

The Independent Directors in Malaysia: The Analysis of the Legal Requirements for Conventional and Shariah Business Companies

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Abstract: The severity of the concept of independent directors in Malaysia is reflected through the introduction of corporate governance in this country. Although both Acts 125 and 777 are silent on the provision for independent director, the emphasis on the need for independent director to exist within the board composition can be seen in the Bursa Malaysia Listing Requirements ('LR') and the Malaysian Code on Corporate Governance ('MCCG'). This paper will examine the basis and the significance of their existence in decision making process through board meeting, which commonly takes place in companies running conventional or Shariah compliance businesses. The method used in this study is analysis of the LR and MCCG provisions and reported cases. The analysis revealed that the independent directors carry substantial obligations by ensuring effective functions of the board which reflects good corporate governance within the company.

Key words: Independence of directors' · Company · Corporate governance

INTRODUCTION

External or independent directors are not engaged on full time basis nor are they privileged to a fixed compensation and yet their presence is crucial for the board in carrying out the monitoring activities of the board committee [1]. There are many arguments on the significance of independence directors particularly the basis for their existence in the composition of board of directors. O'Sullivan *et al.* highlighted that there is possibility that non-executive directors may become less effective after serving for many years in the board in view of their inclination to establish close relations with executive directors. In other words, the longer the period of his service in the same board, the less independent the director will become [2]. This shows that the element of independence deteriorates as time goes by especially when they remain engaged with the same board members for a long time.

Weir *et al.* highlighted that the existence of the non-executive directors (which include independent directors) is crucial in order to ensure effective monitoring of the board performance [3]. Beleya, P *et al.* also stated that in order to fulfill the oversight role and protect shareholders

interest as well as the other stakeholders' preferences, independent directors must be independent of the corporate management [4]. It means the independent director cannot be a member, investor, staff nor employee of the company. In view of these factors, the MCCG emphasized on the importance of outsider on the board to bring an independent judgment to the board and to enhance its effectiveness [5].

The Concept of and Requirement for Independent Directors: It is important to note that countries over the globe may define their own concept of independent directors.

The Cadbury for example describes independent directors must be independent from management which reflects the shareholding structure of companies in the UK where it typically involves a separation of management and control. Therefore, efforts are generally directed towards strengthening controls over management [6].

The Toronto Stock Exchange (TSE) Committee report on corporate governance on the other hand specifies two elements of independence of the board. First is the concept of unrelated directors who are essentially

directors independent of management. The second element is being independent from controlling shareholders. Further, it ensures existence of component of the board reflecting the investment of the public or minority shareholder and they are not related to significant shareholder of the company [7].

In Malaysia, the LR [8] and the MCCG have become the main documents referred to define and deliberate matters relating to board composition. The definition of “independent director” is stated under Chapter 1 of the LR. Paragraph 1.01 of the LR expressly defines independent directors as a director who is independent of management and free from any business or other relationship which could obstruct the exercise of independent judgment or the aptitude to perform in the best interests of the company as a listed issuer. Without limiting the generality of the foregoing, an independent director is one who –

- Is not an executive director of the applicant, listed issuer or any related corporation of such applicant or listed issuer (each corporation is referred to as “said Corporation”);
- Has not been within the last 2 years and is not an officer (except as a non-executive director) of the said Corporation. For this purpose, “officer” has the meaning given in the Companies Act;
- Is not a major shareholder the said Corporation;
- Is not a family member of any executive director, officer or major shareholder of the said Corporation; The term “major shareholder” is defined in Chapter 1 of the LR.
- Is not acting as a nominee or representative of any executive director or major shareholder of the said Corporation;
- Has not been engaged as an adviser by the said Corporation under such circumstances as prescribed by the Exchange or is not presently a partner, director (except as an independent director) or major shareholder, as the case may be, of a firm or corporation which provides professional advisory services to the said Corporation under such circumstances as prescribed by the Exchange; or
- Has not engaged in any transaction with the said Corporation under such circumstances as prescribed by the Exchange or is not presently a partner, director or major shareholder, as the case may be, of a firm or corporation (other than subsidiaries of the applicant or listed issuer) which has engaged in any transaction with the said Corporation under such circumstances as prescribed by the Exchange.

Based on the given definition above, independent director bears two significant features, namely; being independent from company’s management and being independent from major shareholder, as stated in the above definition in the Malaysian context.

The exigency for the independent directors arises due to the demand for a strong framework of corporate governance in the functioning of the company. The Acts 125 and 777 do not deliberate much on their role and responsibility as independent directors. The enforcement of the LR and the implementation of the MCCG 2000 [9] however reflect the urgency of the role and responsibility of independence directors to be put in place. The corporate governance confers several functions and obligations on the independent directors which are different from the executive or non-independent directors. The reason being that an independent director serves to safeguard the members particularly the minority members of a company and also to ensure the company shall and not solely the majority members, benefit from the decision passed by the company. This aim can be achieved when the independent directors maintain their independence and fairness and review every decision passed through board or general meetings which are exercised by the directors and the members particularly majority members respectively.

Chapter 15 of the LR provides provision that highlights on the requirement to appoint independent directors as board members of companies. Paragraph 15.02 of the LR requires at least number of two directors or one third of the board of directors of a listed issuer, whichever is the higher, to be independent directors within the composition of the board. It further provides that if the number of directors is not three or a multiple of three, then the number nearest to one third must be used. This provision is applicable to all listed companies in Malaysia, hence must be strictly complied with.

Similar requirement is further accentuated through the MCCG 2000 provisions. Paragraph A II of Part 1 for example requires that the board of directors should include a balance of executive directors and non-executive directors (including independent directors) so that no individual or group can dominate the board’s decision making. Further, paragraph AA III of Part 2 states that in order to constitute an effective board, at least one third of the board members must comprise of independent directors. The board has to also make a disclosure on an annual basis as to whether its one third of the board members is

independent. This requirement is set forth in paragraph AA VI which serves to guarantee the participation of the non-executives and the independent directors in the board decision making.

Looking into the various provisions above on the need for independent directors, it clearly shows that the regulators and the stakeholders demand for certain numbers of neutral individuals who are able to reflect impartiality in decision making, to sit in the board in order to ensure transparency in decision making process and to protect the company's interest as a whole.

Significance of the Independent Directors: The values of independent directors are measured from their capability in bringing an outside perspective into the board meetings as well as their ability to reflect independence in their ideas, thoughts and views. MCCG 2012 has been introduced for this purpose [10]. In order to provide effective leadership and reflect good corporate governance within the board, they also review and evaluate any corporate strategy and direct on the company's policy and overall internal supervision. The requirement for this value in the recommendation 2.1 of MCCG 2012 which is similar to paragraph 15.08A of the LR, states that the board should establish a Nominating Committee which should comprise exclusively of non-executive directors, a majority of whom must be independent. The Nominating Committee is charged with the responsibility of overseeing the selection and assessment of directors. It is important to have an effective Nominating Committee in a company as such Nominating Committee will ensure the board compositions to achieve the expectation of the company. The chair of the Nominating Committee should be the senior independent director identified by the board. In short, the function of a Nominating Committee is to nominate, assess and elect appropriate candidate to sit in the board.

The ability to act independently for the interest of the company by independent director has also been emphasized by the courts in describing the requirement and expectation on an independent directors. In the case of *Kingdom Seekers Ventures Sdn Bhd v Dato' Sri Chong Ket Pen & Ors* [2015] MLJU 390, Harmindar Singh Dhaliwal J highlighted in his judgment that "*Independent directors are required to exercise independent judgment and act in the best interests of the company as per their declaration to Bursa Malaysia Securities Bhd ("Bursa Malaysia") as required under the Main Market Listing Requirement"*.

With regard to supervisory function, independent directors play a vital role when they are required to sit in various companies' internal committees. Examples of these committees are the nominating committee, the audit committee and the remuneration committee. Further, they are also responsible to assess the performance of the board members as a whole. The independent directors assist in restoring leadership qualities of the board by issuing a requisite reports to the company members to advise on the suitable remedies taken in case of board's poor performance. An example of supervisory function can be illustrated in the case of *QOGT Inc v International Oil & Gas Technology Ltd* [2014] EWHC 1628 (Comm), 2012 Folio No 82, (Transcript), where the independent directors urged the company by issuing a notice in writing to the management services team for them to work together constructively and cooperatively in order to improve the company's services, as the responsibility did not solely fall on the manager alone, but also to the whole team involved. The notice from the independent directors was considered to be critical in order to avoid further breach on the part of the management team for failure to provide appropriate services.

The requirement to supervise the board performance includes the performance of the independent directors. This is in view of recommendation 3.1 of MCCG 2012 which clearly states that the board is also expected to undertake an assessment of its independent directors annually as stipulated therein.

The existence of independent directors brings independent and objective judgment to the board in order to reduce risks arising from conflict of interest or undue influence from interested parties. It is important for the board to undertake an annual assessment of the independence of its independent directors as their presence on the board by itself may not ensure the exercise of independent and objective judgment. This is because an independent judgment can be compromised by, amongst others, familiarity or close relationship with other board members. Therefore, the board should focus beyond the independent director's background, economic and family relationships and consider whether the independent director can continue to bring independent and objective judgment, when assessing their extent of independence. The Nominating Committee should develop the criteria to assess independence. The board should apply these criteria upon admission, annually and when any new interest or relationship develops. The board should disclose that it has conducted such

assessment in the annual report and in any notice convening a general meeting for the appointment and reappointment of independent directors.

The involvement of independent directors is also crucial in ensuring reliable information in respect of the financial statement of a company. Para 15.09 of the LR provides amongst others that all the audit committee members must be non-executive directors, with a majority of them being independent directors. The independent directors being members of the Audit Committee is required to ensure financial statements comply with the applicable financial reporting standards as required in the recommendation 5.1 of MCCG 2012.

As mentioned earlier in the introduction of this paper, the element of independence within the directors may deteriorate as time goes by especially when they remain engaged with the same board members for a long time. This is in view of their inclination to build their relationship with all board members. In order to mitigate this possibility, MCCG 2012 recommends that the board must justify and seek shareholders' approval in the event it retains as an independent director, a person who has served in that capacity for more than nine years. The capping of nine years is highlighted in the recommendation 3.3 of the MCCG 2012. The length of the tenure of engagement as an independence director is taken into account as it can impair independence. To safeguard the requirement on independence, nine years capping is imposed as the maximum tenure of appointment of an independent directors. The nine years can either be a consecutive service of nine years or a cumulative service of nine years with intervals. If an independent director continues to serve the board over the maximum period of nine years, he will be considered as a non-independent director.

The above discussion clearly reflects that independent directors do not fully engage themselves with the daily business operation of a company, yet their presence is crucial in order to ensure the board to be accordingly well-functioned. As described by Popplewell J in *QOGT Inc v International Oil & Gas Technology Ltd* [2014] EWHC 1628 (Comm), 2012 Folio No 82, (Transcript) "Everyone knew that the independent directors would be part time non-executive officers, who lacked the time and expertise to do the management job themselves and were not being paid to do so". Their appointment as members of the board nevertheless signifies several importances as mentioned above. Their existence in the board is not solely to complete its composition. Their credibility as prominent figure with excellent judgment in business adds value to the company which board they are sitting in. In

other words, their appointment is not merely to comply with the regulation or the recommendation of the code of corporate governance.

Shariah Framework on Independence of Decision Making: With effect from 1 January 2011, a new guideline on Shariah Governance Framework for Islamic Financial Institutions (Shariah Framework) was enforced by the Bank Negara Malaysia in order to supersede the 2004 guideline [11]. This Shariah Framework is applicable to all Islamic financial institutions in Malaysia. It is important to note that this Shariah Framework is regarded as additional sources of corporate governance. In other words, if the respective Islamic financial institutions are also public listed companies they must comply all the three sources of the corporate governance namely MCCG, LR and the Shariah Framework.

The Shariah Framework highlights the element of independence of decision making as under Principle 3 which states that independence of the Shariah Committee shall be observed at all times in exercising their duties to make objective and informed judgment. In this respect, the board shall recognise the independence of the Shariah Committee and ensure that the Shariah Committee is free from any undue influence in deliberating issues brought before them by allowing them to exercise objective judgment. Correspondingly, the Shariah Committee is expected to make sound decisions on Shariah matters in an independent and objective manner.

The relation between the boards (including independent directors) with the Shariah Committee is described under Principle 2 which amongst others states that the board, upon consultation with the Shariah Committee shall approve all policies relating to Shariah matters. Further, the Shariah Committee members are appointed by the board upon the recommendation of its Nomination Committee.

Further, the board is recommended to appoint at least one member of the Shariah Committee as a member of the board. This is to reduce gap between the board and the Shariah Committee. By identifying a director with sound Shariah knowledge, the board members are expected to be able to appreciate the wisdoms behind every decision made by the Shariah Committee.

CONCLUSION

The concept and development of independent directors in Malaysia is a journey towards implementing the best practice and corporate governance in this country. The MCCG and the LR are often revisited and

reviewed in order to confer and enhance the functions of and empowerment upon independent directors. This is crucial towards ensuring better management of a company. Nevertheless, greater accountability and stricter rules of conducts are also imposed on them. This is to protect their integrity and preserve their independence in their decision making. It is also imperative to bear in mind that the entire board especially the independent directors must function effectively to reflect good corporate governance which will benefit both minority and majority members, as well as in order to create and preserve a good corporate image in the market. Indeed, the independent directors carry substantial obligations by ensuring effective functions of the board which reflects good corporate governance within the company, as intended by the regulators, members and stakeholders.

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