

# INDEPENDENT DIRECTORS ARE FOR SMALL INVESTORS

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In a society plagued with corruption and malpractices, are we not being unrealistic to expect a very small sub-section-that of the listed companies-to behave ethically? As our economy matures and as we globalise, there is an urgent need to put in place systems of checks and balances to ensure fair play in all areas. Clause 49 is a right move in this direction. Morality and ethics cannot be mandated, yet corporate governance regulations should not turn into just an exercise of check boxes. It is in this context that external oversight in the form of independent directors can make a significant contribution to better governance. Several listed companies have already demonstrated so.

SEBI's deadline of December 31, 2005 mandating that 50 per cent of the board of directors of all listed companies should comprise of independent directors is now over. Without the benefit of information, it would still be safe enough to presume that most companies would have beaten the guideline by getting such people on board who are within their "control"-like friends and relatives, qualified or not. Compliance was necessary, as SEBI had warned of stern measures against companies for non-compliance which will become a "continuing offence" with a fine for each day of the offence. However, very soon, as information flow begins, it would be known how many companies did finally comply with this guideline, but more importantly, whether the compliance has been just in letter or also in spirit. It is certain that the regulators, media and investors would get down to analyzing how Corporate India went about fulfilling this mandate.

Why was SEBI so adamant on not extending the deadline? Because this issue has been debated enough - for as long as five years, including fine-tuning of the guidelines by a committee headed by Infosys founder

N.R.Narayana Murthy, which had charted out various corporate governance rules for companies, including specifying the number of independent directors on their boards.

The issue of independent directors should be seen against the background of several financial scandals globally involving listed companies, which alerted the regulators. In 2003, both NYSE and LSE made it mandatory for boards of listed companies to have at least half of their directors to be independent (earlier one-third). Let us look at it another way. If a company accepts outside shareholders (because that suits it as they provide it with funds), where is the logic of not accepting outside directors who would essentially look after the interests of the outside shareholders? Independent directors, in fact, are substantially about small investor protection.

For decades, we in India have witnessed a blatant pursuit of private gains by a majority of promoters. The root of evil, in fact, starts in most companies at the time of the promotion of the company in the form of promoter's contribution. As most know, this comes from over-invoicing, fund rotation, and from sundry entries. While all kinds of disclosures have been mandated, no one has ever asked the source of promoter's contribution. Once having raised public money, the promoters treat companies as their personal fiefdoms. All and sundry expenses are booked on the company and disguised very well to pass all tests of propriety. All actions are done to maximize the gains for the promoters, the gains to the public investors are at best incidental. When personal gains to promoters override, the companies go sick. Our laws unfortunately result in sick companies but never poor promoters!

Little wonder, the major opposition to the concept of independent directors has come from the companies

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themselves, and very strongly from the 'old generation' companies. They surely do not want 'strangers' on their boards. They present an argument, though untenable, that an outside director may actually be harmful as his knowledge is limited to the few meetings and he may, just to prove a point, stall even good policies. The reality is that most companies have more to hide than tell and hence the opposition.

The corporate arrogance is in fact disturbing. Though clause 49 which is all about better governance is now in place, many corporates are not even willing to acknowledge it. Look at the plethora of malpractices which have abounded even during the run up to the deadline...for example, several undeserving companies splitting shares, publishing bloated unaudited quarterly results, indulging in insider trading.

In fact, to stall the SEBI's mandate, a ridiculous argument did the rounds for over a year, mainly from some industry associations- obviously on behalf of the companies they represent- that there is a paucity of qualified/trained independent directors. The truth is that there is enough talent in the country, and there are thousands of professionals who are both willing and qualified. The problem surely has been how to find them. A few months ago, the National Foundation for Corporation Governance had asked the apex chambers and professional bodies to prepare a database of independent directors. Nothing much happened thereafter.

A new website, [primedirectors.com](http://primedirectors.com) (with which the author is involved) thwarts the ground that there are not enough professionals. More importantly, the website addresses the core issue of how to reach out to the professionals to get them on the boards. Presently, companies can only contact persons known to them or through word-of-mouth, thereby limiting the horizon. On the other hand, interested professionals do not know how to let the listed companies know about themselves and get invited. This website is a free-of-charge platform both for the professionals to enroll and for the listed companies to reach them.

The response to this website has been overwhelming. As on 26 December 2005, profiles of 7386 professionals have already been hosted on the website. Profiles of another 5033 professionals are currently being processed, bringing the total to 12419. In addition, on an average 75-100 new enrolments are taking place every day.

The professionals who have enrolled are not only from the corporate world; they represent very diverse streams ...from defence to railways and from academics to research. A review of the profiles already hosted on the website show that some very eminent persons have enrolled. This includes retired/existing chairman/CMD of BSRB, BIFR, CBDT, CERC, MRTPC, Canara Bank, Dena Bank, CIBIL, EXIM Bank, Federal Bank, IDBI, IFCI, New India Assurance, NHB, PNB, PSB, SBICAP, UCO Bank, United Bank of India, BEML, CMC, Coal India, Cochin Shipyard, Goa Shipyard, Hindustan Photo Films, HMT, IDPL, Lubrizol, MSEB, MTNL, NALCO, NFL, Paradeep Phosphates, PEC, RCF and STC.

It also includes retired/existing managing directors of BSE, CDSL, Centurion Bank, ICICI Venture Funds, LIC, State Bank of Hyderabad, SBI, State Bank of Mysore, UTI Securities, Akzo Nobel, Bakelite Hylam, Berger Paints, Birla Yamaha, Business India, Carrier Aircon, Delphi Automotives, Eicher, Electrolux Kelvinator, GEC Alstom, GHCL, Haldia Petrochemicals, Hindustan Dorr Oliver, Mangalore Chemicals, Mukand, Otis Elevator, Singer, SOL Pharmaceuticals, HAL, HPCL, Mumbai Railway Vikas and SAIL.

In addition, there 170 are professors of IITs/IIMs/IISc, several IAS officers (in all 229 are retired civil servants), UN experts, Army Generals/Air Marshalls, IT Commissioners, Ministers, Ambassadors and even one Governor. Significantly, 299 professionals already hold 475 independent directorships.

A further analysis shows that the quality of professionals who have submitted their profiles is very high. For example there are 375 IIM graduates, 2217 engineers of whom 589 are from IITs, 90 from BITS and 40 from IT-BHU, 665 graduates from foreign universities including Stanford, Wharton, Sloan, Harvard and Kellogg, 2224 chartered accountants, 960 company secretaries, 394 cost accountants, 1162 lawyers and 91 medical doctors. As many as 616 hold Doctorates. Interestingly, 157 professionals are based in 119 foreign cities.

The real hurdle in getting professionals, of course, is the harassment on account of matters on which the independent directors have no control. This includes the practice of some government departments to issue notices to all directors for any lapse of default by the company. There is now some relief from the Supreme

Court...independent directors would no longer be liable under section 138 for dishonoured cheques.

A question has often been raised if there can ever be truly 'independent' directors. Typically, only such directors are invited to the boards as are known to the promoters. The 'independence' may thus get compromised, compounded by high remuneration. This is expected to be reversed with the increasing review and accountability of independent directors, as they would safeguard their own reputations and to ensure they do not get into "compromising positions".

As we go forwards, independent directors would be expected to ensure that the promoters do not enrich themselves in any wrongful manner. They would be essentially required to ensure compliance, prevent malpractices and take action in the interests of the non-promoter shareholders. Thus, it is important not only to have independent directors but also have them in a sufficient number to exert an influence.

Significantly, as the markets mature and as more questions are asked, more and more companies would increasingly realize that good governance makes good business sense and would become more serious about independent directors. There would be an admittance by the companies of the reality that if they have to have independent directors (even as a "necessary evil"), they may as well get professionals who would, with their expertise, not only add value to their companies but also build confidence among the existing shareholders and potential investors, which can also help in raising capital. They would realize that it is better to fill board positions by persons unknown to them but who are professionals rather

than with people who are known to them but are unqualified. The question of remuneration, of course, is a ticklish one – it ought not to be so low as to disinterest competent persons from accepting board positions, nor too high to impact their independence.

On another front, we should recognize that in companies where the promoters hold 60 or even 80 per cent holdings, corporate governance is a difficult aim. Public holding continues to be miniscule so the public cannot exercise much pressure. There is hardly any shareholders' activism. India has just 8 investor associations...and all very small. The answer lies in dispersal of shareholding. It is when institutional and other investors take a substantive stake that corporate governance can become meaningful. Corporate lenders have failed in ensuring corporate governance; equity investors have however been very successful. In this context, it may be mentioned that 86 per cent of the US equity assets and over 20 per cent of the world equity assets are owned by the US institutional investors. The role and responsibility of the audit firms and of company secretaries would also need to undergo a significant change. The answer also lies in exemplary punishment to errant promoters including disgorgement that would act as a deterrent to potential offenders.

Any which way, the listed corporate India would begin to change soon, forever. Clause 49 is only a beginning. The coming years would witness new levels of corporate governance in India, substantially aided by the new breed of independent directors. A time will then come when corporate governance is extended rightfully to the unlisted world, because that in India comprises over 95 per cent of the economic activity.