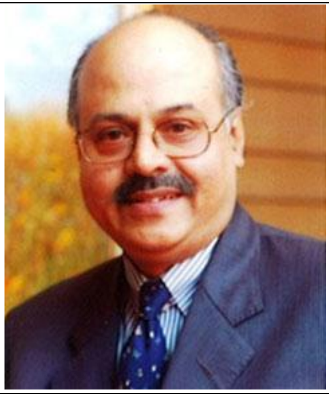
Role of Independent Directors in Corporate Governance



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This article talks about 'redefining' the role of Independent Directors. But let us understand if the role has, in the first place, been defined ! Some background on the subject will put things in perspective.

Corporate Governance is the system that helps firms control and direct operations. It also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. In today's businesses, the main external stakeholder groups are Shareholders, Debt-holders, Trade creditors, Suppliers, Customers and Communities affected by the company's activities. Internal stakeholders are the Board of Directors, Executives, and other Employees.

Origin of Corporate Governance & its adoption in India

The concept of Corporate Governance originated in the U.S. and the U.K. In the US, it is the Sarbanes-Oxley Act (known as Sox) and in the UK it is the recommendations of the Cadbury Committee which guides Corporate Governance. In the last decade, the practice shifted to several other countries, including India. However, the transplantation has occurred to the systems in respective countries, that possess different shareholding structures and differing norms and practices. In the US and the UK, it is the 'outsider model', in which usually the owners of firms tend to have an interest in the firm without having close relationships with those in senior managerial positions within the company. On the contrary, countries like India have the 'insider model', in which the owners of firms may tend to have an enduring interest in the company and often hold positions on the Board of Directors or other senior managerial positions. Such systems are characterized by stable and close relationships between management and shareholders.

Due to this dissimilarity in the very nature of Corporate Governance in the US / UK and in India, among all the transplanted concepts, the Independent Director is presented with a great number of challenges. And the Independent Director plays a seminal role in Corporate Governance. He/she is a member of the Board of Directors of a company. He/she is not part of the executive management team. He/she is not an employee of the company or affiliated with it in any other way. They are differentiated from Inside Directors, who are members of the Board, who also serve or have previously served as executive managers of the company (most often as Corporate Officers). Independent Directors are responsible for counterbalancing management weaknesses and ensure legal and ethical behaviour in the company. Overall they are required to provide strength and depth to the Board of Directors.

The concept of Independent Directors is just a decade old in India. In 1999, it was recommended by the Kumar Mangalam Birla Committee on Corporate Governance, and was mandated by the Securities and Exchange Board of India (SEBI) as Clause 49 of the listing agreement. In 2003, the Naresh Chandra Committee gave Governance more thought. In 2004, the Narayanamurthy Committee effected changes to Clause 49 of the Listing Agreement which was to come into effect on 1st April 2005. However, the date of compliance was extended to 31st December 2005, as a large number of companies were not prepared for it. Finally from 1st January 2006, it came into effect. It was further amended in 2008. Clause 49 in its present form provides for the following key features of Corporate Governance:

1. Board of Directors of listed companies must have a certain minimum number of Independent Directors, with 'independence' being defined in a detailed manner.
2. Listed companies must have Audit Committees of the Board with a minimum of three Directors, two-thirds of whom must be Independent. The roles and responsibilities of the Audit Committee are specified in detail.
3. Listed companies must periodically make various disclosures regarding financial and other matters to ensure transparency.
4. The CEO and CFO of listed companies must (a) certify that the financial statements are fair and (b) accept responsibility for internal controls.
5. Annual reports of listed companies must carry status reports about compliance conforming to corporate governance norms.

There are proposals to reform some of these Corporate Governance provisions, specifically those relating to Independent Directors, under the Companies Bill, 2009, which is pending in Parliament. In all probability the Independent Director's responsibility will increase.

Current Situation

Although SEBI has taken significant action and made some things mandatory, in the true sense in India ,different companies look at Independent Directors differently. In well-managed companies, Independent Directors are viewed as partners of management and as outside mentors who are committed to ensuring that management stays focused to deliver shareholder value, whereas some other companies, may consider Independent Directors as a burden, to be carried along mainly to satisfy regulatory rules of compliance.

Post the Satyam scandal, the role of Independent Directors came under the scanner. Independent Directors are not expected to take just sitting fees without knowing the business. They should be closely watching the business. On the contrary, in companies which consider them as burden, they are deliberately not told about the business or their voice goes unheard. This clearly shows a gap from either side which can be plugged through appropriate Government and Industry intervention.

Issues and Solutions

There are a few issues which have been highlighted below. Resolving them may improve the role of Independent Directors. One of the key issues surfacing these days is the Nomination and appointment of Independent Directors. Clause 49 does not contain any specific procedure for Nomination and appointment of Independent Directors, and the process remains the same like for any other Board Director's appointment.

Currently, Independent Directors are appointed by the Board of Directors post approval from majority shareholders. This has resulted in the emergence of two schools of thought; one says nomination of Independent Directors should be done by the Board, whereas the other suggests it should be done by the Nomination Committee of the Board. If a Nomination Committee is formed, how can the independence of the Nomination Committee be ensured and in case of Board of Directors, how can we ensure that the controlling shareholders will not be able to influence the process of nomination and appointment of Independent Directors?I will comment on this at the end of this article.

Independent Directors have to protect the interest of minority shareholders. We need to have a Nomination & appointment process mechanism in place which ensures that the elected Independent Director should abide by the very purpose he/she has been appointed by the company. Also there is a clear cut need to define role and responsibilities. As per Clause 49, there is no indication as to the constituencies that Independent Directors are to serve. It is not clear whether Independent Directors are to serve the interests of the shareholder body as a whole, or whether they are required to pay greater attention to the interests of the minority shareholders. Considering that Indian companies predominantly display concentrated share ownership, it seems logical that Independent Directors should hold the interests of minority shareholders in mind. But there is no direct evidence of that intention in the wording of Clause 49.

There is no separate task or function assigned to Independent Directors. The most prominent among such functions in the context of the majority-minority agency problem could have been for Independent Directors to consider and approve related party transactions that involve self-dealing by controlling shareholders. But, there is nothing of the kind predicted. Independent Directors are treated like any other Director for purposes of role and decision making and there is neither a specific privilege conferred nor a specific duty or function imposed on Independent Directors, in either case specifically by law, or by the Board.

However, as far as Board Committees are concerned, there are some specific requirements pertaining to Independent Directors. There are usually three types of Board Committees viz. Audit Committee, Shareholders/ Investors Grievances Committee, and Remuneration Committee.

We need to outline the role and responsibilities of Independent Directors at different levels i.e. at Company level, Shareholders level & Board level etc.

It is evident from what is stated above that Corporate Governance and the role of the Independent Director is getting more complex because of the sheer power and size of the enterprise. Business is spread across continents & shareholders too are scattered across the world. To be effective the Independent Director has to have sound judgment, and inquiring mind. He/she should question, debate and challenge, all in a constructive way, so that the executive management listens and responds in a positive way without feeling marginalized & getting demotivated. The Independent Director must have the ability to listen with sensitivity, the views of others on the Board and have the finer instinct to not only look inside but also give the executive management a window to the outside world.

Now the question of getting the right Independent Director! Certainly it would be difficult to get a good person if we make the life of an Independent Director hell. The basic Director's liability apart, being a Corporate Board Director may invite liabilities under a plethora of Central, State and Local laws. Most often, notices, summons, etc are addressed to all Directors. Sometimes, IT searches also do not make a distinction between Executive Directors and Independent Directors. Government has to look into this.

In my mind, ultimately the Independent Director and the Executive Director/Promoter Director, both must have high moral values. The Independent Director must be a person of stature, not recognized just because of the high profile that he/she has cultivated. On the other hand the role of Independent Directors is now embracing other important attributes, such as, contributing to sustainable development, and adhering to the highest standards of objectivity, honesty and moral rectitude in order to deliver true value to all the stakeholders of the enterprise including society at large. Only then will Independent Directors be unafraid to report breaches of propriety. Remuneration to Independent Directors can also be increased to attract such exemplary persons.

Way Ahead

India is one of the fastest growing economies of the world. Corporate governance has also been one of the factors to determine the inflow of Foreign Direct Investment (FDI) and in attracting Private Equity investments. To further strengthen Corporate Governance,Independent Director's role and responsibilities need to be drafted well, looking into the demands of the Company's business. Also a proper acclimatization through detailed induction and training programs should be provided for Independent Directors to discharge their duties towards all the stakeholders involved. With efforts by both Government and Industry, I believe that the roles, responsibilities and selection procedure of Independent Directors will get a leg up. This would help in shaping and projecting Indian Inc. better in the market place just not at home ground ,but on the global platform.

Views expressed are personal