

# Clause 49 of Listing Agreement on Corporate Governance

—Dilip Kumar Sen

SEBI has revised Clause 49 of the Listing Agreement pertaining to corporate governance vide circular dated **October 29, 2004**, which supersedes all other earlier circulars issued by SEBI on this subject. The article highlights important changes in the corporate governance norms.

Clause 49 of the Listing Agreement, which deals with Corporate Governance norms that a listed entity should follow, was first introduced in the financial year 2000-01 based on recommendations of Kumar Mangalam Birla committee. After these recommendations were in place for about two years, SEBI, in order to evaluate the adequacy of the existing practices and to further improve the existing practices set up a committee under the Chairmanship of Mr Narayana Murthy during 2002-03. The Murthy committee, after holding three meetings, had submitted the draft recommendations on corporate governance norms. After deliberations, SEBI accepted the recommendations in August 2003 and asked the Stock Exchanges to revise Clause 49 of the Listing



Agreement based on Murthy committee recommendations. This led to widespread protests and representations from the Industry thereby forcing the Murthy committee to meet again to consider the objections.

The committee, thereafter, considerably revised the earlier

recommendations and the same was put up on SEBI website on 15<sup>th</sup> December 2003 for public comments. It was only on 29<sup>th</sup> October 2004 that SEBI finally announced revised Clause 49, which will have to be implemented by the end of financial year 2004-05. These revised recommendations have also considerably diluted the original Murthy Committee recommendations. Areas where major changes were made include:

- Independence of Directors
- Whistle Blower policy
- Performance evaluation of non-executive directors
- Mandatory training of non-executive directors, etc.

The changes in corporate governance norm as prescribed in the revised Clause 49 are as follows:

## A. Composition of Board

The revised clause prescribes six tests, which a non-executive director needs to pass to qualify as an Independent Director. The existing requirement is that to qualify as an Independent Director, the director should not have, apart from receiving director's remuneration, any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the Board may affect independence of judgment of the director. This requirement finds place in the revised clause also

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except that the relationship will now extend to its management, its holding company and its associates in addition to the existing list.

Further the Board is no longer required to judge the independence status of a director as at present. Five new clauses have been added to determine independence of a director. These are:

- (i) He is not related to promoters or persons occupying management positions at the board level or at one level below the board;
- (ii) He has not been an executive of the company in the preceding three financial years;
- (iii) He is not a partner or an executive or was not partner or an executive during the preceding three years of (a) the statutory audit firm or the internal audit firm that is associated with the company; and (b) the legal and consulting firms that have a material association with the company.
- (iv) He is not a material supplier, service provider or customer or a lessor or lessee of the company, and
- (v) He is not a substantial shareholder of the company owning two per cent or more of the block of voting shares.

The new tests of 'independence', the readers would recall, were mostly included in the Companies (Amendment) Bill, 2003. The important and practical change that has now been made is addition of the word 'material' in item (iv) above. Without use of the word 'material', technically even a single supply or purchase by the director to or from the company would have taken away independence status if he/she was other-

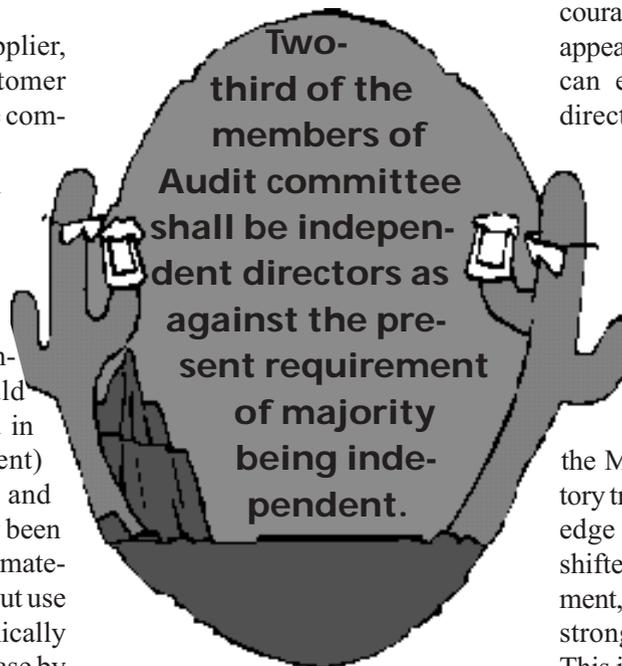
wise eligible. However, the word 'material' has not been defined.

Nominee directors of Institutions are now to be considered as 'Independent Director'.

While on the subject of Independent Director one must remember that no one is invited to join a board to act as a non-executive director unless he/she is well known to the Promoters or the Chairman or the Managing Director. All non-executive directors, whether or not independent, need support of Promoter Group for their reelection. If the purpose or objective of having a specified number of independent directors on the boards of listed companies is to ensure that boards are not



directors can freely raise questions at board meetings. Is it right that a vast majority of them invariably support every proposal of management? Only a few persons who are eminent in their own fields may ask right questions, even if they look inconvenient, at board meetings but the majority may not muster enough courage to do so. It may therefore appear that no amount of regulation can ensure how an independent director should behave at board meetings. After all independence is a matter of attitude and a director who is conscious about his responsibilities, will always raise right questions at board meetings, whether or not he holds the independent status. The original recommendation of the Murthy Committee for mandatory training and updating of knowledge of directors has now been shifted to non-mandatory requirement, most probably in the face of strong opposition from industry. This indeed is sad as a vast majority of directors are in need of training in the business model of the company and for updating of knowledge. I do



packed with 'yes-men' or to ensure constructive criticism one needs to ponder how many independent

believe that a beginning in this regard was immediately necessary. It may not be out of place to mention here that under the Listing requirements of UK all directors are mandatory required to regularly update and refresh their skills and knowledge.

From the point of view of listed companies, a declaration should be obtained annually from all independent directors confirming compliance with all six conditions of independence.

### B. Non-Executive Directors' compensation & disclosures

A new requirement has been provided for obtaining prior approval of shareholders for payment of fees/compensation to non-executive directors. If there is stock option, the limit for the maximum number that can be granted to non-executive directors in any financial year and in aggregate should be disclosed.

According to the Companies Act, 1956 fees paid to directors do not form part of Managerial remuneration and hence no approval of shareholders for payment of fees to directors is required. Listed companies will now need to obtain prior approval of shareholders for payment of sitting fees to directors. Unless the Government is contemplating to change the law and bring sitting fees within the ambit of Managerial remuneration this contradiction should have been avoided.

### C. Other provisions relating to Board

- (i) Gap between two meetings has been reduced to three months from four months ruling at present.

### The CEO/CFO Certification is a new requirement and is based on Sarbanes Oxley Act of USA. Five new items have been added under non-mandatory requirements and the existing item on Postal ballot has been deleted.

- (ii) A code of Conduct for Board members and senior management has to be laid down by the Board which should be posted on the website of the company. All Board members and senior management should affirm compliance with the code on annual basis and the annual report shall contain a declaration to this effect signed by the CEO.

### D. Audit Committee

Following are the changes with regard to Audit Committee:

- (i) Two-third of the members of Audit committee shall be independent directors as against the present requirement of majority being independent;
- (ii) Earlier, only non-executive directors could be members of Audit committee. The revised clause has omitted this requirement.
- (iii) All members of the Audit committee shall be financially literate (as defined in the revised clause) as against the existing requirement of at least one member having financial and accounting knowledge.
- (iv) Minimum number of Audit committee meetings in a year increased to 4 from 3.

- (v) Role of the Audit committee has been enlarged to include (a) matters required to be included in Directors' Responsibility statement; (b) to review the functioning of Whistle Blower mechanism if the same is existing and (iii) review of performance of statutory and internal auditors.
- (vi) The Audit committee will also mandatorily review (a) Management Discussion and Analysis of Financial condition and results of operations; (b) statement of significant related party transactions; (c) Management letters/letters of

internal control weaknesses issued by the



- statutory auditors; (d) Internal audit reports relating to internal control weaknesses, and
- (v) To review the appointment, removal and terms of remuneration of the Chief Internal Auditor. The Audit committee will no longer be required to review the company's financial and risk management policies. Risk assessment and minimization procedures will now be reviewed by the Board. Listed companies should now

ascertain from their respective Audit committees the frequency of reporting related party transactions, frequency of discussing Management letters issued by the statutory auditors etc.

### E. Subsidiary Companies

These are new requirements, which provide for the following:

- (i) At least one independent

director on the Board of the holding company shall be a director on the board of a material non-listed Indian subsidiary company;

- (ii) The audit committee of the holding company shall review the financial statements, in particular, the investments made by the unlisted subsidiary company;
- (iii) The minutes of board meetings of the unlisted subsidiary company shall be placed at the board meeting of the holding company. The management should periodically bring to the attention of the holding company a statement of all significant transactions and arrangements entered into by the unlisted subsidiary company.

Attention of the readers is

drawn to the following:

- (a) Material non-listed Indian subsidiary has been mentioned only for Board representation. In respect of review of financial statements of unlisted subsidiary by the audit committee of holding company and placing of minutes and significant transactions entered into by subsidiary, it is significant that the words 'material' and 'Indian'

have not been used. It can therefore be interpreted that board meeting minutes, financial statements and significant transactions of all unlisted subsidiaries whether incorporated in India or abroad are to be placed before the board of the holding company or to be reviewed by the audit committee of the holding company. Is this the intention?

- (b) Material non-listed Indian subsidiary shall mean an unlisted subsidiary, incorporated in India, whose turnover or net worth exceeds 20% of the con-

solidated turnover or net worth respectively of the listed company and its subsidiaries. This definition is likely to exclude most of the unlisted subsidiaries as they are not likely to meet the turnover or net worth test.

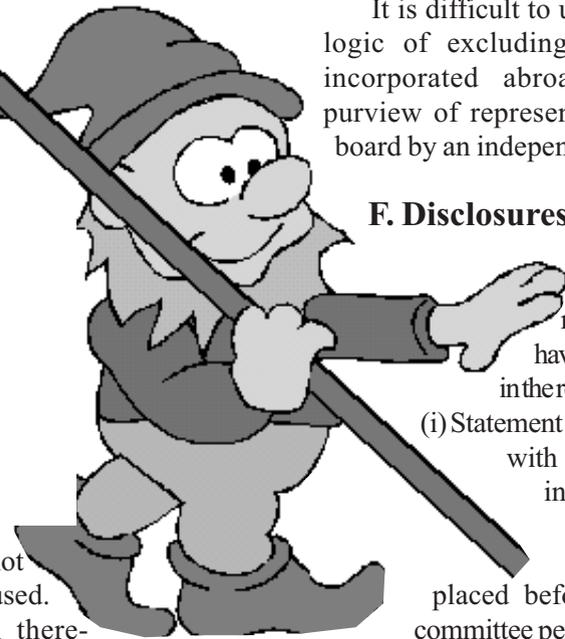
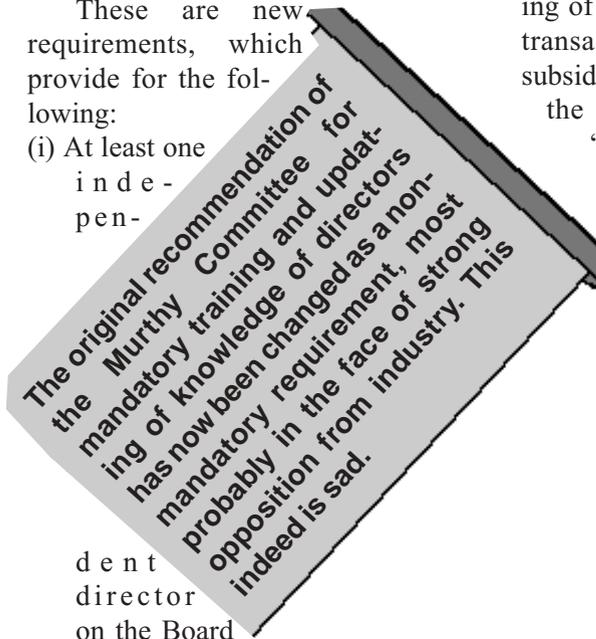
- (c) Significant transaction or arrangement shall mean any individual transaction that exceeds 10% of the total revenues/expenses/assets/liabilities of the subsidiary.

It is difficult to understand the logic of excluding subsidiaries incorporated abroad from the purview of representation on the board by an independent director.

### F. Disclosures

Following new disclosure requirements have been specified in the revised clause 49:

- (i) Statement on transactions with related parties in the ordinary course of business shall be placed before the Audit committee periodically;
- (ii) Details of material individual transactions with related parties which are not in the normal course of business shall be placed before the Audit committee; and
- (iii) Details of material individual transactions with related parties or others, which are not on arm's length basis should be placed before Audit committee together with management's justification for the same. Here also, the word 'material' has not been defined. Listed companies should ascertain



from their respective audit committees the frequency of reporting such transactions.

- (iv) Financial statements should disclose together with management's explanation any accounting treatment different from that prescribed in Accounting Standard.
- (v) The company will lay down procedures to inform board members about the risk assessment and minimization procedures which shall be periodically reviewed by the Board.
- (vi) The company shall disclose to the Audit committee on a quarterly basis the use of funds raised through public/ rights/preferential issues. Annually a statement showing use of funds for purposes other than those stated in Offer document/prospectus should be placed before the Audit committee. Such statement should be certified by the statutory auditors.
- (vii) Under 'Remuneration of Directors' new disclosure requirements have been prescribed, which include criteria of making payments to non-executive directors, shares and convertible instruments held by non-executive directors and shareholding (both own and held on beneficial basis) of non-executive directors to be disclosed in the notice of general meeting called for approving appointment of such director.

### G. CEO/CFO Certification

This is a new requirement and is based on the Sarbanes Oxley Act of USA. This had also been recommended by the Naresh Chandra Committee set up by the Centre in

2002-03. The revised Clause only requires CEO and CFO to certify to the Board the annual financial statements in the prescribed format.

While this certification will certainly provide comfort to the non-executive directors and will indeed act as the basis for the Board to make Directors' Responsibility Statement in terms of section 217(2AA) of the Companies Act, 1956, it is not clear why SEBI did not require the listed companies to include such certification in the Annual Report.

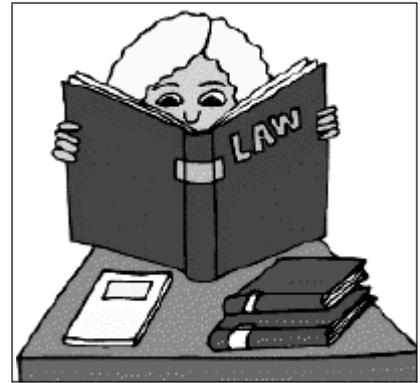
**While the new corporate governance norms are more stringent than the existing requirements it must be appreciated that while regulations in these areas are necessary, regulations per se cannot and will not ensure good corporate governance.**

### H. Compliance Report

The format of quarterly report to be submitted to the Stock Exchanges has been revised and the new format follows the revised requirements of Clause 49. The CEO or the Compliance officer can now sign the compliance report. The annual corporate governance report should disclose adoption or non-adoption of non-mandatory requirements.

### I. Non-mandatory requirements

Five new items have been added under non-mandatory require-



ments and the existing item on Postal ballot has been deleted.

The first new item states that Independent directors may not have tenure not exceeding in the aggregate a period of nine years on the Board of the company. The next item relates to companies moving towards a regime of unqualified audit report. The third item deals with training of board members in the business model of the company as well as risk profile of the business parameters of the company and responsibilities of directors and how best to discharge it. The fourth item deals with performance evaluation of non-executive directors by a peer group comprising the entire Board. The fifth item relates to setting up of a whistle blower policy in the company.

While the new corporate governance norms are more stringent than the existing requirements it must be appreciated that while regulations in these areas are necessary, regulations per se cannot and will not ensure good corporate governance.

Attention of readers is drawn towards the Report on Observance of Standards and Codes carried out under a joint programmed of World Bank and IMF. This report benchmarks the observance of corporate governance in India against the benchmark Principles of Corporate

Governance laid down by the Organization for Economic Cooperation and Development (OECD). The assessment team had extensively interviewed issuers, institutional investors, financial institutions, market analysts, lawyers, accountants and auditors. The report was also discussed by Government of India and cleared by the DEA for publication in June 2004. **Following are the areas identified for reform in the World Bank report:**

**a. Sanctions and enforcements:**

Sanctions and enforcements should be credible deterrents to help align business practices with the legal and regulatory framework, in particular with regard to related party transactions and insider trading.

b. The current framework places the oversight of listed companies partly with DCA, partly with SEBI and partly with Stock exchanges. This fragmented

structure gives rise to regulatory arbitrage and weakens enforcement.

c. If boards are to move away from simply 'rubber stamping' the decisions of management or promoters they must have a clear understanding of what is expected from them. They should know their duties of care and loyalty to the company and all shareholders. They should know their responsibilities and should be familiar with the changes in this regard arising from changes in laws and regulations. A key missing ingredient is a strong focus on professionalism of directors. Director training institutes can play a key capacity building role and expand the pool of competent candidates.

d. Institutional investors acting in a fiduciary capacity should be encouraged to form a comprehensive corporate governance

policy including voting and board representation.

It will be observed that the World Bank report has stressed the need of training and updating of knowledge of directors. Unfortunately the recommendation of Murthy Committee in this regard has now been shifted as non-mandatory requirement. The rationale of industry's objection to mandatory training, etc. of directors is not readily understandable. Hopefully, when the governance norms are reviewed next the training and knowledge updating would be made mandatory requirement.

A new requirement has been provided for obtaining prior approval of shareholders for payment of fees/compensation to non-executive directors. If there is stock option, the limit for the maximum number that can be granted to non-executive directors in any financial year and in aggregate should be disclosed. ■

## Leading light of CA world, SN Desai passes away

One of the highly revered Chartered Accountants and a leading light of the profession, ICAI's former-president Shri Shantanu Nanubhai Desai passed away on 10<sup>th</sup> November 2004 in Mumbai. Born on 26<sup>th</sup> January 1925, he became a member of our Institute in 1949 and rose to become one of the pillars of the profession. Having become President of ICAI in 1961-62 at a young age of 35, he had served as a Central Council member for decades.



He was actively associated with Indian Merchants Chamber as its Managing Committee member for a long period of 32 years. He became its President in 1976. He had held several distinguished positions in his illustrious professional life, including as Member of the High Powered Sachar Committee on Company Law & MRTTP Reforms, as Chairman/ Director of several reputed public companies besides as a member of ASSOCHAM.

Mr. Desai was also the founder member of the Bombay Chartered Accountants Society. A Rotarian of repute and a veteran of several Committees, Mr. Desai was a free, frank and modest personality—a thorough gentleman who endeared one and all with his qualities of both head and heart.

Mr. Desai's services to the cause of our profession and his long career of more than 50 years as one of our profession's most distinguished ambassadors will long be remembered and will continue to inspire new generation of Chartered Accountants.