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Will the Truly Independent Director Please Stand Up?

By Willie Cheng

Several years ago, the chairman of a multi-billion-dollar enterprise said to me: "Let's face it – there is no such thing as a totally and truly independent director."

That remark put the brakes on the discussion about the independence of a particular director on the board.

On reflection, he was, in a sense, right, of course. Independence, after all, is a state of mind. Who is to really know what is (and what could be) in the mind of a director when a decision is being made?

Tests of blood and money

Instead, the regulations seek to develop yardsticks of director independence that are based largely on arguable relationships of blood and money.

Thus, Guideline 2.3 of the Code of Corporate Governance says a director is independent when he or she "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 judgement with a view to the best interests of the company".

It goes on to provide a long list of examples of specific relationships or circumstances that are likely to affect, or could appear to affect, a director's judgement. These include the director or an immediate family member being a 10 per cent shareholder, or being employed by the company and its related corporations, or having received significant payments for services (other than directorship).

Where such situations occur, the director is deemed to be not independent, although the board can still declare otherwise; in which case, it must state the reasons for that conclusion and fully disclose the nature of the director's relationship in the company's annual report.

Compliance with the Code

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Many boards and nominating committees spend much time applying these specific examples in the Code quite literally in determining whether a director is technically considered independent. That's because having more independent directors on the board is important to them - firstly, to meet the rules for the minimum number of independent directors; and secondly, to create a better public perception of a well-governed company.

What boards sometimes forget is that the Code expressly states that an independent director must be "independent in character and judgement and (there should not be any) relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement" (Guideline 2.3).

The specific examples provided in the Code are therefore not meant to be exhaustive. Indeed, the general test of independence in Guideline 2.3 applies in all situations, and boards have a responsibility to ensure that their independent directors pass the test in being really independent.

That said, since the Code is based on a "comply or explain" model, many boards push the envelope further by choosing to explain rather than comply, although these explanations are not always credible either. For example, the 2014 SID-ISCA Singapore Directorship Report found several instances of widespread non-compliance with the Code guidelines on independent directors.

"When the board chairman is non-independent, at least half the board should comprise independent directors (Guideline 2.2)." The report showed that over 47 per cent of boards that need to do so do not meet this requirement (although it should be noted that the application of this requirement is deferred to financial years commencing after May 2016). A smaller 3 per cent of listed boards do not even have one-third of their boards comprising independent directors.

"When the board chairman is non-independent, a Lead Independent Director should be appointed (Guideline 3.3)." Over 45 per cent of firms which need to do so fail on this test.

"The independence of a director who has served more than nine years should be subject to particularly rigorous review (Guideline 2.4)." Over 54 per cent of companies that have been listed for more than nine years have at least one director who is declared independent, despite having served nine years or more.

Whither the independent director?

The value of having independent directors has been questioned. A large part of the debate arises because while most independent directors meet the regulatory definition, their substantive independence may not always be there.

In fact, in too many corporate failures and scandals, the presence of independent directors has not made a difference, notwithstanding that these directors are otherwise competent men and women of substance.

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However, imperfect as the definition, role and practices have been, the independent director is unlikely to become an endangered species.

That's because no one has, to date, come up with a better solution to the need for a level of objectivity on the board that is independent of major shareholders and management.

The answer, in my view, is not to do away with independent directors. Rather, it is to ensure that boards are populated with the right individuals with the professionalism and moral courage to challenge and ask the important questions, and to take a stand – notwithstanding their relationships, no matter how close, with management and major shareholders.

That challenge is within the power of each and every individual director – formally independent or otherwise – to rise to the occasion, and be counted as truly independent.

The writer is chairman of the Singapore Institute of Directors. This article first appeared in BTInvest, <http://www.btinvest.com.sg/specials/boardroom/will-the-truly-independent-director-please-stand-up/>