

Report of the SEBI Committee on Corporate Governance

February 8, 2003

Preamble

Corporations pool capital from a large investor base both in the domestic and in the international capital markets. In this context, investment is ultimately an act of faith in the ability of a corporation's management. When an investor invests money in a corporation, he expects the board and the management to act as trustees and ensure the safety of the capital and also earn a rate of return that is higher than the cost of capital. In this regard, investors expect management to act in their best interests at all times and adopt good corporate governance practices.

Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct and about making a distinction between personal and corporate funds in the management of a company.

It was the belief of the Securities and Exchange Board of India ("SEBI") that efforts to improve corporate governance standards in India must continue. This is because these standards themselves were evolving in keeping with market dynamics. Accordingly, the Committee on Corporate Governance (the "Committee") was constituted by SEBI, to evaluate the adequacy of existing corporate governance practices and further improve these practices. The Committee comprised members from various walks of public and professional life. This includes captains of industry, academicians, public accountants and people from financial press and from industry forums.

The issues discussed by the Committee primarily related to audit committees, audit reports, independent directors, related parties, risk management, directorships and director compensation, codes of conduct and financial disclosures. The Committee's

*This report contains 30 pages and two enclosures
Enclosures consist of 10 pages*

recommendations in the final report were selected based on parameters including their relative importance, fairness, accountability, transparency, ease of implementation, verifiability and enforceability.

The key mandatory recommendations focus on strengthening the responsibilities of audit committees; improving the quality of financial disclosures, including those related to related party transactions and proceeds from initial public offerings; requiring corporate executive boards to assess and disclose business risks in the annual reports of companies; introducing responsibilities on boards to adopt formal codes of conduct; the position of nominee directors; and stock holder approval and improved disclosures relating to compensation paid to non-executive directors.

Non-mandatory recommendations include moving to a regime where corporate financial statements are not qualified; instituting a system of training of board members; and the evaluation of performance of board members.

The Committee believes that these recommendations codify certain standards of "good" governance into specific requirements, since certain corporate responsibilities are too important to be left to loose concepts of fiduciary responsibility. When implemented through SEBI's regulatory framework, they will strengthen existing governance practices and also provide a strong incentive to avoid corporate failures.

Some people have legitimately asked whether the costs of governance reforms are too high. In this context, it should be noted that the failure to implement good governance procedures has a cost beyond mere regulatory problems. Companies that do not employ meaningful governance procedures will have to pay a significant risk premium when competing for scarce capital in today's public markets.

The Committee would like to thank Mr. G.N. Bajpai, Chairman of SEBI and Mr. Pratip Kar, Executive Director, SEBI for their support. In addition, the Committee would like to thank Mr. P. K. Bindlish, General Manager, Mr. Manoj Kumar, Assistant General Manager and other staff at SEBI along with Mr. Sumanth Cidambi of Progeon Limited, who assisted in the preparation of this report.

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Mumbai
February 8, 2003

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1. Introduction

1.1 The need for corporate governance

- 1.1.1 A corporation is a congregation of various stakeholders, namely, customers, employees, investors, vendor partners, government and society. A corporation should be fair and transparent to its stakeholders in all its transactions. This has become imperative in today's globalized business world where corporations need to access global pools of capital, need to attract and retain the best human capital from various parts of the world, need to partner with vendors on mega collaborations and need to live in harmony with the community. Unless a corporation embraces and demonstrates ethical conduct, it will not be able to succeed.
- 1.1.2 Corporate governance is about ethical conduct in business. Ethics is concerned with the code of values and principles that enables a person to choose between right and wrong, and therefore, select from alternative courses of action. Further, ethical dilemmas arise from conflicting interests of the parties involved. In this regard, managers make decisions based on a set of principles influenced by the values, context and culture of the organization. Ethical leadership is good for business as the organization is seen to conduct its business in line with the expectations of all stakeholders.
- 1.1.3 Corporate governance is beyond the realm of law. It stems from the culture and mindset of management, and cannot be regulated by legislation alone. Corporate governance deals with conducting the affairs of a company such that there is fairness to all stakeholders and that its actions benefit the greatest number of stakeholders. It is about openness, integrity and accountability. What legislation can and should do, is to lay down a common framework – the “form” to ensure standards. The “substance” will ultimately determine the credibility and integrity of the process. Substance is inexorably linked to the mindset and ethical standards of management.
- 1.1.4 Corporations need to recognize that their growth requires the cooperation of all the stakeholders; and such cooperation is enhanced by the corporation adhering to the best corporate governance practices. In this regard, the management needs to act as trustees of the shareholders at large and prevent asymmetry of benefits between various sections of shareholders, especially between the owner-managers and the rest of the shareholders.
- 1.1.5 Corporate governance is a key element in improving the economic efficiency of a firm. Good corporate governance also helps ensure that corporations take into account the interests of a wide range of constituencies, as well as of the communities within which they operate. Further, it ensures that their Boards are accountable to the shareholders. This, in turn, helps assure that corporations operate for the benefit of society as a whole. While large profits can be made taking advantage of the asymmetry between stakeholders in the short run, balancing the interests of all stakeholders alone will ensure survival and growth in the long run. This includes, for instance, taking into account societal concerns about labor and the environment.

- 1.1.6 The failure to implement good governance can have a heavy cost beyond regulatory problems. Evidence suggests that companies that do not employ meaningful governance procedures can pay a significant risk premium when competing for scarce capital in the public markets. In fact, recently, stock market analysts have acquired an increased appreciation for the correlation between governance and returns. In this regard, an increasing number of reports not only discuss governance in general terms, but also have explicitly altered investment recommendations based on the strength or weakness of a company's corporate governance infrastructure.
- 1.1.7 The credibility offered by good corporate governance procedures also helps maintain the confidence of investors – both foreign and domestic – to attract more “patient”, long-term capital, and will reduce the cost of capital. This will ultimately induce more stable sources of financing.
- 1.1.8 Often, increased attention on corporate governance is a result of financial crisis. For instance, the Asian financial crisis brought the subject of corporate governance to the surface in Asia. Further, recent scandals disturbed the otherwise placid and complacent corporate landscape in the US. These scandals, in a sense, proved to be serendipitous. They spawned a new set of initiatives in corporate governance in the US and triggered fresh debate in the European Union as well as in Asia. The many instances of corporate misdemeanours have also shifted the emphasis on compliance with substance, rather than form, and brought to sharper focus the need for intellectual honesty and integrity. This is because financial and non-financial disclosures made by any firm are only as good and honest as the people behind them. By this very principle, only those industrialists whose corporations are governed properly should be allowed to be a part of committees. This includes the Prime Minister and Finance Minister’s advisory councils, committees set up by the Confederation of Indian Industry (“CII”), the Securities and Exchange Board of India (“SEBI”), the Department of Company Affairs, ministries, and the boards of large banks and financial institutions.
- 1.1.9 Corporate governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance – a voluntary code published by the CII, and the first formal regulatory framework for listed companies specifically for corporate governance, established by the SEBI. The latter was made in February 2000, following the recommendations of the Kumarmangalam Birla Committee Report.
- 1.1.10 The term “corporate governance” is susceptible to both broad and narrow definitions. In fact, many of the codes do not even attempt to articulate what is encompassed by the term. The motives for the several corporate governance postulates engaged in these definitions vary, depending on the participant concerned. The focal subjects also vary accordingly. The important point is that corporate governance is a concept, rather than an individual instrument. It includes debate on the appropriate management and control structures of a company. Further it includes the rules relating to the power relations between owners, the Board of Directors, management and, last but not least, the stakeholders such as employees, suppliers, customers and the public at large.

- 1.1.11 The majority of the definitions articulated in the codes relate corporate governance to “control” – of the company, of corporate management, or of company conduct or managerial conduct. Perhaps the simplest and most common definition of this sort is that provided by the Cadbury Report (U.K.), which is frequently quoted or paraphrased: “Corporate governance is the system by which businesses are directed and controlled.”
- 1.1.12 The definition in the preamble of the OECD Principles is also all encompassing ? “[C]orporate governance . . . involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”
- 1.1.13 The most common school of thought would have us believe that if management is about running businesses, governance is about ensuring that it is run properly. All companies need governing as well as managing. The aim of “Good Corporate Governance” is to enhance the long-term value of the company for its shareholders and all other partners. The enormous significance of corporate governance is clearly evident in this definition, which encompasses all stakeholders. Corporate governance integrates all the participants involved in a process, which is economic, and at the same time social. This definition is deliberately broader than the frequently heard narrower interpretation that only takes account of the corporate governance postulates aimed at shareholder interests.
- 1.1.14 Studies of corporate governance practices across several countries conducted by the Asian Development Bank (2000), International Monetary Fund (1999), Organization for Economic Cooperation and Development (“OECD”) (1999) and the World Bank (1999) reveal that there is no single model of good corporate governance. This is recognized by the OECD Code. The OECD Code also recognizes that different legal systems, institutional frameworks and traditions across countries have led to the development of a range of different approaches to corporate governance. Common to all good corporate governance regimes, however, is a high degree of priority placed on the interests of shareholders, who place their trust in corporations to use their investment funds wisely and effectively. In addition, best-managed corporations also recognize that business ethics and corporate awareness of the environmental and societal interest of the communities within which they operate, can have an impact on the reputation and long-term performance of corporations.

1.2 The Kumarmangalam Birla Committee on Corporate Governance

- 1.2.1 SEBI had constituted a Committee on May 7, 1999 under the chairmanship of Shri Kumarmangalam Birla, then Member of the SEBI Board “to promote and raise the standards of corporate governance”. Based on the recommendations of this Committee, a new clause 49 was incorporated in the Stock Exchange Listing Agreements (“Listing Agreements”).
- 1.2.2 The recommendations of the Kumarmangalam Birla Committee on Corporate Governance (the “Recommendations”) are set out in Enclosure I to this report.

1.3 Financial reporting and disclosures

1.3.1 Financial disclosure is a critical component of effective corporate governance. SEBI set up an Accounting Standards Committee, as a Standing Committee, under the chairmanship of Shri Y. H. Malegam with the following objectives:

- ✍ To review the continuous disclosure requirements under the listing agreement for listed companies;
- ✍ To provide input to the Institute of Chartered Accountants of India (“ICAI”) for introducing new accounting standards in India; and
- ✍ To review existing Indian accounting standards, where required and to harmonise these accounting standards and financial disclosures on par with international practices.

1.3.2 SEBI has interacted with the ICAI on a continuous basis in the issuance of recent Indian accounting standards on areas including segment reporting, related party disclosures, consolidated financial statements, earnings per share, accounting for taxes on income, accounting for investments in associates in consolidated financial statements, discontinuing operations, interim financial reporting, intangible assets, financial reporting of interests in joint ventures and impairment of assets.

1.3.3 With the introduction of these recent Indian accounting standards, financial reporting practices in India are almost on par with International Accounting Standards.

1.4 Implementation of corporate governance requirements

1.4.1 The Recommendations were implemented through Clause 49 of the Listing Agreements, in a phased manner by SEBI.

1.4.2 They were made applicable to all companies in the BSE 200 and S&P C&X Nifty indices, and all newly listed companies, as of March 31, 2001.

1.4.3 The applicability of the Recommendations was extended to companies with a paid up capital of Rs. 100 million or with a net worth of Rs. 250 million at any time in the past five years, as of March 31, 2002.

1.4.4 In respect of other listed companies with a paid up capital of over Rs. 30 million, the requirements were made applicable as of March 31, 2003.

1.4.5 The accounting standards issued by the ICAI, which are applicable to all companies under sub-section 3A of Section 211 of the Companies Act, 1956, were specifically made applicable to all listed companies for the financial year ended March 31, 2002, under the Listing Agreements.

1.5 Compliance with the Code and SEBI's experience

1.5.1 In terms of SEBI's Circular No. SMD/Policy/CIR-03/2001 dated January 22, 2001:

✍ All companies are required to submit a quarterly compliance report to the stock exchanges within 15 days from the end of a financial reporting quarter. The report has to be submitted either by the Compliance Officer or by the Chief Executive Officer of the company after obtaining due approvals. SEBI has prescribed a format in which the information shall be obtained by the Stock Exchanges from the companies. The companies have to submit compliance status on eight sub-clauses namely:

- ? Board of Directors;
- ? Audit Committee;
- ? Shareholders / Investors Grievance Committee;
- ? Remuneration of directors;
- ? Board procedures;
- ? Management;
- ? Shareholders; and
- ? Report on Corporate Governance.

✍ Stock exchanges are required to set up a separate monitoring cell with identified personnel, to monitor compliance with the provisions of the Recommendations. Stock exchanges are also required to submit a quarterly compliance report from the companies as per the Schedule of Implementation. The stock exchanges are required to submit a consolidated compliance report within 30 days of the end of the quarter to SEBI.

1.5.2 Both the Mumbai and National Stock Exchanges have submitted a consolidated quarterly compliance report for the quarter ended September 30, 2002. It was observed that 1,848 and 741 companies were required to comply with the requirements of the Code, for the Mumbai and National Stock Exchanges, respectively. Of these, compliance reports were submitted in respect of 1,026 and 595 companies, for the Mumbai and National Stock Exchanges, respectively.

1.5.3 The status of compliance with respect to provisions of corporate governance analysed from data submitted by the Mumbai Stock Exchange for the quarter ended September 30, 2002 is set out below.

Board of Directors	Audit Committee	Shareholders' Grievance Committee	Remuneration Committee	Board procedures	Management	Shareholders	Report on Corporate Governance	Total
999	981	1,005	677	575	774	998	786	1,026

*Applicable to 1,848 companies

- 1.5.4 The key observations contained in the consolidated compliance report sent by the Mumbai and National Stock Exchanges are set out below.
- ✍ The compliance level in respect of requirements relating to Board of Directors, Audit Committee, Shareholders Grievance Committee and Shareholders is very high;
 - ✍ Many companies are yet to comply with the requirements relating to Remuneration Committee (which is not mandatory), Board Procedures, Management and Report on Corporate Governance; and
 - ✍ Few companies have submitted that the provisions relating to Management and Board Procedures are not applicable.
- 1.5.5 SEBI observed that the compliance with the requirements in clause 49 of the Listing Agreement is, by and large, satisfactory; however, an analysis of the financial statements of companies and the report on corporate governance discloses that their quality is not uniform. This is observed on parameters such as the nature of qualifications in audit reports, the quality of the corporate governance report itself (which is often perfunctory in nature), and the business transacted and the duration of audit committee meetings. Variations in the quality of annual reports, including disclosures, raises the question whether compliance is in form or in substance; and emphasise the need to ensure that the laws, rules and regulations do not reduce corporate governance to a mere ritual. This question has come under close scrutiny in recent times.
- 1.5.6 SEBI has analysed a few recently published annual reports of companies to assess the quality of corporate governance. The directors' reports could be classified into the following categories:
- ✍ Reports where there is no mention about the compliance with corporate governance requirements;
 - ✍ Reports that state that the company is fully compliant with clause 49 of the Listing Agreement, but where independent auditors have made qualifications in their audit reports;
 - ✍ Reports that mention areas of non-compliance with clause 49 of the Listing Agreement and provide explanation for non-compliance; and
 - ✍ Reports that mention areas of non-compliance with clause 49 of the Listing Agreement but provide no explanation for auditor's qualification or for reasons for non-compliance.
- 1.5.7 SEBI also observed that there is a considerable variance in the extent and quality of disclosures made by companies in their annual reports.

1.6 Rationale for a review of the Code

- 1.6.1 SEBI believes that efforts to improve corporate governance standards in India must continue. This is because these standards are themselves evolving, in keeping with market dynamics. Recent events worldwide, primarily in the United States, have renewed the emphasis on corporate governance. These events have highlighted the need for ethical governance and management, and for the need to look beyond mere systems and procedures. This will ensure compliance with corporate governance codes, in substance and not merely in form.

- 1.6.2 Again, one of the goals of good corporate governance is investor protection. The individual investor is at the end of a chain of financial information, stretching from corporate accountants and management, through Boards of Directors and audit committees, to independent auditors and stock market analysts, to the investing public. Many of the links in this chain need to be strengthened or replaced to preserve its integrity.
- 1.6.3 SEBI, therefore, believed that a need to review the existing code on corporate governance arose from two perspectives, (a) to evaluate the adequacy of the existing practices, and (b) to further improve the existing practices.
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2. The Committee, Terms of Reference and Approach

2.1 Constitution of the Committee

- 2.1.1 In the context of the rationale set out in Section 1.6 of this Report, SEBI believed it necessary to form a committee on corporate governance, comprising representatives from the stock exchanges, chambers of commerce, investor associations and professional bodies.
- 2.1.2 The SEBI Committee on Corporate Governance (the “Committee”) was constituted under the Chairmanship of Shri N. R. Narayana Murthy, Chairman and Chief Mentor of Infosys Technologies Limited.
- 2.1.3 A list of names of the members of the Committee is set out in Enclosure II to this report.
- 2.1.4 The Committee met thrice on December 7, 2002, January 7, 2003 and February 8, 2003, to deliberate the issues related to corporate governance and finalize its recommendations to SEBI.

2.2 Terms of Reference

- 2.2.1 The terms of reference of the Committee are set out below.
- ✍ 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.
- 2.2.2 The recommendations of the Committee are presented in this Report.

2.3 Approach

- 2.3.1 Members of the Committee met to deliberate the issues related to corporate governance, primarily relating to audit committees, audit reports, independent directors, related parties, risk management, directorships and director compensation, codes of conduct and financial disclosures.
- 2.3.2 The Committee felt that that the regulator should clearly define regulations and be able to effectively enforce the recommendations. The regulations should be as few as possible and the role of the regulator should primarily be that of a catalyst in enforcement.

- 2.3.3 The issues relating to corporate governance were discussed by the Committee. Based on the responses / suggestions to the issues, draft recommendations were prepared. These recommendations were circulated to the members. Members were asked to rate the recommendations on a scale of 1 (Least) through 10 (Most) across the seven following parameters:
- ✍ Importance – *How important is the recommendation to the member?*
 - ✍ Fairness – *Does the recommendation enhance fairness to all stakeholders, by minimizing asymmetry of benefits?*
 - ✍ Accountability – *Does the recommendation make corporate management more accountable?*
 - ✍ Transparency – *Does the recommendation enhance transparency?*
 - ✍ Ease of implementation – *Is the recommendation easy to implement?*
 - ✍ Verification – *Is the recommendation objectively verifiable?*
 - ✍ Enforcement – *Can the recommendation be effectively enforced?*
- 2.3.4 The ratings received from members were first aggregated across recommendations and tabulated. Recommendations whose ratings were 7 and above were then aggregated, on each of the seven parameters set out above. The rating score for each such recommendation was aggregated.
- 2.3.5 The recommendations were then sorted in descending order of importance. The top 20 recommendations were presented to the Committee for their views. These recommendations were discussed in detail by the members and will form the basis of the final recommendations of the Committee.
- 2.3.6 Certain recommendations that were not part of the top 20 recommendations were also presented to the Committee. This was because of their important nature.
- 2.3.7 Certain recommendations that were already contained in the Report of the Naresh Chandra Committee on Corporate Audit and Governance (the “Naresh Chandra Committee”) were also discussed briefly. The members of the Committee agreed in principle with the recommendations set out by the Naresh Chandra Committee that are directly related to corporate governance.
- 2.3.8 It was therefore decided by the Committee, that in making the final recommendations to SEBI, the Committee would also recommend that the mandatory recommendations in the report of the Naresh Chandra Committee, insofar as they related to corporate governance, be mandatorily implemented by SEBI through an amendment to clause 49 of the Listing Agreement. These recommendations are contained in Section 4 of this Report.
- 2.3.9 The Committee accepted that ratings were not received from all members. It was of the view that members who have not submitted their ratings should not raise objections to the Committee’s recommendations at a later stage.

- 2.3.10 The Committee also acknowledged that the ratings methodology did not capture the qualitative comments of the members. Further, it was also accepted that a few recommendations could not be rated since they were more of a qualitative nature for which it was difficult to assign a numerical weight.
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3. Key Issues Discussed and Recommendations

3.1 Background

3.1.1 The key issues debated by the Committee and the related recommendations are discussed below.

3.2 Audit Committees

3.2.1 Review of information by audit committees

3.2.1.1 Suggestions were received from members that audit committees of publicly listed companies should be required to review the following information mandatorily:

- ✍ Financial statements;
- ✍ 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.

3.2.1.2 The Committee noted that most of this information was already reviewed by audit committees during the audit committee meeting. Further, it was already contained as a recommendation in the Kumarmangalam Birla Committee on Corporate Governance.

3.2.1.3 The Committee also noted that the recommendation in the Birla Committee Report cast a responsibility on the audit committee vis-à-vis their duties and role. Further, the compliance report of the Mumbai Stock Exchange showed that approximately only 53% of the companies complied with this requirement contained in the Birla Committee Report.

- 3.2.1.4 In view of the above deliberations, the Committee makes the following mandatory recommendation:

Mandatory recommendation

Audit committees of publicly listed companies should be required to review the following information mandatorily:

- ✍ **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.**

3.2.2 *Financial literacy of members of the audit committee*

- 3.2.2.1 Suggestions were received that all audit committee members should be “financially literate” and at least one member should have accounting or related financial management expertise. It was also suggested that all audit committee members should be able to read and understand financial statements at the time of their appointment rather than within a reasonable period.
- 3.2.2.2 The Committee was of the view that the first recommendation was acceptable. It was also of the view that the definition of the phrase “financially literate” should be explained further.
- 3.2.2.3 Based on the above discussions, the Committee accordingly makes the following mandatory recommendation:

Mandatory recommendation

All audit committee members should be “financially literate” and at least one member should have accounting or related financial management expertise.

Explanation 1 – The term “financially literate” means the ability to read and understand basic financial statements i.e. balance sheet, profit and loss account, and statement of cash flows.

Explanation 2 – 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.

3.3 Audit Reports and Audit Qualifications

3.3.1 *Disclosure of accounting treatment*

3.3.1.1 It was suggested that in case a company has followed a treatment different from that prescribed in an accounting standard, independent / statutory auditors should justify why they believe such alternative treatment is more representative of the underlying business transaction. This should also be explained clearly in the footnotes to the financial statements.

3.3.1.2 The Committee noted that accounting policies and principles are selected by a company's management. Consequently, the onus should be on management to explain why they believe such alternative treatment is more representative of the underlying business transaction. The auditor's responsibility is to express a qualification in case he disagrees with the explanation given by the company's management. The responsibility should not be cast on the auditor to justify such departures from an accounting standard. The members were of the view that the auditor may either concur or disagree with management's viewpoint. The auditor may draw reference to this footnote without necessarily making it the subject matter of an audit qualification, unless he disagrees with the departure from the accounting standard, in which case he would be required to issue a qualification.

3.3.1.3 In light of the above deliberations, the Committee was of the view that the suggestion should be modified to reflect this. The Committee therefore makes the following mandatory recommendation:

Mandatory recommendation

In case a company has followed a treatment different from that prescribed in an accounting standard, management should justify why they believe such alternative treatment is more representative of the underlying business transaction. Management should also clearly explain the alternative accounting treatment in the footnotes to the financial statements.

3.3.2 *Audit qualifications*

3.3.2.1 Suggestions were received that where financial statements contain qualifications, companies should be given a reasonable period of time within which to cure the qualifications, by SEBI / Stock Exchanges. Mere explanations from companies may not be sufficient.

3.3.2.2 The Committee noted that the above recommendation be dropped since adequate safeguards already exist. It was also of the opinion that it may not be possible to cure a taint in some cases and this would lead to undue hardship on companies.

3.3.2.3 Based on this discussion, the Committee accordingly makes the following recommendation:

Non-mandatory recommendation

Companies should be encouraged to move towards a regime of unqualified financial statements. This recommendation should be reviewed at an appropriate juncture to determine whether the financial reporting climate is conducive towards a system of filing only unqualified financial statements.

3.4 Related Party Transactions

3.4.1 Basis for related party transactions

- 3.4.1.1 Suggestions were received that for each related party, a statement shall be recorded disclosing the basis / methodology for various types of transactions.
- 3.4.1.2 It was also suggested that the records of all transactions with related parties including their bases / methodology should be placed before the independent audit committee at each Board meeting for formal approval/ratification. This should include any exceptional transactions that are not on an arm's length principle together with reasons for such deviation.
- 3.4.1.3 The Committee noted that a statement disclosing the basis / methodology for various types of transactions entered into with related parties should be prepared and submitted for the information of the audit committee. It also opined that this statement should include transactions which are not on an arm's length principle. The company's management should explain to the audit committee the reasons for the non-arm's length nature of the transaction.
- 3.4.1.4 The Committee also noted that the definition of "arm's length" should be clarified in the recommendation. It noted that a reference may be made to the report of the Department of Company Affairs' Expert Group on Transfer Pricing Guidelines for a suitable definition.
- 3.4.1.5 Based on the above discussions, the Committee accordingly makes the following mandatory recommendation:

Mandatory recommendation

A statement of all transactions with related parties including their bases should be placed before the independent audit committee for formal approval / ratification. If any transaction is not on an arm's length basis, management should provide an explanation to the audit committee justifying the same.

3.4.2 Definition of "related party"

- 3.4.2.1 It was suggested that SEBI should clarify the definition of the term "related party".
- 3.4.2.2 The Committee noted that Accounting Standard 18, *Related Party Transactions* ("AS 18") issued by the ICAI contained the definition of this term.
- 3.4.2.3 Based on this discussion, the Committee adopted the definition of "related party" as set out in AS 18 and makes the following mandatory recommendation:

Mandatory recommendation

The term "related party" shall have the same meaning as contained in Accounting Standard 18, *Related Party Transactions*, issued by the Institute of Chartered Accountants of India.

3.5 Risk Management

3.5.1 Board disclosures

3.5.1.1 The Committee believes that it is important for corporate Boards to be fully aware of the risks facing the business and that it is important for shareholders to know about the process by which companies manage their business risks.

3.5.1.2 In light of this, it was suggested that procedures should be in place to inform Board members about the risk assessment and minimization procedures. These procedures should be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. These risks will include global risks; general, economic and political risks; industry risks; and company specific risks.

3.5.1.3 It was also suggested that management should place a report before the Board every quarter documenting any limitations to the risk taking capacity of the corporation. This document should be formally approved by the Board.

3.5.1.4 The Committee believes that this recommendation is important. This is because the Management Discussion, and Analysis of Financial Condition and Results of Operations, are the responsibility of a company's management. It is, therefore important, that the audit committee be made aware of the risks faced by a company. It is management's responsibility to demonstrate to the audit committee the measures taken to address business risks. Further, it was added that the Compliance Officer of the company should certify the Risk Management report placed before the audit committee.

3.5.1.5 The Committee also noted that it was not practicable to put the responsibility of review of risk management only on the audit committee. It agreed that there must be a process by which key risks are reviewed by the entire Board of Directors and not just the audit committee. Further, there must be evidence demonstrating that this review process has actually taken place. Investors in a company would therefore know how the company has identified and addressed its business risks.

3.5.1.6 It was also mentioned that verifiability and enforceability of this recommendation was difficult. This was because companies could obtain a sign-off from the Board members that such procedures were complied with.

3.5.1.7 Based on the above deliberations, the Committee makes the following mandatory recommendation:

Mandatory recommendation

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

Management should place a report 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 should be formally approved by the Board.

3.5.2 *Training of Board members*

- 3.5.2.1 It was also suggested that Board members be trained in the business model of the company as well as the risk profile of the business parameters of the company.
- 3.5.2.2 The Committee noted that there is a real necessity for Board members to understand the components of the business model and the accompanying risk parameters. However, the Committee also noted that Board members can always ask for information relating to the business model of the company.
- 3.5.2.3 It also observed that the process of Board review of business risks will be a mandatory recommendation of the Committee. Therefore, training of Board members could be made recommendatory.
- 3.5.2.4 Based on the above deliberations, the Committee makes the following non-mandatory recommendation:

Non-mandatory recommendation

Companies should be encouraged to train their 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.

3.6 **Proceeds from Initial Public Offerings (“IPO”)**

3.6.1 *Use of proceeds*

- 3.6.1.1 It was suggested that companies raising money through an Initial Public Offering should disclose the uses / application of funds by major category (capital expenditure, sales and marketing, working capital, etc) on a quarterly basis as part of their quarterly declaration of (unaudited) financial results.
- 3.6.1.2 The Committee noted that that disclosure of unspecified uses of IPO proceeds would be a more transparent measure. A statement of funds utilised for purposes other than those stated in the offer document / prospectus should be prepared by management. This statement should be certified by the independent auditors of the company and approved by the audit committee.
- 3.6.1.3 Based on the above discussion, the Committee makes the following mandatory recommendation:

Mandatory recommendation

Companies raising money through an Initial Public Offering (“IPO”) should 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.

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 should be certified by the independent auditors of the company. The audit committee should make appropriate recommendations to the Board to take up steps in this matter.

3.7 Code of Conduct

3.7.1 *Written code for executive management*

3.7.1.1 It was suggested that there should be a written code of conduct of Board members (by category of directors – executive directors, independent directors, nominee directors and promoter directors). Further, there should be a written code of conduct for senior financial personnel including the Chief Financial officer, Treasurer and Financial Controller (or the officer who discharges these functions).

3.7.1.2 The Committee noted that the Birla Committee Report had defined the broad roles and responsibilities of management. It was obligatory on the part of the Board of Directors of a company to define a code of conduct for itself and the senior management of the company, not just senior financial personnel. Concerns were expressed on two main areas, (a) enforceability, and (b) definition of senior management. The Committee also noted that sample codes were available at www.choan.edu.

3.7.1.3 Based on the deliberations and views expressed by several members, the Committee makes the following mandatory recommendation:

Mandatory recommendation

It should 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.

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 off by the CEO and COO.

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 Board of Directors). Normally, this would comprise all members of management one level below the executive directors

3.8 Nominee directors

3.8.1 *Exclusion of nominee directors from the definition of independent directors*

3.8.1.1 It was suggested that nominee directors should be excluded from the definition of independent directors.

3.8.1.2 The Committee felt that the institution of nominee directors creates a conflict of interest that should be avoided. Such directors often claim that they are answerable only to the institutions they represent and take no responsibility for the company’s management or fiduciary responsibility to other shareholders. It is necessary that all directors, whether representing institutions or otherwise, should have the same responsibilities and liabilities.

- 3.8.1.3 If the institution, whether as a lending institution or as investing institution, wishes to appoint its nominee on the Board, such appointment should be made through the normal process of election by the shareholders.
- 3.8.1.4 The Committee noted a dissenting view that FI nominees should not be granted any Board representation rights. Management should treat them on par with other investors and disseminate the same information that other shareholders would obtain. By virtue of their Board seat, FIs are placed in an advantageous position over the other shareholders, in terms of company price-sensitive information.
- 3.8.1.5 Based on the above distinction, the Committee makes the following mandatory recommendation:

Mandatory recommendation

There shall be no nominee directors.

Where an institution wishes to appoint a director on the Board, such appointment should be made by the shareholders.

An institutional director, so appointed, shall have the same responsibilities and shall be subject to the same liabilities as any other director.

Nominee of the Government on public sector companies shall be similarly elected and shall be subject to the same responsibilities and liabilities as other directors.

3.9 Non-Executive Director Compensation

3.9.1 Limits on compensation paid to independent directors

3.9.1.1 The Committee discussed the following issues relating to compensation of independent directors:

- ✍ Whether limits should be set for compensation paid to independent directors and how should these limits be determined;
- ✍ What are the disclosures to be made to ensure transparency; and
- ✍ In case of stock-based compensation, the vesting timeframe of the options and the parameters that trigger vesting such as average return on capital employed, turnover criteria, etc.

3.9.1.2 Based on its deliberations, the Committee makes the following recommendation:

Mandatory recommendation

All compensation paid to non-executive directors may be fixed by the Board of Directors and should be approved by shareholders in general meeting. Limits should 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.

Companies should publish their compensation philosophy and statement of entitled compensation in respect of non-executive directors in their annual report. Alternatively, this may be put up on the company's website and reference drawn thereto in the annual report.

Companies should disclose on an annual basis, details of shares held by non-executive directors, including on an "if-converted" basis.

Non-executive directors should 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.

3.10 Independent Directors

3.10.1 Definition of independent directors

- 3.10.1.1 The Committee noted that the definition of independent directors should be clarified in the recommendations. It observed that the definition of independent directors as set out in the code of the International Corporate Governance Network may be referred to. The Committee also noted that the Naresh Chandra Committee report has attempted to define the term “independent director”. The Committee was of the view that the same definition may be used to define independent directors.
- 3.10.1.2 An issue often raised in the context of independence is whether independent directors are entitled to any material benefits from the company other than sitting fees, remuneration, and travel and stay arrangements. Such benefits include stock options and performance bonuses that executive directors may be entitled to. The central issue is whether such benefits serve as incentives or hindrances to the objectivity of decision-making and hence, compromise its quality. It also needs to be considered that restrictions such as these could disenchant a person from accepting the position of independent director that carries onerous responsibilities without appropriate reward.
- 3.10.1.3 The Committee decided that the term “Independent director” shall have the same meaning as contained in paragraph 4.1 of the Naresh Chandra Committee report.
- 3.10.1.4 Based on its deliberations, the Committee makes the following recommendation:

The term “independent director” is defined as a non-executive director of the company who:

- ✍ **apart from receiving director 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;**
- ✍ **is not related to promoters or management at the board level or at one level below the board;**
- ✍ **has not been an executive of the company in the immediately preceding three financial years;**
- ✍ **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.**
- ✍ **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.**

The considerations as regards remuneration paid to an independent director shall be the same as those applied to a non-executive director.

3.11 Whistle Blower Policy

3.11.1 Internal policy on access to audit committees

- 3.11.1.1 It was suggested that personnel who observe an unethical or improper practice should be able to approach the independent audit committee without necessarily informing the Board. There should also be a mechanism for employees to be aware of this privilege.

- 3.11.1.2 The Committee agreed with this suggestion. It also noted that the suggestion may be accepted, with one modification i.e. the word “board” be replaced with “supervisor”.
- 3.11.1.3 Based on the above, the Committee makes the following recommendation:

Mandatory recommendation

Personnel who observe an unethical or improper practice (not necessarily a violation of law) should be able to approach the audit committee without necessarily informing their supervisors.

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.

- 3.11.2 *Whistle blower policy*
- 3.11.2.1 It was also suggested that SEBI should monitor compliance with the recommendation set out in Section 3.11.1 above.
- 3.11.2.2 The Committee noted that companies should affirm periodically (at least on an annual basis) that they have complied with this requirement.
- 3.11.2.3 The Committee also noted that it was necessary to provide protection to the internal auditor by enhancing his independence. This can be done by mandating that the appointment, removal and terms of remuneration of the chief internal auditor must be subject to review by the Audit Committee.
- 3.11.2.4 Based on this discussion, the Committee makes the following mandatory recommendation:

Mandatory recommendation

Companies shall annually affirm that they have not denied any personnel access to the audit committee of the company (in respect of matters involving alleged misconduct) and that they have provided protection to “whistle blowers” from unfair termination and other unfair or prejudicial employment practices.

The appointment, removal and terms of remuneration of the chief internal auditor must be subject to review by the Audit Committee.

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.

3.12 Subsidiary Companies

- 3.12.1 *Audit committee requirements*
- 3.12.1.1 It was suggested to the Committee that the requirements relating to non-executive / independent directors and audit committees should be extended to subsidiaries of listed companies. Further, the scope of the Audit Committee should be enlarged to include review of investments made by subsidiaries and associates to ensure that Section 77 of Companies Act, 1956 is not violated.

3.12.1.2 The Committee noted the following additional suggestions:

- ✍ It may be difficult to monitor compliance with the suggestion, in the case of associate companies, insofar as it related to a review of investments. This requirement may, therefore, be made applicable to subsidiary companies only;
- ✍ It should be recommended to the Central Government that the Companies Act, 1956 should be amended to exclude common directorships in holding and subsidiary companies, in computing the limits on directorships that an individual may hold;
- ✍ The provisions relating to the composition of the Board of Directors of the holding company shall also be made applicable to the composition of the Board of Directors of subsidiary companies;
- ✍ At least one-third of the Board of Directors of the subsidiary company shall be non-executive directors of the parent company;
- ✍ The Audit Committee of the parent company shall also review the financial statements of the subsidiary company;
- ✍ The minutes of the Board meeting of the subsidiary company shall be placed for review at the Board meeting of the parent company; and
- ✍ The Board report of the parent company should state that they have reviewed the affairs of the subsidiary company also.

3.12.1.3 Based on the deliberations, the Committee makes the following mandatory recommendation:

Mandatory recommendation

The provisions relating to the composition of the Board of Directors of the holding company should be made applicable to the composition of the Board of Directors of subsidiary companies.

At least one independent director on the Board of Directors of the parent company shall be a director on the Board of Directors of the subsidiary company.

The Audit Committee of the parent company shall also review the financial statements, in particular the investments made by the subsidiary company.

The minutes of the Board meetings of the subsidiary company shall be placed for review at the Board meeting of the parent company.

The Board report of the parent company should state that they have reviewed the affairs of the subsidiary company also.

3.13 Real Time Disclosures

3.13.1 Disclosure of critical business events

- 3.13.1.1 It was suggested that SEBI should issue rules relating to real-time disclosures of certain events or transactions that may be of importance to investors, within 3-5 business days. These would include events such as (a) a change in the control of the company, (b) a company's acquisition / disposal of a significant amount of assets, (c) bankruptcy or receivership, (d) a change in the company's independent auditors, and (e) the resignation of a director.
- 3.13.1.2 The Committee noted that there are certain practical problems in ensuring timely disclosures. For example, a business transaction that is under negotiations may have an impact on the market price. However, its disclosure may prejudice the underlying business negotiations.
- 3.13.1.3 The Committee also noted the issue of rumor verification by stock exchanges. It noted a view that Board decisions that were price sensitive should be disclosed to the markets within 15 minutes. Stock exchanges are currently responsible for rumor verification. The Committee however believed that this issue needs to be studied with much greater depth by SEBI and the stock exchanges, and should not be restricted to a corporate governance perspective alone.
- 3.13.1.4 The Committee was of the view that no recommendation would be made to SEBI in respect of this suggestion.

3.14 Evaluation of Board Performance

3.14.1 Mechanism for evaluating non-executive board members

- 3.14.1.1 The Committee received the following suggestions:
- ✍ 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.
- 3.14.1.2 The Committee noted that evaluation of Board members is in a germane stage in India. It is necessary to have a robust process in place for such evaluation. It is also necessary to ensure continuity of top leadership, including CEO succession planning. However, the Committee believes that this should be of a recommendatory nature at first, before becoming a mandatory requirement. This will help companies develop robust processes for Board evaluation. This may be made mandatory after a period of 4 – 5 years.
- 3.14.1.3 Based on the above deliberations, the Committee makes the following non-mandatory recommendation:

Non-mandatory recommendation

The performance evaluation of non-executive directors should be 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.

3.15 Analyst Reports

3.15.1 Disclosures in reports issued by security analysts

3.15.1.1 It was suggested that rules should be put in place by SEBI regarding reports issued by security analysts.

3.15.1.2 The Committee noted that the integrity and credibility of reports issued by security analysts could be compromised owing to pressures to which the security analyst may be subject. This is because of the conflict of interest that arises between the stock analysts and their employing brokerage / investment- banking firms, on the one hand and the listed companies that the stock analysts write reports about, on the other hand.

3.15.1.3 Based on the discussions, the Committee makes the following mandatory recommendation:

Mandatory recommendation

SEBI should make rules for the following:

- ✍ **Disclosure in the report issued by a security analyst whether the company that is being written about is a client of the analyst's employer or an associate of the analyst's employer, and the nature of services rendered to such company, if any; and**
- ✍ **Disclosure in the report issued by a security analyst whether the analyst or the analyst's employer or an associate of the analyst's employer hold or held (in the 12 months immediately preceding the date of the report) or intend to hold any debt or equity instrument in the issuer company that is the subject matter of the report of the analyst.**

4. Recommendations of the Naresh Chandra Committee

4.1 Background

4.1.1 Section 2.3.8 of this Report states that the Committee would also recommend that the following mandatory recommendations in the report of the Naresh Chandra Committee, relating to corporate governance, be implemented by SEBI.

4.1.2 This section sets out such recommendations of the Naresh Chandra Committee that were considered by this Committee.

4.2 Disclosure of Contingent Liabilities (Section 2.5 of Naresh Chandra Committee Report)

4.2.1 The Committee makes the following mandatory recommendation:

Management should provide a clear description in plain English of each material contingent liability and its risks, which should be accompanied by the auditor's clearly worded comments on the management's view. This section should be highlighted in the significant accounting policies and notes on accounts, as well as, in the auditor's report, where necessary.

This is important because investors and shareholders should obtain a clear view of a company's contingent liabilities as these may be significant risk factors that could adversely affect the company's future financial condition and results of operations.

4.3 CEO / CFO Certification (Section 2.10 of Naresh Chandra Committee Report)

4.3.1 The Committee makes the following mandatory recommendation:

For all listed companies, there should be a certification by the CEO (either the Executive Chairman or the Managing Director) and the CFO (whole-time Finance Director or other person discharging this function) which should state 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, as well as the cash flow statements and the Directors' Report;
- ✍ These statements do not contain any material untrue statement or omit any material fact nor do they contain statements that might be misleading;
- ✍ 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;
- ✍ They are responsible for establishing and maintaining internal controls and have evaluated the effectiveness of internal control systems of the company; and they have also disclosed to the auditors and the Audit Committee, deficiencies in the design or operation of internal controls, if any, and what they have done or propose to do to rectify these;
- ✍ They have also disclosed 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; and
- ✍ They have indicated to the auditors, the Audit Committee and in the notes on accounts, whether or not there were significant changes in internal control and / or of accounting policies during the year.

4.4 Definition of Independent Director (Section 4.1 of Naresh Chandra Committee Report)

4.4.1 This has been incorporated in clause 3.10.1.4 of this Report.

4.5 Independence of Audit Committee (Section 4.7 of Naresh Chandra Committee Report)

4.5.1 The Committee makes the following mandatory recommendation:

All audit committee members shall be non-executive directors

4.6 Independent Director Exemptions (Section 4.10 of Naresh Chandra Committee Report)

4.6.1 The Committee makes the following recommendation:

Legal provisions must specifically exempt non-executive and independent directors from criminal and civil liabilities under certain circumstances. SEBI should recommend that such exemptions need to be specifically spelt out for the relevant laws by the relevant departments of the Government and independent regulators, as the case may be.

However, independent directors should 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, defense should not be permitted on the ground that the independent director was unaware of this responsibility.

5 Other Suggestions and the Committee's Response

5.1 Background

5.1.1 The Committee also received certain other suggestions relating to corporate governance. These suggestions and the Committee's response / recommendation are set out in the following paragraphs.

5.2 Harmonization

5.2.1 It was suggested that SEBI should work towards harmonizing the provisions of clause 49 of the Listing Agreement and those of the Companies Act, 1956.

5.2.2 The Committee noted that major differences between the requirements under clause 49 and the provisions of the Companies Act, 1956 should be identified. SEBI should then recommend to the Government that the provisions of the Companies Act, 1956 be changed to bring it in line with the requirements of the Listing Agreement.

5.3 Removal of Independent Directors

5.3.1 It was suggested that companies should inform SEBI / stock exchanges within five business days of the removal / resignation of an independent director, along with a statement certified by the managing director / director / company secretary about the circumstances of such removal / resignation (specifically whether there was any disagreement with the independent director that caused such removal / resignation). Any independent director sought to be removed or who has resigned because of a disagreement with management should have the opportunity to be heard in general meeting.

5.3.2 The Committee noted that under the existing provisions, companies are required to inform the stock exchanges of any changes in directors. The existing safeguards are adequate and hence no further action is required.

5.4 Disgorgement of Profits

5.4.1 It was suggested that CEOs / COOs / CFOs should disgorge equity or incentive-based compensation, or profits arising from trading in company stock, if a restatement of financial statements is required or if there is any corporate misconduct leading to a financial liability.

5.4.2 The Committee noted that this was one of the recommendations of the Naresh Chandra Committee. Therefore, the Committee resolved that no further action is required at this stage.

5.5 Term of Office of Non-Executive Directors

5.5.1 It was suggested that there must be a cap on the term of office of a non-executive director.

5.5.2 The Committee noted that persons should 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). *[Also refer to recommendation under Section 3.9 of this Report]*

5.5.3 The Committee also noted that it would be a good practice for directors to retire after a particular age. Companies may fix the retirement age at either 65 or 70 years.

5.5.4 The Committee recommends that the age limit for directors to retire should be decided by companies themselves. Corporate Boards should have an adequate mechanism of self-renewal, as part of corporate governance best practices.

5.6 Corporate Governance Ratings

5.6.1 It was suggested that corporate governance practices followed by companies should be rated using rating models. It was also suggested that companies should be rated based on parameters of wealth generation, maintenance and sharing, as well as on corporate governance.

5.6.2 The Committee deliberated and noted that corporate governance ratings are desirable, as this will provide a process of independent appraisal. Certain rating agencies have begun work in this area; however, the process is still in a development phase and may need to be evolved based on future experience.

5.6.3 The Committee is therefore of the view that for the time being, it should not be mandatory for companies to be rated on corporate governance parameters. However, it should be left to the management of companies to decide whether they want to be rated or not, on corporate governance.

5.7 Media Scrutiny

5.7.1 The Committee considered the views expressed by members on scrutiny of the media, especially the financial press. A code of conduct for the financial media is already prescribed by the Press Council of India. However, verifying adherence to this code of conduct is difficult in the current circumstances. The Committee suggests that it is desirable for SEBI to review this issue in greater detail, keeping in mind issues like transparency and disclosures, conflicts of interest, etc, before making any final rule.

5.7.2 The Committee noted that SEBI should consider discussing this issue with representatives of the media, especially the financial press.

6 Implementation and Way Forward

- 6.1 The Committee noted that the recommendations contained in this Report can be implemented by means of an amendment to the Listing Agreement, with changes made to the existing clause 49.
- 6.2 A primary issue that arises with implementation is whether the recommendations should be made applicable to all companies immediately or in a phased manner since the costs of compliance may be large for certain companies. Another issue is whether to extend the applicability of these recommendations to companies that are registered with BIFR. In the case of such companies, there is likely to be almost little or no trading in their shares on the stock exchanges.
- 6.3 The Committee believes that the recommendations should be implemented for all companies to which clause 49 apply. This would also continue to apply to companies that have been registered with BIFR, subject to any directions that BIFR may provide in this regard.

End Note

- 6.4 There are several corporate governance structures available in the developed world, but there is no one structure, which can be singled out as being better than the others. There is no “one size fits all” structure for corporate governance. The Committee’s recommendations are not, therefore, based on any one model, but, are designed for the Indian environment. Corporate governance extends beyond corporate law. Its fundamental objective is not mere fulfillment of the requirements of law, but, in ensuring commitment of the Board in managing the company in a transparent manner for maximizing long-term shareholder value.
- 6.5 Corporate governance has as many votaries as claimants. Among the latter, the Committee has primarily focused its recommendations on investors and shareholders, as they are the prime constituencies of SEBI. 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, systems of corporate governance need to continually evolve. The Committee believes that its recommendations raise the standards of corporate governance in Indian firms and make them attractive for domestic and global capital. These recommendations will also form the base for further evolution of the structure of corporate governance in consonance with the rapidly changing economic and industrial environment of the country in the new millennium.
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Signatures Page:

Shri N R Narayana Murthy, Chairman & Chief Mentor, Infosys Technologies Limited - Chairman of the Committee	
Shri Y H Malegam, Managing Partner, S B Billimoria & Co.	
Shri Ravi Narain, Managing Director, NSE	
Shri A C Muthiah, President, FICCI	
Shri R K Somany, President, ASSOCHAM	
Shri Ashok Soota, President, CII	
Shri M K Doogar, Representative, PHDCCI	
Shri Sumit Mazumder, President, BCCI	
Shri Kamlesh S. Vikamsey, Member – Central Council, ICAI	
Shri S Gangopadhyay, President, ICSI	
Shri T. R. Ramaswami, CEO, AMBI	
Dr. Manoj Vaish, Executive Director, BSE	
Shri A K Narayan, President, Tamil Nadu Investors Association	
Shri Nitin Shingala, Investors Grievances Forum	
Prof. Manubhai Shah, Managing Trustee, CERC	
Shri Omkar Goswami, Chief Economist, CII	
Ms Sucheta Dalal, Consulting Editor, Financial Express	
Shri R Gopalakrishnan, Executive Director, Tata Sons Ltd.	
Shri D M Satwalekar, M D & CEO, HDFC Standard Life Insurance	
Shri M K Chouhan, Chairman, Mahendra & Young Knowledge Foundation	
Ms. D N Raval, Executive Director, SEBI	
Shri Pratip Kar, Executive Director, SEBI	
Shri P K Bindlish, General Manager, SEBI, Member Secretary	

EXECUTIVE DIRECTOR
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SMDRP/POLICY/CIR-10/2000
February 21, 2000

The Presidents/Executive Directors
Managing Directors of all Stock Exchanges

Dear Sir/Madam,

SEBI had constituted a Committee on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla, Member, SEBI Board to promote and raise the standard of Corporate Governance in respect of listed companies. The SEBI Board in its meeting held on January 25, 2000 considered the recommendation of the Committee and decided to make the amendments to the listing agreement in pursuance of the decision of the Board, it is advised that a new clause, namely clause 49, be incorporate in the listing agreement as under:

49. Corporate Governance

I. Board of Directors

- A) 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, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors.

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, which in judgement of the board may affect independence of judgement of the director.

- B) The company agrees that all pecuniary relationship or transactions of the non-executive directors viz-a-viz. the company should be disclosed in the Annual Report.

II Audit Committee

- A) The company agrees that a qualified and independent audit committee shall be set up and that :
- a) 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;
 - b) The chairman of the committee shall be an independent director;
 - c) The chairman shall be present at Annual General Meeting to answer shareholder queries;
 - d) The audit committee should invite such of the executives, as it considers appropriate (and particularly the head of the finance function) to be present at the meetings of the committee, but on occasions it may also meet without the presence of any executives of the company. The finance director, head of internal audit and when required, a representative of the external auditor shall be present as invitees for the meetings of the audit committee;
 - e) The Company Secretary shall act as the secretary to the committee.
- B) The audit committee shall meet at least thrice a year. One meeting shall be held before finalisation of annual accounts and one every six months. The quorum shall be either two members or one third of the members of the audit committee, whichever is higher and minimum of two independent directors.
- C) The audit committee shall have powers which should include the following :
- a) to investigate any activity within its terms of reference.
 - b) to seek information from any employee.
 - c) to obtain outside legal or other professional advice.
 - d) to secure attendance of outsiders with relevant expertise, if it considers necessary.
- D) The company agrees that the role of the audit committee shall include the following.
- a) Oversight of the company's financial reporting process and the disclosure of its financial information to ensure that the financial statement is correct, sufficient and credible.
 - b) Recommending the appointment and removal of external auditor, fixation of audit fee and also approval for payment for any other services.
 - c) Reviewing with management the annual financial statements before submission to the board, focusing primarily on;
 - ✍ Any changes in accounting policies and practices.
 - ✍ Major accounting entries based on exercise of judgement by management.
 - ✍ Qualifications in draft audit report.
 - ✍ Significant adjustments arising out of audit.
 - ✍ The going concern assumption.
 - ✍ Compliance with accounting standards.
 - ✍ Compliance with stock exchange and legal requirements concerning financial statements
 - ✍ Any related party transactions i.e. 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.

- d) Reviewing with the management, external and internal auditors, the adequacy of internal control systems.
 - e) Reviewing the adequacy of internal audit function, including the structure of the internal audit department, staffing and seniority of the official heading the department, reporting structure coverage and frequency of internal audit.
 - f) Discussion with internal auditors any significant findings and follow up there on.
 - g) Reviewing the findings of any internal investigations by the internal auditors into matters where there is suspected fraud or irregularity or a failure of internal control systems of a material nature and reporting the matter to the board.
 - h) Discussion with external auditors before the audit commences nature and scope of audit as well as have post-audit discussion to ascertain any area of concern.
 - i) Reviewing the company's financial and risk management policies.
 - j) To look into the reasons for substantial defaults in the payment to the depositors, debenture holders, shareholders (in case of non payment of declared dividends) and creditors.
- E) If the company has set up an audit committee pursuant to provision of the Companies Act, the company agrees that the said audit committee shall have such additional functions / features as is contained in the Listing Agreement.

III. Remuneration of Directors

- A) The company agrees that the remuneration of non-executive directors shall be decided by the board of directors.
- B) The company further agrees that the following disclosures on the remuneration of directors shall be made in the section on the corporate governance of the annual report.
 - ? All elements of remuneration package of all the directors i.e. salary, benefits, bonuses, stock options, pension etc.
 - ? Details of fixed component and performance linked incentives, along with the performance criteria.
 - ? Service contracts, notice period, severance fees.
 - ? Stock option details, if any – and whether issued at a discount as well as the period over which accrued and over which exercisable.

IV. Board Procedure

- A) The company agrees that the board meeting shall be held at least four times a year, with a maximum time gap of four months between any two meetings. The minimum information to be made available to the board is given in *Annexure-I*.
- B) The company further agrees that a director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.

V. Management

- A) The company agrees that as part of the directors' report or as an addition there to, a Management Discussion and Analysis report should form part of the annual report to the shareholders. This Management Discussion & Analysis should include discussion on the following matters within the limits set by the company's competitive position:
- a) Industry structure and developments.
 - b) Opportunities and Threats.
 - c) Segment-wise or product-wise performance.
 - d) Outlook
 - e) Risks and concerns.
 - f) Internal control systems and their adequacy.
 - g) Discussion on financial performance with respect to operational performance.
 - h) Material developments in Human Resources / Industrial Relations front, including number of people employed.
- B) Disclosures must be made by the management to the board relating to 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.)

VI. Shareholders

- A) The company agrees that in case of the appointment of a new director or re-appointment of a director the shareholders must be provided with the following information:
- a) A brief resume of the director;
 - b) Nature of his expertise in specific functional areas ; and
 - c) Names of companies in which the person also holds the directorship and the membership of Committees of the board.
- B) The company further agrees that information like quarterly results, presentation made by companies to analysts shall be put on company's web-site, or shall be sent in such a form so as to enable the stock exchange on which the company is listed to put it on its own web-site.
- C) The company further agrees that a board committee under the chairmanship of a non-executive director shall be formed to specifically look into the redressing of shareholder and investors complaints like transfer of shares, non-receipt of balance sheet, non-receipt of declared dividends etc. This Committee shall be designated as 'Shareholders/Investors Grievance Committee'.
- D) The company further agrees that to expedite the process of share transfers the board of the company shall delegate the power of share transfer to an officer or a committee or to the registrar and share transfer agents. The delegated authority shall attend to share transfer formalities at least once in a fortnight.

VII. Report on Corporate Governance

The company agrees that there shall be a separate section on Corporate Governance in the annual reports of company, with a detailed compliance report on Corporate Governance. Non compliance of any mandatory requirement i.e. which is part of the listing agreement with reasons there of and the extent to which the non-mandatory requirements have been adopted should be specifically highlighted. The suggested list of items to be included in this report is given in *Annexure-2* and list of non-mandatory requirements is given in *Annexure - 3*.

VIII. Compliance

The company agrees that it shall obtain a certificate from the auditors of the company regarding compliance of conditions of corporate governance as stipulated in this clause and annexe the certificate with the directors' report, which is sent annually to all the shareholders of the company. The same certificate shall also be sent to the Stock Exchanges along with the annual returns filed by the company.

Schedule of Implementation:

The above amendments to the listing agreement have to be implemented as per schedule of implementation given below:

- ✍ By all entities seeking listing for the first time, at the time of listing.
- ✍ Within financial year 2000-2001, but not later than March 31, 2001 by all entities, which are included either in Group 'A' of the BSE or in S&P CNX Nifty index as on January 1, 2000. However to comply with the recommendations, these companies may have to begin the process of implementation as early as possible.
- ✍ Within financial year 2001-2002, but not later than March 31, 2002 by all the entities which are presently listed, with paid up share capital of Rs. 10 crore and above, or networth of Rs 25 crore or more any time in the history of the company.
- ✍ Within financial year 2002-2003, but not later than March 31, 2003 by all the entities which are presently listed, with paid up share capital of Rs.3 crore and above
- ✍ As regards the non-mandatory requirement given in Annexure - 3, they shall be implemented as per the discretion of the company. However, the disclosures of the adoption / non-adoption of the non-mandatory requirements shall be made in the section on corporate governance of the Annual Report.

Yours faithfully,

PRATIP KAR

Encl. : Annexures.

Annexure 1**Information to be placed before board of directors**

1. Annual operating plans and budgets and any updates.
2. Capital budgets and any updates.
3. Quarterly results for the company and its operating divisions or business segments.
4. Minutes of meetings of audit committee and other committees of the board.
5. The information on recruitment and remuneration of senior officers just below the board level, including appointment or removal of Chief Financial Officer and the Company Secretary.
6. Show cause, demand, prosecution notices and penalty notices which are materially important
7. Fatal or serious accidents, dangerous occurrences, any material effluent or pollution problems.
8. Any material default in financial obligations to and by the company, or substantial non-payment for goods sold by the company.
9. Any issue, which involves possible public or product liability claims of substantial nature, including any judgement or order which, may have passed strictures on the conduct of the company or taken an adverse view regarding another enterprise that can have negative implications on the company.
10. Details of any joint venture or collaboration agreement.
11. Transactions that involve substantial payment towards goodwill, brand equity, or intellectual property.
12. Significant labour problems and their proposed solutions. Any significant development in Human Resources/ Industrial Relations front like signing of wage agreement, implementation of Voluntary Retirement Scheme etc.
13. Sale of material nature, of investments, subsidiaries, assets, which is not in normal course of business.
14. Quarterly details of foreign exchange exposures and the steps taken by management to limit the risks of adverse exchange rate movement, if material.
15. Non-compliance of any regulatory, statutory nature or listing requirements and shareholders service such as non-payment of dividend, delay in share transfer etc.

Annexure 2

Suggested List Of Items To Be Included In The Report On Corporate Governance In The Annual Report Of Companies

1. A brief statement on company's philosophy on code of governance.
2. Board of Directors:
 - ? Composition and category of directors for example promoter, executive, non-executive, independent non-executive, nominee director, which institution represented as Lender or as equity investor.
 - ? Attendance of each director at the BoD meetings and the last AGM.
 - ? Number of other BoDs or Board Committees he/she is a member or Chairperson of.
 - ? Number of BoD meetings held, dates on which held.
3. Audit Committee.
 - ? Brief description of terms of reference
 - ? Composition, name of members and Chairperson
 - ? Meetings and attendance during the year
4. Remuneration Committee.
 - ? Brief description of terms of reference
 - ? Composition, name of members and Chairperson
 - ? Attendance during the year
 - ? Remuneration policy
 - ? Details of remuneration to all the directors, as per format in main report.
5. Shareholders Committee.
 - ? Name of non-executive director heading the committee
 - ? Name and designation of compliance officer
 - ? Number of shareholders complaints received so far
 - ? Number not solved to the satisfaction of shareholders
 - ? Number of pending share transfers
6. General Body meetings.
 - ? Location and time, where last three AGMs held.
 - ? Whether special resolutions
 - ? Were put through postal ballot last year, details of voting pattern.
 - ? Person who conducted the postal ballot exercise
 - ? Are proposed to be conducted through postal ballot
 - ? Procedure for postal ballot
7. Disclosures.
 - ? Disclosures on materially significant related party transactions i.e. transactions of the company of material nature, with its promoters, the directors or the management, their subsidiaries or relatives etc. that may have potential conflict with the interests of company at large.
 - ? Details of non-compliance by the company, penalties, strictures imposed on the company by Stock Exchange or SEBI or any statutory authority, on any matter related to capital markets, during the last three years.

8. Means of communication.

- ? Half-yearly report sent to each household of shareholders.
- ? Quarterly results
- ? Which newspapers normally published in.
- ? Any website, where displayed
- ? Whether it also displays official news releases; and
- ? The presentations made to institutional investors or to the analysts.
- ? Whether MD&A is a part of annual report or not.

9. General Shareholder information

- ? AGM : Date, time and venue
- ? Financial Calendar
- ? Date of Book closure
- ? Dividend Payment Date
- ? Listing on Stock Exchanges
- ? Stock Code
- ? Market Price Data : High., Low during each month in last financial year
- ? Performance in comparison to broad-based indices such as BSE Sensex, CRISIL index etc.
- ? Registrar and Transfer Agents
- ? Share Transfer System
- ? Distribution of shareholding
- ? Dematerialization of shares and liquidity
- ? Outstanding GDRs / ADRs / Warrants or any Convertible instruments, conversion date and likely impact on equity
- ? Plant Locations
- ? Address for correspondence

Annexure – 3

1. **Non-Mandatory Requirements**

2.

a) **Chairman of the Board**

A non-executive Chairman should be entitled to maintain a Chairman's office at the company's expense and also allowed reimbursement of expenses incurred in performance of his duties.

b) **Remuneration Committee**

- i. The board should set up a remuneration committee to determine on their behalf and on behalf of the shareholders with agreed terms of reference, the company's policy on specific remuneration packages for executive directors including pension rights and any compensation payment.
- ii. To avoid conflicts of interest, the remuneration committee, which would determine the remuneration packages of the executive directors should comprise of at least three directors, all of whom should be non-executive directors, the chairman of committee being an independent director.
- iii. All the members of the remuneration committee should be present at the meeting.
- iv. The Chairman of the remuneration committee should be present at the Annual General Meeting, to answer the shareholder queries. However, it would be up to the Chairman to decide who should answer the queries.

c) **Shareholder Rights**

3. The half-yearly declaration of financial performance including summary of the significant events in last six-months, should be sent to each household of shareholders.

4.

5. d) **Postal Ballot**

6. Currently, although the formality of holding the general meeting is gone through, in actual practice only a small fraction of the shareholders of that company do or can really participate therein. This virtually makes the concept of corporate democracy illusory. It is imperative that this situation which has lasted too long needs an early correction. In this context, for shareholders who are unable to attend the meetings, there should be a requirement which will enable them to vote by postal ballot for key decisions. Some of the critical matters which should be decided by postal ballot are given below :

7.

- a) Matters relating to alteration in the memorandum of association of the company like changes in name, objects, address of registered office etc;
- b) Sale of whole or substantially the whole of the undertaking;
- c) Sale of investments in the companies, where the shareholding or the voting rights of the company exceeds 25%;
- d) Making a further issue of shares through preferential allotment or private placement basis;
- e) Corporate restructuring;
- f) Entering a new business area not germane to the existing business of the company;
- g) Variation in rights attached to class of securities;
- h) Matters relating to change in management

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