Tenure of independent directors

MCCG Intended Outcome 4.0
Board decisions are made objectively in the best interests of the company taking into account diverse perspectives and insights.

MCCG Practice 4.2
The tenure of an independent director does not exceed a cumulative term limit of nine years. Upon completion of the nine years, an independent director may continue to serve on the board as a non-independent director.

If the board intends to retain an independent director beyond nine years, it should justify and seek annual shareholders’ approval. If the board continues to retain the independent director after the twelfth year, the board should seek annual shareholders’ approval through a two-tier voting process.

MCCG Step Up 4.3
The board has a policy which limits the tenure of its independent directors to nine years.

The internalisation and application of the content “Why” and “How” should be read in tandem with the line of sight outlined by the Intended Outcome.

Why

The case for change

The notion of independence is inherently situational and is more than anything, a state of mind. Viewed as a solution for balancing influence, independent directors are expected to display a strong element of objectivity, both in appearance (“perceived independence”) as well as of mind (“independence in thought and action”) as illustrated below.

What could go wrong:

- Lack of a robust challenge process during board deliberations.
- Implementation of poor decisions by the company and perpetuation of poor decision-making due to the tendency of directors to defend their previous actions and/or lack of robust deliberations.
- Inability of the board to respond to the evolving and changing business circumstances.
In order to carry out their mandate effectively, independent board members must have the intellectual honesty and moral courage to advocate professional views without fear or favour. The presence of such attributes will allow independent directors to constructively challenge decisions proposed by other board members and contribute in meaningful ways to the strategic objectives and stewardship of companies.

The definition of an independent director is well-enumerated in paragraph 1.01 of Bursa Securities Listing Requirements.

**Paragraph 1.01 of Bursa Securities Listing Requirements**

**Definition of an independent director**

Independent director means a director who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgement or the ability to act in the best interests of an applicant or a listed issuer. Without limiting the generality of the foregoing, an independent director is one who –

(a) 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”);
(b) 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 section 2 of the Companies Act;
(c) is not a major shareholder the said Corporation;
(d) is not a family member of any executive director, officer or major shareholder of the said Corporation;
(e) is not acting as a nominee or representative of any executive director or major shareholder of the said Corporation;
(f) 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
(g) 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.

*Note: Practice Note 13 of Bursa Securities Listing Requirements provides clarification on certain aspects of the definition of independent director.*

Similar provisions are applicable for financial institutions under **Standard 11.7 of Bank Negara Malaysia’s Policy Document on Corporate Governance**.

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2 CalPERS Revises Governance Policy, Adopts 12 Years as Threshold for Director Independence on Corporate Boards 2016, CalPERS
In addition to the factors outlined above, the length of service of an independent director is increasingly being recognised as a key element in the review of a director’s independence. Whilst it is recognised that independence is ultimately a subjective element, there are heightened concerns amongst stakeholders that extended tenure may give rise to independent directors having a close relationship with board and management and thus, becoming too sympathetic to their interests or too accepting of their work. Tenure is also increasingly regarded as a potential indicator of entrenchment and thus, the need for board refreshment.

Against this backdrop, the MCCG has stipulated a limit on the tenure of independent directors. As with many other jurisdictions, the yardstick adopted by the MCCG is a cumulative (consecutive or intermittent) term of nine years.

Why is a quantitative tenure limit of nine years prescribed?

It is important to note that the establishment of quantitative tenure limits is not arbitrary but rather it is based on well-founded empirical and research studies.

For example, a prominent research study undertaken by a distinguished scholar from INSEAD Business School in 2013 highlighted that the objectivity and performance of independent directors commonly reach a turning point between the seventh to eleventh year. The said turning point is the period at which an independent director has accumulated the benefits of institutional knowledge but has yet to accumulate the costs of entrenchment. Beyond this point, there is commonly a shift in an independent director’s performance (from rigorous oversight to complacency). The performance and objectivity of independent directors against tenure are illustrated in the diagram below:

![Performance and objectivity of independent directors against tenure](image)

Given that long tenures of independent directors may potentially erode the board’s objectivity, the board should consider utilising tenure limits as a mechanism to facilitate board renewal and thus, enhance the effectiveness of the board. As an exemplary practice, Step Up 4.3 of MCCG urges companies to establish a policy which limits the tenure of their independent directors to 9 years. A similar enumeration is also encapsulated in Bank Negara Malaysia’s Policy Document on Corporate Governance.

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2 Huang, S, 2013, Zombie Boards: Board Tenure and Firm Performance, Essays on Corporate Finance
3 Standard 11.9 of Bank Negara Malaysia’s Policy Document on Corporate Governance states that the tenure limits for independent directors should generally not exceed nine years, except under exceptional circumstances or as part of transitional arrangements towards full implementation of the succession plans of the financial institution.
The practice in substance

Recognising that all companies are not homogenous, **Practice 4.2 of MCCG** provides companies with the flexibility, in exceptional circumstances, to retain an independent director beyond nine years. As stated in **Practice 4.2**, “if the board intends to retain an independent director beyond nine years, it should justify and seek annual shareholders’ approval. If the board continues to retain the independent director after the twelfth year, the board should seek annual shareholders’ approval through a two-tier voting process”. In the case of Large Companies however, **Guidance to Practice 4.2 of MCCG** recommends that they are not encouraged to retain an independent director for a period of more than twelve years.

The aforementioned two-tier voting process is encapsulated in the timeline below:

![Timeline Diagram](image)

Key considerations relating to the application of **Practice 4.2 and Step Up 4.3 of MCCG** are discussed below:

**How can the nominating committee or board assess if a long-serving independent director continues to be “independent in mind”**?

In assessing whether a long-serving independent director continues to be “independent in mind”, the nominating committee should consider if the said director displays some of the following key characteristics:

- possesses sufficient self-esteem and confidence to stand up for an independent point of view;
- approaches any transaction that requires board’s approval with a watchful eye and an inquiring mind (professional scepticism);
- is unafraid to express an unpopular stance on issues or express disagreement on matters and actively pursues them with the rest of the board and with the management team; and
- does not shy away from asking hard and uncomfortable questions during board deliberations and willing to delve deeper if the responses provided are not satisfactory.

**Dos**

- Conducting a thorough annual assessment on directors’ independence and outlining the reasons for determining that a director is independent notwithstanding the long tenure.
- Incorporating enabling provisions in the company’s constitution to allow for the operationalisation of two-tier voting as enumerated in **Practice 4.2 of MCCG**.

**Don’ts**

- Maintaining that an annual assessment of directors’ independence is a substitute for not obtaining shareholders’ approval.
- Providing generic justification to accompany a resolution seeking to retain a long-serving independent director (e.g. “tenure has not impacted the independent director and the board is of the view that the said director continues to be independent”).
- Reducing shareholders’ approval via the two-tier voting process to an advisory vote.
What are the potential indicators of entrenchment amongst independent directors?

Some of the signs of entrenched independent directors include the following:

- failure of independent directors to act independently because of strong personal ties that have developed over the years;
- tendency of independent directors to defend decisions and policies that have been supported in the past, but now, are no longer relevant; and
- lack of new insights and the display of passivity during deliberations.

In addition, it is important to note that as stated in the Guidance to Practice 4.2 of MCCG, there could also be occasions where an independent director may become a "dependent" director due to prolonged insular recruitment processes and attractive remuneration packages and material benefits.

What should a justification to retain a long-serving independent director contain?

The board in proposing to retain an individual independent director beyond 9 years, should seek shareholders’ approval annually and provide strong justification in the explanatory notes to the resolution in the notice of AGM.

However, it should be noted that disclosure in this area has been generally poor. As stated in the “Analysis of Corporate Governance Disclosures in Annual Reports” performed by Bursa Malaysia in 2016 across 280 listed issuers, listed issuers were commonly found to provide weak justification for re-appointing independent directors beyond 9 years. In many instances, the explanatory notes to the resolution in the notice of AGM provided the same justification for several independent directors.

In this regard, boards should provide shareholders with clear and strong justification so as to enable shareholders to make an informed decision on whether the said director should be re-elected as an independent director. The considerations that should be contained in the justification to retain a long-serving independent director are as follows:

- nature of the assessment performed to evaluate the independence of the said independent director;
- the outcome of the assessment and the bases for arriving at that outcome;
- a statement by the board as to whether the said director can continue to perform his or her duties without being subjected to undue influence; and
- additional considerations such as the peculiarities of the company itself, possession of special knowledge and commitment displayed by the said director.
How does the two tier-voting process operate?

Under the two-tier voting process, shareholders’ votes will be cast in the following manner at the shareholders’ meeting:

Tier 1: Only the Large Shareholder(s)\(^5\) of the company votes; and

Tier 2: Shareholders other than Large Shareholder(s) votes.

The decision for the aforementioned resolution is determined based on the vote of Tier 1 and a simple majority of Tier 2. If there is more than one Large Shareholder, a simple majority of votes determines the outcome of the Tier 1 vote. The resolution is deemed successful if both Tier 1 and Tier 2 vote in favour of the resolution.

Examples of possible scenarios and the corresponding outcomes are outlined below:

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Tier 1</th>
<th>Tier 2</th>
<th>Successful/ not successful</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario I</td>
<td>✔</td>
<td>✔</td>
<td>Successful</td>
</tr>
<tr>
<td>Scenario II</td>
<td>Abstained</td>
<td>✔</td>
<td>Not successful</td>
</tr>
<tr>
<td>Scenario III</td>
<td>✔</td>
<td>✗</td>
<td>Not successful</td>
</tr>
<tr>
<td>Scenario IV</td>
<td>✗</td>
<td>✔</td>
<td>Not successful</td>
</tr>
</tbody>
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Regional/international perspectives

Alongside Malaysia, many jurisdictions including United Kingdom, India, Hong Kong and Singapore have put in place tenure limits for independent directors. The quantitative limits placed and approach adopted are outlined on the following page:

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\(^5\) As stated in the Guidance to Practice 4.2 of MCCG, Large Shareholder means a person who is entitled to exercise, or control the exercise of, not less than 33% of the voting shares in the company; is the largest shareholder of voting shares in the company; has the power to appoint or cause to be appointed a majority of the directors of the company; or has the power to make or cause to be made, decisions in respect of the business or administration of the company, and to give effect to such decisions or cause them to be given effect to.
<table>
<thead>
<tr>
<th>Country</th>
<th>Tenure limit</th>
<th>Approach</th>
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</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>9 years</td>
<td>Comply or explain (Provision B.1.1 of Corporate Governance Code)</td>
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<td></td>
<td></td>
<td>Note: The board should state its reasons if it determines that a director is independent notwithstanding that the independent director has served on the board for more than nine years.</td>
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<tr>
<td>Hong Kong</td>
<td>9 years</td>
<td>Comply or explain (Provision A.4.3 of Corporate Governance Code and Corporate Governance Report)</td>
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<td></td>
<td></td>
<td>Note: Appointment beyond the ninth year should be subject to a separate resolution for the approval of shareholders.</td>
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<tr>
<td>Singapore</td>
<td>9 years</td>
<td>Comply or explain (Guideline 2.4 of Code of Corporate Governance)</td>
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<td></td>
<td></td>
<td>Note: The independence of any director who has served on the Board beyond nine years from the date of his first appointment should be subject to particularly rigorous review.</td>
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<tr>
<td>India</td>
<td>10 years</td>
<td>Mandatory</td>
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<td></td>
<td></td>
<td>[Section 149(10) and (11) of Companies Act 2013]</td>
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<td>Note: Director shall hold office for a term up to five consecutive years on the Board of a company, but shall be eligible for reappointment on passing of a special resolution by the company and disclosure of such appointment in the Board’s report.</td>
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<td></td>
<td></td>
<td>Notwithstanding the above, no independent director of a public listed company shall hold office for more than ten years, but such independent director shall be eligible for appointment after three years of ceasing to become an independent director.</td>
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</tbody>
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