

Independent Directors: Long way to go

Introduction

Over the years, the Securities and Exchange Board of India (“SEBI”) and Ministry of Corporate Affairs are continuously focusing on incorporating corporate governance principles into the regulatory framework governing listed companies. Independent directors play a major role in ensuring corporate governance of a company by monitoring the activities of stakeholders and the board. Investors view them as both a safeguard against oppressive practices by the management, as well as a source of competitive advantage as they normally bring varied expertise and can help in strategic decision making. They are responsible for improving corporate credibility and governance standards, maintain transparency in a promoter dominated corporate structure and manage risks. The legal framework governing such independent directors is prescribed in the Companies Act 2013 (“CA 2013”) and Clause 49 of SEBI’s listing agreement.

The present newsletter seeks to highlight the role played by these individuals in implementing corporate governance standards and questions their ability to overcome the challenges in the system.

1. Criterion for Independent Directors

It is essential to explain the qualifications stipulated for this position, before analyzing the responsibilities entrusted to these directors for maintenance of ethical standards. Section 149(6) of CA 2013 defines an “independent director” as one who is not a whole-time or nominee director of the company and prescribes the following:

- Such individuals should have integrity¹ with relevant experience and expertise;
- They should neither be promoters or be related to the promoters or directors of the company, or its affiliates;
- There should not be any pecuniary relationship² with the company or any of its affiliates during the two immediately preceding financial years or during the financial year when they are appointed;
- Their relatives should not have had pecuniary relationship with the company or its affiliates, amounting to 2% or more of its gross total income or INR 5 million (about US \$78,125)³, whichever is less, during the two immediately preceding or current financial year;
- The individuals and their relatives should not have held any kind of relationship - be it key managerial person⁴ or employee, either of the company or its affiliates in any of the three financial years immediately preceding the year in which they are proposed to be appointed;

¹ It is the board that decides whether the individuals have integrity.

² The MCA has clarified in June 2014 that the term “pecuniary relationship” does not refer to any transaction that is carried out in the ordinary course of business with an independent director at arm’s length price.

³ 1 USD = 64 approximately

⁴ This is a new term introduced in 2013. Section 25 of CA 2013 specifies managing director, CEO, manager, whole-time director, company secretary and CFO as key managerial personnel.

- The individuals and their relatives should not be the proprietor, partner or employee of an audit, legal or other consulting firm engaged by the company or its affiliates, where such work generates 10% or more of the gross turnover of the entity;
- Such individuals must not hold 2% of the voting rights, either by themselves or together with their relatives;
- They or their relatives must not be the Chief Executive or director of a non-profit that receives 25% or more of its receipts from the company or its affiliates.

Once a person is appointed, it is necessary that they make the necessary statutory disclosures, pursuant to section 149(7) of CA 2013 within a defined period, all of which then are public documents. Clearly, the purpose of the foregoing criterion is directed to avoid conflict of interest by the proposed nominee. From the above list, it is clear that at the time of appointment, the primary focus appears to be more on compliance with mandates of CA 2013 and SEBI regulations, coupled with amenability of the nominee with the management versus examination of competency of the individual to undertake the stringent duties. The idea ought to be that when a person is appointed and weighs in on issues at the board meetings, he/she is able to view the operations and take objective decisions which are not based on promoting vested interests, directly or indirectly.

2. The Key Problem

It would not be incorrect to state that the entire edifice of good corporate governance is dependent on the effectiveness of independent directors. Ever since the head of Satyam⁵ made public disclosures of colluding with people internally and externally to modify and misrepresent the company's financial data, India and the world was shocked that none of the independent directors could spot the discrepancies. After the Satyam fiasco happened, efforts were made to tighten the regulatory environment, but despite everything concerns remain over the ability of such persons to take decisions in the best interest of the company and *de hors* the influence of the promoters. Even in the recent boardroom battle between Mr. Ratan Tata and Mr. Cyrus Mistry, concerns relating to independence of independent directors were raised. The latest large conglomerate to join that space is Infosys. Both the TATA group and Infosys have been considered as benchmark for good corporate governance practices in India. In fact, recently, SEBI chairman also expressed his views "*Auditors' committee is not working, independent directors are not independent and there is no stewardship code. This is a serious issue which is engaging the attention of SEBI. We will come out with more discussion soon*".

2.1 SEBI Measures

In the wake of these financial scams, SEBI has proposed serious changes to the process of removal of independent directors, currently being followed under the CA 2013.⁶ At present, independent directors can be removed by means of an ordinary resolution, which requires only a simple majority of the shareholder votes of a company.⁷ However, for the re-appointment of such

⁵ One of India's largest technology companies that confronted severe problems in 2009 when its chairman admitted that he had connived to falsify the accounts.

⁶ See "Sebi seeks changes in Companies Act; independent directors' ouster may get tougher now" available at [http://economictimes.indiatimes.com/articleshow/59099740.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst\(last](http://economictimes.indiatimes.com/articleshow/59099740.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst(last) accessed on Sep 22, 2017).

⁷ See Section 169 of CA 2013

directors, a special resolution is passed requiring the votes of at least 75% or more shareholders in accordance with section 149(10) of CA 2013. SEBI wants the removal of independent directors to be done by means of a special resolution, thereby raising the bar of the votes at the shareholder level and, hopefully, effectively ensure that removal is not easy and, definitely, not at the whim of family-controlled promoters who may still be able to call the shots at the board level.

Furthermore, on January 5, 2017 the regulator furnished guidelines⁸ for detailed evaluation of members of the board stressing on the need to have an organized and objective evaluation of their performance, based on competence, qualifications, transparency in appointment, regularity in attending meetings and other criteria. This becomes all the more important given that the term of an independent director is for five years, it is essential that selection is done with due consideration so that, once appointed, such persons can effectively contribute to the operations and growth of the company. In circumstances where independent directors are compelled to resign due to shareholder disputes, even the approach of the judiciary is to caution the companies since “independent directors play crucial role in maintaining corporate governance and the resignation of such directors at the instance of major shareholders will be detrimental to the interests of the company and its public stakeholders.”⁹

3. Code of Conduct

For the first time, the statute prescribes a code for independent directors. Schedule IV of CA 2013 describes the duties to be performed by them in a way that they focus on applying best management practices and effectively comply with the spirit and letter of law. Needless to say, integrity in actions remains a crucial aspect. It is noteworthy to repeat and in India, most business groups are family-owned and controlled leading effectively to a situation where the promoters' interests often over-shadow those of other shareholders. The code imposes different obligations on the directors including, amongst others:

- satisfying themselves on the integrity of financial information by periodically reviewing flow of funds;
- scrutinize the performance of management in meeting agreed goals;
- determine appropriate levels of remuneration of key managerial persons, and play a key role in their appointment and removal

These directors also have to meet separately, once a year to evaluate the performance of members of management in an impartial manner, without any fear or inhibition.¹⁰ This means that due attention has to be given to the selection of an individual who has the ability to provide specialist skills, possesses a questioning mind as well as a vision of a leader. While it is necessary to see that the independent director conforms with the code, yet it is even more critical that the individual should have the necessary skill sets and a conviction to remain firm with a certain articulated position, despite the pressures to change a stance.

⁸ The guidelines can be accessed at https://www.nseindia.com/content/equities/SEBI_Circular_05012017.pdf. SEBI has constituted a committee under Mr. Uday Kotak, vice-chairman of Kotak Mahindra to suggest measures for ensuring active participation of independent directors, improve standards of disclosures in related party transactions, amongst others.

⁹ See Jang Bahadur Singh and others vs. Frick India Limited and Ors. MANU/NULL/0328/2017

¹⁰ See Schedule IV CA 2013

Conclusion

If India Inc. is to align itself with the changing business environment, leave alone matching the expectations of shareholders and/or foreign investors, different stakeholders – be it regulators, or companies’ boards, or key officers, and even external advisers – all have to come together to ensure that independent directors are allowed to operate independently. This may mean bringing about further change to the business ecosystem. Furthermore, in times to come, as seasoned people take on key roles, it is also important and imperative that they should be trained regularly in sync with global standards and the law as well as corporations should give them adequate in-built protections and provide safeguards so that no undue liability is fastened on them. Unless regular and consistent efforts are made to invest in independent directors, their independence runs the risk of remaining mere lip-service.

Author

Bhavani Navaneethan