

Independent Directors - Going Forward



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Since 1970's, when US first introduced the concept, a key focus area globally, has been on Independent Directors and the role they can play in ensuring good Corporate Governance. Some of the key issues are discussed below.

Panacea for all Corporate Ills?

The expectations from the Independent Directors are too high

considering they only meet about four times a year and have serious information dissymmetry vis-à-vis executive directors.

Regulators however, would increasingly rely on Independent Directors as panacea for various corporate ills, in spite of empirical evidence clearly showing limitations of this belief. This however does not take away the fact that the ID's do bring various benefits to the board by bringing in diverse skills and expertise, providing a check & balance, even if not perfect, and enabling independent views on critical issues.

Recruitment of Independent Directors

How do you ensure independence, if the Independent Director owes his position solely to controlling / majority shareholders? Recent requirement to have special resolution for appointment of ID's would ensure greater check and balance. Institutional investors will increasingly play a bigger role in appointment of ID's. Companies would have to clarify how the proposed director's qualifications align with the company strategy. Comments of Proxy Advisory firms on such appointments would also become more relevant.

Introduction of "Qualifying Exam" for independent directors was a novel step by Ministry of Corporate Affairs (MCA). There has been some opposition, though I fully support this. However, the current training modules and examination system would need a huge up-gradation.

Gender Diversity

Historically and currently the boards have been male dominated. Most board have been all males with a few having one or two women as members. Recent regulations have ensured that boards have at least one women member. Going forward we would see much greater gender balance than what is currently seen. The addition of women on boards would not be just to meet the legal requirement, but for the wider range of skills, expertise,

backgrounds and personal characteristics that women bring.

Younger Profile

The average age of new class of directors would get younger each year. A major contributing factor would be the two-term rule imposed by Companies Act 2013, where several ID's sitting on boards for decades, would no more be eligible for reappointment. Certain skill sets and perspectives are best available from younger age group and having a mix of age profile in the board would be seen as positive.

Newer Skill Sets

Skills being added to the board, by independent directors, would get more diversified. While Knowledge, skill and expertise in Strategy, Public Policy/Regulatory, Administration, Finance, Audit/Tax and Law will always be required, the future world needs much more – in Technology (digital world / AI), Risk Management (Cyber Security), Marketing (Social Media), International Business and so on.

Lead Independent Director

If CEO is also the chairman of the Board, there is an inherent conflict of interest. To ensure a check and balance in the decision making and governance structure, splitting Chairman and CEO position would gather pace. Where Chairman is either the CEO or from Controlling Shareholders, the power equation gets tilted. To make ID's more effective, there would be acceptance of "Lead Independent Director", as strong independent voice, which helps in communicating the perspective and position of independent directors and other stakeholders to the board.

Super Majority Boards

More and more we are seeing emergence of large corporates with no controlling shareholder. We will see boards with majority of independent directors, and even "Super Boards" with all independent directors except the CEO. In these cases, the ID's would have a greater involvement in strategy and business development than seen in other boards.

Use of External Auditors and Consultants

ID's meet only a few times a year. The most important tool in their hand to increase their effectiveness is the use of external auditors and external consultants. These must be appointed by committee or board directly, with well-defined scope of work and compensation determined directly by the committee / board. The report of the auditor / consultant must also be submitted to the committee / board and not to the management. The use of Auditors and Consultants by Independent Directors through Boards and Committees would increase manifold in the coming years.

Overcoming Cultural Issues

Most of us are reluctant to disturb the collegiality and conviviality in the board. In my two decades in the boards of various companies, I have not seen a single case where a director recorded his dissent to a decision. On one occasion, where there was such a serious difference in views of board members that a secret vote had to be taken, with the resolution just passing by a single vote majority, the decision was still recorded in the minutes as “Unanimous”.

With increasing expectation and risk associated with their position, ID’s would actively seek information and ask questions – including tough ones. Being a “nice guy” and avoiding any conflicting view and statement can reduce the effectiveness of the ID. They would have to show the courage to record their dissent, where the situation demands it, especially for their own protection.

Role in ESG and Sustainability

ESG refers to the three central factors in measuring the sustainability and societal impact of a company. The question is, to what extent these factors determine the future financial performance of the company?

Investors are increasingly giving more importance to ESG in their investment decisions. The investment though is still mostly based on total return expectation, in which ESG plays a role, rather than solely on ESG. Mutual Funds and Asset Managers recently have been offering ESG themed products. These are all at nascent stage and we should see much more developments in this space.

Independent Directors will play a vital role in this space.

More Committees and more frequent meetings

Quite a few changes have been brought in the role of board committees. They have been given more power and more responsibilities. This trend would continue. I see Independent Directors being mandated to be part of more committees – like Risk Management Committee. I further see role of committees expanding. The Shareholder Grievance Committee would most likely encompass all stakeholders. The Audit Committee would continue to have additional areas to look at.

Protection of Independent Directors

It’s important that ID’s are held accountable only if they have an explicit role in commitment of an offence. The regulations must ensure that, though it’s unlikely that ID’s would get complete protection under the laws of the land.

ID’s on their part must, therefore, take all steps possible to protect themselves.

Keeping oneself updated on the business of the company and the environment that affects it is the starting point. This learning is a continuous process. The learning should also cover regulations, basic finance and risk management.

Reading the agenda and coming fully prepared for the meetings is necessary. More often than not, one sees inadequate preparation by ID’s for the meetings.

ID’s will have to keep a hawk’s eye on related party transactions, a root cause of some of the biggest corporate scams.

At the risk of repeating, I would again emphasize on taking on the issue without trying to be a nice guy and using external independent resources (Auditors / Consultants) to investigate / understand issues and arrive at an informed decision wherever necessary.

Insurance covers for Directors would become necessary and larger.

Compensation

Regulators seem to have taken a position that there is an inverse relationship between compensation and independence. I personally believe that independence is much more a personal trait and the ethical & moral beliefs and value system are more important than compensation. Paying enough to encourage capable persons to take up the risk and challenges of ID position, without compromising his/her independence would continue to get much attention.

Conclusion

While the Institution of independent Directors is neither perfect, nor a panacea for all corporate ills, I believe that the Corporate Boards are better off with Independent Directors than without. They would continue to play an increasingly important role in Corporate Boards, amidst ongoing debates and discussions on increasing their effectiveness.