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ROLE OF INDEPENDENT DIRECTOR IN CORPORATE GOVERNANCE: A CRITICAL STUDY OF SEBI CONSULTATIVE PAPER

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Abstract:

In India, the role of an Independent Director in corporate governance is crucial for maintaining accountability, transparency, and ethical practices within a company. Independent Directors are appointed to the board by shareholders of a company to provide an unbiased and objective perspective in decision-making and supervisory functions. Their principal responsibility is to protect the interests of all stakeholders, including shareholders, workmen and employees, consumers, and the public at large.

Since good corporate governance is the key to the growth of the companies and overall economic growth of India, the laws and policies related to rehauling corporate governance in India, introduced the role of independent directors (IDs) as a crucial factor in good governance of companies in India.

This paper studies the concepts of IDs and the role of IDs in the wake of achieving the good notion of corporate governance. This paper will thoroughly analyze the Consultation Paper on "Review of Regulatory Provisions Relevant to Independent Directors" and presents suggestive ideas for good corporate governance.

Keywords: Corporate Governance, Independent Directors, Corporate Regulations, SEBI

Introduction

Corporate governance has been a hot topic around the world, especially in the wake of the global financial crisis, which pushed many economies into recession. The importance of good corporate governance and overall economic well-being has been the subject of much contemporary discussion.

India's corporate governance is based on a role relationship between promoter and management, with a small group of families owning a majority of the country's businesses. These promoters are usually individuals or groups of individuals who own a majority interest or shareholding in the company and therefore have the power to exert dominant influence over the company's decision-making process.

Evolution and Development of the Concept of Independent Director

The concept of Independent directors was embraced around the 1950s as a part of improving corporate governance in the United States (US) before they were made mandatory by law. Following the Cadbury Committee Report in the United Kingdom in 2002, companies in the United States and the United Kingdom adopted a more number of IDs. In India, the Securities and Exchange Board of India (SEBI) was established in 1992 to assist Indian corporations to improve their corporate governance. in the late 1990s, the SEBI mandated that all large publicly traded companies in India have a minimum number of Independent Directors for board independence and smooth corporate governance. The four major committees were formed by the SEBI to

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suggest measures to strengthen the corporate governance framework in India:

i. Bajaj Committee, 1996,

ii. the Kumar Mangalam Birla Committee, 2000,

iii. the Naresh Committee, 2002, and

iv. the Narayanan Murthy Committee, 2004,

Clause 49 of the Listing Agreement and Corporate Governance

Clause 49 of the Listing Agreement was enacted by the SEBI to formally embrace these laws and reforms. The number of Independent (outside) directors, addressing the issue of duality, and having financial experts in board rooms is all addressed by these measures. Clause 49 of the Listing Agreement was also revised in 2005 (effective January 1, 2006), requiring a minimum number of Independent (outside) directors on the board.

Clause 49 of the SEBI Listing Agreement outlines the requirements and guidelines for corporate governance practices that listed companies in India are expected to adhere to. It sets forth principles and provisions to ensure transparency, accountability, and protection of the interests of shareholders and other stakeholders. The SEBI's aim in bringing in independent directors to corporate boards was to secure minority shareholders' interests.

Clause 49 of the Listing Agreement states that "if the Chairman of the Board is a non-executive director, at least one-third of the Board must be made up of independent directors," and "if he is an executive director (including a non-executive promoter chairman), at least half of the Board must be made by independent directors." In any case, non-executive directors must have at least fifty percent of the Board.

Apart from the Composition of the Board and Independent Directors, Clause 49 of the Listing Agreement also focused on the Audit Committee, Nomination and Remuneration Committee, Risk Management Practices, Related Party Transactions, Protection of Whistleblower Mechanisms and Disclosures, and Transparency.

The Companies Act, 2013 and Independent Director

On April 1, 2014, the Companies Act of 2013 took effect. The Companies Act aimed to combine some of the most essential characteristics provided by the SEBI in Clause 49 of the Listing Agreement. The Companies Act introduced many new features such as mandatory selection of independent directors, a minimum number of independent directors, a database for independent director appointment, tenure, and a cooling-off period between re-appointments, a code for independent directors, and independent directors' liability were major reforms.

The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 and Independent Director

The Securities and Exchange Board of India (SEBI) (Listing Obligations and Disclosure Requirements) Regulations, 2015 were released on September 2, 2015. This was intended to simplify and unify the conditions of the current listing agreement for various parts of the capital markets, for making easier compliance. Listed entities must send a quarterly compliance report on corporate governance to recognized stock exchanges, according to regulation 27(2) of the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. Regulations 17 to 27 were implemented in the provisions of Clause 49 of the previous listing agreement into effect.

Corporate governance has been the focus of corporate academics for the past two decades. The incorporation of Independent Directors has been suggested as a solution to problems such as governance failure, corporate fraud, and so on in all jurisdictions. However, practice hasn't always been on our side. Companies have struggled in the past despite having a large

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number of independent directors on their boards.

Role of Independent Director in Corporate Governance

Traditional definitions of independence include freedom from others' power or influence. The objective requirements of the term" independent director" are not met by directors' independence. Autonomous individuals are capable of defining and achieving their objectives. Independence is an essential but insufficient prerequisite for such a goal. The following is how the Delaware Supreme Court described independence in the case of *Aronson v. Lewis*:

"The term 'Independence' refers to a director's decision being based on the business merits of the matter before the board rather than external variables or considerations. Although directors may confer, debate, and resolve their differences through compromise or reasonable reliance on the expertise of their colleagues and other qualified persons, the result must be that each director has brought his or her informed business judgment to the corporate merits of the issues without succumbing to pressure."

An independent director is an individual appointed to the board of directors of a company who does not have any material or pecuniary relationship with the company or its management. The concept of an independent director is based on the principle of impartiality and objectivity in corporate decision-making.

Governance is believed to be all about 'guiding' an organization in the proper direction. Former SEBI Chairman, Mr. M. Damodaran, defined corporate governance as a "continual process that goes beyond the scope of the legislation." He was implying that "governance requires actions for which legislative standards can only serve as a starting point." Independent directors are "functionaries" who bring "different perspectives" to the Board, according to the former Chairman. Another speaker referred to them as the "conscience keepers, "people who could steer the company on the right path while others were influenced by extraneous factors.

The overall corporate governance system includes independent directors. Their appointment ensures that the boards run smoothly and efficiently. The board of directors is widely regarded as the most important tool for ensuring corporate governance compliance. Therefore, the composition and oversight of this board are critical.

Independent directors assist the board of directors by constructively challenging policy decisions and business plans. They also assess management's performance and keep them accountable for their actions. Due to the lack of associations that could influence their decisions, their freedom allows them to finish these activities more quickly. They are less likely to be influenced by personal gain while being responsible for the company's decisions. As a result, they are in a unique and advantageous position to challenge the company's policies. Because of this, independent directors have traditionally been regarded as "adversaries" on the board of directors.

Independent directors' status has become more acceptable as it has been clear that they "bring something unique to the table." Even if they oppose the other directors for any ideas, they merely contribute to idea pooling rather than creating any impact or tension on the floor. Thus they are supposed to bring more balanced and novel perspectives and ideas to the table in the long run.

Regulatory frameworks enhance the standards for the selection of independent directors, ensuring not only that these directors are eligible, but also that a minimum fixed proportion of independent directors serves on the board.

India- Past Experience

In India, large family-owned businesses have previously created substantial hurdles to transparency and accountability in the past, and the Indian corporate sector has been

criticized for its poor corporate governance enforcement record. Traditionally, the key stakeholders in these enterprises have been family members who did not perceive the need to disclose enough details to the independent directors. The independent directors found it difficult to maintain accountability and transparency, especially since they only attended a few meetings each year, most of which were mostly ceremonial.

Independent directors were unable to fully understand and take on any of the problems before the board and be held responsible in broad corporate structures, working with varied interests and investments. Looking at the real situation, they are treated as associates of management and as "outside guardians" whose duty is to ensure the primary focus of company management is towards shareholders and about increasing their value profit.

Committees on Corporate Governance

The Kumar Mangalam Birla Committee's ('the Birla Committee') Report on Corporate Governance in 1999, criticised the customary practice of hand-picking independent directors, claiming that such selection takes away the directors' independence. This problem has yet to be completely tackled, and it continues to pose a paradox: how autonomous can a director be if his work is dependent on promoters? The remuneration given to independent directors is another flaw that has not been adequately addressed. The Birla Committee believed that appropriate pay packages for independent directors should be provided so that their positions were financially appealing, attracting talent and ensuring honesty in their work.

Even the Naresh Chandra Committee, in 2002, recommended that the companies protected by Clause 49 be expanded. As a result of all three reports stated above, the notion of independent directors has become clearer in the Indian context and the scope of their application has expanded as a result of all three reports listed above.

Clause 49 of the listing agreement provisions should be extended to all "large" corporations, according to the J.J. Irani Committee, 2004. The Committee reiterates its position that corporate governance and independent directors are intrinsically linked and that having enough of them on the board will improve governance.

The Committee suggests a way for widening the scope of Clause 49 that is responsive to different types of businesses and avoids a "one size fits all" approach. Any organization with a public interest must have at least 1/3 of its board of directors must make up of Independent directors. The Committee specifically cautions that nominal board members who serve institutions should not be confused with Independent directors because they exclusively represent the institution.

SEBI Consultation Paper on Review of Regulatory Provisions Relevant to Independent Directors

The Securities and Exchange Board of India (SEBI) through Listing and Disclosure Requirements (LODR) Regulations, 2015 provides for accountability, transparency, and fair disclosures by India Public Listed Companies. The SEBI has been putting lots of effort to strengthen the institution of Independent Directors and has established various committees in the past. Concerns about the effectiveness of independent directors as part of a corporate governance system, always need continuous improvement and strengthening. As a result, there is a need to further improve IDs' independence and effectiveness in protecting minority shareholders' interests and performing other functions.

SEBI has been actively engaged in reviewing and enhancing regulations related to independent directors to further strengthen corporate governance practices in India. SEBI periodically releases consultation papers to seek public comments and gather stakeholders'

views on proposed regulatory changes. SEBI released a Consultation Paper on "Review of Regulatory Provisions Relevant to Independent Directors" in 2021. The Consultation Paper seeks public feedback on initiatives such as expanding the eligibility requirements for IDs, streamlining the process of selection, re-appointment, and removal of IDs, improving accountability in ID nomination and resignation, and strengthening the composition of Board Committees, among other things. In addition, opinions are sought on the need for a study of ID remuneration.

IDs play a key role in strengthening corporate governance practices because they are required to bring objectivity to the board's functioning and ensure compliance with values such as openness and accountability. The planned amendments are unquestionably a positive move forward.

They do not, however, explicitly answer the underlying problem confronting the regulatory system regulating IDs, which is the imbalance between the onerous duties imposed on IDs and the liability risks they face, which stem from numerous flaws and contradictions throughout the existing framework. In other words, the proposed changes are focused on a piecemeal strategy that addresses specific immediate problems in the current structure rather than resolving broader structural concerns that, if tackled comprehensively, would only increase the effectiveness of SEBI's reforms.

Issues in the Current Legal Framework dealing with Independent Directors

The most important issues in the current legal framework dealing with IDS are as follows:

(i) the Companies Act, 2013 contains certain provisions limiting the liability of IDs and non-executive directors, there are various laws governing offenses dealing with securities fraud, money laundering, and tax evasion which fail to grant legal protection and recognize the difference between executive directors and non-executive directors;

(ii) the legal protection under section 149(12) of the Companies Act has its limitations and directors may be held guilty not only for errors but also for 'passive' negligence. In other words, If they have attended the meeting they cannot plead innocence if they have not recorded their objections.

(iii) multiple law enforcement agencies and regulatory bodies adopt fragmented and conflicting procedures for the investigation and prosecution of corporate crimes, including the issuance of summons to IDs even without prima facie evidence against them; and

(iv) certain factors in the existing legal regime compromise the independence of IDs, namely, the processes related to their appointment, removal, and payment of remuneration which affect their ability to perform their functions efficiently.

Critical Analysis of the Proposed Reforms

The 'Review of Regulatory Provisions Applicable to Independent Directors' proposed strict regulatory amendments to the 'Listing Obligation and Disclosure Requirements Regulations (LODR/ Listing Regulations)' relating to:

1. Eligibility requirements for determining director independence
2. Shareholder approval is required before the appointment of IDs.
3. The appointment/re-appointment/ID removal process
4. Improving the transparency of ID nominations
5. Resignation of IDs

6. Improving the composition of Board Committees, and so on.
7. Review of ID remuneration.

1. Eligibility Criteria for Determination of Independence of Directors

Existing Provision: Regulation 16 of the SEBI LODR Regulations lays out the criteria for determining a director's independence. There are only a few such parameters:

a) Individuals who were employees/Key Managerial Personnel (KMPs) of the listed or their families were KMPs of the listed In the last three years, no corporation, its holding company, affiliate, or associate company has been named as an ID.

b) A two-year cooling-off period applies when an individual or a relative has a material pecuniary relationship with the listed firm, its holding company, affiliate, or associate company.

Proposal: SEBI proposes to extend the definition of "freedom" by broadening the scope of the restrictions imposed by the said Regulation while also standardizing the cooling-off duration. In addition to the existing definition, the paper proposes two changes to the ID independence criteria:

a) KMPs, employees of companies in the promoter category of the listed company, and relatives of such KMPs should not be allowed to serve as an ID until a three-year cooling-off period has passed. This would be in addition to the current restrictions on the listed entity's KMP and employees, as well as their holding, affiliate, or associate business.

b) Another suggested change in the Listing Regulations is to extend the cooling-off time in Regulation 16(1)(iv) and Regulation 16(1)(v).

Analysis: The Regulations currently provide for a two-year cooling-off period in the event of a material pecuniary transaction involving an individual or a relative and the listed entity, its holding, affiliate, or associate business. This is proposed to be extended to three years to match the other requirements of Regulation 16 that enable a three-year cooling-off period to be fulfilled.

This proposal seeks to broaden the independence requirements so that the promoter party organizations cannot gain an unfair advantage due to ambiguities in the law's language. The proposal for extending the cooling off time, on the other hand, is intended to make the freedom requirement universal throughout.

2. Appointment of ID: Prior approval of Shareholders

Existing Provision: Companies currently nominate independent directors to serve as additional directors, subject to shareholder approval at the next general meeting. Current rules provide for 3 months to select a new Independent Director in the event of a vacancy caused by resignation or dismissal. The shareholders' approval, on the other hand, will be sought at the next AGM.

Proposal: Only with the approval of the shareholders at a general meeting will independent directors be named to the board. If a casual vacancy occurs as a result of resignation, removal, death, or failure to be re-appointed, shareholders must approve the vacancy within three months. If this gap is narrowed or closed, shareholders can have a greater say in the selection process.

Analysis: The proposed amendment will bring much needed accountability, fairness, and transparency in the appointment of Independent Directors in the Public Listed Companies.

3. Appointment/re-appointment/Removal of IDs: Process

Existing provision: The Nomination and Remuneration Committee ("NRC") recommends an ID, which is then approved by the Board, according to the current regulatory norms.

Accordingly, shareholders accept the appointment of IDs in a regular resolution.

Proposal: The paper recommends substantial changes to the appointment or reappointment process, as well as the elimination of IDs. Let us point out that the IDs must be recommended by the NRC before being accepted by the shareholders in the general meeting. In the current situation, the IDs must be named by a simple majority vote of the shareholders. A special resolution must be passed by the shareholders in the event of re-appointment. The following is the proposed protocol for such an appointment/re-appointment via "dual approval" from shareholders:

a) Ordinary shareholder resolution (Special Resolution in case of reappointment) and

b) "Majority of minority" resolution

If one of the two resolutions fails, the organization can propose a new ID or submit the same proposal for a second vote.

a) Only after a cooling-off period of 90 days, but no more than 120 days, will a second vote be held.

b) A special resolution allowing all shareholders to participate in the second vote should be passed.

c) Furthermore, the proposal makes shareholder approval a prerequisite for every appointment of an ID.

d) In the event of a temporary ID vacancy, the Listing Regulations currently allow for a filling period of up to three months or before the next Board Meeting, whichever comes first. SEBI recommends a time limit of three months from the date of the vacancy to name a new ID.

Analysis: SEBI has prescribed a dual voting method for the elimination of IDs, which is close to the principle of dual voting. SEBI has stated in its consultation paper that the current system of ID appointment could be affected by promoters – both in terms of proposing the name of the ID and in terms of the approval process – due to shareholding. This might jeopardize IDs' freedom.

SEBI believes that the current method of appointing IDs could be affected by promoters – both in terms of proposing the name of the ID and in terms of the approval process – because of their shareholding. This could limit ID's "independence" and limit their ability to differ from the promoter, particularly if the promoter's and minority shareholders' interests are not aligned.

Furthermore, since the primary responsibility of Independent Directors is to protect the interests of minority shareholders, minority shareholders should have a greater say in the appointment, re-appointment, and removal of IDs.

Furthermore, since the primary responsibility of IDs is to protect the interests of minority shareholders, minority shareholders should have a greater say in the selection and re-appointment of IDs.

As a result, SEBI has suggested a "dual approval" model following Israel's and the United Kingdom's legislative requirements, especially in the interests of minority shareholders.

Since the ID may be withdrawn with a simple majority vote, the promoter can have a substantial say in the process due to his or her shareholding. As a result, it has been suggested that the "dual approval" paradigm be applied to control the removal of IDs as well.

Furthermore, the provision of shareholder approval as a precondition for the appointment of any ID follows current practice, in which an ID is named as an additional director by the Board of a corporation and then approved by the shareholders at the next AGM. This practice results in a considerable time delay between the appointment of an independent director and shareholder acceptance, which is not in the best interests of minority shareholders in particular. As a result, SEBI is attempting to eliminate this time lag by requiring shareholder approval in advance.

4. Enhancing transparency in the nomination

Existing Provision: The nomination and remuneration committee (NRC) has the following role in the appointment of IDs, according to the LODR Regulations:

a) Establishing requirements for assessing a director's credentials, positive characteristics, and independence

b) Identifying people who are eligible to be directors based on the qualifications established, and recommending their appointment and removal to the board of directors.

c) Whether to extend or continue the independent director's term of office, based on the independent director's performance assessment report

Proposal: The NRC will use the following method to choose a suitable candidate for the position of ID:

a) The procedure for shortlisting candidates

i. The NRC will assess the following things in candidates for each appointment- a balance of skills, knowledge, and experience. A summary of the position and capabilities needed for a specific appointment will be written based on the results of this assessment.

ii. The ID candidate being recommended to the Board should possess the skills mentioned above.

b) Required shareholder disclosures: The following disclosures must be included in the notice of directorship appointment:

i. The skills and abilities needed for the ID's appointment, as well as how the proposed person meets the role's requirements.

ii. The methods for locating suitable applicants.-for any recommendation made via any person from the inside, it must be put in any of the categories- for example, promoters, institutional shareholders, directors (non-executive, executive, ID), and so on, for better identification of the channel.

Analysis: This move is proposed by SEBI to improve disclosures regarding the procedure used by NRC to select candidates for the position of ID. While the legislation requires NRC to provide detailed requirements and attributes for directors, there appears to be a lack of accountability in NRC's operation. As a result, there is a need to mandate disclosures about the NRC's process for selecting candidates for the ID role.

5. Resignation of IDs

Existing Provision: According to current LODR provisions, the resigning ID must report specific reasons for his resignation to stock exchanges within 7 days of his resignation, as well as a confirmation that there are no other material reasons for resignation other than those already mentioned.

Proposal: Through the Paper, it becomes clear that SEBI's goal is to closely track ID resignations, where the true reason for resignation should be known rather than the obvious reason that the company and ID will try to demonstrate. In two cases, the Paper provides for a one-year cooling-off period:

a) A one-year cooling period is required before joining another Board as an ID if an ID resigns for any reasons being of discretionary nature- such as preoccupation, personal reasons, or other responsibilities.

b) a one-year cooling period is also required when transitioning from ID to WTD within the same business.

Furthermore, the Paper recommends that the outgoing ID's full resignation letter be reported to the stock exchange. A one-year cooling-off period before transitioning an ID to a WTD in the same organization has been proposed to

ensure that the director's independence is not jeopardized during his tenure as an ID.

Analysis: IDs very often leave companies and then join the boards of other businesses, for several reasons, *viz.* pre-occupations, personal reasons, or other obligations. As a result, there is a need to reinforce the disclosures around Independent Director resignations. This amendment is suggested by SEBI to improve the disclosures around Independent Director resignations.

6. Strengthening the composition of Board Committees, etc

Existing Provision: The Audit Committee (two-thirds of its members are independent directors) has particular duties under the LODR Regulations to review financial statements, scrutinize inter-corporate loans and investments, and value the listed entity's undertakings and properties, where applicable.

Proposal: The paper also proposes several amendments to the NRC and AC's constitutions. The following modifications are proposed:

a) 2/3rds of IDs will make up the NRC (presently alteast one-half IDs are required)

b) The AC will be made up of 2/3rds IDs and 1/3rds non-executive directors (NEDs) who are not linked to the promoter (currently, the AC must have at least 3 members, with at least 2/3rds being IDs).

Analysis: Given the role of the Audit Committee concerning related party transactions and financial matters, it is recommended that the audit committee be made up of 2/3 IDs and 1/3 NEDs, and should not have been related to the promoter or nominee director. SEBI proposes this amendment in light of the Audit Committee's relevance concerning related party transactions and financial matters.

7. Review of remuneration of IDs

Existing Provision: Apart from reimbursement of expenses, the Companies Act allows IDs to be charged sitting fees (up to 1 lakh) and profit-related commissions up to a certain amount. Furthermore, IDs cannot be granted stock options under the Companies Act or the LODR Regulations.

Proposal: The consultation paper makes several recommendations on ID remuneration. The following are some of the proposals:

a) Profit-related commissions have been eliminated.

b) Fees for sitting have gone up.

c) ESOPs with a long vesting duration are being released.

Analysis: The abolition of profit-linked commissions and an increase in sitting fees was suggested for IDs to be compensated based on their value and time contributions to the company, rather than based on the company's income. This will result in IDs receiving a fixed fee without having any interest in the company's long-term success.

The concern that benefits or performance-linked commissions can promote short-termism and lead to conflicts can be resolved by allowing Employee Stock Ownership Plans (ESOPs) to use Independent Directors (rather than profit-linked commissions) with a long-term period, such as five years.

Conclusion

Finally, Corporate Governance goals could not be addressed as effectively without the existence of independent directors in the wider scheme of things. This is especially true in the context of India's rising economy, which has seen large amounts of money pouring into companies from both within and outside the country. It is to be expected that with the growth of the business market and business interest, Indian businesses will tend to follow corporate governance practices to attract investors.

Long-standing concerns for greater accountability in the operation of Indian companies are now being addressed through a range of suggestions, one of which is a

welcome change: a greater position and a stronger role for independent directors.

Independent directors owe the company a fiduciary obligation, and their actions and omissions may expose them to civil and criminal liability under the law. In the case of boards, independence allows a director to analyze the company's success and well-being without conflict of interest or undue influence from interested parties.

The proposed changes are substantial and would have a significant effect on listed companies' corporate governance. Although more transparency can be accomplished through amendments such as enhanced disclosure on resignation, nomination, candidate selection as IDs, and so on, the proposal relating to dual voting may not achieve the goal due to the existence of a second round of voting choice. First and foremost, the reforms seek to restrict promoter influence at all levels of corporate governance and provide much greater independence to the Independent Directors, far more autonomy in both letter and spirit. However, the proposed standards seem to be too strict in certain cases, which could stymie the concept of "ease of doing business. The approved amendments will strengthen the Corporate Governance framework through the institution of Independent Directors in India.

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