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The 'Independent' Director - Measure of independence and performance evaluation

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Good governance in the board room prescribes the need for the nomination of at least one third independent directors ('IDs') to balance the conflicting interests of various stakeholders, ensure sound financial reporting and prevent fraud. Although effectiveness and 'true independence' of these directors has been in question on some occasions, the faith of the regulators in the IDs has increased worldwide with each successive corporate scam from Enron in 2001 to Satyam in 2009 and Reebok India in 2012. In India, most of the companies are controlled and managed by business groups sometimes even with minority promoter shareholding. The effectiveness of IDs in India has not been exceptional till date with the promoter groups appointing IDs who are not likely to question the promoters or management. Will the role of IDs in the board room truly become 'independent' and how will this be evaluated under the Companies Act, 2013 thus, becomes a key question.

Independent Directors in the corporate jigsaw

Theoretically, IDs are primary custodians of the governance process. The board comprising ID's, professional whole time directors and promoter nominees act as a collective body and have oversight over all important decisions including strategy and financial reporting, growth plans and fair and accurate financial reporting. IDs evaluate management decisions and encourage transparency with respect to company disclosures. As board members, they lend their expertise and insight to management decisions involving high-level strategy, risk assessment and performance evaluation. The IDs bring an objective viewpoint in the evaluation of key areas, such as executive remuneration, mergers and acquisitions, planning for succession, and auditing. By doing so, they establish a balance between the interests of promoters, lenders, management, employees and minority shareholders.

Independent Directors in Indian companies

The recommendations made in Kumar Mangalam Birla Committee Report and Narayan Murthy Committee Report led Securities and Exchange Board of India ('SEBI') to introduce Clause 49 in the Listing Agreement of stock exchanges. Clause 49 covers the following two situations: (a) Where the Chairman of the Board is a non-executive director, at least one-third of the board should comprise of independent directors; and (b) Where the Chairman of the board is an executive director and/or a promoter, at least half of the board should comprise of independent directors.[1]

The Listing Agreement defines an ID as a non-executive director, who apart from receiving director's remuneration does not

[1] Clause 49(A)(ii) of Listing Agreement

have any '*material pecuniary* relationships or transactions' with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect his independence.[2] However, the Listing Agreement in its current form does not prescribe any threshold limit for defining 'material' and leaves it to the discretion of the boards of companies.

Clause 49 however tries to lay down certain minimal requirements to judge the independence of directors such as: (a) IDs cannot be related to promoters or persons occupying management positions at the board level or one level below the board; and (b) IDs should not have been an executive of the company in the immediately preceding three financial years etc.

However, it is the general norm that no one is invited to join a board as an ID unless the person is at least an acquaintance if not close friend of the Promoters. All non-executive directors, whether or not independent, need support of the Promoter Group for their re-election. If the objective of having a specified number of IDs on the board of listed companies is to ensure constructive criticism and these directors are to be appointed by other board members whose decisions shall ultimately come under the scrutiny of the IDs, the institution of IDs loses its meaning. Hence, the procedure for appointment and appraisal of IDs has been a much debated area with little or no guidelines governing the same.

The Companies Act, 1956 does not provide for appointment of 'Independent Directors'. Hence, private limited companies and unlisted public companies are presently under no compulsion to appoint IDs.

Key implications of the Companies Act, 2013

Sections 149 and 150 of the Companies Act, 2013 ('Companies Act') provide for the appointment of IDs on the board of listed public companies and some other classes of public limited companies. Section 149(4) mandates that at least one third of the total number of directors of such companies shall be IDs. The draft rules issued by MCA[3] ('Draft Rules') clarify that if a higher number of IDs is prescribed by any other law or regulation in force, the relevant category of companies shall be bound by such higher limits prescribed.[4]

The Draft Rules also specify that the following classes of unlisted public companies shall also appoint one third of the board as IDs: (a) Public companies having a paid up capital or net worth of INR 100 crore or more; or (b) Public companies having aggregate outstanding loans, borrowings, debentures or deposits exceeding INR 200 crore or more.

Although definition of IDs under Section 149(6) is similarly worded to Clause 49, the requirements are more watertight. Section 149(6) requires that neither the ID nor any of his relatives have *any pecuniary interest* or are promoters, key managerial persons, employees

2 Clause 49(I)(A)(iii)(a) of Listing Agreement

3 Draft Companies Rules, 2013 issued by MCA on September 7, 2013

4 Provisio to Rule 11.2

etc. not only in the concerned company but also its holding, subsidiary or associate companies. A new condition is that a Chief Executive or Director of a non profit organization receiving 25% or more of its receipts from the company, its promoters, directors, holding, subsidiary or associate companies shall also not be eligible for appointment as an ID. Further, the Draft Rules state that an ID shall possess appropriate balance of skills, experience and knowledge in one or more fields of finance, law, management, sales, marketing, administration, research, corporate governance, technical operations or other disciplines related to the company's business and the board shall furnish a statement confirming such qualifications of the ID in the Board Report published after the first time appointment of the ID.[5]

As per the Companies Act, the Audit Committee of listed companies and other prescribed companies shall consist of minimum 3 IDs forming a majority.[6] The Nomination and Remuneration Committee of listed companies and other prescribed companies shall consist of three or more non executive directors with at least half of them being IDs and shall formulate the criteria for determining the qualifications, positive attributes and independence of directors.[7] Although the present mechanism still provides great scope for exercise of promoter's discretion in appointment of IDs, the same is partially remedied by the appointment of Nomination and Remuneration Committee which shall recommend IDs for appointment and the establishment of a public database where IDs may register by payment of requisite fees. The Draft Rules however caution the companies to conduct their own due diligence before appointment of an ID through the database thereby diluting the value of holding an ID registration with the MCA.

Evaluation of performance of Independent Directors

The evaluation mechanism should ideally be used to measure effectiveness of individual contribution as well as that of the board as a group against pre-agreed parameters for increasing the overall value of the company instead of turning the process into another item on the box ticking exercise of compliance checklists. The Companies Act also prescribes that the details and mechanics of evaluation should be disclosed in the board report to the shareholders.

Annexure 1D of Clause 49 of the Listing Agreement states that the performance evaluation of non-executive directors may be done by a peer group comprising the entire board excluding the director being evaluated and determine whether to extend/ continue the terms of the appointment of non-executive/independent directors. However, the said mechanism is not mandatory. A similar mandatory process is now provided under Schedule IV of the Companies Act. The board is required to prepare a performance evaluation report on the basis of which the

5 Rule 11.3

6 Section 177(2)

7 Section 178(1)

reappointment or removal of the ID shall be considered. However, there is presently no regulatory stranglehold in the Companies Act or Draft Rules on the manner of conducting the evaluation.

Basis for performance evaluation of Directors

A plethora of factors have to be considered while evaluating the performance of IDs to assess how the IDs are performing and to identify how certain elements of their performance areas might be improved. The Higg's Report[8] suggests various questions to be asked for performance evaluation of the IDs such as preparation for and attendance at meetings, willingness to participate in company events apart from board meetings, contribution in development of strategy and risk management, how resolute IDs are in holding to their views, resisting pressure from others, following up matters on which they expressed concern, etc.

Some of the questions in this list could also be made applicable to their committee in which they serve. The companies can further customize the list based on their area of operation and manner of conducting business. A comprehensive evaluation programme may be designed by the companies in-house or with the help of external advisors. Some methodologies of performance evaluation are: a) Peer-to-Peer Performance Evaluation where each member of the committee/ board may mark each ID on a scale of 1 to 10 in a feedback form developed for purpose of evaluation; or b) Evaluation through presentation where each ID can make a presentation of their performance before the committee/ board.

Conclusion

Evaluation programs must be designed keeping in mind that the IDs have a two-fold role of advisory and monitoring. Although it may be difficult for the companies to identify IDs who are efficient at both, the companies should endeavour to reflect a group of IDs balancing both the qualities. The evaluation programme should be a positive exercise enabling IDs to focus more on their areas of weakness and build on their strengths. Training of IDs to understand their roles and responsibilities and honing of their skills to meet the specific criterion may become a key issue. Lastly, the Government shall also have to be flexible in reviewing and amending the rules as per the response of the industry towards effective implementation of the scheme. More power to non-promoter groups, minority shareholders and independent committees in the appraisal and appointment of IDs may also go a long way in ensuring their independence.

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8 The Higgs Report (2002): Review of the role and effectiveness of non-executive directors submitted to the UK Department of Trade and Industry

Notifications & Circulars

Inter-corporate loans and investments: Ministry of Corporate Affairs has clarified that although Section 185 of Companies Act, 2013 dealing with loans to directors by companies has been notified, Section 372A of the Companies Act, 1956 dealing with inter-corporate loans continues to remain in force till the corresponding provision viz., Section 186 of the Companies Act, 2013 is notified. General Circular No. 18/2013, dated 19-11-2013 has been issued in this regard.

Online submission of data on issuance of guarantees/ LoUs/ LoCs by banks: Reporting of data on issuance of guarantees/ LoUs/LoCs by all AD banks in quarterly consolidated statement shall now be made through XBRL platform from quarter ended September 30, 2013. As per A.P. (DIR Series) Circular No. 75, dated 19-11-2013 issued by the Reserve Bank of India, while banks who have already submitted data for the said period are also required to report the same data online, henceforth this data has to be submitted by 10th of the month succeeding the quarter. Submission of manual statements has been dispensed with.

FII - Long term investors for Infrastructure Debt Fund: Regulated foreign feeder funds, having at all times, at least 20% of their assets under management held by investors belonging to one or more of the categories of specified FIIs, shall also be categorized as FIIs which are long term investors, for the purpose of IDF. According to Circular CIR/IMD/DF/20/2013, dated 29-11-2013 issued by SEBI, foreign central banks, governmental agencies, sovereign wealth funds, international/multilateral organizations/ agencies, insurance funds and pension funds are the specified FIIs which had been designated as long term investors for purpose of IDF in April this year.

SEBI - Extension of time to modify ESOP Scheme: Securities and Exchange Board of India has extended the time line for alignment of existing employee benefit schemes with the SEBI (ESOS and ESPS) Guidelines, 1999 and the related amendments to the Equity Listing Agreement, to June 30, 2014. Circular CIR/ CFD/POLICYCELL/14/2013, dated 29-11-2013 has been issued in this regard.

Ratio Decidendi

Powers of TRAI and TDSAT: The Supreme Court of India has held that exercise of power by the Telecom Regulatory Authority of India (TRAI) under Section 36(1) of the Telecom Regulatory Authority of India Act, 1997 is not controlled or limited by Section 36(2) or Sections 11, 12 and 13. It was held that in exercise of power under Section 36(1), the Authority can make regulations which may empower it to issue directions of general character applicable to service providers and others and it cannot be said that by making such regulations the Authority has encroached upon the field occupied by Sections 12(4) and 13 of the Act. The Apex Court in this regard noted that there is nothing in the language of Section 36(2) from which it can be inferred that the provisions contained therein control the exercise of power by the Authority under Section 36(1) or that Section 36(2) restricts the scope of Section 36(1). It was noticed that power to make regulations under Section 36 is non-delegable. Further, it was held that Telecom Disputes Settlement Appellate Tribunal (TDSAT), in exercise of the power vested in it under Section 14(b) of the Act, does not have the jurisdiction to entertain challenge to the regulations framed by the Authority under Section 36 of the Act. [*Bharat Sanchar Nigam Ltd.* v. *Telecom Regulatory Authority of India* – Supreme Court Judgment dated 6-12-2013]

Licence fees – Reimbursement from beneficiaries: The Electricity Appellate Tribunal has held that the transmission licensee, not paying any license fee prior to the amendment, is entitled to reimbursement of the said licence fee paid by it later and that the same can be directed to be passed through to the beneficiaries. It was held that licence fee cannot be allowed to be paid by the transmission licensee out of its profits in the changed circumstances. It was contended that since the licence fee has become a new component of cost to the transmission licence under O&M stage of the project, in case of the projects for which tariff is to be decided under the provisions of 2004 and 2009 regulations which do not specifically capture the cost associated with the licence fee, there is a requirement to categorize licence fee as an expense and allow reimbursement to the transmission licensees. Earlier the Central Commission had rejected the contention of the beneficiaries that licence fee is in the nature of eligibility fee to carry on the business of transmission and accordingly, the licensees should bear the licence fee from their own profits. [*Uttar Pradesh Power Corporation Ltd.* v. *Central Electricity Regulatory Commission* - Appellate Tribunal for Electricity Order dated 3-12-2013 in Appeal No. 87 of 2012]

One-sided contracts are unfair: Competition Commission of India has held that condition in the contract which gives liberty to one party to breach the contract at the peril and cost of the other party is, *prima facie,* an unfair condition. Noting that one of the parties to the contract was in dominant position, it was held that such condition in the contract amounts to abuse of dominant position. The Commission while directing the DG to investigate further, observed that the bid document, in present case, provided for a penalty for failure of performance of contract on the part of successful bidder alone and that there was no provision for penalty for non-performance of the contract on the part of the auctioner-opposite party. [*Bijay Poddar* v. *Coal India Ltd.* – CCI Order dated 18-11-2013 in Case No. 59 of 2013]

Penalty for violation of SEBI provisions – Imposition and quantum: Securities Appellate Tribunal has held that a person who has violated provisions of SEBI Act and the Regulations made thereunder cannot escape penalty merely because that person has not made unlawful gains or that the investors have not suffered or that the violations were committed for the first time. The Tribunal in this regard observed that such factors are relevant for determining quantum of penalty and cannot be made basis for imposition of penalty. [*Sunita Gupta* v. *Securities and Exchange Board of India* – SAT Order dated 12-12-2013 in Appeal No. 56 of 2013]