The Rise of the Independent Director

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Introduction

The importance of good financial services corporate governance is a topic that continues to be cited as an area of focus in many countries and no less so, is this true than here in Asia. The Independent Director has an increasingly essential function in being able to be 'independent' meaning he or she can step away from executive bound corporate structure and take a broader view of proposals and strategic policies, taking the best interests of all stake holders into account. Over the years we have seen corporate scandals that were a result of maleficent executive actions, negligence, groupthink, or unethical practices. Some of the more recent corporate debacles were Volkswagen Emission Scandal, Nissan CEO Scandal, Uber Reputational Incidents and Tesla's Lockdown Defiance.

The Non-Executive Director (NED) is a better-known concept amongst public limited companies. In many cases, a NED is Independent but there are exceptions. A NED is a director who does not participate in the day to day running of the company and focuses only on its governance. As mentioned, he or she may be independent or not independent. If they are not Independent it is deemed so due to a relationship with the company and its associated entities e.g., he or she could be a shareholder of more than 5%, perhaps a retired or ex senior executive or family member of the ultimate beneficiary owner. This is also why many countries have rules to test the independent nature of directors on listed Companies and in many cases, the results of these assessments are detailed in listed company reports.

Our focus in this document will primarily be on the Independent Directors and NED who are truly independent.

We see an increasing demand for Independent Directors on boards of companies seeking regulatory approval and licenses to provide financial services in new markets. The increasing wealth in Asia and the advent of innovative technologies are driving new and more nimble financial services companies to establish footprint in these new markets around the world. Leveraging their innovative technology capabilities, these companies can deploy their capabilities in a relatively short period of time, demonstrating significant time to market advantages over their traditional financial services rivals. To deploy their services in these new markets, these financial services companies are required to establish local entities and apply for the relevant regulatory licences. Hence, the demand for Independent Directors with local jurisdictional experience and knowledge is growing.

A key challenge for an Independent Director in this pool of opportunities is to remain independent and exercise his or her powers of independence. Many will say, just follow the rules established for listed companies and in essence that is the case – but reality is that it is much harder to exercise the functional responsibilities. Starts up and smaller companies by nature are different animals to large corporates as they seek the ability to arbitrage resources across functions, often blurring lines that represent board of directors versus management team and owners versus shareholders. This document explores some of those challenges that can be encountered and some of the steps necessary to mitigate the problems that may arise.

Rise of the Independent Director and Non-Executive Director (NED) Role

Over the past years, NED have found their voice and regulations have been written to incorporate their value on public listed company boards. Many stock exchanges around the world publish guidelines that highlight the importance of the NED as part of good corporate governance. Many rules also specify why, when, and how many NEDs are required subject to the type or ownership and corporate management structures that the company utilises. It is now a better-defined world, with seasoned individuals performing NED functions with backgrounds in academia, private enterprise, or political office. Listed Companies with deeper pockets fund the infrastructure required to support NED in their functions whether that be office space, secretarial support, documentation or indeed access to third parties to gain independent analytical reports.

Singapore Fund Directors Association (SFDA)

A particularly good example of the evolution of Independent Directors can be found in the recently formed Singapore Fund Directors Association. The SFDA which was launched early in 2021 is an industry-driven initiative established to create and support an ecosystem within Singapore's financial industry for fund directors. This group has an exclusive focus around the Fund Management Industry which is supporting Singapore leading position in Funds and wealth management in the region.

Many public funds and trust companies often require Independent Directors to make sure fiduciary responsibilities are executed to the highest standards. As the roles of Independent Directors continue to evolve, and with the increasingly tightening of laws by regulatory bodies, it is becoming more important for Independent Directors to acquaint themselves on new regulations surrounding corporate governance and mandatory regulation.

A director on the board of a fund is expected to have a sound knowledge of risk management, regulations, compliance matters and all other aspects to do with fund management. With this added role, independent directors too will be regulated in the same way as fund managers soon.

Martin O Regan, Managing Director of Solas Fiduciary Services and Chairman of SFDA Executive Committee stated that SFDA's main objectives were to establish the Non-Executive Fund Director (NEFD) talent pool within Singapore, develop and implement a code of conduct for its members and provide training to both broaden and deepen the NEFD talent pool.

Independent Director – Listed Companies

In Asia, the function of an Independent Director varies from market to market depending on regulation and the different ownership structures amongst others. In Asia, culture and family or concentrated ownership structures further blur the lines, especially in those instances where ownership rests in one family and where family members take leading positions on the board.

The Chartered Financial Analyst (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 or other groups exerting control over the management or shareholders. The Singapore Institute of Directors defines this as a director who does not have a material or business relationship with the company or related persons, except in respect of the director fees. The code further defines this as 'a person who is independent in conduct, character, and judgment'. An Independent Director is a member of the board but has no Executive responsibility. As a member of the board, the Independent Director is responsible for advising, guiding, incentivising, and persuading the company's management to conduct its executive affairs in accordance with the agreed strategy and policies.

The value is seen in the fact that as an Independent Director you take the best possible view of all stakeholders rather than just taking the side of a specific corporate policy. In contrast the Executive directors have clear lines of responsibility for operating the company in line with the strategic vision and policy established by the entire board of directors.

Best practice suggests that true Independent Directors are a key to good, balanced, and unbiased corporate governance. They can balance argument and issues in favour of the company rather than taking supportive position strongly motivated by an Executive member of the board. Where Independent Directors can exercise 'independence" this has shown that better corporate governance and superior decisions have been made in favour of not only the company but also its shareholders and employees.

As previously mentioned, the term Independent Director does not in all cases equal the term of a Non-Executive Director (NED). Independent Directors must be shown and proven to be Independent. A NED may be affiliated and cannot demonstrate independence. Most stock exchanges (SGX is no exclusion) provides extensive guidance in their rule books to listed companies around corporate governance and the inclusion of Independent Directors as an important part of good governance. The SGX highlights (amongst other key items) in the rule book the importance of a 'strong element of Independent Directors on a board'. The SGX further highlights that where Chairman and CEO are the same individual or Chairman and CEO are same immediate family, that Independent Directors should make up at least 50% of the entire board. It further lists out the terms of what independence means and how any Nominating committee would make selections and how this is to be reported in the annual financial accounts. The Madoff Investment scandal in 2008, demonstrates the need for independence and transparency in governing family run entities.

Independent Director – Non-Listed Companies

So much of what has been said above applies to the Independent Director in Non listed companies however many of the mitigants specified with listed Companies become bigger challenges with smaller non-listed entities. The listing itself can be argued creates chances for a shareholder to get transparency around the process of decision making and the impact of independence. Arguably the same level of scrutiny also exists in non-listed companies, however the actors tend to be different.

Independent Directors to mutual fund companies tend to have a clearer established set of responsibilities. We want to focus specifically on the functions of Independent Directors to companies that not publicly listed or attached to mutual fund boards. The following are all relevant to each category but tend to be much more pronounced in this third category which excludes the listed companies and fund boards.

Executive versus Independent Directors – Facilitating Sound Judgement

In the eyes of the law, both executive and independent directors on the board have a fiduciary duty to the company requiring them to act in the interest of the company. A director must demonstrate the required degree of care and diligence that a reasonable person would demonstrate in that position. We have seen significant errors in judgement made by corporate leadership in scandals such as Enron, Well Fargo, Wirecard and Luckin Coffee

When companies are young or just born, they tend to have a good mixture of individuals who are all working hard to get operations up and running. In short, directors and executives tend to be working towards the common objective of getting the company up and running. The board of directors will include executives who clearly own responsibility to execute strategy.

In these instances, the board is often 2 or 3 people excluding the appointed company secretary. The Independent Director is often a single individual charged to work alongside the executive team. It can be difficult in the initial years to force independence, especially in situations where executive focus could be on pure growth. It is times like this where the Independent Director can make a substantial contribution by taking an independent viewpoint on policy and strategy to benefit of the firm – the Independent Director brings the relevant knowledge and experience in providing their independent judgement on matters. The ability to do this effectively depends on the individual and how he/she can work with the team, adding value at times of substantial growth and during stressful period to achieve the company's strategic objectives. Sustaining the focus and keeping the peace during the initial period can be challenging.

Board of Directors versus Management – Separate time for Dialogue

Where the Board of Directors becomes synonymous with the management team, challenges are clearly preprogramed – the distinction between governance and management functions become blurred. In these situations, the addition of an Independent Director will help to separate the two – so that board meetings are kept formal and to the point allowing time for dialogue to review strategy and focus versus a Management Meeting which clearly focuses on running the business. Until clear lines are established between management functions versus board functions getting good governance will be challenging.

Often in smaller companies the function of Management is blended with that of the board of directors. Key Management often sits on the board – partly since they see this as a hierarchical or status benefit and secondly due to the need to manage resources so that expenses are kept to a minimum. Why hire a board member if that board member could also be Head of Sales or Operations?

It is often assumed that all directors of a company have control over every facet of company's business and affairs encompassing both operational and strategic matters. This assumption is invalid as it is certainly not the case when independent non-executive directors are involved. It is incumbent on the independent non-executive directors to be able to guide, influence and persuade the executive the conduct their executive actions in a manner that is consistent with the agreed strategies.

It is important to bear in mind that the board is responsible for ensuring that the business and affairs are conducted to the required standard and that it also takes a longer view when overseeing these matters. Management on other hand should focus on delivering the strategy and managing the short-term challenges associated with the execution of the strategy.

Shareholder or Ultimate Beneficial Owner (UBO) part of the Board and Management – Countering Groupthink

Where we then add the primary shareholder or ultimate beneficial owner into the scope of both the board of directors and or a function in management, the picture is substantially challenging. Here again conflict of interest is a serious risk, and the Independent Director can play a meaningful function to segregate the meetings and focus on the key aspects of each of these separate functions. The key benefit that an Independent Director brings to this situation is that their capacity to exercise independent judgement and actions. In doing so, they help optimise decision making, and counter groupthink. Shareholder, versus Board Directors versus the Management team in smaller companies can be a complex and intense dynamic.

Company Administration – Instilling Discipline

All companies are required to have a Company Secretary -often a function outsourced to a reputable service provider. The Company Secretary will be responsible for recording the minutes and the official proceeding of the company. The Board Minutes are a definitive source of information about key decisions taken by the board of Directors. It is also particularly good practice to keep records of meeting notes from all Management Meetings.

Especially in smaller companies’ minutes and formalities tend to be pushed aside in favour of other times sensitive issues. The Independent Director plays an important function to instil discipline in the process of involving the Company Secretary and ensuring that Minutes are written and accurately reflect the relevant discussions.

Capital & Financial Resources – Enabling Success

The Independent Director in a smaller company must be able to access resources and the pre-requisite support to enable him or her to effectively perform his or her function. Unlike the large, listed companies where a board may have several Independent Directors and a well-oiled established process to respond to questions and provide answers, this will probably be more challenging in a smaller organisation.

The Independent Director will need to know the key resources, be able to frame questions to get the information required to effectively discharge their obligations and follow up if those questions are not being responded to or if the responses received are less than satisfactory. The onus remains with the Independent Director to manage the need for information, read and understand issues and follow up. There may be no organisational depth in early years to call upon to research and investigate matters and often this burden falls on the Independent Director to manage that process.

The Australian Corporation Act introduced the “Best Judgement Rule” to provide directors defence against claims of negligence and failing to be diligent when conducting their obligations. The burden of proof lies with the director, and it is advisable that a director familiarises themselves with these similar types of rules in their respective jurisdictions.

Finally, all directors have a duty to ensure that the company is not trading whilst it is in an insolvent position. This duty does not extend to the officers of the company and resides solely with the directors. If the director has grounds to believe that the company is insolvent or is danger of becoming insolvent because of some planned activity, then the director should take all reasonable steps to understand the situation and circumstances and make the appropriate decisions.

Environmental Social and Corporate Governance (ESG) – Sustainability

Every company needs to incorporate a clear vision and approach to ESG – so that it can be explained to employees, customers, shareholders, and other stakeholders. Many new companies have embraced these themes, but it remains important that board clearly focuses on this as part of the overall strategy. While there are many ways to think about intangible assets and how to measure them, they are used with an ultimate objective of measuring elements relating to sustainability and the social impact of a business on society. Enterprise that operates in multiple locations need to think about these aspects and consider the local environment and community and focus on ensuring their sustainability.

The Independent Director can also help in these instances to make sure the issue of ESG is not put on the back page of documents but debated at board meetings. When implementing policy, ensuring that (especially *if* adopted from another country of operation) it is adapted to local market conditions and practices, and socially acceptable. More importantly it is not about being seen to ‘do the right thing’ but that the company is actually ‘doing the right thing’.

Culture/ Language/ Custom – Establishing a Common Platform

With respect to foreign companies placing a footprint into Singapore or any country outside their own home base of Headquarters local customs and attitude play a big part in the governance process. These challenges can directly impact the ability of the Independent Director to execute his or her responsibilities.

Adopting an international language as the primary business language (English) of the company and having suitable resources available able to hold a conversation, understand business terminology and engage in written correspondence is simply a pre-requirement. A local company in Singapore operates in the English so all documents need to be available in that language. It is a logical conclusion for the Company to operate in English so that there is a clear common denominator to connect staff, vendors, clients' shareholders, regulators, and board of directors. The way we speak and engage with one another is also a custom and matter of respect for the host country.

The Independent Director needs to manage these key attributes to make sure he or she can fully understand the business, feel confident that questions raised can be understood and responded to by competent English-speaking individuals. This is especially important where the local entity has contracted to source service or where offshore operations support the entity in Singapore. The Independent Director can help facilitate this process guiding the norms and support concepts that build and support good corporate governance. Furthermore, the local Independent Director can assist other foreign domiciled directors and officers of the company better understand the local market practices and the local regulatory posture on specific matters.

AlfaSec Advisors provides adaptable and experienced Independent Directors to companies in Financial Services in Singapore. We aim to support companies during their Planning, Creation, Licencing, and Operational establishment in Singapore – known as a critical gateway to Southeast Asia.

Let us talk!

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This document was edited by James Collins.

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