

## Hearts & Minds

I was looking at the new UK Corporate Governance Code, a document not without its flaws, and reflecting on the arbitrary time limit it retains in determining a director's independence. Nine years, the Code says.

To be fair, the UK Code doesn't say that you're suddenly useless, but if independence was a special attribute which warranted your presence as a director, somehow your usefulness is watered down overnight. If I forget about leap years, this happens before dawn on day 3286 of your appointment. After that you are no longer independent, or the company must at least go through the painful process of justifying why you should continue to be considered independent.

The UK argument is that the passage of time brings familiarity and, with that, a tendency to accept the status quo, to move with the rhythm. I used to think this was reasonable and, although you could argue about a different time limit, a guideline was useful. That was until I was confronted by a feisty old friend.

"David, I've been an independent director of *ABC Berhad* for over thirty years and, I tell you, I'm better qualified to be independent today than I was when I first joined the Board."

Strong stuff, but knowing him for all those three decades, I doubt this is an empty boast. "It's what's in your head and your heart, and how you use it, which determines whether you're independent. What does time have to do with it? Experience helps you if you're independent in the first place."

That started me thinking. Is it reasonable to assume the resolve to be independent weakens? What if it has less to do with some sort of commitment to be independent, than with that innate element in your character which means your views are always your own, you dance to your own tune?

I thought I'd examine this idea that independence has a shelf-life.

Describing independence is not easy. The UK Code doesn't offer a definition, nor does our Companies Act or the Malaysian Code on Corporate Governance. This seems to be quite common. The reference to independence the UK Code and in various other regulatory guides, is in the form of a list of things that can't be present if independence is to exist. That's about as helpful as having a gardening book which tells you only where a plant won't do well. Still, with many qualities the negative is easier to recognise than the positive.

Judging by those I've spoken to, in our context, independence is about bringing to the Boardroom all those things which meant you were wisely chosen when you were originally appointed as a director. Part of it is diplomacy and an ability to listen as well as to speak your mind. In the end, it means contributing your skills, knowledge and experience to a debate which results in a decision that is well-considered, based on adequate information and proper enquiry.

Is there a mantra for this? The Chairman of one public company put it this way: "It's to do with integrity and a focus on delivering shareholder value, come what may."

Apart from the regulatory criteria, there are situations and behaviour patterns which can compromise the ability to be independent. One independent director told me he left a Board after only nine months. Board papers were habitually delivered the night before and often at the meeting itself. These were complicated papers, but urgent decisions were demanded. He told the Chairman, privately at first and then in the meeting, that this was not acceptable, but nothing changed. When this happened for a fourth time, he resigned.

Another senior independent director told me of a situation where management insisted that it should proceed with proposed related party transactions involving the controlling shareholder. Management wanted only to submit these to the independent directors for endorsement every quarter. “I made the point that it was *my* signature on the annual circular to shareholders, not management’s or the controlling shareholder’s signature. I have to put my hand on my heart and say these transactions have been properly considered, are on commercially justified terms, and in the best interests of the company. This means I have to look at what’s proposed beforehand, not endorse some *fait accompli*. When management complained this would slow things down, I told them it isn’t the Board’s job to compromise the proper process for the sake of management’s convenience. It’s not our job either to become a hindrance to the efficient conduct of business. So, independent directors agreed to meet monthly to consider proposed related party transactions, and more often if necessary. In fact, management has found it can usually cope within the regular schedule of meetings, my colleagues feel they are able to make good decisions, and the controlling shareholder (another public company) has supported the process because they can show genuine transparency when the same transactions are put to their shareholders.”

This brings up another point. The independent director is not meant to be a stumbling block, at least not habitually so. “Rocking the boat can be helpful; sinking the boat isn’t!” another Chairman friend said. “If you’re in constant conflict with your colleagues on the Board, with management or a controlling shareholder, then something is not functioning right. If you’re in a minority of one all the time, it may mean everyone else *is* wrong but doesn’t care to change. In that case, it’s time to go for the sake of your own integrity. On the other hand, it may mean you really are a thorn in everyone else’s side. Not considering the views of your colleagues and arguing until you get your own way is tyranny, so it can’t be in the best interests of the company that you stay on and prejudice functionality.”

We were reflecting on a mutual acquaintance who sits as an independent director and chairs the Audit Committee in the public company where my friend is Executive Chairman and a major shareholder. “What I appreciate about XYZ is his ability to ask the unscripted question. He makes us sit up and think. We’re always better for that. He’s done it from day one. I encourage this in all my directors.”

Several other independent directors took a similar line. They saw confrontation not only as being opposed to our culture, but often as an ineffective way of getting the directors’ job done. As one director put it: “You build a rapport with the Chairman and your colleagues over the years. It allows you to express your views privately. You can argue for change, even record your views in writing, but you should avoid acrimony in the Boardroom.”

While harmony is welcome in any Boardroom, as long as it is not synonymous with “group think” and a supine Board, my preference is for a more transparent, diplomatic debate which is reflected in the minutes. Maybe it’s my Western roots showing, but I think record is far preferable to recollection when it comes to dealing with disputes.

Either way, one thing is clear, independence thrives when it has an ally in the Chairman. Indeed, there was universal agreement that the role of the Chairman is vital. He is essential in drawing out the independent opinion, to challenge what is proposed and to validate what is recommended. One independent director, who sits on the Board of several public companies, even saw the Chairman as a determining factor in whether he would accept an invitation to serve as an independent director. “I need to know both that I can contribute to the company and that I will be allowed to contribute. The culture of the Board must make this possible, and it’s easier if there isn’t a dominating shareholder. But, in the end it’s the Chairman who determines what happens.”

An independent director in one major group said: “We have a controlling shareholder and they have their nominees, but half the Board is independent. If we know how the shareholder thinks we know how the nominees will vote. But our Chairman, who is also a nominee, gets us all involved. He tells us everyone’s view matters. We must think of the group as a whole. It’s not so much that we look after the minority; that’s too narrow. It’s that we think of the interests of all the stakeholders, which includes the majority and the minority. Then he (the Chairman) makes sure the minutes reflect what we’ve discussed, without us forcing the issue.”

This director goes on to offer a view that there are only a limited number of situations when independence is actually called for. The annual decision on dividends or other distributions to shareholders is one, as would be any decision to raise significant new funds, either from shareholders or from lenders. Major transactions, including mergers and acquisitions, are another, especially the price to be paid and the currency of the payment (cash or shares). Finally, he says independent directors need to be closely involved in the selection and evaluation of the Chief Executive.

Others think strategy is an area of contribution. Management and major shareholders, they suggest, tend to have either too bold or too narrow a focus on strategy. In the case of the far reaching vision of the future, it benefits from challenge, while the examination of broader horizons, at least in the formulation stages, can add value to the more tightly focused approach.

A similar attitude is needed when it comes to controls and risk. There is a tendency to believe that controls are functioning perfectly well and to believe that management will deal with any glitches. Verifying that this is actually the case and that controls are adequate is a Board responsibility. The same applies to the risks being adopted by the company, and both require that independent Board committees have the help of independent staff functions in evaluating the quality and efficacy of the control and risk assessment processes.

To be effective in this role, an independent director sometimes needs special knowledge, but he also benefits immensely from familiarity with the industry and the peculiarities of the company itself. Another long serving independent director described it this way: “I’ve had the same office the entire time I’ve been on the Board. The view outside my window has changed a lot in a quarter of a century, and often for the better. I enjoy being part of that. However, I also recognise when things look familiar and I’m able to talk about how we managed before in a similar situation. I’m part of the institutional memory and my grey hair belongs to the institution.”

So, there seems to be a balance to be struck between refreshment and renewal, and continuity at the Board. Perhaps those who argue for the former need to reflect on the fact that refreshment and renewal does not have to come exclusively from a change of faces. New knowledge in old heads has many advantages. And this brings me to another universal observation. Those who are independent by nature never lose their hunger for learning, for exploring issues and for re-examining the virtues of the status quo.

They are not there for the fees or the prestige associated with the position of being a director. They are not there just to keep a seat warm. They are there because they believe they can contribute and would not want to stay on if they thought that was no longer the case.

For these people independence is a label which satisfies a rule or regulation. That's not a concern for them. Their job, as they see it, is to be the best director they can. And who can argue with that? The reality which emerged from my conversations is that independence is a quality which, at its best, accompanies all those other attributes that make for a good director. It might be difficult to reduce to a definition, but true independence is incapable of compromise; it is a timeless trait that endures in the hearts and minds of those who possess it.

This makes for a real challenge for Nominations Committees. From what I saw, I can't say I'm convinced any longer about a nine year rule to limit independence. That doesn't mean the issue should be abandoned, however. There are certainly many directors of long standing who continue to be capable and truly independent contributors. There are others who are seat warmers. Perhaps the solution is greater rigor in the evaluation process which accompanies any recommendation for renewal of a directors' appointment, and transparency in describing to shareholders how that process works. This will provide the justification why a long serving director should be retained. His independence is an attribute any wise company should welcome.

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