



COMPLIANCE WITH CLAUSE 49 OF LISTING AGREEMENT AND CORPORATE GOVERNANCE (A STUDY OF SELECTED PHARMACEUTICAL COMPANIES IN INDIA)

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Abstract

SEBI is the regulator of Indian securities market. Stock exchanges are controlled by SEBI. Its fundamental objective is to protect investors' interests and to develop securities market through its control and regulatory measures. Investors' trust is a key for success of the business entities. As a measure to ensure that company management does not hinder the interests of shareholders and stakeholders, exchanges issue listing agreement that has to be complied with by those companies who desire their stocks to be listed in stock exchanges. One such clause of listing agreement is clause 49, which provides guidelines and a format for reporting corporate governance practices. This paper is taken with the objectives to study the importance of clause 49 of SEBI's listing agreement and to assess the level of compliance with provisions of clause 49 in selected pharmaceutical companies in India. Pharmaceutical companies listed in National Stock Exchange and Bombay Stock Exchange are taken for the study and data collected from the annual reports. 100 % compliance with provisions on composition of board and audit committee, negligence of companies towards compliance with subsidiary companies requirements and disclosure of pecuniary relationship of non-executive directors relationship with company ect., are some of the major findings of the paper. The study is restricted to only to evaluate the compliance with listing requirements in governance reports.

Key Words: *Listing Agreement, Clause 49, Corporate Governance, Pecuniary Relationship, Mandatory and Non-Mandatory Requirements, Compliance.*

INTRODUCTION

Securities Exchange Board of India is the securities market regulator in India. It was established in the year 1992 through the SEBI Act, 1992. The basic function of SEBI, as said in its preamble, is to protect the interests of investors and to promote and develop securities market. SEBI regulates the business of stock exchanges and businesses companies and stock intermediaries are regulated by stock exchanges. As a measure to ensure that company management does not hinder the interests of shareholders and stakeholders, exchanges issue listing agreement that has to be complied with by those companies who desire their stocks to be listed in stock exchanges. SEBI requires companies to follow the listing agreement rules in order to trade on their securities in capital market. Among various clauses of listing agreement, clause 49 is meant exclusively for governance practices of corporate entities. It includes certain provisions regarding corporate governance.

Corporate governance practices reflect the way an organisation is managed. The essential element of good corporate governance is honesty and integrity. SEBI as a regulator of capital market strives to bring in accountability in companies and thereby, protect the interests of shareholders through clause 49 of the listing agreement.

This clause provides guidelines and a format for reporting corporate governance practices. And the provisions are in the form of mandatory and non-mandatory requirements, reporting of which is based on comply or explain principle. Hence, those who do not follow any listing agreement rule may give reasons for non-compliance. And also, though they report 100% compliance with listing rules, how many of them follow the practices in true spirit is questionable which requires a thorough analysis at present as we are witnessing a number of corporate misconducts.

NEED FOR THE STUDY

Pharmaceutical industry is growing rapidly and expanding its domestic as well as global markets. There has been emergence of foreign companies in India and some large Indian companies are also making their presence felt outside India. Governance of such large multinational companies is becoming more complex and challenging. We consider pharmaceutical industry to have empirical evidence regarding corporate governance practices with reference to clause 49 of the listing agreement.

OBJECTIVES OF THE SECURITY MARKET REGULATORS

Regulatory system of a country plays an important role in creating an effective governance environment (NFCG, 2007-08). SEBI is an important player in Indian corporate governance framework. Its fundamental motive is to safe guard the investors' money. The chairman of SEBI, U K Sinha said that, from the time of its inception till date SEBI has been striving to regulate the securities market and protect investors' interests (Handbook of Statistics on Indian Securities Market 2013). Hence, it takes different measures to meet its purpose of existence. SEBI through stock exchanges and their listing agreements attempts

to gather and diffuse the accurate information about the companies in which investors have stake or in which they wish to invest (existing or potential investors). This plays key role in investors' protection.

A timely and relevant disclosure by companies to SEBI is a major source of information from which SEBI analyses each company's and industry's strengths, weaknesses, lacunas. Analysis and communication of such information helps the investors to take informed decisions. Therefore, SEBI requires each of the listed companies to follow its guidelines. Violation of those rules is subject to punishment and legal actions. Clause 49 of SEBI's listing agreement contains some guidelines pertaining to corporate governance that ought to be met by all listed companies.

OBJECTIVES

This paper is taken with the following objectives.

1. To study the importance of clause 49 of SEBI's listing agreement.
2. To assess the level of compliance with provisions of clause 49 in selected pharmaceutical companies in India.

COMPLIANCE WITH CLAUSE 49

This clause gives exhaustive notes on Board of directors, Audit committee, Subsidiary companies, disclosures about various aspects, CEO-CFO certification, report on corporate governance and compliance with the requirements. Each of the provision enlisted in this clause embraces different elements which are crucial for ensuring good governance in the firm. However, comply or explain principle give room for non-compliance with mandatory requirements given with reasons thereof. Thus, it lacks rigidity and increases the chances of non-compliance by companies.

Annexure IC contains the suggested list of items to be included in the corporate governance report and annexure ID gives a list of non-mandatory requirements. This paper focuses on compliance or the extent to which companies follow the suggested list of items to be included in the report on corporate governance in the annual reports.

The listing agreement of SEBI is similar to the listing agreement issued by SEBI's counterparts in other countries such as SEC (Securities Exchange Commission).

Following tables contain mandatory and non-mandatory recommendations of Clause 49 of SEBI's listing agreement

Table- 1, Mandatory Requirements

SI.No	Heading	Sub- headings	Aspects included
1.	<u>Board of Directors</u>	a. Composition b. NED's compensation & disclosures c. Other provisions- Board & Committees d. Code of conduct	i. Combination of ED & NEDs ii. No. of IDs with respect to nature of chairmanship iii. Definition of ID i. Board meetings ii. No. of membership/chairmanship in other boards/committees iii. Review of compliance reports iv. Replacement of ID i. Lay down code of conduct ii. Affirm compliance on COC



<p>2.</p>	<p><u>Audit Committee</u></p>	<p>a. Qualified & Independent AC</p> <p>.....</p> <p>b. Meeting of AC</p> <p>.....</p> <p>...</p> <p>c. Powers of AC</p> <p>.....</p> <p>...</p> <p>d. Role of AC</p> <p>.....</p> <p>...</p> <p>e. Review of info. By AC</p>	<p>i. Composition</p> <p>ii. Financial literacy</p> <p>iii. ID as chairman</p> <p>iv. Presence of chairman in AGM</p> <p>v. Who <i>may</i> be invited to AC meetings?</p> <p>vi. CS as secretary of AC</p> <p>.....</p>
<p>3.</p>	<p><u>Subsidiary Companies</u></p>		<p>i. ID of holding co. in UISC*</p> <p>ii. Review of financial statement</p> <p>iii. Reporting the minutes to BOD</p>
<p>4.</p>	<p><u>Disclosures</u></p>	<p>a. Basis of RPT**</p> <p>.....</p> <p>b. Disclosure of Accounting treatment</p> <p>.....</p> <p>c. Board's disclosures- Risk management</p> <p>.....</p> <p>d. Public, right, preferential issues' proceeds</p> <p>.....</p> <p>e. Remuneration of directors</p>	<p>i. Summary of RPTs placed before AC</p> <p>ii. Material individual RPT not in normal course of business placed before AC</p> <p>iii. Details of RPT not in AL*** placed before AC with management justification</p> <p>.....</p> <p>i. Disclosure of pecuniary relation/transaction of NED with co. in AR</p> <p>ii. Elements of remuneration package, performance linked pay along with performance criteria, service contracts, notice period, severance</p>

		<p>.....</p> <p>f. Management</p> <p>.....</p> <p>g. Shareholders</p>	<p>fees, and stock option details if any.</p> <p>iii. Criteria of payment to NEDs.</p> <p>iv. No. shares & convertible instruments held by NEDs.</p> <p>v. Disclosure by NEDs their shareholdings in a listed co. proposed to be appointed as director, prior to their appointment, which will be disclosed in the notice to general meeting for appointment of such director.</p> <p>.....</p> <p>i. MDA# as part/addition to director's report in AR.</p> <p>ii. Disclosure to board by senior management about all material financial/ commercial transactions of personal interest conflicting with the co. interest.</p> <p>.....</p> <p>i. Information to be provided to the shareholders at the time of appointment/ reappointment of a director.</p> <p>ii. Quarterly results and presentation made to the analysts to be communicated to the SE through its own website/through any other proper means.</p> <p>ii. Forming shareholders/ investors grievance committee, chaired by a NED.</p> <p>v. Delegation of the power to an officer/ committee/registrar to attend to the share transfer formalities fortnightly.</p>
5.	CEO/CFO Certification		
6.	Corporate Governance Report		<p>i. Separate sec. on CG and compliance report thereon.</p> <p>ii. Submission of the quarterly compliance report within 15 days from close of the particular quarter.</p>
7.	Compliance		<p>i. Compliance certificate from the auditor/practicing CS</p> <p>ii. Compliance with mandatory requirements and adoption or non-adoption of non-mandatory requirements disclosed in the CG section</p>

Source: Extract of clause 49

Note: * Unlisted Indian Subsidiary Company

** Related Party Transaction

*** Arm's length

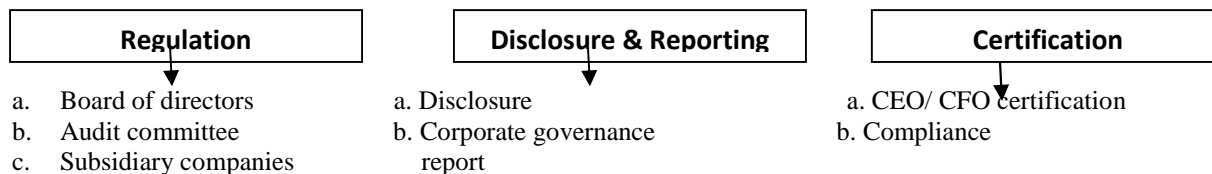
Management Discussion and Analysis

Table- 2: Non- Mandatory Requirements

Si. No.	Provision	Explanation
1.	Board	<ul style="list-style-type: none"> i. NED may hold chairman’s post at the expense of the company and may avail the reimbursement of the expenses incurred. ii. ID may have a tenure not exceeding nine years. iii. Co. may appoint ID with requisite qualification for the benefit of the company.
2.	Remuneration Committee	<ul style="list-style-type: none"> i. May have a remuneration committee to determine remuneration policy and packages for EDs. ii. RC may comprise at least 3 NEDs and ID as chairman to avoid conflict of interest. iii. All members to be present at the meeting. iv. Chairman of RC could be present in the AGM to answer the shareholders queries.
3.	Shareholders Rights	<ul style="list-style-type: none"> i. Summary of performance and major events in the last six months may be sent to the household of each shareholder.
4.	Audit Qualification	<ul style="list-style-type: none"> i. May move towards unqualified financial statements.
5.	Training of Board Members	<ul style="list-style-type: none"> i. May train directors on business model, parameters, their duties and best ways to discharge those duties.
6.	Evaluation of NEDs performance	<ul style="list-style-type: none"> i. Peer group could assess the performance of NEDs in the absence of director being assessed. The assessment decides the continuation of his/ her term of appointment.
7.	Whistle Blower Policy	<ul style="list-style-type: none"> i. May have a mechanism for reporting wrong doings/ violation of rules. <p>Adequate safeguard measures to the blowers. Creating awareness about the existence of such mechanism.</p>

Source: Extract of clause 49

Table 1 contains the provisions which are binding and must be complied with. The provisions of the clause highlight the important dimensions of governance. A number of important requirements are included under each broad dimension which intends to ensure compliance as well as proper, accurate and timely disclosure and reporting. In this study, we make three classifications of provisions (mandatory) based on the purpose they serve. They are; Regulation, Disclosure & reporting and Certification. Each of the seven dimensions is put under different purposes. However, they also serve the other purposes too.



Regulation: This part of the agreement regulates the three major areas of the corporate governance (listed as above). They regulate the composition, qualification and role, powers of board and audit committee, code of conduct, management and governance of subsidiary companies. The main purpose of these provisions is to bring in an efficient administration in the firm.

Disclosure and Reporting: Disclosure of management and governance aspects is as essential as financial disclosure. Thus, such provisions which concentrate majorly on disclosing and reporting of various governance aspects are grouped under this head. The disclosure of all requirements and reporting of the same to the stock exchanges and shareholders without deviation would definitely ensure transparency. Shareholders get insight into the aspects such as; who are the companies’ related parties and what are the bases of transaction with related parties? What are the pecuniary relationships of the related parties with the company? What benefits the directors are getting? Has the firm deviated from any accounting standard? What is the extent of compliance with mandatory and non- mandatory requirements, ect.

Certification: Regulation and disclosure should also be accompanied by a review and appraisal by an authority. Corporate governance practices and their disclosure will not be accepted unless they are certified. The deficiencies, frauds, if any, are to be specified. There are two certificates; firstly, CEO/ CFO certification to the board which is internal and secondly, auditors/practicing company secretaries certificate to the shareholders and stock exchanges which is for external users.

RESEARCH METHODOLOGY

Sample selection

Simple random sampling technique is used to choose the samples.

Sample size

Ten pharmaceutical companies listed in National Stock Exchange and Bombay Stock exchange are considered for the study and 10 companies are selected as sample companies considering the criteria of market capitalization. These companies are in the list of top 100 companies and the annual reports for the financial year 2012-13 are collected.

Tools

The data are collected from the annual reports. The extracted information were analysed with the help of content analysis method. As the data is textual, the information has been coded to suit it to statistical analysis.

ANALYSIS AND DISCUSSION

In this section we have attempted to arrive at the statistical evidences for hypotheses testing. Each listing requirement is considered as separate variable the compliance with which have been taken as complied, not complied; mentioned, not mentioned and as disclosed, not disclosed.

Table- 3, Review of Compliance Report by Board

	Frequency	Mean	SD
Not complied	7	.30	.483
Complied	3		

Source: Annual reports

Table- 4, Financial Literacy of Audit Committee Members

	Frequency	Mean	SD
Not complied	5	.50	.527
Complied	5		

Source: Annual reports

Table- 5, Company Secretary as Secretary of Audit Committee

	Frequency	Mean	SD
Not mentioned	1	.90	.316
Mentioned	9		

Source: Annual reports

Table- 6, Power of Audit Committee

	Frequency	Mean	SD
Not mentioned	8	.20	.422
Mentioned	2		

Source: Annual reports

Table -7, Review of Financial Statements by Board of Holding Company

	Frequency	Mean	SD
Not mentioned	5	.50	.527
Mentioned	5		

Source: Annual reports

Table- 8, Reporting the Minutes of Meetings to Board

	Frequency	Mean	SD
Not mentioned	6	.40	.516
Mentioned	4		

Source: Annual reports

Table- 9, Boards' Disclosure about Risk Management

	Frequency	Mean	SD
Not disclosed	3	.70	.483
Disclosed	7		

Source: Annual reports

Table – 10, Disclosure about Accounting Treatment

	Frequency	Mean	SD
Not disclosed	8	.20	.422
Disclosed	2		

Source: Annual reports

Table- 11, Non- Executive Directors Pecuniary Relationship with Company

	Frequency	Mean	SD
Not disclosed	8	.20	.422
Disclosed	2		

Source: Annual reports

Table -12, Criteria of Payment to Non-Executive Directors

	Frequency	Mean	SD
Not disclosed	7	.30	.483
Disclosed	3		

Source: Annual reports

Table -13, Senior Managers Disclosure about Conflicting Interests

	Frequency	Mean	SD
not disclosed	8	.20	.422
disclosed	2		

Source: Annual reports

Table -14, Details of Directors Seeking Appointment & Reappointment

	Frequency	Mean	SD
Not disclosed	1	.90	.316
Disclosed	9		

Source: Annual reports

Table- 15, Submission of Quarterly Compliance Report

	Frequency	Mean	SD
not complied	8	.20	.422
complied	2		

Source: Annual report

Table -16, Compliance with Mandatory & Adoption of Non- Mandatory Requirements

	Frequency	Mean	SD
Not complied	1	.90	.316
Complied	9		

Source: Annual reports

There is 100 % compliance with provisions on composition of board and audit committee. All companies in the sample have adequate number of executive and non-executive directors. And the companies who have executive director acting as chairman of the board, have 2/3 (more than 2/3 in some companies) independent directors. The no. of meetings held by the boards and audit committees is as per the requirement and the gap between two meetings does not exceed four months. Boards of all companies have taken due care to lay down code of conduct which are put in companies website and which are complied with by directors and senior management personnel. The composition of audit committee is according to the agreement's requirement. However, the disclosure of financial and accounting literacy of audit committee members, power vested with the committee, its role is not adequate.

The study shows the negligence of companies towards compliance with subsidiary companies requirements. We found not even a single company which discloses whether an independent director holds director's position in material non-listed Indian subsidiary company. Only half of the sample companies mentioned that the subsidiary companies' financial statements are reviewed by the holding companies' audit committee and only 40% of the companies report the minutes of board meetings of subsidiary companies to the boards of holding companies. It shows inadequate disclosure about subsidiary companies in corporate governance reports.

There is zero percent non-compliance as regards the disclosure about related party transactions by companies. However, the disclosure of risk management procedure and accounting treatment is not proper. We found that, 30 % companies do not disclose the procedure of risk mitigation. Only two companies mentioned that the financial statements are prepared in accordance with Indian GAAP.

We found 100 % compliance with disclosure of public, right and preferential issue proceeds, details of remuneration package of non-executive directors, share and instruments held by them, details of directors seeking appointment/ reappointment, management analysis and discussion, quarterly results and presentations put in websites, presence of share transfer system, CEO/ CFO and auditors' certification. But, many companies have not complied with key aspects viz, non-executive directors pecuniary relationship with firms, organisation's criteria of payment to non-executive directors, disclosure of senior managers personal interest in companies affairs that conflict with the companies interest, submission of compliance report within 15 days from the close of each quarter (see above tables).

The study observes a significant difference between reporting practices among companies. Very few companies have taken extreme care in the preparation of corporate governance reports which are comprehensive. The flow of information in those reports follows the content sequence as in the listing agreement. From among the non-mandatory requirements, formation of remuneration committee and whistle blower policy are the two major requirements which are adopted by some companies. And non-adoption of the other requirements in spite of their importance and the benefits they would serve shows the managements apathy towards them.

SUGGESTION

It is difficult to arrive at the exact causes of poor compliance with listing requirements. The companies may consider the listing agreement as only a mere listing requirement or unawareness about the long term value that would be brought by compliance with agreement. And 'comply or explain' principle may also create mindset among firms which lead to flexibility in compliance. Though it's been argued by some that the comply or explain principle give companies space for thinking out-of-box and be innovative, the principle may also tempt firms to deviate from the provisions. Moreover, the weak enforcement of governance provisions is a major issue (Mirza & Mohanty, 2014). Hence, as exchanges act as a body to oversee the companies' compliance with the regulations, we suggest stock exchanges to bring in more rigidity to the agreement and enforcement mechanism made to be more strong rather than bringing in some other regulations.

Due to its role and responsibilities, audit committee in an important organ of governance structure of a firm. But, compliance with some of the provisions relating to audit committee is not good enough. There is scope for improvement in aspects such

as disclosure of qualification of audit committee members, power and role of audit committee, criteria of payment to non-executive directors, pecuniary relationship of non-executive directors and senior management executives with the companies, risk management, etc. Exchanges should put non-compliance or any fraud under severe punishment which may reduce deviation from the listing requirements.

CONCLUSION

Corporate entities funded by external sources such as individual and institutional investors, banks and financial institutions, need to be transparent and fair in their dealing in order survive in market driven economy. Nevertheless, the capital market players also rely more on the disclosures of the companies. This need for information is abridged through corporate governance reports. Mandating a separate section on corporate governance in annual reports discloses other aspects which are as important as financial disclosures. Enforcement of the important requirements through listing agreement is helpful to bringing transparency in companies' governance and shareholders protection. However, some corporate frauds such as Sathyam which enjoyed a reputation and investor confidence until it came out, questions the purpose served by the listing agreement. We see the difference in governance practices among different industries. This study has made an attempt to study the reporting practices among pharmaceutical companies in India in comparison with clause 49 of the listing agreement. And found non-compliance with many aspects as disclosure of pecuniary relation of non-executive directors, senior management, submission of quarterly compliance report etc. The study is restricted to only to evaluate the compliance with listing requirements in governance reports.

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