

Role and responsibilities of Independent directors under the Companies Act



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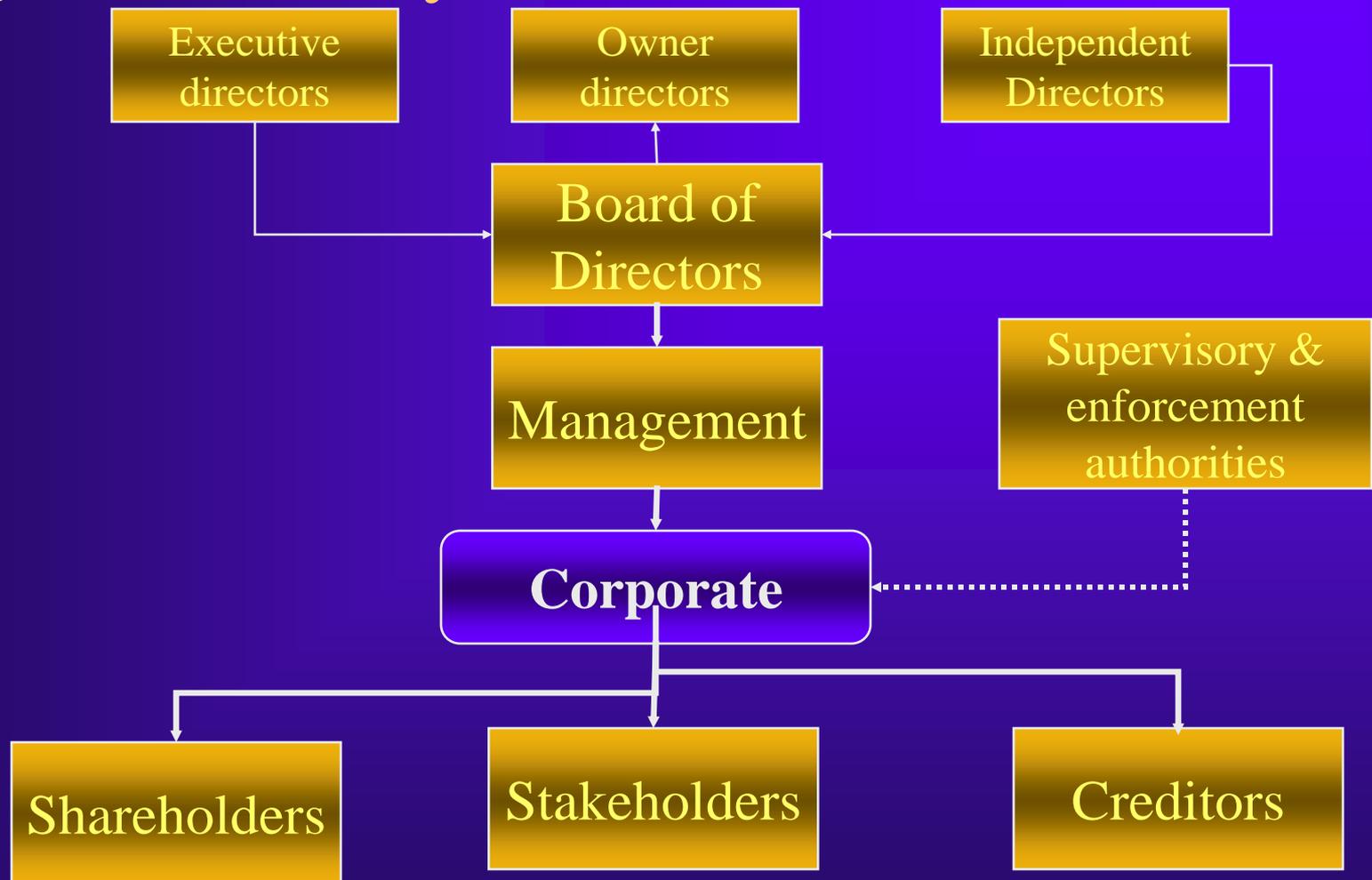
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Why it is needed ?

- ◆ Two major changes over the past scenario:
 - variety of stakes in a modern corporation, apart from the stake of the legal equity holders; and
 - thanks to capital markets, major diversification of the equity capital leading to ever larger distance between the owners of capital and the managers.
- ◆ The decline of banking and the rise of the institutional investor
- ◆ Increasing power and size of enterprises
 - Working of the economic system
 - enterprises spreading offices and employees in dozens of countries
 - Business activities spreading across the continents
 - Shareholders scattered across the world
 - Investments by institutional investors
- ◆ Systems of corporate governance should be reconciled with ground realities of the country in question:
 - Corporate ownership and control not uniform in emerging markets and developed capital markets
 - Emerging markets are dominated by “family enterprises”



A basic design of existing corporate governance systems





Key objectives

- ◆ Role of owners in electing the Board
- ◆ Protection of minorities
- ◆ Role of other stakeholders in management
- ◆ Board structure and objectivity of the Board
- ◆ System of reporting and accountability
- ◆ Audit and internal control
- ◆ Effective supervision and enforcement by regulators
- ◆ To encourage Sustainable Development of the Company and its stakeholders

Principles of OECD code on Corporate Governance 2005

- ◆ The corporate governance system should promote transparent and efficient markets; should be consistent with rule of law and should lay down clear roles of various regulatory and enforcement authorities.
- ◆ Corporate governance system should protect and facilitate shareholder rights.
- ◆ The system should facilitate equitable treatment to all shareholders, including minority and foreign shareholder.
- ◆ Corporate governance should recognise the rights of stakeholders established by law or mutual contract; should encourage cooperation between the corporate and the stakeholders to create value
- ◆ Disclosure and transparency: System should ensure timely and accurate information about financial situation, performance, ownership and governance
- ◆ Board management structure





OECD principle – shareholder rights

- ◆ OECD principles on shareholders' rights
 - Basic shareholder rights: registration and transfer of shares, right to vote at meetings, obtain relevant information, appoint and remove directors and share in the profits
 - Fundamental corporate structure changes to require shareholder participation
 - Shareholders to vote on directors' and KMP's remuneration and equity options
 - Voting in absentia
 - Market for transfer of control to be transparent
- ◆ In practice, shareholders' rights have largely been a myth:
 - Widespread shareholding, including cross-border holding
 - Role of the institutional investors
- ◆ Back to OECD principles



OECD principle – equitable treatment to all shareholders

- ◆ **Protection of minority interest**
- ◆ **Impediments to cross border voting should be removed**
- ◆ **Insider trading and abusive self-dealing should be prohibited**
- ◆ **Board members and KMPs to disclose their interest in material contracts**
- ◆ **Back to OECD principles**



OECD principle: Stakeholders' interest

- ◆ Employees participation in management: performance enhancing mechanisms to be promoted
- ◆ Whistle-blowers' interest to be protected
- ◆ Creditors' rights:
 - Through security interest enforcement and bankruptcy laws:
 - Current enforcement is tardy
- ◆ Back to OECD principles



OECD principle: disclosure and transparency

- ◆ Disclosures on:
 - The financial and operating results of the company.
 - Company objectives.
 - Major share ownership and voting rights.
 - Remuneration policy for board and KMPs, and information about board members, their qualifications, the selection process, other company directorships and whether they are regarded as independent by the board.
 - Related party transactions.
 - Foreseeable risk factors.
 - Issues regarding employees and other stakeholders.
 - Governance structures and policies
- ◆ Annual audit by independent and competent auditor.
 - Non-audit functions of auditors are being restricted in many countries
- ◆ External auditor should be accountable to the shareholder and should owe a duty of professional care in conduct of the audit.
- ◆ Corporate governance to be complemented by a system that promotes the provision of advice, analysis, rating, etc. for shareholders to make informed decisions; however, system should avoid conflicts of interest.
- ◆ [Back to OECD principles](#)



OECD principle: Board composition and structure

- ◆ Some key functions should be fulfilled by Board:
 - Strategy formulation, budgets, business plans, etc.
 - Monitoring the effectiveness of the company's governance practices;
 - Selecting, compensating, monitoring key executives and overseeing succession planning.
 - Executive and board remuneration;
 - Ensuring a formal and transparent board nomination and election process.
 - Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
 - Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, ensuring control systems for risk management, financial and operational control, and compliance.
 - Overseeing the process of disclosure and communications.
- ◆ Ability to exercise independent decision:
 - The most current theme is the number and role of independent directors
 - Sufficient independent directors
 - Mandate of committees to be clear
- ◆ [Back to OECD principles](#)

Who are Independent Directors

As per Clause 49 of the Listing Agreements an 'independent director' shall mean 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 senior management or its holding company, its subsidiaries and associated companies;
- b. is not related to promoters or management 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 of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years. This will also apply to legal firm(s) and consulting firm(s) that have a material association with the entity.
- e. is not a supplier, service provider or customer of the company. This should include lessor-lessee type relationships also; and
- f. is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

[Institutional directors on the boards of companies shall be considered as independent directors whether the institution is an investing institution or a lending institution.]



Other Definitions:

- ◆ Higgs' definition: "that a non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no *relationships or circumstances* which could affect, or appear to affect, the director's judgement".
 - Such "relationships" are enumerated
- ◆ NYSE definition: Director or immediate family member -
 - not to be an executive of the company receiving \$100000
 - Not to be affiliated in professional capacity
 - Not to be one who or whose immediate family members work on another company where the executives of the company serve on the compensation committee.
 - A director or his immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services in an amount which, in any single fiscal year, exceeds the greater of \$1 million, or 2% of such other unit's three years company's consolidated gross revenues, would not be independent
 - "Family" defined to include person's spouse, parents, children, siblings, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than domestic employees) who shares such person's home.
- ◆ To state simply the expression 'Independent Directors' has been defined to mean directors who apart from receiving director's remuneration, do not have any other material pecuniary relation or transactions with the company, its promoters, its management or its subsidiaries, which in the judgement of the board may affect independence of judgement of directors.





Selection of Independent Director

- ◆ The selection and appointment of independent directors should be transparent and on certain valued basis.
- ◆ Therefore, the companies should have an entirely independent nomination committee which should determine the qualifications for Board membership and should identify and evaluate candidates for nomination to the Board.
- ◆ It would be more appropriate that the code of Corporate Governance of a company should specifically include the qualifications and attributes that the company seeks of an independent director.
- ◆ A critical element of a director being independent is his independence to the management both in fact and perception by the public.
- ◆ In considering the independence, it is necessary to focus not only on whether a director's background and current activities qualify him as independent but also whether he can act independently of the management.
- ◆ In other words, the independent directors must not only be independent according to the legislative and stock exchange listing standards but also independent in thought and action i.e. qualitatively independent.
- ◆ Such qualitative independence will ensure that directors think and act independently without regard to management's influence.



Roles & Responsibilities

- ◆ The role and responsibility of an individual director, of course, would depend upon the nature of his directorship.
- ◆ Broadly, there are three types of directors.
- ◆ Full time, executive director who is normally a paid employee of a company having some functional responsibility.
- ◆ Non executive but non independent director who is normally a promoter of the company or having high stakes in the company.
- ◆ And finally independent directors who are not full time directors. There is another class of directors known as nominee directors representing some interests like lending institutions etc.
- ◆ An executive director, by very nature has much more responsibilities than non executive directors. In law it is their responsibility to ensure compliance with provisions of law failing with they could be held liable as officers in default. As far as independent directors are concerned, the position of law is nebulous.



Role of Independent Directors

- ◆ Independent directors broadly fit into the overall structure of corporate governance, and are necessary to ensure effective, balanced boards
- ◆ The board is the most significant instrument of corporate governance
- ◆ **Role Of Independent Directors**
 - The non-executive directors should:
 - * Contribute to and constructively challenge development of company strategy.
 - * Scrutinize management performance.
 - * Satisfy them that financial information is accurate and ensure that robust risk management is in place.
 - * Meet at least once a year without the chairman or executive directors - and there should be a statement in the annual report saying whether such meetings have taken place.
 - * Be prepared to attend AGMs and discuss issues relating to their roles (especially chairmen of committees).
 - * Have a greater exposure to major shareholders (particularly the senior independent director).
- ◆ Effectiveness of the board as the oversight body to oversee what the management does
- ◆ Is there a better way to do it, in view of
 - Recent scandals of disclosures and audits
 - Size and scope of present day enterprise
 - Complexity of operations

Responsibilities of Independent Directors

- ◆ Independent Director shall however periodically review legal compliance reports prepared by the company as well as steps taken by the company to cure any taint. In the event of any proceedings against an independent director in connection with the affairs of the company, defence shall not be permitted on the ground that the independent director was unaware of this responsibility.
- ◆ To function to properly according to the spirit of corporate governance as a director on the board and as Member/Chairman across various committees viz. the Audit Committee, the Shareholders' Grievance Committee and the Remuneration Committee of the company.
- ◆ A director shall not be a member in more than 10 committees or act as Chairman of more than five committees across all companies in which he is a director. Furthermore it should be a mandatory annual requirement for every director to inform the company about the committee positions he occupies in other companies and notify changes as and when they take place.
- ◆ At least one independent director on the Board of Directors of the holding company shall be a director on the Board of Directors of the subsidiary company.





PROVISIONS OF SARBANES OXLEY ACT

- ◆ CEO and CFO to certify appropriateness of financial statements
- ◆ Forfeiture of bonuses and profits in certain circumstances
- ◆ Officer and director Bars and Penalties; Equitable relief:
 - If there is a restatement of financial statements due to material non-compliance, the CEO/CFO reimburse the company for its losses
- ◆ Prohibition on personal loans to executives
- ◆ Disclosure of transactions involving management and principal stockholders:
 - Directors, officers and 10% shareholders to report designated transactions within 1 day
- ◆ Annual report to contain a report by management on internal control



IMPLICATIONS OF SARBANES OXLEY ACT

- ◆ Issuers, who must comply with enhanced disclosure requirements and adopt more stringent corporate governance standards, as well as enhanced SEC review of their annual and periodic report.
- ◆ Directors and officers, who must certify annual and periodic reports (including financial statements).
- ◆ Employees, who will be shielded by whistle-blower protections.
- ◆ Attorneys, who will have the obligation to report evidence of material violations of securities laws or breaches of fiduciary duty to an issuer's Board of Directors.
- ◆ Auditors, who will be subject to oversight and discipline by a newly created independent board, as well as additional restrictions and limitations on non-audit services that they may provide to audit clients.
- ◆ Investment banks and research analysts, who will be subject to more stringent rules regarding conflict of interest between analysts and investment bankers and disclosure by analysts, of actual and potential conflicts of interest.

The Act also created a number of new federal crimes related to violations of the security laws and the provisions of the Act itself and increased the penalties and extended the statute of limitations of certain existing laws.

NEW YORK STOCK EXCHANGE REGULATIONS

- ◆ Majority of Board to comprise of independent directors
 - Definition of independent director tightened
- ◆ Non-executive directors to meet at regular intervals without the management
- ◆ Listed companies to compulsorily establish following committees consisting of independent directors only –
 - Corporate Governance Committee
 - Compensation Committee
 - Audit Committee
- ◆ Listed companies to have an internal audit function
- ◆ Listed companies to frame and disclose corporate governance guidelines, consisting the following matters –
 - director qualification standards
 - director's responsibilities
 - director's access to management
 - director's compensation
 - management succession
 - annual performance evaluation of the Board
- ◆ Listed companies to compulsorily adopt a Code of Business Conduct and Ethics for directors, officers and employees
- ◆ CEO to certify annually that there are no listing agreement violations





Experience with independent directors

- ◆ Studies into impact of independent directors:
 - US study (Hermalin and Weisbach, 2001) shows:
 - No relation between board composition and performance
 - However, impact on quality of management:
 - Companies with independent board showed more CEO sensitivity to performance
 - Acquirers viewed such companies more positive
 - KMP compensation schemes were more transparent
 - UK study (Dahya et al 2002):
 - No connection with profitability
 - Less senior management turnover

Independent Directors under Listing Agreement in India

- ◆ Composition of the Board:
 - Not less than 50% of the board to be non-executive directors
 - Independent Directors:
 - If the chairman executive:
 - At least half of the board should comprise of independent directors
 - If Chairman non-executive:
 - At least one- third of the board should comprise of independent directors
- ◆ Non-executive directors' remuneration to be approved by shareholders
- ◆ Board meetings – to meet at least 4 times, with gap not exceeding 3 months. Minimum information for board meetings laid down
- ◆ Committees of Directors –
 - Audit Committee: requirements other than those u/s 292A
 - shall have minimum 3 members all of them being non-executive and majority of them being independent
 - Chairman of the committee shall be an independent director
 - To meet at least thrice a year
 - Company Secretary to act as secretary to the committee
 - Remuneration Committee
 - Shareholders/Investors Grievance Committee
 - Limits on committee memberships and chairmanships



Recommendations of the Irani Committee on Independent directors

- ◆ There cannot be a single prescription for all companies
 - Number may be prescribed by rules
- ◆ A minimum one third recommended for a company having public interest
- ◆ Nominees of institutions should not be considered “independent” as they represent sectional interests
- ◆ Suggests a definition:
 - Based on pecuniary interest that may affect independence
 - Lays some statutory illustrations of situations where independence does not exist
- ◆ Independent directors should make self-declaration of eligibility to be so appointed





Derek Higgs report on independent directors: some interesting data

- ◆ Average age of non-executive directors in FTSE 100 companies is 59, with 75% at 55 or over
- ◆ Average age of the chairman is 62; almost 40% are over 65
- ◆ The average remuneration of FTSE non-executive director is GBP 44000 in FTSE 100 companies; average remuneration of FTSE 100 chairman is GBP 426000.
- ◆ Average time in post is 4.3 years



Do independent directors help?

- ◆ Experience in corporate America is very mixed:
 - Independent directors marginalise and demotivate executive management
- ◆ How to be a good independent director – the Derek Higgs dose:
 - Non-executive directors need to be sound in judgement and to have an inquiring mind. They should question intelligently, debate constructively, challenge rigorously and decide dispassionately. And they should listen sensitively to the views of others, inside and outside the board.

Companies Act and Independent Directors

- ◆ The Companies Act looks at all directors alike:
 - Throws some extra compliances in case of whole time directors
 - Requires some disclosures by interested directors
 - Defines “officer in default” giving a degree of immunity to directors other than the whole time directors
- ◆ Does not exempt independent directors from any of the duties, liabilities, responsibilities of the Board
- ◆ Independent directors as much as part of the corporate governance team as any other director
- ◆ Independent directors have the same power that other directors have



Legal provisions

- ◆ Sec 5: officer in default:
 - Independent directors are treated as such only where the company does not have a wholtime director, or no specific director is charged with a particular compliance:
 - Alas – this provision is not applicable for compliances under any other law
- ◆ Sec 267-269 applicable only to wholtime directors
- ◆ Sec 274: applicable to all directors
- ◆ Sec 284: procedure for removal of directors applicable to all directors
- ◆ Sec 291 – general powers exercisable through board meetings
- ◆ Sec 292 – certain powers may be delegated to wholtime directors
- ◆ Sec 292A – composition of the audit committee to include a majority of directors other than wholtime directors
- ◆ Sec 297, 299, 300 – applicable to all directors
- ◆ Sec. 309 (4):
 - Separate limits and restrictions applicable on remuneration of independent directors
- ◆ Explanation IV to Schedule XIII: Managerial remuneration:
 - Appointment and remuneration of managerial personnel to be decided upon by the remuneration committee. Committee to consist of at least 3 non-executive independent directors





Liabilities under other laws

- ◆ The basic directorial liability apart, being a corporate director may invite liabilities under myriad Central, State and Local laws:
 - Most often, notices, summons, etc are addressed to all directors
- ◆ Sometimes, IT searches are also unable to distinguish between working directors and independent directors



Recent examples of liability of independent directors

- ◆ In case of Worldcom and Enron, directors settled liabilities:
 - \$ 18 million by 10 outside directors in Worldcom
 - \$ 13 million by 10 directors in Enron
- ◆ In Walt Disney case, the court did not impose liability on directors:
 - Ruling based on Delaware law
 - Duty of care, fiduciary duty and gross negligence discussed at length
- ◆ India:
 - The conclusion is inevitable that the liability arises on account of conduct , act or omission on the part of a person and not merely on account of holding an office or a position in a company. SC ruling in SMS Pharmaceuticals Ltd, Sept 2005



Mitigating directors' liability

- ◆ Business judgement rule (BJR)
- ◆ Exculpation and Indemnification:
 - Specific restrictions, eg. Sec. 310 of UK Companies Act 1985
- ◆ D&O insurance



Way out...

- ◆ Clearly, it would be difficult to get right individuals if we make the life of an independent director hell
- ◆ Hence, the two tier board is an ideal situation:
 - Executive board and supervisory board distinction
- ◆ Since, admittedly, independent directors do not have an executive role or censuring of executing actions, they do not have liabilities of executive management
- ◆ In fact, dual board system allows for easy functioning of the company as executive decisions do not come to the supervisory board



Thank

You