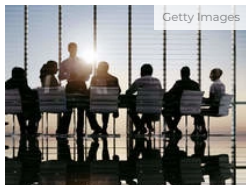


Independent directors: Sebi lesson for proxy advisers

Synopsis

How the SEBI consultation paper on appointment of independent directors is likely to impact recommendations by proxy advisers, as India Inc gears up for the annual general meeting season in the next quarter.



Independent directors are often seen as the vanguards of shareholders, especially minority shareholders in the corporate boardroom. They hold a fiduciary position, which is critical to corporate governance. Proxy advisors (PAs), on the other hand, stand guard for their clients which are typically institutional investors and provide voting recommendations, as for and against the resolution, after vetting the subject matter of shareholder resolutions of a company.

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Given the significant role played by independent directors, resolutions related to their appointment and reappointment undergo greater scrutiny at the hands of proxy advisors, who provide voting

recommendations.

This article analyses how the recent **Securities and Exchange Board** of India (Sebi) **consultation paper** titled 'Consultation Paper on Review of Regulatory Provisions related to Independent Directors' issued on 1 March 2021 to solicit views from the public by 1 April 2021 (**SEBI** Consultation Paper) is likely to impact recommendations by **proxy advisers**, as **India Inc** gears up for the annual general meeting season in the next quarter.

The Sebi Consultation Paper

The SEBI Consultation Paper focuses on almost all aspects of IDs and in a way suggests a 360-degree overhaul in all aspects pertaining to the role an ID plays at a company, right from eligibility to appointment/ reappointment, removal, resignation and remuneration to the participation of IDs in board committees. The Sebi Consultation Paper is indicative of the pro-active role of the regulator in streamlining the legal regime vis-à-vis independent directors in India. The key takeaways are listed below:

Definition of independent directors

Restriction on key managerial personnel or employees of promoter group companies, and their relatives from being appointed as IDs in the company, unless there has been a cooling period of 3 years.

The appointment and reappointment process of independent directors

Appointment and re-appointment, by way of ordinary and special resolution, respectively, is based on dual approval of shareholders as well as 'majority of the minority' (simple majority) shareholders minus promoter and promoter group shareholders, in a single voting process and meeting.

In case such a resolution is not passed, either the same person is proposed after a cooling period and within the window of 90-120 days or an altogether new candidate is proposed.

There is a dual approval mechanism for removal, and in case such a resolution is not passed, re-tabling the proposal after a cooling period, both processes are similar to the suggested process for appointment and re-appointment of independent directors.

Exchanging and bringing in more transparency in the role of nomination and remuneration committee

The nomination and remuneration committee will constitute 2/3rd independent directors.

Process for shortlisting of candidate identification and recommendations

Disclosure in the notice for appointment of independent directors is sent to shareholders to include skills and capabilities of candidate proposed for appointment as ID along with explanation on how the candidate is suited for the requirements of the company, as well as channel used for searching the candidates.

Prior approval of shareholders for appointment of independent directors

Appointment of independent directors by board follows prior approval of shareholders at a general meeting. In case of an appointment to fill casual vacancy, approval of shareholders is needed within three months.

In case an independent director resigns, the resignation letter has to be disclosed along with a list of their present directorships and memberships. If the independent director resigns for reasons like preoccupation, other commitments or personal reasons, a mandatory cooling off period of 1 year is needed before the person can join the board of any other company.

Composition of the audit committee

The audit committee will constitute of 2/3rd independent directors and 1/3rd non-executive directors, who are not related to the promoter, including a nominee director, if any.

Review of remunerations

Open ended suggestion to explore granting of employee stock option plans ("ESOPs") with long vesting period of 5 years to independent directors and a possible maximum limit of remuneration through ESOPs, instead of profit linked commission.

How does this impact recommendations of proxy advisers?

A proxy adviser would, at times, apply standards that are more rigorous than the bare minimum legal requirement. This is the reason why the Sebi circular titled 'Procedural Guidelines for Proxy Advisors' dated 3 August 2020, requires proxy advisers to disclose in their recommendations the legal requirement vis-à-vis higher standard that has been applied and the rationale behind the recommendation of higher standards.

In terms of existing higher standards adopted by the PAs operating in India

Media reports have shown that in the past, wherever a proxy adviser had asked shareholders to vote against the resolution proposing appointment of a family member of a previously tenured independent director to the post of independent director of the company. The rationale for such recommendation was not based on the merit of candidate recommended but was linked with affinity of the family member(s) and relative(s) with the company and inter alia the possibility of gratification.

On similar lines, as a matter of internal charter policy, namely Proxy Voting

be financial or personal or otherwise that a reasonable person would conclude potential influence on objectivity to hamper the director's individual ability to satisfy requisite fiduciary standards), either directly or indirectly, to the company (other than a board seat) or the dissenting significant shareholder.

Another PA based on its self-adopted 'Proxy Advisory Guidelines', examines the relationship/ association of the proposed candidate with the company, promoters, other directors, senior management or holding company, subsidiaries and associates, to ascertain independence and assess independent decision making capacity based on proposed candidate's conflict of interest. Flags are also raised as to in the instance there are any pecuniary relationship(s) other than the director remuneration involved. The PA does not favourably view the appointment of a partner/ proprietor of a consultancy/ law firm as independent director, where the company avails services from such entity.

Another higher standard typically adopted is recommending against a candidate who has been a part of two or more board failures, as repetitive board crises are indicative of ineptitude.

Attendance of an independent director at the board and committee meetings is also a higher standard adopted in the voting recommendation by the proxy advisers, as a reflection of how proactive the director is and the level of involvement and engagement with the company.

Other factors for consideration are inter alia board interlock/ cross linkages across multiple boards, former and/ or prolonged association with company/ promoter/ promoter group, representative of large shareholders/ lenders, reputation risk and inexperienced family members/ relative proposed to be appointed.

The aspects discussed in the Sebi Consultation Paper, which are most relevant for proxy advisers while compiling voting recommendation are the suggestions relating to eligibility, appointment and reappointment as well as disclosure relating to candidature in the notice for meeting, especially the statement of the company reasoning the suitability of candidate proposed to be independent directors. In lines with the existing higher standards, the proxy advisers can now inter alia recommend against the appointment of a candidate, who has ties with the promoter or promoter group, as an independent director, with greater vigour.

The other relevant aspect would be the suggested reconstitution of the nomination and remuneration committee as well as the audit committee. Typically, the proxy advisers make a note of the legal compliance for constitution of board committees. The suggestions in the Sebi Consultation Paper provide a basis for the PAs to suggest investors to engage in conversation with the company for strengthening its corporate governance by imbibing suggestions in the Sebi Consultation Paper.

Conclusion

Although, the suggestions in the Sebi Consultation Paper have not taken the form of law yet, and are at the public scrutiny review level, the fact that such suggestions have been recommended by the market regulator are enough to be adopted as higher standards by proxy advisers and institutionalised as a factor while arriving at the voting recommendation. This is expected to inter alia streamline appointment of independent directors, given the rigorous level of scrutiny a candidate shall now be subject to at the hands of the proxy advisers analysing the appointment resolution. This should hopefully result in truly

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