

Commissioned Article

Board Independence & Corporate Governance in India: Recent Trends & Challenges Ahead

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The failure to detect internal crisis early on and act in a timely manner to put the organization back on track before difficulties become irreversible engages the attention of analysts worldwide. In India too, the renewed focus on the functioning of corporate boards along with a debate on the rights and responsibilities of board members followed the disclosure failures at Satyam Computer Services. This paper examines some important policy issues related to board independence based on “lessons of experience” from implementing board reforms across the countries including India. The paper seeks to put in perspective the progress made in India regarding the adoption of international best practices for the constitution and functioning of independent boards.

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Introduction

The increasing attempts at reforming extant governance systems in both developed and developing countries have come in the wake of major corporate scandals in internationally renowned companies like Enron, Tyco and Worldcom as well as the East Asian crisis of the early nineties. One of the factors that has been identified to be common across all these major corporate failures around the world has been the “failure of the board of directors of a corporation to detect internal crisis early on and act in a timely manner to put the organization back on track before difficulties become irreversible” (Jensen 1993). In India, the renewed focus on the functioning of corporate boards along with a debate on the rights and responsibilities of board members followed the disclosure failures at Satyam Computer Services reportedly to the tune of Rs. 7000 crore which, by the company’s founder-chairman’s own admission, had continued for seven long years. It is thus not surprising that with every major corporate scandal and the subsequent crisis that it unleashed, renewed attempts have been made to reform corporate boards of publicly held

corporations to make these structurally and operationally more effective in ameliorating agency problems between shareholders and owners/managers. This has included a whole gamut of reforms evolving over time to deal with the constitution and functioning of corporate boards, the most important of which are regulations aimed at ensuring board independence from internal management and improving the quality of board governance.

The objective of this article is to examine some important policy issues related to board independence based on “lessons of experience” gained from implementing board reforms across the countries, including India. In doing so, the article seeks to put in perspective the progress made in India regarding the adoption of international best practices for the constitution and functioning of independent boards as well as discuss their implications on the quality of board governance. Foremost among these are the determination of the optimal proportion of independent directors, the sufficiency of the set of criteria for defining director independence, the quality of independent directors, and the larger question of whether board independence actually matters in corporate performance.

Board Independence & Corporate Governance

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shareholders who need to delegate the responsibility of running the day-to-day operations of the corporation to professional managers. Since these shareholders find it costly and lack the incentive to monitor management, managers may behave opportunistically to run the company in their interests rather than that of the shareholders. Managerial opportunism imposes “agency costs”, manifested in “unobservable” and often “unverifiable” actions taken by them such as expanding firm size beyond optimal level, consuming perquisites, or satisfying managerial hubris, all of which increase their private benefits but which reduce the value of the firm and hence the benefits to the shareholders.

The board of directors acts as one of the most important governance mechanisms in aligning the interests of managers and shareholders. The important functions of the board, as laid down in the *Report on the Financial Aspects of Corporate Governance* issued in 1992 by the Cadbury Committee that brought into forefront the role that corporate boards can play in governance, are to define a company’s purpose, to strategize and draw up plans to achieve that purpose, to appoint the chief executive, to monitor and assess the

performance of the executive team and last but not the least, to assess their own performance. In executing these functions, the universally accepted principle is that the board of directors acts as fiduciaries of shareholders' and other stakeholders' interest. Nevertheless, the nature of the agency problems that a board mediates is different for widely held corporations and those with concentrated ownership and control. In widely held corporations that are typical of the US and the UK, the board's role is one of "vertical governance" that entails working on behalf of the shareholders to minimize managerial opportunism and maximize shareholder wealth (Roe 2004). In contrast, in corporations with concentrated ownership and control, the board's role is that of "horizontal governance", of mediating between the dominant stockholders who are also part of management, and the outside dispersed shareholders and preventing expropriation of the latter by the former (Roe 2004). This is the prototype governance problem of countries in continental Europe, Japan, East Asian economies and many emerging economies including India, where family owned corporations belonging to business groups dominate and family members with substantial ownership and control rights occupy managerial positions with the objective of controlling the firm. Whichever the case, the governance problem that a board is required to deal with is one of extraction of private benefits by either the management or the dominant shareholder. It is in this context that the

increasing consensus worldwide on the need to have boards that are "independent" of inside management can be best understood.

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The need to have independent boards arises from the agency-theoretic premise that if boards exist to monitor shirking or self-dealing by inside management, then outside directors in general, and independent directors in particular, should be more effective monitors than are insiders whose interests may be at odds with outside shareholders (Weisbach 1988). Independent directors have the incentive to promote the interests of shareholders and be effective monitors, in order to protect their reputational capital and being sued by shareholders (Bhagat et al. 1987, Fama 1980). Further, from a resource dependency perspective, outside directors apart from providing their expertise can, through their interlocks with other companies, generate benefits by helping to bring in needed resources, suppliers and customers to a company (Pfeffer 1972).

An alternative view questions the efficacy of independent directors in mitigating managerial opportunism and serving shareholder interests. This viewpoint, rooted in social psychology and behavioral finance argues that independent directors are unlikely to be truly independent of management (for a

review, see for example, Morck 2004, Fink 2006). While, formally, shareholders are required to elect directors, it is generally the case that the CEO plays a critical role in the nomination process. Given the informal control of the CEO over the nomination process, it is unlikely that CEOs will choose directors who will oppose them. Thus Morck (2004) remarks that “many independent directors are still beholden to the firm’s CEO and that “directors seem paralyzed in the presence of powerful CEOs.” It is also argued that in the presence of alternative governance mechanisms such as competitive product markets and active capital markets, outside directors could add little to managerial discipline (Mace 1986, Patton & Baker 1987).

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Despite conflicting viewpoints on the role of independent directors, a scanning of corporate governance reform initiatives across a cross-section of countries irrespective of their underlying institutional contexts reveals that these initiatives have been predominantly influenced by the agency-theoretic view that independent boards are good for corporate governance and protect shareholder and other stakeholder interests. The concept of an “independent director” became part of the corporate governance lexicon in the 1970s, and the move towards board independence that originated in the US

as a “good governance exhortation” soon acquired the status of a legal requirement (Gordon 2008). Between 1994 and 2000, at least 18 countries came out with recommendations or stipulations on the minimum requirements (either in absolute terms or as a proportion of total board strength) for outside directors on company boards (Dahya & McConnell 2003). With corporate boards gradually being seen more in a monitoring role rather than in an advisory role, often due to governance failures, the shift towards having more outsiders on the board, and in particular having more independent directors has become increasingly pronounced, legally binding, and more stringent with time. As estimated by Gordon (2007), between 1950 and 2005, the proportion of independent directors on company boards in the US steadily increased from around 20 per cent in 1950 to around 75 per cent in 2005.

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Board Independence in India

In India, board regulations for all registered companies are laid down by the Companies Act, 1956, and additional regulations applicable to the sub-set of listed companies are laid down by SEBI under Clause 49 of the Listing Agreement. This Clause was adopted in February 2000 following the recommendations of the Kumara Managalam

Birla Committee Report on Corporate Governance. While matters such as minimum board size, appointments and rotation of directors, limits on directorships, board procedures, responsibilities of board members are laid down in detail under the Companies Act of 1956, regulations regarding board independence, financial disclosures, board procedures that are specifically relevant to listed companies have come under SEBI's domain. A greater overlap of the Companies Act of 1956 and SEBI regulations is being mooted in the proposals to amend the existing Companies Act, as is evident in the

Report on Company Law prepared by the J. J. Irani Committee, where explicit recommendations have been made on matters such as independent boards and independent directors largely in line with the current SEBI regulations.

Under Clause 49 of the Listing Agreement all listed companies are required to have no less than half of its board comprising non-executive directors. Additionally, regulations require the constitution of independent boards, the structural rules for which were firmed up over a period through successive amendments of Clause 49 (Box 1).

Box 1: Major Revisions of Clause 49 of Listing Agreement with respect to Board Composition and Independence

Clause 49 (original) February 21, 2000	Clause 49 (revised) October 29, 2004	Clause 49 (revised) April 8, 2008
Board composition The company agrees that the board of directors of the company shall have an optimum combination of executive and non-executive directors with not less than fifty percent of the board of directors comprising of non-executive directors. The number of independent directors would depend whether the Chairman is executive or non-executive. In case of a non-executive chairman, at least one-third of board should comprise of independent directors and in case of an executive chairman, at least half of board should comprise of independent directors.	Board Composition Similar as February, 2000 Determination of Independence Revised For the purpose of the sub-clause (ii), the expression 'independent director' shall mean a non-executive director of the company who: <i>a.</i> apart from receiving director's remuneration, does not have any material pecuniary relationships or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associates which may affect independence of the director;	Board Composition Additional qualification for boards with non-executive chairman "If the non-executive Chairman is a promoter or is related to promoters or persons occupying management positions at the board level or at one level below the board, at least one-half of the board of the company should consist of independent directors." Determination of Independence
Determination of Independence 'independent directors' means directors who apart from receiving director's remuneration,	<i>b.</i> is not related to promoters or persons occupying management positions at the board level or at one level below the board;	Similar as October 2004

do not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, which in judgement of the board may affect independence of judgement of the director.

c. has not been an executive of the company in the immediately preceding three financial years;
d. is not a partner or an executive or was not partner or an executive during the preceding three years, of any of the following:
(i) the statutory audit firm or the internal audit firm that is associated with the company, and
(ii) the legal firm(s) and consulting firm(s) that have a material association with the company.
e. is not a material supplier, service provider or customer or a lessor or lessee of the company, which may affect independence of the director;
and
f. is not a substantial shareholder of the company i.e. owning two per cent or more of the block of voting shares.

Thus, while the original regulation as of February, 2000 required that at least one-third of the board must have independent directors if the chairman is non-executive, and at least half of the board to be independent if chairman is an executive, this requirement was revised and tightened subsequently in April 2008 with an added qualification that in case a non-executive chairman is either a promoter or related to the promoter or management, the requirement for board independence would have to be at par with that when a chairman is also an executive director. Similarly, the set of criteria defining the “independence” of a director itself underwent significant changes in consonance with international best practices, from being largely subjective to becoming more objective.

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While board independence worldwide has been defined based on an objective criteria requiring either the presence of a minimum number or a minimum proportion of independent directors, the challenging issue among policy makers and academics alike has been to define “independence” of a director as much as possible in objective terms based on “relationship standards.” The evolution of independence standards in India as highlighted in Box 1 is a case

in point. In the original version of Clause 49, a director could be considered independent if the individual apart from receiving director's remuneration did not have any other material pecuniary relationship or transactions with the company, its promoters, its management or its subsidiaries, *which in the judgment of the board* (emphasis added) may affect the independent judgment of the director. As the Naresh Chandra Committee on Corporate Audit and Governance recognized, while such a broad definition of independence may be pragmatic and flexible, it is "circular and tautological," and a more rigorous definition needed to be adopted. The subsequent amendments to Clause 49 addressed such concerns and itemized in detail a more stringent and objective checklist that a director has to satisfy to be deemed independent (Box 1). The revised definition of independence in India closely came on the heels of the

enactment of the Sarbanes-Oxley Act, 2002 in the US following the Enron scandal and the incorporation of a set of "bright line" tests for independent directors by the New York Stock Exchange in their new listing standards in 2003.

The trends in the proportion of non-executive directors and independent directors in India for the period 2003 to 2007 based on the balanced panel of 186 large companies (leading to 930 company-year observations) are presented in Tables 1(a) – 1(c)¹. These tables, and all the subsequent ones, are culled from the disclosures made in the corporate governance reports filed by these companies. The year 2003 marks the period when all listed firms came under the new corporate governance regulations under Clause 49 of the Listing Agreement of the Securities and Exchange Board of India.

Table 1(a): Distribution of Companies according to Percentage of Outside Directors

Percentage of Outside Directors	2003	2004	2005	2006	2007
Less than 50	3.23	4.30	4.84	5.38	3.23
50 – 74	45.16	42.47	48.92	47.85	50.54
75-100	51.61	53.23	46.24	46.77	46.24
Total	100.00	100.00	100.00	100.00	100.00
Total Number of companies	186	186	186	186	186

1 Using a balanced panel ensures that time trends are not driven by changes in the composition of the sample. Of the 186 companies, 24 (12.90%) are government owned, 108 (58.06%) are Indian

group companies, 28 (15.05%) are Indian standalone companies, 24 (12.90%) are foreign companies and 2 (1.08%) are joint -sector companies.

Table 1(b): Distribution of Companies by Proportion of Independent Directors - Companies with Non-executive Chairman

Proportion of Independent Directors	Year				
	2003	2004	2005	2006	2007
Less than 1/3	8.74	10.42	9.57	4.55	1.06
1/3 to Less than 1/2	37.86	37.50	40.43	47.73	52.13
1/2 to Less than 3/4	36.89	35.42	40.43	40.91	39.36
3/4 to 1	16.50	16.67	9.57	6.82	7.45
Total	100.00	100.00	100.00	100.00	100.00
Total Number of companies	103	96	94	98	94

Table 1(C) : Distribution of Companies by Proportion of Independent Directors - Companies with Executive Chairman

Proportion of Independent Directors	Year				
	2003	2004	2005	2006	2007
Less than 1/3	6.02	7.78	7.61	6.12	5.43
1/3 to Less than 1/2	12.05	10.00	11.96	10.20	8.70
1/2 to Less than 3/4	67.47	60.00	68.48	71.43	77.17
3/4 to 1	14.46	22.22	11.96	12.24	8.70
Total	100.00	100.00	100.00	100.00	100.00
Total Number of companies	83	90	92	98	92

Judged in the context of Clause 49 regulations requiring listed companies to have boards with at least 50 per cent non-executive directors, Table 1(a) shows that save for a small percentage of companies (around 3 – 5 per cent), all have complied with the regulation. In fact, almost half of these companies have had super-majority boards of 75 per cent or more, a phenomenon commonly witnessed in the US, although this has noticeably declined in recent years. Turning to the constitution of independent boards when Chairman is non-executive (Table 1(b)) and when Chairman is executive (Table 1(c)), we find a striking difference

between the two with respect to the level of compliance under the respective regulations. Given that in the case of non-executive chairman, at least one third of the board should comprise independent directors, while non-compliance was as high as 10.42 per cent in 2004, it declined sharply to only 1.06 per cent in 2007 despite the implementation of an increasingly stringent definition of director independence since January 2006. In contrast, in the case when boards are headed by a executive chairman and are required to have at least fifty per cent independent directors, the level of non-compliance is noticeably higher at around

14 per cent as of 2007, although down from a peak of 19.57 per cent in 2005.

There could be two possible reasons for the higher level of non-compliance in the case of executive chairman, one that the minimum requirement of at least fifty per cent independent directors is too high a bar to satisfy given the current supply of independent directors, and two that there may be a greater resistance on the part of an executive chairman to hire independent directors for fear of losing control over the board.

While having more independent directors on board can be beneficial for shareholder interests, it is important to strike an optimal balance between inside and outside directors.

Within companies that have complied with the independence regulations, super-majority independent boards have been noticeably declining over the period. This may be due to a growing recognition that while having more independent directors on board can be beneficial for shareholder interests, it is important to strike an optimal balance between inside and outside directors. As is being increasingly recognized, having sufficient number of inside directors is beneficial for the effective functioning of independent directors as, more often than not, they provide the board with “credible source of information” necessary for the independent directors to properly assess managerial performance as well as help in creating a bond between the board and the management team of the company.

Finally, trends in board characteristics for the panel of 186 firms

Table 2: Trends in Board Characteristics: 2003 - 2007

		2003	2004	2005	2006	2007	All Years
Board Size	Mean	9.81	9.83	8.97	9.27	9.46	9.47
Percentage of Inside Directors	Mean	27.93	28.84	30.12	29.01	27.74	28.73
Percentage of Grey Directors	Mean	17.44	16.76	18.54	19.44	19.96	18.43
Percentage of Independent Directors	Mean	54.63	54.40	51.34	51.56	52.30	52.84
CEO_Chair	Mean	0.33	0.31	0.31	0.36	0.33	0.33
Executive_Chair	Mean	0.45	0.48	0.49	0.53	0.49	0.49
Promoter_Chair	Mean	0.22	0.22	0.28	0.37	0.32	0.28
Percentage of Busy Inside Directors	Mean	65.64	66.43	62.49	62.83	61.87	63.85
Percentage of Busy Independent Directors	Mean	68.59	68.43	63.45	68.05	70.23	67.75

are presented in Table 2 for the period 2003-2007. The Table not only presents estimates of the average constitution of a board in terms of its mix of inside and outside directors, but also present key measures of the board quality that have been the focus of reform initiatives. Among these are (i) the busyness of directors in terms of the number of directorships held which could make directors overcommitted and compromise on their ability to monitor effectively (ii) the incidence of CEO duality where the positions of Chairman (responsible for the functioning of the board) and the CEO (responsible for the day to day management of the company) are held by the same individual, and (iii) the presence of controlling shareholders on the board. Both (ii) and (iii) can potentially lead to conflicts of interests and a shift in the balance of power in favor of inside management. While board independence is generally considered to be a necessary condition for effective monitoring, there is a growing recognition that it is not board independence *per se* but rather board quality that is important for governance.

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On an average, there are nine members on a board with the board size not showing significant variation over the years. Likewise, despite some variation in the intervening years, the percentage of inside directors in 2007,

at around 28 per cent, was almost of the same magnitude as that in 2003. Among the outside directors, the percentage of grey (i.e., affiliated directors) ranged between 17 and 20 per cent, increasing marginally over the last four years. Most importantly, on an average more than 50 per cent of directors on a company board are independent directors. With regard to the incidence of multiple directorships, if one denotes a director with three or more directorships as “busy”, then on an average more than sixty per cent of all inside directors on a board are busy, with busyness declining marginally over the years. The incidence of busyness among independent directors is several notches higher (around 70 per cent in 2007) and is found to increase over time. This could be on account of an increase in demand for independent directors as more stringent regulations on independence came into effect.

Neither companies with CEO as chairman, nor companies with executive chairman show any trend implying that companies are not shifting to non-executive chairs. In the UK, there has been a clear move towards separation, and in recent years, institutional investors and shareholder advocacy groups have become vocal in requiring that the chairman be chosen from the pool of non-executive directors. In India no such trends are evident despite the fact the requirement of minimum proportion of the independent directors are much less stringent for companies with non-executive chairman compared to those with executive chairman. Strikingly, the proportion of the

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companies with promoter as chairman has increased significantly from 0.22 to 0.32 from 2003 to 2007. Means tests conducted for differences in board characteristics for the initial and terminal years interestingly reveal that except for the increased presence of promoters on company boards, there is no evidence of statistically significant differences in board characteristics between the two years.

Does Board Independence Matter in Governance?

While the move towards constituting independent directors has gained increasing momentum over the years, and companies are embracing board independence relatively easily as has been the case in India, surprisingly no conclusive empirical evidence exist to suggest that board independence matters in firm performance. This is the case even with respect to countries with a long tradition of having independent boards like the US, thereby raising questions as to whether the “outside director mania” across the countries and the presumption that outside directors matter, “rests more on faith than on evidence” (Dahya & McConnell 2003).

While some studies find the beneficial effects of more independent boards on firm performance (Dahya & McConnell 2003), on discrete tasks such as hiring and firing of chief executive officers (Weisbach 1988), on hostile takeovers (Brickley et al. 1994, Byrd and Hickman 1992) and on determining CEO compensation (Core et al. 1999), a significant number of studies find results to the contrary (see for example, Bhagat & Black 2002, Hermalin & Weisbach 1991). Time series analysis of director independence by Bhagat and Black (2002) in the context of US even concludes that a “moderate number” of inside directors can lead to higher performance, that firms with a high percentage of independent directors may perform worse (Yermack 1996, Agrawal & Knoeber 1996), and that federally mandated governance standards to improve board performance may not be desirable (Fisch 2004).

Compared to the large body of evidence existing for developed countries like the US and UK dominated typically by corporations with dispersed ownership, there is relatively less evidence from countries with concentrated ownership and control structures as those in Continental Europe and Japan, as also with respect to transition and emerging economies, like countries in Eastern Europe, India and China, that have recently moved towards constituting independent boards as part of their governance reforms. Here too, the scant evidence that exists on the effect of outside directors on governance is far from being conclusive. For

instance, while Miwa and Ramseyer (2005) in the case of Japan, Peng et al. (2003) in the case of Russia, and Andres et al. (2005) in the case of OECD countries find no conclusive evidence that firms with a higher proportion of outside directors necessarily out-perform firms that have fewer outside directors, the research by Yeh and Woidtke (2005) with respect to Taiwan and Peng (2003) with respect to China find evidence that outside directors do make a difference to firm performance and governance.

Evidence with respect to India has been emerging only recently,² given that the phase-wise adoption of listing standards that mandated the constitution of independent boards was completed only in 2003 and the definition of director and board independence were in a state of revision until as late as April 2008. The limited evidence that does exist on the functioning of corporate boards is based either on the empirical analysis of cross-section data of large Indian companies (Ghosh 2006, Sarkar et al. 2008, Sarkar & Sarkar 2009) or on reviews of corporate governance practices based on company surveys (Grant Thornton – Ficci 2009).

With respect to the role of outside directors on firm performance, a study of 127 listed manufacturing companies in India for the year 2003 (Ghosh 2006) finds no statistically significant effect. In similar vein, Sarkar et al. (2008) do not find any effect of board independence on

² See Chakrabarti et al. (2008) for a survey of corporate governance in India.

Earnings management is found to be influenced by the quality of boards as captured in terms of the diligence of the independent directors manifested in their ability to devote time to company affairs.

opportunistic earnings management for a sample of 500 large companies for the years 2003 and 2004. Instead, earnings management is found to be influenced by the quality of boards as captured in terms of the diligence of the independent directors manifested in their ability to devote time to company affairs (beneficial effect), CEO duality (adverse effect), and the presence of controlling shareholders on board (adverse effect). A more detailed analysis of the effect of multiple directorships on firm value for 2003 (Sarkar & Sarkar 2009) finds that multiple directorships of independent directors correlate positively with firm value. These findings lend support to both the “quality hypothesis” that outside directors with multiple directorships are busy by virtue of being of better quality, and the “resource dependency hypothesis” that independent directors with multiple directorships by virtue of being better networked, may help a company to establish more beneficial linkages with its external environment. In contrast, and as one would expect, multiple directorships by inside directors are, negatively related to firm performance.

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Additional insights into the role played by Clause 49 on board governance can be obtained from a recent survey of 500 “mid-market” listed companies in India for 2009 (Grant Thornton - Ficci 2009). A large majority of the companies surveyed report that Clause 49 with its increasingly stringent regulations has had a beneficial effect on companies in terms of strengthening the transparency of company operations and improving shareholder perceptions of the company.

Board Governance in India: Important Policy Issues

The “uncertain” relationship between board independence and governance evident from the extensive literature on the subject seems to run counter to the unambiguous policy position taken across countries irrespective of their governance systems, that board independence is critical for mitigating agency problems in public corporations. How does one resolve this puzzle of the gap between policy prescription and the results on the ground? What then is the future of board independence?

The reasons underlying the puzzle could be two, the first a purely econometric issue, and the second related to the fundamental question of the “functionality” of the concept of independence. With regard to the first, the predominant absence of a statistical relationship between board independence and company performance can be due to the fact that boards could be

endogenously selected so as to have an optimum mix of different types of directors (Dahya & McConnell 2003). As a result, it would be difficult to detect a relationship between board composition and corporate performance in any cross-section analysis. Additionally, in countries like the US on which most of the evidence is based and which has a long history of shareholder activism, companies, irrespective of existing regulations, may voluntarily choose to have few outsiders on boards with little variance in board composition over time. This would again imply that the effect of changes in board composition on corporate performance may be difficult to detect. Estimates of board independence for a sample of US companies for 1991 show that at a time when there was no regulatory standard for board independence, around sixty per cent of board members were independent directors (Bhagat & Black 2002)

The second reason for the inability to find “consistent linkages between board independence and corporate performance” could be that director independence, howsoever defined, is a myth. This possibility is more important than the first one and can have important policy implications. The basis for questioning the very concept of director independence in the context of corporate boards lies in real-life experiments in social psychology that highlight how simple elements of human behavior like loyalty impede independent decision making of an individual. With reference to the famous Milgram experiment (1963, 1974), Morck (2004) argues that

in the absence of complementary institutional mechanisms, “genuine” independence of directors from management may prove to be elusive. The Milgram experiment showed how ordinary individuals (the subject), out of a sense of loyalty to an experimenter (authoritative figure) were, on the instructions of the experimenter, willing to cause extreme harm to perfect strangers disregarding their own assessment of the consequences of such actions. Morck (2004) drawing an analogy of the experimental set up with a corporate board observes that directors of a board often owe allegiance to a CEO (possibly because a CEO has the most say in nominating them) and would, out of a sense of loyalty, seldom oppose a CEO’s decisions even at the expense of a director’s fiduciary duty to the shareholders. Milgram’s experiment in fact suggests that directors enjoy a positive sense of well-being from their “reflexive obedience” to the CEO.

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The more stringent norms of director independence that have been introduced in India and elsewhere under which independence is defined in terms of objective relationship standards that rule out any form of material and business/pecuniary relationships with the management of a company (including its CEO) other than director compensation,

would potentially weaken the “loyalty” factor. Still the look-back period of three years to define the relationships may not be enough to snap ties with internal management arising from the previous employment, family ties and other business relations. Also, while material ties can be objectively defined and used as a test for independence, it is difficult to rule out a director’s social ties with senior management (Fink 2006). Such ties are particularly relevant in countries like India where relational contracting based on kinship, social and family ties is often the norm and outside directors particularly in group affiliated firms are sourced from within an informal network rather than from the formal managerial market.

The possibility of independent directors acting as obedient agents of a “powerful” CEO is a distinct possibility in India given that around 33 per cent of boards have been characterized by CEO duality, around 50 per cent have company executives acting as chairman and equally significantly there is a significant increasing trend towards boards having promoters doubling up as chairmen (Table 2). It has generally been the practice that outside directors are identified by promoters with whom they have “comfort levels” or with well known personalities who can bring credibility to the board (Grant Thornton - Ficci 2009). A recent analysis of multiple directorships in Indian companies (Sarkar & Sarkar 2009) identifies the existence of an “inner circle” with respect to independent directors sitting on corporate boards of

family-owned group affiliates — about 67 per cent of independent directors in group affiliates are also located within other group affiliates, with 43 per cent of directorships on an average concentrated within a *single* group. These estimates were found to be substantially higher than corresponding estimates for independent directors of non-affiliated firms.

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Given that the new standards of independence have been only recently introduced, it remains to be seen whether these will lead to an improvement in the quality of governance. Nevertheless, several policy initiatives have been instituted in countries like the US and UK and incorporated in listing regulations and best practice codes to reduce the potential cost of dissension by independent directors on boards with powerful CEOs and allow independent directors to act as a peer group independent of the CEO. This is perhaps in response to a growing recognition that “rewarding consent and discouraging conflicts” can not only have an adverse effect on both CEO and company performance, but can also, in the absence of the “monitoring and criticism of an active and attentive board,” cause a series of small problems to eventually blow up to a crisis (Jensen 1993). Among

the policies designed to make independence more functional are (i) the requirement to have a Nomination Committee constituting entirely of independent directors which, among other functions, would be responsible for identifying candidates who would be qualified to become board members and oversee the evaluation of the board and management³ (ii) the appointment of a Senior Independent Director whose responsibilities as specified in governance codes include meeting with other members of the board in the absence of the CEO/chairman at least annually and evaluate and appraise the performance of the CEO/chairman, and (iii) the requirement that non-management directors of a company meet at regularly scheduled sessions without members of the management.

These regulations have the potential of reducing “misplaced loyalty” of independent directors and enable them to be effective gatekeepers as evidenced by the different variants of the Milgram experiment that found the subject to act more responsibly when removed from the proximity of the experimenter and

In India, the more stringent minimum requirement of independence for boards with executive chairman or when a non-executive chairman is linked directly or indirectly to promoters/current management

³ See NYSE Listing Requirements for a detailed list of functions of a Nominating Committee.

when the experimenter was challenged by an equally imposing peer (Morck 2004). In India, the more stringent minimum requirement of independence for boards with executive chairman or when a non-executive chairman is linked directly or indirectly to promoters/current management, does have merit since these seem to recognize the need to neutralize disproportionate CEO power in decision-making that is endemic to such boards. However, the current board regulations in India do not mandate adoption of either a Nomination Committee, or the appointment of a senior independent director, or include provisions for outside directors to convene meeting independent of the management. Such board procedures and practices seek to empower directors to *exercise* their independence, enable them to shift from an advisory to a monitoring role, and allow them to demand greater accountability from management, the importance of all of which cannot be underscored enough in the light of the comprehensive failure of governance at Satyam and its economy-wide ramifications.

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