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HOW LITTLE IS TOO LITTLE?

A luminary was once asked whether money was important to him. He replied "It is not important; it is terribly convenient." Why inconvenience Independent Directors by giving them peanuts?

Corporate governance conversations have, in recent months, centred around Audit Committees (ACs), Auditors, Independent Directors (IDs) and, more recently, Those Charged With Governance (TCWG), the last being a relatively recent addition to the active vocabulary of corporate governance. Common among all of these is the institution of IDs. While it existed in other jurisdictions, the institution of IDs was formally given birth to in Clause 49 of the Listing Agreement, after which it assumed a statutory basis through The Companies Act, 2013 (The Act).

Corporate governance failures have often resulted in fingers being pointed at IDs. The most common question asked is whether they were sleeping on the job. Even less charitable is the explanation that having been appointed by the promoters, they consciously chose to look the other way when governance shenanigans were playing out for all to see. These episodes have also given rise to the questions - "Who needs IDs?", "What purpose do they serve?", and "Whose interests are they safeguarding in boardroom discussions?".

The foregoing are clearly extreme positions to take. At the other end of the spectrum there is an increasing number of promoters and controlling stakeholders who have seen, and are continuing to see, value in having IDs. As one promoter stated unambiguously - "I recognise that the ID is on the company's Board to protect me from myself. Any excesses that I resort to consciously or unconsciously might not survive the scrutiny of diligent IDs." If the institution of IDs is to continue to exist, and to play a significant role, it is necessary to ask ourselves - why persons with no stake in the fortunes of the company should agree to come on the Board, and expose themselves to the liabilities and risks that necessarily go with Board positions. As in every contractual relationship, there ought to be consideration as one of the elements of the contract. It is in that context that an attempt is being made in subsequent paragraphs to examine how, to what extent, and in what manner, Directors, especially IDs, should be compensated.

There is no need to lead evidence to support the proposition that if the compensation is inadequate, the wrong persons, including those with ulterior motives, might get onto Boards. At the same time, it can be contended, with reasonable certainty, that excessive compensation will negatively impact the independence that is expected in the process of decision-making. Clearly therefore, a balance ought to be struck between what is too little and what is too much. There is a section of observers, fortunately not too many, who believe that being on a Board is tantamount to public service, and should not be in the expectation of receiving any compensation. The expectation that pro bono service will be provided by

Directors does not sit well with the challenges of being a part of the Board. Why should any sensible person agree to serve on a Board, without being compensated, when legal and regulatory liabilities keep increasing by the day?

How then are Directors to be compensated? The first element that is normally spoken about is the sitting fees paid to Directors for attending meetings of the Board and the committees. Presently, there is a statutory cap of Rs 1 lakh per meeting that is payable to members of Boards or committees. Many companies pay lesser amounts, with perhaps the unstated explanation that meetings in any event are formalities, where not much business gets discussed, and not many decisions get taken, leaving it to the management to chart, with minimal Board intervention, the course that companies ought to take. There is also the specious argument that payment of sitting fees is avoidable expenditure, and therefore the number of meetings have to be bare minimum.

Conversations with Board and committee members, and a study of the minutes of meetings, as also the agenda, will establish that much of the heavy lifting is being done by the Board committees, especially the AC. Therefore, treating committee meetings as mere calendar items should not pass muster in well intentioned companies. It is important to note that sitting fees is paid for attending meetings. It is paid at a uniform rate to all members, and does not differentiate between those that contributed significantly to discussions and decision-making, and those that remained steadfastly silent. Clearly sitting fees is not intended to be an instrument of compensation that recognises and rewards performance.

The only other manner of compensation that Indian law recognises for IDs is the payment of commission based on the profits of the company. Here again, there is a statutory cap imposed by the Act, which stipulates that the total commission payable to all Non-Executive Directors (NEDs), independent or non-independent, taken together should not exceed 1% of the profits of the company. Surveys undertaken by Excellence Enablers in the last few years have revealed that the total commission paid to the Directors of companies does not come anywhere near the statutory limit of 1%. The question therefore arises whether the gap between the statutory limit, and the amount of commission paid, should be reduced, if not totally eliminated. Earlier no commission could be paid to IDs on Boards of loss-making companies. This was a counterproductive stipulation since it was the loss-making companies that needed to have good Directors on the Boards, to help them turnaround. Mercifully, this has been partially addressed by permitting a modest commission in such cases.

One fundamental issue that needs to be addressed is whether all Directors on the Board ought to get equal compensation. Unlike in the case of sitting fees, there is clearly an opportunity available to differentiate between performing Directors and non-performing Directors, and to compensate each of them based on their contribution. In some companies, the unfortunate practice of deriving contribution from the number of meetings attended still persists. Some others use a base number and provide for additional compensation for holders of positions such as the Chair of the AC or the Chair of some other important committee. This too does not travel far enough because compensation thus calculated is derived from the positions held, example AC Chairpersonship, and not from contribution.

What then is the best method to assess contribution? Schedule IV of the Act stipulates that there shall be an annual evaluation or review of the performance of Directors. If the process of evaluation is undertaken honestly, and is a robust and no holds barred exercise, it will be

possible to identify those that contribute, and those that merely make up the numbers in the boardroom. The box-ticking approach to evaluation undertaken by a large number of companies does not serve any useful purpose. To address this, it is necessary for the Securities Markets Regulator to mandate that once in 2-3 years, the process of Board evaluation should be undertaken by outside experts, and should not be the kind of peer evaluation that rates every Director as God's gift to humankind.

Basis a robust and honest Board evaluation process, the commission to be paid to Directors should be determined. There is no other satisfactory method to incentivise and reward performance in boardrooms.

A third element of compensation, which existed before the Act dealt it a death blow was the grant of stock options to IDs. Buying into the argument that the grant of stock options would promote short termism, the lawmakers abandoned it without considering remedies. The problem, largely imaginary, of short termism could have been addressed by getting the shares received by IDs locked-in, so that during their term of office as ID, they would be prevented from dealing in those shares. In fact, going further, it could have been prescribed that such shares, as the Directors have on the basis of stock options, should be locked-in for a period of at least 2 years after they have demitted office. In some cases, shareholders attending Annual General Meetings have perused the shareholding pattern, as reflected in the annual reports, and asked Directors why they were not holding company shares, and how they could be trusted with identifying themselves with the company where they did not own shares. It is reasonable to believe that persons who have shares in companies will act in the interest of the companies in order to bolster the company's financial position, and to ensure better returns to all stakeholders. The present position of denial of stock options to IDs is a travesty of justice.

When it comes to Executive Directors (EDs) on the Board, with executive responsibilities, performance is expected to be measured in terms of KRAs, with a sizeable component of the compensation being variable pay. It has been noticed that sometimes there is a disconnect between the KRAs and the compensation paid to EDs. Absent this correlation, there is no incentive for EDs to perform to the best of their ability. Nomination and Remuneration Committees seem to be turning a blind eye to this aspect of their remit. One other matter that tends to get ignored is the phenomenon of clawback. It stands to reason that an ED, who is compensated excessively in relation to his or her performance should be subjected to clawback, so that unjust gains do not accrue, at the expense of the other stakeholders. In some jurisdictions, especially following the global financial crisis, executive compensation has been an object of scrutiny. In India, only in a couple of cases has clawback been attempted. Shareholders have also expressed their unhappiness at excessive compensation being paid to EDs, when the company's performance has moved southwards. It is time that the subject of compensation for both NEDs and EDs is thoroughly debated, so that a commonsensical solution can emerge, leading to adequate compensation for performing Directors. This one measure will contribute to more productive boardroom conversations, translating to the better interest of all stakeholders, and a brighter future for the company.

Disclosure in regard to compensation are sometimes unclear, and leaves the reader of reports less informed. In a somewhat negative development, the US Regulator has indicated an intention to move in the direction of lesser disclosures on compensation in regard to some categories of highly paid employees.

It is not that there have been no conversations on this subject. They have regrettably not led to worthwhile decisions. It is yet another instance of the truism that “when all is said and done, more will be said than done”.



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