CFA Institute

INDEPENDENT DIRECTORS IN ASIA PACIFIC

REGULATIONS AND PRACTICE IN SELECTED MARKETS

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1. Executive Summary

> *I have been on 20 public company corporate boards, not counting any Berkshire subsidiaries. So, I've seen a lot of corporate boards operate. And the independent directors, in many cases, are the least independent.*[1]
>
> *When seeking directors, CEOs don't look for pit bulls. It's the cocker spaniel that gets taken home.*[2]
>
> *Warren Buffet*

Good corporate governance not only protects the interests of investors and improves their trust in capital markets, but also acts as a key driver of investment performance. As an organization driven by the mission to lead the investment management profession globally for the ultimate benefit of the society, CFA Institute considers improving corporate governance standards an important part of its advocacy efforts.

Board independence is one of the cornerstones of corporate governance. Independent board directors are key to mitigating the agency problem of corporations[3] in which ownership and control are separated. They monitor and counterbalance executive management or controlling shareholders on the board by ensuring that decisions are made in the best interest of the company and are fair to all shareholders. When independent directors fall short or breach their duties and responsibilities, the quality of decision making by the board and its overall competence and effectiveness become impaired.

CFA Institute defines an independent director as a member of the board of directors who is not biased or otherwise controlled by the company management, other groups exerting control over the management, or shareholders.[4] As a matter of best practice, independent directors should constitute a majority of the board, and play a significant role on board committees, such as the nomination, audit, and remuneration committees. We also believe that the chair of the board should be an independent director.

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[1]Berkshire Hathaway, "2019 Berkshire Hathaway Shareholder Meeting," 2019, https://assets.empirefinancialresearch.com/uploads/2019/05/Transcript-of-Berkshire-Hathaway-annual-meeting-5-4-19.pdf.
[2]Berkshire Hathaway, "Berkshire's Performance vs. the S&P 500," 22 February 2020, https://www.berkshirehathaway.com/letters/2019ltr.pdf.
[3]Lukas Setia-Atmaja, Janto Haman, and George Tanewski, "The Role of Board Independence in Mitigating Agency Problem II in Australian Family Firms," *British Accounting Review* 43, no. 3 (September 2011): 230–246.
[4]Matt Orsagh, Linda Rittenhouse, and Jim Allen, *The Corporate Governance of Listed Companies: A Manual for Investors*, 3rd ed. (CFA Institute, 2018), https://www.cfainstitute.org/en/advocacy/policy-positions/corporate-governance-of-listed-companies-3rd-edition

In practice, the roles and functions of independent directors vary significantly from market to market because of differences in regulation, ownership structure, types of shareholders, history, and cultural context. Similarly, regulatory definitions of independence and the criteria used for its evaluation differ among markets. These differences are particularly pronounced among markets in Asia Pacific—a region with a wide range of historical, legal, regulatory, and cultural contexts, where weak legal protections and concentrated ownership structures are common. It is not uncommon, for example, that independent directors are incentivized to submit to the decisions of the controlling shareholders because they tend to have much greater influence on the election and retention of independent directors.[5] Studies have found that powerful management, especially those holding both CEO and chairperson positions, could weaken the independence of independent directors, because they are empowered to adjust board members' compensation.[6] Given these challenges, the ability for independent directors to disagree with founders and top management so they may uphold corporate governance standards becomes vital.

In 2010, CFA Institute published the report *Independent Non-Executive Directors—A Search for True Independence*.[7] This report covered regulations and codes of corporate governance in Hong Kong SAR, Singapore, India, and the Philippines, with a handful of case studies.

In that report, we recommended that regulators require a majority of independent directors on the board and that an independent director should serve as the chair of the board. We also recommended strengthening the definition of independence in relation to both management and controlling shareholders as well as the role of minority shareholders in the appointment of independent directors. We recommended that companies provide shareholders with all necessary information about candidates and strengthen training and certification requirements for independent directors.

Ten years on, some of these areas have seen significant improvements, notably on definition of independence, training, and disclosures. Modest improvements are noted in other areas, for example, in the director appointment processes.

In this report, which updates the earlier publication, we revisit three of these markets—Hong Kong SAR, India, and Singapore—to examine the changes that have taken place in the past decade and the role of independent directors as a tool for good corporate governance. We add to our analysis Australia and Malaysia—to highlight their

[5]L. A. Bebchuk and A. Hamdani, "Independent Directors and Controlling Shareholders," *University of Pennsylvania Law Review* 165, no. 6 (2017): 1271–1315.

[6]D. Cossin and A. H. Lu, "The Four Tiers of Conflict of Interest Faced by Board Directors" (IMD Global Board Centre, 2017).

[7]Lee Kha Loon and Angela Pica, "Independent Non-Executive Directors—A Search for True Independence in Asia" (CFA Institute, January 2010), https://www.cfainstitute.org/en/advocacy/policy-positions/independent-non-executive-directors.

leadership in the region and best practices—and Japan, which is making fast progress on adopting global best practices in corporate governance in a particularly conservative business environment.

In particular, we explore the following key points:

- the effectiveness of regulatory reforms in strengthening the role and responsibilities of independent directors;
- issues limiting director independence;
- the extent to which independent directors act with true independence, particularly in markets with controlling shareholders;
- the adequacy of qualifications and skillsets of independent directors; and
- whether having an independent chair, separate from the CEO, contributes to board effectiveness.

We examine regulatory frameworks and codes of corporate governance to understand how regulators and standard setters approach board and director independence. Our research was also informed by insights from industry practitioners who shared how these concepts are applied in practice. We conclude by presenting recommendations for regulators, issuers, and investors.

1.1. Summary of Issues

Over the past 50 years, the growth of Asia Pacific companies, stock exchanges and economies has been remarkable. Although each market is in its own stage of economic growth and development, we observe that progress has been made toward broader recognition of the role of independent directors in improving corporate governance. The responsibilities and expectations of independent directors continue to increase, and we see this as a positive step toward more engaged and effective company boards.

Our review of the six Asia Pacific markets revealed some commonalities as well as significant differences. We next present high-level observations and market highlights.

Independence does not have a standard definition: Each of the six markets we analysed defines independent directors differently through regulation or market practice. This relates to the actual level of independence directors can exercise in different markets.

Particular challenges exist when companies are majority-owned or controlled by their founder, a family, a group of related shareholders, a government, or an individual able to exert behind-the-scenes influence (promoter).

Consensus is lacking on the minimum representation of independent directors on boards: Although regulations in all six markets require that boards appoint independent directors, the minimum requirement varies among markets.

The value of the separation of the roles of chair and CEO is not universally recognized: Different standards apply regarding the separation of the roles of chair and CEO in the six markets. Although nominally separated, in some markets, it is common for the chair to be a retired CEO of the company who already has a relationship with the company's management or with a controlling shareholder.

Adoption of lead independent directors is low: Although recognized as beneficial for corporate governance of a company, lead independent directors, who directly represent investors, are not common in Asia Pacific.

The process of nomination and removal of independent directors is often dominated by controlling shareholders: Although practices differ among markets, directors' independence is undermined if a company is dominated by a controlling shareholder who controls the nomination process.

Independent directors resign without disclosing true reasons: This issue is most prevalent in India, which saw a spate of director resignations, but without substantive disclosure about the cause. This silence led to heightened investor concerns of potential material events.

Consensus is lacking on how independent directors should be remunerated. Concerns in the markets vary from excessive remuneration compromising directors' independence to inadequate remuneration leading to a misalignment between the remuneration and potential liabilities of directors.

The level of diversity on boards varies among markets. Gender is one of the factors that contributes to the diversity of boards, which in turn improves the quality of discussion and the effectiveness of decision making.

Consensus is lacking on the optimal maximum tenure of independent directors: Long tenures are seen as potentially weakening directors' independence, but standards differ, from no formal rules, to additional approval requirements, to a mandatory cap on tenure.

Required cooling-off period requirements vary and generally are too short: Longer cooling-off periods, before a former insider can be considered an independent director, make it more likely that the individual will be truly independent and bring a fresh perspective. The existing requirements in five out of the six markets (from one to three years) are inadequate.

Means to curb overboarding vary among markets: Hard limits on the number of concurrent directorships held by an individual are in place in three of the six markets, whereas the other three markets have no such restrictions.

Independent directors in corporate groups and state-owned enterprises face additional challenges: Independent directors in company groups face additional conflicts of interest, in particular when considering related-party transactions. Those in state-owned enterprises also face potential politicization of management, lack of transparency, and weak protections of minority shareholders.

1.2. Market Highlights

Australia

- Australia's standards in relation to director independence are seen as high in terms of regulation and practice. It stands out among the markets covered in this report by requiring that company boards consist of a majority of independent directors and that the chair be an independent director.
- Although these requirements, issued as guidelines by the Australian Securities Exchange (ASX), are enforced on a comply-or-explain basis, many Australian companies adhere to global best practices, with a higher proportion of independent directors on boards and a more common separation of the roles of chair and CEO than in most other markets we covered.
- Australian companies tend to be widely held with a relatively low level of ownership concentration compared with other Asia Pacific markets. Family-dominated companies and those with a controlling shareholder are relatively rare. Institutional investors tend to be active in holding boards to account.

Recommendations

- Guidelines on director independence would be better implemented as requirements.
- A more robust fit-and-proper test for company directors is needed and should be incorporated into the ASX Corporate Governance Principles and the Listing Rules.

Hong Kong SAR

- Many large companies listed in Hong Kong SAR are dominated by a controlling shareholder, which can be a family group or a mainland Chinese parent company, often a state-owned enterprise. Under such structure, controlling shareholders often play a critical role in the selection, election, and retention of independent directors on the board. Such arrangements potentially undermine the independence of directors and the effectiveness of their oversight of the board.

- The separation of the roles of chair and CEO is not mandatory for listed companies in Hong Kong SAR, but are required on a comply-or-explain basis under the Corporate Governance Code. There is no requirement for the chair to be independent. A company can have a chair who is a part of the executive management team or related to a controlling shareholder. Such arrangement dilutes the effectiveness of the Corporate Governance Code, which supports a clear division of responsibilities between the chair and CEO.

- Board diversity in Hong Kong SAR has room for improvement. In particular, the lack of gender diversity on boards continues to be a long-standing challenge. Despite positive steps taken by the Hong Kong Stock Exchange to address gender imbalance over the past decade, Hong Kong SAR continues to lag behind a number of international markets in this aspect.

Recommendations

- Mandatory separation of chair and CEO and a requirement for the chair to be an independent director are needed.

- A lead independent director accountable to noncontrolling shareholders when the chair of the company is not independent should be designated.

- The maximum tenure of an independent director should have a hard cap.

India

- India follows a mandatory, rules-based approach to corporate governance. The rules cover all aspects of independent directors, including definition, size, tenure, and the maximum number of concurrent directorships. Although the mandatory nature of the rules has brought some positive change in boardroom practices, it also has led to a focus on compliance as the primary motivation and has not prevented the recurrence of corporate governance scandals.

- Board governance of companies with controlling shareholders lags other markets, in both form and substance. Many family-owned companies comply with the letter of the law, but true independence may be compromised, with controlling shareholders calling the shots on most decisions. Similarly, Indian subsidiaries of multinational companies tend to be controlled by their parent companies whose interests often outweigh those of minority shareholders. Government-controlled companies often fall short of listing regulations, because of competing government authorities or bureaucratic delays.

- The attractiveness of board directorships as a profession has suffered in recent years. Companies find it more difficult to attract, motivate, and retain talent. Directors' remuneration is seen as inadequate compensation for the level of responsibility and liability they assume. India's recent corporate governance scandals have attracted a zealous response from investigating agencies, including arrests of independent directors even before investigations were completed and their wrongdoing proven in courts. This has led to a wave of resignations in recent years.

Recommendations

- Minority shareholders should have more power in the appointment and removal of independent directors.

- Rules should be applied uniformly to all listed companies, including government-owned ones.

- Companies should provide greater emphasis on ongoing training in the areas of related-party transactions, fiduciary duties, and business ethics, supported by disclosures, which not only will add value to the board but also will be viewed positively by investors.

Japan

- Traditionally, the oversight role in Japanese companies is performed by the board of statutory auditors, which is separate from the board of directors in a two-tier board structure. Board directors are most often insiders and are responsible for managing the company's operations. The role of the board of directors as an oversight body is gradually finding acceptance, as a result of pressure from foreign investors and promotion of global best practices by the Tokyo Stock Exchange.

- The Tokyo Stock Exchange, in its Code of Corporate Governance, requires that companies appoint at least two independent directors, on a comply-or-explain basis. However, it leaves the definition of independence to the companies. In November

2020, 78% of listed companies met that minimum requirement. Among the TSE First Section, 58% of companies had boards that were one-third independent. This represents fast progress over the past decade and a growing acceptance of global best practices in corporate governance. In March 2021, the Financial Services Agency (FSA) unveiled plans to amend the corporate governance code, further strengthening the role of boards.

- In most Japanese companies, the CEO is also the chair of the board, contrary to global best practices. Encouraging the separation of these roles and appointing an independent director as the chair are not on the regulatory agenda at the moment.

Recommendations

- A better definition of director independence should be provided by a regulator or a standard-setting body.
- Companies should be required to appoint more independent directors. We recommend adopting a target of one-third of the board as an intermediate step toward the ultimate goal of majority-independent boards.
- The separation of the roles of CEO and chair of the board should be encouraged by regulators.

Malaysia

- Independent directors are a significant component of Malaysian boards, with a median representation of about 55% in top 100 companies as of June 2020. Gender diversity is also one of the highest in the region.[8] The separation of chair and CEO is nearly ubiquitous, although independent chairs are relatively less prevalent.
- Regulators are active when it comes to enforcement and oversight. Bursa Malaysia brings enforcement actions on companies and independent directors, commonly in the area of financial reporting and corporate transgressions, such as violation of material related-party transaction requirements, with penalties typically ranging from private/public reprimands to fines or mandatory training.
- However, concerns over public governance and cronyism has intensified in recent years, as a result of the 1MDB scandal. Public governance concerns, opacity in company structures, and appointment of directors with political and government links increase the risk of regulatory capture, rent-seeking, and corruption.

[8]FactSet data.

Recommendations

- Although the regulations have been friendly to minority shareholders in many aspects, there is a scope to improve ownership disclosures in group companies, so that investors understand the motivations of independent directors and potential conflicts of interest.

- Companies need to continue providing ongoing training for independent directors, with a focus on scrutinizing related-party transactions, strengthening board independence by having an independent chair, creating a culture of inclusion, and allowing independent directors to perform their jobs more effectively.

Singapore

- Singapore has a high number of family-owned and government-controlled companies. Recent corporate governance scandals (notably Noble and Hyflux) have brought to the fore the need for better oversight by independent directors to ensure that the rights of common shareholders are safeguarded. In 2018, Singapore introduced the world's first family stewardship code to guide controlling shareholders to act as stewards of their companies and promote long-term success of the family business. This follows the "Stewardship Principles for Responsible Investors" issued in 2016.

- The appointment of a lead independent director when the chair is not independent provides an important channel for shareholders to communicate concerns when normal channels to the chair or CEO fail. The duties of the lead independent director may include chairing board meetings in the absence of the chair and working with the chair in leading the board. The role provides a channel to the board for confidential discussions on any concerns and facilitates resolution of conflicts of interest.

- The board diversity of Singapore companies has room for improvement. Although the Corporate Governance Code specifies that boards should include directors with a "diversity of skills, experience, gender, and knowledge of the company," female board participation is still low in listed companies. The Singapore Institute of Directors noted that only one in nine listed board seats are filled by women.

Recommendations

- Mandatory separation of chair and CEO and a requirement for the chair to be an independent director are needed.

- The maximum tenure of an independent director should have a hard cap.

- Director training focused on relevant competencies should be mandatory for independent directors.

1.3. Recommendations

Following a review of the six Asia Pacific markets, we make the following broad recommendations for regulators and standard setters to further improve the independent director frameworks in all markets. These recommendations are in addition to specific recommendations for each market outlined in the previous section.

1. Promote globally recognized best practices in appointing independent directors to company boards. In particular, a majority of directors on a company board should be independent.

2. Require companies to separate the roles of CEO and chair of the board, and require that the chair be an independent director.

3. Promote board diversity, in particular of gender and professional experience, to foster better quality of debates and decision making.

4. Encourage engagement of independent directors with shareholders. Where the chair is not an independent director, boards should designate a lead independent director, accountable to public shareholders.

5. Require that all independent directors undergo comprehensive training and continuing professional development.

1.4. Methodology

This report is a result of a thorough review of existing regulations, academic research, news reports and relevant industry publications.

A quantitative snapshot of the independent directors landscape was based on the analysis of data provided by FactSet in June 2020, reflecting companies' 2019 filings. The data covers 2,324 listed companies in the six markets with market capitalization of US$500 million or more.

We obtained additional insight into practices and attitudes in a series of interviews with industry practitioners in all the markets we covered.

1.5. Structure of the Report

In presenting our analysis, we focus on each of the six markets in turn, devoting a chapter to each. The chapters follow a uniform structure and touch on the same set of issues. Not all issues carry the same importance across the six markets, however, necessitating a degree of flexibility in their treatment.

We tried to make each chapter useful on its own, thinking of readers who may be interested in only one market. Each chapter includes therefore a brief executive summary and conclusions, where we present market-specific recommendations.

These six chapters are preceded by a general overview of common issues related to director independence and a brief summary of the most relevant literature on the subject.

Table 1.1 Summary of markets and key principles

Market	Australia	Hong Kong SAR	India
Main regulator of corporate governance	Australian Securities and Investments Commission (ASIC)	Securities and Futures Commission (SFC) The Stock Exchange of Hong Kong Limited (SEHK)	Securities and Exchange Board of India (SEBI) Ministry of Corporate Affairs (MCA)
Key corporate governance codes and principles	Corporate Governance Code	Corporate Governance Code (Appendix 14 of Main Board Listing Rules)	SEBI (Listing Obligations and Disclosure Requirement) Regulations, 2015
Corporate governance regime	Comply or Explain	Comply or Explain	Mandatory
Ownership structure (end of 2017)[9]	Institutional investors (27%), Family / Corporation (9%), Public sector (3%), Retail (62%)	Institutional investors (12%), Family / Corporation (23%), Public sector (38%), Retail (27%)	Institutional investors (20%), Family / Corporation (45%), Public sector (17%), Retail (19%)
Definition of director independence	Freedom of conflicts of interest that might influence ability to exercise independent judgement and act in the interest of shareholders	A set of criteria, including on share ownership, business relationships, previous employment etc, none of which is conclusive on its own. Companies can argue a director's independence despite failing these criteria.	A set of criteria on shareholding, financial arrangements, audit and consulting relationships, relationships with promoters and key management.
Required cooling-off period for director independence	Three years	Two years for most relationships; one year for business activities with the company	Three years for key positions; two years for pecuniary relationships or transactions
Minimum representation of independent directors on boards	Majority	Three directors or one-third of the board, whichever is higher	One-third or two, whichever is higher; One half for companies where chairperson is related to controlling shareholder
Tenure limits for independent directors	No cap	No cap; After nine years require separate shareholder resolution and board justification	Maximum of two consecutive term of five years each, and a cooling-off period of three years after
Limit on the number of concurrent directorships	None	None; if an independent director holds more than six listed company directorships, then an issuer must explain why it has proposed to elect an independent director who holds a seventh or more directorship and still believes the individual to be able to devote sufficient time to the company's board	Capped at seven, or three if the independent director is a full-time director of another listed company
Appointment and removal	Majority of shareholder votes at the AGM required for appointment or removal	Majority approval for appointment and removal	Majority approval for appointment; 75% approval for removal
Separation of the roles of chairperson and CEO	Recommended, standard business practice (98%)	Recommended, common practice (71%)	To be mandated for top 500 companies, pending implementation in 2022. Common practice (80%)
Independence of chair	Independent chair recommended	No requirement for the chair to be independent	Chair to be a nonexecutive, with no relationship with CEO for top 500 companies with controlling shareholding from April 2022

Source: OECD (2019)[10]

[9] A. De La Cruz, A. Medina, and Y. Tang, "Owners of the World's Listed Companies" (OECD Capital Market Series, Paris, 2019), www.oecd.org/corporate/Owners-of-the-Worlds-Listed-Companies.htm.
[10] *OECD Corporate Governance Factbook* (Paris: OECD, 2019), https://www.oecd.org/corporate/Corporate-Governance-Factbook.pdf.

Japan	Malaysia	Singapore
Financial Services Agency (FSA) Securities and Exchange Surveillance Commission (SESC)	Securities Commission Malaysia (SCM)	Monetary Authority of Singapore (MAS) Accounting and Corporate Regulatory Authority (ACRA)
Corporate Governance Code	Malaysian Code on Corporate Governance	Code of Corporate Governance
Comply or Explain	Apply or Explain an Alternative	Comply or Explain
Institutional investors (37%), Family / Corporation (21%), Public sector (11%), Retail (31%)	Institutional investors (12%), Family / Corporation (29%), Public sector (40%), Retail (19%)	Institutional investors (12%), Family / Corporation (41%), Public sector (12%), Retail (34%)
Absence of conflict of interest with general shareholders. Companies can define specific criteria.	Independence of management and freedom from relationships that could interfere with the exercise of independent judgement or the ability to act in the best interests of the company	Absence of relationship with the company, related corporations, substantial shareholders, or officers, which could interfere with the exercise of independent judgement.
10 years	Three years	Three years
Minimum two	One-third or two, whichever is higher (listing requirements); at least half, and majority for large companies (corporate governance code)	Minimum two or one-third of the board, whichever is higher; a majority for companies where the chair is nonindependent
No cap	Maximum of nine years; between nine to twelve years require majority shareholder approval; after twelve years, require approval by a two-tier voting process	No cap; After nine years require approval by a two-tier voting process
None	Capped at five	None; if an independent director holds many directorships, the company to provide a reasoned assessment of the ability of the director to diligently discharge his or her duties
Majority of shareholders' approval for appointment and removal	Majority approval for appointment and removal	Majority approval for appointment and removal
No requirement or recommendation. Rare (17%)	Recommended, standard business practice (97%)	Not required, common practice (82%)
No requirement for chair to be independent	Independent Chair recommended; where Chairperson is nonindependent, majority of board should be independent	No requirement for the chair to be independent

2. Setting the Scene

CFA Institute promotes strong corporate governance based on, among other things, the principle that company boards should have an independent majority. An independent majority on the board is more likely to consider the best interests of shareowners first. Our position remains that current and former executives and directors of an issuer should not be permitted to sit as independent nonexecutive directors until five years after leaving the relevant positions, and then only under certain restrictions. Similarly, independent nonexecutive directors should not have been connected to a director, chief executive, or substantial shareowner of the issuer within the preceding five years. Individuals with such links to insiders are more likely to make decisions on the basis of those connections than on what is best for shareowners.

The position of CFA Institute represents but one view, and relevant stakeholders, including regulators, exchanges, companies, and governance score issuers, have not reached a clear consensus as to what constitutes a balanced board structure and what defines director independence. Given the wide disparity of practices, a closer examination of the practical issues as well as the relevant local codes of corporate governance would be instructive in understanding how board and director independence has been evolving in Asia Pacific. In this section, we examine the following issues in relation to independent directors:

- Definition
- Minimum representation of independent directors on boards
- Separation of chair and CEO
- Lead independent directors
- Nomination and removal of independent directors
- Independent director resignations
- Remuneration
- Tenure
- Minimum cooling-off period
- Board diversity
- Maximum number of board seats held by an individual

- Role of independent directors in corporate groups
- Role of independent directors in state-owned enterprises

2.1. Definition

Director independence can be thought of as the absence of ties with a company. The ties could be through family, employment, shareholding, professional, and business relationships. Among the markets covered in this report, Australia and Japan allow companies the discretion to define independence, while also providing broad guidance on the criteria.

Other markets provide the specific criteria for director independence. The rules are defined in terms of familial ties with senior management, shareholding thresholds, and cooling-off periods for employment and business relationships. Some markets also define additional restrictions—for example, India prohibits mutual interlocking directorships.[11]

At first glance, clear rules might appear to be better than guidance, but such rules do not automatically imply more independence. For example, are close friends or relatives of a senior manager (who fall outside the definition) any more independent than the individuals who are formally disqualified? Despite limitations such as these, the definitions provide a basic, if imperfect, starting point, from which other characteristics can be evaluated.

2.2. Minimum Representation of Independent Directors on Boards

Despite concerns in the region about the independence and effectiveness of independent directors, markets reflect a strong preference to have a greater proportion of independent directors. Some countries like the United States have gone to the extreme of having boards composed of solely independent directors with the exception of the CEO, but others have argued for a balance between executive and independent directors. This balance would reduce information asymmetry and increase the level of board expertise, both of which can result in more effective boards.

Most of the markets in our study recommend a minimum representation of independent directors on boards, either in terms of numbers (usually two) or percentages (typically one-third), or both. Higher thresholds are recommended for larger companies (Malaysia) and under certain conditions, for example, when the chair is not a nonexecutive director (India), or if the chair is not an independent director (Singapore).

[11]Mutual interlocking directorships arise when an executive of company A is an independent director of company B, and when an executive of company B serves as a director of company A.

2.3. Separation of the Roles of Chair and CEO

Separation of the roles of chair and CEO is considered to be a good corporate governance practice. For example, in our corporate governance manual, we caution that a dual role may "give undue influence to executive board members and impair the ability and willingness of board members to exercise their independent judgment.[12]" A joint chair-CEO role concentrates power and goes against the principle of checks and balances in the company. Among several companies in our study, an individual who is chair and CEO often has an added dimension of a being a controlling shareholder.

With the exception of Japan, all markets in our study stress the importance of the separation of the two roles and of the chair being an independent director. India mandated the separation of chair and CEO for its top 500 companies by market capitalization beginning April 2020, but the rule's implementation was deferred for two years in the face of concerns from issuers. In practice, most markets are making progress on role separation. That said, even in companies that separate these roles, independent chairs are still relatively uncommon. In these companies, the chair is most often a trusted insider, a recently retired chief executive, or a family member in the case of family-owned companies.

2.4. Lead Independent Directors

Some companies that have not separated the roles of chair and CEO may appoint a lead independent director (LID) as a compromise. An LID is responsible for serving as a liaison between independent directors and the CEO, chairing nonexecutive directors' meetings, and acting as a focal point of contact for institutional investors.

A 2018 study of LIDs in a sample of US companies found that LID adoption was more likely when firms needed additional monitoring (firms with dual chair-CEO role, large cash holdings, and strong antitakeover provisions). The study also found that firms with high institutional holdings and a high percentage of independent directors were more likely to adopt LIDs. Furthermore, the study found evidence of an association between the LID role and involuntary CEO turnover following poor performance, which was consistent with an improvement in corporate governance.[13]

[12] M. Orsagh, L. Rittenhouse, and J. Allen, The Corporate Governance of Listed Companies, 3rd ed. (CFA Institute, 2018). www.cfainsti-tute.org/en/advocacy/policy-positions/corporate-governance-of-listed-companies-3rd-edition.

[13] Phillip Lamoreaux, Lubomir Litov, and Landon Mauler, "Lead Independent Directors: Good Governance or Window Dressing," SSRN (23 February 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2485502.

Similar studies, however, have not been conducted on companies in the Asia Pacific region, where the LID adoption is low and where the independence of independent directors is concerning for a variety of reasons. Although investors can support the adoption of the LID role, they also need to evaluate the effectiveness of LIDs, to ensure that they are not appointed as a window-dressing measure.

2.5. Nomination and Removal of Independent Directors

The process of nomination and removal of independent directors has a great bearing on independence. In all of the markets in our study, nomination committees composed of independent directors are responsible for identifying and recommending independent directors, after consideration of their relevant skills and experience, among other factors.

In practice, the candidate pipeline is generated through referrals or by professional headhunting firms. The referral process can be less time consuming than headhunting and can result in greater board cohesion. However, it also may result in less diversity, greater familiarity, and potentially lower independence. This is especially true when the candidates are referred by the management or the controlling shareholder.

In most countries, professional recruitment firms are playing an increasingly bigger role in hiring independent directors. Although professional firms may have access to a larger pool of candidates, this may not automatically lead to an improvement of the independence or quality of the candidates, unless the board sets out clear expectations based on skillsets, qualities, and expertise.

The threat to independence arising from the controlling shareholder's role in the hiring process, combined with the approval by a majority of shareholders, is a common concern across the markets we studied. Some have suggested a majority-of-minority vote for independent directors as a solution to this problem. Other solutions, such as proportional representation or cumulative voting, however, allow for better representation of noncontrolling, minority shareholders on boards, without disenfranchising the rights of controlling or majority shareholders. Some market participants also suggested that directors who are opposed by a sizeable percentage of minority shareholders should not be put up for subsequent re-election.

Independent directors can be removed by way of an ordinary resolution in the markets we studied.[14] Due process is another key feature, and this includes the director's right

[14]In India, independent directors who are serving their second term can be removed only by way of special resolution, and after due process.

to speak at a shareholder's meeting. That said, it is much more common for independent directors to resign than to be removed.

2.6. Independent Director Resignations

A resignation by an independent director before the end of the term is a material event for the company. Regulations in most countries mandate the disclosures of the resignation, along with reasons, to be filed with stock exchanges within a certain time frame. In practice, directors rarely provide clear reasons for their resignation, even in cases in which the company has come under scrutiny over governance issues. Directors have many reasons to disguise their true motives for resigning, such as not wanting to damage business relationships or future employment opportunities, or to suffer material consequences from adverse market reaction if they own stock options.

This issue is most salient in India, where a rise in the number of independent director resignations in recent years, combined with opaque reasoning, has attracted attention from the regulator. But this issue can be observed in one form or another across markets. Independent directors play an important role in protecting minority shareholders' interests. When they have fundamental disagreements with the board or believe that the interests of minority shareholders are oppressed, and resign in the process, it is important that they provide substantive reasons for their resignations. Otherwise, the lack of transparency will increase volatility and leave minority shareholders guessing.

A potential solution is to improve access to independent directors by minority shareholders, for example, through a quarterly or biannual meeting. If noncontrolling shareholders are given an opportunity to establish a relationship with an independent director and gain a better understanding of the company's direction and strategy as well as the contributions of, and value added by, the independent director, then even in the event of a surprise resignation and in the absence of meaningful disclosures, investors would be in a better position to assess whether this reflects a fundamental change in the company's outlook.

2.7. Remuneration

Remuneration of independent directors has a bearing on independence. Two key issues with respect to remuneration are the level and structure of the compensation.

The level of independent directors' compensation is a matter of intense debate. In theory, the director remuneration and incentives should reflect the companies' demands and complexities, skillsets needed to perform the job, time commitment, and the level of responsibility and liability. According to one school of thought however, if directorships are a predominant source of an individual's income, his or her independence may be compromised. The corporate governance codes of Malaysia and Singapore caution against excessive remuneration of independent and nonexecutive directors that may compromise their independence.

In several markets in our study, however, the concern is that director compensation is too low when their responsibilities and potential liabilities are considered. This is especially true for smaller companies, where a combination of potential corporate governance concerns and low pay were cited as factors making it difficult to attract the right talent.

The other issue is the potential misalignment between the incentive structure with the long-term objectives of the company. Markets have taken different approaches to tackle the incentive structures. India prohibits independent directors from receiving stock options, as it may compromise their independence, but it allows directors, including independent directors, to receive a share of profits as a part of their compensation. Other markets typically allow stock options, and in some markets, independent directors are allowed to hold shares in the company (up to certain thresholds) as this would align their interests with those of other shareholders. This approach, however, also raises the concern that a director's independence is compromised as soon as he or she becomes a shareholder.

Given the diversity in levels and structures, accurate disclosures of director compensation on a named basis becomes important. This disclosure allows investors to evaluate whether the remuneration is commensurate with the director's contribution.

2.8. Tenure

Director tenure is an important determinant of independence. On one hand, independent directors with a long tenure have a better knowledge of the business and the industry, which in turn increases board effectiveness. Long tenure fosters camaraderie and may improve independence if it increases the ability of independent directors to question management without fear of social isolation.[15]

Conversely, long-tenured directors may become entrenched, indifferent to shareholder concerns, and deferential to management. Research on director tenure and firm performance puts the optimum average tenure of independent directors at 10 years, which

[15]David Katz and Laura McIntosh, "Renewed Focus on Corporate Director Tenure," *New York Law Journal* (22 May 2014), http://www.wlrk.com/webdocs/wlrknew/AttorneyPubs/WLRK.23346.14.pdf.

strikes a balance between effectiveness and entrenchment. The study also finds that long tenure has a negative effect on firm performance where the CEO is entrenched.[16]

The markets in our study have tackled director tenure in different ways. India is the only country with a mandatory cap on tenure of 10 years. In Singapore and Malaysia, long-tenured directors need to be approved by a two-tier vote, with the second tier consisting of shareholders unaffiliated with management (Singapore), or minority shareholders (Malaysia). In Hong Kong SAR, long-tenured independent directors are subjected to a separate shareholder resolution along with justification from the board, whereas Australia and Japan have no formal rules.

While an argument can be made for allowing some discretion to the board and shareholders, it is hard to justify that directors with 15 or even 20 years of tenure are truly independent, as we observed in some markets. If a company believes that a long-tenured independent director is indispensable, it should redesignate them as nonindependent.

2.9. Minimum Cooling-Off Period

Several markets in our study have introduced or lengthened the cooling-off periods for former employees, auditors, and other stakeholders as part of the definition of independence. Therefore, it is worth considering the issues surrounding these periods.

On their own, companies have an interest in continuously having a person's experience and knowledge of the company, and merely switch his or her role from an insider to an independent director. On the flip-side, cooling-off periods reduce not only the conflicts arising out of familiarity, loyalty, and relationships, but also more tangibly, reduce the conflicts that may result from being in a position to monitor processes or strategies the chair previously may have developed or implemented. Viewed from this perspective, the practice of appointing former CEOs as board chair severely compromises board independence (we cover the topic of independent chair separately). While there is variation in cooling-off periods (ranging from just one year to three years in most of the six markets, to 10 years in Japan), across markets and relationship categories, short of an outright ban, long cooling-off periods (five years or more) are appropriate for other reasons. Indeed, independent directors are valued for their fresh perspective, and individuals with recent experience might not only be uncritical of existing approaches but also actively discourage new ideas. The presence of a potential former insider pool might disincentivize companies from broadening their search for qualified independent directors.

[16] Sterling Huang, and Gilles Hilary, "Zombie Board: Board Tenure and Firm Performance," (2018), hal-01736889, https://hal.archives-ouvertes.fr/hal-01736889/document.

2.10. Board Diversity

The diversity of background, qualifications, experience, and skills of board directors has come into the focus in the past decade. In particular, measures have been introduced in several markets to increase the gender diversity of boards, which historically tend to be strongly dominated by men.

Diversity of perspectives is important for the quality of decision making on company boards. It improves their effectiveness and lessens the risk of groupthink.[17] Factors contributing to diversity include gender, age, cultural background, educational background, and professional experience.

Addressing gender imbalance in practice has been a challenge in all of the markets we analysed; however, some have made faster progress than others. In Australia and Malaysia, women constitute more than a quarter of board directors. In Hong Kong SAR, India, and Singapore, women's share of board seats is around 15%, whereas Japan lags the other markets, with less than 6% of women directors in 2020, according to FactSet data.

In some of the markets that require women on boards, a box-ticking approach to compliance is not uncommon. Unqualified candidates, such as family members, may be appointed to make up the numbers either because of a shortage of suitable candidates or unwillingness of the boards to seek them out.

In markets where women's participation in top management is low, director training programs should focus on helping women in senior positions to develop skills that will make them qualified to serve as board directors.

2.11. Maximum Number of Board Seats Held by an Individual

The number of directorships held by an individual is another important dimension for independent directors. Directors who have competing interests and commitments cannot devote the same time and focus compared with those who serve on fewer boards.

There are arguments in favour of directors serving on multiple boards. Multiple directorships may be a testimony of an independent director's abilities and connections.

[17]See HKEX, "Guidance for Board and Directors" (HKEX, July 2018), https://www.hkex.com.hk/-/media/hkex-market/listing/rules-and-guidance/corporate-governance-practices/guide_board_dir.

These directors are more likely to add value by bringing the knowledge and best practices they glean from other companies. But multiple directorships also could be due to a small talent pool. A stronger pipeline of directors could add diversity to skillsets and perspectives without the issue of time commitment.

There are compelling arguments for preventing overboarding and limiting concurrent directorships. Board responsibilities are increasing. In addition to their traditional responsibilities, boards are expected to tackle new challenges, such as cybersecurity, climate change and sustainability, reconfiguration of supply chains, and digital disruption. During a crisis, such as the COVID-19 pandemic, the demand on a director's time increases significantly. This is especially true of an independent director who also serves as a full-time executive of another company—it is inconceivable that he or she would be able to provide any more than a token involvement in a company dealing with a crisis.

Singapore, Japan, and Australia are the only countries that do not specify a cap on directorships. They do, however, recommend that boards consider the directors' time commitment while appointing them and keeping the issue in view during their term. Other countries specify a number of terms between five and seven, and India mandates an additional lower threshold of three directorships for persons working as full-time executives.

Companies report basic measures of time commitment, such as attendance in meetings. Independent third-party board evaluations must examine each director's contribution from a holistic perspective.

2.12. Role of Independent Directors in Corporate Groups

Crossholdings among companies play a significant role in ownership structures of companies in almost all countries except Australia. This gives rise to additional governance concerns. Crossholdings can result in accumulated voting rights disproportionate to the economic rights attributed to crossholders. Crossholdings, because of its opacity, increases the potential for making decisions detrimental to minority shareholders, particularly abusive related-party transactions. Finally, crossholding companies tend to vote with management on most issues. All of this increases the importance of independent directors in protecting the rights of minority shareholders.

The other issue in corporate groups is the common directorships across group companies. When an independent director serves two companies within a group, each with a different set of minority shareholders, he or she faces a clear conflict of interest when faced with decisions that potentially affect both companies, such as apportioning business contracts, or related-party transactions. Some countries, such as India and Malaysia, recommend that companies put in place group governance policies to manage such conflicts of interest.

2.13. Role of Independent Directors in State-Owned Enterprises

Public sector ownership is significant in several markets in our study, especially in Malaysia (40%), and Hong Kong SAR (38%). The state-owned companies deliver critical services such as utilities, banking, and natural resources.

Government ownership exacerbates the principal-agent problem of companies. A World Bank report lists six governance challenges in state-owned enterprises: multiple principals with ownership responsibilities exercised through various government bodies, competing goals and objectives, protection from competition, politicized boards and management, low levels of transparency and accountability, and weak protection of minority shareholders.

From the point of view of investors, the key issue with state-owned enterprises is whether the board has the right mix of skillsets, expertise, and qualifications to perform its duties effectively. Independent directors in state-owned enterprises not only allow the boards to operate at arm's length and have more open discussions but also potentially bring in requisite skillsets.

3. Australia

3.1. Executive Summary

Australia's standards of corporate governance in relation to company boards and directors are seen as high, both in terms of regulation and in practice. The Australian Securities Exchange (ASX) issues guidelines pertaining to boards and directors which apply to all listed companies and are enforced on a comply-or-explain basis.

Although the formal rules of corporate governance are not as strict as in some other jurisdictions, many companies adhere to a high standard in practice, with a high proportion of independent directors on boards and a separation of the roles of board chair and CEO being the norm. Financial institutions, regulated by the Australian Prudential Regulatory Authority (APRA), are subject to additional, more stringent governance requirements regarding board structure and independent directors.

The ownership of Australian companies tends to be broad, with active institutional investors that hold boards to account. Family-dominated companies and those with a controlling shareholder are relatively rare, especially by Asia-Pacific standards. There are no formal qualification requirements for board directors, but training courses and certification are available. Despite the high proportion of independent directors, recent examples—many stemming from misconduct identified in financial institutions—suggest the need for directors to be more aware of issues, to challenge management, and to ask questions.

3.2. Introduction

Australia's standards of corporate governance in relation to boards and directors are generally seen as high.

Australia has few family-dominated firms, which we often see in other regional markets. In 2012, for example only 4% of companies in Australia had a controlling shareholder.[18] A relative lack of large shareholdings or family influence in most major listed Australian

[18] Matt Orsagh, "Shareowner Rights Across the Markets: Individual Reports for 28 Different Markets," (CFA Institute, July 2013), https://www.cfainstitute.org/en/advocacy/policy-positions/shareowner-rights-across-the-markets.

companies means that fewer friends and family are appointed to boards.[19] Share registries tend to be dominated by large institutional shareholders, such as superannuation (pension) funds and large local and global asset managers. The institutional investors tend to be active, working through organizations, such as the Australian Council of Superannuation Investors (ACSI),[20] to provide strong checks on company boards.

The percentage of independent directors on boards of Australian companies is high and in almost all companies the roles of CEO and chair of the board are separated. Despite these positive factors however, cases continue to come to light, particularly in the financial sector, in which boards have not been on top of issues. This would suggest that despite "ticking all the boxes," Australian boards need to be more willing to seek pertinent information and to challenge management.

A review of a FactSet sample of 219 listed companies[21] found that around 60% of directors in Australian listed companies are independent. In larger companies, with market capitalization over $A6.0 billion (US$4.2 billion), the percentage of independent directors is even higher. We also found that in almost all companies in the sample the roles of chair and CEO are separated.

Board directors in Australian companies are appointed for a period of three years, and each year, one-third of the directors must stand for re-election. Although this process does not help avoid board entrenchment, the risk is mitigated by shareholders' ability to remove board members without cause by calling an extraordinary general meeting.[22] They may do so if they have 100 or more shareowners or own at least 10% of the company's shares. The average tenure of directors in companies in the FactSet sample is around seven years, and approximately 70% of the directors have been on the board between four and nine years.

The requirements covering board composition and independent directors in Australia are mostly provided in the guidelines issued by the ASX rather than mandated by legislation. Regulated financial entities face more stringent requirements, however, which are imposed by their regulators.

[19]"Independent Non-Executive Directors: A Search for True Independence in Asia" (CFA Institute, January 2010).
[20]ACSI members include 37 Australian and international asset owners and institutional investors, who collectively own, on average, approximately 10% of each ASX200 company. The organization, founded in 2001, provides a collective voice on ESG issues on behalf of its members.
[21]CFA Institute calculation using FactSet Data as of August 2020.
[22]Orsagh, "Shareowner Rights Across the Markets."

3.3. Overview of the Regulatory Landscape

Table 3.1 Corporate governance rules and regulations in Australia

Governing body	Applicable to	Legislation / Regulation / Code	Level of requirement
Australian Securities and Investments Commission	All listed and unlisted companies	Corporations Act 2001	Mandatory
Australian Stock Exchange	Listed companies	Corporate Governance Principles and Recommendations	Comply or explain
Australian Prudential Regulatory Authority	Banking, insurance, and superannuation	Prudential Practice Guide, Fit and Proper Criteria for Responsible Persons	Mandatory

The Corporations Act 2001[23] requires public companies to have at least three directors, two of whom must ordinarily reside in Australia. A director must be at least 18 years of age and not be disqualified on the basis of bankruptcy or offences of dishonesty.

The major regulatory guidelines for listed companies are set out by the ASX in its listing rules. These guidelines include recommendations on corporate governance, in particular around the composition of the board and the appointment of independent directors. In 2002 the ASX established the Corporate Governance Council, which published the Principles of Good Corporate Governance and Best Practice Recommendations[24] (the Principles) in 2003. The Principles, in their most recent fourth edition (published February 2019),[25] apply to all ASX-listed companies, but they are not mandatory. Listed companies are expected to report their compliance with the Principles on a comply-or-explaingbasis, by disclosing in their annual reports if they follow the guidelines, and if not, explaining why they choose not to.

The Principles state that "a majority of the board of a listed entity should be independent directors"; the chair of the board should be an independent director; the chairs of board committees, and a majority of their members, should be independent directors; and the

[23]Australian Government, Corporations Act 2001 (registered 29 January 2018), https://www.legislation.gov.au/Details/C2018C00031.

[24]ASX Corporate Governance Council, "Principles of Good Corporate Governance and Best Practice Recommendations" (March 2003), https://www.asx.com.au/documents/asx-compliance/principles-and-recommendations-march-2003.pdf.

[25]ASX Corporate Governance Council, "Corporate Governance Principles and Recommendations," 4th ed. (February 2019), https://www.asx.com.au/documents/asx-compliance/cgc-principles-and-recommendations-fourth-edn.pdf.

roles of the board chair and the CEO should be separate. These principles are in line with what CFA Institute believes is best practice in this area.

Australia does not have a fit-and-proper-person test for company directors, except for directors of regulated financial institutions. The ASX listing rules,[26] however, do require that, at the time of listing, each director is "of good fame and character."

ACSI and the Australian Shareholders Association (ASA), a body representing retail shareholders, also have corporate governance guidelines regarding boards and directors. Both bodies provide voting advice to their members on specific board elections. ACSI, in particular, is a strong proponent for good board governance practices and works closely with its members, who typically are institutional investors active in monitoring boards and management.

3.3.1. Independent Director Definition

A definition of director independence is set out in the ASX listing rules. The commentary accompanying the Recommendation 2.3 of the ASX Corporate Governance Principles states that:

> A director of a listed entity should only be characterized and described as an independent director if he or she is free of any interest, position, association or relationship that might influence, or reasonably be perceived to influence, in a material respect his or her capacity to bring an independent judgement to bear on issues before the board and to act in the best interests of the entity and its security holders generally.[27]

The ASX also recommends that a listed entity should disclose the names of the directors considered by the board to be independent directors and set out the length of service of each director. If a director has a potential conflict of interest, the company should explain why the board still considers that person to be independent.

3.3.2. Requirements for Regulated Financial Institutions

Nonexecutive directors (independent or otherwise) of regulated financial entities face more stringent requirements under the prudential standards set out by APRA.[28]

[26] ASX Listing Rules, Requirements for listing 1.1, condition 20.
[27] ASX Corporate Governance Council, "Corporate Governance Principles and Recommendations."
[28] Prudential Practice Guide, "SPG 520—Fit and Proper" (APRA, July 2013), https://www.apra.gov.au/sites/default/files/prudential-practice-guide-spg-520-fit-and-proper-july-2013_0.pdf.

APRA-regulated entities are required to have a minimum of five directors, a majority of whom must be independent. Board committees must be chaired by independent directors and the role of chair must be separated from that of CEO. APRA also requires that "a majority of directors present and eligible to vote at all board meetings must be non-executive directors."

Each director must satisfy the requirements of propriety, including character, honesty, integrity, diligence, and judgement, and is expected to contribute to the requirement of fitness at a collective level. The APRA guidelines place the onus for assessing potential and current directors onto the financial firm. The firm must satisfy APRA that it has adequate procedures in place to assess whether a person is "fit and proper" and must disclose who carries out this assessment and how. APRA does not conduct any such assessments.

In addition to the fitness and propriety criteria, directors of banks are also subject to the Banking Executive Accountability Regime (BEAR). The regime was introduced in 2018 "to establish clear and heightened expectations of accountability for authorized deposit-taking institutions, their directors and senior executives, and to ensure there are clear consequences in the event of a material failure to meet those expectations."[29] The recent Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Hayne Royal Commission)[30] highlighted many cases of failings by boards and senior management of financial services firms and banks to monitor risk adequately. It recommended that BEAR be extended to all APRA-regulated entities.

3.4. Board Structure and Composition

3.4.1. Board Size

Principle 2 of the ASX Corporate Governance Principles states that a company should "structure the board to be effective and add value: A listed entity should have a board of an appropriate size, composition, skills and, commitment and knowledge of the entity and the industry in which it operates, to enable it to discharge its duties effectively and to add value. However, it should not be so large as to be unwieldy."

The appropriate size of a company's board depends on the nature and complexity of the company and its operations, as well as on the range of skills needed for the board to successfully carry out its duties. KPMG has suggested that a board that is either much

[29]Prudential Practice Guide, "SPG 520—Fit and Proper."

[30]Royal Commission, "Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry" (February 2019), https://www.royalcommission.gov.au/royal-commission-misconduct-banking-superannuation-and-financial-services-industry.

smaller or much larger than the boards of comparable companies could be regarded as a "red flag."[31] The proxy advisory firm CGI Glass Lewis believes that a board size of 14 or more may find it difficult to reach consensus and make timely decisions.[32]

The Corporations Act 2001 prohibits boards to limit the number of board members if that number would be lower than that specified in the company's constitution. Board limits must be voted on by all shareholders at an annual general meeting.[33]

APRA-regulated entities also face special rules around board representation, with the underlying principles being proportionality and consistency, to ensure that board representation is commensurate with the equity interest of a shareholder, taking into account the size of board.[34]

The average size of the board of an Australian company listed in the ASX 300 index was 7.1 in June 2020 and has not changed substantially since 2005.[35]

The data from the FactSet sample of 219 Australian listed companies[36] showed that just over half of Australian boards have between seven and nine directors. A further 35% have between four and six directors. Larger companies tend to have larger boards. Around 10% of companies have larger boards, between 10 and 12 directors. These companies have an average market capitalization of around $A15 billion.

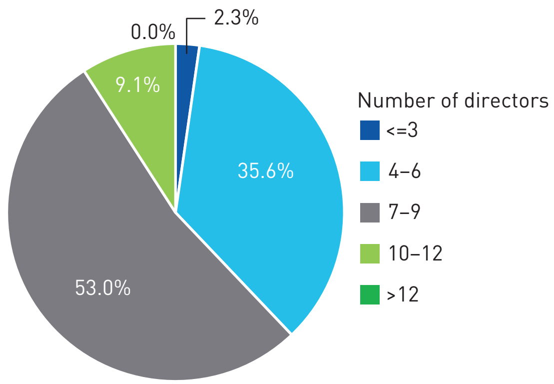
3.4.2. Board Structure

All companies listed on the S&P/ASX 300 are subject to ASX Listing Rule 12.7, which requires a company in that index at the beginning of its financial year to have an audit committee during that same year. The ASX corporate governance guidelines recommend that an independent director be the chair of the audit committee.

The ASX Principles also recommend that companies have a nomination committee, a risk committee, and a remuneration committee. For each of these committees, the Principles

[31] "The Director's Tool Kit" (KPMG Australia, February 2020).
[32] "The Director's Tool Kit."
[33] Corporations Act 2001, S201P.
[34] Prudential Standard CPS510(34).
[35] "Many Are Called, Few Are Chosen: An Analysis of the Composition of ASX 300 Boards from 2005-2020," Ownership Matters (25 October 2020), https://www.ownershipmatters.com.au/research-news/2020/10/25/many-are-called-few-are-chosen/.
[36] CFA Institute calculations using FactSet data as of August 2020.

Figure 3.1. Size distribution of Australian boards (August 2020)



Source: FactSet.

suggest that it should have at least three members, a majority of whom should be independent directors, and that it should be chaired by an independent director.

3.5. Independent Directors

3.5.1. Nomination and Removal of Independent Directors

In Australia, any shareholder can make a nomination for a board position. A candidate is allowed to nominate himself or herself.

The election or appointment of a director to the board, and the removal of a director, is conducted by an ordinary resolution of shareholders (a simple majority of votes cast) at an annual general meeting. In case of a removal of a nonexecutive director, the company must offer the individual an opportunity to put his or her case to members by giving the company a written statement for circulation to members and by speaking to the removal motion at the shareholders' meeting.

While most directors are re-elected with high levels of support, a 2017 analysis by ACSI[37] of proxy voting records of Australian fund managers and superannuation funds indicates

[37]Shareholder Resolutions in Australia, Australian Council of Superannuation Investors (October 2017), https://acsi.org.au/wp-content/uploads/2020/02/Shareholder-resolutions-in-Australia.Oct17.pdf.

that they do, on rare occasions, vote against a director seeking re-election. Interviewees in the ACSI survey say that these are difficult decisions to make. This may explain why this option is not used more frequently Fund managers interviewed for the ACSI survey noted that it is very difficult to evaluate the performance of a director from the outside. They also noted that they can look at skillsets, diversity, and other board characteristics but they do not have visibility on the dynamics inside the board room.

ACSI research found that resolutions to elect non-board-endorsed directors are relatively rare in Australia. Passing such resolutions is even less common. The ACSI research showed that only five non-board-endorsed directors were elected to the boards of ASX 300 companies between 2012 and 2017.[38]

3.5.2. Independent Directors on Boards

According to Ownership Matters[39], as of June 2020, companies in the ASX 300 index had on average 5.9 nonexecutive directors (independent and nonindependent), representing 83% of the board, an increase from 4.9, or 70%, in 2005.

According to the 2020 FactSet sample of 219 Australian listed companies, 60% of board directors are independent. Furthermore, the larger the size of the company is by market capitalization, the higher the proportion of independent director tends to be.[40]

The *Ownership Matters* analysis[41] highlights an issue of "in-pool appointments," that is, when director vacancies tend to be filled from within the existing pool of ASX 300 directors. Since 2005, 38.2% of all vacancies were filled by directors with a board seat on another ASX 300 company.

This phenomenon has created an exclusive "directors' club," membership in which carries privileges, not least a higher chance of being offered another board seat. It also disincentivizes directors from asking hard questions at board meetings and holding management to account, lest the individual be blacklisted from future board opportunities.

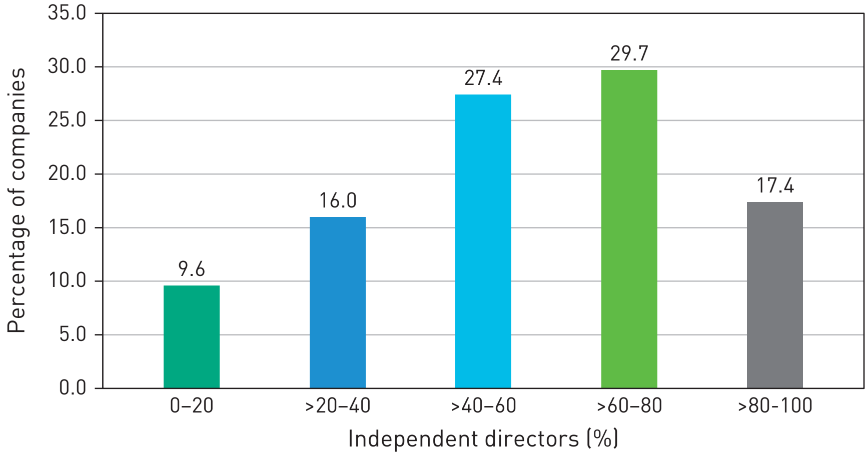
[38] Shareholder Resolutions in Australia, "Australian Council of Superannuation Investors."

[39] "Many Are Called, Few Are Chosen: An Analysis of the Composition of ASX 300 Boards from 2005-2020," *Ownership Matters* (25 October 2020), https://www.ownershipmatters.com.au/research-news/2020/10/25/many-are-called-few-are-chosen/.

[40] CFA Institute calculations using FactSet data as of August 2020.

[41] "Many Are Called, Few Are Chosen."

Figure 3.2. Percentage of independent directors on Australian boards



Source: FactSet.

The share of in-pool appointments, which constituted 36% of new director appointments in the year to 30 June 2020, has been trending down. In 2006, 43.4% of appointments were in-pool.

3.5.3. Tenure

No formal rules govern tenure of directors in Australia. Nevertheless, both the ASX guidelines and the APRA requirements for financial institutions explicitly state that companies should declare the length of service of each director. ASX and APRA see board tenure as a key factor for shareholders to consider, as it can be a consideration in determining directors' independence.

The data around directors' tenure is encouraging. Companies are paying attention to board renewal and making an effort to minimize board entrenchment. For example, research by Ownership Matters[42] shows that the average board tenure of nonexecutive directors in ASX 300 companies between 2005 and 2020 was just under six years. According to MSCI,[43] entrenched boards (with at least one director with tenure over 15 years

[42]"Many Are Called, Few Are Chosen."

[43]Ric Marshall, "Entrenched Boards: Director Tenure and Performance," MSCI (April 2015), https://www.msci.com/documents/10199/2c45977b-fb6e-4f4d-859a-bb8c115d2569.

or directors over 70 years of age) were "virtually nonexistent" in Australia. A study published in 2015[44] by Egan Associates found that only 7% of independent directors had been on a board for more than 12 years, and only 3% had served for more than 15 years. For companies in the FactSet sample, just under 10% of all directors had been on boards for more than 12 years.

A lengthy board tenure is generally seen as something that could bring into question the independence of a director, because long-serving directors risk becoming too close to management and can find it difficult to question existing policies and decisions. Long-serving board members may lose the ability to hold management to task and may become too reliant on information fed to them by senior management.

There are, however, reservations about setting prescriptive term limits. In a 2016 survey of company chairs carried out by the Australian Institute of Company Directors (AICD),[45] noted that for a board to be effective, diversity of perspective is important. Having directors that have experienced different business cycles is as important as board renewal. In this context, establishing an effective, robust performance evaluation process that ensures objective assessment and renewal of board talent would be crucial.

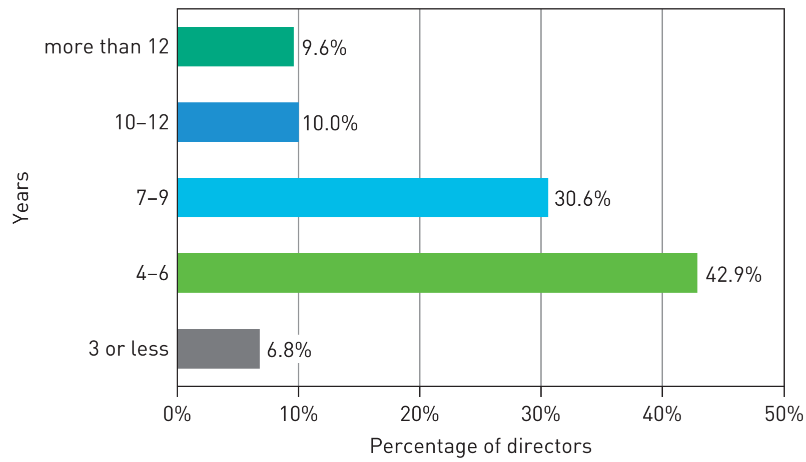
In its corporate governance guidelines,[46] ACSI states that it considers directors' tenure and capacity in recommending how members should vote in board elections. However, it also states: "We believe that a mix of directors with varying lengths of tenure improves board decision making. The fact that a director has served on a board for a substantial period does not necessarily mean that she or he has become too close to be considered independent."

The ASA believes that any director who has served more than 12 years on a board should no longer be considered independent.

Although not specifying time limits, APRA prudential standard 510 (45) for regulated entities states that they should have policies on board renewal, "in order to ensure it remains open to new ideas and independent thinking, while retaining adequate expertise."[47]

[44]Australia Institute of Company Directors, "Examining Director Tenure," *Company Director Magazine* (1 September 2015), http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2015-back-editions/september/insight-examining-director-tenure.
[45]Robert Kay and Chris Goldspink, "Rethinking Independence," (Australian Institute of Company Directors, April 2016), https://www.companydirectors.com.au/~/media/cd2/resources/advocacy/governance-leadership-centre/pdf/05449-1-pol-glc-independence-research-paper-april16-a4-web.ashx.
[46]Australian Council of Superannuation Investors, "Corporate Governance Guidelines" (October 2019).
[47]Prudential Standard CPS510; Governance APRA (July 2019).

Figure 3.3. Tenure of Australian directors (August 2020)



Source: FactSet.

The analysis by Ownership Matters[48] estimates the average yearly turnover of board seats in ASX 300 companies at 12.75% between 2005 and 2020. One might expect that poorly performing companies would refresh their boards at a higher rate. Indeed, the companies in the bottom decile by annual performance had a director turnover of 19% in the following year, and those in the second lowest decile had turnover of 16%.

Tenure is perhaps even more of an issue for the board chair. This role requires a significant time commitment. A long-serving chair is even more susceptible to becoming "part of the firm" and close to management, particularly given that they usually have more interaction with senior management than would other directors.

The ASA recommends that not only should the chair be an independent director but also that they should serve on the board for at least a year before becoming its chair and that they should not be in this role more than 10 years. The ASA also recommends that when a chair steps down, he or she should resign from the board, "so that the incoming chair has a clear run at any legacy issues."[49]

[48] "Many Are Called, Few Are Chosen."

[49] "ASA Voting and Engagement Guidelines for ASX 200 Companies," Australian Shareholders' Association, updated June 2020, https://www.australianshareholders.com.au/common/Uploaded%20files/Advocacy/ASA%20voting%20guidelines%202020.pdf

3.5.4. Training and Qualifications

No formal qualification or training is required to serve on a company board in Australia, with the notable exception of regulated financial entities. It is, however, very important that directors have knowledge and experience to contribute to the work of the board. The board should reflect a combination of skills and experience to allow it to cover all issues relevant to the company and its industry.

The ASX recommends that companies disclose a board skills matrix that sets out the mix of skills and the level of diversity of the directors. The matrix may reflect the current state or the target the company aims to achieve. Such board skills matrix can be useful in the director nomination and succession planning processes.

Organizations regulated by APRA are required to ensure that directors have "the full range of skills needed for the effective and prudent operation of the institution" and that "each director has skills that allow them to make an effective contribution." [50]

The ASX requires that a listed entity disclose a process for evaluating the performance of the board, its committees, and individual directors, and to let shareholders know if such an evaluation has been undertaken during the reporting period.

APRA's regulations are stricter. It requires that the board performance and that of its individual directors be assessed at least annually. Regular assessment is an important principle, as it allows a focus on issues such as the skills mix of the board and whether individual directors have the time to commit to their board duties.

The Commonwealth Bank of Australia is a good example of a company following these guidelines in practice. It states in its annual report that:

> The Board uses a Skills Matrix (Matrix) which sets out the desired skills and experience important for the effectiveness of the Board. It is reviewed annually to ensure it reflects the appropriate mix of skills, expertise and experience required to address existing and emerging business and governance issues, and to enable Directors to effectively review the performance of management.[51]

In its 2019 annual report,[52] the bank also noted that directors were asked to assess their own skills and that the results of this self-assessment were calibrated using the skills

[50]Prudential Standard CPS 510; Governance APRA (July 2019).
[51]Commonwealth Bank of Australia, *2019 Annual Report*, 2019.
[52]Commonwealth Bank of Australia, *2019 Annual Report*, 2019.

matrix for a review and approval by the nominations committee and the board. The results of this assessment were presented in a clear graphic in the annual report, showing how many directors were rated as either competent or highly competent in each category of the desired skills.

The AICD offers a Company Director Course, aimed specifically at company directors in Australia. The course, which allows fee-paying members to use the title Graduate of Australian Institute of Company Directors (GAICD), is described as giving "a comprehensive grounding in the roles and duties of board directors."[53] It includes topics on effective decision making, the legal aspects of directorship, financial literacy, and strategy, as well as lessons on putting the knowledge into practice. While it is common for Australian directors to have taken the AICD course, it is not a prerequisite for a board role. AICD offers also a range of other company director courses, notably "Boardroom Mastery," for senior directors.

3.5.5. Maximum Number of Board Seats

Australia does not set legal limits on the number of board seats held by an independent director. In its recommendations, ASX highlights the importance for the board and the nomination committee to review the time required from nonindependent directors, as well as the obligation for a director to inform the chair before accepting additional positions that require a significant time commitment. ASX stops short, however, of setting a hard number against board directorships, whether independent or otherwise, in contrast with other markets examined in this report. Despite this lack of regulation, there is pressure from major institutional shareholders, proxy advisory firms, and industry associations in Australia to limit the number of directorships held by a single individual.

In particular, ASA's guidelines suggest capping the number of separate and unrelated listed board seats to five per individual. As chairs are typically more involved in board activities, ASA deems a chair role to be equivalent to two director roles, and any director who chairs two public companies should not serve on more than one additional board. Proxy advisory firm CGI Glass Lewis has a policy[54] that considers nonexecutive directors who serve on more than five major boards "overcommitted" and likely would vote against such appointments. ASCI has a similar view regarding the time intensiveness of the chair's role and recommends boards to consider limiting the number of chair roles and board positions held by the chair, but it does not provide hard limits.[55]

[53] "What Kind of Director Will You Become," Australian Institute of Company Directors, https://aicd.companydirectors.com.au/education/courses-for-the-director/company-directors-course.
[54] "An Overview of the Glass Lewis Approach to Proxy Advice" (Australia), 2019/20.
[55] "ASA Voting and Engagement Guidelines for ASX 200 Companies," May 2019.

Research by Ownership Matters[56] shows that as of June 2020, among 1,362 directors of ASX 300 companies, 67.9% held only one board seat, 20.5% held two, 9% held three, and 2.6% held four or more. Women tended to hold more board seats per person, on average, with only 59.4% of female directors holding one seat, 22.3% holding two seats, 13.3% holding three, and 5% holding four or more. In total, 20 women and 16 men held four or more board seats. Two individuals among them held five seats each and one individual held seven.

3.5.6. Disclosures About Independent Directors in Corporate Announcements

Large listed companies in Australia generally provide a significant amount of information about their independent directors. The information is released to the stock exchange and media at the time of a director's initial appointment and subsequently is included in the company's annual reports and on its website.

The December 2018 announcement[57] of the appointment of Mike Roche to the board of Wesfarmers Limited is an excellent example of providing the necessary level of detail and explanation. It sets out the new director's employment background, academic qualifications, other board memberships, and corporate commitments.

The website of the Commonwealth Bank of Australia, one of the country's largest companies, lists nine directors, eight of whom—including the chair—are independent. The CEO is the only executive (nonindependent) director. The bank lists each director's background, qualifications, other board roles, tenure on the board, and membership of board committees. The announcement of the appointment of a director also states whether or not they are considered to be independent.

3.6. Effectiveness of Independent Directors on Boards

The view of CFA Institute is that it is important to have a majority of independent directors on a board. It is equally important, however, that those directors actually be able to question the company's management and to raise issues and concerns independent of

[56] "Many Are Called, Few Are Chosen."
[57] "Board Appointment," Westfarmers (14 December 2018), https://www.wesfarmers.com.au/util/news-media/article/2018/12/14/board-appointment.

the management. This requires having access to information and the necessary skillset to understand the industry and the operations of the company.

It also requires a sceptical mind-set. In a 2014 speech, then–ASIC chair Greg Medcraft stated that scepticism was an important attribute for directors who "must question the information provided to them. There is no defence for wilful blindness." [58]

The effectiveness of independent directors in Australian companies is a matter of debate. A recent report by the global professional services firm EY stated that "even with a well-balanced and diverse board, it is possible to squash input and underutilize your assets."[59]

A 2019 survey of board directors by KPMG and AICD[60] found that although 50% of respondents felt they had access to all the tools and information needed to challenge management, 35% were not confident in the information the board was receiving and whether it was sufficient to facilitate rigorous challenge and debate.

An earlier report published by CPA Australia, titled "Who Should Be a Director?"[61] noted that "biased" boards—those with an over-representation of industry insiders, management, or self-interested large shareholders—are prone to flawed judgment. These boards should be questioned to determine whether they represent genuine leadership, and whether they can objectively consider the company's strategic needs and those of its shareholders.

The 2018 APRA prudential review into the Commonwealth Bank[62] found inadequate oversight and insufficient challenging by the board and its committees of emerging nonfinancial risks. The review recommended that individual directors obtain additional information from management or seek external legal advice if they have misgivings about decisions taken by the board or actions of the company's management.

[58]Greg Medcraft, "What ASIC Expects of Directors," speech, Directors Lunch, Australian Institute of Company Directors, 24 June 2014.
[59]Sharon Sutherland, "Setting the Pace or Keeping Up—Is Your Board Future-Fit?" EY Global Center for Board Matters, 31 July 2019, https://www.ey.com/en_us/board-matters/setting-the-pace-or-keeping-up-is-your-board-future-fit.
[60]"Creating Value and Balancing Stakeholder Needs: The Board's Role," KPMG & AICD, 2019, https://aicd.companydirectors.com.au/advocacy/research/creating-value-and-balancing-stakeholder-needs-aicd-kpmg-report.
[61]Patrick Gallagher and Nonna Martinov-Bennie, "Who Should Be a Director?" (CPA Australia, 2015), https://www.cpaaustralia.com.au/~/media/corporate/allfiles/document/professional-resources/sustainability/who-should-be-a-director.pdf?la=en.
[62]The Australian Prudential Regulation Authority (APRA), "Final Report of the Prudential Inquiry into the Commonwealth Bank of Australia (CBA)" (May 2018).

It is notable that at the time of the review the board of the bank was composed of only independent directors, with the exception of the CEO. This highlights the view that although appointing a majority of independent directors is a step toward good corporate governance, that alone is not sufficient. The independent directors must have the necessary skills and, more important, must be active and willing to challenge management and hold it to account.

"Inadequate oversight by the board" was also cited in a claim against Westpac, another of Australia's major banks, over systemic noncompliance with the Anti-Money Laundering and Counter-Terrorism Financing Act 2006, by AUSTRAC, the country's anti-money-laundering and terrorism financing regulator.

Australia's major banks all have majority independent directors, but as the Hayne Royal Commission highlighted, many boards still failed to prevent serious misconduct and mistreatment of clients. In his final report, Commissioner Hayne[63] noted two cases in which inadequate board oversight failed to identify and stop such practices. The first related to an internal audit report for the Commonwealth Bank that raised "red flags." According to the board chair at that time, the report was not provided to the board's audit committee and the committee did not request it.

The other example was related to the National Australia Bank. Bank employees noticed issues relating to fees charged to clients. They were reported to ASIC and APRA in December 2014, but the board did not hear about them until August 2015. The Royal Commission's final report drew attention to some of the failings, including the following:

- Inadequate information on the issues was provided to the board
- Omission in highlighting the fact that issues were not new but had not been relayed to the board previously
- Insufficient emphases on the serious nature of the issues and the involvement of the corporate regulator
- Insufficient clarity on the potential consequences of the issues raised

These examples have highlighted the need for independent directors to question and challenge management on the information they provide. Directors play an important role and they have the responsibility to be aware of issues affecting the business and to ask questions

[63]Royal Commission, "Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry," 3.1.

or request further information. The shortcomings highlighted by these examples not only are cultural issue but also are issues that reflect the value of independent directors.

Academic research on the value of independent directors on Australian boards has not been strong. A 2008 paper by Wang, Brooks and Oliver[64] found "no strong relationship between board independence, and past or subsequent firm performance" and noted that "the level of board independence does not have any significant effect on firm risk."

An earlier study in 1999 by Lawrence and Stapleton[65] found no statistically significant link between the proportion of independent directors and company performance based on various accounting measures. The authors, however, highlight that this could be due to complacency and a lack of questioning of management by directors in the period studied (1985–1995).

Finally, Nottage and Aounis in their research raised the following issue:

> By persisting with independent director requirements, a subconscious "status quo bias" may be operating. . . . Indeed, there is arguably now a large (and well-connected) anointed group of incumbent independent directors, as well as various professional associations tasked in "training" them.[66]

Directors may be less willing to raise concerns and question decisions out of fear of losing their board role or not being selected for other boards.

3.6.1. Are Independent Directors Truly Independent?

It can be difficult for investors to ascertain the true independence of directors. They do not have access to board minutes or discussions and generally must rely on company claims in that matter.

Investors, however, can consider relationships arising from memberships in other board or executive roles that the directors hold or used to hold. An example is an

[64]Yi Wang, A. Brooks, and J. Oliver, "Antecedents and Performance Outcome of Board Independence: Australian Evidence," in *Proceedings of the AFAANZ Conference 2008, 6–8 July 2008* (Sydney, Australia: EJ, 2008).
[65]Jeffrey Lawrence and Geoff Stapledon, "Do Independent Directors Add Value?" (Centre for Corporate Law and Securities Regulation, University of Melbourne, Australia, 1999).
[66]Luke Nottage and Fady Aoun, "Corporate Governance, Corporate Responsibility and Law: Independent Director Requirements in Australia and the Asian Region" (Sydney University Law School, Australia, March 2017).

Australian company in which a current director shares links with a provider of investment banking services. The director is listed as independent by the company but has previously worked as an investment banker on capital raisings for this company and remains on the board of that investment bank. The links could raise questions about the director's ability to remain independent if the board was again seeking investment banking services.

The other issue, mentioned earlier, is the potential impact of long tenure on independence. It is possible for long-serving directors to become less independent as they become more ingrained in a company's culture and closer to its management.

3.6.2. Board Diversity

Australia does not set targets for gender diversity on boards, but increasing diversity is actively encouraged. The federal Workplace Gender Equality Agency monitors the Workplace Gender Equality Act 2012, which requires non-public-sector employers with 100 or more staff to submit a report each year about gender equality issues. This is a soft approach to encourage companies to reach equality goals through a "name-and-shame" process rather than by setting hard targets.

In June 2020, women constituted 29.3% of nonexecutive directors on the boards of companies included in the ASX 300 index.[67] The number increased from a low base of 8.5% in 2005. The share of women started growing at a rapid pace in 2011, as companies pushed to include them on their boards.

Women directors tend to hold multiple board seats more often than men do. A female director held, on average, 1.45 board seats in 2020 while a male director held 1.18 seats. This disparity has become more pronounced since 2005, when women held 1.4 seats and men 1.23 seats, on average.[68]

As a result, the share of all director seats in ASX 300 companies occupied by women was 33.1% in 2020, having increased from 9.6% in 2005.[69]

The *Ownership Matters* study[70] observed that the presence of women on the boards had a positive effect on the performance of companies. Companies with fewer than 10% of

[67] "Many Are Called, Few Are Chosen."
[68] "Many Are Called, Few Are Chosen."
[69] "Many Are Called, Few Are Chosen."
[70] "Many Are Called, Few Are Chosen."

female directors tended to perform worse than those with more gender-diverse boards as measured by average three-year returns since 2011. Note, however that the number of companies with fewer than 10% of women directors has drastically decreased, from 57% in 2011, to 8% in 2020.

Recommendation 1.5 of the ASX Corporate Governance Guidelines requires listed companies to disclose at the end of each reporting period their measurable objectives for achieving gender diversity set by the board, or by a relevant committee of the board, and progress achieved.

A 2018 study[71] highlighted the relative lack of ethnic and racial diversity of Australian boards. Traditionally "male, pale, and stale" boards – 70% of directors are of Anglo-Celtic background – fail to reflect the diversity of the country's population, which is 18% non-Anglo-Celtic European, 21% non-European, and 3% indigenous. A 2021 report by Russell Reynolds Associates[72] notes that companies should expect growing criticism on that issue.

3.6.3. Shareholder Activism

Australia has an active institutional investor base. Both ACSI and to a lesser extent ASA are active in corporate governance and hold boards to account.

Despite this active base, it does not appear common for Australian shareholders to speak with independent directors, to question or confirm information being released by the company, or to seek alternative views. The investor relations department of a large listed company told CFA Institute that, outside of the executive, shareholders generally only meet with the chair of the board, and—occasionally—with the chair of the remuneration committee.

According to the ASA,[73] in making recommendations to its members on voting for a director's re-election, it takes into account the performance of companies on whose boards that director serves. This performance could include current or past directorships. In assessing the performance of a chair, the ASA consider whether they have been responsible for decisions that have led to poor performance.

[71]Dimitria Groutsis, Rae Cooper, and Greg Whitwell, "Beyond the Pale: Cultural Diversity on ASX 100 Boards" (The University of Sydney Business School, Australia, July 2018).
[72]Rusty O'Kelley, Anthony Goodman, and Laura Sanderson, "2021 Global and Regional Trends in Corporate Governance," 2021 Global and Regional Trends in Corporate Governance, March 2021, https://corpgov.law.harvard.edu/2021/03/03/2021-global-and-regional-trends-in-corporate-governance/.
[73]"ASA Voting and Engagement Guidelines for ASX 200 Companies," May 2019.

3.7. Separation of the Roles of Chair and CEO

3.7.1. Independence of the Board Chair

The ACSI corporate governance guidelines recommend that "the chair should be selected from the pool of independent directors on the board. Combining the roles of chair with CEO or executive director positions generally creates an unacceptable concentration of power and diminishes the degree of accountability that would usually result from a separation of the two roles." [74]

ASX Corporate Governance Guidelines (Recommendation 2.5) specify that 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 that entity. Having an independent chair can contribute to a culture of openness and constructive challenge that allows for a diversity of views to be considered by the board. Good governance demands an appropriate separation between those charged with managing a listed entity and those responsible for overseeing its managers. One individual holding both roles is unlikely to be conducive to the board effectively performing its role of challenging management and holding them to account.

Almost all companies (98%) in the FactSet sample of Australian listed companies we analysed adhere to the principle of separation of the two roles.

3.8. Conclusions

Australia generally ranks well within the region on corporate governance issues and specifically on having good board practices and independent directors. Although its formal rules are not as strict as some other jurisdictions, company practice is generally excellent. An active institutional shareholder base and critical financial media help to keep boards on their toes.

Despite those good practices, a lack of adequate oversight of management by boards remains an issue, particularly visible in the financial industry. Over the past decade, Australia has had "as many as 70 public inquiries concerning the conduct of banks and

[74] "ACSI Governance Guidelines" (Australian Council of Superannuation Investors, October 2019), https://acsi.org.au/wp-content/uploads/2020/01/ACSI-Governance-Guidelines-2019.pdf.

their associates."[75] Many of these inquiries have highlighted that boards either do not have adequate information or are not effective in holding management to task.

CFA Institute supports the recommendations contained in the ASX Corporate Governance Guidelines and believes that having a majority of independent directors on a board is vital to good governance and to the ability of the board to question management and hold them accountable. The need for an independent chair is particularly important, as this role leads the board and is the key connection between the board and management. Having a nonindependent chair, we believe, seriously compromises the ability of the board to carry out its oversight function.

3.8.1. Recommendations

Although we see it as a positive that the ASX has robust guidelines on director independence, we believe it would be better to see them as requirements rather than recommendations. These are important requirements to protect shareholders and, as such, we believe all companies need to follow them.

We also believe that a more robust fit-and-proper test is needed that would apply to directors of all public companies. This test should be incorporated into the ASX Corporate Governance Guidelines and the listing rules for companies listed on the ASX.

3.9. Case Study: Harvey Norman Holdings Limited

CFA Institute believes that good practice should see the separation of the roles of chair and CEO and that an independent director should serve as chair. Listed Australian retailer Harvey Norman has separated the roles. The chair, however, is not independent. Moreover, the CEO and chair are husband and wife, which would appear to counter any idea of independence. Mr Gerry Harvey owns approximately 30% of the company and occupies the role of executive chair.

In its 2019 annual report, the company acknowledges that the ASX Corporate Governance Guidelines recommend that an independent director should be chair, but it provides the following justification for why it does not follow this recommendation:

[75]Royal Commission, "Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry," Vol. 1, 3 (interim report, 28 September 2018), https://financialservices.royalcommission.gov.au/Pages/interim-report.aspx.

> The Board recognizes the CGC's recommendation that the Chair should be an independent director. As Chair, Mr Gerald Harvey is not an independent director. The Board believes that Mr Gerald Harvey is the most appropriate person to lead the Board as Executive Chair and that he is able to bring, and does bring quality independent judgement to all relevant issues falling within the scope of the role of Chair and that the Company, as a whole, benefits from his long standing experience of its operations and business relationships.[76]

Only three of the 10 directors on the company's board are considered to be independent, which is against ASX guidelines and recommended practice for good corporate governance. Of these three independent directors, one has been on the board for 17 years and one for 15 years. This long tenure again raises questions about the extent to which they remain independent. In its 2019 annual report, the company acknowledges that this is not in keeping with the ASX guidelines and provides the following justification:

> The Board believes that each executive director (and each non-executive director who is not independent) is able to bring, and does bring quality independent judgement to all relevant issues falling within the scope of the role of that director and that the Company, as a whole, benefits from the long-standing experience of that director in relation to the operations and business relationships of the Company. The Board notes that while the two independent, non-executive members have each served more than nine years, having regard to the totality of the defining characteristics of an independent director and the specific skills and experience of these directors, the Board still believes each of them are able to bring quality independent judgement to the issues that come before the Board.[77]

At the company's 2019 Annual General Meeting, shareholder activist Mr. Stephen Mayne self-nominated for a position on the board and was backed by several proxy advisory firms. Given that more than 50% of the shares are held by Mr Harvey and the family of co-founder Mr. Norman, however, it was not likely he would be elected. Mr. Mayne was not endorsed by the board and failed to win election.

[76] Harvey Norman Holdings Limited, *2019 Annual Report,* 2019.
[77] Harvey Norman Holdings Limited, *2019 Annual Report,* 2019.

Harvey Norman Holdings Limited does comply with the ASX Corporate Governance Guidelines in terms of committee membership. The nominations committee, the audit committee, and the remuneration committee each consist of a majority of independent directors (two out of three) and all are chaired by an independent director. As noted previously, however, it is debatable how independent those directors actually are. The executive chair is not a member of any of those committees.

4. Hong Kong SAR

4.1. Executive Summary

Hong Kong SAR is a leading financial centre in Asia. The Hong Kong Stock Exchange (HKEX) ranked fourth globally by market capitalization[78] and second by the value of initial public offering (IPO) market in 2020 after NASDAQ.[79] With an established legal and regulatory framework, the spotlight on corporate governance in Hong Kong SAR's publicly listed companies has significantly grown over the years. In 2014, the Companies Ordinance was revamped to modernize Hong Kong SAR's company law and codify directors' roles and duties of care, skill, and diligence. Various updates were also made to HKEX's Listing Rules and its Corporate Governance Code (CG Code) to modernize standards and keep up with international best practices.

Currently, the board of a listed company must include at least three independent directors, and one-third of the board must be composed of independent directors as required by the Listing Rules.[80] Also, at least one independent director must possess appropriate professional qualifications, or accounting or related financial management expertise.[81] Over the years, expectations have grown for independent directors to enhance corporate governance. Under certain situations, the role and responsibilities of independent directors become even greater, such as in related-party, or connected transactions, in which the company must establish an independent board committee that consists of independent directors to assess the merits of such transactions and advise shareholders on how to vote. Moreover, for listed companies with weighted voting rights (WVR, or dual-class shares), the company must establish a corporate governance committee consisting of independent directors to focus on risks and potential conflicts of interest arising from the WVR structure of the company.

Notwithstanding a strong and robust corporate governance framework in Hong Kong SAR, deep-rooted challenges remain. Many large listed companies are controlled by a family or a majority shareholder. Such shareholders often play a critical role

[78]Caproasia Institute, "2019 Top 10 Stock Exchange in the World," Caproasia, 2 March 2020, https://www.caproasia.com/2020/03/02/2019-top-10-stock-exchange-in-the-world/

[79]HKEX, *Market Statistics 2020*, https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/Annual-Market-Statistics/2020-Market-Statistics.pdf

[80]See HKEX Listing Rule, Sections 3.10 and 3.10A.

[81]See HKEX Listing Rule, Section 3.10.

in the selection, election, and retention of independent directors on the board and potentially can undermine the independence of directors and the effectiveness of their oversight of the board.

The separation of the roles of chair and CEO is not mandatory for listed companies in Hong Kong SAR but rather is recommended on a comply-or-explain basis under the CG Code.[82] Although the Listing Rules require companies to have a minimum number of independent directors on the board, there are no additional requirements when the roles of chair and CEO are held by the same individual. Unlike Singapore, Hong Kong SAR lacks the design of appointing a lead independent director when the company has a non-independent chair.

The lack of gender diversity on corporate boards continues to be a long-standing problem in Hong Kong SAR. Despite steps taken by the HKEX to address gender imbalance in the last decade, Hong Kong SAR continues to lag behind a number of international financial centres on board gender diversity.

4.2. Introduction

The requirement to appoint independent directors on Hong Kong SAR–listed company boards came into effect in 1993.[83] Over time, the role of the independent director greatly broadened in scope and importance. Following various consultations and amendments of the Listing Rules and the CG Code, the role and functions of the independent director have expanded, with greater assumption of responsibilities and a higher level of participation on board committees to enhance shareholder protection.[84]

Regulatory scrutiny also increased: they not only have enacted more rules affecting the duties of independent directors but also have increased enforcement actions against independent directors who breached their duties. As in many markets around the world, regulatory expectation on the obligations of independent directors to improve corporate governance has intensified in recent years.

[82] See CG Code, Section A.2.1.

[83] Carlye W. L. Tsui, "An Overview of Corporate Governance in Hong Kong," Hong Kong Institute of Directors (June 2003), http://home.chuhai.hk/~charmaine/Business%20Ethics%20&%20Corporate%20Governance/OLD%20Lecture%20Notes/Lecture%2008/corporate%20governance.pdf.

[84] Initial HK listing rule requirement had two independent directors on the board in 1993. It later changed to three independent directors and one-third of the board. See HKEX Listing Rule, Sections 3.10 and 3.10A.

4.3. Overview of the Regulatory Landscape

Table 4.1. Corporate governance rules and regulations in Hong Kong SAR

Governing body	Applicable to	Legislation / Regulation / Code	Level of requirement
Companies Registry	All listed and unlisted companies	Company Ordinances	Mandatory
Stock Exchange of Hong Kong	Listed companies	Corporate Governance Code (Appendix 14 of the Main Board Listing Rules	Comply or explain
Hong Kong Monetary Authority	Authorized institutions (banking, and deposit-taking institutions)	Empowerment of Independent Non-Executive Directors (INEDs) in the banking industry in Hong Kong	Mandatory

Hong Kong SAR's corporate governance framework evolved from general fiduciary provisions of English law to today's strong regulatory framework that includes corporate and securities laws and regulations; Listing Rules, which include the CG Code; and common law. Responsibility for upholding and enforcing corporate governance standards are shared between different bodies.[85]

The Companies Ordinance (CO) is the primary legislation relating to company law in Hong Kong SAR. The law contains provisions relating to directors and the scope of their duties. The CO requires a director of a company to be at least 18 years old. A director can be of any nationality and is not required to be a Hong Kong SAR resident.[86] In carrying out their duties, directors are required to exercise a reasonable standard of care, skill, and diligence.[87] Any director who fails to comply with their duties may be liable to civil or criminal court proceedings.

The HKEX imposes corporate governance standards for listed companies through the Listing Rules and the CG Code, a nonstatutory document on a comply-or-explain basis. If a listed company deviates from a CG Code provision, it must provide an explanation in its interim and annual reports.

[85]Syren Johnstone and Say H. Goo, "Report on Improving Corporate Governance in Hong Kong," 15 December 2017, https://www.hkicpa.org.hk/-/media/HKICPA-Website/HKICPA/section5_membership/Professional-Representation/corporate-governance/HKICPA_CG_Report_on_Improving_Corporate_Governance_in_Hong_Kong.pdf.
[86]Companies Ordinance, Section 459.
[87]Companies Ordinance, Section 465(1).

The CG Code had undergone several public consultations on amendments since inception. Notable changes regarding independent directors were introduced following the latest 2017 public consultation and the resulting changes became effective in January 2019. For example, a listed company proposing to appoint an independent director who holds seven or more directorships must explain to shareholders why the company considers that the individual would still be able to devote sufficient time to the proposed directorship.[88] Other amendments include a requirement, on a comply-or-explain basis, to disclose the process used to identify independent director candidates and explain how the proposed independent director contributes to board diversity.[89] Another new requirement is for the chair to hold a meeting with only independent directors at least annually to provide a platform for open discussion without the presence of management.[90] While the intention is to foster more open communications, this requirement would not be effective if the chair is an executive chair.

In April 2021, the HKEX published a consultation paper[91] in which it proposes further changes to the CG Code aiming, among others, to strengthen board independence, by addressing issues with long-serving independent directors and board diversity. If the proposal is implemented, companies will be required to have and disclose "a policy to ensure independent views and input are available to the board,"[92] which must be reviewed annually.

Director independence is defined in the Listing Rules, which contains a list of factors HKEX considers when assessing independence, none of which is conclusive on its own. The Listing Rules state that a director's independence is likely to be questionable if the director:

1. holds more than 1% of the company's shares;
2. has received securities of the company as a gift or financial assistance from the company or its connected persons;
3. within the last two years was a director, partner, or principal of a professional adviser that provided services to the company;
4. within the last year had business activities with the company or its connected persons;
5. is on the board specifically to represent the interests of an entity whose interests are not the same as those of the shareholders as a whole;

[88] HKEX CG Code Provisions, Section A.5.5, https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/h/k/HKEX4476_3828_VER10.pdf.
[89] HKEX CG Code Provisions, Section A.5.5.
[90] HKEX CG Code Provision, Section A.2.7.
[91] Review of Corporate Governance Code and Related Listing Rules", HKEX Consultation Paper, April 2021, https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/April-2021-Review-of-CG-Code-and-LR/Consultation-Paper/cp202104.pdf?la=en.
[92] HKEX Consultation Paper, Para. 65.

6. within the last two years has been connected or related to the CEO, a director, or a substantial shareholder of the company;
7. within the last two years was an executive or director (other than an independent director) of the company; or
8. is financially dependent on the company or its connected person.[93]

If an independent director fails to meet any of these guidelines, the company must demonstrate to the satisfaction of HKEX why that person is considered independent.[94]

Moreover, the Listing Rules require companies to include in their annual filing a Corporate Governance Report, consisting of mandatory disclosures, such as corporate governance practices, board composition, board committee information, nomination policy for selection and appointment of directors, and directors' securities transactions. Failure to do so is regarded as a breach of the Listing Rules and may lead to sanctions in the form of a private or public reprimand, rectification requirement, suspension of trading, and cancellation of the listing.

Over the years, Hong Kong SAR's securities regulator, the Securities and Futures Commission (SFC) also increased its oversight of independent directors. In May 2017, the SFC clarified in its *Enforcement Reporter* publication the expectations of directors and stated that those who fail to perform their duties can expect tough enforcement actions if the company or its minority shareholders are materially harmed. The SFC noted that although independent directors are not responsible for day-to-day management of a company, they serve an important role in supervising its management and protecting shareholders' interests. When independent directors disagree with the board or believe that shareholders' interests are jeopardised, they should openly communicate their views to all shareholders. If they choose to resign, they should provide substantive reasons for their resignations.[95] In practice, however, this rarely happens and there is almost no transparency or disclosure when major negative issues are developing. Many independent directors resign without providing substantive reasons, likely for concerns that they may be labelled as difficult to work with or be deemed trouble-makers.

[93]HKEX, Listing Rule, Section 3.13, https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/h/k/HKEX4476_2064_VER41.pdf.
[94]HKEX Listing Rule, Section 3.14.
[95]SFC, *Enforcement Reporter*, no. 2 (May 2017), https://www.sfc.hk/web/EN/files/ER/Reports/Enforcement%20Reporter/Enforcement%20Reporter_ENG_24%20May%202017_final.pdf.

4.3.1. Requirements for Financial Institutions

The Hong Kong Monetary Authority (HKMA), the banking regulator, plays an active role in overseeing bank corporate governance. In 2016, the HKMA published best practice guidelines for independent directors targeted at locally incorporated banks.[96] The guidelines require that independent directors must have appropriate background and expertise, including professional knowledge of operational, financial, and reputational risks. At least one independent director on the board should have a background in accounting, banking, or the financial industry. The board of each bank should establish an audit committee with a majority of independent directors, and the chair of the committee should be an independent director with a background in the financial industry. Independent directors are required to devote sufficient time to meetings with management as well as briefings on industry developments and regulatory requirements. Last, banks should assess whether independent directors remain independent if they have served on the board for more than nine years.

To promote these guidelines, HKMA set up a web page on "Director Empowerment," which provides guidance for independent directors and promotes effective leadership in bank governance.[97] In October 2017, HKMA launched an onboarding program for newly appointed independent directors that provides important and practical knowledge with a special focus on Hong Kong SAR's banking regulatory environment. In April 2018, HKMA provided a Knowledge Kit covering six areas of the financial system, including financial market infrastructure, banking supervision, risk management, governance and ethics, and banking services and operations, to help newly appointed independent directors discharge their obligations and responsibilities more effectively.

4.3.2. Companies with Controlling Shareholders

In Hong Kong SAR, many listed companies are dominated by a controlling shareholder, which can be a family group, a founding shareholder, or a mainland Chinese parent company, often a state-owned enterprise. As a result, public shareholders may have limited influence on the company's governance.

Family-controlled interests are a prevalent characteristic of many companies, in shareholding, management, and board composition. The growth and success of family businesses often stem from the leadership of one person or family who not only holds the

[96]"Empowerment of Independent Non-Executive Directors (INEDs) in the Banking Industry in Hong Kong," HKMA Circular BP/149C (14 December 2016), https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2016/20161214e1.pdf.
[97]"Director Empowerment," HKMA, https://www.hkma.gov.hk/eng/key-functions/banking/banking-conduct-supervision/director-empowerment/.

majority or near majority of the shareholding but also is part of the day-to-day management of the business.[98] It is estimated that close to 70% of companies listed in Hong Kong SAR are family businesses.[99]

For a mainland Chinese company listed in Hong Kong SAR, the controlling shareholder can be a mainland Chinese parent company, often a state-owned enterprise. As China opened up its economy and market, the number of mainland Chinese companies listed in Hong Kong SAR significantly grew. In 1998, about 680 companies were listed on HKEX. By 2019, the number of listed companies had reached 2,449 companies, of which around 50% (1,241) were from mainland Chinese.[100] In 2019, mainland Chinese companies accounted for about 73% of market capitalization and for 79% of turnover.[101]

This trend of mainland Chinese companies seeking a listing in Hong Kong SAR continues unabated. This presents great opportunities for Hong Kong SAR as a capital-raising centre, but also poses challenges in regulation and enforcement. This challenge is evidenced by the number of corporate scandals involving mainland Chinese companies listed in Hong Kong SAR over the past two decades, ranging from accounting scandals, allegations of embezzlement, lack of disclosure on relevant corporate developments, and missing or fleeing CEOs.

These ownership characteristics have raised concerns about corporate governance, particularly around connected transactions between issuers and controlling shareholders. This reinforces the importance of having effective independent directors to provide checks and balances, to scrutinize board decisions and protect minority shareholders. Independent directors also play a vital role in selecting, monitoring, rewarding, or removing executive management and directors.

4.4. Board Structure and Composition

The CO requires a minimum of at least two directors[102] but does not set an upper limit on the number of directors on a board. Under the Listing Rules, however, listed compared are required to have at least three independent directors and they must make up

[98]Tsui, "An Overview of Corporate Governance in Hong Kong."
[99]"Innovation and Technology in Asian Family Businesses" (HKUST Business School, October 2019), http://www.afbes.ust.hk/system/files/2020-02/HKUSTBiz_201910_Innovation%20and%20Technology%20in%20Asian%20Family%20Businesses.pdf.
[100]*HKEX Fact Book* (HKEX, 2019), https://www.hkex.com.hk/-/media/HKEX-Market/Market-Data/Statistics/Consolidated-Reports/HKEX-Fact-Book/HKEX-Fact-Book-2019/FB_2019.pdf
[101]*HKEX Fact Book*.
[102]Companies Ordinance, Section 453.

at least one-third of the board.[103] While independent directors may come from different backgrounds, the Listing Rules require at least one independent director to possess appropriate professional qualifications, or accounting or related financial management expertise.[104]

In a 2020 survey conducted by the Hong Kong Institute of Directors (HKIoD), major companies listed on the stock exchange showed a wide range of board sizes from 6 to 29 directors, with a mean of 11.33 directors.[105]

4.4.1. Representation of Independent Directors On Board Committees

The key board committees are the nomination, audit, and remuneration committees. The HKEX expects that these committees advise the board and carry out the board's corporate governance responsibilities.[106]

4.4.1.1. Nomination Committee

While rules relating to the audit and remuneration committees are set out in the Listing Rules, those relating to the nomination committee are set out in the CG Code as a comply-or-explain requirement. (The April 2021 HKEX consultation paper[107] proposes upgrading this requirement to a listing rule.) A nomination committee should be chaired by either the chair of the company or an independent director and also should account for a majority of independent directors.[108]

[103] HKEX Listing Rule, Sections 3.10 and 3.10A.
[104] HKEX Listing Rule, Section 3.10.
[105] Hong Kong Institute of Directors, the survey reviewed public information for financial year 2018–2019 of Hong Kong-listed constituent stocks in the Hang Seng Index, Hang Seng China-Affiliated Corporation Index, Hang Seng China Enterprises Index, and Hang Seng Hong Kong Large Cap Index. Sample size of the survey was 135 listed firms including 1,529 director positions. "HKIoD Survey Findings Revealed Listed Companies with Wide Range of Board Sizes and Room for Gender Diversity," press release, Hong Kong Institute of Directors, 2020, https://www.hkiod.com/e_news/document/2020/HKIoD_Board_Characteristics_Survey_2020_PR_Eng.pdf.
[106] HKEX, "Guidance for Boards and Directors," Provision 3.2.
[107] Review of Corporate Governance Code and Related Listing Rules", HKEX Consultation Paper, April 2021, https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/April-2021-Review-of-CG-Code-and-LR/Consultation-Paper/cp202104.pdf?la=en
[108] HKEX CG Code Provision, Section A.5.1.

One of the key functions of the nomination committee is board recruitment. It must evaluate and assess board composition taking into account the company's strategy and objectives, identify potential candidates, assess the independence of independent directors, and make recommendations to the board on the appointment or reappointment of directors.[109] Issuers are required to disclose its nomination policy, selection process, and appointment and reappointment of directors in their annual Corporate Governance Report.[110]

While the nomination committee has the responsibility to identify and propose independent director candidates, potential issues may arise if the nomination committee is led by an executive chair who may not necessarily look for truly independent directors for the board for concerns that they may be too challenging or difficult to work with.[111]

HKEX's new proposal addresses this issue. If adopted, the new rules will make the nomination committee mandatory. They will also require that it be chaired by an independent director, and that a majority of the committee members be independent.

4.4.1.2. Audit Committee

The audit committee monitors the integrity of the company's financial statements, annual and interim reports and accounts, risk management, and internal control and also maintains a relationship with external auditors.[112] The Listing Rules require the chair of the audit committee to be an independent director and the audit committee is made up entirely of nonexecutive directors. The committee should have a minimum of three members, at least one of whom is an independent director with appropriate professional qualifications or accounting or related financial management expertise.[113]

4.4.1.3. Remuneration Committee

The main function of the remuneration committee is to advise the board on remuneration of board members and senior management.[114] The Listing Rules require the chair of the

[109]HKEX CG Code Provision, Section A.5.2.

[110]CG Code L.(d)(ii).

[111]Dan W. Puchniak, Harald Baum, and Luke Nottage, "Independent Directors in Asia: A Historical, Contextual and Comparative Approach (International Corporate Law and Financial Market Regulation)" (2 November 2017).

[112]HKEX, "Guidance for Boards and Directors," Provision 3.10.

[113]HKEX Listing Rule, Section 3.21.

[114]HKEX, "Guidance for Boards and Directors," Provision 3.16.

remuneration committee to be an independent director and the committee to be composed of a majority of independent directors.[115]

4.4.2. Connected Transactions

Generally, a connected transaction is any transaction between a listed company or any of its subsidiaries and a connected person. Rules governing connected transactions are set out in the Listing Rules to ensure that the interests of shareholders as a whole are safeguarded.[116] Connected transactions are subject to shareholder approval at a company's general meeting and any shareholder with a material interest in the transaction has to abstain from voting on the resolution.[117]

Once a connected transaction exceeds certain size thresholds, the company must establish an independent board committee composed of only independent directors who have no material interest in the connected transaction. The independent board committee advises shareholders on whether the terms of the transaction are fair and reasonable and whether it is in the interests of the company and its shareholders as a whole. The committee also advises shareholders on how to vote, taking into consideration recommendations of an independent financial adviser appointed by the company acceptable to the HKEX.[118] Connected transactions are a frequent occurrence in Hong Kong SAR, and independent directors must take their responsibility in scrutinizing these transactions in a serious manner.

4.5. Independent Directors

4.5.1. Nomination and Removal of Independent Directors

The CG Code provides that there should be formal and transparent procedures for the appointment, re-election, and removal of independent directors for listed companies.[119] The election and removal of directors is by ordinary resolution in which 50% or more of shareholders must vote to approve. Independent directors are appointed for a specific term and are subject to re-election.[120] Under the CO, any director's service contract with a term that exceeds three years must be approved by the shareholders of the company.[121]

[115] HKEX Listing Rule, Section 3.25.
[116] HKEX Listing Rule, Section 14.A.01.
[117] HKEX Listing Rule, Section 14A.36.
[118] HKEX Listing Rule, Section 13.39(6)(a); Rule 13.39(6)(b).
[119] CG Code, Section A.4.
[120] CG Code, Section A.4.1.
[121] Companies Ordinance, Section 534.

Names and biographical information of director candidates are provided to shareholders in compliance with the Listing Rules to allow shareholders to make an informed decision on their election or re-election. For the resignation or removal of directors, a listed company must disclose in an announcement and explain the reasons for the resignation or removal.[122] A director may be removed before the end of his or her term of office pursuant to the company's articles of association or under the CO.[123] This resolution, however, must be approved by shareholders at a general meeting during which the director has the right to attend and speak.[124]

4.5.2. Tenure

Hong Kong SAR does not set a specific cap on the number of years that a person can serve as an independent director on a board. If, however, an independent director has served more than nine years, then his or her continuing appointment is subject to a separate resolution to be approved by shareholders. The board should provide an explanation accompanying that resolution to shareholders why the board believes the director is still independent.[125]

That said, it is not uncommon for listed companies to have independent directors with a tenure of more than nine years, whom HKEX deems "long-serving". For example, more than half of the independent directors on the board of New World Development, a property company, had a tenure of more than nine years. Table 4.2 illustrates the tenure of the five independent directors, as of November 2020.

The April 2021 HKEX consultation paper[126] proposes a requirement that any re-appointment of a long-serving independent director be subject to approval by independent shareholders. It also proposes broadening the requirement for relevant disclosures of the nominating process.

The proposal includes a new provision requiring the disclosure of the tenure of long-serving directors by name. If all independent directors are long-serving, the company will have to appoint a new independent director at the nearest AGM.

[122]HKEX Listing Rule, Section 13.51(2).
[123]Companies Ordinance, Section 462(1).
[124]Paul Westover, Karen Lau, and Stephenson Harwood, "Corporate Governance and Directors' Duties in Hong Kong: Overview," Thomson Reuters, https://uk.practicallaw.thomsonreuters.com/7-506-8920?transitionType=Default&contextData=(sc.Default)&firstPage=true#co_anchor_a349518.
[125]CG Code, Section A.4.3.
[126]"Review of Corporate Governance Code and Related Listing Rules", HKEX Consultation Paper, April 2021, https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/April-2021-Review-of-CG-Code-and-LR/Consultation-Paper/cp202104.pdf?la=en.

In the consultation paper, the HKEX signals its long-term intention to gradually "phase out" all long-serving independent directors.[127]

Table 4.2. Independent directors of New World Development, November 2020

Name	Year of appointment or redesignation as independent director	Tenure (years)
Mr. Yeung Ping-Leung, Howard	1999	21
Mr. Lee Luen-Wai, John	2004	16
Mr. Ho Hau-Hay, Hamilton	2007	13
Mr. Liang Cheung-Biu, Thomas	2012	8
Mr. Ip Yuk-Keung, Albert	2018	2

Source: New World Development.[128,129]

4.5.3. Qualifications and Continuous Professional Development

In general, the Listing Rules require a director to have the requisite character, experience, and integrity and to be able to demonstrate a standard of competence commensurate with the position.[130] HKEX may request further information on the background, experience, character or business interests of a director.[131] Moreover, directors of SFC-licensed companies[132] and HKMA authorized institutions[133] have to meet fit-and-proper criteria before taking up their positions.

[127]HKEX Consultation Paper, Par. 75.

[128]New World Development, *2020 Annual Report*, 2020, https://cms.nwd.com.hk/downloadIR/report/177/0017%20NWD%2020AR%20Eng%20ESS%20201023_0.pdf.

[129]New World Development, Company Announcement, "List of Directors and Their Role and Functions" (November 2020), https://cms.nwd.com.hk/downloadIR/1048/E_List%20of%20D%20role%20%20function%20(demise-Payson)_2020.11.09_0.pdf.

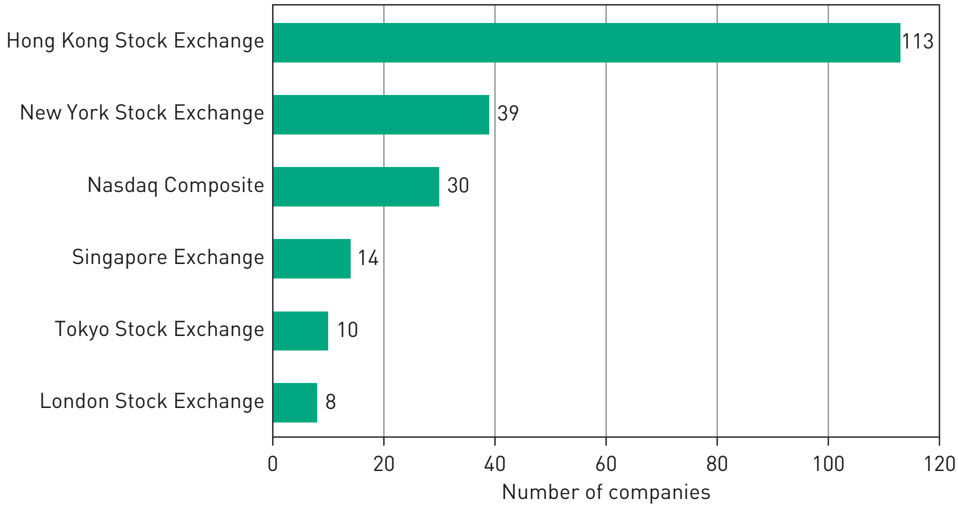
[130]HKEX Listing Rule, Section 3.09.

[131]HKEX Listing Rule, Section 3.09.

[132]SFC, "Licensing Handbook" (July 2020), https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/licensing-handbook/licensing-handbook.pdf. A corporation (that is not an authorized financial institution), which is granted a license to carry on one or more regulated activities under section 116 of the SFO.

[133]"Guide to Hong Kong Monetary, Banking and Financial Terms," HKMA, revised 23 November 2020. https://www.hkma.gov.hk/eng/data-publications-and-research/guide-to-monetary-banking-and-financial-terms/authorized_institut/. An institution authorized under the Banking Ordinance to carry on the business of taking deposits. Authorized institutions are supervised by the HKMA.

Figure 4.1. Listed companies with a director on more than six boards



Note: Based on an analysis of data reported by listed companies
Source: Bloomberg

Hong Kong SAR does not have formal certification requirement for directors. Professional bodies like the HKIoD and the Hong Kong Institute of Chartered Secretaries offer director training programs leading to certificates, but no formal requirement specifies that a director must receive director training or be a member of a professional body like HKIoD.[134] HKEX launched a training program with a series of director training web-casts and e-trainings to provide practical advice and tips to improve board performance. Although not mandatory, all directors are encouraged to complete the training program.[135]

Following a 2010 public consultation, the requirement for directors to engage in continuous professional development was upgraded to a comply-or-explain basis.[136]

[134]Johnstone and Goo, "Report on Improving Corporate Governance in Hong Kong."
[135]HKEX, "Exchange Launches Director Training Webcasts," 31 March 2017, https://www.hkex.com.hk/news/regulatory-announcements/2017/170331news?sc_lang=en#:~:text=The%20Stock%20Exchange%20of%20Hong,and%20functions%20of%20board%20committees%22.
[136]HKEX Consultation in 2010, amendment effective in 2012, https://www.hkex.com.hk/News/News-Release/2011/111028news?sc_lang=en.

Listed companies are now responsible for arranging and funding training, and all directors should participate in continuous professional development to ensure that their skillsets and contribution remain informed, current, and relevant.[137]

This emphasis on training and continued development is important, but it also is necessary to recognize the need to provide differentiation when it comes to training and development for independent directors. For example, independent directors play a crucial role in vetting connected transactions, so they should be better equipped in assessing valuation and transaction parameters.

4.5.4. Maximum Number of Board Seats

In its 2017 public consultation, HKEX considered the issue of "overboarding." When an independent director sits on too many boards, it becomes questionable whether the independent director can devote sufficient attention to each company.

In 2018, Bloomberg analysis revealed that HKEX had 113 listed companies for which a director served on more than six boards, compared with 39 listed on the New York Stock Exchange.[138]

Ultimately, HKEX concluded that independent directors sitting on multiple boards of listed companies must ensure that they can devote sufficient time to each board to discharge their obligations properly. Accordingly, effective in 2019, the CG Code was amended to a comply-or-explain requirement that sets a general cap for independent directors not to hold directorships in more than six listed companies. If the independent director holds more than six listed company directorships, then the company must explain to shareholders why it has proposed to elect an independent director who holds a seventh or more directorship and still believes the individual can devote sufficient time to the company's board.[139]

4.5.5. Disclosures Made About Independent Directors in Corporate Announcements

Under the Listing Rules, a company is required to make the following mandatory disclosures about directors, which include independent directors under the following circumstances:

[137]CG Code, Section A.6.5.
[138]"Director 'Overboarding' Spark Calls for Reforms," *Hong Kong Business*, 12 November 2018, https://hongkongbusiness.hk/markets-investing/news/director-overboarding-spark-calls-reforms.
[139]CG Code, Section A.5.5.

- appointment, resignation, redesignation, retirement, or removal of any independent director;[140]
- changes in information regarding a director (including any public or regulatory sanctions, bankruptcy orders, or judgments made against him) during his or her term of office;[141]
- notice from a shareholder to propose a person for election as director at a general meeting is received by the issuer after publication of the notice of meeting;[142]
- number of independent directors falls below the required minimum or their qualifications fail to meet the requirement of at least one independent director having appropriate professional qualifications or accounting or related financial management expertise;[143] or
- failure to set up an audit or remuneration committee or appoint appropriate members to such committees.[144]

Under the CG Code, after an independent director candidate has been identified by the nomination committee, the board proposes a resolution in respect to the election of an independent director. The company should make the following disclosures in the circular or statement to shareholders:[145]

- the process used for identifying the individual and why the board believes the individual should be elected and the reasons why it considers the individual to be independent;
- if the proposed independent director will be holding their seventh (or more) listed company directorship, why the board believes the individual would still be able to devote sufficient time to the board;
- the perspectives, skills, and experience that the individual can bring to the board; and
- how the individual contributes to diversity of the board.

[140] HKEX Listing Rule, Section 13.51(2).
[141] HKEX Listing Rule, Section 13.51B(2).
[142] HKEX Listing Rule, Section 13.70.
[143] HKEX Listing Rule, Sections 3.11 and 3.14.
[144] HKEX Listing Rule, Sections 3.23 and 3.27.
[145] CG Code, Section A.5.5.

4.5.6. Weighted Voting Rights Regime

WVR create an imbalance of power within the company by effectively disenfranchising for noncontrolling shareholders. In such situations, it is even more important for independent directors to represent their interests.

To mitigate this risk, in Hong Kong SAR's WVR regime, independent directors have been assigned additional responsibilities. Companies with WVR are required to have a corporate governance committee consisting entirely of independent directors. The committee focuses on risks related to the WVR structure, with an emphasis on reviewing and monitoring how conflicts of interest are managed and compliance with requirements for connected transactions. Its purpose is to prevent the beneficiaries of WVR from undertaking actions that benefit only themselves and harm the interests of other shareholders.

As of September 2020, only two WVR companies have had primary IPO listings in Hong Kong: Xiaomi Corporation and Meituan Dianping. A review of their corporate board composition shows that both companies deviated from the CG Code provision on the separation of the role of chair and CEO.[146] In each company, the roles of chair and CEO are filled by the same person. Both companies have the minimum number of three independent directors that make up at least one-third of the board. The following table shows the board composition of both companies in 2019.

Table 4.3. Board composition of Xiaomi and Meituan Dianping, 2019

	Executive directors	Nonexecutive directors	Independent directors	Total number of board members
Xiaomi Corporation	3	1	3	7
Meituan Dianping	3	2	3	8

Note: Executive directors include the chair and CEO.
Source: CFA Institute; Xiaomi Corporation, *2019 Annual Report*,[147] and Meituan Dianping, *2019 Annual Report*.[148]

[146] CG Code, Section A.2.1.
[147] Xiaomi Corporation, *Annual Report*, 2019, https://cnbj1.fds.api.xiaomi.com/company/announcement/en-us/2019_AR_E.pdf.
[148] Meituan Dianping, *Annual Report*, 2019, http://meituan.todayir.com/attachment/2020041708160280279238680_en.pdf.

4.6. Effectiveness of Independent Directors on Boards

The effectiveness of independent directors is highly dependent on the selection, quality, and performance of independent directors. When controlling shareholders have the power to influence the nomination and appointment of independent directors, true independence becomes an issue. In Hong Kong SAR, the rules allow the chair of a company to also chair the nomination committee that selects and nominates independent directors.[149] If the chair is a controlling shareholder, then it becomes questionable whether independent director candidates were selected on merit. In large family-owned listed companies in Hong Kong SAR, the practice of "cross-boarding,", in which founding shareholders or families elect their friends to each other's boards, is common.[150] Independent directors are often appointed on the basis of trust, that is, those who do not disrupt the status quo rather than those who challenge management.[151]

Table 4.4 sets forth some examples of HKEX-listed companies for which the chair is a controlling shareholder of the company who also chairs the nomination committee.

Table 4.4. HKEX-listed companies whose chair is also the chair of the nomination committee, 2019

Company	Stock code	Founder/ Founder's family	Position	Controlling shareholder	Nomination committee chair
CK Hutchison Holdings	1.HK	Founder Family	Chair and Group Co-Managing Director	Victor Li	Yes
Tencent	700.HK	Co-Founder	Chair and CEO	Huateng Ma	Yes
Country Garden Holdings	2007.HK	Founder	Chair	Kwok Keung Yeung	Yes
Meitu	1357.HK	Founder	Chair	Wensheng Cai	Yes
China Evergrande Group	3333.HK	Founder	Chair	Ka Yan Hui	Yes

Source: 2019 Company Annual Reports.

[149]The nomination committee can be chaired by the chair or independent director and comprises a majority of independent directors. See HKEX CG Code Provision, Section A.5.1.
[150]Puchniak, Baum, and Nottage, "Independent Directors in Asia."
[151]Johnstone and Goo, "Report on Improving Corporate Governance in Hong Kong."

CFA Institute has a long-standing view that the nominations committee should be composed of independent board members that are responsible for recruiting board members. This committee must remain independent for the benefit of the company and to ensure that the performance assessment of current board members is fair and appropriate.[152]

4.7. Separation of the Roles of Chair and CEO

While the chair and CEO are collectively responsible for the leadership of the company, each should play a distinct role to ensure the balance of power and authority. CFA Institute supports the separation of the role of chair and CEO. Otherwise, a combination of these two positions may give undue influence to executive board members and impair the ability and willingness of board members to exercise their independent judgment.[153]

In Hong Kong SAR, the separation of the roles of chair and CEO is not mandatory. The CG Code supports and states that the need for a clear division of responsibilities between the chair who is responsible for the management of the board and provides oversight over management, and the CEO who is responsible for the day-to-day management of the business. The objective is to ensure a balance of power and authority. Notwithstanding this objective, the requirement is given only a comply-or-explain basis one. CFA Institute analysed the FactSet data and found that only 71% of listed companies in Hong Kong SAR had chair–CEO separation, compared with 98% in Australia, 97% in Malaysia, and 82% in Singapore.

In addition, the rules do not require the chair to be independent.[154] A company can have a chair who is a part of the executive management team or be a controlling shareholder. This dilutes the CG Code's intention and purpose behind the separation of the roles of chair and CEO.

One example is the Bank of East Asia (BEA), a banking and financial institution listed in Hong Kong SAR. BEA continues to be run by the founder's family. In its 2019 annual report,[155] BEA disclosed that the chair was the former CEO of the company and is the father of the current co-CEOs. In addition, several nonexecutive directors on the board are relatives of the chair.

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[152] Orsagh, Rittenhouse, and Allen, *The Corporate Governance of Listed Companies*.
[153] Orsagh, Rittenhouse, and Allen, *The Corporate Governance of Listed Companies*.
[154] CG Code, Section A.2.1.
[155] BEA, "Biographical Details of Directors and Senior Management," *2019 Annual Report* (2019), https://www.hkbea.com/pdf/en/about-bea/investor-communication/annual-and-interim-reports/2019/E_2019%20Annual%20Report.pdf.

4.7.1. Independent Chair

Growing research suggests shareholders are better served when the board is led by an independent chair. The independent chair can better oversee company executives without undue management influences, with enhanced effectiveness.[156]

Hong Kong SAR does not have any requirements for the chair to be an independent director, and issuers with an independent chair are few and far between. One example is the Link REIT, a real estate investment trust: its chair is an independent director and its board has 12 board members, nine of whom were independent directors.[157] Another example is AIA Group Limited (AIA), a life insurance group: in addition an independent chair, AIA has 10 board members, nine of which are independent.[158]

4.7.2. Lead Independent Director

In major financial markets like the United States, United Kingdom, Australia, and Singapore, when the company has a nonindependent chair or a combined chair and CEO role, the company appoints a lead independent director as a compromise. The lead independent director helps to ensure that there is an independent counterbalance with the chair. The lead independent director is made available and accountable to public shareholders and becomes an independent spokesperson for shareholders.[159] Hong Kong SAR lacks the design of a lead independent director when a company has a nonindependent chair and falls short in this regard compared with other international financial centres.

Some of the benefits of having a lead independent director are as follows: overseeing the company's relations with shareholders, being available for direct communications with shareholders, advising the board on conflicts of interest, providing leadership to independent directors, presiding over board meetings in the chair's absence, giving input into board meeting agendas, evaluating the board or individual directors, selecting board candidates, and overseeing board succession.[160]

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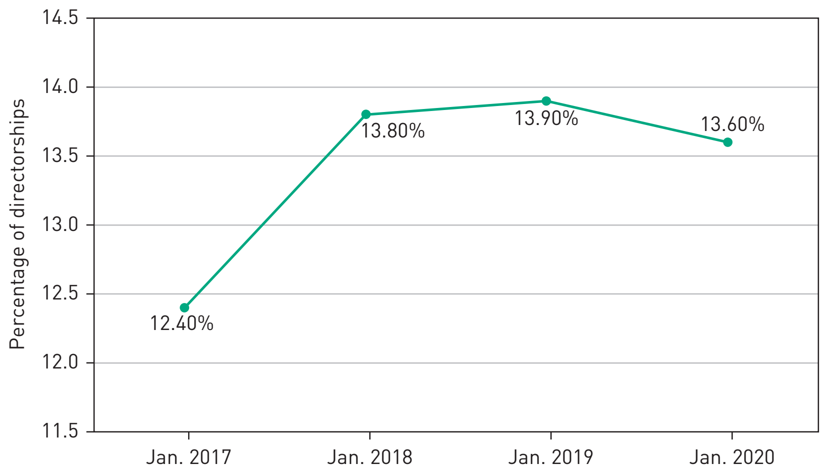
[156] "In-Depth: Independent Board Chairman," Glass Lewis, March 2016, http://www.glasslewis.com/wp-content/uploads/2016/03/2016-In-Depth-Report-INDEPENDENT-BOARD-CHAIRMAN.pdf
[157] Link REIT, "Biographical Details of Directors and Management Team," *2019/2020 Annual Report*, https://www.linkreit.com/linkcorp/api/v1/file/SiteAssets/CorporateWebsite/InvestorRelations/FinancialReports/EW00823_book%202.pdf?y=68ae28ae24672e0cb9e5ec43402a48a1.
[158] "AIA List of Directors and Their Role and Function," AIA Group Limited, 12 March 2021, https://www.aia.com/content/dam/group/en/docs/board-of-directors/e_List%20of%20Directors.pdf.
[159] Orsagh, Rittenhouse, and Allen, *The Corporate Governance of Listed Companies*.
[160] Holly Gregory, "Board Leadership and the Role of the Independent Lead Director," *Capital Markets and Corporate Governance*, March 2018, https://www.sidley.com/-/media/publications/mar18_governancecounselor.pdf.

4.8. Board Diversity

Greater diversity of directors is good for corporate governance because it promotes board effectiveness and enables better decision making because of the lessened risk of groupthink.[161] In 2019, HKEX upgraded the need for every listed company to have a diversity policy from a comply-or-explain requirement to a listing rule. Moreover, the nomination committee must have a policy concerning diversity on board members, and the company has a mandatory requirement to disclose the policy or its summary in its corporate governance report.[162] The listing rules further state that diversity of board members can be achieved through different factors that include but are not limited to gender, age, cultural, and educational background or professional experience.[163]

Figure 4.2. Percentage of women on boards in Hong Kong SAR



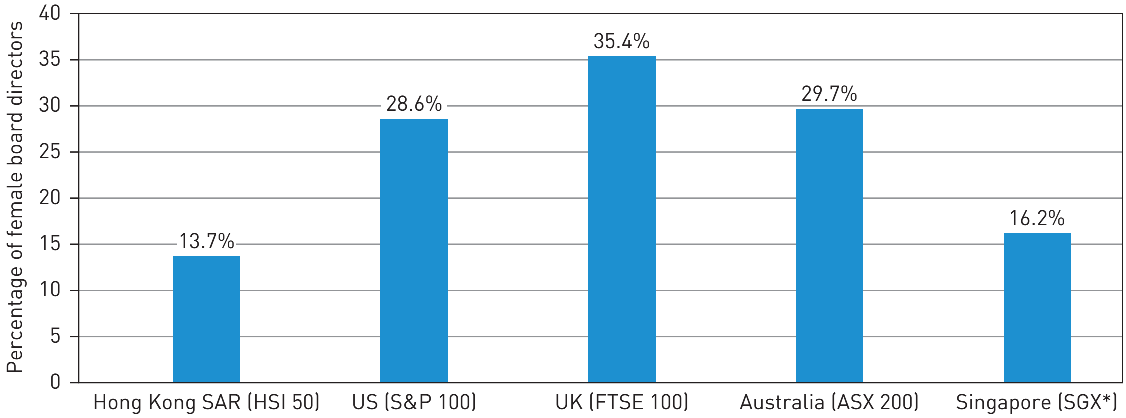
Source: Community Business.[165]

4.8.1. Gender Diversity

Although Hong Kong SAR is a major financial centre, gender diversity on boards of companies listed on HKEX can be further improved. Figure 4.2 shows the percentage of women on the boards of the Hang Seng Index 50 (HSI 50) constituent companies.[164]

[161] HKEX, "Guidance for Board and Directors."
[162] HKEX Listing Rule, Section 13.92; CG Code L(d)(ii).
[163] HKEX Listing Rule, Section 13.92.
[164] "Women on Boards Hong Kong 2020: Q1," Community Business, https://www.communitybusiness.org/women-boards-2020-Q1.
[165] Women on Boards Hong Kong 2020: Q1," Community Business, https://www.communitybusiness.org/women-boards-2020-Q1.

Figure 4.3. Women on boards of top listed companies



Source: Community Business; 30 Percent Club; and Council for Board Diversity[166]
*For Singapore, top 100 primary-listed companies by market capitalization on the Singapore Exchange (SGX).

Although in most markets the number of all-male boards has decreased between 2019 and 2020, an opposite trend could be observed in Hong Kong SAR. In 2020, 37% of boards of Hong Kong SAR companies included in the MSCI ACWI Index had no women directors, compared to 32% in 2019.[167]

Moreover, Hong Kong SAR currently lags behind a number of international financial centres on gender diversity on the board. Figure 4.3 shows how Hong Kong SAR compares with other major financial markets.

To further enhance board diversity, the stock exchange took an additional step to address gender imbalance on boards of HKEX-listed companies by requiring specific gender diversity disclosure for new listing applicants. In its guidance letter on producing IPO

[166]"Women on Boards," Community Business," April 2019, https://www.communitybusiness.org/women-boards; "30% Club of the United States," 30% Club, November 2020, https://us.30percentclub.org/; "United Kingdom," 30% Club, November 2020, https://30percentclub.org/about/chapters/united-kingdom; "Business Leadership: The Catalyst for Accelerating Change," 30% Club, June 2019, https://30percentclub.org/assets/uploads/30__Club_Information_Booklet_2019.pdf; "With More Companies Appointing Women to Their Boards," press release, Council for Board Diversity, December 2109, https://www.councilforboarddiversity.sg/wp-content/uploads/2020/03/2020-03-17-CBD-NewsRel-More-companies-appointing-women-to-their-boards.pdf.
[167]Christina Milhomem, "Women on Boards: 2020 Progress Report", MSCI, November 2020, https://www.msci.com/documents/10199/9ab8ea98-25fd-e843-c9e9-08f0d179bb85.

listing documents, the stock exchange requires listing applicants to include its board diversity policy, specifically on gender, in its IPO prospectus. If the company has a single-gender board, then additional disclosures are required to explain how and when gender diversity would be achieved after listing. The IPO prospectus also must include details of measurable objectives the company has set for implementing gender diversity and the measures it has adopted to develop its board pipeline to achieve gender diversity.[168]

In the April 2021 consultation paper,[169] HKEX emphasizes that "diversity is not considered to be achieved by a single-gender board."[170] It proposes a requirement that the companies set and disclose numerical targets and timelines for achieving gender diversity on the board. If the proposal is implemented, single-gender boards would have three years to appoint a female director, and companies filing for an IPO would be expected not to have single-gender boards.

4.9. Conclusions

Hong Kong SAR was one of the first markets in Asia to introduce independent directors in 1993. Over the years, not only have more rules and standards been implemented to improve corporate governance but also more enforcement actions have been take toward independent directors who breach their duties. Today, independent directors are an integral part of good corporate governance of listed companies.

While much has been achieved in the past few decades, challenges remain on the selection process as well as the effectiveness of independent directors, particularly in a market in which many companies are dominated by controlling shareholders. Although the CG Code supports a clear division of responsibilities between the chair and CEO, it is only a comply-or-explain requirement, with no obligation for the chair to be independent. Other challenges remain, such as the issue of cross-boarding in which company directors elect their friends to each other's boards, leading to an appearance of an old boys' club, a common practice that weakens corporate governance and board diversity.

[168]Herbert Smith Freehills, "Hong Kong Stock Exchange Introduces Specific Gender Diversity Disclosure Requirements for New Listing Applicants," *Hong Kong Corporate Bulletin* (27 May 2019), https://sites-herbertsmithfreehills.vuturevx.com/23/20022/compose-email/hong-kong-stock-exchange-introduces-specific-gender-diversity-disclosure-requirements-for-new-listing-applicants-.asp.

[169]"Review of Corporate Governance Code and Related Listing Rules", HKEX Consultation Paper, April 2021, https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/April-2021-Review-of-CG-Code-and-LR/Consultation-Paper/cp202104.pdf?la=en.

[170]HKEX Consultation Paper, Para 23.

4.9.1. Recommendations

To further strengthen the role of independent directors and improve corporate governance in Hong Kong SAR, we have the following recommendations:

- Ensure mandatory separation of chair and CEO and require the chair to be an independent director.
- Designate a lead independent director accountable to noncontrolling shareholders when the chair of the company is nonindependent.
- Place a hard cap on the maximum tenure of an independent director.
- Provide mandatory director training with relevant competences for independent directors.

4.10. Case Study: Long Success

The case of Long Success International, delisted from the Growth Enterprise Market in 2016, underscored the necessity for independent executive directors to take their duties and responsibilities seriously and not to defer decision making to one individual on the board. The Court of First Instance found that the board was dominated by the chair with no effective internal controls and that all directors, including one nonindependent executive director and three independent directors, neglected or omitted their responsibilities by allowing the chair to control the company's affairs. The court stated that while nonexecutive directors may, to some extent, reasonably rely on the executive directors to perform their duties, companies may look to nonexecutive directors to exercise independent judgement and supervise executive management. Nonexecutive directors cannot place unquestioning reliance on others to do their job.

Although the company was in the gaming and entertainment business in Macau, the directors approved an acquisition agreement with profit guarantees for a paper manufacturing business in which the company had no experience or expertise. When the paper manufacturing business did not meet the profit targets and the guarantee became payable, Long Success did not claim the compensation due and deferred and then effectively waived the payment by agreeing in certain confirmation letters that a force majeure term applied. The Court stated that there was no objective, rational, or commercial reason for the company not to enforce the payment. The agreement to the confirmation letters was plainly to the financial detriment of Long Success. Moreover, the company also guaranteed the personal liabilities of the chair, without any objective, rational, or commercial reason.[171]

The SFC obtained orders from the court resulting in the chair being disqualified from being a director or being involved in the management of any listed or unlisted corporation in Hong Kong SAR for five years. The nonexecutive directors – independent and nonindependent – were disqualified from directorships and from the involvement in the management of any listed or unlisted corporation in Hong Kong SAR for a period of two to two and a half years.[172]

[171] "Disqualification Order Obtained by SFC for Breach of Directors' Duties," Simmons and Simmons, 30 April 2020, https://www.simmons-simmons.com/en/publications/ck9mxeepc9w7q0930wfeb4348/director-disqualification-orders-obtained-by-the-sfc-for-breach.
[172] "SFC Obtains Disqualification Orders Against Former Directors of Long Success International (Holdings) Limited," SFC, 27 April 2020,https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/enforcement-news/doc?refNo=20PR38.

5. India

5.1. Executive Summary

India follows a mandatory, rules-based approach rather than a principles-based approach to corporate governance. The rules cover almost all of the aspects of board governance, including definition, size, composition, tenure, and disclosures. The rules also go into some detail about the processes that the board and its committees need to follow, especially in the area of related-party transactions.

India has seen a flurry of rulemaking in the realm of corporate governance the past few years. These include a complete overhaul of the Companies Act in 2013 (hereafter the Companies Act), the first time since 1956, and a significant update to listing regulations, the Listing Obligations and Disclosures Regulations (LODR) in 2015, with several amendments to both since. The extent of overhaul can be attributed to the corporate governance scandals, starting with Satyam Computers (dubbed India's Enron moment) in 2009, to most recently IL&FS, a troubled lender, in 2018, all of which provided strong impetus for reforms.

Minority investor protection is a priority given the context of ownership in India. Promoters[173] and crossholdings by other companies are prevalent, accounting for 45% of all shareholding in listed Indian companies according to the Organisation for Economic Co-operation and Development (OECD), the highest among the markets examined in this report.[174] The governance risk has been borne out by multiple scandals involving abusive related-party transactions in which conflicts of interest arose when the interests of large shareholders were not aligned with those of minority shareholders. This, coupled with a lack of activist investors or an effective shareholder watch or investor monitoring group, and a legal avenue for redress, has led to reliance on black letter regulations in the area of independent directors.

Indian regulators actively engage in international forums, stay on top of trends in corporate governance and other areas, and are keen to learn about international best practices. Indian regulators respond quickly to emerging issues, but this has a downside of being perceived as reactive and lacking in a holistic approach to finding solutions or preventing problems from escalating

[173]In the Indian context, the term promoter refers to a person who controls the affairs of the company as a shareholder or director, or whose advice the board of directors usually act upon, but excludes those who are merely acting in a professional capacity.
[174]De La Cruz, Medina, and Tang, "Owners of the World's Listed Companies," 39.

Overreliance on mandatory rules have consequences. First, at least some of them might be seen as extreme—for example, the introduction of a government-administered proficiency test for independent directors, with a 60% pass requirement, is without precedent; the rule has found little support among companies, investors, intermediaries, and, unsurprisingly, independent directors. One independent director we interviewed said the board discussions have become process oriented, with strategic discussions taking a backseat.

Second, the regulations are segmented and not evenly enforced. In addition to the Companies Act and listing regulations, the corporate governance regime for listed public sector undertakings (PSUs)—or state-owned enterprises—is governed by the Department of Public Sector Enterprises. Corporate governance of banks and nonbanking financial companies (NBFCs) are in the remit of the Reserve Bank of India (RBI). This results in divergent outcomes in terms of level of compliance and quality of enforcement.

A rules-based system, without a commensurate oversight, could lead to noncompliance, or at the very least, to superficial checkbox compliance which does not meet the desired objectives. There have been instances of both, as we will see in the report. On the flip side, there is a tendency to rush into extreme, corrective measures once corporate governance scandals come to light, which reduces the attractiveness of directorships and the available talent pool for companies.

5.2. Introduction

Corporate governance reform in India is of a relatively recent origin. In the late 1990s, as India was getting increasingly integrated into global markets, a strong need was felt to go above the company law and incorporate corporate governance best practices that would lead to an increase in shareholder value. In 1998, the Confederation of Indian Industry (CII) released "Desirable Corporate Governance: A Code" with recommendations covering board structures, financial disclosures, capital market issues, and creditor rights.[175] While its recommendations were far-reaching, few firms adopted the code.

In 2000, the Securities and Exchange Board of India (SEBI) implemented the recommendations of the Kumar Mangalam Committee on Corporate Governance drawn in turn from the CII code, in the form of clause 49 of the listing agreement; it subsequently tightened the enforcement and required disclosures in 2004.[176]

[175]CII, *Desirable Corporate Governance in India—A Code* (1998), https://ecgi.global/code/desirable-corporate-governance-india-code.
[176]SEBI, *Corporate Governance in Listed Companies—Clause 49 of the Listing Agreement* (2004), www.sebi.gov.in/legal/circulars/oct-2004/corporate-governance-in-listed-companies-clause-49-of-the-listing-agreement_13153.html.

While the basic corporate governance rules were in place, the need for far-reaching reforms accelerated after 2009, with revelations of one of the biggest accounting frauds at Satyam Computer Services, then one of the largest and most respected technology companies. The public and regulatory scrutiny that followed led to the resignation of 620 independent directors in 2009, an unprecedented figure at the time.[177] The Companies Act was amended in 2013, with wide-ranging provisions related to independent directors' roles, responsibilities, and liabilities. The corporate governance regulations in clause 49 of the SEBI listing regulations were subsumed into the LODR in 2015 and came into effect in December that year. In recognition of the principle of proportionality in corporate governance, the Companies Act defines the minimum standards of governance for all companies, whereas the LODR provides stricter requirements for listed and large listed companies in certain areas like term limits and board affiliations.

Since 2018, a wave of corporate governance scandals like the IL&FS, an NPFC, Fortis Healthcare, and others have once again put corporate governance and the role of independent directors under the spotlight. In the remainder of this section, we review the overall regulatory landscape and specific provisions related to independent directors, and the issue of board independence in the Indian context.

In March 2021, SEBI proposed[178] a review of regulatory provisions related to independent directors of listed companies. The proposals included broadening the eligibility criteria for independent directors, developing the process of appointment and removal, enhancing transparency in the nomination and resignation of IDs, strengthening the composition of board committees, and reviewing remuneration. We welcome the proposal and believe that the changes, if implemented, will strengthen board independence. We recognize, however, that these measures will be effective only if they are broadly accepted by major shareholders, and this will require a major cultural shift within the business community.

[177] V. S. Khanna and S. J. Mathew, "The Role of Independent Directors In Controlled Firms in India: Preliminary Interview Evidence," *National Law School of India Review 22* (2010), papers.ssrn.com/sol3/papers.cfm?abstract_id=1690581.
[178] SEBI, "Consultation Paper on Review of Regulatory Provisions related to Independent Directors" (1 March 2021), https://www.sebi.gov.in/reports-and-statistics/reports/mar-2021/consultation-paper-on-review-of-regulatory-provisions-related-to-independent-directors_49336.html.

Riding a Tiger: The Satyam Scandal

On 7 January 2009, Ramalinga Raju, the chair and CEO of Satyam Computers Ltd. (Satyam), confessed to fabricating Satyam's accounts, overstating cash and bank balances by Rs 50 billion ($1.04 billion), understating liability by Rs 12.3 billion ($253 million), and overstating revenues and profits in Q2 2009 alone by Rs 5.9 billion ($122 million). It was a shocking revelation, considering Satyam (Sanskrit word for truth) had won several corporate governance and innovation awards over the years, including the prestigious golden peacock award for corporate governance only five months before.

For years, Satyam had been inflating revenues and profits to meet analyst expectations. Reported revenues grew by an annual compound growth rate of 35% between 2003 and 2008. "What accounted as a marginal gap between actual operating profit and the one reflected in the accounts continued to grow over the years. This gap reached unmanageable proportions as company operations grew significantly," wrote Raju in his letter to the board.

Raju fretted that if the company was seen to be performing poorly, it could become a takeover target, potentially exposing the gap. He wrote it was like "riding a tiger, not knowing how to get off without being eaten." Between 2006 and 2008, he pledged his shares as collateral to raise US$250 million to support the business, and his shareholding dwindled from 14% to 2.2%, as his shares were sold off in response to margin call triggers.

As a last-ditch effort to plug the gap, he tried to engineer an acquisition of Maytas (Satyam in reverse) Infrastructure and Maytas Properties, two firms he controlled, for US$1.6 billion. This would have allowed an injection of much-needed real assets in Satyam. Satyam's board, which had five independent directors, rubber-stamped the acquisition without shareholder approval, despite questions over its rationale and valuation. But the deal was abandoned after Satyam's American depository receipts crashed by 52% and institutional shareholders threatened to sue, ironically on the grounds that the promoters were trying to siphon off Satyam's cash to Maytas.

As the company came under increasing scrutiny from the media and the government, the independent directors resigned, and Satyam appointed investment bank Merrill Lynch to find a suitable buyer for the company. Merrill Lynch terminated the engagement and blew the whistle shortly after it found financial irregularities. Raju's confession letter followed.

While the auditors came under the most scrutiny for failing to audit cash balances, the board and independent directors' role in the saga also attracted attention. Satyam is forever associated with corporate governance, first as an exemplar and later as a cautionary tale, catalysing far-reaching reforms in India.

Source: See "Hayne Royal Commission," in *Sales Inducements in Asia Pacific* (CFA Institute, 2019), 14, https://www.cfainstitute.org/-/media/documents/article/position-paper/sales-inducements-in-asia-pacific.ashx.

5.3. Overview of the Regulatory Landscape

Table 5.1 Corporate governance rules and regulations in India

Governing Body	Applicable to	Legislation / Regulation / Code	Level of Requirement
Ministry of Corporate Affairs (MCA)	All listed and unlisted companies	Companies Act 2013	Mandatory
Securities and Exchange Board of India (SEBI)	Listed companies	Listing Obligations and Disclosure Regulations (2015)	Mandatory
Reserve Bank of India (RBI)	Banks, Nonbank Finance Companies (NBFCs)	Various Circulars and Guidelines	Mandatory
Department of Public Enterprises (DPE)	Public Sector Undertakings (PSUs)	Guidelines on Corporate Governance of Central Public Sector Enterprises	Mandatory

The corporate governance framework in India is primarily established by the Companies Act, and the LODR. The former is applicable to all companies, and the latter is applicable to listed companies. The corporate governance framework for banks and NBFCs is the remit of the RBI. The Department of Public Enterprises (DPE) provides guidelines for PSUs, in addition to the requirements in the LODR. The remainder of this section focuses on the requirements of the Companies Act and the LODR.

The Companies Act requires public companies to have at least one-third of the total number of directors as independent directors, or at least two independent directors.[179] Per LODR requirements, listed companies with a nonindependent chairperson must fill at least half of the board with independent directors.[180]

5.3.1. *Independent Directors Definition*

Both the Companies Act, and the LODR provide a detailed set of criteria for independent directors. The Companies Act defines an independent director as a person of

[179]Ministry of Corporate Affairs, *The Companies Act, 2013*, 98, www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf.

[180]SEBI, *Listing Obligations and Disclosure Requirements* (Securities and Exchange Board of India, 2020), 16, www.sebi.gov.in/legal/regulations/jan-2020/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-regulations-2015-last-amended-on-january-10-2020-_37269.html.

integrity and with relevant expertise in the board's opinion. Independence is defined in terms of shareholding, loans and guarantees, relationships with promoters and key management personnel, and other audit or consulting relationships. For example, an independent director, along with his or her relatives, should not hold more than 2% of the company's voting power; he or she should not have a pecuniary relationship with the company, other than their remuneration, in excess of 10% of their total income in each of the preceding two years.[181]

Additionally, the LODR requires that independent directors of listed companies must be over 21 years of age; furthermore, nonexecutive directors must be less than 75 years of age at the time of appointment unless passed by a special resolution with justification for the appointment. The LODR prohibits interlocked directors—if an executive director on a listed company A, is also an independent director on company B, then no director of company B can be an independent director in Company A, to avoid concerns of quid pro quo.

5.4. Board Composition

5.4.1. Size

The LODR requires the top 2,000 listed companies by market capitalization to have at least six directors on the board.[182] The Companies Act limits the maximum number of directors to 15, unless a higher number is approved through a special resolution by shareholders.[183]

As of June 2020, a sample of 318 Indian companies with a market capitalization of more than US$500 million had a median board size of nine.[184] Larsen and Toubro, a conglomerate with business in technology, engineering and construction, had the highest number of directors at 19, with Indian Oil Corporation and DLF, a real estate company, not far behind at 17.

5.4.2. Representation of Independent Directors on Board

According to LODR requirements, the boards of listed companies must have at least 33% independent directors, and at least 50%, if the listed entity does not have a nonexecutive chairperson.

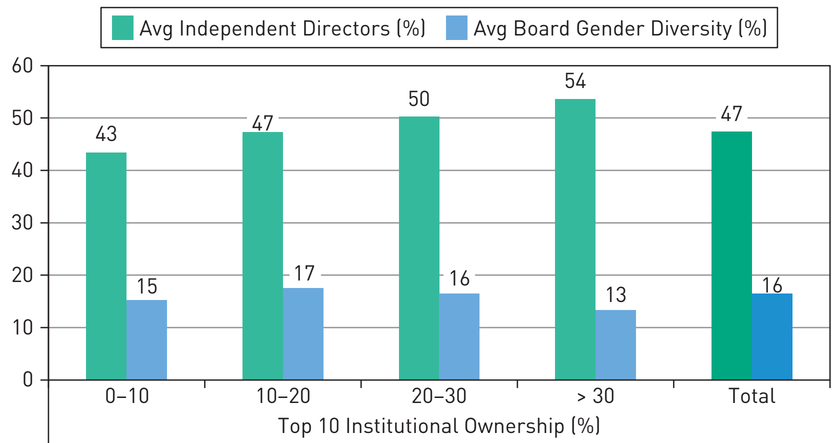
[181]Ministry of Corporate Affairs, *The Companies Act, 2013*, 98–99.
[182]SEBI, *Listing Obligations and Disclosure Requirements*, 17.
[183]Ministry of Corporate Affairs, *The Companies Act, 2013*, 98.
[184]CFA Institute calculations based on FactSet data.

Based on the sample of 318 Indian companies, the median proportion of independent directors was exactly 50% and the average was 47.4%. Two-thirds of companies had at least half of their boards composed of independent directors, and exactly half—presumably the regulatory minimum—for 98 companies (31%).

A few companies such as City Union Bank, Ramco Cements, Dr Reddy Labs, and KEC International had more than 80% independent director representation on their board. City Union Bank had the highest proportion of independent directors (90%) and also had an independent chairperson.

In addition to the rules which mandate at least one-third or one-half of the board to be composed of independent directors, the percentage of independent directors is also strongly correlated with institutional ownership. As figure 5.1 shows, in companies in which the top 10 institutional investors accounted for more than 30% shareholding (16 in number), independent directors accounted for 54% of board composition on average, compared with 43% for companies with less than 10% shareholding (81). Gender diversity of the board, however, was not correlated with institutional ownership, as one might have expected.

Figure 5.1. Relationship between institutional ownership, independence, and diversity



	0–10	10–20	20–30	> 30	Total
Number of companies	81	141	78	16	316

Source: FactSet.

5.4.3. Representation of Independent Directors on Board Committees

LODR requires the majority of board committees to be composed of independent directors, and the requirements are tightened in the case of a company with dual-class shares. For example, audit committees are expected to have at least two-third independent directors, or be fully independent in the case of a company with dual-class shares.[185]

Audit committees, in particular, have come under sharp scrutiny in India in recent years. The salient issues for audit committee are related-party transactions, audit independence, and whistle-blower complaints.

5.4.3.1. Related-party Transactions

Abusive related-party transactions done at the expense of minority shareholders have been a salient corporate governance issue in India. Given its significance, LODR specifies checks and balances to protect minority shareholders, with audit committees playing a prominent role. All related-party transactions are subject to prior approvals by audit committees. Furthermore, the audit committee must review related-party transactions entered into by the company on a quarterly basis.

In a 2020 consultation paper, SEBI proposed an expanded role for audit committees, detailing the requisite information they must review before granting approval to related-party transactions. Such information would include terms of the transaction, source of funds, valuation reports, and the rationale for the transaction.[186] There are heightened expectations that audit committees would intensify their scrutiny on related-party transactions in the coming years.

5.4.3.2. Audit Independence

The corporate scandals and the resulting scrutiny have led to a spate of auditor resignations, in parallel with independent director resignations. In several cases, auditors resigned just before the audit report was to be issued, without providing reasons. This led SEBI to tighten disclosures around auditor resignation, requiring companies to

[185]CFA Institute calculations based on FactSet data, 20.
[186]SEBI, "Report of the Working Group on Related Party Transactions," 27 January 2020, www.sebi.gov.in/reports-and-statistics/reports/jan-2020/report-of-the-working-group-on-related-party-transactions_45805.html.

disclose resignations as well as the reason for their resignation to stock exchanges within 24 hours.[187] Auditors are compelled to complete and submit their audit reports if the resignation takes place around the reporting period.[188]

Audit committees have a responsibility to ensure audit quality and independence. They are expected to ensure adequate flow of information and protect auditors from undue pressure from management. In a recent consultation paper on audit effectiveness, the Ministry of Corporate Affairs (MCA) proposed that appointments of auditors be made by external authorities to reduce the inherent conflict of interest. This would effectively remove the power of appointments from audit committees.[189] CFA Society India, in its response, reiterated the importance for audit committees to maintain control over appointments, budgets, and reporting of auditors, separate from management and controlling shareholders.[190]

5.4.3.3. Whistle-blower Complaints

Audit committee roles also have come under scrutiny as a result of whistle-blower allegations, in the case of Infosys (alleged accounting problems) and ICICI Bank (conflict of interest). While the outcomes of investigation are important, the role of audit committee in proactively investigating any alleged wrongdoing in a prompt and fair manner would go a long way toward engendering trust, and investors are quick to punish any collusion or indecision, real or perceived, on the part of audit committees.

5.5. Independent Directors

5.5.1. Appointments and Removal of Independent Directors

In theory, independent directors are identified and nominated by the nomination committee based on their skills, experience, and track record. Promoters with significant shareholding have a large say in board appointments, however, potentially compromising

[187] SEBI, *Listing Obligations and Disclosure Requirements*, 81.
[188] SEBI, "Resignation of Statutory Auditors from Listed Entities and Their Material Subsidiaries," 18 October 2019, www.sebi.gov.in/legal/circulars/oct-2019/resignation-of-statutory-auditors-from-listed-entities-and-their-material-subsidiaries_44703.html.
[189] Ministry of Corporate Affairs, "Consultation Paper on Audit Independence and Accountability," 6 February 2020. www.mca.gov.in/Ministry/pdf/Comments_08022020.pdf, 5.
[190] CFA Society India, "Response to MCA Consultation Paper on Audit Independence and Accountability," February 2020, https://cfasocietyindia.org/wp-content/uploads/Media-Uploads-Advocacy/CFA-Society-India-Response-to-Consultation-Paper-to-examine-the-existing-provisions-of-law-make-suitable-amendments-therein-to-enhance-audit-independence.pdf.

their independence. In the report and member survey titled "The Case for Mandatory Separation of Chairperson and CEO Roles in India," jointly published by CFA Institute and CFA Society India,[191] 56% of the 108 respondents disagreed with the statement that independent directors are effectively discharging their duties. An overwhelming majority (85%) of those who disagreed cited dependence on the promoter for appointments as the top reason for their ineffectiveness, well behind other reasons, such as lack of relevant skills, limited time spent, or groupthink.

The Companies Act includes provisions for minority shareholders to have a say in independent director appointments; section 163 allows companies the option of proportional representation,[192] whether through a single transferable vote or cumulative voting; section 151 allows 1,000 small shareholders (defined as holding less than Rs 20,000 or US$275 in a company) to submit a resolution for appointing a small shareholder director. However, there is no evidence of either in practice. Some commentators have raised the idea of a majority of minority vote for independent directors, although others have noted this goes against the majority principle. In our conversations, some market practitioners have suggested a hybrid model in which the nomination committee would not renominate a director who had low support from minority shareholders for subsequent election, unless there were sound reasons.

The threat of removal of independent directors who might disagree with the promoters is another cause for concern. In 2016, disagreements between the chair and the dominant shareholder at Tata group, one of the largest and most respected business groups in the country, led to the chair's ouster. The independent directors at these companies had come out in support of the chair. After the chair's ouster, the independent directors who supported the chair were removed from three of the group companies, with the motions legally requiring just a simple majority.[193] Section 169 of the Companies Act was subsequently amended in February 2018, requiring special resolution with 75% votes to remove an independent director in a second term, and only after according due process. As with the case of appointments, however, controlling shareholders could still muster enough votes to remove directors who might disagree with them, potentially impairing objectivity.

[191]Sivananth Ramachandran, "The Case for Mandatory Separation of Chairperson and CEO Roles in India" (CFA Society India, June 2020), https://www.arx.cfa/-/media/regional/arx/post-pdf/2020/07/08/the-case-for-mandatory-separation-of-chairperson-and-ceo-roles-in-india.ashx.

[192]Proportional representation is a system in which the distribution of seats corresponds with the distribution of voting power. It requires many seats to be filled at once, from among several candidates who stand for election. In Single Transferable Vote (STV), a shareholder could rank her preferences, and the candidates with the least number of preferences are eliminated successively until only those corresponding to the number of seats up for election remain. In cumulative voting, the shareholder could allocate his votes among many candidates rather than one, and candidates with the highest cumulative votes are selected.

[193]Note that proxy firms supported the proposal, and the motions garnered more than 90% majority.

5.5.2. Remuneration

Remuneration is a key driver for creating the right incentives. LODR prohibits independent directors from getting stock options, to avoid potential threats to independence. This has been an area of debate, with many promoters and others arguing for independent directors to have "skin in the game" and closer alignment with management for the purposes of value creation.[194] Tying compensation to stock prices without adequate safeguards around vesting, however, might have an impact on independence and the monitoring role that is expected to be played by independent directors.

While stock options are prohibited, the Companies Act allows an independent director to be paid in the form of a percentage of net profits of the company, provided it does not exceed 1%.[195] Market practitioners have suggested that independent directors often have a small percentage of net profit as a part of their compensation. This practice is unique to India and can create potential conflicts of interest—an independent director may hesitate to expose issues that may result in a drop in reported earnings, to which their remuneration is tied.

5.5.3. Tenure

The Companies Act states that an independent director may be appointed for a term of five years and is eligible for reappointment for one additional term on passing a special resolution. An independent director can be appointed for a maximum of two consecutive terms, even if the term is less than five years. Last, independent directors who served two consecutive terms would require a cooling-off period of three years before they could be reappointed at the same company again as independent directors.[196]

While term limits for independent directors are considered good corporate governance practice, critics have pointed out that the tenure of an independent director on the date the rule went into effect (1 April 2014) was not counted toward the term, potentially lengthening the actual tenure.[197]

[194]N. Narayanan and M, Gogate, "'Skin in the Game': A Case for Incentivising Independent Directors," *National Law University Jodhpur: Journal on Governance* 1, no. 6 (2012), papers.ssrn.com/sol3/papers.cfm?abstract_id=2244621.
[195]Ministry of Corporate Affairs, *The Companies Act, 2013*, 123.
[196]Ministry of Corporate Affairs, *The Companies Act, 2013*.
[197]Ministry of Corporate Affairs, *General Circular*, no. 14/2014, 2, www.mca.gov.in/Ministry/pdf/General_Circular_14_2014.pdf.

5.5.4. Training and Qualification Requirements

The Companies Act states that an independent director shall possess "appropriate skills, experience and knowledge in one or more fields of finance, law, management, sales, marketing, administration, research, corporate governance, technical operations, or other disciplines related to the company's business."[197] The LODR requires companies to disclose a matrix of board skills in the context of its business and sectors for the company to function effectively, and effective March 2020, to disclose the names of directors who possess those skills.[199]

Almost all the 2020 annual reports we reviewed reported director skills as a long list, rather than a matrix of director skills against required board skills. For example, Infosys Ltd., a major technology services provider, listed eight or nine skills for each of its directors, of which six were common across directors, such as diversity; leadership; mergers and acquisitions; global business; board service and governance; and environmental, social, and governance (ESG) issues. This may appear to be a great deal of information, but in reality, it provides little insight into the board's relative strengths and weaknesses, and the contribution of each individual director.

In October 2019, the MCA enacted section 150 of the Companies Act, requiring independent directors to register themselves in a databank of people eligible and willing to act as independent directors. As part of the requirement, potential candidates must pass an online proficiency test conducted by the Indian Institute of Corporate Affairs, which is responsible for maintaining the databank and administering the test. The test covers company law, securities law, accountancy, and other relevant areas. The intention is to create a strong pipeline of independent directors, with a focus on basic proficiency and continuous learning. It is also seen as a response to concerns that independent directors are a close club from which companies hand pick directors merely to make up the numbers.[200]

While the test is not required for individuals who have served as independent directors or senior managers for more than 10 years, the rules have been met with resistance, with some independent directors citing the test as the reason for their resignation.[201]

[198]Ministry of Corporate Affairs, "Qualifications of Independent Directors," 2013, ebook.mca.gov.in/Actpagedisplay.aspx?PAGENAME=18080.

[199]SEBI, *Listing Obligations and Disclosure Requirements*, 97.

[200]Press Trust of India, "Independent Director Kingpin of Corp Governance; Can't Remain in 'Cosy Club'," *Business Standard,* 10 April 2020, www.business-standard.com/article/pti-stories/independent-dir-kingpin-of-corp-governance-can-t-remain-in-cosy-club-srinivas-120041000727_1.html.

[201]R. Mascarenhus, "Independent Directors Not Keen on MCA Test, Many Prefer to Quit," *Economic Times,* 3 March 2020, economictimes.indiatimes.com/news/company/corporate-trends/independent-directors-not-keen-on-mca-test-many-prefer-to-quit/articleshow/74432641.cms.

Others felt that "the best exam was the individual's professional experience, track record, and attitude and not answering an exam."[202]

5.5.5. Maximum Number of Board Seats

Section 165 of the Companies Act requires that no individual shall act as a director in more than 20 companies, and no more than 10 publicly listed companies. Since April 2020, the LODR has imposed a much tighter requirement of not serving on more than seven boards per individual, or three if the individual serves as a full-time or managing director of a listed company. Before the rule became effective this year, it was not unusual to find individuals who served as independent, nonexecutive, or alternate directors for more than 20 companies, or with tenure over 40 years.[203]

5.5.6. Disclosures About Independent Directors in Corporate Announcements

5.5.6.1 Appointments

In case of an appointment of a director, companies must provide shareholders with the person's brief resume, the nature of their expertise, corporate affiliations, and shareholding, in the case of nonexecutive directors.[204]

5.5.6.2. Corporate Governance Disclosures

The corporate governance section of the annual report must cover details of any training programs provided to independent directors, a board skills matrix along with the names of directors who possess those skills, and a confirmation that, in the board's opinion, the independent directors fulfil the condition of independence as specified by regulations.[205] The corporate governance report should detail the meetings and attendance in board committee meetings, remuneration of nonexecutive directors, and performance evaluation criteria for independent directors.

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[202] R. Bhattacharya, "India Inc Has a Boardroom Problem," *Economic Times*, January 2020, prime.economictimes.indiatimes.com/news/73654913/corporate-trends.
[203] S. Layak, "Independent Republic," *Economic Times*, January 2017, www.primedatabasegroup.com/newsroom/M162.pdf.
[204] SEBI, *Listing Obligations and Disclosure Requirements*, 42.
[205] SEBI, *Listing Obligations and Disclosure Requirements*, 96–97.

5.5.6.3. Resignation

Schedule III of the LODR requires companies to report the resignation of independent directors to exchanges within seven days with detailed reasons, as well as confirmation from the director that there is no other material reason than the one provided by the company.[206]

Most disclosures tend to be boilerplate, with reasons including personal, health, or preoccupation. The SEBI chair, in a speech in October 2020, said "we have observed an increasing trend in the number of resignations by independent directors since the last 2–3 years. If any such resignation is on account of some governance concern, considering the role of and expectations from independent directors, I urge the resigning directors to come forward and state the same clearly to the public at large."[207] In January 2020, the independent director of Yes Bank resigned citing deteriorating governance, making it a rare instance. In November 2020, the chairperson of the audit committee of a leading Indian mining company resigned, citing the need to balance family and work commitments. The company had been under scrutiny over its decision to extend close to US$1 billion in intercompany loans to its parent company. Commentators have wondered whether there was more to the resignation than met the eye, noting that the director was only nine months away from completing her second term and had not resigned from any other boards.[208]

5.6. Effectiveness of Independent Board Directors

Academic studies that research independent directors with corporate performance in India are few and far between. Jackling and Johl (2009) found support for some aspects of agency theory, as a greater percentage of independent directors on Indian boards was associated with improved firm performance as measured by accounting (return on assets) and market (Tobin's Q) measures. The study also found a negative impact of director busyness (measured as number of directorships) and firm performance. The study, however, did not find a positive effect of separation of chair and CEO and firm performance.[209]

[206]SEBI, *Listing Obligations and Disclosure Requirements*, 81.

[207]SEBI Chair, speech, CII 11th Financial Markets Summit, 21 October 2020, https://www.sebi.gov.in/media/speeches/oct-2020/chairman-s-speech-dated-october-21-2020-at-cii-s-11th-financial-markets-summit-2020_47918.html.

[208]"Shareholders Ask Lalita Gupte True Reasons for Resigning from Vedanta Board," IANS, updated 9 November 2020, http://ianslive.in/index.php?param=news/Shareholders_ask_Lalita_Gupte_true_reasons_for_resigning_from_Vedanta_board-736049/BUSINESS/5.

[209]B. Jackling and S. Johl, "Board Structure and Firm Performance: Evidence from India's Top Companies," *Corporation Governance,* 17, no. 4 (2009): 492–509, www.academia.edu/24569239/Board_Structure_and_Firm_Performance_Evidence_from_Indias_Top_Companies.

Balasubramanian, Black, and Khanna (2010) found an association between an Indian Corporate Governance Index (ICGI) they constructed and Tobin's Q, with more profitable companies having a higher Tobin's Q compared with less profitable ones.[210] The authors suggested that there was evidence that this association points towards causation between governance and performance, based on tests to assess whether control variables (such as profitability) predict firm's governance choices.

A more recent study by Haldar et al. (2017) analysed the relationship between board independence and financial performance for a set of 500 large Indian firms between 2004 and 2016.[211] The financial performance was based on accounting indicators, such as return on assets and return on equity, and Tobin's Q. Different regression models were run, with the full model controlling for board size, firm size, board busyness (number of directors serving in more than three companies), leverage and valuation (book to market ratio), industry, and time-period effects.

The study found that the percentage of independent directors on a board had a positive effect on financial performance. In addition, the presence of an independent director had a significant positive impact on performance over time. The study also found a negative relationship between board size and performance, whereas director busyness had no impact.

5.6.1. Ownership Structure and the Impact on Board Independence and oversight

India has a high concentration of ownership by controlling shareholders. According to the OECD, private corporations and individuals accounted for 45% of ownership in public listed companies.[212] The figure masks the extent of control wielded by private corporations as controlling shareholders. In nearly 60% of listed Indian companies, another private corporation was the single largest shareholder, with an average holding of more than 40%.

[210] B. Balasubramaniam, B. S. Black, and S. V. Khanna, "The Relation Between Firm-Level Corporate Governance and Market Value: A Study of India," *Emerging Markets Review* 11 (2010): 25–26, papers.ssrn.com/sol3/papers.cfm?abstract_id=1586460.

[211] A. Haldar et al., "Assessment of the Role of Independent Director and Its Effectiveness for the Growth and Development of Shareholders' Value of the Firm" (National Foundation for Corporate Government, September 2017), https://www.independentdirectorsdatabank.in/pdf/partners/NFCG/SPJAIN-assessment%20of%20the%20role%20of%20independent.pdf.

[212] De La Cruz, Medina, and Tang, "Owners of the World's Listed Companies," 39.

Indian companies have many subsidiaries. An OECD study calculated the median number of subsidiaries among the top 500 listed Indian companies by market capitalization at six, and the average number of subsidiaries at 18.[213]

The Companies Act prohibits subsidiaries from owning shares in the holding company[214] and restricts the number of layers of subsidiaries to two.[215] Companies that had multiple layers at the time of regulation, however, were grandfathered in, and the rules were not applicable for banking, insurance, and systemically important NBFCs. IL&FS, the troubled NBFC, had 256 group companies, with multiple layers and crossholdings, but was unchallenged because of its eligibility under both exemptions. As a result, it routed many related-party transactions through its myriad of subsidiaries to third parties. Its complex group structure made it almost impossible for the board and regulators to monitor these transactions. In August 2020, RBI, the banking and NBFC regulator, strengthened the rules to limit the number of layers to two. Companies with multiple layers have been given a period of time in which to make the transition and are required to simplify their structure no later than 31 March 2023.[216]

Regulators have tried to address governance issues in companies with complex group structures in multiple ways. The LODR imposes an affirmative obligation on the audit committee of a listed parent company to review the financial statements and investments made by unlisted subsidiaries, and the board of a listed parent company to review the significant transactions and arrangements entered into by its unlisted subsidiaries. While other markets try to discourage overlapping independent directorships in group companies, India is perhaps the only market that affirmatively requires listed companies to have one of its independent directors to also be the director of a material, unlisted subsidiary—a material subsidiary is one whose income or net worth exceeds 20% in the consolidated accounts—in order to provide additional oversight.[217] SEBI, in a 2018 circular, encouraged companies with a large number of unlisted subsidiaries to monitor their governance through a dedicated group governance unit or governance committee made up of members of its board of directors, although there are few examples of this in practice.[218]

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[213]"Duties and Responsibilities of Company Groups: India Case Study," OECDiLibrary, 2020, https://www.oecd-ilibrary.org/sites/859ec8fe-en/1/3/3/index.html?itemId=/content/publication/859ec8fe-en&_csp_=4b849e35212422a5d4105067181d1034&itemIGO=oecd&itemContentType=book#section-d1e11487

[214]Ministry of Corporate Affairs, *The Companies Act, 2013*, 33.

[215]Ministry of Corporate Affairs, *The Companies Act*, Restriction on Number of Layers, Reg. No. D.L.-33004/99 (2017), https://www.mca.gov.in/Ministry/pdf/CompaniesRestrictionOnNumberofLayersRule_22092017.pdf.

[216]"Review of Guidelines for Core Investment Companies," Reserve Bank of India, RBI/2020-21/24 (13 August 2020), https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11949&Mode=0.

[217]SEBI, *Listing Obligations and Disclosure Requirements*, 25.

[218]SEBI, "Circular for Implementation for Certain Recommendations of the Kotak Committee of Corporate Governance," no. SEBI/HO/CFD/CMD/CIR/P/2018/79 (Securities and Exchange Board of India, 10 May 2018), https://www.sebi.gov.in/legal/circulars/may-2018/circular-for-implementation-of-certain-recommendations-of-the-committee-on-corporate-governance-under-the-chairmanship-of-shri-uday-kotak_38905.html.

5.6.6.1. Board independence and oversight for listed PSUs

The OECD estimates the public sector ownership of Indian companies at 17%. PSUs in India are required to follow the corporate governance guidelines laid out by the Department of Public Enterprises.[219] Listed PSUs are also required to follow the LODR in addition to these guidelines.

In practice, PSUs fall short of various regulatory requirements with limited consequences. Table 5.2 shows the corporate governance characteristics of selected listed PSUs. None of them have a separate chair and CEO, all but two of them have fewer than one-third independent directors, and gender diversity on 9 of 10 boards is lower than 30%.

Table 5.2. Corporate governance characteristics of selected PSUs

Company[220]	Government holding	Separation of chair and CEO (Y / N)	Independent directors (%)	Gender diversity (%)
Steel Authority of India Ltd.	75%	No	20%	10%
Coal India Ltd.	66%	No	50%	14%
Bharat Heavy Electricals Ltd.	63%	No	43%	7%
Oil and Natural Gas Corporation	60%	No	10%	10%
State Bank of India	58%	No	29%	7%
Bharat Petroleum	53%	No	17%	0%
Gas Authority of India Ltd.	52%	No	11%	33%
Indian Oil Corporation	52%	No	18%	18%
Hindustan Petroleum Corporation Ltd.	51%	No	13%	0%
National Thermopower Corporation Ltd.	51%	No	20%	0%

Source: Company websites, September 2020.

[219] Ministry of Heavy Industries and Public Enterprises, Department of Public Enterprises, "Guidelines on Corporate Governance for Central Public Sector Enterprises (CPSEs)" (14 May 2010), https://dpe.gov.in/sites/default/files/R-2.pdf.

[220] The companies in the list are called Maharatnas (great gems), which owing to their size, are accorded flexibility to make investments up to Rs 5,000 crores without government approval.

Table 5.3. Sample of PSU companies where institutional shareholders have voted against director appointments

Name of PSU	Proxy year	Appointment	Institutional shareholders against (%)	Outcome
Container Corp.	2019	Government nominee	61%	Passed
BHEL	2020	Independent director	19%	Passed
GAIL	2020	Nominee director	44%	Passed
NTPC	2020	Nominee director	23%	Passed
Engineers India	2019	Independent director	14%	Passed

Source: BSE.

The agency problem with PSUs is different from promoter-led companies. PSUs are subjected to additional oversight by the Comptroller and Auditor General (CAG) and Parliament. Some commentators have suggested providing relaxations from corporate governance provisions for PSUs.

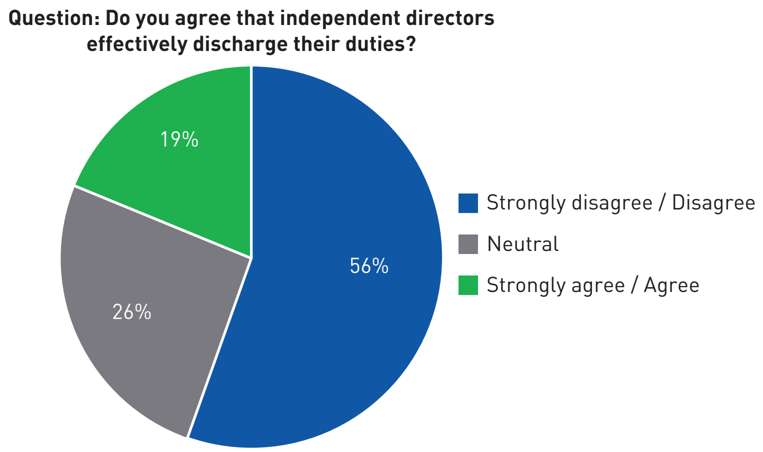
Government appointments and actions are not altogether benign nor do they provide effective oversight. There are concerns that independent directors at these companies are given to people on the basis of their political affiliations rather than their skillsets or value added. Voting results show that institutional investors have voted against nominees and independent directors from time to time for reasons ranging from a lack of attendance to political affiliation, which highlight the need for improvement in the corporate governance of PSUs.

5.7. Are Independent Directors Truly Independent?

SEBI Chair Ajay Tyagi, in a speech in November 2019, said the "concerns of independent directors not being truly independent, especially in promoter-dominated companies continue and for right reasons. While such directors meet the regulatory requirements on paper, their independence in conduct and decisions is often under the cloud."[221]

[221] A. Tyagi, speech at the 2019 OECD-Asian Corporate Governance Roundtable, Mumbai, 27 November 2019, www.sebi.gov.in/media/speeches/nov-2019/chairman-s-speech-dated-november-27-2019-at-the-2019-oecd-asia-corporate-governance-roundtable-at-mumbai_45085.html.

Figure 5.2. Opinions regarding independent directors' discharge of duties



Source: CFA Institute, "Survey on Mandatory Separation of Chair and CEO Roles" (2020).

Investors share those concerns. In the report survey conducted by CFA Institute and CFA Society India, CFA Society India members representing the investment profession gave their opinion about the effectiveness of independent directors (figure 5.2).[222] Of the 108 respondents, only 19% of the respondents agreed or strongly agreed that independent directors effectively discharged their duties, and 56% disagreed; the remaining 26% was neutral.

Most respondents (85%) who disagreed with the statement thought independent directors were not truly independent of the promoter, and many (46%) thought independent directors did not spend enough time with the companies. In addition, one respondent thought that the reliance on information from management about transactions made independent directors less effective, and one thought independent directors could not do justice to their roles if they served on the boards of more than two or three companies. In this case, such positioning might become a source of income and would increase the director's proclivity to collude with management.[223]

[222]"The Case For Mandatory Separation of Chairperson and CEO In India" (CFA Institute, June 2020), https://www.cfainstitute.org/en/research/survey-reports/the-case-for-mandatory-separation-of-chairperson-and-ceo-in-india.
[223]"The Case for Mandatory Separation of Chairperson and CEO in India."

5.7.1. Role of Independent Directors

The Companies Act laid down the code of conduct for independent directors. Among other things, it requires independent directors to bring "an independent judgment to bear on Board's deliberations . . . and safeguard the interest of all stakeholders, particularly minority shareholders."[224]

Khanna and Mathew (2010) conducted interviews of several independent directors of top 100 companies in the Bombay Stock Exchange soon after the Satyam accounting scandal.[225] These interviews revealed that independent directors viewed their role principally as that of a strategic advisor to promoters and did not perceive their role as monitoring or providing oversight to promoters and management. Many opposed a monitoring role, citing practical (limited time) or philosophical reasons (hindering board collegiality and functioning). On a positive note, however, most independent directors commented that discussions in the boardroom were expansive and of a high quality and that board members were highly receptive of their opinions.

Our recent conversations with industry experts indicated that for many promoter-led companies, the role of independent directors is still largely seen as an advisory role rather than on of oversight. Important decisions like raising capital or investments still rest with the CEO or the promoter. Another leading independent director suggested that independent directors should not be a watchdog, but rather someone whose interest is aligned with that of the company.[226] While the code for independent directors in the Companies Act specifies the monitoring role for independent directors, the 2010 study and our recent conversations suggest that much more work needs to be done in terms of clarifying and raising the awareness of the this among directors and boards, as well as a need for training with a focus on fiduciary responsibility.

5.8. Independence of Chair: Separation of the Roles of Chair and CEO

Separation of the roles of chairperson and CEO is considered to be a good corporate governance practice.

[224]Ministry of Corporate Affairs, *Code for Independent Directors*, 2014, ebook.mca.gov.in/Actpagedisplay.aspx?PAGENAME=17920.

[225]V. S. Khanna and S. J. Mathew, "The Role of Independent Directors In Controlled Firms in India: Preliminary Interview Evidence," *National Law School of India Review 22* (2010): 35, papers.ssrn.com/sol3/papers.cfm?abstract_id=1690581.

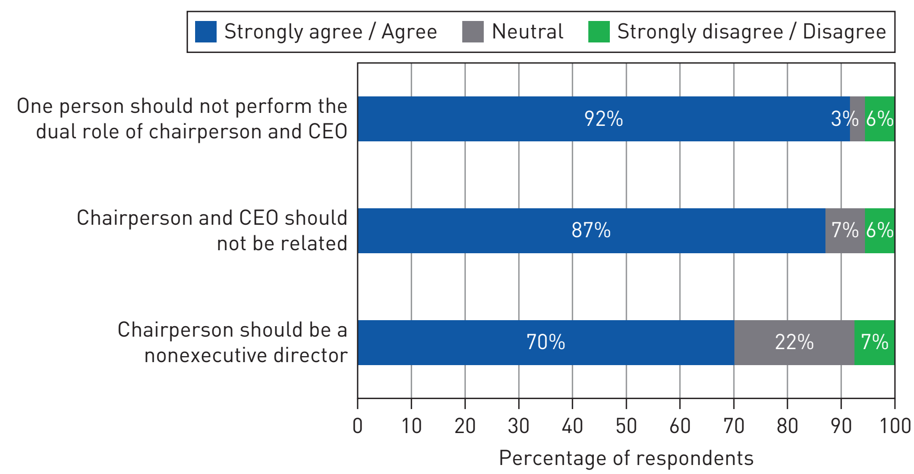
[226]R. Dave, "'We Are Trying to Criminalize Every Non Compliance': Kiran Mazumdar Shar," *Bloomberg, 23* November 2019, https://www.bloombergquint.com/law-and-policy/we-are-trying-to-criminalise-every-non-compliance-kiran-mazumdar-shaw.

In India, the Kotak Committee on Corporate Governance issued a report recommending the separation of chair and CEO in companies with significant public shareholding.[227] In response, in early 2018, SEBI mandated the separation of chair and CEO for the top 500 Indian companies, ranked by market capitalization, effective April 2020. In particular, the rule specified that the chairperson should be a nonexecutive director and should not related to the CEO. The rule does not apply to companies with dispersed shareholding with no identifiable promoters. The rule, however, faced stiff resistance from the industry, and in January 2020, SEBI deferred the implementation by two years, to April 2022.[228]

In the survey conducted by the CFA Institute, we asked members to provide their opinion on each of the three requirements of chairperson/CEO separation: (1) one person should not perform both roles, (2) the two should not be related, and (3) the chairperson should be a nonexecutive director.

An overwhelming 92% of the 108 respondents agreed or strongly agreed with the first statement; 87% agreed with the second; and 70% agreed with the requirement of nonexecutive director (figure 5.3).

Figure 5.3. Views on chair/CEO separation



[227]SEBI, "Report of the Committee on Corporate Governance" (Securities and Exchange Board of India, 5 October 2017), www.sebi.gov.in/reports/reports/oct-2017/report-of-the-committee-on-corporate-governance_36177.html.
[228]SEBI, *Listing Obligations and Disclosure Requirements.*

Board Independence in Indian Subsidiaries of Multinational Companies

Board independence in India is typically seen in the context of family-owned and promoter-controlled companies. But our analysis shows that listed Indian subsidiaries of multinational companies (MNCs) fare little better when it comes to board independence.

Table 5.4. Selected listed Indian subsidiaries of MNCs and their board structure

Company	Parent company holding	Separation of chair and CEO (Y/N)	Independent chair (Y/N)	Independent directors (%)	Royalty payment to parent (% of net profits)
Maruti Suzuki	56%	Yes	No	33%	68%
Bosch India	71%	Yes	No	50%	106%
Nestle India	63%	No	No	63%	29%
Hindustan Unilever	62%	No	No	56%	10%
Siemens Ltd	75%	Yes	Yes	40%	0%
Ambuja Cements (Holcim)	63%	Yes	No	33%	7%
Colgate India	51%	Yes	No	55%	24%

Source: Annual reports. Data as of 2020. Royalty payments include royalty, license, consultancy or professional fees, and technical service fees.

All of the seven listed Indian subsidiaries of MNCs we analyzed were majority owned by their parent companies. None of them had the combination of chair/CEO separation, an independent chair, and a majority of independent directors on the board. While five out of the seven companies had separated the roles of chair and CEO, six out of seven did not have an independent chair, and four out of seven did not have a majority of independent directors.

This lack of board independence has contributed to decisions to the detriment of minority shareholders. Most of these companies paid a significant amount of royalties as a proportion of their net profits to their parent companies, and the amount in several cases exceeded the dividend payments by a significant margin. The royalty payments by Indian subsidiaries to parent MNCs have come under sharp scrutiny from minority shareholders in recent years, with several related-party transaction resolutions being defeated or pushed back.

We asked respondents to provide a reason for their opinion. Among those who supported the measure, the top reasons cited were fostering greater accountability and vibrant debate (75%) and a lower likelihood of promoters enriching themselves at the expense of minority shareholders (74%).[229]

In some developed markets, if the chairperson is not independent, a lead independent director is usually appointed as a compromise. Few companies in India have a lead independent director tasked to interact with institutional shareholders. Without a direct communications channel with investors, the board may not hear about concerns on strategy or management and may end up with only an indirect and filtered perspective controlled by management.

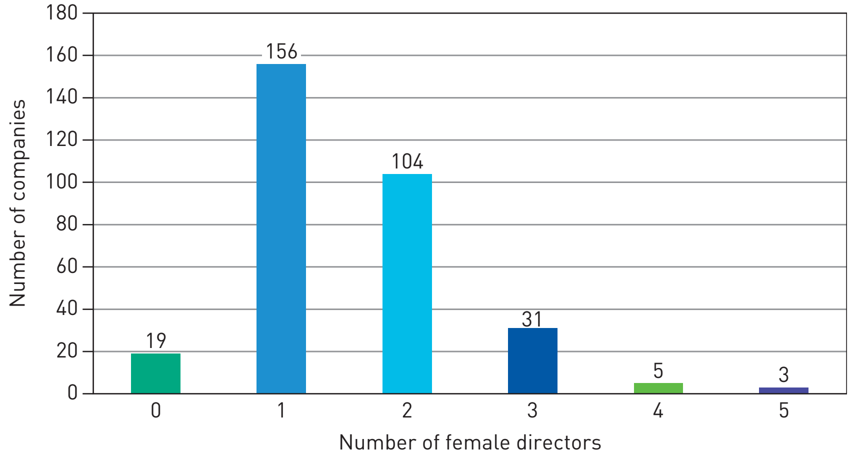
5.9. Board Diversity

Section 149 of the Companies Act requires listed companies to have at least one woman director effective beginning 1 April 2014. In May 2016, in a response to challenges in the parliament that more than half of the companies had appointed wives and family members of promoters at top Indian companies to satisfy the requirement, the minister of Corporate Affairs noted that "companies can appoint any woman who is not otherwise disqualified for appointment as a director in terms of requirements of the Companies Act and such a director can be either executive or nonexecutive or independent or nonindependent directors."[230]

In response to concerns that this measure had become a box-ticking exercise, however, SEBI made it a requirement that at least one *independent* woman director be appointed in each of the top 500 listed companies by market capitalization beginning 1 April 2019, and in each of the top 1,000 listed companies beginning 1 April 2020. More than 100 firms missed the deadline to appoint independent women directors to comply with the directive; 37 of these firms were PSUs.[231]

[229]The amounts given throughout the report and in figures may not sum to 100% because of rounding.
[230]Rajya Sabha, Unstarred question no. 1783, Ministry of Corporate Affairs (answered 10 May 2016), https://www.mca.gov.in/Ministry/pdf/Rajya_Unstarred_que1783.pdf.
[231]S. P. Mampatta, "Covid-19 Crisis: Over 100 Firms Missed Deadline to Appoint Women Directors," *Business Standard*, 16 April 2020, https://www.business-standard.com/article/companies/over-125-firms-fail-to-appoint-women-directors-amid-covid-19-crisis-120041500409_1.html.

Figure 5.4. Distribution of female directors in listed companies in India



Source: FactSet.

Figure 5.4 shows the distribution of female directors in Indian companies as of June 2020. Excluding PSUs, most companies had one female independent director, the minimum legal requirement. In contrast, 27 companies had at least 30% gender diversity, against an overall diversity of 16.5%, and three companies (i.e., Godrej Consumer Products Ltd., Apollo Hospitals, and Godrej Agrovet Ltd.) had five women directors on their boards.

Efforts to develop and induct women directors in companies continue. For example, the Women on Corporate Boards program, an initiative by Federation of Indian Chambers of Commerce & Industry (or FICCI, an industry association), identifies high-potential women executives and provides mentorship, training and development, and visibility. The program has successfully placed several women independent directors on Indian boards.[232]

5.10. Conclusions

In India, the institution of independent directors is a work in progress. Over the years, independent directors have become more aware of their roles and responsibilities, are better prepared at board meetings, and are more inclined to voice their dissent.

[232]Ministry of Corporate Affairs, *The Companies Act, 2013*, 99.

Positives:

- New rules and regulations have strengthened the corporate governance framework by setting and clarifying requirements on independent director definitions, tenure, number of directorships, and board diversity.
- Independent directors in India face a high degree of scrutiny, which narrows the pool to include only those who take their role seriously.
- Over the years, independent directors have become better aware of their roles and are better prepared at board meetings, and companies are more responsive to concerns expressed by them.

Challenges:

- Promoters still wield a substantial role in hiring, performance reviews, and removal of independent directors.
- Companies are reluctant to embrace further reforms—for example, rules requiring mandatory separation of chairperson and CEO have been delayed by two years after resistance from the industry.
- Governance in PSUs, including banks, continues to be a source of concern.
- The quality of disclosures needs improvement, like the recently introduced board skills matrix disclosure discussed earlier in the report, which gives investors no clarity on board's relative strengths and weaknesses, the presumed intent of the regulation.
- While corporate governance enforcement needs to be strengthened, on the flip side, the tendency is to have an extreme reaction once corporate governance scandals come to light. This, and rules like passing a government-administered test, are perceived to reduce the attractiveness of the independent director profession except at marquee companies.

5.10.1. Recommendations

Regulators:

- Enforce rules evenly across all listed companies, including at PSUs.
- While the regulations of independent directors have been far-reaching, support rules that give more power to minority shareholders in the appointment and removal of independent directors.

- Provide better oversight and guidance to improve the quality of disclosures, particularly in out-of-term resignations.
- Encourage the establishment of a national minority investor protection group as a prominent voice of minority investors in the area of corporate governance, similar to the Minority Shareholder Watchgroup in Malaysia or the Securities Investors Association of Singapore

The Industry:

- Encourage and celebrate role models in the form of industry leaders, who are not afraid to ask difficult questions even at the risk of being branded troublemakers and denied future employment at other companies.
- Provide greater emphasis on ongoing training in the areas of related-party transactions, fiduciary duties, and business ethics, supported by disclosures, which not only will add value to the board but also be viewed positively by investors.
- Continue to improve board diversity, including gender and cognitive diversity, which is shown to increase engagement and debate.

Investors:

- Encourage domestic institutional block holders to play an active stewardship role to complement the monitoring role of independent directors, in a market where corporate governance risks remain high.

5.11. Case Study: Independent Directors' Liability, Prosecutions, and Directors and Officers Insurance

In the corporate scandals involving IL&FS (2018), PMC Bank (2019), and Amrapali Group (2015), the independent directors were arrested along with auditors and executive directors, even though the Companies Act has safe harbour provisions, stating that an independent director and nonexecutive director "shall be held liable, only in respect of such acts of omission or commission by a company which had occurred with his knowledge . . . and with his consent or connivance or where he had not acted diligently."[233]

[233]FICCI Center for Corporate Governance, http://www.ficci-ccg.com/.

This led to a slew of resignations, as independent directors weighed the increased risks of liability and prosecution, against modest remuneration and other incentives. In a role that previously was seen as a comfortable post-retirement post, this increased accountability is welcome. A rush to initiate criminal proceedings, however, even before evidence of negligence or fraud was established, has raised concerns of overreach. The MCA, in a circular in March 2020, reminded its own staff of safe harbour provisions and asked them to ensure that "civil or criminal proceedings are not initiated against IDs and NEDs, unless sufficient evidence exists to the contrary."[234] It also asked them to seek approval from the ministry before initiating any proceedings. The circular, however, does not prevent other investigating agencies not under its jurisdiction to launch criminal proceedings.

In this context, the importance of directors and officers (D&O) insurance, which protects directors from liabilities arising from discharging their duties, has increased both for directors and for companies looking to attract the right talent. Regulations have recognized the importance of insurance, with the LODR requiring top 500 companies by market capitalization to provide D&O insurance for independent directors.

The D&O insurance covers defence costs to appear before courts or the National Company Law Tribunal, and investigation costs.[235] There is also provision for lifetime coverage for retired directors, since section 168 of the Companies Act clarifies that "director who has resigned shall be liable even after his resignation for the offences which occurred during his tenure."[236] Table F of the Companies Act, however, clarifies that companies shall indemnify officers "in which judgment is given in his favour or in which he is acquitted or in which relief is granted to him by the court or the Tribunal."[237]

[234]Ministry of Corporate Affairs, "Clarifications on Prosecutions Filed or Internal Adjudication Proceedings Initiated Against Independent Directors," no. 1/2020 (1 March 2020), 2, www.mca.gov.in/Ministry/pdf/Circular_03032020.pdf.

[235]S. Panda, "Corporate India Seeks to Barricade Brass from Frauds, Bankruptcy Concerns, "Business Standard, 25 February 2020, www.business-standard.com/article/finance/corporate-india-seeks-to-barricade-brass-from-frauds-bankruptcy-concerns-120022501666_1.html.

[236]Ministry of Corporate Affairs, *The Companies Act, 2013*, 106.

[237]Ministry of Corporate Affairs, *The Companies Act,* 248.

6. Japan

6.1. Executive Summary

In Japan's traditional business culture, companies are run by insiders for the benefit of a wide range of stakeholders, board directorships are the culmination of an executive's corporate career, and the board chair is most often the company's CEO. Shareholders are given little voice in the way the company is run and independent views are not solicited.

Under pressure from foreign investors, a modern approach to governance, in which boards of directors fulfil an oversight function, shareholders' interests are prominent, and independent views are valued, has been promoted in the wake of Japan's "lost decade." To date, however, only a small minority of companies has adopted global best practices regarding governing structures. This is also true regarding the number of independent directors on the boards of Japanese companies, which is generally lower than in other developed markets.

Regulatory efforts to steer companies toward appointing independent directors have resulted in an overly complex governance system. Japanese companies can adopt one of three board structures: a two-tier board with statutory auditors (*kansayaku*), a board with three committees, and a board with an audit and supervisory committee. The traditional two-tier structure was the only option before 2002, and as of 2020, a majority of listed companies still had two-tier boards. The board structure with three committees—audit, nomination, and remuneration—although closest to international best practices, is the least common, with only 2% of companies having adopted it. The board structure with an audit and supervisory committee was introduced in 2014, and as of 2020, has been adopted by 30% of listed companies.

Japan's Companies Act defines the concept of outside director, as an individual who is not an employee or an executive of the company or its affiliated entities. It mandates that the majority of each board committee be outsiders, effectively requiring two outside directors on all one-tier boards. The Tokyo Stock Exchange (TSE) uses the term "independent director," defined as an individual who has no conflict of interest with general shareholders. The TSE listing rules mandate at least one independent director, and the Corporate Governance Code recommends at least two independent directors on a comply-or-explain basis. In November 2020, 78% of listed companies had two or more independent directors.

In 83% of Japanese listed companies, the CEO is also the chair of the board. In a further 15%, the role is filled by a former CEO. In just 2% of companies, the roles are clearly separated. Japan's regulations do not address this issue.

We observed several positive trends. The TSE has taken the initiative in promoting the appointment of independent directors by issuing guidelines in its Corporate Governance Code that go beyond those in the Companies Act. It also showcases leading companies through inclusion in the JPX-Nikkei 400 Index. Several prominent companies have gone beyond the minimum requirements, adopting international best practices of corporate governance, such as a majority-independent board and separation of the chair and CEO roles.

The number of independent directors on boards continues to grow. Nevertheless, if attracting foreign investors is the goal, further steps are needed to bring Japan's corporate governance closer to global best practices. These practices include a better definition of director independence, a requirement for one-third of directors on a board to be independent, better training for directors, and a separation of the roles of the board chair and CEO.

6.2. Introduction

The evolution of corporate governance in Japan should be considered in parallel with changes in Japan's approach to management. In the traditional model, which has been in place since the late 1950s, a company is seen as a "community of employees, wrapped in close relationships with customers, business partners, and financial institutions."[238]

Many Japanese listed companies are family-owned. In 2008, 36% of listed firms were managed by the firm's founder or descendants, and founding families were the largest shareholder in around 25% of listed firms.[239] Many of these companies have a long history. In 2016, close to 4,000 public and private firms in Japan had been in business for more than 200 years.[240]

[238]Christina L. Ahmadjian, "Japan's Evolving Corporate Governance System," *Japan Spotlight* (May/June 2008): 10–13, https://www.jef.or.jp/journal/pdf/159th_cover02.pdf.
[239]Takuji Saito, "Family Firms and Firm Performance: Evidence from Japan," *Journal of the Japanese and International Economies* 22, no. 4 (December 2008): 620–646, https://www.sciencedirect.com/science/article/pii/S0889158308000373.
[240]Kazuyoshi Takei, "The Evolution of Japanese Family Business Governing Principles," *FFI Practitioner*, 17 August 2016, https://ffipractitioner.org/the-evolution-of-japanese-family-business-governing-principles/.

A typical company's top management consists of lifelong employees who have moved up in the corporate ranks. Traditionally, its board of directors is large (a size of more than 30 was not unusual until recently) and consists of the company's top executives, for whom the seat on the board is a culmination of their professional career. While sitting on the board, they retain their day-to-day executive responsibilities, typically as heads of the company's divisions.

In this traditional model, the company's goal is the maximization of value for a variety of stakeholders, which include trade partners such as main banks, suppliers, and affiliated companies. The interests of common shareholders have a lower priority.

Directors in such traditional board would make most decisions with deference to the board's president and the company's CEO (most often the same person), to whom they functionally report. Independent views are not solicited, and directors may find it difficult to voice contrarian opinions.

Such decision making extends to board appointments and succession. Decisions often would be made with a carte-blanche agreement from corporate shareholders. The board's president might designate his or her successor, who would be appointed automatically.

Such a traditional, relationship-based approach to doing business extends beyond a single company. Japanese companies tend to organize themselves into groups (*keiretsu*) linking them with subcontractors, suppliers, and customers, and across industries through a web of long-term cross-shareholdings. They also establish long-term relationships with their principal banks, on which they rely for financing, as well as with law firms, accountants, and consultants. These affiliated entities, in particular the main bank, exercise a degree of informal oversight over the company's strategic decisions.

Such relationships also involve long-term, stable cross-shareholdings in affiliated companies, which displace arm's-length shareholders, diminishing their significance. Japanese shareholders in large companies tend to have a weaker voice compared with shareholders in the United States or Europe.

The oversight function traditionally is performed by a separate board of statutory auditors (*kansayaku*), in a two-tier board structure, which is still the most common among Japanese companies.

This rigid adherence to the traditional governance model has faced growing scrutiny and criticism in the wake of Japan's "lost-decade" crisis of the 1990s—a period of prolonged stagnation which followed a crash of the real estate and equity markets.

As part of efforts to restart the economy, Japan's government embarked on reforms that would free companies from some of the traditional constraints, inject new vigour into them by improving productivity and profitability, and boost the notoriously low returns on Japanese stocks.

The key to this was improved corporate governance. The reforms, which started in the mid-1990s, incorporated elements of Western-style corporate governance, emphasizing the monitoring function of the board of directors and a focus on shareholder value. These reforms led to the enactment of a new Companies Act in 2005, most recently amended in 2014.[241]

In particular, the reforms broadened the range of governance structures available to companies, encouraged a shift in the role of the board from management to oversight, and introduced the requirement to appoint outside directors.

The regulators' gradual, tentative approach to the reforms, however, has resulted in a high degree of complexity in the legal and regulatory system, creating opacity and confusion, not just among foreign investors, but also among locals.[242]

In 2015, the TSE implemented a Corporate Governance Code,[243] as part of the effort by Japan's prime minister, Abe Shinzo, to improve governance in Japanese companies. Unlike the exchange listing rules, which are mandatory, the provisions of the Corporate Governance Code are enforced by the TSE on a comply-or-explain basis, with possible sanctions for failing to do so.

The code highlights the board of directors' "fiduciary responsibility and accountability to shareholders" and states that "carrying out effective oversight of directors and the management from an independent and objective standpoint" is one of the main responsibilities of the board, regardless of the company's board structure. It also introduces a requirement that each listed company appoint at least two independent directors.[244]

[241]Bruce Aronson, Souichirou Kozuka, and Luke Nottage, "Corporate Legislation in Japan" in *Routledge Handbook of Japanese Business and Management*, ed. Parissa Haghirian (New York: Routledge, 2016).
[242]"CG Watch 2018: Hard Decisions: Asia Faces Tough Choices in CG Reform" (Asian Corporate Governance Association and CLSA Limited, Hong Kong SAR, December 2018), https://www.acga-asia.org/cgwatch-detail.php?id=362.
[243]"Japan's Corporate Governance Code" [provisional translation] (Tokyo Stock Exchange, 2018), https://www.jpx.co.jp/english/news/1020/b5b4pj000000jvxr-att/20180602_en.pdf.
[244]Japan's Corporate Governance Code, Principle 1.4.

In 2014, TSE created the JPX-Nikkei 400 Index to feature large-cap and mid-cap companies "with high appeal for investors, which meet requirements of global investment standards, such as efficient use of capital and investor-focused management perspectives."[245] In effect, it showcases and promotes companies with higher governance standards and a stronger focus on shareholder value.

Although Japan's Ministry of Economy, Trade, and Industry (METI) has no formal authority on company structures or corporate governance, in July 2020, it published *Practical Guidelines for Independent Directors*,[246] adding its voice to the discussion on the importance and the role of independent directors in Japanese companies.

These reforms have achieved considerable effect, in particular an increase in the number of independent directors, and shifting companies' focus toward shareholder value. Although their momentum appeared to have stalled in the late 2010s,[247] companies continued to add independent directors to their boards in 2020. By year end, 58% of companies in the TSE First Section—Japan's blue chips—had boards that were one-third independent. The share of independent directors tends to be lower in smaller companies, and on average, Japan still lags behind many other developed markets on this measure.

The Japan Exchange Group, the corporation that operates Japan's securities exchanges including TSE, makes public a searchable database of all disclosures related to corporate governance made by listed companies. Every two years, the TSE publishes the *TSE-Listed Companies White Paper on Corporate Governance*, a detailed analysis of the disclosures, providing a picture of the current state of corporate governance in Japan and its trends. The most recent white paper was published in 2019, covering disclosures made by companies in their 2018 annual reports. Our observations in sections 6.4 and 6.5 are based mainly on the TSE data.

[245]"JPX-Nikkei Index 400 Factsheet" (Nikkei Indexes, 2020), https://indexes.nikkei.co.jp/nkave/archives/file/jpx_nikkei_index_400_factsheet_en.pdf.
[246]"Practical Guidelines for Independent Directors" (Ministry of Economy, Trade and Industry, 31 July 2020), https://www.meti.go.jp/english/press/2020/0731_003.html.
[247]Nicholas Benes, "Japan's Unfinished Reforms," *Ethical Boardroom* (2019), https://ethicalboardroom.com/japans-unfinished-reforms/.

6.3. Overview of Regulatory Landscape

Table 6.1. Corporate governance rules and regulations in Japan

Governing Body	Applicable to	Legislation / Regulation / Code	Level of Requirement
Ministry of Justice	All listed and unlisted companies	Companies Act 2015	Mandatory
Tokyo Stock Exchange	Listed companies	Corporate Governance Code	Comply or Explain
Ministry of Economy, Trade, and Industry (METI)	Companies	Practical Guidelines for Corporate Governance Systems (CGS Guidelines) 2018	Voluntary

6.3.1. Directors and Statutory Auditors (Kansayaku)

A majority of Japanese companies have a two-tier board structure (see Section 6.4.1, Board Structures). In addition to a board of directors, the structure includes a separate board of statutory auditors (*kansayaku*).

The role of *kansayaku* is to audit the accounts of the company and to ensure the accuracy of its financial statements and the legality of its activities, with a focus on accounting and reporting practices. [248]

Kansayaku typically are accountants or lawyers. Their duties are compared by some to those of compliance officers, as their oversight does not just focus on the CEO and top management, but extends to all employees.

We include *kansayaku* in our consideration of directors' independence because, like directors, they are appointed by, represent the interests of, and are accountable to the company's shareholders. Although the specific responsibilities of *kansayaku* differ from those of board directors, they partially overlap with those of audit board committee members in one-tier boards.

The notions of outsidership and independence, described in the next section, apply both to directors and to *kansayaku* in companies with two-tier boards.

[248] Aronson, Kozuka, and Nottage, "Corporate Legislation in Japan."

6.3.2. Nonexecutive, Outside, and Independent Directors

Japan's legislation and stock listing rules use three terms to describe the degree of a director's independence from the company's executives: nonexecutive, outside, and independent.

- **Nonexecutive director:** a board director who is not an executive officer of the company.
- **Outside director:** a board director who—or whose close family member—is not, or has not been within the previous 10 years, an executive director, officer, or employee of the company or of its subsidiary, parent, sister, or controlling company.
- **Independent director:** a board director who does not have a conflict of interest with general shareholders. In particular, employees of the parent or sister company or a bank with which the company does business; consultants, accountants, or lawyers of the company; and their family members would not be considered independent.

The concept of a nonexecutive director was adopted first in the mid-1990s. In 1997, in a trailblazing transformation, Sony reduced its board size from 38 to 10, and gave the individuals who were removed from the board the title of "corporate executive officers" (*shikkoyakuin*). Board directors who were not executive officers became nonexecutive directors.

The objective of this transformation was to clearly separate strategic oversight from implementation and to shift the board's focus away from operations toward making strategic decisions, monitoring management, and ensuring a better representation of the interests of the firm's stakeholders.[249] By 2019, more than 52% of companies had adopted the *shikkoyakuin* system.[250]

The distinction between executive and nonexecutive directors was formalized in the Companies Act in 2002.[251]

[249]Christina L. Ahmadjian, "Changing Japanese Corporate Governance," in *Japan's Managed Globalization: Adapting to the Twenty-first Century*," ed. Ulrike Schaede and William W. Grimes (London: Routledge, 2003).

[250]"TSE-Listed Companies: White Paper on Corporate Governance 2019" (Tokyo Stock Exchange, May 2019), https://www.jpx.co.jp/english/equities/listing/cg/02.html.

[251]Aronson, Kozuka, and Nottage, "Corporate Legislation in Japan."

“Outside directors” were first defined in the Companies Act of 2005.[252] Initially, current or former employees of parent companies would qualify as outside directors of subsidiaries, because they could not be intimidated by the company’s CEO.

This definition was amended in 2014 to further exclude employees, directors, and officers of parent and sister companies and those of controlling shareholders, as well as their close family members. Employees of trade partners, such as main banks and *keiretsu*-affiliated companies, are not excluded.[253]

In 2010, apart from the legal requirements of the Companies Act, the TSE, in its listing rules,[254] introduced a concept of “independence” that is more stringent than the “outside” requirement. The term is also used in Japan’s 2015 Corporate Governance Code,[255] which sets out requirements for the appointment of independent directors.

In Principle 4.9 of the Corporate Governance Code, TSE requires that companies make their own judgments in assessing directors’ independence and that the criteria the companies use be disclosed. In July 2018, 87% of outside directors were considered independent by their companies.

In a well-connected economy such as Japan, it is difficult to find qualified individuals to serve as directors, who have no prior business relationship whatsoever with the company, including through their employer. Some companies, therefore, have defined quantitative criteria for a permissible level of business relationships, below which they are deemed not to generate a conflict of interest.

For example, an employee or an executive of a supplier company would be deemed an independent director on the board of a company with which the supplier does business, as long as the size of that business constitutes less than 2% of consolidated total sales of the supplier. Similar criteria are used by companies with respect to employees or executives of their major lenders, lawyers, consultants, or large shareholders.

Approximately 14% of the companies that comply with the Principle 4.9 have established such quantitative criteria of business independence.[256]

[252]Companies Act, Act No. 86, 26 July 2005 [English translation], http://www.japaneselawtranslation.go.jp/law/detail/?printID=&id=3206&re=02&vm=02.
[253]Aronson, Kozuka, and Nottage, “Corporate Legislation in Japan.”
[254]Securities Listing Regulations (Tokyo Stock Exchange, 1 June 2018), https://www.jpx.co.jp/english/rules-participants/rules/regulations/.
[255]Japan’s Corporate Governance Code.
[256]“TSE-Listed Companies: White Paper on Corporate Governance 2019.”

6.3.3. Legal and Regulatory Requirements

6.3.3.1. Outside and Independent Directors

The issue of mandating director independence has been controversial in Japan. Efforts to mandate at least one outside director in a company failed as recently as 2014, after much debate.[257]

The hard law—the Companies Act—uses the term "outside" in reference to board directors and *kansayaku*. Soft laws—regulations including TSE listing rules and the Corporate Governance Code—instead use the more restrictive term "independent."

The Companies Act does not specifically require that any directors in a company with a two-tier board must be independent or even an outsider. It does require, however, at least two outside *kansayaku*: a company with a two-tier board structure must have at least three *kansayaku* and at least half of them must be outsiders.

The 2012 Reform Bill imposed on all listed companies without outside directors a duty to explain at their annual general meeting why they have none. This provision effectively makes having one outside director a requirement on a comply-or-explain basis.

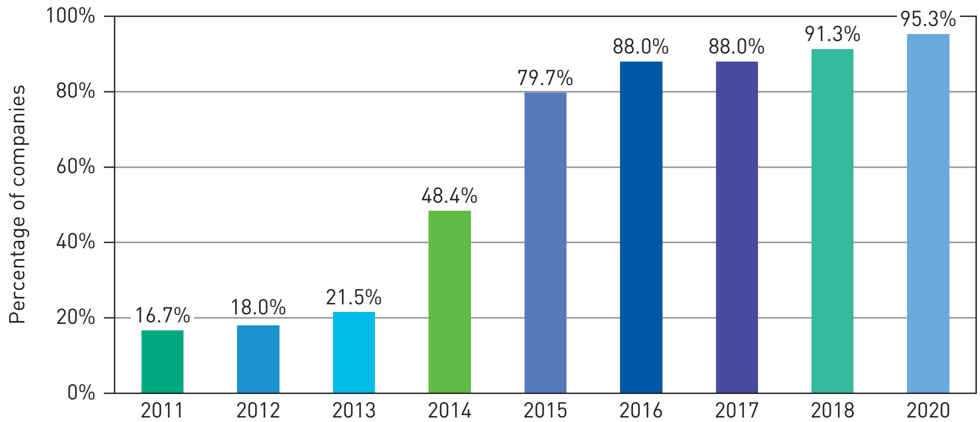
A similar requirement is in place for companies with an audit and supervisory committee and for those with three committees (see Section 6.4.1, Board Structures). The majority of the members of a committee—who are board directors—must be outsiders. Because each committee is required to have at least three members, such companies must have at least two outside directors. In a company with three committees, the same outside directors can serve on all three committees.

The 2010 TSE listing rules required that each company must have at least one independent director or *kansayaku*. In 2014, TSE shifted the emphasis, by "strongly recommending" that each company has at least one independent director, rather than a *kansayaku*.

In 2015, Japan adopted the Corporate Governance Code,[258] which requires listed companies to appoint at least two independent directors, on a comply-or-explain basis. This requirement applies to all three board structures; however, it has had the most significant

[257]Gen Goto, Manabu Matsunaka, Souichirou Kozuka, "Japan's Gradual Reception of Independent Directors" in *Independent Directors in Asia*, ed. Dan W. Puchniak, Harald Baum, and Luke Nottage (Cambridge: Cambridge University Press, 2017).
[258]Japan's Corporate Governance Code.

Figure 6.1. Companies with two or more independent directors (TSE First Section)



Source: Tokyo Stock Exchange.[259]

impact on the traditional, and most common, two-tier boards. The requirement, like all provisions of the Corporate Governance Code, applies on the comply-or-explain basis and is enforced by the TSE, which can impose sanctions for noncompliance.

Japanese companies moved relatively quickly to meet the requirement, as seen in figure 6.1. In November 2020, 95.3% of companies listed in the TSE First Section had two or more independent directors.[260]

In April 2021, a council established by the FSA and TSE proposed revisions to the Corporate Governance Code,[261] which require, among others, that at least one-third of the board of a company listed on the Prime Market[262] be independent. Companies listed in other market segments will be required to appoint two independent directors. Some companies would be required to have majority-independent boards, including in particular companies with a controlling shareholder.

[259]"Enhancing Corporate Governance: TSE-Listed Companies: White Paper on Corporate Governance 2019," Japan Exchange Group, May 2019, https://www.jpx.co.jp/english/equities/listing/cg/02.html.
[260]Based on data obtained from Japan Exchange Group, Tokyo Stock Exchange, through Corporate Governance Information Search, https://www2.tse.or.jp/tseHpFront/CGK020010Action.do?Show=Show.
[261]The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code, "Revisions of Japan's Corporate Governance Code and Guidelines for Investor and Company Engagement", 2021, https://www.fsa.go.jp/en/news/2021/20210406/01.pdf.
[262]TSE is planning to introduce new market segmentation in April 2022. The Prime Market will be the top segment, expected to attract both domestic and global investors.

6.3.3.2. Hybrid Boards

Some companies with the traditional two-tier board have voluntarily increased the number of outside and independent directors beyond the required number and even have established board committees, typically a nomination committee. Such structures are hybrids of the traditional model and the Western-style model.

By recommending having at least two independent directors, the Corporate Governance Code encourages the evolution of boards toward such hybrid structures. It further emphasizes the role of the independent directors by recommending that they have a say on nomination and compensation issues.

6.3.3.3. Outside and Independent Kansayaku

The Companies Act requires that at least half of *kansayaku* must be outsiders. Their term of office—four years—is longer than that of board directors (two years), a provision meant to strengthen their independence and protect them from pressure from the CEO. The strengthening of the role of *kansayaku* has been seen by some as making them a possible substitute for independent directors. [263]

Although *kansayaku* lack the power to supervise management, they can launch investigations and enquiries at the company and its subsidiaries, and can request a court injunction when an illegal act is committed. Their role increasingly encompasses aspects of risk management.

The Corporate Governance Code does not set out a requirement for a minimum number of independent *kansayaku*. The TSE's requirement of appointing at least one independent director can be satisfied by appointing an independent *kansayaku*; however, the TSE recommends against it.

[263] Aronson, Kozuka, and Nottage, "Corporate Legislation in Japan."

6.3.3.4. Term of Directorship

The Companies Act states that the term of directorships is, in principle, two years for companies with a *kansayaku* board. It may, however, be shortened to one year, to allow for flexibility and to improve accountability to shareholders. Among listed companies with a *kansayaku* board, 60.5% have directors with a one-year term.[264]

Directors of companies with a one-tier board serve for one year, except for those sitting in the audit and supervisory committee of companies with one committee, who serve for two years.[265]

Upon completion of their term, directors and *kansayaku* may stand for re-election. The rules do not distinguish among executive, nonexecutive, outside, and independent directors.

6.3.3.5. Financial Institutions

Japan's FSA, the regulator of banks, insurance, and securities exchanges, has more stringent guidelines on corporate governance. Although it does not have a separate governance code for banks, it articulates its expectations by posing questions to banks on topics such as the quality, ability, and gender of board candidates.

6.3.3.6. Disclosures Made About Independent Directors in Corporate Announcements

Japan's Corporate Governance Code states that companies should disclose, among other things, explanations regarding nominations of directors and *kansayaku*, their attendance at board meetings, directors' remuneration, and the results of the board's self-evaluation.

In their bi-annual report "CG Watch 2018: Hard Decisions: Asia Faces Tough Choices in CG Reform,"[266] CLSA and the Asian Corporate Governance Association (ACGA) found such reporting inadequate in regards to board committees, directors' attendance, training, remuneration, and board evaluation. The report notes that such disclosures are "full of boilerplate" and that it is often impossible to confirm the independence of directors to ascertain what value they add and why they have been chosen.

[264] "TSE-Listed Companies: White Paper on Corporate Governance 2019."
[265] "TSE-Listed Companies: White Paper on Corporate Governance 2019."
[266] "CG Watch 2018: Hard Decisions."

6.4. Board Composition

6.4.1. Board Structure

Today Japanese companies may adopt one of three board structures: a two-tier board with statutory auditors, a one-tier board with three committees, or a one-tier board with an audit and supervisory committee.

6.4.1.1. Two-tier Board with Statutory Auditors (Kansayaku)

The two-tier model is the oldest and most common structure of corporate boards of Japanese publicly listed companies. Its origins can be traced to the 1899 Commercial Code, based on German corporate law.

Members of both boards are appointed by shareholders at the annual general meeting. The Companies Act specifies that there must be at least three *kansayaku*, appointed for a term of four years, and at least one *kansayaku* must be appointed on a full-time basis. *Kansayaku* must attend board meetings and express their opinions when needed, but they have no voting rights on the board, and no power to appoint or dismiss directors or senior officers.[267]

Foreign investors have criticised the opaque character of the two-tier board structure, saying that it tends to be difficult to judge the independence of the auditors and the degree to which they can efficiently oversee the business.

A 2013 paper published by the Asian Corporate Governance Association compared *kansayaku* boards with audit committees on a one-tier board and noted that "the powers of *kansayaku* boards are weaker than those of audit committees, which are an integral part of the board and their members full participants in board decisions."[268]

The most prominent example of a company with a two-tier board is Japan's largest and enormously successful company, Toyota Motor Corporation. Long professing its commitment to the traditional board structure, in which all members were insiders, the company made some changes in the early 2010s, adding outside directors for the first time. The

[267] Aronson, Kozuka, and Nottage, "Corporate Legislation in Japan."

[268] Charles Lee and Jamie Allen, "The Roles and Functions of Kansayaku Boards Compared to Audit Committees" (Asian Corporate Governance Association, Hong Kong SAR, October 2013), https://www.acga-asia.org/upload/files/advocacy/20170330102329_21.pdf.

Table 6.2. Board structure

	Relevant legislation or Code	Two-tier board with statutory auditors (*kansayaku*)	Board with three committees (audit, nomination, remuneration)	Board with an audit and supervisory committee
Share of Companies		68%	2%	30%
		Mandatory Requirements		
Committees and structures	Companies Act	*Kansayaku* board	■ Audit committee ■ Nomination committee ■ Remuneration committee	Audit and supervisory committee
Outside directors	Companies Act	■ Minimum of three *kansayaku* ■ Majority of *kansayaku* must be outsiders ■ At least one *kansayaku* must be full time	■ Each committee must have at least three members ■ Majority of members of each committee must be outsiders	■ The audit and supervisory committee must have at least three members ■ Majority of committee members must be outsiders
Independence requirements	TSE listing rules	At least one director or *kansayaku* must be independent	At least one director must be independent	At least one director must be independent
		Comply-or-Explain Requirements		
Outside directors	2012 Reform Bill	At least one director should be an outsider	At least one director should be an outsider	At least one director should be an outsider
Independence requirements	Corporate Governance Code	At least two directors should be independent	At least two directors should be independent	At least two directors should be independent
		Recommendations		
Optional committees	Corporate Governance Code	■ Nomination committee ■ Remuneration committee	N/A	■ Nomination committee ■ Remuneration committee

changes were prompted by the fallout of a problem with unintended sudden acceleration of its vehicles in the United States, which led to a wide recall and a criminal lawsuit. In 2020, Toyota's board of directors consisted of nine individuals. Three of them were outside directors and also were considered independent.[269] The company's *kansayaku* board now consists of six individuals, of whom three are outsiders.[270]

Although the two-tier board structure is still the most common among Japanese companies, its prevalence has been decreasing. As of November 2020, 68% of TSE-listed companies had two-tier boards,[271] a decrease of 12 percentage points from 79.8% in 2016.[272]

6.4.1.2. One-tier Board with Three Committees

Since 2002, Japanese companies have had an option to adopt a one-tier, Western-style board structure. This structure was introduced to facilitate listings of Japanese companies on US stock exchanges. The option was incorporated into the Companies Act in 2006.

The structure consists of the board of directors and three mandatory committees: audit, compensation, and nomination. Each committee has a minimum of three board directors. The nomination and compensation committees have a built-in level of independence, as decisions made by them cannot be overruled by the board of directors.

Companies that have adopted this structure cite faster decision making, stronger oversight with outside directors, and clear separation of oversight and business execution as advantages over the traditional two-tier model.[273] Foreign investors tend to prefer companies with this board structure, as it provides more transparency and makes it easier to understand accountability and independence of each committee.

Despite these benefits, as of July 2020, the three-committee board was the least common model, with only 2% of listed companies (76 out of 3,673) having adopted it.[274]

[269]"Corporate Governance Report" (Toyota Motor Corporation, 24 June 2020), https://global.toyota/pages/global_toyota/ir/library/corporate-governance/corporate_governance_reports_e.pdf.

[270]Toyota Motor Corporation, *Annual Report* 2019, 2019, https://global.toyota/pages/global_toyota/ir/library/annual/2019_001_annual_en.pdf.

[271]Japan Exchange Group, Tokyo Stock Exchange, Corporate Governance Information Search, https://www2.tse.or.jp/tseHpFront/CGK020010Action.do?Show=Show.

[272]"TSE-Listed Companies: White Paper on Corporate Governance 2017" (Tokyo Stock Exchange, March 2017), https://www.jpx.co.jp/english/equities/listing/cg/02.html.

[273] "TSE-Listed Companies: White Paper on Corporate Governance 2019."

[274]Japan Exchange Group, Tokyo Stock Exchange, Corporate Governance Information Search, https://www2.tse.or.jp/tseHpFront/CGK020010Action.do?Show=Show.

One suggested reason behind this unpopularity is the reluctance to hand over the control of nominations and compensation to outside directors, who must constitute the majority on each committee.[275]

A prominent company with this structure is Sony Corporation, which adopted it as early as 2003. At that time, Sony also appointed a majority-independent board of directors, to satisfy new requirements of the New York Stock Exchange, where the company has been listed since 1970. In 2020, 9 of the 12 members of the board were independent.

The new structure did not unequivocally prove to be a recipe for good governance, and the company suffered a series of business challenges throughout the 2000s and in the early 2010s. The independent directors were criticised for their lack of relevant business experience and inability to monitor the performance of the executives and to hold them accountable.

6.4.1.3. One-tier Board with an Audit and Supervisory Committee

The most recent board structure, introduced in the 2014 amendment to the Companies Act, is a company with a board of directors and a single audit and supervisory committee. This model has met with a much higher interest than the three-committees model. As of July 2020, six years after its introduction, nearly a third (30%) of all TSE-listed companies had adopted it.[276]

TSE's Preparation Guidelines for Corporate Reports include examples of comparative advantages of this structure over the two-tier model: faster decision making, increased transparency of management, and support from foreign investors. In their disclosures, companies cite as an advantage stronger oversight with outside directors, but relatively few mention faster decision making or separation of oversight and business execution compared with the companies with three committees.[277]

The rush to adopt this governance model can in part be explained by companies' desire to meet the TSE's requirement of appointing at least two independent directors, while the pool of available candidates is small.

[275]Goto, Gen, "Recent Boardroom Reforms in Japan and the Roles of Outside/Independent Directors" (October 25, 2018), in Hiroshi Oda, ed., "Comparative Corporate Governance: The Case of Japan," *Journal of Japanese Law*, Special Issue 12 (Carl Heymanns Verlag, 2018), https://ssrn.com/abstract=3272634.
[276]Japan Exchange Group, Tokyo Stock Exchange, Corporate Governance Information Search, https://www2.tse.or.jp/tseHpFront/CGK020010Action.do?Show=Show.
[277]"TSE-Listed Companies: White Paper on Corporate Governance 2019."

The one-committee structure provides a shortcut toward meeting that goal. Companies with a two-tier board structure would essentially "flatten" it to one tier by naming their *kansayaku* directors and appointing them to the newly created audit and supervisory committee. Because, typically, at least two *kansayaku* are already outsiders, and companies have some leeway in defining independence of their directors, such manoeuvring makes the company instantly compliant with the TSE's requirement. This explains, in part, the fast adoption and popularity of this most recently introduced board structure.

On the surface, the rush to switch to the one-committee structure has quickly boosted the average number of independent directors in Japanese companies—a trend welcomed by foreign investors—and despite a persisting "deep ambivalence that Japanese managers hold towards independent directors."[278]

In reality, the situation is more complex. On one hand, the former *kansayaku* are used to having a degree of independence from the board of directors, even though their focus previously has been on the company's financials. They tend to know the company well and have desired skills as accountants or lawyers. Although the scope of their work as directors in the new audit and supervisory committee is broader, they are well qualified for these roles.

On the other hand, critics have pointed out that the transition is often purely symbolic, as the dynamics between the newly appointed directors (the former *kansayaku*) and the members of the former board of directors can remain essentially the same. These critics also question the true independence of such *kansayaku*-turned-directors.

Honda Motor Co. serves as an example. In 2017, the company switched from a two-tier board structure to a one-tier structure with an audit and supervisory committee, appointing four out of its five *kansayaku* to the board and making them members of the new committee.

Proponents of the Western-style governance tend to dislike the one-committee structure, which they say is not much different from the traditional two-tier structure. The audit and supervisory committee essentially replaces the *kansayaku* board, and often consists of the same individuals after the transition. Critics see this development as a distraction from the efforts to promote global best practices of corporate governance and the appointing of highly qualified, genuinely independent directors.

[278]Ahmadjian, "Japan's Evolving Corporate Governance System."

6.4.1.4. Effectiveness of the Board's Monitoring Function

Although there has been much discussion of which structure allows the board to best fulfil its monitoring function, many still believe that the traditional *kansayaku* board is best equipped to do it. According to this view, a *kansayaku*, who is not a director responsible for a long-term well-being of the company, is in a better position to execute oversight over the company's management.

This view reflects doubts—still common in Japan's relationships-based business culture—that a board director, even nominally independent, can exercise enough independence to be an effective check on practices of the board and management. Foreign investors, however, tend to prefer the three-committee board, for its transparency and the independence of each committee.

6.4.2. Board Size

The average size of the board of directors among Japan's listed companies was 8.3 persons in 2018, with the number very slowly trending downwards since 2008.[279] Seventy-six listed companies (2%) had boards consisting of 15 or more directors and another 871 companies (25%) had 10 or more directors. Although common in the past, boards with 20 or more directors are now a rarity. As of November 2020, only four companies had such large boards.[280] Nipro Corporation, a medical equipment manufacturer, had the largest board, with 28 members.

Board size tends to correlate with the size of companies, as measured in sales. In 2018, the companies with sales exceeding ¥1 trillion (US$9.6 billion), had on average 11.6 members on the board, whereas those with sales lower than ¥10 billion had 6.3 members.[281] The dominance of traditional nomination practices, whereby heads of divisions are appointed to the board, likely contributes to this trend, because larger companies will have a higher number of top-level executives.

6.4.3. Directors' Tenure

Listed companies are not required to disclose the tenure of their board directors in the annual reports or the corporate governance reports. The TSE does not collect this information, nor makes it available in its bi-annual report. Many companies disclose the tenure

[279] "TSE-Listed Companies: White Paper on Corporate Governance 2019."
[280] Japan Exchange Group, Tokyo Stock Exchange, Corporate Governance Information Search, https://www2.tse.or.jp/tseHpFront/CGK020010Action.do?Show=Show.
[281] "TSE-Listed Companies: White Paper on Corporate Governance 2019."

in their annual reports or annual general meeting notices, but many others do not. It is difficult, especially for foreign investors, to obtain this information, which is relevant when evaluating directors' independence.

Based on such incomplete data, one cannot reliably compare the average tenure of board directors in Japan with that in other countries. The average is most likely inflated by the presence of long-time insiders and executive directors on the board, while many independent directors were appointed in the past few years, so their tenures likely tend to be shorter.

6.4.4. Board diversity

Unlike some other markets, Japan does not have a legal stipulation mandating that a set percentage of board seats be filled by women. The Corporate Governance Code stresses that boards should strive for diversity of gender and international experience. The revisions[282] proposed in 2021 add to it work experience and age.

Nevertheless, many companies have made efforts to increase the number of women among senior executives and directors.

The number of women in these roles is much lower than that in many Western countries, mostly because of the traditionally male-dominated corporate environment of Japan. It is growing, however, in part thanks to Japan's government promoting the participation of women in the economy. In 2012, only 1.6% of all directors and *kansayaku* were women, but by 2018, the number had grown to 4.1%.

The number of foreigners on the boards of Japanese companies is also lower than in Western markets. Executive search firm Spencer Stuart notes that 3% of board members at Japanese companies are foreigners, compared with 8% in the United States and 25% in Germany. Only 73 of the top 500 companies listed on the TSE have one or more non-Japanese members on their board.[283]

[282]The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code, "Revisions of Japan's Corporate Governance Code and Guidelines for Investor and Company Engagement", 2021, https://www.fsa.go.jp/en/news/2021/20210406/01.pdf.

[283]S. Bhattacharya, R. Davis, and K. Narioko, "A Successful Strategy for Activist Investors in Japan: Ask, Don't Tell," *Wall Street Journal*, 17 April 2019, https://www.wsj.com/articles/a-successful-strategy-for-activist-investors-in-japan-ask-dont-tell-11555506003.

6.5. Independent Directors

6.5.1. Appointment of Independent Directors

Directors are nominated by the board and are elected through a resolution at a shareholders' meeting. If a company has a board with three committees, the nominating committee is responsible for nominating directors.

6.5.2. Independent Director Nomination and Voting Process

Under Japanese law, there is no special provision that enables minority shareholders to appoint directors who would protect their rights. Directors are generally obligated to work towards maximizing value for all shareholders and cannot pursue interests of specific shareholders to the detriment of others.[284]

Shareholders in Japanese companies, in general, have the right, guaranteed in the Companies Act, to submit proposals at the shareholder meeting and to vote on them. This includes the right to request adding to the agenda the election of directors and to nominate candidates. The Company Act gives these rights to all shareholders, even those holding only one share.

Shareholders who have held their shares continuously for more than six months also have a right to address illegal conduct of directors. They can request ceasing of such conduct and request initiating legal action against the directors. Holders of at least 1% of voting rights can also request pursuing legal action against directors in the ultimate parent company.[285]

6.5.3. Training and Qualification Requirements

There are no age or nationality restrictions on individuals who can serve as directors of a company in Japan. The following three categories of individuals are prohibited from serving as directors:

[284]"Minority Shareholder Rights 2016—Japan" (International Bar Association, May 2017), https://www.ibanet.org/Document/Default.aspx?DocumentUid=6990FBD3-0D61-4E23-8EAA-BA9FBF4739A8.
[285]"Minority Shareholder Rights 2016—Japan."

- an adult ward or a person under curatorship;[286]
- a person who has been sentenced to a penalty for a violation of the Companies Act or other laws, during the sentence and for two years after it has ended; and
- a person who was sentenced to imprisonment or a more severe penalty for a violation of other laws, during the sentence, unless the execution of the sentence has been suspended.

An amendment to the Companies Act is scheduled to come into force by June 2021 that will remove the first restriction.[287]

The Companies Act stipulates that directors must perform their duties "with the care of a prudent manager" and "in a loyal manner in compliance with laws and regulations, the articles of incorporation, and resolutions at shareholders meetings."[288]

There is no "fit-and-proper" criterion for individuals who serve on a board of directors, and there are no training or qualification requirements specified in the Companies Act. The Code of Corporate Governance, however, states that companies "should provide and arrange training opportunities suitable to each director and *kansayaku* along with financial support for associated expenses," Companies are required to disclose such training initiatives and 98% did so in their 2018 annual statements.[289]

The 2021 proposal to revise the Corporate Governance Code[290] stresses the importance of skills the board needs to function in its strategic oversight role. If the revisions are

[286]An "adult ward" is a person under "guardianship"—a system of protection and support for individuals who "constantly lack mental capacity" due to mental disorders, such as dementia or intellectual disability. A court-appointed guardian acts on behalf of the ward in performing certain legal acts. "Curatorship" is a similar system for individuals who "have significantly insufficient mental capacity" as a result of mental disorders. Such individuals require the consent of a court-appointed guardian to conduct certain legal acts. See Ministry of Justice, "Adult Guardianship System," http://www.moj.go.jp/EN/MINJI/minji17.html.

[287]Katsuyuki Yamaguchi, Kaoru Tatsumi, and Mamiko Komura, "Corporate Governance and Directors' Duties in Japan: Overview," *ThomsonReuters Practical Law*, 1 May 2020, https://uk.practicallaw.thomsonreuters.com/1-502-0177?__lrTS=20180129035106732&transitionType=Default&contextData=%28sc.Default%29.

[288]Companies Act, Act No. 86 (26 July 2005).

[289]"TSE-Listed Companies: White Paper on Corporate Governance 2019."

[290]The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code, "Revisions of Japan's Corporate Governance Code and Guidelines for Investor and Company Engagement", 2021, https://www.fsa.go.jp/en/news/2021/20210406/01.pdf.

adopted, companies will be required to disclose a skill matrix of board members. They will also be encouraged to appoint directors with management experience in other companies.

Several organizations provide training for board directors. The Japan Association of Corporate Directors was established in 2002. Its mission is to "encourage Japanese companies to take an active interest in corporate governance and to become more competitive globally through the study of governance and management."[291] It provides education and ongoing training in the form of seminars for executive and independent directors.

Similarly, the Japan Audit and Supervisory Board Members Association, established in 1974, is a professional organization of *kansayaku*. It provides training on auditing standards and other relevant subjects.

In 2009, a group of business leaders established the Board Director Training Institute (BDTI), a nonprofit organization. Its mission is to improve corporate governance and promote effective management methods. BDTI provides one-day training courses for board directors on Japan's corporate governance, in English and Japanese.

The Japan Corporate Governance Network is another nonprofit institution, formed in 2012 by a merger of three organizations. Its goal is to establish "transparent and fair corporate management through . . . improving independence and diversity of boards of directors." It conducts a range of training and educational activities, as well as research, through the Japan Corporate Governance Research Institute. It "provides the infrastructure for bridging the gap between companies and independent director candidates," which consists of a database of candidates who are recommended to companies based on their requirements.

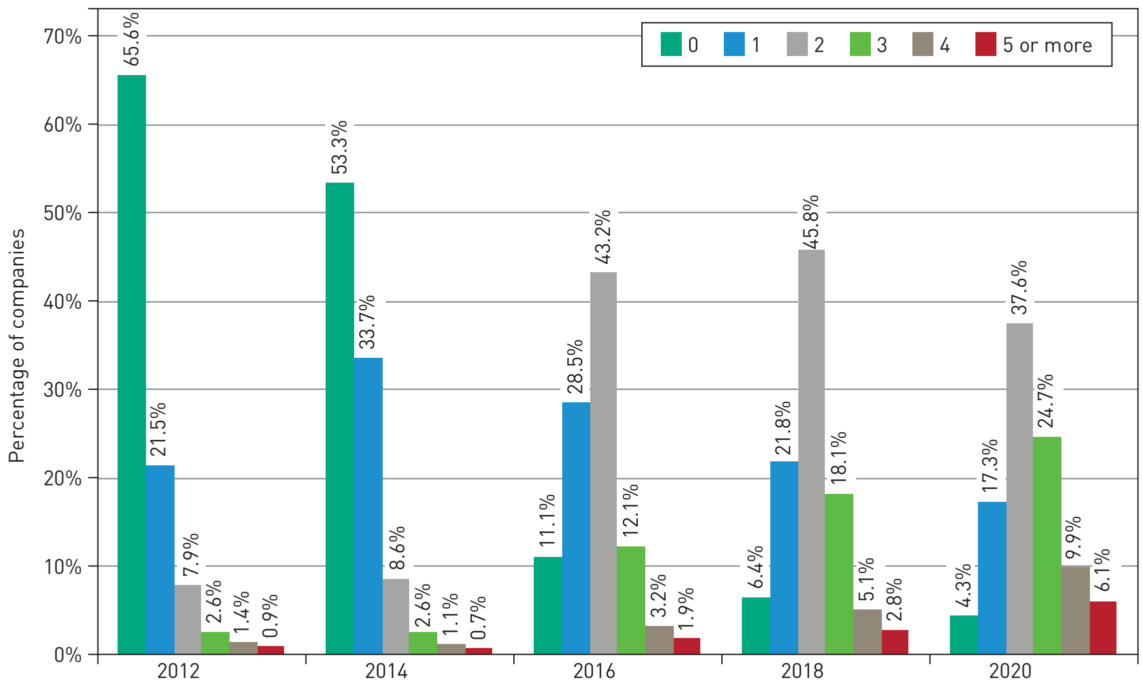
6.5.4. Representation of Independent Directors on the Board

Notwithstanding some progress in appointment of independent directors, the board of an average Japanese company is still dominated by insiders.

In 2018, Japanese companies had, on average, 2.03 outside directors, an increase from 1.9 two years earlier. A vast majority of TSE-listed companies, 97.7%, have appointed at least one outside director, as of 2018. The number grew from 95.8% in 2016.

[291]Japan Association of Corporate Directors, http://jacd.jp/en/.

Figure 6.2. Number of independent directors in listed companies



Source: Tokyo Stock Exchange.[292]

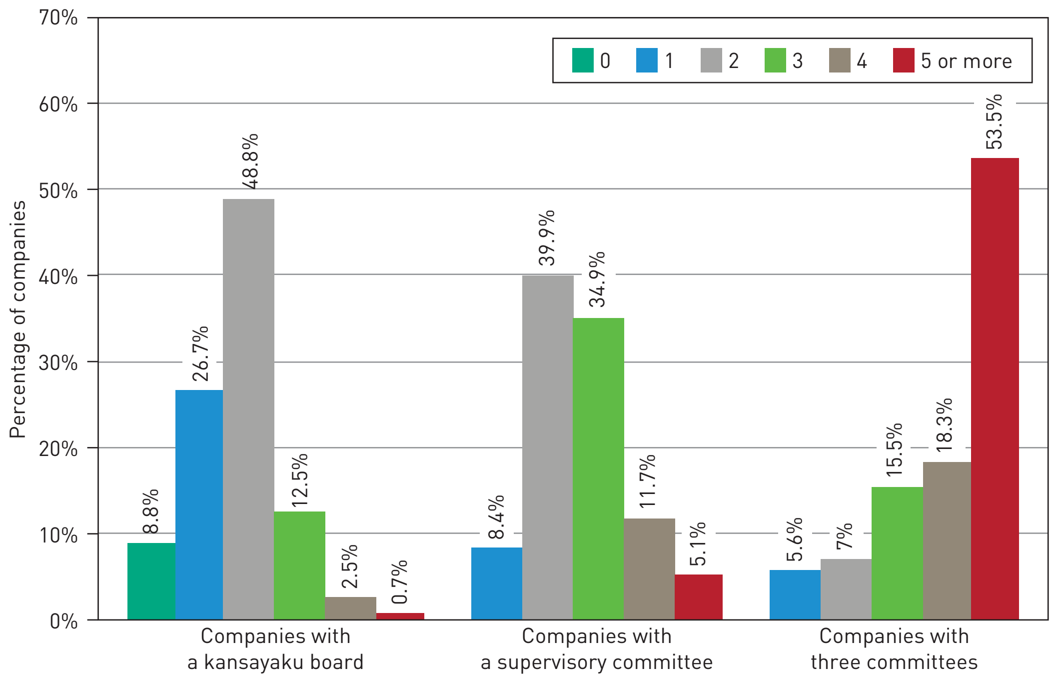
Among outside directors, 87.3% were considered to be independent. The average number of independent directors stayed relatively flat between 2016 and 2018, at 1.8.[293] As of 2018, 93.6% of companies had appointed at least one independent director, an increase from 88.8% two years earlier.

The outside directors who are not considered independent typically would be employees or executives of major noncontrolling shareholders, *keiretsu*-affiliated companies, main banks, and trade partners.

[292]"TSE-Listed Companies: White Paper on Corporate Governance 2019," Japan Exchange Group, May 2019, https://www.jpx.co.jp/english/equities/listing/cg/02.html.

[293]"TSE-Listed Companies: White Paper on Corporate Governance 2019."

Figure 6.3. Number of independent directors by board structure



Source: Tokyo Stock Exchange.[294]

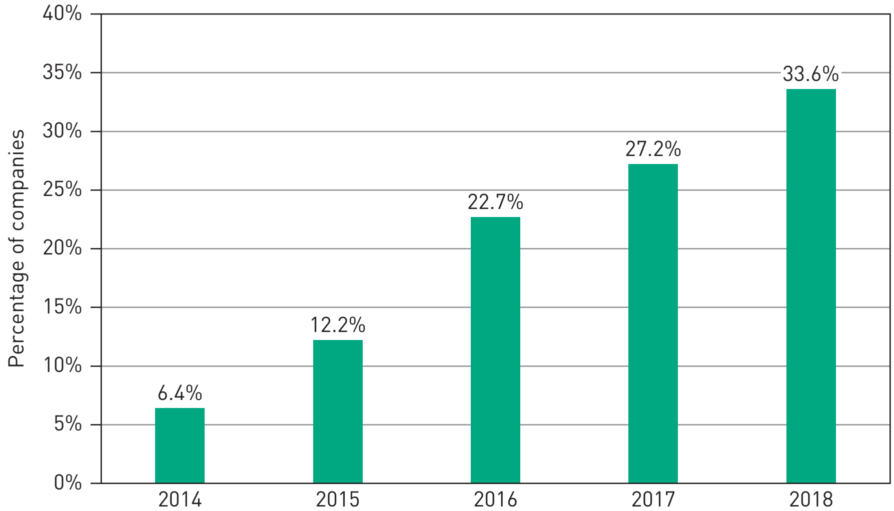
The Corporate Governance Code requires at least two independent directors and 78.4% of companies met this requirement in 2020, up from 71.8% in 2018, as figure 6.2 shows. In 2020, 40.7% of companies had three or more independent directors, up from 35.9% in 2018. The TSE explains this increase as a result of drive for diversity of the board and a response to institutional investors calling for at least one-third of the directors on the board to be independent.

In 2018, 82 listed companies with a *kansayaku* board (3.2%) disclosed that they did not have outside directors. By November 2020, that number fell by half, to 39 companies.[295] The reasons the companies cited included difficulties in finding qualified

[294]"TSE-Listed Companies: White Paper on Corporate Governance 2019.

[295]Japan Exchange Group, Tokyo Stock Exchange, Corporate Governance Information Search, https://www2.tse.or.jp/tseHpFront/CGK020010Action.do?Show=Show.

Figure 6.4. Companies with 33% or more independent directors (TSE First Section)



Source: Tokyo Stock Exchange.[296]

individuals, satisfaction with the functioning of the current board and its committees, and a concern that the board's functioning would deteriorate after directors without sufficient knowledge are appointed.[297]

Hoya, Toshiba, Hitachi, Sony, and Japan Post Holdings stand out as large listed corporations with 70% or more independent directors on their boards. All of them have boards with three committees and more than 30% of foreign shareholding, except for Japan Post Holdings, which is majority held by the government of Japan.

Takeda Pharmaceutical had the largest number of independent directors, 11 on a 16-person board (a 69% share). This company has an audit and supervisory committee and more than 30% foreign shareholding.

Companies with three committees most commonly have boards with a large number of outside and independent directors. Conversely, companies with a two-tier board

[296] "TSE-Listed Companies: White Paper on Corporate Governance 2019.

[297] "TSE-Listed Companies: White Paper on Corporate Governance 2019."

structure tend to be those with a lower number of outside and independent directors. Among those, in 2018, 3.1% had no outside directors and 8.8% had no independent directors.

Around 28.2% of all listed Japanese companies met the global best practice of having at least one-third of the board comprise independent directors in 2018. Among the largest ones—those listed on TSE First Section—the share was 33.6%, which has been steadily growing. Nevertheless, only 2.7% of all listed companies had a majority-independent board (see figure 6.4).[298]

The number of independent directors is highest in companies with the largest percent of foreign shareholdings. More than half (57%) of those with more than 30% of their shares held by foreign investors (337 companies in August 2020) had at least three independent directors. In 49% of these companies, independent directors held more than one-third of the board seats.

Although many outside directors in Japanese companies meet criteria of independence defined by the TSE and by the companies themselves, not all do. Companies are required to state in their annual reports whether their outside directors are considered independent. On average, in all listed companies, 87% of outside directors were declared to be as independent by the companies they served in 2018.[299]

6.5.5. Representation of Independent Directors on Board Committees

Mandatory committees must consist of a majority of outside directors. This applies to the audit, nomination, and remuneration committees in the three-committee board structure and to the audit and supervisory committee in the one-committee board structure.

In addition to the mandatory committees specified in the Companies Act, the Corporate Governance Code recommends establishing an optional nomination and remuneration committees in the two board structures that do not mandate them, on a comply-or-explain basis. In 2018, 26% of companies had an optional nomination committee and 28% had an optional remuneration committee.

[298]"TSE-Listed Companies: White Paper on Corporate Governance 2019."
[299]"TSE-Listed Companies: White Paper on Corporate Governance 2019."

The code does not require a minimum of independent directors serving on committees, but it does state that independent directors should "make significant contributions" in decisions made in these committees.

These voluntary committees tend to have more members (4.5 on average) than their mandatory equivalents (4.2 for mandatory nomination committees and 3.9 for mandatory remuneration committee). They also tend to have a lower share of outside directors and are more often chaired by an inside director than the equivalent mandatory committees.

An audit committee, in one form or another, is mandatory for all three board structures. In companies with three committees, the audit committee typically consists of four members, 80% of whom, on average, are outsiders. Also, in 80% of cases, they are chaired by an outside director.

The share of outside directors in audit committees is slightly lower for companies with an audit-and-supervisory committee (77%) and a *kansayaku* board (69%). In 60% of cases, the audit-and-supervisory committee is chaired by an inside director.[300]

The 2021 proposal to revise the Corporate Governance Code[301] includes a provision that makes establishing a nomination committee and a remuneration committee required on a comply-or-explain basis for all listed companies. Prime Market companies will be required to fill the seats on these committees with a majority of independent directors.

6.5.6. Attributes of Independent Directors

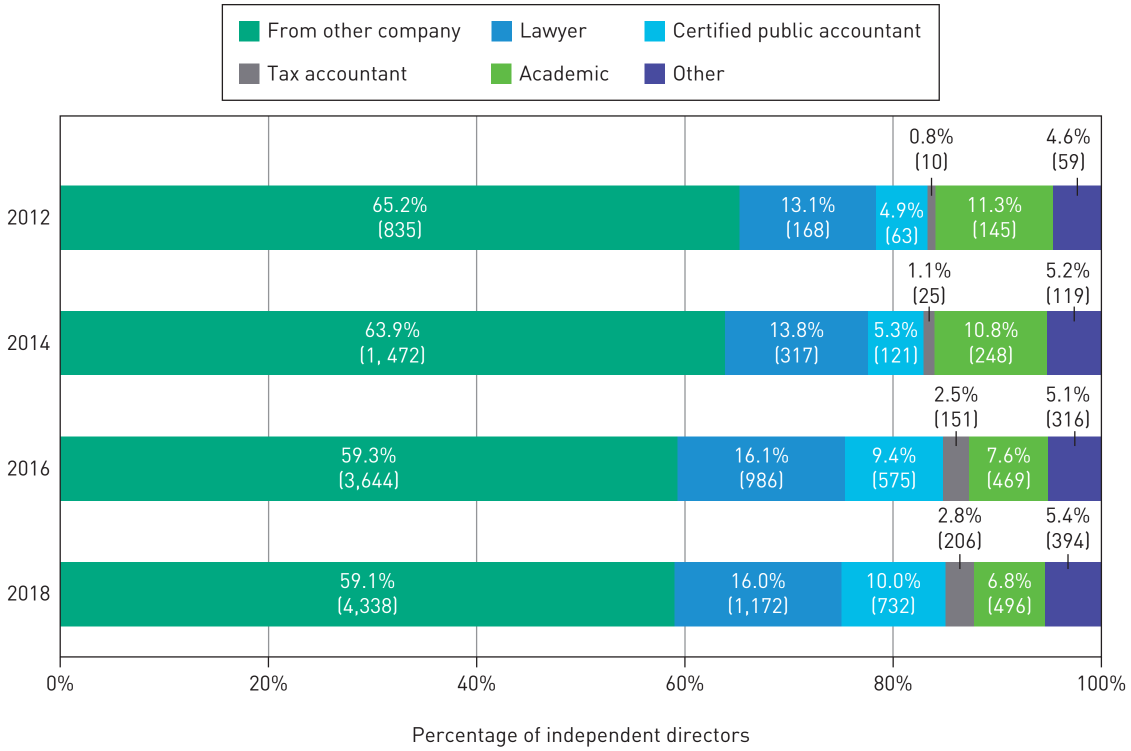
Although the number of independent directors in Japanese companies keeps growing, the share of individuals with business experience serving as directors declined after 2014. As figure 6.5 shows, around 59% came from other companies in 2018, compared with 65% in 2012. The share of lawyers and accountants, conversely, grew.

This can likely be explained by to the rush of companies with the two-tier structure converting to the one-committee structure, and naming their outside *kansayaku*

[300] "TSE-Listed Companies: White Paper on Corporate Governance 2019."

[301] The Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code, "Revisions of Japan's Corporate Governance Code and Guidelines for Investor and Company Engagement", 2021, https://www.fsa.go.jp/en/news/2021/20210406/01.pdf.

Figure 6.5. Attributes of independent directors (TSE First Section)



Source: Tokyo Stock Exchange.[302]

(typically lawyers and accountants) independent directors. Companies with an audit-and-supervisory committee have a larger share of lawyers and accountants on their boards (21% and 22%, respectively), compared with those that have a *kansayaku* board (13% and 8%) and with three committees (14% and 12%).[303]

6.5.7. Limits on Outside Directorships

The Corporate Governance Code stipulates that "outside directors, outside kansayaku, and other directors and kansayaku should devote sufficient time and effort required to

[302]"TSE-Listed Companies: White Paper on Corporate Governance 2019."
[303]"TSE-Listed Companies: White Paper on Corporate Governance 2019."

Table 6.3. Number of outside directorships held concurrently by individuals

Number of concurrent positions	Number of individuals	Percentage of total
1	10,453	81.4%
2	1,841	14.3%
3	418	3.3%
4	113	0.9%
5	20	0.1%
6	2	0.0%
7	2	0.0%
Total	**12,849**	**100%**

Source: Tokyo Stock Exchange.[304]

appropriately fulfil their respective roles and responsibilities. Therefore, where directors and kansayaku also serve as directors, kansayaku or the management at other companies, such positions should be limited to a reasonable number and disclosed each year."[305]

"Overboarding" of outside directors does not appear to be a serious issue in Japan, as 81% of individuals serve on only one board and a further 14% on two. In 2018, only 10 TSE-listed companies had directors who sat on six or more boards, compared to 14 companies in Singapore and 113 in Hong Kong SAR.[306]

6.5.8. Board Independence and Firm Performance

Academic research on board independence and firm performance is mixed. A 2016 study by Arikawa et al.[307] found a positive relationship between presence of

[304] "TSE-Listed Companies: White Paper on Corporate Governance 2019."
[305] Japan's Corporate Governance Code.
[306] "Director 'Overboarding' Spark Calls for Reforms," *Hong Kong Business*, 12 November 2018, https://hongkongbusiness.hk/markets-investing/news/director-overboarding-spark-calls-reforms.
[307] Yasuhiro Arikawa, Inoue Kotaro, and Saito Takuji. "Corporate Governance, Employment Laws, and Corporate Performance in Japan: An International Perspective" (Tokyo Institute of Technology Working Paper No. 2016-9, Tokyo, Japan, 2016), https://educ.titech.ac.jp/iee/eng/publications/file/pub_13111.pdf.

independent directors on the board and firms' performance. Conversely, a 2020 study by Kojima et al.[308] found that in family-operated firms, which constitute around 40% of Japanese listed companies, the presence of independent directors (which they define as outsiders) on boards correlated with their poorer performance. This effect was not observed for non-family-operated firms.

6.5.9. Independence of Chair

There is no legal requirement or even recommendation in Japan that a chairperson of the board be an outsider or independent. Although the TSE has acknowledged calls from investors who have made that suggestion, it has labelled this as a "future issue." Currently only 0.8% of companies have a board that is chaired by an outside director.

6.5.10. Separation of the Roles of Chair and CEO

There is no legal restriction on the roles of board members within the corporation. In particular, there is no requirement for the mandatory separation of the roles of chair and CEO, or for the chair to be a nonexecutive director.

It is a well-established and routine practice that a company CEO is the board chair. Moreover, when the president retires, he would often be given the title of the company chairperson (*kaicho*) and continue in the role of the board chair. In 2018, the company CEO was the board chair in 83% of listed companies, and the *kaicho* held this role in a further 15% of companies.

Effectively only around 17% of Japanese listed companies formally separate the roles of CEO and board chair. In most of them, however, the chair is the retired CEO (*kaicho*). In only around 2% of companies, the chair is not the current or the former CEO.

6.5.11. Growth of Shareholder Activism

The reforms introduced by Prime Minister Abe Shinzo have been credited with energizing shareholders, and in particular activist investors, in their efforts to shake up corporate management. Many have focused on improving corporate governance by adding independent directors, increasing the diversity of the board, or suggesting changes in the board structure.

[308]Kojima Koji, Bishnu Kumar Adhikary, and Le Tram, "Corporate Governance and Firm Performance: A Comparative Analysis Between Listed Family and Non-Family Firms in Japan," *Journal of Risk and Financial Management* 13, no. 9 (2020): 1–20, https://www.mdpi.com/1911-8074/13/9/215/pdf.

They have found that, despite conservative attitudes and strong attachment to traditional models of governance, some companies are open to change, especially if approached with a good understanding of the consensus-based corporate culture.

Such "soft activism" represents a big contrast with more aggressive attempts of foreign investors to force change in Japanese companies in the late 1980s and 1990s. Those earlier attempts elicited strong negative reaction and "led Fortress Japan to raise its drawbridges."[309]

Behind-the-scenes negotiations have resulted, for example, in Toshiba amending its own proposal in 2019 to include more external and non-Japanese directors, rather than face an impending shareholder proposal to replace the board of directors, put forward by activist investor King Street.

6.6. Conclusions

The approach to corporate governance in Japan is dominated by a traditional mind-set and a model that prioritizes interests of a wide group of stakeholders, while those of shareholders are often neglected. Shareholder-friendly views of governance are slowly taking hold, however, encouraged by Japan's financial regulators and foreign investors. A combination of entrenched practices on one hand and a string of recent reforms on the other have led to a complex regulatory environment. Some companies have opted to modernize, but others remain unconvinced.

Japan's approach to corporate governance has several positives:

- The TSE recognizes the value of the approach to corporate governance based on globally accepted best practices, and in particular, the value of independent directors. It promotes their appointment by companies through the Corporate Governance Code. Companies with best corporate governance practices are showcased by inclusion in the JPX-Nikkei 400 Index.

- While still a minority of all listed corporations, several prominent companies have gone beyond the minimum requirements adopting the three-committee structure, and appointing a majority of independent directors to their boards.

Japan also faces many challenges to further evolve its corporate governance:

[309]Bhattacharya, Davis, and Narioko "A Successful Strategy for Activist Investors in Japan: Ask, Don't Tell."

- The international best practices of corporate governance, the role and the value of independent directors, and the focus on shareholders are not universally recognized, and they continue to encounter resistance. The regulators who increasingly promote the new approach face resistance stemming from traditional attitudes and business culture.
- Regulatory requirements are relatively light compared with those in other jurisdictions, reflecting the still present resistance to adoption of independent directors in Japanese companies, and only a gradual evolution of the approach to corporate governance.
- The efforts of the regulators to promote these changes, while recognizing the deeply established business norms, have resulted in an overly complex governance landscape, whose nuances are at times difficult for foreign and domestic investors to grasp.
- Company reporting is often opaque and boilerplate.
- Appointment of independent directors has been pushed for in the corporate governance code. Most companies meet the minimum requirement, but the average number of independent directors is still lower than in other developed markets.
- The push for appointing of at least two independent directors has revealed a shortage of talent from within the business world. Companies have resorted to hiring individuals from the academia, lawyers, or accountants. Although some of them serve on more than one board, overboarding is not a significant issue.
- The introduction of a third board structure, with an audit and supervisory committee, has allowed many companies to quickly meet the independent director requirement by appointing their outside *kansayaku* as independent directors, but in many cases without a substantial change to the functioning of the board.
- The separation of the roles of the board chair and CEO is still rare and not part of the best practices recommended in the Corporate Governance Code.
- The diversity of Japanese boards remains low compared with other markets, on the basis of gender or nationality.

6.6.1. Recommendations

CFA Institute recognizes certain benefits of the stakeholder-oriented approach to governance, common in Japan, which today are echoed in calls for corporate social responsibility and a higher awareness of broader impact of doing business, often articulated through ESG factors. Nevertheless, we consider the presence of a majority of qualified independent directors on a company's board as crucial for good governance. In light of this, we offer the following recommendations:

- Articulate, promote, and reinforce the importance and potential for value creation in shifting the board's role towards strategic oversight.
- Better define director independence in the next iteration of Japan's Corporate Governance Code, taking away companies' leeway to define it for themselves and phase out use of "outside director."
- Increase the minimum number of independent directors on a company's board to three, or one-third of the board size, whichever is higher, and make this requirement mandatory for all listed companies. Promote majority independent boards as the gold standard of corporate governance.
- Mandate better disclosures regarding independent directors, in particular on their board tenure, to improve transparency.
- Incorporate separation of the roles of the board chair and the CEO in the Corporate Governance Code.
- Expand director training and make it mandatory.
- Promote the adoption of the one-tier board structure with three committees, which is most consistent with globally accepted best practices of corporate governance and most transparent to investors.

6.7. Case Study: Olympus

Although the Olympus scandal of 2011 is not considered a direct driver of corporate governance reforms in Japan, it played out at a time of heated discussions about a reform of the Companies Act and the role of independent directors in Japanese companies.

Olympus Corporation is a Japanese manufacturer of optical equipment. In October 2011, it fired its chief executive Michael Woodford, after only two weeks in the role, when he exposed extensive and long-running loss-hiding schemes at the company.[310]

[310]Hiroko Tabuchi, "Corporate Japan Rocked by Scandal at Olympus," *New York Times*, 9 November 2011.

The losses stemmed from a series of risky financial transactions going as far back as the early 1990s, which were meant to make up for a decline in earnings of the company's main business. Among them was a particularly damaging incident of June 1998, when the company suffered large losses on derivatives trading. If fully booked, the loss would have made the company insolvent.

At that time, the company denied the rumour of loss. Instead, as it had become its practice, the company's management hid the hole in its balance sheet with a series of inflated payments for acquisitions, conducted through obscure overseas funds.[311]

Later investigations showed that losses of more than US$1.5 billion were concealed over a period of more than 20 years, overseen by three company presidents. During that time, false securities reports were filed, accountants who challenged questionable transactions were changed, and the board of directors was not informed of these practices.[312]

After Woodford blew the whistle, the company admitted wrongdoing, its president and chair Tsuyoshi Kikukawa resigned in disgrace, and its stock lost three-quarters of its value.

The scandal reverberated in Japan as "possibly the worst corporate governance debacle"[313] in the country to date. It exposed weaknesses in Japan's corporate governance and regulatory oversight. It highlighted the consequences of a lack of an effective system to monitor top management. It forced a re-examination of the purpose of boards of directors and the monitoring role of outside and independent directors. It also prompted calls for adoption of elements of the Western system, with strong enforcement through private litigation, and an active role for external audit firms.[314]

Olympus transitioned from the two-tier board structure to the three-committee structure in June 2019. Its board consists of 12 members, including nine who are outside directors and eight who are independent.

[311]Tabuchi, "Corporate Japan Rocked by Scandal at Olympus."
[312]Tabuchi, "Corporate Japan Rocked by Scandal at Olympus."
[313]Bruce E. Aronson, "The Olympus Scandal and Corporate Governance Reform: Can Japan Find a Middle Ground Between the Board Monitoring Model and Management Model?" *Pacific Basin Law Journal* 30-93 (2012).
[314]Aronson, "The Olympus Scandal and Corporate Governance Reform."

6.8. Case Study: Nissan

In November 2018, Nissan, an automobile manufacturer, ousted its chair Carlos Ghosn, after he was arrested over allegations of false accounting at the company in relation to under-reporting of his compensation and personal use of company's assets. Additional charges were later added and Ghosn spent more than a year in detention and under house arrest, before fleeing Japan in late 2019 in a daring escape, which made front-page news at the time.

In its analysis of the case, CLSA noted Ghosn's case as a management coup, which was made possible by the lack of independent directors on its board.[315] The coup was a way for Nissan to reduce the board representation of Renault, Nissan's partner in the Renault-Nissan-Mitsubishi Alliance. Ghosn was the chair and CEO of Renault and of the alliance at that time. He was planning a full merger of Nissan and Renault, which was opposed by Nissan's executives, in particular its then-CEO Saikawa Hiroto.

Despite ousting, Ghosn and Greg Kelly, Ghosn's top aide and a director of Nissan who was also arrested, were not dismissed from Nissan's board of directors, as that would require a shareholder vote, thereby preventing Renault from replacing them. This reduced Renault's representation on Nissan's nine-member board from four to two, despite Renault's control of 43% of voting shares of Nissan. Nissan's nine-member board included three Nissan insiders and two independent directors at that time. The plans to merge the two companies fell apart.

Saikawa resigned as CEO in September 2019, following a revelation of payments he received from Nissan beyond his salary.[316] He did manage, however, to shepherd a governance overhaul at Nissan in June 2019, which included expanding the board of directors to 11 (it grew to 12 in June 2020), with a majority of seven independent directors, including an independent board chair. As of August 2020, Renault was represented by only two directors, the remaining three being Nissan insiders. Saikawa remained a director until June 2020.

CLSA stated in the early 2019 that the events at Nissan "laid bare the risk associated with the main defect in many Japanese companies' corporate governance: the lack of outside directors." By nominating a majority-independent board, Nissan appears to have made the right steps towards following global governance standards.

[315]"CG Watch 2018: Hard Decisions."

[316]S. McLean, "Nissan Ousts CEO Saikawa as Car Maker Seeks to Revive Business," *Wall Street Journal*, 9 September 2019, https://www.wsj.com/articles/nissan-ceo-saikawa-resigns-11568031651.

7. Malaysia

7.1. Executive Summary

The Malaysian corporate governance framework consists of the Companies Law (2016) (the Companies Law), the Malaysian Code on Corporate Governance (MCCG or the Code), and the Bursa Malaysia listing requirements. The Companies Law and the listing requirements lay down the minimum legal requirements, and the Code lays down the best practices in the form of three principles—board leadership and effectiveness, audit and risk management, and corporate reporting.

Viewed in terms of statistics, Malaysia is a corporate governance success story. Independent directors are a significant component of Malaysian boards, with a median representation of about 55% in the top 100 companies as of June 2020. Gender diversity is also one of the highest in the region.[317] Separation of chair and CEO is nearly ubiquitous, although having an independent chairperson is relatively less prevalent.

The corporate governance regulations are forward looking, and friendly to minority shareholders. Related-party transactions exceeding the 5% threshold based on any of the prescribed financial ratios require minority shareholder approval. For independent directors, the 2017 version of the Code recommended their tenure to be restricted to nine years; for tenures between 10 and 12 years, companies should seek annual shareholder approval, and after the 12th year, companies are required to seek approval through a two-tier process involving both large and minority shareholders. In April 2021, SC issued an update of the Code, in which the trigger for seeking approval through a two-tier process was shortened to nine years. Since the introduction of the tenure limits in 2017, long-tenured directors in several companies have resigned.

The regulators are active when it comes to enforcement and oversight. Bursa Malaysia brings enforcement actions on companies and independent directors, commonly in the area of financial reporting and corporate transgressions, such as violations of material related-party transaction requirements, with penalties typically ranging from private/public reprimands to fines and mandatory trainings. In June 2020, the Securities Commission (SC) extended its oversight responsibilities to fiduciary duties of directors, through its Guidelines on Conduct of Directors of Listed Issuers and Their Subsidiaries. The oversight of fiduciary duties was earlier under the purview of Companies Commission of Malaysia (SSM), but the actions it had taken were few and far between. The SC guidelines

[317] FactSet data.

address group governance and require company groups to establish procedures to address conflict-of-interest situations between listed corporations and their subsidiaries.

Corporate governance concerns remain, however. Concerns over public governance and cronyism have intensified in recent years, as a result of the 1MDB scandal. This growing concern has led to additional scrutiny on Malaysian companies particularly in relation to government ownership and appointments of directors with government or public sector–related backgrounds to company boards. According to the Organisation for Economic Co-operation and Development (OECD), public sector ownership accounted for 40% in listed Malaysian companies, and private corporations (pyramids and crossholdings) and strategic individuals accounted for 29% at the end of 2017.[318] Among the top 100 listed companies in Malaysia, one-fifth of all directors had public sector experience before their appointment.[319]

Public governance concerns, opacity in company structures, and appointment of directors with political and government links increase the risk of regulatory capture, rent-seeking, and corruption. The government has gone some way to address these risks, through the introduction of a stringent corporate liability provision in the Malaysian Anti-Corruption Commission Act, which went into force in June 2020. The provision makes directors and senior officers liable for any acts of corruption done for the benefit of the organization or their employees.

Malaysia has largely avoided significant company failures or corporate governance scandals seen in other developing countries in recent years, but regulators, investors, and companies need to be vigilant to the potential governance risks and need to continue to strengthen boards and to improve oversight, accountability, public perception, and trust.

7.2. Introduction

Corporate governance reforms in Malaysia can be traced to the 1997–1998 Asian financial crisis. Following the crisis, the government, through the SC, issued the Report on Corporate Governance in 1999. The committee studied the broad approaches to the issue of corporate governance undertaken by jurisdictions around the world—prescriptive, non-prescriptive, and a hybrid approach. The committee recommended a hybrid approach to

[318] De La Cruz, Medina, and Tang, "Owners of the World's Listed Companies."

[319] RHL Ventures, "Detailed Analysis on Malaysia's Top 100 Companies Board Composition" (Ministry of International Trade and Industry, Ministry of Finance, 2019), https://74g.054.myftpupload.com/wp-content/uploads/2020/02/Top-100-Malaysian-Companies-Board-Composition-Analysis.pdf?time=1600851329.

corporate governance, which involved setting out broad principles, and recommended that companies should include in the annual report a narrative statement of how they applied the relevant principles to their particular circumstances. This resulted in the release of the MCCG in March 2000.

The developments were complemented by the introduction of the Capital Market Master Plan by the SC, and the Financial Sector Master Plan by Bank Negara Malaysia in 2001 to chart the direction of capital markets and financial sector over the next decade. These plans contained elements of corporate governance to enable mobilization of capital and provide confidence to investors. To create institutional capacity for corporate governance, there were several government initiatives, including the creation of a number of institutions:

1. Malaysian Institute of Corporate Governance (MICG): Established in 1998, the MICG seeks to promote good corporate governance practices and provide education and training for the benefit of its members;

2. Minority Shareholders Watch Group (MSWG): Established in 2000, the MSWG seeks to protect the interests of minority shareholders. It is one avenue of market discipline to encourage good governance among publicly listed companies with the objective of raising shareholder value over time.

3. Institute of Corporate Directors Malaysia (ICDM): ICDM, the Malaysian version of the Institute of Directors (IoD), provides training, placement, and advocacy on behalf of directors.

7.3. Overview of the Regulatory Landscape

The SSM is a statutory body formed in 2002 as a result of a merger between the Registrar of Companies (ROC) and the Registrar of Businesses (ROB) in Malaysia, which regulate all listed and unlisted companies.

The SC is the main regulator for the capital markets in Malaysia. Established through the Securities Commission Act 1993, it reports to the Minister of Finance. Bursa Malaysia, which owns and operates the Kuala Lumpur Stock Exchange, and is a for-profit company listed on its own exchange. It has a significant role through setting listing rules and then exercising surveillance over the market and enforcing breaches of the rules. Bank Negara Malaysia, the central bank, also has responsibilities for regulation and supervision of financial institutions.

Table 7.1. Corporate governance rules and regulations in Malaysia

Institution	Applicable to	Legislation / Regulations / Code	Level of requirement
Companies Commission of Malaysia (SSM)	All listed and unlisted companies	Companies Act 2016	Mandatory
Securities Commission (SC)	Listed companies	Malaysian Code for Corporate Governance or MCCG (2021)***	Apply or Explain an Alternative
Bursa Malaysia	Listed companies	Listing regulations*	Mandatory
Bank Negara Malaysia	Banks, Investment Banks, Islamic Banks, Insurers, Holding Companies	Corporate Governance Standards	Mandatory **

* The listing regulations is a combination of rules, practice notes, and guidance, all of which are mandatory.
** While most of the sections are mandatory, some of them (denoted by the letter G) are recommendations that are encouraged to be adopted.
***MCCG 2021 became effective on 28th April 2021.
Source: OECD, Bursa Malaysia, BNM, SSM, SC.

Malaysian companies operate with a unitary board structure. This means that a single board may include executive, nonexecutive, and independent board members. The Companies Act 2016 requires a public company to have at least two directors. Directors ordinarily must reside in Malaysia and have a primary place of residence in Malaysia. The Act also disqualifies anyone from being a director if the person is an undischarged bankrupt or has been convicted of an offence related to fraud or dishonesty. The Bursa Malaysia listing requirements[320] contain similar prohibitions.

The Companies Act of 2016 repealed the Companies Act of 1965 and reformed almost all of the aspects of company law in Malaysia, introducing several pro-governance measures:

- a codification of directors' duties and responsibilities, with increased penalties;
- updated shareholder rights, such as making it easier to call general meetings; and
- making director's service contracts available for shareholders to review.

The SC-issued MCCG contains principles and internationally recognized practices of corporate governance that are above and beyond the minimum required by statute or by

[320]Bursa Malaysia, Main Market Listing Requirements (as of January 2018).

regulations as well as those prescribed by Bursa Malaysia. While compliance by issuers with the Code's best practices is voluntary, Bursa Malaysia nevertheless requires each listed firm either to comply with or explain the reasons for departure from such best practices.

In 2017, the Code was revised and upgraded to an "apply or explain an alternative" approach. Companies that are not applying the practices prescribed by the code must provide an explanation for the departure, and disclose an alternative practice that meets the intended outcome of the principles of the Code.

The Code is based on the three principles of (1) board leadership and effectiveness, (2) effective audit and risk management, and (3) integrity in corporate reporting and meaningful relationship with stakeholders. Under each principle, the following is provided:

- intended outcomes;
- practices, including actions and processes that will achieve the intended outcomes; and
- guidance to assist companies in applying the practices.

In the spirit of flexibility and proportionality, certain practices are applicable only to large companies (Large Companies).[321] For example, although the Code recommends that at least half of the board be made up of independent directors, for Large Companies, the recommendation is more than half, or a majority of independent directors. Similarly, although independent directors with a tenure of 12 years are recommended to be re-elected through a two-tier approval of large and minority shareholders, Large Companies are not encouraged to retain an independent director for more than 12 years and are encouraged to limit the tenure of their independent directors to nine years.

The listing requirements state that a listed company must ensure "that its board of directors provides an overview of the application of the Principles set out in the MCCG, in its annual report."

In April 2021, SC issued an update of the MCCG. The update focused on, among others, selection and nomination criteria for directors, strengthening board diversity targets, and the role of the board and senior management in addressing sustainability risks and opportunities of the company. The updated Code became effective on 28 April 2021, and the first batch of companies reporting on their adoption will be those with the financial year ending on 31 December 2021.

[321]The Code defines Large Companies as the top 100 companies in the FTSE Bursa Malaysia Top 100 Index, or companies with a market cap of at least $2 billion at the start of the companies' financial year.

7.3.1. Independent Director Definition

Bursa Malaysia's listing rules[322] define an independent director as one who is independent of management and free from any business or other relationship that could interfere with the exercise of independent judgement or the ability to act in the best interests of the company. The general rule is accompanied by seven specific conditions, including the following:

1. not being an executive director of the company or related issuer;
2. not been with the company within the past three years and is not an officer, as defined by the Companies Act;
3. not a major shareholder;
4. not a family member of an executive director, officer, or a major shareholder;
5. not acting as a nominee or representative of an executive director or a major shareholder;[323]
6. not engaged as an advisor or part of a firm that provides advisory services to the company within the past three years; and
7. not engaged in transactions with the company either personally or as a partner, director, or a major shareholder of an entity within the past three years, and the consideration exceeds 5% of the gross revenue of the director or the entity, or RM 1 million, whichever is higher.

The listing requirements had long imposed a two-year cooling-off period for the second, sixth, and seventh conditions. In August 2019, Bursa Malaysia proposed lengthening the cooling-off period to three years and subjecting nonexecutive, nonindependent directors to a three-year cooling-off period as well. These requirements were made effective in August 2020.[324]

[322]Bursa Malaysia, Main Market Listing Requirements, 1.01.
[323]Major shareholder defined as shareholder with more than 15%, or considered a "promoter" of the said corporation, but excludes collective investment schemes and statutory institutions managing public funds.
[324]Bursa Malaysia, Main Market Listing Requirements, Appendix I, Amendments in Relation to New Issue of Securities and Other Amendments, https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/content_entry5ce3b5005b711a17644454c1a/5f352a6e5b711a7f8d753cfd/files/App1_MainLR_NewIssue-Other_Amendments_13Aug2020.pdf?1597319979.

7.3.1.1. *Extra Requirements for Regulated Financial Institutions*

Like many other countries, the financial sector has additional, stricter requirements imposed on it by the banking and insurance regulator, Bank Negara Malaysia:[325]

- A director must have been assessed by the nominations committee to have complied with the fit-and-proper requirements.
- A director must not have competing time commitments that impair his ability to discharge his duties effectively. The board must maintain a policy on the maximum number of external professional commitments that a director may have, commensurate with the responsibilities placed on the director, as well as the nature, scale, and complexity of the financial institution's operations.
- A director of a financial institution must not be an active politician.

Bank Negara also has to approve all appointments of directors for regulated financial institutions and these are subject to a fit-and-proper test. This takes into account personal integrity, reputation, competency and capability, and financial integrity. Bank Negara has absolute discretion to approve or disapprove of proposed appointments.

7.4. Board Structure and Composition

7.4.1. Board Size

There are no legal prescriptions on board size in Malaysia other than the required minimum of two resident directors for listed companies. For financial institutions, Bank Negara Malaysia provides the following guidance:

The board and the board committees must be of a size that promotes effective deliberation, encourages the active participation of all directors and allows the work of the various board committees to be discharged without giving rise to an over-extension of directors that are required to serve on multiple board committees.[326]

[325]Bank Negara Malaysia, Corporate Governance (August 2016).
[326]Bank Negara Malaysia, Corporate Governance.

Board composition influences the ability of the board to fulfil its oversight responsibilities. An effective board should include the right group of people, with an appropriate mix of skills, knowledge, experience, and independent elements that fit the company's objectives and strategic goals.

The average board size in Malaysia, based on a sample of 98 largest companies was 8.6 as of June 2020.[327]

7.4.2. Representation of Independent Directors on Board

Bursa's listing requirements state that a listed company must ensure that at least two directors or one-third of the board, are independent, whichever is higher.[328]

The Code goes further than the listing requirements and recommends that at least half of the board be made up of independent directors. For Large Companies, the recommendation is that the board include a majority of independent directors.

According to the *Corporate Governance Monitor* (2020) published by the SC, 60% of the 937 listed companies had a majority of independent directors in their boards, with no meaningful differences across large-, mid-, and small-cap segments.

The percentage of independent directors has a weak relationship with the level of institutional ownership. Figure 7.1 shows the percentage of independent directors and gender diversity, by level of institutional ownership, defined as cumulative ownership by the top 10 intuitional shareholders in the company. Malaysian companies for which the top 10 institutional shareholders accounted for more than 30% shareholding (13 in number) had 57% independent directors on board on average, compared with 50% for companies that had less than 10% shareholding (18). The influence of institutional ownership on percentage of independent directors on boards is weaker compared with the effect of regulation. Furthermore, the board gender diversity level was not correlated with institutional ownership, as one might have expected.

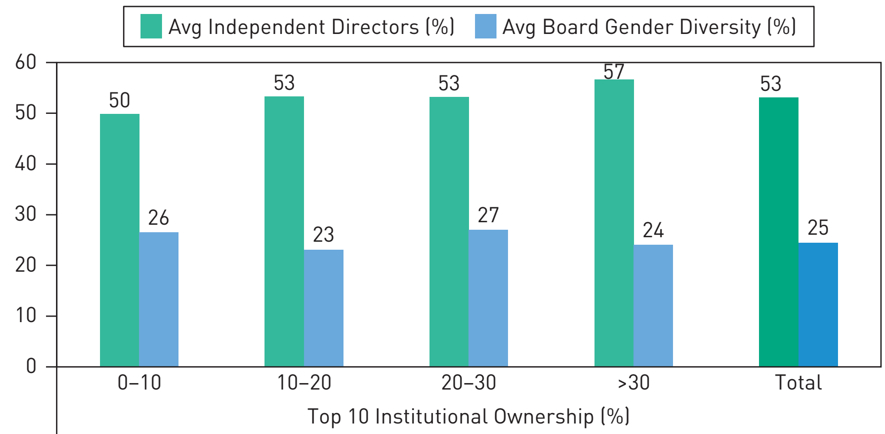
7.4.3. Representation of Independent Directors on Board Committees

The listing requirements also require the establishment of a nomination committee, audit committee, and risk committee, all of which should consist of exclusively nonexecutive

[327]FactSet data.

[328]Bursa Malaysia, Main Market Listing Requirements.

Figure 7.1. Average independent directors and board diversity by institutional ownership concentration (%)



	0–10	10–20	20–30	>30	Total
Number of companies	18	48	16	13	95

directors, the majority of whom should be independent directors. Audit committees have an additional requirement that at least one member be a qualified accountant.

The Code recommends that the chair of the audit committee not be the board chair and requires a three-year cooling-off period for a former key audit partner to join the audit committee.[329] The Code's step-up practice, applicable for Large Companies, recommend audit committees be composed entirely of independent directors and that risk management committees have at least a majority of independent directors.

According to the *Corporate Governance Monitor* (2020), two-thirds of companies had audit committees composed entirely of independent directors.[330] Market practitioners, however, have suggested that the audit committees of Malaysian boards are one area that need improvement. Some audit committees do not have the expertise to challenge management or to thoroughly review the accounts. The issue of key audit partners sitting out the

[329]The 2017 version of the Code had a cooling off period of two-years.

[330]Securities Commission Malaysia, *Corporate Governance Monitor 2020* (Kuala Lumpur: Securities Commission Malaysia, 2020), 12, https://www.sc.com.my/api/documentms/download.ashx?id=ff69ce0d-a35e-44d4-996a-c591529c56c7.

cooling-off period before joining the committee was also cited as a concern, with some suggesting a total ban on the practice.

7.4.4. Extra Requirements for Regulated Financial Institutions

Bank Negara's corporate governance guidelines[331] require written approval before a financial institution can publicly announce the proposed appointment of a director. This approval is also required before a financial institution removes an independent director and when an independent director resigns from his or her position.

Furthermore, the board chair must not be an executive and must not have served as a CEO of the financial institution in the past five years.

Bank Negara also sets out specific rules for board committees. These rules include the requirement to establish audit, nominations, risk, and remuneration committees and that each of those committees have at least three directors with a majority being independent (including the chair). They also state that a director serving on those committees should have skills and expertise relevant to the committee.

7.4.5. Related-party Transactions

According to the listing rules, companies must obtain minority shareholder approval for related-party transactions that exceed 5% for any one of the percentage ratios defined in terms of total assets, net assets, or net profits.

For related-party transactions of smaller ticket sizes, however, it is up to the independent directors to critically examine their merits. In June 2020, Leong Hup International (LHI) acquired the confectionary maker The Baker's Cottage (TBC) from Emerging Glory Sdn Bhd for RM 20 million, at a premium of 20% over TBC's net asset value. Emerging Glory is owned by the chair of LHI, which counts the chair's brothers and nephews on its board. TBC had been loss-making for the previous four consecutive years, and commentators have suggested the acquisition is a bailout in disguise because there was little justification for acquiring a loss-making business at a premium. Despite the concerns expressed in the media and by corporate governance experts, there is no evidence that the board or the independent directors were held to account.

[331]Bank Negara Malaysia, Corporate Governance.

According to the 2018 MSWG corporate governance report, only 18% of the 866 companies disclosed having a related-party transactions policy that would require the companies to conduct these transactions at arm's length, whereas 82% of the companies had no such policies, with most of the companies indicating that their related-party transactions were conducted on a "negotiated basis."[332] Another study by MSCI cited concerns on disclosures around related-party transactions, with companies presenting transaction values in aggregate without detailed information on individual counterparties, precluding a thorough analysis.[333] In the absence of such disclosures, it is difficult for investors to judge the quality and merits of these transactions, and the ability and willingness of independent directors to scrutinize related-party transactions becomes paramount.

7.5. Independent Directors

7.5.1. Appointment and Removal Process

Given the ownership context, the appointment and removal of independent executive directors (INEDs), which are driven by major shareholders, is occasionally cited as an issue. A 2016 study on the independent director appointment process, based on interviews of chairs of a small sample of 21 companies, showed that the candidate proposals came from the board of directors (66%), controlling shareholders (42%), and the CEO (33%). Only 28% of the participants said they used a head-hunter or a recruitment agency. On proposals from the board of directors, one participant remarked that "if the board prefers someone, they can always nominate and submit the name to the nomination committee. We will evaluate the strengths of the particular person in terms of his expertise and how he can add value to the company." On proposals from controlling shareholders, participants remarked that "the majority shareholders have the company's interests at heart more than any other person. They bring in independent directors so that they could help them with ideas." The participants also mentioned that nominating from the network was a faster way of recruitment compared with headhunting firms.

A majority of the participants (80%) said the final decision rests with the board, but the board tends to accept the recommendation of the nomination committee. In other cases,

[332]"Malaysia-ASEAN Corporate Governance Report 2018" (Minority Shareholders Watch Group, 2019), 18, https://mswg.org.my/sites/default/files/Asean%20CG%202018%20%28July%2022%29%20Lowres.pdf.
[333]"Corporate Governance in Malaysia" (MSCI ESG Research LLC, October 2017), https://www.arx.cfa/~/media/59E0F0BF61F64775B7BF74FE596A74C9.ashx.

the controlling shareholder makes the final decision. One participant remarked that "they do not state it explicitly, but rather we have to check with them first."[334]

Given the increasing focus on gender diversity and the establishment of organizations, such as ICDM with a mission to professionalize Malaysian boards, things are improving. But critics have wondered how independent the major-shareholder-appointed directors could be and have called for a better process for election of independent directors.[335]

7.5.2. Remuneration

The Code advises boards to "ensure that the remuneration and incentives for independent directors do not conflict with their obligation to bring objectivity and independent judgment on matters discussed at board meetings." It also cautions that there could be occasions in which an independent director may become a "dependent" director because of prolonged insular recruitment processes and attractive remuneration packages and material benefits.

In practice, the remuneration of independent directors has lagged that of executive directors. Although the concerns have come largely from the independent directors, this has been backed up by statistics. MSWG's corporate governance report showed that while the remuneration for nonexecutive directors had seen a compound annual growth rate of 8% over the past five years, it lagged the average remuneration of executive directors by a factor of 10 in 2018.[336] From our discussions, low remuneration is a particular problem for midsize companies, and as a result, they struggle to attract experienced and qualified professionals. The low remuneration must be seen in the context of increases in penalties and enforcement actions against board members, including independent directors. Fair remuneration, commensurate with responsibilities, is needed to ensure a sustainable high-quality pipeline of independent directors.

7.5.3. Tenure

The Code limits the tenure of independent directors to nine years, beyond which they are redesignated as nonexecutive directors. However, the process for retaining the

[334]S. N. Abdullah, N. H. Zainal Abidin, I. S. Abu Bakar, and A. U. Rahman, "The Appointment Process for Independent Directors in Malaysian Companies," *Corporate Ownership and Control* 14, no. 1 (2016): 519–531, http://www.virtusinterpress.org/IMG/pdf/10-22495_cocv14i1c3p12.pdf.

[335]K. Siew Li, "Independent Directors: DO Your Job Without Fear or Favour," *Edge Weekly,* 14 November 2019, https://www.theedgemarkets.com/article/cover-story-independent-directors-do-your-job-without-fear-or-favour.

[336]"Malaysia-ASEAN Corporate Governance Report 2018," 22.

independent director status for long-tenured directors has evolved. In the 2017 version of the Code, if the board wants to retain the independent director status of those who have exceeded the nine-year limit, the board must justify and obtain approval annually from the firm's shareholders. If the board continues to retain the independent director after the 12th year, the board must seek annual shareholders' approval through a two-tier voting process. In its April 2021 update, the trigger for seeking approval through a two-tier process was shortened to nine years. In addition, Bursa Malaysia plans to introduce a 12-year tenure limit without further extension for independent directors in an update of the listing requirements in the late 2021.[337]

The two-tier process gives more power to minority shareholders. Under the two-tier voting process, large shareholders and smaller shareholders vote separately. For this purpose, the large shareholder is defined as the shareholder who controls no less than 33% of the voting shares in the company, has the power to appoint or cause to be appointed the majority of directors in the company, or has the power to make major business decisions. If there is more than one large shareholder, a simple majority of votes determine the outcome of tier-one vote. Both tier-one and tier-two categories must vote in favour to allow the director to remain.

Data from the MSWG annual corporate governance scorecard[338] show that the average tenure of independent directors of top 100 companies was five years. It also found, however, that 33% of independent directors had tenures of nine years or longer. The *Corporate Governance Monitor* (2020) conducted a study on shareholder resolutions relating to independent director tenure. Of the 440 resolutions for independent directors with a tenure of 12 years or longer, 172 followed a voting method based on simple majority, whereas 268 followed the two-tier voting process. Of these 268 resolutions, 98% of the resolutions passed, with barely more than one-half of votes cast on average. Of the resolutions that passed, one-fifth were for directors with a tenure of more than 20 years. Five resolutions were defeated, with three of them redesignated as nonindependent directors, and two directors resigned from the board.

These results show that regardless of the shareholder mandate, it is hard to argue that directors with a long tenure are independent. Following the 2021 update of the Code, Bursa Malaysia plans to introduce a 12-year tenure limit without further extension for

[337]SC Updates the Malaysian Code on Corporate Governance to Promote Board Leadership and Oversight of Sustainability. April 2021. https://www.sc.com.my/resources/media/media-release/sc-updates-the-malaysian-code-on-corporate-governance-to-promote-board-leadership-and-oversight-of-sustainability.
[338]"Malaysia-ASEAN Corporate Governance Report 2018," 84.

independent directors in the listing requirements to be issued in the late 2021, which will go some way in addressing this issue.[339]

7.5.4. Training and Qualification Requirements

The listing requirements of the Bursa Malaysia state that directors of listed companies attend trainings prescribed by the exchange from time to time. It also requires boards of directors to evaluate and determine the training needs of directors. Additionally, the issuers should disclose a statement of training, which includes an assessment of training needs undertaken by the board, a description of the type of training the directors have attended for the financial year, and justifications in case a director has not attended any training during the year.[340]

The listing requirements mandate training for new directors. They are required to attend a Mandatory Accreditation Programme (MAP) organized by a body approved by the exchange. A director must complete the MAP within four months of the appointment.[341]

The SC noted that many other countries have established IoDs to support continuous professional development and drive the adoption of corporate governance best practices among issuers. The SC thus established the Institute of Corporate Directors Malaysia (ICDM) on 19 July 2017. In addition to training programs, ICDM also offers director registry and placement, as well as board and director evaluation services.

In terms of skills evaluation, the Code suggests that the board should undertake a formal and objective annual evaluation to determine the effectiveness of the board, its committees, and each individual director. The board should disclose how the assessment was carried out and its outcome. For Large Companies, the board should engage independent experts periodically to facilitate objective and candid board evaluations.

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[339]SC Updates the Malaysian Code on Corporate Governance to Promote Board Leadership and Oversight of Sustainability. April 2021. https://www.sc.com.my/resources/media/media-release/sc-updates-the-malaysian-code-on-corporate-governance-to-promote-board-leadership-and-oversight-of-sustainability.
[340]Bursa Malaysia, Listing Rules, Chapter 15: Corporate Governance (1 June 2020), https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/content_entry5ce3b50239fba2627b2864be/5ce3b5ce5b711a163beae1bd/files/MAIN_Chap15__Anti-corruption_1June2020.pdf?1590748016.
[341]Bursa Malaysia, Practice Note 5: Training for Directors (15 February 2001), https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/content_entry5ce3b50239fba2627b2864be/5ce3b7595b711a155e9506e3/files/listing_requirement_practice_note_5.pdf?1570701420.

The Code also recommends that individual directors be assessed according to their ability to challenge and ask the right questions, their confidence to stand up to a particular point of view, and their character and integrity in handling situations that involve a conflict of interest.[342]

An excellent example of director assessment is provided by Maybank which, in its annual report, provides a detailed writeup of its board evaluation, including points that it has incorporated into its improvement plan, notably on director training for business disruption and cybersecurity and on improving ESG practices and processes.

Bursa Malaysia emphasizes ongoing trainings of directors. It also imposes mandatory training as one of the remedial actions against directors for breaches pertaining to corporate governance requirements; it imposed such requirement on directors of 21 companies in 2019.[343] In September 2020, Bursa Malaysia reprimanded Asdion Bhd and its directors for violation of listing rules, including not ensuring that all its directors attend a training programme pertaining to financial statements.[344]

7.5.5. Maximum Number of Board Seats

Bursa's listing requirements[345] state that a person cannot hold more than five directorships in listed companies.

Although there are no hard caps for financial institutions, Bank Negara requires that a director must not have competing time commitments that may impair his or her ability to discharge his or her duties effectively. It requires boards to maintain a policy on the maximum number of external professional commitments that a director may have, commensurate with the responsibilities placed on the director, as well as the nature, scale, and complexity of the financial institution's operations.

Abdullah et al. (2016) found that, on average, an independent director in Malaysia holds two other directorships.[346]

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[342]Securities Commission Malaysia, *Malaysian Code of Corporate Governance* (Kuala Lumpur: Securities Commission Malaysia, 2020), pg 45, https://www.sc.com.my/api/documentms/download.ashx?id=239e5ea1-a258-4db8-a9e2-41c215bdb776.

[343]"Enforcement Statistics," Bursa Malaysia, 2020, https://www.bursamalaysia.com/regulation/about_bursa_malaysia_regulatory/enforcement/enforcement_statistics.

[344]"Asdion Directors Reprimanded by Bursa Malaysia," *Malay Mail,* 22 September 2020, https://www.malaymail.com/news/money/2020/09/22/asdion-directors-reprimanded-by-bursa-malaysia/1905628.

[345]Bursa Malaysia, Main Market Listing Requirements.

[346]Shamsul Nahar Abdullah, Nor Hafizah Zainal Abidin, Intan Suryani Abu Bakar, and Anis Ur Rahman, "The Appointment Process for Independent Directors in Malaysian Listed Companies" (Dubai Business School, University of Dubai, UAE, 2016).

7.5.6. Disclosures about Independent Directors in Corporate Announcements

Disclosures from large listed companies in Malaysia on independent directors tend to be highly detailed and typically are done through releases to the stock exchange, annual reports, and company websites. In addition, the listing rule mandates the disclosure of directors' remuneration on a named basis.

An example is the 2018 announcement of the appointment of a new chair for CIMB Group, a financial conglomerate. The company's release highlights that the new chair was previously the senior independent director and outlines his professional qualifications and background as well as his other board roles.

The CIMB Group website and annual report also give extensive detail on directors, highlighting whether or not they are considered independent and setting out their professional experience, qualifications, and tenure on the board. As an example, CIMB notes that one of its directors is the former deputy CEO and is not considered independent. The annual report also lists committee membership and attendance at board and committee meetings.

The SC's 2019 *Corporate Governance Monitor* highlights that one of the key tenets of the Comprehend, Apply, and Report (CARE) approach espoused by the MCCG is the need to provide reliable and meaningful disclosure on the company's corporate governance practices. Companies should put themselves in the shoes of the users of this information and ensure that the disclosure provides the explanation, discussion and data (where relevant) required for users to understand and assess the company's corporate governance practices. Disclosure which promotes real transparency is a pivotal feature of market-based monitoring of companies, and critical to enable shareholders to exercise their rights on an informed basis. Disclosure can also be a powerful tool for influencing the behaviour of companies and protecting investors.[347]

7.6. Effectiveness of Independent Board Directors

CFA Institute is firmly of the view that it is important to have a majority of independent directors on a board, but it is also key that those directors actually are able to question management and raise issues and concerns independently of management. This requires

[347]Securities Commission Malaysia, *Corporate Governance Monitor 2019*, 16, https://www.sc.com.my/api/documentms/download.ashx?id=98f99389-e438-4546-85e4-754717fa56ed.

both access to information and the necessary skillsets to understand the industry and operations of the company.

Market practitioners have suggested that only a small proportion of independent directors are actively using their independence to question and challenge management. Many are swayed by a strong chair or CEO. They also suffer from a cultural unwillingness to challenge senior board members, particularly in cases in which these more senior directors are "titled" (such as Tan Sri or Dato).

Market practitioners also suggested that it is difficult to assess the effectiveness of boards or the dynamics of boards in their interactions with the CEO or senior management. Not only is there information asymmetry, but information could be withheld from the board, even if the board members ask the right questions.

7.6.1. Are Independent Directors Truly Independent?

The Corporate Governance Guidelines published by Bursa Malaysia trace the causes that commonly hinder independent directors from acting independently to four practical barriers:

1. Personal authority: Individual directors, particularly managing directors might display high handed leadership style and view any challenge as causing offense or a trait of disloyalty.

2. Positional authority: The positions of managing directors are vested with high degree of power and in the absence of balancing factors their views not to be challenged.

3. Information asymmetry: Independent directors' lack of detailed understanding of the business can deprive them of the confidence to challenge management and evaluate their responses.

4. Cultural environment: The emphasis placed on harmony makes it difficult for independent directors to express a divergent point of view.

In addition to cultural and behavioural factors, the challenges to board independence also need to be seen in the context of ownership structures.

7.6.2. Ownership Structure and the Impact on Board Independence and Oversight

Malaysia has a very high level of public ownership and ownership by controlling shareholders, frequently through crossholding between companies. According to the OECD, the market cap–weighted public sector ownership was 40%, the highest of the markets examined in this report, whereas private corporations and individuals accounted for another 29%.[348] The latter figure masks the extent of control wielded by private corporations as controlling shareholders. In more than 50% of the Malaysian companies, another private corporation was the dominant shareholder, with an average holding of more than 40%.

7.6.2.1. Corporate Holdings and Crossholdings

Many conglomerates in Malaysia tend to appoint the same independent directors to the boards of multiple listed companies within the group. For example, one independent director of Berjaya Group is also an independent director of Berjaya Land, a listed subsidiary with 77% ownership by its parent company. The independent chair of Genting Plantations, a listed subsidiary with 55% stake held by Genting Berhad, is also an independent director in Genting Malaysia, another listed subsidiary with 49.5% stake held by the parent.

The governance issues for listed companies within a larger listed groups and crossholdings are different and more complex than those with simpler structures. When group companies have common independent directors but different sets of minority shareholders, it inevitably gives rise to conflicts of interest issues. This is particularly pertinent in the area of related-party transactions, in which the same independent director could be on both sides of the transaction. Bursa Malaysia's corporate governance guide notes that directorships in multiple entities within the group potentially may create undue dependence in terms of remuneration received by independent directors, thus raising concerns on the objectivity of these directors.[349]

Current regulations not only allow common independent directors between a listed parent and its listed subsidiary but also allow a nonexecutive director of an unlisted subsidiary to be appointed as the independent director of the listed parent. This potentially could give

[348]De La Cruz, Medina, and Tang, "Owners of the World's Listed Companies," 39.

[349]"Presence of Independent Directors on the Board," in *Corporate Governance Guide* (Bursa Malaysia), pullout 1, https://bursa-malaysia.s3.amazonaws.com/reports/Pullout-I-13-Practice-4-1.pdf.

raise to sharper conflicts of interest, especially if the subsidiary has minority shareholders whose interest may diverge from the shareholders of the parent. Even where the subsidiary is wholly-owned, conflicts of interest may still arise, for example, in relation to the treatment of creditors and employee compensation arrangements.[350]

In July 2020, the SC released its guidelines for conduct of directors in listed companies and its subsidiaries, encouraging companies to establish policies and procedures to manage potential conflict-of-interest situations between a director and the listed company, and the listed company and its subsidiary.[351]

Given the prevalence of complex ownership structures, there are gaps in ownership disclosures. OECD's report on company groups shows that although there are mandatory disclosure requirements for group structures, major shareholding, and beneficial ownership, it does not require mandatory disclosure of shareholder agreements and cross-holdings, unlike several other emerging markets such as India, Russia, and Mexico.[352] Without these disclosures, it is hard for shareholders to understand the incentives of boards and independent directors, some of whom are common across different but related entities.

7.6.2.2. Public Sector Ownership

Government is the single largest shareholder in many Malaysian-listed companies. Directors with public sector backgrounds also dominate the boards of Malaysian companies. According to research by RHL Ventures published in 2019, 18% of all directors in the top 100 Malaysian companies had a public sector experience, with most of them having previously worked at the Ministry of International Trade and Industry.[353] Among the directors with private sector experience, the most common background is Petronas, a government-linked company (GLC).

[350] Bursa Malaysia, Appendix 2: Q&A New Issue of Securities and Other Amendments (13 August 2020), https://www.bursamalaysia.com/sites/5bb54be15f36ca0af339077a/content_entry5ce3b5005b711a1764454c1a/5f352ad039fba2739b6d9a5b/files/App2_MainFAQ_13Aug2020.pdf?1597319993.

[351] Securities Commission Malaysia, "Guidelines on Conduct of Directors of Listed Corporations and Their Subsidiaries," SC-GL/4-2020 (Securities Commission Malaysia, Kuala Lumpur, July 2020), https://www.sc.com.my/api/documentms/download.ashx?id=89757255-2711-4cff-bbe2-71d4346f5197.

[352] "Duties and Responsibilities of Boards in Company Groups," OECDiLibrary, June 2020, https://www.oecd-ilibrary.org/sites/55ea4b91-en/index.html?itemId=/content/component/55ea4b91-en#back-endnotea0z18.

[353] RHL Ventures, "Detailed Analysis on Malaysia's Top 100 Companies Board Composition."

The political appointments in GLCs have raised conflict-of-interest concerns in recent times.[354] For example, in August 2020, the appointment of an independent director in an oil company sparked concerns, because the person not only had political ties in the region but also shareholding in a company that was trying to secure a contract from the company in that region.

In response to these concerns, the 2021 update of the Code discourages listed companies from having an active politician on their boards, which is an important step in improving professionalism.

7.7. Separation of the Roles of Chair and CEO

The MCCG best practice guidelines note that "separation of the positions of the chair and CEO promotes accountability and facilitates division of responsibilities between them. In this regard, no one individual can influence board's discussions and decision-making."[355]

According to the 2018 MSWG corporate governance report, among 866 publicly listed Malaysian companies, 84% had separation of chair and CEO but only 47% had an independent chair. Companies that do not have an independent chair are recommended to appoint a lead independent director who could act as a liaison between the board and its stakeholders. Only one-quarter of companies (221 out of 866 companies), however, had appointed a lead independent director with a clearly defined role.

More recent CFA Institute research[356] found that 97% of 98 listed companies in Malaysia have a separation of the roles of chair and CEO. This applies equally across both smaller and larger companies.

7.7.1. Independence of Chair

The MCCG recommends an independent chair, if the board chair is not independent, it states that the majority of the board members should be independent.

[354]"Risks, Conflicts Raised in Political Appointments to GLCs," Focus Malaysia, 27 May 2020, https://focusmalaysia.my/mainstream/risks-conflicts-raised-in-political-appointments-to-glcs/.
[355]Securities Commission Malaysia, *Malaysian Code of Corporate Governance* (Kuala Lumpur: Securities Commission Malaysia, 2020), 35–36, https://www.sc.com.my/api/documentms/download.ashx?id=70a5568b-1937-4d2b-8cbf-3aefed112c0a.
[356]CFA Institute calculations based on FactSet data as of August 2020.

One of Malaysia's largest companies, Tenaga Nasional, does separate the role of chair and CEO. The chair, however, is not an independent director and has been on the board for 15 years (well beyond the nine-year limit recommended in the MCCG).

Among prominent family conglomerates, all but one have either a professional CEO or chair, with little family presence in the board. These conglomerates also have a majority of independent directors on their board, in line with MCCG recommendations. YTL is the only case with both family leadership and weak presence of independent directors in its boards. (See Table 7.2)

7.8. Board Diversity

The right board composition will ensure sufficient diversity and independence to avert "groupthink" or "blind spots" in the decision-making process. It also enables the board to be better equipped to respond to challenges that may arise and deliver value.

The Code recommends that companies disclose in their annual report the company's policies on gender diversity, as well as its targets and measures to meet those targets. The 2017

Table 7.2. Family conglomerates in Malaysia

Company	Family	CEO	Chair	Number of family directors
Hong Leong Financial	Kwek / Quek	External	Quek Leng Chan	1
Hong Leong Bank		External	Quek Leng Chan	2
IOI	Lee	Lee Yeow Chor	External	2
IOI Properties		External	External	3
Genting	Lim	Lim Kok Thay	Lim Kok Thay	2
Genting Malaysia		External	Lim Kok Thay	2
Genting Plantations		External	External	1
YTL	Yeoh	Yeoh Sock Kian	Yeoh Sock Ping	7
YTL Power		Yeoh Sock Hong	Yeoh Sock Ping	7

Source: Company websites; data as of September 2020.

version of the Code recommends that Large Companies must have at least 30% women directors. In 2021, this recommendation was expanded to all companies.

Malaysian boards had the second-highest proportion of women directors (24.4%) among the six countries we analysed in this report, behind only Australia (29.6%) according to our calculations.[357] The *Corporate Governance Monitor* (2020) notes that the Code's guideline on gender diversity is one of the areas with significant improvement in adoption, with a year-on-year increase of 9% in the number of companies with formal gender diversity targets.

Unlike approaches to gender diversity that have been seen in some other markets, Malaysia has not just adopted a box-ticking approach. Bank Negara has strictly enforced the qualification and experience requirements for female directors in the finance sector, and targets are being met.

7.9. Conclusions

Malaysia has made significant strides in corporate governance in recent years, with the introduction of MCCG with an apply-or-explain alternative, a greater focus on outcomes, and practical application and guidance to companies. The SC also monitors the implementation of the Code through an annual corporate governance monitor. It complements this oversight with enforcement against both companies as well as their independent directors for corporate governance violations. The actions include fines and mandatory training, among others.

Significant issues remain, however. The relative opacity in ownership of company groups, the deficiencies in related-party transaction disclosures, and the high incidence of directors with public sector backgrounds, combined with increasing concerns about public governance post-1MDB scandal have heightened the risks of regulatory capture, rent-seeking, and corruption.

7.9.1. Recommendations

In this context, the need for strong independent directors to protect minority shareholders has never been greater. Although Malaysia has one of the highest number of independent directors, how they assert their independence in the presence of strong CEOs and in a culture that values harmony matters.

[357]FactSet data based on 98 Malaysian companies with at least $500 million in market cap as of June 2020.

Regulators:

- Continue to improve ownership disclosures in group companies so investors understand the motivations of independent directors and potential conflicts of interest.
- Mandate improvements in related-party transactions disclosures.

Companies:

- Carefully examine the backgrounds of independent directors, and evaluate their independence in fact and appearance, and whether the appointments would increase shareholder trust in companies.
- Continue to provide ongoing trainings for independent directors, with a focus in the area of scrutinizing related-party transactions.
- Strengthen board independence by having an independent chair.
- Create a culture of inclusion and allow independent directors to perform their jobs effectively.

7.10. Case Study: Tenaga Nasional

Tenaga is one of Malaysia's largest listed companies. It exemplifies some of the good and not-so-good corporate governance practices in Malaysia.

The company's annual report gives excellent detailed information on the members of the board of directors. It lists clearly whether or not directors are considered independent. Details of their professional qualifications and background are listed. Board tenure is also clearly stated. The board has a majority of independent directors (6 out of 11), which is in line with good corporate governance practice. The key board committees of risk, audit, and nomination and remuneration are all chaired by independent directors. One independent director who was a long-term employee of the company, however, joined the board after retirement as a nonindependent director and was redesignated as an independent director in 2020 (presumably after the cooling-off period). Another independent director was a partner at the audit firm that performs the company audits.

The role of chair and CEO are separated, but the chair is not an independent director and has been on the board for 15 years (well beyond the nine year limit recommended in the

MCCG). The chair is appointed by the government in its role as the special shareholder of Tenaga. Similarly, four of the five nonindependent directors are appointed by either the Ministry of Finance or Khazanah Nasional Berhad, the Malaysian sovereign wealth fund and major shareholder of Tenaga. The government as "special shareholder" has the right under the company's articles of association to appoint up to six directors to the board.

7.11. Case Study: Sunway Group

Sunway Group is a family-owned conglomerate firm with interests in construction, education, hospitality, and healthcare. Sunway Group and Sunway Construction won two corporate governance awards at the Minority Shareholders Watch Group (MSWG) ASEAN Corporate Governance Awards 2019. Both companies were among the top 30 companies with best corporate governance disclosures out of a total of 866 public-listed companies in Malaysia assessed by MSWG in 2019.

Market practitioners have highlighted the improvement in Sunway's corporate governance over the years. Sunway Group has a nonindependent founding chair. It has a majority of independent directors, and a senior independent director in line with best practices. The company departs from the corporate governance code in a few areas—such as board gender diversity target of 30% and board evaluation using independent outside experts (rather than nomination committee evaluation). It also allows shareholders to participate remotely and permits voting in absentia. In these areas, the company reported that it is in the process of complying with best practices within a specific time frame.

8. Singapore

8.1. Executive Summary

Singapore operates a single-tier board system. Listing rules require companies to have a minimum of two independent directors.[358] The Corporate Governance Code (CG Code) requires, on a comply-or-explain basis, that independent directors constitute at least one-third of the board of a listed company. This provision will become a mandatory listing rule in January 2022.[359]

According to the Companies Act, at least one director on a company board must be a Singapore citizen or a permanent resident.[360] Listing rules also require that companies must ensure that director appointments meet a set of fit-and-proper criteria. The central bank and financial regulator, the Monetary Authority of Singapore (MAS) defines a fit-and-proper person as competent, honest, demonstrating integrity, and of sound financial standing.[361] Directors must also meet minimum standards for professional experience and education.

The listing rules require companies to establish committees necessary to perform the functions of a nominating committee, audit committee, and remuneration committee. Banks and insurers are required to also have a risk committee; for other companies, however, it is suggested under the CG Code but not mandated.

The separation of the roles of chair and CEO is not mandatory for listed companies. If the roles are not separated or if the chair is nonindependent, then companies are required to have a majority of independent directors on the board and to name a lead independent director. [362]

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[358]"Corporate Governance and Directors' Duties in Singapore: Overview," Thomson Reuters Practical Law, 2021, https://uk.practicallaw.thomsonreuters.com/9-502-3233?transitionType=Default&contextData=(sc.Default)&firstPage=true#co_anchor_a396446.

[359]Monetary Authority of Singapore, Code of Corporate Governance (CG Code), 6 August 2018, Provision 2.2, Footnote 7, https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulatory-and-Supervisory-Framework/Corporate-Governance-of-Listed-Companies/Code-of-Corporate-Governance-6-Aug-2018.pdf.

[360]Companies Act 145(1) (2 April 2021), https://sso.agc.gov.sg/Act/CoA1967?ProvIds=P1V-#pr145-.

[361]"Guidelines on Fit and Proper Criteria" (Monetary Authority of Singapore, February 2020).

[362]CG Code, Provision 2.2 and 3.3.

8.2. Introduction

The regulatory framework of corporate governance for publicly listed companies in Singapore stems from a number of sources, including corporate governance rules, principles, and recommended practices, administered by several regulatory bodies.

The primary sources are the Companies Act, stock exchange listing rules, and the CG Code. The CG Code has gone through various amendments over the years and is currently issued by the MAS. Although stock exchange listing rules are mandatory for listed companies, the CG Code operates on a comply-or-explain basis. Principles for good corporate governance and provisions that underpin those principles are set out in the CG Code. Companies are expected to comply with the provisions and any deviations from the provisions are acceptable to the extent companies explicitly explain how their practices are consistent with the aim of the principle in question.[363]

8.3. Overview of the Regulatory Landscape

The Companies Act regulates corporate entities and has undergone multiple amendments over the years since it was enacted in 1967 to reflect Singapore's evolving business environment. Amendments typically were made after public consultation administered by Singapore's corporate regulator, the Accounting and Corporate Regulatory Authority (ACRA). The Companies Act applies to all companies incorporated in Singapore and regulates aspects of companies from incorporation, corporate structure, and role and responsibilities of directors and management to winding up.

Singapore implemented its CG Code on a comply-or-explain basis in 2001. When Singapore's Council on Corporate Disclosure and Governance proposed a revised CG Code in July 2005, the issue to include independence from significant shareholders was brought up but explicitly rejected.[364] It was not until a later version of the CG Code in 2015, that its definition of independence was expanded to require independence from both management and significant shareholders.

In February 2017, the Corporate Governance Council (Council) was established to conduct a comprehensive review of the CG Code and to make recommendations relating to

[363]CG Code.

[364]"Consultation Paper: Proposed Revisions to the Code of Corporate Governance" (The Council on Corporate Disclosure and Governance, Singapore, December 2004).

Table 8.1. Corporate governance rules and regulations in Singapore

Governing body	Applicable to	Legislation / Regulation / Code	Level of requirement
Accounting and Corporate Regulatory Authority (ACRA)	All listed and unlisted companies	Companies Act	Mandatory
Monetary Authority of Singapore (MAS) and Singapore Stock Exchange (SGX)	Listed companies	Corporate Governance Code	Comply or Explain
Monetary Authority of Singapore (MAS)	Financial institutions	Guidelines on Corporate Governance	Comply or Explain

boards and independent directors.[365] To strengthen director independence, the Council recommended a reduction in the shareholding threshold for associations from 10% to 5% and introduced a nine-year tenure rule for independent directors and a two-tier shareholders' vote (by all shareholders and then all shareholders excluding directors or CEO and associates). The Council also recommended measures to enhance board composition and diversity, demanding that at least one-third of the board be independent; that the majority of the board be composed of independent directors if the chair is nonindependent; and that a board diversity policy and progress be disclosed.

In August 2018, the Council submitted its recommendations to the MAS. The MAS accepted all of the recommendations and issued a revised CG Code and accompanying Practice Guidance.[366]

On 12 February 2019, MAS established the Corporate Governance Advisory Committee (CGAC) as a permanent, industry-led body to advocate good corporate governance practices among listed companies in Singapore. The CGAC is tasked with identifying current and potential risks to the quality of corporate governance in Singapore and monitoring international trends. The CGAC is also mandated to review and revise the Practice Guidance to clarify the CG Code from time to time and to recommend updates to the CG Code.

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[365] Corporate Governance Council, "Recommendations to Enhance Corporate Governance in Singapore," https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulations-Guidance-and-Licensing/InfographicCorporateGovernanceCouncilsrecommendationstoenhancecorporategovernanceinSingapore.pdf?la=en&hash=208819C0D06D20CDF7A4E2439202205FAA22599E.

[366] Monetary Authority of Singapore, Code of Corporate Governance, 6 August 2018, https://www.mas.gov.sg/regulation/codes/code-of-corporate-governance.

8.3.1. Independent Director Definition

The CG Code describes an independent director as one who is independent in conduct, character, and judgement and has no relationship with the company, its related corporations, its substantial shareholders (shareholder owning more than 5% of company shares), or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement in the best interests of the company.[367] Also, the CG Code states that the nominating committee of the board should determine at least annually if a director is actually independent, taking into account any relationships with the company.[368]

8.3.2. Need for Improved Practices

Two recent cases have highlighted the need for continuing efforts to improve corporate governance practices and to strengthen the role of independent directors.

In January 2018, Noble Group, a commodity trader, issued a restructuring proposal, which included a debt-for-equity swap, to deal with its high debt. The proposal outraged minority shareholders, whose stake would be diluted to only 10% of the new entity, whereas senior management would be allocated 20%.[369] At the time, the company's board was criticized for lack of independence and inability to safeguard shareholders' interest.[370] The management blocked efforts by a major stakeholder, Goldilocks Investment, to appoint more independent directors and discontinued the role of the lead independent director. Following a lawsuit, Noble resolved the dispute by improving its offer to existing shareholders and allowing Goldilocks to nominate a director to the board.

In May 2018, Hyflux, a water treatment company, filed for bankruptcy protection after reporting an unexpected large net loss for the previous year. An investigation by MAS and Singapore Exchange Regulation uncovered lapses in disclosures and noncompliance with accounting standards. Analysts pointed out lapses in corporate governance at the company, related to its independent directors. Some had very long tenures, others were former employees who had satisfied the three-year cooling-off requirement, and still

[367]CG Code, Provision 2.1.
[368]CG Code, Provision 4.4.
[369]"CG Watch 2018: Hard Decisions."
[370]Mak Yuen Teen, "Will New Noble Be More of the Same?" *The Business Times*, 21 March 2018, https://governanceforstakeholders.com/2018/03/21/will-new-noble-be-more-of-the-same/.

others did not bring in relevant skills or chaired committees that were not the best match for their expertise. Moreover, independent directors received share options even in the year when the company suffered the big loss.[371]

8.3.3. Requirements for Financial Institutions

In Singapore, regulations for banks are more stringent. Unlike the CG Code, the regulations for banks are enforceable under law and failure to comply can result in a fine or conviction.[372] Under the Banking Act, banks must seek approval from the MAS before appointing anyone as a director.[373]

8.3.4. Companies with a Controlling Shareholder

Singapore has a large number of family-controlled firms. A 2013 study by Dielman et al.[374] noted that up to 60.8% of publicly listed companies could be classified as family firms. In these firms, 78.6% of CEOs and 72.9% of chairs were family members. In 42.8% of family firms, the positions of CEO and chair are combined; in contrast, only 17.0% of non-family firms combine the positions of CEO and chair. The study revealed that the average tenure of family member directors in family firms was 15.7 years (for nonfounding directors) to 20.7 years (for founding directors) as compared with 7.5 years for non-family-member directors.

To help guide family businesses, Singapore introduced a "Stewardship Principles for Family Businesses" in October 2018.[375] According to Puchniak and Tang, Singapore is the first country in the world to introduce a family stewardship code.[376] The family stewardship code is a set of seven principles that aims to "articulate the mindset and attitudes,

[371]Mak Yuen Teen, "Hyflux Is Worth Trying to Save," *Governance for Stakeholders*, 25 May 2018, https://governanceforstakeholders.com/2018/05/25/hyflux-is-worth-trying-to-save/.

[372]Orsagh, "Shareholder Rights Across the Markets."

[373]Banking Act (2 April 2021), Section 53, https://sso.agc.gov.sg/Act/BA1970?ProvIds=P1VII-#pr53A-.

[374]M. Dieleman, J. Shim, and M. Ibrahim, "Success and Succession: A Study of SGX-Listed Family Firms" (National University of Singapore, Centre for Governance, Institutions and Organisations, Singapore, 2013), https://bschool.nus.edu.sg/cgio/wp-content/uploads/sites/7/2018/10/Success-and-Succession-2013.pdf.

[375]"Stewardship Asia Centre Publishes 'Stewardship Principles for Family Businesses'" (press release, Stewardship Asia, October 2018), https://www.stewardshipasia.com.sg/sites/default/files/2020-09/SAC%20Publishes%20SPFB%20Press%20Release%2002-10-2018.pdf.

[376]Dan Puchniak and Samantha Tang, "Singapore's Puzzling Embrace of Shareholder Stewardship: A Successful Secret," *Vanderbilt Journal of Transnational Law* 53 (2019): 989–1021, https://b6840033-54a4-44a7-acca-23e4b7815763.usrfiles.com/ugd/b68400_8bf1f13b3708493e91ef0dc91dbe6147.pdf.

as well as the behaviours and practices that would foster the success, significance and sustainability for family businesses."[377] As noted by Puchniak and Tang, the importance of the family stewardship code "is underscored by the significant incentives that family-controlling shareholders have to act as 'stewards' of their companies by monitoring and directly intervening in the company's management to promote the long-term success of the family business."[378]

The other factor about Singapore is the role of government as a shareholder. Sim[379] notes that the government, through its holding company Temasek Holdings Pte Ltd. (Temasek), is the controlling shareholder in many of Singapore's largest listed companies. Temasek has approximately S$74 billion (US$55 billion) invested in Singapore and has significant holdings in several local companies, including 52% of Singapore Telecommunications, 40% of Capital Land, 56% of Singapore Airlines, and 29% of DBS Group.[380] The Ministry for Finance (MOF) has the right to appoint, reappoint, or remove board members in Temasek. This is subject, however, to the Singapore president's agreement.[381]

The policy of the MOF is not to interfere in the corporate affairs of government-linked companies, and legislation is in place to ensure that the government does not have undue influence over them. As such, no one connected with the government would likely qualify as a "directly associated" person provided in the independence definition.[382]

Temasek's disclosure and transparency on governance structure, operations, and returns has earned it the highest possible ranking of 10/10 among sovereign wealth funds by the Linaburg-Maduell Transparency Index.[383]

[377]"Stewardship Asia Centre Publishes 'Stewardship Principles for Family Businesses'."
[378]Puchniak and Tang, "Singapore's Puzzling Embrace of Shareholder Stewardship."
[379]I. Sim, S. Thomson, and G. Yeong, "The State as Shareholder: The Case of Singapore" (National University of Singapore, Centre for Governance, Institutions and Organisations, Singapore, 2014), https://www.cimaglobal.com/Documents/Our%20locations%20docs/Malaysia/Centre%20of%20Excellence/NUS%20-%20The%20State%20as%20Shareholder%20-%20compressed.pdf.
[380]See Temasek, "Our Portfolio" (data as of 31 March 2020), https://www.temasek.com.sg/en/what-we-do/our-portfolio.
[381]Sim, Thomson, and Yeong, "The State as Shareholder."
[382]Dan Puchniak, Harold Baum, and Luke Nottage, ed., *Independent Directors in Asia* (Cambridge: Cambridge University Press, International Corporate Law and Financial Market Regulation, 2017), 343.
[383]Carl Linaburg and Michael Maduell, "Linaburg-Maduell Transparency Index" (LMTI) (Sovereign Wealth Fund Institute, 2020), https://www.swfinstitute.org/research/linaburg-maduell-transparency-index.

8.4. Board Structure and Composition

8.4.1. Board Size

There is no legal cap as to the number of board directors a listed company may have. The Companies Act requires that companies have at least one director who is a Singapore resident.

The CG Code currently provides for a comply-or-explain requirement that at least one-third of the board be made up of independent directors, and this provision will be upgraded to a mandatory listing rule effective January 2022.[384] The CG Code also provides for a comply-or-explain requirement for independent directors to make up a majority of the board in cases in which the chair is nonindependent.

8.4.2. Representation of Independent Directors on Boards

Research by the National University of Singapore Business School found that almost all (99.1%) of the companies they surveyed had boards with at least one-third independent directors in 2019 and that 69% of the companies had boards with 50% to 74% independent directors, as set out in figure 8.1.[385]

8.4.3. Representation of Independent Directors on Board Committees

The listing rules require companies to establish committees[386] necessary to form the functions of a nominating committee, audit committee, and remuneration committee.[387] Each committee should have written terms of reference that clearly set out its authority and duties. The CG Code sets out the provisions for these committees.

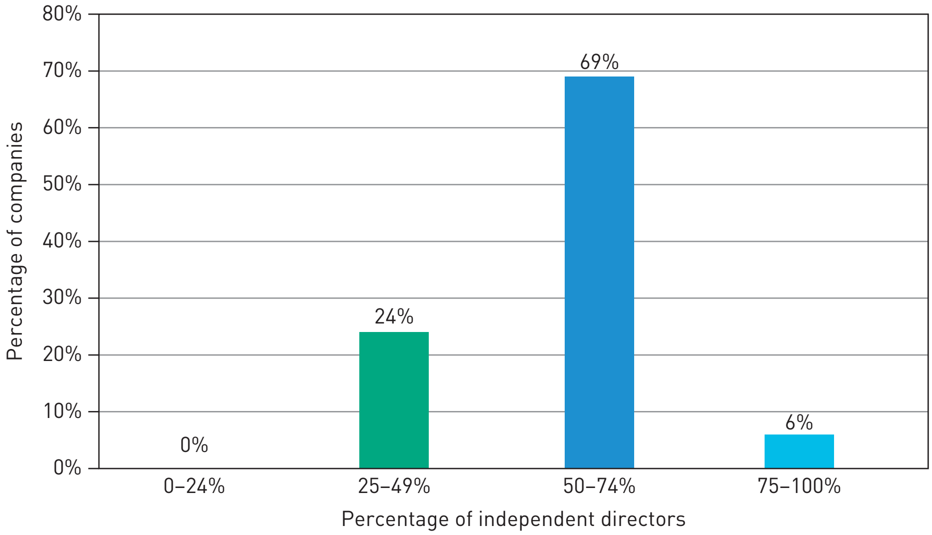
[384] CG Code, Provision 2.2 Footnote 7.

[385] Lawrench Loh and Zecharias Chee, "Corporate Governance Highlights 2019" (National University of Singapore Business School, Singapore, December 2019), https://bschool.nus.edu.sg/cgio/wp-content/uploads/sites/7/2020/04/CGIO_SGTI-Corporate-Governance-Highlights-2019.pdf.

[386] Lawrench Loh and Zecharias Chee, "Corporate Governance Highlights 2019" (National University of Singapore Business School, Singapore, December 2019), https://bschool.nus.edu.sg/cgio/wp-content/uploads/sites/7/2020/04/CGIO_SGTI-Corporate-Governance-Highlights-2019.pdf.

[387] See SGX Listing Rule 210(5)(e).

Figure 8.1 Percentage of independent directors on company boards, 2019



Source: NUS Business School, Corporate Governance Highlights, 2019.

8.4.3.1. Nominating Committee

The nominating committee is responsible for establishing a formal and transparent process for the appointment and reappointments of directors. The nominating committee includes at least three members, a majority of whom, including the chair, are independent directors. The lead independent director, if any, is a member of the nominating committee.[388]

8.4.3.2. Audit Committee

The audit committee is responsible for oversight and review of functions, such as financial reporting, internal controls, and risk management systems, and appointment and removal of external auditors.[389] The audit committee includes at least three directors, all of whom are nonexecutive and the majority of whom, including the chair, are independent. At least two members, including the audit committee chair, have recent and relevant accounting

[388] CG Code, Provision 4.2.
[389] CG Code, Provision 10.1.

or related financial management expertise or experience.[390] Former partners or directors of the company's auditors within the past two years are prohibited from being on the audit committee as well as those who still have a financial interest in the company's auditors.[391]

8.4.3.3. Remuneration Committee

The remuneration committee reviews and makes recommendations to the board on remuneration packages for directors and key management personnel. The remuneration committee includes at least three directors, all of whom are nonexecutive directors and the majority of whom, including the chair, are independent.[392]

8.5. Independent Directors

8.5.1. Independent Director Nomination and Removal

In Singapore, the process for the selection, appointment, and reappointment of directors should consider the composition and progressive renewal of the board, as well as each director's competencies, commitment, contribution, and performance (e.g., attendance, preparedness, participation, and candour), including, if applicable, his or her performance as an independent director.[393]

The election and removal of directors is by ordinary resolution, which means that 50% or more of shareholders must vote in favour. The listing rules require key information on directors to be provided with each resolution on the proposed appointment and reappointment of directors.[394] The practice guidelines suggest that companies should provide sufficient information on the background of directors, their contributions to the company, and the board and committee positions they are expected to hold upon election.[395]

Moreover, to facilitate shareholders' understanding of its nomination process, the board should disclose the channels used in searching for appropriate candidates, whether

[390] CG Code, Provision 10.2.
[391] CG Code, Provision 10.3.
[392] CG Code, Provisions 6.1 and 6.2.
[393] "Practice Guidance" (Monetary Authority of Singapore, February 2020), https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Practice-Guidance-Feb-2020v2.pdf?la=en&hash=ACB56F927EE43E2F44B942EA7226B466606FA76C.
[394] Rule 720(6) of the SGX Listing Rules.
[395] "Practice Guidance."

through search services or personal networks. It should also disclose the criteria used to identify and evaluate potential new directors, including whether only relevant experience and skillsets to the company's business are considered, or whether broader search criteria, such as diversity and technological expertise also are included.

When a company proposes a resolution to remove a director, the Companies Act allows that director to provide a written defence that must be circulated to all shareholders and also gives him or her the right to speak at the meeting before the resolution is voted on.[396]

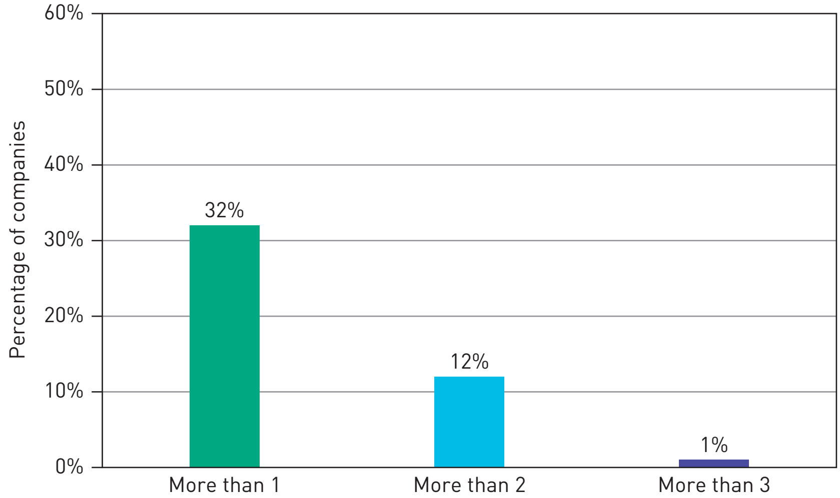
8.5.2. Tenure

The CG Code states that the board should have a formal and transparent process for the appointment and reappointment of directors, taking into account the need for progressive renewal of the board.[397]

During the 2018 public consultation on the proposals by the Corporate Governance Council for revisions to the CG Code, the Council noted that almost 30% of independent directors of listed companies had served for more than nine years, some of whom had served for more than 30 or 40 years, raising concerns of their independence. Two proposals were put forth to either set a hard limit of nine years for an independent director or to introduce a requirement of a two-tier vote on any independent director who wished to serve more than nine years.[398] In the end, the two-tier vote, perceived as less stringent, prevailed. The rationale was that the two-tier vote provides companies with flexibility to retain quality independent directors beyond nine-years, empowers shareholders to assess the independence of long-tenured independent directors and encourages active engagement.[399]

[396] Companies Act, Section 152.
[397] CG Code, Principle 4.
[398] "Consultation Paper: Recommendations of the Corporate Governance Council," P002-2018 (Monetary Authority of Singapore, Singapore, January 2018), https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulatory-and-Supervisory-Framework/Corporate-Governance-of-Listed-Companies/Consultation-2018-Jan-16/Consultation-paper-on-Corporate-Governance-Councils-recommendations.pdf.
[399] "Response to Feedback Received: Recommendations of the Corporate Governance Council" (Monetary Authority of Singapore, Singapore, August 2018), https://www.mas.gov.sg/-/media/MAS/Regulations-and-Financial-Stability/Regulatory-and-Supervisory-Framework/Corporate-Governance-of-Listed-Companies/Consultation-2018-Jan-16/Response-to-consult/Response-paper-on-Councils-recommendations.pdf.

Figure 8.2. Independent directors serving more than nine years



Source: NUS Business School, Corporate Governance Highlights, 2019.[400]

Accordingly, under the two-tier vote, a director who has been on the board for more than nine years can continue to be considered independent only if approved by the majority of all shareholders and by the majority of all shareholders after excluding those who also serve as directors or CEO of the company and their associates.[401]

The Corporate Governance Highlights 2019 report found that 32% of the companies had more than one independent director serving more than nine years, 12% of the companies had more than two independent directors serving more than nine years, and 1% of the companies had more than three independent directors serving more than nine years.[402]

[400]Lawrench Loh and Zecharias Chee, "Corporate Governance Highlights 2019" (National University of Singapore Business School, Singapore, December 2019), https://bschool.nus.edu.sg/cgio/wp-content/uploads/sites/7/2020/04/CGIO_SGTI-Corporate-Governance-Highlights-2019.pdf.
[401]"Practice Guidance, Practice Guidance 2: Board Composition and Guidance" (Monetary Authority of Singapore, February 2020), https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Practice-Guidance-Feb-2020v2.pdf?la=en&hash=ACB56F927EE43E2F44B942EA7226B466606FA76C.
[402]See Loh and Chee, "Corporate Governance Highlights 2019."

8.5.3. Training and Qualification Requirements

The CG Code contains broad recommendations for educational standards and professional experience for directors. It requires that the board and board committees be composed of directors who as a group provide the appropriate balance and mix of skills, knowledge, experience, and other aspects of diversity, such as gender and age, to avoid groupthink and to foster constructive debate.[403] It also requires boards to undertake a formal annual assessment of the effectiveness of the board as a whole as well as of each of its board committees and individual directors.[404]

The Corporate Governance Highlights 2019 report found that 81% of companies disclosed their process for board appraisal in 2019. Companies were more willing to disclose their criteria for board appraisals (87%) than to do so for individual director appraisals (49%).[405]

On training, the listing rules require any director who has had no prior experience as a director of a listed company to undergo training in the roles and responsibilities of a listed company director.[406] The CG Code also provides that the induction, training, and development provided to new and existing directors be disclosed in the annual report.[407]

In Singapore, various organizations offer courses for directors, such as the Singapore Institute of Directors and the Singapore Management University. The courses cover topics such as the role of directors, corporate governance, succession planning, and compensation. ACRA, the corporate regulator, also offers a free online course on director's duties and responsibilities.

8.5.4. Maximum Number of Board Seats

There are currently no caps on the number of board seats held by directors in Singapore. The CG Code provides that a company disclose in its annual report the number of listed company directorships and principal commitments of each director. In cases in which a director holds a significant number of such directorships and commitments, the company should provide the nominating committee's and the board's reasoned assessment of the ability of the director to diligently discharge his or her duties.[408]

[403] CG Code, Provision 2.4.
[404] CG Code, Principle 5.
[405] See Loh and Chee, "Corporate Governance Highlights 2019."
[406] See Listing Rule 210(5)(a).
[407] CG Code, Provision 1.2.
[408] CG Code, Provision 4.5.

8.5.5. Disclosures about Independent Directors in Corporate Announcements

The listing rules require the disclosure of the director's appointment biographical details, including academic and professional qualifications, past and present directorships, and any significant relationship with management or substantial shareholders. In addition, the CG Code recommends that the information be included in the annual report with the names of directors up for election and re-election.

As noted in the Corporate Governance Highlights 2019 report, it is of paramount importance for companies to disclose essential information regarding all directorships and director tenures, to assure investors that directors have the time and ability to contribute to their companies. The report found that 76% of companies disclosed all directorships held at present and over the past three years in 2019, compared with 61% in 2017.[409]

8.5.6. Dual-class Share Regime

Singapore introduced its dual-class share framework in June 2018, allowing companies with dual-class share structures to seek primary listings on the Singapore Exchange. Enhanced corporate governance measures were implemented as safeguards, among them an enhanced voting process in which all shares carry one vote each regardless of class, for the appointment and removal of independent directors or auditors, variation of rights attached to any class of shares, a reverse takeover, a winding up, or a delisting,[410] as well as requiring the majority of the audit committee, the nominating committee, and the remuneration committee, and each of their respective chairs, to be independent directors.

8.6. Effectiveness of Independent Board Directors

8.6.1. Independent Directors in Family-controlled and Government-dominated Companies

In Singapore, informal connections between independent directors in family firms and family controllers tend to be a defining characteristic in such firms.[411] Ng and

[409]See Loh and Chee, "Corporate Governance Highlights 2019."
[410]Angela Tan, "SGX Enters New Era as It Starts Dual-Class Shares for Qualifying IPOs," *The Business Times*, June 2018, https://www.businesstimes.com.sg/stocks/sgx-enters-new-era-as-it-starts-dual-class-shares-for-qualifying-ipos
[411]Puchniak, Baum, and Nottage, *Independent Directors,* 108.

Roberts[412] found that the independent directors appointed in these family-controlled firms help the companies to meet good corporate governance standards while still allowing family members to retain control. They also found that they often play a useful role as mediators between family members.

As noted earlier, Temasek has a policy of remaining at arm's length from companies in which it has significant shareholdings. Puchniak and Kim stated that "in Singapore's Government Linked Companies, independent directors appear to play a purely managerial-monitoring role as Singapore's unique institutional architecture has purposefully limited the ability of the government to exercise its full powers as a controlling shareholder."[413]

According to a previous CFA Institute publication, "Shareholder Rights Across the Markets,"[414] "corporate governance is generally stronger at banks in Singapore than at non-bank entities because regulations are more stringent for banks than for other listed companies and they impose higher independence hurdles on bank directors."

8.6.2. Lead Independent Director

The CG Code provides for the appointment of a lead independent director when a company has a nonindependent chair. The lead independent director is available to minority shareholders in cases in which they have concerns and for which contact through the normal channels of communication with the chair or management are inappropriate or inadequate.[415] The role of the lead independent director performs a more enhanced function than the independent director, which may include chairing board meetings in the absence of the chair, working with the chair in leading the board, and providing a channel to nonexecutive directors for confidential discussions on any concerns and to resolve conflicts of interest.[416]

CFA Institute believes that the adoption of a lead independent director is essential to strengthening of independence and improving shareholder communication.[417]

[412]W. Ng and J. Roberts, "'Helping the Family': The Mediating Role of Outside Directors in Ethnic Chinese Family Firms," *Human Relations* 60, no. 2 (2007): 292.
[413]Dan W. Puchniak and Kon Sik Kim, "Varieties of Independent Directors in Asia: A Taxonomy" (NUS Law Working Paper 17/01, National University of Singapore Business School, Singapore, 2017).
[414]Orsagh, "Shareholder Rights Across the Markets."
[415]CG Code, Provision 3.3.
[416]"Practice Guidelines, Practice Guidelines 2: Role of the Lead Independent Director" (Monetary Authority of Singapore, February 7, 2020), https://www.mas.gov.sg/-/media/MAS/News-and-Publications/Practice-Guidance-Feb-2020v2.pdf?la=en&hash=ACB56F927EE43E2F44B942EA7226B466606FA76C.
[417]Orsagh, Rittenhouse, and Allen, *The Corporate Governance of Listed Companies.*

8.6.3. Separation of the Roles of Chair and CEO

According to Corporate Governance Highlights 2019, only 25% of listed companies had a chair who was an independent director. In 39% of the companies, the chair was a non-independent director, and the majority of the board were independent directors (up from 33% in 2018).[418]

CFA Institute firmly believes that separation of the roles of CEO and chair is important for good corporate governance. The CG Code does not require a separation of chair and CEO but does require a majority of independent directors on a board in cases in which the separation of the roles does not exist.

8.6.4. Board Diversity

The CG Code requires board construction to consider "aspects of diversity such as gender and age, so as to avoid groupthink and foster constructive debate." The board diversity policy and progress made towards implementing the board diversity policy, including objectives, must be disclosed in the company's annual report.

According to the Council for Board Diversity, the largest primary-listed companies by market capitalization on the Singapore Exchange had achieved 16.2% of female board participation as of December 2019.[419] Figure 8.3 shows the trend for women on the board of companies listed on the Singapore exchange from 2013 to 2019.[420]

The Singapore Institute of Directors previously noted that[421] "Singapore is still playing catch-up in the global diversity agenda—only one in nine listed board seats are filled by women."[422]

According to research by the National University of Singapore, "There is a positive linear relationship between the number of female independent directors and company financial

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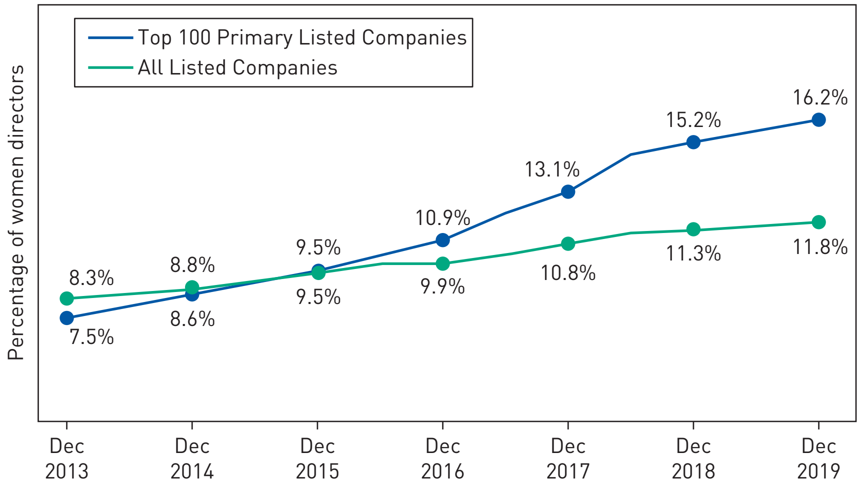
[418]Loh and Chee, "Corporate Governance Highlights 2019."
[419]"With More Companies Appointing Women to Their Boards, Those with Few or No Women on Boards Need to Take Decisive Action" (press release, Council for Board Diversity, March 17, 2020), https://www.councilforboarddiversity.sg/wp-content/uploads/2020/03/2020-03-17-CBD-NewsRel-More-companies-appointing-women-to-their-boards.pdf.
[420]"With More Companies Appointing Women to Their Boards."
[421]"With More Companies Appointing Women to Their Boards."
[422]"Women on Board—Making a Real Difference" (Singapore Institute of Directors, 2018), https://www.sid.org.sg/Web/Publications/Women_on_Board.aspx.

Figure 8.3. Women's participation on boards of companies listed on SGX



Source: Council for Board Diversity

performance. That is, in general, financial performance of companies with more female independent directors would be better than those with fewer or no women on the board."[423]

8.7. Conclusions

Singapore has a strong regulatory framework covering boards and independent directors. The CG Code is issued by the regulator rather than by the stock exchange. MAS amended the CG Code in 2018 to elevate corporate governance in Singapore by providing clearer guidance on director independence, providing that nonexecutive directors make up a majority of the board, enhancing board diversity, and upgrading prior comply-or-explain code provisions to mandatory listing rules, such as requiring independent directors to make up at least one-third of the board.

Singapore also has a high number of family-owned and government-controlled companies. This makes the need for independent directors more important to ensure that the rights of minorities are preserved.

[423]Mak Yuen Teen, "Independent Directors: From Good to Ridiculous," *Governance Stakeholders* (blog), 22 August 2018, https://governanceforstakeholders.com/2018/08/22/independent-directors-from-good-to-ridiculous/.

Over the years, Singapore has actively made reforms to evolve with international best practices in corporate governance. The adoption of appointing a lead independent director when the chair is nonindependent provides a channel for shareholders to communicate concerns when normal channels to the chair or CEO fail.

8.7.1. Recommendations

Singapore has a strong and robust corporate governance framework, but challenges remain, particularly for companies that are family-controlled or are owned by a majority shareholder. Our recommendations for Singapore are as follows:

- Require mandatory separation of chair and CEO and require the chair to be an independent director.
- Place a hard cap on the maximum tenure of an independent director.
- Provide mandatory director training with relevant competences for independent directors.
- Implement a cap on multiple directorships that independent directors can concurrently hold.
- Tighten the criteria determining independence. For example, the background of independent directors should be evaluated more carefully for their relationship with the controlling shareholder and company executives, beyond the definition of "immediate family."

8.8. Case Study: Asian Micro Holdings Limited

A review into the independent directors of Singapore-listed company, Asian Micro Holdings[424] shows an example of questionable independence. On August 21, 2018, Mr. Lee Teck Meng Stanley was redesignated as an independent director after serving as a nonexecutive and nonindependent director of the company since 2016. Mr. Lee is also the nephew of the company's executive chair and CEO.[425] The company disclosed the following in its 2018 corporate announcement:[426]

[424]Listed on the SGX-ST Catalist Board.

[425]Asian Micro Holdings Limited, *Annual Report 2020*, 2020, http://asianmicro.listedcompany.com/newsroom/20201006_185654_585_OL3W3IQD01QYSSVC.1.pdf.

[426]Asian Micro Holdings Limited, Company Announcement (21 August 2018), http://asianmicro.listedcompany.com/news.html/id/675873.

> The NC and the Board, having reviewed the independence of Mr Lee Teck Meng Stanley, are of the view that he is independent in character and judgement, for the purposes of Catalist Rule 704(7) and the Code of Corporate Governance, and there are no circumstances which would likely affect or appear to affect his judgement. His familial relationship, as a nephew of Mr Lim Kee Liew @ Victor Lim (the Group's Executive Chairman, Chief Executive Officer and Managing Director) and his spouse, Ms. Leong Lai Heng (a Controlling Shareholder and a Director of the subsidiaries of the Company) is not deemed as an immediate family member for the purposes of the Code of Corporate Governance. His familial relationship does not interfere, or be reasonably perceived to interfere, with the exercise of his independent business judgement with a view to the best interests of the company.

As highlighted by Mr. Mak Yuen Teen, associate professor of accounting at the NUS Business School, who specializes in corporate governance, the company straddles a fine line between the letter and the spirit of the rules on director independence. Although Mr. Lee is a nephew and not deemed to be an immediate family member under the listing rules and CG Code, it is questionable that such a family relationship "does not interfere, or be reasonably perceived to interfere, with the exercise of his independent business judgement." As Mr. Mak had noted, if it was not for his close relationship with his uncle and aunt, would he have been appointed as a director in the first place? Did the nominating committee do a "global search" and find him to be the best candidate, or did they select him because of his familial relationship?[427] As seen in this case, there is room for improvement for independent directors to be better evaluated on their independence based on backgrounds and relationships with the controlling shareholder or executive management.

[427]Lawrence Loh and Mai Huong Nguyen, "Board Diversity and Business Performance In Singapore-Listed Companies: The Role of Corporate Governance" *Research Journal of Social Science and Management* 7, no. 10 (February 2018): 95–104.

9. Conclusions

The roles and responsibilities of independent directors in Asia Pacific have grown in importance in the past decade. Regulators have placed them under greater scrutiny to improve corporate governance on company boards and to protect minority shareholders. Greater attention has been placed on clarification of director independence, strengthening the role of independent directors on company boards and boosting their participation on board committees.

Our review of the six Asia Pacific markets shows that while the standards of corporate governance have improved broadly, challenges still exist, particularly in those markets where many companies are dominated by founding shareholders and controlled by a family or by a group of related shareholders. In such situations, giving independent directors more weight on the board is viewed as a means to monitor and counterbalance the power of the executive management or controlling shareholders. The task of independent directors is to ensure that decisions are made in the best interest of the company and fair to all shareholders.

Although a more prominent presence of independent directors enhances the quality of corporate governance, it cannot prevent all corporate misconduct or transgressions. CFA Institute believes that the following factors contribute to an engaged, productive, and effective company board:

- Board directors must have periodic conversations about whom they owe their primary duty to and how they balance their responsibilities among various stakeholders. They should evolve a common understanding of how they approach various issues.
- Performance evaluation of boards not only must take into account resources, capabilities, and performance objectives but also evaluate the perceived psychological safety of members and tolerance for dissenting views.
- Boards have made progress in gender diversity. They must equally focus on diversity of skills and competencies, providing an egalitarian setting in which the views of all members are actively solicited and equally valued. They should include members with relevant qualifications in decision making (including appointments in important committees) to derive the benefits of diversity. Otherwise, the exercise risks being little more than tokenism, or box-checking.

Boards and independent directors provide their greatest value guiding companies during times of disruption. As companies navigate an increasingly turbulent world, the importance of good leadership, strategic insight, and monitoring that boards provide has never been greater. We hope that our discussion of issues surrounding director independence, regulations, and best practices around the region will advance the cause of good corporate governance and board effectiveness.

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