

White Paper on
**GOOD GOVERNANCE
BUSINESS ETHICS
AND
SME STOCK EXCHANGE**

Released by

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Chairman, Securities & Exchange Board of India

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**SMALL & MEDIUM BUSINESS
DEVELOPMENT CHAMBER OF INDIA**


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Release of White Paper



Mr. C.B. Bhave - Chairman, Securities & Exchange Board of India (SEBI) releasing the White Paper on "Good Governance & Business Ethics and SME Stock Exchange" at 15th Foundation Day Function of Small & Medium Business Development Chamber of India (SME Chamber of India) on 9th July 2010 at Mumbai.

(From left to right) **Mr. Bhairav B. Kothari** - Managing Director, Super CFO Services Pvt. Ltd., **Mr. Hemant Shah** - Chairman & Managing Director, Ackruti City Ltd., **Mr. Chandrakant Salunkhe** - President, SME Chamber of India and Maharashtra Industrial and Economic Development Association (MIEDA), **Mr. Joseph Massey** - MD & CEO, MCX Stock Exchange Ltd., **Mr. A. Rameshkumar** - Chairman, Northern Region, SME Chamber of India and **Mr. Madhu Kannan** - MD & CEO, Bombay Stock Exchange Ltd.



Small & Medium Business Development Chamber of India is working for the development of SMEs for many years. The Chamber provides a platform for networking and contact building as well as create awareness about various business opportunities and facilities.

SME Chamber of India has developed key strategies to promote and support the MSME sector. The Chamber also regularly organises Seminars, Conferences, Workshops, Training Programs, Delegations, Study Visits and other trade promotional activities to educate & create awareness amongst the SMEs.

Objectives

- Capacity Building
- Motivation
- Market & Skill Development
- Connectivity and Networking
- Quality Improvement
- Industrial Development
- Technology Development
- Training Programs & Education

Assistance & Support Services for SMEs

- Promotion of Domestic Trade and Export
- Acquire latest technology
- Technology Transfer and Joint Ventures
- Contract manufacturing tie-ups and collaborations
- Source & import quality products, machinery and equipments
- Marketing strategy & investment opportunities
- Business Matchmaking and Buyer-Seller Meet
- Guidance to obtain bank & project finance and credit rating
- Guidance for upgrading skills & knowledge of entrepreneurs
- Quality assurance and packaging improvements to meet global standards
- Market Survey and Research on various products & services and Projects
- Preparation of project reports & financial and commercial documents
- Set up new manufacturing units in India and abroad
- Revival of sick units
- Design, Development and Launch of products
- Indian products and services permanent display centre in various countries
- Liaise with Government Departments & Agencies, Overseas Organisations
- Arrange study tours & visits to factories / industrial plants / trade fairs / exhibitions in India and abroad
- Arrange business / trade delegations and missions
- Assistance to represent and participate in exhibitions, trade fairs, seminars and conferences

Our Initiatives

- SME Export Promotion Council of India
- SME Training Institute of India
- Indian SME Knowledge Forum
- Indian Young Entrepreneurs Forum
- SME Consultancy & Research Institute
- SME Technology Development Council
- CFO and Financial Advisory Council for SMEs
- Indian SME Digest - A Monthly Publication
- SME Grievance Forum
- SME Business Club
- Indian Products & Services Permanent Display Center

SuperCFO is India's leading Virtual CFO Services provider. Increasingly, Start-ups and SMEs are recognising the need to access professional CFO services and it is this space that SuperCFO focuses on. It engages with its client companies as a Strategic Partner, ensuring quality CFO services, on a continuous ongoing basis and at a frequency as desired by them. Thus, depending on the need, size and the growth stage of the client company, it lets the company design a flexible engagement model.

SuperCFO has worked with a diverse portfolio of clients, across different industries like Retail, Staffing, Renewable Energy, Guarding, Media & Entertainment, Facilities Management, Analytics and BPO, among others. Having engaged with some of the most exciting start up ventures and innovative projects being developed by growth stage companies, the team has handled projects ranging from Strategic Planning, Costs & CashFlow Management, Setting up of Systems & Processes, Corporate Governance, Fund Raising, Transaction Support in terms of M&A deals, IPO support and Operational Support. The strengths lie in complementing the companies' existing Finance & Accounting team and working towards building core competencies within the team.

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Preamble

A Practical Guide to SMEs (Small & Medium Enterprises)

The purpose of this document is to create awareness and share practical insights about Corporate Governance as well as benefits to SMEs by becoming a Public Company.

SEBI has already announced rules for setting up SME Stock Exchange on the lines of similar exchanges in certain other countries. In this guide we have provided a glimpse of various benefits to SMEs by listing on the SME Stock Exchange. We have also included certain framework guidelines and related industry information.

“Good governance practices enhance companies' value and stakeholders' trust resulting into robust development of capital market, the economy and also help in the evolution of a vibrant and constructive shareholders' activism.” These were the opening remarks in the Preamble to The Corporate Governance Voluntary Guidelines 2009.

While IPO sounds exciting and is perhaps every entrepreneur's dream; the biggest concern with SMEs raising Public Funds is Corporate Governance. But with some effort and discipline, an SME could easily overcome that barrier with high standards of Corporate Governance which would make the SME a definite winner in the eyes of the Investors as well as in the Corporate World.

Should you have any feedback/suggestions, please write to us at

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Disclaimer:

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Board of Directors

Appointment

A well governed company entrusts its Nomination Committee to evaluate, search and recommend appointment of all its Directors, whether Executive or Non-Executive.

In case of appointment of Non-Executive Directors (NEDs), Companies should issue formal letters of appointment, as is done by them while appointing employees and Executive Directors.

The letter should specify:

- The term of the appointment;
- The expectation of the Board from the appointed director;
- The Board-level committee(s) in which the director is expected to serve and its tasks;
- The fiduciary duties that come with such an appointment along with accompanying liabilities;
- Provision for Directors and Officers (D&O) insurance, if any,;
- The Code of Business Ethics that the company expects its directors and employees to follow;
- The list of actions that a director should not do while functioning as such in the company; and
- The remuneration, including sitting fees and stock options etc, if any.

Upon appointment, the company should undertake a comprehensive induction program introducing and familiarizing the New Director to the Company's business, strategy, financials, regulatory constraints, pending litigations, management team and key advisors.

Chairman of the Board

Leadership:

The Chairman of the Board plays the most important role of lending leadership and implementing best practices in Corporate Governance. All Board Meetings, as well as all key decisions in the Company are driven by its Chairman.

Chairman's duties; more than just presiding the Board Meeting:

- The Chairman interacts with all key shareholders regularly and conveys their views/thoughts to the Board.
- The Chairman regularly evaluates Internal Controls and Corporate Governance matters.
- The Chairman creates an environment for healthy discussions in Board Meetings and ensures that Board Agenda along with related documents are circulated to all Directors well in time.
- The Chairman holds meetings with all Non-Executive Directors at regular intervals to discuss strategic matters independently.

Separation of the Chairman & the CEO roles:

To prevent unfettered decision making power with a single individual, there should be a clear demarcation of the roles and responsibilities of the Chairman of the Board and that of the Managing Director/Chief Executive Officer (CEO). The roles and offices of Chairman and CEO should be separated, as far as possible, to promote balance of power.

Independent Directors

Attributes for Independent Directors:

- i: Integrity, experience, expertise, foresight, managerial qualities and ability to read and understand financial statements.
- ii: All Independent Directors should provide a detailed Certificate of Independence at the time of their appointment, and thereafter annually.

Tenure for Independent Director

- i: An Individual may not remain as an Independent Director in a company for more than six years.
- ii: A period of three years should elapse before such an individual is inducted in the same company in any capacity.
- iii: No individual may be allowed to have more than three tenures as Independent Director in the manner suggested in 'i' and 'ii' above.
- iv: The maximum number of public companies in which an individual may serve as an Independent Director should be restricted to seven.

Independent Directors to have the Option and Freedom to meet Company Management periodically:

- i: In order to enable Independent Directors to perform their functions effectively, they should have the option and freedom to interact with the company management periodically.
- ii: Independent Directors should be provided with adequate independent office space and other resources and support by the companies including the power to have access to additional information to enable them to study and analyze various information and data provided by the company management.

Conduct of Board Meetings

- Meeting Agenda should be circulated well in advance along with detailed information that enables the Board Members to study the Agenda Proposals before the meeting.
- Board members may recommend any additional agenda items for inclusion in the Board Meeting.
- Board and Committee Meetings should be held at regular intervals.
- Related Party transactions should be clearly highlighted and arm's length arrangement must be demonstrated. Moreover, Interested Directors should refrain from voting on related party agenda items.
- Risks associated with various decisions should be clearly explained
- Detailed minutes of the meeting should be drafted & circulated for approval

Board Remuneration

i: Linking Corporate & Individual Performance:

- Provide reasonable and sufficient level remuneration to attract, retain and motivate the directors required for the company.
- Ensure that the relationship of remuneration to performance is made clear.
- Incentive schemes should be designed around appropriate performance benchmarks, which should be disclosed to the members annually.
- Remuneration packages should involve a balance between fixed and incentive pay.
- The performance-related elements of remuneration should form a significant proportion of the total remuneration package of the Executive Directors and should be designed such that it is aligned with shareholders interests.

ii: Remuneration of Non-Executive Directors (NEDs)

- The company should pay a fixed remuneration to its NEDs, subject to an appropriate ceiling depending on the size of the company; OR an appropriate percent of the net profits.
- The remuneration structure should be uniform for all NEDs.
- If NEDs are paid a fixed remuneration, then they should not be eligible for any commission on profits.
- If stock options are granted as a form of payment to NEDs, then these should be held by the concerned director until three years of his exit from the Board.

iii: Remuneration of Independent Directors (IDs)

- In order to attract, retain and motivate Independent Directors of quality to contribute to the company, they should be paid adequate sitting fees which may depend upon the twin criteria of Net Worth and Turnover of companies.
- The IDs may not be allowed to be paid stock options or profit based commissions, so that their independence is not compromised. Independent directors should be paid adequate sitting fees to attract, retain and motivate which may depend upon the twin criteria of Net Worth and Turnover of companies.

Board Responsibilities

Training Directors

- It should be ensured that Directors are inducted through a suitable familiarization process covering, inter-alia, their roles, responsibilities and liabilities.
- The Board should have the company undertake a comprehensive induction program introducing and familiarizing the New Director to the Company's business, strategy, financials, regulatory constraints, pending litigations, management team and its key advisors.
- Efforts should be made to ensure that every director has the ability to understand basic financial statements and information and related documents/papers.

Besides this, the Board should also adopt suitable methods to enrich the skills of directors from time to time.

Managing Risks

The Board, its Audit Committee and its executive management should collectively identify the risks impacting the company's business and document their process of risk identification, risk minimization and risk optimization as part of a risk management policy or strategy.

The Board should also affirm and disclose in its report to members that it has put in place critical risk management framework across the company, which is overseen at least once every six months by the Board. The disclosure should also include a statement of those elements of risk, that the Board feels, may threaten the existence of the company

Evaluating Board Effectiveness

The Board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. The Board should state in the Annual Report how performance evaluation of the Board, its committees and its individual directors has been conducted.

The following is an illustrative list of few questions one may consider to evaluate the effectiveness of the Board. The evaluation process should be strictly used constructively, as a mechanism to improve board effectiveness, maximize strengths and tackle weaknesses.

Evaluate Board Effectiveness

How well has the board performed against any performance objectives that have been set?

What has been the board's contribution to the testing and development of strategy?

What has been the board's contribution to ensuring robust and effective risk management?

Is the composition of the board and its committees appropriate, with the right mix of knowledge and skills to maximize performance in the light of future strategy? Are inside and outside the board relationships working effectively?

How has the board responded to any problems or crises that have emerged and could or should these have been foreseen?

Are the matters specifically reserved for the board the right ones?

How well does the board communicate with the management team, company employees and others? How effectively does it use mechanisms such as the AGM and the annual report?

Is the board as a whole up to date with latest developments in the regulatory environment and the market?

How effective are the board's committees? [Specific questions on the performance of each committee should be included such as, for example, their role, their composition and their interaction with the board.]

(Source: The Combined Code on Corporate Governance, 2003, UK)

Ensuring Compliance With Laws

The Board should ensure that the company complies with all applicable laws. It should also ensure that adequate systems and controls are in place to ensure compliances.

Moreover, for every agenda item at the Board meeting, there should be attached an “Impact Analysis on Minority Shareholders” proactively stating if the agenda item has any impact on the rights of minority shareholders. The Independent Directors should discuss such Impact Analysis and offer their comments which should be suitably recorded.

Board Committees

A well governed Board functions efficiently with well appointed Committees. Key Board Committees are:

- **Nomination Committee**
- **Audit Committee**
- **Remuneration (Compensation) Committee**

Nomination Committee

- i: Companies may have a Nomination Committee comprising of majority of Independent Directors, including its Chairman. This Committee should consider:
 - Proposals for searching, evaluating, and recommending appropriate Independent Directors and Non-Executive Directors [NEDs], based on an objective and transparent set of guidelines which should be disclosed and should, inter-alia, include the criteria for determining qualifications, positive attributes, independence of a director and availability of time with him or her to devote to the job;
 - Determining processes for evaluating the skill, knowledge, experience and effectiveness of individual directors as well as the Board as a whole.
- ii: The Nomination Committee should also evaluate and recommend the appointment of Executive Directors.
- iii: With a view to enable the Board to take proper and reasoned decisions, Nomination Committee should ensure that the Board comprises of a balanced combination of Executive Directors and Non-Executive Directors.
- iv: A separate section in the Annual Report should outline the guidelines being followed by the Nomination Committee and the role and work done by it during the year under consideration.

Audit Committee

The Audit Committee should have at least three-members, with majority being Independent Directors & the Chairman of the Committee should be an Independent Director. All the members of the audit committee should have knowledge of financial management, audit and accounts.

The Audit Committee should have the power to -

- have independent back office support and other resources from the company;
- have access to information contained in the records of the company; and
- obtain professional advice from external sources.

The Audit Committee should also have the facility of having separate discussions with both internal and external auditors as well as the management.

The Audit Committee should have the responsibility to -

- monitor the integrity of the financial statements of the company;
- review the company's internal financial controls, internal audit function and risk management systems;
- make recommendations in relation to the appointment, reappointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process

The Audit Committee should also monitor and approve all Related Party Transactions including any modification/amendment in any such transaction.

Remuneration (Compensation) Committee

The Remuneration Committee should comprise of at least three members, majority of which should be Non Executive Directors & at least one Independent Director.

- The Committee should have the responsibility of determining remuneration for all executive directors and the executive chairman.
- The Committee should also determine principles, criteria and the basis of remuneration policy of the company which should be disclosed to the shareholders, with their comments, if any.
- The Committee should also recommend and monitor the level and structure of pay for senior management
- The Committee should make available its terms of reference, its role, the authority delegated to it by the Board, and what it has done for the year under review to the shareholders in the Annual Report.

Auditors

i. Appointment of Auditors

The Audit Committee of the Board should be the first point of reference regarding the appointment of auditors. The committee should have regard to the profile of the audit firm, qualifications and experience of audit partners, strengths and weaknesses, if any, of the audit firm and other related aspects.

To discharge its duty, the Audit Committee should:

- discuss the annual work programme and the depth and detailing of the audit plan to be undertaken by the auditor, with the auditor;
- examine and review the documentation and the certificate for proof of independence of the audit firm, and
- recommend to the Board, with reasons, either the appointment/re-appointment or removal of the statutory auditor, along with the annual audit remuneration.

ii. Certificate of Independence

The company should obtain a certificate from the auditor certifying his/its independence and arm's length relationship with the client company.

The Certificate of Independence should certify that the auditor, together with its consulting and specialized services affiliates, subsidiaries and associated companies or network or group entities has not/have not undertaken any prohibited non-audit assignments for the company and are independent vis-à-vis the client company.

iii. Rotation of Audit Partners and Firms

In order to maintain independence of auditors with a view to look at an issue (financial or non-financial) from a different perspective and to carry out the audit exercise with a fresh outlook, the company may adopt a policy of rotation of auditors which may be as under: -

- Audit partner - to be rotated once every three years
- Audit firm - to be rotated once every five years.

A cooling off period of three years should elapse before a partner can resume the same audit assignment. This period should be five years for the firm.

iv. Need for clarity on information to be sought by the auditor and/or provided by the company to him/it

With a view to ensure proper and accountable audit, there should be clarity between the company management and the auditors on the nature and amount of information/documents/ records etc and the periodicity/frequency for supply/obtaining such information/ documents/ records etc.

In any case the auditor concerned should be under an obligation to certify whether he had obtained all the information he sought from the company or not. In the latter case, he should specifically indicate the effect of such non receipt of information on the financial statements.

Secretarial Audit

Since the Board has the overarching responsibility of ensuring transparent, ethical and responsible governance of the company, it is important that the Board processes and the compliance mechanisms of the company are robust. To ensure this, the companies may get the Secretarial Audit conducted by a competent professional. The Board should give its comments on the Secretarial Audit in its report to the shareholders.

Whistle Blowing

The companies should ensure the institution of a mechanism for employees to report concerns about unethical behavior, actual or suspected fraud, or violation of the company's code of conduct or ethics policy. The companies should also provide for adequate safeguards against victimization of employees who avail of the mechanism, and also allow direct access to the Chairperson of the Audit Committee in exceptional cases.

SME Stock Exchange

Background

The Small and Medium Enterprises (SMEs) play a catalytic role in the development process of most economies as they constitute a major part of the industrial activity in these economies. This is reflected in the form of their increasing number and rising proportion in the overall product manufacturing, employment, technical innovations and promotion of entrepreneurial skills.

The micro, small and medium enterprises contribute significantly to the manufacturing output, employment and exports of the country. It is estimated that in terms of value, the sector accounts for about 45 per cent of the manufacturing output and 40 per cent of the total exports of the country.

The sector is estimated to employ about 66 million persons in over 28 million units throughout the country. Further, this sector has consistently registered a higher growth rate than the rest of the industrial sector. There are over 6000 products ranging from traditional to high-tech items, which are being manufactured by the MSMEs in India. It is well known that the MSME sector provides the maximum opportunities for both self-employment and jobs after agriculture sector.

Though SMEs are included in the priority sector within the economy, they continue to face problems related to finance. As traditional way, banks lend this segment against collateral & security and most of SMEs end up being under financed. Today's concern areas to SMEs are:

- Lack of availability of adequate and timely credit
- High cost of credit & Collateral requirements;
- Limited access to equity capital
- The current means of financing are not adequate as they do not have easy access to funds from Angel Investors, VCs and PE players.
- Most costs of compliance in raising capital under the existing guidelines are fixed. As a result, the costs become burdensome for smaller issues.

Source: Discussion paper on developing a market for SME in India-SEBI Annual Report, 2009-10. Ministry of Micro, Small and Medium Enterprises,)

Global Scenario

Internationally, many countries have provided for a separate exchange / trading platform to facilitate listing of securities of growth companies / new economy companies / small and medium companies e.g Alternative Investment Market (AIM), London, the Growth Enterprises Market (GEM), Hong Kong and MOTHERS, JAPAN. Out of these, the GEM is a separate dedicated stock exchange whereas the AIM and the MOTHERS are trading platforms of their respective main stock exchanges.

AIM provides for ease of entry and less onerous disclosure requirements but appropriate level of regulation for smaller companies. It also provides faster admission process and no pre-vetting by the regulator.

GEM operates on the philosophy of "buyers beware" and "let the market decide" based on a strong disclosure regime. Here the rules and requirements are designed to foster a culture of self compliance by the listed issuers in the discharge of their responsibilities.

In the case of MOTHERS, the emerging companies applying there must have the potential for high growth though there are no specific numerical criteria for determining growth potential. Further, the applicant company is mandated to make a public offering of at least 500 trading units. At the time of listing, it should have at least 2,000 trading units and the market capitalization of its listed shares should be more than 1 Billion Yen. The applicant must also have a continuous business record of not less than 1 year dating back from the day on which it makes listing application.

(Source: Discussion paper on developing a market for SME in India-SEBI)

Benefits of Listing

SME Stock Exchange will immensely benefit SMEs, some of which are explained herein below:

● Access to a wide pool of equity capital

It is very difficult for SMEs to raise clean equity funds. The only option after exhausting friends & family is raising PE/VC funds. However these equity investments come with many terms, conditions and preferential rights. In most situations, these PE/VC investments carry minimum guaranteed return, redemption option and other restrictive provisions on the company & the promoters. With SME Stock Exchange, an SME would be able to raise clean equity capital and focus on business, rather than be concerned about Restrictive Investment Covenants.

● Increased status and credibility

When it comes to new client acquisition or key vendor negotiations or bank funding, a public company always commands better credibility and helps companies to close arrangements at better terms.

● Listing of existing share

How do you know the value of your company? What do you do if you want to sell off a piece of your equity stake? All this could be addressed if your equity shares are listed and freely tradeable.

● Employee Reward/Retention

Equity participation is considered an excellent tool to retain and reward key employees. However, if the company is private there is no exit option for the employees. Moreover, valuation in case of a private company is not visible. But once a company is listed, employees can see their wealth grow and by setting up right incentive structure, companies can retain and reward all its key employees without having to pay cash compensation.

● Currency for acquisition

Pursuing inorganic expansion plans would become easier for SMEs once they are a Public Company. With its shares listed, an SME could offer the same as acquisition consideration, as well as raise additional funds from issue of further shares.

● Enhanced Profile & Visibility

Listing on a Stock Exchange helps companies build their profile and enhance visibility. This in-turn helps companies in acquiring new business and resources.

● Good Interim listing before graduating further

If the aim is to be listed on the main stock exchange eventually, SME Stock Exchange is a very good platform to graduate to the same slowly & steadily. Through this listing experience, an SME and its Senior Management team could setup required infrastructure that would be expected of a large Public Company.

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