

Independent Director – The Messiah?



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“...in particular, the appointment of appropriate non-executive directors should make a positive contribution to the development of their businesses.”

*Cadbury
Committee Report*

Since the days of Cadbury Committee, regulators all over the world have made a concerted effort to make a Messiah of the Independent Director.

The latest effort being SEBI's Consultation Paper on the subject. The proposals not only contain some minor rationalisations, more disclosures regarding eligibility of Independent Directors and the reasons for resignations but also major dilution of the powers of the promoters.

Before delving deeper into the subject it will be helpful to understand the major dilutions of the powers of promoters suggested in the Consultation Paper.

The most important of these is the dual approval process for appointment (which is now to be done prior to appointment). It involves

- i. Approval of shareholders.
- ii. Approval of majority of the minority shareholders.

Minority' shareholders would mean shareholders, other than the promoter and promoter group. If this does not come through then appointment is made after passing a Special Resolution. Further it has been proposed to remove Executive Directors from the Audit Committee.

Before we discuss the implications of the latest SEBI efforts it will be helpful to understand the institution of Independent Directors in a little depth

1. Evolution of Independent Directors

Non-Executive Directors or Independent Directors as they are known in India enjoy the position of a pivot in the the corporate governance systems throughout the world. In the early days of companies, directors were the major shareholders in the company.

Frauds perpetrated in the second half of the nineteenth century led to distrust of companies and their directors. A practice of seeking titled people to join boards evolved in order to provide reassurance to investors and creditors, although references in popular culture suggest that they were not always held in high regard. The Oxford English Dictionary definition of "guinea pig" cites a usage from 1871 as "the pleasant name for those gentlemen of more rank than means...who have a guinea and a copious lunch when they attend board meetings."¹

It has been quite a significant leap from such dishonourable beginnings to the present exalted status. It is interesting to note that an attempt to keep a major investor out of the Board of Directors led to formulation of a theory that gave respectability to Non Executive Directors. The story belongs to an investor asking Chairman of a major corporation to have representation on the Board and pointing out that most of the directors on the Board owned no shares. The Chairman came up with an explanation that gave justification for the non-share owning non-executive directors. Let's enjoy the story.

Between 1905 and 1907, financier Clarence Mackay purchased some five percent of AT&T's outstanding shares, giving him four times as much stock as the next largest owner. Such a large stake, Mackay argued, entitled him to representation on the company's board of directors. As Mackay wrote to AT&T president Frederick P. Fish, "Not one of your eighteen Directors . . . owns over 2,000 shares of your stock in his own right . . .". Control rested in the hands of AT&T managers. Thirty-six percent of the stock was in the company treasury, voted by the AT&T directors through a trust agreement. Directors voted an even higher percentage when proxies were added in. Mackay had pointedly raised the issue of control in a corporation composed of numerous stockholders. It was an issue that would grow enormously important in the coming decades with AT&T as one of the central firms in the debate over who had the right to control and manage big firms. After consulting with other AT&T directors, Fish penned a lengthy reply. Each director, he wrote, had an obligation to serve "each and all of the stockholders," and it was "unwise to have any stock interest specifically represented on the Board." This was somewhat disingenuous because AT&T had several constituencies on its board. As Mackay noted, for example, the telegraph giant Western Union owned just 20% of the stock of New York Telephone (a large AT&T subsidiary), yet held five of the thirteen directorships. But most outrageous, in Mackay's opinion, was what he termed Fish's "new theory" that a large owner was somehow disqualified from management. By that logic, Mackay scoffed, "it would be better if the directors own no stock whatsoever, which, of course, is contrary to the theory on which corporations . . . are organized."²

2. Independent Director – Keystone in the Theoretical Edifice

Everyone, whatever theoretical approach she prefers, needs Independent Directors and that is why they have now assumed centre-stage in corporate governance. We shall shortly see how they fulfil the imperatives of all theories of Corporate Governance. It will be useful to have a quick refresher of the theoretical framework

Agency Theory – keep a check on Management
Since **Berle and Means (1932)** identified a separation of

corporate ownership from operational control, the issue of how a diversified or-organizations can be governed has been central to governance studies (Fama, 1980; Fama and Jensen, 1983). The dominant theoretical lens for examining corporate governance is Agency Theory. Agency Theory pro-vides a rationale for how the modern organizations can be governed, primarily through the provision of two broad sets of controls: an external mechanism, the market for corporate control, and internal mechanisms, primary among them the Board of Directors. Decision-making responsibility is delegated by shareholders to executives, but potential agency costs are then reduced by the boards through laying down the policy and monitoring managerial decision-making and performance.

Agency assumptions have had an important influence on the process of governance reform as directed at boards and non-executive directors. Effectiveness is assumed to be a function of board's independence from management, trust relations are formally discounted and the 'control' role of the independent non-executive director is emphasized. Through successive rounds of governance failure, the non-executive director has been the target of both blame and reform. As a target of blame, Agency Theory assumptions point towards the dangers of too close a relationship between executive and non-executive directors and the capture and collusion that this might imply. As a target of reform, these concerns have led to the splitting of the roles of chairman and chief executive, a progressive increase in the prescribed number of 'independent' non-executive directors, and an insistence that they should dominate audit, remuneration and audit committees, where conflict of interest are most likely.³

Stakeholder Theory- Look after everyone's interest

The proponent of the Stakeholders Theory hope that Independent Directors would act as voice of all stakeholders and not just the shareholders. Logically, it appears to be a strange presumption because it is the shareholders who approve appointment of independent directors in the General Meeting and why should they approve someone who is not looking after their interests exclusively. To resolve the anomaly, academicians have tilted towards the diversity in boards to explain that a diverse board will be more sensitive to the needs of all the stakeholders. Board diversity has been studied more deeply in the context of Women Directors. Coffey and Wang (1998) assert that the proportion of women and minority directors is positively correlated to corporate philanthropy. Webb(2004) says that socially responsible firms have more women on their boards.. Williams (2003) say firms with a higher proportion of women on the boards engage in a greater extent in charitable giving. However the stakeholder theory's proponents' belief in the magic omnipotence of independent directors is rather naïve for two reasons. First, whatever research has been done is rather limited and establishes only correlation and not causality. It is very well possible that rather than women directors causing more philanthropy, the philanthropic

firms are more likely to choose women directors. Second, in the ultimate analysis mere independence from the company and its majority shareholders does not mean that independent directors will start representing society at large in absence of any legal or social contract.

Stewardship Theory - I hold it for you in trust

According to its proponents, Independent Directors are supposed to work selflessly like a trustee. There is no reason to quarrel with this view as the theory presumes that even the majority shareholders will also act as trustees for the benefit of the society at large. Mahatma Gandhi extended this trusteeship theory to all business irrespective of its form, corporate or otherwise. One cannot quarrel with the idea but only hope that humans were really that altruistic.

Resource Dependency Theory - you bring value to the company

Independent Directors bring invaluable experience and connections. Again, none can quarrel with the idea that Independent Directors can bring expertise and connections but only hope that they don't turn boards into Mutual Benefit Societies.

Institutional Theory- the power of reward and punishment

The proponents of this theory believe that the Institutions such as regulators reward good corporate governance and punish bad. Such reward and punishment leads to better performance of the company. In such a framework it is believed that Independent Directors who do not represent any particular interest will work towards the better corporate governance without any conflict of interest.

3. Role Prescribed to Independent Directors by Regulators

Independent Directors are expected to bring in independent judgement; are supposed to evaluate performance of other Independent Directors, Chairman and the Board; are required to monitor management; are required to satisfy themselves regarding the integrity of financial statements; are required to safeguard the interest of all the stakeholders and balance the divergent interests of various stakeholder and decide on remuneration of Executives. For discharging these functions the personal attributes that are needed to be ethical, objective, constructive, discrete, skilled and knowledgeable and devote ample time and above all be really independent.

4. Committees – The Structures through which Independent Directors Operate

The Board Committees should not be thought of as a mere administrative means by which the Board delegates the lengthy and tedious work to smaller Committees, which can devote more time to the work. These assume larger importance as Independent Directors call the shots in the these committees. These are the structures through which Independent Directors are supposed to operate and wield much more influence than what the sheer numbers in the Boards will suggest.

5. Are the Expectations Realistic?

How do we find directors who are independent? The job of finding and inducting independent directors is left to the Boards and their nomination committees. Whosoever holds sway over the Board, whether it is the professional management or the promoters, or even a group of Independent Directors will willy-nilly appoint persons with whom they are comfortable. They are more likely to add old friends and colleagues. There is little chance that a person so inducted will go publicly against the person who gave him the position and in case of severe misconduct by the management; she is more likely to tender resignation on personal grounds rather than confronting. SEBI's expectations that IDs will put their real discomfort in their resignation letter at the pain of denying them further positions appear to be more of wishful thinking. Better known corporations might induct retired bureaucrats or other persons of eminence to the Boards. While doing so, they will take care not to recruit any person who is known to be pleasant and pliant.

Now suppose, that by sheer chance, the board does recruit a person who is really independent. Even such a person finds it an uphill task to differ from the management / promoter stance because of severe information asymmetry. She can form her opinion only on the information that is in public domain or has been supplied by the management who take care to control such information.

Further suppose that such a person is a near genius and is able to connect the dots provided by the scanty information at his disposal, the question is why should she devote all that time and effort? Is she being compensated to do so? If she is being paid nominally, it is very unlikely that she will devote any substantial time to the Board matters. On the other hand if she is paid substantially, where is independence?

Even a Board composed of such ideal Independent Directors who represent all the stakeholders might have to struggle with the resolution of conflicts of interest. For example, the interests of the equity and debt holders are diagonally opposite as far as risk appetite is concerned. The debt holders might like to minimize all risks so as to ensure repayment of their debts even if it means sacrificing future growth prospects.

Finally, the institutional theory depends upon the actions of the Institutions in ensuring better governance. The problem here is to create credible institutions for which there does not seem to be a sure recipe. And even when we have succeeded in creating efficient and credible institutions, the tools in their hands have a doubtful efficacy. Disclosure is considered to be a universal tool for enhancing corporate governance but it is easy to subvert it by inundating the users with information which is mandated, is accurate and is perfectly useless. The idea behind these paragraphs is not to belittle the importance of corporate governance but to recognize the difficulties in enforcing it and appreciating the regulators' difficulties.

6. Will SEBI Consultation Paper give rise to even more issues?

There is a principle in Chemistry known as Le-Chatelier's principle.

When any system at equilibrium for a long period of time is subjected to a change in concentration, temperature, volume, or pressure, (1) the system changes to a new equilibrium, and (2) this change partly counteracts the applied change.

This principle is broadly applicable to all systems in equilibrium. When the regulator changes the rules in such a way that ethical, better informed persons are appointed as Independent Directors and they run the company in the interest of all stakeholders, the system is likely to act in such a manner as to undo the change. For example a controlling shareholder who might genuinely think that he knows how to best run his business and can hardly tolerate the smug theoreticians who the regulator thinks greatly of. Such a person is likely to push for appointment of persons who tick all the boxes but are known not to understand much. The controlling shareholder will have a Board composed of dummies rather than interfering busybodies. The more rules propose more power and punishment to Independent Directors, the more likely it is, at least in the short run, that there will be adverse selection and dummies will populate the Boards till the system finds a new equilibrium state.

The second issue is the dual approval process and total dominance of committees by the Independent Directors. The process if applied correctly would mean that the promoters will have very little say in appointment of Independent Directors. Suppose the promoter has 51% shareholding, she can easily get the ordinary resolution passed but she will need the support of at least 24.5% of the minority shareholders to get the approval in dual process. In case the dual process fails then the alternative before her is go for a Special Resolution. For this she will again need the support of 24% of the minority shareholders. Thus looked at dispassionately, appointment of Independent Directors in the proposed regulations will mostly be in the hands of minority shareholders. Coupled with the fact that Audit Committee and Nomination and Remuneration Committee are totally dominated by these Independent Directors, how logical will it be to call the 51% Equity Holder as Controlling Shareholder? The concept of promoters and security laws' insistence of punishing the promoters in case of any wrongdoing will need to be looked at afresh.

As a corollary, a minority shareholder with substantial holding such as 15% will have disproportionate influence on the company.

This is not to say that such a state of affairs is necessarily bad, but before adopting such regulatory framework, it will be useful for the regulator to review the entire framework relating to promoters along with the regime for Independent Directors.