

Corporate Governance-2004

Revised Clause 49 in the Offing

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< EXECUTIVE SUMMARY >

◆ Happy New Year. What's in store? SEBI takes a leap in the leap year. Revised Clause 49 introduced on 26.8.2003, scheduled for implementation from 31.3.2004 has been put up for public comments. For the time being, implementation is deferred

as implications are long term and far reaching. The amendments send waves across corporate boards, audit committees and what not Corporate world keeps its fingers crossed.....

1. RECENT DEVELOPMENT



The Securities and Exchange Board of India (SEBI), the market regulator has just announced the complete revision of Clause 49 in the listing agreement of stock exchanges vide circular dated August 26, 2003. SEBI had introduced principles of corporate governance to be followed by all the listed companies with a paid-up capital of Rs. 3 crore and above, through the route of the listing agreement. With effect from February 21, '00, clause 49 was added to the listing agreement laying down principles of corporate governance. This clause was amended twice in '00, thrice in the year '01 and now replaced based on the recommendations of the Committee on Corporate Governance constituted by SEBI under the Chairmanship of Shri. N.R. Narayana Murthy. SEBI convened another meeting of Narayana Murthy committee on November 17, 2003 for deliberating the suggestion and representations received after the issue of circular. As per press release 303/2003

dated 15.12.2003, the committee has since submitted its report to SEBI proposing certain amendments to revised clause 49 and that the report had been put for public comments on SEBI's website for a period of 14 days from 15.12.03 to 28.12.03.

2. APPLICABILITY

As per circular dated 26.8.2003, the provisions of the revised clause 49 call for compliance by all entities seeking listing for the first time at the time of listing and by all listed entities having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company, on or before March 31, 2004. It is stated by SEBI that for other listed entities, which are not companies, but body corporates (e.g., private and public sector banks, financial institutions, insurance companies etc.) incorporated under other statutes, the revised clause will apply to the extent that it does not violate their respective statutes. The revised clause is not applicable to the Mutual Fund

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Schemes. The listed companies have to submit a quarterly compliance report to the stock exchanges as per sub clause (IX) (ii), of the revised clause 49, within 15 days from the quarter ending 31st March 2004. The report has to be submitted either by the Compliance Officer or the Chief Executive Officer of the company after obtaining due approvals.

3. IMPLEMENTATION DEFERRED

Since the revised clause 49 of the listing agreement is being revisited by SEBI, implementation of the same is deferred till further notices from SEBI. Why? Let us study clause by clause. Before that, a quick glance at the roots and branches.

4. PROMOTER

In normal practice 'promoter' is the person who thinks of and brings into existence a company. He is the person who bears all the preliminary expenses, makes arrangement for share capital and so on. Prior to the year 1995, the word 'promoter' had not been defined anywhere in Indian laws including the Companies Act, 1956. In 1995 the Securities and Exchange Board of India (SEBI) constituted the Malegam Committee for disclosure requirements in offer documents. The committee, interalia, suggested a definition which was accepted by SEBI and given in Disclosure and Investor Protection guidelines (DIP). A reconvened committee under Chairmanship of Justice P.N. Bhagwati while reviewing the entire Takeover Regulations recommended tightening of the definition of promoter which was taken into account by SEBI in the Takeover Regulation 2002 which is different from DIP.

The journey of definition of the term 'promoter' started in 1995 and since then it has undergone so many changes in keeping with the needs of business, laws and financial environment of the country. There may be ambiguities in the definition, but it remains that defining the term 'promoter' is not an easy job. Promoter is to be understood in its generally acceptable meaning namely person or persons who are in overall control of the company. Promoters would mean individual promoters and corporate promoters unless specifically excluded. It is to be carefully seen that the concept of promoter group has not been brought in. In the absence of definition of promoter even in revised clause 49, it is left open to the

Courts to take the meaning on the basis of facts and circumstances of each case.

5. NON-EXECUTIVE DIRECTORS (NED)

Non-Executive directors mean part time directors. The role and responsibilities of NEDs in India has been increasing in recent times. This is evidenced from the requirements of Companies Act viz., Directors' Responsibility Statement 217(2AA), Disqualification of Directors 274(1)(g), membership of remuneration committee (Schedule XIII on remuneration) etc., and as imposed by the listing agreement on audit committees (of which he is a member) and matters of governance. This is in addition to the burden on the NED imposed by other statutes. This has led to a situation where remuneration to these directors is not commensurate with the responsibilities involved. Realizing that only adequate compensation can draw the best talent to their board, companies like Reliance, HLL, ACC, L&T, ICICI Banks have reportedly raised the sitting fees per meeting to Rs. 20,000 which is the enhanced statutory limit effective 24th July 2003.

6. AUDIT COMMITTEE

An audit Committee is a committee of the Board of Directors comprising of non-executive directors. The core function of the Audit Committee is to assist the Board in carrying out its responsibilities towards the shareholders and other outside parties who have a stake in the organisation. Audit Committee concept is in force in USA since 1940s. In December 1999, US-SEC came out with the new rules concerning the Audit Committees of listed companies based on the recommendations of the Blue Ribbon Committee set up by the New York Stock Exchange (NYSE) and National Association of Securities Dealers (NASAD). The USSEC model of a Audit Committee provides for improvement of effectiveness and disclosure relating to the functioning of Audit Committees and to enhance the reliability and credibility of financial reporting by listed public companies. In the United Kingdom there is no statutory requirement for the establishment of audit committee. In India, on the recommendation of the Kumar Mangalam Birla Committee, the concept of audit committee was introduced as a measure to ensure corporate governance. Reading Companies Act and listing agree-

ment together in a nutshell, all private limited companies and those public limited companies whose paid up share capital is less than Rs. 5 crores are not required to have an audit committee [Section 292A] while a public limited company which is listed on any of the recognised stock exchanges is required to form an audit committee whether or not its paid up share capital is more than Rs. 5 crores [Clause 49]. Under sub sections (8) & (9) of Section 292A of the Companies Act 1956, the recommendation of the audit committee on any matter relating to financial management including the audit report, shall be binding on the board and if the board does not accept the recommendations of the audit committee, it shall record the reasons therefor and communicate such reasons to the shareholders. Thus audit committee is a powerful tool and organ of the company.

The audit committee has to cover a large number of items in their agenda. While the listing agreement spells out some for quarterly or annual review or is linked to events, there are certain subjects like oversight (review) of the company's financial reporting process, reviewing the adequacy of internal audit function, reviewing company's financial and risk management policies where the frequency of review has not been specified. The freedom and flexibility is perhaps intended for the committee to decide the frequency based on need, scale of operation, complexity, management recommendation etc. But in any case, it should not be 'one time' subject for consideration in the first meeting upon constitution of audit committee. Rather it would be a good corporate action if these are atleast made as annual subjects i.e. for consideration in the first audit meeting of every year given their criticality. This in turn will ensure discipline, timely remedial measures etc.

7. INDEPENDENT DIRECTORS - FILTER INTRODUCED

Currently under the Companies Act, there are two types of directors, namely executive and non-executive directors. Executive director refers to Managing Director or whole time director and non-executive directors refer to part time directors. But the revised listing provisions contemplate three types of directors namely executive directors, independent non-executive directors and non-independent non-executive directors. The executive directors are considered as non-indepen-

dent directors. The provisions introduced in revised clause 49 laying down the yardstick for determining as to who will qualify as an independent director are more or less in line with the ingenuity ingrained in the provisions of section 252A proposed in the Companies Amendment Bill 2003. The corporate world opposed this vehemently for being unreal and impractical. When the foundation Bill itself has been withdrawn in October 2003, a doubt arises as to whether SEBI can introduce these provisions in a different route. It remains that independence is a subjective matter which cannot be so objectively laid down. Independence is a state of mind, which cannot be seen, measured or felt. The independent director has no special rights or duties and remains on par with other non-executive directors. Nevertheless, considering the big demand (?) for an independent director, it may be necessary in his interest as well as in the interest of the corporate world that a limit is laid down on the number of public limited companies in which he can hold independent directorships.

The experience the world over however is that independent directors, on whom so much faith has been reposed by the listing agreement, often turn out to be uninterested directors.

8. TODAY'S SCENARIO

Quoting Prof. Sumantara Ghoshal of London Business School, worldwide people do not trust managements and corporate leaders and the distrust is growing and not reducing. The trustworthiness survey showed that managers were way down in trustworthiness score. He said that business academicians have created moral practices of management, managers have made the practice unreasonable and consultants are guilty of making the practices of management heroic. In this backdrop, the rigorous amendments in revised clause 49 are welcome in an era of decreasing tolerance for corporate misdeeds.

9. DIAGNOSIS

SEBI is bringing out reforms, revising the process of corporate governance marking an accelerated evolution. The amendments (fragrant and also flagrant) are analysed in two parts: Part A showing the comparison of old and revised provision and Part B capturing the new provisions.

PART A : COMPARISON OF OLD AND REVISED PROVISIONS - MAJOR CHANGES.

| Old Clause | | As Revised by Circular dated 26.8.2003 | | Rationale & proposal released by SEBI based on representations received on revised clause |
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| Ref. | Particulars | Ref. | Particulars | |
| 1 | 2 | 3 | 4 | 5 |
| I.A. | Board of Directors- Composition | I.A. | Board of Directors- Composition | |
| (i) | <p>The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the chairman is executive or non-executive. In case of a non-executive chairman, atleast one-third of board should comprise of independent directors and in case of an executive chairman, atleast half of board should comprise of independent directors.</p> <p>Explanation: For the purpose of this clause the expression "independent directors" means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, <i>which in judgement of the board may affect independence or judgement of the director.</i></p> | <p>(i)</p> <p><i>There is no change in the number of directors. However there is a sea change in the concept of independent directors.</i></p> <p>As per the new explanation, "independent director" means a <u>non-executive director</u> of the company who</p> <p>a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its <u>senior management</u> or its holding company, its subsidiaries and <u>associated companies</u>;</p> <p><i>Sub clauses (b) to (f) have been added:</i></p> <p>b. is not related to promoters or management at the board level or at one level below the board;</p> <p>c. has not been an executive of the company in the immediately preceding three financial years;</p> <p>d. is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for</p> | <p>In the proposal, clause (i) (a) has been modified as below conferring powers on the board</p> <p>"apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies which in the judgement of the board may affect independence of judgement of the director."</p> <p>In the proposal, clause (i)(e) has been substituted</p> <p>Rationale</p> <p>Explanation (i)(e) restricts any supplier service provider or customer of the company from being an independent director. This clause should ideally only bar persons who are material suppliers, service providers etc.</p> <p>Proposed</p> <p>Hence the proposed (i)(e) would be</p> | |

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| <p>The italics portion was deleted in the revised provisions but since restored.</p> | <p>e. f</p> | <p>the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity. is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and is not a substantial shareholder of the company, i.e., owning two percent or more of the block of voting shares.</p> | <p>".... Is not a material supplier, service provider or customer of the company, which in the judgement of the board may affect the independence of the director"</p> <p><i>The following definitions have been added.</i></p> <p>(a) Associated company is as per Accounting Standard (AS) 23, "Accounting for Investments in Associates in Consolidated Financial Statements" issued by the Institute of Chartered Accountants of India.</p> <p>(b) "Relative" is as defined in section 2(41) and section 6 of the Companies Act, 1956.</p> |
| <p>Comments</p> <p><u>Sub clause a.</u></p> <p>* <i>The circular withdrew the power of the board to pass judgement on the materiality of transaction(s) entered into by a non-executive director with the company. This was protested and has been restored in the proposal.</i></p> <p>* <i>Materiality is the governing consideration. Materiality is however a floating concept. It varies from situation to situation, from company to company. Given this, it needs to be spelt out as to who will decide which is material and which is not. The process of assessment may result in different levels of materiality depending on the matter under reference. Further it is to be clarified whether materiality is to be judged from the view point of the director or the company? A contract may not be material from the company's point of view but may constitute the sole or the major income of the director. It is better if seen from the view point of the director since the question involved relates to independence of a director and not the independence of the company. To avoid any misunderstanding, materiality may be defined as a percentage of the value of transaction(s) to his total earnings.</i></p> <p>* <i>Associates are now included. As per AS 23, if the company holds, directly or indirectly, through subsidiary(ies) 20% or more of the voting power of the investee, the later becomes an associate. This widens the coverage significantly.</i></p> <p>* <i>Further remuneration to NEDs would cover sitting fees (Sec.309(2)) and periodic payments / commission (Sec.309(4)). These are paid to the directors in his capacity as a director. In case of professional services, though Sec.309(1) deems such payments to a director as part of his remuneration, yet understandably these are made to him in his capacity as a professional (say for engineering, legal, technical service etc.,) and not as a director. Such payments in the authors' view cannot be treated as being directors' remuneration within the meaning of clause e and hence, if material, will disqualify the director from being an independent director. This may be clarified by SEBI.</i></p> <p><u>Sub clause b.</u></p> <p>* <i>A director is disqualified from being an independent director if related to promoters. It is common knowledge that most promoters are companies, therefore the application of this clause poses a question as relatives are used with reference to human beings.</i></p> <p>* <i>As per Sec. 2(26), Managing Director means a director who is entrusted with the powers of management. It also includes a director who is not designated as MD but occupies the position of MD by any name. Similarly in terms of Sec. 2(24) a manager means an individual who has the management of the whole, or substantially the whole of the affairs of a company and includes a director or any other person occupying the position of a manager, by whatever name called. Thus a NED who is related to managing director or manager or any other applicable person will not become independent. By corollary, a NED (Mr. A) who is related to another NED (Mr. B) in the same board can be reckoned as independent, if he (Mr. A) is not affected by other qualifying criteria.</i></p> <p>* <i>Relative is as per section 6 of the Companies Act covering as many as 24 relationships. It is suggested that SEBI should consider a smaller definition of relatives for this purpose including only near and immediate relationships.</i></p> | | | |

Sub clause c.

The expression executive needs to be defined. Does it refer to managers or it includes supervisors also?

Sub clause d

A view is being taken that the restriction applies only to a partner or an executive of firm and thereby executives of the sole proprietor and for that matter the sole proprietor himself is not disqualified from being counted as an independent director. This view is too narrow since it would not be in line with the spirit of the regulation.

Sub clause e

** We can understand if the distributors or dealers of goods or services are excluded, if they are related to the directors of the company. It is difficult to understand how a customer can be included if the pricing, delivery and other terms are competitive and on par with others in the industry.*

** Further, it is presumed that the addition of the word material before suppliers would cover service providers and customers also. It needs to be stated that this restriction would bar only those individuals from being considered as independent who supply goods or provide services in their personal capacity and will not bar them so if he is a partner or director of the firm or company which transacts with the company. Also, experts opine that sub clause e may be redundant as it is covered by sub clause a. There is a view that sub clause a is wide enough to cover not only sub clause e but also financial transactions such as borrowing and lending of money between the company and the director.*

** Giving power to the board to decide on materiality in the proposal is a good and broad minded move but makes the board responsible. Perhaps the board could record the reasons for its judgement in its minutes.*

Sub clause f

2 % holders are sought to be excluded. All the directors are elected by the shareholders, including those holding two percent or more of securities. Such a person has a financial stake in the company's performance and therefore may take a greater interest in the affairs of the company leading to improved efficiency and profitability. There could be rival argument that holders of securities of 2% or more would work hand-in-glove with those managing the affairs of a company. Such a theory does not appear to be empirically established and hence unnecessary in the authors' view.

General

Interestingly a non-executive chairman will be counted as independent director if he is not covered by any of the disqualifications.

Summary

Thus independent directors are identified as those having no direct or indirect material relationships with the company's management or promoters whose sole aim would be to advance the shareholders' interest.

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| IA Expln. | Institutional directors Institutional directors on the boards of companies shall be considered as independent directors whether the institution is an investing institution or a lending institution. | | No change made by circular dated 26.8.2003. | This gave rise to various doubts as stated in the rationale. Rationale The explanation does not make it clear that even an institutional director must in order to be considered as independent, satisfy the tests laid down in clauses (a) to (f). Proposed explanation a. There shall be no nominee directors. |
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| | | | | Where an institution wishes to appoint a director on the Board, such appointment should be made by the shareholders. |
| | <p>b. An institutional director on the boards of companies shall be considered as an independent director unless he does not satisfy the requirements of any of the clauses (a) to (f) listed above.</p> | | | |
| | <p>Comments</p> <p><i>There is a paradigm change. Today, nominee directors are appointed by lending institution on the basis of loan covenants with the borrowing company.</i></p> <p><i>An institutional director should also fulfill the requirement laid down for an independent director.</i></p> | | | |
| III. A. | <p>Compensation to NEDs</p> <p>The company agrees that the remuneration of non-executive directors shall be decided by the board of directors.</p> | I.B. | <p>Compensation to NEDs</p> <p>The provisions have been enlarged.</p> <p>(i) All compensation paid to non-executive directors shall be fixed by the Board of Directors and shall be approved by shareholders in general meeting. Limits shall be set for the maximum number of stock options that can be granted to non-executive directors in any financial year and in aggregate. The stock options granted to the non-executive directors shall vest after a period of at least one year from the date such non-executive directors have retired from the Board of the Company.</p> <p>(ii) The considerations as regards compensation paid to an independent director shall be the same as those applied to a non-executive director.</p> <p>(iii) The company shall publish its compensation philosophy and statement of entitled compensation in respect of <u>non-executive directors</u> in its annual report. Alternatively, this may be put on the <u>company's website</u> and reference drawn thereto in the <u>annual report</u>. Company shall disclose on an annual basis, details of <u>shares held by non-executive directors, including on an "if-converted" basis</u>.</p> | <p>In the proposal, clause I(B)(i) has been modified.</p> <p>Rationale</p> <p>A clarification has been added to <u>statute</u> that non-executive directors include independent director.</p> <p>Proposed</p> <p>"All compensation paid to non-executive directors, <u>including independent directors</u>, shall be fixed by the Board of Directors and shall be approved by shareholders in general meeting....."</p> <p>As a result of this, clause I(B)(ii) has been deleted.</p> |

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| | | (iv) | Non-executive directors shall be required to disclose their stock holding (both own or held by / for other persons on a beneficial basis) in the listed company in which they are proposed to be appointed as directors, prior to their appointment. These details should accompany their notice of appointment. | |
| Comments | | | | |
| <p><i>The expression compensation is generally understood in negative sense. The word remuneration would be a better substitute.</i></p> <p><i>Payment of sitting fees would require approval of shareholders in terms of this clause, while it is not so under the Companies Act.</i></p> <p><i>Under SEBI (Employee Stock Option Scheme) Guidelines 1999 which is applicable to permanent employees and whole time directors (i.e. executive director), the vesting of option is one year lock-in from the grant of option (para 9.1). In respect of non executive director (part time) who is not an employee, the vesting of option is provided as one year after their retirement from the board of the company. This elongated time frame is harsh and needless and hence NEDs proposed to be brought at par with executive director.</i></p> | | | | |
| IV B | Board procedures A director cannot be a member in more than 10 committees or act as a Chairman of more than five committees across all public limited companies (whether listed or not) in which he is a director. For the above only three committees viz. the Audit committee, shareholders' Grievance committee and remuneration committee would be considered | I.D. (iii) | No change. | In the proposal, clause I.D.(iii) has been modified. Rationale There is currently a shortage of independent directors. Further, The formation of a remuneration committee is not mandatory and it meets only occasionally. Proposed That only two committees viz. the Audit Committee and the shareholders' Grievance Committee shall be considered for this purpose. |
| Comments | | | | |
| <p><i>The cap on the memberships and chairmanships of committees continues to apply to all executive and non-executive directors (independent and non-independent).</i></p> | | | | |
| II. A. 1. | Audit committee The audit committee shall have minimum three members, all being non-executive directors, with the majority of them being independent, and with at least one director having financial and accounting knowledge; | II. A. i. ii. | Audit Committee Radically modified. The audit committee shall have minimum three members. All the members of audit committee shall be non-executive directors, with the majority of them being independent. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise. Explanation (i): The term "financially literate" means the ability to read and understand basic financial statements ie., balance sheet, profit and loss account, and statement of cash flows. | No change |

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| | | | Explanation (ii): A member will be considered to have accounting or related financial management expertise if he or she possesses experience in finance or accounting, or requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a Chief Executive Officer, Chief Financial Officer, or other senior officer with financial oversight responsibilities. | |
| | Comments | | | |
| | | | <i>The term financial literate is too generic and in the event of a litigation, it may be difficult to prove that a person is not a financial literate in the context of the given definition. The definition may be made objective by specifying some minimum educational qualification (say a degree or diploma in commerce). It would be necessary to deem persons from non finance background who have had the experience of declaring, handling financial results of a profit center / investment center to be financially literate.</i> | |
| II. A. 3. | The chairman of the audit committee shall be present at the annual general meeting to answer the shareholders queries. | II.A. (iv) | No change. | <p>In the proposal, clause II.A.(iv) has been modified.</p> <p>Rationale</p> <p>It may not be practicable for the chairman of the audit committee to be present at all annual general meetings due to various reasons like travel, ill health etc.,</p> <p>Proposed</p> <p>"The chairman of the audit committee, or in his absence, a designated member of the audit committee, who is an independent director shall be present at the annual general meeting to answer the shareholders queries".</p> |
| II.B. | <p>Meeting of Audit Committee</p> <p>There should be a minimum of three meetings in a year.</p> <p>Gap between two meetings cannot exceed six months.</p> <p>Quorum is either two members or one third of the members of the audit committee, whichever is higher and minimum of two independent directors.</p> | | <p>Meeting of Audit Committee</p> <p>No change</p> | <p>Rationale</p> <p>Clause II.D.(i) requires that the audit committee should have an oversight of the disclosure of financial information. A listed company is required to publish quarterly financial results and annual financial statements. It is therefore necessary that the audit committee should meet at least four times in a year.</p> <p>Proposed</p> <p>There should be a minimum of four meetings in a year.</p> |

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| | | | | Gap between two meetings cannot exceed four months. No change in quorum. |
| II.D. c. | Role of Audit Committee Amongst various other matters, the committee has to review with management any related party transactions ie., transactions of the company of material nature, with promoters or the management, their subsidiaries or relatives etc that may have potential conflict with the interests of company at large. | II.D. 3h. | Role of Audit Committee The committee has to review with the management all related party transactions. Explanation (i): The term "related party transactions" is as per Accounting Standard 18, Related Party Transactions, issued by The Institute of Chartered Accountants of India. | In the proposal, clause II.D has been modified as below: "The committee has to review with the management disclosure of any related party transactions." Further, it is reworded that the audit committee has to review with the management matters required to be included in the directors' responsibility statement to be included under section 217(2AA) in the boards' report. (subclause 4a.) |
| Comments <i>To avoid duplication, the entries calling for review of going concern assumption and compliance with accounting standards has been deleted in sub clause 4 since these requirements are a part of section 217(2AA)</i> <i>A thorough knowledge of AS 18 is required to ensure that there are no lapses.</i> | | | | |
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| | VII.A. | A statement of all transactions with related parties including their basis shall be placed before the Audit Committee for formal approval / ratification. If any transaction is not on an arm's length basis, management shall provide an explanation to the Audit Committee justifying the same. | The clause is proposed to be modified. Rationale : It may be cumbersome and unnecessary for the audit committee to review all transactions with related parties which are in the ordinary course of business. It should therefore be sufficient if these transactions are placed periodically in a summary form before the audit committee. It is however necessary that material individual transactions which are not in the normal course of business are placed before the audit committee. Proposed (i) A statement in summary form of transactions with related parties in the ordinary course of business shall be placed periodically before the audit committee. (ii) Material individual transactions with related parties, which are not in the normal course of business shall be placed before the audit committee. (iii) Material individual transactions with related parties or others, which are | |

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| | | | | not on an arm's length basis should be placed before the audit committee, together with Management's justification for the same. |
| | <p>Comments</p> <p>Though the frequency of placing the transactions before the committee has not been stated, it would be ideal to do it on quarterly basis at the minimum. Also, from the wordings, it appears that what is contemplated is ratification and not prior approval of the transaction.</p> <p>Also, if a transaction is not at arm's length (i.e colourable), management justification is necessary whether the transaction is in the normal course or otherwise.</p> <p>The requirement is much wider in scope than the summary of transactions presented to the board under section 297 and 299 namely contracts in which directors are interested etc.</p> | | | |
| V.B. | Disclosure by management to Board Disclosure of all material financial and commercial transactions where they have personal interest, that may have a potential conflict with the interest of the company at large. (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.) | VII.E. (i) | Retained and no change. | This disclosure is required from senior management. Explanation: For this purpose, the term "senior management" shall mean personnel of the company who are members of its management / operating council (i.e. core management team excluding independent directors). This would also include all members of management one level below the executive directors |
| | <p>Comments</p> <p>The disclosure instead of being from all and sundry in charge of management is now proposed to be restricted to senior management.</p> | | | |
| Postal Ballot | Non-Mandatory requirements The listing agreement suggested that certain critical matters should be decided by postal ballot to ensure larger participation by shareholders and the consequent corporate democracy. | Annex. IC Para 4 | No change except for deletion of one non mandatory matter viz., sale of whole or substantially the whole of the undertaking. | |
| | <p>Comments</p> <p>The whole of the postal ballot portion covered under non-mandatory requirement is now proposed to be deleted. This is a welcome measure since Sec. 192A of the Companies Act and the related rules already contain provisions on postal ballot.</p> | | | |

PART B - NEW PROVISIONS VIDE CIRCULAR DATED 26/08/2003

| Ref. | As Introduced | Rationale & proposal released by SEBI based on representations received on revised clause |
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| I.C. | <p>Independent Director:</p> <p>i. Independent director shall periodically review legal compliance reports prepared by the company as well as steps taken by the company to cure any taint. In the event of any proceedings against an independent director in connection with the affairs of the company, defence shall not be permitted on the ground that the independent director was unaware of this responsibility.</p> | <p>This clause is proposed to be modified.</p> <p>Rationale</p> <p>The board as a whole should have the responsibility.</p> <p>Proposed</p> <p>" The board shall periodically review legal compliance reports prepared by the company as well as steps taken by the company to cure instances of non-compliances".</p> |
| I.E. | <p>Code of conduct</p> <p>i. It shall be obligatory for the board of a company to lay down the code of conduct for all Board members and senior management of a company. This code of conduct shall be posted on the website of the company.</p> <p>ii. All Board members and senior management personnel shall affirm compliance with the code on an annual basis. The annual report of the company shall contain a declaration to this effect signed by the CEO and COO.</p> <p>Explanation : For this purpose, the term "Senior management" shall mean personnel of the company who are members of its management / operating council (ie., core management team excluding Board of Directors). Normally, this would comprise all members of management one level below the executive directors.</p> | No change |
| | <p>Comments</p> <p><i>Each company is now required to draft and adopt a code of conduct of board members. In the interest of standardization and uniformity, it is necessary that SEBI comes out with the code of conduct, laying down atleast the barest minimum norms.</i></p> | |
| I.F. | <p>Term of office of Non-executive directors</p> <p>i. Person shall be eligible for the office of non-executive director so long as the term of office did not exceed nine years in three terms of three years each running continuously.</p> <p>(draconian provision)</p> | <p>In the proposal, clause I.F.(i) has been modified as below.</p> <p>A director shall be considered to be an independent director only so long as his tenure on the board does not exceed, in the aggregate, a period of nine years, such period to be considered as commencing on or after the date the circular comes into force or the date of his first appointment as a director, whichever is later. After the expiry of the said period, a director may continue to be a member of the board and be eligible for reappointment on expiry of his term, but he shall not be considered to be an independent director.</p> |

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| | <p>Comments</p> <p><i>It is not understood how a person who serves on the board of the company as an independent non executive director for a period of nine years can be deemed as non-independent non executive director from the 10th year onwards. This provision will create a paucity of independent directors. It may also be noted that even Company Law does not restrict the term of office of a director (the maximum number of years for which one can serve as a director).</i></p> |
| | <p><i>Independence refers to a state of mind. The criteria for a non executive of the company to become an independent director has been defined in explanation (i) to clause LA(i). Having defined this, it should be that as long as the director fulfils the criteria, he should continue his status as an independent director irrespective of the length of his innings in the board. The underlying principle should be 'once an independent director always an independent director, subject to fulfillment'.</i></p> <p><i>Further the proposed clause disqualifies a person to act as an independent director if he holds office for a consecutive term of 9 years in three terms of three years each. The rigour of this requirement is liable to dilution by re-appointing the director as an additional director after a break of few weeks.</i></p> <p><i>Also, the time limit of 9 years is an artificial yardstick without any empirical findings that a director loses his independence after the ninth year. If this can be accepted theoretically, it can be argued that he may lose his independence even before the 9th year, say, the 6th year or the 7th year.</i></p> |
| II.E. | <p>Mandatory review of information by audit committee of directors.</p> <p>The audit committee shall mandatorily review the following information:</p> <ol style="list-style-type: none"> 1. Financial statements and draft audit report, including quarterly / half-yearly financial information; 2. Management discussion and analysis of financial condition and results of operations; 3. Reports relating to compliance with laws and to risk management; 4. Management letters / letters of internal control weaknesses issued by statutory / internal auditors; and 5. Records of related party transactions 6. The appointment, removal and terms of remuneration of the Chief Internal Auditor shall be subject to review by the Audit Committee. |
| | <p>II.E is proposed to be substantially modified</p> <p>Rationale - Related Party</p> <p>It is not practical to expect audit committees to review the records of related party transactions. It should be sufficient if management places before the audit committee for review, a statement of significant related party transactions and gives details of related party transactions that are not at an arm's length basis with reasons for the same.</p> <p>Accordingly this clause has been modified as 'Statement of significant related party transactions (as defined by the audit committee), submitted by management'.</p> <p>Rationale - Risk Management</p> <p>Clause VII provides that risk management procedures should be reviewed by the Board. Therefore, there is no need for the audit committee to also perform this review.</p> <p>Accordingly there has been deletion of clause 3.</p> <p>Comments</p> <p><i>What is a significant related party transaction is as defined by the audit committee and not as in management's view. This shows the lack of trust in management and overwhelming faith in audit committees which predominantly comprises of independent directors.</i></p> <p><i>In this din and bustle, it is of relief to note that the audit committee of the holding company is not required to review the consolidated accounts whose preparation is mandatory for listed companies.</i></p> |

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| III. | <p>Audit reports and audit qualifications</p> <p>Disclosure of accounting treatment</p> <p>In case it has followed a treatment different from that prescribed in an Accounting Standards, management shall justify why they believe such alternative treatment is more representative of the underlined business transactions. Management shall also clearly explain the alternative accounting treatment in the footnote of financial statement.</p> | <p>This clause has been deleted but being a matter of disclosure, this has been included as a amended clause under clause VII as sub-clause (AA).</p> <p>Rationale</p> <p>SEBI has expressed that the language in the clause does not bring out the intention.</p> <p>Proposed</p> <p>"Where in the preparation of financial statements, a treatment different from that prescribed in an Accounting Standard has been followed, the fact shall be disclosed in the financial statements, together with the management's explanation as to why it believes such alternative treatment is more representative of the true and fair view of the underlined business transaction."</p> |
| IV. A. | <p>Whistle Blower Policy (<i>Break through amendment</i>)</p> <p>i. Personnel who observe an unethical or improper practice (not necessarily a violation of law) shall be able to approach the audit committee without necessarily informing their supervisors.</p> <p>ii. Companies shall take measures to ensure that this right of access is communicated to all employees through means of internal circulars, etc. The employment and other personnel policies of the company shall contain provisions protecting "Whistle blowers" from unfair termination and other unfair prejudicial employment practices.</p> <p>iii. Company shall annually affirm that it has not denied any personnel access to the audit committee of the company (in respect of matters involving alleged misconduct) and that it has provided protection to "whistle blowers" from unfair termination and other unfair or prejudicial employment practices.</p> <p>iv. Such affirmation shall form a part of the Board report on Corporate Governance that is required to be prepared and submitted together with the annual report.</p> <p>v. The appointment, removal and terms of remuneration of the chief internal auditor shall be subject to review by the Audit Committee.</p> | <p>This clause is proposed to be substantially modified.</p> <p>Rationale</p> <p>SEBI has expressed that the intention of this clause is that management establishes a mechanism for employees to report concerns about unethical behavior, actual or suspected fraud or violation of the companies code of conduct or ethics policy. The exact details of such mechanism should be left to each company through its board of directors to decide but the existence and implementation must be reviewed by the audit committee. The mechanism must have adequate provisions to ensure that there is no victimization of employees who avail of this procedure and hence reworded accordingly.</p> <p>Proposed</p> <ul style="list-style-type: none"> i. The company will establish a mechanism for employees to report to the management concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy. ii. The mechanism must provide for adequate safeguards against victimization of employees who avail of the mechanism. iii. The mechanism must also provide, where senior management is involved, direct access to the Chairman of the audit Committee. iv. The existence of the mechanism must be appropriately communicated within the organisation. v. The Audit Committee must periodically review the existence and functioning of the mechanism. <p>Clause IV.A.(v) on chief internal auditor is deleted since it is covered under II.E.6.</p> |

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| | <p>Comments</p> <p><i>The concept of whistle blowers may not work due to the following reasons.</i></p> <ul style="list-style-type: none"> * <i>Identity of the whistle blower and the information provided by him would be very difficult to guard due to leakages in the system. Ultimately it may end in harassment of the informant.</i> * <i>The investigative mechanism may be unable to swiftly zero-in on the tip received.</i> * <i>The whistle blower may become a victim of corruption.</i> <p><i>At best whistle blowing may be confined to reporting of suspected or actual financial frauds otherwise this mechanism may be misused by disgruntled employees to make obnoxious complaints against their superiors especially under the cover of anonymity. Matters regarding industrial relations should be excluded from Whistle Blowing since there are other mechanisms under various labour laws to safeguard the interest of workers.</i></p> <p><i>It may be necessary to have a whistle blowers Act as such a law exists in many developed countries.</i></p> | |
| V. | <p>Subsidiary Companies</p> <p>i. The company agrees that provisions relating to the composition of the Board of Directors of the holding company shall be made applicable to the composition of the Board of Directors of subsidiary companies.</p> <p>ii. Atleast one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of the subsidiary company.</p> <p>iii. The Audit Committee of the holding company shall also review the financial statements, in particular the investments made by the subsidiary company.</p> <p>iv. The minutes of the board meetings of the subsidiary company shall be placed for review at the Board Meeting of the holding company.</p> <p>v. The Board report of the holding company should state that they have reviewed the affairs of the subsidiary company also.</p> | <p>This clause is proposed to be substantially eased.</p> <p>Rationale</p> <p>SEBI has expressed that it has been pointed out</p> <ol style="list-style-type: none"> 1. Subsidiaries are often small size and it may be too onerous if all the provisions regarding the composition of the board as applicable to a holding company are made applicable to every subsidiary. 2. Where there are a large number of subsidiaries, independent directors on the board of the parent company may not be willing to become directors on the board of a subsidiary, particularly where such a directorship is included in the number of directorships to which the ceiling prescribed under the companies Act, 1956 applies. 3. It may be very expensive for a company if the independent director is required to attend board meetings of foreign subsidiaries. 4. The concept of materiality has to be borne in mind. <p>Proposed</p> <ol style="list-style-type: none"> i. At least one independent director on the Board of Directors of the holding company shall be director on the Board of Directors of a material non listed Indian subsidiary company. ii. The Audit Committee of the listed holding company shall also review the financial statements, in particular the investments made by the unlisted subsidiary company. iii. The minutes of the Board meetings of the unlisted subsidiary company shall be placed for review at the Board meeting of the listed holding company. The management should periodically bring to the attention of the Board of directors of |

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| | <p>the listed holding company, a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.</p> <p>Explanation (i): The "material non-listed Indian subsidiary" shall mean an unlisted subsidiary, incorporated in India, whose turnover or networth (i.e. paid up capital and free reserves) in the preceding accounting year exceeds 20% of the consolidated turnover or networth respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.</p> <p>Explanation (ii): The term "significant transaction or arrangement" shall mean any individual transaction or arrangement that exceeds or is likely to exceed 10% of the total revenues or total expenses or total assets or total liabilities, as the case may be, of the unlisted subsidiary for the immediately preceding accounting year.</p> <p>Explanation (iii): Where a listed holding company has a listed subsidiary company which is itself a holding company, the above provisions shall apply to the listed subsidiary insofar as its subsidiaries are concerned.</p> |
| | <p><i>Comments</i></p> <p><i>Review of financial statements of subsidiaries by the Audit committee (A.C.) of holding company would place them under strain due to the volume of work, more so because of complexity as the subsidiaries may not operate in the same industry, thereby necessitating the audit committee to have an overall knowledge of industries under review. The planning for this review and coordinating with the boards and audit committee of subsidiaries would turn out to be a Herculean task.</i></p> <p><i>The provisions of Companies Act do not place the audit committee of holding company under such an obligation. The provision is likely to hamper the working relationships amongst senior officials of holding company on one hand and subsidiaries on the other hand.</i></p> <p><i>Boards may have to determine whether audit-committee members have excessive commitments to other audit-committee work. If an audit committee member simultaneously serves on the audit committees of other public companies, the board has to exercise its judgement to determine whether the member can still serve effectively on the listed company's audit committee.</i></p> <p><i>The A.C. of listed holding company is not required to review the accounts of a listed subsidiary which has its own audit committee. This also avoids duplication in review. (clause ii)</i></p> |
| | <p><i>Clauses (ii) and (iii) apply to all unlisted subsidiaries and not confined only to material unlisted subsidiaries.</i></p> <p><i>If, on the review of financial statements, minutes etc., of the subsidiary company the audit committee of the holding company (ACHC) does not agree, then adequate powers must be expressly conferred on them to issue directions/instructions to the subsidiary. Otherwise the very purpose of review is lost. Moreover it is to be noted that the members of the ACHC may be treated as a person in accordance with whose directions or instructions the board of subsidiary company is accustomed to act, as a result of which all the members of the ACHC may be deemed to be officers in default of the subsidiary within the meaning of Sec.5 of the Companies Act.</i></p> <p><i>The sub clause (i) extending the provisions relating to composition of board of directors of the holding company to unlisted subsidiary companies has been deleted based on corporate comments. In the first round, foreign subsidiaries were left out but retaining material unlisted Indian subsidiaries. In the second round, this was also deleted as by no stretch of imagination can it be extended to unlisted companies since there is no listing agreement between the stock exchange and the unlisted company.</i></p> |

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| VI. | <p>Disclosure of contingent liabilities</p> <p>i. The company agrees that management shall provide a clear description in plain English of each material contingent liability and its risks, which shall be accompanied by the auditor's clearly worded comments on the management's view. This section shall be highlighted in the significant accounting policies and notes on accounts, as well as, in the auditors' report, where necessary.</p> | <p>The clause is proposed to be deleted in its entirety.</p> <p>Rationale :</p> <p>Disclosure of contingent liabilities is already required under schedule VI to the Companies Act. It is also impracticable for auditors to comment on management views and any such view may be construed as an admission of the liability.</p> |
| | <p>Comments</p> <p><i>It is a welcome deletion.</i></p> | |
| VII.B. | <p>Board disclosures - risk management</p> <p>i. Management shall place a report certified by the compliance officer of the company, before the entire Board of Directors every quarter documenting the business risks faced by the company, measures to address and minimize such risks, and any limitations to the risk taking capacity of the corporation. This document shall be formally approved by the Board.</p> | <p>Rationale :</p> <p>The compliance officer of the company may not be the right person to attest / certify disclosure of the business risks faced by a company. Hence deleted.</p> |
| | <p>Comments</p> <p><i>The risk management procedure stands removed out of the purview of both audit committee and the board. This has happened due to the deletion from both clauses II.E. and VII.B. above. While making the deletion in clause II.E. it is observed in the discussion paper that Clause VII provides that risk management procedures should be reviewed by the board and therefore, there is no need for the audit committee to also perform this review. But it has been inadvertently deleted in VII.B. also. Hence it needs to be restored in VII.B.</i></p> <p><i>Assuming the restoration would take place in VII.B., this exercise will require the following:</i></p> <ul style="list-style-type: none"> ● <i>Definition of risk</i> ● <i>Assessment of risk based on availability, reliability and relevance of information.</i> ● <i>Classification of risk.</i> ● <i>Time span involved</i> ● <i>Recurring measures to minimize the risk</i> ● <i>Onetime measure to minimize the risk</i> ● <i>Phase of trade cycle.</i> ● <i>Competitor strength and weakness.</i> ● <i>Passing of risk.</i> <p><i>Business risks would include risk associated with litigation against company, criminal and civil and also risk associated with intellectual property rights (trade mark, patent and design).</i></p> | |

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| VII.C. i. | <p>Proceeds from Initial Public Offerings (IPOs)</p> <p>When money is raised through an Initial Public Offering (IPO) it shall disclose to the Audit Committee, the uses / applications of funds by major category (capital expenditure, sales and marketing, working capital, etc.), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilised for purposes other than those stated in the offer document / prospectus. This statement shall be certified by the independent auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in this matter.</p> | <p>This clause is proposed to be modified.</p> <p>Rationale :</p> <p>It appears that companies are to disclose the use of IPO proceeds without specifying any time limitation. The disclosure is perhaps required only till funds are spent.</p> <p>Proposed</p> <p>"When money is raised through an Initial Public Offering (IPO) it shall disclose to the Audit Committee, the uses // applications of funds by major category (capital expenditure, sales and marketing, working capital, etc), on a quarterly basis as a part of their quarterly declaration of financial results. Further, on an annual basis, the company shall prepare a statement of funds utilized for purposes other than those stated in the offer document./prospectus and place it before the audit committee. Such disclosure shall be made only till such the the full money raised through the IPO has been fully spent. This statement shall be certified by the independent auditors of the company. The audit committee shall make appropriate recommendations to the Board to take up steps in the matter."</p> |
| Comments | | <i>This is in addition to clause 43 which requires the companies to furnish on a quarterly basis a statement showing the variations between projected and actual utilization of funds.</i> |
| VII.D . (ii)(a) | All elements of remuneration package of all the directors, i.e., salary, benefits, bonuses, stock options, pension etc have to be disclosed in this section on corporate governance of the Annual Report. | <p>This clause is proposed to be modified.</p> <p>Rationale :</p> <p>It is recommended that the disclosure of remuneration provided to directors should be aggregated by major category and disclosed. This will facilitate a robust disclosure of director's remuneration.</p> <p>The proposed clause VII.D.(ii)(a) is given below:</p> <p>"All elements of remuneration package of individual directors, summarized under major groups, such as salary, benefits, bonuses, stock options, pension etc."</p> |
| Comments | | <i>The summarized details are required for each individual director.</i> |
| VIII. | <p>CEO / CFO certification</p> <p><i>Not given here since the same has been restructured by SEBI in a simple and more elegant manner. It removes the scope for any doubt. This is given in the next column.</i></p> | <p>CEO / CFO certification</p> <p>The CEO (either the Executive Chairman or the Managing Director or Manager) and the CFO (either whole-time Finance Director or any other person heading the finance function) discharging that function shall certify to the Board that</p> <p>a. They have reviewed the financial statements and cash flow statement and the directors' report that</p> |

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| | <p>these statements do not contain any materially untrue statement or omit any material fact and represent the true and fair view of the company's affairs and are in compliance with the existing accounting standards, applicable laws and regulations</p> <p>b. No transactions entered into by the company are fraudulent, illegal or violative of the company's code of conduct or ethics policy.</p> <p>c. They accept responsibility for establishing and maintaining internal controls and have evaluated the effectiveness of internal control systems of the company and disclosed to the auditors and audit committee about the deficiencies in internal controls, if any, of which they are aware and corrective action taken.</p> <p>d. They indicated to the auditors and the Audit Committee</p> <ul style="list-style-type: none"> i. significant changes in internal control during the year, ii. significant changes in accounting policies during the year and the same have been disclosed in the notes to the financial statements and iii. the instances of significant fraud of which they have become aware and the involvement, if any, of the management or an employee. |
| | <p>Comments</p> <p><i>As per Section 269 /388 of the Companies Act, a company having a paid-up share capital of Rs. 5 crores and above is compulsorily required to have a Managing Director/ Manager. There is no requirement in the Act to appoint an executive chairman. However Clause 49 is applicable to all existing listed companies with paid-up share capital of Rs. 3 crores and above stipulating the certificate from executive chairman or Managing Director or Manager. Effectively companies whose paid up share capital is in the range of 3 crores to 5 crores will be compelled to have a executive Chairman or Managing Director Manager although it is not mandatory under the Companies Act. .</i></p> <p><i>In its original form, the manager was not included in the scope of CEO, the omission of which has been set right. Further, there was a doubt as to whom the certificate was to be given by the CEO/CFO which has been made clear by requiring the submission of certificate to the board. Also, the requirement of disclosure by CEO/CFO to the auditors and audit committee on the instances of fraud was worded in a sweeping form which has now been made realistic by requiring this disclosure only in respect of those fraud of which they have become aware.</i></p> <p><i>This certificate from the CEO/CFO would also enable the statutory auditor of the company to make his report regarding fraud under the new CARO regulations.</i></p> |

This is a quick analysis of the subject. The amendments awaiting the next round of public comments are aimed at corporate excellence, investor protection and increased disclosures. The much talked about idea of governance ratings which are offered by some rating agencies does not find place. SEBI has released the revision for corporates to adjust and adapt which is appreciable. While one may view that there is too much of intervention, and the suggestion on independent directors are discriminatory against promoters, a wise man would conclude that SEBI as a market regulator in a developing economy is not trying to legislate business ethics but laying down an effective framework by which a balance could be struck among the conflicting interests of various stake holders of a company.