

Conflict of Interest



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CONCEPT

A conflict of interest can be described as a situation in which a person has multiple interests, one of which could possibly affect the motivation.

"A conflict of interest is a set of circumstances that creates a risk that professional judgement or actions regarding a primary interest will

be unduly influenced by a secondary interest." *Primary interest* refers to the principal goals of the profession or activity, such as the protection of clients, the health of patients, the integrity of research, and the duties of public office. *Secondary interest* includes not only financial gain but also such motives as the desire for professional advancement and the wish to do favours for family and friends, but conflict of interest rules usually focus on financial relationships because they are relatively more objective, fungible, and quantifiable. The secondary interests are not treated as wrong in themselves, but become objectionable when they are believed to have greater weight than the primary interests.

The conflict in a conflict of interest exists whether or not a particular individual is actually influenced by the secondary interest. It exists if the circumstances are reasonably believed (on the basis of past experience and objective evidence) to create a risk that decisions may be unduly influenced by secondary interests.

The Supreme Court in **Tarak Singh vs. Jyoti Basu, (2005)1 SCC 201** observed that-

"Integrity according to Oxford dictionary is moral uprightness; honesty. It takes in its sweep, probity, innocence, trustfulness, openness, sincerity, blamelessness, immaculacy, rectitude, uprightness, virtuousness, righteousness, goodness, cleanness, decency, honour, reputation, nobility, irreproachability, purity, respectability, genuineness, moral excellence etc. In short it depicts sterling character with firm adherence to a code of moral values."

"There is nothing wrong in a Judge having an ambition to achieve something, but if the ambition to achieve is likely to cause a compromise with his divine judicial duty, better not to pursue it. Because, if a Judge is too ambitious to achieve something materially, he becomes timid. When he becomes timid there will be a tendency to make a compromise between his divine duty and his personal interest. There will be a conflict between interest and duty."

CONFLICT OF INTEREST ARISING IN DIFFERENT AREAS

In case of Companies

In the case of Board of Director a conflict of interest may occur whenever the company is considering entering into a contract with one of its board members, firm/company, association of persons, society, etc. in which a Board of Director is interested in. The affected board member in such a situation has a potential for divided loyalties. To avoid problems, the minutes should show that the board member disclosed the potential conflict, that there was a full discussion about how the proposed deal was in the best interests of the company and that the board member with the conflict abstained from the discussion and vote. The proposed transaction must actually be in the best interest of the company.

A promoter is generally under an obligation to do nothing that would conflict with the interests of those to whom his obligations extend and to do those things that would best serve their interests. The promoter assumes the position of a company's fiduciary when he undertakes to act to organize a projected company. A promoter is legally charged with an affirmative duty to disclose an interest in any transaction with the company. The duty of the disclosure extends to those persons with whom the promoter stands in a fiduciary relationship: that is, co-promoters and the company to be formed. Disclosure to the company to be formed may be made by disclosure to:

- An independent board of directors
- All shareholders or subscribers at the time of the incorporation of the Company
- all the future stakeholders

An example of a promoter's breach of fiduciary responsibilities is if the promoter transferred overvalued property to the company in return for company's stock without disclosing all of the elements of the transaction to all interested parties.

A conflict of interest arises in the company when an employee has competing interests or loyalties that either are, or potentially can be, at odds with each other.. Conflicts of interest are generally forbidden in company codes of conduct and /or Companies internal policies. Example of a situation in which an employee might experience a conflict of interest is an employee starts a company that provides similar services to similar clients as those of his full time employer.

Conflict of Interest arise in the company when the auditor of the company provides a non-audit services to the companies they audit.

LAWS GOVERNING CONFLICT OF INTEREST

COMPANIES ACT 2013

The Companies Act 2013 intends to improve corporate governance by requiring disclosure of nature of concern or interest of every director, manager, any other key managerial personnel and relatives of such a director, manager or any other key managerial personnel.

The 2013 Act for the first time defines 'insider trading and price-sensitive information and prohibits any person including the director or key managerial person from entering into insider trading [section 195 of 2013 Act].

Further, the Act also prohibits directors and key managerial personnel from forward dealings in the company or its holding, subsidiary or associate company [section 194 of 2013 Act].

Disclosures under the prospectus of a company

Currently, the matters and reports to be included in the prospectus are specified in parts I and II of Schedule II of the 1956 Act.

In the 2013 Act, the information to be included in the prospectus is specified in section 26 of 2013 Act. The 2013 Act mandates certain additional disclosures:

Any litigation or legal action pending or taken by a government department or a statutory body during the last five years immediately preceding the year of the issue of prospectus against the promoter of the company

Sources of promoter's contribution - The 2013 Act has relaxed the disclosure requirements in some areas. Examples of certain disclosures not included in the 2013 Act are as follows.

- Particulars regarding the company and other listed companies under the same management, which made any capital issues during the last three years
- Export possibilities and export obligations
- Details regarding collaboration

The 2013 Act states that the report by the auditors on the assets and liabilities of business shall not be earlier than 180 days before the issue of the prospectus [section 26 (1) (b)(iii) of 2013 Act].

Annual General Meetings

The 2013 Act envisages that besides director and manager, the nature of concern or interest of every director, manager, any other key managerial personnel and relatives of such director, manager or any other key managerial personnel in each item of special business will also need to be mentioned in the notice of the Annual General meeting [section 102 (1) of 2013 Act]. Also, the threshold of disclosure of share holding interest in the company to which the business relates of every promoter, director, manager and key managerial personnel has been reduced from 20% to 2% [section 102 (2) of 2013 Act].

Listed companies will be required to file with the ROC a report in the manner prescribed in the rules on each

annual general meeting including a confirmation that the meeting was convened, held and conducted as per the provisions of the 2013 Act and the relevant rules [section 121 of 2013 Act].

The 2013 Act also lays down the 'Code for Independent Directors' (Code) under Schedule IV which broadly prescribes the following for independent directors:

- Professional conduct
- Role and functions
- Duties
- Manner of appointment
- Reappointment
- Resignation or removal
- Holding separate meetings
- Evaluation mechanism

Audit Committee

Audit committees are a measure of ensuring self discipline, constituted with the object to strengthen and oversee management in public companies and to ensure that the board of directors discharge their functions effectively. The 2013 Act acknowledges the importance of an audit committee and entrusts it with additional roles and responsibilities [section 177 of 2013 Act].

- As per the 2013 Act, the audit committee should have majority of independent directors.
- Chairman of the audit committee need not be an independent director.
- A majority of the members of the audit committee should be financially literate, i.e. should have the ability to read and understand the financial statements.
- Every listed company and the following class (es) of companies as prescribed in the draft rules should establish a vigil mechanism for directors and employees to report genuine concerns such as -
 - Companies which accept deposits from the public
 - Companies which have borrowed money from banks and public financial institutions in excess of fifty crore rupees

In Securities Market

Securities Exchange Board of India has defined intermediaries as stock brokers and sub-brokers, share transfer agents, bankers to an issue, trustees of trust deeds, registrars to an issue, merchant bankers, underwriters, portfolio managers, investment advisers, depositories and depository participants, custodians of securities credit rating agencies, asset management companies, clearing members, trading members and any other intermediary who may be associated with securities markets in any manner.

These intermediaries are required in the Securities Market to match its demand and supply forces. Further the investors in the securities market are not homogenous but heterogeneous. To connect and manage such diverse groups, a mature market with sophisticated middlemen is essential.

Conflict of Interest arises in case of intermediaries by the vast and diversified client base, endless product innovations, undisclosed and complex market mechanics, and simultaneous operations in multiple intermediary services. Example of conflict of interest arising in the Securities market is while representing and advising multiple investors in the same issue may be attractive for the intermediary's revenue/commission, it may result in the intermediary rendering wrongful advice to one client so as to benefit another, which is influenced by the varying depth of client relationships

SEBI

SEBI has also issued certain Guidelines for dealing with Conflict of Interest for investment/ trading by Credit Rating Agencies (registered with SEBI), Access Persons and other employees.

Under these guidelines, SEBI directs Intermediaries and their Associated Persons to comply with the following—

- high standards of integrity in the conduct of business;
- fair treatment of clients and no discrimination amongst them;
- avoidance of conflict of personal interest with the client and primacy of clients' interest;
- appropriate disclosure to the clients of possible source or potential areas of conflict of interest;
- reducing the opportunities for conflict through prescriptive measures;
- appropriate restrictions on transactions in securities while handling a mandate of issuer or client;
- not to deal in securities while in possession of material non published information;
- not to communicate the material non published information
- not to manipulate the demand for, or supply of, or to influence prices of, securities.
- not to have an incentive structure that encourages sale of products not suiting the risk profile of the clients;
- not to share client information for the personal interest;

Listing Agreement

SEBI has including various disclosures to be provided by the companies in the Listing Agreement. These disclosures are to prevent conflict of interest at large. Following are disclosures required under the Listing Agreement.

Clause 49(F)(ii) of listing Agreement states that Senior management shall make disclosures to the board relating to all material financial and commercial transactions, where they have personal interest that may have a potential conflict with the interest of the company at large (for e.g. dealing in company shares, commercial dealings with bodies, which have shareholding of management and their relatives etc.)

Clause 53 of the Listing Agreement requires the company to notify the stock exchange and also disseminate through its own website, immediately upon entering into agreements with media companies and/or

their associates, the following information:-

- a. Disclosures regarding the shareholding (if any) of such media companies/associates in the company.
- b. Any other disclosures related to such agreements, viz., details of nominee of the media companies on the Board of the company, any management control or potential conflict of interest arising out of such agreements, etc.
- c. Disclosures regarding any other back to back treaties/ contracts/agreements/MoUs or similar instruments entered into by the company with media companies and/or their associates for the purpose of advertising, publicity, etc.

Further the report on corporate governance under the Listing agreement requires the company to disclose on materially significant related party transactions that may have potential conflict with the interests of company at large.

Further the Remuneration Committee, which would determine the remuneration packages of the executive directors may comprise of at least three directors, all of whom should be non-executive directors, the Chairman of committee being an independent director, this has been done to avoid conflict of interest

NATIONAL SECURITIES DEPOSITORY LIMITED (NSDL)

NSDL has also laid down a 'Code of Ethics' for directors and key management personnel of NSDL. It is aimed at improving the professional and ethical standards in the functioning of depository thereby creating better investor confidence in the integrity of the market.

Following rules were framed under the Code of Ethics for dealing with the issues of Conflict of Interest -

- a) No director of the governing board or member of any committee of the depository shall participate in any decision making/adjudication in respect of any person /matter in which he is in any way, directly or indirectly, concerned or interested.
- b) Whether there is any conflict of interest or not in a matter, should be decided by the governing board.

Disclosures of beneficial interest

All directors and key management personnel shall disclose to the governing board, upon assuming office and during their tenure in office, whenever the following arises:-

- a) any fiduciary relationship of self and family members and directorship/partnership of self and family members in any depository participant or registrar and transfer agent;
- b) shareholding, in cases where the shareholding of the director, directly or through his family exceeds five per cent. in any listed company or in other entities related to the securities markets;
- c) any other business interests.

Conclusion

Conflicts of interest are inevitable and cannot be eliminated completely. However, efforts have been made to curtail it and mitigate the risks and consequent losses and are visible in various Company regulations, Code of Conduct, the SEBI enforcement actions, and the SEBI Guidelines. Creating robust internal control systems and self-regulation are the two primary and predominant mechanisms to curtail Conflict of Interest Codes of

ethics also help to minimize problems with conflicts of interests because they can spell out the extent to which such conflicts should be avoided, and what the parties should do where such conflicts are permitted by a code of ethics. Thus, the individuals cannot claim that they were unaware that their improper behavior was unethical. The threat of disciplinary action also helps to minimize unacceptable conflicts or improper acts when a conflict is unavoidable¹.

¹ http://en.wikipedia.org/wiki/Conflict_of_interest