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Black holes in corporate governance ecosystem

"Best practices" are often adopted without sufficiently considering whether they'll work or add value in the environment where they are to be implemented. BY MAK YUEN TEEN

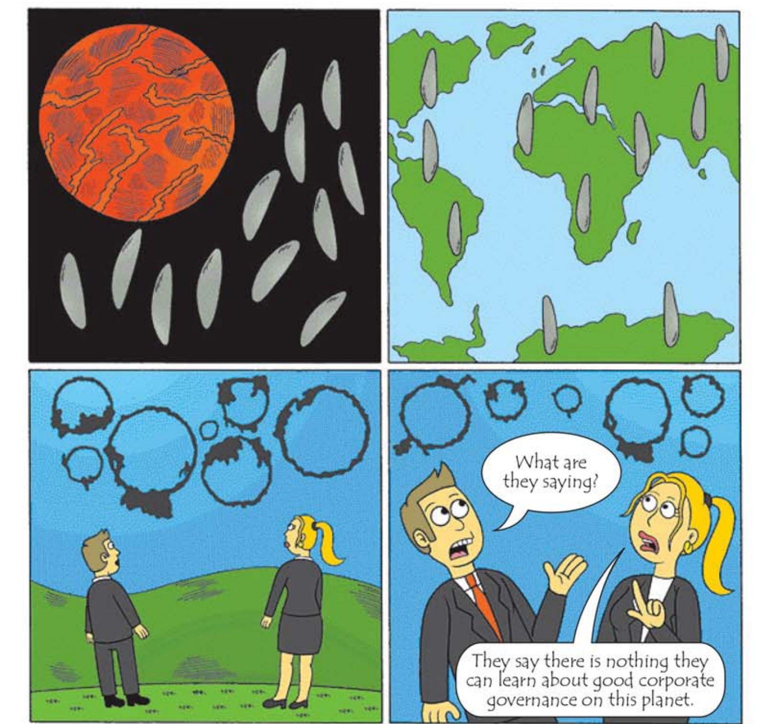

Illustration: Mak Yuen Teen

IN my favourite movie of 2016, *Arrival*, 12 giant pod-shaped spacecraft descended onto Earth, and mankind scrambled to decipher the complicated circular symbols that the aliens used in their communication. If these aliens had come to earth to learn about corporate governance, they would no doubt be scrambling to decipher the rituals and anomalies that are like black holes in our corporate governance ecosystem.

Perhaps the most glaring anomaly is that directors who are chosen by controlling shareholders and can be easily removed by them are considered independent.

Some countries, however, have tried to strike a better balance between the views of controlling and minority shareholders in the appointment of independent directors (IDs) by changing the election process. In the UK, IDs of premium-listed companies with controlling shareholders are elected through a dual-voting system involving all shareholders and independent shareholders, although if these two votes diverge, a second vote of all shareholders prevails.

While this means controlling shareholders ultimately still determine the outcome, the UK has also put in place other measures to reduce their influence.

Countries such as Israel have gone further. IDs for companies incorporated under Israeli company law (called "external directors") are elected through special majority voting rules involving a majority vote of all shareholders and a second vote based on majority support of "disinterested shareholders" or no more than 2 per cent of "against" votes of "disinterested shareholders". Two Israeli-incorporated companies listed on Singapore Exchange (SGX), Sarine Technologies and The Trendlines Group, elect their IDs this way.

Changing the way IDs are elected will be more impactful than tweaking independence criteria or the proportion of IDs.

Nominating committees

Another anomaly is the nominating committee (NC), which faces wide-ranging conflicts in discharging its responsibilities because its members are all incumbent directors. These responsibilities include considering the appointment and re-appointment of directors, assessing director independence, reviewing board composition and assisting with board-related performance assessments.

Let's consider the NC's assessment of independence of the IDs who are themselves serving on the NC. This is how I explain the process to my students, using an example of a "wholly independent" NC. Athos, Porthos and Aramis are IDs on the NC. Athos leaves the room (or pretends he is not there) while Porthos and Aramis consider Athos's independence. Athos returns to the room, Porthos leaves, and Athos and Aramis do the same for Porthos. And ditto for Aramis. Getting my students to role play this sometimes gets them rolling in laughter at the absurdity of such a ritual.

Let's now apply this to a company such as Bonvest Holdings. It has a board of five directors, comprising the chairman/managing director (MD), another executive director and three IDs. Two of the IDs have served for 26 years and the third, for 22 years. The NC consists of the three IDs and the chairman/MD, and is tasked with considering each director's re-appointment and the independence of the IDs. Each director is not supposed to be involved in deciding his own re-appointment and independence. The NC with the three extremely long-serving IDs would go through the above ritual and check off each other's independence annually.

In Bonvest's case, having the chairman/MD on the NC is not going to make the process any more objective, given that the IDs are supposed to oversee management. In fact, many listing rules and codes require or recommend that executive directors should not be on the NC at all.

Of course, the board is supposed to make the final determination. However, even if there are other IDs, their own re-appointment and independence will be largely in the hands of the NC. It is unlikely that they will overrule the NC.

In Bonvest's case, there are no other IDs on the board. Bonvest states that each ID abstained from the board's deliberations of his own independence. In effect, each ID's independence is cleared by the two other IDs whose independence will also have to be cleared in turn, plus the two executive directors (EDs) whom the three IDs are supposed to oversee (one of whom is already on the NC). Frankly, if I keep role playing this with my students, their minds would drift off to La La Land.

There is potentially another safeguard because the IDs still need to be elected by shareholders at the annual general meeting (AGM). However, in many companies, management are also controlling shareholders. For Bonvest, the chairman/MD has direct and deemed interests totalling 82.7 per cent of all the voting shares. In effect, he controls the election of the IDs at the AGM.

This type of scenario is repeated in many companies.

Changing the way IDs are elected as described above can help to better ensure that IDs are not beholden to controlling shareholders. However, there are other conflicts faced by the NC because its members are all incumbent directors. For example, in assessing board composition, the NC members may favour competencies that they themselves possess.

To help mitigate this, Sweden has a system of a shareholder-led NC, with members elected at the AGM or through a process agreed at the AGM. The majority of NC members must not be directors and a majority must be independent of the company and management. No member of management can be on the committee and at least one member must be independent of the largest shareholder or group of shareholders acting in concert. The board chairman or other director must not chair it. A 2010 report by Tomorrow's Company in the UK has advocated that UK considers introducing the Swedish-style NC.

Of course, if such a system is introduced into environments like ours, steps must be taken to avoid major shareholders controlling the NC – which in many cases they already indirectly do. A large Singapore charity recently appointed a non-director to chair its NC to enhance the objectivity of the NC.

Management-controlled boards

In theory, management is accountable to the board but it is common in many companies for management to make up a majority of the board.

Codes often recommend that at least one-third of the board should be independent, but ignore the other two-thirds. Based on data from the 2016 issue of the Governance Evaluation for Mid- and Small-Caps, 36.5 per cent of SGX-listed companies with a market cap of S$500 million or less have EDs making up at least half the board. Such management-controlled boards are also common in other economies with many family and founder-owned companies, such as Hong Kong.

In several Singapore companies where disclosure, corporate governance and financial issues have recently arisen, the boards are management-controlled. Lapses are hardly surprising as independent oversight is severely compromised.

Board assessments

Board assessments recommended by codes are another ritual. Unlike the 180-degree or 360-degree performance assessments undertaken throughout a company, the board assessment generally involves "ownself checking ownself". Further, board assessments are often a paper exercise and the results not used to improve board effectiveness.

There are rare cases of board assessment that include feedback from senior management, although management may not be willing to give truthful feedback and may be quite happy with a rubber-stamping board. Boards ought to get feedback from shareholders too. This may be informal when institutional shareholders have one-to-one meetings with boards. They may also look into how different groups of shareholders are voting on key resolutions in shareholder meetings.

Boards should also be open about engaging with shareholders constructively at general meetings (and through Q&A on their company's investor relations platform) and use them as an opportunity for receiving feedback, rather than treating these meetings as purely procedural affairs to be dispensed with as quickly as possible. Perhaps they may also consider leveraging on the technology used for electronic poll voting in general meetings to get more structured feedback from shareholders about how they are doing. Of course, they may not like the feedback.

> Anomalies in our corporate governance ecosystem are ignored and rituals institutionalised. Perhaps the most glaring anomaly is that directors who are chosen by controlling shareholders and can be easily removed by them are considered independent.

Remuneration

Remuneration is another area full of rituals and anomalies. The remuneration committee (RC) made up of non-executive directors (NEDs) typically recommends to the board a remuneration policy (including fee structure) for NEDs and remuneration packages for individual directors. Although each director is not supposed to be involved in determining his own remuneration, NEDs on the RC and the board would be indirectly involved in recommending their own and each other's remuneration.

The UK Code states that, where permitted by the articles, the board may delegate the setting of NED remuneration to another committee, which might include the chief executive officer (CEO). The idea is not to have just NEDs setting NED remuneration. However, having the CEO involved in a committee setting NED remuneration creates another potential conflict. It's a conundrum.

We saw the inherent conflict played out in the 2015 AGM of SingPost, where a shareholder asked the then chairman about the increase in NED fees. Probably cognisant of the conflict in having the RC chair or an NED justify NED fees, the chairman turned to the then CEO. Not surprisingly, the CEO spoke glowingly of the board of directors.

The task of proposing NED remuneration may be best left to a shareholder-led NC, as discussed earlier. In Sweden, that is in fact part of the role of the shareholder-led NC.

The total recommended NED remuneration is then supposed to be approved by shareholders, but companies can get around this rather easily. I had in a recent article explained how many companies still do not include non-cash emoluments in the amount put to shareholders for approval. The other way is to appoint directors as advisers or consultants and pay them additional fees.

For example, on March 21, the newly constituted board of Natural Cool Holdings announced that it was appointing its new independent chairman as an adviser for an initial period of three months (that can be extended), and paying him an additional fee.

The company did not disclose how much the fee is and technically does not have to put this to shareholders for approval – because he is paid for services as an "adviser" and not as a "director". To be fair, some companies do put up such advisory fees for shareholders' approval.

While NED remuneration is subject to shareholders' approval, remuneration paid to directors in their capacity as executives, and senior executive remuneration, generally do not require shareholders' approval. This is despite NED remuneration being typically only a fraction of the remuneration paid to key executives.

The reason for this "anomaly" is that management is supposed to be accountable to the board and it is thought appropriate for executive remuneration to be approved by the board and not by shareholders. However, in the case of EDs, it seems to be splitting hairs to say that if he is paid a fee for his service as a director, that fee must be included as part of the remuneration approved by shareholders, but his much larger remuneration for his "executive" role does not.

For key executives who are not directors, having the RC and board, but not shareholders, approve their remuneration may make sense where the board and RC are truly independent of management. However, it breaks down when key executives are themselves major shareholders who control the appointment of the IDs involved in setting their pay. Not surprisingly, there is a global trend towards giving shareholders a binding or advisory "say on pay" on executive remuneration. But this trend has yet to impact Asia, where the problem is arguably even worse.

Another anomaly is that executive and director remuneration is not considered a related party or interested person transaction (IPT) in various jurisdictions, including Singapore. Consider an example of a SGX-listed company with net tangible assets of S$100 million. If the major shareholder sells an asset to the listed company for S$3 million, it will require an immediate announcement as a disclosable IPT since it crosses the 3 per cent threshold. If it's S$5 million, it will require independent shareholders' approval. The annual report must disclose the exact amount and the identity of the interested person as long as it's more than S$100,000.

However, if the same shareholder is paid S$10 million of remuneration – or 10 per cent of net tangible asset – minority shareholders may not even know, let alone get to approve it. Essentially, he sold an asset in the first case and services in the second. IPT rules do cover receipts and payments for services generally, but carve out directors' and employment remuneration which are also payments for services provided to the company. In the remuneration report, shareholders may only see that each executive earned remuneration of "S$500,000 and more".

It's difficult to understand why remuneration in such situations should not be subject to similar rules to those for IPTs. Remuneration received by management who are also major shareholders which meet IPT disclosure thresholds should likewise be disclosed in detail. Arguments such as fear of poaching are not credible in such cases. Hong Kong listing rules in fact require exact remuneration of each individual director to be disclosed – like in many other developed markets.

A problem in corporate governance reforms is that so-called "best practices" are often adopted without sufficient consideration as to whether they will actually work or add value in the local environment where they are to be implemented. Anomalies are ignored and rituals institutionalised. Over time, the list of "best practices" grows, imposing additional compliance costs without substantively improving corporate governance. A better approach is to better understand the key deficiencies first and focus attention on addressing them.

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