

Review of Regulatory provisions related to Independent Directors

1 Objective

1.1 This memorandum seeks to review the regulatory provisions related to Independent Directors (IDs) and amendment of SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“LODR Regulations”).

2 Background

2.1 In order to further strengthen the independence of IDs, a proposal was placed before the Board in its meeting held on February 17, 2021 for initiating a public consultation on various regulatory provisions related to IDs.

2.2 Subsequently, a Consultation Paper (**Annexure A**) on the review of regulatory provisions related to Independent Directors (IDs) was issued for public comments on the following proposals:

- 2.2.1 Definition of Independent Directors
- 2.2.2 Appointment and re-appointment process of Independent Directors
- 2.2.3 Removal of Independent Directors
- 2.2.4 Enhancing and bringing in more transparency in the role of NRC
- 2.2.5 Prior approval of shareholders for appointment of IDs
- 2.2.6 Resignation of Independent Directors
- 2.2.7 Composition of the Audit Committee
- 2.2.8 Review of remuneration

2.3 An analysis of the public comments received on the aforementioned proposals was placed before the SEBI Primary Market Advisory Committee (PMAC) for deliberation.

3 Summary of public comments

3.1 Comments (including suggestions) were received from 135 entities/ persons, which included Chartered Accountants Firm, Company

Secretaries, Consultants, Corporates, Exchange, Forums, Individuals, Industry bodies, Investors, Investor associations, Legal firms, Proxy advisors etc.

- 4 Analysis of public comments and the proposal is discussed in detail in the following paras:

4.1 Definition of Independent Directors

4.1.1 Proposal in the Consultation Paper

- a) 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.
- b) The prescribed cooling-off period across all eligibility conditions for a person to be appointed as an ID shall be harmonized to 3 years.

4.1.2 Rationale

- a) 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.
- b) At present, different cooling off periods are prescribed for various eligibility conditions for an ID, on the basis of the relationship viz. pecuniary relationship or other association viz. KMP/employee/relative of KMP. A uniform cooling off period shall ensure uniformity and ease of compliance with the regulations.

4.1.3 Comments/ suggestions received and our views

- a) Majority of the comments received are in favour of the proposal to enhance the scope and strengthen the criteria for independence of

IDs and to harmonise the cooling off periods for various eligibility conditions. Suggestions on cooling off period vary from 2 years to 5 years while few have raised concerns on the proposal saying that it would further exacerbate the scarcity of IDs and lead to non-eligibility of many qualified people who are in promoter group companies in diverse sectors despite such companies having never interacted with each other.

- b) Considering, that the majority of the comments received are in favour of the proposal, it is felt that extending the scope to promoter group companies and having a uniform cooling off period of 3 years proposed in the consultation paper strikes a healthy balance of having a reasonable cooling off period while upholding the independence of the proposed ID. PMAC was also in agreement with the proposal.

4.1.4 Proposal

- a) 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.
- b) The prescribed cooling-off period across all eligibility conditions for a person to be appointed as an ID shall be harmonized to 3 years.

4.2 **Appointment, re-appointment and removal process of Independent Directors**

4.2.1 Proposal in the Consultation Paper

- a) 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.

- b) 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.

- c) A similar process was proposed for removal of IDs

4.2.2 Rationale

- a) 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 role of Independent Directors inter-alia includes protecting the interest of minority shareholders, there is a need for minority shareholders to have greater say in the appointment / re-appointment process of IDs.

4.2.3 Comments/ suggestions received and our views

- a) Majority of the comments received are against the proposal citing practical difficulties in implementation, delays in appointment of ID in case of a deadlock, unintended voting skews due to a minority public shareholders having a significant shareholding etc. Few of the suggestions received are to have only 'majority of minority' approval, alternatively consider 'dual approval' or approval through a special resolution in companies having promoter shareholding above a certain threshold.
- b) The comments received on the proposal on removal of independent directors through dual approval are similar to those received on the appointment process.
- c) From the disclosure of shareholding pattern, it is observed that around 60% of the listed companies have promoter/promoter group shareholding of more than 50%. Such companies comprise around 67% of the total market capitalization. In such companies, it may be relatively simple to pass an ordinary resolution without much support from minority shareholders, however their support may be required for passing of a special resolution.
- d) Hence, there is support for the basic premise of the proposal in the consultation paper of giving more say to minority shareholders in the appointment, re-appointment and removal process of IDs. However, considering the views received, the practical challenges cited, and the possibility of delays in appointment of IDs, it is pragmatic to take a balanced view in the matter by introducing a process which is simpler to implement and covers greater set of shareholders. Such an approach was also recommended by the PMAC.

4.2.4 Proposal

- a) Appointment/re-appointment and removal of IDs may be through special resolution for all listed entities.

4.3 Enhancing and bringing in more transparency in the role of NRC

4.3.1 Proposal in the Consultation Paper

- a) The following procedure shall be followed by NRC for selection of candidates for the role of ID:

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 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:

- i. Skills and capabilities required for the appointment of the ID and how the proposed individual meets the requirement of the role.
- ii. 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.

- c) Composition of NRC may be modified to include 2/3rd IDs instead of majority of IDs.

4.3.2 Rationale

- a) 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.
- b) Further, there is a need to strengthen the composition of IDs in NRC in order to increase its independence from the promoters.

4.3.3 Comments/ suggestions received and our views

- a) Majority of the comments are in favour of the proposal regarding the process for shortlisting of candidates and the composition of NRC citing that it would increase the transparency in the functioning of NRC which would be good from the governance perspective. However, such comments received are majorly against the disclosure on channels used for searching citing that it would discourage people from making worthy recommendations to the NRC, and for making an informed decision only the skill set of the ID may be required not the channel used. It has been further stated that the use of search agencies would skew the process in favour of the same pool of candidates.
- b) Considering the comments received and in order to avoid unintended consequences of shareholders getting biased based on the source of search/recommendation, it is proposed that we may not go ahead with the disclosures on the channels used for searching. Further, use of search agencies is an option that can be explored by the NRC for identifying suitable candidates and is not mandatory.
- c) PMAC, while agreeing with the proposal, has further recommended that the notice to shareholders may also include disclosure on directorships of the candidates in the past 3 years, including resignations.

4.3.4 Proposal

I. 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, if required
- 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 disclosures regarding the skills and capabilities required for the appointment of the ID and how the proposed individual meets the requirement of the role. Further, it shall also include directorships in the past 3 years including resignations, if any.

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

4.4 Approval of shareholders for appointment of IDs within a stipulated timeframe

4.4.1 Proposal in the Consultation Paper

- a) Independent Directors shall be appointed on the board only with prior approval of the shareholders at a general meeting.
- b) 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.

4.4.2 Rationale

- a) As per the current practice, companies appoint independent directors as additional directors, subject to approval of the shareholders at the next general meeting. Due to this, 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.
- b) 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. Reduction/ elimination of this gap may give more say to shareholders in the appointment process.

4.4.3 Comments/ suggestions received and our views

- a) Majority of the comments are against the proposal citing reasons that it would increase the compliance burden of the companies without any corresponding benefit. Alternatively, it has been suggested to take shareholder approval within a time frame of 3 – 6 months for appointments as well as casual vacancy.
- b) Considering that majority of the public comments received are against the proposal citing practical difficulties and that the intent of

this proposal was to reduce the possible gap of up to 1 year between the appointment of an ID and the approval of shareholders, it is proposed to prescribe a time frame, within which the approval of shareholders may be taken. Further, in order to bring consistency and ease of compliance, the PMAC, while agreeing with the proposal, recommended that such time frame may also be applied in case of approval of appointment of all directors viz. IDs, Executive Directors, Non-Executive Directors, MDs/WTDs etc.

4.4.4 Proposal

- a) Approval of shareholders for appointment of IDs shall be taken at the next general meeting or within a time period of 3 months from the date of appointment on the Board, whichever is earlier. This requirement shall be applicable on all appointments including that arising due to casual vacancy. Further, this requirement shall be applicable for appointment of all directors including Executive Directors and Non-Executive Directors.

4.5 Resignation of IDs

4.5.1 Proposal in the Consultation Paper

- a) The entire resignation letter of an ID shall be disclosed along with a list of his/her present directorships and membership in board committees.
- b) 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.
- c) 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.

4.5.2 Rationale

- a) 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.
- b) 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 regulations around resignation of Independent Directors.
- c) 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.

4.5.3 Comments/ suggestions received and our views

- a. While majority of the commentators are in favour of disclosure of the resignation letter they are against the cooling off period in case of resignation due to personal reasons or time commitments. There is a mixed response on the cooling off period for transitioning from ID to WTD.
- b. Few of the views against the proposal have cited situations where there may be genuine reasons for citing 'personal reasons' for resignation, such as where ID is not getting along-with other board members or may feel that he/she is unable to contribute to the Board. In such cases, it may not be fair to undergo a cooling-off period else the director may feel pressurized to continue on the

Board, which may not be in the best interest of the Company. Views have also been expressed that IDs may find ingenious reasons for their resignations and may avoid using words like pre-occupation, other commitments or personal reasons alternatively, IDs may first join the board of other companies and then resign from the current company, thus, bypassing this requirement. PMAC was also of a similar view and suggested doing away with this provision.

- c. In respect of transitioning from ID to WTD while few are in support of the proposal others against the proposal have expressed that owing to the existing knowledge and expertise of the ID, regarding the business, change in role from ID to WTD may be in the interest of the Company and shareholders. PMAC was also of a similar view and recommended not to go ahead with the proposal on stipulating a cooling off period for transitioning from ID to WTD.
- d. Considering that LODR Regulations already require disclosure of detailed reasons for resignation along-with a confirmation that there is no other material reason other than those provided by the ID, the disclosure of the entire resignation letter is only an extension of this requirement. Since the majority of the comments are in favour of greater transparency through enhanced disclosures, it is proposed to go ahead with the proposal. PMAC also recommended the same.
- e. Considering the comments received on the proposal of cooling-off period on resignation citing personal or other commitments, it is felt that in such cases the directors may not be able to leave a board and may continue to work in compelling circumstances, which may not be in the best interest of the Company. Thus, this requirement may not serve the intended purpose of strengthening the disclosures around resignation.
- f. With respect to the proposal regarding a cooling off period while transitioning from ID to WTD, while PMAC has recommended against the proposal, it is felt that a cooling-off period would reduce

potential impairments to an independent director's impartiality in decision-making in instances where an ID knows that he/she may move to a larger role in the company in the near future. It is therefore proposed to go ahead with the proposal. It may also be clarified that this provision would be applicable in case of transitioning to WTD in the same company/ holding/subsidiary/associate company or any company belonging to the promoter group.

4.5.4 Proposal

- a) The entire resignation letter of an ID shall be disclosed along with a list of his/her present directorships and membership in board committees.
- b) Cooling-off period of 1 year before an ID can transition to a whole-time director in the same company/ holding/subsidiary/associate company or any company belonging to the promoter group.

4.6 **Composition of the Audit Committee**

4.6.1 Proposal in the Consultation Paper

- a) 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.

4.6.2 Rationale

- a) 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 IDs should give their recommendations on open offers and schemes of arrangements.

4.6.3 Comments/ suggestions received and our views

- a) Majority of the comments received are against the proposal citing reasons such as it would reduce the flexibility of the companies on selecting 1/3 members despite the majority of audit committee being independent and that NEDs not related to promoters are effectively equivalent to IDs. Further, the company may not have any NED not related to the promoter. While majorly the views received concur with the important role that audit committee plays in the affairs of the company and the need to keep it independent, they are of the view that prescribing conditions for the remaining 1/3 members may not lead to much benefit.
- b) Considering the comments received, to ensure a balance between independence and efficiency of the audit committee the existing composition of 2/3rd of IDs may be replaced with at least 2/3rd of IDs. Also, in order to further enhance the scrutiny around Related Party Transactions (RPTs) it is proposed that only Independent Directors forming part of the Audit Committee may approve RPTs. PMAC has also recommended the same.

4.6.4 Proposal

- a) At least 2/3rd of the members of the audit committee shall be independent directors.
- b) All RPTs shall be approved by only Independent Directors on the Audit Committee.

4.7 **Review of remuneration**

4.7.1 Views sought in the Consultation Paper

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

4.7.2 Rationale

- a. At present, in terms of both Companies Act and LODR Regulations, IDs cannot be given stock options. There is a need to adequately compensate the IDs on the basis of their value and time-commitments to the company. 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.
- b. 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.

4.7.3 Comments/ suggestions received and our views

- a. Majority of the comments received are against ESOPs replacing profit linked commission and instead, ESOPs as an additional option of remuneration have been suggested with the reasoning that ESOPs being market linked are not guaranteed and therefore cannot be the only way to remunerate IDs. Views have also been received that while ESOPs may be suitable for start-ups, it may

not be fair to get compensated after 5 years, for services done today; considering that the average age of IDs is more than 65 years. Majority of the views have suggested on upward review of the threshold on sitting fees.

PMAC was of the view of giving flexibility to the company to decide the remuneration within the overall ceiling and suggested that ESOP may be issued within the existing threshold of remuneration, in the same manner as is being issued to other directors and valuation may be done as prescribed under IndAS.

4.7.4 Proposal

- a) A reference may be made to MCA, for giving greater flexibility to companies, by permitting all directors to be eligible for remuneration including profit linked commissions, sitting fees, ESOPs etc. within the overall prescribed limit specified under Companies Act, 2013. Further, the valuation of ESOPs may be done based on approved valuation methods under IndAS.

Additional proposals

4.8 Directors and Officers Insurance for IDs

4.8.1 Existing Provision

- a) Regulation 25 (10) of LODR Regulations mandated that with effect from October 01, 2018, the top 500 listed entities by market capitalization 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.

4.8.2 Suggestions received as part of consultation process and our views

- a) In this regard, suggestions have been received that considering the increased expectation from IDs and heightened regulatory scrutiny, adequate protection under a proper D and O insurance policy will help Directors perform their duties more effectively. Thus, the requirement of mandatory D and O insurance should be extended to all listed entities.
- b) IDs have significant responsibilities in their capacity as board members and even more so in their capacity as an IDs. It is possible that the liabilities arising from such responsibilities may act as a deterrent for several good quality IDs from joining corporate boards. In view of the same, the requirement to undertake D&O insurance for all its IDs was introduced based on the recommendations of the Committee on Corporate Governance, chaired by Shri. Uday Kotak (“Kotak Committee”). The Kotak Committee had also recommended that over time, this requirement of mandatory D&O insurance may be extended to all listed entities.
- c) Considering that over 2 years have elapsed from the introduction of mandatory D&O insurance for IDs of the top 500 companies, it is felt that this requirement may now be extended to a larger set of entities. Further, considering the cost implications, sufficient time may be given to companies, for compliance. PMAC was also in favour of the proposal.

4.8.3 Proposal

- a) The requirement of undertaking Directors and Officers insurance may be extended to the top 1000 companies (by market capitalization).

4.9 **Eligibility conditions for IDs in respect of the relationships of their relatives with the listed entity, its holding, subsidiary or associate company**

4.9.1 Existing regulatory provision

a) As per Regulation 16 (1) (b) (v) and 16 (1) (b) (vi) (A) of LODR Regulations, the eligibility conditions of appointment as ID include:

- i. Regulation 16 (1) (b) (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.
- ii. Regulation 16 (1) (b) (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) Provisions in Companies Act

- i. The definition of independent director under Section 149 of the Companies Act, 2013 was amended with effect from May 7, 2018, to:
 - include a wider set of pecuniary transactions with relatives
 - Permit relatives of employees of the company, its holding, subsidiary or associate company (in the preceding three financial years) to be appointed as independent director

4.9.2 Our views

a) SEBI has received many representations from various stakeholders to harmonise the aforesaid provisions of LODR Regulations with that of Companies Act, 2013.

- b) In view of this, it is proposed that the eligibility requirements for independent directors in LODR Regulations, may be aligned with the aforementioned changes in Companies Act subject to retaining lower threshold for pecuniary relationship of relatives as per existing provisions in the LODR.

4.9.3 Proposal

- a) Regulation 16 (1) (b) (v) of LODR Regulations may be modified to include transactions between the relatives and the listed entity, its holding, subsidiary or associate company or their promoters, or directors viz. holding any security of or interest, being indebted, having given a guarantee or security, or any other pecuniary transaction or relationship. This alignment may be done while retaining lower threshold for pecuniary relationship of relatives as per existing provisions in the LODR.
- b) Regulation 16 (1) (b) (vi) of LODR Regulations, may be amended to permit relatives of employees of the company, its holding, subsidiary or associate company (in the preceding three financial years) to be appointed as IDs.

4.10 **Time-period for filling up casual vacancy of Independent Directors**

4.10.1 Existing regulatory provision

- a) As per Regulation 25 (6) of LODR Regulations, 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.

- b) As per Companies Act, 2013 (Schedule IV (VI) (2)) -An independent director who resigns or is removed from the Board of the company shall be replaced by a new independent director within "three months" from the date of such resignation or removal, as the case may be.

4.10.2 Our views

- a) It is proposed that the time period for filling the vacancy of ID arising due to resignation or removal prescribed under LODR Regulations may be aligned with the corresponding provision under Companies Act, 2013.

4.10.3 Proposal

- a) Regulation 25 (6) of LODR Regulations may be modified to allow maximum three months for filling the vacancy in the position of ID arising due to resignation or removal.

5 Proposal for the consideration of the Board

5.1 The Board is requested to consider the proposals at para 4.1 to 4.10 and approve the amendments to SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 placed at **Annexure B**. These amendments are proposed to be made applicable with effect from Jan 01, 2022.

5.2 The Board is also requested to authorize the Chairman to take consequential and incidental steps to give effect to the decision of the Board.

ANNEXURE A

The Consultation Paper is available on www.sebi.gov.in.

ANNEXURE B

This shall be notified at a later date.