Independent Director Models in India and the United States:A Comparative Assessment

The role of independent directors features prominently in corporate governance codes. US public companies continue to adopt the best practices within the framework of strengthened securities market listing standards and legal requirements that developed, beginning with the passage of the Sarbanes-Oxley Act and have continued with the financial crisis and the passage of the Dodd-Frank Act. In India, key corporate governance laws had not kept pace with the changing contours of the economy until the recent enactment of the Companies Act of 2013, which completely revamps the country's corporate governance code. In this research study, the author presents a comparative assessment on the independent director models both in India and the US on several key parameters, i.e. definition and selection, board and committee composition, manner of appointment, term of office, remuneration, and duties and liabilities. Here, he has considered only those laws which are applicable to publicly-listed companies in India and the US. Read on...

Introduction

Corporate governance generally places a fair amount of emphasis on the independence of a Board. Corporate governance models in India borrow heavily from those in the US and the UK. For example, most corporate governance norms in India have been largely borrowed from the recommendations of Cadbury Committee (1992) of the UK and the Sarbanes-Oxley Act of 2002 of the US. Governance in the US aims at disciplining the management, while this aims at disciplining the dominant shareholder and protecting interests of minority shareholders in India. Independent directors, who are truly independent, can be an effective barricade against corporate frauds. Active oversight and prudent judgment may suffer when large numbers of directors are closely associated with the executive leadership.

Let us compare and assess independent director models in India and the US on the parameters of

CA. Hrishikesh Desai

(The author is a member of the Institute who may be contacted at hrishikesh.desai@yahoo.co.in.)

definition and selection, board and committee composition, manner of appointment, term of office, remuneration, and duties and liabilities, without considering disclosure obligations, while considering all laws applicable to publicly-listed companies in India and the US and ignoring the specific exceptions.

Independent Director Model in India

Corporate governance-related regulatory-framework in India concerning director independence is based on:

- The Companies Act, 2013 (hereafter referred to as "2013 Act"), which came into existence on 29th August, 2013, is a landmark legislation in India that replaced the old Companies Act, 1956 (hereafter referred to as "1956 Act"). Not all provisions of the 2013 Act came into force immediately, as a number of them require the Government of India to draft rules and regulations for their implementation. These rules will be drafted in the coming months in consultation with stakeholders.
- Clause 49 of the Listing Agreement, 2005 (hereafter referred to as "Listing Agreement") by the SEBI.

Independent Director Model in the US

Corporate-governance-related regulatory framework in the US concerning director independence is based on:

- Statutory law of the state in which the company is incorporated. Most US public companies are incorporated in the state of Delaware. The majority of other states base their legislation on Delaware law, or on the Revised Model Business Corporations Act (RMBCA) of 2002.
- Federal Securities laws, such as:
  - Rules and regulations promulgated by the Securities and Exchange Commission (SEC).
  - Sarbanes-Oxley Act of 2002 (hereafter referred to as "SOX Act") and Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (hereafter referred to as "Dodd-Frank Act")
- Listing standards published by registered stock exchanges, most notably, the New York Stock Exchange Listed Company Manual (NYSE Listing Manual) and the National Association of Securities Dealers Automatic Quotations Stock Market Rules (NASDAQ Stock Market Rules).
- Company's certificate of incorporation and bye-laws.

In India, the 1956 Act did not contain any reference to independent directors and the definition of independent directors in the Listing Agreement was applicable to listed companies only. The definition in the 2013 Act, which is wider in scope than the one in the Listing Agreement, defines an *independent director* and draws the criteria for becoming the one.

Comparative Assessment of Independent Director Models in India and the US

1. Definition and Selection Criteria

In India, the 1956 Act did not contain any reference to independent directors and the definition of independent directors in the Listing Agreement was applicable to listed companies only. The definition in the 2013 Act, which is wider in scope than the one in the Listing Agreement, defines an *independent director* as:

An independent director, means a director other than a managing director or a whole-time director or a nominee director,—

(a) who, in the opinion of the Board, is a person of integrity, and possesses relevant expertise and experience;

(b) who is or was not a promoter of the company or its holding, subsidiary or associate company and who is also not related to the promoters or directors of those companies;

(c) who has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the current or 2 immediately preceding financial years;

(d) none of whose relatives has or had pecuniary relationship or transaction with the company, its holding, subsidiary or associate company, or their promoters, or directors, amounting to 2% or more of its gross turnover or total income or $80,000[1], whichever is lower, during the current or 2 immediately preceding financial years;

(e) who, neither himself nor any of his relatives—

(i) holds or has held the position of a key managerial personnel or is or has been employee of the company or its holding,

[1] *US $1 has been considered as equivalent to ₹62.50 here and in all subsequent instances.*

subsidiary or associate company in any of the 3 immediately preceding financial years;

(ii) is or has been an employee or proprietor or a partner, in any of the 3 immediately preceding financial years, of a firm of auditors or company secretaries of the company or its holding, subsidiary or associate company; or any legal or a consulting firm that has or had any transaction with those companies amounting to 10% or more of the gross turnover of such firm;

(iii) holds together with his relatives 2% or more of the total voting power of the company; or

(iv) is a chief executive or director, of any non-profit organisation that receives 25% or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds 2% or more of the total voting power of the company.

In the US, NYSE and NASDAQ listing standards and SEC rules have established mandates for director independence. The SEC rules do not impose any additional independence criteria. Rather, the rules simply seek to elicit additional disclosures.

NYSE proposes the following standards for independent directors:

a) A director is independent only if the Board affirmatively determines that he or she has no material relationship with the company.

i. This assessment is fact specific, since there are several circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to the company.

ii. When assessing the materiality of such relationship, the Board should consider the issue not merely from the standpoint of the director, but also from that of persons or organisations with which the director has an affiliation.

iii. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independent from management, NYSE does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

b) A director is not independent if:

i. The director is, or has been within the last 3 years, an employee of the company.

ii. A family member is, or has been within the last 3 years, an executive officer of the company.

iii. The director or a family member has received more than $120,000 in direct compensation from the company during any 12-month period within the last 3 years (other than Board and committee fees, pension or other forms of deferred compensation for prior service, provided such compensation is not contingent in any way on continued service and compensation paid to a family member employed by the company (other than as an executive officer)).

iv. The director is an employee, or a family member is an executive officer, of a company that has made payments to the company or received payments from the company for property or services in an amount which, in any of the last 3 fiscal years, exceeds the greater of 2% of the other company's consolidated gross revenues and $1 million. (For NASDAQ, these figures are 5% and $200,000 respectively)

v. The director or a family member is, or was within the last 3 years, a partner or employee of a firm that is the company's internal or external auditor.

vi. The director or a family member is, or has been within the last 3 years, employed as an executive officer of another company where any of the company's present executive officers serve or served at the same time on that company's compensation committee.

As per the NASDAQ listing standards, a director is independent only if the Board affirmatively determines that he or she has no relationship with the company that would interfere with the director's exercise of independent judgment in carrying out his or her responsibilities. NASDAQ listing standards have more or less similar independence criteria as the NYSE listing standards.

In the US, Section 301 of the SOX Act requires that the audit committee of each listed issuer be composed of independent directors. Current NYSE and NASDAQ rules rely heavily on SEC Rule 10A-3, which requires that each member of the audit committee of the company be independent in accordance with 2 criteria, one which bars any compensation from the company or its subsidiary, and the other which bars any control relationship ("affiliation") with the company or its subsidiary (other than by reason of service as a director).

2. Board and Committee Composition

a. Board Composition

In India, the Listing Agreement requires that the number of independent directors in the Board would depend on whether the chairman is executive or non-executive. In case of a non-executive chairman, at least 1/3rd of the Board would comprise of independent directors and in case of an executive chairman, at least 1/2 of the Board would comprise of independent directors. The 2013 Act relaxes this requirement by mandating that only 1/3rd of the Board of publicly listed companies is to comprise of independent directors.

In the US, as per NYSE and NASDAQ listing standards, companies must have a majority of independent directors in the Board. State laws do not place any restrictions on the Board composition.

b. Audit Committee Composition

In India, the Listing Agreement requires that 2/3rd of the members of audit committee be independent directors. The 2013 Act states that majority of directors in audit committees are to be independent.

In the US, Section 301 of the SOX Act requires that the audit committee of each listed issuer be composed of independent directors. Current NYSE and NASDAQ rules rely heavily on SEC Rule 10A-3, which requires that each member of the audit committee of the company be independent in accordance with 2 criteria, one which bars any compensation from the company or its subsidiary, and the other which bars any control relationship ("affiliation") with the company or its subsidiary (other than by reason of service as a director).

c.Remuneration/Compensation Committee Composition

In India, the 2013 Act requires that at least ½ of the total directors in the Remuneration Committee are to be independent (applicable to listed companies only).

In the US, NYSE and NASDAQ listing standards require companies to have a compensation committee composed entirely of independent directors and have more or less similar independence criteria. The NYSE listing standards on independence criteria of compensation committee members state as follows:

A director is independent only if the Board affirmatively determines that he or she has no material relationship with the company that adversely affects his or her ability to be independent from management in connection with the duties of a compensation committee member. This assessment is fact specific and when assessing the materiality of such relationship, the Board should consider:

- The source of the director's compensation, including any consulting, advisory or other compensatory fees. This includes consideration of whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the company's executive compensation.
- Any affiliate relationships between the director and the company. This includes consideration of whether an affiliate relationship places the director under the direct or indirect control of the company or its senior management.

The 2013 Act establishes an elaborate code of conduct which independent directors are expected to abide by and also lays down broad guidelines for their duties. Under the provisions of the 2013 Act, the independent directors of the company would have to meet at least once in a year, without the presence of non-independent directors and members of management.

3. Manner of Appointment

In India, as per the provisions of the 2013 Act, the appointment process of independent directors shall be independent of the company management. The appointment of an independent director shall be approved at the annual shareholders' meeting. Constitution of nomination committees is not mandated by the 1956 Act or the Listing Agreement. The 2013 Act, for the first time, requires all listed companies to constitute a Nomination committee that has at least ½ of its members as independent directors and that formulates the criteria for selection of directors.

In the US, generally, independent directors are nominated by the board for election at the annual shareholders' meeting. Companies listed on the NYSE normally must have a nominating committee, composed entirely of independent directors, that identifies individuals qualified to become board members and recommends their nomination to the board. NASDAQ has similar requirements, but does not require a formal committee.

An independent nomination committee may be effective for the US companies, where shareholding

is dispersed. But such a system may not apply to Indian companies, where shareholding tends to be concentrated. Although a nomination committee may recommend candidates, the election of such candidates is still subject to voting at shareholders' meetings, where the controlling shareholders dominate.

4. Term of Office

In India, as per the 2013 Act provisions, the term of independent directors is to be non-rotational, *i.e.* independent directors shall not be liable to retire by rotation. They will have upto 5 years (original term) and 5 years (additional term subject to a special resolution). After the expiry of term, an individual is ineligible for re-appointment for 3 years. The same person can be considered for re-appointment after a lapse of the 3 years period. This relaxation is obviously provided since the lawmakers wish to address the shortage of independent directors in India.

In the US, the term limits for directors are relatively uncommon, although Delaware's General Corporation Law allows a company's certificate of incorporation or bye-laws to prescribe various qualifications for directors, including the term of appointment. As per the 2012 Shearman and Sterling LLP's Corporate Governance Survey, while 72 of the Top 100 US companies discuss the topic of term limits for directors in their proxy statements, only 5 have adopted mandatory term limits.

5. Remuneration

In India, as per the 1956 Act, an independent director could be remunerated by way of grant of stock options in addition to fees/commissions. The 2013 Act prohibits the issuance of stock options to independent directors, in a bid to address the concern that it might be causing a conflict of interest. It would have been more relevant instead, to place restrictions either on the total amount of stock options or put a time limit on exercising these options, rather than having a complete ban.

The corporate governance systems in the US tend to foster a more equitable distribution of information and place a stronger emphasis on the protection of shareholders rights and, in particular, those of minority investors.

Apart from the restriction on stock options, the remuneration of independent directors has also been limited to sitting fees, reimbursement of expenses for participation in the board and other committee meetings and profit-related commission as may be approved by the shareholders. The 2013 Act does not eliminate profit-related commission, which could create a conflict of interest, since the commission is linked to the company's performance.

In the US, an independent director's compensation may include cash, the company's shares or options on, or other derivatives of, the shares. NYSE and NASDAQ listed companies must obtain shareholder approval of equity remuneration plans covering directors. The equity compensation component better aligns independent director interests with shareholders, however, independent directors could be motivated to game the financial reporting system. SOX Act does not permit payment of a profit-related commission to independent directors. In response to the Dodd-Frank Act, the SEC adopted rules providing shareholders with a non-binding advisory Say-on-Pay vote on most highly compensated executives (Say-on-pay is a rule whereby a firm's shareholders have the right to vote on executive remuneration)as well as a non-binding advisory vote on "golden parachute" compensation (a golden parachute is agreement between a company and a top executive specifying that the employee will receive certain significant benefits if employment is terminated). The results of the votes will not be binding on the Board. However the Compensation Committee will take into account the outcome of the vote when considering future executive compensation arrangements.

6. Duties and Liabilities

In India, the 1956 Act looks at all directors alike. Neither the Listing Agreement nor the 1956 Act precisely define the duties and liabilities of an independent director. The 2013 Act establishes an elaborate code of conduct which independent directors are expected to abide by and also lays down broad guidelines for their duties. Under the provisions of the 2013 Act, the independent directors of the company would have to meet at least once in a year, without the presence of non-independent directors and members of management.

The 2013 Act also seeks to provide immunity to independent directors by making them liable only in respect of such wrongdoings which had occurred

with their knowledge, attributable through Board processes, and with their consent or connivance or for lack of due diligence.

In the US, both the NYSE and NASDAQ require that independent directors have regularly scheduled meetings, referred to as executive sessions. NYSE and NASDAQ listing standards differ slightly on this point. The NYSE rules require either non-management directors or independent directors to meet at regularly scheduled executive sessions. In addition, if a company chose to include all non-management directors, it should hold an executive session including only independent directors at least once a year. The NASDAQ listing standards require executive sessions of independent directors only to occur at least twice a year.

Directors of the US companies generally have some liability protection coverage in their bye-laws and/or in indemnification agreements with the corporation as well as through Directors and Officers liability insurance coverage. Negligence on the part of a director does not result in personal liability unless the director failed to act in good faith. Most states allow a company to eliminate or limit directors' personal liability to the company or its shareholders for breach of their fiduciary duty.

Conclusion

There is no single model of corporate governance and each country has through time developed a variety of mechanisms to overcome the agency problems arising from the separation of ownership and control. India has imported its independent director regulatory framework from abroad and tried to mould it to suit the Indian corporate scenario. The 2013 Act greatly empowers independent directors in India and also makes them accountable. The corporate governance systems in the US tend to foster a more equitable distribution of information and place a stronger emphasis on the protection of shareholders rights and, in particular, those of minority investors. Both the Indian and the US corporate governance approaches are rule-based and they differ on several key parameters as highlighted above. What is required at this stage is that companies in both countries follow the laws in spirit and not in letter alone. ■