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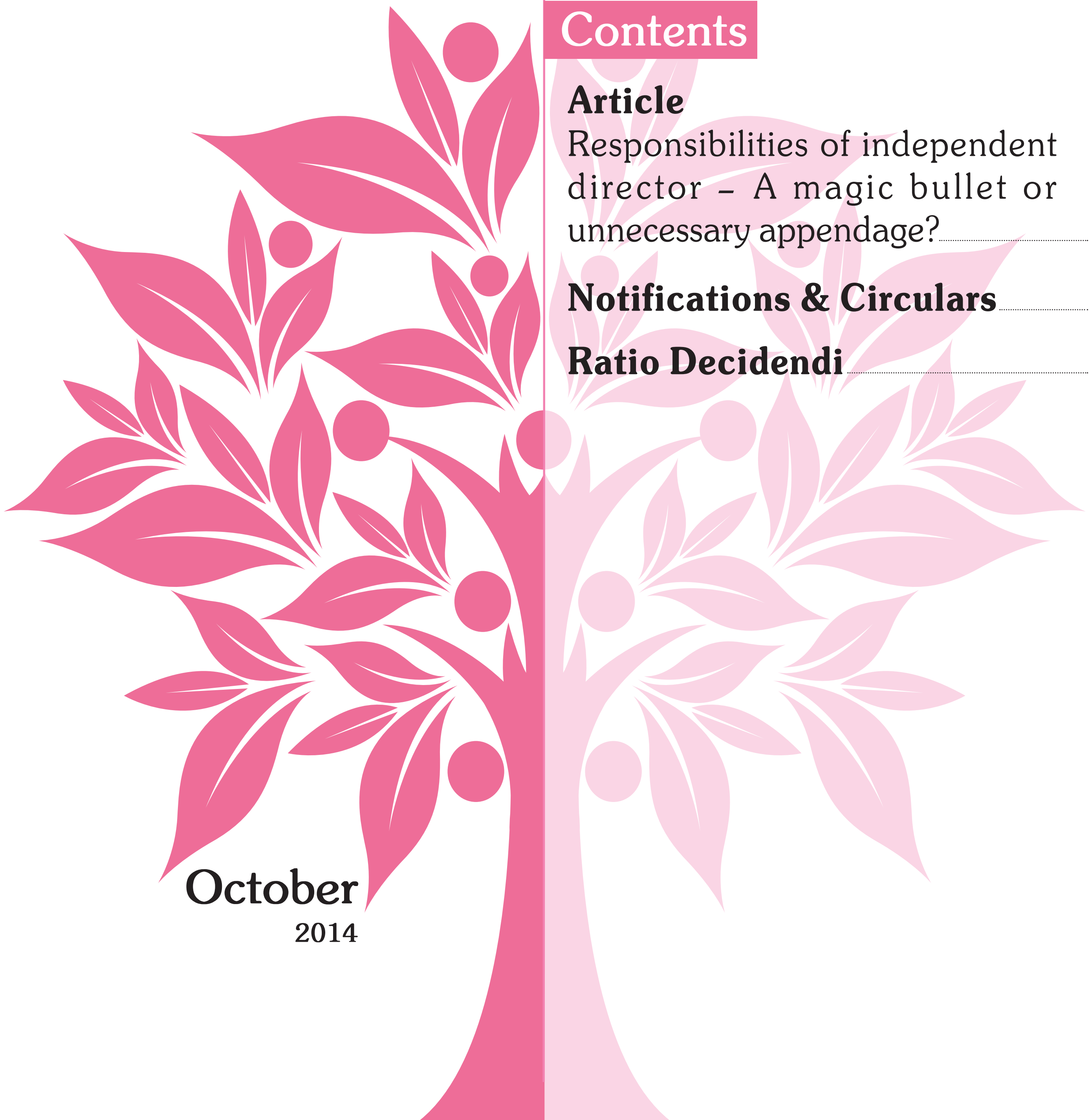

Article

Responsibilities of independent director – A magic bullet or unnecessary appendage?

By **Devaditya Chakravarti and Varun Chablani**

The recently enacted Companies Act, 2013 ("Act"), has not only ushered in a new legislative framework but has also put in a place a new paradigm of corporate governance with detailed provisions as to appointment of independent directors. In the past few months, this model has been further bolstered by the clarifications issued by the Securities and Exchange Board of India ("SEBI") Circular dated April 17, 2014[1] and the Ministry of Corporate Affairs ("MCA") Circular dated June 9, 2014.[2]

The Satyam debacle raised a number of concerns on the role, effectiveness and responsibilities of independent directors. The Companies Act, 2013 seeks to rectify the lack of clear direction in the old Act and lay down in comprehensive detail a code for the mode of appointment, role and responsibilities, remuneration and extent of liability of independent directors. The new Act has made company law in India more globally compliant and meaningful in the realm of investor protection, timeliness and quality of disclosures, matters to be referred to the Board, scope of director's role as well as related party transactions.

Number of independent directors

Framework under the Companies Act, 1956:

The Companies Act, 1956 required independent directors to be mandatorily appointed only on Boards of listed companies. Clause 49 of the Listing Agreement applicable only to publicly listed companies set out the relevant provisions on the qualifications and number of persons to be appointed as independent directors; one-third of the board where the chairman is a non-executive director, or one-half of the board where the chairman is an executive director or a promoter.

Framework under the Companies Act, 2013:

The newly-enacted Act, while conferring the Central Government with the power to prescribe the minimum number of independent directors has set out the kinds of companies that are required to appoint independent directors.

- Public listed company: Here, at least one third of the board is to be comprised of independent directors, and
- At least two independent directors need to be appointed in companies that fulfil any one of the following criteria:
  - Public companies having paid up share capital of INR 10 crores or more.
  - Public companies which have, in combined, outstanding debentures, loans and deposits that exceed INR 50 crores or more.
  - Public companies having a turnover of INR 100 crores or more.

[1] Corporate Governance in Listed Entities- Amendments to Clauses 35B and 49 of the Equity Listing Agreement, *Circular No. CIR/CFD/POLICY CELL/2/2014*

[2] Circular No. CIR/CFD/POLICY CELL/2/2014 dated April 17, 2014 ("SEBI Circular") w.e.f. October 1, 2014.

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Additionally, the Nomination and Remuneration Committee of the Board should comprise of at least three non-executive directors of whom at least one half shall be independent directors for the abovementioned class of companies. The rules also require independent directors to be proficient in general management or specific disciplines that are relevant for the company's business.

Section 135 of the Act also requires that appointment of at least one independent director out of 3 or more directors to the Corporate Social Responsibility ('CSR') Committee of the company which has a net worth of INR 500 Crores or more, or turnover of INR 1000 Crores or more, or net profit of INR 5 Crores or more during any given financial year. This is a rather favourable course correction in that independent directors can now exercise greater oversight over CSR activities and ensure that the company contributes to social, environmental, or economic development activities in an effective manner.

Prescribed criteria for qualification

Framework under the Companies Act, 1956:

Clause 49 of the Listing Agreement defines "non-executive director" as a person who:

- apart from receiving Director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its senior management or its holding company, its subsidiaries and associated companies;
- is not related to promoters or management at the Board level or at one level below the Board;
- has not been an executive of a company in the immediately preceding three financial years;
- is not a partner or an executive of the statutory audit firm or the internal audit firm that is associated with the company, and has not been a partner or an executive of any such firm for the last three years;
- is not a supplier, service provider or customer of the company; and,
- is not a substantial shareholder of the company, i.e. owning two percent or more of the block of voting shares.

There have been several committee reports in the past which have delved into the meaning of independent directors by suggesting that majority of the directors of the company should be independent and "independent from management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment"[3].

The Kumarmangalam Birla Committee Report states that "independent directors are those who apart from receiving the director's remuneration do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in the judgment of the board may affect their independence of judgment".[4]

[3] Report of the Cadbury Committee on the Financial Aspects of Corporate Governance, United Kingdom, 1992, ISBN 0 85258 913 1, Burgess Science Press, available at http://www.ecgi.org/codes/documents/cadbury.pdf

[4] Report of the Committee Appointed by the SEBI on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla, available at http://web.sebi.gov.in/commreport/corpgov.html

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Framework under the new Companies Act, 2013:

A considerable amount of detail is prescribed in the Act and relevant rules regarding the qualifications, number on Board and committees, expectations, duties and obligations, liability and manner of appointment and resignation. Section 149 (6) of the new Act defines an independent director as a person

- who is not a managing, whole-time or nominee director,
- of integrity and experience in the Board's view, and
- With relation to a company, its holding, subsidiary or associate ("Entity")
  - Was/is not a promoter or related to any director or promoter of any of them;
  - Has/had no financial transaction/ relationship of any sort with any Entity or their promoters or directors for current and previous two financial years;
  - Is not a CEO or director of a NGO that receives 25% funding from the company, its promoters or directors;
  - Holds by himself/herself or with relatives in excess of 2% shareholding/voting interest in the company;
  - Relatives of such director have no pecuniary transaction with any Entity for the current or two previous financial years exceeding 2% of their gross turnover or income exceeding INR 5 million;
  - Relative/ director not a KMP, employee of any Entity for the preceding 3 years;
  - Relative/director was not a partner or employee for 3 preceding years of a firm of auditors, company secretaries, cost auditors of any Entity;
  - Relatives/director not a partner, employee for preceding 3 years of legal or consulting firm that was involved in any monetary transaction with an Entity exceeding 10% gross turnover of such firm.

The Listing Agreement provides that an independent director must not have "any material pecuniary relationship" or transaction with the company at the time of appointment as an independent director; the Act prescribes more stringent conditions and confines it to "any pecuniary relationship" with the company in the current financial year or the immediately preceding two financial years. This divergence has, however, been reasonably reconciled by the SEBI circular dated April 17, 2014.[5], applicable from 1st October, 2014. The Ministry of Corporate Affairs has recently clarified that any services provided to the independent director by a company that is provided on the same terms to any member of the general public (like telephone, insurance, etc.)

The Expert Committee on Company Law Report states that the term should be understood from the point of view of the recipient and not that of the company. 10% or more of recipient's consolidated gross revenue/receipts for the preceding year would be a material condition that could affect impartiality of the independent director. Also, any transactions with an entity in which the director or his relatives hold more than 2% shareholding should also be treated as materially affecting the judgment of the independent director.

[5] Supra note 1.

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The SEBI Circular has made peace with the position as it exists in the Act as it mentions that any person having any "pecuniary interest" in the company would stand to disqualify as an Independent Director.[6] The recently issued MCA circular[7] states that an independent director should have no pecuniary relationship with the company concerned or its holding/subsidiary/ associate company during the current and last two preceding years. However, it goes on to state that the following transactions which have been undertaken by the independent directors under the above circumstances will not fall within the ambit of pecuniary relationship:

- transaction(s) done in ordinary course of business at arm's length;
- receipt of remuneration by way of sitting fees;
- re-imbursement of expenses for attending board and other meetings;
- any profit related commission as approved by members.

This is a welcome move as there was a great deal of opacity as to what would not qualify as pecuniary relationship and the MCA has once and for all laid to rest such transactions that fell in no man's land. The authors believe that the disqualification as to previous two financial years under the Act is technically onerous as it disables those prospective directors who may have been the promoter or director of a counter-party or company which has been selected in the recent past through an independent tender process.

Threshold of liability

Framework under Companies Act, 1956:

In this context, SEBI order[8] dated March 11, 2011 is still fresh in the minds of many where the three independent directors of Pyramid Saimara Theatre Limited were restrained by the regulatory board from discharging their role in any listed company for a period of two years. The same was done on the premise that the said directors had omitted in preventing false and misleading disclosures made by the company in its accounts. The company had apparently made out inflated profit margins and revenues through made-up entries. While the directors argued that they merely participated in board room discussions where broad policy matters were discussed, SEBI refused to accept that they could not be responsible for the day-to-day affairs of the company. SEBI reiterated the 'duty of care' test for non-executive directors when it came to financial reporting and stated in these many words:

> "While the extent of responsibility of an independent director may differ from that of an executive director, an independent director has the duty of care. This duty calls for exercise of independent judgment with reasonable care, diligence and skill which should be reasonably exercised by a prudent person with the knowledge, skill and experience which may reasonably be expected of a director in his

[6] Report of the Expert Committee on Company Law, http://www.mca.gov.in/Ministry/chapter4.html

[7] Supra note 2.

[8] SEBI Order, No. WTM/MSS/ID2/92/2011, 11th March, 2011, available at http://www.sebi.gov.in/cmorder/pyramid-mar2011.pdf

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position and any additional knowledge, skill and experience which he has."

It went on further to state that the directors despite noticing numerous red flags in the flow of revenue, profits did not bother to ask the right questions at the right point of time. SEBI's ominous refrain went to the extent of deploring the conduct of the independent directors as a *"disgrace to the institution of independent directors and the audit committee of a listed company"*.

The Companies Act, 1956 in its Section 5 characterized this situation as falling into the mischief of Section 5. It defined the term "officers-in-default" as including the managing director(s), the whole-time director(s), the manager, any director(s) who may be specified by the Board where the company does not have whole-time or managing directors.

The MCA in its circular dated 25th March, 2011[9] brought about more clarity on this issue as it stated that penal actions against non-executive directors can be maintained only where the Registrar of Companies concludes reasonably that such directors are officers in default and have not acted diligently. A prosecution against them cannot succeed where the violation occurred without their knowledge or consent. It conferred discretion on the Registrar to confirm and verify before issuing notice to the non-executive director. This principle-based approach protected the non-executive directors from frivolous litigation based on rigid notions of culpability as they could be protected now in the event of their innocence.

Framework under Companies Act, 2013:

The legacy of "safe harbor" provisions in the old Act has been continued in the new Act as well. The Act has been more of a balancing act as it assimilates the wide spectrum of the many obligations, functions and duties as are ordinarily imposed on independent directors. Under the penal framework of the new Act, the liability of independent directors is limited to matters which are directly relatable to them. To this extent, Section 149(12) limits the culpability "only in respect of acts of commission or omission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance where he had not acted diligently".

This legislative manoeuvre should hopefully instill confidence in the minds of otherwise competent and capable individuals for taking unfettered decisions who were until now apprehensive of taking up or continuing with their board positions. SEBI's order and the Satyam scam had a major role in serving as a serious disincentive following which several hundred independent directors relinquished their positions for fear of prosecution, unwarranted or otherwise.

Conclusion

The clarifications as provided by the MCA in its recent circular are purely from a procedural standpoint as it seeks to clear out the murky state of operation of the 2013 Act. With more coherence as to the definition of pecuniary relationship, the burden on businesses will definitely ease in the

[9] MCA Circular no. 8/2011 No.2/13/2003/CL V dated 25th March, 2011

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times to come. The authors here hope that with further representations having been made by industry associations and the new government itself for a review of the 2013 Act, the element of uncertainty surrounding company law reform in India will subside for good.

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Notifications & Circulars

CSR Policy Rules amended: Ministry of Corporate Affairs has by Notification dated 12-9-2014 [G.S.R. 644(E)], amended sub-rule (6) of Rule 4 of the Companies (Corporate Social Responsibility Policy) Rules, 2014. According to this amendment, limit of 5% of total CSR expenditure, for the purpose of building CSR capacities of own personnel, will also include expenditure on administrative overheads.

Forward contracts for foreign currency - Hedging under past performance route: Importers are now allowed to book forward contracts, under the past performance route, up to 100% of the eligible limit, which is average of the previous three financial years' import turnover or previous year's actual import turnover, whichever is higher. RBI A.P. (DIR Series) Circular No. 34, dated 30-9-2014 issued for this purpose further states that importers who have already booked contracts up to previous limit of 50% in the current financial year, shall be eligible for difference arising out of the enhanced limits.

FDI - Issue of equity shares against legitimate dues: Equity shares can be issued against any other funds payable by the investee company, remittance of which does not require prior permission of the Government of India or Reserve Bank of India. Reserve Bank of India has by A.P. (DIR Series) Circular No. 31, dated 17-9-2014, clarified that such shares shall be issued as per the FDI guidelines on sectoral caps, pricing guidelines, etc. It is also stated that issuance of such shares shall be subject to tax laws as applicable to the funds payable and the conversion to equity should be net of applicable taxes.

Trust / Trustee of REIT / InvITs can be partner in an LLP: MCA has clarified that a trust or a trustee representing a Real Estate Investment Trust (REIT) or Infrastructure Investment Trust (InvITs) or such other trusts set up under the relevant regulations of SEBI can become a partner in an LLP. General Circular No. 37/2014 dated 14-10-2014 clarifies this issue.

National Advisory Committee on Accounting Standards constituted: Ministry of Corporate Affairs has constituted a National Advisory Committee on Accounting Standards. The names of the members of the committee, consisting of one chairperson and 12 members, have also been announced. Notification dated 18-9-2014, GSR-2425E, issued in this regard further states that the chairperson and members will hold office for one year or till constitution of National Financial Reporting Authority.

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Single registration for stock brokers & clearing members: Stock brokers and clearing members are now required to register only with one stock exchange or clearing corporation, and there is no requirement of obtaining registration for each stock exchange/ clearing corporation. As per SEBI's Notification No. LAD-NRO/GN/2014-15/15/1671, dated 8-10-2014 as clarified by Circular CIR/ MIRSD/ 4/ 2014, dated 13-10-2014 issued for the purpose, for operating in any other stock exchange/clearing corporation, approval will be required from the stock exchange concerned or clearing corporation. Detailed guidelines which include procedure for existing entities registered with any stock exchange and who wish to operate in another exchange, have been issued in this regard.

Ratio Decidendi

FERA violation – Liability on directors of company and continuation of proceedings under FEMA: Delhi High Court has held that for the purposes of Section 68 of Foreign Exchange Regulations Act (FERA), where the contravention is by a company, liability cannot be fastened on its directors if the company itself is not proceeded against. The court found entire proceedings against the directors of the two companies in their individual capacities, unsustainable in law as neither of the companies were proceeded against for contravention of FERA. Noting that the wording of Section 68 of FERA was identical to the wording of Section 141 of the Negotiable Instruments Act, 1881, the court relied upon Supreme Court judgment in the case of *Aneeta Hada*, wherein it was held that in the absence of making the company, which issued the dishonoured cheque, an accused, vicarious liability cannot be fastened under that provision on the directors of the company.

Further, the court held that revision petition which was filed when FERA was in force would automatically continue before the Appellate Tribunal under the Foreign Exchange Management Act (FEMA) provisions. It was observed that wording of Section 49(6) of FEMA read with Section 6(e) of the General Clauses Act, 1897 reflects the legislative intent that revision petition which was filed prior to the effective repeal of FERA would continue before the Tribunal functioning under FEMA. Further, noting that it cannot be said that there is no saving clause with respect to revision petitions filed under Section 52(4) of FERA, the court held that it was intended that if within the sunset period under Section 49(3) of FEMA, a revision petition was filed under Section 52(4) FEMA, such revision petition would continue before the Tribunal even after the repeal of FERA. [*Rakesh Jain* v. *Union of India* – Judgement dated 24-9-2014 in CRL.A. Nos. 630, 756 and 818 of 2008, Delhi High Court]

Penalties for non-disclosure/delay in disclosure under SEBI provisions: Securities Appellate Tribunal has upheld penalty imposed under various provisions governing trading of shares of enlisted entities. In one such case, penalty was upheld for non-disclosure of disposal of shares in excess of the

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limit prescribed under Regulation 13(3) of SEBI (Prohibition of Insider Trading) Regulations, 1992 and Regulation 29(2) of SEBI (Substantial Acquisition of Shares & Takeovers) Regulations, 2011. The Tribunal in this regard held that reporting in BSE's website in bulk deal data and disclosures under the Listing Agreement to BSE, would not absolve the person concerned from making disclosures under the respective regulations which was mandatory.

In another case penalty was upheld for violation of same SEBI provisions, for delay in disclosure of receipt of shares exceeding specified limit, consequent to approved scheme of amalgamation. It was held that irrespective of whether the shares were purchased from open market or were received on account of amalgamation or by way of bonus shares, if as a result of such acquisition/ receipt, percentage of shares held exceeds the limits prescribed, it is mandatory to make disclosures under these regulations. It was also noted that penal liability is neither dependent upon intention of parties nor gains accrued from delay in disclosure. [*Ashlesh Gunvantbhai Shah* v. *SEBI* – SAT Order dated 8-10-2014 & *Akriti Global Traders Ltd.* v. *SEBI* – SAT Order dated 30-9-2014]

Electricity tariff – Private educational institutions and government run schools/colleges are different: Electricity Appellate Tribunal has held that educational institutions run by private bodies and societies on commercial basis for the purpose of earning profits cannot be treated at par with educational institutions run by the Government of NCT of Delhi and Municipal Corporations of Delhi. It was noted that the government is under constitutional mandate to provide educational facilities to all it's citizens irrespective of social or economic status and hence the two type of institutes are not equal. [*DAV College Managing Committee* v. *Delhi Electricity Regulatory Commission* - Order dated 8-10-2014 in Appeal No. 256 of 2013, Appellate Tribunal for Electricity] [*For similar decision wherein private hospitals and government run hospitals were found to be different by the Electricity Appellate Tribunal, refer Corporate Amicus-September 2014 issue*]

SEBI has jurisdiction to rule on market manipulation using GDRs: SEBI has held that it had jurisdiction in matters related to Global Depository Receipts (GDRs) listed on stock exchanges outside India since the underlying securities were Indian securities which allow two way fungibility i.e. conversion of GDRs in Indian market and vice versa. The companies in this case had issued GDRs, which were acquired by various foreign institutional investors (FIIs) or their sub-accounts. The GDRs were thereafter converted into underlying equity shares of the issuing company, which were then sold in large (synchronized) deals to several buyers, such as stock brokers, who in turn sold these shares to other investors. SEBI however after investigation found that the companies, the lead manager to the GDRs, the FIIs/sub-accounts and the stock-brokers were all acting in common as a group and were able to maintain the stock price of the company through these transactions without symmetry of information to outside investors who may have paid a high price. It was noted

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that the impact of such issuance, cancellation/ conversion and sale/transfer of shares so converted has direct bearing on the securities market in India.

It was further held by SEBI that the noticees created an illusion of liquidity in the market by trading in the securities *inter se* through sub-accounts and later offloading the securities and such activities were in the nature of 'manipulation' or 'fraud'. SEBI found this to be an instance of market manipulation and passed an order restraining the relevant companies and investors from participating in the capital market. In the final order passed by SEBI, it prohibited several entities from accessing the capital market and dealing in securities for a five-year period. [*Basmati Securities Pvt. Ltd.* - SEBI Order No. WTM/SR/ISD/69/09/2014, dated 19-9- 2014]

Inadequate disclosure of holding-subsidiary relationship: In a recent order, SEBI has held that the purported transfer of shareholding in three companies was sham transaction to camouflage the 'holding–subsidiary' relationship with such companies. According to the order even if a company is able to influence the management decisions of another company through an employer-employee relationship, the two companies shall be considered to be in a 'holding-subsidiary relationship' and since the permanent employees of holding company were directors of the companies, the three companies were subsidiaries of the parent company. It held that once the holding-subsidiary relationship was established, the holding company violated DIP by not disclosing 'material information' in the nature of related party transactions with the three subsidiary companies and the FIR filed by the complainant against one of the subsidiary companies as required by DIP Guidelines.

It was further held that the definition of 'Key Managerial Personnel' would not be not relevant for disclosure under the DIP guidelines and ICDR Regulations. The purchase of shares of the three companies by the housewives of three directors of holding company who were not regular share traders, did not have an independent source of income and made payment for shares through joint accounts held with their husband (the respective directors), made the directors related parties in relation to any transaction of holding company. Hence, the holding company should have disclosed the names of these three directors as related parties in the IPO documents. The order prohibits the company concerned, few of its promoters and directors from trading in securities for the next three years. [*DLF Limited* - SEBI Order WTM/RKA/IVD-7/117 - 124/2014, dated 10-10-2014]

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