



## **CORPORATE GOVERNANCE**

### **INDEPENDENT DIRECTORS AS CORPORATE WATCHDOGS**

The Companies Act doesn't have the concept of independent directors. The Act delegates the charge of some sections relating to listed companies to the Securities & Exchange Board of India ("SEBI"). SEBI in its circular to stock exchanges in October '04, revised clause 49 of the listing agreement, which mainly deals with independent directors and audit committees. The circular said a public listed company with an executive chairman must reserve at least half the board for independent directors. If the chairman is non-executive, one third will do. There is no such rule for non-listed companies. The JJ Irani Committee set up to advise on the proposed new company law, said the condition for non-listed companies may be considered in due course.

The core of good corporate governance is to increase shareholder value with transparency, adequate disclosure and accountability.

Not many are aware that the Indian corporate governance code is much tighter than those in most of the world, including Europe, Japan and South Korea. Even today, in Europe there is no requirement of disclosure of quarterly results, something we have had since 2000.

Based on this, we proceed with the requirement of independent directors made mandatory by the latest corporate governance guidelines under clause 49 of the listing agreement:

### **DEFINITION & MEANING**

An independent director is a non-executive director on the board of a company who has integrity, expertise and independence to balance the interests of various stakeholders.

As per SEBI, the expression 'independent director' shall mean a non-executive director of the company who:

- a. Apart from receiving director's remuneration, does not have any material

pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;

- b. Is not related to promoters or persons occupying management positions at the board level or at one level below the board;
- c. Has not been an executive of the company in the immediately preceding three financial years;
- d. Is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
  - i. The statutory audit firm or the internal audit firm that is associated with the company, and
  - ii. The legal firm(s) and consulting firm(s) that have a material association with the company.
- e. Is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and
- f. Is not a substantial shareholder of the company i.e. owning two percent or more of the block of voting shares.

### ***Explanation***

- a. Associate shall mean a company which is an “associate” as defined in Accounting Standard (AS) 23, “Accounting for Investments in Associates in Consolidated Financial Statements”, issued by the Institute of Chartered Accountants of India.
- b. Senior management” shall mean personnel of the company who are members of its core management team excluding Board of Directors. Normally, this would comprise all members of management one level below the executive directors, including all functional heads.
- c. Relative” shall mean “relative” as defined in section 2(41) and section 6 read with Schedule IA of the Companies Act, 1956.

Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be independent directors. (“Institution’ for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a “corresponding new bank” as defined in section 2(d) of the Banking

Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts].”

According to Sebi, having a ‘pecuniary’ relationship with the company or its arms, other than receiving the director’s remuneration, is a disqualification. The independent director must not be related to the promoters or anyone in senior management position from one level below the board. He shouldn’t have been an executive of the company or of its audit, consulting or legal firms in the past three financial years.

Owning 2% or more voting shares or being a service provider to the company is a disqualification. Nominee directors appointed by an institution that has invested in or lent to the company shall be deemed independent directors. If the Irani panel’s suggestion that director nominated by an FI or by the government isn’t independent is accepted and the Parliament enacts the new companies bill, this view will prevail upon the Sebi definition. The panel had suggested a minimum period of no-association with the company or its arms as one year

The clause will apply to listed entities which are not companies, but in cases of body corporate such as private and PSU banks, FIs and insurance companies, only to the extent that it does not violate the laws governing them. Revised clause 49 doesn’t apply to Mutual Funds.

## **THE NEED FOR INDEPENDENT DIRECTORS**

Events at Enron, WorldCom, Tyco and now even AIG have cast doubt on the integrity of managements and independent directors are therefore seen as a check on managements, as an oversight mechanism, apart from the value addition that they bring to board deliberations.

There is a very significant difference between Indian managements, and managements in the US and the rest of the developed world. More than 75 per cent of large listed Indian companies are family-owned, in which a family has a significant (30 per cent upwards) shareholding in the company.

In a company managed by "owners", there is a very strong motivation for managements to work for a long-term share price increase, i.e. long-term earnings increase, because the family's prosperity and reputation ride on the prosperity and ethical dealings of the company.

In a competitive market situation, the real controls on management come from the marketplace. Managements (that is promoters) can't be unfair to any shareholder,

including the small shareholder, and expect to go unpunished.

Now, if we were to believe this, the ownership structure of Indian companies should, *ipso facto*, eliminate agency conflicts. However, decades-long experience points to an even more serious problem — self-seeking behavior and pursuit of private gains of control. How else can one explain the phenomenon of promoter-run companies falling sick by the day, even as the promoters prosper?

Obviously, all the value destruction has been forced, perhaps to a great extent by the lenders, on the non-promoter shareholders and even on the employees. Indian company managements, with exceptions, have made an art of self-dealing, self-aggrandizement, at the cost of the companies they control, and at the cost of non-promoter stakeholders, through a variety of means, such as purchases, sales and diversification.

But is that something independent directors can successfully deal with. With the promoters having the controlling shareholding and for all practical purposes, it is the promoter who actually appoints the director, independent or otherwise, how independent can the independent director truly be. In the current scenario, this entire regime seems redundant and in fruituous.

On the flip side, the important point is that far from declaring that independent directors are redundant, India needs to strengthen the institution of independent directors so that they can actually play an effective role, not expected of them in the past. The few reported instances of the effective role played by the independent directors in handling delicate corporate situations clearly underscore the importance of this emerging institution. In many of the cases, they were able to play an effective role only because they were in sufficiently large numbers. Thus it is important that there are a sufficient number of outside directors on company boards, enough to have an influence.

This is why in the US, for listing on the New York Stock Exchange or Nasdaq, companies in which a group has a controlling interest of over 50 per cent are statutorily not required to have any independent directors.

### **Conclusion: Do we really need the reform?**

Independent directors play an active role in various committees to be set up by a company to ensure good governance. Listed companies are required to set up audit committees of minimum three directors, on which, two thirds should be independent directors, chaired by an independent director.

Nothing can be more disparaging to the efforts and labor of the promoter who has strived for the success of the company than the fact that his views and opinions are subservient to a handful of independent directors, who may have absolutely no sense

of belonging towards the company.

An independent director is an oxy-moron in a country where owning/promoting families have substantial ownership and control. Rarely have we seen independent directors taking a vastly different view than the promoters. To look at the flip side, the independent director may even cause delay and damage to the company by questioning genuine business decisions / resolutions. Sometimes, these independent directors are not even aware of what is happening in the company being retired civil servants or professionals lacking exposure and experience in the industry, or sometimes due to plain lack of interest in the company.

We in India seem to prefer form over substance, structure over process. We want to be seen as doing something to solve a problem. Whether the problem gets solved or not is something that is not a major concern. We are disregarding the fundamental fact that it is the whole-time directors and promoters who are primarily responsible for the successful running of a company. They should have the authority and freedom to function.

