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Clause 49 of Listing Agreement : Overview

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Securities and Exchange Board of India ("SEBI") has overhauled the existing Clause 49 of the Listing Agreement and replaced it with a revised Clause 49 (the "New Clause" or the "Clause")[2]. The New Clause, which will be effective from 1 October 2014, serves the following objectives: align the provisions of Listing Agreement with the provisions of the newly enacted Companies Act, 2013 and also provide additional requirements to strengthen the corporate governance framework for listed companies in India. Most of the requirements under the New Clause are in line with the changes brought about in corporate governance by the Companies Act 2013. However, certain requirement under the New Clause goes a step further and imposes more stringent requirements of corporate governance to listed companies.

The New Clause is based on the principle of ensuring equitable treatment to all shareholders and recognising the rights of all stakeholders in the company. The New Clause is attempting to achieve this object by setting up an effective corporate governance frame work within the company and providing for timely and accurate disclosures.

The key aspects of the New Clause are discussed below:

Independent Directors

The New Clause confers greater power and responsibility on the independent directors to on matters relating to corporate governance. The Clause incorporates methods to ensure professional, independent and transparent approach for selection and appointment of independent directors. The Clause retains the requirement of having at least one third of directors as independent directors if the chairman of the board of directors is a non-executive director. If the company does not have a regular non-executive Chairman, at least half of the board of directors should comprise of independent directors. Certain key changes in respect of the independent directors are listed below :

***Tenure of Independent Directors* :** The New Clause restricts the total tenure of an Independent Director to a two terms of 5 years each. However, if a person who has already served as an Independent Director for 5 years or more in a listed company as on the date on which the amendment to Listing Agreement becomes effective, he shall be eligible for appointment for one more term of 5 years only. Further, if an independent director has been completed his total tenure, he shall be eligible for reappointment only after a period of three years.

Restriction on the number of Boards Independent Directors can serve : The New Clause restricts the maximum number of boards an independent director can serve on listed companies as seven. If such person is serving as a whole time director in a listed company, then he cannot be serve more than three boards of listed companies.

***Separate meeting of independent directors* :** The New Clause provides that independent directors shall conduct a separate meeting at least once in year. A separate meeting without the presence of the management/ executive directors provides them an opportunity to express their opinion freely and independently.

***Performance evaluation of independent directors* :** The New Clause makes it mandatory to conduct the performance evaluation of the independent directors. The evaluation shall be done by the whole board except the directors being evaluated. The decision to extend/ continuer the terms of the independent directors are made on the basis of such performance evaluation.

***Prohibition of stock option to independent directors* :** In line with the Companies Act 2013, the New Clause makes it clear that the independent directors are not entitled to any stock option in the company. One of the main arguments against granting stock options to independent directors is the conflict interest resulting out of such options. If they are permitted to hold stock options in the company, they will have a financial interest in the company which will affect their independence. The New Clause also makes it categorically clear that the independent directors should not have any pecuniary interest in the company apart from the director's remuneration.

Exclusion of nominee directors from the definition of independent director : The New Clause excludes nominee directors from the definition of the independent directors. This is another step to avoid the inherent conflict of interest in allowing the nominee directors to act as independent directors. The nominee directors have a clear cut mandate to safeguard the constituency they represent, which are generally the lenders of the company. Hence, including them with in the pool of independent directors may not be appropriate for the overall corporate governance of the Company. Hence, the new Clause excludes them within the definition of Independent directors.

Related Party Transactions ("RPT")

Abusive RPT are one of the main concerns of corporate governance in India. Most of the abusive RPT are carried out between group companies. The shareholding patterns of these companies are concentrated among the controlling shareholders. Hence, requirement of obtaining shareholders' approval for such transaction does not serve any purpose as the majority of voting rights are held by the controlling shareholders.

The New Clause provides that all material RPT requires prior approval of the shareholders through a special resolution and the related parties are prohibited from voting such resolutions. Mandating the approval of RPT by the majority of the shareholders who are not interested in the transactions can curb abusive RPT.

Audit Committee has been entrusted with the role of preventing the abusive RPT. Currently, the Audit Committee reviews RPT on a periodical basis. The periodical reviews do not serve much purpose as a transaction already carried out cannot be undone. Hence, the New Clause provides that all RPT requires prior approval of Audit Committee.

The New Clause also widens the definition of RPT significantly. Even a transaction between related parties without any charge has been included in the definition of RPT.

The Clause requires that all material RPTs have to be disclosed in the quarterly compliance report on corporate governance.

Subsidiary Company

The New Clause extends certain principle of corporate governance to material subsidiaries of listed companies. A material subsidiary is defined as a subsidiary whose income or net worth exceeds 20% of the consolidated income or net worth, as the case may be, of the listed holding company. The Clause mandates that at least one Independent Director on the board of the holding company shall 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.

There have been instances where the where ownership of major subsidiaries was transferred to controlling shareholders, without taking the approval of other shareholders. The New Clause states that no company shall dispose of shares in its material subsidiary which would reduce its shareholding to less than 50% or cease the exercise of control over the subsidiary without passing a special resolution in its general meeting. The Clause also provides that selling, disposing and leasing of assets amounting to more than twenty percent of the assets of a material subsidiary shall require prior approval of shareholders by way of special resolution.

Expanded role of Audit Committee

To align with the requirement of the Companies Act 2013, the New Clause significantly enhances the power of the Audit Committee entrusting it with various responsibility to ensure corporate governance standards. The Clause requires Audit Committee to have minimum three directors as members and two third of members shall be independent directors. The Audit Committee has been given a significant role regarding the appointment and monitoring of auditors, financial reporting of the Company, monitoring inter corporate loans, RPTs, reviewing the functioning of the whistle blower mechanism, etc.

Compulsory Whistle Blower mechanism

The New Clause makes it mandatory for companies to establish a vigil mechanism to enable directors and employees to report unethical behaviour and frauds. The mechanism should also provide adequate safeguards to prevent victimisation of the whistle blower. In the light of the growing corporate scams and scandals, development of a legislative framework for adequate whistle blower mechanism is a move towards the right direction.

Nomination and Remuneration Committee

The New Clause makes it mandatory for companies to set up a Nomination and Remuneration Committee to formulate criteria for determining qualifications, positive attributes and independence of a director and recommend a policy relating to the remuneration of the directors, key managerial personnel and other employees. The Committee will be formulating criterion to evaluate independent directors and identifying people who are qualified to be appointed as directors and at the senior management levels.

Other Requirements

- The Clause requires the board of directors to form a code of conduct and strict compliance with such code. A declaration to this effect shall be incorporated in the annual report.
- The board of directors shall be responsible for framing, implementing and monitoring the risk management plan for the company. The Company shall also constitute a risk management committee.
- The Clause also provides for detailed disclosure requirements in respect of RPT, accounting treatments, information about the directors, their appointment letters, reasons for resignation, etc.
- In line of the Companies Act 2013, the Clause mandates representation of at least one woman director in the board.

[2] *External Link*