

RULES ON CORPORATE GOVERNANCE FOR LISTED COMPANIES

The Institute of Chartered Accountants of Sri Lanka (ICASL) and the Securities and Exchange Commission of Sri Lanka (SEC) in consultation with the Colombo Stock Exchange have spearheaded a joint initiative with a view to formulating standards on corporate governance for mandatory compliance by companies listed on the Colombo Stock Exchange. These standards are to be incorporated into the Listing Rules of the Colombo Stock Exchange.

The draft standards were formulated by a select committee, which took account of Corporate Governance standards in several jurisdictions including the United Kingdom and New York.

It was agreed by this committee that while a minimal approach should be followed in the first instance that the draft standards should reflect an inclusion of principal requirements for sound corporate governance and survive scrutiny as a balanced but minimal code.

The standards have been drafted in a descriptive manner in order to facilitate better understanding of the provisions which are to be mandated and to enable enforcement of same. These standards relate to the minimum number of non-executive and independent directors, the bases for determining 'independence', disclosures required to be made by listed companies in respect of its directorate, the minimal requirements to be met by listed companies in respect of the audit committee and the remuneration committee.

In the event of a breach of the Listing Rules, as a first step, it is envisaged that there would be publication of the fact of breach together with the names of the companies which are in violation and the names of directors of such companies. The companies which continue to act in violation of the listing rules may be transferred to the default board and could be subject to a de-listing.

The ICASL in conjunction with the publication of these rules will be publishing a comprehensive set of guidelines for good corporate governance which may be followed by companies on a voluntary basis. It is envisaged that the mandatory rules are to be introduced in the first quarter of 2007.

It is believed that mandatory compliance with the Rules on Corporate Governance will uplift the standards of governance in listed companies.

Public comment is invited to reach the SEC by **23rd July 2006**.

PROPOSED RULES AND COMMENTARY:

The proposed rules are stated below along with the committee's views which are stated in italics.

Corporate Governance Code / Listing Rules

Every company listed on a Stock Exchange and every company which makes an application for listing, whether or not such listing has taken place or such application for listing has been made prior to the coming into force of the listing requirements of that Stock Exchange, is required to comply with the following listing requirements, including any amendments, additions and variations that may be made to them from time to time.

1) Non – Executive Directors

- (a) **The board of directors of a listed company shall include at least**
 - two non-executive directors; or**
 - such number of non-executive directors equivalent to one third of the total number of directors**
 - whichever is higher.**
- (b) **The total number of directors is to be calculated based on the number as at the conclusion of the immediately preceding annual general meeting.**
- (c) **Any change occurring to this ratio shall be rectified within 90 days from the date of the change. This time period may be extended in consultation with the CSE.**

It was decided that the board of directors of a listed company should be comprised of both executive and non-executive directors. Taking into consideration companies with only two directors and comments received from listed companies it was decided to mandate that a board should comprise of “two non-executive directors or such number of non-executive directors equivalent to one third of the total number of directors, whichever is higher.” Provision has also been made with respect to calculating this number and the procedure for filling casual vacancies which may occur.

2) Independent directors

- (a) Where the constitution of the board of directors includes only two non-executive directors in terms of clause 1 above, both such non-executive directors shall be ‘independent’. In all other instances the majority of non-executive directors appointed to the board of directors shall be ‘independent’:**
- (b) The board shall require each non-executive director to submit a signed and dated declaration annually of his/her independence or non-independence against the specified criteria set out in specimen form in “.....”.**

In reviewing international practice the role of the independent director takes on great significance. In these rules it has been mandated that the majority of non-executive directors should be independent. This is also a decision taken pursuant to comments received from listed companies and in order that the mandatory requirements do not become too onerous while also not compromising on the requirement for independent directors.

Criteria for assessing independence has been given below. Further in keeping with the disclosure based premise of these rules, provision has been made for the non-executive directors to make a self-declaration as to their independence.

3) Disclosures relating to directors

- (a) The board shall make a determination annually as to the independence or non-independence of each non-executive director based on such declaration and other information available to the board and shall set out in the annual report the names of directors determined to be ‘independent’.**
- (b) In the event a director does not qualify as ‘independent’ against any of the criteria set out in..... below (refer to the relevant Rule No. once finalized) but if the board, taking account of all the circumstances, is of the opinion that the director is nevertheless ‘independent’, the board shall specify the criteria not met and the basis for its determination in the annual report.**

The Committee was of the opinion that there may be instances when a non-executive director may not qualify as “independent” within the strict definitions of the criteria given but may still be able to function as an independent director and to that end it was decided that the board of directors may be given the discretion of deciding that such person continues to function as an independent director. However it was decided that the board be asked to disclose the bases for such decision in order to maintain transparency of decision making. Thus casting a responsibility on the board for such decisions which would be subject to scrutiny by the shareholders.

(c) In addition to disclosures relating to the independence of a director set out above, the board shall publish in its annual report a brief resumé of each director on its board which shall include information on:

- (i) the nature of his/her expertise in relevant functional areas;**
- (ii) the names and addresses of companies in which the director holds directorships.**

(d) Upon appointment of a new director to its board, the company shall forthwith provide to the Exchange a brief resumé of such director for dissemination to the public. Such resumé shall include information on the matters itemized in paragraphs (a), (b) and (c) above.

As a further measure for ensuring compliance with the requirements set out in these rules and in order to ensure relevant disclosure, it was decided to mandate publication of directors' resúmes.

Criteria for defining “Independence”

Subject to Clause 3 (a) and (b), a non-executive director shall not be considered independent if he/she:

The criteria enumerated below from (i) – (viii) has been devised to encompass the following which may impact upon the independence in decision making of a director.

- (i) has been employed by the Listed Company during the period of two years immediately preceding appointment as director;**

A period of two years preceding appointment as a director was decided upon after consideration of international practice in this regard.

- (ii) currently has/had during the period of two years immediately preceding appointment as director, a Material Business Relationship with the Listed Company, whether directly or indirectly;**

This clause endeavours to capture a relationship resulting in a significant monetary gain to the director in his personal capacity. In this instance too a period of two years preceding appointment as a director was decided upon after consideration of international practice in this regard.

- (iii) has a Close Family Member who is a director, Chief Executive Officer (and/or an equivalent position) in the Listed Company;**

(iv) has a Significant Shareholding in the Listed Company;

(v) has served on the board of the Listed Company continuously for a period exceeding nine years from the date of the first appointment;

A period of nine years was decided upon after consideration of international practice in this regard.

(vi) is employed in another company or business,

- a) in which a majority of the other directors of the Listed Company are employed or are directors; or**
- b) in which a majority of the other directors of the Listed Company have a Significant Shareholding or Material Business Relationship; or**
- c) that has a Significant Shareholding in the Listed Company or with which the Listed Company has a Business Connection;**

(vii) Is a director of another company,

- a) in which a majority of the other directors of the Listed Company are employed or are directors; or**
- b) that has a Business Connection in the Listed Company or a Significant Shareholding;**

(viii) Has a Material Business Relationship or a Significant Shareholding in another company or business,

- a) in which a majority of the other directors of the Listed Company are employed or are directors; and/or**
- b) which has a Business Connection with the Listed Company or Significant Shareholding in the same;**

Criteria (vi) – (viii) has been included to capture a situation whereby an independent director of a listed company may have relationships with other directors of the listed company which may impair his/her independence.

For the purposes of this Clause:

- “Close Family Member” shall mean and include the director’s spouse, parents, grandparents, children, brothers, sisters, grandchildren and any person who is financially dependent on such a director.**

Financial Dependent individuals include any person who received more than half of their support for the most recent fiscal year from a director and/or his or her spouse.

In defining “Close Family Member” the committee was of the opinion that having a limited scope would be advisable especially in the introductory phase. However financial dependence was included in order to capture relationships which would otherwise not get caught up.

- **“Listed Company” shall mean the listed company to the board of which the director is appointed, its parent and/or subsidiary company, and a subsidiary of the parent company.**

The definition of a “Listed Company” has been included to address the issue of a group company structure.

- **“Material Business Relationship” shall mean a relationship resulting in income/non-cash benefits equivalent to 10% of the director’s annual income.**

The quantum of 10% of the director’s annual income was decided on after deliberations by the Committee, taking into consideration a percentage which would generally be considered as having a significant impact.

- **“Business Connection” shall mean a relationship resulting in transaction value equivalent to 10% of the turnover of that company or business.**

- **“Significant Shareholding” shall mean a shareholding carrying not less than 10% of the voting rights of a company.**

A percentage of 10% was decided upon taking into consideration the fact that presently any person acquiring 10% of the issued share capital of a listed company is required to make a public disclosure of that fact and that it gives the shareholder significant voting power.

4) Remuneration Committee

A listed company shall have a remuneration committee in conformity with the following:

Composition

The remuneration committee should be comprised by a minimum of two independent non-executive directors (in instances where a company has only two directors on its board); or

exclusively by non-executive directors a majority of whom shall be independent, whichever shall be higher.

In a situation where both the parent company and the subsidiary are ‘listed companies’, the remuneration committee of the parent company may be permitted to function as the remuneration committee of the subsidiary.

However, if the parent company is not a listed company, then the remuneration committee of the parent is not permitted to act as the remuneration committee of the subsidiary (i.e the subsidiary should have a separate remuneration committee).

One non-executive director shall be appointed chairman of the committee by the board of directors.

The Committee decided to mandate that the remuneration committee be comprised of a minimum of two independent non-executive directors (in instances where a company has only two directors on its board) or exclusively by non-executive directors a majority of whom shall be independent, whichever shall be higher.

Taking into consideration a request made by group companies and in a bid to facilitate commercial activity such as the need for a single remuneration policy within a group structure, the committee agreed to permit the remuneration committee of the parent company to act as the remuneration committee of a subsidiary with the proviso that the parent should be a listed company if this is to be possible. This decision was taken on the basis that the parent company would be subject to public scrutiny and have to make disclosures.

Functions

The Remuneration Committee shall recommend the remuneration payable to the executive directors and Chief Executive Officer of the listed company and/or equivalent position thereof, to the board of the listed company which will make the final determination upon consideration of such recommendations.

It was decided that the mandate of the remuneration committee should be limited to the remuneration payable to executive directors and chief executive officer or equivalent positions. It was felt their mandate should not be extended to other positions at this point in time.

Disclosure

The annual report should set out the names of directors (or persons in the parent company’s committee in the case of a group company) comprising the remuneration committee, contain a statement of the remuneration policy and set out the aggregate remuneration paid to executive and non-executive directors.

It was the committee’s view that it would be more prudent to state the aggregate remuneration paid to executive and non-executive directors rather than the separate aggregate totals taking into consideration the social culture of the country.

The Term “remuneration” shall make reference to cash and all non-cash benefits whatsoever received in consideration of employment with the listed company.

(excluding statutory entitlements such as Employees Provident Fund and Employees Trust Fund)

5) Audit Committee

A listed company shall have an audit committee in conformity with the following:

Composition

The audit committee should be comprised of a minimum of two independent non-executive directors (in instances where a company has only two directors on its board); or

exclusively by non-executive directors a majority of whom shall be independent whichever shall be higher.

In a situation where both the parent company and the subsidiary are ‘listed companies’, the audit committee of the parent company may function as the audit committee of the subsidiary.

However, if the parent company is not a listed company, then the audit committee of the parent is not permitted to act as the audit committee of the subsidiary (i.e the subsidiary should have a separate audit committee).

The Committee decided to mandate that the audit committee be comprised of a minimum of two independent non-executive directors (in instances where a company has only two directors on its board) or exclusively by non-executive directors a majority of whom shall be independent, whichever shall be higher.

Taking into consideration a request made by group companies based on existing practice and in a bid to facilitate commercial activity such as the need for a single policy on internal controls within a group structure, a clause has been included for the audit committee of the parent company to act as the audit committee of a subsidiary with the proviso that the parent should be a listed company if this is to be possible. This decision was taken on the basis that the parent company would be subject to public scrutiny and have to make disclosures.

One non-executive director shall be appointed chairman of the committee by the board of directors.

Unless otherwise determined by the audit committee the chief executive officer and the chief financial officer of the listed company shall attend audit committee meetings.

The chairman or one member of the committee should be a Member of a recognised professional accounting body.

It was decided that at least one member should have the requisite financial acumen to carry out the functions of this committee and to advise the other members of the committee. It was stated that this person should be a Member of a recognised professional accounting body due to the difficulty in quantifying “financial acumen”.

Functions

Shall include

- **Oversight of the preparation, presentation and adequacy of disclosures in the financial statements of a listed company, in accordance with Sri Lanka Accounting Standards.**
- **Oversight of the Company’s compliance with financial reporting requirements, information requirements of the Companies Act and other relevant financial reporting related regulations and requirements.**
- **Oversight over the processes to ensure that the Company’s internal controls and risk management, are adequate, to meet the requirements of the Sri Lanka Auditing Standards.**
- **Assessment of the independence and performance of the Company’s external auditors.**
- **To make recommendations to the board pertaining to appointment, re-appointment and removal of external auditors and to approve the remuneration and terms of engagement of the external auditors.**

Disclosures

The names of the directors (or persons in the parent company’s committee in the case of a group company) comprising the audit committee should be disclosed in the annual report.

The committee shall make a determination of the independence of the auditors and shall disclose the basis for such determination in the annual report.

The annual report shall contain a report by the audit committee, setting out the manner of compliance by the Company in relation to the above, during the period to which the annual report relates.

DECLARATION

I,full name ofplace of residence

being a Christian make oath and say .../

not being a Christian solemnly, sincerely and truly affirm and declare as follows
in terms of rule of the Listing Rules:

a. I am a non-executive director of(Company) being so
appointed on

b. I have been / have not been employed by the Listed Company*, during the
period of two years immediately preceding my appointment as director of the
Company.

c. I currently have / do not have a Material Business Relationship with the Listed
Company, directly or indirectly.

d. I had / did not have during the period of two years immediately preceding
appointment as director, a Material Business Relationship with the Listed
Company, directly or indirectly.

e. I have / do not have a Close Family Member(s) who is a director or chief
executive officer (or equivalent position) in the Listed Company;

f. I have / do not have a Significant Shareholding in a Listed Company;

g. I have / have not served on the board of the Listed Company for a period
exceeding nine years from the date of the first appointment;

h. I am / am not employed in another company or business,

(i) in which a majority of the other directors of the Listed Company are
employed or are directors; or

(ii) in which a majority of the other directors of the Listed Company have
a Significant Shareholding or Material Business Relationship; or

(iii) that has a Significant Shareholding in the Listed Company or with
which the Listed Company has a Business Connection;

- i. I am / am not a director of another company,
 - (i) in which a majority of the other directors of the Listed Company are employed or are directors; or
 - (ii) that has a Business Connection in the Listed Company or a Significant Shareholding;
- j. I have / do not have a Material Business Relationship or a Significant Shareholding in another company or business,
 - (i) in which a majority of the other directors of the Listed Company are employed or are directors; and/or
 - (ii) which has a Business Connection with the Listed Company or Significant Shareholding in the same;
- k. Disclosure of such other information which the applicant believes could reasonably be construed to have a bearing on the independence of such director.

*** Listed Company as referred to in this clause shall be the listed company to the board of which the director is appointed and would include any parent or subsidiary company of the Listed Company and any subsidiary of the parent company.**

Sworn/ affirmed by ...(name of deponent)

on this day of.....

at ...(place of attestation.....)

Before me
Justice of the Peace/
Commissioner for Oath