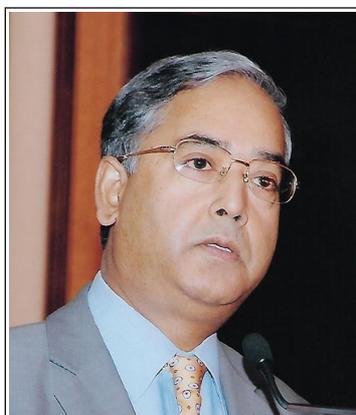


# Redefining the Process of Appointment of Independent Directors



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## **Introduction**

The requirement of appointing independent directors on the Board of Directors (“**Board**”) of a company has assumed a pivotal status in the corporate governance regime around the world. In simple terms, an independent director is a director who is independent of the management/promoters of the company and possesses relevant professional expertise and experience enabling him/her to supervise the affairs of the company in an effective and unbiased manner. Often regarded as ‘gatekeepers’ of corporate governance, the primary responsibility of an independent director is to safeguard the interest of all the stakeholders of a company, including minority shareholders and creditors. They are expected to bring on board an

independent and objective opinion thereby, preventing the Board from exhibiting biased or preferential mentality towards one set of stakeholders.

The journey of an independent director in a company starts with his appointment. Even the most stringent provisions of law will not achieve the desired impact if the process of appointment is not robust. In this article the focus will be on the process of appointment of independent directors in different jurisdictions and what has been the progress in India. Some new ideas for future implementation have also been discussed.

## **Evolution of the concept of Independent Directors**

The requirement to appoint an independent director on the Board of a company was introduced on a voluntary basis, as a measure of good corporate governance in the United States of America (“**USA**”) in 1950s.<sup>1</sup> Later, the Sarbanes Oxley Act, 2002 gave statutory recognition to independent directors<sup>2</sup> and rules of the stock exchanges provided for majority of directors to be independent<sup>3</sup>. In the United Kingdom (“**UK**”), a principle-based approach has been followed. There the discussion around the requirement of independent directors was first triggered by the Cadbury Committee Report in 1992<sup>4</sup>. Many changes have been made to the governance framework since then, the last being the UK Corporate Governance Code of 2018<sup>5</sup>.

In India, the concept of independent directors was first introduced in 1998 by the Confederation of Indian Industries (“**CII**”) under the Desirable Code of Corporate Governance (“**CII Code**”)<sup>6</sup>. The CII Code provided that any listed company having turnover above prescribed limits should appoint professionally competent, independent, non-executive directors. The Securities and Exchange Board of India (“**SEBI**”) appointed Committee on Corporate Governance under the Chairmanship of Kumar Mangalam Birla<sup>7</sup>, in its report in 1999, inter-alia, suggested a definition for the term ‘independent director’. It stated that an independent director is a director who apart from receiving director’s remuneration, does not have any other material pecuniary relationship or transaction with the company, which in the opinion of the Board, will affect his/her independence. The concept of independent directors was given statutory recognition in India under Clause 49 of the SEBI Listing Agreement<sup>8</sup> in 2000. Further refinements were suggested by the SEBI Committee on Corporate Governance under the Chairmanship of Narayana Murthy in 2003.<sup>9</sup> Later, the Companies Act, 2013 (“**2013 Act**”) laid down a comprehensive definition of the term ‘independent director’<sup>10</sup> and also introduced other requirements for them. In 2015, SEBI notified the SEBI (Listing Obligations and Disclosure Requirements) Regulations (“**LODR Regulations**”) to consolidate the corporate governance requirements for listed companies under the Clause 49 and other SEBI Regulations. The LODR Regulations have also defined the term “independent directors”. While the definition<sup>11</sup> laid down by the LODR Regulations is largely in line with that under the Act, it provides for certain additional exclusionary criteria. Further, the governance requirements under the LODR Regulations are more exhaustive in comparisons with the 2013 Act. Pursuant to the recommendations made by the Committee on Corporate Governance under the Chairmanship of Uday Kotak (“**Kotak Committee**”)<sup>12</sup>, the LODR Regulations were amended in 2018.

### ***Process of Appointment of Independent Directors in UK and USA***

In the UK, the Corporate Governance Code, 2018 recommends that the Board should establish a nomination committee, comprising of majority independent non-executive, to lead the process for appointment of all directors.

<sup>13</sup> Any appointment must be approved by the Board and shareholders of the company by way of an ordinary resolution. Additionally, the UK Listing Rules provide that, in the case of a listed company having a controlling shareholder (more than 30% voting power), the election of a person as an independent director must be approved by two set of shareholders: (i) the shareholders; and (b) the independent shareholders.<sup>14</sup> If the resolution is not approved by both the set of shareholders and the listed company still wishes to appoint a person as an independent director, it must propose a second resolution to elect the said person, after expiry of 90 days from the date of the original vote and the second resolution must be approved by the shareholders of the listed company.<sup>15</sup> The requirements in UK have given prominence to non-promoter or public shareholders by having the requirement of putting the resolution to vote again in case it did not get approved by such shareholders. Further, the imposition of a 90 days cooling off period gives an opportunity to both public and non- public shareholders to engage in discussions and reach a decision that is acceptable to both.

Interestingly, during her campaign, in July 2016, Theresa May, the future Prime Minister had outlined her intentions to develop a framework for the appointment of employee representatives on Boards. However, there was a strong resistance from the business community and also from within the cabinet<sup>16</sup> and consequently, the Green Paper on Corporate Governance Reforms<sup>17</sup> (“**Green Paper**”) that was introduced in November 2016, merely ‘recommended’ employee representation on Boards. The Green Paper outlined the following three options for strengthening the voice of stakeholders at boardroom level:

- (i) Creation of a stakeholder advisory panel, whose view could be sought on particular issues or who might be invited to attend meetings of the Board when relevant agenda are to be discussed; or
- (ii) Designate existing non- executive directors to ensure that the voices of key interested groups, especially that of employees, is being heard at the Board level; or
- (iii) Appoint individual stakeholder representatives to company Board.

In the USA, the New York Stock Exchange Listed Company Manual<sup>18</sup> lays down a comprehensive definition of who can be an independent director. It provides that listed companies must have a nominating committee composed entirely of independent directors, which will select qualified candidates for the office of director for submission to the shareholders meeting.

### ***Process of Appointment of Independent Directors in India***

The process of appointment of independent directors has been prescribed under 2013 Act read with the Companies (Appointment and Qualification of Directors) Rules, 2014 (“**Appointment Rules**”). The nomination and remuneration committee (“**NRC**”), which is comprised of a majority independent director, identifies candidates who qualify the criteria of independence laid down under the 2013 Act and the LODR Regulations, in case of a listed company. The NRC then recommends the same for approval by the Board and subsequently by the shareholders of the company by passing an ordinary resolution. The LODR Regulations provide that a special resolution has to be passed if the proposed person is above seventy-five years of age or his proposed term will extend beyond his attaining seventy-five years.<sup>19</sup> Normally, the resolutions for appointment of independent directors are passed without a hitch. But, in one large company the proxy advisers recommended that the motion for appointment of independent directors should be defeated as the concerned persons were serving on the Board for a long period had exceeded the age of seventy-five years, the motion was reportedly defeated. To avoid any embarrassment, both the candidates quietly withdrew from the race and resigned.

The 2013 Act also provides for annual evaluation of the performance of independent directors<sup>20</sup>. The independent directors have to regularly provide the disclosures about remaining independent and not being conflicted in any way<sup>21</sup>. There is also a requirement that the independent directors have to meet separately without the associate directors being present to discuss independently the affairs of the company.<sup>22</sup>

A robust process of appointment of independent directors must also ensure that the process of their removal does not compromise their independence. An independent director can be appointed for a maximum of two terms of up to five years each. While the initial appointment can be made by an ordinary resolution passed by the shareholders, in case of a second term, a special resolution has to be passed by the shareholders of the company. It is interesting to point out that under the 2013 Act the premature removal of a director before expiry of his/her term was earlier possible through an ordinary resolution passed by the shareholders. After the Tata-Mistry controversy when some independent directors in the listed companies of the TATA group were removed before completing their terms this issue gained public attention. Subsequently, in 2018 the 2013 Act was amended to provide that a premature removal of a re- appointed independent director would require a special resolution by the shareholders to be passed<sup>23</sup>.

**Data Bank:** It is pertinent to note that, section 150 of the 2013 Act states, “*subject to the provisions contained in sub-section (5) of section 149, an independent director may be selected from a data bank containing names, addresses and qualifications of persons who are eligible and willing to act as independent directors, maintained by any body, institute or association, as may be notified by the Central Government, having expertise in creation and maintenance of such data bank and put on their website for the use by the company making the appointment of such directors.*” The Central Government notified the rules in this regard in 2019.

With a view to make the process of appointment more stringent and fairer, on October 22, 2019, the Government introduced certain additional requirements for appointing an independent director, by amending the Appointment Rules<sup>24</sup>, and notifying the Companies (Creation and Maintenance of Databank of Independent Directors), 2019 (“**Databank Rules**”)<sup>25</sup>. On the same day, vide a notification, the responsibility to maintain the data bank was vested in the Indian Institute of Corporate Affairs (“**IICA**”). The Databank Rules also provide that IICA shall create and maintain a databank of persons willing and eligible to be appointed as independent directors, and such databank will be placed on the website of IICA.<sup>26</sup> The databank will, *inter alia*, contain prescribed details such as name, DIN, gender, nationality, educational and professional qualifications, directorships and email address in respect of each person included in the databank.<sup>27</sup>

As per the amended Appointment Rules<sup>28</sup> an individual who is or who aspires to be appointed as an independent director, has to apply to the IICA to have his/her name included in the data bank for a period of one year or more or for lifetime<sup>29</sup> and subsequently clear an online proficiency self-assessment test conducted by the IICA within a period of one year from the date of inclusion of his/her name in the data bank, failing which, the name will stand removed from the databank of the IICA.<sup>30</sup> A candidate who has scored a minimum of score of 60% will be deemed as pass in the online test.<sup>31</sup> No bar has been put on the number of attempts that may be taken by a candidate to pass the examination.<sup>32</sup> Individuals who have acted as a director or a key managerial position in prescribed class<sup>33</sup> of companies for a period of ten years or more, are exempt from the requirement of undertaking the said test.<sup>34</sup>

As per the Databank Rules, the exam is to be conducted online and would test a person on the companies law, securities law, basic accountancy and such other areas as may be relevant to the functioning of an individual as an independent director.<sup>35</sup> For the convenience of the applicants, the Databank Rules also provide that the IICA has to prepare a basic reading material, online training<sup>36</sup> and also the option to undertake advance test.<sup>37</sup>

It maybe noteworthy that, no jurisdiction that follows a governance model similar to that of India, has introduced requirements like clearing an examination to qualify as an independent director. As per reports, by the end of January 2020, more than 1,000 individuals registered with the IICA.<sup>38</sup> However, it should not be forgotten that some candidates who chose to become independent directors possess immense knowledge, expertise and are highly regarded in their respective fields. They bring their vast experience to Boards and are not always driven by monetary considerations. It will be interesting to see how many of such people will appreciate the new requirement and will be keen on taking the examination introduced by Central Government. As per a report, about 170 independent directors of NSE-listed companies resigned from Boards between January and March 2020.<sup>39</sup> Further, it has been argued by many that the role of an independent director varies from industry to industry and a single examination may not be able to assess all the attributes that an independent director may be required to possess.

### **Going Forward**

Substantial progress has been made in the last decade towards strengthening the institution of independent directors. There is more clarity on their role and more accountability for their actions. Besides the 2013 Act, SEBI Regulations, the Insolvency and Bankruptcy Code, 2016 and other statutes have also attempted to specify the accountability of independent directors. There are also substantial precedents available in this regard.

However, the starting point for strengthening the framework for independent directors has to be a robust appointments process. Section 150(4) of the 2013 Act empowers the Central Government to prescribe the manner and procedure of selection of independent directors.

One important area of improvement is the manner in which the NRC recommends a name for appointment as independent director. No specific process has been prescribed. It is understood that generally, the chairman of the NRC informally discusses names with other members of the NRC and also the chairman/managing director/promoter of the company. This informal consultation is formalised in a subsequent meeting of the NRC and the Board. Every Board is expected to identify the skill-sets that its directors possess, identify the gaps in the existing skill-sets and try to fill in these gaps in subsequent appointments. The questions such as whether a set of candidates were considered by the NRC keeping in mind the existing gaps in skill-sets and what was the process followed in preparing the sort-list have to be satisfactorily addressed. Ideally, the NRC should record the relative merits of short-listed candidates which are sent to the Board for approval. Another approach could be to permit the minority shareholders to recommend names, which could be considered by the NRC along with other names. Like the UK, India may adopt a framework whereunder, more power is given to non-promoter shareholders in the process of appointment of independent directors.

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Lastly, if the intention of the Central Government is that all independent directors and those desirous of becoming one should get registered with a databank then instead of IICA having a monopoly over maintaining a databank of independent directors, the Central Government should notify multiple databanks to be maintained by different agencies of repute so as to provide companies with multiple options to choose from. Of course, these data banks will have to be properly regulated in order to maintain high standards.

That being said, the actual impact of the new requirements is yet to be seen and we can only hope that they succeed in creating the desired results and enhance the corporate governance standards across the Boards of companies in India.

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- <sup>1</sup> Jeffrey N. Gordon, 'The Rise of Independent Directors in the United States, 1950-2005: Of Shareholder Value and Stock Market Prices', 59 STAN. L. REV. 1465, 1473.
  - <sup>2</sup> Sarbanes-Oxley Act of 2002, § 301.
  - <sup>3</sup> Umakanth Varottil, 'Evolution and Effectiveness of Independent Directors in Indian Corporate Governance' 6 HASTINGS BUS. L.J. 281 (2010).
  - <sup>4</sup> Supra, note 1.
  - <sup>5</sup> Financial Reporting Council, The UK Corporate Governance Code (2018), available at, <https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.pdf> (last accessed on August 4, 2020).
  - <sup>6</sup> Confederation of Indian Industries, 'Desirable Code of Corporate Governance' (1998) available at, [https://www.mca.gov.in/Ministry/latestnews/Draft\\_Report\\_NareshChandra\\_CII.pdf](https://www.mca.gov.in/Ministry/latestnews/Draft_Report_NareshChandra_CII.pdf) (last accessed on July 18, 2020).
  - <sup>7</sup> Securities and Exchange Board of India, 'Report of the Committee on Corporate Governance' (1999) available at, <http://www.nfcg.in/UserFiles/kumarmbirla1999.pdf> (last accessed in July 18, 2020).
  - <sup>8</sup> Securities and Exchange Board of India, Circular SMDRP/POLICY/CIR-10/2000 dated February 21, 2000 available at, [https://www.sebi.gov.in/legal/circulars/feb-2000/corporate-governance\\_17930.html](https://www.sebi.gov.in/legal/circulars/feb-2000/corporate-governance_17930.html) (Last accessed on July 20, 2020)
  - <sup>9</sup> Securities and Exchange Board of India, 'Report of the SEBI Committee on Corporate Governance' (2003), available at, [https://www.sebi.gov.in/reports/reports/mar-2003/the-report-of-shri-n-r-narayana-murthy-committee-on-corporate-governance-for-public-comments-\\_12986.html](https://www.sebi.gov.in/reports/reports/mar-2003/the-report-of-shri-n-r-narayana-murthy-committee-on-corporate-governance-for-public-comments-_12986.html) (Last accessed on August 4, 2020).
  - <sup>10</sup> Section 149(6), Companies Act, 2013.
  - <sup>11</sup> Regulation 16(1)(b), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015.
  - <sup>12</sup> Securities and Exchange Board of India 'Report of the Committee on Corporate Governance' (2017) available at, [https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance\\_36177.html](https://www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html) (Last accessed on July 20, 2020)
  - <sup>13</sup> Provision 17, UK Corporate Governance Code, 2018.
  - <sup>14</sup> LR.9.2.2ER, UK Listing Rules.
  - <sup>15</sup> LR.9.2.2.FR, UK Listing Rules.
  - <sup>16</sup> European Foundation for the Improvement of Living and Working Conditions, 'United Kingdom: Government Launches Consultation on Worker Representatives on Company Boards' (2017), available at, <https://www.eurofound.europa.eu/publications/article/2017/united-kingdom-government-launches-consultation-on-worker-representatives-on-company-boards> (last accessed on August 1, 2020).
  - <sup>17</sup> UK Department for Business, Energy and Industrial Strategy, 'Green Paper: Corporate Governance Reforms' (2016), available at, [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/584013/corporate-governance-reform-green-paper.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/584013/corporate-governance-reform-green-paper.pdf) (last accessed on August 1, 2020).
  - <sup>18</sup> The New York Stock Exchange, Listed Company Manual, available at, <https://nyseguide.srorules.com/listed-company-manual> (Last accessed on August 1, 2020).
  - <sup>19</sup> Regulation 17(1A), Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015.
  - <sup>20</sup> Para VIII (1), Schedule IV, Companies Act, 2013.
  - <sup>21</sup> Section 149(7), Companies Act, 2013.
  - <sup>22</sup> Para VII, Schedule IV, Companies Act, 2013.
  - <sup>23</sup> First Proviso to Section 169(1), Companies Act, 2013.
  - <sup>24</sup> These rules were further amended on February 28, 2020.
  - <sup>25</sup> Became effective from December 1, 2019.
  - <sup>26</sup> Rule 3(1), Companies (Creation and Maintenance of databank of Independent Directors) Rules, 2019.
  - <sup>27</sup> Rule 3(2), Companies (Creation and Maintenance of databank of Independent Directors) Rules, 2019.
  - <sup>28</sup> Became effective from December 1, 2019.
  - <sup>29</sup> Rule 6(1), Companies (Appointment and Qualification of Directors) Rules, 2014.
  - <sup>30</sup> Rule 6(4), Companies (Appointment and Qualification of Directors) Rules, 2014.
  - <sup>31</sup> Explanation (b), Rule 6, Companies (Appointment and Qualification of Directors) Rules, 2014.
  - <sup>32</sup> Explanation(c), Rule 6, Companies (Appointment and Qualification of Directors) Rules, 2014.
  - <sup>33</sup> (a) listed public company; or (b) unlisted public company having a paid-up share capital of rupees ten crore or more; or (c) body corporate listed on a recognized stock exchange.
  - <sup>34</sup> First Proviso to Rule 6(4), Companies (Appointment and Qualification of Directors) Rules, 2014.
  - <sup>35</sup> Rule 4(1)(a), Companies (Creation and Maintenance of databank of Independent Directors) Rules, 2019.
  - <sup>36</sup> Rule 4(1)(b), Companies (Creation and Maintenance of databank of Independent Directors) Rules, 2019.
  - <sup>37</sup> Rule 4(1)(c), Companies (Creation and Maintenance of databank of Independent Directors) Rules, 2019.
  - <sup>38</sup> Press Trust of India, 'More than 1,000 Individuals Register with Independent Directors' Databank' (2020), available at, [https://www.business-standard.com/article/pti-stories/over-1-000-individuals-register-with-independent-directors-databank-120010600732\\_1.html](https://www.business-standard.com/article/pti-stories/over-1-000-individuals-register-with-independent-directors-databank-120010600732_1.html) (Last accessed on August 1, 2020).
  - <sup>39</sup> Rajesh Mascarenhas, 'Independent Directors Not Keen on MCA Test, Many Prefer to Quit' (2020) available at, <https://economictimes.indiatimes.com/news/company/corporate-trends/independent-directors-not-keen-on-mca-test-many-prefer-to-quit/articleshow/74432641.cms> (Last accessed on August 1, 2020).
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