Presence of independent directors on the board

MCCG Intended Outcome 4.0

Board decisions are made objectively in the best interests of the company taking into account diverse perspectives and insights.

MCCG Practice 4.1
At least half of the board comprises independent directors. For **Large Companies**, the board comprises a majority independent directors.

The internalisation and application of the content "Why" and "How" should be read in tandem with the line of sight outlined by the intended outcome.

Why — The case for change

Independent directors have the mandate of bringing objectivity to the oversight function of the board. The objectivity inherent to these directors allows them to debate with and challenge the senior management team in a relatively more unbiased manner compared to executive directors, who play a key role in developing strategic direction and running the business.

Whilst the roles of independent directors are well-defined, there are growing observations that independent directors are often impeded in standing up for their views, thus, affecting their ability to influence decision-making by the board.

The underlying causes commonly hindering independent directors from acting independently in name and deed can be attributed to the following practical barriers outlined on the following page[1].

What could go wrong:

- Lack of scrutiny on key proposals and transactions.
- Decision-making is unfairly biased towards the interest of controlling shareholders, dominant directors or a member of the management team.

[1] *Growth and Emerging Market Report* 2016, International Organisation of Securities Commission

Practical barriers for independent directors:

Personal authority	Positional authority
Individual directors may display traits of a domineering character and high-handed leadership style (commonly observed in charismatic managing directors). Such directors may regard challenge as causing offence or a trait of disloyalty.	The positions of chairman and managing director are vested with a high degree of power, conferring them with positional authority. In the absence of balancing factors, there is a natural tendency for their views to be deferred to and agreed with.
Information asymmetry	**Cultural environment**
Due to limited engagement with the company, independent directors generally lack detailed knowledge about the business. Lack of granular understanding can deprive independent directors of the confidence to challenge management and evaluate their responses.	The emphasis placed on harmony makes it difficult for board members to express divergent points of view.

It is clear that, lacking the counterweight, directors, even those with all the requisite elements and levers of independence often find it difficult to move boldly against convention, rally for support and facilitate a robust deliberation process in the boardroom. Succinctly put, the collective voice of the incumbent independent directors may be encumbered.

The reasoning behind calling upon companies to have a prescribed number of independent directors is thus to create a "critical mass" of directors, who can encourage, support and drive each other in the value creation and sustainability of the business[2].

How — The practice in substance

Whilst there is no absolute formula in determining an ideal composition of independent directors, boards with a balanced or higher proportion of independent directors would certainly go a long way in alleviating boardroom dominance, stereotype discussions and complacency. Meaningful application of this practice would mean that boards must go beyond the existing prescriptions in **Bursa Securities Listing Requirements**.

[2] *Independent Non-Executive Directors: A Search for True Independence in Asia 2010,* Chartered Financial Analyst ("CFA") Institute

Paragraph 15.02(1) and (2) of Bursa Securities Listing Requirements

Composition of the board of directors

(1) A listed issuer must ensure that at least 2 directors or 1/3 of the board of directors of a listed issuer, whichever is the higher, are independent directors.

(2) If the number of directors of the listed issuer is not 3 or a multiple of 3, then the number nearest 1/3 must be used.

In addition, **Standard 11.6 of Bank Negara Malaysia's Policy Document on Corporate Governance** outlines that the board of financial institutions must have a majority of independent directors at all times.

Point for reflection

In the course of ensuring that at least half of the board comprises independent directors, boards are not expected to compromise on the business imperative and make unwieldy changes to its composition.

In order to create a more conducive environment for insightful deliberations and informed decision-making, boards may consider enlisting independent directors who to some extent, understand the nature of the company's business (e.g. business model, key drivers that are shaping in the industry and key risk factors).

Independent directors who are conversant with the business are able to exercise intelligent reviews of transactions involving management, directors and controlling shareholders. They could also prove to be a valuable resource in the arena of strategic planning and risk management by providing insights on trends and forecasts.

Key considerations relating to the application of this Practice are discussed below:

How to harness the collective wisdom and benefit from the greater participation of independent directors?

- Having a private session of independent directors without the presence of executive directors and senior management is increasingly recognised as a good practice. It is commonplace for company secretaries to organise a private session of independent directors after the meeting of a board or board committee and the frequency of such sessions will vary based on the nuances of the company. Apart from independent directors, these sessions will typically involve key gatekeepers of the company such as external and internal auditors[3]. This provides independent directors with the opportunity to candidly share concerns about the company and exchange views on potential improvements in governance.
- Having in place a balanced or higher proportion of independent directors allows these directors to rotate across board committees. The committees will be able to benefit from greater checks and balances, and deliberations would be enhanced from the contributions of directors with diverse backgrounds.

Dos

- ✓ Minimising or limiting independent directors sitting on subsidiaries.
- ✓ Developing a policy to rotate independent directors across board committees.
- ✓ Providing independent directors with a platform to meet privately without the presence of executive directors.

Don'ts

The following would render the application of this practice ineffective:

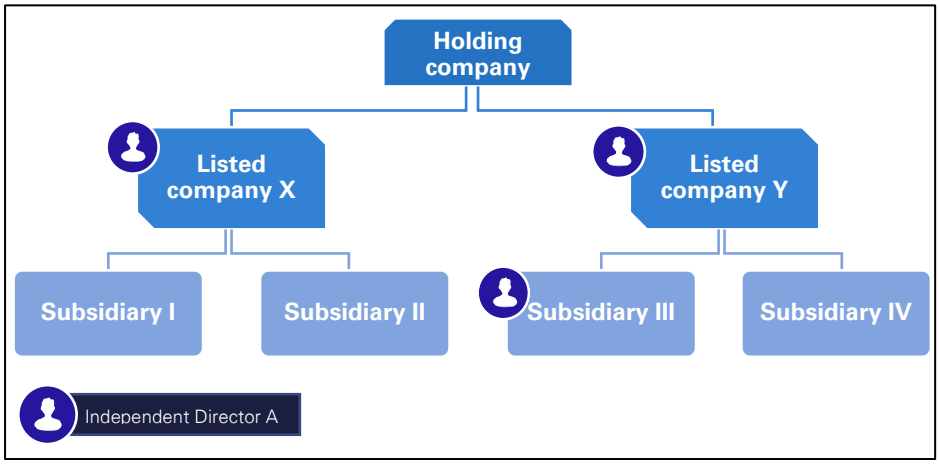
- × Accepting the separation of chairman and CEO as a substitute for not having a balanced board or a majority of independent directors.
- × Maintaining that adherence to **Bursa Securities Listing Requirements** (i.e. one third of the board comprising independent directors) is the be-all and end-all.
- × Having in place an internal policy on meritocracy that overrides the element of independence.

[3] *In Camera Directors' Meetings* 2013, Minden Gross LLP

Why should a company limit the same independent directors from sitting across group entities?

Whilst common directors can contribute to group alignment, excessive overlaps of independent directors (as shown in the diagram below) may result in conflict of interest situations. Directorships in multiple entities within the group may also potentially create undue dependence in terms of remuneration received by independent directors, thus, raising concerns on the objectivity of these directors.

The need for financial institutions to minimise excessive common directorships in group entities is highlighted in **Standard 11.11 of Bank Negara Malaysia's Policy Document on Corporate Governance.**

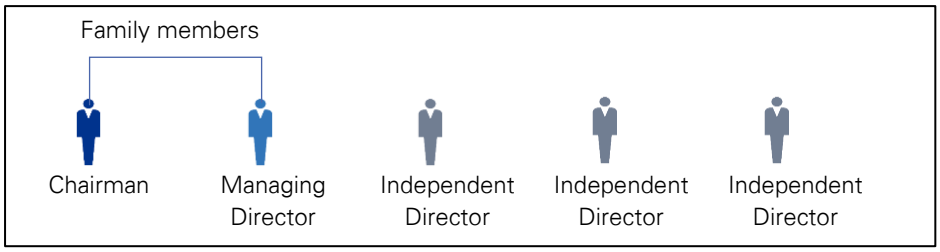


How do owner-managed companies with a small board size structure their composition of independent directors?

In owner-managed companies (particularly those with a small board size), whilst the chairman and managing director may be two different individuals, they are often related to each other and/or to the controlling shareholders.

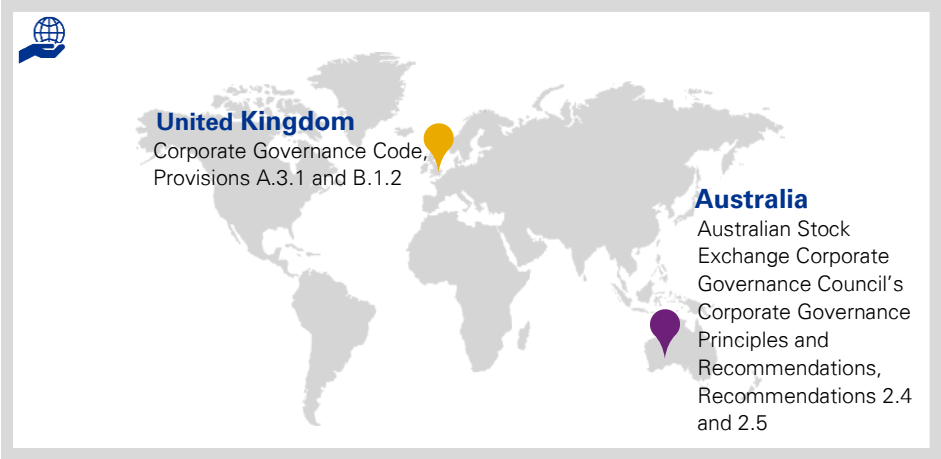
In such a situation, the need for a majority of independent directors becomes even more imperative to prevent deliberations and decision-making from being dominated by a select group of individuals, comprising family members.

An example of a structure for a board size with five members and related chairman-managing director is outlined below:



Where — Regional/international perspectives

Similar to the case of Malaysia, there has been a move by global regulators (as noted in countries like United Kingdom and Australia) to prescribe a more even balance of independent and non-independent directors on the board.



Country	Provision(s)
United Kingdom	The chairman should on appointment meet the independence criteria. A chief executive should not go on to be chairman of the same company. If exceptionally a board decides that a chief executive should become chairman, the board should consult major shareholders in advance and should set out its reasons to shareholders at the time of the appointment and in the next annual report (***Provision A.3.1***). Except for smaller companies[4], at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent. A smaller company should have at least two independent non-executive directors ***(Provision B.1.2)***.
Australia	A majority of the board of a listed entity should be independent directors ***(Recommendation 2.4)***. The chair of the board of a listed entity should be an independent director and, in particular, should not be the same person as the CEO of the entity ***(Recommendation 2.5)***.

[4] A smaller company is one that is below the FTSE 350 throughout the year immediately prior to the reporting year.