

***AN ANALYSIS
OF
REVISED CLAUSE 49 OF THE LISTING AGREEMENT***

Team : Maheshwari and Co.

Introduction

Good Governance in capital market has always been high on the agenda of SEBI. Corporate Governance is looked upon as a distinctive brand and benchmark in the profile of Corporate Excellence. This is evident from the continuous updation of guidelines, rules and regulations by SEBI for ensuring transparency and accountability. In the process, SEBI had constituted a Committee on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla. The Committee in its report observed that “the strong Corporate Governance is indispensable to resilient and vibrant capital markets and is an important instrument of investor protection. It is the blood that fills the veins of transparent corporate disclosure and high quality accounting practices. It is the muscle that moves a viable and accessible financial reporting structure.”

Based on the recommendations of the Committee, the SEBI had specified principles of Corporate Governance and introduced a new clause 49 in the Listing agreement of the Stock Exchanges in the year 2000. These principles of Corporate Governance were made applicable in a phased manner and all the listed companies with the paid up 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, were covered as of March 31, 2003.

SEBI, as part of its endeavour to improve the standards of corporate governance in line with the needs of a dynamic market, constituted another Committee on Corporate Governance under the Chairmanship of Shri N. R. Narayana Murthy to review the performance of Corporate Governance and to determine the role of companies in responding to rumour and other price sensitive information circulating in the market in order to enhance the transparency and integrity of the market. The Committee in its Report observed that “the effectiveness of a system of Corporate Governance cannot be legislated by law, nor can any system of Corporate Governance be static. In a dynamic environment, system of Corporate Governance need to be continually evolved.”

With a view to promote and raise the standards of Corporate Governance, SEBI on the basis of recommendations of the Committee and public comments received on the report and in exercise of powers conferred by Section 11(1) of the Securities and Exchange Board of India Act, 1992 read with section 10 of the Securities Contracts (Regulation) Act 1956, revised the existing clause 49 of the Listing agreement vide its circular SEBI/MRD/SE/31/2003/26/08 dated August 26, 2003. It clarified that some of the sub-clauses of the revised clause 49 shall be suitably modified or new clauses shall be added following the amendments to the Companies Act 1956 by the Companies (Amendment) Bill/Act 2003, so that the relevant provisions of the clauses on Corporate Governance in the Listing Agreement and the Companies Act remain harmonious with one another.

Schedule of Implementation

The circular specifies following schedule of implementation of the revised clause 49 :

- (i) All entities seeking listing for the first time, at the time of listing,
- (ii) 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.

The companies are required to comply with the requirements of the clause on or before March 31, 2004. The companies which are required to comply with the requirements of the revised clause 49 have been put under an obligation 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 is required to be submitted either by the Compliance Officer or the Chief Executive Officer of the company after obtaining due approvals.

Application of Revised Clause 49

The revised clause 49 is applicable to the listed companies, in accordance with the schedule of implementation given above. However, 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, and guidelines or directives issued by the relevant regulatory authorities. The revised clause is not applicable to the Mutual Fund Schemes.

Obligations on Stock Exchanges

The Stock Exchanges are put under obligation to ensure that all the provisions of Corporate Governance have been complied with by the company seeking listing for the first time, before granting any new listing. For this purpose, it would be satisfactory compliance if these companies set up the Boards and constitute committees such as Audit Committee, shareholders/ investors grievances committee, etc. before seeking listing. The stock exchanges have been empowered to grant a reasonable time to comply with these conditions if they are satisfied that genuine legal issues exists which will delay such compliance. In such cases while granting listing, the stock exchanges are required to obtain a suitable undertaking from the company. In case of the company failing to comply with this requirement without any genuine reason, the application money shall be kept in an escrow account till the conditions are complied with. The Stock Exchanges have also been required to set up a separate monitoring cell with identified personnel to monitor the compliance with the provisions of the Corporate Governance, and to obtain the quarterly compliance report from the companies which are required to comply with the requirements of Corporate Governance. The stock exchanges are required to submit a consolidated compliance report to SEBI within 30 days of the end of each quarter.

Highlights of the New Amendments

1. Widening the Definition of Independent Director

Under the revised clause 49, the definition of the expression ‘independent director’ has been expanded. The expression ‘independent director’ mean non-executive director of the company who —

- (a) 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;
- (b) is not related to promoters or management at the board level or at one level below the board;
- (c) has not been an executive of the company in the immediately preceding three financial years;
- (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 the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
- (e) is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and
- (f) is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

It has been clarified that the Institutional Directors on the boards of companies are independent directors whether the institution is an investing institution or a lending institution.

2. Compensation to Non Executive Directors and Disclosure thereof

As per earlier clause 49, the compensation to be paid to non-executive directors was fixed by the Board of Directors, whereas the revised clause requires all compensation paid to non-executive directors to be fixed by the Board of Directors and to be approved by shareholders in general meeting. There is also provision for setting up of limits 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 to be vested after a period of at least one year from the date of retirement of such non-executive directors.

Placing the independent directors and non-executive directors on equal footing, the revised clause provides that the considerations as regards compensation paid to an independent director shall be the same as those applied to a non-executive director. The companies have been put under an obligation to publish their compensation philosophy and statement of entitled compensation in respect of non-executive

directors in its annual report. Alternatively, this may be put up on the company's website and a reference thereto in the annual report. The company is also required to disclose on an annual basis, details of shares held by non-executive directors, including on an "if-converted" basis.

The revised clause also requires non-executive directors to disclose prior to their appointment 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,. These details are required to be accompanied with their notice of appointment.

3. Periodical Review by Independent Director

The revised clause 49 requires the Independent Director to periodically review legal compliance reports prepared by the company and any steps taken by the company to cure any taint. The revised clause specifies that no defence shall be permitted that the independent director was unaware of this responsibility in case of any proceedings against him in connection with the affairs of the company.

4. Code of Conduct

The revised clause 49 requires the Board of a company to lay down the code of conduct for all Board members and senior management of a company and the same to be posted on the website of the company. Accordingly, all Board members and senior management personnel have been put under an obligation to affirm compliance with the code on an annual basis and a declaration to this effect signed by the CEO and COO is to be given in the Annual Report of the Company.

It has been clarified that the term senior management will include personnel of the company who are members of its management / operating council (i.e. core management team excluding Board of Directors). Normally, this would comprise all members of management one level below the executive directors.

5. Non-Executive Directors – Not to hold office for more than Nine Years

Revised clause 49 limits the term of the office of the non-executive director and provides that a person shall be eligible for the office of non-executive director so long as the term of office does not exceed nine years in three terms of three years each, running continuously.

6. Audit Committee

Two explanations have been added in the revised clause 49. The first explanation defines the term "financially literate" to mean the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows. It has also been clarified that a member is 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(CEO), Chief Financial Officer(CFO), or other senior officer with financial oversight responsibilities.

7. Review of information by Audit Committee

The Audit Committee is required to mandatorily review financial statements and draft audit report, including quarterly / half-yearly financial information, management discussion and analysis of financial condition and results of operations, reports relating to compliance with laws and to risk management, management letters/ letters of internal control weaknesses issued by statutory / internal auditors, and records of related party transactions.

The appointment, removal and terms of remuneration of the Chief Internal Auditor shall be subject to review by the Audit Committee.

8. Disclosure of Accounting Treatment

The revised clause 49 requires that in case a company has followed a treatment different from that prescribed in an Accounting Standards, the management of such company shall justify why they believe such alternative treatment is more representative of the underlined business transactions. Management is also required to clearly explain the alternative accounting treatment in the footnote of financial statements.

9. Whistle Blower Policy

Companies have been required to formulate an Internal Policy on access to Audit Committees. Personnel who observe any unethical or improper practice (not necessarily a violation of law) can approach the Audit Committee without necessarily informing their supervisors.

Companies are also required to 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 should also contain provisions protecting "whistle blowers" from unfair termination and other unfair or prejudicial employment practices. Companies have also been required to 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. Such affirmation should form part of the Board's report on Corporate Governance that is required to be prepared and submitted together with the annual report.

10. Subsidiary Companies

The revised clause 49 provides that the provisions relating to the composition of the Board of Directors of the holding company are also applicable to the composition of the Board of Directors of subsidiary companies. The clause further requires that at least one independent director on the Board of Directors of the holding company should be a director on the Board of Directors of the subsidiary company.

The Audit Committee of the holding company has been empowered to review the financial statements, in particular the investments made by the subsidiary company and the minutes of the Board meetings of the subsidiary company to be placed for review at the Board meeting of the holding company. It is further required that the Board's report of the holding company should state that they have reviewed the affairs of the subsidiary company also.

11. Disclosure of contingent liabilities

The revised clause 49 requires the management to 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 is required to be highlighted in the significant accounting policies and notes on accounts, as well as, in the auditor's report, where necessary.

12. Additional Disclosures

The revised Clause 49 of the Listing Agreement requires the following additional disclosures:

(A) Basis of related party transactions

A statement of all transactions with related parties shall be placed before the Audit Committee for formal approval/ratification. If any transaction is not on an arm's length basis, management is required to justify the same to the Audit Committee.

(B) Board Disclosures –Risk management

The Board members should be informed about the risk assessment and minimization procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework.

Management shall place a quarterly report certified by the compliance officer of the company, before the entire Board of Directors 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.

(C) Proceeds from Initial Public Offerings (IPOs)

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. 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.

13. Certification by CEO/CFO

CEO (either the Executive Chairman or the Managing Director) and the CFO (Whole-Time Finance Director or other person discharging this function) of the company has been put under an obligation to certify that, to the best of their knowledge and belief, they have reviewed the balance sheet and profit and loss account and all its schedules and notes on accounts, the cash flow statements as well as the Directors' Report and these statements do not contain any materially untrue statement, omits any material fact or do they contain statements that might be misleading. Further they are required to certify that these statements together present a true and fair view of the company, and are in compliance with the existing accounting standards and/or applicable laws/regulations.

The revised clause requires them to be responsible for establishing and maintaining internal controls, to evaluate the effectiveness of internal control systems of the company, and to disclose to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any. They are also required to disclose to the auditors as well as the Audit Committee, instances of significant fraud, if any, that involves management or employees having a significant role in the company's internal control systems, whether or not there were significant changes in internal control and / or of accounting policies during the year.

14. Report on Corporate Governance

The companies have been required to submit a quarterly compliance report in the prescribed format to the stock exchanges within 15 days from the close of the quarter. The report has to be submitted either by the Compliance Officer or the Chief Executive Officer of the company after obtaining due approvals.

15. Company Secretary in Practice to Issue Certificate of Compliance

This is a landmark amendment authorizing Company Secretaries in Practice among other professionals to issue certificate of compliance of clause 49. The revised clause requires the company to obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance and annex the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate is also required to be sent to the Stock Exchanges along with the annual returns filed by the company.

16. Additional disclosure in the Report on Corporate Governance

The following additional items are required to be disclosed in the suggested list of Items to be included In the Report on Corporate Governance in the Annual Report of Companies.

- (i) Disclosure of accounting treatment, if different, from that prescribed in Accounting Standards with explanation.
- (ii) Whistle Blower policy and affirmation that no personnel have been denied access to the audit committee.

17. Additional Disclosures under Non-Mandatory Requirements

The following additional disclosures are required to be made under the non-mandatory requirements:

- (i) Audit qualifications

Company may move towards a regime of unqualified financial statements.

- (ii) Training of Board Members

Company shall train its Board members in the business model of the company as well as the risk profile of the business parameters of the company, their responsibilities as directors, and the best ways to discharge them.

- (iii) Mechanism for evaluating Non-Executive Board Members

The performance evaluation of non-executive directors should be done by a peer group comprising the entire Board of Directors, excluding the director being evaluated; and Peer Group evaluation should be the mechanism to determine whether to extend / continue the terms of appointment of non-executive directors.

Conclusion

The recent events worldwide, particularly in the United States have renewed the emphasis on Corporate Governance the worldover. These events have highlighted the need for ethical governance and require management to look beyond their systems and procedures. Reacting swiftly and spontaneously, the United States enacted Sarbans Oxley Act, 2002 bringing out fundamental changes in every dimension of Corporate Governance. Back home in India, the need for strengthened norms for Corporate Governance is also felt. The revised clause 49 of the Listing Agreement is, therefore, most timely and provides much needed disclosure requirements, widened definition of independent director, periodical review by independent director, whistle blower policy, quarterly compliance report in the prescribed format and issue of certificate of compliance. It is hoped that the revised clause 49 would go a long way in providing corporates good governance framework.