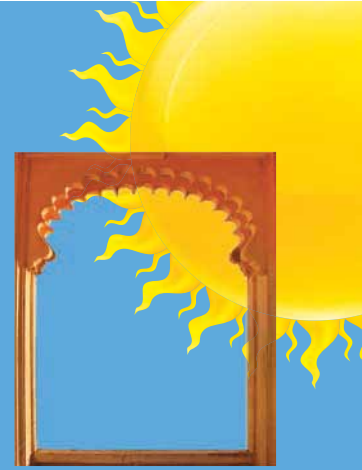


## Independent Directors under the new dispensation

Chief Contributor: Jamil Khatri <sup>1</sup>



### Executive Summary

- Independent Directors (IDs) play a critical role in implementing sound corporate governance practices in companies.
- Stakeholders are increasingly relying on IDs to deliver on their responsibilities to enhance corporate governance standards.
- To make IDs more effective instruments for raising corporate governance standards, there have recently been some sweeping changes in the legal and regulatory framework.
- Under the new dispensation, the key responsibilities of IDs relate to (a) strategy, risk management and internal financial controls, (b) related party transactions, (c) ethical and compliance oversight and (d) succession planning and executive remuneration.
- To effectively discharge their expanded responsibilities, IDs need to devote sufficient time, undergo training, focus attention on agenda setting, seek independent professional advice and ensure that the board evaluation process is effective.
- Moving forward, India will do well to increasingly brace for the global trends such as emergence of Lead IDs, diversity in board composition, increasing shareholder activism and a transition toward stakeholder approach.

<sup>1</sup> Partner and Head Assurance KPMG in India

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## I. Overview

The Companies Act, 2013 aims to bring in sweeping changes to the corporate governance environment in India. One of the areas which the new law brings into sharper focus is the role of IDs, who are expected to bring in 'outside-in views', in enhancing corporate governance standards. IDs are expected to assist in implementing sound corporate governance practices, thus contributing to transparency, performance and overall good governance. The roles and responsibilities of IDs have been codified for the first time in statute to respond to (1) fast changing business environment, (2) corporate malpractices and failures, and (3) governance lapses.

## II. Additional requirements for IDs under new dispensation

The key incremental requirements under the Companies Act relating to IDs are:

- The ID should, in the opinion of the board, be a person of integrity and possess relevant expertise and experience.
- The ID will be appointed for a period of five years and be eligible for reappointment subject to certain conditions for two terms. Thereafter, the ID shall be eligible for reappointment after a cooling-off period of three years.
- Nominee directors shall not be considered as IDs.
- An ID will not be entitled to any stock options in the company.
- A person cannot serve as an ID in more than seven listed companies, and if such person is a whole-time director in any listed company, then the limit on independent directorship gets reduced to three listed companies.
- At least one ID on the board of directors of the holding company shall be a director on the board of directors of a material non-listed Indian subsidiary company.
- The ID should not be less than 21 years of age.
- The ID should not be material supplier, service provider or customer or a lessor or lessee of the company.

## III. Roles and responsibilities

Some of the key roles and responsibilities of an ID are analyzed below, focusing on the manner in which these responsibilities can be effectively discharged.

### III.1 Key responsibilities

The key responsibilities of IDs relate to broadly 4 categories:

- Strategy, risk management and internal financial controls
  - Related party transactions
  - Ethical and compliance oversight
  - Succession planning and executive remuneration
- a. **Strategy, risk management and internal financial controls:** IDs are expected to actively contribute to and monitor strategy, risk management and internal financial control.

Strategy: Reviewing, adding value to and approving the strategy are crucial to the board's governance role. Through the board's distinct position of connecting the company with its external environment, IDs can contribute by providing:

- Information about other companies, their strategies and industry trends.
- Their own experience and expertise accumulated during their professional careers.

- New perspectives and fresh ideas.
- An independent and objective point of view.

Risk management: IDs are expected to give thoughtful consideration to the benefits of building a comprehensive risk management infrastructure and enhancing the organisation's ability to respond effectively to risk events and capture new strategic opportunities. They need to ensure that companies have begun the Enterprise Risk Management (ERM) journey, which may include (a) compiling a risk inventory, (b) formulating assessment techniques and risk response strategies, (c) creating a risk appetite and improving tolerance levels, (d) ensuring effective communication and monitoring and (e) integrating ERM with operational systems.

In the case of top 100 listed companies, listing obligations necessitate the formation of a Risk Management Committee (RMC), whose roles and responsibilities overlap with that of the Audit Committee to some extent. Since the RMC does not necessarily comprise of IDs, it is advisable that key risks are also evaluated by the audit committee. This will also enable the audit committee to effectively discharge its responsibilities relating to Internal Financial Controls (IFC) discussed below.

Internal Financial Controls: IDs, by virtue of their representation on the Audit Committee and the board, are required to review the process by which the management develops sufficient evidence to support its assessment and conclusion of the efficiency and adequacy of the IFC. Areas of focus for the IDs would essentially include: risk of material misstatement, entity level controls, significant accounts and disclosures, relevant financial assertions, significant processes, deficiencies and remedial measures and communication of the same to the Audit Committee and the board.

- b. **Related party transactions:** IDs, in their capacity as majority directors of audit committees are required to focus a great deal on related party transactions. The Companies Act, 2013 requires all related party transactions to be approved by the Audit Committee. This puts a lot of focus on the role of IDs in assessing these transactions and satisfying themselves of the appropriateness of such transactions prior to approving them. One of the duties of IDs codified in the new Companies Act includes paying sufficient attention and ensuring that adequate deliberations are held before approving related party transactions. The IDs are also required to assure themselves that related party transactions are in the interest of the company.

The Companies Act also requires that certain related party transactions such as sale/purchase of goods or property and leasing need to be approved by the board of directors or shareholders, in case such transactions are not at arms' length or not in the ordinary course of business.

- c. **Ethical and compliance oversight** is a responsibility placed on the IDs through their statement in the Board Report. In the report, they have to state that they have complied with all applicable rules and regulations. IDs are also required to review the vigil mechanism established by the company and ensure that whistleblowers are not victimised. IDs, as part of their responsibility, need to periodically evaluate the extent and effectiveness of the code of conduct trainings, whistleblowing incidents, reporting systems and disciplinary actions. In certain cases, they may even request for audits by the internal or external auditors to satisfy themselves that the programs are running effectively.
- d. **Succession planning and executive remuneration:** Management succession is one of the most significant strategic risks a business faces, especially in promoter-owned companies which are common in India. IDs through their representation on the Nomination and Remuneration Committee can focus their attention on this issue. Another area where the role of the Nomination and Remuneration Committee is important and where IDs have a critical role, relates to devising effective executive remuneration policies that tie compensation to company performance by mixing base salary with short and long term incentives. The right reward-mix should be determined by reference to many factors, including the size of the organisation, its industry and international presence.

### III.2 Effective discharge of responsibilities

- a. **Devote sufficient time and attention:** As IDs face increasing scrutiny from investors, regulators and other stakeholders, the time spent by them to make effective contribution at board and committee meetings is also increasing. Several boards have placed restrictions on services to minimise the possibility of direc-

tors becoming 'over boarded' with insufficient time to devote to board-related responsibilities. As per the Spencer Stuart board index 2015, more than three-quarters of S&P 500 boards (77 %) limit directors from accepting other corporate directorships – an increase from 71 % in 2010.

- b. **'Induction' and 'continuing education' Programs:** The Companies Act, 2013 requires appropriate training for IDs. IDs may insist on an induction program for new directors to better understand the company.

### *Findings of the Spencer Stuart Governance Survey 2015: Director onboarding*

- As per the Spencer Stuart board index 2015 on 'Director Onboarding', 71% of the directors (from S&P 500 companies) felt that the new directors get to know the company through site visits.
- 18% said the new directors need to participate in third-party development/education programs.
- 17% required the new board members to attend all committee meetings during their first year.
- More than half of the respondents indicated that director orientation in their companies includes meetings with a variety of company executives.

*Source: Spencer Stuart Governance Survey 2015*

- c. **Agenda setting:** Boards that lose track of their agendas can lose control of their companies. Though agenda setting is typically handled by the chairperson and senior management, IDs may recommend items for discussion, if required. It is a good practice for IDs to recommend companies to develop an annual agenda for the board and its committees. They can then resolve to address critical matters and ensure board and committee time is not frittered away. To improve productivity, agendas should include consideration of content, the order of items, the allocation of time for each item and the invitees. It would be advisable for the directors to suggest a procedure for decision-making outside the boardroom.
- d. **Independent professional advice:** IDs should bring independent judgment to board decisions. When one or a number of directors (including IDs) have concerns about the advice given to the board in relation to an issue, it may be prudent for the board to seek the point-of-view of an independent professional. It is a good practice for the IDs to request for this provision to be incorporated in their terms of reference at the time of appointment.
- e. **Performance assessments:** An additional responsibility placed on IDs is to have a separate meeting wherein they evaluate (a) the board, (b) the information placed before the board, (c) the non-Independent Directors and (d) the chairperson.

Some of the tasks IDs need to consider while designing an evaluation process include:

- i. Specify the type of assessment process
- ii. Choose the person responsible for performing the evaluation
- iii. List the expectations at the beginning of the evaluation period
- iv. Communicate clear outcomes and action plans.

## **IV. Risks, liabilities and remuneration of the IDs**

- a. **The Companies Act 2013 states that an ID shall be held liable**, only in respect of such acts of omission or commission by a company which has occurred with his knowledge attributable through board processes, and with his consent or connivance or where he has not acted diligently. Penalties as defined under the Act can be monetary sums and/or imprisonment.

What is diligence in this context? As per Schedule IV (III) (6) of Companies Act 2013, where ID have concerns about the running of the company or a proposed action, they should ensure that these are addressed by the board and, to the extent that they are not resolved, insist that their concerns are recorded in the minutes of the board meeting. This is an important safeguard to demonstrate that ID's have acted

diligently.

- b. **Shareholder class action litigation is a powerful determinant of the demand for Directors and Officers (D&O) liability insurance.** Any ID sitting on a board or contemplating to sit on a board should become familiar with D&O insurance and review the company's policy. IDs must understand the extent of their potential personal liabilities, and the extent to which they can be indemnified for these liabilities through indemnities granted by the company and the provision of D&O liability insurance.
- c. **It is increasingly acknowledged that director remuneration should be structured to achieve two main purposes:**
  - Reward directors for their contribution, thus attracting highly trained and competent directors
  - Align the interests of stakeholders and directors.

Several organisations are developing a reward system for the directors based on the number of the committees in which they participate and whether they participate as the chairperson or member. Some other factors to be considered when setting remuneration are the experience and knowledge of the potential director; the indicative level of remuneration being paid to directors in comparable companies; and the size and complexity of the business.

- d. **Certain risks for the IDs typically arise due to the composition or functioning of the boards,** some of which are listed below:
  - Board appointments are decided by the chairperson with little input from other directors.
  - Board discussions are dominated by one or two directors.
  - Gaps identified in board's assessments are not actioned upon in a timely manner.
  - No formal (or insufficient) Board induction is provided to new board members.
  - The board receives no reports or information regarding the whistle-blower policy and complaints under the policy.
  - Some directors have family ties or cross-directorships that have not been discussed or are overlooked.
  - The board accepts management's strategy without in-depth probing or questioning.
  - Risks inherent in the strategy are not identified or managed.
  - A compliance map does not exist to provide a gap analysis on assurance activities.

IDs should have a strategy of addressing these risk factors; if the risks cannot be mitigated, IDs must evaluate whether they want to be associated with the company.

## V. Global trends

### V.1 Role of Lead IDs

The concept of Lead ID is yet to gain popularity in India. However, a vast majority of U.S. boards now have IDs who serve as Lead IDs. The specific responsibilities of a Lead ID vary among companies, but may include:

- Leading the appraisal process of the chairperson.
- Collaborating with the chairperson in preparation of the board agenda and supporting papers.
- Acting as an intermediary, where necessary, between IDs and the non-independent chairperson.
- Setting the agenda, leading executive sessions of the IDs and briefing the CEO on issues arising from those sessions.

As a good practice, the company leadership structure should be openly discussed and agreed by the board

with the responsibilities and accountabilities of the chairperson, Lead ID and CEO being clearly documented.

## V.2 Diversity is an integral part of effective board composition

There is much discussion about the value of 'diversity' on boards, much of which is done through the appointment of IDs. In structuring the board to add value, a company should consider the mix of skills, backgrounds, experience, age, gender and perspectives of its directors that would be necessary to meet the unique requirements of the company. An emphasis on director diversity should yield three key benefits:

- An increase in the intellectual resources of the board
- Lessen the risk of 'group- think'
- A stronger connection with customers, employees and other stakeholders.

To promote gender diversity Norway already mandates 40% women directors on boards, while the French listed companies need to reserve the same proportion of board seats for women by 2017. Closer home, the Companies Act 2013 mandates one women director on the boards of listed and certain unlisted public companies.

## V.3 Shareholder activism

Shareholder activism in the last decade has increased the importance of communication between the board members and shareholders. Institutional investors surveyed (FTI Consulting 2015) rank the following as the top 3 reasons why a company may be targeted for activism:

- Poor stock price performance
- Ineffective or inefficient capital deployment and
- Poor corporate governance.

Many shareholder activists, in furtherance of their stated agenda, nominate independent directors to serve on the boards of the companies they target. About 77% of institutional investors surveyed believed that the companies benefit from shareholder nominated IDs. To address risks arising from shareholder activism, many IDs are now seeking to become more active in their companies' investor relations programs.

## V.4 Stakeholder versus Shareholder oriented approach

Corporate scandals at various organisations have caused many to question the theory of maximizing shareholder returns. Many now advocate a stakeholder-oriented approach, balancing the interests of a company's various constituencies even if it reduces shareholder returns in the short-term. Stakeholder theory, often believed not to take into account the interests of shareholders, in fact does so by seeking to ensure the long-term sustainability of the company. Boards are increasingly seeking to balance the interests of both the shareholders and a wider group of stakeholders in their decision-making, and articulating this perspective in all organizational communications. The role of IDs in the transition to the stakeholder approach is paramount.

## VI. Conclusion

IDs can play the role of change agents in building good governance practices in organisations in which they serve. Having a better understanding of roles and responsibilities, as well as risks and liabilities, can help IDs add greater value to their organizations and become more effective as an instrument of corporate governance mechanism.

## References

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## 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.