Proposed Changes To The Definition Of "Independence"

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Introduction

Guideline 2.1 of the existing Code of Corporate Governance 2005 (the "Code") defines an "independent" Director as one who has no relationship with the company, its related companies or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the Director's independent business judgment with a view to the best interests of the company.

When the Council for Corporate Disclosure and Governance ("CCDG") was first tasked with reviewing the Code, its recommendations to the Ministry of Finance in June 2005 included tightening the definition of "independent Director" to exclude Directors who are, or directly associated with, substantial shareholders. This expanded definition would have gone beyond the current test in Guideline 2.1 which merely measures independence from management, and would have been consistent with the approach taken in other major capital market jurisdictions such as the UK, Hong Kong and Australia. The tighter definition of independence was recommended to be applied to all the various Board committees such as the Nominating, Remuneration and Audit Committees. The intention of CCDG was to prevent potential mismanagement by excluding Directors who may be influenced by any relationship with interested parties, and to ensure that no particular shareholder group's interests dominate. The key principle subscribed to by the CCDG was that of ensuring fairness and equality across the shareholder spectrum. This principle was seen to be particularly important where controlling shareholders may be able to select, or influence the selection of, all Board members.

The Government however did not accept this recommendation in 2005. The Government, in its response to the CCDG report, said that the critical feature for Directors to be able to exercise their duties effectively is independence of mind and independence from management, rather than independence from substantial shareholding per se. It maintained that substantial shareholders

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do not pose the kind of principal-agent problems that executive Directors can potentially pose, and to equate them by treating both as non-independent Directors would not be right. The view then was that substantial shareholders have a greater stake in the success of the company and their interests, more often than not, will be aligned with those of all the shareholders in the company. Furthermore, there are already sufficient provisions in the Companies Act and the SGX Listing Rules on conflicts of interests and related party transactions to safeguard against mismanagement by substantial shareholders or vested interests.

Another concern that the Government had then was that tightening the definition would deprive companies, especially those with substantial shareholders which are large establishments, of the pool of talent from the shareholder companies which can enhance the quality of the Directors on the Boards and committees of the companies. Given Singapore's relatively small and young economy, there was seen to be only a limited pool of talent from which to draw keen and well-qualified Directors, and the tighter definition could in turn lower the standard of corporate governance. The Government assessed that there was a risk that companies, especially the large companies and conglomerates, which find it unduly onerous to meet the tightened definition of independent Directors proposed by the CCDG, may just decide to list their subsidiaries in alternative jurisdictions.

Key Changes Proposed for the Revised Code on the Test of "Independence"

The proposed changes to be made by the Corporate Governance Council ("CGC") to the definition of an "independent" Director under the Code include making the following relationships as additional instances where a Director will be deemed non-independent:

- if the Director is or was, in the current or any of the past three financial years, a substantial shareholder, partner, executive officer, or Director of organisations to which the company or any of its related corporations made, or received significant payments or material services in the current or immediate past financial year;
- if the Director is a substantial shareholder or an immediate family member of a substantial shareholder of the company;
- if the Director is or has been directly associated with a substantial shareholder of the company in the current or any of the past three financial years; and
- if the Director has served on the Board for more than nine years from the date of his or her first election.

These changes acknowledge that in some circumstances, relationships with substantial shareholders may influence an independent Director's exercise of objective judgement. The CGC has accordingly recognised that to enable independent Directors to act effectively in companies, it is important that independent Directors do not possess any relationship with stakeholders such as substantial shareholders or organisations providing material services to the companies.

This view reflects the reality that Singapore's securities markets are sufficiently mature, and the domestic pool of experienced professionals and business executives wide and deep enough to provide a sufficiently large reservoir of talent from which to draw experienced independent Directors. As such, there would be no reason to consider people linked to substantial shareholders as being independent, since only independent Directors who are not aligned with major shareholders can be relied upon to look after the interests of all shareholders, big and small. It is difficult to expect an independent Director to exercise his or her mind impartially against the wishes or interests of the majority shareholder, when the tenure of his or her office depends on their appointment by the majority shareholder.

The CGC has also propounded the view that the independence of Directors may be compromised after a long period of service due to their friendship and collegiality with management. The CGC considers nine years as an appropriate tenure for the board to deliberate afresh the issue of independence of a Director, while the Nominating Committee retains the responsibility and prerogative to decide if a Director remains independent beyond the nine years, taking into account the differing circumstances for each Director.

This proposal can said to have attracted a significant amount of controversy. Although some Directors may be overstaying their welcome and term limits can ensure a regular infusion of new thinking into the Board, the danger in setting nine years as an

arbitrary limit may result in Boards being overly fixated on tenure as a measurement of independence.

The benefits to having long serving Directors include continuity of organizational and historical knowledge, a harmonious and collegiate environment, credibility in the market, Board stability and improved board dynamics. The Institutional Shareholder Services (a US-based provider of corporate governance solutions to the global financial community) Proxy Voting Manual states:

"Although establishing limits on the number of times a Director may be elected to the board provides a mechanical or 'bloodless' means for addressing a real or potential performance issue with a Director, it does not take into consideration the fact that a board member's effectiveness does not necessarily correlate with the length of board service."

That said, is there an optimum tenure of service that can apply to all Boards and is nine years that limit? In fact, an optimum tenure presumes that up to that time, Board members add value and enhance performance, but beyond that period, their value contribution declines as their independence may be compromised. This may not necessarily be the case all the time.

For example, if the argument is that the relationship between the independent Director and management may become too "cosy" after a long-standing relationship on the Board, thereby "dulling" the independence of the independent Director, would this argument still apply if there has been a change in control or change in major shareholders over the course of the nine year period such that management has also been overhauled? That way, it cannot be said that an overly collegiate atmosphere will have necessarily developed between the independent Directors and management since there is a break in the chain of management serving over the nine years.

One view is that Boards should be encouraged to not just over-emphasize or focus on tenure in isolation but instead focus more broadly on Board talent management. Criteria like tenure should be placed in the broader context of strategic succession management for the Board. Companies that manage Board talent effectively focus on ensuring that the company has the right number of Directors and the right type and quality of Director talent at any point in time. This means balancing tenure and skills so that the distribution of length of tenure across Board members represents a good mix of "old" and "new" thinking, and skill sets are appropriately diverse. Length of service should only be one of the elements that are assessed to enhance overall Board effectiveness.

The SID Board of Directors Survey 2010 shows that 22% of independent Directors on the Boards of respondent companies have served on their Boards for more than nine years and only 7% of companies set a mandatory retirement age and/or specified period for non-executive Directors to leave the Board. These results are consistent with a study conducted by Aon Hewitt on the 2010 Annual Reports of listed companies in Singapore, in which a total of 24% of all the independent Directors (amounting to a surprisingly large number of 513 Directors in aggregate) were found to be serving on a listed Board for nine years or more.

Having said this, instead of setting nine years as an arbitrary limit to the independence of a Director, perhaps all Boards should be required to disclose the period of service of each Director on the Board to-date and articulate in sufficient detail in the company's annual report what is its specific Board composition strategy and how it plans to approach Board tenure and rotation as part of an overall plan to manage Director contributions. Having Boards address their minds to the issue of tenure and disclosing their position on a mandatory retirement age will be an approach that is consistent with that already taken in the proposed changes to Guideline 4.4 of the Code where the Board is tasked with deciding for itself and disclosing the maximum limit of listed company directorships that Directors may hold without the Code imposing an arbitrary limit on all Boards, regardless of size and circumstance.

The Audit Committee Guidance Committee Guidebook provides useful further direction for companies to consider when determining the independence or otherwise of Directors. It states that the consideration of independence is often a matter of substance rather than of strict compliance with specific rules. The individual Director would be in the best position to determine his independence having regard to his circumstances and relationships with the company and related parties. However, there are additional factors set out in a non-exhaustive list in the Guidebook which Directors could consider when confirming their independence. For example:

- Gift or financial assistance: The receipt of shares or other securities in the company by way of a gift or financial assistance from the company or its major shareholders for the purchase of shares/securities in the company other than pursuant to an approved scheme.
- Business dealings: Material business dealings or involvement with the company or its related parties in the recent past.
- Financial dependence: Financial dependence on the listed issuer or its related parties, e.g. if a Director has no other major sources of income and is financially dependent on the fees, he would need to carefully consider whether he can indeed exercise the independent judgement required of him.