

Nomination and Remuneration Committee (NRC) — A Modest Proposal to Improve its Effectiveness

Chief Contributors: Asish K Bhattacharyya ¹ and Nirmal Mohanty ²



Executive Summary

- Given the increasing volatility and complexity of the business environment in which firms operate today, the criticality of their Nomination and Remuneration Committee (NRC) for their growth and sustainability cannot be overemphasized.
- In important jurisdictions worldwide, the significance of the committees responsible for nomination and remuneration functions are well recognized and attempts have been made to ensure that they are strong and independent. In contrast, in India, many experts feel that the NRC is not given due importance, with the dominant shareholders, promoters and holding companies often intervening in (a) selection of board members and senior management, and (b) decisions relating to their remuneration, and thereby, undermining the functioning of the NRC.
- The Kotak Committee, which was set up to recommend governance reforms, was able to remedy the situation to some extent; although it missed out some key reforms.
- This Note suggests some regulatory reforms, notably replacing NRCs by two separate committees-- nomination committee and remuneration committee--in line with international best practice and rationalizing the committee's responsibilities. More significantly, the promoters and the top management need to recognize the significance of the strength and independence of NRCs for the sustainability of the company, and act accordingly.

¹ Director of the Institute of Management Technology Ghaziabad.

² Member Secretary, NSE CECG and Chief Economist, NSE.

Valuable inputs from Prof. Bala N Balasubramanian and Prof. Umakanth Varottil are gratefully acknowledged.

Disclaimer: "The National Stock Exchange of India Limited is proposing, subject to receipt of requisite approvals, market conditions and other considerations, an initial public offer of its equity shares and has filed a Draft Red Herring Prospectus dated December 28, 2016 ("DRHP") with the Securities and Exchange Board of India ("SEBI"). The DRHP is available on the websites of SEBI and the BSE Limited at www.sebi.gov.in and www.bseindia.com, respectively and of the Managers, Citigroup Global Markets India Private Limited at <http://www.online.citibank.co.in/rhtm/citigroupglobalscreen1.htm>, JM Financial Institutional Securities Limited at www.jmfi.com, Kotak Mahindra Capital Company Limited at <http://www.investmentbank.kotak.com>, Morgan Stanley India Company Private Limited at <http://www.morganstanley.com/about-us/global-offices/india/>, HDFC Bank Limited at www.hdfcbank.com, ICICI Securities Limited at www.icicisecurities.com, IDFC Bank Limited at www.idfcbank.com and IIFL Holdings Limited at www.iiflcap.com. Investors should not rely on the DRHP for making any investment decision, and should note that investment in equity shares involves a high degree of risk, and for details see the section titled "Risk Factors" in the red herring prospectus, when available.

Any securities referred to herein have not been and will not be registered under the U.S. Securities Act of 1933, as amended (the "Securities Act"), and may not be offered or sold in the United States absent registration or an exemption from registration under the Securities Act. There is no intention to register any securities referred to herein in the United States or to make a public offering of the securities in the United States.

The views expressed in this document are those of the authors and do not necessarily reflect the views of the organisations they are affiliated to. NSE does not guarantee the accuracy of the information included in this document."

I. Introduction

Effective oversight of the executive function--carried out under the leadership of the CEO--by an independent and competent board of directors has emerged as the main mechanism to protect the interests of the company and its various stakeholders. With increase in volatility, uncertainty, complexity and ambiguity in their business environment, several companies are continuously in the transformational mode and consequently, engagement of the board with the CEO has increased significantly. Under the circumstances, to ensure that they are in a position to steer the company in the changing internal and external contexts, both the board and the company management must adjust their capabilities constantly by retiring existing directors and top managers, and inducting new ones. Succession planning at the board level and the top management level is also an integral part of this function, which at a broader level is known as the 'nomination function'. Regulations worldwide assign this function to the board. The board is also mandated to carry out the 'remuneration function', which involves the responsibility of attracting appropriate talents for positions in the board and senior management, and retain them by structuring appropriate compensation packages. Corporate governance laws typically encourage boards to establish board committee(s) to carry out these responsibilities. The balance between the board delegating these responsibilities to the committees while retaining the oversight responsibility, is done by the committees making recommendations to the board, which in turn takes a decision on accepting them.

With the aim of maintaining the independence of the nomination committee and remuneration committee, and ensuring that the capacities available within them are proportional to the tasks assigned, the regulations generally, provide for the scope and structure of these committee(s), which however vary across jurisdictions. This Quarterly Briefing compares the Indian regulations and practices relating to NRC with those in other jurisdictions and makes some suggestions for improved discharge of the nomination and remuneration functions of the board.

II. Indian regulation

The most significant feature of Indian regulations with respect to nomination and remuneration is that boards of Indian companies are required to constitute only one committee, the 'nomination and remuneration committee' (NRC). The structural requirements mandated by regulations relating to NRC include:³

- all members to be non-executive directors;
- at least 50 percent of directors to be independent directors (IDs);
- Chairperson to be ID;
- committee to have at least 3 members.

The structural reforms recommended by the Kotak committee, relating to the NRC and the SEBI's response to them are given below.⁴

³ As per SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR).

⁴ The Kotak Committee, which was set up to make recommendations aimed at improving corporate governance in listed companies in India, submitted its report to SEBI on October 5, 2017 and subsequently, SEBI decided on what recommendations to accept in its board meeting held on Mar 28, 2018.

Table 1: Recommendations by the Kotak Committee relating to the NRC and their acceptance status

Kotak Committee Recommendations	Acceptance status
At least two-thirds of the members of the committee shall be IDs.	Not accepted.
The quorum for a meeting of the NRC shall be either two members or one third of the members of the committee, whichever is greater, with at least one ID.	Accepted (Earlier, no such restriction was there).
The NRC shall meet at least once in a year.	Accepted (Earlier, no such requirement was there).
For the purpose of determination of the limit on chairpersonships and memberships of board committees that a person can accept, the NRC to be <i>also</i> considered.	Not accepted (The current norm is that for the purpose of determination of limit on chairpersonships and memberships of board committees that a person can accept, the Audit Committee and the Stakeholders' Relationship Committee alone shall be considered).

As regards responsibilities, the LODR specifies the NRC's role as follows:

- 1) formulation of the criteria for determining qualifications, positive attributes and independence of a director and recommend to the board of directors a policy relating to the remuneration of the directors, key managerial personnel and other employees;
- 2) formulation of criteria for evaluation of performance of IDs and the board of directors;
- 3) devising a policy on diversity of board of directors;
- 4) identifying persons who are qualified to become directors and who may be appointed in senior management in accordance with the criteria laid down, and recommend to the board of directors their appointment and removal;
- 5) whether to extend or continue the term of appointment of the ID, on the basis of the report of performance evaluation of IDs;
- 6) recommend to the board, all remuneration, in whatever form, payable to senior management.

In short, the NRC is responsible for ensuring that (a) the composition of the board (in terms of capabilities, diversity and independence) is appropriate, (b) the succession planning is robust, and (c) remuneration policy structures are appropriate to attract and retain talent at the board and senior management levels.

III. Comparison with international scenario

Table 2 summarises the regulations in five important jurisdictions.

Table 2: Structure of Nomination and Remuneration Committees

Sl. No.	Jurisdiction	Regulations
1.	New York Stock Exchange ⁵ (NYSE)	(i) Separate committees - Nominating/Corporate Governance Committee and Compensation Committee; (ii) Committees are constituted of only IDs.
2.	Euronext ⁶ (Amsterdam)	(i) Separate committees – Nomination and Governance Committee, and Remuneration Committee; (ii) Both committees require a minimum of three directors, who are appointed by the Supervisory Board. More than half of its members must be independent. The Supervisory Board appoints one of its members as the Chairman of the respective committees.
3.	Hong Kong Stock Exchange ⁷	(i) Separate committees - Nomination Committee and Remuneration Committee; (ii) Both committees should comprise of five independent non-executive directors. For the nomination committee, at least two of them should be elected directors.
4.	U.K. Code of Corporate Governance ⁸	(i) Separate committees - Nomination Committee and Remuneration Committee; (ii) The Nomination Committee should be chaired by the chairperson of the board or an ID and majority of its members must be IDs, while the Remuneration Committee must be chaired by an ID and must have at least three IDs (at least two IDs in case of smaller companies).
5.	Japan Exchange Group ⁹	(i) Separate committees – Nomination Committee and Compensation Committee; (ii) Nomination Committee to comprise five directors, four of whom must be IDs. Compensation Committee to comprise five directors, three of whom must be IDs.

An analysis of the data given in Table 2 suggests that separate committees for remuneration and nomination is the norm followed in important international jurisdictions. India, however, is an exception in this respect. Further, an attempt is made across the world to maintain the independence of nomination committee and remuneration committee by mandating at least a majority of IDs. Here, it is worth noting that the recommendation of the Kotak Committee to raise the threshold on the share of IDs in NRC from at least half to two-thirds was not accepted by the SEBI (see Table 1). Further, the Committee missed an opportunity to recommend a bifurcation of NRC into nomination committee and remuneration committee.

As regards the role and responsibilities assigned to the NRC, the Indian regulations are detailed and exhaustive, and are broadly comparable to those in other jurisdictions. Space constraint does not allow the authors to elaborate on this.

5 <http://wallstreet.cch.com/LCMTTools/PlatformViewer.asp?selectednode=chp%5F1%5F4%5F3&manual=%2F1cm%2Fsections%2F1cm%2Dsections%2F>

6 <https://www.euronext.com/fr/investors/corporate-governance/supervisory-board>

7 <http://www.hkexgroup.com/About-HKEX/Organisation/Board-and-Committees>

8 <https://www.frc.org.uk/getattachment/ca7e94c4-b9a9-49e2-a824-ad76a322873c/UK-Corporate-Governance-Code-April-2016.pdf>

9 <https://www.jpex.co.jp/english/corporate/>

Can NRCs be allowed to have the flexibility of inducting members who are not members of the company's board? In some Nordic countries, such as Sweden, Norway and Finland, companies may choose to have a nomination board composed of external experts. Members of the board are elected directly by the (usually three) largest shareholders. The Finnish Corporate Governance Code, 2010, for example, recommends both an external nomination board elected by largest shareholders and an internal nomination committee composed of board members. In other countries, such as Sweden, only an external nomination board is included in the Corporate Governance Code. In India, a person who is not a board member, cannot be a member of the NRC, although the NRC has the authority to appoint an agency to make specific recommendations relating to nominations or remuneration.

Do shareholders who are not members of NRC have the access to the director nomination process? In Canada, the Canadian Business Corporations Act (CBCA) provides access to the director nomination process by shareholders. The U.K. Companies Act 2006, allows a shareholder, who holds at least 5% of the shares of the company, to submit a proposal for the nomination of a director. Australia has an exactly same provision. The Indian Companies Act 2013 provides that a member may propose candidature of an individual for the position of a director, provided he or she makes a deposit of a specified amount.¹⁰ In effect, however, in case of companies controlled by promoters, it is almost impossible for a nominee, other than the board's nominee to get elected, as directors need to be elected with simple majority.

IV. Is NRC an underrated committee?

Some experts have (rightly) observed that NRC is an underrated committee in India; in other words, it has not been accorded the significance it deserves. While SEBI's acceptance of the Kotak Committee's recommendations for designing a quorum of the NRC and mandating at least one meeting in a year (see Table 1) has somewhat raised the significance and relevance of the NRC, the fact that SEBI did not accept the recommendation to consider NRC, while determining the maximum number of memberships that a person can have in board committees of listed companies, indicates that the authorities do not still treat NRC as a key committee, at least not on par with committees such as Audit Committee or Stakeholder Relationship Committee. Furthermore, even though NRC has been assigned a high and rising array of responsibilities, the minimum requirement for members in this committee is only 3, while in several important jurisdictions, two separate committees with minimum membership of 3 each, are assigned similar roles. In this respect, the Indian companies on their part have hardly exceeded the mandate of minimum membership of 3, with the average number of memberships in (compliant) NSE listed companies being 3.5 (source: NSE) —a clear indication that they do not see NRC as a significant committee.

V. What deters effective functioning of NRC?

Table 2 shows that most important jurisdictions require at least a majority of IDs in nomination and remuneration committees, with NYSE requiring all members of these committees to be IDs. In India, regulation requires IDs to constitute at least 50 percent (not majority) in these committees; this clearly falls short of norm followed internationally. The authorities' rejection of the Kotak Committee's recommendation to raise the share of IDs in NRC--from at least 50 percent to two-thirds--does not augur well for the independence of the NRC, although the provision in the Companies Act that came into effect in 2014 that the chairperson of the board must not be the chairperson of NRC is a step in the right direction, as it removes a 'conflict of interest' situation.¹¹

¹⁰ Section 160 of the Companies Act 2013.

¹¹ Section 178 of Companies Act, 2013.

One of the criticisms of the NRC is that it operates in the shadow of the promoters. For example, even if the NRC nominates a person for appointment as a director, such appointment is still subject to election by shareholders where the promoters can call the shots. Hence, the NRC will likely not nominate someone who is unacceptable to the promoters. For example, there was a high profile company case in 2017 that showed that directors cannot be appointed without the tacit approval of an influential promoter or his or her nominee. There have also been instances of the holding company directly intervening in the constitution of the board of its subsidiary companies and in the appointment of its CEO. For this reason, some experts believe that the board of a subsidiary typically does not see any significant role for NRC and hence constitutes the Committee only to comply with the legal requirements and its members lack the motivation to invest time in NRC activities.

Finally, many observers feel that, given its size, the NRC is burdened with too many tasks, with the result that the committee often fails to pay adequate attention to some of its important responsibilities.

VI. Way forward

Some reforms undertaken recently in areas other than NRC can have a significant bearing on the functioning of the NRC. For example, the recent decision by SEBI to mandate that the top 500 listed entities (by market capitalization) with a public shareholding of 40 per cent or more, have to separate the office of CEO/MD and Chairperson with effect from April 1, 2020 will improve the constitution and functioning of NRC in those companies, particularly if the chairperson is an ID, by balancing the power between the CEO and the board. Additionally, the following suggestions may help.

First, a necessary condition for improved functioning of NRC is that the dominant shareholder, promoter and CEO of companies must give it its due importance and recognize that but for a strong and independent NRC, it would be impossible to have appropriate capabilities at the board and the management level, which are key for achieving the company's mission. The management of companies that operate in a complex and volatile environment typically realise this fact early on, while the companies whose business environment is relatively stable, may not find the strength and independence of NRC much relevant *from their own perspective*. From other stakeholders' standpoint, however, NRC's independence is critical even for the latter companies, as the selection of directors without the intervention of the dominant shareholder or the incumbent management, enhances the board's effectiveness.

Second, there is a case for dividing the NRC into two separate committees--nomination committee and compensation committee--in line with the international best practice. Structuring compensation package and deciding the level of compensation require expertise different from designing the job profiles and personal profiles of desirable candidates, and identifying right candidates for induction into the board and senior management. Separate committees are also advisable from a 'conflict of interest' point of view. For example, there is obvious self-interest for the directors serving the remuneration committee to recommend themselves (or their close associates) for reappointment and they will have the power to do so, if they are also in the nomination committee. Finally, the separation of the tasks between the two committees will bring objectivity in formulating remuneration policy, as remuneration policy will no longer be formulated keeping in view the individuals who are invited to join the board.

Third, as a single committee that can and does get constituted with just 3 members, the NRC is burdened with too many tasks. Changing the law to bifurcate NRC may take time; in the interim, boards may increase the strength of NRC, say from three to six, and the NRC may divide the work to two sub-groups constituted within the committee. There is also a need to rationalize the workload of NRC. For example, instead of getting directly involved in selecting senior management personnel, the NRC's role in this respect should be confined to recommending job profiles, desirable competencies and personal traits of candidates to be inducted in senior management.

References

Appiah, Kingsley Opoku, and Amon Chizema. "The impact of board quality and nomination committee on corporate bankruptcy." *Advances in Accounting* 35 (2016): 75-81.

Arranz-Aperte, Laura, Nomination Committee and the Choice of a Diverse Board (May 1, 2015). *Nordic Journal of Business* 65 (1):41-61. Available at SSRN: <https://ssrn.com/abstract=2906778>.

Eulaiwi, Baban, Ahmed Al-Hadi, Grantley Taylor, Khamis Hamed Al-Yahyaee, and John Evans. "Multiple directorships, family ownership and the board nomination committee: International evidence from the GCC." *Emerging Markets Review* 28 (2016): 61-88.

Institute of Governance of Private and Public Organisations, Montreal. "Who should pick board members? Proxy access by shareholders to the director nomination process". Policy paper no. 8 (2015). Available at: <http://ssrn.com/abstract=2685790>.

Kostyleva, Valentina, and Hector Lehuede. "Board Formation: Nomination and Election in OECD Countries and Russia." (2012). *The Companies Act 2013*.

Kotak Committee Report submitted to SEBI on October 5, 2017.

About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavoured to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.