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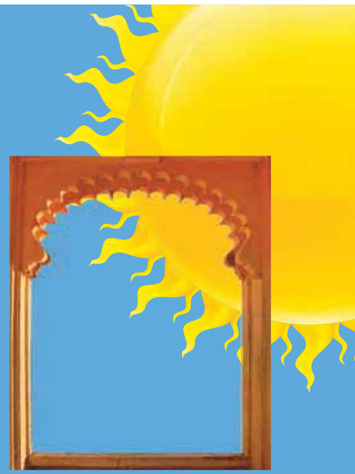
Indian Corporate Board Structure: Moving Towards Best Practices?



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Executive Summary

- In terms of structure and composition of boards and its committees, Indian corporate governance regulations have evolved towards international best practices, although there have been some departures.
- The minimum percentage of independent directors required on the Board varies across countries, with India's Clause 49 requirements comparing quite favourably with international best practices.
- India's regulations, however, fall short of international best practices in two important areas:
    - Firstly, while it is an international best practice to have separate nomination and remuneration committees, Indian regulations require a combined committee.
    - Secondly, as per international best practices, executive directors are not allowed to be a part of the Audit Committee and the Remuneration Committee, because of the possibility of self-review by management and obvious conflict of interest. In India, however, executive directors are allowed in both these committees.

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I. Introduction

It is well known that the structure and composition of the corporate board and its committees, particularly with respect to the presence of independent directors, have a significant bearing on the board's effectiveness. In this respect, since the notification of the now famous Clause 49 (CL49) Regulations on February 21, 2000, corporate governance regulations in India have rapidly evolved. As part of the evolution of CL49, two important revisions were made on October 29, 2004 and April 8, 2008, respectively. Finally, following the enactment of the Companies Act, 2013, the updated version of CL49 was notified on April 17, 2014. Based on the industry response, some provisions in CL49 were amended and the SEBI (Listing Obligations & Disclosure Requirements) Regulations were notified on September 2, 2015.

The revisions that were made to governance regulations in India represent an effort towards moving towards international best practices. This Quarterly Briefing studies the evolution of the CL49 regulations and compares and contrasts the current provisions with governance regulations existing in mature economies of US, UK and Australia, and in the emerging economies of South Africa and Singapore.

II. The Board of Directors

Although the original version of CL49 in India had a detailed prescription regarding the composition of the Board of Directors, it defined independent directors perhaps ambiguously. Independent directors were defined as "…. 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 the judgment of the board* (emphasis added), may affect the independent judgment of the director (SEBI 2000)."

The 2004 version of CL49 saw a significant change, with the definition of independent directors moving towards international best practice by itemizing an objective checklist of conditions that a director has to satisfy to be deemed independent. These conditions made it very similar to the "bright line" tests[2] for independence of directors under the NYSE listing standards. These tests are now widely used by many countries in their definition of independent director.

Further, the 2008 revision of CL49 brought companies having a promoter (or a person related to the promoter) as Chairman, even if non-executive, under a stricter requirement entailing presence of a larger number of independent directors on the Board. This seemed sensible, given the institutional setup in India, where promoter-controlled companies dominate the corporate landscape, and thereby tilt the balance of power in the board towards the management.

The latest version of CL49, notified on April 17, 2014, and further amended on 15 September 2014, preserved the Board composition as was specified in the 2008 version, but introduced the provision of having at least one woman director on the Board. This is one aspect in which India's regulation differs from other nations.

The current version of India's CL49 regulations stands out among other nations by having separate specifications with respect to non-executive directors and independent directors (Table 1). However, on the issue of whether the Board Chairman should be an independent or non-executive director, the CL49 regulations refrain from taking a definitive view (as in UK and Australia). Instead, it requires presence of a higher number of independent directors in the board in case the company has an executive Chairman than if it has a non-executive Chairman (similar to Singapore). Further, a comparison of Board composition across countries shows that India's CL49 regulations compare very well with international best practices.

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[2] http://www.emcorgroup.com/files/9214/0630/2842/StandardsDirIndependence08.pdf

Table 1: Board of Directors: Comparison of Standards across Countries

Regulation (Country)	Rules
Companies Act 2013 (India)	Composition: At least one third of total directors must be independent; at least one woman director must be present Chairman: Separation of offices of CEO and Chairman required unless articles of the company permit otherwise or the company does not have multiple businesses
SEBI Clause 49, 2014 (India)	Composition: Not less than 50% non-executive; at least one third independent when Chairman is non-executive and at least half when Chairman is executive or promoter; at least one women director must be present Chairman: Separation of offices of CEO and Chairman advised.
NYSE Listing Standards, 2004 (USA)	Composition: The majority of directors must be independent Chairman: No specifications
ASX Corporate Governance Council (Australia)	Composition: A majority of total directors must be independent Chairman: Chairman must be an independent director.
Combined Code on Corporate Governance, 2003 (UK)	Composition: At least half of total directors must be independent, in smaller companies at least two independent directors must be present on the board Chairman: Chairman must be an independent director.
Code of Corporate Governance, 2005, (Singapore)	Composition: At least one third of total directors must be independent; at least half should be independent when CEO and Chairman are the same, or related, or if Chairman is part of management team, or not independent Chairman: The Chairman and CEO, in principle, should not be the same person. In addition, a Lead Independent Director should be appointed if CEO and Chairman are the same, or related, or if Chairman is part of management team, or not independent.
King Code of Governance III, 2009 (South Africa)	Composition: A majority of total directors must be non-executive, and a majority of those non-executive directors must be independent. Chairman: Chairman must be an independent director.

Source: Author's compilation from various governance codes.

III. Committees of the Board

III.1 The Audit Committee

The original CL49 regulations (SEBI, 2000) required the audit committee to have a minimum of three members consisting of only non-executive directors, with independent directors forming a majority and the Chairman an independent director. The first amended CL49 (SEBI, 2004) removed the non-executive director requirement and instead specified that the audit committee should have a minimum of three members with two-thirds of them being independent. Thus, with this revision, executive directors were allowed to be present in Audit Committee. It may be noted however that the increase in the requirement of independent directors from majority to two-thirds did not make any material difference in audit committees which had three members.

Table 2: Audit Committee: Comparison of Standards across Countries

Regulation (Country)	Size	Composition	Chairman
Companies Act 2013 (India)	Minimum 3	All Non-executive: No Independent: Majority	Independent Not required
SEBI Clause 49, 2014 (India)	Minimum 3	All Non-executive: No Independent: 2/3	Independent
NYSE Listing Standards, 2004 (USA)	Minimum 3	Independent: All	Independent*
ASX Corporate Governance Council (Australia)	Minimum 3	All Non-executive: Yes Independent: Majority	Independent
The Combined Code on Corporate Governance, 2003 (UK)	Minimum 3[3]	Independent: All	Independent*
Code of Corporate Governance, 2005, (Singapore)	Minimum 3	All Non-executive: Yes Independent: Majority	Independent
King Code of Governance III, 2009 update (South Africa)	Minimum 3	Independent: All	Independent

** By implication. Not explicitly mentioned in the regulation*

Source: Author's compilation from various governance codes.

A comparison of the composition of audit committee across countries shows that allof them require the audit committee to consist entirely of non-executive directors with many countries making an even stricter requirement of only independent directors (Table 2). India's CL49 regulations stand out in sharp contrast to this. Hence, this is one area in which India seems to lag behind international best practices in corporate governance.

[3] Two in case of smaller companies.

III.2 The Remuneration Committee

The original CL49 regulations of February 21, 2000 did not require companies to have a mandatory remuneration committee. Instead the requirement was non-mandatory in nature. The Companies Bill of 2009 turned this non-mandatory provision into a mandatory requirement and specified that every listed company shall constitute a remuneration committee consisting of only non-executive directors, out of which at least one should be an independent director (Clause 158). It, however, did not explicitly require the Chairman of the remuneration committee to be an independent director.

The Companies Act, 2013 modified the provisions of the Companies Bill of 2009 with two important changes. First, it changed the committee name to the Nomination and Remuneration Committee, thereby expanding the functions of the committee, and second, the requirement of independent directors was increased from at least one to at least half (Section 178). The SEBI notification of April 2014 made an addition to the provisions of the Companies Act, 2013 by further requiring the Chairman of the Nomination and Remuneration Committee to be an independent director.

Table 3: Remuneration Committee: Comparison of Standards across Countries

Regulation (Country)	Size	Composition	Chairman
Companies Act 2013 (India)	Minimum 3	All Non-executive: Yes Independent: At least 50%	Independence not required
SEBI Clause 49, 2014 (India)	Minimum 3	All Non-executive: Yes Independent: At least 50%	Independent
NYSE Listing Standards, 2004 (USA)	Not specified	Independent: All	Independent*
ASX Corporate Governance Council (Australia)	Minimum 3	All Non-executive: No Independent: Majority	Independent
The Combined Code on Corporate Governance, 2003 (UK)	Minimum 3[4]	Independent: All	Independent*
Code of Corporate Governance, 2005, (Singapore)	Minimum 3	All Non-executive: Yes Independent: Majority	Independent
King Code of Governance III, 2009 update (South Africa)	Not specified	All Non-executive: No, only majority Independent: Majority of non-executive	Independence not required

Source: Author's compilation from various governance codes.

A cross country comparison of regulations relating to size and composition of remuneration committee (Table 3) shows that the CL49 regulations are near the best practices. However, one rider was added in the Companies Act, 2013, which was also carried forward in the SEBI 2014 regulation which led to deviation from international best practices. This rider allowed the chairperson of the company (whether executive or non-executive) to be appointed as a member of the Nomination and Remuneration Committee, but could not chair the committee. This departs sharply from the regulations under the NYSE Code, the UK Code, and the code in Singapore.

[4] Two in case of smaller companies

III.3 The Nomination Committee

In the original CL49 regulations, there was no mention of constitution of a Nomination Committee even as a non-mandatory requirement. The Standing Committee on Finance[5] was the first to mention the requirement of a Nomination Committee in its Report of August 31, 2010. However, instead of requiring a separate nomination committee, it recommended the creation of a Nomination and Remuneration Committee; this recommendation was finally enacted into law under the Companies Act, 2013, as outlined earlier.

Cross country comparison shows that all countries have a separate Remuneration Committee and a Nomination Committee. India's CL49 regulation stands out as the only one to have a combined one.

IV. Discussion

In light of the above observations, are majority of the corporate governance regulations in India at par with international best practices? The answer is clearly 'no'. Are we moving towards best practices? Here, the answer is decidedly mixed. Measures such as tightening the definition of independent directors, requiring greater presence of independent directors in promoter-chairman companies and mandating the presence of woman director on the Board are certainly moves towards international best practices. However, allowing executive directors to be present in the Audit Committee and creating a combined Nomination and Remuneration Committee(NRC), where executive directors are allowed, are deviations from international best practices and need to be eschewed. Allowing executive members in NRCs, for example, basically means that executive directors can have a say in deciding their own compensation!

The departure from best practices is unfortunate for at least two reasons. First, the requirement of a combined Nomination and Remuneration Committee, where executive directors are allowed, was enacted in 2013 - several years after international best practices had already been established where in these two committees were mandated to be kept separate. Second, the discussion on the removal of the provision allowing executive directors to be part of the audit committee had begun in 2009 following the report of the CII task force on corporate governance chaired by Naresh Chandra, but nothing in this respect has happened yet. This inaction is happening at a time when the case for an independent Audit, for which the audit committee is critical, has been firmly established and recognized worldwide.

Of course, adopting international best practices does not mean that governance regulations must mimic the regulations of other countries. Best practices can be modified to suit the institutional conditions of a specific country as is advocated under the notion of "functional convergence." However, some of the deviations in India do not seem to be based on arguments of functional efficiency, but rather reflect the pulls and pressures that could possibly have their roots in the dominance of promoter-owned companies with concentrated ownership structures.

This in turn raises a difficult governance dilemma in India. Promoters of Indian companies having majority ownership may insist that final decision making power in important committees ought not to rest overtly with outside directors. This perhaps explains the rather frequent use of the "at least half" or "at least fifty percent" rule in several clauses relating to presence of non-executive or independent director while most other countries uniformly use the word "majority" in their specification. This slight difference in specification can potentially make a huge difference in governance of those companies that have even-sized boards headed by an executive Chairman, who may have a decisive say in case of voting ties. However, regulations that reduce effective say of independent directors in promoter controlled companies goes against the very grain of good governance. Besides, this may lead to the market discounting those companies because of their heightened governance risk, thereby resulting in higher cost of capital and slow down of growth of those companies.

V. Way Forward

Creating the most ideal governance setup is a difficult task. Nevertheless, the preceding discussion suggests that it is possible to further strengthen the evolving governance framework in India. Hopefully with some appropriate modifications in line with the earlier discussion, especially that of constituting the audit and the remuneration committee with only non-executive directors and consistently using the word "majority" in place of "at least half" or "at least fifty percent," the Indian governance regulations can become a model code for other countries to follow.

[5] http://www.nfcgindia.org/pdf/21_Report_Companies_Bill-2009.pdf

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