15

Strengthening the Institution of Independent Directors

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1. Introduction

Corporate governance reforms in developed and developing countries have focused on making corporate boards more effective in ameliorating agency problems between shareholders and managers in publicly held corporations. An important element of this reform has been to make corporate boards more outsider-oriented, with a mandate specifying the ratio to be maintained between the number of independent directors and executive directors comprising the board. The rationale behind this move has been the agency theoretic view that independent directors—due to their presumed independence relative to insiders on boards—can be more effective in curbing managerial opportunism as these directors have incentives to promote the interests of shareholders in order to protect their reputational capital and to prevent being sued by shareholders (Bhagat et al., 1987; Fama, 1980).

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A typical board of modern corporations consists of inside or executive directors who are full time employees of the company and are involved in its day to day operations and outside or non-executive directors who do not have any executive responsibilities and play a mostly advisory role. The outside directors are generally further classified into affiliated directors (or grey directors) who are former company officers, relatives of company officers, or those who have existing business relationships with the company such as investments bankers and lawyers; and non-affiliated directors who are outside directors with no such affiliation. Non-affiliated outside directors, commonly referred to as non executive independent directors or simply as independent directors, are the ones who are expected to perform the monitoring role and are widely regarded as the fiduciaries of the shareholders' interest.

Since the board consists of both management or executive directors as well as non-executive directors, this raises the obvious question: "If the board is responsible for formulating and implementing the business strategy then how credible is it to expect that it will be forthright in ensuring the accountability of the very actions that it has taken by itself?" In the early days when modern corporations were being formed, the principle of "accountability through disclosure" was the primary method of holding executives responsible for their actions. Outside directors were expected to provide expert vision and fresh thinking to foster the growth of the company rather than to monitor executive actions. However, with the increase in size and complexity of operations of modern organisations the effectiveness of the principle of accountability through disclosure has been severely attenuated. While regulations in most countries now require a large amount of information disclosures, and have prescribed standards and codes for financial reporting, executives still retain a large degree of freedom in financial reporting due to the existence of ambiguities and alternatives in financial reporting. Indeed instances of creative accounting practices and earnings management are widely documented in academic studies. Under these circumstances, regulations in many countries have started emphasising the monitoring role of the independent directors as the principle way of ensuring the accountability of executives for their actions. This move has been strengthened by the collapse of some large corporations in the UK and the US that were believed to have had very efficient boards and highly celebrated CEOs, and by reported instances of self dealings by insiders particularly with respect to executive compensation. Thus the Combined Code of the Financial Reporting Council in the UK, the Securities and Exchange Commission's regulations in the US, and the stock exchange listing agreements' Clause 49 in India (as mandated by the Securities and Exchange Board of India), all emphasised both the need for and the role of the independent directors in ensuring high standards of corporate board governance.

The theoretical arguments behind the composition and functioning of the board of directors have their origin in the works of Fama and Jensen (1983a, 1983b) who distinguished between the concepts of decision management and decision control. Decision management refers to the initiation and implementation of decisions, while decision control refers to the ratification and monitoring of decisions. Agency costs arising from separation of ownership and control which are characteristic of modern day corporations are minimised when decision management and decision control rests with two independent groups—decision management resting with the executive directors who have the necessary skills and expertise to operate the firm in the most profitable way, and the decision control rests on the residual claimants, or the representatives of the residual claimants, who bear the cost of managerial discretion. Thus the composition of the board of directors serves a vital role in ensuring that managerial discretion is exercised in the best interests of the shareholders.

2. The need for independent boards in Asian corporations

The need to have an independent board is heightened in the case of Asian economies including India, where family owned corporations belonging to business groups dominate the corporate landscape, and where family members with substantial ownership and control rights occupy managerial positions with the objective of controlling the firm. When ownership and control are concentrated in the same hands, the nature of the agency problem changes vis-à-vis diffused ownership structures, from shareholder manager conflicts (Type I or "vertical" agency problems) to conflicts between two categories of principals—the controlling inside shareholders, and minority outside shareholders (Type II or "horizontal" agency problems). While controlling shareholders have a strong incentive to monitor and thus limit Type I agency problems, they also have both the incentive and the opportunity to extract and optimise private benefits for themselves at the expense of minority shareholders (Morck et al., 2005). Gaining effective control of a corporation enables the controlling owner to determine not just how the company is run, but also how profits are being shared among the shareholders (Claessens & Fan, 2002). Although minority shareholders are entitled to the cash flow rights corresponding to their share of equity ownership, they face the uncertainty that an entrenched controlling owner may opportunistically deprive them of their rightful share of profits through various means.

Several Type II agency costs are associated with family and other dominant ownership *per se*. Agency costs can arise on account of the family owning substantial stocks in family enterprises, by virtue of which it gets directly involved in the operational management in the capacity of CEO or as members of senior management. This gives them large discretionary power over a firm's decisions, which in turn can facilitate expropriation of minority investors. Bautista (2002) for instance observes that owing to the dominance of family members in decision making and the non-transparency in functioning, minority shareholders are often kept in the dark regarding the actual state of the corporation. Further, expropriation of minority shareholders can occur through controlling owners acquiring control rights in excess of ownership rights by using pyramidal structures in the organization of several group firms. When controlling shareholders are widely held corporations instead of families, agency problems with respect to minority shareholders can stem from corporations making deals between a parent firm and a subsidiary through related-party transactions that may not benefit the subsidiary's minority shareholders.

The empirical evidence from Asia and Europe with regard to the presence of Type II agency costs in the context of corporations with concentrated ownership and control is substantial. For instance, cross-country analyses of business group firms in East Asian and Western European economies, as well as emerging markets find a negative association between firm value and the wedge between control and cash flow rights (Claessens et al., 2002; Faccio et al. 2001; Lins, 2003). Country-specific studies also indicate similar results. The study by Joh (2003) of Korean business groups finds that firm performance is negatively related to the divergence between control and cash flow rights suggesting the presence of expropriation; Bertrand et al. (2002) find evidence of tunnelling in Indian business groups. The accounting literature on earnings management and earning quality has also produced evidence that a greater divergence between control and cash flow rights leads to higher earnings manipulation by the controlling shareholders. Based on a sample of Korean firms Kim and Yi (2005) conclude that a greater divergence between ownership and control results in higher opportunistic earnings management because controlling shareholders want to hide their private benefits of control. Further firms affiliated to business groups are engaged in higher earnings management compared to non-affiliated firms. Studies with respect to Chinese listed companies find that earnings management in China is driven by related-party transactions (Jian & Wong, 2003), and is induced by the controlling shareholders' incentives to tunnel. Liu and Lu (2007) find that firms with better governance (represented by a composite corporate governance index) engage in lower earnings management in China.

3. Promoter dominance in Indian companies

Promoter dominance in corporate ownership

The Indian corporate sector is characterised by firms with concentrated ownership and control akin to those dominating most developing and emerging economies. Domestic private sector firms are either affiliated to business groups or are non-affiliated standalone firms. Both standalone and group-affiliated firms are largely family firms with considerable equity holdings by family members as well as family involvement in the management of the companies. Since the early days of industrialisation, corporate sector activities in India have been dominated by business groups. The dominance of group affiliates is evident from the fact that the percentage of group affiliates in the top 50 corporate sector firms ranked by assets has remained around 80% over the years. In 2006, eighteen of the top 20 listed firms ranked by market capitalisation belonged to business groups.

Both group affiliates and standalones can be either widely held or have concentrated ownership. However, an examination of the ownership structure of a large sample of listed firms reveals that a large majority of firms in India (irrespective of their ownership affiliation) are characterised by concentrated ownership and control structures and widely-held firms (where no shareholder controls 20% votes)[1] are an exception rather than the rule. As of 2006, the percentage of such firms in a sample of 1965 listed Indian private sector non-financial and non-financial firms (accounting for more than 80% of the total market capitalisation) is only 5.5%. As is evident from Table 1, which presents roughly comparable estimates of widely-held firms across different countries, this percentage is substantially lower than the estimates derived for countries dominated by widely-held firms, such as the UK, the US and Japan, and is also relatively lower than the percentage in countries in Europe and East Asia, which are typically dominated by concentrated ownership structures. The estimates for widely held companies in India are however comparable to Hong Kong, Indonesia, Singapore, and Thailand (Table 1). If one considers the percentage of widely held companies in the largest 20 corporates across countries, India stands out as an exception—none of the top 20 listed companies, ranked either in terms of market capitalisation or asset size, are widely held. In fact, the largest blockholders in these companies, with an average market capitalisation of Rs. 376310 million (approximately $8362 million), are families with an average holding of around 48%, the minimum and maximum holdings across the companies being 22% and 85%, respectively.

Table 1: Control of publicly traded companies in select countries

Countries	Percentage of listed firms widely held[1] (i)	Percentage of top 20 firms widely held[2] (ii)
India	7.2	10
US and Europe		
US	Not available	80
UK	63.1	90
Germany	10.4	50
Italy	13.0	20
East Asia		
Japan	79.8	90
Hong Kong	7.0	5.0
Indonesia	5.1	15.0
Korea	43.2	65.0
Malaysia	10.3	30.0
Philippines	19.2	40.0
Singapore	5.4	20.0
Taiwan	26.2	45.0
Thailand	6.6	10.0

Source: The data presented in column (i) for select European countries was sourced from the study by Faccio and Lang (2002) of 5232 listed firms across 13 European countries. The data in (i) for East Asian corporations was sourced from a study by Claessens et al. (2000) of 2980 publicly traded corporations for the year 1996. The data in column (i) presented for India was computed by the author based on a sample of 1965 publicly traded Indian companies for the year 2006 based on data obtained from CMIE Prowess database. The data in column (ii) for US and Europe were sourced from La Porta et al. (1999). The sources of the remaining data are the same as in column (i).

The pervasiveness of family control among Indian corporates is further evident from Table 2. Unlike most other countries in East Asia, family control in India is common both among the large companies (top 20) as well as in the smaller companies (bottom 50), and is highest when compared to East Asian countries. From the estimates in Table 1 and Table 2, it can be inferred that Type 1 agency problems would be less important in India, while given the complex structure of family owned business groups, Type II agency problems are likely to exist in a large measure.

Table 2: Family ownership of listed firms in select countries

Countries	Percentage of listed firms held by family by size		
	Largest 20 (i)	Smallest 50 (ii)	All (iii)
India	85.0	94.0	88.0
East Asia			
Japan	5.0	57.0	9.7
Hong Kong	72.5	57.0	66.7
Indonesia	60.0	93.0	17.5
Korea	20.0	97.0	48.4
Malaysia	35.0	84.0	67.2
Philippines	40.0	45.0	44.6
Singapore	32.5	67.0	55.4
Taiwan	15.0	80.0	48.2
Thailand	57.5	76.7	61.6

Source: The data presented for East Asia was sourced from a study by Claessens et al. (2000) of 2980 publicly traded corporations for the year 1996. The data for India was computed by the author based on a sample of 1965 publicly traded Indian companies for the year 2006 based on data obtained from CMIE Prowess database.

Promoter influence on corporate boards

This extensive dominance of promoters in corporate ownership in India is mirrored in their dominance on corporate boards. Table 3 presents the trends in board composition and promoter dominance for the period 2003–2008 in Indian companies. A typical board in India comprises 30% executive or inside directors and 70% non-executive or outside directors. While the presence of such a large percentage of outside directors might suggest outsider dominance, about 20% of these outside directors are in reality affiliated directors, many of whom are promoters or relatives who occupy board seats as non-executive members. The figures in Table 3 show that the composition of the typical board has remained quite stable over the years.

In 2003 two out of every five companies in India typically had a promoter present on the board. More importantly, the presence of promoters on company boards has increased significantly over the years with a noticeable jump in 2005—approximately around the time when stricter governance regulations became applicable to virtually all listed companies. By 2008, every three out of five Indian companies had a promoter on board. The disaggregated data shows that while promoters have increasingly taken up positions both as inside and outside directors, the increase has been much more significant for positions as inside directors. Thus while the proportion of companies having promoters as outside directors increased from 26% in 2003 to 33% in 2008, the proportion of companies with promoters as inside directors increased from 32% in 2003 to 47% in 2008, suggesting an escalating promoter role in executive management.

Table 3: Promoter influence in company boards

	2003	2004	2005	2006	2007	2008	All Years
Board Size	9.80	9.56	9.01	9.11	9.20	9.41	9.34
Board composition							
Percentage of Inside Directors	28.61	29.31	30.86	29.43	28.14	28.23	28.99
Percentage of Grey Directors	17.87	18.40	18.53	21.54	21.91	19.90	19.93
Percentage of Independent Directors	53.52	52.29	50.61	49.03	49.95	51.87	51.08
Proportion of companies having							
A Promoter Director	0.40	0.45	0.54	0.63	0.56	0.59	0.54
A Promoter as an Executive Director	0.32	0.37	0.41	0.50	0.44	0.47	0.43
A Promoter as a Non-Executive Director	0.26	0.28	0.37	0.41	0.32	0.33	0.33
In companies with a promoter director, percentages of board seats held by							
Promoter Directors	30.86	31.26	32.61	30.21	28.68	27.98	29.91
Promoter Executive Directors	16.79	17.10	16.71	16.94	16.30	16.38	16.66
Promoter Executive Directors	14.06	14.16	15.90	13.27	12.38	11.60	13.25
In companies with a promoter director, proportion of companies where							
Promoter is Chairman or Managing Director	0.81	0.82	0.92	0.94	0.94	0.95	0.91
Promoter is Chairman	0.72	0.73	0.85	0.87	0.85	0.86	0.83
Promoter Share (%)	54.45	54.69	53.22	52.50	52.63	53.17	53.35

Source: Author's calculations based on a sample of top 500 listed companies in India. The data was compiled from the Corporate Governance Reports contained in the Annual Reports of Companies.

When promoters are present as directors in a company, they exert a significant influence on the board. Table 3 shows that in 2003 promoters occupied three out of every ten seats in companies where they were present as directors. This proportion has remained essentially the same over the years with a slight decrease in 2007 and 2008. The board seats were almost equally split between inside and outside positions in 2003–2005 but showed a relative shift towards inside positions since 2006. In 2008, in those companies where promoters were present, they occupied 16% of these seats as inside directors compared to 12% as outside directors. More importantly, Table 3 shows that when promoters are present in the board, they occupy key board positions. In 2003, when promoters were present on the board, they occupied the position of either the chairman or the managing director in 80% of the companies. This percentage increased very significantly over the next five years and by 2008, except for 5% of the companies, promoters occupied the position of chairman or managing director in all the companies where they were present on corporate board. Finally, as the last row of Table 3 indicates, promoter ownership has been well over 50% giving the promoter absolute control over these companies.

The above analysis suggests that Indian companies (at least the large ones) are virtually controlled by promoters in terms of both ownership as well managerial discretion. While this might reduce Type I agency costs, the possibility of expropriation of minority shareholders in this setting is high. One way of exerting corporate governance is to publicise the ownership structure of these firms, and then let investors take their own decisions based on their informed judgment. If agency costs are really serious—with increasing Type II agency costs outweighing the benefits of concentrated ownership—then stock discounts will automatically endogenise the costs of family ownership and force companies to move towards better corporate governance practices. Moreover shareholders can initiate litigation in a court of law if there are fraudulent practices. This seems to be the approach in the New York Stock Exchange (NYSE) Regulations which do not require the adoption of the NYSE codes related to board independence and independence of nomination and compensation committees[2] with respect to controlled companies. However in emerging economies where investor education is low and legal protection is weak, there is merit in proactive steps being taken by the regulator to safeguard the interest of the minority shareholders. If one accepts this view then designing appropriate mechanisms for good governance is a must.

In this scheme of things, the board of directors, and especially the institution of independent directors, becomes an important regulatory mechanism for the protection of minority shareholders. It could be argued that there are many other internal and external mechanisms like the market for corporate control, the managerial labour market, shareholder activism, debt bonding, performance contingent managerial compensation contracts, and so on which could act as alternative governance mechanisms. However, in each of these cases, the crucial input is information disclosure. When control is concentrated both in terms of ownership as well as management discretion, the production of information that gives a full and fair view of the operations of the company is paramount for governance. Given the proliferation of listed companies worldwide and especially in the growing economies in East Asia and certainly in India, oversight of the financial reporting process by the regulator becomes infeasible. In such cases, the oversight of information production must rest with a body that is internal to the company and that is independent of the management. The institution of independent directors offers this internal mechanism. It is therefore not surprising to find that regulations in many countries, whether developed or emerging, are increasingly moving towards having independent boards, and are requiring that audit committees, nomination committees, and compensation committees be composed solely of independent directors (see for example the amended NYSE Regulations, effective November 2009). The excessive managerial remuneration that has been identified as one of the most important reasons behind the financial crisis of 2008 has also led to an increasing demand for compensation committees to be staffed by independent directors to avoid self dealing by inside directors. While there could be considerable debate over the exact procedures involved in designing an independent board and independent audit committees and compensation committees, the very idea of strengthening the concept of independence probably cannot be questioned especially in the context of East Asian corporations and India.

4. The move towards independent boards across the world

Though an alternative view questions the efficacy of independent directors in mitigating managerial opportunism and serving shareholder interests (see Fink, 2006; Mace 1986; Morck, 2004, among others for a review), a survey of corporate governance reform initiatives across a cross-section of countries irrespective of their underlying institutional contexts reveals that these initiatives have been predominantly influenced by the agency theoretic view that independent boards are good for corporate governance and for protecting shareholder and other stakeholder interests. The concept of an independent director became part of the corporate governance lexicon in the 1970s, and the move towards board independence that originated in the US as a good governance exhortation soon acquired the status of a legal requirement (Gordon, 2007). Between 1994 and 2000, at least 18 countries came out with recommendations or stipulations on the minimum requirements (either in absolute terms or as a proportion of total board strength) for outside directors on company boards (Dahya & McConnell, 2003).

With corporate boards gradually being expected to perform more of a monitoring role rather than merely an advisory role (often due to governance failures), the shift towards having more outsiders on the board, and in particular having more independent directors, has become increasingly pronounced, legally binding, and more stringent with time. As estimated by Gordon (2007), between 1950 and 2005, the proportion of independent directors on company boards in the US steadily increased from around 20% in 1950 to around 75% in 2005. Regulations in many developed countries now require or recommend a majority or substantial presence of independent directors on corporate boards. For example, the NYSE Listing standards (Section 303A.01 of NYSE Listed Companies

Manual)[3] now require all public companies to consist of a majority of independent directors, while the UK Combined Code on Corporate Governance, and the Australian Stock Exchange recommend a majority of independent directors on corporate boards.

Emerging economies too seem to be moving towards the constitution of more independent boards. The IBGC Guidelines of Code of Best practice in Brazil recommends that corporate boards have a majority of independent directors, while the HKEx Main Board Listing Rules in Hong Kong requires boards have a minimum of three non-executive independent directors, and the Code of Corporate Governance in Singapore recommends that at least one-third of the board should comprise independent directors. Following the general trend worldwide, the current Clause 49 regulations in India require at least one-third of the board to consist of independent directors if the company has a non-executive chairman, and at least half of the board to consist of independent directors if the company has an executive chairman or the chairman is related to the promoter.

One notable difference between developed countries and emerging economies is that the regulatory requirement for the percentage of independent directors in general seems to be low for emerging economies. This is quite surprising because corporations from emerging economies which represent higher insider control would be more in need of independent oversight. One potential explanation for the lower requirement of independent directors could be that the evolution of corporations and the dominance of family business in these economies make the process of change more gradual.

What is interesting however, is that while regulatory requirements both in developed and emerging economies require a majority of independent directors on company boards (for example the NYSE regulation), the percentage of independent directors actually employed by companies far exceeds the regulatory requirements. Thus in the US, a typical corporate board comprises 75% independent directors (the regulatory requirement is for a majority of independent directors on the board), while a typical board in Australia and Canada has slightly more than 70% independent directors.

While the Code of Corporate Governance in Singapore recommends at least one-third of the board to consist of independent directors, a typical board contains 50% independent directors. The board composition of these countries seem to suggest that companies perceive independent boards as adding value to a company, and leading to favourable assessment by outside investors with corresponding benefits of lower cost of capital and ultimately higher value of the company.

5. Does board independence matter in governance?

Given the move towards independent boards across the world, we next look at what the empirical literature has to say on the effect of board independence on corporate governance in general, and firm performance in particular. Here, the evidence can be divided into two parts—the first analyzing the performance of independent boards in accomplishing discrete tasks (such as hiring and firing of CEOs, response to takeovers, determining CEO compensation, and the probability of litigation), and the second analyzing the effect of independent boards on firm value in the long run.

With respect to accomplishing discrete tasks, the empirical literature suggests that boards with more independent directors tend to behave differently compared to boards with a lower representation of independent directors. One of the primary tasks of the board is to monitor the CEO and replace him in the event of serious underperformance. Weisbach (1988) finds that boards with more independent directors are more likely to replace a CEO following poor performance compared to boards with a lower measure of independence. Scott and Kleidon (1994) who look at firm performance pre and post CEO replacement find that firms with majority-outside boards who fire their CEO have worse pre-replacement performance compared to other firms. With respect to takeovers, Cotter et al. (1997) find that tender offer targets with majority-independent boards realise 20% higher stock price returns compared to targets without majority-independent boards. Byrd and Hickman (1992) report that tender offer bidders with non majority-independent boards tend to have significant negative returns while bidders with majority independent boards do not suffer any such loss. With respect to securities litigation, Helland and Sykuta (2005)—using data from 21500 private securities litigations as well as Securities and Exchange Commission (SEC) filings in Federal Court between 1988 and 2000—find that firms with boards having a higher proportion of outside directors have a lower probability of being sued, and that outside directors do a better job of monitoring management.

While the findings suggest that more independent boards behave differently from less independent boards, they do not tell us if long term firm performance improves say after the firing of the CEO. For every CEO who is fired, a new one has to be employed and it is not clear from these studies if the board is qualified enough to do this job (Bhagat & Black, 1998). While this is indeed an important question, this critique essentially mixes two issues—replacing a poorly performing CEO, and hiring a new one. A new CEO can be hired only if the currently poor performing one is fired, and therefore the positive effect of an independent board in accomplishing the first objective is a signal of the competence of the board. Hiring decisions are not the primary responsibility of the independent directors, and independent directors are not hired for their specialised skills in CEO recruitment. In any case, the independent directors can take the help of external hiring experts to assist them in hiring a new CEO.

The evidence from developed countries and those from emerging economies offer a contrasting picture with regard to whether having independent boards correlates with the long term value of the firm. In developed countries with a long tradition of independent boards like the US, the correlation is admittedly weak, raising doubts as to whether the "outside director mania" across countries and the presumption that the outside directors matter "rests more on faith than on evidence" (Dahya & McConnell, 2003). Baysinger and Butler (1985) and Hermalin and Weisbach (1991) report no significant correlation between board composition and various measures of corporate performance. In a comprehensive study of 957 large US public corporations over the period 1983–1995. Bhagat and Black (2002) found no consistent evidence that the proportion of independent directors affects firms' performance based on a number of stock price and accounting indicators. Their study showed that while the proportion of independent directors is associated with slower past growth and stock price performance (suggesting that poorly performing firms might hire more independent directors), this association disappeared for future performance. Some studies suggest that firms with more independent directors might actually perform worse, with the proportion of independent directors correlating negatively with Tobin's Q (Agrawal & Knober, 1997; Yermack, 1996), though these extreme results are not robust when using alternative measures of performance; besides some of these studies use outside directors as opposed to independent directors to study the effect of board composition.

While the evidence on the correlation between board independence and firm value from developed countries is weak, the evidence from the growing empirical work on emerging economies tends to suggest that higher board independence correlate with higher firm value (see for instance Peng, 2004 in the context of China; Yeh & Woidtke, 2005 in the context of Taiwan; Black et al., 2006 in the context of South Korea; Sarkar & Sarkar, 2009 in the context of India). The study by Peng (2004) provides evidence of a positive effect of independent directors on firm performance for a sample of listed Chinese firms when performance is measured in terms of sales growth, but of no impact if performance is measured as return on equity. Results similar in spirit to the Chinese study are reported with respect to a sample of Taiwanese firms (Yeh & Woidtke, 2005)—companies with boards dominated by members affiliated with the controlling family do worse than companies where the board is dominated by non-affiliated members. Black et al., (2006) in their analysis of listed companies in South Korea find a strong correlation between board composition and firm value, with companies consisting of a majority of outside directors showing significantly higher value. An empirical analysis of the effect of boards dominated by independent directors in large Indian companies (Sarkar & Sarkar, 2009) finds firm value to be positively correlated with the expertise of the independent directors, proxied by the extent of their multiple directorships. The findings from these studies tend to suggest that an independent board can act as a potential countervailing mechanism to diminish the influence of controlling shareholders on corporate boards, and can be successful in ensuring that managerial discretion is exercised in the best interests of all the shareholders.

Additional evidence related to the positive effects of independent boards and independent audit committees which are created from a subset of the directors on the board, comes from the extant accounting literature that looks at the effect of board composition on earnings management and earnings quality. Using a sample of 92 US firms under SEC investigation for manipulating earnings, Dechow et al. (1996) find that firms with a higher proportion of independent directors, smaller boards, and with an audit committee have lower earnings manipulation. Studies with respect to UK largely mirror these findings. Peasnell et al. (2000) in their empirical analysis of the effect of the recommendations of the Cadbury Committee Report on a large sample of UK firms found that non-executive directors had become more efficient in constraining earnings management practices in firms adopting the Committee's recommendations. Peasnell et al. (2005) also provide evidence that independent directors reduce earnings manipulation, and that their effectiveness in doing so increases when the board appoints an audit committee.

Though studies on the effect of board or audit committee independence on earnings management with respect to emerging economies are limited, the few that exist find that even if board independence per se does not reduce earnings management, the expertise and diligence of the independent directors do have a significantly positive effect. For example, Sarkar et al. (2008) in their study of 500 large companies in India for the years 2003 and 2004 find that the quality of board as captured in terms of the diligence of the independent directors (manifested in their ability to devote time to company affairs) has a strong beneficial effect on reducing earnings management, while CEO duality and the presence of controlling shareholders on boards seem to increase earnings management.

6. What explains the weak relation between board independence and firm value?

While the evidence on the correlation between board independence and firm performance tends to suggest that independent boards seem to do better with respect to discrete tasks and other performance measures like earnings management and earnings quality, their effect on firm value from developed and emerging economies offer contrasting results. In emerging economies, the evidence mostly suggests that an independent board tends to neutralise the effect of controlling shareholders on the board; however evidence of its strong direct effect on long term firm value remains somewhat elusive. The uncertain relationship between board independence and governance seems to run counter to the unambiguous policy position taken across countries irrespective of their governance systems, that board independence is critical for mitigating agency problems in public corporations. How does one resolve this puzzle of the gap between policy prescription and ground realities? What then is the future of board independence?

There are two reasons for these differences. In developed countries alternative control structures like CEO compensation, takeover markets, ownership patterns, etc. have adjusted optimally to the corporate governance needs of different firms, and so it is difficult to find any relation between firm performance and a specific control mechanism. Secondly, firms in developed countries (especially in the US on which most of the evidence is based and which has a long history of shareholder activism) irrespective of existing regulations, may have voluntarily chosen to have a few outsiders on boards with little variance in board composition over time. This would again imply that the effect of changes in board composition on corporate performance may be difficult to detect. This conclusion seems consistent with the fact that in the US, corporate boards seem to contain independent directors far in excess of what is required under regulations. Until the current changes in December 2003 (most of the studies on board independence in the US predate this), US regulations required company boards to have a minimum of three independent directors. Yet a typical corporate board of 11 members contained six independent directors (Bhagat & Black, 2002).

However, while this equilibrium argument can explain the lack of any systematic relation between board independence and firm value in developed countries, it is inadequate to explain the lack of any strong evidence with respect to emerging economies which are still evolving in terms of their governance structures. An explanation for this might come from the findings of experiments in social psychology which suggest that behavioural issues in the presence of an authoritative figure may often hinder the exercise of independent judgment; this might explain the lack of a strong relationship between firm value and independence of corporate boards. These experiments highlight how simple elements of human behaviour (like loyalty) impede the independent decision making process of an individual. Referring to the famous Milgram experiment (1963, 1974),[4] Morck (2004) argues that in the absence of complementary institutional mechanisms, genuine independence of directors from management may prove to be elusive. The Milgram experiment showed how ordinary individuals out of a sense of loyalty to an experimenter (the authoritative figure) were willing to cause extreme harm to perfect strangers disregarding their own assessment of the consequences of such actions on the instructions of the experimenter. Morck (2004) drawing an analogy between the experimental set up and the corporate board observes that the directors of a board often owe allegiance to the CEO (possibly because teh CEO has the most say in nominating them) and would, out of a sense of loyalty, seldom oppose the CEO's decisions even at the expense of a director's fiduciary duty to the shareholders. An extension of the results of Milgram's experiment would in fact suggest that directors enjoy a positive sense of well-being from their "reflexive obedience" to the CEO. If independent directors are subject to the influence of an "authoritative" CEO, this might explain the weak relation between firm value and board independence in general, and in emerging economies in particular.

The possibility of independent directors acting as the obedient agents of a powerful CEO is a distinct possibility in emerging economies given that our earlier analysis shows that corporations of these economies are dominated by controlling shareholders who often occupy important positions in corporate boards, and are therefore in a position to exert significant influence on the selection and appointment of independent directors. Similar observations are applicable with respect to India given that a large proportion of the boards in India are additionally characterised by CEO duality; also there is a significantly increasing trend of boards having promoters doubling as chairmen in boards. It has generally been the practice that promoters often identify and induct outside directors with whom they have a certain comfort level, or who are well-known personalities who can bring credibility to the board (–FICCI-Grant Thornton, 2009). An analysis of multiple directorships that points to the existence of an inner circle with respect to independent directors (Sarkar & Sarkar, 2009) sitting on corporate boards of family-owned group affiliates also reinforces this possibility.

However, while reflexive obedience is an innate characteristic of human nature, variants of the Milgram experiment do show that altering the environment of the interaction can substantially diminish, and in some cases, eliminate this reflexive obedience. The Milgram experiment suggests that "dissenting peers" and "rival authorities" substantially weaken the subject's loyalty to an authoritative figure and stimulate independent thinking. While the results of the Milgram experiment that were conducted in different social settings may not be fully applicable to evaluate the behaviour of directors on corporate boards, the results from this experiment do provide insights that highlight the importance of designing an effective board process that can help independent directors to exercise their independence. Regulations in many developed countries seem to be borrowing the insights from the Milgram experiment while undertaking governance reforms with respect to corporate boards. Several policy initiatives have been instituted in countries like the US and the UK which have been incorporated in listing regulations and best practice codes to reduce the potential cost of dissent by independent directors on boards with powerful CEOs, and to allow independent directors to act as a peer group independent of the CEO. This is perhaps in response to a growing recognition that rewarding consent and discouraging conflicts can not only have an adverse effect on both the CEO and the company performance, but also—in the absence of the "monitoring and criticism of an active and attentive board"—cause a series of small problems that could eventually blow up to a crisis (Jensen, 1993).

Among the policies designed to make independence more functional are (1) the requirement to have a Nomination Committee comprised entirely of independent directors which (in addition to other functions) would have the responsibility of identifying candidates qualified to become board members and overseeing the evaluation of the board and management;[5] (2) the appointment of a senior independent director; and (3) the separation of the positions of CEO and Chairman. In addition, the responsibilities of directors prescribed in most governance codes require meetings with other members of the board in executive sessions without the presence of the CEO/chairman at least annually, to evaluate and appraise the performance of the CEO/chairman. An additional requirement is that non-management directors of a company meet at regularly scheduled sessions without members of the management. These regulations have the potential to reduce the misplaced loyalty of independent directors, and enable them to be effective gatekeepers as evidenced by the different variants of the Milgram experiment that found the subject to act more responsibly when removed from the proximity of the experimenter, and when the experimenter was challenged by an equally imposing peer (Morck, 2004).

7. Do the Clause 49 regulations on board of directors address the ground realities in India?

The discussion in the previous section suggests that it is not enough to have an independent board; an enabling environment that helps independent directors to exercise their independence is also required. Regulations in emerging economies—many of which exhibit the strong presence of controlling shareholders—have to take care of the ground realties of their respective countries. Next we look at whether the governance regulations with respect to the composition of corporate boards and the framework supporting the exercise of independent judgment take into account the ground realties in India.

Commencing in 1998, and through a series of committee recommendations in the following years, the governance regime in the country has received serious attention, culminating (in the case of publicly traded companies) in the now famous Clause 49 of the Stock Exchange Listing Agreement, which was first notified in February 2000,[6] and became applicable in a phased manner to all listed companies by March 2003.

Under Clause 49, listed companies are required to have no less than half of their board composed of non-executive directors; concurrently, it also mandated at least half the board to be composed of independent directors where the board chair and the CEO were the same individual, or where the board chair was also a promoter, or related to a promoter, or management.Similarly, the set of criteria defining the "independence" of a director itself underwent significant changes in consonance with international best practices, from being largely subjective to becoming more objective.

While board independence has been defined globally based on a minimum number or proportion of independent directors, the challenging issue for policy makers and academics alike has been to define the independence of a director in objective terms based on "relationship standards." The evolution of the independence standards in India as highlighted in Box 1 is a case in point. In the original version of Clause 49, a director could be considered independent if the individual (apart from receiving director's remuneration) did not have any other material pecuniary relationship or transactions with the company, its promoters, its management, or its subsidiaries, *which in the judgment of the board* (emphasis added) may affect the independent judgement of the director. As the Naresh Chandra Committee on Corporate Audit and Governance recognised, while such a broad definition of independence may be pragmatic and flexible, it is "circular and tautological," and a more rigorous definition needed to be adopted. The subsequent amendments to Clause 49 addressed such concerns and itemised in detail a more stringent and objective checklist that a director has to satisfy to be deemed independent. The revised definition of independence in India came on the heels of the enactment of the Sarbanes-Oxley Act, 2002 in the US following the Enron scandal, and the incorporation of a set of "bright line" tests for independent directors by the NYSE in their new listing standards in 2003.

Box 1: Major revisions of Clause 49 of Listing Agreement with respect to board composition and independence

Clause 49 (original)* February 21, 2000	Clause 49 (revised)** October 29, 2004	Clause 49 (revised)*** April 8, 2008
Board composition The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the Chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors. **Determination of Independence** 'independent directors' means directors who apart from receiving director's remuneration, do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgement of the board may affect independence of judgement of the director.	**Board Composition** Similar as February, 2000 **Determination of Independence** *Revised* For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who: a. apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of thedirector; b. is not related to promoters or persons occupying management positions at the board level or at one level below the board; c. has not been an executive of the company in the immediately preceding three financial years; d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following: (i) the statutory audit firm or the internal audit firm that is associated with the company, and (ii) the legal firm(s) and consulting firm(s) that have a material association with the company. e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director; and f. is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.	**Board Composition** *Additional qualification for boards with non-executive chairman* "If the non-executive Chairman is a promoter or is related to promoters or persons occupying management positions at the board level or at one level below the board, at least one-half of the board of the company should consist of independent directors." **Determination of Independence** *Similar as October 2004*

* See Circular No. SMDRP/POLICY/CIR-10/2000, dated, February 21, 2000. http://www.sebi.gov.in/

** See Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in/

*** See Circular No. SEBI/CFD/DIL/CG/1/2008/08/04, dated April 08, 2008. http://www.sebi.gov.in/

While the Clause 49 regulations did a commendable job in specifying board composition, especially in recognising the promoters' presence on corporate boards, and defining the concept of independence, it fell short on one very crucial issue—requiring the companies to constitute a Nomination Committee for the selection of independent directors. The failure to insist on the formation of a Nomination Committee is particularly striking given the reality of family dominance in Indian companies, and the documented evidence of powerful promoters occupying dual positions of CEO and Chairman, with correspondingly large power to influence the selection and election of independent directors. Other shortcomings of the Clause 49 regulations with respect to board independence are the failure to recommend separate meetings without the management, and the appointment of a senior independent director in line with the requirements and recommendations of the best practices in other countries. Currently the Clause 49 regulations only require that two-thirds of audit committees be composed of independent as compared, for example, to the US Sarbanes-Oxley mandate of a fully independent audit committee. There is no mandate for a compensation committee as is required in many developed countries. Thus controlling insiders in Indian companies continue to exert significant influence over the choice of independent directors and the determination of their compensation.

Perhaps the institutional setting and the influence and evolution of family business play a dominant role in determining the pace of governance reforms. But these reforms have to be undertaken in the near future to improve the standards of governance particularly in order to signal to the outside world that Indian companies comply with the best practices adopted in many countries across the world.

8. Board governance in India: Way forward

These issues of behavioural and procedural aspects of director and board independence clearly suggest the path for future reforms in India in these areas, which need to address the conditions that break the "reflex obedience" to loyalty, and enable independent directors to exercise their judgment. The following aspects deserve consideration.

Board composition

The board should consist of a majority of independent directors. Adequate representation of independent directors on corporate boards is necessary to make their voice heard and their decision count, especially due to promoter dominance in Indian companies. The more stringent minimum requirement of independence for boards with executive or non-independent chairman recognises the need to minimise disproportionate CEO powers in decision-making that is endemic to such boards.

The Companies Bill of 2009 has however proposed a minimum of one-third of the total number of directors, irrespective of whether the Chairman is executive or non-executive, independent or not. This recommendation ignores the ground reality of promoter dominance in Indian companies. The Companies Bill's laudable aim to return the ultimate power over corporate decisions to shareholders has to be tempered by the fact that promoters in most of the large listed companies are majority or dominant owners. The institution of independent directors—the key mechanism to protect the interests of minority shareholders—would thus be largely dysfunctional, being overly vulnerable to the influence of the controlling shareholders. Under the 2009 Bill it would be possible to have boards with two-thirds of inside directors with a promoter as CEO and/or Chairman, leaving independent directors virtually powerless to preempt potential managerial abuses. One should be moving towards a majority of the board being independent. With this, there will also be no need to persevere with the distinction of board independence based on the affiliation of the Chairman. Even otherwise, Stock Exchanges could and should seriously explore the possibility of demanding higher standards of board independence from Indian companies than is prescribed by legislation.

It is often argued, that any over-specification of independence criteria may actually lead to an erosion of board contribution since those who bring in their domain expertise—the so-called "value directors" who form the "brain trust" of companies (Clarke, 2007) —may not qualify as independent because of the professional level fees that may have to be paid to recruit and retain them. This argument does not have much merit because nothing stops companies from hiring them as independent consultants and advisors if their services are required.

Nominee directors

Nominee directors should not be counted as independent directors. A particular issue specific to India regarding independent directors is the treatment of nominee directors who are appointed by financial institutions on account of their significant equity and debt holdings in the company. Clause 49 stipulates that "Nominee directors appointed by an institution which has invested in or lent to the company shall be deemed to be an independent director".[7]

Independent directors are fiduciaries of shareholders interests. Nominee directors by definition represent the interest of the financial institutions that nominate them. If the financial institutions are only equity holders then their interests will coincide with that of the other shareholders. On the other hand, if the financial institutions are also significant debt holders (as is often the case) then the interest of such nominee directors will diverge from that of the shareholders. These directors are then less likely to support risky projects which are otherwise economically profitable because as debt holders they do not benefit from any increased returns generated by the company. Their main task would be to secure the fixed stream of debt servicing payments to their parent institutions. Such nominee directors cannot be considered as independent directors. In addition, there is further conflict of interest since the institutions that appoint nominee directors are often major players in the stock market in respect of shares of the companies in which they have nominees.

One argument advanced for having nominee directors is that they are required to protect public interest, as these financial institutions as repositories of public savings. However, protection of public interest can be easily accomplished by writing suitable covenants in debt contracts. If these institutions wish to have their directors because of their equity holdings then they could as well get them elected using the same process available to all other shareholders instead of seeking any automatic representation rights, and be satisfied with the same information inputs as are available to other directors and shareholders.[8]

Almost all corporate governance committees constituted in India have all suggested that nominee directors should not be treated as independent directors and it is time that these recommendations are mandated. Although the provisions of Companies Bill (2009) seem to imply this disqualification, greater drafting clarity may be necessary to establish this beyond doubt (see Clause 132.(5) of the New Companies Bill 2009). At any rate, stock exchanges can help by clearly mandating such a disqualification in unequivocal terms.

Nomination committee

Regulations should require the immediate constitution of an independent Nomination Committee. The insistence on higher board independence will have little meaning without the setting up of proper procedures for selecting independent directors. Foremost among these is the need to have a mandatory Nomination Committee composed entirely of independent directors to identify a pool of independent directors for the board to choose from and recommend for shareholders' approval. All independent directors who are shortlisted by the Nomination Committee should be required to sign an "affirmative declaration of independence" stating that they fulfill all the prescribed independence requirements. This may be particularly important given that it may not be possible to lay down all the "exclusions" that lead to the rejection of "presumption of independence." As current NYSE Listing Regulations mention, "it is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company" (Section 303A.02 of NYSE Listed Company Manual).

Notwithstanding the screening of independent directors by the Nomination Committee, promoters in many Indian companies are in a position to exercise their preference in the choice of independent directors by virtue of having more than majority ownership. Minority shareholders therefore may have to be proactively given a minimum representation in the board of directors through cumulative voting (as in Chile), or through mandatory representation of minority shareholders on the board of directors (as in Italy).

Effective board process

The environment that helps independent directors to exercise their independence should be strengthened. Coupled with the constitution of a majority independent board, other reforms will be required to set up effective board processes that create a more enabling environment for independent directors to exercise their independence, such as the nomination of a *Senior Independent Director,* and provisions requiring outside directors to convene *meetings without the management*. As the KPMG Audit Committee Institute points out, relevant information that *clearly outline the agenda items of board meetings* as well as give *sufficient time to prepare for the meetings* are some of the most important factors that can lead to the strengthening of the institution of independent directors, and the regulation ought to mandate these requirements as part of the duties of company managements.

Tenure of independent directors

There is a need to set a limit on the tenure of independent directors, and to recognise that concentration of directorships contributes to erosion of independence. Inextricably related to the issue of independence is the tenure of independent directors. In the case of long-serving directors, their willingness and ability to discharge their duties and responsibilities independent of the management are open to question. The tenure distribution of independent directors based on a sample of over 2200 listed companies (Table 4) shows the mean tenure of independent directors to be 8 years. 10% of the independent directors have tenure of 14.5 years or more, while 5% have tenure in excess of 16.75 years, with the maximum tenure reaching as high as 37.50 years. There are significant differences in the tenure characteristics of independent directors serving on the boards of group and standalone companies. The mean tenure of independent directors in group companies is higher by about two years compared to that in standalone companies. There is a widening of this difference as one moves up along the distribution. Thus while 5% of the directors in standalone companies have tenure of 15.25 years or above, the corresponding figure for group companies is 19.67 years. The maximum tenure of independent directors in group companies is 36 years compared to 28 years in standalone companies.

Table 4: Tenure of independent directors in Indian companies (2008)

	All Companies	Group Companies	Non-Group Companies
Min	1.00	1.00	1.00
10th Percentile	3.00	3.33	3.00
First Quartile	4.25	5.00	4.00
Mean	7.85	8.89	7.12
Median	6.80	7.80	6.00
Upper Quartile	10.15	11.50	9.00
90th Percentile	14.50	15.57	13.00
Max	37.50	36.00	28
Percentage of companies with mean tenure of independent directors greater than 9 years	0.30	0.39	0.25

Source: Author's calculation based on data on 2217 listed companies contained in the Directors' Database, Bombay Stock Exchange in association with Prime Database.

A similar problem is also evident in the case of concentrated directorships with people on the boards of various group or affiliated companies. Since the primary reasons for potential tenure-based erosion of independence are familiarity and alignment, the prospects of such erosion are not limited to just one company as a standalone entity but to a group of companies and other entities with affiliations with the same set of promoters. A recent analysis of multiple directorships in Indian companies (Sarkar & Sarkar, 2009) identifies the existence of an "inner circle" with respect to independent directors sitting on corporate boards of family-owned group affiliates—about 67% of independent directors in group affiliates are also located within other group affiliates, with

43% of directorships on an average concentrated within a *single* group. These estimates were found to be substantially higher than corresponding estimates for independent directors of non-affiliated firms.

Regulations in most countries do not currently impose any upper limit on the number of years that an independent director can serve on company boards. Clause 49 requires that independent directors do not have an aggregate tenure that exceeds nine years, but this is only a non-mandatory requirement (and that too only with respect to a single company which does not recognise tenures in affiliated company boards). In most cases the law requires that a fraction of the independent directors retire every year, but they are eligible for re-election. This is in marked contrast to the fact that the law in almost every country requires a rotation of the audit partner. The principal reason behind audit partner rotation is the notion of “familiarity threat” whereby the auditor can potentially lose his/her objectivity and independence as a result of long interactions with the management. While this notion of rotation is very well accepted with respect to auditors, it is not clear why the same notion should not be applied by regulators with respect to independent directors whose interaction with inside management is more frequent than in the case of the external auditors. Perhaps the regulators put added emphasis on the advisory or strategic role that independent directors are supposed to play on company boards compared to the monitoring role that these directors are supposed to play to protect shareholders’ interest.

However, in light of the major corporate failures around the world and the seeming inability of the board to act in time, there is a growing recognition that the regulations should emphasise the monitoring role of the independent directors as fiduciaries of the shareholders’ interests compared to their strategic or advisory role. With this recognition, the tenure of independent directors has become a critical issue in governance. Though proposed tenure restrictions will need to balance the benefits of better advice that come with the experience of serving on the board for many years with the reduced independence that comes from long association with a company and its management, a cut-off level for tenure for independent directors must exist. Therefore there is a strong argument for moving the non-mandatory provisions on tenure restriction of Clause 49 to the list of mandatory requirements. In the absence of any empirical guidelines, such tenure restrictions will necessarily have to be framed exogenously to begin with.

Emphasise the monitoring role of independent directors

Finally, the regulations must clearly specify the primary role of the independent directors. Under the current regulations (in India and elsewhere), independent directors are required to wear "two hats" (Ezzamel & Watson, 1997)—one for discharging their advisory role, and the other for discharging their monitoring role. It is highly doubtful if independent directors can really fulfil their role of monitoring within management and hold them accountable for poor performance, if they themselves have been involved in advising management for the company's strategy and vision. It is time to start recognising that the primary role of independent directors is to act as monitors of management and not to advise them on how to improve company value. This is the task of the inside managers and the value directors, i.e. non-executive directors who are specifically hired for their professional advice. The primary responsibility of the independent directors should be to act as monitors especially in areas such as information disclosure, executive remuneration and board governance because these are the areas where controlling insiders and outside shareholders' interests are most likely to diverge. Moreover these are the types of decisions where independent directors' influence and monitoring abilities should be the greatest because such decisions are less likely to involve issues directly related to the management's technical expertise. The very origin of the corporate governance problem dictates that monitors are required to reduce agency costs, and independent directors are primarily expected to fulfil this monitoring role. This may require changes in the Company Law which currently does not make any legal distinction regarding the duties of executive and independent directors. Alternatively, stock exchange regulations can specify a separate charter for the duties of the independent directors that can specify their responsibilities.

Initiate formal training of independent directors

Independent directors should be given proper training to make them aware of their rights and responsibilities encoded under the various statutes like the Companies Act of 1956, and the Clause 49 regulations. In particular, this training should emphasise the fiduciary role of the independent directors as protectors of shareholders' interests. Too often, independent directors seem to think that they are present on the board as advisors.

Proper training and certification of independent directors would increase the directors' understanding and awareness of what it means to be an independent director, and will help to create a pool of well qualified professionals from where companies can make their choice. The Professional Non-Executive Director (PRO NED) program that was started in 1981 in the United Kingdom, and the National Association of Corporate Directors (NACD) that was formed in 1977 in the US have been instrumental in educating directors of their governance responsibilities, promoting employment of better and well informed nonexecutive directors, and helping companies seeking to employ independent directors on their Boards. The Australian Institute of Company Directors (AICD) has a formal course in director training that leads to an internationally recognised qualification. The Indonesian Institute of Corporate Directorship, and the Philippine Institute of Corporate Directors are also contemplating instituting formal training for independent directors. There is a case for similar professional training and continuing education in India for those who aspire to serve as independent directors of companies.

In conclusion, the institution of independent directors remains a crucial internal mechanism in ensuring good corporate governance in companies. This importance is heightened in the context of India where the protection of minority shareholders remains the specific goal of the regulator. In addition, good corporate governance is required for attracting outside capital and promoting the growth of Indian companies, and ultimately accelerating the nation's economic growth. Governance risk is a key determinant of the market pricing of listed securities. A high independence quotient of a company's board could be perceived to be reassuring to the absentee shareholders, thereby reducing the risk premium that would otherwise be required, and consequently reducing the cost of capital to the company. Strengthening independence so that this objective is better subserved also provides a strong business case for strengthening board independence. Admittedly, there are many issues that need to be addressed. However, with proper processes for selecting independent directors, giving them the necessary training, creating the right environment where they can exercise their independence, rewarding them suitably, and making them aware of their duties and responsibilities, the institution of independent directors can be a powerful governance mechanism for the protection of minority shareholders in India.

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Notes

[1] This is the standard cut-off applied in the literature to define widely-held firms (see Faccio & Lang, 2002; La Porta et al. 1999; Claessens et al. 2000).

[2] See Section 303A.00 of the Listed Company Manual of NYSE Stock Exchange. http://nysemanual.nyse.com/lcm (Accessed on 18 August, 2010).

[3] For details, see the Listed Company Manual, NYSE Stock Exchange. http://nysemanual.nyse.com/lcm/ (Accessed on 18 August, 2010).

[4] Stanley Milgram, an Assistant professor of psychology at Yale, began a series of experiments in 1961 in social psychology to test how the innate quality of loyalty could make individuals take actions which do not reflect their independent thinking when instructed to do so by an authoritative figure. The Milgram experiment showed that people could suppress their internal ethical standards if these came in conflict with loyalty to an authoritative figure. Based on variants of the experiment (where it was found that changing the environment of the experiment had a substantial effect on the obedience rate of the subjects), Milgram concluded that peer rebellion, disputes between rival authority figures and lack of proximity from the experimenter helped to bring back rational judgment and reduce the effect of loyalty and thereby undercut the experimenter's authority (Milgram, 1963, 1974).

[5] See NYSE Listing Requirements for a detailed list of the functions of a Nominating Committee.

[6] See Circular No. SMDRP/POLICY/CIR-10/2000, dated February 21, 2000. http://www.sebi.gov.in/ (Accessed on 18 August, 2010).

[7] See SEBI/CFD/DIL/CG/2004/12/10) circular dated October 29, 2004. "Institution" for this purpose means a public financial institution as defined in Section 4A of the Companies Act, 1956 or a "corresponding new bank" as defined in section 2(d) of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 [both Acts].

[8] See the dissenting view recorded in the Narayana Murthy Committee report, paragraph 3.81.4., on financial institutions receiving price-sensitive information by virtue of their board status.

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