NEW MISADVENTURES IN INDEPENDENCE

There's a need to allow non-controlling shareholders more say in the nomination and election of directors and the determination of their independence. **BY MAK YUEN TEEN**

A FEW years ago, I expressed frustration on the issue of independence of independent directors or IDs ("Looping around the problem", BT, July 5, 2010) and said that "the lack of independence of independent directors here is such an intractable issue that there's little hope of any improvement".

Five years on, have I become more hopeful? Unfortunately not. I have previously commented on key changes in the Code of Corporate Governance in Singapore and the strengthening of director independence guidelines ("Now let's see the practical impact", BT, June 16, 2011; "Good code, pity about the governance culture", BT, Nov 24, 2011). However, there have been new challenges in implementing tougher independence guidelines, here and in other countries.

There have been some interesting cases of directors being redesignated from non-independent to independent directors. There are those directors who were redesignated after they passed the "cooling off" or "look back" periods of "past three financial years" (for employment relationships) or "immediate past financial year" (for business relationships). Some were redesignated as soon as the "cooling off" period lapsed. These directors were not independent when they went to bed, but became independent when they woke up the next day.

Recently, there was a company that redesignated a non-independent director to an independent director. This director had served on the board for 11 years as a non-independent director, including three years as a non-independent chairman. Unlike the more typical situation of directors being redesignated from independent to non-independent after nine years, this director was re-designated from non-independent to independent after 11 years. This is like someone who was not a virgin and then became one.

Redesignations of directors can be expected to become more common as companies try to meet stricter guidelines on proportion of independent directors on the board – without adding new independent directors. The true independence of redesignated independent directors may be questionable.

Perhaps the most common question I have been asked about implementing the revised 2012 Code guidelines is how a "particularly rigorous review of independence" should be undertaken when an independent director has served more than nine years.

Many companies have not really done anything more than going through what ought to be the usual approach to determining independence and/or asserting that they have done a particularly rigorous review.

One Singapore company has taken a step further by hiring a premier executive search/talent management consulting firm to conduct interviews with directors to confirm that three independent directors who have served terms ranging from nine to 16 years are able to exercise independent judgment and therefore can continue to be considered independent. While it is difficult to criticise this company for going beyond the non-rigorous "particularly rigorous review" that other companies have used, it may be difficult for fellow directors (including the long-tenure directors who are giving feedback on other long-tenure directors) to tell the consultants that they do not believe a particular director is independent, even if the responses are aggregated and anonymised.

Further, one must wonder how much the consultants would cost the company and its shareholders especially if the exercise is repeated until the directors retire (bearing in mind that the assessment of independence should be an ongoing process, not just one-off). It is unrealistic to expect companies to pay substantial sums to consultants to help confirm independence, and for the consultants to confirm that the directors are in fact not independent.

There is also the issue that even if the directors are independent, is the company having healthy board renewal by retaining some of the independent directors for such long periods? It is possible that this process will be repeated and the same directors are still considered independent 10 or 20 years from now (but fortunately, not as long as "independent auditors" who may serve the same company for more than 100 years!).

The lack of guidance on what constitutes a "particularly rigorous review" means that, in practice, such "reviews" are usually no more than rituals. In my opinion, such a review should include obtaining actual evidence of a director constructively challenging management and taking positions which may not necessarily be in line with the wishes of major shareholders. There should be substantive examples of a director doing this, rather than have directors provide vague feedback that a director has demonstrated independent judgment. However, companies will lose credibility with respect to director independence and board renewal if they repeatedly claim to have done a particularly rigorous review and have decided that every long-serving independent director should be retained.

In the 2001 and 2005 Codes, a threshold of S$200,000 annually was included as guidance to determine if payments and receipts pursuant to business relationships involving the company and an organisation associated with a director are "significant". The term "significant" is now also used to determine independence when a director himself has a business relationship, but there is no guidance on what is significant in this case. In addition, the 2012 Code introduced the term "material services". What does "material services" mean?

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Accounting standards use the term "material" and both the nature and amount of the item usually need to be evaluated together in determining materiality. Similarly, I would submit that in considering whether "material services" are provided in assessing independence, it is necessary to take into account both the nature of the services provided and the amount involved. Factors relevant to assessing the nature of the services may include whether the services are one-off or recurring, and whether the services create a "self review" threat to the independent director.

For example, if a law firm provides ongoing legal services to a company, I would argue that this may constitute "material services" even if the annual amounts are well below the suggested threshold of S$200,000. This may be contrasted with the situation of a law firm being appointed for a one-off assignment. The type of services provided should also be considered. For example, if a consulting firm advises management and the advice forms the basis of proposals or reports that are approved by the board, then the independence of the director who is associated with that consulting firm would be in doubt.It is common practice for companies to have independent directors complete a form to confirm their independence. The forms I have seen are often inadequate for supporting the "principle-based" approach to determining independence as intended by the Code, because they merely ask directors to tick the boxes based on the specific factors set out in the Code – and use exactly the same language as the Code without providing additional guidance. For example, they use terms such as "significant payments" and "material services" without clarifying what they mean.

In conducting training for directors serving on nominating committees, I have developed a form that asks directors to declare all payments and services and to provide details of these payments and services. I also include a question that asks directors to declare "any other relationships or arrangements" with the company, its related corporations, its key officers and major shareholders. This puts the onus on an independent director to declare, for example, that he has been the regular golfing partner of the CEO over the last 20 years. Otherwise, it is challenging for the nominating committee to know the full extent of relationships and do a proper assessment.

There have been cases where an external consultant, such as a lawyer, was engaged to confirm a director's independence in accordance with the guidelines in the Code. This is usually no more than ticking off the specific independence criteria in the Code, rather than applying the intended principle-based approach. Directors who find prescriptive independence criteria inconvenient often argue that independence is a state of mind. If this is so, then what is needed is not a lawyer but a mind reader to help assess independence.

One of the good things about the 2012 Code is that it recognises the importance of independence from major shareholders. One of the weaknesses is that in the general definition of an independent director, it specifically states independence from a 10 per cent shareholder. It would have been preferable in my view for the general definition to use terms such as "significant shareholders" or "major shareholders" as some other Codes have done, and then suggest 10 per cent (or 5 per cent) as a guideline (similar to S$200,000 as a guideline for "significant payments"). Putting a "bright line" of a 10 per cent shareholder in a definition of independent directors runs counter to the intent of the definition to set out the broad principles of what constitutes an "independent director".

The 2012 Code also introduced the concept of "direct association" with a 10 per cent shareholder. It says a director is "directly associated" with a 10 per cent shareholder "when the director is accustomed or under an obligation, whether formal or informal, to act in accordance with the directions, instructions or wishes of the 10 per cent shareholder in relation to the corporate affairs of the corporation". In practice, it may be very difficult to determine if a director is "directly associated" with a 10 per cent shareholder, especially if the obligation to represent the major shareholder's interest is "informal". Therefore, while the guideline looks good on paper, implementation is a real challenge.

The examples I have discussed here indicate why the search for true independence is a bit like the search for the holy grail. Until we allow non-controlling shareholders more say in the nomination and election of directors or the determination of their independence, this search will continue to prove to be elusive

▮ The writer is an associate professor at the NUS Business School where he teaches corporate governance and ethics

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