

# **Emerging issues in Company Law**

**Subject: Commerce**

**Lesson: Emerging issues in Company Law**

**Course Developer: Dr. Anu Panday, Assistant Professor**

**College/ Department: Motilal Nehru College, University of Delhi**



# Emerging issues in Company Law

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# Emerging issues in Company Law

## Introduction

In the modern economy, the corporate sector has been assigned the role of the main leader of the growth process. To act as the engine of growth, the companies require a conducive legal environment. Thus, the company laws have evolved over the past decade. The impetus for such change came from changes in the world economy, advancements in information technology and the limitations of existing regulations. While at some points, regulations needed to provide more flexibility, at others, there was a need for strengthening the laws. Moreover, a number of events occurred internationally which brought new issues to the fore. Three such issues, namely, 'producer companies', 'corporate governance' and 'depositories' have been discussed in this lesson. While, the concept of producer companies was developed as an alternative to existing cooperative society regulations, the issue of corporate governance was brought to light after a number of corporate scandals. The innovations in technology and need for faster and easy transactions resulted in the creation of depository system. A discussion of these concepts and related issues follows in the coming sections.



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## 9.1. Producer Company

An economy can flourish only when there is a balanced growth of all sectors. Both the rural and urban sectors of the economy must be developed simultaneously. Developing rural sector requires encouragement of agriculture and cottage industries. In India, there are many forms of business organization, namely, sole proprietorship, partnership, company, cooperative societies etc. Of these traditionally, cooperative societies have been engaged in promotion of rural business.

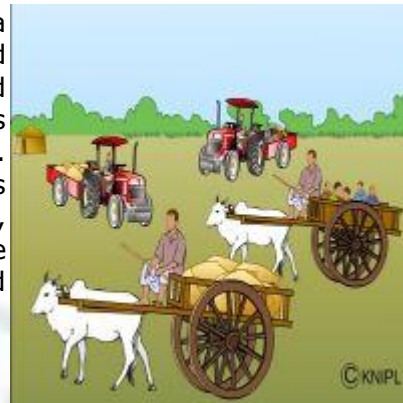


Figure 9.1 Rural & Urban Sectors

But these suffer from major limitations such as paucity and misuse of funds, lack of expertise and inefficient operations. To counter these problems and find a viable solution, the government constituted a committee under the chairmanship of Dr Y.K. Alagh. The committee suggested a framework that enabled the incorporation and conversion of existing cooperatives into companies and ensured that the unique features of cooperative business are merged with a strong regulatory framework of companies. The recommendations of the committee were incorporated in the Companies (Amendment) Act, 2002. A new Part IX A was inserted in the act. This led to the conceptualisation of 'Producer Company'.

The producer company is an alternative to cooperative society without many of the associated flaws. It helps in making funds available as there is no limit on the maximum number of members it can have. Even an institution (like a cooperative) can be a member of Producer Company. The company form of organization ensures transparency and makes professional expertise available to the company. Moreover, being a company, it is governed by a strict framework of regulations which reduces chances of misuse and mismanagement of funds.

### 9.1.1. Concept and Formation Formation

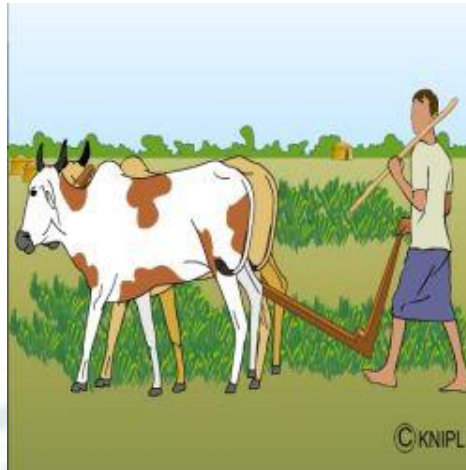
As mentioned above, a producer company is an alternative to cooperative societies. According to section 581C of the Companies Act, 1956 any 10 or more individual producers, or 2 or more producer institutions, or a combination of 10 or more individuals and producer institutions which have objects as specified in section 581B may form an incorporated Company called a Producer Company. Only those who are engaged in an activity connected or related to 'primary produce' <sup>1</sup> can become members of a producer company. If the Registrar is satisfied that all the requirements regarding registration have been complied with, a certificate of incorporation is issued within 30 days. Producer Company is treated like a private limited company in respect of most of the provisions applying to it. The liability of the members is limited to the amount unpaid in respect of the shares of companies. Thus, members' shares cannot be traded publicly but can only be transferred.

### Objects of a Producer Company

As per section 581B of the Companies Act, 1956, a producer company can be formed for any of the objects given below:

(a) Production, harvesting, procurement, grading, pooling, handling, marketing, selling, export of 'primary produce' of the Members or import of goods or services for their benefit.

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**Figure 9.1 Rural & Urban Sectors**

Illustration :

Hari, Sonu, Jayanti, Prakash, Sam, Iqbal, Hira, Shambhu, Ganpat and Mala are farmers who grow rice. They can come together and form a Producer Company to export rice as per section 581C of Companies Act, 1956.

## **Objects of a Producer Company**

Processing including preserving, drying, distilling, brewing, vinting, canning and packaging of produce of its Members,

(b) Manufacture, sale or supply of machinery, equipment or consumables mainly to its Members,

(c) Providing education to its Members and others;

(d) Rendering technical and consultancy services, training, research and development and all other activities for the promotion of the interests of its Member

## **Weaving**



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## Illustration :

Prasanna cooperative society is engaged in providing training to those who are engaged in handloom industry. Das society supplies charkhas to those who make handlooms. Both the cooperatives can come together and form a Producer Company engaged in promoting handlooms as per section 581C of Companies Act, 1956.

- (e) Generation, transmission and distribution of power, revitalisation of land and water resources, their use, conservation and communications relating to primary produce,
- (f) Insurance of producers or their primary produce,
- (g) Promoting techniques of mutuality and mutual assistance,
- (h) Welfare measures or facilities for the benefit of Members,
- (i) Any other activity, ancillary or incidental to any of the activities referred above.
- (j) Financing of procurement, processing, marketing or other activities mentioned above which include extending of credit facilities to its Members.

## Illustration :

Hari, Sonu, Jayanti, Prakash, Sam, Iqbal, Hira, and Ganpat practise animal husbandry. Das society insures livestock. Prasanna cooperative society is engaged in providing loans to help those who are engaged in animal husbandry. The individuals as well as the cooperatives can come together and form a Producer Company engaged in animal husbandry as per section 581C of Companies Act, 1956.

## Benefits to Members.

- **In respect of produce supplied:** All the members would initially receive only such value for the produce pooled and supplied as the Board of Producer Company may determine. The remaining price may be distributed later in cash or in kind or by allotment of equity shares as may be decided by the Board.
- **Return:** Every member will receive a limited return on the share i.e. the capital contributed. Members may be allotted bonus shares.
- **Distribution of Surplus:** The surplus left after making provision for payment of limited return and reserves may be disbursed as patronage bonus among the members, in proportion to their participation in the business of the Producer Company, either in cash or by way of allotment of equity shares, or both, as may be decided by the Members at the general meeting.

## Voting rights of Members of Producer Company

As per Section 581D of the Companies Act, 1956, members of the Producer Company have the following voting rights:

- Where all the members are individuals, each member would have a single vote irrespective of the shares held by him / her.

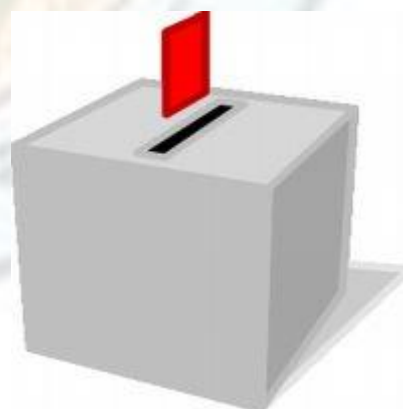


Figure 9.2 Voting Rights

## Illustration :

Hari, Sonu, Jayanti, Prakash, Sam, Iqbal, Hira, Shambhu, Ganpat and Mala are the sole members of a Producer Company. Hari holds 60% of the shares in the company. Shambhu holds 24% shares. All the other members hold 2% votes each. Then as per Section 581D of the Companies Act, 1956 all of them have one vote each in a meeting.

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- Where the membership consists of institutions only, the voting rights of such Producer institutions shall be determined on the basis of their participation in the business of the Producer Company in the previous year, as may be specified by articles. However, in the first year the voting rights will be determined on the basis of the shareholding by such Producer institutions.

### **Illustration :**

Prasanna cooperative society and Das society are the members of a Producer Company. They hold the shares in the ratio of 3:2. In the first year of formation, their voting rights are also in the ratio of 3:2 ( as per section 581D of Companies Act, 1956).

### **Illustration :**

Prasanna cooperative society and Das society are the members of a Producer Company. They hold the shares in the ratio of 3:2. In the last year, they participated equally in business. In the current year they would have equal voting rights ( as per section 581D of Companies Act, 1956).

- Where the both individuals and Producer institutions are members, each member would have a single vote.

### **Illustration :**

Hari, Sonu, Jayanti, Prakash, Sam, Iqbal, Hira, Ganpat, Das society and Prasanna cooperative society are the members of a Producer Company. Prasanna cooperative society holds 70% of the shares. Yet, as per Section 581D of the Companies Act, 1956, it has only a single vote (same as others).

However, irrespective of the above provisions, a Producer Company may, if so authorised by its articles, restrict the voting rights to active members<sup>2</sup>, in any special or general meeting. Further, if any person has any business interest which conflicts with business of the Producer Company, he cannot become or continue to remain a member of the Company.

### **Management**

Every producer company must have a minimum of 5 and not more than 15 directors (Section 581 O). It is also mandatory for the board to appoint a full time chief executive. He should be an ex-officio director and is not liable to retire by rotation. He would have substantial powers of management as the board may determine (section 581W).

### **Comparison between Private and Producer Company**

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Producer Company is treated like a private limited company in respect of most of the provisions applying to companies. However, it differs from a private company in some of the aspects. These are summarized in Table given below.

**TABLE 9.1- Difference between Private Company and Producer Company**

	<i>Basis Distinction</i>	<i>Private Company</i>	<i>Producer Company</i>
1	Minimum Individual Membership	Even two individuals can form a private company.	At least 10 individuals are required to form a producer company.
2	Maximum Membership	In a private company maximum membership is limited to 50.	In a producer company there is no limit to the maximum number of members.
3	Minimum paid-up capital	A private company must have a minimum paid-up capital of Rs. 1 lakh.	The provision relating to does not apply to producer companies.
4	Inclusion of certain words in the Name	The company must include the word "Private" in its name	The name of the company must have the words "Producer Company Limited" in the end.
5	Minimum number of Directors	A private company must have a minimum of 2 directors.	A producer company must have a minimum of 5 directors.
6	Appointment of Chief Executive	A private limited need not have any chief executive	It is mandatory for the board to appoint a full time chief executive.
7	Internal Audit	Internal audit is not compulsory for private companies.	Every producer company should carry out internal audit of its accounts by chartered accountants.

### 9.1.3 Reconversion of Producer Company to Interstate Cooperative Society

As per the provisions of Section 581ZS a producer company which was formed from conversion of inter-State co-operative society under section 581J, may make an application for converting it back to original form. The producer company has to apply to the high court for this purpose. This can be done either on passing a resolution in the general meeting (at least 2/3rd of its Members present and voting) or on request by the creditors (representing 3/4th value of its total creditors).



**Figure 9.4 Cooperative Company**

Illustration :

Sawan Producer Company Ltd. was formerly an inter-state cooperative society. It has 300 members and 80 creditors. The application to become a cooperative society must be made by:



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- 200 or more members must agree to conversion. or
- 60 or more creditors.

The High Court on receiving the application would order the conduction of the meeting (of Members or creditors). If a majority in number representing 3/4th in value of the creditors / members are present and vote in favour of re-conversion and if an approval is given by the High Court, then the producer company is converted back to inter state cooperative society.

The company or the person who applies for re - conversion must disclose all the material facts relating to the company to the Court. These facts include the latest financial position of the company, auditor's report and the any pending investigations in relation to the company etc. The order of the Court becomes effective only after a certified copy of the order is filed with the Registrar.

Every Producer Company which has been sanctioned re-conversion by the High Court shall make an application, under the relevant acts for its registration as multi-State co-operative society or co-operative society, within six months of conversion. It is also required to file a report of the same to the High Court, the Registrar of companies and Registrar of the co-operative societies (under which it has been registered).

### 9.1.4 Amalgamation, Merger or Division to form new Producer Companies

According to section 581ZN, of the Companies Act, 1956, a Producer Company may undergo an amalgamation, merger or division by passing a resolution in its general meeting. In order to amalgamate or merge, it transfers its assets and liabilities to another Producer Company. For division, it divides assets and liabilities two or more new Producers Companies.



**Figure9.5 Company Merger**

The Producer Company then sends a notice of its intentions along with a copy of the proposed resolution to all the members and creditors for their consent. The resolution of a Producer Company for this purpose is to be passed in its general meeting by a majority of members (with at least 2/3rd of its members present and voting). Such a resolution contains all details of the transfer of assets and liabilities. The resolution passed by a Producer Company will be effective after the expiry of 1 month or after the assent of all the members and creditors is obtained, whichever is earlier. Those members who do not consent to the resolution would, within 1 month of the notice, have the option to transfer his / her shares with the approval of the board to any active member. The non - consenting creditors may withdraw his / her deposit or loan or advance within the same time period.

The resolution also has details of the future shareholding patterns, any modifications in the management, agreements, liabilities and any other incidental matters. After the resolution is effective, the assets and liabilities of the transferor become the assets and liabilities of the transferee.

When all the assets and liabilities of a Producer Company are transferred to another Producer Company, the registration of the transferor company or the merging company would be cancelled while the new company (or companies) come into existence.

To summarize one may say, a producer company is an alternative to cooperative society

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without many of the associated flaws. Its creation is a step in strengthening the rural sector and allowing it to flourish along with the urban sector. By bringing more capital, technical expertise and professional management to the rural enterprises it certainly is a push towards balanced economic growth.

## 9.2 Corporate governance

The concept of corporate governance gained importance in 1980s after a number of reputed companies failed suddenly resulting in large corporate scandals. The Junk Bond Fiasco in USA and the failure of Polypeck and Bank of Credit and Commerce International in UK highlighted the necessity of having guidelines for good governance. The first important step in this direction was the setting up of a committee in UK under Sir Adrian Cadbury in 1991. The committee gave 19 recommendations which were considered in the creation of the 'Code of Best Practices' in UK.

In India, measures for corporate governance were initiated in 1996 by Confederation of Indian Industries (CII). A committee was constituted under the chairmanship of Mr Rahul Bajaj which submitted its report titled 'Desirable Corporate Governance- A Code' in 1998. This code suggested some desirable practices for good corporate governance. However, the recommendations were not made mandatory but a company could voluntarily adopt these practices. Corporate governance further gained momentum when the recommendations of Kumar Mangalam Birla Committee were incorporated in the listing agreement by SEBI in 2000<sup>3</sup>. In the same year, Companies (Amendment) Act, 2000 introduced provisions relating to corporate governance. Later, the Ministry of Corporate Affairs in association with Confederation of Indian Industry (CII), Institute of Company Secretaries of India (ICSI) and Institute of Chartered Accountants of India (ICAI) set up National Foundation for Corporate Governance (NFCG) in 2004 to improve the implementation and enforcement of various laws related to corporate governance. NFCG aims at better self-regulation in the Indian industry and providing training and research accordingly.

In the coming sections, the concept of corporate governance and its importance are discussed. The mandatory requirements of listing given by SEBI are also summarized.

### 9.2.1. Definition

**Corporate governance has been defined differently by different people. Some of the definitions are given below:**

"Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance."

-Overseas Economic Council for Development (OECD)

"Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled."  
[http://en.wikipedia.org/wiki/Corporate\\_governance](http://en.wikipedia.org/wiki/Corporate_governance)

"Corporate governance is maximizing the shareholder value in a corporation while ensuring fairness to all stakeholders, customers, employees, investors, vendors, the government and the society-at-large. Corporate governance is about transparency and raising the trust and confidence of stakeholders in the way the company is run. It is about owners and the managers operating as the trustees on behalf of every shareholder - large or small."  
- Mr N.R. Narayana Murthy, Infosys Limited.

The various definitions emphasize the following aspects:

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- Corporate governance aims at running a company in a responsible manner.
- It helps the company to treat all the stakeholders fairly.
- It is based on based on the principles of transparency and accountability.

**These aspects of corporate governance are interdependent and are discussed below:**

**Running a company in a responsible manner** - Corporate governance refers to the adoption of good business practices and values. It means that the affairs of the company are conducted in a responsible and honest manner. A company having good governance is able to establish a positive corporate image. A good public image improves investor confidence. This, in turn, can influence a company's share price as well as the cost of raising capital.

Treat all the stakeholders fairly-

A company has many stakeholders –shareholders, employees, consumers, government and society at large. A business has a responsibility towards each of them. Corporate governance involves a set of relationships amongst the company's management, shareholders and other stakeholders. Good corporate governance aims at treating all the stakeholders fairly and protecting their interests. It ensures that the



**Figure9.6 Corporate Governance Framework**

management does not misuse its powers for personal gains. The shareholders must get a fair return on their investment, capital appreciation as well as speedy grievance redressals. The employees should be given fair wages, proper working conditions and should be treated as strategic partners. Consumers must be provided quality goods and services at fair prices. Business must act as a corporate citizen; pay taxes and fulfil its social obligations.

**Principles of transparency and accountability-** Corporate governance is founded on the twin pillars of transparency and accountability. Transparency means that the company discloses all the relevant information to the stakeholders in a timely manner so as to enable them to make informed decisions. The management of a company is accountable to its stakeholders. Any decision that they take should be for the betterment of the organization and benefit of the stakeholders. Transparency and accountability are essential for the management or board of a company to act with integrity.

Corporate governance is being applied in India not only voluntarily but is also a mandatory requirement according to SEBI. This is discussed in the next page.

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## 9.2.2. SEBI Code of Corporate Governance

As in other parts of the world, the importance of corporate governance was recognized in India as well. The Bajaj committee submitted its report on desirable corporate governance practices in 1998. But the adoption of its recommendations was not compulsory for the companies. To make the framework binding, SEBI constituted a committee under the chairmanship of Mr. Kumar Mangalam Birla to suggest reforms for corporate governance in 1999. The committee submitted its report in 2000<sup>4</sup>.



**Figure 9.7 SEBI**

The recommendations of Kumar Mangalam Birla Committee were incorporated in the listing agreement by SEBI as a new clause – Clause 49. This clause had provisions regarding composition of the board, audit committee, director's remuneration, disclosure etc. which were to be complied by the companies listed on the exchange. In October, 2004 however this clause was revised and replaced by a new Clause 49. The provisions of the clause define the responsibilities and obligations of the boards and the management in instituting the systems for good corporate governance and protect the rights of stakeholders by ensuring transparency and accountability. It is a system of control that enhances the ability to compete in the market place.

### **Who has to comply with Clause 49?**

#### **The revised clause applies to:**

- Entities which wish to be listed on the stock exchange applying for the first time - Such entities must comply with the provisions before seeking in-principle approval for listing.
- Any existing listed entity – Any listed entity having a paid up share capital of Rs. 3 crores and above or net worth of Rs. 25 crores or more at any time in the history of the company.

Thus, the revised Clause 49 applies to all the listed companies. However, other listed entities which are not companies e.g. banks, financial institutions, insurance companies etc., which were incorporated under other statutes have to comply with Clause 49 only to the extent that it does not violate their respective statutes and guidelines. The provisions of revised Clause 49

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do not apply to Mutual Funds.

## Provisions of Clause 49 of Listing Agreement

This clause discusses the provisions for corporate governance under 7 main heads. The provisions are mandatory unless stated otherwise. These are:

1. Board of Directors
2. Audit Committee
3. Subsidiary Companies
4. Disclosures
5. CEO/CFO certification
6. Report on Corporate Governance
7. Compliance

Some of the important provisions of the revised Clause 49 are briefly listed below <sup>5</sup>:

### 1 Board of Directors-

i) The Board of directors of the company should have an optimum combination of executive<sup>6</sup> and non-executive directors<sup>7</sup>. Not less than 50% of the board of directors of the company should be non-executive directors.



Figure 9.8 Board of Directors

Illustration :

Pooja Textiles Ltd is a listed company. Its board of directors consists of 6 directors then as per the provisions of clause 49 at least 3 of the directors must be non - executive directors.

ii) Where the Chairman of the Board is a non-executive director, at least one-third of the Board should comprise of independent directors and in case he / she is an executive director, at least half of the Board should comprise of independent directors.

Illustration :

In the above illustration, the chairman of the board Ms Saraswati is a non – executive director, then at least 2 of the directors must be independent directors.

Illustration :

In previous Illustration', the chairman of the board Ms Saraswati is an executive director, then as per the provisions of clause 49 at least 3 of the directors must be independent directors.

iii) For the above purpose, the term 'independent director' means a non-executive director of the company who:

(1) Does not have any material pecuniary relationships with the company

Illustration :

Manas Software Ltd is a listed company. Murthy is one of the directors on the board. He gave a loan of Rs. 10 lakhs to the company which is still outstanding. He is not an independent director of the company.

(2) Is not related to promoters or persons occupying management positions at the board level or at one level below the board;

(3) Has not been an executive of the company in the past three financial years;

(4) Is not a partner or an executive or was not partner or an executive during the preceding

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three years, of any of the following:

1. The statutory audit firm or the internal audit firm that is associated with the company, and
2. The legal and consulting firms that have a material association with the company.

Illustration :

saucy jams ltd is a listed company. salman is one of the directors on the board. he is also a chartered a audit firm. this audit firm performed statutory audit of albert jams ltd last year. he is not an independent

(5) Can not be a material supplier, service provider or customer or a lessor or lessee of the company

(6) Can not be a substantial shareholder of the company i.e. holding at least 2% of the block of voting shares.

v) All the fees paid to non-executive directors, would be fixed by the Board of Directors with the prior approval of shareholders in general meeting.

v) The board should meet at least four times a year, with a maximum time gap of three months between any two meetings.

vi) A director can not be a member in more than 10 committees or the Chairman of more than 5 committees across all companies in which he is a director.

vii) The Board would lay down a code of conduct. All the Board members and senior management personnel of the company must comply with the code. The Annual Report of the company would contain a declaration as to the compliance signed by the CEO.

## 2) Audit Committee

The purpose of an audit committee is to ensure transparency. It oversees the company's financial reporting process and the disclosures to ensure that the financial statements represent a true and reliable picture of the financial affairs of the company. It aims to curb frauds, and violation of rules.

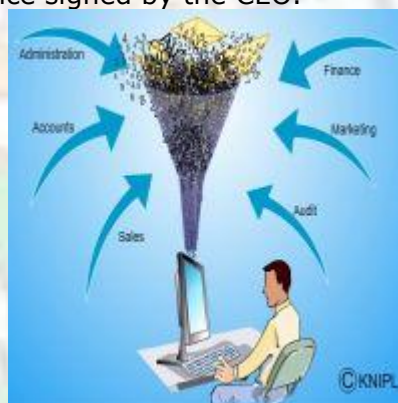


Figure 9.9 Audit Review

- i) Every company must constitute an audit committee comprising of at least 3 directors.
- ii) Two – third of the members of the audit committee must be independent directors.

Illustration :

Parampara Ltd is a listed company. It must constitute an audit committee. If the audit committee has 6 members, then out of these, 3 or more members must be directors of the company. Also, 4 members must be independent directors.

iii) At least one member should have expertise in accounting or finance. The audit committee must be chaired by an independent director.

Illustration :

Sonia Travels Ltd is a listed company. It constitutes an audit committee which has 6 members. Out Sonia, Tarak and Monica, are independent directors of the company. Sonia is the chairperson of the members of the audit committee. He is also a chartered accountant by profession. This committee is with the provisions of Clause 49.

iv) The audit committee must meet at least four times in a year and the gap between two meetings should not more than four months.

**Role of Audit Committee** - Following are the main roles played by the audit committee:

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- i) Oversees the company's financial information to ensure its correctness and credibility.
- ii) Recommends the appointment, re-appointment, replacement or removal and the fixation of audit fees of the statutory auditor.
- iii) Reviews the financial statements before submission to the board for approval particularly the matters which are to be included in the Director's Responsibility Statement; any changes in accounting policies and practices; compliance with listing and other legal requirements.
- iv) Examines the performance of auditors, adequacy of the internal control systems and internal audit function.
- v) Reviews and reports the findings of internal investigations by the internal auditors into matters of fraud or irregularity.
- vi) Discussion with statutory auditors about the nature and scope of audit as well as any area of concern.
- vii) To explore the reasons for substantial defaults in payment to the depositors, debenture holders, shareholders and creditors.
- viii) To evaluate the functioning of the Whistle Blower mechanism.

### 3) Subsidiary Companies

The clause provides that at least one independent director on the Board of Directors of the holding company shall also be appointed a director on the Board of material non listed Indian subsidiary company<sup>8</sup>. The Audit Committee of the listed holding company shall also review the financial statements of the unlisted subsidiary company. The minutes of the Board meetings of the unlisted subsidiary company should be placed at the Board meeting of the listed holding company.



Figure 9.10 Subsidiary Companies

A company must make the following disclosures:

- i) Disclosures about the related party transactions are to be placed before the audit committee.
- ii) Disclosures about the accounting treatment where it differs from that prescribed in an Accounting Standard along with the management's justification for the same.
- iii) The company must disclose the procedures to inform the Board about the risk assessment and minimization procedures.
- iv) When a company raises money through an issue it must periodically disclose to the Audit Committee how the funds are utilized.
- v) Disclosures regarding the details of pecuniary transactions and shareholding of the non-executive directors as well as the details of the remuneration paid to the directors must be made in the Annual Report.
- vi) Senior management personnel are required to disclose material financial transactions, where they have personal interest which may conflict with the interest of the company at large.
- vii) The shareholders must be provided details about the directors (resume, expertise, other directorships etc). Company's quarterly results should be made available on company's website. A committee called, 'Shareholders/Investors Grievance Committee' should be formed to look into investor grievances.

### 5) CEO/CFO certification

The CEO and the CFO shall certify to the Board that to the best of their knowledge and belief:

- i) They have reviewed financial statements and the cash flow statement for the year these



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statements do not contain any materially untrue or misleading statement or material omission. They also have to certify that the statements present a true and fair picture of the company's affairs and have been prepared in compliance with accounting standards, laws and regulations.

- ii) The company has not entered any fraudulent or illegal transactions.
- iii) The effectiveness of internal controls has been evaluated and the deficiencies have been disclosed to the auditors and the Audit Committee.
- iv) The Audit committee has been briefed about the significant changes in accounting policies and internal control system during the year.

### 6) Report on Corporate Governance

The Annual Report of the company must include a distinct section on Corporate Governance which provides a detailed compliance report on Corporate Governance. If any of the mandatory requirements are not complied with, the same must be stated giving reasons thereof. Also, the compliance of non-mandatory requirements should be specifically brought to light. The companies have to submit a quarterly compliance report to the stock exchanges within 15 days from the close of quarter. The report has to be signed either by the Compliance Officer or the Chief Executive Officer of the company.

### 7) Compliance

The company has to obtain a certificate from either the auditors or practicing company secretaries regarding compliance of conditions of corporate governance and is to be sent to the shareholders along with the director's report. The certificate would also be sent to the Stock Exchanges along with the annual report filed by the company.



Figure 9.11 Compliance

### 9.2.3. Importance of Corporate Governance

Corporate governance is very important concept and has many benefits for the company as well as the economy. It strengthens the unitary board system, significantly, increase its effectiveness and ultimately serve the objective of maximising shareholder value. Its importance may be understood from the following diagram:

Figure 9.4 Importance of Corporate Governance

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### These are explained below:

- Good corporate governance helps in building long-term trust between the management of companies (Board of directors) and the other stakeholders i.e., the small shareholders and creditors. The corporate governance provisions of disclosure of information, postal ballot etc. inspire confidence in these parties which are otherwise ill organized and do not have much say in the decision making of the organization. **Building Trust –**
- **Attracting global investment:** In the current era of globalisation, a company not only looks forward to raising capital at home but also tapping the foreign capital. The foreign institutional investors closely examine the corporate governance practices and the quality of boards before taking investment decisions. Also, where an Indian company wishes to get listed on an international stock exchange, good corporate practices and the credentials of independent directors are important factors for success.
- **Development of Financial Markets –** In the modern times an economy is as strong as its financial markets. Good corporate governance is vital to the sustenance of vitality in the capital markets as it is an important mode of protecting the interests of the investors. Practices of timely disclosure of sensitive information and proper financial reporting are a must to inspire investor confidence and for the development of strong financial markets.
- **Better decision making and performance –** Corporate governance practices like having competent independent directors in the board improves the quality of decision making because these directors bring a wealth of experience new ideas and creativity with them. This improves the overall performance of the firm.
- **Good Public Image –** Following corporate governance practices helps in improving the overall reputation of the company. The company is seen to be socially responsible, fair in its dealings, transparent and reliable which further have a positive impact on investor confidence and company's share price as well as the cost of raising capital.

# Emerging issues in Company Law

Strong corporate governance is indispensable to vibrant capital markets and is an important instrument of investor protection. Good corporate governance not only benefits the companies but also enhances overall market confidence, efficiency of international capital allocation, the renewal of countries' industrial bases, and ultimately the nations' overall wealth and welfare. The above points illustrate that the importance of good corporate governance cannot be undermined. Although, a number of steps have been taken to improve corporate governance, yet, the recent scandal of 'Satyam' leaves a lot to be desired. The government needs to strengthen the efforts and amendments must be made in various laws to ensure that companies follow ethical conduct and the stakeholder rights are protected.

## 9.3. Depositories Act, 1996

In the last two decades many developments have been made in Indian capital market. The market has grown manifold in terms of the number of listed companies, volumes traded, market intermediaries, investors etc. However, this increase in size has given rise to lots of problems. Traditionally (before the depository system), the transactions involved the buying and selling of paper based securities. The trading and settlement required handling of huge volumes of paper work.

The market was further plagued with the problems of stolen shares, fake signatures, duplication and mutilation of shares, loss of securities in transfer etc. Most of these problems arose from the physical form in which the securities had to be traded. To overcome these problems, Depositories Act was passed in August 1996. With this act the capital market switched over from the paper based system to an automated, technology based 'Depository System' which allowed an online screen-based trading system.

### 9.3.1. Meaning

#### What is a Depository?

Depository system is the system in which the ownership and transfer of securities takes place electronically through book entries. Since depository system leads to elimination of securities in paper form, it is also called as 'scrip - less system' of trading. The depository system lead to the creation of a new category of market intermediaries called as the 'Depositories'. According to Depositories Act, 1996, 'depository' means "a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992." A depository is a company which provides for holding and transacting securities in electronic form. A depository offers settlement of transactions in an efficient and effective way. In India there are 2 depositories registered with SEBI, namely, National Securities Depository Limited (NSDL) and Central Depository Service (India) Limited (CDSL).

A depository carries out its activities through service providers like Depository Participants (DPs), Issuing companies and their Registrars and Share Transfer Agents, Clearing corporations/ Clearing Houses of Stock Exchanges. These entities need to get integrated into depository system to be able to provide various services to the investors and Clearing Members.

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### **National Securities Depository Limited (NSDL)**

NSDL is a public limited company incorporated under the Companies Act, 1956 in 1996. Unit Trust of India (UTI), Industrial Development Bank of India (IDBI), National Stock Exchange of India (NSE), and State Bank of India (SBI) are the participants in NSDL. NSDL interfaces with the investors through players or business partners. Depository is linked with brokers, registrar and transfer agents, company or issuer, stock exchange, bank depository participant and investors for the settlement of trades.



**Figure 9.12 NSDL**

### **Central Depository Service (India) Limited (CDSL)**

With the increase in the volume of online trading, another depository, CDSL, was formed in 1999. Major participant in CDSL are LIC, GIC and BSE. Main functions of CDSL are centralized database and accounting. CDSL and NSDL have an inter-depository connectivity. Thus, both these agencies are linked with each other.



**Figure 9.13 CDSL**

### **Who/ What is Depository Participant?**

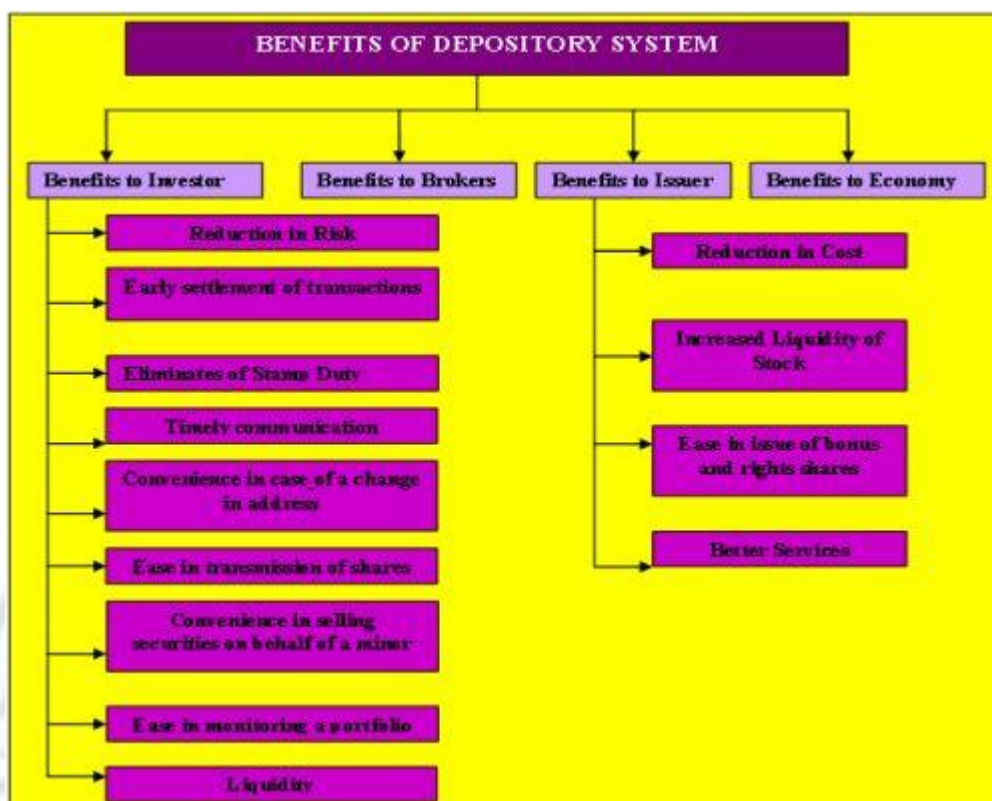
To avail the services of a depository, the investor must open an account with a Depository Participant. "Depository Participant" is an agent of the depository who is authorised to offer depository services to investors. Any financial institution, bank, or broker who fulfils the conditions laid down by SEBI can be registered as Depository Participant. A Depository Participant becomes operational only after it is registered by SEBI, which is based on the recommendation from the depository as well as SEBI's independent assessment. A depository participant acts as an intermediary, linking the company issuing the securities and the investors on behalf of the depository. The investor who wishes to transact in securities online opens an electronic demat account with a depository participant. Depository Participant handles the investor's accounts and periodically keeps him aware of the account status. A depository participant performs various functions. These include converting the physical securities into electronic form and vice versa. It also maintains an account of security transactions entered into by the investor. Some of the entities registered as depository participants are ABN Amro Bank, DSP Merrill Lynch Ltd., ICICI Bank, IDBI Bank, Sharekhan Limited etc.

### **9.3.2. Benefits of Depository**

The traditional system based on transfer of physical securities involved huge volumes of paper work. The transactions also resulted in problems of loss or theft of share certificates, duplication and mutilation of shares etc. The depository system overcomes these limitations and has a number of advantages over the paper based system. These benefits are shown in the figure below:

Figure 9.6 Benefits of Depository System

# Emerging issues in Company Law



## Benefits to the Investor

**Reduction in Risk:** The depository system reduces risks associated with holding the share certificates in physical form. Since the shares are held in scrip – less form, it minimizes the chances of loss, theft, mutilation etc. It also helps avoid bad delivery problem thereby reducing the risks for the investors.



**Figure 9.14 Benefits to the Investor**

**Early settlement of transactions:** The online trading has reduced the time of settlement of transactions as well as registration of shares which is beneficial for the investors. It also facilitates a faster payment on sale of shares.

**Elimination of Stamp Duty:** No stamp duty is to be paid by the investors on transfer of shares electronic ally.

**Timely communication:** Depository system enables faster communication with the investors. The investors are periodically provided with the status of their accounts to keep them updated.

**Convenience in case of a change in address:** In case of change of address, investor does not have to intimate each company or registrar. He is only required to inform his depository participant and the necessary changes would be made in the database of all the companies where the investor is a shareholder.

**Ease in transmission of shares:** In case of depository system, the process of transmission is fairly easy because the formalities for all securities can be completed by submitting the relevant documents to the depository participant. There is no need for the legal heir or nominee to correspond separately with each company in which shares are held.

**Convenience in selling securities on behalf of a minor:** The natural guardian of a minor

## Emerging issues in Company Law

can sell the securities on behalf of a minor without seeking the court's permission in the new system.

**Ease in monitoring a portfolio:** The investor under this system is able to receive a consolidated position of all his investments from time to time which makes portfolio monitoring and management easy.

**Liquidity:** It provides more acceptability and liquidity of securities.

### **Benefit to the Issuers of Securities**

**Reduction in Cost:** Since the shares are to be made available in electronic form, the printing and distribution costs are reduced. Thus, the company's cost of raising capital is reduced.

**Increased Liquidity of Stock:** The electronic nature of transactions has made the trade settlement cycle shorter. The investors can transfer the securities without much delay and procedural hassles. This has increased the turnover of stock. The improved liquidity makes the stock more attractive for the investors and facilitates the company to raise fund.

**Ease in issue of bonus and rights shares:** In the depository system the company can easily make bonus and rights issue. These are directly credited to the accounts of the shareholders electronically.

**Better Services:** It provides better facilities for timely communication and status reports to the investors leading to better measure of control for the company.

### **Benefit to Brokers**

**Dealing in scrip** – less securities reduces the back office cost of handling paper for the brokers. This increases their profitability. The brokers may further pass on the benefit of reduced costs to investors making the system more profitable for all parties concerned.

India has adopted the depository system of stock trading in which the securities are held in electronic form. Such securities are called as dematerialized or demat securities. Demat securities do not exist in physical form as paper certificates but only as electronic book entries with the depositories. Since the demat securities have no physical form they are fungible i.e. they do not possess any distinguishing features like certificate number. Thus, once a security is dematerialized it loses its individual identity. Such demat securities can even be traded in odd lots as each share is considered marketable lot.



**Figure 9.16 Demat Account**

According to the Depositories Act, 1996, an investor has the option to hold securities either in physical or electronic form. But as per SEBI notifications, the settlement of transactions in listed securities must be done only in the demat form. Further, under Section 68 B of the Companies Act, 1956 every Initial Public Offer of more than Rs. 10 crores brought out by a listed company must be made in dematerialized form.

### **Procedure for Dematerialization**

An investor can apply for dematerialization of all kind of equity and debt instruments including listed as well as unlisted equity shares, preference shares, bonds, debentures, commercial papers, certificates of deposit, government securities, etc. For getting the physical securities dematerialized, the investor should have a demat account with a depository participant. Further, only those securities which are registered in the name of the account holders can be dematerialized by him / her. The procedure for dematerialization is given below:

- A person who wishes to have his / her shares dematerialized must first choose a depository participant. The decision would be based on factors like reputation of the depository participant, services offered and fees charged by the depositories. **Selecting**

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## a Depository participant:

- The depository participant then surrenders the shares to the Company (through the Depository) along with the request for dematerialization. After verification of the documents, the Company, would cancel the physical shares and intimate the depository participant (through the depository) of the demat. The name of the shareholder is removed from the register of members and the depository's name is added instead.**Cancellation of Shares:**
- **Credit to the demat account:** On getting confirmation about the dematerialization, the depository participant would credit the investor's demat account with the number of shares dematerialized. The shares will be held in the dematerialized form thereafter by the depository participant on behalf of the investor. The shareholder is now the 'Beneficial Owner'<sup>9</sup> of the shares.

### Illustration :

Vipul has 1000 shares of Komal Ltd. He wishes to have these shares dematerialized. He approaches ICICI bank (depository participant with CDSL) with his voter's ID and photographs. He fills an account opening form and signs a 'Participant-Client Agreement' with ICICI Bank. The bank opens his demat account with CDSL. The bank assigns him a client ID number. Then Vipul submits a Dematerialization Request Form and surrenders his share certificates to ICICI bank. ICICI Bank sends the shares along with a request for dematerialization to Komal Ltd through CDSL. Komal Ltd verifies the certificates received and cancels the physical shares. It informs CDSL about the demat. CDSL, in turn, intimates ICICI Bank. After receiving this confirmation ICICI credits Vipul's demat account with 1000 shares of Komal Ltd. Vipul can now transact in these shares electronically.

### Trading and Settlement in Demat Shares

A person who has demat account can buy or sell the securities electronically. The transactions are carried out through a broker. The depository participant only facilitates the delivery or receipt of securities in case of a transaction.



**Figure 9.18 Buying & Selling Online**

When the securities are sold in demat form, the shareholder on receiving the confirmation of execution of trade from his / her broker, issues the 'delivery instruction slip' to his / her depository participant. The delivery instruction slip contains details of the transaction including the name of the company whose securities were sold, nature of the security, the date of transaction and the number of shares sold. On receiving the delivery instruction slip, the depository participant debits the beneficial owner's account with the concerned securities. The account of the depository will be debited by the same. Usually, the seller is also required to pay transaction charges to the depository participant.

Similarly, the buyer of the shares also intimates the depository participant on being informed by the broker. The instructions can be one-time standing instruction for receiving securities in his/her account) or may issued from time to time. In the later case, a separate 'receipt instruction slip' is issued to the depository participant whenever the purchase is made. The depository participant on receiving the slip credits the demat account of the beneficial owner with the purchased securities.

### Illustration :

Sumit has 1000 shares of Kapas Ltd. in his demat account with NSDL. He sells these shares to

## Emerging issues in Company Law

Vanisha who also has a demat account with NSDL. On selling shares, Sumit submits a 'delivery instruction slip' to ICICI bank (his depository participant) along with the transaction fee charged by the bank. ICICI Bank debits Sumits demat account with the amount of shares and credits the account of NSDL with the same. At the same time Vanisha submits a 'receipt instruction slip' to IDBI Bank (her depository participant). After the payment is made by Vanisha in respect of the shares, her account is credited with 1000 shares of Kapas Ltd and NSDL's account is debited.

### Re-materialization of Shares

Rematerialisation is the reverse of dematerialization process. It is the process by which a security holder can get his demat securities converted back into the physical paper form. For rematerializing the securities the person is required to fill up a 'remat request form' and submit it to the depository with whom he has demat account. The request is processed and the investor receives certificates for the shares held by him. These new certificates may not bear the same folio or distinctive numbers as when they were not dematerialized. The process of rematerialisation takes 30 days.

To conclude, it can be said the Indian capital market has shown tremendous growth. To counter the problems and complexities associated with growing volume of transactions, clearing and settlement Indian capital market adopted the new Depository system. This system provides for speedy transactions, improves liquidity and reduces the risks associated with paper based transactions. By doing so it has boosted investor confidence and also brought efficiency in the capital market. It has benefited all the market participants. In future, continuous review and improvement in the systems can be instrumental in the qualitative development of the capital markets and hence the economy.

## Summary

**Producer Company – Why and how?**



# Emerging issues in Company Law

## Why was it formed?

- For developing rural sector and encouragement of agriculture and cottage industries.
- To counter the problems cooperative societies face such as paucity and misuse of funds, lack of expertise and inefficient operations.

## How were they conceptualized?

- Through Alagh committee recommendations which were incorporated in Companies (Amendment) Act, 2002 by adding a new Part IX A to the act.

## Formation of Producer Company - Section 581C of the Companies Act, 1956

- Any 10 or more individual producers, Or
- 2 or more producer institutions, Or
- a combination of 10 or more individuals and producer institutions which have objects as specified in section 581B may form a producer company

## Objects of a Producer Company - Section 581B of the Companies Act, 1956

- Production, harvesting, procurement, grading, pooling, handling, marketing, selling, export of 'primary produce' of the Members or import of goods or services for their benefit.
- Processing including preserving, drying, distilling, brewing, vinting, canning and packaging of produce of its Members
- Manufacture, sale or supply of machinery, equipment or consumables mainly to its Members
- Providing education to its Members and others;
- Rendering technical and consultancy services, training, research and development and all other activities for the promotion of the interests of its Members
- Generation, transmission and distribution of power, revitalisation of land and water resources, their use, conservation and communications relating to primary produce,
- Insurance of producers or their primary produce,
- Promoting techniques of mutuality and mutual assistance,
- Welfare measures or facilities for the benefit of Members,
- Any other activity, ancillary or incidental to any of the activities referred above.
- Financing of procurement, processing, marketing or other activities mentioned above which include extending of credit facilities to its Members.

## Benefits to Members - Section 581E of the Companies Act, 1956

- Receive some value for the produce pooled.
- Receive limited return on the share capital.
- Distribution of Surplus.

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## **Voting rights of Members - Section 581D of the Companies Act, 1956,**

**Where all the members are individuals** - each member has a single vote.  
**Where all members are institutions** - the voting rights are determined on the basis of participation in the business of the Producer Company in the previous year.

**Where the both individuals and Producer institutions are members** - each member has a single vote.

## **Management of Producer Company**

Minimum number of directors - 5 directors

Maximum number of directors -15 directors

## **Corporate Governance -Definition**

"Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way a corporation (or company) is directed, administered or controlled."

[http://en.wikipedia.org/wiki/Corporate\\_governance](http://en.wikipedia.org/wiki/Corporate_governance)

## **Aspects of Corporate Governance**

- Running a company in a responsible manner
- Treat all the stakeholders fairly-
- Principles of transparency and accountability

## **SEBI Code of Corporate Governance – Clause 49**

1. Board of Directors
2. Audit Committee
3. Subsidiary Companies
4. Disclosures
5. CEO/CFO certification
6. Report on Corporate Governance
7. Compliance

## **Who has to comply with Clause 49?**

- Entities which wish to be listed on the stock exchange applying for the first time.
- Any existing listed entity.

## **Importance of Corporate Governance**

- Building Trust
- Attracting global investment
- Development of Financial Markets
- Better decision making and performance

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- Good Public Image

## What is a Depository?

- According to Depositories Act, 1996, 'depository' means "a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (1A) of section 12 of the Securities and Exchange Board of India Act, 1992."
- In India there are 2 depositories registered with SEBI, namely, National Securities Depository Limited (NSDL) and Central Depository Service (India) Limited (CDSL).

## Who/ What is Depository Participant?

- "Depository Participant" is an agent of the depository who is authorised to offer depository services to investors.
- Any financial institution, bank, or broker who fulfils the conditions laid down by SEBI can be registered as Depository Participant.

## Benefits of a Depository System

### Benefits to the Investor

- Reduction in Risk
- Early settlement of transactions
- Elimination of Stamp Duty
- Timely communication
- Convenience in case of a change in address
- Ease in transmission of shares
- Convenience in selling securities on behalf of a minor
- Ease in monitoring a portfolio
- Liquidity

### Benefit to the Issuers of Securities

- Reduction in Cost
- Increased Liquidity of Stock
- Ease in issue of bonus and rights shares
- Better Services

### Benefit to Brokers

### Benefit to the Economy.

### Demat Shares

These are the securities which are held in electronic form.

### Procedure for Dematerialization

## Emerging issues in Company Law

- Selecting a Depository participant
- Opening a Demat Account
- Dematerialization Request Form
- Surrender of shares
- Cancellation of Shares
- Credit to the demat account

### Re-materialization of Shares

- It is the process by which a security holder can get his demat securities converted back into the physical paper form.

