

CONSULTATION PAPER ON REVIEW OF REGULATORY PROVISIONS RELATED TO INDEPENDENT DIRECTORS

1. Objective

- 1.1. To solicit public comments / views on the proposals on review of regulatory provisions related to Independent Directors (IDs) on the boards of listed entities.

2. Background and rationale for review

- 2.1. The concept of Independent Directors (IDs) emerged from the need to have a certain number of directors on the Board who would think and act independently to bring about a healthy balance between the interests of the promoters and other stakeholders including minority and small shareholders. IDs are an important component in the overall framework of Corporate Governance.
- 2.2. SEBI has over the years, strengthened the institution of IDs through the recommendations of various committees. This institution has thus evolved considerably since 1999, when SEBI had first introduced the concept of Independent Directors based on the recommendations of the Committee on Corporate Governance under the Chairmanship of Shri Kumar Mangalam Birla. The latest amendments emanate from the Committee on Corporate Governance set up under the chairmanship of Shri Uday Kotak in 2017.
- 2.3. The Ministry of Corporate Affairs (MCA) also introduced the requirement of Independent Directors in the Companies Act of 2013 (“Companies Act”) and even laid down a Code of Conduct for IDs.
- 2.4. As per the Code of Conduct, IDs are expected to pay specific attention on the integrity of financial information and on related party transactions along-with safeguarding the interests of the minority shareholders. Accordingly, the Audit Committee of the board which is responsible for approving related party transactions and for oversight of the financial reporting process and the sanctity of financial information, is mandated to have at least two-third of Independent Directors. Besides, IDs are also expected to bring in independent judgement on the Board’s deliberations especially on issues of strategy, performance, risk management, resources, key appointments and standards of conduct; as well as bring an objective view in the evaluation of the performance of board and management.
- 2.5. Despite the above provisions and various measures taken, concerns around the efficacy of independent directors as a part of corporate governance framework continue. There is therefore a need to further strengthen the

independence of IDs and enhance their effectiveness in protection of the interest of the minority shareholders, and other functions.

- 2.6. In this regard, sharper focus is required in the areas of appointment and role of the independent directors. Accordingly, proposals including broadening the eligibility criteria for IDs, the process of appointment / re-appointment and removal of IDs, enhancing transparency in the nomination and resignation of IDs, strengthening the composition of Board Committees, are being placed for public consultation. Additionally, views are also sought on the need for review of remuneration of IDs.

3. Present provisions in SEBI (LODR) Regulations, 2015 (LODR Regulations)

- 3.1. The existing provisions related to IDs under LODR Regulations are placed at **Annex- 1**.

4. Proposals

4.1. Definition of Independent Directors

1. Regulation 16 of SEBI LODR Regulations set out certain objective conditions (enclosed at **Annex- 1**) for determination of independence of a director. These conditions include areas of relationship of self and of relatives (including material pecuniary relationship) with the listed entity, its promoter or directors, its holding, subsidiary or associate companies and shareholding in the listed entity.
2. One of the eligibility conditions is that persons who have been employees/ KMPs or his/her relatives have been KMPs of the listed entity / its holding company / subsidiary / associate company in the past 3 years, cannot be appointed as IDs. In order to establish the independence of the person it is important that KMPs or employees of companies forming part of the promoter group and relatives of such KMPs should also be excluded from acting as independent directors.
3. Currently, as per SEBI LODR Regulations, a cooling-off period has been prescribed for the person to be eligible for acting as an ID, *inter-alia* as follows:
 - a. Cooling-off period of 3 years in case the person has been an employee / KMP or his / her relative has been a KMP of the listed entity / its holding company / subsidiary / associate company
 - b. Cooling-off period of 2 years in case of a material pecuniary relationship between person or his / her relative and the listed entity / its holding company / subsidiary / associate company

Since, this cooling off period is not uniform, there is a need to harmonize the same.

Proposal

4. *It is proposed that KMPs or employees of promoter group companies, cannot be appointed as IDs in the company, unless there has been a cooling-off period of 3 years. The said restriction shall also extend to relatives of such KMPs for the same period.*
5. *The prescribed cooling-off period for eligibility condition at 3(b) above shall be harmonized to 3 years.*

4.2. Appointment and re-appointment process of Independent Directors

1. As per the extant regulatory norms for appointment of IDs, the Nomination and Remuneration Committee (“NRC”) proposes a person as ID, who is then appointed by the Board. Subsequently, shareholders approve the appointment through an ordinary resolution (special resolution in case of re-appointment).
2. As may be seen from the above, the present system of appointment of IDs may be influenced by the promoters – in recommending the name of ID and in the approval process by virtue of shareholding. This may hinder the “independence” of IDs and undermine their ability to differ from the promoter, especially in cases where the interests of promoter and of minority shareholders are not aligned. Additionally, considering that the primary duty of Independent Directors is to protect the interest of minority shareholders, there is a need for minority shareholders to have greater say in the appointment / re-appointment process of IDs.
3. Some jurisdictions, like Israel, have provisions for appointment of independent directors by minority shareholders. In UK, for premium listed companies which have a controlling shareholder, a dual voting structure has been adopted whereby the appointment of independent directors must be approved both by the shareholders as a whole and by the independent shareholders. If either of the resolutions fails, but the company still wants to propose the person as an independent director, it is allowed to put the matter to a second vote of all shareholders (including the controlling shareholder(s)).

Proposal

4. *Appointment and re-appointment of IDs shall be subject to “dual approval”, taken through a single voting process and meeting following two thresholds: –*
 - i. *Approval of shareholders*

- ii. *Approval by ‘majority of the minority’ (simple majority) shareholders. ‘Minority’ shareholders would mean shareholders, other than the promoter and promoter group.*

The approval at point (i) above, shall be through ordinary resolution in case of appointment and special resolution in case of re-appointment.

5. *If either of the approval thresholds are not met, the person would have failed to get appointed / re-appointed as ID. Further, in such case, the listed entity may either:*
 - i. *Propose a new candidate for appointment / re-appointment or*
 - ii. *Propose the same person as an ID for a second vote of all shareholders (without a separate requirement of approval by ‘majority of the minority’), after a cooling-off period of 90 days but within a period of 120 days. Such approval for appointment/re-appointment shall be through special resolution and the notice to shareholders will include reasons for proposing the same person despite not getting approval of the shareholders in the first vote.*

4.3. Removal of Independent Directors

1. *At present, an ID can be removed through a simple majority in the first term and through a special resolution in case of second term, after giving him a reasonable opportunity to be heard. Since, the ID may be removed through a simple majority, the promoter may have significant influence in the removal process by virtue of shareholding.*
2. *Consistent with the greater say of the minority shareholders proposed in the appointment of an ID, minority shareholders, should also be given a say in the removal process of IDs as well.*

Proposal

3. *Removal of IDs shall be subject to “dual approval”, taken through a single voting process and meeting following two thresholds: –*
 - i. *Approval of shareholders.*
 - ii. *Approval of ‘majority of the minority’ (simple majority) shareholders. ‘Minority’ shareholders would mean shareholders, other than the promoter and promoter group.*

The approval at point (i) above, shall be through ordinary resolution in case of removal in the first term and special resolution in case of removal in the second term.

4. *If either of the approval thresholds are not met, the person would have failed to get removed as an ID. In such case, the removal of such ID may again be proposed through a second vote of all shareholders (without a separate requirement of approval by 'majority of the minority'), after a cooling-off period of 90 days but within a period of 120 days. Such approval for removal shall be through special resolution and the notice to shareholders will include reasons for proposing the removal again despite not getting approval of the shareholders in the first vote.*

4.4. Enhancing and bringing in more transparency in the role of NRC

1. At present, all members of the NRC should be non-executive, with a majority of independent directors. Further, LODR Regulations prescribe the following role of the nomination and remuneration committee (NRC) in the matter of appointment of IDs:
 - a. Formulation of the criteria for determining qualifications, positive attributes and independence of a director
 - b. Identifying persons who are qualified to become directors in accordance with the criteria laid down, and recommend to the board of directors for their appointment and removal
 - c. Whether to extend or continue the term of appointment of the independent director, on the basis of the report of performance evaluation of independent directors.
2. While the law requires NRC to lay down detailed criteria of qualifications and attributes for directors, apparently there is a lack of transparency in the process followed by NRC. There is therefore, a need to prescribe disclosures regarding the process followed by NRC for selection of candidates for the post of ID.

Proposal

3. *The following procedure shall be followed by NRC for selection of candidates for the role of ID -*
 - a. *Process for shortlisting of the candidate*
 - i. *For each appointment, the NRC shall evaluate the balance of skills, knowledge and experience on the board. In the light of this evaluation, a description shall be prepared of the role and capabilities required for a particular appointment.*
 - ii. *The person who is recommended to the Board for appointment as ID should have the capabilities identified in this description.*

iii. *For the purpose of identifying suitable candidates, the committee may:*

- *Use services of an external agencies*
- *Consider candidates from a wide range of backgrounds, having due regard to diversity and*
- *Consider the time commitments of the appointees*

b. *Disclosures to be made to shareholders*

The notice for appointment of director shall include the following disclosures:

- Skills and capabilities required for the appointment of the ID and how the proposed individual meets the requirement of the role.*
- Channels used for searching appropriate candidates. In case, one of the channels is 'recommendation from a person', the category of such person (viz. promoters, institutional shareholders, directors (non-executive, executive, ID) etc) shall be disclosed.*

4. *Composition of NRC may be modified to include 2/3rd IDs instead of majority of IDs.*

4.5. Prior approval of shareholders for appointment of IDs

1. As per the current practice, companies appoint independent directors as additional directors, subject to approval of the shareholders at the next general meeting. It is therefore possible that a person gets appointed as an additional independent director, just after an AGM and then serves on the board of directors, without shareholder approval, till the next AGM.
2. In the case of vacancy of an Independent Director due to resignation or removal, existing provisions provide a time-period of up to 3 months to appoint another director. However, the approval of shareholders would be taken at the next AGM, which could potentially be up to another 9 months away.
3. As mentioned above, there can be a significant time gap between the appointment of an independent director and approval of shareholders, which is not in the best interest of especially the minority shareholders. There have been cases in the past where the shareholders have rejected the appointment of IDs while these IDs had served on the Board for few months.

4. Reduction/ elimination of this gap may give more say to shareholders in the appointment process.

Proposal

5. *Independent Directors shall be appointed on the board only with prior approval of the shareholders at a general meeting.*
6. *In case, a casual vacancy arises due to resignation / removal / death / failure to get re-appointed etc., the approval of shareholders should be taken within a time period of 3 months.*

4.6. Resignation of Independent Directors

1. As per current provisions of LODR, the resigning ID within 7 days of his resignation, has to disclose to stock exchanges, detailed reasons for the resignation along-with a confirmation that there is no other material reason for resignation other than those already provided.
2. It is observed that IDs often resign for reasons such as pre-occupation, other commitments or personal reasons and then join the boards of other companies. There is, therefore, a need to further strengthen the disclosures around resignation of Independent Directors.
3. Cases have also been observed where IDs have resigned and then joined the same company as an executive director. While there may be valid reasons for transition from an ID to executive director, such instances where an ID knows that he/she may move to a larger role in the company in the near future, may practically lead to a compromise in independence.

Proposal

4. *The entire resignation letter of an ID shall be disclosed along with a list of his/her present directorships and membership in board committees.*
5. *If an ID resigns from the board of a company stating reasons such as pre-occupation, other commitments or personal reasons, there will be a mandatory cooling-off period of 1 year before the ID can join another board.*
6. *It is proposed that there should be a cooling-off period of 1 year before a director can transition from an ID to a whole-time director.*

4.7. Composition of the Audit Committee

1. The LODR Regulations cast specific responsibilities on the Audit Committee (two-thirds of its members are independent directors), to review financial statements, scrutinize inter-corporate loans & investments and valuation of undertakings and assets of the listed entity, wherever applicable. In case of related party transactions, prior approval of the Audit Committee is mandatory. SEBI has mandated that a committee of Independent directors should give their recommendations on open offers and schemes of arrangements.

Proposal

2. *Considering the importance of the Audit Committee with regard to related party transactions and financial matters, it is proposed that audit committee shall comprise of 2/3rd IDs and 1/3rd Non-Executive Directors (NEDs) who are not related to the promoter, including nominee directors, if any.*

4.8. Review of remuneration

1. As per the Companies Act, apart from reimbursement of expenses, IDs are permitted to be paid sitting fees (max 1 lakh) and profit linked commission within an overall limit. Further, in terms of both Companies Act and LODR Regulations, IDs cannot be given stock options.
2. While there are concerns that a large remuneration may compromise the independence of ID, lesser compensation may also not attract competent IDs on the boards of the listed entities.
3. In this regard, one area of debate is removal of profit linked commission and increase in sitting fees paid to Independent Directors. This is with a view that the remuneration to IDs should be on the basis of their value and time-commitments to the company, without linking the same to the profits of the company. This would lead to IDs getting a fixed fee, without having any stake in the long-term growth of the company.
4. On the other hand, linking remuneration to profit or performance linked commission ensures that IDs have “skin-in-the-game”. The concern with this approach - that profit or performance linked commission may encourage short-termism and lead to conflicts, may be addressed by permitting ESOPs to IDs (instead of profit linked commission) with a long vesting period of say, 5 years. ESOPs are a commonly used method of remuneration for employees, especially in technology and start-up companies, since it ensures alignment of interests of the company and of the employees.

5. Since any modification in the existing remuneration structure of IDs will require changes to the Companies Act, based on the comments received and further analysis of the same, appropriate recommendations will be sent to the Ministry of Corporate Affairs (MCA) for their consideration.

Views sought

6. Whether there is a need for reviewing the remuneration structure for IDs. If so,
- Whether ESOPs with a long vesting period of 5 years, be permitted for IDs, in place of profit linked commission and
 - What should be the maximum limit of remuneration through ESOPs.

5. Public comments

Comments on the above proposals may be sent on or before April 01, 2021 in the following format:

Name of entity / person / intermediary/ Organization:			
Sr. No.	Proposal	Suggestions	Rationale

Comments may be sent:

- By email to consultationcmd2@sebi.gov.in and/or Mr. Ishan Sood, Assistant Manager, at ishans@sebi.gov.in
- By post to the following address:

Ms. Surabhi Gupta,
General Manager
Corporation Finance Department, CMD-II,
Securities and Exchange Board of India
SEBI Bhavan, Plot No. C4-A, "G" Block,
Bandra Kurla Complex, Bandra (East),
Mumbai -400 051

Annex 1: Regulatory provisions related to Independent Directors in SEBI (LODR) Regulations, 2015

1. Regulation 4(2)(f)(iii)(14): The board of directors and senior management shall facilitate the independent directors to perform their role effectively as a member of the board of directors and also a member of a committee of board of directors.
2. Regulation 16(1)(b): "Independent director" means a non-executive director, other than a nominee director of the listed entity:
 - i. who, in the opinion of the board of directors, is a person of integrity and possesses relevant expertise and experience;
 - ii. who is or was not a promoter of the listed entity or its holding, subsidiary or associate company or member of the promoter group of the listed entity;
 - iii. who is not related to promoters or directors in the listed entity, its holding, subsidiary or associate company;
 - iv. who, apart from receiving director's remuneration, has or had no material pecuniary relationship with the listed entity, its holding, subsidiary or associate company, or their promoters, or directors, during the two immediately preceding financial years or during the current financial year;
 - v. none of whose relatives has or had pecuniary relationship or transaction with the listed entity, 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 from time to time, whichever is lower, during the two immediately preceding financial years or during the current financial year;
 - vi. who, neither himself, nor whose relative(s) —
 - (A) holds or has held the position of a key managerial personnel or is or has been an employee of the listed entity 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;
 - (B) 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 —
 - (1) a firm of auditors or company secretaries in practice or cost auditors of the listed entity or its holding, subsidiary or associate company; or

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

(C) holds together with his relatives two per cent or more of the total voting power of the listed entity; or

(D) is a chief executive or director, by whatever name called, of any non-profit organisation that receives twenty-five per cent or more of its receipts or corpus from the listed entity, 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 listed entity;

(E) is a material supplier, service provider or customer or a lessor or lessee of the listed entity;

vii. who is not less than 21 years of age.

viii. who is not a non-independent director of another company on the board of which any non-independent director of the listed entity is an independent director

3. Regulation 17 (1) (a), (b), (d): The composition of board of directors of the listed entity shall be as follows:

(a) board of directors shall have an optimum combination of executive and non-executive directors with at least one-woman director and not less than fifty per cent of the board of directors shall comprise of non-executive directors;

Provided that the Board of directors of the top 500 listed entities shall have at least one independent woman director by April 1, 2019 and the Board of directors of the top 1000 listed entities shall have at least one independent woman director by April 1, 2020

(b) where the chairperson of the board of directors is a non-executive director, at least one-third of the board of directors shall comprise of independent directors and where the listed entity does not have a regular non-executive chairperson, at least half of the board of directors shall comprise of independent directors:

Provided that where the regular non-executive chairperson is a promoter of the listed entity or is related to any promoter or person occupying management positions at the level of board of director or at one level below the board of directors, at least half of the board of directors of the listed entity shall consist of independent directors.

Explanation - For the purpose of this clause, the expression "related to any promoter" shall have the following meaning:

- (i) if the promoter is a listed entity, its directors other than the independent directors, its employees or its nominees shall be deemed to be related to it;
 - (ii) if the promoter is an unlisted entity, its directors, its employees or its nominees shall be deemed to be related to it.
- (d) where the listed company has outstanding SR equity shares, at least half of the board of directors shall comprise of independent directors.
- 4. Regulation 17(2A): The quorum for every meeting of the board of directors of the top 1000 listed entities with effect from April 1, 2019 and of the top 2000 listed entities with effect from April 1, 2020 shall be one-third of its total strength or three directors, whichever is higher, including at least one independent director.
- 5. Regulation 17 (5) (a) and (b):
 - (a) The board of directors shall lay down a code of conduct for all members of board of directors and senior management of the listed entity.
 - (b) The code of conduct shall suitably incorporate the duties of independent directors as laid down in the Companies Act, 2013.
- 6. Regulation 17 (6) (d): Independent directors shall not be entitled to any stock option.
- 7. Regulation 17A (1) and (2):
 - (1) A person shall not be a director in more than eight listed entities with effect from April 1, 2019 and in not more than seven listed entities with effect from April 1, 2020:
Provided that a person shall not serve as an independent director in more than seven listed entities.
 - (2) Notwithstanding the above, any person who is serving as a whole time director / managing director in any listed entity shall serve as an independent director in not more than three listed entities.
- 8. Regulation 18 (1) (b) and (d):

Every listed entity shall constitute a qualified and independent audit committee in accordance with the terms of reference, subject to the following:

 - (b) Two-thirds of the members of audit committee shall be independent directors and in case of a listed entity having outstanding SR equity shares, the audit committee shall only comprise of independent directors.
 - (d) The chairperson of the audit committee shall be an independent director and he shall be present at Annual general meeting to answer shareholder queries.

9. Regulation 18 (2) (b): The quorum for audit committee meeting shall either be two members or one third of the members of the audit committee, whichever is greater, with at least two independent directors.
10. Regulation 19 (1) (c): The board of directors shall constitute the nomination and remuneration committee as follows: at least fifty percent of the directors shall be independent directors and in case of a listed entity having outstanding SR equity shares, two thirds of the nomination and remuneration committee shall comprise of independent directors.
11. Regulation 19 (2): The Chairperson of the nomination and remuneration committee shall be an independent director.
12. Regulation 19 (2A): The quorum for a meeting of the nomination and remuneration committee shall be either two members or one third of the members of the committee, whichever is greater, including at least one independent director in attendance.
13. Regulation 20 (2A): At least one independent director, shall be member of the Stakeholders Relationship Committee and in case of a listed entity having outstanding SR equity shares, at least two thirds of the Stakeholders Relationship Committee shall comprise of independent directors.
14. Regulation 21 (2): In case of a listed entity having outstanding SR equity shares, at least two thirds of the Risk Management Committee shall comprise of independent directors.
15. Regulation 24 (1): At least one independent director on the board of directors of the listed entity shall be a director on the board of directors of an unlisted material subsidiary, whether incorporated in India or not.
Explanation - For the purposes of this provision, the term “material subsidiary” shall mean a subsidiary, whose income or net worth exceeds twenty percent of the consolidated income or net worth respectively, of the listed entity and its subsidiaries in the immediately preceding accounting year.
16. Regulation 25: Obligations with respect to independent directors
 - (1) No person shall be appointed or continue as an alternate director for an independent director of a listed entity with effect from October 1, 2018.
 - (2) The maximum tenure of independent directors shall be in accordance with the Companies Act, 2013 and rules made thereunder, in this regard, from time to time.

- (3) The independent directors of the listed entity shall hold at least one meeting in a year, without the presence of non-independent directors and members of the management and all the independent directors shall strive to be present at such meeting.
- (4) The independent directors in the meeting referred in sub-regulation (3) shall, *inter alia*-
 - (a) review the performance of non-independent directors and the board of directors as a whole;
 - (b) review the performance of the chairperson of the listed entity, 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 management of the listed entity and the board of directors that is necessary for the board of directors to effectively and reasonably perform their duties.
- (5) An independent director shall be held liable, only in respect of such acts of omission or commission by the listed entity which had occurred with his knowledge, attributable through processes of board of directors, and with his consent or connivance or where he had not acted diligently with respect to the provisions contained in these regulations.
- (6) An independent director who resigns or is removed from the board of directors of the listed entity shall be replaced by a new independent director by listed entity at the earliest but not later than the immediate next meeting of the board of directors or three months from the date of such vacancy, whichever is later: Provided that where the listed entity fulfils the requirement of independent directors in its board of directors without filling the vacancy created by such resignation or removal, the requirement of replacement by a new independent director shall not apply.
- (7) The listed entity shall familiarise the independent directors through various programmes about the listed entity, including the following:
 - (a) nature of the industry in which the listed entity operates;
 - (b) business model of the listed entity;
 - (c) roles, rights, responsibilities of independent directors; and
 - (d) any other relevant information.
- (8) 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, submit a declaration that he meets the criteria of independence as provided in clause (b) of sub-regulation (1) of

regulation 16 and that he is not aware of any circumstance or situation, which exist or may be reasonably anticipated, that could impair or impact his ability to discharge his duties with an objective independent judgment and without any external influence.

(9) The board of directors of the listed entity shall take on record the declaration and confirmation submitted by the independent director under sub-regulation (8) after undertaking due assessment of the veracity of the same.

(10) With effect from October 1, 2018, the top 500 listed entities by market capitalization calculated as on March 31 of the preceding financial year, shall undertake Directors and Officers insurance ('D and O insurance') for all their independent directors of such quantum and for such risks as may be determined by its board of directors.

17. Regulation 46 (2): The listed entity shall *inter-alia* disseminate the following information under a separate section on its website:

- terms and conditions of appointment of independent directors;
- details of familiarization programmes imparted to independent directors including the following details: -
 - i. number of programmes attended by independent directors (during the year and on a cumulative basis till date),
 - ii. number of hours spent by independent directors in such programmes (during the year and on cumulative basis till date), and
 - iii. other relevant details

18. Clause 7(A) of Part A of Schedule III: Resignation of independent director

In case of resignation of an independent director of the listed entity, within 7 days from the date of resignation, the following disclosures shall be made to the stock exchanges by the listed entities:

- i. Detailed reasons for the resignation of independent directors as given by the said director shall be disclosed by the listed entities to the stock exchanges.
- ii. The independent director shall, along with the detailed reasons, also provide a confirmation that there are no other material reasons other than those provided.
- iii. The confirmation as provided by the independent director above shall also be disclosed by the listed entities to the stock exchanges along with the detailed reasons as specified in sub-clause (i) above.