ACGA submission to the Council on Corporate Disclosure and Governance, Singapore

Regarding: Proposed Revisions to the Code of Corporate Governance

February 22, 2005

The Asian Corporate Governance Association (ACGA) welcomes the opportunity to comment on Singapore's revised Code of Corporate Governance and applauds the Council on Corporate Disclosure and Governance (CCDG) for undertaking this initiative. Our submission will cover the following issues:

- Proposal 2: Proportion of independent directors
- Proposal 3: Independence criteria
- Proposal 4: The role of the board
- Proposal 5: Lead independent director
- Proposal 6: Director selection
- Proposals 11/12: Audit committee
- Proposal 13: Proxy attendance at AGMs
- Proposal 16: Institutional investors

Proposal 2: Proportion of independent directors

> The consultation paper proposes retaining the current one-third requirement for independent directors on listed company boards.

It is difficult to dictate the right proportion of independent directors for the board of an average Asian company. While one-third seems a reasonable minimum on paper, it may not be sufficient if the total board size is only 9-10 people and the three independent directors are asked to sit on multiple sub-committees (audit, nomination, remuneration, etc) in addition to attending four to six board meetings each year. On the other hand, while prescribing an artificially large number of independent directors may look good on paper, it may not produce a greater degree of independent action (since management or the controlling shareholder will be incentivised to select only compliant directors).

A pragmatic way to approach the issue of proportion would be to advise companies to ensure that the number of independent directors is sufficient for their needs, with one-third as the practical minimum and one-half as possibly necessary depending on the size and structure of their board. Hence, for a board of nine people with only one sub-committee (eg, audit), three independent directors may suffice. For a board of 15 people with one to two sub-committees (eg, audit, remuneration), five independent directors may be enough. But for a board of 12 people that has two to three sub-committees (eg, audit, remuneration, and nomination or governance/risk management), then four independent directors is unlikely to be sufficient. There will be too much work for each independent to

do. This will be compounded if those directors have full-time jobs and other directorships.

We recommend that companies be required to disclose in the corporate governance statements in their annual reports how the number of independent directors on their boards is sufficient for their needs (given their board structure and size).

Proposal 3: Independence criteria

The consultation paper suggests that the Code's guidance notes be expanded to include the following:

- Directors who represent "substantial shareholders" (ie, defined as those with an interest of 5% or more in voting shares) should also be deemed to be non-independent.
- In judging the non-independence of family directors, the term "immediate family member" should be replaced with a broader phrase, "close family member".

The sum of S$200,000 will remain the benchmark for assessing the independence of directors linked to business associates or professional advisors.

While some minority shareholders in Asia may question the independence of a director representing a "substantial minority shareholder" (since the latter might act in its own interest, rather than in the interest of all minority shareholders, as the paper notes), most are far more concerned at present about the effectiveness of directors appointed by and representing controlling shareholders. In this regard, we note that the consultation paper does not include a proposal to revise the basic definition of board independence in the Code. The relevant sentence of Principle 2 still reads: "There should be a strong and independent element on the Board, which is able to exercise objective judgement on corporate affairs independently, in particular, from Management."

We recommend adding the words "and controlling shareholders" at the end of this sentence.

This recommendation is in line with the proposal to deem all directors that represent substantial shareholders as non-independent.

The 5% threshold

Although as a matter of principle it is right to say that directors who represent substantial shareholders are not independent, defining the threshold mark for such shareholders is more difficult. In markets such as the UK and Australia, where listed companies are often widely held, a shareholder with a stake as high as 5% could well have influence

over management and be seen as a quasi "insider". But in Asia, where the norm is closely held family or state-owned companies, a shareholder with 5% may have little sway over management and is likely to be an outsider.

Whether directors representing, or nominated by, a shareholder with 5% or more of voting shares will act independently is likely to depend on a number of factors:

1. Who nominated them for the board—the board/controlling shareholder? A substantial minority shareholder? Or a group of minority shareholders?

   If the director was nominated by the board/controlling shareholder, the presumption in the market would be that they are not independent. However, if they were nominated by a minority institutional shareholder—and were supported by other minority shareholders—then the market might view them quite differently. (Although most Asian listed companies are closely held, and few minority shareholders nominate candidates for the position of independent director, this situation is slowly changing as the ownership structures of companies change and investors take more interest in board composition.)

2. How dispersed or concentrated is the company's ownership?

   The more dispersed the ownership, the more likely that minority institutional shareholders will be successful in nominating candidates for independent directors—and, assuming their stakes are sufficiently large, the more incentive they will have to ensure these directors act independently. Conversely, the more concentrated the ownership, the more difficult it would be for minority candidates to be nominated without the controlling shareholder's blessing (which brings us back to the presumption of non-independence).

3. Is the investor currently or potentially conflicted?

   Is the investor part of a financial conglomerate that has a close banking relationship with the company that could, in turn, impair the investor's independence or perceived independence? Or does the investor have a special deal with the company, such as a private equity investor owning convertible bonds, that could cause its interests to conflict with those of other minority shareholders?

It is difficult if not impossible, therefore, to state categorically that any director representing or nominated by a substantial minority shareholder with a stake of 5% or more will not, by definition, be independent. Indeed, it is entirely possible that such directors could be capable of far more independent action than most existing independent directors in Asia (many of whom are friends, acquaintances or business associates of management and/or the controlling shareholder).

Although the 5% threshold has a certain logic to it—since the level at which ownership must be disclosed is 5%—setting such a limit on independence could deny a company a pool of potential independent directors with a strong economic incentive and the knowledge to play an effective governance role. Furthermore, if such independent directors received the backing of other minority institutional and retail shareholders, this would strengthen the credibility of both their position and the board. It would also help to remove or minimise concerns about conflict of interest.

Many institutional investors, even if not conflicted, may well prefer not to accept an appointment as an independent director for a variety of reasons (eg, being on a board may inhibit the ability of a fund to sell its shares). But this would be a decision they would need to make either on a case-by-case basis or as a matter of internal policy.

We recommend that the Code allows more flexibility on this point.

What is also critical is that companies provide sufficient transparency in their AGM notices, annual reports and websites as to their reasons for nominating any individual as an independent director—whether they come from a substantial minority shareholder or not. And there should be full disclosure as to their relationship with management and controlling shareholders.

We recommend that companies be encouraged to provide more substantive information to investors as to their reasons for nominating certain people as independent directors.

Close family members

The suggestion to replace "immediate family member" with "close family member" in the Code's description of non-independence seems sensible. However, we note that the commentary on this issue defines "immediate family members" clearly, but not "close family members". Is the latter term intended to include cousins, in-laws and so on?

We recommend that the relevant commentary be further clarified.

The S$200,000 threshold

Setting a monetary threshold to dictate independence or the lack of it is problematic, for the following reasons:

- While the stated sum is relatively small for a large business or professional firm, it could represent a significant portion of the income of a small firm (the type that could provide directors to small-cap companies).
- It is likely to encourage some firms to structure their business relationships with advisors so as to come close to, but not exceed, the threshold.
- It does not take into account the possibility that an advisory firm may, over the longer term, wish to significantly expand its business with a listed company on

which one of its officers sits as an "independent director"—and this could negatively affect the behaviour and independence of that director.

The simpler and more robust solution would be to remove the monetary threshold and state in the guidance notes to the Code that any director linked to a business associate or professional advisor is likely to be perceived by the market as not independent. Rather than appoint them to their boards as independent non-executive directors—and run the risk of an appearance of conflict of interest—companies could instead be encouraged to make them non-executive directors.

If companies wish to appoint business associates and advisors to their boards, we recommend that they be called "non-executive directors", not independent directors.

Other issues: the three-year threshold

The guidance notes also set a time threshold of three years to govern independence. For example, a director who has been employed by a company or any of its related companies in the previous three years would not be regarded as independent.

Such time thresholds are as problematic as monetary ones and can lead to equally distorted results. A person who has loyally worked for a company in a senior capacity for a couple of decades, rose to the rank of executive director on the board in his or her last few years, then remained on the board as a non-executive director during retirement, could only a few years later be appointed as an independent director. It is highly unlikely that the market would take such an appointment seriously, unless the individual was known to be a strong personality.

A more robust solution would be to remove the three-year threshold and state that any individual who has been employed by the company in the past is likely to be seen as non-independent. Such people could still serve on boards as non-executive directors.

If companies wish to appoint former employees to their boards, we recommend that they be called "non-executive directors", not independent directors.

Other issues: related companies

The guidance notes also state that an independent director is one who has no relationship with, among others, the related companies of the listed entity. The term "related companies" is defined as including subsidiaries (which are 50% owned by a company), fellow subsidiaries and the parent company. It does not include "associates" of the listed company (ie, companies in which the latter's ownership stake is 20% or more). Yet a close relationship with an associate company could clearly undermine the independence of an independent director.

We recommend the inclusion of the word "associates" in the definition of related companies in the Code.

Proposal 4: The role of the board

The consultation paper suggests providing more guidance on the roles of the board, the chairman and the non-executive directors.

In principle, providing further guidance in the Code on the respective roles of the board, the chairman and the non-executive directors is a good idea; and we agree with most of the points of elaboration in the consultation paper.

However, the new wording in the Code itself appears to place more emphasis on the board's role in setting strategic aims and providing "entrepreneurial leadership" than on actively monitoring management performance and ensuring effective internal controls (ie, under Principle 1). There should be a clear balance between these two functions.

We recommend combining the phrase " entrepreneurial leadership" in clause 1.1.a with the discussion of strategy in clause 1.1.b. There should be a separate clause emphasising the board's responsibility to ensure effective internal controls and risk management. And we recommend replacing the somewhat passive phrase "review management performance" with a more active statement such as "monitor management performance and its progress in implementing the company's governance objectives".

Proposal 5: Lead independent director

The consultation paper recommends the appointment of a lead independent director.

We agree with the recommendation that companies appoint a lead independent director where the chairman and CEO is the same person, or where they are related by close family ties.

We would go slightly further, however, and suggest that the Code recommends that companies appoint a lead independent director as a matter of best practice. Apart from being an additional point of liaison for minority shareholders, a lead independent director could be invited at each AGM to give an account of the contribution made by all the independent directors during the year (and to take questions from minority shareholders).

The one scenario in which a lead independent director would not be necessary is where the company chairman was demonstrably independent already.

Proposal 6: Director selection

The consultation paper recommends that companies provide shareholders with a description of the process for selecting and appointing new directors.

In principle we agree with the proposal that companies provide investors with more information on how they choose directors, especially independent directors. If done well, this could raise market confidence in the company's overall board composition strategy, the integrity of the processes used by the company and the directors chosen.

One concern, however, is the possibility that such disclosure could quickly become formulaic and, being focussed on generic processes, offer little substantive information to investors. Another concern is that such disclosure, if done badly, will only add more pages to annual reports while bringing little of value in return.

What might be of more benefit to investors is a clear description from a company as to its board-composition strategy:

- What are the current strengths and weaknesses of the board (eg, in terms of the composition of skills)?
- How does the company plan to develop the board in the coming years?
- How does it plan to strengthen the independent element on the board as the business becomes more complex and ownership structure changes?

Another useful piece of information would be an explanation of the rights of minority shareholders, under the company's Articles, to participate in the nomination of directors.

Proposals 11/12: Audit committee

The consultation paper proposes retaining the current requirement that audit committees comprise at least three directors, all non-executive and a majority of who are independent (including the chairman). It also proposes that the committee review arrangements by which staff may raise concerns about possible improprieties in financial or other matters.

We agree that three people is the minimum practical size for an audit committee (rather than, say, two persons, which is the practice in some other markets). With three members, the committee can still meet even if one is unable to attend. We also agree with a majority of members being independent, as opposed to all, as long as the chairman is independent.

Given the expanding responsibilities of audit committees, however, and the increasing complexity of the work they are required to do, it may be advisable for companies to

appoint four or five people rather than just three. A larger committee would be able to share the workload more effectively and would comprise a wider range of skills, especially in finance and risk management.

We recommend that the Code advises companies, especially the larger ones, to consider whether the size of their audit committee is optimal for their needs.

The second proposal on the review of whistleblowing procedures also seems sensible.

Proposal 13: Proxy attendance at AGMs

> The consultation paper proposes that companies amend their Articles to avoid imposing a limit on the number of proxies that the nominee companies of custodian banks (ie, the legal owners of shares) can appoint to a company AGM.

We strongly support this proposal, as it will allow fund managers who hold shares in "omnibus accounts" managed by the nominee companies of sub-custodian banks to attend AGMs in Singapore. This is in line with practice in other major markets around the world, including Hong Kong, the United Kingdom and Australia, and with Singapore's policy of encouraging institutional investors to take an active interest in corporate governance matters and, more specifically, to attend company meetings.

We held meetings on this issue with the CCDG and the Accounting and Corporate Regulatory Authority (ACRA) in Singapore during 2004 and are currently preparing a detailed submission for the government.

Proposal 16: Institutional investors

> The consultation paper proposes not to follow the UK Combined Code model and include a section in the Singapore Code on the role of institutional investors (ie, to engage in a dialogue with companies and to make considered use of their votes).

Although it is true to say that the Code is intended for listed companies, not institutional investors, it is a national document that provides an excellent opportunity for the government and the regulatory authorities to underscore the importance of investors in the corporate governance process. Incorporating the relevant sections from the UK Code, or using similar language, would merely lay down the bare minimum that is expected of institutional investors acting as fiduciaries for their clients. Indeed, it is a logical progression from Principles 14 and 15 in the Code, which state, respectively, that "companies should engage in regular, effective and fair communication with shareholders" and "companies should encourage greater shareholder participation at AGMs".

We recommend that this proposal be reconsidered.