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In search of the truly independent director

By Willie Cheng, Chairman, Singapore Institute of Directors

Several years ago, the chairman of a multi-billion dollar enterprise said to me, 'Let's face it, there is no such thing as a totally and truly independent director.' That remark put the brakes on the discussion about the independence of a particular director on the board.

On reflection, he was, in a sense, right, of course. Independence, after all, is a state of mind. Who is to really know what is – and what could be – in the mind of a director when a decision is being made?

Instead, the regulations seek to develop yardsticks – based largely on arguable relationships of blood and money – by which to judge a director's independence.

The subject of director independence and the independence of a particular director can thus be a hotly debated one.

In this chapter, we will seek to shed some light on this heated subject by discussing:

- the rationale for director independence
- the criteria for director independence
- the particular case of the nine-year rule
- the number of independent directors required on a board and its committees
- the emergence of the lead independent director
- the inevitable conflicts of interest that arise even with independent directors.

Rationale

In the unitary board system, which is adopted in Singapore, the US and many other Commonwealth countries, the board's composition can include executive and other directors. The notion of directors who have no relationship with the company (other than directorship), its management and major shareholders was introduced to ensure that there will be independent and objective watchdogs on the board.

In other words, the role of independent directors is to provide an independent and objective perspective on board matters and decisions. They act as a check and balance on the acts of the company's board and management. They are the vigilant guardians of the company who ensure that corporate assets are used only for, and in the interests of, the company.

To that end, the 2012 Singapore Code of Corporate Governance ('Code') sets out the criteria for a director's independence as well as the minimum number of independent directors on a listed board and its committees.

The Code operates on a 'comply or explain' basis – meaning a company has to either comply with each requirement or satisfactorily explain why it has not.

As independent directors stand apart from major shareholders, there is an expectation in some quarters that they exist primarily to promote the interests of minority shareholders. That would not be correct. Independent directors – as with all other directors – exist to serve the interests of the company.

In fact, the Code insists that '*All* directors must objectively discharge their duties and responsibilities at all times as fiduciaries *in the interests of the company*'.[1] For its part, the Companies Act does not distinguish between different types of directors in terms of their fiduciary duties; the law holds executive and non-executive directors equally responsible and liable for their acts and omissions as officers of the company.

Of course, in being objective and balanced, independent directors must consider the interests of minority shareholders as well as that of other shareholders and stakeholders of the company. By being objective and by querying anything that may seem amiss, independent directors may thus give the impression that they are promoting the best interests of minority shareholders, when, in reality, they are promoting the interests of all stakeholders as a whole.

Criteria

The Code's Principle 2, 'Board Composition and Guidance' and its guidelines provide two sets of criteria on director independence: general and specific.

The general criteria are that an independent director must be 'independent in character and judgement and [there should not be] relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement'.[2]

The Code then goes on to identify specific situations in which a director could be considered to be independent or not independent. Before we examine them, it is useful to note the definition of two common recurring terms:

- A related corporation of a company could be its subsidiary, or its holding company, or the other subsidiaries of the holding company.[3]
- An immediate family member of a person means the person's spouse, child, adopted child, step-child, brother, sister, and parent.[4]

For the specific criteria of independence, the Code says a director is independent when he or she 'has no relationship with the company, its related corporations, its 10 percent shareholders or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement with a view to the best interests of the company'.[5]

It then goes on to provide examples of specific relationships or circumstances that are likely to affect, or could appear to affect, a director's judgement:[6]

- A director is employed by the company or its related corporations for the current and past three financial years.
- A director has an immediate family member who, in the current and past three financial years, is or has been employed by the company or its related corporations, and whose remuneration is determined by the remuneration committee.
- Other than director fees, a director or an immediate family member accepts any significant compensation from the company or its related corporations for the provision of services for the current or immediate past financial year.
- A director or an immediate family member who, in the current or immediate past financial year, is, or was (a) a 10 percent shareholder of: (b) a partner in (with 10 percent or more stake): (c) an executive director of: or (d) a director of, any organisation to which the company or its subsidiaries made, or from which the company or any of its subsidiaries received, significant payments or material services, including auditing, banking, consulting and legal services in the current or immediate past financial year. As a guide, payments aggregated over any financial year in excess of S$200,000 are deemed significant.
- A director who is a 10 percent shareholder, or is an immediate family member of a 10 percent shareholder, of the company.
- A director is, or has been, directly associated with a 10 percent shareholder of the company in the current or immediate past financial year.

If any of the situations described earlier occur, the director is deemed to be not independent. Should the board consider a director to be independent notwithstanding the existence of any of these situations, the board has the responsibility of stating the reasons for its determination and should disclose in full the nature of the director's relationship in the company's annual report.[7]

The independence of a director who has served on the board beyond nine years is described in the next section.

The examples and factors set out earlier are not exhaustive. The general guideline is, in fact, a catch-all for all other 'relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement'. These, a board should identify and assess accordingly.

Examples of other situations in which the independence of a director could be called into question are:[8]

- **Gift or financial assistance:** The director receives a gift of shares or other securities, or financial assistance from the company or its major shareholders for the purchase of shares or other securities in the company outside an approved scheme.
- **Shareholder representative:** The director is appointed to represent or protect the interest of a shareholder which may not be aligned with those of the other shareholders.
- **Financial dependence:** The director is financially dependent on the company, group of companies or associates. For example, he or she has no other major source of income and is financially dependent on the director's fees.
- **Relationships with major shareholders or senior management:** The director has close personal friendships – or current or past business dealings – with major shareholders, executive directors or other key executives that could interfere, or be reasonably perceived to interfere, with the exercise of his or her independent business judgment.

The nine-year rule

The Code requires that 'the independence of any director who has served on the board beyond nine years from the date of his or her first appointment should be subject to particularly rigorous review'.[9]

While a director will not be automatically deemed non-independent, the board will need to explain why the director is deemed independent after a 'particularly rigorous review'.

The nine-year rule is controversial in both its rationale and implementation.

Opponents of the rule ask, 'How did I suddenly lose my independence upon crossing the nine-year mark?' The answer is that, of course, a person does not suddenly lose his or her independence. However, over-familiarity with the business or management team can affect a director's ability to constructively or unemotionally challenge senior management and existing company policies and practices. The line therefore does have to be drawn at some point in time.

Another objection is that a long-serving director who understands the company is more valuable than a new one. The nine-year rule is, however, stated in the context of the need for 'progressive refreshing of the board'.[10] Taken with the quantitative limit on the proportion of non-independent directors allowed on a board,[11] the rule effectively enforces board renewal.

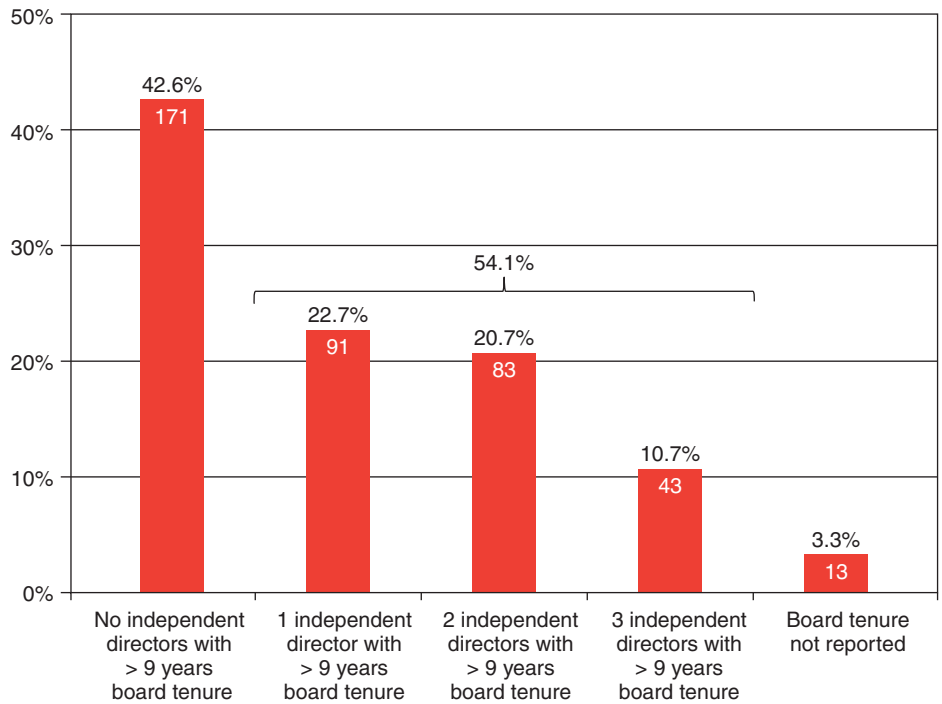
Many jurisdictions around the world restrict tenures of directors. For example, the European Commission recommends a maximum service of 12 years for an independent director, and in Hong Kong, nine years unless shareholders approve the re-appointment via a special resolution. The UK Corporate Governance Code has a more rigorous nine-year rule than the Singapore Code.

That said, Singapore does specifically address the concern of keeping long-serving directors for their value by allowing boards some flexibility to extend their appointments beyond nine years.

However, the effectiveness of the nine-year rule has yet to be proven. The 2014 Singapore Directorship Report (Directorship Report) produced by the Singapore Institute of Directors ('SID') and the Institute of Singapore Chartered Accountants ('ISCA')[12] reveals that more than half, or 54.1 percent, of companies that have been listed for more than nine years have at least one director who is declared independent despite a standing of nine years or more (see Chart 1).

The explanations provided for considering directors who have served on the board beyond nine years as independent have not been adequate either. Most of the companies baldly state that the

Chart 1: Percentage of firms (listed prior to 2005) having independent directors with various tenures



board has conducted a review and concluded that the director is independent.

This dissatisfactory state could be partly explained by the lack of clarity on what, precisely, the Code means by 'particularly rigorous review'. Here, the SID's Nominating Committee Guide provides some key considerations that a board and its nominating committee could consider:[13]

- Results of annual director performance evaluation revealing that the director possesses positive personal attributes such as independent thinking and keen observation, and demonstrates ability to maintain integrity and strong principles.
- Actual examples of situations in which the director has constructively and rigorously challenged proposals that are supported by management and major shareholders.
- Feedback from independent third parties with whom the company deals with, on the director's independence in his or her dealings with these third parties.

Number of independent directors

Having a critical mass of independent directors allows outside directors to feel they have support in raising contrary points of view. For this reason, the Code specifies that independent directors should make up at least one third of the board.[14]

However, the one-third requirement goes up to at least half the board where the board chairman is also the CEO, or is an immediate family member of the CEO, or is part of the management team, or is not an independent director.[15]

In addition, the board's three major committees – audit, nominating and remuneration, – are required to have at least three directors,

the majority of whom, including the chairman, should be independent. For the audit and remuneration committees, all committee members (if not independent) must be non-executive, and the lead independent director (see section below) should also be a member of the nominating committee.[16]

According to the Directorship Report, there are 4,839 board seats in all the 717 listed entities: 34.1 percent are taken up by executive directors, 47.5 percent by independent directors, and the remaining 18.4 percent by non-independent non-executive directors.

The proportion of independent directors on boards is shown in Chart 2.

Further analysis shows that:

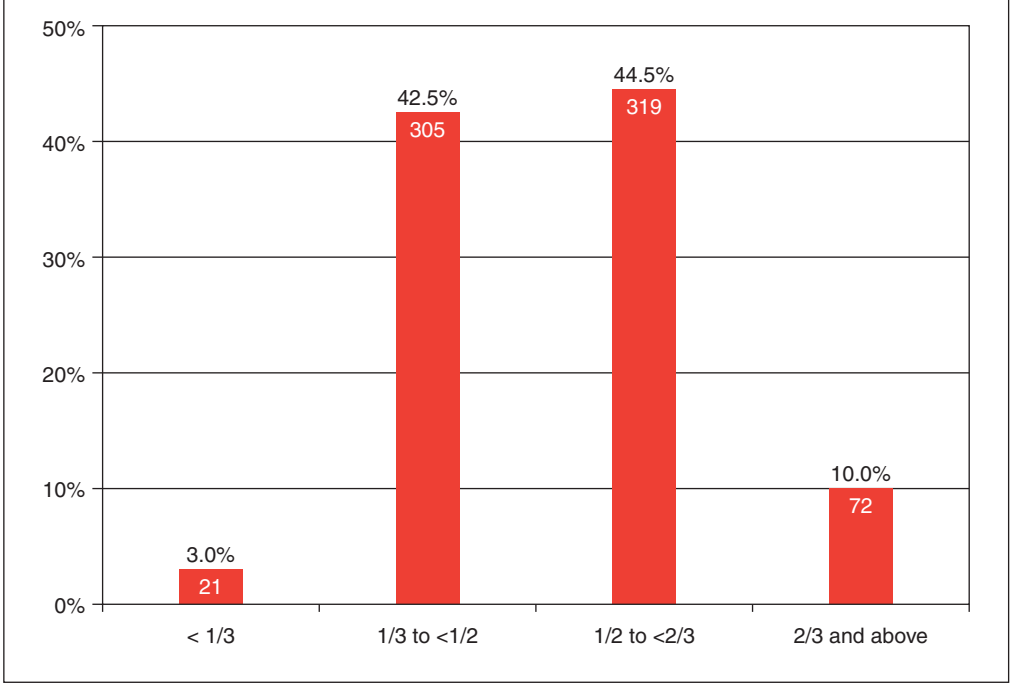
- The proportion of independent directors is higher for larger companies, specifically those with market capitalisation of more than S$1 billion. Here, 62 percent have more than half of their board seats taken up by independent directors, and for 28 percent, the proportion is more than two thirds.
- Firms in the finance and real estate industries lead the way with 77.8 percent and 50 percent, respectively; having more than half of their boards comprise independent directors.
- About 81 percent of the companies have a board chairman who is not independent. Of these, only 52.7 percent comply with the requirement that independent directors form half the board. Again, a disproportionate number of large cap firms meet the guideline.

The lead independent director

The Code requires the board chairman and the CEO to 'be separate persons, to ensure an appropriate balance of power, increased accountability and greater capacity of the board for independent decision making'.[17] This is the case for 69.2 percent of the firms in the Directorship Report.

Although many companies do separate the two roles, the board chairman may be part of the

Chart 2: Proportion of independent directors on boards



management team as an executive board chairman, or is a relative of the CEO. Such chairmen would not be deemed to be independent. Many of these companies tend to be controlled by a family or the founder.

In Singapore, it is considered best practice for the board to be chaired by an independent director. Where this is not the case, the Code requires the appointment of a lead independent director[18] as well as a majority of the board to comprise independent directors.[19]

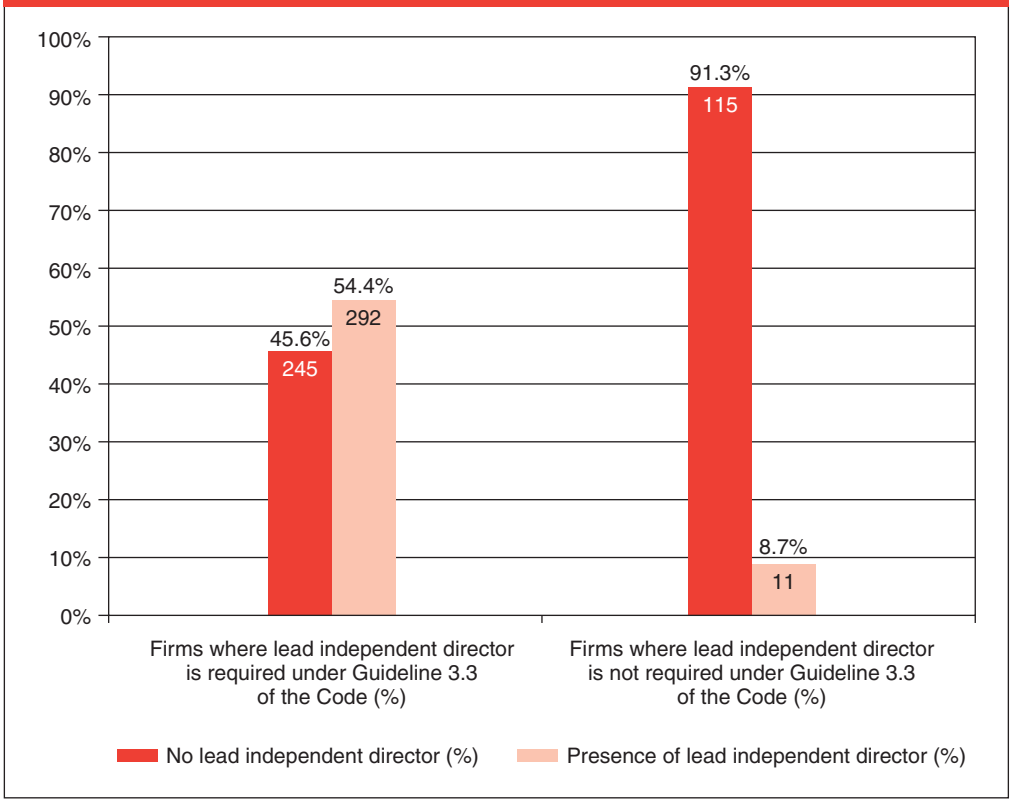
Chart 3 summarises the findings of the Directorship Report on lead independent directors. It shows that of the 537 firms (or 81 percent) that should, under the Code, appoint a lead independent director, only 54.4 percent actually did.

The lead independent director is appointed by the board. He or she can be appointed annually, or, if the board decides, for a longer term. In some cases, the position is even rotated amongst the independent directors over time.

The Code identifies only two roles of the lead independent director:

- He or she should be available to shareholders where they have concerns and for which contact through the normal channels of the board chairman, the CEO or the chief financial officer (or equivalent) has failed to resolve the concerns or is inappropriate.[21]
- He or she should arrange to meet the other independent directors without the presence of the other directors and provide feedback to the board chairman after such meetings.[22]

Chart 3: Presence of lead independent directors (and compliance with Code Guideline 3.3)[20]



Some companies have added to these roles of the lead independent director such as chairing the board in the absence of the chairman and being a mediator to resolve conflicts.[23] Some of these duties are not unlike those of a deputy chairman.

Conflicts of interest

A key purpose of the independent director is to minimise the areas and number of conflicts of interest. However, the complex and multi-faceted business environment in which companies operate today means that conflicts of interest are almost inevitable.

Conflicts of interest typically arise when:

- Directors have a direct or indirect material interest in transactions that the company enters into. Here, an interest of a family member of a director is treated as the director's interest under the Companies Act.
- Directors hold positions or offices or possess property that may result in conflicting duties.
- Directors stand to benefit from information received, or opportunities that are made available to them, in their capacity as directors.

In dealing with conflicts of interest, directors must be cognisant of the following:

- **Prohibited situations:** Certain situations are specifically prohibited by the Companies Act (for example, the granting of loans to directors, their family members or director-related companies under sections 162 and 163) whilst others require compliance with specified procedures (for example, shareholders' approval for payments in respect of loss of office under section 168).
- **Interested person transaction:** Chapter 9 of the Listing Manual of the Singapore Exchange Securities Trading Limited ('SGX Listing Manual') describes 'an interested person' (including directors and their associates) and 'an interested person transaction', and the required processes and disclosures.
- **Disclosure requirements:** Section 156 of the Companies Act requires directors to declare the nature of specified conflicts at a board meeting, or to send a written notice to the company as soon as they are aware of circumstances giving rise to such conflict. As a matter of best practice, conflicted directors should ask the company secretary to email information about the conflict to the rest of the board as soon as practicable. Formal disclosure should then be made and minuted at the next board meeting.

  Even if they may have complied with their statutory obligations to disclose conflicts of interest to the board, directors are not absolved from their more general fiduciary duties. Their duty not to put themselves in a position where their personal interest may conflict with that of the company except with the company's fully informed consent is an ongoing one that cannot be abrogated. Therefore, a director owes a common law duty to disclose such conflicts to the company's shareholders at a general meeting. Companies are, however, permitted to have a constitution that provides that directors' disclosure requirements are deemed to have been met, so long as there has been a disclosure to the board, or compliance with section 156. It is common for directors to generally declare to the board and the company, when they join the board and when their circumstances change, their directorships and significant shareholdings that could potentially create a conflict of interest.

  In any event, it is necessary for listed companies to disclose in their annual reports particulars of material contracts of the companies and its subsidiaries that involve the interests of their CEOs, directors or controlling shareholders. Where there is no such contract, a statement to that effect must be included in the annual report.[24]
- **Participation in meeting:** Whether or not directors who are conflicted are allowed to be present at a meeting depends on the company's constitution. However, it is good practice that they recuse themselves when the subject of the conflict is discussed unless the board is of the opinion that their presence and participation are necessary to enhance the efficacy of such discussion.

  Even if the directors are permitted to be present at these meetings and there are no laws or rules that prohibit their participation in discussions, it is, nevertheless, good practice that they do not do so, unless they are specifically invited

to or, with the consent of the board, they believe, in good faith, that they can lawfully provide information without which the board cannot make a sound decision.

And even if conflicted directors are allowed to participate, it is good practice that they recuse themselves for an appropriate period during the discussion to allow the other directors to have a full and frank discussion.

- **Voting:** Unless they are specifically prevented by the company's constitution, conflicted directors may vote on conflicted matters after they have disclosed their interests. That said, it is good practice that they do not. They should also offer to excuse themselves from the meeting at the time of voting.

  Note, too, that a company listed on the SGX is required to have a provision in its constitution that prohibits its directors from voting on any contract or proposed contract or arrangement in which they have a direct or indirect personal material interest.[25]

Whither the independent director?

The value of having independent directors has been and will likely continue to be debated.

Much of this debate arises because though most independent directors meet the technical definition, their independence in substance may not always be there. What's more, too many corporate failures and scandals have shown that the presence of independent directors did not make enough of a difference, notwithstanding that they were otherwise competent men and women of substance.

However imperfect as the definition, role and practice may be, the independent director is unlikely to become an endangered species because no one has come up with a better solution to the need for a level of objectivity on the board that is independent of major shareholders and management.

In my view, the solution is not to do away with independent directors. Rather it is to ensure that boards are populated with the right individuals with the professionalism and moral courage to challenge and ask the important questions and to take a stand, notwithstanding their relationships, no matter how close, with management and major shareholders.

That challenge is within the power of each and every individual director to rise to the occasion and be counted as truly independent.

Endnotes

1. Guideline 1.2 of the Code.
2. Guideline 2.3 of the Code.
3. The Code referring to the definition of 'related corporation' set out in section 6 of the Singapore Companies Act.
4. The Code referring to the definition of 'immediate family' set out in 'Definitions and Interpretations' in the SGX Listing Manual.
5. Guideline 2.3 of the Code.
6. The situations are listed in Guideline 2.3 of the Code.
7. Guideline 2.3 of the Code.
8. These practices are drawn from SID Nominating Committee Guide, Section 4.4.3.
9. Guideline 2.4 of the Code.
10. Guideline 2.4 of the Code.
11. See section below on 'Board and committee composition'.
12. The report collected and analysed information for all 717 listed entities in SGX for their financial year-ends in 2013.
13. SID Nominating Committee Guide, Section 4.5.3.
14. Guideline 2.1 of the Code.
15. Guideline 2.2 of the Code.
16. The guidelines of the Code for the composition of the respective committees are as follows: Guideline 12.1 – audit committee; Guideline 7.1 – remuneration committee; and Guideline 4.1 – nomination committee.
17. Guideline 3.1 of the Code.
18. Guideline 3.3 of the Code.
19. Guideline 2.2 of the Code.
20. This sample excludes REITs, business trusts and secondary listings.
21. Guideline 3.3 of the Code.
22. Guideline 3.4 of the Code.
23. Potential additional functions of a Lead Independent Director is found in Section 4.6.2 of the SID Nominating Committee Guide.
24. Listing Rule 1207(8) of the SGX Listing Manual.
25. Appendix 2.2 of the SGX Listing Manual, paragraph 1(9)(e).