INDEPENDENT DIRECTORS: HOW INDEPENDENT ARE THEY

"One of the most powerful notions in corporate governance is the presence of 'independent' or 'non-executive' directors on the board of a company. These are the white knights of shareholders, expected to provide an ongoing strategic direction and support to the executive management through their expertise, experience and most critically, their independence. Bringing in 'stakeholder interest first' in every corporate decision and action, is the key expectation from these stalwarts. However, some of the recent examples in corporate history have questioned this very fundamental premise – independence of an independent director! This article tracks the events and developments surrounding this theme in global as well as Indian context and attempts to provide an objective response to this all-critical question.

In September 2003, Richard Grasso, the celebrated chairman of New York Stock Exchange resigned due to public uproar against his mega pay package of $140 million. A subsequent report found that the Board, made up of majority of independent directors, approved the package "based on incomplete and inaccurate" information. What followed was the biggest board shakeup in the history of 211-year-old stock exchange. Most of the members of the board who were part of the decision left and a whole new board was formed.

If this was an example of ineffective independent directors, consider an example of 'the strong hand' of independent directors. In early February of current year, the celebrated Hewlett-Packard CEO, Carly Fiorina was ousted by the Board. The non-executive chairman Patricia C. Dunn said after the decision was made public – "The board reviews this company's performance and leadership performance on an ongoing basis and concluded a change now was in the best interest of the company".

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While one would find many examples on either side of the court, there is a unanimous view of increased responsibilities of non-executive directors. Yet, there is limited research that has gone into factors that influence the functioning of non-executive directors, especially the softer issues such as independence. With this background, this article tries to explore following fundamental questions on functioning of non-executive directors:

- What are the expectations from a non-executive director for an effective functioning of a Board of Directors
- Given these expectations, how critical is independence and what are the steps that must be taken by the company/director to fulfill it in letter and spirit
- Finally, having set the benchmarking standards on independence, gauge the recent boardroom examples to assess whether the current practices live up to the standard.

Through out the article, I will use the title 'non-executive director', which is technically a more superior description of the position as compared to term 'independent director', which presumes the very question of independence we are trying to address.

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Key Expectations from Non-Executive Directors

The question we should start from is why do we need independent directors in the first place? I mean, we all know that the company is run by the executive management and if at all, they are better at understanding the key issues and finding right solutions than somebody who attends to company's affairs only once in a quarter and in most cases, has a bigger responsibility of running his/her company.

Especially so, since there is no decisive evidence that a majority of independent directors produce superior corporate performance. Two independent studies done by Sanjai Bhagat of the University of Colorado and Boulder and Black of the Stanford Law School found that companies where at least half the directors were independent did not seem to perform any better than companies that had fewer independent directors.

However, there is enough evidence to show that effective discharge of duty by an independent director would have salvaged many of the corporate scandals we have seen in recent past. The chairman of the audit committee of Enron was no less a person than the Dean of Stanford Business School. You cannot get a more competent person to detect any irregularity in the accounts. The question here is not whether there was indeed any negligence on the part of the independent directors, but the fact is that timely whistle-blowing in this case may have saved millions of dollars of shareholder money.

From that perspective, in my view, the fundamental role of the non-executive directors in the boardroom is to provide external objectivity. This objectivity can be split in two – firstly the provision of support, a ready ear and a wider commercial view to the executives and secondly leading the board, through the relevant committees, in the consideration of matters where the executives have a real or perceived conflict of interest.

In relatively smaller quoted companies, the specific skill-set or experience of a non-executive may provide a valuable additional resource, which can be called on to support the executives in appropriate circumstances. An additional and valuable by-product often sought from a non-executive is access to a wider network of contacts whose views can be tapped.

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Derek Higgs, in his seminal report on "Review of Role and effectiveness of non-executive directors" suggests following key responsibilities of the non-executive directors:

- **Strategy:** Non-executive directors should constructively challenge and contribute to the development of strategy.
- **Performance:** Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

- **Risk:** Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.
- **People:** Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.

Beyond this, the role of non-executive directors involves acting as bridge between the shareholders and the management. Hence it is expected that non-executive directors be sufficiently involved in the regular contact with shareholders to be sure that they are aware of shareholder views. Whenever shareholders initiate dialogue with companies on specific issues, it is often the norm that the senior non-executive directors, or where relevant the non-executive director chairing the Audit or the Remuneration Committee as appropriate, are expected to front-end the dialogue on behalf of the board.

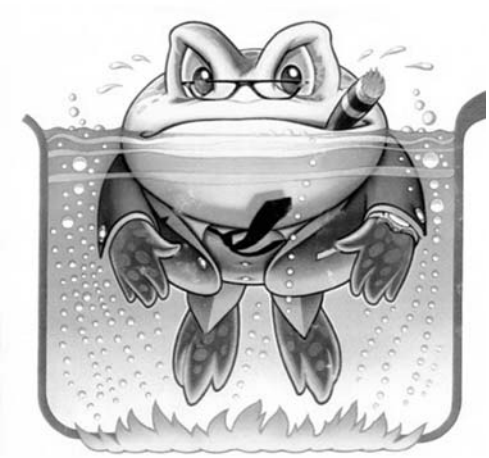
Importance of Independence

Fundamental question one wants to ask here is – "who proposes independent directors?" The answer is: executive management team. If so, why are we even attempting to call them 'independent directors'?

This is the reason why it is often accused that Corporate bosses appoint executive directors of other

companies on the principle, "You scratch my back, I'll scratch yours." Its not surprising, therefore, to see why almost invariably, independent directors postpone dropping the bomb for as long as possible and give much larger rope to an undeserving CEO than desired. General Motors floundered for a decade whilst its board, mainly non-executive, failed to oust Roger Smith or his successor, Robert Stempel. At Tomkins, a troubled British engineering conglomerate, it was a shareholder and not the board who launched the campaign that eventually persuaded Greg Hutchings to leave.

To counter this primary fallacy, Security Exchange Commission of USA proposed a rule last year for publicly traded company. The proposed rule provides certain shareholders access to their companies' proxy materials (shareholder meeting notice & resolutions) to have their nominees to the board included along with management's nominees in an election to the board of directors. This arrangement is known as 'proxy access system'. Shareholders and shareholder groups that own more than five percent of the issuer's securities for at least two years would be able to exercise their right if one of two proposed triggers occurred. One trigger would be shareholder approval of a shareholder proposal to opt into the proxy access system where the proposal was submitted by a one percent shareholder. The other trigger would occur if 35 per cent of stockholders withheld votes for any particular director candidate. If either happened, as proposed, then the next year at the annual shareholders' meeting, that issuer would be subject to a new rule in which the described five percent group of shareholders can propose one candidate for election to the board that the issuer would be required to include in its proxy materials. The candidate has to be an independent director under listing standards applicable to the issuer and must also be independent of the shareholders that nominate him or her.



Probably no other proposal has produced as much controversy and lobbying – including full page advertisements in the Wall Street Journal and the New York Times, serious lobbying done in the halls of Congress and number of comments received by SEC, over 14,000, suggest that a lot of people care about this issue.

However, if one were to accept the current system as it is and instead look at the positive side, the biggest benefit of having non-executive directors is undeniably the independence. This independence may be manifested in many ways - wider experience, functional expertise in a given subject or a fresh perspective to board proposals.

Barring a small percentage of systemic & individual failures, independence of non-executive directors well exists and the role as torchbearers for shareholders' interest is being increasingly embraced by these white knights in India. There are not many examples of 'board activism' in India but it is still too early to reach any judgment.

Independence is critical. When one studies the board dynamics of a public company, there is a natural potential for conflict between the interests of executive management and shareholders in the case of director remuneration, or audit (where decisions on the financial results can have a direct impact on remuneration). And hence the only good shepherd in monitoring such decisions is the group of non-executive management, independent in letter & spirit.

The legislation also underlines the independence aspect of non-executive directors. Requiring a greater degree of independence on boards has been a central theme in the recent US corporate governance reform measures. The Sarbanes-Oxley Act requires all members of the audit committee to be independent. Under the new NASDAQ listing rules and the new NYSE listing rules, a majority of the board must be independent. The Bouton report on corporate governance in France also recommended that half the board should be independent.

That brings us to the question – what constitutes independence? Higgs' report suggests following definition, which I find is a well-rounded working guide:

- A non-executive director is considered independent when the board determines that the director is independent in character and judgment and there are no relationships or circumstances which could affect, or appear to affect, the director's judgment. Such

relationships or circumstances would include where the director:

- is a former employee of the company or group until five years after employment
- has, or has had within the last three years, a material business relationship with the company either directly, or as a partner,
- shareholder, director or senior employee of a body that has such a relationship with the company;
- has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;
- has close family ties with any of the company's advisers, directors or senior employees;
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;
- represents a significant shareholder; or
- has served on the board for more than ten years.

Having talked about 'rule-based hard factors', the most critical factor still remains soft – 'state of mind'. The classic question in this regard is "would you have endorsed that proposal if you were doing it in your own company or if it was your personal capital with which the project is being funded?" So long as a non-executive directors' behaviour falls affirmatively within the boundaries set by this question, the board and the shareholders are benefiting from his or her presence on the board.

Let us now assess how well this concept has been working in real life situations and whether tangible benefits have accrued to shareholders. Let me share a nice little case study from a recently published note by none other than the legendary investment guru Warren Buffet.

The study focused on how 'independent' directors—as defined by statute—had performed in the mutual fund field. The Investment Company Act of 1940 mandates such directors, and that means that there is an extended test of time on actual performance delivered against the intent of the act. The study looked at the record of fund directors in respect to the two key tasks board members should perform—whether at a mutual fund business or any other. These two all-important functions are, first, to obtain (or retain) an able and honest manager and then to compensate that manager fairly.

The results were not encouraging. Year after year, at literally thousands of funds, directors had routinely rehired the incumbent management company, however pathetic its performance had been. Just as routinely, the directors had approved fees that in many cases far exceeded those that could have been negotiated. Then, when a management company was sold — invariably at a huge price relative to tangible assets — the directors experienced a 'counter-revelation' and immediately signed on with the new manager and accepted its fee schedule.

In effect, the directors decided that whoever would pay the most for the old management company was the party that should manage the shareholders' money in the future.

Within a few months of publishing this study, the public began to learn that many fund-management companies had followed policies that hurt the owners of the funds they managed, while simultaneously boosting the fees of the managers. Prior to their transgressions, it should be noted, these management companies were earning profit margins and returns on tangible equity that were the envy of corporate America. Yet to swell profits further, they trampled on the interests of fund shareholders in an appalling manner.

So what were the directors of these looted funds doing after this hue & cry? Nothing much. A follow-up assessment done one year after the original study was published found that most of them had not terminated the contract of the offending management company

The study points finger at painful reality that neither the decades-old rules regulating investment company directors nor the new rules such as Sarbanes Oxley foster the election of truly independent directors.

Yet, all is not lost. There have been ample examples since early 2000 that point towards the fact that, if used well, independent directors is an effective weapon against the unhealthy greed that exists in corporate corridors of executive power. In case of Walt Disney, accusations were made that Bass family's 25% holdings in the company and their support of Michael Eisner, 20 Year CEO of Walt Disney gave him an "unassailable grip" on the top management job — despite some major mistakes, such as the hiring and firing of super-agent Michael Ovitz in 1996, which is estimated to have cost Disney $140 million. However, Board acted decisively after Bass family sold almost two third of their holdings in post 9/11 crash, depriving Eisner crucial support. As the final result of battle, Eisner had to relinquish the title of 'Chairman' and was forced to name a retirement date.

We are also seeing more instances where the non-executive directors

have played a crucial role in maintaining highest standard of integrity and ethics of the organization. More recently, Boeing's Board of Directors ousted Chief Harry Stonecipher because of an incidence that involved carrying on a personal relationship with a female executive. The board concluded that the facts reflected adversely on Harry's judgment and would impair his ability to lead the company.

Finally, there is a sense of higher proactiveness of approach by non-executive directors and swift action is initiated as soon as there is enough evidence of wrongdoing by an executive. Recently, American International Group was the target of federal and state-level regulatory probes into various business and accounting practices. Within days of unearthing revelation about these practices, the board of directors forced long-time CEO Maurice Greenberg to resign. In addition, the company's chief financial officer, Howard Smith, and another executive have been placed on leave. This is a marked shift from earlier instances of giving long rope to reining executives.

Independent Directors in Indian Context

New Clause 49 of the Listing Agreement regulations talk about the provisions related with independent auditors. I will focus on only three key aspects of the regulations – definition of independent directors, compensation of independent directors and finally, their key responsibilities.

The clause defines expression 'independent director' as non-executive director of the company who (a) apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director. (b) is not related to promoters or persons occupying management positions at the board level or at one level below the board; (c) has not been an executive of the Company in the immediately preceding three financial years (d) is not a partner or an executive or was not partner or an executive during three preceding years of statutory audit firm, internal audit firm, legal firm and consulting firm that have a material association with the company (e) is not a material supplier, service provider or customer or a lessor or lessee of the company, which may effect the independence of the directors.

The clause requires that All fees/compensation, if any paid to non-executive directors, including independent directors, shall be fixed by the Board of Directors and shall require previous approval of the shareholders in the general meeting. The shareholders resolution shall specify the limit for the maximum number of stock options that can be granted to non-executive directors, including independent directors, in any financial year and in aggregate.

Finally, the role of independent directors has been considerably expanded to bring in more onerous responsibilities, particularly as members of audit committee, of which at least two third members necessarily need to be independent directors.

The key trend I decipher from the evolution of clause 49 is that it's becoming much more progressive. For example, the definition of independent directors has been widened considerably from current clause 49. The compensation disclosure is a new disclosure requirement and the previous approval of shareholders is now mandatory. So far as role of independent directors is concerned, new clause now requires all members of the Committee to be financially literate and at least one member to have accounting or related financial management expertise.

While we may not be the thought-leaders on the subject, the pace at which Indian legislation has been benchmarking with global best practice is very encouraging.

Conclusion

There are fundamental questions today, which challenge the existence and effectiveness of true independence of non-executive directors. We have seen more than one example where the so-called independence has only existed on paper and failed to shield shareholders from greedy & unethical behaviour of executive management.

And yet, there are more examples on the other side of the table that prove the success of the concept of independent directors. It can also be seen that as time passes, one is seeing more decisive intent and actions from non-executive directors than before.

Hence my overall submission on the subject is that, barring a small percentage of systemic & individual failures, independence of non-executive directors well-exists and the role as torchbearers for shareholders' interest is being increasingly embraced by these white knights.

One is surprised to find not many examples of this 'board activism' in India. Yet, it is early days to reach any judgement, as having independent directors on the board is a more recent phenomenon in India than in west. The concluding note for India Inc therefore is that we are on right track so far and we should continue our journey, through regulation and practice, of taking our companies to greater heights of value creation by following best corporate governance practices. ■