Independent Directors – A Tool for Investor Protection

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Corporate managements around the globe have been continuously under a scanner particularly after the WorldCom, Enron etc. debacles. Consequently, Governments in various countries have been making persistent efforts to improve the standards of corporate governance and the induction of independent directors on the Boards of companies is being seen as a panacea to instill professionalism, avoid corporate frauds and ultimately protect investors and other stakeholders' interests.

In the emerging scenario, there is considerable unanimity amongst regulators, policy makers, academia and other bodies that independent directors provide valuable contribution in the progress of an enterprise. In fact independent directors are considered as both a safeguard and a significant source of competitive advantage. Shareholders, as the primary stakeholders, who have invested their funds in the corporate entity, expect the Boards to manage their funds in the best possible common interest and Independent Directors are expected to oversee fulfillment of their justified expectations.

Various Committees constituted world over to suggest norms on Corporate Governance in companies, have emphasized on the presence of independent Board to bring an independent judgement oversight to the Board deliberations and to device effective strategies aimed at investor protection. Independence of Board was first advocated by Cadbury Committee of UK, followed by Blue Ribbon Committee of USA, Hampel Committee and Higgs Review Board of UK, OECD Principles of Corporate Governance etc. In India, various Committees which have advocated independence of Board are Kumar Mangalam Birla Committee, Naresh Chandra Committee , N.R. Narayanamurty Committee, Dr. JJ Irani Committee etc.

Blue Ribbon Committee of USA laid down considerable stress on the role of Independent Directors and rationalized the call for a majority of Independent Directors on the Board of the Directors as "independence is critical to ensuring that the Board fulfills its objective oversight role and holds management accountable to shareholders".

California Public Employees' Retirement System (CalPERS), the largest US pension fund, in its Core Principles and Governance Guidelines codified Board Independence as cornerstone of accountability. Under OECD principles of corporate governance, it is stipulated that the Board should be able to exercise objective judgment on corporate affairs and that it should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest.

Kumarmangalam Birla Committee (in India), was of the view that the non-executive directors including those who are independent, help bring an independent judgement to bear on Board's deliberations especially on issues of strategy, performance, management of conflicts and standards of conduct. It stated that "It has been proved time and again in the USA, Great Britain, Germany and many other OECD countries that the quality of the board and, hence, corporate governance improves with the induction of outside professionals as non-executive directors."

The Naresh Chandra Committee felt that to be really effective, independent directors need to have a substantial voice, by being in a majority. The Committee therefore recommended that independent directors have adequate presence and strength on the Board, especially in the companies that are listed or, being public companies above a particular threshold limit.

Dr. J.J. Irani Committee Report on New Company Law also mandated the presence of Independent Directors on the Boards as a measure of balancing various interests and improving corporate governance. The Committee observed that independent directors would be able to bring an element of objectivity to Board processes in the general interests of the company and thereby to the benefit of minority interests and smaller shareholders.

The listing codes and agreements of various countries including New York, London, Australia, Canada etc. mandate the appointment of Independent Directors on the Boards of Companies. The requirements of New York Stock Exchange require that listed companies must have a majority of Independent Directors as such majority is expected to enhance the quality of Board supervision and reduce the probability of damaging conflicts of interests. London Stock Exchange which has incorporated under its listing requirement, Principles of Good Corporate Governance, states that the Board should include a balance of executive and non-executive directors such that no individual or small group can dominate the Board's proceedings.

It is therefore apparent from the above, that to arrest untoward trends in corporate management, the governments are routed to bank heavily on the concept of Independent Directors. The hope appears to stem from the perception that outside directors who are in no way connected with the ownership or management of the company or its promoters or its subsidiaries, can help in improving transparency and accountability in the company management.

Role and number of Independent Directors

The most important aspect of governance and management is a strong and competent board of directors. Infact being an Independent Director today requires appropriate attitude and capability and demands time and attention.

There should be a very strong element of independence on the Board of directors to ensure objectivity in board processes. Infact today there is a great demand for good independent directors and Companies are realizing the significance of competitive and good independent directors who not only contribute valuable expertise but ensure quality in board oversight.

SEBI has prescribed 50 percent of the Board to be independent in case Chairman is Executive and one-third of the Board to be independent in case Chairman is non-executive. Requirement of presence of Independent Directors may vary depending on the size and type of Company. There cannot be a single prescription to suit all companies. However, the Irani Committee felt that a minimum of one-third of the total number of Directors as Independent Directors would be adequate for a company having significant public interest. Regulator can always stipulate a higher number for companies falling within their regulatory domain i.e. listed entities, therefore there seems to be no conflict of interest.

Anyway what is important is the quality and effectiveness of independent directors rather than the number. Defining independence would not guarantee independence of judgment. That has much to do with the choice of directors, the skills that they bring to the board, the roles they play in various committees, quality of information provided to them and a host of other factors. Managements I think today understand that good governance and following best practices makes good business sense today.

It is very important for Independent Directors to maintain objectivity and stand firm, though a difficult task, but not impossible. What is required is the will and courage to say no when things are not moving in the interest of the Company and its stakeholders specially including minority shareholders.

As the executive directors and managements of companies cannot evaluate their own performance, independent directors help to monitor their performance objectively and ensure protection as well as furtherance of interests of all investors and stakeholders.

Independent Directors are expected to perform the following important role and functions :

- Critical oversight function;
- Balancing the conflicting interests of stakeholders;
- Succession Planning;
- Filling gaps in experience and skills of senior management
- Acting as coach and mentor for management of the company;
- Providing independent judgment and wider perspective.
- Creating sound business policies and strategies, reviewing, detailed plans and budgets and assessing company's performance in the context of goals and objectives of the company.
- Providing fresh objective input to strategic thinking and decision making.
- Monitoring reporting of performance and suggesting reforms.

The role of independent chairman is even more onerous as he not only sets each Board agenda, but also directs a Board's attention to the matters most in need of critical review and oversight.

Duties and Responsibilities of Directors

The contribution of directors is critical for ensuring appropriate directions with regard to leadership, vision, strategy, policies, monitoring, supervision, accountability to shareholders and other stakeholders with a view to achieving greater levels of performance on a sustained basis as well adherence to best practices.

In doing the above the directors must exercise a certain degree of skill and care while carrying out their duties as might be reasonably expected from someone of their ability and experience. They have both collectively and individually a continuing duty to acquire and maintain sufficient knowledge and understanding of the companies' business to enable them to discharge their duties. No role of universal application can be formulated for the above.

The Companies Act, 1956 does not make any express provision regarding duties of directors except duty of disclosure of interest, duty of declaration of insolvency, etc. However, certain Sections indirectly refer to the fiduciary duties of the directors. The codes for corporate governance applicable to listed entities in US, UK, Australia provide for list of duties / responsibilities of directors and related disclosures. OECD principles too recommend certain basic duties i.e., board members should act on a fully informed basis, in good faith with due diligence and care in the best interests of the company and shareholders. Where board decision may affect different shareholders groups differently, the board should treat all shareholders fairly. The new clause 49 too has made it mandatory for listed Companies to have a code of conduct for its directors and senior management based on Narayan Murthy and Naresh Chandra Committee recommendations.

The Irani Committee has recommended that the law may include certain basic duties for directors, with civil consequences to follow for non-performance. However, the law should provide only an inclusive, and not exhaustive list of duties in view of the fact that no rule of universal application can be formulated as to the duties of the directors. It is important that certain basic duties should be spelt out in the Act itself such as (a) duty of care and diligence; (b) exercise of powers in good faith, i.e., discharge of duties in the best interest of the Company, no improper use of position and information to gain advantage for themselves or someone else (c) duty to have regard to the interest of the employees, etc.

Who are Independent Directors?

The question as to how to determine the 'independence' of a director and as to who could be treated as 'independent' director has engaged the attention of regulators the world over.

Various Committees and the Codes of Corporate Governance have laid down the criteria for determining the independence of Director.

Cadbury Committee Report, while recommending that majority of non-executives on a Board should be independent of the company, has elaborated that apart from their director's fees and shareholding, the Independent Directors should be independent of management and free from any business or other relationships which could materially interfere with the exercise of their independent judgement. It is for the Board to decide, in particular cases, whether this definition is met with.

Naresh Chandra Committee while examining the concept of independent director had rightly remarked that "this is an issue that has vexed the minds of the most Corporate Governance experts and has spawned myriad definitions". While referring to independence of auditors, it very rightly observed that 'like hunger, independence is easy to perceive, but difficult to define". The KumarMangalam Birla Committee defined the term 'independent director' in a manner that it does not hinder the smooth working of the Board. The Committee agreed that "material pecuniary relationship which affects independence of a director" should be the litmus test of independence.

Dr. JJ Irani Committee too has stated that the appointment of independent directors should be made by the company from amongst persons, who in the opinion of the company, are persons with integrity, possessing relevant expertise and experience and who satisfy the criteria for independence as laid down. This will indirectly ensure that people with necessary knowledge, skills and ethics are kept on the Boards of companies. Independence is not to be viewed merely as independence from promoter interests but from the point of view of vulnerable stakeholders who cannot otherwise get their voice heard. Dr. JJ Irani Committee has also laid down a detailed criteria from defining a person as independent director. Though similar to Clause 49 of Listing Agreement, the definition amongst others, also includes besides director's relationships, their relatives' relationships to establish independence. Relationship with non-profit organization which had received significant funding (25%) has also been brought within the purview of definition of independent director.

Though various codes have made an attempt to define independent director, the question of 'Independence' becomes a matter of individual judgement. One may describe directors who are fully independent as those whoare really men of integrity, honesty and adhere to the highest standards of code of ethics and best practices in life. Only that class of people who practice Dharma of karma and are free from greed would be able to bring about objectivity and independent judgement in the decision making process of the board of companies thereby ensuringexcellence in corporate governance. It is also well established that the existence of any significant pecuniary relationship between the company and an individual, acts against that person's capacity, to act independently of promoter's / management's interests.

Profile of Independent Director

Independent directors should be individuals with certain personal characteristics and core competencies. They should have imbibed in themselves, abilities for recognition of Board's tasks, have integrity, a heightened sense of accountability, track record of achievements, and the ability to pose tough questions. They should have financial literacy if not acumen, knowledge of law and judicial happenings, experience, leadership qualities and the ability to think strategically. They should devote adequate time for meetings – alongwith their preparation and analysis, have marketing and branding literacy, sector expertise, experience of mergers, acquisitions and change management; mentoring capabilities, networking, and independence of mind are other characteristics that need to be imbibed and developed.

Selection of Independent Directors

Given the importance of their distinctive contribution, non-executive directors should be selected with great care and impartiality. In the opinion of Cadbury Committee. "We recommend that their appointment should be a matter for the board as a whole and that there should be a formal selection process, which will reinforce the independence of non-executive directors and make it evident that they have been appointed on merit and not through any form of patronage. We regard it as good practice for a nomination committee to carry out the selection process and to make proposals to the board."

Various studies have been conducted on the effectiveness of independent directors. Of the various roles being identified for an independent director, the most effective has been found to be development of sound business strategies and monitoring performance. It has also been revealed that there is a strong and positive co-relation between the time an independent director spends on strategy role and the perceived level of impact that his contribution has, on business performance. An interesting finding has also been that the span of time for which an individual has been as an independent director appears to make little difference to his perceived impact on business performance. This suggests that while selecting new Board Members, the individuals' skills sets is more important than his experience as an independent director and therefore adequate attention be paid to their selection.

Training of Independent Directors

To enhance the merit and competence of independent directors, a comprehensive training in the form of desired skill matrix should be provided to them. This may involve, carefully designed induction or orientation programmes on the company and its functioning. The programme should be well balanced on leadership, strategy, business and financial risks, performance evaluation, financial reporting, legal and regulatory compliances and key corporate governance issues such as code of conduct, business ethics, values, accountability, disclosures and social responsibility. Such an induction programme of an independent director may accelerate the process by which a director can effectively contribute to the Board. The Government may also identify accredited institutions for the purpose of imparting training to such directors.

The specialized programmes are expected to develop sound understanding of the role and responsibilities of an independent director in the changing global environment. In this regard the National Foundation for Corporate Governance (NFCG) was founded at the initiative of Ministry of Company Affairs with the Institute of Company Secretaries of India, the CII, the Institute of Chartered Accountants of India as the trustees. The Foundation is engaged in creating and invigorating the culture and framework of corporate governance in this part of the world and, through accredited Institutes, imparts training for individuals to become value-adding independent directors.

Some concerns and suggestions

A critical element of a director being independent is, his independence to the management - both in fact and perception by the public. 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. Mere presence of directors who are independent in terms of the provisions of law does not mean that there would be checks and balances. What is to be ensured is that these directors think and act independently. There should be an effective Board and Director Appraisal Process in place. In fact, there is a need to institutionalize the whole concept of independent directors.

Considering the important role being played by the independent directors, they need to be conscious to the fact that they do not join hands with the board or promoters and lose their independence. However, in some countries, independent directors are found to be so closely allied to executive directors, that if the company is taken over, the independent directors resign at the same time as the executive directors and the new controlling shareholder appoints new 'independent' directors of their choice. It is also being observed that even though in law, the directors (including IDs) are to be elected by the shareholders, yet in practice, the directors proposed for election are normally the hidden nominees of promoters. Instances of financial dealings by such so called independent directors, even in reputed companies are coming to the fore. This is a serious matter which needs to be looked into.

Another emerging cause of worry for the corporate India today is the lack of credible and talented independent directors. To tackle this problem, a panel of independents directors is being maintained by regulatory bodies, industrial associations, professional and private bodies etc. which may be accessed to by the companies desirous of appointing independent Directors.

To improve their effectiveness the independent directors should, on their part, enhance their oversight function, always be investors' advocates in board rooms and stand up to managements, if necessary and as appropriate. They must review each proposal that comes before them and ask how it affects investors and what management conflicts, if any, are presented by the proposal. As front line gatekeepers, the independent directors, must be committed to performing their watch dog role and thereby restore investor confidence.

End Note

It has rightly been observed that not all well governed companies do well in the market place, nor do the badly governed ones always sink, but even the best performers risk stumbling some day if they lack strong and independent boards of directors.

It is heartening to note that managements today also empathise that good governance makes good business sense and investors are willing to pay a premium to corporates following best practices.

To conclude, the role and responsibility of independent directors are onerous as they are relied upon by the regulatory bodies alongwith stakeholders as their representative on the board. They provide assurance to all those dealing with the company that the Board's decision will not be based on narrow vision and that there would be efficient corporate functioning.