INDEPENDENT DIRECTORS – HOW TO MAKE THEM AN EFFECTIVE INSTRUMENT OF CORPORATE GOVERNANCE

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INTRODUCTION

Two important events of considerable significance to the Corporate Sector are expected to materialise any time now. One is the much awaited introduction in parliament the re-codified companies bill and the other relates to implementation of the revised clause 49 of the listing agreement, The companies bill is expected to confer for the first time, statutory recognition to the concept of independent directors on the Corporate Boards in the case of both listed and unlisted public companies.

What these events convey to the corporate sector ? They convey in clear terms the unhappiness of the regulatory authorities about the manner in which the corporate boards are functioning, particularly in the case of family owned concerns. From the positive angle, the emerging trends indicate unmistakly innovation which is the hall mark of creative thinking in Corporate management. This is needed more than ever before, when we are operating in a highly competitive and complex business environment. Law, as an instrument of regulatory mechanism is being increasingly used to set in motion new benchmark in Corporate governance. Reconstruction of corporate boards with independent directors seem to herald an innovative approach in corporate management at least conceptually.

STATUTORY RECOGNITION FOR INDEPENDENT DIRECTORS

The draft companies Bill accompanying the concept paper, in Section 63 provides that every public company having a paid up capital or turnover of such amount as may be prescribed should have a minimum of seven [7] directors, of which not less than three or such number as near to 50% of the strength of the Board, whichever is higher, should consist of independent directors, possessing such attributes as may be prescribed. However, the companies in existence at the commencement of the Act will have to fall in line with the aforesaid requirement within such time as may be prescribed. This means that the existing public companies will not be required to fall in line with the requirement of independent directors during the period of moratorium. This, however, will not prevent the public companies to induct independent directors voluntarily.

An independent director is defined in Section 2 [45] of the Bill to mean a non-executive director of a company, who apart from receiving director's remuneration, does not have any material pecuniary relationship or transactions of such amount as may be prescribed, with the company, its promoters, managing director, whole time director, other directors, manager or its holding company and its subsidiaries.

This is the legal frame work envisioned in the bill. However, the concept of independent directors is already in vogue since the year 2002 through clause 49 of the listing agreement, which has been throughly revised by SEBI and implemented with effect from January 1, 2006. In so far as the composition of the Board is concerned, there is no material change in the listing agreement. However, the revised clause 49 incorporates the category of persons who cannot be appointed as independent directors. This has been taken from section 252A of the Companies [Amendment] Bill 2003. Those who are ineligible for appointment as independent directors are those holding the position of managing or whole time directors, persons having transaction with the company or its chairman, managing or whole time director or secretary or manager or any officer of the company, any relative of the aforesaid category of persons, an ex-employee, auditor, internal auditor, supplier, vendor or customer of goods or services, a

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person holding two percent or more of the securities of a company etc.. This is a negative clause and casts the net very wide. The intention is to prevent independent directors from having significant and material pecuniary interests which will conflict with the interests of the company. This is intended to secure independence of independent directors, so that they may participate in the board proceedings in a free and dispassionate manner and take business decisions in an objective manner in the larger interests of the company. While these are the gate-ways to keep the independent directors from the benaful influence of promoters having a controlling stake in the company, the prohibition should not affect the transactions with the chairman or Managing or whole time directors of a company in their individual capacity, un-related to the business affairs of the company. However, it should be conceded that SEBI is endeavouring to improve the standard of corporate governance in line with the need of a dynamic market and to protect the investors interests.

IRANI COMMITTEE RECOMMENDATIONS

The Irani Committee is of the view, that while directors representing specific interests would be confined to the perspective dictated by such interests, independent directors would be able to bring an element of objectivity to Board process in the general interests of the company and this will benefit minority interests and small shareholders. Independence, therefore, is not to be viewed merely as independence from promoter interests. Law should recognise the principle of independent directors and spell out their role, qualifications and liability. The requirement of independent directors may vary depending upon the size and type of the company.

The committee is also of the view that a minimum of one third of the total number of directors as independent directors should be adequate for a company having significant public interest, irrespective of whether the chairman is executive or non-executive, independent or not. This requirement should be extended to public listed companies and companies accepting public deposits, with liberty to regulators to specify the requirement of independent directors for companies falling under their domain. The Committee also took the view that the nominee director appointed by any institution in pursuance of any agreement or Govt. appointees cannot be considered as independent directors, as they represent specific interests.

As regards the mode of appointment, the committee is of the view that independent directors should be appointed by the company from amongst persons, who in the opinion of the company, are persons of integrity, possessing relevant expertise and experience, who satisfy the criteria for independence. An independent director should make a self declaration that he satisfies the conditions for appointment as such director, at the time of appointment. This should be disclosed by the BOD in the director's report to the Shareholders.

One of the requirement for being an independent director is that such a director, apart from receiving director's remuneration, does not have and none of his relatives or firms/companies controlled by him, have any material pecuniary relationship or transactions with the company, its promoters, its directors, etc. The committee is of the view that 'materiality' is relevant from the recipients point of view and not from the point of view of the company. Accordingly, the Committee has recommended that 10% or more of recipient's consolidated gross revenue / receipts for the preceding year should form a material condition affecting independence. In respect of pecuniary relationship, transactions with an entity in which a director or his relative hold more than 2% shareholding should be considered.

PROFILE OF INDEPENDENT DIRECOTRS

Excluding the categories of persons who are disqualified to act as independent directors, those who are eligible for such appointment are presumably business leaders, Bureaucrats, Professionals like company secretaries, Advocates, etc., unless they are disqualified under one or more of the negative list of disqualifications. The disqualifications are intended to ensure that they do not have interests conflicting with the larger interests of the company. This will enable them to participate in the decision making process in an objective manner, uninfluenced by promoter or other directors. This is possible, if the independent directors have the business acumen, the ability to look ahead of our times in terms of emerging trends in business etc., as the corporate boards are business boards. This calls for considerable experience and exposure. If they are to succeed in changing the nowledge base of the corporate boards, they have to go through a course of intensive training and updation

programmes in the art of managing corporate business. As the independent directors enter corporate boards with different backgrounds and exposure, an intensive training will have the effect of enhancing their capabilities. The Professional bodies like the ICSI will have to take an early lead in this direction.

In the context of implementation of revised clause 49 of the listing agreement from January 2006, the number of independent directors required to fill the position in corporate boards is tremendous. Listed companies numbering about 9,000 requires about 45,000 independent directors, if they are form 50% of the corporate boards. No doubt, SEBI has taken a welcome lead in establishing a web site – Prime directors.com – free of charge platform for professionals to enrol themselves for the position of independent directors by filing their profiles. The website is open to access by listed companies. This will surely help the listed companies to look for persons of their choice and requirement and make qualitative addition to their boards.

SECURING INDEPENDENCE TO INDEPENDENT DIRECTORS PROBLEM AREAS

The functional role of independent directors is more relevant in the case of listed companies because of Public interest. It is therefore, necessary that the concept of independent directors is implemented fully and effectively, in the first instance, in the case of listed companies. They are un-attached directors, i.e., they are not attached to any specific interest or groups. They are there to provide expertise essentially in the areas of financial and general management, as technical and operational aspects are looked after by managing or whole time directors by virtue of their expertise in these areas. The composition of the Audit Committee in the case of Public Companies of certain size gives the independent directors an exclusive area in oversight financial management. However, there are certain problem areas which may hinder effective functioning of independent directors. These are de-stabilising factors. They are : -

(a) De-listing of Securities. Many companies, including multi-national companies are resorting to de-listing of their securities from the stock exchanges. If this trend continues, the number of listed companies will decrease and the de-listed companies will no longer be required to comply with Clause 49 of the listing agreement.

(b) With the de-listing of securities, some companies are converting themselves into private limited companies. This will effectively take them out of requirement of having to have independent directors.

(c) Independent directors will have to be appointed by the shareholders in the same way as other directors. No special procedure is envisaged for appointment of independent directors, as they will have decisive say in the decision making process. Distinctiveness of their functional responsibility needs to be highlighted.

(d) Appointment of independent directors is a direction to the company. Whom do we hold responsible for non-compliance ? Is it the promoter directors or the chairman of the Board or all the directors on the board ? This is not clear.

(e) Independent directors will have to look to and depend upon promoter and other persons holding substantial stake in a company, for their election to the board. This means election of independent directors will have to be sponsored and supported by the promoters and others. How can the independent directors act independently in the strict sense of the term in such circumstances ?

(f) The promoters and others are increasing their stake taking advantage of the provisions of SEBI [Substantial Acquisition & Take over] Regulations and buy back of securities under the provisions of the companies Act. While these are permitted under the regulatory provisions, the affect is more severe on the independent directors. Their dependence on promoters will further increase and jeopardise the independence of such directors.

(g) The on-going dis-investment in PSU's, foreign investors and foreign financial institutions role in the matter of FDI and the secondary market operations are helping them to improve their shareholding and tighten their control over their companies. In the recent bull run on the stock exchanges, it is reported, that many promoters and others holding controlling stake in Indian Companies, have increased their stake substantially. This may hinder effective functioning of independent director, on the corporate boards.

(h) When we talk of independent directors as forming certain percentage of the total strength of Board, we are only talking of form of better governance, without considering at the same

time, what needs to be done to enable them to function effectively. There is an urgent need to formulate guidelines for observance of the corporate boards and how to make the independent directors an effective partners in the decision making process.

(i) Independent directors are not in reality in a position to function as independent segment of the Board as all the powers conferred on the board by the Companies Act and the articles of a company devolve on the Board, as a collective body. No individual director has any power to exercise, except as a member of the board. This does not prevent the Board from delegating certain powers for administrative convenience. This does not at the same time affect the supremacy of the Board. Accordingly independent directors have to function as integral part of the corporate boards, and carry the entire board in the decision making process. Here counts the qualities of head and heart of independent directors, which they can bring to bear in the decision making process.

INDEPENDENT DIRECTORS AS AN EFFECTIVE INSTRUMENT OF GOVERNANCE

The objective of re-structuring of corporate boards with independent directors is further to improve the standard of corporate governance, with better accountability to stakeholders and transparency in the operational activities by adequate and meaningful disclosure of financial and non-financial data through annual and other periodical reports. It has been rightly recognised that the Board of Directors [BOD] occupies a pivotal place in the corporate hierarchy and is therefore charged with the responsibility of formulating and implementing governance norms. What the law prescribes in regard to governance norms is minimal in nature and it is for the corporate entitles to raise above the minimal observance of governance norms.

Needless to say that the corporate entities have function within the social and economic milieu in which they operate. Therefore, the functional aspects of corporate organisations have to sub-serve larger social and economic interests and promote social hormony. Looked at from this angle, governance norms are not abstract regulations but they should reflect social and economic ethos and ethical values of our times. The independent directors, coming as they do, from different social and economic backgrounds are in a better position to contribute significantly in this regard. It follows that business values and perceptions have to be dovetailed to ethical values of what is right and wrong.

There should be an Ethics Committee of the Board consisting entirely of the independent directors and other persons of eminence drawn outside the Board, with the oversight function of ensuring adherance to ethical behavior on the part of Board members and second the level functionaries.

The Induction of independent directors is expected to qualitatively change the composition of the Board. The directors, whether independent or otherwise are the trustees and agents of the company and their timely actions or lack of it will affect the corporate body in a serious manner. It is, therefore, necessary to focus on this aspect. But the Companies Act does not define the duties of directors, though a number of Judicial decisions have laid down the basic duties expected of a director curiously disqualification of directors and vacation of office by directors are dealt with in the Act significantly. As rightly recommended by the Irani Committee, it is necessary that certain basic duties of directors should be spelt out in the Act. They are duty of care and diligence, exercise of power in good faith and duty to have regard to the interests of the employees, etc. Needless to say that responsibility of directors flows out of duties. Such a prescription of directors duties is absolutely necessary, particularly in the context of induction of independent directors.

CONCLUSION

Corporate boards are pyramidal in design and uni-dimensional in structure. The induction of independent directors is an attempt to restructure corporate boards in tune with the complex nature of modern business. The rules of international trade are changing very fast, in the context of on-going WTO negotiations. We are in for professionalisation and socialisation of corporate boards. What does such a board reflect ? It does not wholly reflect ownership and control of promoters but it will be an amalgam of both ownership and social control, with a decisive voice being given to independent directors. With the result, the ownership control gets subsumed in the over all control of the board. In the final analysis, the corporate boards should achieve better than the best and a cut above the rest.