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INDEPENDENT DIRECTORS: SEBI TIGHTENS FRAMEWORK

INTRODUCTION

The ballast for the efficient and seamless operation and administration of a business is corporate governance and the powerhouse that facilitates this governance is the board of directors ("**the Board**"). One of the many obstacles encountered by the Board when making executive decisions is balancing the multitude of interests of the various stakeholders in the business. The need was soon realized for an autonomous voice to speak on behalf of the minority shareholders. Accordingly, the Companies Act, 2013 introduced the concept of independent directors and the requirement that at least one-third of the total directors in every public listed company are independent directors and it also laid down requirements for their appointment and code of conduct to be adhered to by the independent directors.[1] Independent directors ("**ID**") were expected to offer a fresh perspective, lend technical business acumen and independent judgement on the Board's deliberations on a multitude of issues ranging from strategy & risk management to performance evaluation of the board itself.

However, a need was felt to further strengthen the regulatory framework for the IDs not just to address the concerns around efficacy of the IDs but also to safeguard the larger interests of the minority shareholders. Accordingly, on March 01, 2021, the Securities and Exchange Board of India ("**SEBI**") released a consultation paper on 'Review of Regulatory Provisions Related to Independent Directors' ("**Consultation Paper**").

KEY PROPOSALS

A. INDEPENDENCE OF THE DIRECTORS AND COOLING PERIOD

Existing Position

Under the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**LODR**"), one of the criteria for determining the independence of a director is the relationship of such director and its relatives (including material pecuniary relationship) with the listed entity, its promoter or directors, its holding, subsidiary or associate companies and shareholding in the listed entity.[2]

The extant provision in the LODR *inter alia* provides that a person shall not be eligible to be an ID in case:

1. such person either himself or if any of its relatives have had a material pecuniary relationship with the listed entity (or its holding, subsidiary or associate entity) in the immediately preceding two (2) financial years/ during the current financial year;
2. such person either himself or any of its relatives have been in the position of key managerial personnel ("**KMPs**") or been an employee of the listed entity (or its holding, subsidiary or associate entity) in the immediately preceding three (3) financials years/ during the current financial year.

Proposal

In an attempt to have a uniform cooling off period across the 2 different scenarios, it is proposed that:

1. Cooling-off period for cases where there exists a material pecuniary relationship between person or its relatives with the listed entity (or its holding, subsidiary or associate entity), has been increased to three (3) years;
2. KMPs or employees of companies forming part of the promoter group and relatives of such KMPs should also be excluded from acting as independent directors, unless there has been a cooling-off period of three (3) years.

B. APPOINTMENT AND RE-APPOINTMENT

Existing Position

The extant procedure for appointment and re-appointment of IDs involves the Nomination and Remuneration Committee ("**NRC**") nominating a suitable candidate who will get confirmed as an ID upon the approval of the shareholders by way of an ordinary resolution (or special resolution in case of re-appointment).[3]

The potential hindrance with this framework is that significant weightage is given to promoters and majority shareholders in the selection of IDs thereby bringing into question the "independence" of the chosen candidate.

Proposal

To alleviate this quandary, the proposed framework introduces a secondary stage of approval, or "*dual approval*", taken through a single voting process which will work as follows:

1. Approval of shareholders by ordinary resolution in case of appointment and special resolution in case of re-

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appointment; AND

2. Approval by 'majority of the minority' (simple majority) shareholders. 'Minority' shareholders would mean shareholders, other than the promoter and promoter group

If either of the above approvals do not come in, the person cannot be appointed / re-appointed as an ID and in that case, the listed entity may either: (i) propose a new candidate; or (ii) propose the same person as an ID for a second vote of all shareholders (without a separate requirement of approval by 'majority of the minority'), within a period of 90 (ninety) days and no later than the expiry of 120 (one hundred and twenty) days. Such approval for appointment/re-appointment shall be through special resolution and the notice to shareholders will include reasons for proposing the same person despite not getting approval of the shareholders in the first vote.

C. REMOVAL OF INDEPENDENT DIRECTORS

Existing Position

An ID can be removed through a simple shareholder majority in the first term of its appointment and through a special resolution in case of second term, after giving him a reasonable opportunity to be heard.[4]

Proposal

Given the requirement of simple majority for removal in the first term, there were concerns around the fact the promoters, being the controlling shareholders are taking advantage of their vote to oust an ID even if the minority shareholders do not approve of such removal.

To solve for this and in line with the proposal for appointment, removal of IDs shall also be subject to "dual approval", taken through a single voting process and meeting the two approval thresholds, as required for appointment of directors above. The approval of the shareholders shall be through ordinary resolution in case of removal in the first term and special resolution in case of removal in the second term.

If either of the approval thresholds are not met, the person will not get removed as an ID and the listed entity may again propose the removal of such ID through a second vote of all shareholders (without a separate requirement of approval by 'majority of the minority'), within a period of 90 (ninety) days and no later than the expiry of 120 (one hundred and twenty) days.

D. INDEPENDENT DIRECTOR AS ADDITIONAL DIRECTORS AND CASUAL VACANCY

Existing Position and Related Concerns

In case of: (i) appointment of ID; and (ii) filling up of casual vacancy due to resignation or removal, the ID is appointed as an additional director till the approval of the shareholders at the next annual general meeting.[5]

The time gap between the appointment and ratification by the shareholders' has been a concern since many a times it has been observed that while the IDs have served on the Board for a few months after their appointment, but since their appointment doesn't get approved by the shareholders in the general meeting, they are required to step down from the Board.

Proposal

1. IDs shall be appointed on the board only with prior approval of the shareholders at a general meeting.
2. In case, a casual vacancy arises due to resignation / removal / death / failure to get re-appointed etc., the approval of shareholders should be taken within a maximum period of 3 (three) months.

E. RESIGNATION OF INDEPENDENT DIRECTORS

Existing Position

In relation to resignation, the ID is required to disclose to the stock exchanges within 7 (seven) days of his resignation, detailed reasons for the resignation along with a confirmation that there is no other material reason for resignation other than those already provided.[6]

However, while the reasons for resignation are usually standard, it has been observed that the ID has resigned and joined boards of other companies or IDs have re-joined the same company as an executive director. While joining boards of other companies poses less of a threat, joining the same listed entity as a n executive director poses challenges and questions the independence of the ID (while he was serving as an ID) given that he has knowledge that immediately after his resignation as an ID, he is moving into an executive role with the same entity.

Proposal

1. The resignation letter of an ID shall be accompanied with a list of his/her present directorships and membership in board committees.
2. If an ID resigns from the board of a company (stating reasons such as pre-occupation, other commitments or personal reasons), there will be a mandatory cooling-off period of 1 (one) year before the ID can join another board.
3. There should be a cooling-off period of 1 (one) year before a director can transition from an ID to a whole-time director.

F. REVIEW OF REMUNERATION

Existing Position

Under the LODR, IDs are permitted to be paid sitting fees (maximum of INR 1,00,000) besides being entitled to profit linked commission within an overall limit and re-imbursement of expenses and shall not be entitled to stock options.[7]

Proposal

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There are multiple arguments as to how should the remuneration of the independent directors be determined. On one hand, argument is in favour of removal of profit linked commission and increasing the sitting fees as this would lead to IDs getting a fixed amount without having any stake in long-term growth of the company, whilst on the other hand, there are discussions around linking remuneration to profit or performance linked commission to ensure the IDs have some "skin-in-the-game".

There are also deliberations if IDs should be entitled to employee stock options which as of date is not permitted under the Companies Act, 2013. Appropriate recommendations in this regard are also being shared with the Ministry of Corporate Affairs.

G. OTHER RECOMMENDATIONS

The Nomination & Remuneration Committee ("**NRC**") is the pivot in the identification and selection process for suitable candidates for the position of an ID. The Paper stresses on the need for greater transparency in the administration and operation of the NRC while identifying, shortlisting and selecting suitable candidates. The proposed framework recommends that the NRC assess each candidate basis the following criterion – skills, knowledge and experience on the Board. Accordingly, the NRC will need to prepare a brief description of the responsibilities and duties affiliated with a particular appointment and examine how closely each candidate satisfies the description. The NRC will also be obligated to disclose the channel through which it has identified each candidate. The most significant change being proposed to the composition of the NRC is the increased threshold for the number of IDs on the NRC from fifty percent[8] to two-thirds of the NRC.

CONCLUSION

The Paper acknowledges that the need of the hour is to bolster the independence of the IDs by ensuring that the process of selection, appointment and resignation of the IDs is more transparent on a holistic level. The key sentiment that is echoed throughout the Paper is that by inculcating more transparency into the present system, the voices and needs of minority shareholders will be more adequately heard and addressed. In practice, it will take far more than the proposed measures to overhaul a system that inherently favours majority shareholders in a listed entity. Nonetheless, the measures being recommended by the Paper should be lauded.

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You can direct your queries or comments to the authors

[1] Section 149(4), Companies Act, 2013.
[2] Regulation 16, LODR Regulations.
[3] Section 152, the Companies Act, 2013.
[4] Section 169(1), the Companies Act, 2013.
[5] Regulation 25(6), LODR Regulations.
[6] Clause 7(A) of Part A of Schedule III, LODR Regulations.
[7] Regulation 17(6)(d), LODR Regulations.
[8] Regulation 19(1)(c), SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.