

Guest blog

Pillars of Governance: Nomination and Remuneration Committee

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The regulatory architecture under the Companies Act, 2013 (“**Act**”), and the SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 (“**LODR**”), envisages a key role for the Nomination and Remuneration Committee of the Board of Directors (“**NRC**”) – in ensuring that the company attracts and retains the best talent - and there is transparency in the process of appointment/ re-appointment and payment of remuneration to directors, key managerial personnel (“**KMPs**”) and senior management¹.

The NRC’s role can be divided into four broad buckets - (a) appointment/ re-appointment of directors, KMPs, senior management; (b) recommending remuneration (both fixed and variable component) of directors, KMP, senior management; (c) performance evaluation of Board members, including the MD/ CEO and other WTDs; and (d) succession planning.

While this may seem to be ‘minimalistic’ when compared to the multifarious responsibilities cast on the Audit Committee – the NRC’s role is often underestimated, and at times ignored, in the circles of India Inc. After the Audit Committee, the NRC is perhaps the second most-important Board Committee under the corporate governance architecture.

However, given that approximately 75% of India Inc is promoter-driven, there exists a fundamental *dichotomy* in the NRC’s role. Under Sections 196, 197, read with Schedule V of the Act – the appointment and remuneration of all directors requires shareholders’ approval – and the voting rights at the general meeting are exercised by the promoter/ majority shareholders – who are not bound by the NRC’s recommendations.

¹ It is interesting to note that prior to the enactment of the 2013 Act, and the subsequent notification of the LODR in 2015, the erstwhile corporate governance architecture only provided for the constitution of a ‘remuneration committee’. In fact, the draft Companies Bill, 2009 had only provided for a ‘remuneration committee’ – and the ambit of the NRC was widened (to cover both appointment and remuneration) based on the recommendations of the Parliamentary Standing Committees that examined the draft Bill.

By virtue of this, especially in a promoter-driven set-up, the NRC's recommendations may not carry much weight. This begs the question – what value does the NRC truly add to India's corporate governance architecture? In this article, the authors' highlight the fundamental dichotomy that exists in relation to the NRC's role in the Indian context, the challenges faced by the NRC, and suggest reforms that can be adopted to strengthen this institution.

NRC's Responsibilities

Section 178 of the Act and Regulation 19, read with Schedule II of the LODR, inter alia sets out the following key responsibilities of the NRC:

1. Formulating criteria for determining qualifications and 'independence' of a director;
2. Recommending remuneration policy to the Board;
3. Evaluating candidature of individuals proposed to be appointed as independent directors ("**IDs**");
4. Formulating performance evaluation criteria of all directors;
5. Devising a Board-diversity policy;
6. Identifying persons who are qualified to become directors and who may be appointed in senior management, in accordance with the prescribed criteria;
7. Recommending whether to extend the term of an ID, basis their performance evaluation;
8. Recommending to the Board, all remuneration payable, in whatever form, to senior management.

While the NRC can engage search firms, compensation consultants, legal advisors, etc. - the responsibilities relating to recommending appointments/ re-appointments and remuneration vests with the NRC. As per Regulation 19 of the LODR, only an ID can be appointed as the NRC Chairperson.

The role of the NRC Chairperson is not limited merely to attending Board Meetings/ Board Committee Meetings scheduled during the financial year – he/ she has an onerous responsibility and is expected to play a key role in developing a succession planning framework, reviewing the performance of the CEO, CFO, etc.

One of the important responsibilities of the NRC is to undertake a thorough review of the CEO's performance – to evaluate whether the CEO should be re-appointed for another term. A thorough review would be based on objective parameters (such as the performance of the company during his tenure, whether

he has met his targets, success of his key initiatives, etc.), as well as other behavioural and cognitive aspects. But how many NRCs undertake a cogent and scientific review of the CEO's performance? Do they engage in discussions with other members of the management team to obtain informal feedback? Most significantly, to what extent is their final recommendation insulated from the views of the promoter?

Another aspect to be noted is the Kotak Committee's suggestion² that the NRC should be responsible for recommending to the Board, all remuneration, in whatever form, that is payable to senior management – which was incorporated by SEBI by amending the LODR. Given that certain members of the senior management team (such as CFO, CEO of a particular division, etc.) may not be appointed as whole-time directors on the Board, this has brought about certain amount of transparency/ accountability in the compensation paid to senior management. However, even in terms of remuneration, how many NRCs undertake a cogent analysis of market remuneration benchmarks, provide adequate justification for variable remuneration components (such as ESOPs or performance bonus)?

NRC's Challenges

The fundamental dichotomy

Since approximately 75% of India Inc is promoter-driven, to what extent are the NRC's recommendations insulated from the promoter's views? Further, as highlighted above, under Sections 196, 197, read with Schedule V of the Act – the shareholders have the final say in the appointment and remuneration of directors – and are not bound by the NRC's recommendations.

The fiduciary duties prescribed under Section 166 of the Act apply at the Board-level, and not while casting a vote during the shareholders' meeting. This results in a situation where the NRC may be relegated to a mere recommendatory body – despite having done a significant amount of groundwork in identifying the right candidate.

The effectiveness of the NRC's recommendations is constrained by the fact that the promoter's vote is required to implement the recommendations of the NRC, particularly in matters of appointments and fixing of remuneration of MD/ WTD

² Report of the Kotak Committee on Corporate Governance, at Pg. 38 and 39.

– and it could lead to an ‘awkward situation’ when a candidate recommended by the NRC is not supported by the promoter.

It is difficult for the law to address this dichotomy, as this is also linked to behavioural/ cultural aspects that pervade the boardrooms.

Boardroom dynamics

Another challenge from a behavioural/ cultural standpoint is that on many occasions, members of the senior management team may insist on being present in the NRC meeting room, when discussions take place relating to their own performance, variation in their own remuneration, etc. It becomes difficult for IDs and other non-executive directors (“**NEDs**”) to request them to vacate the room, given that this may impact the overall relationship dynamics at the Board-level.

Such situations cannot be legislated for – the law cannot address certain behavioural/ cultural aspects that may pose challenges for the NRC to effectively perform its role. The regulator cannot legislate what happens inside the Board/ Board Committee meetings – and such practical difficulties are required to be handled by the NRC members with ‘professionalism’ and ‘tact’.

However, this is easier said than done. On many occasions, NRC members are required to weigh competing interests and also keep in mind the necessity of a good working relationship between the MD/ WTDs and the NEDs/ IDs on the Board.

Scrutiny by proxy advisors

The NRC is one committee that is closely watched by the proxy advisors, who have, in the recent past, actively scrutinised and opposed proposed appointments of KMPs and IDs.

Further, during the Covid period, when companies in certain business sectors (such as the automobile sector) were facing losses, the proxy advisors had also opposed proposals to pay additional remuneration to MDs and other WTDs – that was beyond the remuneration limits prescribed under Section 197, read with Schedule V of the Act.

The NRC is required to closely balance the competing interests that may be involved in attracting/ retaining talent – and respecting the views of the market, and that of other key stakeholders.

Has the NRC added value to the corporate governance architecture?

Despite the challenges faced and the concerns regarding the effectiveness of the NRC's recommendations, the NRC of certain listed companies has done a commendable job in developing a robust framework for appointments, filling of vacancies on time, payment of remuneration that is commensurate with market standards, etc.

1. With effect from January 01, 2022, two-thirds of the NRC members are required to be IDs. The presence of IDs has improved the quality of deliberations at the NRC meetings.
2. By virtue of their experience, on many occasions, IDs have brought about an 'alternative' and 'unbiased' perspective to the deliberations. Especially in relation to payment of remuneration to KMPs, senior management, etc., the NRC has, on many occasions, proposed robust solutions that achieve a fine balance between the twin objectives of talent retention and respecting the views of other key stakeholders (such as proxy advisors, analysts, etc).
3. The IDs have also, on certain occasions, acted as a sounding board to the management, in situations where the credentials of a candidate proposed by the management may be below par, or in situations where the remuneration proposed by the management is disproportionately above market standards.

Concluding Thoughts and Recommendations

The NRCs of listed companies undoubtedly have a vital role to play in the corporate governance architecture of companies. There is a perception in some quarters that NRCs have diluted the role of the CEO when it comes to finalising compensation for the top management team. However, the NRC process brings about more transparency, objectivity, and impartiality in finalising senior management remuneration.

However, there are areas where NRCs have not been very effective – and one such area is performance evaluation of Board members and the CEO. Most NRCs have not adopted a very robust process and are mechanically filling up the performance evaluation forms to comply with the law.

One also needs to keep in mind that the NRC only has the power to recommend, and the recommendations need to be approved by the Board and the shareholders, when it comes to appointment/ re-appointment of managerial personnel and fixing of their remuneration. Unless the promoter supports the

recommendations of the NRC at the general body meeting, the recommendations will remain merely on paper.

This has led to most companies appointing at least one promoter nominee as a NED and member of the NRC – so that IDs on NRCs can get a sense of the promoter's thinking on appointments/ re-appointments of managerial personnel. Further, a meritorious rating by the NRC does not prevent majority shareholders from removing an MD/ WTD by invoking powers under Section 169 of the Act – by passing an ordinary resolution at a general meeting. Shareholders are not bound by the recommendations of the NRC.

This dichotomy is also highlighted by the recent judgment of the Division Bench of the Bombay HC in the ***Invesco v. Zee case***³ – where it was held that the shareholders' right to nominate a director under Section 160 of the Act is not in any way circumscribed by the fact that such an appointment is not 'recommended' by the NRC.

Regulation 19 of the LODR prohibits the Chairperson of the Board from being the Chairperson of the NRC. In practice, this may lead to differences of opinion in matters of performance evaluation of the CEO and complexities relating to personality dynamics. It is recommended that the NRC Chairperson has regular meetings with the Chairperson of the Board and the CEO, and performance feedback is not provided only at the end of the financial year, but throughout the year to prevent any unpleasant surprises.

NRC's role will get simplified if the performance evaluation criteria has both quantitative and qualitative aspects and they are clearly articulated at the beginning of the year. It may be unwise to have a statutory prescription of the same, but the SEBI could perhaps provide certain objective criteria when it comes to performance evaluation of CEOs of listed companies.

The NRC Chairperson also needs to have a good rapport with the Chief Human Resource Officer (CHRO) on a regular basis – so that there is no information asymmetry between the company management and the NRC.

Lastly, it is pertinent to note that Section 177(8) of the Act provides that where the Board has not accepted any recommendation of the Audit Committee, the

³ *Invesco Developing Markets Fund v. Zee Entertainment Enterprises Ltd.*, 2022 SCC OnLine Bom 630.

same shall be disclosed in the Board's Report along with the reasons thereof. Similar provision is required in the Act and the LODR, in relation to non-acceptance of any recommendations of the NRC.

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