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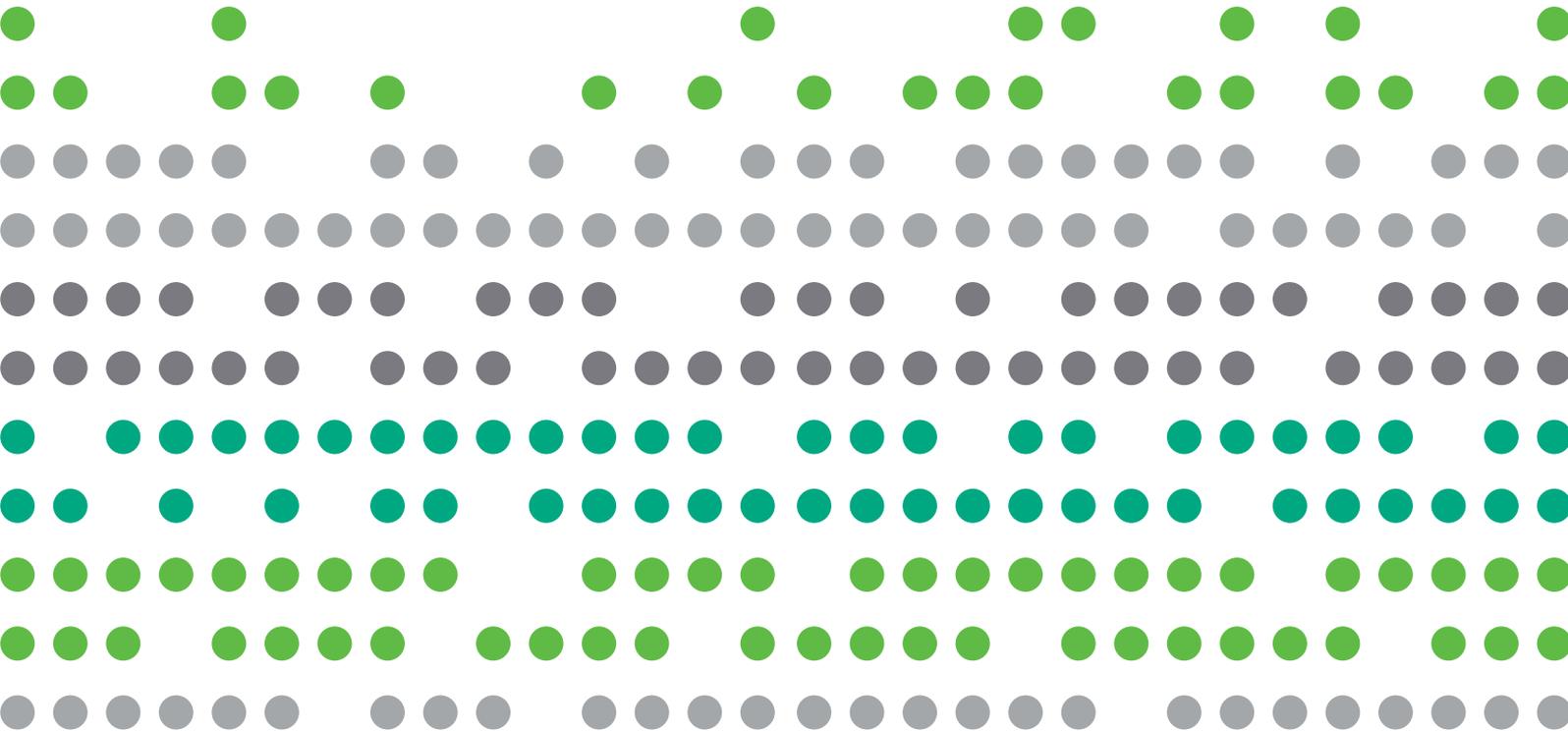
INDIA INSIGHTS

THE CASE FOR MANDATORY SEPARATION OF CHAIRPERSON AND CEO ROLES IN INDIA

Results of a Membership Survey Conducted by
CFA Institute in Partnership with CFA Society India

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Executive Summary

Separation of the roles of chairperson and CEO is considered to be a good corporate governance practice. *The OECD Principles of Corporate Governance* recommends this separation.¹ CFA Institute, a global not-for-profit representing the investment community, published *The Corporate Governance of Listed Companies*, a resource to help investors determine whether the board chair also should hold the title of chief executive. As the manual cautions, this dual role may "give undue influence to executive board members and impair the ability and willingness of board members to exercise their independent judgment."²

In India, the Kotak Committee on Corporate Governance issued a report recommending the separation of chair and CEO in companies with significant public shareholding.³ In response, in early 2018, the Securities and Exchange Board of India (SEBI), the Indian securities regulator, mandated the separation of chair and CEO for the top 500 Indian companies, ranked by market capitalization, effective April 2020. The rule, however, faced stiff resistance from the industry, and in January 2020, SEBI deferred the implementation by two years, to April 2022.⁴

Throughout this debate, one thing that has been clearly lacking is the investors' perspective. To address that deficiency, CFA Institute worked with CFA Society India to conduct a survey of its members, seeking their opinions about the measure, additional safeguards they would consider given the deferment, and their views on independent directors.

The results are instructive. We asked members to provide their opinion on each of the three requirements of chairperson/CEO separation: (1) one person should not perform both roles, (2) the two should not be related, and (3) the chairperson should be a non-executive director. We wanted to not only assess overall support for these requirements but also uncover any nuances – for example, an investor may oppose one person performing a dual role but may not be concerned about an executive director performing the role of chairperson.

An overwhelming 92% of the 108 respondents agreed or strongly agreed with the first statement; 87% agreed with the second; and 70% agreed that the chairperson should

¹ OECD, *G20/OECD Principles of Corporate Governance* (Paris: OECD, 2015). www.oecd.org/corporate/principles-corporate-governance/.

² M. Orsagh, L. Rittenhouse, and J. Allen, *The Corporate Governance of Listed Companies*, 3rd ed. (CFA Institute, 2018). www.cfainstitute.org/en/advocacy/policy-positions/corporate-governance-of-listed-companies-3rd-edition.

³ SEBI, *Report of the Committee on Corporate Governance*, 5 October 2017. www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html

⁴ SEBI, *Listing Obligations and Disclosure Requirements* (Mumbai: Securities and Exchange Board of India, 2020). www.sebi.gov.in/legal/regulations/jan-2020/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-regulations-2015-last-amended-on-january-10-2020-_37269.html

be a non-executive director. Those in support cited as their principal reasons as a lower likelihood of promoters⁵ enriching themselves at the expense of minority shareholders as well as a greater likelihood of fostering accountability and vibrant debates.

Corporate performance is frequently offered by advocates and opponents alike as a reason for their views. Thus, we asked members about their expectation of performance of companies that had a separation of roles versus companies that did not have a separation. Of those surveyed, 81% believed that companies with a separation of roles may outperform or slightly outperform those that do not separate the roles.

Given SEBI's decision to defer the rule, we also asked members what interim additional measures they would support to strengthen board independence in companies without a separation of roles. More than half of the respondents (59%) supported increasing the proportion of independent directors; in other words, although the current rules already set the floor on independent directors at 50%, our members supported having more independent directors than executive directors in such companies. In addition, 48% supported the idea of setting fixed chairperson terms, with an extension subject to the approval of disinterested shareholders. Other choices – including incentives such as premium listings in exchanges (24%) or no safeguards required (14%) – did not garner as much support.

The need for separation goes hand in hand with the effectiveness of independent directors. More than half of the respondents (56%) disagreed or strongly disagreed with the statement, "Independent directors have effectively discharged their duties in the last few years, given expectations from their roles," and only 19% agreed with this statement. Most respondents who disagreed (85%) cited the lack of independence from the promoter, and their lack of preparation in board meetings (46%), as the reasons for their disagreement. A few respondents cited groupthink among board members and lack of relevant qualifications as the reasons for their disagreement.

Board independence is a cornerstone of corporate governance, and Separation of Chairperson and CEO Roles is a key component of this independence. Transitions are never easy, and we must acknowledge that SEBI's decision to defer the rule was a prudent one, considering the circumstances. The reasons for the rule remain, however, whether because of the dominance of family-owned firms, abuse of minority shareholders as evidenced in related-party transactions, or relatively weak legal protections for minority shareholders. We hope that SEBI stays the course and implements the measure in 2022 to strengthen India's corporate governance.

⁵ In Indian context, the term promoter refers to a person who controls the affairs of the company, or whose advice the board of directors usually act upon

Introduction

The concept of separation of ownership and control in corporations has a long history. In their seminal book, *The Modern Corporation and Private Property*,⁶ Adolf Berle and Gardiner Means described the agency problem of corporations and suggested that in a world of depersonalized ownership, boards acting as trustees of shareowners might be preferable to relinquishing property rights in favor of agents. They describe the role of the board as follows:

the group in control of a corporation would be placed in a position of trusteeship in which it would be called on to operate or arrange for the operation of the corporation for the sole benefit of the security owners despite the fact that the latter have ceased to have power over or to accept responsibility for the active property in which they have an interest.

Given the trusteeship role of the board, it is not surprising that structures that tackle agency problems of conflict of interest directly, such as independent directors and Separation of Chairperson and CEO Roles, are considered good corporate governance practices. *The OECD Principles of Corporate Governance* recommends such separation, as it can "help to achieve an appropriate balance of power, increase accountability and improve the board's capacity for decision making independent of management."⁷

In *The Corporate Governance of Listed Companies*, CFA Institute guides investors in determining whether the board chair also holds the title of chief executive. As stated in the manual, this dual role may "give undue influence to executive board members and impair the ability and willingness of board members to exercise their independent judgment."⁸

Regulations governing the separation of the roles of chairperson and CEO are becoming increasingly prevalent globally. According to the *OECD Corporate Governance Factbook*,⁹ recommendations or requirements for the separation of the board chair and CEO across 49 international jurisdictions have doubled in the past four years to 70%, of which 30% are required. The 2015 edition of the *Factbook* reported a binding requirement in only 11% of the jurisdictions, with another 25% recommending this separation in codes.

⁶ A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: Transaction Publishers, 1932). p.311.

⁷ OECD, *G20/OECD Principles of Corporate Governance*.

⁸ Orsagh et al., *Corporate Governance of Listed Companies*.p.14.

⁹ OECD, *OECD Corporate Governance Factbook 2019*, 11 June 2019. www.oecd.org/corporate/corporate-governance-factbook.htm.

Separation of Chairperson and CEO Roles in the Indian Context

In India, the Separation of Chairperson and CEO Roles has been incentivized through board composition since 2004. On the basis of the recommendations of the *Report of the Kumar Mangalam Birla Committee on Corporate Governance*,¹⁰ in late 2004 SEBI amended clause 49 of the listing agreement. This amendment made it mandatory for companies with a non-executive chair to have at least one-third of the board composed of independent directors, and for companies with an executive chair to have at least one-half.¹¹ The report also included a recommendation for a non-executive chairperson.

In late 2017, the Kotak Committee on Corporate Governance report recommended separation of the roles of chairperson and CEO for companies with at least 40% public shareholding, and expanded this recommendation to all listed companies by April 2022. In response, in early 2018, SEBI mandated the Separation of Chairperson and CEO Roles for the top 500 Indian companies by market capitalization, effective April 2020. The rule faced stiff resistance from the industry, and SEBI deferred the implementation of the rule by two years, to 1 April 2022.¹²

Given the lack of consensus, it is worth reiterating some of the arguments for making separation mandatory in the Indian context. The critics of the regulation argue that separation is a Western concept that is not applicable in India. But separation is good practice across regions, even if the context is different. In the Western hemisphere, where companies have a more diversified shareholding structure, separation is important to manage agency conflict between management and shareholders. Agency conflicts manifest as outrageous executive compensation not linked to company performance, and loans extended to directors and officers, for example. In India and similar markets, where most companies are family owned, the separation is important to protect the minority shareholders from actions of promoters. Several markets, such as Brazil, Chile, and Israel, with similar ownership patterns as India, also have mandatory Separation of Chairperson and CEO Roles.

In weighing these arguments, we have to consider whether making separation mandatory is too stringent, compared with a recommendation, or even a comply-or-explain regime. Would a different edict drive change in behaviour?

¹⁰ SEBI. *Report of the Kumar Mangalam Birla Committee on Corporate Governance*. 2000. ecgi.global/code/report-kumar-mangalam-birla-committee-corporate-governance

¹¹ SEBI. *Corporate Governance in listed Companies - Clause 49 of the Listing Agreement*. 2004. www.sebi.gov.in/legal/circulars/oct-2004/corporate-governance-in-listed-companies-clause-49-of-the-listing-agreement_13153.html.

¹² SEBI. *Listing Obligations and Disclosure Requirements* (Mumbai: Securities and Exchange Board of India, 2020). www.sebi.gov.in/legal/regulations/jan-2020/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-regulations-2015-last-amended-on-january-10-2020-_37269.html

Putting the right structures in place is important. Many auditors began to assert their roles only after multiple scandals highlighted their shortcomings. Although the institution of independent directors has existed for some time now, many are still perceived to be beholden to promoters. The problem with a comply-and-explain rule is that companies likely provide boilerplate language to avoid compliance. With the right structures, best practices would permeate over time and behaviours would improve.

Critics of the regulation approach also have argued that the question of separation should be left to shareholders. The problem with this view is that shareholder activism in India is still at a nascent stage. Although class-action suits were introduced a few years back, litigation remains non-existent, because of the adverse nature of the process and a lack of finality in the outcomes. Given the weak legal protections in place for minority shareholders, a case can be made for strengthening regulations.

Throughout this debate, the investors' perspective has been clearly lacking. To address this deficiency, CFA Institute in partnership with CFA Society India conducted a survey of its members, seeking their opinions about the measure, additional safeguards they would consider given the deferment, and their views on independent directors.

Survey Methodology and Highlights

The survey consisted of seven questions: five of the questions asked the respondents for their opinions on the separation rule, and two questions addressed the topic of independent directors. The survey was sent to CFA Society India members, who most likely had an informed opinion of the measure. We received 108 responses from the target population of 3,207 members, a response rate of 3.4%. Please see Appendix I for a review of survey demographics. The survey was sent on 10 February 2020 and closed on 21st February 2020.

- An overwhelming 92% of the respondents agreed with the statement, "One person should not perform the dual role of chairperson and CEO." An additional 87% agreed that the two should not be related, and 70% preferred a nonexecutive chairperson.
- Respondents who supported separation cited the principal reasons for such support as fostering greater accountability and vibrant debate (75%), and a lower likelihood of promoters enriching themselves at the expense of minority shareholders (74%).
- Of those surveyed, 81% believed that companies with a separation of roles may outperform or slightly outperform those that do not separate the roles.
- Considering deferment of the decision for mandatory separation, more than half of the respondents (59%) supported increasing the proportion of independent directors as interim additional safeguards.
- More than half the respondents (56%) disagreed or strongly disagreed with the statement, "Independent directors have effectively discharged their duties in the last few years, given expectations from their roles," and only 19% agreed.
- Among the respondents who disagreed, 85% cited the lack of independence from the promoter, and lack of preparation for board meetings – reading the briefs, coming prepared with questions, making pre-meeting requests, and so on... (46%), as the reasons for their disagreement.

Separation of Chairperson and CEO Roles

We asked members for their opinion on each of the three requirements of chairperson/CEO separation: (1) one person should not perform both roles, (2) the two should not be related, and (3) the chairperson should be a non-executive director (figure 1). We wanted to not only assess overall support for this separation but also uncover any nuances – for example, an investor may oppose one person performing a dual role but may not be concerned about an executive director performing the role of chairperson.

Figure 1. Separation of Chairperson and CEO.

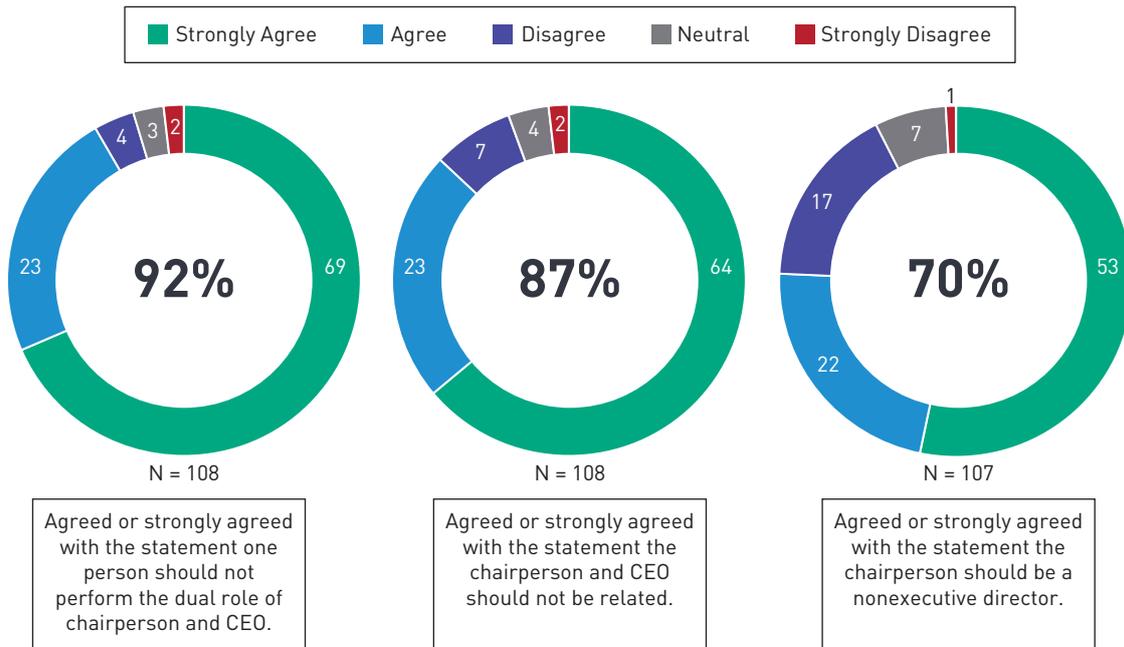
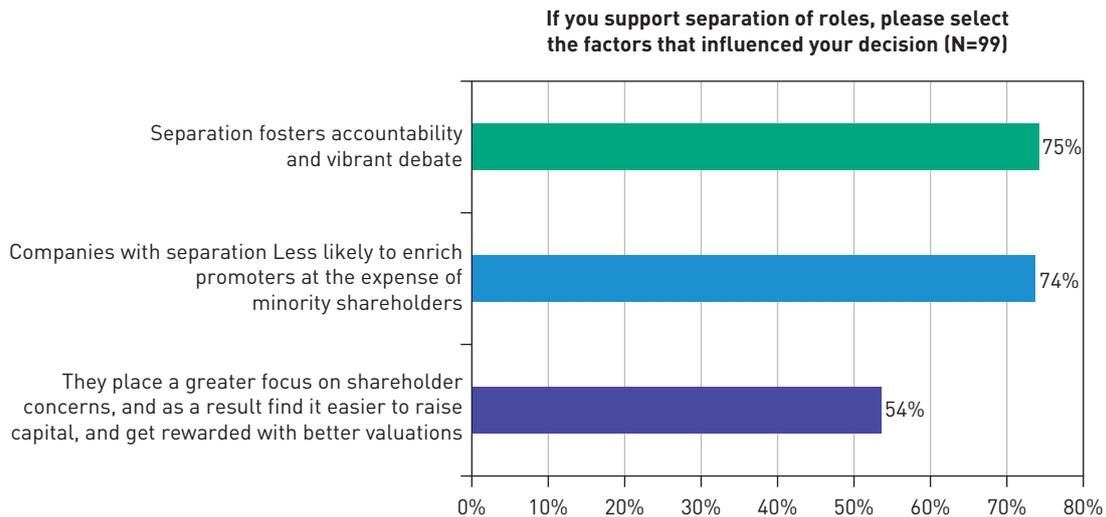


Figure 2. Factors that Influenced Support.



We asked respondents to provide a reason for their opinion. Among those who supported the measure (figure 2), the top reasons cited were fostering greater accountability and vibrant debate (75%) and a lower likelihood of promoters enriching themselves at the expense of minority shareholders (74%).¹³

¹³ The amounts given throughout the report and in figures may not sum to 100% because of rounding.

In support of separation, reasons cited included that it was just better corporate governance and that these companies were less likely to have vested interests. One respondent suggested not allowing dominant shareholders (>5%) to hold any position such as chair or CEO.

We also asked respondents to select their top reasons for opposing separation (figure 3). Interestingly, only 23 responses were given. Notably, a small number of respondents (16) identified some reasons for concentration of power appealing, even if they opposed it on balance.

Other respondents cited the energy and dedication of founders, and greater accountability, as reasons for opposing a separation of roles.

Corporate performance is frequently offered by advocates and opponents as a reason for their views. To better understand this view, we asked members about their expectation of performance of companies with a separation of roles versus companies without a separation (figure 4). Not surprisingly, in line with their support for separation, most respondents believed companies with Separation of Chairperson and CEO Roles also would tend to outperform those without separation.

Given that the regulator has deferred Separation of Chairperson and CEO Roles, we asked our members what they would consider to be reasonable interim safeguards, including the option "no additional safeguards are needed" (figure 5). The top reasons cited were mandating a majority composition of independent directors in which there would be no Separation of Chairperson and CEO Roles, and a requirement for approval from disinterested shareholders for fixed terms. Other reasons, such as incentives or even no safeguards necessary, did not find much support.

Figure 3. Factors that Influenced Opposition.

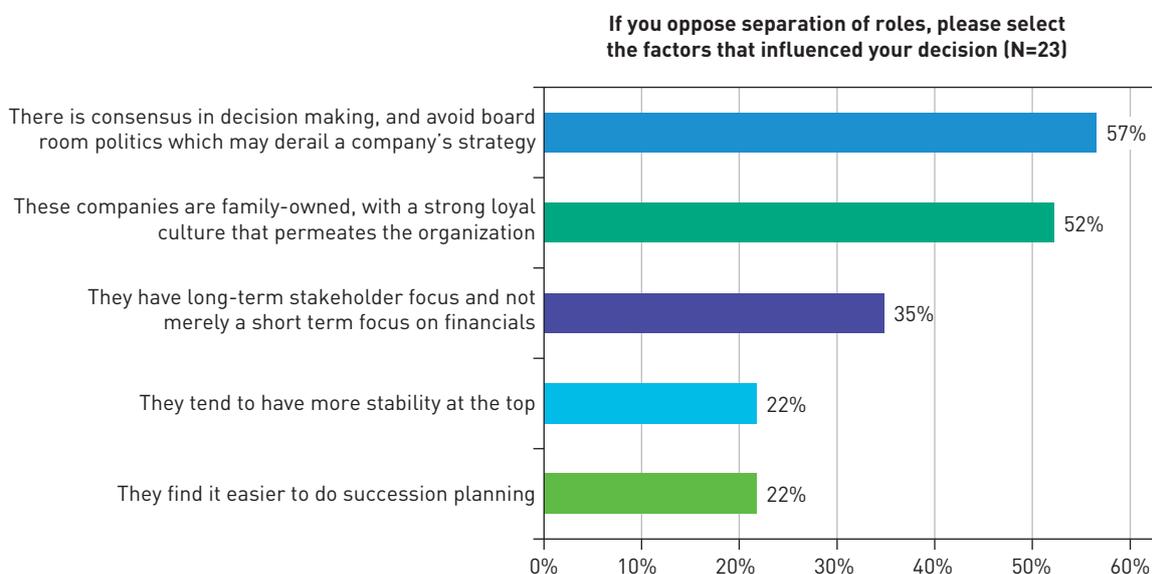


Figure 4. Expectations of Corporate Performance on the Basis of Separation.

Do you believe that companies where the chairperson and CEO are the same or related outperform or underperform versus other companies?

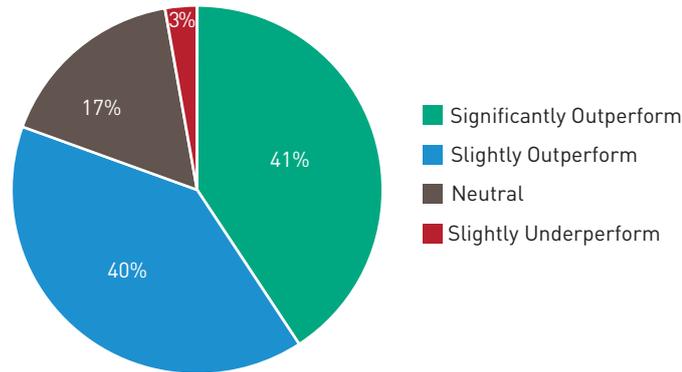
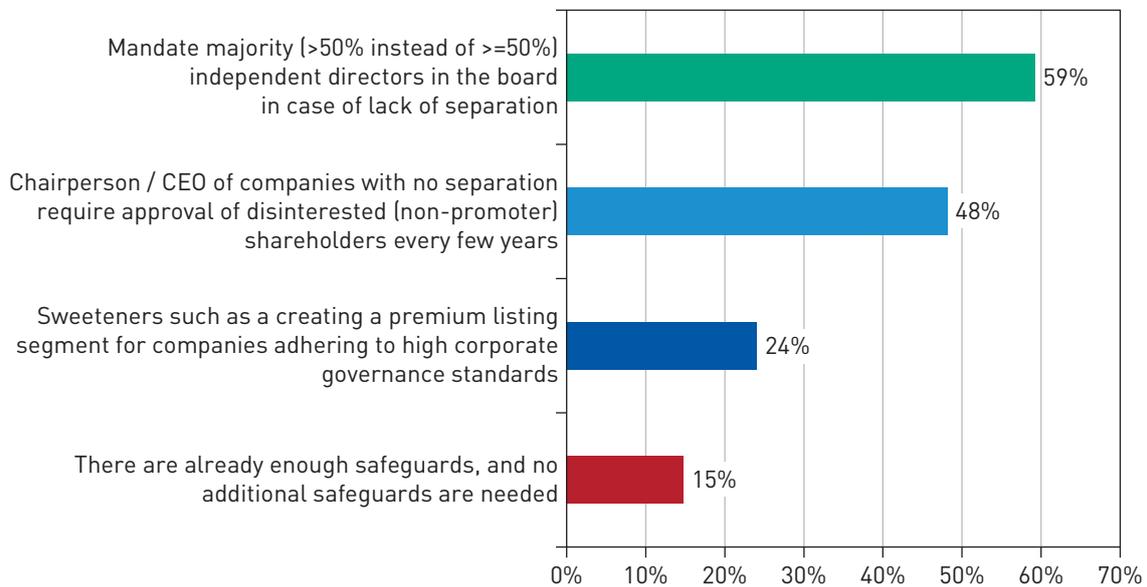


Figure 5. Safeguards in Lieu of Mandatory Separation.

As the regulator has deferred the mandatory separation rule by 2 years, which of the following would you consider the most reasonable additional safeguards in the interim?



Independent Directors

Any thorough discussion of Separation of Chairperson and CEO Roles must consider an assessment of independent directors. We asked our members for their opinion about the effectiveness of independent directors (figure 6). Only 19% of the respondents agreed or strongly agreed that independent directors effectively discharged their duties, and 56% disagreed; the remaining 26% neither agreed nor disagreed with the statement.

Figure 6. Opinions Regarding Independent Directors' Discharge of Duties.

Please indicate your opinion for the statement "Independent directors have effectively discharged their duties in the last few years, given expectations from their roles"

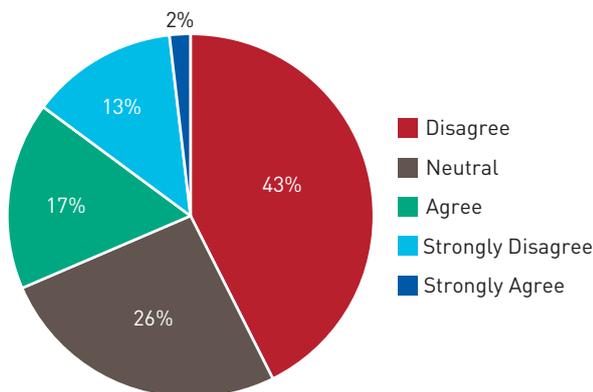
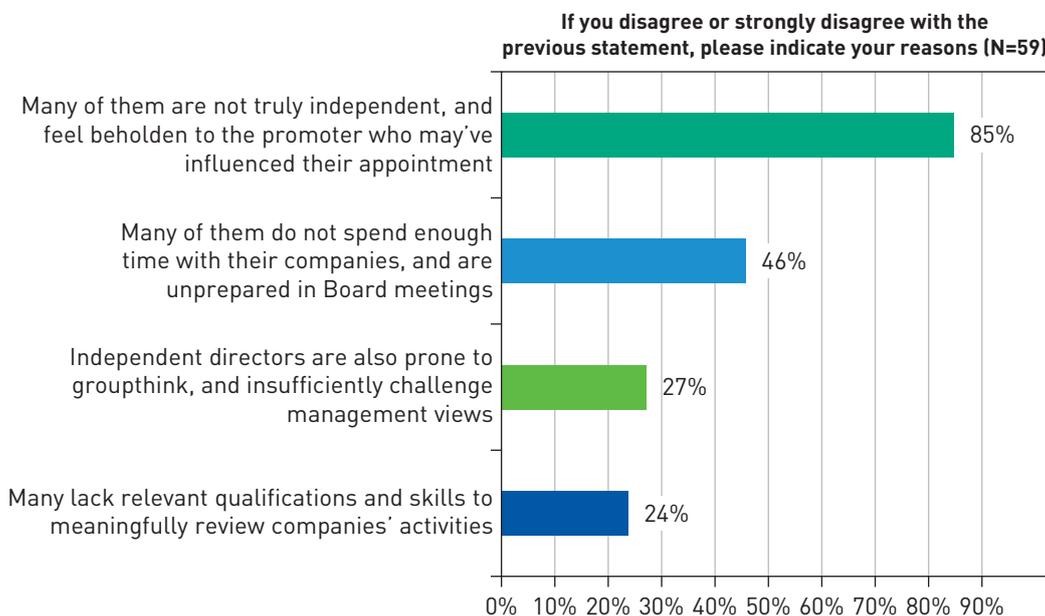


Figure 7. Reasons for Opinion on Independent Directors' Effectiveness.



Most respondents (85%) who disagreed with the statement thought independent directors were not truly independent of the promoter, and a few (46%) thought independent directors did not spend enough time with the companies. In addition, one respondent thought that the reliance on information from management about transactions made independent directors less effective, and one thought independent directors could not do justice to their roles if they served on the boards of more than two or three companies. In the case, such positioning might become a source of income and increases the director's proclivity to collude with management.

Conclusion

Board independence is a cornerstone of corporate governance, and Separation of Chairperson and CEO Roles is a key component of this independence. According to our survey, the investment community has demonstrated strong support for a measure calling for separation of roles.

Transitions are never easy. We acknowledge that SEBI's decision to defer the rule was a prudent one, particularly considering the circumstances. The sound reasons for this rule remain, however, whether because of the dominance of family-owned firms, abuse of minority shareholders as evidenced in related-party transactions, or relatively weak legal protections for minority shareholders. We hope that SEBI stays the course and implements this measure in 2022 for the sake of strengthening India's corporate governance.

Appendix I – Profile of Survey Correspondents

Figure I.1. Entity or organization.

Which best describes the entity / organization for which you work? (N=107)

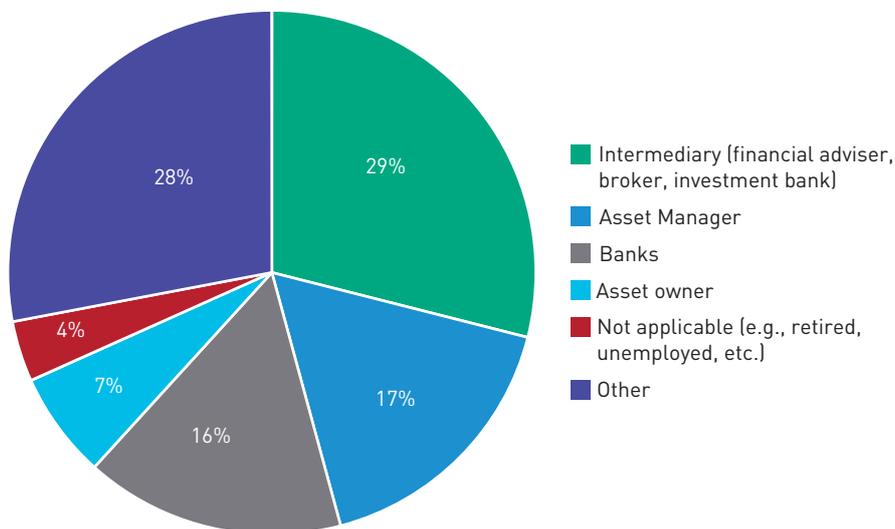
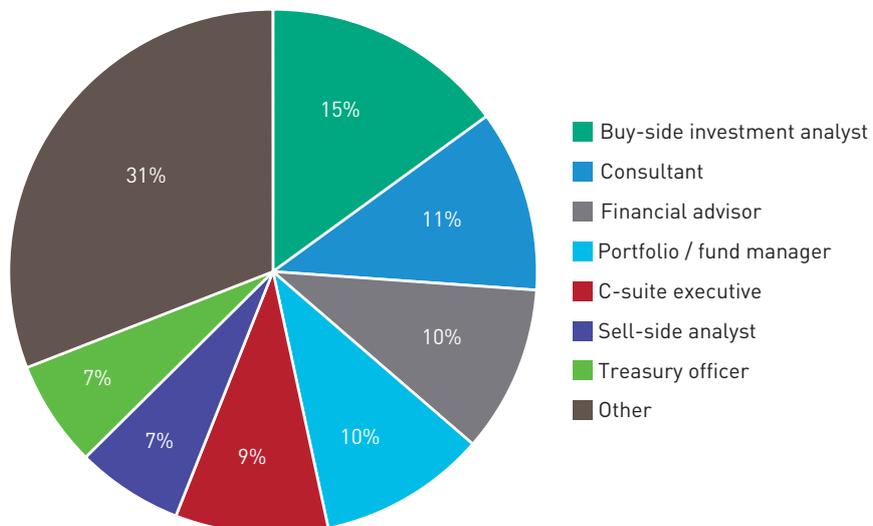


Figure I.2. Current occupation.

Which of the following best describes your current occupation?



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