Corporate Governance and Independence

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We have come to expect too much of independent directors. Compared to big shareholders, they have less to lose or gain if an organisation either succeeds or fails. On the contrary, they have a lot to lose if the entity falters on matters concerning legal compliance. Effectively, then, IDs end up as representatives of the government who are there mainly to ensure compliance. Perhaps it would be better to allow organisations to govern themselves, providing rewards for good governance, and stiff punishment for fraud or malpractice.

The Board's changing role

At one time, a Board of Directors was meant, primarily, to direct the management of an organisation on behalf of the owners, and to protect the interests of all stakeholders. Board members were expected to listen to the owners, and understand their perspective on various issues. They also had an obligation to report major decisions and results to the owners. Further, they were expected to help the owners understand the 'what' and 'why' of any decision, and the impact of its results. On the flip side, by keeping a pulse on the owners' expectations, the Board would ensure that there was no attempt of any premature or unwarranted bailout.

An organisation's results are a product of the collective efforts of people in critical managerial roles. In so far as the CEO and the management team are concerned, the Board's responsibility is to reflect on these results and assess how the management team might positively impact the firm's plans and performance. Additionally, the Board is expected to provide directional inputs for steering both the company's growth plans and its future trajectory. It also needs to play a role in assessing the performance of prominent leadership positions (the KMPs) and be a sounding board in their selection, redirection, and if necessary, replacement.

> Earlier, Boards were primarily meant to direct the management of an organisation on behalf of the owners

There are, however, particular nuances in the case of listed companies. There, ownership is diversified – often made up of a faceless number of unconnected people whose interests in the company will vary. Also, thanks to trading on stock exchanges, ownership is something that is continually shifting. The Board may consist exclusively of representatives of some of these owners – usually the founders or the principal shareholders – while other owners may be unrepresented.

Today, the Board is meant to ensure the longevity and success of an organisation - and it is the ID's job to help meet this purpose

The decisions that get taken thus tend to favour the founders or principal shareholders, at times even for mala fide reasons. Those owners who are not adequately represented may find themselves at the wrong end of such decisions. To obviate such situations, the laws were amended to require 'Independent Directors' to be part of the Board. To be genuinely independent, such IDs needed to have adequate voice/representation on the Board, and hence the requirement to have IDs occupy half of all Board positions.

In contrast, the current view is that the Board is responsible for ensuring the longevity and success of an organisation – and consequently, it is now considered the job of IDs to help meet this purpose. No longer are they meant, as they originally were, to merely serve the interests of minority shareholders.

Appointment and qualifications of IDs

Ironically, the process of selecting IDs usually begins with recommendations from owners or current Board members. The mandate is to induct people who not only have the necessary competence, but who can also work effectively with other Board members and the management team. So, effectively, the appointment of 'independents' is mainly dependent upon the owners/founders. This raises the question of whether such Directors are independent in the real sense of the word.

Certain criteria have been laid down for determining independence – and only those who pass the various tests of independence concerning the company and its Board qualify as IDs. While rules exclude the nomination of family members of founders/large shareholders from taking on ID roles, friends – but ones who do not have any material pecuniary interests in the same organisation – are considered independent under the law!

In the absence of objective competence thresholds, there are a limited number of well-known, competent Directors, who tend to be sought-after by the larger companies. (In some sense, this is a symbiotic relationship, where corporations get the rub off from the standing of the ID, and the ID from the company's reputation.) This can create situations where a Boards may have to make do with less-competent IDs. None of this, though, answers the question: Are IDs genuinely independent?

Concentration of power

The general norm is that a corporation needs to have one leader at the top. However, various committees that frame the criteria for governance tend to push for the reduction of such concentration of power in the hands of a single individual. The current trend is to separate the office of the Chairman from that of the CEO/Managing Director. Nearly anyone who has worked in an organisation with two power centres, though, will have witnessed situations where the two fall out with each other. Do we truly understood the repurcussions of having multiple power centers in and organisation? If the founder/large shareholder is actively involved in operations, is there really a need to get in another power center? Is it better for the government to have successful organisations, or should they be focussed on reducing the concentration of power?

The role of IDs has never been well understood, so if the Board is to ensure the corporation's success and longevity – and not serve the interests of any one stakeholder or set of stakeholders – is independence the best way to achieve that? Shouldn't successful organisations be precluded from the need to replace IDs periodically, since their purpose is already being met?

Is Board independence really the best way to achieve the goals of success and longevity?

Vested interests

Who is more vested in the success of an organisation – its founders, the government, small shareholders, or large shareholders? What is really the ID's stake? For the most part, it is the commission he or she earns, or possibly his/her reputation, that matters more than that of the entity itself. The quantum of the fee paid is far lower than the value of the founder's stake, or the large shareholder's stake. So who would be more vested in working towards the long-term success of the enterprise? Who stands to gain more or lose more if the organisation succeeds or fails? The implication is clear: in most organisations, the ID's impact is quite limited. More often than not, stringent regulations actually reduce the incentive to take up the role of an ID – and the person's focus, consequently, is more on regulatory compliance than on long-term success! Why would any reasonably competent person want to be an ID?

If the underlying principle of most rules, regulations or guidelines is that the founders or large shareholders are all people with malintent, then the incentive for risk-taking and being enterprising are significantly reduced. (The recent report of a committee on Corporate Governance is even more prescriptive. If accepted, it may have far reaching implications for business in the country.) Have we forgotten that one of the main reasons why Indian businesses have succeeded so far is the enterprise of a few individuals or families? Some have probably exploited the situation, but one would have thought that the way to deal with that situation is to take legal action against the fraudsters, instead of making tighter rules for everyone else. This will only result in stifling business and enterprise, making life tougher for true entrepreneurs while the fraudsters continue to thrive! ■