'Paper'ing over the cracks

Independent directors – cats on a hot tin roof

M DAMODARAN

The comparison is odious, but it best explains the situation. The concept of an independent director (ID) is like a fishbone, stuck in the throat, which cannot be easily swallowed or spat out. Unlike in the case of the fishbone, where the intent to deal with it swiftly is unambiguous, the case of the ID is shrouded in confusion and avoidable complexity.

One way that has been found to deal with the problem of the ID is to put out yet another paper for consultation. The armchair commentariat, with their feet firmly in their mouth, will then pronounce on matters of which they neither have had, nor are likely to have, first-hand experience. In this process, the ID has become one of the favourite punching bags of the Regulator, the reader and the reviewer alike.

The Securities and Exchange Board of India's (Sebi's) latest consultation paper (the Paper) addresses many matters from birth (appointment) to death (resignation or removal) of IDs. What it mercifully does not attempt to hold forth on is what happens between birth and death, namely, how they conduct themselves in the universe of the boardroom.

The Paper starts with yet another attempt to define the concept of ID. The specific provisions that are sought to be added in the present Paper relate to the restrictions sought to be imposed on Key Managerial Personnel (KMPs) or employees of promoter group companies, to the effect that they cannot be appointed as IDs in the company, unless there has been a cooling off period of three years. The same restriction, for the same period, is proposed to be extended to the relatives of such KMPs. There are two problems with this formulation. Firstly, this restriction applies only to KMPs or employees of promoter group companies. This perpetuates the myth that all promoters and promoter groups ought to be tarred with the same brush of distrust, while proceeding on the assumption that all non-promoter companies are bathed in milk. Secondly, while the restriction applies to KMPs or employees, it is limited to the relatives of "such KMPs". Presumably, relatives of employees, other than KMPs, can get appointed without being subjected to the said cooling off period.

Having established the nature of the baby to be born, it is now appropriate to look at the process of birth. The background to the proposal states inter alia that "considering that the primary duty of Independent Directors is to protect the interest of minority shareholders, there is a need for minority shareholders to have greater say in the appointment/ re-appointment process of IDs" (emphasis supplied).

A plain reading of the provisions in the Companies Act, 2013 (the Act) and the Sebi Listing Obligations and Disclosure (LODR) Regulations, 2015 (the Regulations) gives the lie to the statement that the primary duty of IDs is to protect the interest of minority shareholders. Section 166(2) and Articles I and II of Schedule IV of the Act are relevant.

It is important that every person being considered for a Board appointment should be willing to serve on one or more Board committees

Premised on this misunderstanding is the new proposal stating that the appointment and removal of directors should be subject to "dual approval", the new element being approval by the majority of the minority (simple majority) shareholders. Minority shareholders would mean shareholders, other than the promoter and promoter group. While the proposal might be seen by some as laudable, at least in theory, it is useful to look at how this will play out in companies where institutional shareholders have far more shareholding than retail shareholders. It is the institutional shareholders who will determine significantly the decisions of the majority of the minority. Recently published figures indicate that while institutional shareholding, especially foreign institutional investor (FII) shareholding, has gone up in the larger companies, the percentage of retail shareholders has gone down. There are no prizes for guessing whether the small shareholder will have any significant voice in determining the appropriateness of a director coming up for appointment or re-appointment. It is also important to note that the large majority of IDs have got elected with more than 95 per cent of the votes being cast in their favour. This clearly demonstrates that at least until now, non-promoter shareholders have not thought it fit to vote in large numbers against the candidates put up by the management/promoter.

If the intention is to ensure that the small shareholders' voice must be directly heard in the boardroom, the provisions of Section 151 of the Act, which contemplate the appointment of a small shareholder director, could be made mandatory.

The role of the midwife is important in the process of birth, and it is through that lens that we should look at the additional provisions relating to the role of the Nomination and Remuneration Committee (NRC). The objective seems to be to bring in more transparency. The Paper states that "while the law requires NRC to lay down detailed criteria of qualifications and attributes for directors, apparently there is a lack of transparency in the process followed by NRC".

The present legal and regulatory provisions require the NRC to identify the gaps in skill and experience that are required to be filled in the Board. Therefore, the need for additional transparency is not clear. What is necessary is for the NRCs to address, in letter and in spirit, what the Act and the Regulations mandate.

While quite a few specific details have been sought to be provided, one major omission needs to be mentioned. With increasing responsibilities cast on the Board, it logically follows that Board committees will be required to do the deep dive into an increasing number of complex issues. Therefore, it is important that every person being considered for a Board appointment should be willing to serve on one or more Board committees. A survey recently brought out by Excellence Enablers (disclosure — I am associated with the survey) brings out that in the Nifty 50 companies, 40 IDs do not serve on any Board committees, and 45 serve on all Board committees. The resultant asymmetry of information among IDs renders the Board dysfunctional and suboptimal.

The author is Chairperson, Excellence Enablers and Former Chairman, Sebi, UTI and IDBI

▸ *Tomorrow: 'Paper'ing over the cracks — Part 2*

'Paper'ing over the cracks — Part 2

M DAMODARAN

The constituency of the independent director (ID) is vast and varied. When appointing an ID, what should shareholders look for?

Sebi's Paper on IDs proposes that the skills and capabilities required for the appointment of ID, and the manner in which the proposed individual meets the requirement of the Board, should be disclosed to the shareholders prior to the appointment. Also to be disclosed is the channel used for searching for the appropriate candidates. What shareholders should be more concerned with is the number of Boards on which the proposed candidate already serves, and whether he/she would be able to devote adequate quality time to the affairs of this company. The assessment of skillsets is, in fact, so subjective that every company in the Nifty 50 list has indicated that it covers all skillsets on the basis of the requisite skillsets that they have identified for the Board members.

Some companies have been known to resort to the devious practice of appointing IDs one day after the annual general meeting (AGM), and to bring up the candidature of that ID for approval at the next AGM, which is close to a year after the appointment. This has been sought to be addressed by providing that IDs shall be appointed only with the prior approval of the shareholders at a general meeting. In the case of a casual vacancy, the approval of shareholders would be obtained within a period of three months. What follows is that at the time of initial appointment, a shareholder will have to consider the previous track record, in other companies, of the candidate proposed to be appointed, as also the skillsets that he/she brings in relation to what "the job description" requires. If a person has not been an ID on any Board earlier, there will be no past track record as a director to go by, and only a theoretical matching of the job requirements and the skillsets will be possible. Going by this, the non-Board experience of distinguished persons being considered for appointment for the first time is fraught with danger, since past performance is no guarantee of future returns.

Resignation of IDs has also been addressed in the Paper. One of Sebi's most salutary prescriptions in recent times is that in the letter of resignation, an ID should, in addition to indicating the reasons for resignation, confirm that there are no other material reasons, other than those already provided. This is as good a provision as it can get. To attempt to improve it is to gild the lily. The prescription of a cooling off period for IDs who are resigning is more procedural than substantive, since IDs will find a way to get back should they choose to do so. It is not as if there are several IDs who exit for short periods and return to Boards in the same capacity or in some other capacity.

Considering the importance of the audit committee (AC), "it is proposed that audit committee shall comprise of 2/3rd IDs and 1/3rd Non-Executive Directors (NEDs) who are not related to the promoter, including nominee directors, if any". Firstly, the syntax needs to be improved. Secondly, while providing for the revised composition, it might have been worthwhile to mention that all members of the AC should be equipped in terms of financial knowledge and experience to do justice to their membership of the committee.

Shareholders who expect value from IDs should ask Boards and managements whether the compensation presently given to IDs is adequate, having regard to their role

Any attempt to deal with the institution of IDs should necessarily look at how they are compensated. The proposal in the Paper does not tinker with the sitting fees payable to IDs. A concern that profit- or performance-linked commission may encourage short-termism, and lead to conflicts, has suddenly emerged. Profit-linked commission is subject to a statutory ceiling of 1 per cent of net profits for all NEDs taken together. There is no company, at least among the bigger companies, where the total commission paid to NEDs is anywhere near 1 per cent of the net profits. Therefore, to believe that IDs could function in a manner that would inflate the profits, in order to enhance their commission, is somewhat fanciful. If anything, shareholders who expect value from IDs should ask Boards and managements whether the compensation presently given to IDs is adequate, having regard to their role.

ESOPs to IDs (instead of profit-linked commission) with a long vesting period of five years, is proposed as a solution for the short-termism that profit-linked commissions allegedly bring. In the case of many companies, ESOPs given to employees are under water, and have ceased to be a worthwhile instrument to attract and retain talent. How an instrument of this nature can help to get and keep good IDs in the boardroom is worth thinking about? Further, even if this was seen as the instrument that would enhance boardroom quality, it is unlikely to pass the scrutiny of the Standing Committee and Parliament, which had discontinued ESOPs because they were led to believe that ESOPs promoted short-termism.

The Paper addresses the problems at either end of the spectrum by saying that while "there are concerns that a large remuneration may compromise the independence of ID, lesser compensation may not attract competent IDs". Mercifully, the focus is not only on the question — "How much is too much?", but also on the corollary — "How little is too little?". As for start-ups, a separate compensation formula could be considered in terms of deferred payments to directors, rather than stock options, when no certainty is attached to future value of the shares.

The question whether we need IDs should be addressed once and for all. With our inability to decide whether to swallow or spit, the fishbone remains firmly stuck in the throat.

The author is Chairperson, Excellence Enablers, and Former Chairman, SEBI, UTI and IDBI