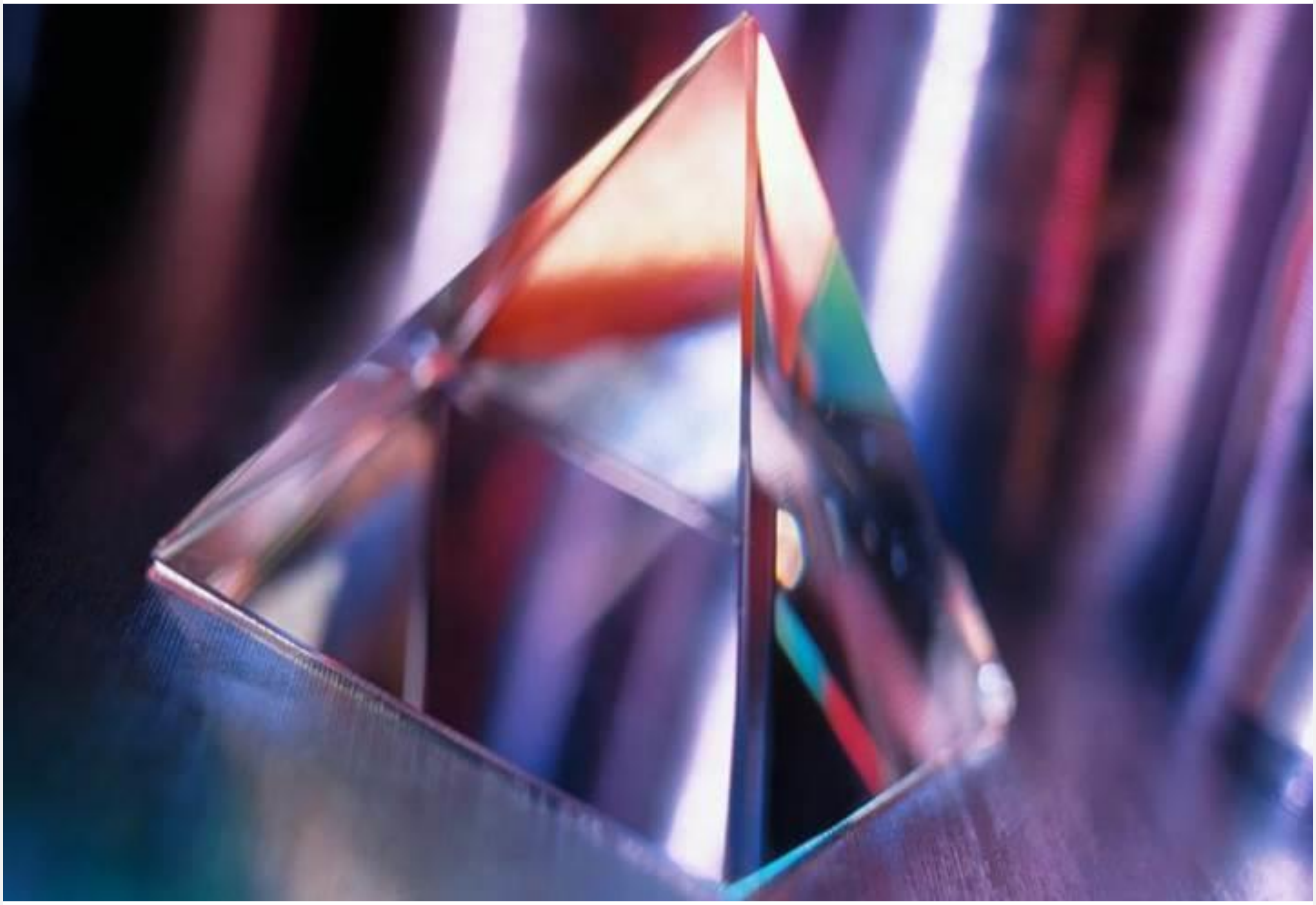
Deloitte.



D’Prism

A series on the Companies Act, 2013

Independent directors

Overview

Corporate governance is the acceptance by management of the inalienable rights of shareholders as the true owners of the corporation and of their own role as trustees on behalf of the shareholders. It is about commitment to values, about ethical business conduct, and about making a distinction between personal and corporate funds in the management of a company[1]. Independent directors are one of the pillars to ensure good governance.

The Companies Act, 2013 (the '2013 Act') intends to make corporates transparent and accountable to stakeholders. This has, in part, been achieved by revising the requirements relating to constitution of the board of directors, inter alia, through 'independent directors' and enhancement of the roles and responsibilities of directors. The Companies Act, 1956 (the '1956 Act') did not require boards to have independent directors. The requirement to have independent directors on the board was first introduced by the Equity Listing Agreement (ELA) with stock exchanges ('Clause 49') for listed entities and has now found a place in the 2013 Act. The requirement for having independent directors in the 2013 Act varies with the extent of public interest in an entity – it is required for listed companies and certain other public companies. Since independent directors cannot be from the promoter group and generally cannot have a pecuniary relationship with the company, it is expected that this would enable them to be objective and act in the interest of the company and all the stakeholders without any self-interest.

The requirement for specified class of companies to have at least one third of the total board comprising of independent directors comes into effect from 1 April 2014 and a period of one year has been given to companies to comply with these new provisions.

Issue 4: Independent directors[2]

December 2014

In this issue:

[1] Report of Narayana Murthy Committee on Corporate Governance, 2003.
[2] Includes updates up to 28 December 2014.

Classes of companies to have independent directors

The table below compares the class of companies that are required to have independent directors under the 2013 Act and revised Clause 49. Other regulators may also have the requirement for the presence of independent directors on the board, in which case the requirements of the specific regulator should also be considered in addition to the requirements below.

Particulars	2013 Act	Clause 49
Applicability	• Listed companies; and • Public companies[3]: — Having paid-up share capital[4] of Rs. 10 crore or more; or — Having turnover of Rs. 100 crore or more; or — Which have, in aggregate, outstanding loans, debentures and deposits, exceeding Rs. 50 crore. *Note: Paid-up share capital or turnover or outstanding loans, debentures and deposits, referred to above is as existing on the last date of the latest audited financial statements.*	• Applicable to all companies whose equity shares are listed on a recognised stock exchange. However, compliance with the provisions of Clause 49 will not be mandatory, for the time being, in respect of the following class of companies: — Companies whose equity share capital is listed exclusively on the SME and SME-ITP platforms. — Other companies having paid-up equity share capital not exceeding Rs. 10 crore and net worth[5] not exceeding Rs. 25 crore, as on the last day of the previous financial year (to be complied within six months from the date on which the provisions become applicable to the company).
Compliance timeline	Within one year from 1 April 2014	From 1 October 2014

Turnover here would mean the standalone company's turnover and is not to be determined on a consolidated basis. The turnover would mean 'Revenue from Operations', including other operating income.

---

[3] Public company means a company which (a) is not a private company; (b) has a minimum paid-up share capital of five lakh rupees or such higher paid-up capital, as may be prescribed: Provided that a company which is a subsidiary of a company, not being a private company, shall be deemed to be public company for the purposes of this Act even where such subsidiary company continues to be a private company in its articles. (Note that the words "of five lakh rupees or such higher paid-up capital" are proposed to be removed by the Companies (Amendment) Bill, 2014).

[4] Paid-up share capital means such aggregate amount of money credited as paid-up as is equivalent to the amount received as paid-up in respect of shares issued and also includes any amount credited as paid-up in respect of shares of the company. Paid-up share capital includes preference capital, whether convertible or redeemable and are the amounts reflected as share capital paid-up in the financial statements but exclude Securities Premium Account.

[5] As per Amendments to SEBI (Disclosure and Investor Protection) Guidelines, 2000, net worth means aggregate of value of the paid-up equity capital and free reserves (excluding reserves created out of revaluation) reduced by the aggregate value of accumulated losses and deferred expenditure not written off (including miscellaneous expenses not written off). Since the intention is to cover net worth, this should include Securities Premium Account as in the case of the 2013 Act, though not specifically stated in the guidelines.

It should be noted that a subsidiary of a public company would always be a public company. Accordingly such subsidiary, even if incorporated as a private company but meeting the thresholds above, will need to have independent directors.

While it is possible that the intent requires public companies with public interest to have independent directors, it appears that the criteria insofar as it relates to outstanding loans and debentures will comprise all such balances including from related parties and other companies, although deposits would only relate to those specifically covered as such under the 2013 Act (commonly referred to as public deposits).

Definition of independent director

As per the 2013 Act, read with the Rules thereunder and clarifications issued, an independent director in relation to a company is a director, other than the managing director, whole-time director or nominee director, who:

- Should not be/should not have been a promoter and should not be related to the promoters or directors of the company, its holding, subsidiary or associate company.
  - Promoter means any person, other than a person acting merely in a professional capacity (a) who has been named as such in a prospectus or is identified by the company in the annual return; or, (b) who has control over the affairs of the company, directly or indirectly whether as a shareholder, director or otherwise; or, (c) in accordance with whose advice, directions or instructions, the board of directors of the company is accustomed to act[6].
  - Relative with reference to any person means (a) members of a Hindu Undivided Family, (b) husband and wife, (c) father (including step father), mother (including step mother), son (including step son), son's wife, daughter, daughter's husband, brother (including step brother), sister (including step sister).
- Should not have/should not have had any pecuniary relationships (such pecuniary relationship should not have existed either in the current financial year or immediately preceding two years) with the company, its holding, subsidiary or associate company or their promoters or directors. The Ministry of Corporate Affairs (MCA) has clarified that transactions entered into in the ordinary course of business at arm's length price by an independent director with the company at par with and at the same price payable by members of public would not be considered for the purposes of determining 'pecuniary relationship'. Similarly, receipt of remuneration from one or more companies by way of sitting fees, reimbursement of expenses for participation in board/other meetings and profit related commission approved by members should also be excluded when determining 'pecuniary interest'.

[6] 'Accustomed to act' has been dealt with in D' Prism: Issue 3 on Related Parties.

There could be a case where an individual is no longer an employee of the company but is entitled to certain post-retirement benefits in lieu of services rendered in the past where a company will have an outflow of resources.

Where there are post-employment benefits which are part of the original employment contract, and where an individual draws such benefits on similar terms as other employees in the same class/grade, a clarification will be required from the MCA whether these could be scoped out from the term ‘pecuniary benefits’. It is interesting to note that in the UK, for a member of the company’s pension scheme, the board would have to state its reason if it determines that such a director is independent notwithstanding the existence of such a relationship. Hence, there is no automatic preclusion of such members of the pension scheme from being an independent director in the UK and the board, after application of judgement on a case by case basis will determine if such a member of the pension scheme would in letter and in spirit qualify to be ‘independent’.

The MCA has scoped out receipt of remuneration from one or more companies by way of sitting fees, reimbursement of expenses for participation in board/other meetings and profit related commission approved by members when determining ‘pecuniary interest’. A question that arises is whether any remuneration paid to an independent director of a company not making adequate profits/loss making company with the approval of the Central Government will also be excluded from ‘pecuniary interest’. In view of the MCA clarification referred to in this paragraph, it is reasonable to expect that such exemption would be available for such companies as well.

A clarification that will be required from the MCA is whether a director who receives an annual retainer fee from the parent of an Indian subsidiary in a jurisdiction which allows such a payment to the director without affecting his ‘independent’ status in the parent company, would be considered to have a ‘pecuniary relationship’ under the 2013 Act and, hence, be precluded from being an independent director of that company’s Indian subsidiary since such compensation paid by the parent to him would not fall within the ambit of sitting fees, reimbursement of expenses for participation in board/other meetings and profit related commission.

It remains to be seen how the term ‘pecuniary’ should be interpreted when there is a merger or amalgamation between two or more companies. There could be an independent director on the board of the amalgamated company who may have had a pecuniary relationship with the amalgamating company in the past two years. Would that mean that from the date of such merger/amalgamation, he would cease to be an independent director solely because of such a relationship entered into with the amalgamating company when the two companies were totally unrelated?

- Should not have/should not have had relatives who in the current year or in the two preceding financial years, have/have had a pecuniary relationship or transactions with the company, its holding, subsidiary or associate company or their promoters or directors subject to certain limits. These limits currently are the lower of Rs. 50 lakhs or 2 percent of its gross turnover or total income.

In determining independence having regard to pecuniary relationships or transactions with relatives, the determination should be made for the aggregate of pecuniary relationships or transactions of all relatives of each independent director separately. However, there is no aggregation required between independent directors (unless they have a common relative, in which case, such common relative should be aggregated with other relatives of each of the directors).

For the determination of pecuniary relationship of relatives of the directors, for each independent director:

1. The list of relatives should be obtained.
2. The list of transactions such relatives have with the company, holding company, subsidiary, associate company or their promoters or directors should be obtained.
3. Such transactions to be aggregated and compared to the thresholds provided.

The above may be tabulated as under:

Director	Value of transactions with						
	Company	Holding Company	Subsidiary	Associate Company	Promoter[7]	Director[8]	Total
Director A	No pecuniary relationship permitted						0
Relatives of Director A							
Relative 1	X	X	X	X	X	X	XX
Relative 2	X	X	X	X	X	X	XX
Relative 3	X	X	X	X	X	X	XX
TOTAL	XX	XX	XX	XX	XX	XX	Less than 2% of gross turnover or total income or Rs. 50 lakhs whichever is lower

[7] Promoter means promoter of the company, its holding, subsidiary or associate company.
[8] Director means director of the company, its holding, subsidiary or associate company.

The limits prescribed are the limits for each year and should be complied with in the current and the preceding two financial years and needs to be determined based on the gross turnover or total income of the company that proposes to appoint the independent director. An annual exercise would have to be carried out to ensure continuing independence.

There may be situations where an individual may be an independent director in a holding company though he may not be independent in a subsidiary due to the monetary limit set or vice versa.

The definition of the term relative covers several relationships. It may be cumbersome for directors to track down for the past, as well as monitor on an ongoing basis, scoped in relationships that his relatives (including those where the director may have no influence over the relative's financial decisions) have had with the company, its holding company, subsidiary or associate company or their promoters or directors.

While companies may be able to track down certain transactions from their databases if they have a complete list of relatives, in other cases it may be quite cumbersome to track down all transactions with all relatives in which case they may have to go by declarations given by the independent directors. Companies will have to exercise due care to ensure the continued independence of the director, with the company secretary being primarily responsible for such compliance.

- Should not be/have been/his relative should not be/have been an employee/key managerial personnel in any of the three preceding financial years of the company, its holding, subsidiary or associate company.
- Should not be/have been/his relative should not be/have been an employee/proprietor/partner of firm of auditors/company secretaries/cost auditors in any of the three preceding financial years providing services to the company, its holding, subsidiary or associate company.
- Should not be/have been/his relative should not be/have been an employee/proprietor/partner of a legal or consulting firm in any of the three preceding financial years with whom any transaction of 10 percent or more of the gross turnover of such firm has been entered into by the company, its holding, subsidiary or associate company.
- Should not hold 2 percent or more of voting power in the company either himself and/or through his relatives.
- Should not be/his relative should not be a Chief Executive or director of any non-profit organisation that receives 25 percent or more of its receipts from the company, any of its promoters/directors/its holding, subsidiary or associate company.
- Should not be/his relative should not be a Chief Executive or director of any non-profit organisation that holds 2 percent or more of voting capital of the company.

Appointment and tenure of independent directors

Like other directors, the appointment of an independent director is required to be approved in a general meeting, but is not subject to annual retirement rotation rules. However, for an independent director, the explanatory statement needs to indicate the justification for choosing the relevant person as an independent director and a statement by the board that he fulfils the conditions for appointment. The independent director, once appointed, needs to give a declaration that he meets the criteria for independence in the first board meeting he attends and thereafter at the first board meeting in every year. The MCA has clarified that in view of the provisions of Schedule IV, appointment of independent directors under the 2013 Act would need to be formalised through a letter of appointment.

While the 2013 Act provides for the maintenance of a databank of independent directors, as may be notified by the Central Government, the responsibility of exercising due diligence before selecting a person from such databank would rest with the company.

An independent director holds office for a period of two terms of up to five consecutive years each and such independent director has a cooling period of three years and in that timeframe is not permitted to be appointed in or be associated with the company in any other capacity, either directly or indirectly. Tenure of an independent director on the date of commencement of the 2013 Act is not to be counted for this purpose.

The MCA has clarified that appointment for a term of less than five years would be permissible; however appointment for any term (five years or less) is to be treated as one term. Since no person can hold office of independent director for more than two consecutive terms, such a person will have to vacate office on the completion of two terms, even if the total number of years in such two consecutive terms is less than ten years.

Further, a window of one year has been provided by the 2013 Act for companies to bring in the required number of independent directors. It has also been clarified by the MCA that if it is intended to appoint existing ‘independent directors’ under the 2013 Act, such appointment would have to be made expressly under the said Act within one year from 1 April 2014.

If an existing ‘independent director’ (as per the ELA of SEBI) is to be considered as an independent director as per the requirements of the 2013 Act, such director would need to be specifically appointed under the provisions of the 2013 Act and Rules thereunder and his tenure under the 2013 Act would commence from such date of appointment.

For e.g., Let us look at two tenures of five years each, say, 1 April 2014 to 31 March 2024 (assuming the independent director, Mr. X is being appointed for the full five year period under each such tenure). The term held by Mr. X as an 'independent director' (as per the ELA of SEBI) prior to the commencement of the 2013 Act (prior to 1 April 2014) is required to be ignored.

Now, let us assume that Mr. X is appointed as an independent director in accordance with the requirements of the 2013 Act on 31 December 2014, the tenure between 1 April 2014 and 30 December 2014 will not be counted as that of an independent director under the 2013 Act, considering the clarification given by the MCA in this regard.

Duties and liabilities of independent directors

For the first time, a Code for independent directors has been prescribed as a Schedule in Schedule IV to the 2013 Act. This broadly contains the following:

- Guidelines of professional conduct
- Role and functions
- Duties
- Manner of appointment
- Re-appointment
- Resignation or removal
- Separate meetings
- Evaluation mechanism

The aforesaid Code, inter-alia, requires the independent directors to:

- Bring an independent judgement on the board's deliberations especially on issues of strategy, performance, risk management, resources, key appointments and standards of conduct.
- Bring an objective view in the evaluation of the performance of the board and management.
- Ensure that their concerns are addressed by the board and, to the extent that they are not resolved, insist that their concerns are recorded in the minutes of the board meeting.
- Ensure that adequate deliberations are held before approving related party transactions and assure themselves that they are in the interest of the company.
- Satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible.

The 2013 Act imposes onerous duties on independent directors, and in case of failure to perform the same, gives recourse to members and depositors to file class action suits against them. However, the 2013 Act also grants reasonable immunity to an independent director or a non-executive director not being a promoter or key managerial personnel, whereby such a director will be held liable only (a) in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through board processes, and with his consent or connivance or (b) where he had not acted diligently.

This will be demonstrated largely by specific recording of the minutes of the board/committee. It is expected that independent directors will exercise due caution in ensuring that the minutes faithfully represent individual actions (especially when dissenting) at such meetings.

The 2013 Act also requires independent directors to meet at least once a year without the presence of the non-independent directors and members of the management. In such meetings, the independent directors are required to review the performance of the non-independent directors, the board as a whole and the Chairperson of the company and also assess the quality, quantity and timeliness of information flow to the board to enable effective performance of its duties.

There is no specific guidance that has been provided by the MCA with respect to where such separate meetings are to be held, how the minutes are to be recorded, by whom and where these are to be retained. In our view, the company secretary of the company could be present at such a meeting – to record the deliberations, to prepare minutes of such meetings and to ensure the safe custody of such minutes.

Board evaluation is a complex and rather sensitive area. Whilst this concept is somewhat new in India, it is perhaps necessitated by the heightened focus on corporate governance by regulators, stock exchanges, and investors. However, there is no specific guidance that has been provided by the MCA in this regard, though this is fairly common in some countries, for e.g., the UK Corporate Governance Code requires the board to undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors, with the evaluation of the board of FTSE 350 companies being externally facilitated at least every three years.

A robust evaluation of individual board members, as well as that of the whole board of directors and committees of the board, if conducted correctly can contribute to significant improvements in board and organisational performance. A tick in the box approach simply to comply with regulations will not work.

Some of the potential questions that may arise are:

- Do the independent directors have the capability to review the performance of the non-independent directors and the board as a whole or should they appoint any external agency to assist them in such assessment?
- What are the areas the evaluation should focus on?
- How will the issues identified during such an evaluation be actioned? Will it result in an action plan for the board?

Performance evaluations are time consuming and often sensitivities may inhibit the evaluation exercise. Boards will need to invest considerable time and effort to make these exercises meaningful and fruitful for the organisation.

Remuneration to independent directors

The remuneration to independent directors is covered under the 2013 Act and subject to the overall limits of remuneration to directors, namely, 11 percent of the net profits of the company for that financial year, computed in accordance with the requirements of the 2013 Act, and sub-limits thereunder[9]. An independent director will not be entitled to any stock options but may receive remuneration by way of sitting fees, reimbursement of expenses for participation in the board and other meetings and profit related commission as may be approved by the members.

It is clear that from the commencement of the 2013 Act, an independent director will not be entitled to stock options (as a component of remuneration). Although this was earlier permissible under the erstwhile ELA, the revised ELA has now been aligned with the 2013 Act with effect from 1 October 2014.

It is our view, however, that, options granted up to 31 March 2014, yet to be vested, should continue to be available as contracted with such independent director. To remove any resultant doubts, the MCA should clarify the position of such unvested stock options held, which could otherwise be unreasonably considered as a pecuniary relationship during the period over which such options vest.

Companies with inadequate profits may be unable to pay profit related commission to the independent directors without Central Government approval. Since the only other payments permissible to independent directors are sitting fees (maximum of Rs. 1 lakh per meeting) and reimbursement of expenses, the overall compensation in such cases may not be commensurate with the heightened responsibilities that the independent directors now have. This could impact the ability of such companies in need of independent directors to attract best talent to their boards. The MCA could provide an appropriate remedy for such situations.

---

9 Remuneration payable to directors who are neither managing directors nor whole-time directors shall not exceed (a) one per cent of the net profits of the company, if there is a managing or whole-time director or manager; (b) three per cent of the net profits in any other case.

The 2013 Act and revised Clause 49 – a comparison

The SEBI has approved certain amendments to the ELA which are applicable to all listed companies with effect from 1 October 2014. The table below compares the requirements pertaining to independent directors in the 2013 Act and revised Clause 49.

Particulars	**2013 Act**	**Revised Clause 49 (listed companies)**
Tenure	• Two consecutive terms of up to five years each. • Cool off period of three years with no association at all. Prospective application – term served prior to 1 April 2014 to be ignored.	Same as the Companies Act, 2013.
Limits	• No separate limits for independent directors. • Limits for directorship – not more than twenty companies (of which not more than ten public companies).	Can be independent director only in seven listed companies and three in case he is a whole time director in a listed company.
Independent directors proportion on board	At least one-third of the total number of directors.	If the chairman is a non-executive director, then at least one-third of total board should be independent directors and if the chairman is an executive director, then half (no change from existing Clause 49).
Boards of material unlisted subsidiaries of listed entities	No specific requirement to have a common independent director. The subsidiary to have independent directors if it meets the criteria specified for having an independent director.	Board of all material non-listed Indian subsidiaries of a listed parent company to have at least one independent director of the holding company (no change from existing Clause 49). The term 'material non-listed Indian subsidiary' means an unlisted subsidiary, incorporated in India, whose income or net worth (i.e. paid-up capital and free reserves) exceeds 20 percent of the consolidated income or net worth, respectively, of the listed holding company and its subsidiaries in the immediately preceding accounting year.

There is a one year time frame given to companies under the 2013 Act to comply with the requirements pertaining to independent directors i.e., companies will have to comply by 31 March 2015. However, the provisions of revised Clause 49 will be applicable with effect from 1 October 2014. There are subtle differences between the provisions of revised Clause 49 and the 2013 Act insofar as they relate to independent directors, with the provisions of revised Clause 49 being more stringent. Given the one year transition period under the 2013 Act, listed companies are first faced with mandatory compliance with the provisions of revised Clause 49. Therefore, their compliance with revised Clause 49 would also ensure compliance with the 2013 Act.

While the SEBI (Prohibition of Insider Trading) Regulations, 1992 prohibited a person in possession of any unpublished price sensitive information to deal in securities of a listed company, a similar provision has now been introduced in the 2013 Act to specifically prohibit directors (including independent directors) and other key managerial personnel from entering into forward dealings in the securities of the company, or in its holding, subsidiary, or associate company and entering into insider trading of securities.

Conclusion

Hitherto listed companies were required to have independent directors as per the requirements of the ELA of SEBI. This was mandated only for listed companies, since SEBI had jurisdiction only over listed companies. For the first time the 2013 Act has expanded the principle of independent directors to all entities which have public interest. These include listed companies and certain other public companies, where the exemption thresholds are relatively low. Independent directors bring in objectivity, challenge to management, and an overall balance of corporate objectives considering the interests of public stakeholders at large. Since subsidiaries of companies (not being private companies deemed to be public companies) are also covered, the impact of independent directors is wide and far reaching, indicative of their indirect impact on the performance of the public parent and, consequently, there is a need for a more balanced board. We believe that a large part of what independent directors will achieve in enhancing governance will depend on the harmony with which the board operates; harmony is not to be misunderstood with collective agreement. True ‘independence’ is possible only when there is an open mind and free flow of relevant information in a timely manner and a strong deliberation mechanism so as to enable arriving at the most appropriate and effective decision. As has repeatedly been found, good governance enhances shareholder value and, therefore, these provisions should further enable the making of a stronger corporate India.