Trusting in the Independence of Independent Directors

By MAK YUEN TEEN

How do investors trust that independent directors are truly independent? This matter has been a contentious one with many proposed solutions. It will get more play in the coming year with the pending implementation of the nine-year rule in 2022.

The concept of independent directors was formally introduced to corporate Singapore in the first Code of Corporate Governance in April 2001, which was largely modelled on the then 1998 UK Combined Code. It is important to note that the Code is on a "comply or explain" basis, unlike the Listing Rules, which is mandatory for SGX-listed companies.

Since 2011, each revision to the Code has seen some adjustments to the criteria for determining director independence. In the most recent update in 2018, the guidance on the proportion of independent directors increased from one-third in 2011 to a majority where the Chairman is not independent. In addition, from 1 January 2022, the SGX Listing Rules mandates all companies to have at least one-third independent directors.

The last review of the Code also saw employment and family relationships used to determine independence moved to the listing rules, making them binding. Those relating to business and shareholding relationships are now in the practice guidance and no longer subject to "comply or explain". However, the disclosure of such relationships is still expected under the Code.

Nine-year rule

A nine-year term limit for independent directors has also been incorporated into the listing rules starting from 1 January 2022. Those serving more than nine years have to be approved by a two-tier vote to continue as independent directors. Some companies have already started implementing this two-tier voting.

On the surface, progress has been made in strengthening the criteria for determining independence and increasing the proportion of independent directors. However, questions about the true independence of independent directors and their conduct continue to surface regularly.

Trust in independent directors remains a concern.

Perhaps the most important reason why investors do not perceive many independent directors to be truly independent is that they are appointed by the controlling shareholders – even though they are supposed to be independent of these shareholders.

Companies often pay scant attention to perceptions when appointing independent directors, which contributes to scepticism about their true independence (See Box, "Director Independence – Who Decides?").

Director Independence – Who Decides?

In January 2021, Blackrock (the world's largest asset manager) and Norges Bank Investment Management (fund manager for the world's largest sovereign wealth fund) voted against the re-election of all six directors at the annual general meeting of Top Glove. The company has a primary listing in Malaysia and a secondary listing in Singapore.

Blackrock attacked the company's handling of the coronavirus outbreak: "Given Top Glove's role as a leading personal protective equipment manufacturer, we view the board's ineffectiveness in Covid-19 mitigation and inadequate oversight of worker health and safety issues as especially egregious with potentially serious implications for its reputation as a supplier of such equipment to hospitals around the world."

What is less well-known is that in 2015 and 2019, two independent directors retired after serving more than 14 and 18 years, then aged 87 and 90 years old, respectively. In both cases, their daughters, who have entirely different backgrounds from their fathers, replaced them.

Top Glove may well claim enhanced diversity and the two new directors may well be truly independent – but they are unlikely to be perceived to be so, and there will be questions about the board's effectiveness.

Nevertheless, all six directors were re-elected at Top Glove's 2021 AGM.

Another company, City Developments Limited (CDL), has been in the news when three directors (including two independent directors) resigned between October 2020 and January 2021 due to differences with the controlling shareholder and management over the company's investment in Sincere Property. At the same time, CDL brought in five new independent directors.

CDL currently has two independent directors who were ex-KPMG partners. One of the independent directors who recently resigned was also an ex-KPMG partner. KPMG is the long-time auditor of the company. While this may not affect the actual independence of the independent directors or the auditor, there are perception issues and questions about how the independent directors are recruited.

Further, the determination of independence is still mostly based on complying with the strict letter of the rules and "comply or explain". It remains a matter for the nominating committee and the board (with the exception of those criteria that are now in the listing rules).

Global comparisons

Other countries also grapple with how to better ensure that independent directors are truly independent. Many have implemented measures that better empower minority shareholders to appoint independent directors or have more robust criteria or approaches for determining independence.

Using data from the *OECD Corporate Governance Factbook 2019*, supplemented by external sources, my research compared 51 jurisdictions, including Singapore, in three areas:

1. Availability of cumulative voting for directors.
2. Minority shareholders' approval for the appointment of independent directors.
3. Prescriptiveness of the criteria used for determining independence.

The box, "Appointment of Independent Directors and Determination of Independence", shows the

Appointment of Independent Directors and Determination of Independence

Jurisdiction	Cumulative Voting	Separate Minority or Two-Tier Voting for IDs	Criteria for Determining Independence
Australia	-	-	Comply or explain
Canada	Allowed	-	Securities regulation (principle-based with prescriptive tests)
United Kingdom	-	Premium listed companies with controlling shareholders must ensure constitution provides for the election of independent directors separately by shareholders as a whole and independent shareholders	Comply or explain
United States	Allowed	-	Stock exchange rule (principle-based with prescriptive tests)
China	Required if one shareholder and person acting in concert have more than 30% of the voting shares	-	Securities regulator's guidelines
Hong Kong, China	-	-	Stock exchange rule (director to confirm independence to exchange)
India	Allowed	Two-tier voting for independent directors being considered	Company law
Indonesia	-	-	Financial services authority regulation (for independent commissioners)
Japan	Allowed but limited	-	Comply or explain
South Korea	Allowed but limited	-	Commercial Code
Malaysia	-	-	Stock exchange rule (director to confirm independence to exchange)
Philippines	Mandatory	-	Securities regulation
Singapore	-	-	Stock exchange rule (limited) and Code
Taiwan	Mandatory	-	Securities regulation
Thailand	Prescribed but can opt-out and is rare	-	Securities regulation and stock exchange rule
Vietnam	Allowed	-	Enterprise law

Source: Partly based on the OECD Corporate Governance Factbook 2019.

findings for 16 of the 51 jurisdictions covered (four developed Western jurisdictions and 12 Asian ones).

Cumulative voting

Of the 51 jurisdictions, 30 (including Canada, the US, China, India, Japan, South Korea, the Philippines, Taiwan, Thailand and Vietnam) either allow or require cumulative voting for directors.

Investopedia defines cumulative voting as follows: "Typically, each shareholder is entitled to one vote per share multiplied by the number of directors to be elected. This is a process sometimes known as proportional voting. Cumulative voting is advantageous for individual investors because they can apply all of their votes to one candidate."

In other words, cumulative voting makes it easier for minority shareholders to come together and appoint a director of their choice. While cumulative voting remains rare in the many countries that allow it, it is prohibited in Singapore.

Minority shareholders' approval

Minority shareholders' approval for the appointment of independent directors is rarer.

Eight out of the 51 jurisdictions have separate minority shareholders' vote or two-tier voting for independent directors. These are Brazil, Chile, Israel, Italy, Portugal, Spain, Turkey and the UK.

In the UK, two-tier voting applies to premium-listed companies with controlling shareholders. Companies that do not pass the two-tier vote have to convene another EGM where single-tier voting applies.

India is considering introducing two-tier voting for independent directors.

Prescriptive criteria

In assessing how prescriptive the criteria for determining independence are, we can look at whether the independence criteria are included primarily in company law, securities regulation, legally binding code, listing rules, or a "comply or explain" code of corporate governance – or their equivalents.

Twenty-four jurisdictions take a prescriptive approach by setting out criteria for determining independence primarily through company law, securities regulation, a legally binding Code, listing rules, or other prescriptive rules. The others rely primarily on a "comply or explain" approach for determining independence based on a corporate governance code or do not provide any detailed guidance.

Singapore adopts a hybrid approach, whereby certain criteria are now included in the stock exchange rules, but most are in the Practice Guidance of the revised Code of Corporate Governance.

Singapore's approach to determining independence is broadly similar to Australia and the UK, and is less prescriptive compared to Canada and the US and most other Asian markets. In Canada and the US, securities regulation or listing rules provide for a principle-based approach, together with a comprehensive list of independence criteria. A director cannot be considered independent if caught by any of the criteria listed and these criteria are comparable to those used in Singapore.

In the Asian jurisdictions covered, independence criteria are usually set out in mandatory rules, such as company law, securities regulations or listing rules. For instance, in Hong Kong and Malaysia, detailed criteria for independence are in the listing rules.
In addition, independent directors have to

confirm their independence to the stock exchange under these criteria.

The listing rules in Hong Kong specifically state that the exchange may question a director's independence if any of the specified relationships exist. In Singapore, independent directors are not required to confirm their independence to the stock exchange.

There are other practices around the world that enhance the independence of independent directors. For example, while Sweden does not have prescriptive criteria for determining independence, it has a system of external nomination committees tasked with the nomination of directors and assessing their independence. At least one committee member has to be independent of the largest shareholder. Existing directors must constitute only a minority of members, and no more than one current director representing a major shareholder can be on the committee.

This makes the nomination process more arms-length than the prevalent system where a nominating committee made up of existing directors nominates directors and assesses their independence – in effect a self-selection and self-review process.

Taking the three factors together, Singapore is among a small minority of countries where minority shareholders have little say in directors' appointment and follows a mostly non-prescriptive approach for determining director independence.

Building trust

Director independence can also be affected by whether there is robust regulatory and civil enforcement against directors for breaches of duties. In this regard, Singapore fares relatively poorly compared to some other markets.

In contrast, regulators in Australia do pursue criminal and civil penalty actions against directors, including independent directors, for breaches of duties. In Hong Kong, independent directors commonly face sanctions such as public reprimands, including for breaches of duties, since director duties are part of the listing rules. There, the Securities and Futures Commission has also pursued actions against entire boards for failing to exercise reasonable diligence, such as failure to do proper due diligence for acquisitions. In Malaysia, independent directors regularly face reprimands and fines for failure to comply with listing rules.

Building trust in independent directors requires more than a periodic tweaking in the criteria for determining independence or increasing the proportion of independent directors – which is what Singapore has been doing over the last 20 years.

Having independent directors who are effectively appointed by major shareholders, who then opine that the directors are independent of management and the major shareholders who appointed them, is circular logic. It simply cannot lead to trust that there is true independence of independent directors.

Future reforms should focus on giving minority shareholders greater say in the appointment of independent directors, making the criteria for determining independence more prescriptive and the process more robust, and stronger enforcement.

It is better to have fewer independent directors on the board that minority investors can trust than having many independent directors whose true independence is questionable. ■

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