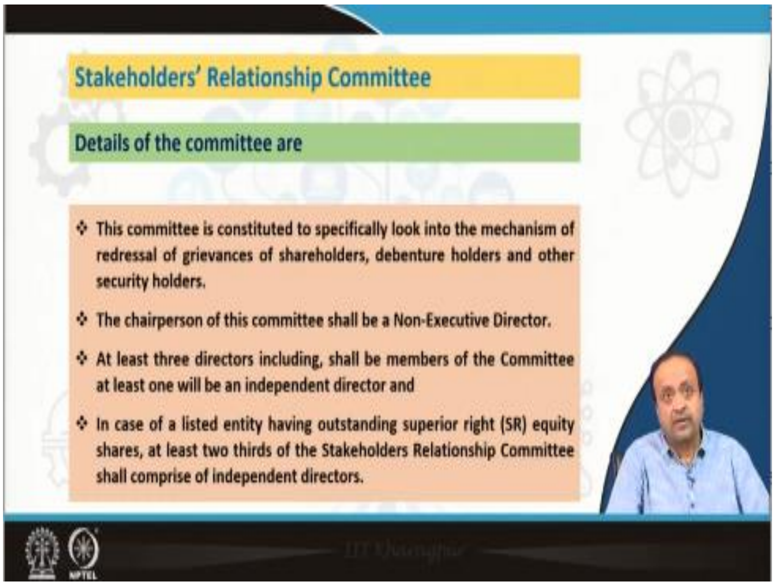

Stakeholders' relationship committee is another important committee which looks into the grievances of the shareholders; many times, the shareholders bring out very pertinent questions, but one thing is to be important understand that shareholders sometime ask questions which are not in public domain.

They may ask innocuous questions about the development of the company, the study of the company, what do we expect about the results of the company, how the company is doing, innocuous questions, but the answer to be take given only to the extent of information available in the public domain. No information can be given which is not available in the public domain.

Companies and companies have made mistakes in that and there have been violations of regulations. Very important regulation will discuss is prevention of insider trading, PIT, prevention of insider trading regulations. If any information is given, which is not in public domain, you know, said even, inadvertently even that will not help. Inadvertently will not help.

It will tantamount to violation and show cause and find an image of the company and therefore the market cap. So, it is very important that this comedy ensures no information goes out, which is not in public debate.

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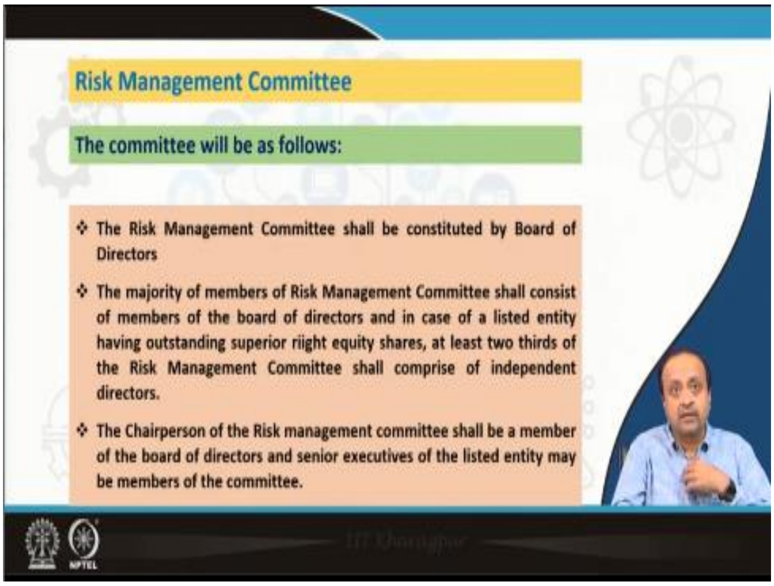

The risk management committee is another important committee which gives very early signals of corporate failure, corporate governance failure, very early signals, it can catch. If a proper risk management committee is there, it will be the first committee who will raise the red flag here is where you need to have your attention and convey that to the audit committee.

The risk management committee chairperson shall be a member of the board of directors, however, not specified to be an independent director, not required, but 2 thirds of risk management shall comprise of independent directors, but most companies have made the chairperson of the risk management committee as an independent director. Now, how does the risk management committee function?

The risk management committee prepares first of all a risk register, robust risk register, every company will have some risks, which are germane to that business means those come businesses are based on those risks. Certain business risk maybe from the procurement side that we have bought only 2 raw materials to produce the product. So, procurement of those 2 raw materials actually is the oxygen of the company.

If those 2 raw materials for any reason is not available, the business will fail. Whatever be the case, we need to develop other sources for those material. Maybe the procurement team will say that we have done everything possible and it was only one source. Now, we have to have developed a second source and they have done their best.

Risk management committee has to highlight this and say that we are still surviving on such a business, robust business with so much products, I mean, so much market share with so much contribution, but the root thing is still remains very thin and narrow. The route is thin and narrow because we are dependent only 2 suppliers. If for any reason, even one of them is cut, the business gets off that huge risk that may be a case of one of the companies or many of the companies.

Then there may be risks where some companies are doing business largely in an area or in a country, in a continent where there is huge political risk, nobody can stop it. Now, can we develop elsewhere? Or how do we mitigate that risk? Another example, there have been 2 or 3 ransom attacks, ransomware attacks, cyber risks. Even after that the management because of other considerations, other pressing business needs has overlooked it.

The risk management committee has noted that there have been 3 cases simultaneously of ransomware attacks. Man in the middle, another concept where you do not know who is doing it. I am sending money to my supplier man in the middle intercepts that money and money goes to him, I do not come to know. My account is still showing the money has gone to the vendor.

Vendor comes and says no, my money has not come to me. Then it has found out the vendor has asked for change your bank account. And I have sent that to the change bank account. The mail has been intercepted and change of bank account mail has been sent to us. This is happening random, men in the middle even during COVID times, this last 2 years this has become random for many companies.

Money is not going. Money has been sent right everything there, but money has gone to somewhere else. Similarly, while money coming, same thing has happened. Somebody has gone into the mail ID or somebody has captured this and done it, man in the middle. Now, the risk management looks at the mitigation misses. First, how the system can we make more robust? Can we do a third-party check?

The IT head says I have done everything. Nothing further can be done. We are absolutely okay now. He gives in writing but what does this mean. His writing does not prove anything that it is the best. So, the audit committee, risk management committees is nil. Let us engage a professional hacker. A professional hacker, these are ethical hacking, they say, ethical hacking, professional ethical hackers.

They will hack, taking your permission that I am hacking and trying to hack and you use all you might to stop me. Still, I will hack and show you I can hack, professional ethical hackers. Risk management committee may say we engage that and find out what is there or not. And last but not the least risk management committee might say, take a robust cyber risk insurance.

Much before everything else the risk management committee can highlight areas where we need to plug, so that governance is not impacted. Today, this is one of the primary committees and it takes a lot of time; this committee takes a lot of time if I have to rank the committees now in today's scenario, it will come very next to the audit committee. Audit committee and then the risk management committee.

Board of directors more of a mother body but the actual functional bodies which are holding the corporate governance together and raising the bar; ensuring there is very few chances of you know failures. I will not say 100% but very, very few narrowing down that are the audit committee and the risk management committee.

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CSR committee is again; is basically a committee to ensure that the policies of CSRs are imbibed. It is socially responsible and that we comply with the law.

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The committee mainly looks into the fact that whatever is stated like 2% of the net profits of the company, the policies that are framed, the pay the areas activities, which are mentioned where you can invest are properly done. Disclosures in the annual report status report very important. The CSR committee has to maintain that. If for any reason, any disclosures is not complying, the CSR committee would be squarely responsible.

CSR again can be environmental, can be philanthropic, ethical, economically responsible. I think economic responsibility is what makes this the CSR strategic in nature. Ethical has to be because it cannot be the do something finally, which brings good too few people. It has to be for all. It cannot be for few; then that is not CSR. Transparency and accountability is very important in CSR.

Philanthropic, we have seen philanthropic is always required in CSR. A part of CSR will always be philanthropy. There will always be some crisis nations call, regions call, call of the heart, somebody is having some problem in doing some studies, you get a request and committee considers that, well, this is a genuine case, we should give help, help the child to have the operation or the studies. So, philanthropy will always be there in CSR.

I mean, there cannot be a CSR when there is no philanthropy. One way, CSR is also, one way you cannot stop, I mean, one should not even think of not doing philanthropic CSR, just because he is not strategic. Philanthropy is a part of CSR even if it is not strategy.

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Environmental obviously, is CSR because environmental aspect has to be taken care of. Corporate Social Responsibility committee is a part of the board. It creates the committee amounts of expenditure incurred, monitors this corporate policy of the company.

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2% of the average net profits of the company is again something which is not, I personally feel is required, but that is the law, one has to abide by the law. And, again, net profits are not during the three immediately preceding financial years. It is not that all the three years you have to earn profits, it can be one year, last two years profit but net there has to be plus minus profit for the three years.

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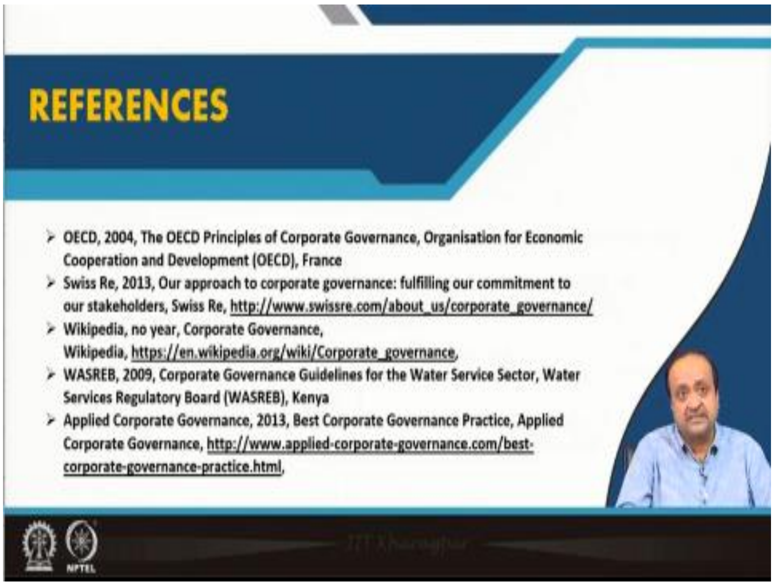

References are taken. As I said from different textbooks, but it is more from my experience that I always share in my slides and when I deliberate on this, being in this for so many years. Thank you so much. Thank you.