How important is the role of an independent director?

By Shabiya Ali Ahlam

While a handful of independent directors are observed to be diverting from their mandated responsibilities, the regulators have continuously emphasised the need for those holding such responsibilities to realise their true role. In an attempt to create awareness amongst independent non-executive directors the importance of their role and expected contribution to corporate governance, the Securities and Exchange Commission of Sri Lanka (SEC) together with The Colombo Stock Exchange (CSE) recently conducted a symposium on the role of independent directors.

Attended by over 200 officials representing public listed companies, the event provided an opportunity for the independent non-executive directors to actively engage and benefit from an array of expert personalities, both international and local.

The event, at which SEC Chairman Nalaka Godahewa delivered the keynote, was addressed by SEC Director Corporate Affairs Harshana P. Suriyapperuma, President’s Counsel Dr. Harsha Cabral and Bombay Stock Exchange (BSE) Chief Regulatory Officer Nehal Vora.

True role of independent directors a boost to investor confidence
In the last 10-15 years corporate governance has become a widely-discussed subject and a very important consideration for investors around the world. Investors and governments have started demanding better governance practices from all the companies particularly after the wide publicity over corporate scandals such as Enron, Parmalat, Xerox, World Com and many others during early parts of this century.

Numerous studies conducted by reputed universities over the years have shown a strong link between good corporate governance and corporate financial performance. Recent studies conducted by Harvard and the University of Pennsylvania have found out that portfolios of companies with strong shareholder rights protections outperform portfolios of companies with weaker protections by 10-12 % per year.

“This is the obvious reason why investors prefer companies that are known for superior corporate governance practices. Particularly at a time when we are seeking a greater engagement of foreign investors in our market, we need to be conscious of the need to promote corporate governance best practices amongst our listed companies. The companies should also understand that better corporate governance means better access to finance," said Godahewa.

**Importance of corporate governance**

Corporate boards have an important role in the implementation of governance and are usually regulated by the corporate law and corporate governance codes in many countries.

In Sri Lanka there is the Company Act of 2007 and the ‘Code of Best Practices on Corporate Governance’ jointly developed by the Institute of Chartered Accountants of Sri Lanka (CA) and the SEC.

Godahewa pointed out that the purpose of corporate governance is to facilitate effective entrepreneurial and prudent
management that can deliver long term success of the company. In order to achieve such an objective, a public company is expected to be headed by an effective board which should lead, direct and control the company. He stressed it is expected there to be a clear division of responsibilities at the head of the company which will ensure a balance of power and authority such that no individual or a small group of individuals has unfettered powers of decision.

"Having truly independent directors to serve on boards of public listed companies has always been considered a best practice and specifically highlighted in our code of best practices for corporate governance."

"We find that the notion and functions of independent directors vary remarkably across companies in Sri Lanka. Firstly, the role of independent directors is not always specified and understood. Secondly, though independent directors often play a role in audit committees and, less frequently, in nomination and remuneration committees, they are rarely tasked with the vetting of related-party transactions and other conflicts of interest situations. Moreover, controlling shareholders often seem to perform some of the functions that are typical of independent directors, such as the hiring and firing of managers and the setting of their remuneration," highlighted Godahewa.

He elaborated that some of the independent directors seem to have been appointed only to accommodate regulatory requirements, but their contributions at board level is observed to be influenced by their appointing authorities.

“This limitation we observe in certain companies could be largely due to the fact that no one has made an effort so far to highlight the issue. We believe that this situation can easily be corrected through better communication and engagement,” he said.

**Regional developments in corporate governance**

One of the most important developments in corporate governance practices in USA, Europe and in many other parts of the world, over the past half century has been the shift in the board composition, that is the moving away from non-independent directors to independent directors.

In USA between 1950 and 2005, the composition of large public company boards dramatically shifted towards independent directors from approximately 20% independents to 75% independents.

In Sri Lanka, the code of best practices on corporate governance advocates at least one third of the board to be independent directors.

“We would like all independent directors of Sri Lankan companies to fully understand and appreciate their role. The ordinary shareholder looks up to the independent directors to bring about the right balance at the board level.

Especially if you are a director of a public listed company you must be conscious of the fact that you are responsible towards a large number of shareholders. By looking after the interests of the company at large, you are actually looking after the interests of all these shareholders,” noted Godahewa.

He emphasised that the code of best practice on corporate governance clearly states that for one to be deemed independent, such director should be independent of management and free of any business or other relationships.
that could materially interfere with the exercise of their unfettered and independent judgment. Godahewa opined that such independence, when it comes to boards, allows a director to be objective and evaluate the performance and well-being of the company without any conflict of interest or the undue influence of interested parties.

**Independence comes down to personal values**

“Your independence also comes from the personal values and professional ethics. A director who is truly independent does so because of the commitment to serve shareholders with integrity, good judgment and common sense. As an independent director you are expected to have the self-esteem and confidence to stand up for an independent point of view at the board level,” expressed Godahewa.

He shared that independent directors in most of the established and well regulated markets solve three different problems: First, they enhance the commitment of managers to fulfill shareholder objectives, as opposed to managerial or stakeholder interests. Second, they enhance the reliability of the firm’s public disclosure, which makes stock market prices a more reliable signal for capital allocation. Third, they provide a mechanism that influences the responsiveness of firms to stock market signals.

Stating that in essence independent directors play an important role as far as the market participants are concerned, Godahewa said to the audience: “I have no doubt that all of you understand your role as independent directors. By ensuring proper corporate governance in the boards you serve, and by ensuring proper disclosure of information to the shareholders, you invariably help improving the market performance of the respective companies you are representing. Naturally your efforts are going to contribute to the overall development of our capital market.”

**Role of independent director as defined by the Companies Act**

Clarifying a common misconception where it is assumed a nonexecutive director is treated differently when it comes to liability, President’s Counsel Dr. Cabral pointed out that all directors are treated the same and there is no segregation as to nonexecutive or otherwise.

Providing valuable tips to those directors in the audience, he advised that no individual holding such responsibilities should trade their principles for money and cautioned them to be mindful of the related party transactions of the company.

“Have an independent mind of your own and do not be under any obligation to the board. Always ensure that the independent directors are truly independent and ensure that the board recognises the views of the directors,” said Cabral.

He stressed the need to be mindful of accepting directorships and said it is imperative to check the history of the
company before joining the board.

He noted it is important to act in the best interest of the company at all times and be familiar with the provisions of the Companies Act, Articles of Association, SEC Act, Listing Rules, Banking Act, Finance Act and all other statutory provisions.

While regularly checking whether the risk management techniques of the company are in operation, Cabral told directors they should always rely on their experience and knowledge in business judgment and be mindful of oppression and mismanagement actions and derivative actions that can be instituted impeaching actions of directors.

If the company is a conglomerate or a group entity, directors are expected to ensure they have a fair knowledge on Holding Companies, Subsidiary Companies, and Associate Companies and their respective roles under the law.

“Make use of your own expertise when you have a superior knowledge on the subject. Make use of the Directors and Officers Insurance cover and ensure that proper ‘Interests Register’ is maintained by the company and all relevant interests of directors are duly entered in the register.

“Ensure that you make note of actions that attract liability and that the internal audit mechanisms of the company are in order,” he shared.

Independent directors should resign no sooner they feel their independence is eroded and if a director feels uncomfortable on the board he should exit forthwith and avoid being a mere passenger on the board endorsing all decisions of the board in a passive manner.

“Do not let your personal interest conflict with the interests of the company. Never discuss board room matters with family members, friends and associates and do not disseminate price sensitive corporate information to any third party who is not entitled to know them.”

Cabral added that while one should not accept board appointments if he cannot dedicate sufficient time for each directorship, it is best for a director to not accept too many directorships if he cannot dedicate sufficient time for each.
Disclosure surveillance

Noting disclosure surveillance is a continuous monitoring process, SEC Director Corporate Affairs Suriyapperuma pointed out the regulator carries out activities in this regard on an annual basis in order to ensure all listed companies
comply with the rules.

“All the rules lead to the single direction, which is to enhance the corporate governance. That is not the destination, it is a journey. That is why we continuously evaluate where we stand,” he expressed.

The Sri Lanka Institute of Directors (SLID) and CA Sri Lanka jointly works with the regulator to ensure the governance process is adequate and the directors are well trained so they achieve the required compliance level required by the regulator.

“In some of the cases we have seen that in high performing companies the corporate governance is not a mere compliance activity, but it is a complementary activity that enhances the value of the entity,” shared Suriyapperuma.

Shedding light on the review process, he pointed out the SEC and CSE jointly checks the degree of compliance the entities have shown during the year through various means, of which one is the publishing of the annual reports on a timely and accurate manner. “We also look into other disclosures and even rumours for that matter that are out in the market. We go through complaints the SEC receives from various participants in the market who highlight issues relating to the company or process. We don’t take any issue in isolation so we can have a better understanding if a company has complied with the requirements laid down by the SEC and CSE,” said Suriyapperuma, while sharing details on how the regulation process is carried out.

When setting the rules the SEC also looks at international best practices and how other jurisdictions have addressed similar concerns. “If it is a correction that is required at policy level, we look at the impact on the market and we strive to make it as simple as possible for the regulator and for those complying with the rules,” he added.

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Expert views on role of independent directors

To present expert views on the role of independent directors, the symposium facilitated a constructive panel discussion.

Moderated by SEC Director Corporate Affairs Suriyapperuma, the panel featured as speakers The Carlyle Group Indonesia Managing Director Rajiv Louis, SEC Director General/Officer in Charge Dhammika Perera, National Chamber of Commerce of Sri Lanka President and SLID Representative Sunil Wijesinha, CSE Director Hiran de Alwis, BSE India CRO Vora and President's Council Cabral.

Q: There is quite a lot the BSE has done in the space of independent directors and corporate governance. I would like to understand the impact it has created among the investor community in India?

Vora: India has the highest number of listed companies in the world, about 5,300. Since we have a range of companies some of them perform well and some don’t. While we were deliberating the need of better corporate governance practice and code in line with international best practice, there was an issue where some of the smaller companies were not able to comply with the provisions. So for about 500 companies we are proposing an enhanced corporate governance code which will be implemented in October.

Before kicking off the implementation process we had discussions with the companies on their views in this regard.
In terms of impact we have seen an increasing number of institutional participation. In 2014 after the new government came in, Foreign Institutional Investors (FIIs) reached an all-time high investment level. The feedback we have is that there is lot more participation which we think will lead to a higher shareholder activity.

The voting patterns of independent directors still remain a mystery. So the regulation has mandated mutual funds to disclosure how they vote and their reasons. That will lead to a higher amount of disclosures. That has led to higher valuation for some of the better managed companies. It's a positive work in progress.

Q: It is now a common practice to make use of private companies to bring in or take out value from entities. These were observed during review processes. In that context, how can the role of independent directors be more effective so investors continue to have faith in the company?

Wijesinha: As an independent director I think you need to have greater degree of care. While an independent director should be familiar with the business, they should also be able to have an independent view ask naïve questions. Some experts in corporate governance recommend that independent directors should not be too familiar with the subject so that they can ask naïve questions that can trigger information to come out. Sometimes on boards it is found that there is too little information on a prospective proposal or is given too much information that one is unsure what is relevant and important.

In the case of investments, there have been issues when increasing capital. If the entity is controlled by large groups they may not want to take decisions that are in the best interest of the company. It may be in their interest. That is an area where independent director have a greater role to play.

Q: When investing of divesting do you consider the role of independent director as an imperative part of the decision making process?

Louis: For us reviewing the independent directors role in meaningful. A reason for that is because majority of businesses in South East Asia are family owned. For them independent directors are family members in the periphery or friends. So during the due diligence process we go through this in a substantial manner. We hire global investigative firms to not just go through family members but also independent directors so we get a feel on what this individual brings to the company.

So if a person does not contribute actively to the board he has no place in the company and that is how we feel.

Q: There is a lot of emphasis to understand the role of independent directors. How is this valid to those who want to invest in the stock exchange?

De Alwis: To have a wall of protection you must make sure companies are run properly and a mechanism is the role of an independent director. Being independent on the board means you have to act independent. The practical reality in Sri Lanka on that is difficult since more people here are friends. We have to understand this reality. So for the independent director, in my view I will advocate
to make use of those terminologies. Those directors have to be independent and that should be done for better protection of the firm and shareholders. Regulation is there for facilitation and should not impede progress. This balance is what is called for.

Q: Can independent directors play a constructive role in an enterprise without attracting liabilities?

Cabral: Firstly, one has to treat himself as a director. So whatever decision is taken by the board collectively, every individual is responsible. It is necessary to go through previous minutes of meetings so you are well aware. You should not take over past sins of the company.

Q: Is becoming an independent director a luxury added to your profile? Is there any obligation that comes from it?

Perera: Becoming an independent director maybe a luxury and privilege under certain circumstances. But of course, being a director you are exposed to certain obligations stemming from the SEC Act and even the listing rules. The Company’s Act does not distinguish the directors. To be more specific the third rule of the SEC act says every listed company has to comply with the listing laws. And rule 17 states that the directors of the listed companies should ensure compliance for the listing requirement on a continuing basis.

Q: Why has The Carlyle Group yet to enter Sri Lanka? What is the outlook you have for the nation?

Louis: We would like to invest in Sri Lanka. It is not that we have shied away from it. It’s just that we have criteria to fulfil from our side. The current size of our Asia fund is about $20 billion so we look for entities which match our investment criteria. Before entering a market we require entities to have a minimum investment of $ 150 million for a stake of 10%. We look at the size, and there are not many companies of that size in Sri Lanka. However we are looking at investing here and are taking active steps towards it. The overall outlook we have for Sri Lanka is positive. But the only challenge is the minimum requirement from our end where we require the criteria to be met.