

GUIDANCE NOTE ON INDEPENDENT DIRECTORS

INTRODUCTION

The Board of Directors of a company play a key role in providing direction to the management in the areas of strategy and governance and also in ensuring that the company conducts its business in the best interests of all its stakeholders. The presence of independent directors on the boards of public companies is the *sine quo non* for a strong governance system. In view thereof, the statutes provide for a board structure which has an optimum blend of both independent and non-independent directors for listed companies and large unlisted companies.

The corporate form of business has multifarious stakeholders viz. shareholders, creditors, banks/financial institutions, vendors, customers, the Government, employees, community and environment. The functioning of the ecosystem hinges on how well the interests of these stakeholders are integrated and sub-served. Conceptually, the institution of independent directors is designed to ensure that they play a pivotal role in enhancing and maintaining highest standards of corporate governance. In a three layered corporate structure, the Board which includes independent directors, act as a bridge between the management and stakeholders. The presence of independent directors in the boardroom to a large extent is considered as an assurance in terms of protection of interest of stakeholders especially minority shareholders; balancing the conflicting interest of the stakeholders; moderate and arbitrate in the interest of the company as a whole, in situations of conflict between management and shareholders' interest.

The Institution of independent directors is still evolving in India and it may take some more time before institutional wisdom takes deeper roots. The effectiveness of the institution of independent directors can be improved to a great extent if independent directors are made more aware of the issues, challenges, responsibilities, statutory duties and liabilities involved with the position of independent directors. Hence, this Guidance Note, besides covering the issues and challenges, also includes statutory and regulatory

provisions, code of conduct and compliances pertaining to independent directors.

Scope

This Guidance Note covers the relevant provisions of the following:

- Companies Act, 2013 read with the Rules made thereunder
- Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015
- Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015
- Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011
- Secretarial Standards (SS-1 & SS-2)

This Guidance Note is prepared on the basis of the above stated laws and regulations as amended from time to time. If due to subsequent changes, any part of the Guidance Note becomes inconsistent with any of the applicable laws, rules and regulations, the applicable laws, rules and regulations shall prevail.

In addition to the requirements stated in this Guidance Note, some sector specific Regulations/Guidelines may require additional compliances by companies operating in specific sectors such as Public Sector Undertakings (PSUs), Banking and Insurance Companies, Non-Banking Financial Companies, Housing Finance Companies etc. Hence, such companies should ensure compliance of applicable sector specific Regulations/Guidelines.

Definitions

The following terms are used in this Guidance Note with the meanings specified:

“Act” means the Companies Act, 2013 (Act No. 18 of 2013) or any previous enactment thereof, or any statutory modification thereto or re-enactment thereof and includes any Rules and Regulations framed thereunder.

“Board of Directors” or “Board”, in relation to a company, means the collective body of the Directors of the company;

“Committee” means a committee constituted by the Board under the Act or the Listing Regulations.

“Listed Company”^{1, 2 & 3} means a company which has any of its securities listed on any recognised stock exchange;

“Listing Regulations” means the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015, including any amendment thereto.

“PIT Regulations” means the Securities and Exchange Board of India (Prohibition of Insider Trading) Regulations, 2015, including any amendment thereto.

“Takeover Regulations” means the Securities and Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 2011, including any amendment thereto.

“SR equity shares” means the equity shares of an issuer having superior voting rights compared to all other equity shares issued by that issuer.

Words and expressions used and not defined herein shall have the same meaning respectively assigned to them under the Act, the Listing Regulations and the Secretarial Standards, as may be applicable.

1. Note: In terms of the Companies (Amendment) Act, 2020 the following proviso has been inserted to the definition of Listed Company:

“Provided that such class of companies, which have listed or intend to list such class of securities, as may be prescribed in consultation with the Securities and Exchange Board, shall not be considered as listed companies.”

2. Note: Entity other than company incorporated under the Act, whose securities are listed, would be regulated by Listing Regulations but provisions of Act would not be applicable to it. This Guidance Note should be read by those entities accordingly.

3. Note: The compliances arising out of Listing Regulations with respect to independent directors shall apply to only those entities whose equity is listed.

Wherever the reference of Companies (Amendment) Act, 2020 is appearing in this Guidance Note, the amended provisions will be applicable from the day when the same are notified by the Government.

GUIDANCE NOTE

1. EVOLUTION OF CONCEPT OF INDEPENDENT DIRECTORS IN INDIA

Corporate Governance models in India, while being unique in themselves, also borrow from models adopted by the US and UK; which were influenced by recommendations of Cadbury Committee and the Sarbanes-Oxley Act.

In the year 1996, the Confederation of Indian Industry (CII) formed a task force. The objective was to develop and promote a code for Corporate Governance to be adopted and followed by the Indian companies. The CII Task Force recommended a “Desirable Corporate Governance: A Code” in 1998 which has extensively debated the issue of independent directors.

In the year, 1999, the Securities and Exchange Board of India (SEBI) set up a committee under the chairmanship of Shri Kumar Mangalam Birla to promote and raise standards of corporate governance in India. The recommendations put forward by the Kumar Mangalam Birla Committee led to the addition of “Clause 49 on Corporate Governance” in the listing agreement in the year 2000. Its applicability was to listed companies satisfying the prescribed thresholds.

In the year 2002, the Government appointed the Naresh Chandra Committee, which, among other recommendations in line with international best practices, recommended that the extant definition of independent director be made more precise.

Another major development took place in the year 2002, when a committee was formed by SEBI under the chairmanship of Shri N R Narayana Murthy for reviewing the implementation of corporate governance code by listed companies. The committee recommended revisions in Clause 49, *inter-alia*, to include the revised definition of ‘*independent director*’.

In the year 2008, SEBI further amended the listing agreement whereby the minimum age for independent directors was prescribed as 21 years. [Reference SEBI Circular SEBI/CFD/DIL/CG/1/2008/08/04 dated April 08, 2008]

Consequent upon the enactment of the Act, SEBI amended the corporate governance norms including aligning the definition of the term ‘independent director’ for listed companies in India.

While the term 'independent director' has been in use since the introduction of Clause 49 in the listing agreement, the concept of independent directors was first proposed in the company legislation through the Companies Bills, 2009 and 2011 which were finally enacted in the form of the Companies Act, 2013. The Act and the relevant Rules made thereunder contain extensive provisions dealing with independent directors. Schedule IV has been prescribed under the Act which contains the "code for independent directors".

On 2nd September 2015, SEBI had notified the Listing Regulations effective from 1st December 2015. The Listing Regulations use the similar definition of independent director as used in Section 149 (6) of the Act. However, it lays down certain additional parameters such as minimum age of 21 years for appointment as independent director.

With the objective to specify limits with respect to pecuniary relationship of a director for eligibility to be appointed as an Independent Director and to specify the scope of restriction on pecuniary relationship entered into by a relative, the Companies (Amendment) Act, 2017 amended the definition of independent director.

In 2017, the SEBI Committee on Corporate Governance was constituted under the Chairmanship of Shri Uday Kotak. The scope of the committee, *inter-alia*, included 'ensuring independence in spirit of independent directors and their active participation in functioning of a company. Most of the recommendations were accepted by SEBI and accordingly, the Listing Regulations were amended in May 2018.

The comparative table highlighting the provisions with regard to independent director in terms of the Act and Listing Regulations is placed as *Annexure-I*.

2. INDEPENDENT DIRECTORS: ISSUES, CHALLENGES AND EXPECTATIONS

2.1 Issues and Challenges – Industry Perspective

The institution of independent directors is still evolving in India and continues to face various issues and challenges. Some of the issues and challenges are universal in character while some are endemic to the Indian scenario. The pertinent issues, which need attention and must be addressed, are listed below:

- (i) **Ownership character of the Indian corporate:** One of the major challenges to the institution of independent directors is the ownership character of Indian corporate which, if not unique to India, is certainly very different from most developed jurisdictions. Most of the Indian companies are predominantly owned and controlled by promoters. Many independent directors might be familiar with promoter(s) or from a known group / circle. Fully realising and appreciating that independence is a state of mind and a personal trait, still the familiarity between promoters and independent directors may impact the independence of directors.
- (ii) **Availability:** Finding an independent director with requisite experience and knowledge, who is unknown to promoter(s) is a challenge. The challenge is not only to appoint a capable person but also to retain him with the company due to increased demand of independent directors. There is a need to increase the 'supply side' of independent directors, to match the 'demand side'.
- (iii) **Knowledge of operations:** Executive directors are involved in day to day affairs of a company and have functional expertise with in-depth knowledge about its operations. On the other hand, independent directors do not have to necessarily possess such detailed knowledge about the operational aspects of the company at the time of their appointment. The first challenge is to familiarise independent directors with the operations of the company to bridge the knowledge gap and to facilitate effective discussions and decision making by the Board of Directors. Once familiar, it is equally important for independent directors to get updated knowledge on the latest developments and technologies having impact on the business of the company.
- A person who has knowledge of the business of the company and who possesses and adheres to strong virtues of independence would be able to forcefully uphold the spirit of independence bearing in mind the interests of all the stakeholders.
- (iv) **Ability to look beyond:** The challenge for independent directors is to develop their ability to look beyond, than what is presented by the management. They must identify the danger signals and also plan for future taking into account recent developments, competition and numerous factors impacting the business. Independent directors should raise their questions without any fear

or favour on the proposals placed for consideration of the Board, its impact on the company and its stakeholders and seek additional information, wherever considered necessary. Independent directors are expected to give objective inputs and advice drawing from their repertoire of varied experience and knowledge.

- (v) **Liability:** Legally, as the non-executive directors, independent directors are not involved in day to day management of a company, they can be held liable only in respect of such acts of omission or commission by a company which had occurred with their express/ implied or tacit knowledge, consent and connivance or where they had not acted diligently.

However, there have been cases where a few independent directors have been drawn into the vortex of legal battles relating to liability for mismanagement or failure. While such situations may arise in any profession or with any person, still there is a need to protect independent directors from such unwarranted legal disputes, as without such protection, competent persons may shy away from taking up the responsibilities of being an independent director.

To address this issue, the Ministry of Corporate Affairs (MCA) vide general circular dated 2nd March, 2020 has issued certain clarifications and directives on prosecution initiated against independent directors and other non-executive directors, relevant excerpts of which are as under:

- (a) Section 149 (12) of the Act is a non obstante clause which provides that notwithstanding anything contained in the Act, the liability of an independent director (ID) or a non-executive director (NED) not being promoter or key managerial personnel would be only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.
- (b) In view of the express provisions of section 149(12) of the Act, IDs and NEDs (non-promoter and non-KMP), should not be implicated in any criminal or civil proceedings under the Act, unless the above mentioned criteria is met.

- (c) All instances of filing of information/records with the registry, maintenance of statutory registers or minutes of the meetings, or compliance with the orders issued by the statutory authorities, including the NCLT under the Act are not the responsibility of the IDs or NEDs, unless any specific requirement is provided in the Act or in such orders, as the case may be.
- (d) At the time of serving notices to the company, during inquiry, inspection, investigation, or adjudication proceedings, necessary documents may be sought so as to ascertain the involvement of the concerned officers of the company. In case, lapses are attributable to the decisions taken by the Board or its Committees, all care must be taken to ensure that civil or criminal proceedings are not initiated unnecessarily against the IDs or NEDs, unless sufficient evidence exists to the contrary.
- (e) In case of any doubts, with regard to the liability of any IDs or NEDs, for any proceeding to be initiated by the Registrar of Companies (RoCs), guidance may be sought from the MCA. Consequently any such proceedings must be initiated after receiving due sanction from the MCA.

The MCA has issued the above circular to all its Regional Directors, Registrars of Companies and Official Liquidators with respect to prosecution proceedings. The said circular articulates the protection to independent directors and other non-executive directors from unnecessary prosecution, unless sufficient evidence exists to the contrary.

- (vi) **Balancing of Interest:** The primary role of independent directors is to ensure that the decisions taken by the Board of Directors are in the interest of all stakeholders. Independent directors need to ensure that they do not have any conflict of interest with the decision taken by the Board. From industry perspective, balancing between efforts, obligations and remuneration of independent directors remains a challenge.

2.2 Issues and Challenges – Regulatory Perspective

The very basis of the institution of independent directors is to ensure board independence, protect the company from any opportunistic indiscretions