

**Does accountability deter individuals from serving as  
independent directors?  
Evidence from a corporate governance reform in India**

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## Motivation

- In the wake of corporate governance scandals in recent years, policy makers have called for increasing the independence of directors as well as their accountability to shareholders.
- Increasing accountability should improve directors' incentive to monitor management (Coffee, 1986; Jensen, 1993) and reduce agency problems and entrenchment.
- Fear of legal liability could deter individuals from serving as directors (Romano, 1989; Sahlman, 1990), or make them risk averse and thereby reduce board effectiveness.
- **Does accountability deter individuals from serving on corporate boards?**

# Background

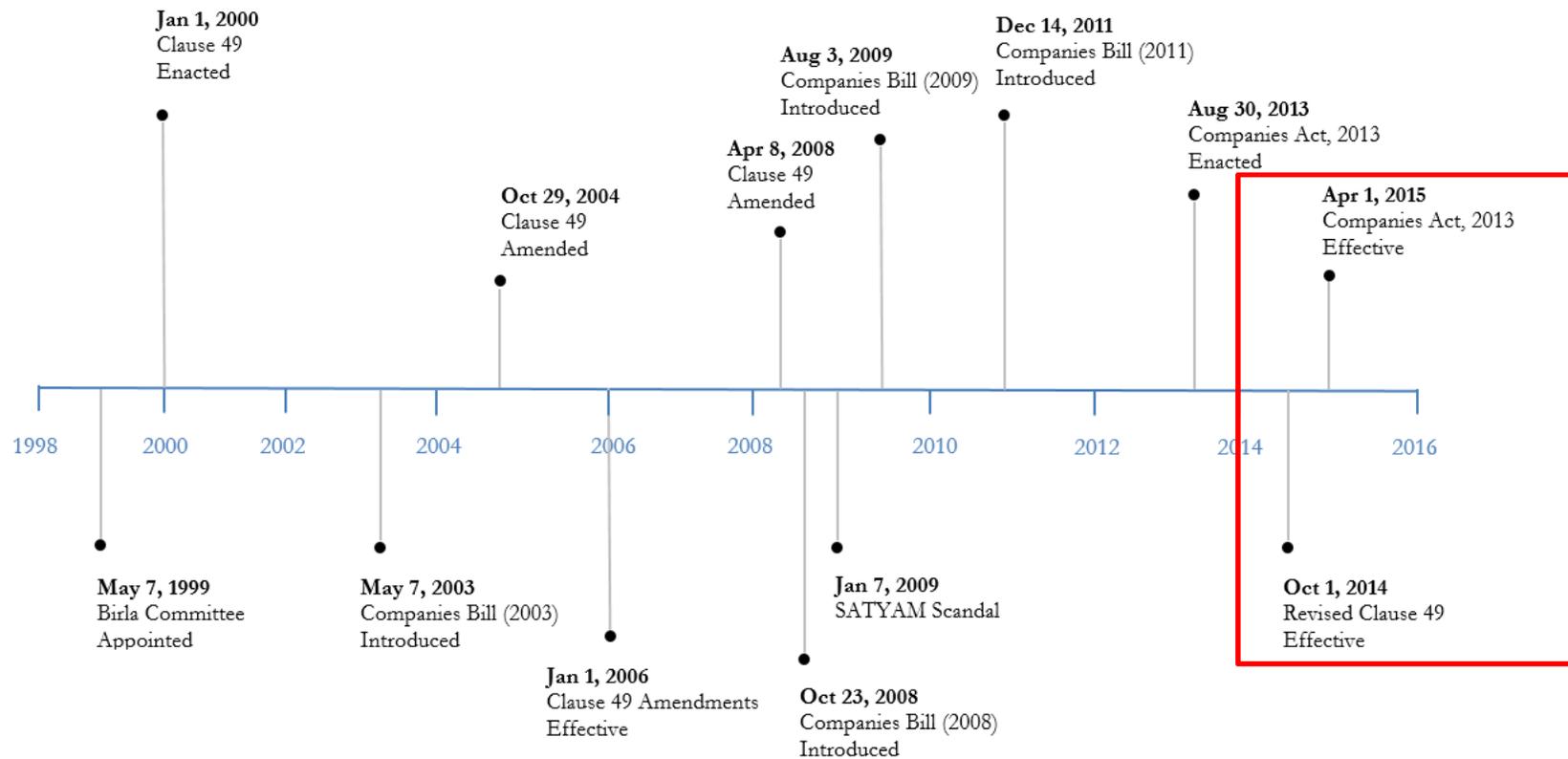
- **Litigation risk**
  - Armour, Black, Cheffins, and Nolan, 2009;
  - Black, Cheffins, and Klausner, 2006;
  - Brochet and Srinivasan, 2014
- **Director elections**
  - Cai, Garner, and Walking, 2009;
  - Aggarwal, Dahiya and Prabhala, 2015
- **Labor market**
  - Fich and Shivdasani, 2007;
  - Ertimur et al., 2012
- **Prior literature on director accountability has focused on director accountability conditional on wrong doing.**

## Research Question

- We hypothesize that the new stringent law will result in increased turnover of independent directors if accountability deters individuals from serving on corporate boards.
- We expect to find stronger deterrence among firms where the pecuniary or reputational incentives to serve as an independent director is weak and in firms that are subject to greater litigation and regulatory risk.
- **Our contribution**
  - Accountability deters individuals from serving as independent directors (Ex-ante)
  - Existence of costs for shareholders associated with the introducing accountability

# Corporate Governance Reforms: India

Figure 1: Timeline of Corporate Governance reforms in India



(8) The company and independent directors shall abide by the provisions specified in Schedule IV.

(9) Notwithstanding anything contained in any other provision of this Act, but subject to the provisions of sections 197 and 198, an independent director shall not be entitled to any stock option and may receive remuneration by way of fee provided under sub-section (5) of section 197, reimbursement of expenses for participation in the Board and other meetings and profit related commission as may be approved by the members.

(10) Subject to the provisions of section 152, an independent director shall hold office for a term up to five consecutive years on the Board of a company, but shall be eligible for re-appointment on passing of a special resolution by the company and disclosure of such appointment in the Board's report.

(11) Notwithstanding anything contained in sub-section (10), no independent director shall hold office for more than two consecutive terms, but such independent director shall be eligible for appointment after the expiration of three years of ceasing to become an independent director:

Provided that an independent director shall not, during the said period of three years, be appointed in or be associated with the company in any other capacity, either directly or indirectly.

*Explanation.*—For the purposes of sub-sections (10) and (11), any tenure of an independent director on the date of commencement of this Act shall not be counted as a term under those sub-sections.

(12) Notwithstanding anything contained in this Act,—

(i) an independent director:

(ii) a non-executive director not being promoter or key managerial personnel, shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently.

(13) The provisions of sub-sections (6) and (7) of section 152 in respect of retirement of directors by rotation shall not be applicable to appointment of independent directors.



## CIRCULAR

CIR/CFD/POLICY CELL/2/2014

April 17, 2014

To  
All Recognised Stock Exchanges

Dear Sir(s)/Madam(s),

**Sub: Corporate Governance in listed entities - Amendments to Clauses 35B and 49 of the Equity Listing Agreement**

1. Please refer to master circular No. SEBI/CFD/DIL/CG/2004/12/10 dated October 29, 2004 on Clause 49 of the Equity Listing Agreement.
2. The Companies Act, 2013 was enacted on August 30, 2013 which provides for a major overhaul in the Corporate Governance norms for all companies. The rules pertaining to Corporate Governance were notified on March 27, 2014. The requirements under the Companies Act, 2013 and the rules notified there under would be applicable for every company or a class of companies (both listed and unlisted) as may be provided therein. It has been decided to review the provisions of the Listing Agreement in this regard with the objectives to align with the provisions of the Companies Act, 2013, adopt best practices on corporate governance and to make the corporate governance framework more effective.
3. The full text of the revised Clause 35B of the Equity Listing Agreement is given in **Part-A** of the circular. The full text of the revised Clause 49 of the Equity Listing Agreement is given in **Part-B** of the circular.
4. **Applicability**
  - 4.1 The revised Clause 49 would be applicable to all listed companies with effect from October 01, 2014. However, the provisions of Clause 49(VI)(C) as given in Part-B shall be applicable to top 100 listed companies by market capitalisation as at the end of the immediate previous financial year.
  4. An independent director shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement.

# Corporate Governance Reforms: India

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## New Companies Act may give directors sleepless nights

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**By Suresh Viswanathan, Company Secretary in Practice**

The old corporate testament of 1956 has been pushed into the annals of history, beginning the All Fools Day this year. 282 vital sections of the new company law have been made effective, giving vent to a modern, resilient regulatory testament.

The new law assumes directors and key management personnel to be the sentinels of governance. It seeks to put in a quandary the questionable independence of independent directors.

A host of rulings by various courts in India in the past have established that a corporate body can be prosecuted and penalised, yet not be imprisoned! But will the new law permeate down to the decision makers harboured behind the facade of a corporate body? The attribution of criminality to the "officer who is in default" is established under section 2(60) of the Companies Act, 2013. He shall be liable to penalty or imprisonment.



*The responsibility of a director under this umbrella law could in all possibility be cited in proceedings under several other laws (like FEMA) wherein a director's responsibility to comply is specifically enshrined.*



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## Changing role and liabilities of independent and non-executive directors – boon or bane?

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Company law is the gamut of laws dealing with the incorporation, workings and winding up of a company. In India, the law relating to companies was governed by the Companies Act, 1956, which has been amended over 25 times since its enactment due to numerous lacunas, and its ineffectiveness, as the provisions had become redundant in today's modern world and changing global business trends. Thus, owing to its shortcomings, the old act was replaced by the Companies Act, 2013. The 2013 Act sets to overhaul the provisions relating to independent directors entirely by conferring greater power and responsibility in the governance of a company.

Independent directors are essentially the custodians of good corporate governance. Though not required to be involved in the day-to-day running of companies, they are expected to monitor the actions of the executives and safeguard the interests of stakeholders. While there were no express

BY

Rajesh Begur

ARA LAW

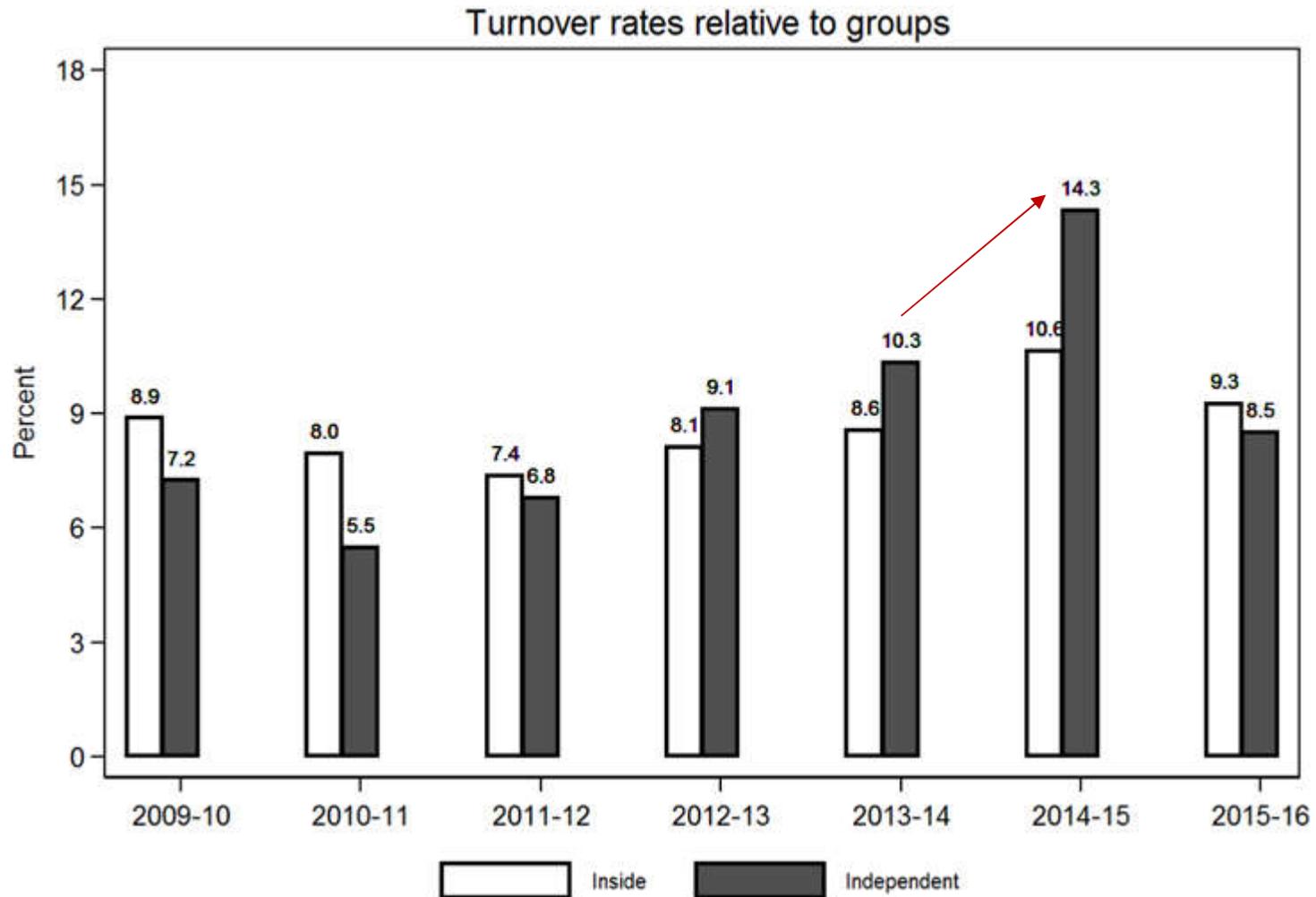
1. Board composition and director characteristics from Indian Boards database
  - » Board and committee composition at the end of financial year
  - » Director remuneration and characteristics
2. Accounting data and financial information from CMIE Prowess
3. Balanced panel of 1,181 firms listed at NSE from 2010 to 2016
4. Caveat
  - » Data on director remuneration only covers the 200 largest firms (by market capitalization).



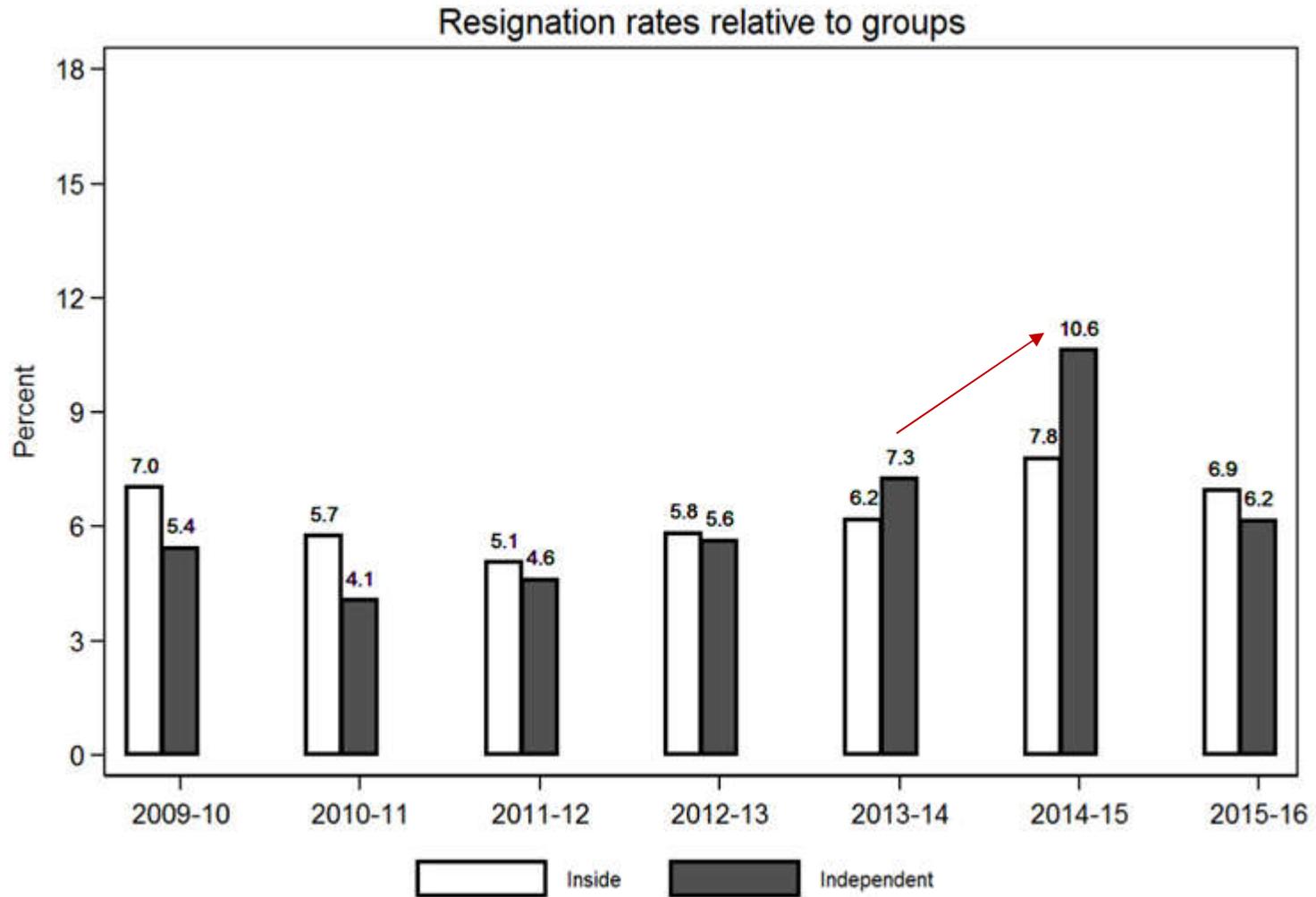
**Table 2: Director and director turnover characteristics**

	All	Type of director		Difference (2)-(1)	t-Stat.
		Independent (1)	Inside (2)		
Number of directors	76,940	37,478	39,462		
<i>Panel A: Director characteristics</i>					
Age (years)	60.5 (12.1)	64.8 (11.1)	56.4 (11.5)	-8.4 (0.09)	-98.1 <sup>***</sup>
Gender (1=female)	0.07 (0.26)	0.06 (0.24)	0.10 (0.3)	0.16 (0.001)	9.4 <sup>***</sup>
Tenure (years)	9.4 (9.0)	7.9 (7.4)	10.8 (10.2)	2.9 (0.07)	43.9 <sup>***</sup>
Education					
Below undergraduate degree	0.02	0.01	0.02	0.01	16.3 <sup>***</sup>
Graduate degree	0.40	0.34	0.46	0.12	33.1 <sup>***</sup>
Postgraduate degree	0.51	0.55	0.47	-0.08	-22.4 <sup>***</sup>
PhD	0.07	0.10	0.04	-0.06	-27.7 <sup>***</sup>
Unknown	0.08	0.07	0.08	0.01	4.6 <sup>***</sup>
<i>Panel B: Turnover characteristics</i>					
Number of turnovers	8,319	3,552	4,767		
Turnover reason (%)					
Resigned	0.54	0.60	0.50		
Retired	0.20	0.19	0.20		
Term expired	0.10	0.07	0.12		
Demise	0.05	0.07	0.04		
Others	0.01	0.01	0.01		
Reason unknown	0.08	0.04	0.09		
$\chi^2$ -statistic					225.8 <sup>***</sup>

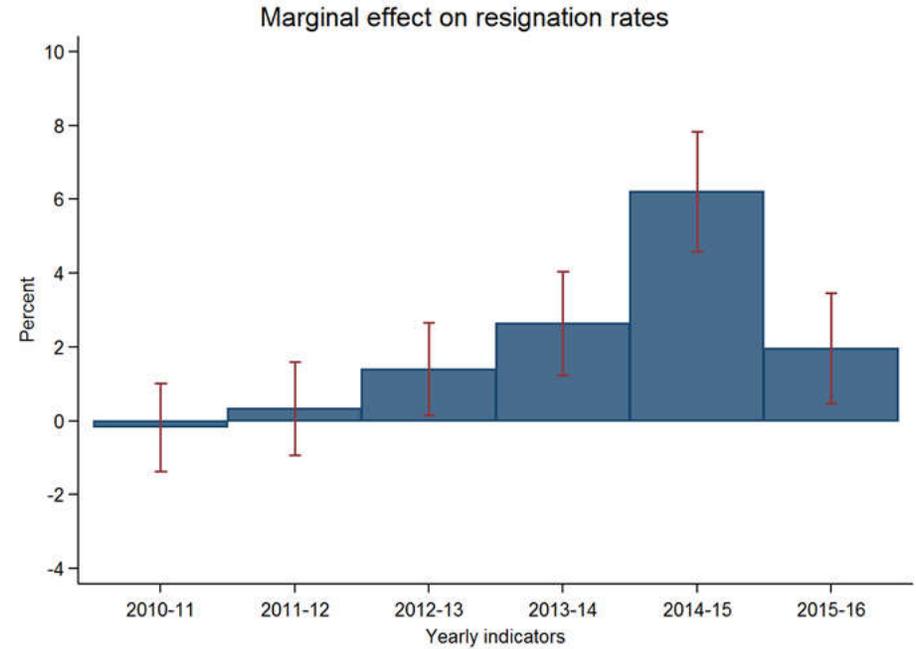
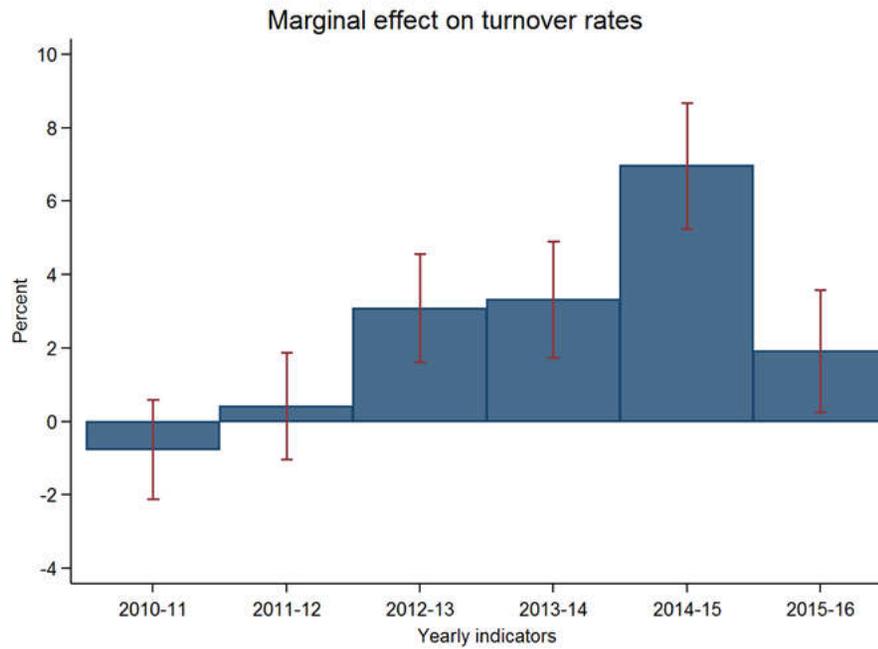
## Effect of reform : Turnovers



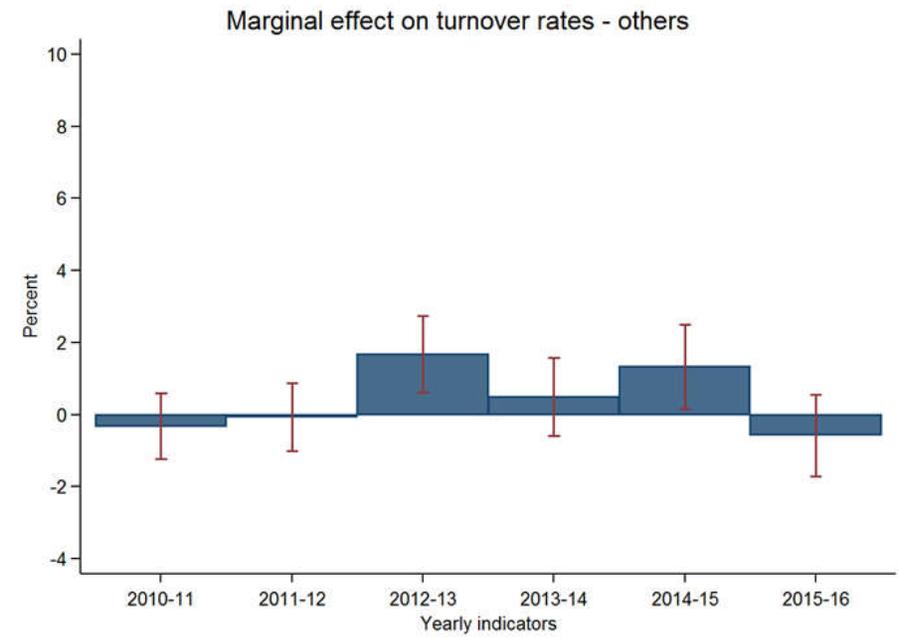
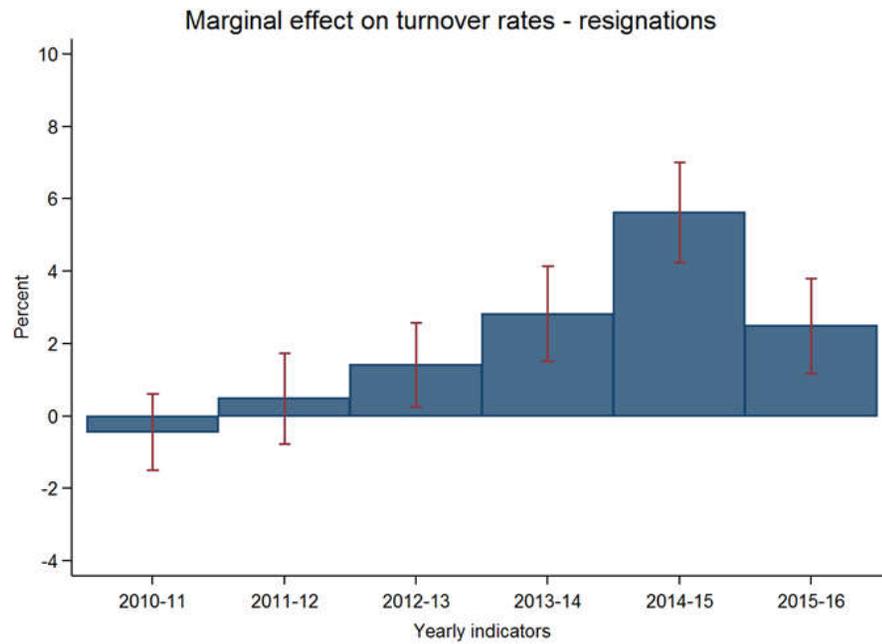
# Effect of reform: Resignations



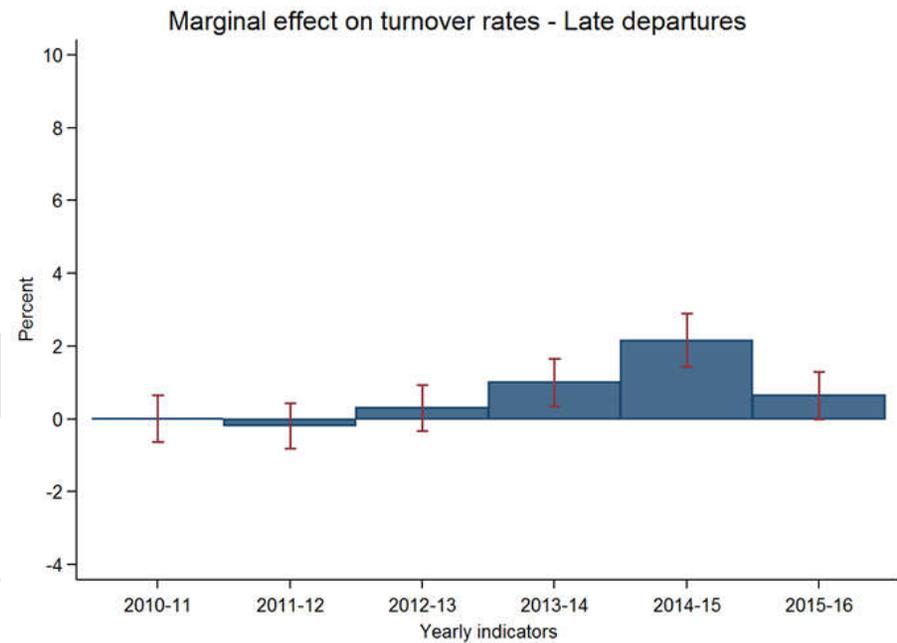
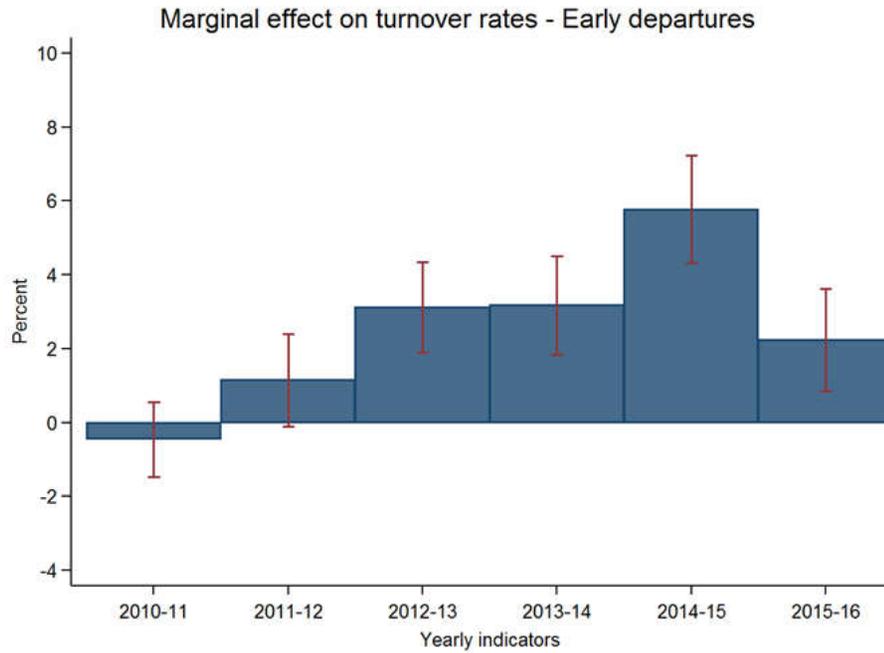
# Marginal effects



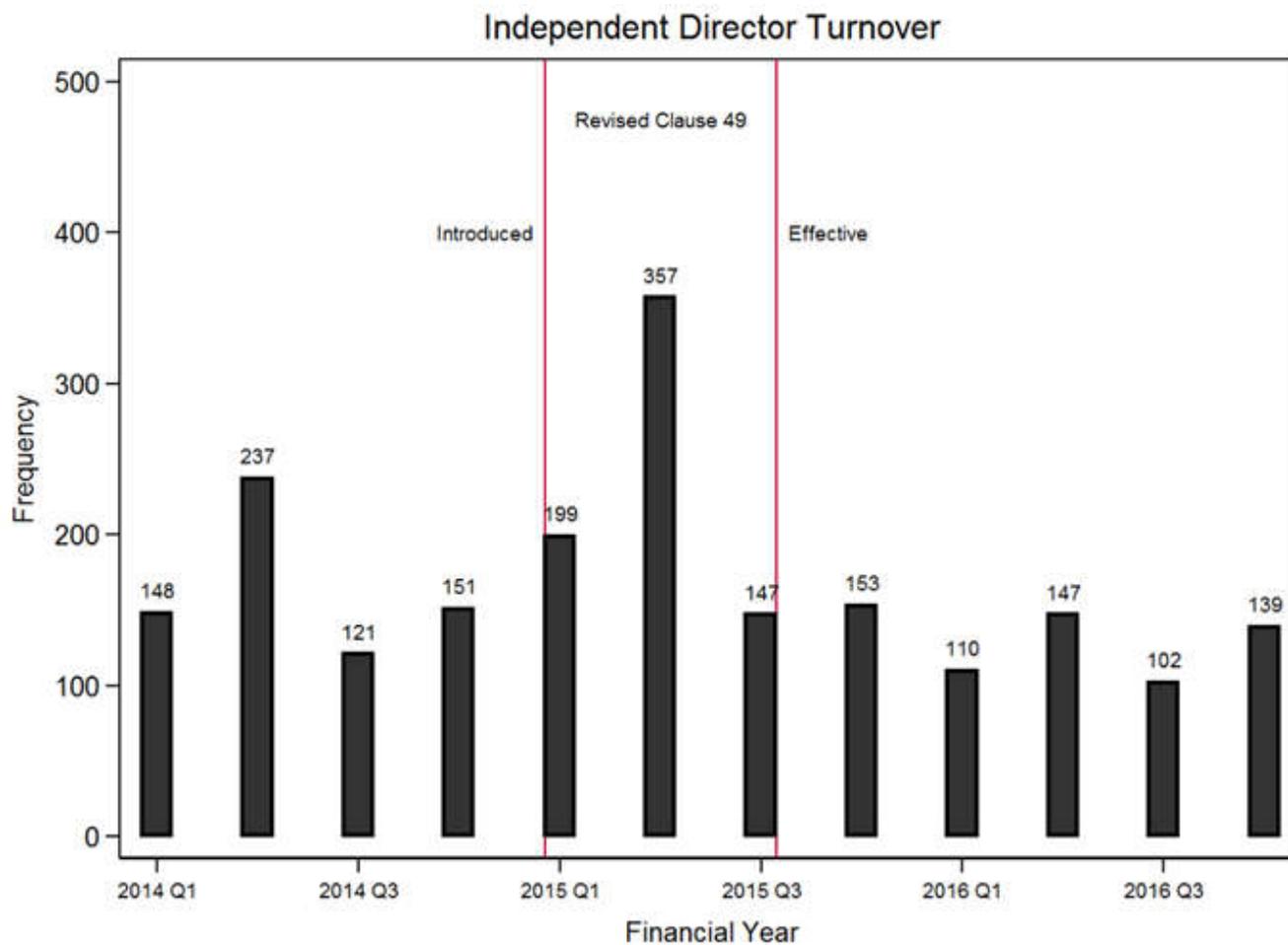
# Marginal effects: Resignations vs Others



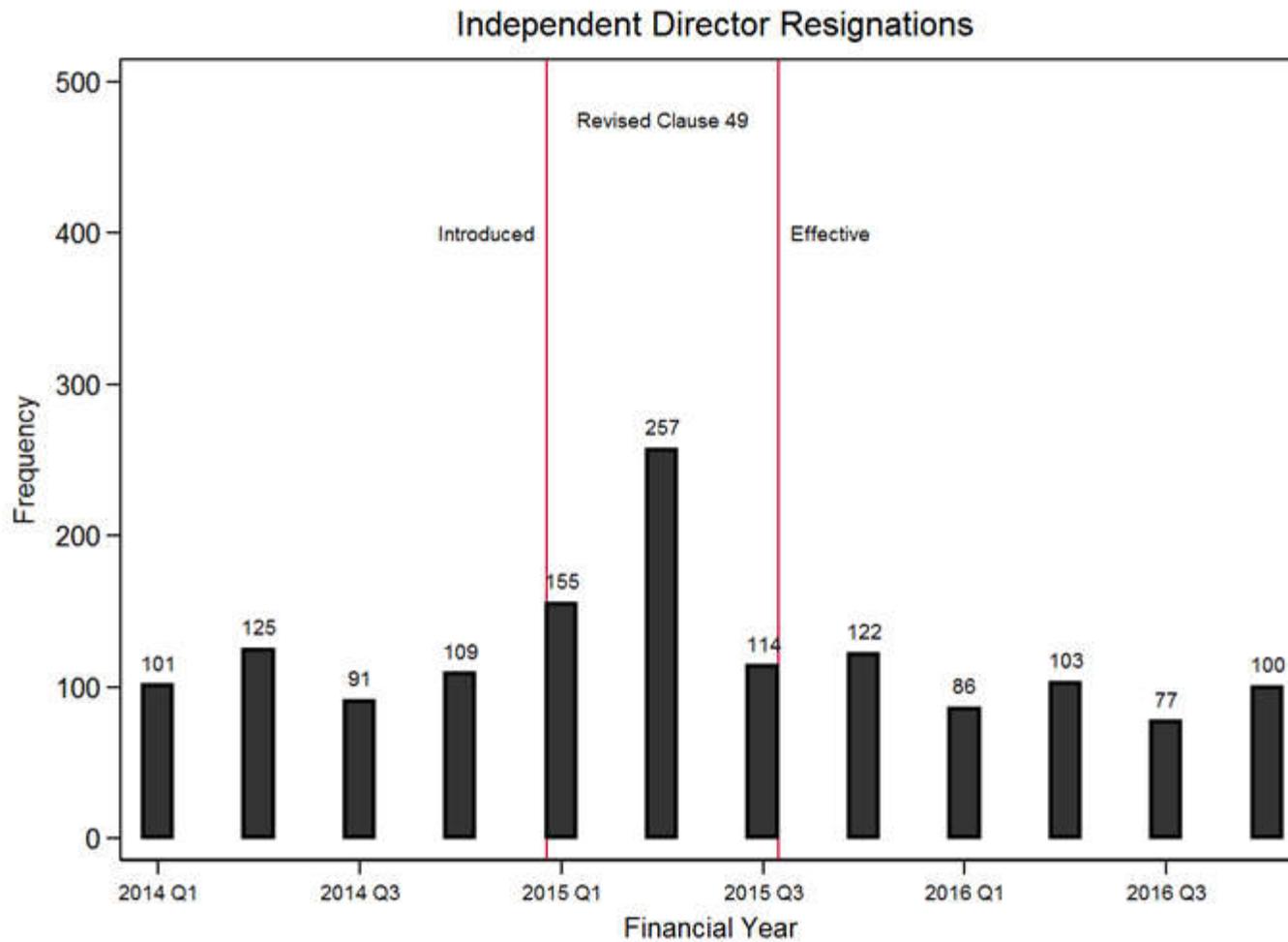
# Marginal effects: Early vs Late departures



# Frequency: Turnovers



# Frequency: Resignations



## Table 3: Director accountability and turnover

Director type Accountability indicator	Independent		Inside		All	
	Post	Introduction	Post	Introduction	Post	Introduction
	(1)	(2)	(3)	(4)	(5)	(6)
Accountability	2.539*** (0.663)	4.821*** (0.740)	0.660 (0.535)	0.916 (0.574)	-	-
Independent director	-	-	-	-	-1.383*** (0.381)	-1.221*** (0.350)
Independent director x Accountability	-	-	-	-	3.153*** (0.708)	5.174*** (1.003)
Return on assets $t-1$	-3.723 (3.576)	-4.727 (3.560)	-1.296 (3.105)	-1.583 (3.081)	-	-
Firm Size $t-1$	2.909** (1.130)	3.097*** (1.031)	0.198 (0.697)	0.334 (0.609)	-	-
Market-to-book value $t-1$	-0.435 (0.662)	-0.033 (0.625)	-0.253 (0.564)	0.348 (0.541)	-	-
Firm fixed effects	Yes	Yes	Yes	Yes	No	No
Firm-year fixed-effects	No	No	No	No	Yes	Yes
Adjusted-R <sup>2</sup>	0.130	0.137	0.165	0.165	0.292	0.296
N	5,702	5,702	5,856	5,856	16,221	16,221

**Table 4: Independent director compensation and turnover**

Accountability indicator	Post			Introduction		
	(1)	(2)	(3)	(4)	(5)	(6)
Accountability	-0.640 (1.861)	1.391 (1.926)	0.114 (2.020)	1.465 (1.824)	1.995 (2.027)	1.287 (1.802)
Low (Total Pay % of Market cap $t_{-1}$ )	-6.702*** (2.134)	-	-	-4.396** (1.802)	-	-
Low (Total Pay % of Market cap $t_{-1}$ ) x Accountability	12.600*** (3.243)	-	-	12.732*** (4.426)	-	-
Low (Sitting fees % of Market cap $t_{-1}$ )	-	-3.473 (2.437)	-	-	-2.481 (2.169)	-
Low (Sitting fees % of Market cap $t_{-1}$ ) x Accountability	-	8.916*** (3.177)	-	-	11.759*** (4.230)	-
Low (Commission fee % of Market cap $t_{-1}$ )	-	-	-3.947 (2.917)	-	-	-0.885 (2.159)
Low (Commission fee % of Market cap $t_{-1}$ ) x Accountability	-	-	12.680*** (4.219)	-	-	13.816*** (4.481)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R <sup>2</sup>	0.241	0.229	0.235	0.107	0.104	0.105
N	1,111	1,111	1,111	1,111	1,111	1,111

## 1. Non-compliance

- » Past non-compliance with listing requirements (SEBI)
- » Submission of annual reports (Clause 31), shareholder information (Clause 35), financial results (Clause 41), and the annual corporate governance report (Clause 41)
- » Penalties
  - » Fines
  - » Suspension of trading
  - » Delisting

## 2. Corporate crimes

- » Corrupt Industry classification based on “Bribery and corruption: Ground reality in India” by EY (2013)

## Table 5: Director accountability and litigation risk

Accountability indicator	Post		Introduction	
	(1)	(2)	(3)	(4)
Accountability	2.259*** (0.680)	1.830** (0.744)	4.396*** (0.762)	3.930*** (0.824)
Accountability x Non-compliance <sub>t-5,t</sub>	3.222*** (1.193)	-	2.512 (1.566)	-
Accountability x Corrupt Industry	-	2.530** (1.209)	-	3.092* (1.694)
Return on assets <sub>t-1</sub>	-3.354 (3.566)	-3.693 (3.579)	-4.697 (3.561)	-4.787 (3.580)
Firm Size <sub>t-1</sub>	3.099** (1.125)	2.832** (1.128)	3.009*** (1.028)	3.071** (1.031)
Market-to-book value <sub>t-1</sub>	-0.377 (0.667)	-0.402 (0.656)	-0.032 (0.626)	-0.034 (0.624)
Firm fixed effects	Yes	Yes	Yes	Yes
Adjusted-R <sup>2</sup>	0.137	0.131	0.138	0.138
N	5,702	5,702	5,702	5,702

## Table 7: Director characteristics and turnover

Accountability indicator	Post				Introduction			
	Baseline	Interaction	Baseline	Interaction	Baseline	Interaction	Baseline	Interaction
	(1)		(2)		(3)		(4)	
Director age (years)	0.000 (0.000)	0.000 (0.001)	0.026** (0.006)	-0.000 (0.000)	0.000 (0.000)	0.000 (0.001)	0.022*** (0.002)	0.000 (0.001)
Tenure (years)	0.002*** (0.000)	-0.000 (0.000)	0.001 (0.001)	-0.001 (0.001)	0.002*** (0.000)	0.000 (0.000)	0.002** (0.000)	0.000 (0.001)
Female director	-0.003 (0.011)	-0.039* (0.017)	-	-0.041* (0.020)	-0.007 (0.010)	-0.066** (0.020)	-	-0.052* (0.022)
Busy director	0.026*** (0.005)	-0.025* (0.010)	0.063*** (0.013)	-0.044*** (0.011)	0.021*** (0.005)	-0.018 (0.014)	0.050*** (0.012)	-0.016 (0.015)
Civil service (1=Yes)	-0.018* (0.008)	0.044** (0.017)	-	0.053** (0.018)	-0.009 (0.008)	0.040 (0.020)	-	0.038 (0.022)
PhD (1=Yes)	-0.014 (0.007)	0.036* (0.016)	-	0.027 (0.018)	-0.003 (0.007)	0.008 (0.022)	-	0.003 (0.023)
Controls	Yes		Yes		Yes		Yes	
Firm fixed effects	Yes		No		Yes		No	
Director fixed effects	No		Yes		No		Yes	
Time fixed effects	Yes		Yes		Yes		Yes	
N	19,658		19,658		19,658		19,658	
Adjusted-R <sup>2</sup>	0.083		0.088		0.082		0.086	

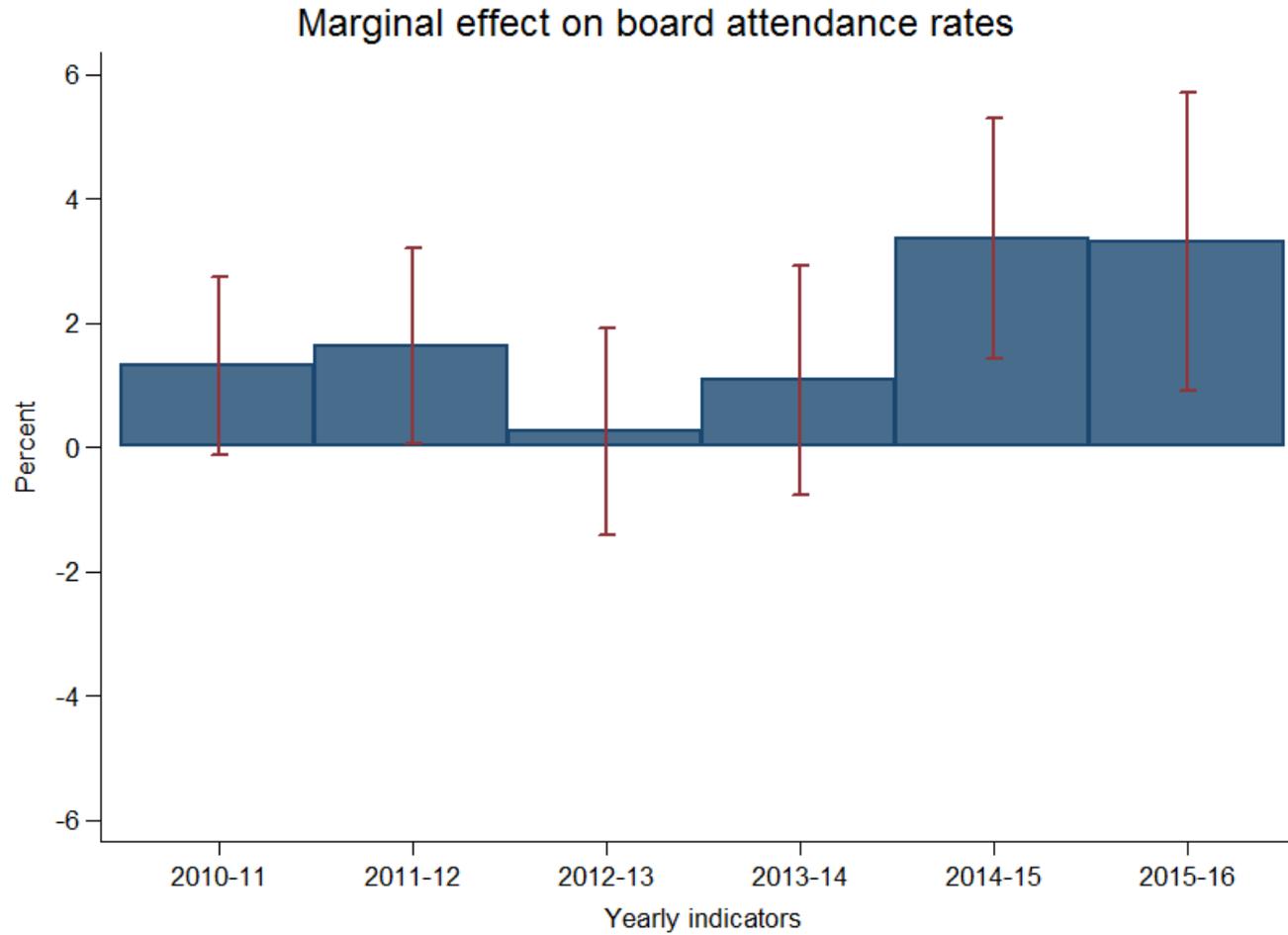
**Table 8: Independent director compensation and turnover**

Accountability indicator	Post			Introduction		
	(1)	(2)	(3)	(4)	(5)	(6)
Accountability	0.118*** (0.025)	0.096*** (0.023)	0.064*** (0.029)	0.155** (0.030)	0.114*** (0.029)	0.074** (0.035)
Total pay <sub>t-1</sub> (Rank)	-0.014*** (0.003)	-	-	-0.017*** (0.003)	-	-
Total pay <sub>t-1</sub> (Rank) x Accountability	-0.023*** (0.005)	-	-	-0.028** (0.006)	-	-
Sitting fee <sub>t-1</sub> (Rank)	-	0.003 (0.003)	-	-	0.001 (0.003)	-
Sitting fee <sub>t-1</sub> (Rank) x Accountability	-	-0.015*** (0.003)	-	-	-0.019*** (0.007)	-
Commission fee <sub>t-1</sub> (Rank)	-	-	0.003 (0.005)	-	-	0.002 (0.004)
Commission fee <sub>t-1</sub> (Rank) x Accountability	-	-	-0.005 (0.007)	-	-	-0.008 (0.009)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm fixed-effects	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R <sup>2</sup>	0.095	0.109	0.107	0.097	0.109	0.107
N	6,303	5,566	5,566	6,303	5,566	5,566

## New results: Board attendance

Accountability indicator	Post			Introduction		
	(1)	(2)	(3)	(4)	(5)	(6)
Accountability	1.694* (0.894)	0.035*** (0.006)	0.034*** (0.007)	3.304*** (0.928)	0.050*** (0.007)	0.046*** (0.008)
Low (Board attendance) <sub>t-1</sub>	-0.848 (0.684)	-	-	-0.930 (0.614)	-	-
Low (Board attendance) <sub>t-1</sub> x Accountability	1.733 (1.185)	-	-	3.642** (1.554)	-	-
Less than 50% board attendance <sub>t-1</sub>	-	0.013 (0.009)	-	-	0.014* (0.008)	-
Less than 50% board attendance <sub>t-1</sub> x Accountability	-	0.049*** (0.018)	-	-	0.109*** (0.027)	-
Less than 75% board attendance <sub>t-1</sub>	-	-	0.014** (0.006)	-	-	0.014** (0.006)
Less than 75% board attendance <sub>t-1</sub> x Accountability	-	-	0.024** (0.012)	-	-	0.063*** (0.017)
Controls	Yes	Yes	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Adjusted-R <sup>2</sup>	0.143	0.065	0.143	0.155	0.069	0.068
N	4,560	18,514	18,514	4,560	18,514	18,514

# New results: Monitoring



# Alternative specifications

Results are robust to alternative specifications

1. Atleast one woman director
2. Less than 7 directorships
3. Less than 3 completed terms
4. Exclude directors with stock options
5. Exclude bank & government firms
6. Sensitivity to performance

## Conclusion

- Investigates whether accountability deters individuals from serving as independent directors.
- We find after the reform
  - Turnover rates and resignation rates increase significantly
  - Stronger deterrence among firms where the pecuniary or reputational incentives to serve as an independent director is weak and in firms that are subject to greater litigation and regulatory risk.
- Overall, fear of legal liability seems to deter individuals from serving as directors, and could potentially reduce board effectiveness.

# Appendix Table A1

Appendix Table A1: Details of Clause 49

Particulars	Clause 49, 2006	Revised Clause 49, 2014
Board Composition	i. 50% (33%) independent directors if chairman is executive director or promoter (neither executive nor promoter)	ii. 50% (33%) independent directors if chairman is executive director or promoter (neither executive nor promoter) iii. At-least one woman director.
Directorships	i. No limitation on number directorships ii. No limitation on the number of terms	i. Individuals can serve as an independent director for max. 7 companies. The max. number is 3 for whole-time directors. ii. Term of an independent director limited to two terms of five years each. Individuals serving as independent director for 5 years or more in a company as on October 1st 2014, are eligible for one more term of up to 5 years only. iii. An Independent director is eligible for reappointment as an independent director only after a 3 year cooling-off period, after completion of two terms.
Committee requirements & limitations	i. A director can at maximum be a member (chairman) of 10 (5) committees. ii. Audit committee size limited to 3. Chairman and one other director should be independent.	i. A director can at maximum be a member (chairman) of 10 (5) committees. ii. Audit committee size limited to 3. Chairman and one other director should be independent. iii. Nomination and remuneration committee sizes are at-least three members. Chairman and at-least half of the members should be independent directors.
Liability of independent directors	i. No explicit liability imposed	i. Held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge, attributable through Board processes, and with his consent or connivance or where he had not acted diligently with respect of the provisions contained in the Listing Agreement.
Stock options	i. Maximum number of stock options granted to be specified through shareholder resolution.	i. Independent directors are not entitled to any stock option.
Performance evaluation of independent directors	i. Non-mandatory requirement	i. Mandatory requirement