Independent Directors

An independent director is a non-executive director of a company and helps the company in improving corporate credibility and governance standards.

The Companies Act 2013, has introduced new provisions relating to independent directors, eligibility criteria, tenure, appointment, qualification, code etc., Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (LODR) contains provisions relating to Independent Director in tune with Companies Act, 2013.

Independent Directors are required because they perform the following important functions i.e

(i) They balance the conflicting interest of stakeholders.

(ii) They fulfill a useful role in succession planning

(iii) They act as a coach, mentor and sounding Board for their full time colleagues.

(iv) They provide independent judgment and wider perspective.

Role of Cadbury Committee

The Cadbury Committee in 1992, which itself was set up following the corporate scandals involving BCCI, Polly Peck and Maxwell, provided respectability to the concept of independent directors, by focusing on independent directors as a part of the new practices for better governance. Independent directors function as an oversight body in monitoring the performance and should raise red flags whenever suspicion occurs. They are expected to be more aware and question the company on relevant issues in their position as trustees of stakeholders.

Who can be an independent director?

Section 149(6) of the Companies Act, 2013, provides that:

Independent director, in relation to a company, means a director other than a managing director or a whole time director or a nominee director -

(Note: A managing director, a whole time director and a nominee director cannot become an independent director.)

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

In case of Government company, **instead of Board**, the Ministry or Department of the Central Government which is administrative incharge of the company.

(b) (i) who is or was not a promoter of the company or its holding, subsidiary or associate company;
(ii) who is not related to promoters or directors in the company, its holding, subsidiary or associate company;

(c) Who has or had no pecuniary relationship with the company, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year. In Government companies, the criteria is not required to be followed.

(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 two per cent. or more of its gross turnover or total income or fifty lakh rupees or such higher amount as may be prescribed, whichever is lower, during the two immediately preceding financial years or during the current financial year;

(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, subsidiary or associate company in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed;

(ii) is or has been an employee or proprietor or a partner, in any of the three financial years immediately preceding the financial year in which he is proposed to be appointed, of—

(A) a firm of auditors or company secretaries in practice or cost auditors of the company or its holding, subsidiary or associate company; or

(B) any legal or a consulting firm that has or had any transaction with the company, its holding, subsidiary or associate company amounting to ten per cent. or more of the gross turnover of such firm;

(iii) holds together with his relatives two per cent. or more of the total voting power of the company;

or

(iv) is a Chief Executive or director, by whatever name called, of any nonprofit organisation that receives twenty-five per cent. or more of its receipts from the company, any of its promoters, directors or its holding, subsidiary or associate company or that holds two per cent. or more of the total voting power of the company; or

(f) Who possesses such other qualifications as may be prescribed.

Clarification of MCA on `Pecuniary Interest'

(i) Section 149(6)(c): "pecuniary interest in certain transactions" :-

(a) This provision *inter alia* requires that an 'ID' should have no 'pecuniary relationship' with the company concerned or its holding/ subsidiary/ associate company and certain other categories specified therein during the current and last two preceding financial years. Clarifications have been sought whether a transaction entered into by an 'ID' with the company concerned at par with any member of the general public and at the same price as is payable/paid by such member of public would attract the bar of 'pecuniary relationship' under section 149(6)(c). The matter was examined and it was hereby clarified that in view of the provisions of section 188 which take away transactions in the ordinary course of business at arm's length price from the purview of related party transactions, an 'ID' will not be said to have 'pecuniary relationship', under section 149(6)(c) in such cases.

(b) Stakeholders also sought clarification whether receipt of remuneration, (in accordance with the provisions of the Act) by an 'ID' from a company would be considered as having pecuniary interest while considering his appointment in the holding, subsidiary or associate company of such company. The matter was examined in consultation with SEBI and it was clarified that 'pecuniary relationship' provided in section 149(6)(c) of the Act does not include receipt of remuneration, from one or more companies, by way of fee provided under sub-section (5) of section 197, reimbursement of expenses for participation in the Board and other meetings and profit related commission approved by the members, in accordance with the provisions of the Act.

Number of independent directors
or
How many independent directors should be there on board?

Every listed public company shall have **at least one-third** of the total number of directors as independent directors and the Central Government may prescribe the minimum number of independent directors in case of any class or classes of public companies.

The following class or classes of companies shall have **at least two** directors as independent directors -

(i) the **Public Companies** having **paid up share capital of ten crore rupees or more**; or
(ii) the **Public Companies** having **turnover of one hundred crore rupees or more**; or
(iii) the **Public Companies** which have, **in aggregate, outstanding loans, debentures and deposits, exceeding fifty crore rupees**:

Relevant date: The paid up share capital or turnover or outstanding loans, debentures and deposits, as the case may be, as existing on the last date of latest audited financial statements shall be taken into account.

A small shareholder's director may also be considered as an independent, if he fulfills the eligibility criteria and if he gives the declaration of his independence under section 149(6).

Provided that in case a company covered under this rule is required to appoint a higher number of independent directors due to composition of its audit committee, such higher number of independent directors shall be applicable to it.

Example :- ABC Ltd. is having 6 directors in its Audit Committee, then 4 directors out of 6 must be Independent Directors (4 is forming majority). As per section 177(2) of the Companies Act, 2013, the Audit Committee shall consist of a minimum of three directors with independent directors forming a majority. Although in terms of the Companies (Appointment & Qualification) Rules, 2014 the company is required to have at least 2 Independent directors, but in this case the limit of 2 will increase to 4 as the company is required to appoint a higher number of independent directors due to composition of its audit committee.

Filling of intermittent vacancies

Any intermittent vacancy of an independent director shall be filled-up by the Board **at the earliest <u>but</u> not later than immediate next Board meeting <u>or</u> three months from the date of such vacancy**, **<u>whichever is later</u>**.

In ABC Ltd., the vacancy of the independent director arises on January 15, 2015. As per the provisions of the Act, the vacancy shall be filled-up by the Board at the earliest but not later than immediate next Board meeting or three months from the date of such vacancy whichever is later.

CASE-A: If the Board meeting is scheduled to be held on February 15, 2015, then the vacancy shall be filled-up by February 15, 2015 or by April 14, 2015 whichever is later. In this case it shall be filled up by ______________.

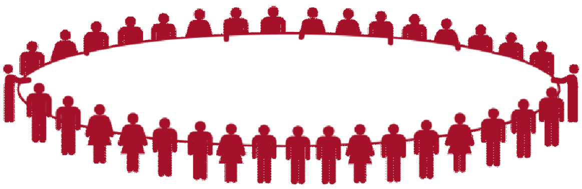
CASE-B: If, for any reason, the meeting of Board of Directors shifted to May 10, 2015, then the vacancy shall be filled-up by May 10, 2015 or by April 14, 2015 whichever is later. In this case it shall be filled up by _______________.

Manner of selection of an Independent Director

1. Maintenance of data bank:

According to section 150(1) of the Act,

(a) An independent director may be selected from a **data bank** containing names, addresses and qualifications of persons eligible and willing to act as independent directors.



(b) The data bank shall be created and maintained in accordance with The Companies (Appointment and Qualification of Directors) Rules, 2014

(c) The data bank may be maintained by the agency (Any body, institute or association as may be authorized by Central Government) having expertise in creation and maintenance of such data bank.

(d) Such agency shall put data bank of independent directors on the website of Ministry of Corporate Affairs or any other notified website.

One such databank as a joint initiative of The Institute of Chartered Accountants of India, The Institute of Company Secretaries of India and The Institute of Cost Accountants of India" under the active encouragement of the Ministry of Corporate Affairs, Government of India has been developed.

This Independent Directors Repository facilitates the individuals who are eligible and willing to act as Independent Directors and also facilitates Companies to select the persons who are eligible and willing to act as Independent Directors.

2. Responsibility of the company to exercise due diligence:
A Company must exercise due diligence before selecting a person from any data bank.

3. Approval of appointment of appointment of independent director by the members:
Appointment of independent directors has to be approved by members in a General meeting and the explanatory statement annexed to the notice must indicate justification for such appointment.

4. Changes in particulars: An existing or applicant of such data bank of independent directors shall intimate any changes in his particulars within fifteen days of such change to the agency i.e. Independent Directors Repository [Rule 6(6)].

5. Requirements for data bank displayed on the website: Rule 6(7) prescribed that the databank posted on the website shall:
a. be accessible at the specified website;
b. be substantially identical to the physical version of the data bank;
c. be searchable on the parameters specified in rule 6(2);
d. be presented in a format or formats convenient for both printing and viewing online; and
e. contain a link to obtain the software required to view print the particulars free of charge.
However, Rule 6(2) has been amended to rationalize the required information from the applicant registering on the databank of Independent Directors by removing the required details of Income Tax PAN, Mother's and Spouse Name from the databank of Independent Directors.

Declaration by independent director [Section 149(7)]

Every independent director shall at the first meeting of the Board in which he participates as a director and thereafter at the first meeting of the Board in every financial year or whenever there is any change in the circumstances which may affect his status as an independent director, give a declaration that he meets the criteria of independence as provided in sub-section (6) of section 149.

Tenure of Independent Director

Section 149(10) provides that subject to the provisions of section 152 -
(a) an independent director shall hold office for a term up **to five consecutive years** on the Board of a company.
(b) He shall be eligible for reappointment on passing of a special resolution by the company and disclosure of such appointment in the Board's report.
(c) No independent director shall hold office for more than two consecutive terms. (Cannot hold for more than 2 consecutive years)

(d) An independent director shall be eligible for appointment after the expiration of three years of ceasing to become an independent director. During the said period of three years, an independent director shall not be appointed in or be associated with the company in any other capacity, either directly or indirectly.

Remuneration of Independent Director

Section 149(9) provides that notwithstanding anything contained in any other provision of this Act, but subject to the provisions of sections 197 and 198, an independent director shall not be entitled to any stock option and may receive remuneration by way of fee provided under sub-section (5) of section 197, reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.

Code for Independent Directors (Schedule IV of the Companies Act 2013)

Section 149 (8) of the Act prescribes that the company and independent directors shall abide by the provisions specified in Schedule IV regarding code for independent directors. It is a guide to professional conduct for independent directors. Adherence to these standards by independent directors and fulfillment of their responsibilities in a professional and faithful manner will promote confidence of the investment community, particularly minority shareholders, regulators and companies in the institution of independent directors.

Code of Conduct includes
- guidelines of professional conduct,
- role,functions and duties,
- manner of appointment and re-appointment,
- resignation or removal,
- separate meetings,
- evaluation mechanism.

I. Guidelines of professional conduct:

An independent director shall:
1) Uphold ethical standards of integrity and probity;
2) Act objectively and constructively while exercising his duties;
3) Exercise his responsibilities in a *bona fide* manner in the interest of the company;
4) Devote sufficient time and attention to his professional obligations for informed and balanced decision making;
5) Not allow any extraneous considerations that will vitiate his exercise of objective independent judgment in the paramount interest of the company as a whole, while concurring in or dissenting from the collective judgment of the Board in its decision making;

6) Not abuse his position to the detriment of the company or its shareholders or for the purpose of gaining direct or indirect personal advantage or advantage for any associated person;
7) Refrain from any action that would lead to loss of his independence;
8) Where circumstances arise which make an independent director lose his independence, the independent director must immediately inform the Board accordingly;
9) Assist the company in implementing the best corporate governance practices.

II. Role and functions:

The independent directors shall:

1) Help in bringing an independent judgment to bear on the Board's deliberations especially on issues of strategy, performance, risk management, resources, key appointments and standards of conduct;
2) Bring an objective view in the evaluation of the performance of board and management;
3) Scrutinize the performance of management in meeting agreed goals and objectives and monitor the reporting of performance;
4) Satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible;
5) Safeguard the interests of all stakeholders, particularly the minority shareholders;
6) Balance the conflicting interest of the stakeholders;
7) Determine appropriate levels of remuneration of executive directors, key managerial personnel and senior management and have a prime role in appointing and where necessary recommend removal of executive directors, key managerial personnel and senior management;
8) Moderate and arbitrate in the interest of the company as a whole, in situations of conflict between management and shareholder's interest.

III. Duties:

The independent directors shall—

1) Undertake appropriate induction and regularly update and refresh their skills, knowledge and familiarity with the company;
2) Seek appropriate clarification or amplification of information and, where necessary, take and follow appropriate professional advice and opinion of outside experts at the expense of the company;
3) Strive to attend all meetings of the Board of Directors and of the Board committees of which he is a member;
4) Participate constructively and actively in the committees of the Board in which they are chairpersons or members;
5) Strive to attend the general meetings of the company;
6) Where they have concerns about the running of the company or a proposed action, ensure that these 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;
7) Keep themselves well informed about the company and the external environment in which it operates;

8) Not to unfairly obstruct the functioning of an otherwise proper Board or committee of the Board;
9) Pay sufficient attention and ensure that adequate deliberations are held before approving related party transactions and assure themselves that the same are in the interest of the company;
10) Ascertain and ensure that the company has an adequate and functional vigil mechanism and to ensure that the interests of a person who uses such mechanism are not prejudicially affected on account of such use;
11) Report concerns about unethical behaviour, actual or suspected fraud or violation of the company's code of conduct or ethics policy;
12) Acting within his authority, assist in protecting the legitimate interests of the company, shareholders and its employees;
13) Not to disclose confidential information, including commercial secrets, technologies, advertising and sales promotion plans, unpublished price sensitive information, unless such disclosure is expressly approved by the Board or required by law.

IV. Manner of appointment:

1) While selecting independent directors the Board shall ensure that there is appropriate balance of skills, experience and knowledge in the Board so as to enable the Board to discharge its functions and duties effectively.
2) The appointment of independent director(s) of the company shall be approved at the meeting of the shareholders.
3) The explanatory statement attached to the notice of the meeting for approving the appointment of independent director shall include a statement that in the opinion of the Board, the independent director proposed to be appointed fulfils the conditions specified in the Act and the rules made thereunder and that the proposed director is independent of the management.
4) The appointment of independent directors shall be formalised through a letter of appointment, which shall set out :

    (a) the term of appointment;
    (b) the expectation of the Board from the appointed director; the Board-level committee(s) in which the director is expected to serve and its tasks;
    (c) the fiduciary duties that come with such an appointment along with accompanying liabilities;
    (d) provision for Directors and Officers (D and O) insurance, if any;
    (e) the Code of Business Ethics that the company expects its directors and employees to follow;
    (f) the list of actions that a director should not do while functioning as such in the company; and
    (g) the remuneration, mentioning periodic fees, reimbursement of expenses for participation in the Boards and other meetings and profit related commission, if any.

5) The terms and conditions of appointment of independent directors shall be open for inspection at the registered office of the company by any member during normal business hours.
6) The terms and conditions of appointment of independent directors shall also be posted on the company's website.

V. Re-appointment:

The re-appointment of independent director shall be on the basis of report of performance evaluation.

VI. Resignation or removal:

1) The resignation or removal of an independent director shall be in the same manner as is provided in sections 168 and 169 of the Act.
2) An independent director who resigns or is removed from the Board of the company shall be replaced by a new independent director within a period of not more than one hundred and eighty days from the date of such resignation or removal, as the case may be.
3) Where the company fulfils the requirement of independent directors in its Board even without filling the vacancy created by such resignation or removal, as the case may be, the requirement of replacement by a new independent director shall not apply.

VII. Separate meetings:

1) The independent directors of the company shall hold at least one meeting in a year, without the attendance of non-independent directors and members of management;
2) All the independent directors of the company shall strive to be present at such meeting;
3) The meeting shall:
   (a) review the performance of non-independent directors and the Board as a whole;
   (b) review the performance of the Chairperson of the company, taking into account the views of executive directors and non-executive directors;
   (c) assess the quality, quantity and timeliness of flow of information between the company management and the Board that is necessary for the Board to effectively and reasonably perform their duties.

VIII. Evaluation mechanism:

1) The performance evaluation of independent directors shall be done by the entire Board of Directors, excluding the director being evaluated.
2) On the basis of the report of performance evaluation, it shall be determined whether to extend or continue the term of appointment of the independent director.

Liability of Independent Director

Section 149(12) provides that, notwithstanding anything contained in this Act, an independent director; a non-executive director not being promoter or key managerial personnel, shall be held liable, only 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 where he had not acted diligently.