

## Clause 49 (Revised) – Future of Corporate Governance



*The Securities and Exchange Board of India, in its April 2014 circular, had issued certain amendments to the Clause 49 of Listing Agreement, which were further amended through its September 2014 circular. These amendments follow the overhaul in the corporate governance norms under the Companies Act, 2013 and the related rules that were notified on 27<sup>th</sup> March 2014, were effective from 1<sup>st</sup> April 2014. These amendments aim to largely align the SEBI requirements with the provisions of the Companies Act and adopt best practices on corporate governance. This Revised Clause on corporate governance shall be applicable to all listed companies with effect from 1<sup>st</sup> October 2014, except for the appointment of a woman director and constitution of a risk management committee. The Clause attempts to set up an effective corporate governance framework within a company, while providing timely and accurate disclosures to its shareholders and stakeholders. This will hopefully help companies in winning back the stakeholders' confidence. The author duo discusses some of the key changes introduced in the Revised Clause and possible implementation challenges in this article. Read on...*



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The Securities and Exchange Board of India (“SEBI”), *vide* its circular dated 17<sup>th</sup> April 2014 issued certain amendments to Clause 49 (hereinafter referred to as “Revised Clause”) of the Listing Agreement. These guidelines were further amended by the circular dated 15<sup>th</sup> September 2014. These amendments follow the overhaul in the corporate governance

norms under the Companies Act, 2013 and the related rules which were notified on 27<sup>th</sup> March 2014 and were effective from 1<sup>st</sup> April 2014 (together "Companies Act"). These amendments aim to largely align the SEBI requirements with the provisions of the Companies Act and adopt the best practices on corporate governance.

The Revised Clause on corporate governance shall be applicable to all listed companies with effect from 1<sup>st</sup> October 2014, except for the clause dealing with the appointment of a woman director, which is applicable with effect from 1<sup>st</sup> April 2015; and for the clause dealing with constitution of a Risk Management Committee which shall apply only to the top 100 listed companies by market capitalisation as at the end of the immediate previous financial year. Through the issue of these guidelines, SEBI has focused on enhancing governance and has accordingly introduced several changes in the roles and responsibilities of the board, board committees and independent directors.

The Revised Clause is attempting to achieve this objective by setting up an effective corporate governance framework within the company and providing for timely and accurate disclosures to all the shareholders and other stakeholders of the Company. Some of the key changes introduced in the Revised Clause along with possible implementation challenges are:

## I. Board of Directors

### a) Composition of Board of Directors:

- Revised Clause has added the requirement of at least one *woman director* to be included on the board in order to align the same with the requirements of Companies Act. However, the implementation of the said clause has been deferred till 1<sup>st</sup> April 2015.
- Further, it has modified the reference to the chairmanship in case of non-executive director. As per the Revised Clause, if the chairman of the Board is not a '*regular non-executive director*', at least half of the Board should comprise independent directors.

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specified that the woman director needs to be independent, companies may resort to appointing women directors from within the promoters' family as directors. This may not necessarily have a desired effect on the governance standards.

### b) Independent Director:

The Revised Clause confers greater power and responsibility on the independent directors on matters relating to corporate governance.

#### ***Changes in the Definition of Independent Directors***

The definition of the independent director has been changed substantially from the existing definition in the earlier Clause 49 in order to align the same with the Companies Act.

- The definition has excluded nominee director from the definition of the independent director. In the earlier Clause 49, there was no specific exclusion of the nominee director. *The same has been aligned with the Companies Act.*
- Promoters of the company, its holding, subsidiary or associate company have been specifically excluded from the definition of independent directors in respect of which the earlier Clause 49 was silent.
- As per the Revised Clause, the director should not have any material pecuniary relationship with the company, and other prescribed related parties during the two immediately preceding financial years or during the current financial year. There was no such restriction in the previous Clause 49.

As per the Companies Act, the director should not have or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year

The Companies Act restricts independent director from having any transaction with the company whereas the Revised Clause restricts an independent director from undertaking *material* transactions with the company. The word *material* has not been defined in the Revised Clause. This difference between the Companies Act and Revised Clause may lead to interpretations and differences in applications by various companies.

#### *Limit on Number of Directorships*

In order to enhance the level of involvement of directors, Revised Clause has limited the number of directorships that an independent director can hold in a company to seven listed companies. Further, in case of a whole-time-director (WTD), the same has been limited to three listed companies. While the objective with which limits have been laid down is appropriate, the minimum sitting fees should have been set at higher limits in order to ensure a right balance between remuneration and responsibilities of independent directors.

#### *Maximum Tenure of Independent Directors*

Through the amendments issued on 15<sup>th</sup> September 2014, SEBI has notified that the maximum tenure of independent directors shall be in accordance with the

— [REDACTED] —

**Per Revised Clause, a *related party* is a person or entity that is related to the company. Per the said definition, parties shall be considered to be related if such entity is a related party under Section 2(76) of the Companies Act; or such entity is a related party under the applicable accounting standards**

— [REDACTED] —

Companies Act and clarifications/circulars issued by the Ministry of Corporate Affairs.

Thus, the term *independent director* is to be considered prospectively. The alignment with the Companies Act has provided a lot of relief to the companies, in complying with the provisions of this clause. This would also give corporations and people desirous of taking on directorships adequate time to enhance skill sets to perform their duties effectively.

#### *Performance Evaluation of the Independent Directors*

Under the existing Clause 49, there was a non-mandatory requirement that the performance of the non-executive directors can be done by the peer group consisting of the entire Board which could in-turn be a mechanism for deciding on the extension/re-appointment of directors.

However, under the Revised Clause, there is a mandatory requirement that performance of the independent directors shall be evaluated by the peer group basis, the evaluation criteria determined by the Nomination Committee. Further, the revised clause requires companies to disclose the said evaluation criteria in their Annual Report. Companies would need to develop qualitative and quantitative benchmarks in order to ensure effective implementation of this requirement.

#### *Separate Meeting of Independent Directors*

The revised clause has laid down a condition requiring companies to hold at least one meeting in a year amongst independent directors alone, with a condition that non-independent director and any member of management shall not be present in such meeting. Further, as per the Revised Clause, the independent directors in the meeting shall review the performance of non-independent directors and board, chairperson of the company and assess the quality, quantity and timeliness of the information between the Board and the management. The same has been aligned

**Revised Clause makes it mandatory for companies to establish a vigil mechanism to enable directors and employees to report unethical behaviour and actual or suspected frauds or violation of the company's code of conduct or ethics policy**

to the Companies Act and is a positive step in enhancing the governance standards.

*Familiarisation Programme for Independent Directors*

The Revised Clause mandates programmes for independent directors to familiarise themselves with the company, their roles, rights and responsibilities, etc. This was a non-mandatory requirement in the existing Clause 49.

Further, as per the amendments to the Revised Clause every listed company is required to disclose the details of familiarisation programmes on the company's website and a weblink thereto shall also be given in its annual report. This will help in enhancing the skill sets required in Board rooms and help in more informed decision making.

*SEBI has taken positive steps to enhance the level of corporate governance through these measures. However, it would be incumbent on companies to ensure that efforts in enhancing governance standards are taken in the right spirit and the exercise does not become a tick in the box approach.*

## II. Related Party Transactions

The Revised Clause adds a detailed new section on related party transactions, which describes what related party transactions are, and defines the term *related party*. As per the Revised Clause, a *related party* is a person or entity that is related to the company. As per the said definition, parties shall be considered to be related if such entity is a related party under Section 2(76) of the Companies Act; or such entity is a related party under the applicable accounting standards.

*There is a school of thought that both the Companies Act and Revised Clause should have only referred to accounting standard*

*for definition of related party. The Ministry of Corporate Affairs is responsible for setting up standards and therefore, multiplicity of definitions could have been avoided.*

As per the Revised Clause, a transaction with a related party shall be considered material if the transaction to be entered into individually or taken together with previous transactions during a financial year exceeds 10% of the annual consolidated turnover of the company as per the last audited financial statements of the company.

*As per the Revised Clause, all related party transactions shall require prior approval of the Audit Committee. However, the Audit Committee shall grant omnibus approval for Related Party Transactions proposed to be entered into by the company subject to fulfillment of certain conditions. Further, all material related party transactions shall require approval of the shareholders through special resolution and the related parties shall abstain from voting on such resolutions.*

With materiality thresholds being set out, lesser number of transactions would require shareholder approval which is a welcome step, as otherwise, even immaterial transactions would have required the nod of the shareholders. The Companies Act however, requires pre-approval of only those related party transactions which are not in the ordinary course of business or are not at arm's length. SEBI and MCA should align the requirements so as to minimise the administrative burden on Companies.

The Revised Clause requires all related parties to abstain from voting on transactions entered into with a related party, irrespective of the fact whether the other related parties were involved in that transaction or not. This may pose challenges for companies. The Companies Act takes a more pragmatic approach and requires only the related party interested in the particular transaction to abstain whereas other related parties may vote on the same. The Clause grants relief in respect of transactions entered into between two government companies or between a holding company and its wholly owned subsidiary, whose accounts are consolidated with the holding company and placed before the shareholders at the general meeting for approval.

### III. Expanded Role of Audit Committee

The Revised Clause has enhanced the role/responsibilities of the audit committee. It is responsible for monitoring auditor's independence and performance, effectiveness of audit process; approval or any subsequent modification of transactions of the company with related parties; scrutiny of inter-corporate loans and investments; valuation of undertakings or assets of the company, wherever it is necessary; and evaluation of internal financial controls and risk management systems.

The Audit committee is an integral element of the corporate governance framework. The above steps would enhance the effectiveness of the audit committee and enhance the oversight role.

In terms of the constitution of the audit committees, the Revised Clause requires two thirds of the members of the audit committees to be independent directors whereas under the Companies Act, the majority needs to be independent director. Therefore, requirements of the Revised Clause are stringent and in our view, would be a catalyst to drive the initiative forward.

### IV. Nomination and Remuneration Committee

The Revised Clause has changed the earlier non-mandatory requirement relating to a remuneration committee (including the constitution of committee) to a mandatory requirement. Accordingly, under the Revised Clause, SEBI has prescribed a set of requirements relating to nomination and remuneration committee.

As per the SEBI, the said committee shall be constituted by the board of directors and shall comprise at least three directors, all of whom shall be non-executive directors and at least half shall be independent. The chairman of the committee shall be an independent director. The said committee shall formulate the criteria for determining qualifications, positive attributes and independence of a director and recommend to the board a policy, relating to the remuneration of directors, KMPs and other employees; formulate a criteria for evaluation of independent directors and the board; devise a policy on board diversity; and identify

persons who are qualified to become directors and recommend to the board appointment and removal of persons.

### V. Subsidiary Companies

The Revised Clause has prescribed the following changes in the requirements relating to subsidiary companies:

- The Revised Clause, has imposed two new requirements in relation to subsidiary companies, viz., no company shall dispose of shares in its material subsidiary which would reduce its shareholding to less than 50%, cease the exercise of control over the subsidiary, and selling, disposing, and leasing of assets amounting to more than 20% of the assets of material subsidiary without passing a special resolution in its general meeting. The exception to this rule being where such divestment is made under a scheme of arrangement duly approved by a Court/Tribunal,
- The Revised Clause mandates that at least one independent director who is on the board of the holding company to be a director on the board of the material non-listed Indian subsidiaries also. The audit committee of the listed holding company shall also review the financial statements of the unlisted subsidiary company (especially the investments made by the unlisted subsidiary).

These are welcome steps to enhance the investor protection.

### VI. Risk Management:

The Revised Clause requires the board to frame, implement and monitor the risk management plan for the top 100 listed companies by market capitalisation as at the end of the immediate previous financial year. The Companies Act requires all companies to develop and implement the risk management policy for all companies.

### VII. Compulsory whistle blower mechanism

The Revised Clause makes it mandatory for companies to establish a vigil mechanism to enable directors and employees to report unethical behaviour and actual or suspected

# Corporate Governance

frauds or violation of the company's code of conduct or ethics policy. The mechanism should also provide adequate safeguards to prevent victimisation of the whistle blower. In the light of the growing corporate scams and scandals, the development of a legislative framework for adequate whistle blower mechanism is in the right direction.

## VIII. Applicability

Vide its circular in September 2014, the SEBI has clarified that the Revised Clause is not mandatory, for the time being, in respect of the following class of companies:

- a. Companies having paid up equity share capital not exceeding ₹10 crore and net worth not exceeding ₹25 crore, as on the last day of the previous financial year (provided where the provisions of Clause 49 becomes applicable to a company at a later date, such company shall comply with the requirements of Clause 49 within six months from the date on which the

provisions became applicable to the company)

- b. Companies whose equity share capital is listed exclusively on the SME and SME-ITP Platforms.

It seems that this has been considered in view of the cost of compliance which could be substantial for all companies.

## Summary

New requirements broadly serve the objectives of alignment with the Companies Act *though differences continue in certain areas*, and making the governance framework more effective. It is expected that the Revised Clause will lead to enhanced levels of corporate governance and will improve the confidence of stakeholders. Organisations need to implement swift changes to align with the requirements of the Revised Clause. It is now incumbent on the corporations to ensure that all these measures are implemented effectively and more importantly in the right spirit. ■

