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Who Should Judge on Independence?

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It is widely recognised that independent directors (IDs) have a key role in upholding corporate governance. They are often regarded as the first line of defence against misfeasance.

There is, however, considerable debate over what constitutes independence, and how a director is truly independent.

The Code of Corporate Governance defines an ID as someone "who has no relationship with the company, its related corporations, its 10 per cent shareholders, or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgment with a view to the best interests of the company".

The Code goes on to require the board, backed by the nominating

committee (NC), to determine "whether the director is independent in character and judgment".

This raises a broader question: is the board or the NC the best judge of a director's independence? And if not, whose judgement counts?

WHO JUDGES INDEPENDENCE?

The Singapore Code considers the board the best arbiter. This is consistent with the approach taken by the New York Stock Exchange and the NASDAQ Stock Market.

However, are board directors themselves the best judge of a fellow director's independence? Is there an inherent conflict of interest when the NC, which comprises mainly of IDs, is asked to vet each other's independence?

This issue is significant in the light of the common practice where the IDs of a listed parent company also serve as IDs on the board of the parent company's listed subsidiary. Can the IDs on the subsidiary's board be truly independent from its major shareholder when they are also directors of the parent company?

THIRD PARTIES?

There have long been calls for shareholders or an independent third party to vet the independence of IDs.

Those who back shareholders making the call argue that since shareholders already hold the right to approve the appointment of directors, it is but a small stretch for them to also vote on the IDs.

Taking the argument further, some observers have proposed that the majority shareholders, who already have board representation,

should not be permitted to influence the choice of IDs. They favour minority shareholders for this role. The rationale is that the IDs are purportedly there to primarily protect the interests of minority shareholders (rather than all shareholders). This is a point of contention in itself and a topic for another discourse.

In practical terms, however, minority shareholders may not be in much of a position to be judge and jury. They are not in a position to observe how a director performs at board meetings, or to assess if he exercises an independent mindset when he questions management, or queries interested party transactions. Minority shareholders simply will not have firsthand visibility of a director's role as an independent voice.

Besides, minority shareholders are not vested with the responsibility to decide such issues with impartiality or objectivity (unlike directors who have such a duty under law). In all likelihood, minority shareholders will be prone to vote for their own self-interests above the company's interests. The argument also holds that it may be too drastic to deny the majority shareholders their right to vote on their shares since not all major shareholders control the composition of the board.

Alternatively, some have called for an independent third party to provide the clearance for IDs, such as the Stock Exchange or even the Singapore Institute of Directors. There is precedence for this in Asia.

The Hong Kong Stock Exchange, while requiring boards to determine independence, also takes it upon itself to assess the independence of such directors. It requires each ID to submit a written confirmation of his suitability to the Exchange. The listed company then supports the credentials to the satisfaction of the Exchange prior to the ID's appointment.

THE WAY AHEAD

There is merit in considering greater rigour in determining directors' independence.

The regulations can perhaps require certain conditions first be met for the acceptance of an ID's independence each year. For example, the rules can insist that nominated IDs specifically disclose pertinent information to shareholders and their approval be obtained, such as when a director may have already served for more than nine years, or if he has a relationship that does not reasonably satisfy the prescribed parameters set out in the Code.

This greater scrutiny will motivate IDs to take their role more seriously. If necessary, the shareholder's vote can be employed as a non-binding one. IDs should be prepared to stand up and be questioned by shareholders at Annual General Meetings. After all, independence should ultimately be a demonstrable and measurable quality, and subject to challenge. ■