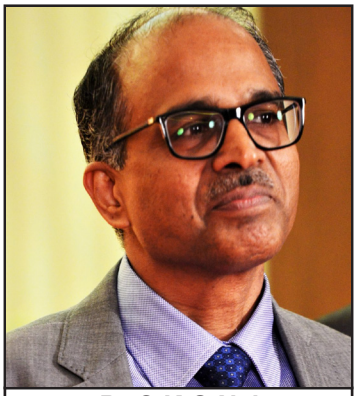
Role of Independent Directors - A Stakeholders' Perspective



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Introduction

India Inc. has travelled some distance in terms of the regulatory framework on Corporate Governance applicable to listed entities. Securities and Exchange Board of India (SEBI) has been proactively fine-tuning the regulations from time to time to address stakeholder concerns arising from non-compliance or failure of Corporate Governance systems of listed entities. Lessons from major examples of governance failures- the Satyam scandal (2009), Kingfisher Airlines (2012), Ranbaxy (2013), ILFS (2019), Jet Airways (2019), Dewan Housing Finance Ltd (2019), Lakshmi Vilas Bank (2020)- led to strengthening the regulatory regime as well. However, some critical, lingering questions like whether independent directors (IDs) have failed to perform their role and address the concerns of stakeholders with regard to governance failures or whether the regulatory provisions are adequate to deal with the governance failures still remain to be fully answered. An impression that the IDs have failed may not be fair to be generalised without analysing the full facts and circumstances.

This article tries to highlight some of the challenges and constraints being faced by the IDs, the existing provisions in the Companies Act, 2013 and the LODR that deal with duties of IDs towards stakeholder concerns. Some amendments to the LODR are also suggested to further strengthen the framework relating to IDs.

Challenges and Constraints faced by the IDs

Literature on corporate governance has been highlighting the differences between the Indian and western world on managing and governing businesses including listed entities are managed and governed with the Indian promoters dominating the Board as well as the management process. This is not typically the case with the mainly professionally managed companies in the western world. Arising out of this scenario, the separation between Strategic Management (Board) and Operating Management (headed by Key and Senior Management Personnel) is a hairline thread, with some promoters taking up key management positions and their relatives or associated persons being entrusted with Key / Senior management positions. As a result, these promoters are in a position to exclusively drive the implementation of strategic initiatives. If in line with the governance norms such an approach may not be a problem as it boosts the performance of the listed entity. However, where the governance norms are breached, it causes grave concerns. Most of the governance related problems in India have been seen to have arisen due to the overlap of roles dictated by the Promoter directors or KMP's with significant influence. Arising out of this scenario, some of the major challenges and constraints faced by the IDs are:

1. **Information on need to know basis or manipulated information**: The IDs are heavily dependent on the information made available to them through the Board process. Where information furnished to the IDs is incomplete for strategic decisions and / or material information is withheld from the IDs on a "Need to know basis" or is manipulated, the IDs have no way of uncovering such actions.
2. **Practically, independence is 'dependence'**: Since IDs are appointed by the listed entity and their remuneration is paid by the listed entity, practically the IDs cannot be regarded as independent. Partly, this situation is now addressed by the requirement of a special resolution for appointment of IDs. Further, the IDs have a dual role – A strategic role as well as a monitoring role. Combining these two roles without conflict is a challenge for the IDs and requires an intellectual approach which all IDs are not able to manage efficiently.
3. **No guarantee that there is no fraud or irregularity**: Typically, most large listed entities are managed on the strength of apparently robust internal control systems. Then there is monitoring and review by the audit committee and the risk management committee. These committees are supported by the Internal Auditors and the Statutory Auditors. Despite such a mechanism, it cannot be guaranteed that there is no major irregularity. Under these circumstances, the IDs have to draw upon their individual intuition backed by professional judgement and exercise due diligence in their functions.

Provisions in the Companies Act, 2013 and the LODR that deal with duties of IDs towards stakeholder concerns

Four pillars of the provisions are the following:

1. **Duty towards Stakeholders**: Section 166(2) of the Companies Act, 2013 requires a director (including ID) of the company to act in good faith for promoting the objects of the company. While doing so the ID shall strive for the benefit of the Company, its shareholders, employees and the community while ensuring protection of the environment.
2. **Recognise the role of stakeholders in Corporate Governance**: Regulation 4(1)(d) of LODR provides that the listed entity shall recognise the rights of its stakeholders and encourage co-operation between the listed entity and its stakeholders. The role of the IDs is to ensure that the stakeholders have the opportunity to obtain effective redressal of violation of their rights and that they have access to relevant, sufficient and reliable information on a timely and regular basis to enable them to participate in corporate governance process. It is also necessary for the listed entity to devise an effective vigil mechanism/ whistle blower policy enabling stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal or unethical practices.
   IDs have a duty to ensure that the rights of stakeholders are respected and recognised. The vigil mechanism is currently used mainly by the directors and employees rather than other stakeholders.
3. **Principles shall prevail**: Regulation 4(1)(h) of the LODR contains a powerful provision that "The listed entity shall make the specified disclosures and follow its obligations in letter and spirit taking into consideration the interest of all stakeholders."
   Most governance failures involve the breach of Regulation 4, though the listed entity may have apparently complied with the technical aspects of other regulations of the LODR. Here the important provision in Regulation 4(3) of LODR is re-iterated – *"In case of any ambiguity or incongruity between the principles and relevant regulations, the principles specified in Regulation 4 shall prevail"*. The IDs are expected to be aware of the principles enshrined in the said Regulation 4.
4. **Business Responsibility and Sustainability Reporting**: Schedule V to the LODR requires listed entities to include a section in the Annual Report under the head "Business Responsibility and Sustainability Reporting format (BRSR)". It is a relatively new addition to the responsibility of the Board. CRISIL Sustainability Yearbook [2022] analysed the performance of 575 plus companies across 53 sectors, however, could find only limited though improving performance on this front.
   The new format for reporting mandated by SEBI, is more detailed and is applicable to the top 1000 listed entities by market capitalisation as on March 31, 2022 and is effective from FY 2022-23. This is expected to be a game changer with a shift to stakeholder approach providing enhanced disclosures and reporting, laying focus on the Environment, Social and Governance (ESG) aspects.

Some suggested amendments in the regulatory framework

The following are some suggested amendments in the regulatory framework through LODR and / or Companies Act, 2013:

1) Minimum number of IDs are presently prescribed for all listed entities under the Companies Act, 2013 and to certain larger listed entities based on meeting minimum thresholds of either Paid Up Capital of Rs. 10 Crores or Net Worth of Rs. 25 Crores under the LODR. Such listed entities need to have at least half of its Board strength as independent directors if the Chairman is an executive director, otherwise at least one-third of the Board should be independent. Instead this minimum number of IDs can be prescribed based on a cumulation of various factors namely ESG ratings, Market Cap and company specific financial ratios. A well governed company does not require regulatory prescription regarding number of IDs.
2) Though highly skilled, experienced and sincere senior professionals are available and have also registered in the panel of IDs, the appointment of IDs continue to be made only through known sources and largely controlled by the promoters. If IDs are to be truly independent in spirit, the promoters should have no say in the appointment process. This should be left entirely to the Nomination and Remuneration Committee where the non-independent directors shall not participate in the discussions and deliberations. Even here close network should not be the criterion of selection.
3) Reducing the number of companies in which IDs can take up directorships from the present maximum of seven to five. This should be coupled with regulatory prescription regarding the minimum sitting fees per meeting payable to IDs having regard to market cap and profitability. This measure can contribute to indirectly maintaining the reward parity based on performance.
4) Separate committee for reviewing and approving Related Party Transactions (RPT's) to be headed by independent directors and consisting of at least one industry / sector expert. Approvals should be taken from this committee, wherever currently mandated to Audit committee. Such a committee which may be called RPT committee would be in a better position to review and approve RPTs.
5) The regulatory overload on IDs need to be flattened. Since the idea of IDs came to the fore, there has been ever rising expectations from this group as if they are some experts capable of performing corporate miracles. More and more regulatory tasks have been assigned to them, without even any weeding out of the unnecessary provisions. This approach of imposition of onerous responsibilities should stop and there must be a holistic relook at their roles and tasks in line with the dynamics of corporate developments, including on the governance front.

Conclusion

The BRSR framework mandates the listed entities to disclose well, including on ESG. This should go a long way in reinforcing best practices on Corporate Governance from a stakeholder perspective. All Directors, including IDs, require to be aware of the change of perspective and need to be trained on how to deal with stakeholder expectations. The proactive response of the IDs on the new framework will go a long way in strengthening the letter and spirit of corporate governance. However, placing the bar of expectations at realistic levels is still needed as IDs are not magicians to do miracles.

References:

1. Companies Act, 2013
2. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015
3. Research Report on Discipline of Independent Directors: From Code to Contribution – published by the Indian Institute of Corporate Affairs in 2019
4. CRISIL Sustainability Yearbook, 2022

Views are personal