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Evolution and Effectiveness of Independent Directors in Corporate Governance

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Abstract

An independent director is a special director appointed to the board of a company who is expected to have expertise in any particular field of marketing and other allied streams and who plays the role of a non-executive director of that particular company. This article documents the rationality behind the introduction of the concept of independent directors on the company board and also presents the evolution of the same from the events that occurred in the USA and UK. The article also discussed the incorporation of the concept of independent directors in the Indian system. It has been seen that diffused shareholding in US and UK plays an important role in checking the managers in their functioning. The corporate governance models differ according to the convictions and laws of different countries in which they are to be practiced. The incorporation of the concept of independent directors in India without taking the Indian corporate structure into consideration may result in undesired outcomes. However, this article collects and presents the various aspects of the incorporation of independent directors in Indian corporate governance. The article effectively discussed the difference and various aspects of corporate governance in different countries like the United Kingdoms, United States, Japan, etc and compared it to the Indian system. This current also discussed the 1997 Asian financial crisis and the role Kumar Mangalam Birla committee played during 1998, formulating the National code on corporate governance in 1999 which is the basis of the formation of the Securities and Exchange Board of India (SEBI).

Disciplinary: Corporate Governance.

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1 Introduction

An independent director in a public listed company comprises a person who is having expertise in any particular field of marketing and other allied streams and who plays the role of a non-executive director of that particular company (Heracleous, 2001). The responsibility of a director incorporates adding to the credibility and governance standards of the company (Leblanc et al., 2003)). It is a mandatory factor here that he or she cannot hold any kind of relationship with the company which might alter or hinder his judgment, which needs to be unbiased yet practical (Levrau & Berghe, 2007). An independent director can be any person having sufficient skills, experience and adroit knowledge in one or more fields of marketing, finance, legal matters, management, administration, research, corporate governance and other similar streams that might be related to the business of the company. Listed companies can have at least a third of the total number of directors under the category and in the case of unlisted public companies, at least two such directors are mandatory (Shleifer & Vishny, 1997).

An independent director acts as the counsel and the mentor to the company. Major roles include enhancing corporate credibility and governance standards by holding accountability on who also is selected or elected to the board and playing a vital role to play in risk management. Their role is multi-disciplinary where they are active participants of various committees formulated by the company for ensuring good governance (Nguyen and Nielson. 2010)

There are two purposes of this article: (i) to identify the rationale for the emergence of independent directors by tracing their evolution in the U.S. and the U.K. where they originated; and (ii) to examine the transplantation of that concept into India with a view to evaluating the effectiveness of independent directors in that country.

2 Incorporating the Independent Director in India by SEBI

The papers that are reviewed above which imply that an independent director is a person who is a non-executive director in a company and is discrete without having any relationship with the company so that the judgments can be unprejudiced and evenhanded. In the context of India, guidelines that need to be followed for the appointment of independent directors have been compiled in section 149 of The Companies Act 2013 (Companies Act (2013)) which should be considered along with rules 4 and rule 5 of the Companies Rules (appointment and qualification of directors) 2014. Section 149 (6) states that an independent director of a company is the one who is apart and aloof from a managing director/whole-time director/nominee director. An independent director is also a person having no relatives related to the company in any way – like security holding (with exceptions); he or his relative doesn’t form any part of the workforce of the company or is not in any managerial position for 3 immediate residing financial years (special rebates under certain conditions allowed) (Varma, 1997).

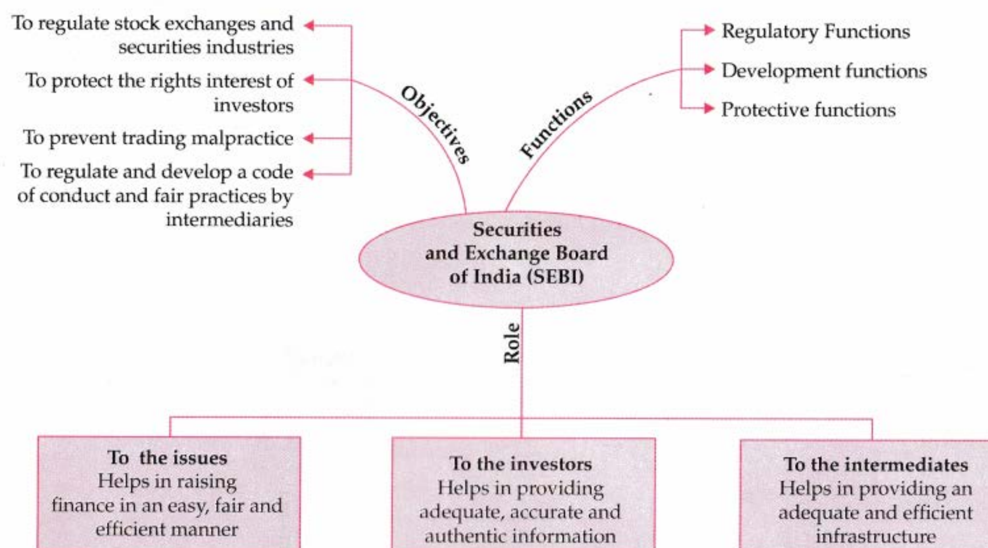

Figure 1: The Objectives, functions and roles of SEBI, India

The US model of corporate governance has significant failures and is not appropriate for a developing economy like India. The Indian industry going hand in hand with SEBI has learned a lot from parallel jurisdictions (which comprise the outsider system) like Cadbury report from UK (Cadbury, 2000) and SOX (Sarbanes – Oxley Act) report from the US to ensure that the most efficient factors and functions can be incorporated into India's growing corporate system. The external concept of independent directors, having a certified CEO or CFO and audit committee needs to be fully implemented with the insider concept of India where regulators, industry, courts, and academia hold their own importance and relevance (Butler, John, Louis Goldberg and Edmond FitzGerald, 2004). It was felt that assimilation and transplantation (25) of these corporate governance measures must happen in Indian corporate ethos which was also verified by clause 49.

3 Comparison of American and UK Model

The corporate governance models differ according to the convictions and laws of different countries in which they are to be practiced (Black et al., 2010). As a result, different models with flexible levels of accountability and disclosure requirements are prevailing. But according to Solani (2005) when organizations plan to step into the international market the major assumed conviction of the stakeholders that become afloat is that their interests are secured and corporate governance will look after various levels of interest (Solani, 2005). A comparison of US and UK models will lead to a better understanding of different kinds of systems active in the world of corporate business (Butler et al., 2004).

The US model or it may be called the Anglo-American model nurtures its various branches of shareholders or directors or/and management personnel (Kaen et al., 1999). The basic framework of the Anglo-American model comprises a system where shareholders elect representatives who are called non-executive directors and who frame the Board of Directors. But this is not universal and can be customized according to the needs because sometimes this board contains both executive

and non-executive directors (Monks et al., 2004). And at another instance the CEO functions as the chairman of the board thus a CEO/Chair duality gets created, and the formation of other functional communities like audit/ nomination/and compensation communities follows. There are certain golden rules of governance which include elements of ethics, strategic management, etc. that need to be followed so that corporate governance becomes efficient for running the business in the country (Oxera Consulting Ltd., 2006).

The beginning of the 21st century hit hard in the US bringing in failures of business entities and business persons in the 2000s. This void made space for Sarbanes - Oxley Act in 2002. This was a much-revised and modern act that took care of the flowers present in the Securities acts of 1933-34; along with came particular amendments and revisions in accordance with the legislature to reincarnate the framework of corporate governance in US (Meier & Meier, 2014).

4 Comparison between US & UK

The idea of a corporate governance code was born in the UK after the work of the Cadbury committee conducted by Sir Adrian Cadbury. The results popularly known as the Cadbury code are one of the best practices used globally with some modifications depending upon the company or country. This can be called the mother of corporate governance (Barnett et al., 2008). It was followed by a trail of various committees formed globally differing on varied principles of corporate governance but we can broadly categorize corporate governance models prevailing in the world under 2 sub-headings which are as follows:

1. Anglo-American model
2. Non-Anglo-American model

Anglo-American model - Another name for it is SWM model (Shareholders' Wealth Maximization model). It further bifurcates into Liberal and Coordinate models. The liberal model is usually seen in Anglo-American Nations and it preserves the interest of shareholders. Also, this is the most popular model and its codes have been seen established both in the US (Hsu, 2010) and the UK. On the other hand, the coordinated model is found in Japan, Europe, etc. and it lays more emphasis on upholding the interest of the workforce, managerial staff, clients, suppliers and community. These being developed countries, exploration of new aspects of corporate governance is well afforded rather to stick to its basic principles (Barnett et al., 2008).

Countries in Southeast Asia (Bhagat & Black, 2000) are developing economies and less capitalistic in nature; such countries are experiencing transformation on business and political fronts. In these countries which are mostly socialistic in nature, the non-Anglo-American model also called Corporate Wealth Maximization (CWM) prevails and this is the one which is found in India too (Balasubramanian et al., 2008). This kind of system is mainly based on 4 prerequisites which can be inked as:

1. The Quality and the dispersal rate of information ought to be convenient.

2. Individuals should get sufficient timekeeping and accountability in a company with enhanced autonomy.

3. Better hierarchical organization needs to be put into practice to watch upon wrongdoings of private companies.

4. Role of the state in regulating and selecting apt government officials should be sincerely played.

5 Corporate Governance in India

The corporate governance boards in India do not enjoy the powers vested by their similar counterparts in Western countries because in India the board is subordinate to the will of the dominant shareholder. The article, here, presents the comparison between various global practices of corporate governance with clause 49 of the stock exchange listing agreement prevailing in India (SEBI. (2004)).

In the year 1997 Asian financial crisis that was born in Thailand quickly disseminated in countries of South East Asia and Japan resulting in the depreciation of currencies, stumbling down of stock markets &asset prices, and enormous dept intensification. This incident was responsible to sow the seed of an organized framework like corporate governance in these countries. Hence, in 1998 CII (Confederation of Indian industries) started working in India on this concept and this attempt was followed by the Kumar Mangalam Birla committee (Securities and Exchange Board of India 2000) which formulated the National code of corporate governance in 1999. And it is on the basis of this that the Securities and Exchange Board of India or SEBI (SEBI. (2004)) came up with clause 49 in 2000 and it contained the listing agreement of stock exchanges. Clause 49 is also known by the name corporate governance clause.

The emergence of corporate governance is not year specific. It rather began after the Cadbury code of the UK earned its success and repute. The most acceptable explanation for this step in the US was that the corporate governance code swiftly made its way through amendments in the already existing legal framework of the US (Black & Kim, 2010).

In the US many different bodies like Security and Exchange Commission (SEC), New York Stock Exchange etc. actively play a part in governing US-listed companies; and two types of levels that are federal and unitary are regulated by their own set of corporate law governing organizations. Hence it can be concluded that in the US owing to its multiple applicability the set of rules needs to be tailored. After the downfall of gigantic corporations like Enron, Xerox, etc. the need to put up a regulatory body to take care of US security loss was desperately felt as the economist believed that the hazardous failure was an alarm to the stakeholders in the security market and future of capitalistic societies which were otherwise independent. This necessity gave birth to reforms that were meant to clear the dilemma of the investors in the US-listed companies (Black & Kim, 2010).

A parallel situation was being lived in India in 1992 when after the Security Scam the investors and stakeholders were feeling devastated and handicapped. Both in India and US, the board of directors is a single-handed body where all directors enjoy uniform powers and who are equally and legally responsible to look after the business of the company but in India J.J. Irani Committee on Companies Act, 1956 stated that differentiating liabilities of directors should be governed by an exclusive and separate set of rules according to the need. So, it can be seen that the US is more liberal and uniform when it comes to deciding the role of directors on the role of the board but in India prevails a well-documented and explanatory role in respective laws (Jackling and Johl, 2009).

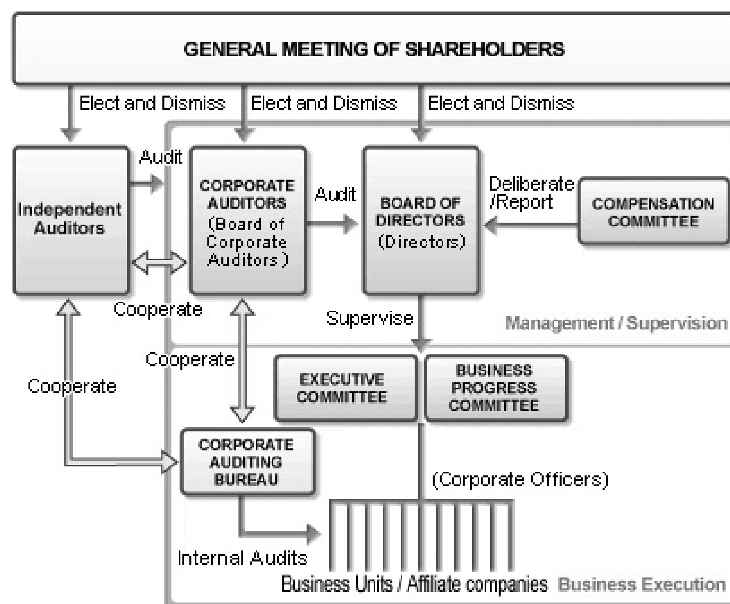

Figure 2: The structural flow of corporate governance in India

6 Effectiveness Of Independent Directors in India

Independent directors can play an important role provided they have autonomy and the opportunity to make decisions that favor the interest of minority shareholders. A detailed study on Infosys company unveiled that Infosys has 8 independent directors and their role gets reflected in the corporate governance practices of that company. Another example taken from Wang Peng 2010 discloses that independent director represents the interests of all shareholders of the company and so their decision should be discrete and objective, should also be impartial and should not reflect trade or relationship influence with any company or person (Murugan, 2018). Therefore, the primary focus of an independent director is always the welfare of the company. Along with accompanying the assurance that the rights of each person associated with the company shall be protected but the interest of the company always stands at first preference. Thus, an independent director is skillful/experienced with the power to take independent decisions that prove virtuous for both the company and the shareholders (Varottil, 2009-2010).

7 Evaluation of Recent Reforms

Reforms in Indian Corporate governance will be effective only after the concept of proportional representation becomes active (by whatever means like cumulative voting or selective voting by only minority shareholders by only minority shareholders).

As per the requirements of the Indian context, there should be one-third or a half majority of independent directors in a board but the problem that springs up here is that if an entire set of independent directors is appointed by "the majority of minority then it will result into abuse by minority" (de Geus, 1997). In absence of provisions (to ensure participation of minority shareholders), by the nomination committee, these reforms were made by SEBI in 2013 that incorporated concepts from other jurisdictions like Italy the idea of appointment of independent directors by minority shareholders was picked up; while from the UK the regulator concept that allowed twin voting which means appointment of independent directors should be through the consent of shareholders as a whole and independent shareholders on an individual basis. Initially, in India, there was no parameter to quantify the level of qualification or experience that should be possessed by a person at the time of appointment to effectively discharge the duties of an independent director. This flaw allowed the companies to appoint people who were rendering satisfying services but did not fit in the job (Varottil, 2010).

8 Future Prospects for Independent Directors In India

The Future prospects of independent directors in India are also reviewed extensively. Independent directors are the need of the hour by listed companies where their liabilities are gaining much work in the eyes of people and hence at the time of disparity the stakeholders lookup towards the independent directors for their salvation and savage of their interests. According to the new rules that should take effect from the year 2022, both the appointment and dismissal of independent directors can happen only by means of a special resolution that gathers the required number of votes from the shareholders. This new rule was brought into action to abolish the role of the promoter in the above process. (Pande & Ansari, 2013; Murugan, 2018).

At least one annual meeting has been made mandatory so that the independent directors get a fair chance to let them get heard on issues of concern. Despite all the powers vested to the independent directors the incidences where they came up to prove their mettle can be just counted on fingers (Pande & Ansari, 2013). They get all the support from SEBI and other stakeholders so it is suggested that the independent directors understand their role to protect companies' interests through they are sagacious decisions that need to be taken and implemented when they are needed the most. Independent directors should not just linger away waiting for the appropriate time to happen but they should act and arrange things in such a manner that agonizing and hurtful incidences are reduced to their minimum (Hora, 2017; Batth et al., 2016).

9 Conclusion

Corporate governance is more sustainable and broader and corporate law is just a sub-branch from it. It aims to achieve maximized long-term shareholder value and keep the company transparent. Supervising the company and letting it run according to the guidelines of law is just one of its appendages. Those who support corporate governance are called claimants. The Kumar Manglam Birla committee had very well absorbed that because investors and shareholders are the prime ingredients of SEBI, hence suggested recommendations to strengthen their bond with the company. The niche of corporate governance cannot be regulated and controlled with the tool of law alone because it is an ever-changing and dynamic system. It cannot be static and stagnant. Along with technological advancements and ever-increasing competition, the physical parameter of distance has been wiped out by a great percentage and means of communication have taken the entire concept to a newer and higher level. Its impact on India cannot be overlooked because India is one country that despite its cultural diversity is always ready to go by the flow, adapt, evolve, and shine. According to the Kumar Manglam committee if India absorbs its suggestions and recommendations then undoubtedly India will become attracting loads of domestic and international capital. And the suggestions will assist and support the corporate governance structure in India to mold according to the requirements of the new millennium.

10 Availability of Data and Material

All information is included in this study.

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