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Nine Year Tenure as Independent Director: Overstaying the Welcome?

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Abstract: An independent director is a person who appointed to the board of director and did not have any material pecuniary relationship or transactions with the company, its promoters, its directors, its senior management or its holding company, its subsidiaries and associate that may affect the independent of the director. Initial studies concerning board structure focused on the number of independent directors on the board and while previous studies have tried to measure the actual independence. The potential impact of board tenure on board independence has not been adequately explored in academic literature and up until recently has escaped the public eye. The purpose of this study is to examine whether 9 year tenure as an independent directorship could affect independence on the board in Malaysian public companies. This research adopts qualitative types of research methodology where primary resources are the Malaysian Companies Act 1965, Malaysian Code of Corporate Governance and Bursa Malaysia listing requirements. The finding of this study is that there are several benefits from having long-serving independent directors hence, the 9 year tenure limit requirement is not followed by most of the Malaysian public companies where the tenure is prolonged for >9 year.

Key words: Independent directors, tenure, corporate governance, public companies, board structure

INTRODUCTION

According to Para 1.01 of the Bursa Malaysia Listing Requirements, an independent director is one who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interest of a listed company. In reviewing the empirical research published on the subject of boards of directors and firm performance, Zahra and Pearch II (1983) have said that the "agency theory is among the most recognized in research on the contribution of the boards". However, it was argued that given that independent directors are non-executive directors, the question remains of what constitutes independent (Farrar, 2001).

Problem statements: Muth and Donaldson (1998) have said that independent directors are the cornerstone of good corporate governance. But the question arise is whether overstaying as independent director could bring some balance on the board so that the decision is impartial and not biased? Initial studies concerning board structure focused on the number of independent directors on the board and while previous studies have tried to measure the actual independence (relative to the officially declared independence) of board directors, their expertise and their networking benefits, there has been little research on tenure as a distinguishing attribute (Dou *et al*., 2015). The potential impact of board tenure on board independence has not been adequately explored in academic literature and up until recently has escaped the public eye (Nili, 2015). It also reported in the Minority Watchdog Shareholders Group's ASEAN Corporate Governance Report 2014 that 53% out of 873 public listed companies have independent directors who have served the company for >9 year. Australia have dropped the proposal to impose 9 year tenure limit saying the mere fact that a director has served an arbitrary number of year does not indicate a lack of independence. This led to a question whether the 9 year tenure of independent directorship in Malaysian public companies should be capped to 9 year?

Literature review: A discussion on independent directors is crucial for this study because an independent board would, at least improve board's performance of monitoring functions. Agency theory suggests that boards dominated by inside directors may be less attentive monitors of management's these directors may intentionally provide self-serving accounts of managerial actions to enhance their status with the firm's CEO (Fama, 1980). The theory which dominates the corporate governance literature, has its basis in the separation of ownership and management and the divergent interests

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between the two. As such, it requires control of management by boards of directors operating as agents for the owners (Koeniardi and Tourani-Rad, 2012). External directors are expected to be free from the influence of the firm's management which allows them to perform their duties more efficiently and provide more value than internal directors. From a perspective of agency theory, a board primarily consisting of independent directors is likely to be vigilant in making more exhaustive and profound evaluations of strategic decisions and management behavior (Luo , 2007). Besides the element of independence, independent non-executive directors are perceived to provide links to the external environment, due to their expertise, prestige and contact (Nicholson and Kiel, 2004). All companies need access to outside resources to succeed in the competitive environment today and the independent non-executive directors can provide that link (Peng, 2004).

Theorists also claim that independence produces superior oversight of management, reduces resistance to leadership change and more effectively aligns board behaviour with shareholder's interests (Langevoort, 2000). The theory of board 'independence' among policymakers is intended to enhance board's monitoring function to improve the company's overall performance (Baysinger and Butler, 1984). The main reason companies engage such individuals in theory is to get their impartial oversight on key decisions such as acquisitions or hiring and firing key executives. Independent directors are viewed as people who can provide better quality and assurance of reasoned corporate judgement (Ferries *et al*., 2003).

Thus, outside directors are thought to be crucial in ensuring that an effective, impartial governance system is allowed to operate within the corporation since outside directors are independent of management (Rashidah and Rizal, 2009). The other characteristics which may have implications for the level of board independence include board size, age of directors, tenure of directors and level of interest alignment with owners versus managers.

A major emphasize in corporate governance writing is the need for non-management directors on the board to serve as a check on management in the interest of shareholders. In other words, non-management directors are there to help the shareholders to solve the agency problem. Historically, inside directors or executive directors played a dominant role on corporate boards, holding most of the seats (Bhagat and Black, 2002). Inside directors cannot be independent because there is a presumption that their managerial position within the company undermines their ability to make objective decisions (Fairfax, 2010). In the United States, insider's dominance has diminished completely and independent directors began holding an increasingly larger portion of corporate board seats (Gordon, 2007).

Tenure tends to foster "cohorts" within an organization (Pfeffer, 1983). For a board, long tenure among directors can mean increased social cohesion and the ability to reach consensus quickly based on shared experience (Knudsen and Meyerson, 1992). Although, directors with long tenure may be thoroughly socialized into adopting the organization's norms and values, their level of commitment and loyalty to the organization and its management is also increased (Muth and Donaldson, 1998). Therefore, social ties between management and independent board members might impact the effectiveness with which boards perform their advising and monitoring roles in different ways (Hoitash, 2011) Experienced directors develop expertise in the industry and firm on whose board they serve through their long tenures exposing them to the company's strategy, finances an competitive environment (Dou *et al*., 2015).

On the other hand, there has been established theory that long board tenure may lead to the entrenchment that reduces the effectiveness of outside directors. Long tenure directors are more likely to have a friendly relationship with the management which is developed over time (Vafeas, 2003). The theory of structural bias proclaims that even if an independent director does not have any financial or employment ties with the firm, he might be still biased in making a decision because of social pressure generated by his personal relationship with the management (Xu *et al*., 2007). The term "structural bias" generally refers to the prejudice that members of the board of directors may have in favor for one another and of management (Velasco, 2014).

MATERIALS AND METHODS

This research adopts qualitative types of research methodology. This methodology is suitable to be employed for exploring complex research areas where little is known, for beginning to understand a phenomenon or for the development of new theories or laws. The primary data for this research are from the Companies Act 1965, Malaysian Code of Corporate Governance and Bursa Malaysia Listing Requirements. The secondary data includes textbooks, articles from journals as well as online sources.

RESULTS AND DISCUSSION

Board composition, appointment and tenure of independent director in Malaysia: Para 15.02 of the

Malaysian Listing Requirements states that at least two directors or 1/3 of the board whichever is higher, must be independent directors. This is in line with the Hampel Report that it is difficult for non-executive to be effective if they made up <1/3 of the board. Should there be a vacancy of independent director position, the company must find a replacement within 3 month. Besides, Recommendation 3.5 of Malaysian Code of Corporate Governance 2012 (MCCG 2012) stipulates that the board must comprise a majority of independent Directors where the Chairman of the Board is not an independent director. According to the commentary section in MCCG 2012, a chairman who is an independent director can provide strong leadership due to him being objective on the board. Alternatively, if the chairman is not independent, then majority of the board must comprise of independent director to ensure balance and authority of the board.

Paragraph 1.01 of the listing requirement of Bursa Malaysia Securities Berhad defines independent director as one who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgment or the ability to act in the best interest of a listed company. For a public company in Malaysia, the appointment of directors is done by the members in the company's general meeting according to its articles of association. Section 123 (4) of the Companies Act 1965 requires any person who shall be appointed a director of a company make and lodge with the Registrar and official receiver a statutory declaration that he is not a bankrupt and consented to the appointment as a director.

Upon appointment, a person who is appointed as an independent director must inform the Bursa immediately about his appointment in a letter in the prescribed in the form which confirms the candidate is an independent director as per the definition of the Bursa Listing Requirements.

Article 67 of the table A states that the number of directors may be increased or reduced at a general meeting. According to Para 7.26 of the Bursa Listing Requirements, all directors shall retire once, at least, every 3 year but they are eligible for re-election. Furthermore, Recommendation 2.2 of the Malaysian Code of Corporate Governance states that the Nomination Committee should develop and maintain and review the criteria to be used in the recruitment process and annual assessment of directors.

The board should establish a Nominating Committee (NC) which should comprise exclusively of non-executive directors, a majority of whom must be independent. Non-executive may also refer to independent director. The NC is mandated to formulate the appointment policy for directors. Generally, the principal responsibilities of NC are to devise the criteria for board membership and also to identify potential candidates for nomination to the board. It also must annually evaluate the performance of individual directors. The NC should comprise exclusively of non-executive directors, a majority of whom are independent.

As for the tenure, according to Recommendation 3.2 of the MCCG 2012, an independent director in Malaysia is recommended to hold office not exceeding cumulative term of 9 year. Upon 9 year, an independent director may continue to serve on the board subject to the director's re-designation as a non-independent director. In the commentary section, it is acknowledged by the securities commission that long tenure could impair independence. Alternatively, the shareholders may approve the independent directors on an annual basis as stated in the Recommendation 3.3 of the MCCG 2012. The authors are of the opinion that the imposition of such threshold is welcome as this will avoid the element of biasness by the independent director. This is supported by many scholars that a long tenure could also make the directors foster social relation with their peers on the board and if this is left unchecked, it could lead to structural bias.

Advantages of having long-serving independent director: It is fair that this study discusses the benefits of having a long-serving independent director on the board. We will highlight the advantages in three parts namely; better monitoring function, the reputation of independent director intertwined with the success of the company and better access to information by the management.

It is researcher's contention that the long serving independent directors could be more effective in exercising their monitoring function. This is because, more often than not, these independent directors are also a member of the audit committee which play a major role in providing check and balance in the management. The audit committee plays a key role in overseeing, monitoring and advising the management and outside auditors in preparing financial statements, conducting audits and implementing internal accounting control systems (Liu and Sun, 2010). Those studies suggest that the audit committee is more effective if more outside directors are sitting on the committee. Understanding auditing process requires long experience and by having a long-serving independent director in the committee, the procedure knowledge (in understanding the accounting) can be obtained at the "on-the-job". They are more experienced compared to the newer board members. The fact that their long experience in the company could be a value-added points for these directors to confront the company's management more firmly.

Furthermore, experienced independent directors have a huge reputation at stake. Long tenure directors may have high reputation developed over time. These directors will be more focused in performing their job because poof performance will impair their reputational capitals among peers. Also, directors who survive long tenure must perform well if the job market of directors is efficient (Vafeas, 2003). More studies have shown that independent directors do not grow tired and complacent in their post just because they have been on a board for a long time (Shireen, 2016). It is submitted that long tenure on the board could propel the company to be more successful. In fact, Dou *et al.* (2015) agreed that the long-serving independent director could make the company be more innovative by being brave to taking the risk. An experienced independent director could guide and support the CEO in making the huge business decision and the shareholder could have more confident in the board.

The independent directors should be informed more frequently by the management on the company's performance. This right to information is entrenched in Section 167 (3) of the Malaysian Companies Act 1965 whereby the accounting and other records shall be made available at all time for inspection by the directors. However, it is common knowledge that the CEO will only inform the independent director the company's information and records only ad-hoc basis. The researchers are of the opinion that the asymmetry of information between the management and directors could be minimized. As a result, the company could be more efficient in decision making and strategy.

In the MWSG's survey on top 100 Malaysian companies in Malaysia in 2014, it was revealed that more than half of have retained independent directors for >9 year. Rita Benoy, the CEO of MWSG has stated that in 300 annual general meeting attended by MWSG in 2015; there were some companies which were either confused or did not want to observe the recommendation and thus did not table the resolution to re-appoint INEDs who had served for >9 year for shareholders approval. This could imply that the companies could be reluctant to comply with the requirement under the MCCG 2012 as it is not mandatory and have no penalty provision for the non-compliance. The high number of non-compliance shows that the Malaysian public companies have found that the benefit of having long-serving independent directors outweigh the impact of impaired independence. Therefore, the researchers are of the opinion that the 9 year tenure limit for the directors in Malaysia should be dropped as we think the advantages are more beneficial to the company.

CONCLUSION

The researchers believe that there must be a strong justification to limit the tenure of the independent directors. Corporate governance research has been dominated by the theories that the long tenure could impair the director's independence. Latest findings by scholars mentioned above have given a new perspective in addressing the issue of independence in the board. Ultimately, the duty of directors is to act in the best interest of the company as enunciated in Section 132 of the Malaysian Companies Act 1965. The researchers also hope that more companies would comply with the MCCG 2012 so that, the investor's confidence could be increased.

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