A Role Separation of Chairperson and MD/CEO

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Introduction

A company's board is it's foremost strategic asset. This has never been tested more than now when Indian economy is trying to recover from the aftermath of the Covid 19 pandemic and its brutal second wave while preparing itself for a potential third wave. Organizations face several challenging situations regarding working capital, cash flow, and employee wellbeing among others as they undertake revival of the trajectory for key business metrics to return to pre-covid levels. In addition, they are also grappling with the challenges of the post-pandemic world such as new operating models, work preferences and other market and customer realities.

Boards are stepping up like never before to provide counsel and direction to executive teams to help navigate a world with a never seen before disruptability quotient exacerbated by rapid impact of climate change, geopolitical landscapes, and an ever-prevailing uncertainty.

And, while dealing with all this, India Inc and the boards are acutely aware that it is less than a year (post one extension already) for the SEBI guidelines of separating the roles of the Board Chairperson and Managing Director/ CEO to come into effect for top 500 listed companies by market cap.

The Context

In 2017, the Kotak committee led an in-depth study on the state of corporate governance and provided recommendations to SEBI and the provisions under its LODR (Listing Obligations and Disclosure Requirement) Regulations. One key focus area was regarding the division of roles of the Non-executive Chairperson and Managing Director/CEO. While referenced in the Companies Act 2013 and mentioned in the SEBI LODR regulations for listed companies, it was not a mandatory but rather a discretionary requirement.

Acting on this suggestion, SEBI shared a notification in May 2018 with specific norms to split the post with effect from April 1, 2020. However, based on representations from the industry, this deadline was extended by two years, till April 1, 2022. In a widely quoted statistic, SEBI Chair Mr. Ajay Tyagi shared that only 53% of the top 500 listed entities had complied with the provision at the end of December 2020 and urged eligible listed entities to be prepared for this prior to the revised deadline.

Global Perspective

The argument to split the roles is an ongoing discussion in India as well as in different parts of the world. While there is wide acceptance as evinced in the UK, large parts of Europe, Japan, Australia, and South Africa, it is still hotly contested in other countries such as the US and France among others. In Europe, greater than 90 percent of FTSE 100 companies have distinct roles defined. The US has also witnessed a strong trend of organizations moving towards the split despite strong opinions for both sides. In the early 2000's, around 16% of large, listed entities in the US had separate roles but this increased to more than 50% in two decades.

One of the vocal advocates of this split is Institutional Shareholder Services, the proxy shareholder firm which has proposed adopting a policy to vote for a split in the Chairperson and CEO roles. This is especially if the company holding the vote has "problematic performance, governance or management issues". While some prominent organizations such as Boeing, AT&T, and Wells Fargo have moved in this direction, others have moved toward combining these roles. In Asia, Alibaba recently indicated that it will soon move towards combining the two roles.

The arguments for separating the two roles are based on a simple premise. The Managing Director and CEO is 100% in charge of the executive/ leadership team, runs day-to-day operations and results and is an officer of the company. The Chairperson's role is to preside over meetings of the board, oversee functioning of committees and is aimed at providing strong governance at the board including overseeing the CEO's performance.

Studies on the effectiveness of one model over the other have yielded contrasting results. In a 2012 study, researchers at GMI Ratings established that companies with combined roles generated a lower return to shareholders as compared to companies with separate roles.

However, in the 2016 paper "Chairman and CEO: The Controversy over Board Leadership Structure", researchers David Larcker and Brian Tayan of Stanford University could not find any evidence of the separation of roles leading an improved correlation with organization performance or governance quality. Another piece of research highlighted how the separation of positions when the organization is doing poorly leads to improved performance. However, its performance suffers if the roles are separated when the company is not struggling.

Hence, the overall body of research globally is inconclusive at best in this area, though there is growing acceptance in its favour.

Our Point of View

In India, with a predominance of large promoter driven organizations with a presence in more than one line of business, it is critical to ensure a fair and just board to provide strong guidance to the management in an increasingly unpredictable environment. It is also important to prevent potential misuse of powers leading to conflict of interest between the role of Chairperson and MD. Though companies may argue that there isn't any compelling data that companies fare better with or without, the case for separation in roles is compelling from conflict-of-interest reasons. Executive pay is decided by a corporate board, meaning a CEO who is also chair votes on their own compensation—a clear conflict of interest. Also, Boards monitor corporate governance, or how the CEO runs the company relative to its mandate and shareholder wishes—making it difficult for a chair/CEO to objectively monitor themselves.

One of the board's main roles is to monitor the operations of the company and to ensure that it is being run in conjunction with the mandate of the company and the will of the shareholders. As the CEO is the management position responsible for driving those operations, having a combined role results in monitoring oneself, which opens the door for conflicting views of the position. A board led by an independent chair is more likely to identify and monitor areas of the company that are drifting from its mandate and to put into place corrective measures to get it back on track.

Though companies may argue that having a well-functioning audit committee to independently review actions of the executive team may achieve the required outcome, a strong and an independent board Chairmanship, distinct from executive is the best and surest way to achieve the required corporate governance outcome.

Conclusion

India Inc needs to plan for and embrace the SEBI mandate and accord Board leadership the same thoughtful, disciplined approach that is now accorded to the CEO succession process. Planning for timely Board succession enables the establishment of the best working relationship between the CEO, the Chairperson, and other directors. Exceptional independent board leadership is not achieved by accident, and ineffective board leadership can destroy value.

Identifying the right non-executive or independent directors involves seeking individuals with high intellectual horsepower, exceptional collaboration and team-building skills, impeccable ethics and integrity, The Chairman needs to be a highly accomplished leader respected by the CEO and the entire board. Having a track record of attracting, energizing, and mentoring top talent with a cool head under pressure is also a critical skillset.

Effective corporate governance has been the north star for the stalwarts at SEBI and progressive custodians of India Inc. who have successfully driven key systematic reforms. The time has come when the separation of roles needs to be actively considered by the Boards of all organizations, and not just limited to the top 500. Let's make it a priority and not just a regulatory driven necessity.