Director tenure: Stricter guidelines needed

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Long-serving directors may have greater knowledge of the company, but their greater familiarity can decrease their effectiveness as a check on management and past decisions. The threat to director independence and board renewal from excessive tenures, when left on its own, will not go away, which is the very reason why regulators (including those in Singapore) need to step in.

The Singapore Directorship Report 2016 shows that 64 per cent of issuers in Singapore which have been listed for nine years or more as at 31 December 2015 have at least one independent director who has served more than nine years and a total of 39 per cent of such directors. Both these percentages increased from 2014.

A recent study, *The Singapore Report on Shareholder Meetings (Volume 2)*, by Chew Yi Hong and me found that 60 per cent of independent directors re-appointed in 2015 who were 70 years or older have served on the board for more than nine years. The longest tenure was 45 years, followed by two independent directors who had served for 33 and 32 years. One independent director had served a cumulative tenure of 96 years on his four boards, and another 80 years on four boards.

A US study, *The "New Insiders": Rethinking Independent Directors' Tenure* by Professor Yaron Nili of the University of Wisconsin, found that the average board tenure increased every year between 2001 and 2013 for S&P 500 firms, from 7.9 years to 8.7 years, although the annual board indices published by Spencer Stuart suggest that this trend may have recently reversed.

Risks of long tenures

Long tenures of independent directors pose a twin threat to director independence and board renewal.

While directors may become more knowledgeable about a company over time, serving too long may cause them to become too close to management, develop blind spots and be less willing to question past decisions.

It may also cause a director's competencies to become less relevant as the business and environment change. The power and influence of a director is also likely to increase with tenure.

Some recent studies indicate that long tenure is harmful to companies and the popular nine-year limit is not off the mark. A study of S&P 1,500 firms (*Zombie Board: Board Tenure and Firm Performance* by Sterling Huang Zhenrui, SMU) found an inverted U-shaped relationship between board tenure and firm value, with firm value reaching a maximum at a board tenure of nine years, and declining beyond that. Further, "the value and quality of corporate decisions such as M&A, financial reporting, CEO compensation and replacement, and innovation also depend non-linearly on board tenure".

A 2016 academic study of 3,000 US firms over an 18-year period, *Do Directors Have a Use-by Date?* by Livnat, Smith, Suslava and Tarlie, also reported that firm value increases with board tenure and reverses after about eight to nine years. The reversal is stronger for high-growth firms, suggesting a greater deterioration in the ability of long-tenure directors to guide such firms.

A recent article, "A blanket cap on board tenure would do more harm than good" in *The Business Times* by Dr Alex Tan of the Lee Kuan Yew School of Public Policy reported a similar inverted U-shaped curve based on an analysis of Singapore companies with a market capitalisation of S$1 billion or more.

While academic research is seldom conclusive, such findings add weight to concerns about long tenure.

Will the problem go away?

The problem of excessive tenure is unlikely to "self-correct" especially in markets where the appointment of independent directors is largely determined by controlling shareholders or management, who may have vested interests in retaining directors who are only nominally independent. Further, nominating committees often have long-tenure directors serving on them and face inherent conflicts in considering this issue.

Interestingly, long tenure has not been viewed in the US specifically as a problem. As Professor Yaron Nili explained, "bright-line" stock exchange rules on independence do not identify tenure as a criterion in determining independence. On the other hand, state law independence standards are vague and ad hoc in nature, with independence assessed on a case-by-case basis based on numerous factors. Further, a majority of US mutual and pension funds do not have board tenure policies and those that do are generally against tenure limits because of concerns about losing good directors.

However, this may be changing.

A 2014 survey of investors by the Institutional Shareholder Services (ISS) which included two-thirds of respondents from the US found that 74 per cent felt that long director tenure was problematic. ISS scrutinises boards where the average tenure of all directors exceeds 15 years.

The threat of shareholder lawsuits and court reviews of independence in the US may to some extent mitigate against threats to independence posed by long tenure and other factors.

Regulators step in

In contrast, Indonesia and Philippines have opted to hard-code term or tenure limits in listing rules or securities regulations. Indonesia limits the term of independent commissioners and independent directors to a maximum of two terms. However, the practical impact is unclear as there is no rule on the length of each term and the Indonesia Financial Service Authority allows independent commissioners to be re-appointed after two terms if they state their independence at the general meeting of shareholders.

The Philippines Securities and Exchange Commission (SEC) has a "5-2-5" rule for independent directors, with a maximum of two five-year terms separated by a two-year cooling off period. Recently, the SEC amended its rule to allow independent directors who have completed the first five-year term to be re-elected for another four years without a cooling off period, with justification for the lack of suitable replacements provided to the SEC. After the second four-year term, these directors no longer qualify as independent for the same companies.

Several other countries have adopted a less prescriptive "comply or explain" approach by incorporating tenure as a consideration in the assessment of director independence in their codes of corporate governance. For example, Australia, Hong Kong, Malaysia, Singapore and UK have done so, but with some variations.

To add more bite to its tenure guidelines, Malaysia recommends that the independence of a director who has served more than nine years should be subject to an annual shareholder vote.

Hong Kong states that a director who has served more than nine years should be appointed through a separate resolution at the general meeting which should include reasons why the board still considers the director to be independent. Hong Kong, however, does not specify an annual shareholder resolution.

A summary of term limits in various jurisdictions is found in the table, "Term Limits for Director Independence".

The Singapore situation

In Singapore, many companies are paying lip service to the Singapore Code's guideline recommending a "particularly rigorous review" of independence after nine years. Further, such

Term Limits for Director Independence

Country	Term Limit	Comment
Singapore	None	The Board is expected to conduct "a particularly rigorous review" of the independence of directors with more than nine years. For banks and REITs, MAS requires that directors over nine years are declared as non-independent.
Malaysia	9 years	Unless approved by separate annual shareholders' vote.
Philippines	9 years	Operative from 2017.
Indonesia	2 terms (10 years)	Each term is usually five years, although there is no set length. More than two terms may also be possible.
Hong Kong	9 years	Code recommends separate shareholders vote on reappointment.
Japan	None	
Australia	None	Board should regularly assess independence if tenure more than 10 years.
India	10 years	
France	12 years	
UK	None	Board needs to explain why a director is independent after nine years (any term of non-executive director exceeding six years subject to particularly rigorous review).
European Commission	12 years (or 3 terms)	EC recommendation to member countries.
US	None	
Canada	None	

a review does not address the issue of board renewal. Additional steps should be taken.

First, the Code should recommend that companies put in place policies for board renewal and disclose them in their corporate governance reports.

Second, where an independent director serves more than nine years, his independence should be subject to an annual shareholder vote as is the case in Malaysia. However, management and major shareholders should abstain from this vote, similar to voting on interested person transactions.

In principle, one can argue that this should be applied whenever an independent director is appointed or re-appointed and not only after nine years since independent directors are supposed to be independent of management and major shareholders. Excluding them from voting only after nine years is a compromise.

Tenure is undoubtedly an imperfect proxy for independence, as are other director independence criteria. A long-serving director who keeps himself up-to-date can also alleviate concerns about loss of relevance of his competencies. However, given the limitation in the ability of the market to "self-correct", the retention of long-tenure independent directors should be subject to greater scrutiny and a higher bar.