Implications of Companies Act, 2013

Governance
The Companies Act, 2013: An overview

The Companies Act, 2013 (‘2013 Act’), enacted on 29 August 2013 on accord of Hon’ble President’s assent, has the potential to be a historic milestone, as it aims to improve corporate governance, simplify regulations, enhance the interests of minority investors and for the first time legislates the role of whistle-blowers. The new law will replace the nearly 60-year-old Companies Act, 1956 (‘1956 Act’).

The 2013 Act provides an opportunity to catch up and make our corporate regulations more contemporary, as also potentially to make our corporate regulatory framework a model to emulate for other economies with similar characteristics. The 2013 Act is more of a rule-based legislation containing only 470 sections, which means that the substantial part of the legislation will be in the form of rules. There are over 180 sections in the 2013 Act where rules have been prescribed and the draft rules were released by the MCA in three batches. It is widely expected that the 2013 Act and indeed the rules will provide for phased implementation of the provisions and in line with this, 98 sections of the 2013 Act have been notified and consequently the corresponding section of the 1956 Act cease to be in force.

The 2013 Act contains a number of provisions which have significant implications on Governance of the companies. In this bulletin we analyse some of the key provisions and have identified certain action steps and challenges associated with the implementation of these provisions for the companies to consider.

“There is lot to note in the new Companies Act as it brings in sweeping changes in the way the corporates are governed in India. The 2013 Act enhances significantly the role and responsibilities of the Board of directors by making them more accountable for their actions while protecting shareholder interest. Also, by mandating a woman director on the board, the intent of the 2013 Act is to improve gender diversity and increase transparency. The 2013 Act clearly sets an example in corporate governance for other economies to emulate.”

— Yogesh Sharma
Partner
Grant Thornton India LLP
## Composition of the Board

### Key changes and requirements

<table>
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<th>Appointment of directors</th>
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<tr>
<td>The 1956 Act provided that the limit for maximum number of directors be based on its articles or twelve whichever is lower. The 2013 Act provides that the company shall have a maximum of fifteen directors on the Board of Directors ('Board') and appointing more than fifteen directors would require approval of shareholders through a special resolution.</td>
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<tr>
<td>The 1956 Act did not prescribe any academic or professional qualifications for directors. The 2013 Act provides that majority of members of Audit Committee including its Chairperson shall be persons with ability to read and understand the financial statements.</td>
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<td>The 2013 Act provides for appointment of at least one woman director on the Board for such class or classes of companies as may be prescribed. A transitional period of one year has been prescribed to companies for the compliance with this provision.</td>
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<tr>
<td>The 2013 Act provides that a company should have at least one director who has stayed in India for a total period of not less than hundred and eighty two days in the previous calendar year.</td>
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<tr>
<td>The 1956 Act required that a public company can have one director elected by small shareholders; however, as per the 2013 Act, this provision is applicable for listed companies only.</td>
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<td>The 2013 Act introduces a new category of a company, One Person Company (“OPC”), which should have at least one director.</td>
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<tr>
<td>For the first time, duties of the directors are defined under the 2013 Act.</td>
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### Analysis and implications

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<tr>
<td>Increasing the maximum limit of directors would bring in more flexibility and enable companies to get more experienced and competent personnel at the Board level.</td>
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<tr>
<td>Providing for the qualification of the audit committee members would enable the company to have quality people on the board to make the board's functioning more effective.</td>
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<tr>
<td>The prescribed minimum women representation on company board, is a step towards making the top deck more gender sensitive. Companies must also bear in mind that whilst women directors can be executive they do not need to be independent.</td>
</tr>
<tr>
<td>The hundred and eighty two days limit is consistent with the Income Tax (“IT”) Act for determining the residential status of a person.</td>
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<tr>
<td>Now, the unlisted public companies would not be required to get a director appointed by small shareholders.</td>
</tr>
<tr>
<td>The OPC provision enables removing nominee/representative directors which were appointed to meet the minimum director limit and as such did not provide any benefit to the company's structure.</td>
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### Action steps

- Companies must put in place a mechanism to assess and periodically monitor foreign travel of its directors so as to ensure that at least one director meets the hundred and eighty two days criterion for being considered as a resident in India.
- Companies should actively start looking for a woman director considering they have only a short period to comply with this requirements of the 2013 Act.
## Composition of the Board

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<th>Key changes and requirements</th>
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<td><strong>Disqualification of directors</strong></td>
<td>The 2013 Act makes directors’ disqualification more stringent, including more scrutiny around related party transactions.</td>
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<tr>
<td>The 2013 Act includes the following additional grounds of disqualification:</td>
<td>The 2013 Act brings in more stringent provisions to include such disqualification for the private companies as well, thereby bringing more discipline in the Board for private companies.</td>
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<tr>
<td>• A person who has been convicted of an offence dealing with related party transactions at any time during the past five years.</td>
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<tr>
<td>• Similar to the public companies under the 1956 Act, the directorship in private companies has also been brought under the ambit of disqualification on ground for non-filing of annual financial statements or annual returns for any continuous period of three years, or failure to repay deposits (or interest thereon) or redeem debentures (or interest thereon) or pay declared dividend and such failure continues for more than one year.</td>
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### Independent directors (‘ID’)

Under 1956 Act, there was no requirement to have IDs. However, under the Listing Agreement, the Board of listed entities having non-executive chairman and executive chairman should comprise of at least one-third and one-half of the Board as ID respectively. The 2013 Act proposes that the Board of listed entities should comprise at least one-third of the Board as ID.

This provision brings in the ID requirements and monitoring under the 2013 Act. It is notable that the existing Listing Agreement requirements are more stringent than the requirement of the 2013 Act.

### Transitional Period

The 2013 Act also provides one year period from the enactment to comply with this requirement.

Other provisions with respect to IDs are discussed in detail in the following paragraphs.

### Action steps

- Private companies to review the director's disqualification and ensure compliance for their existing directors.
- Private companies to consider including disqualification of directors as a part of its articles of association.
## Board functioning

### Key changes and requirements

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<th>Notice of Board meeting</th>
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<tr>
<td>The 1956 Act provided that notice of every Board meeting should be given in writing. However, it did not specify the period of notice. The 2013 Act provides that a minimum of seven days notice to the Board is required to call a Board meeting.</td>
<td>The 2013 Act intends to provide the Board sufficient time to prepare for the meeting.</td>
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<tr>
<td>The company may give a shorter notice to transact urgent businesses, provided at least one ID is present at the meeting. In case of absence of ID from such a meeting, decisions taken at the meeting to be circulated to all the directors and to be made final only on ratification by at least one ID.</td>
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### Frequency of Board meetings

| The 1956 Act required at least one Board meeting to be conducted in every three calendar months and four such meetings in a financial year. Further, Listing Agreement requires at least four meetings in a year with a maximum time gap of four months between two meetings. | The provision makes the requirements for frequency of Board meeting similar for public and listed companies. |
| The 2013 Act, consistent with the Listing Agreement requirement, provides that the company should have at least four meetings in a year with a maximum time gap of one hundred and twenty days between two meetings. | |
| The 2013 Act also requires that the first Board meeting of the company be held within thirty days of incorporation of the company. | |

### Conduct of the Board meeting

| Participation in the Board meeting through prescribed video conferencing or other audio visual means is recognised, provided such participation is recorded and recognised. However, the Central Government (‘CG’) may prescribe matters to be discussed at a physically convened Board meeting. | The provision of conducting the Board meetings through electronic means would bring in more ease to the Board's functioning. |

### Action steps

Companies may need to frame a policy as to what would qualify as an urgent business and related time window for transacting such urgent business in order to comply with the seven-day notice period requirement. For example, the items could include – completion of statutory audits and reports thereon.
Board functioning

### Key changes and requirements

**Audit committee**

The 1956 Act required public companies having paid-up capital of more than Rs 5 crore to constitute audit committee, consisting of minimum three directors and two-third of total members to be directors other than Managing Director (“MD”) or Whole Time Director (“WTD”) of the company. Further, similar to the 1956 Act, listed entities are required to constitute audit committee with two-third of the members to be IDs. Listing agreement also states that all members of the audit committee should be financially literate and at least one should have accounting or financial management expertise.

As per the 2013 Act, audit committees made mandatory for listed companies and other prescribed classes of companies.

The 2013 Act provides that audit committee should consist of minimum of three directors with IDs forming majority. Further, the chairperson and the majority of the members of the audit committee should have the ability to read and understand the financial statements (referred as “financially literate” under the Listing Agreement).

The role of the audit committee includes the following activities as per the 2013 Act:

a) the recommendation for appointment, remuneration and terms of appointment of auditors of the company;

b) review and monitor the auditor’s independence and performance, and effectiveness of audit process;

c) examination of the financial statement and the auditors’ report thereon;

d) approval or any subsequent modification of transactions of the company with related parties;

e) scrutiny of inter-corporate loans and investments;

f) valuation of undertakings or assets of the company, wherever necessary;

g) evaluation of internal financial controls and risk management systems;

h) monitoring the end use of funds raised through public offers and related matters.

The audit committee shall have the authority to investigate into any matter in relation to the items specified above or any such matter referred to it by the Board.

**Analysis and implications**

The 2013 Act makes directors’ disqualification more stringent, including more scrutiny around related party transactions.

The 2013 Act brings in more stringent provisions to include such disqualification for the private companies as well, thereby bringing more discipline in the Board for private companies.

### Action steps

- Unlisted public companies to revisit the need to continue with an audit committee requirement.
- Audit committees would need to devise a mechanism to:
  - form a policy for recommendation and appointment of auditors of the company;
  - review and monitor the auditor’s independence related matters;
  - approval and/or modification of the related party transactions;
  - valuation of undertakings or assets of the company;
  - evaluation of internal financial controls and risk management systems.
### Board functioning

#### Key changes and requirements

<table>
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<th>Nomination and Remuneration Committee</th>
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<tr>
<td>The 1956 Act did not provide for the constitution of a Nomination and Remuneration Committee. Under the Listing Agreement listed entities have an option to constitute a Remuneration Committee and such committee should consist of minimum of three directors, all of whom should be non-executive directors and the chairman should be an ID. The 2013 Act requires all listed companies and other prescribed classes of companies to constitute Nomination and Remuneration Committee that formulates the criteria for selection of the directors, a policy relating to the remuneration for the directors, Key Managerial Personnel (“KMP”) and other employees. Such committee should consist of three or more non-executive directors and at least one-half of the members should be IDs.</td>
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<tr>
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<tr>
<td>This provision will result in mandatory requirement to constitute Nomination and Remuneration Committee for listed companies and other prescribed class of companies. This may result in change in practice for several companies. The 2013 Act does not provide any transitional period for compliance with the constitution of a Nomination and Remuneration Committee.</td>
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<tr>
<th>The Corporate Social Responsibility (CSR) Committee</th>
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<tr>
<td>The 1956 Act did not mandate a company to spend on CSR activities and consequently, there is no requirement to constitute a CSR Committee. The 2013 Act provides that a company meeting certain conditions, should constitute a CSR Committee of the Board, consisting of minimum of three directors. The CSR Committee should consist of a minimum of one ID. The CSR committee should formulate and monitor CSR policies and discuss the same in the Board’s report.</td>
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<tr>
<td>This new committee will frame and monitor the CSR policy of the company and matters incidental thereto. The CSR policy would specify the projects and programs to be undertaken and also their execution modalities and implementation schedules.</td>
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</table>

### Action steps

- Listed entities to form a Nomination and Remuneration Committees even though it is not mandatory as per the Listing Agreement.
- All the companies will need to determine the applicability of the CSR criteria and also the activities that may constitute CSR activities under the 2013 Act, to ensure compliance.
# Board functioning

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<td><strong>Stakeholders Relationship Committee</strong></td>
<td>The provisions have widened the scope of investor/shareholder grievance committee constituted under the requirement of the Listing Agreement. As a result, the 2013 Act protects all security holders in addition to equity investors. This provision applies to non-listed entities, meeting certain prescribed conditions and hence will be a significant change in practice.</td>
</tr>
<tr>
<td>The 1956 Act did not require the constitution of Stakeholders Relationship Committee. The Listing Agreement requires constitution of the committee to look into the redressal of the shareholder and investors complaints under the chairmanship of non-executive directors.</td>
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<tr>
<td>The 2013 Act requires that a company with more than 1000 shareholders, debenture holders, deposit holders and other security holders at any time during the financial year shall constitute a Stakeholders Relationship Committee to resolve their grievances.</td>
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<tr>
<td>The 2013 Act does not prescribe the number of members of such committee consistent with the Listing Agreement, however provides that a non-executive director should be the chairman of such committee.</td>
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## Action steps

A non-listed company with more than 1000 share/debenture or security holders to form stakeholders relationship committee and include one non-executive director.
## Board functioning

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<tr>
<td><strong>Board’s report and responsibility statement</strong></td>
<td>The provision increases the responsibilities and improves transparency of the functioning of the Board.</td>
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<tr>
<td>The 2013 Act seeks to make the board's report more informative with extensive additional disclosures like:</td>
<td>The disclosures may also contain information that is commercially sensitive and accordingly companies will need to develop the disclosures carefully.</td>
</tr>
<tr>
<td>• Extracts of the annual return in prescribed form;</td>
<td>The requirements on internal financial controls are similar to global requirements and may require significant efforts and costs to ensure compliance.</td>
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<td>• Recommendations of the audit committee that are not accepted by the Board and reasons therefore;</td>
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<td>• A statement on declaration by the IDs on their compliance being IDs;</td>
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<td>• Policy developed and implemented by the company on CSR;</td>
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<td>• In case of a listed company, statement indicating the manner in which annual evaluation has been made by the Board of its performance, its committee and individual directors;</td>
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<tr>
<td>• Development and implementation of risk management policy;</td>
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<tr>
<td>• Policy on director's appointment and remuneration, ratio of remuneration to each director to the median employee’s remuneration;</td>
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<tr>
<td>• Material changes and commitments, affecting company’s financial position subsequent to the year end; to which the financial statements relate and the date of the reports;</td>
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<tr>
<td>• Related party transactions not in the ordinary course of business and not at arm’s length basis;</td>
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The 2013 Act has included the following additional matters in the Directors’ responsibility statement:

- in case of a listed company, the directors had laid down internal financial controls to be followed by the company and they are adequate and operating effectively;
- the directors have devised proper systems to ensure compliance with all applicable laws and such systems are adequate and operating effectively.

<table>
<thead>
<tr>
<th>Action steps</th>
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<tbody>
<tr>
<td>• Companies to obtain additional information on transactions to be reported to and approved by the Board.</td>
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<tr>
<td>• The Board to device a mechanism to evaluate its own annual evaluation and events occurring post year end.</td>
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<tr>
<td>• The &quot;internal financial controls&quot; and its monitoring by the board in the 2013 Act will require companies to set up appropriate mechanism/ processes/ systems to be able to give such declarations.</td>
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# Related parties

## Key changes and requirements

### Related party transactions

As against the term “relative” defined under the 1956 Act, the 2013 Act defines the term “related party” for the first time.

The 1956 Act and the Listing Agreement do not require specific approval of the related party transactions by the Board/shareholders. However, Listing Agreement requires listed entities to present list of related party transactions and other related information to the audit committee.

The 2013 Act proposes that all related party transactions which are not in the ordinary course of business or not at arm’s length basis should be approved by the Board.

The 2013 Act also proposes that for the companies with the prescribed share capital, no contract or arrangement or transactions exceeding prescribed amount, shall be entered into with its related party, unless, approved by the shareholders of the company by way of a special resolution. However, the related party shareholders are not permitted to exercise their voting rights, in such special resolution.

The 2013 Act also proposes that a company shall not make investments through more than two layers of investment companies, unless the investments are in an overseas company and the company has overseas subsidiaries and such layers are permitted under the local law of the company being acquired or under the law of the acquiring company.

Every contract or arrangement entered into with a related party shall be referred to in the Board’s report along with the justification for entering into such contract or arrangement.

In addition to the related parties identified under the existing notified accounting standards, the 2013 Act proposes to include more related parties than what has been considered for disclosures in the financial statement.

Based on the size of capital or the size of transactions, certain additional companies may require prior approval of members for related party transactions.

## Analysis and implications

## Action steps

- Companies to identify all related parties since the scope of such parties has been expanded.
- Companies need to identify whether the expanded list of related parties is consistent with the application requirement of the accounting standard.
- Companies to assess whether they are covered in the expanded list as identified by the 2013 Act to require member's approval.
- Resolutions requiring the approval of the members would not have the voting of the concerned related party voting on such transaction.
The concept of ID has been introduced and defined under the 2013 Act as a director other than a managing director or a whole-time director or a nominee director, who:

• is a person of integrity and possesses relevant experience.
• is not a promoter/a relative of a promoter (or director) of the company or its holding/subsidiary/associate company and does not have pecuniary relationship with the company/its holding/subsidiary/associate company / promoters/directors of the company during the current financial year or during the two immediately preceding financial years.
• whose relatives do/did not have pecuniary relationship amounting to two percent or more of the gross turnover or total income or Rs 50 lakh or such higher as may be prescribed, whichever is lower with the company/its holding/subsidiary/associate company / promoters/directors of the company in the current financial year or during the two immediately preceding years.
• is not a KMP or whose relative is not a KMP, of the company or its holding/ subsidiary/associate in the last three years.
• has not been an employee or partner in a firm of auditors or company secretaries or cost auditors of the company/its holding/subsidiary/associate company or in a legal/consulting firm that has or had any transaction with the company /its holding /subsidiary/associate company amounting to ten percent or more of the gross turnover of such firm.
• does not hold more than two percent (individually or with his relatives) of the total voting power.
• is not Chief Executive Officer or director of non-profit organization, receiving twenty five percent or more of its receipts from the company/its promoters/directors/ its holding/subsidiary/ associate company or holds more than two percent of the voting power.

Listed companies shall have at least one-third of the total number of directors as IDs and the CG may prescribe the minimum number of IDs for any class of public companies.

The definition of the term "IDs" is different as compared to the definition under the Listing Agreement with respect to the following:

• The 2013 Act provides quantitative threshold for evaluation of significance of the relationship; and
• Considers all pecuniary relationship (both material and immaterial).

This difference may result in a director being disqualified as an ID under the 2013 Act, however he may still be independent as per the Listing Agreement.
Independent directors

**Term of appointment and other requirements**

The ID shall be appointed for a term of up to five years and be eligible for re-appointment subject to certain conditions for two such terms. Thereafter, the ID shall be eligible for appointment after a cooling off period of three years, subject to certain conditions. Alternate director of an ID can be appointed if such an alternate director is also an ID. This requirement is to be complied within 1 year:

- by existing listed companies from the date of enactment of the 2013 Act; and
- by the prescribed class of public companies from the date Rules are notified.

IDs should provide declaration at the date of appointment and at the first meeting of the Board in every FY confirming that he meets the criteria of independence unless there are changes in the circumstances since last declaration. Currently, under the Listing Agreement there is no such requirement to provide any declaration.

In the 1956 Act, an ID may be remunerated by way of grant of stock options in addition to fees/commissions. The 2013 Act provides that the ID should not be remunerated by grant of stock options.

The 1956 Act did not mandate laying down the code of conduct. However, under the Listing Agreement, listed companies are required to have a code of conduct for all Board members and senior management of the company. The 2013 Act prescribes in a separate schedule, on Code of conduct applicable only for IDs.

The 2013 Act provides that CG is empowered to notify any body or institute or association to maintain a databank containing particulars of the IDs such as name, address, qualification.

**Analysis and implications**

The mandatory rotation period is a significant change in practice and is aimed to improve objectivity of the ID. The availability of qualified personnel to act as ID could pose challenges in implementation of these provisions.

It is also noted that there is no requirement for ID rotation in other developed countries.

The provision is aimed at addressing objectivity of the IDs. However, the 2013 Act does not specify the implication of outstanding stock options granted previously to IDs.

This appears to be inconsistent with Clause 49 read with the applicable SEBI guidelines, pursuant to which IDs may be granted stock options.

The 2013 Act provides a guide to professional conduct for IDs which will provide confidence to the investor community, particularly minority shareholders, regulators and companies in the institution of the independent directors.

The provision will improve the efficiency and effectiveness in selecting qualified personnel. The time frame during which the data bank has to be prepared has not been defined.

**Action steps**

- Potentially, additional public companies may be identified for the requirement of inducting IDs.
- Companies to obtain information from IDs pertaining to them and their relatives to conclude that the independence criteria is met annually.
- Listed companies will need to assess how they would apply the stricter policy of independence as per the 2013 Act and the requirements of the Listing Agreement.
- Determine the course of action for directors that may not qualify as independent under the 2013 Act – such as nominee directors.
- Companies will need to identify outstanding stock options previously granted to IDs and determine the appropriate course of action.
- The directors need to evaluate as to by when they need to get themselves registered with the data bank.
# Other provisions

## Key changes and requirements

### Number of directorships

The 1956 Act provided for maximum directorship of not more than fifteen companies and following directorships were not considered in the limit:
- Private companies
- Unlimited companies
- Associations not carrying on business for profit or which prohibit payment of dividend
- Alternate directorships
- Foreign companies

The 2013 Act provides that a person cannot have directorships (including alternate directorships) in more than twenty companies, including ten public companies. For determination of public companies, directorship in private companies that are either holding or subsidiary company of a public company shall be regarded as a public company.

It is noted that members at their discretion can prescribe a lower number of companies in which a director of the company may act as a director.

The 2013 Act provides for one year period from the enactment to comply with this requirement.

### Restriction on power of Board

As per the 2013 Act, restriction on power of Board to exercise specified powers with general meeting approval extended to private companies. In all cases approval of shareholders by a special resolution made necessary. As per the 1956 Act, it was applicable for the public companies and the private companies being the subsidiary of the public company and there was no mention for the type of the resolution to be passed at the general meeting.

The Board can act on certain prescribed matters only after obtaining the consent of the members by a special resolution.

Private companies would also require to ensure and enlist of the matters that could be transacted by passing a special resolution.

### Resignation

Provisions with respect to resignation of a director have been specifically provided under the 2013 Act. Where all directors of a company resign or vacate the office, the promoter or in his absence, the CG will appoint the required number of directors till new directors are appointed in a general meeting.

### Analysis and implications

The provision increases the number of directorships from 15 to 20. However, it may result in many directors already exceeding the prescribed limits as the directorship in more companies (excluding foreign companies) and alternate directorships are counted for this purpose now.

## Action steps

- Companies and their directors will be required to identify their directorships and transition out over the year if they exceed the limit.
- Companies will also need to identify replacement directors – including IDs.
- The companies need to consider updating their charter documents for incorporating the provisions with respect to duties and resignation of the directors.
## Penalties

### Key changes and requirements

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<th>Prohibition of insider trading</th>
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<tr>
<td>New clause has been introduced with respect to prohibition of insider trading of securities under the 2013 Act.</td>
<td>While the 1956 Act was silent on the provisions relating to insider trading, the 2013 Act on the other hand, lays down provisions relating to prohibition of insider trading with respect to all companies This is a step towards harmonization between the 2013 Act and the SEBI Act; more specifically for listed companies;</td>
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<tr>
<td>The definition of price sensitive information has also been included.</td>
<td>Any person who violates the clause will be punished with a cash fine or imprisonment or both.</td>
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<tr>
<td>No person including any director or KMP of a company shall enter into insider trading except any communication required in the ordinary course of business or profession or employment or under any law.</td>
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### Penalties

The 2013 Act proposes significant penalties for directors for defaults in discharging his duties. It is noted that the instances for levying penalties have increased substantially too.

### Class Action

Unlike the 1956 Act, the 2013 Act provides for class action suits, which will allow a requisite number of members or depositors with common interest, in a matter, to file an application in the National Company Law Tribunal (‘NCLT’) against the company/its management/its auditors or a section of its shareholders for damages or compensation if they are of the opinion that the management or conduct of the affairs of the company are being conducted in a manner prejudicial to their interest.

Class Action suit provides empowerment to minority stakeholders to come together and seek action against the management, advisors and auditors of the company for any oppression or mismanagement. However, in the absence of significant anti-abuse provisions in the implementation rules, this can be misused.

The new risks and liabilities will enforce more responsibility into the role of a director.

### Action steps

- The companies need to develop a mechanism for keeping a check on insider trading and price sensitive information.
- The companies need to prepare a strong mechanism to ensure adherence to the rules and regulations as per the 2013 Act so as to avoid the rigorous penalties laid down under the 2013 Act.
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NEW DELHI
National Office
Outer Circle
L 41 Connaught Circus
New Delhi 110 001
T +91 11 4278 7070

BENGALURU
“Wings”, 1st floor
16/1 Cambridge Road
Ulsoor
Bengaluru 560 008
T +91 80 4243 0700

CHANDIGARH
SCO 17
2nd floor
Sector 17 E
Chandigarh 160 017
T +91 172 4338 000

CHENNAI
Arihant Nitco Park, 6th floor
No.90, Dr. RK Salai
Mylapore
Chennai 600 004
T +91 44 4294 0000

GURGAON
21st floor, DLF Square
Jacaranda Marg
DLF Phase II
Gurgaon 122 002
T +91 124 462 8000

HYDERABAD
7th floor, Block III
White House
Kundan Bagh, Begumpet
Hyderabad 500 016
T +91 40 6630 8200

KOLKATA
10C Hungerford Street
5th floor
Kolkata 700 017
T +91 33 4050 8000

MUMBAI
16th floor, Tower II
Indiabulls Finance Centre
SB Marg, Elphinstone (W)
Mumbai 400 013
T +91 22 6626 2600

NOIDA
Plot No. 19A, 7th Floor,
Sector 16-A,
Noida 201301.
T +91 120 7109001

PUNE
401 Century Arcade
Narangi Baug Road
Off Boat Club Road
Pune 411 001
T +91 20 4105 7000

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