M&A Hotline

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EVALUATION OF THE BOARD OF DIRECTORS OF THE LISTED COMPANY: THE NEED OF THE HOUR?

- Guidance has been provided by SEBI for the purposes of improving the evaluation process of the board of directors of listed entities.
- Reiterates the position in relation to the evaluation process of board of directors under the Companies Act, 2013 and SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015.
- Various aspects of board evaluation process such as the subject of evaluation, process of evaluation, feedback to persons being evaluated, action plan pursuant to evaluation process, frequency of board evaluation, responsibility of board evaluation and review of the entire evaluation process have been covered.

INTRODUCTION AND BACKGROUND

The Securities and Exchange Board of India ("**SEBI**") released a guidance note dated January 5, 2017 on the evaluation of the board of directors of a listed company ("**Guidance Note**") for the purposes of rendering guidance to listed entities in relation to the various aspects involved in an evaluation process of the board of directors and in improving the effectiveness of the board of directors while enhancing corporate governance standards.

In the recent years, India had moved from a regime which contemplated an evaluation of the board of directors of a listed company only at the option of such a listed company to a regime which now mandates listed companies to undertake the evaluation of its board of directors. With the advent of the Companies Act, 2013 ("**CA 2013**") and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 ("**SEBI LODR Regulations**"), listed companies were required to undertake mandatory evaluation of its board of directors and its various committees[1].

However, given that the practice of board evaluation is still considered to be preliminary concept in India, majority of the listed entities merely ensured compliance with the law as laid down under the CA 2013 and the SEBI LODR Regulations to the extent mandated and failed to undertake active evaluation of the board of directors so as to improve the effectiveness of the board of directors. In line with the same, a study conducted by Ingovern revealed that although the Indian listed entities complied with the law as provided, such Indian listed entities did not give much attention to undertaking board evaluations in a manner so as to improve the overall performance of the board of directors.[2] Additionally, the current ongoing battle of the Tatas and Cyrus Mistry required an urgent need to introspect the nature of compliances required to be undertaken by board of directors in terms of improving their effectiveness as well as analyzing the manner in which evaluation process of the board of directors are undertaken by listed entities.

In the present environment, SEBI undertook an analysis of the global practices in various jurisdictions in terms of regulatory requirements, best practices, internal versus external evaluations and disclosure requirements amongst other such relevant practices and accordingly, SEBI decided to issue the Guidance Note so as to assist in the evaluation process of the board of directors of listed entities and deriving best possible results in the effectiveness of the board of directors. These practices are merely recommendatory in nature and are not mandatory.

CURRENT REGULATORY FRAMEWORK

In terms of evaluation, the CA 2013 and the SEBI LODR Regulations require for the boards of directors of listed companies to constitute a nomination and remuneration committee ("**NRC**") which is required to (a) formulate a criteria for evaluation of performance of independent directors and the board of directors; (b) carry out an evaluation of the performance of every director; and (c) determine whether to extend or continue the term of appointment of the independent director based on each of their evaluation reports. Evaluation of an independent director must be done by the board of directors of the listed entity excluding the director being evaluated. Additionally, independent directors are required to (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 (while accounting the views of the executive and non-executive directors); and (c) assess the quality, quantity and timelines of flow of information between the management and the board of directors necessary for the performance of duties of the board of directors.[3]

Various disclosure requirements were also specified where the board of directors of listed companies would be required to provide a statement (placed in the form of a report at a general meeting) specifying the manner in which formal annual evaluation of the board of directors, committees and individual directors have been conducted and the performance evaluation criteria for independent directors in the corporate governance section of the annual report of the respective listed entity.[4]

Effectively, the aforementioned specifications provides that the evaluation of the board of directors is conducted at different levels, namely, at the board level, at the committees level and at an individual director level (including

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chairperson and chief executive officer)

PARTICULARS OF THE GUIDANCE NOTE

The Guidance Note stream lines the evaluation process as follows:

1. pre-evaluation process;
2. evaluation process; and
3. post-evaluation process.

A. Pre-Evaluation

The Guidance Note prescribes the following:

1. *Identifying the objectives of evaluation*: Such objectives may be general (standard objectives in terms of board evaluations) and specific (objectives specific to the board evaluation based on issues of concern, recent events etc).
2. *Criteria of evaluation*: Developing the criteria for evaluation at every level within the board of directors depending on the functions, responsibilities, competencies required, nature of business etc. Here SEBI has also prescribed the specific issues that would require focus in terms of evaluation under each criteria. The criteria for different directors/groups are as follows:
   1. Board of directors (as a whole): SEBI has identified certain criteria in terms of evaluating the board of directors in certain core areas such as

      (i) structure of the board of directors: touch points being competency, qualification and experience of directors, diversity.

      (ii) meetings of the board of directors; touch points being regularity and frequency of the meetings, quality of the agenda and the manner of discussion undertaken, participation of the members attending the meeting and the overall functioning of the board of directors as a team

      (iii) functions of the board of directors;

      (iv) board of directors and management; and

      (v) professional development.

      In addition to the functions of the board of directors described in the SEBI LODR Regulations,[5] the Guidance Note suggests the following additional functions to be undertaken by the board:

      (i) documentation of the role and responsibilities of the board of directors (including the bifurcation of the roles of chairman and chief executive officer, if any);

      (ii) performance and strategy evaluation (in terms of strategic issues plans of actions and risks in relation to the listed entity along with the implementation process of the same);

      (iii) governance and compliance of the boards (in relation to disclosures, reporting requirements and the governance practices of the board of directors);

      (iv) evaluation of risk (review of high risk issues and recognition and assessment of risks);

      (v) grievance redressal for investors;

      (vi) monitoring of conflicts of interests in relation to the management, board of directors and shareholders, stakeholder values, corporate culture; and

      (vii) facilitation of role efficiency of independent directors.

      Additionally, SEBI has also contemplated the following:

      (i) evaluation of the performance of the management by the board of directors along with the independence of the management from the board;

      (ii) access of the management to the board and vice versa;

      (iii) secretarial support rendered for board meetings;

      (iv) fund availability for conducting meeting and seeking expert advice; and

      (v) succession plan for management.
   2. Committees of the Board*:* SEBI specifies the mandate and composition of the committees, effectiveness of the committees, structure and independence of committees and contribution of the committees to decision making by the board as core criterion in terms of evaluation the committees.
   3. Individual directors and chairperson: SEBI has provided three specifications in terms of evaluation of individual directors. Firstly, SEBI specifies that the evaluation of individual directors must be done on a general basis while taking into consideration the qualifications, experience, knowledge and competency, fulfillment of functions assigned to or prescribed under law, ability to function as a team, initiatives taken by individual directors, availability, commitment, contribution and integrity. SEBI has also prescribed additional criteria for independent directors and chairpersons.

However, the aforementioned criteria is not exhaustive and SEBI has provided that different criteria may be assigned depending on the requirements of the listed entity, circumstance, outcomes of previous assessments and maturity of the board.

B. Evaluation process

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The Guidance Note prescribes two methods of evaluation of the board of directors: (a) internal assessment; and (b) external assessment.

1. Internal assessment: Assessment may be undertaken either through a detailed questionnaire to be circulated to individual directors, committees, board of directors etc., or through oral assessments provided by the person on interviews. If required, the questionnaire may enable written answers to be provided on confidential basis. Views of the members may also be taken on a confidential basis by the chairperson if the members are not willing to disclose their inputs in writing.

   Additionally, SEBI has also suggested that the questionnaire should be modeled in a form where the format provides scope for grading, additional comments, suggestions etc., as against a form which merely contemplates a yes/no format.

2. Assessment by external experts: SEBI has suggested the use of external experts with the view that independence is imparted to the evaluation process. SEBI further specifies that the external assessment may be done based on questionnaires/interviews or a combination of the two on a regular basis. Moreover, SEBI has provided that caution should be exercised to ensure that the external assessor is not a related party or conflicted due to closeness of the board of directors so as to ensure impartiality.

C. Post Evaluation

Post the evaluation processes undertaken, SEBI specifies that feedback must be accorded in one or more of the following ways:

1. Orally given by chairman/external assessor or any other suitable person to each member, committees and board of directors; or

2. Written assessment to every member, board of directors and committees.

SEBI has laid down that an active role is required of the chairperson in providing feedback. If the individual members are not comfortable to open individual assessments, provision for confidentiality may be made where possible. SEBI has provided that feedback must be provided honestly and without bias.

D. Action Plan

Based on the analysis of the responses, an action plan may be prepared by the board of directors on the following:

1. Areas of improvement including training, skill building, etc., as may be required for the board of directors;

2. List of actions required detailing nature of actions, timeline, persons responsible for implementation and resources required.

3. Review of actions within a specific time period.

The action plan should be prepared comprehensively while taking suggestions under the assessment processes as detailed above.

E. Disclosure Requirements

In addition to the statutory requirements, SEBI suggests that listed entities voluntarily provide additional disclosures including results of evaluation, action taken on the basis of evaluation, current status of the outcomes requiring actions to the various stakeholders.

F. Frequency of evaluation of board of directors

Although board evaluation is required to be mandatorily conducted once a year[6], SEBI has suggested that the listed entity may conduct board evaluations more frequently so as to be more effective in continuous improvement of the board through continual feedbacks and assessments.

G. Responsibility

While the NRC and independent directors have been provided with major roles in terms of evaluating the board of directors, based on global situations, SEBI has concluded that the primary role of steering the whole process of evaluation of boards and ensuring its effectiveness in improving the efficiency of the board of directors lies with the chairperson. Hence, it would be important to highlight the function of the chairperson in a board evaluation.

H. Review

SEBI has suggested a periodical review to be undertaken for improvement of the effectiveness of the board of directors considering that the evaluation of the board of directors is not a static process. Such responsibility lies with the board of directors and should be done based on feedback from the concerned parties.

ANALYSIS

In the present environment, where the role of a board of directors is garnering more and more importance with the various issues ranging from the Satyam scam to the Mallya-Diageo fiasco and finally, the Tata-Mistry war, this Guidance Note is seen as SEBI's way to enhance and provide additional value to the listed entities at large by emphasizing the need to ensure proper evaluation of the board of directors. Over the recent years, corporate governance has developed in a manner wherein the focus has been purely on establishing procedures to be followed by a board of directors, composition of board of directors and the rising role of independent directors and chairman. However, through issuance of the Guidance Note, SEBI has exhibited a transition to move from mere corporate governance towards inculcating a corporate culture that distinguishes a board of directors as individuals developing moral obligations towards their stakeholders.

Ordinarily, any listed entity would generally ensure compliance with the letter of law so as to ensure that the entity is allowed to function smoothly without any penalties or actions by regulators. However, the Guidance Note is intended to emphasize on the spirit of law so as to demonstrate that board of directors do not merely have a legal obligation to be structurally and statutorily compliant but also have a moral obligation towards the listed entity and its shareholders towards ensuring better functioning of the board of directors and aligning itself with the long term strategy of the listed entity.

These guidelines are not mandatory or all-encompassing, however, it would be difficult for a company to ignore this guidance and yet proclaim adherence to good corporate governance principles. SEBI acknowledges that evaluation processes can vary from entity to entity and evaluation processes cannot be standard for all listed entities given the different structures, business and issues of such listed entities. To a certain extent, the evaluation processes would require customization so as to suit the listed entities accordingly.

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You can direct your queries or comments to the authors

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[1] Section 178(2) of CA 2013 read with Regulation 19 of SEBI LODR Regulations

[2] 2016, Board Evaluation Practices in India, A Study of the Top 100 Companies, CimplyFive & InGovern available at http://www.ingovern.com/wp-content/uploads/2016/05/Board-Evaluation-Practices-in-India-26-05-2016.pdf, last visited January 20, 2017.

[3] Section 178 of CA 2013 read with Part D of Schedule II of SEBI LODR Regulations.

[4] Section 134(p) of CA 2013.

[5] Chapter II of SEBI LODR Regulations.

[6] *Ibid.*
