

Paper Presented by
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at
The Asian Corporate Governance Roundtable 2007,
in Singapore

DIRECTORS' NOMINATION AND REMUNERATION - SOME THOUGHTS

Where do you source your directors from? How can the search and nomination process for independent directors be improved so as to ensure that their ability to exercise independent judgment is not compromised?

How should directors be remunerated? How do you tap the potential from your directors?

Sourcing and Selecting your Independent Directors

The need for strong independent directors has gained currency recently with headline-grabbing stories of fallen CEOs and companies. The inevitable question has been: what were the independent directors doing (to allow this to happen)? As it sometimes turns out, not very much. But life is not as simple as the question and the answer imply, and I try to provide a small solution at the end of this paper to this problem. But coming back to the issue of selecting strong independent directors, I would say that the present selection process is workable, although improvements can still be made.

Independent search for independent directors?

Generally, a Singapore listed company does not hire headhunters to source and appoint independent directors. Most times, the independent directors (at least in Singapore) are known to the majority shareholders. This is not necessarily a bad thing: the issue is really

whether the chosen directors are well-qualified, bring to the Board relevant expertise bearing in mind the needs of the company, understand their duties and responsibilities and are persons of sufficient integrity and strength of character. If the chosen directors have the above stated qualifications, then in my view it does not matter that they are friends of the majority shareholders. Conversely, if they do not possess the stated attributes, it also does not matter that they are not friends of the majority shareholders.

So in my mind the issue of relationship is less important than some jurisdictions would make it out to be. The character of the directors is in my view paramount and individuals who guard their reputations jealously would be high on my list of candidates for independent directors.

It is worth bearing in mind that unfriendly relations between CEO/majority shareholders and independent directors are not good for the company. Equally, good and cordial relationships are not necessarily detrimental to the good governance of the company.

Notwithstanding my remarks above, it is obvious that directors should not be selected mainly on the basis of their close relationship to the majority shareholders. They must be able to pass scrutiny by the most objective of observers so far as their qualifications, experience and reputation are concerned.

A recent case in Singapore created some controversy. A company was on the look-out for strong independent directors, and the CEO announced that he would interview the candidates. That announcement caused some observers to query if that should be the correct procedure, since the CEO would answer to the Board. The openness of the search was certainly a good thing, but in my mind, it is always a difficult decision to decide who should "interview" the prospective director.

Obviously, if the CEO were to do the interview, there would be questions. But if the majority shareholders were to do it (which is often the case) should there also not be questions? Maybe bigger questions than if the CEO were to do the interview.

What if the job is left (entirely?) to the existing independent directors?

The Code of Corporate Governance provides that this task should be vested in the Nominating Committee (which should comprise at least 3 directors, a majority of whom, including the Chairman, should be independent). Principle 4 of the Code provides that there should be a formal and transparent process for the appointment of new directors, and Guideline 4.5 requires a description of the process to be disclosed. (In the case cited above, it appears that the Nominating Committee had disappeared because all the independent directors had resigned.)

I personally do not think there is any magic in any particular selection method or procedure. But are bad appointments sometimes made because the appointment method is not structured?

I think there are 2 aspects, and a sort of instinctive selection may get you someone with integrity, but not necessarily someone with skills or contributions that the company may actually need. The Code (Guideline 2.4) states that the Board should comprise directors who as a group provide core competencies such as accounting or finance, business or management experience, industry knowledge, strategic planning experience and customer-based experience or knowledge. I think there is some merit to the Board and/or the Nominating Committee brainstorming on

- (a) what the company needs in terms of skills, knowledge and experience from its Board,
- (b) what the Board Directors currently bring to the table, and
- (c) what gaps there are on the Board after matching the company's needs against the Board's current composition,

which are accordingly the skills, knowledge and experience a new director coming in should have in order to fill the identified gaps on the Board. Once that's identified and agreed, then the Board should brainstorm on persons that the Board knows who may fit the bill, and then for the NC to interview them. The NC will focus on both whether they are properly qualified with the relevant skills and experience bearing in mind the company's needs, as well as the person's reputation, integrity, intellect and general understanding of his role, etc. If Board Directors do not know anyone who fits the bill, I also think there is some merit to using a headhunter at that stage. I think once the process is instituted, it would be difficult for anyone to criticize the final selection.

After the threshold as to procedure and qualification has been passed, observers will look at the selected candidate. A candidate who is objectively and universally regarded as a bad choice is likely to remain a bad choice even if the minimum standards of selection are adhered to. So ultimately, it behooves every company to select the very best that is available.

Remuneration

I will now move to the remuneration of directors. It is almost a cliché to say that directors (and for that matter, everyone else in this room!) should be "fairly compensated". But where does one draw the line? When is compensation too low or excessive?

The remuneration of directors is now usually measured against recorded and established standards, so that a director's compensation will usually be fixed at a percentile rate against the established norm. This is safe and uncontroversial. I would like to clarify that when I refer to directors, I mean non-executive directors. Quite commonly in Singapore, executive directors do not receive directors' fees in addition to their wages and benefits as executives of the company, though this is not always the case. In addition to the basic fee as a member of the board, a director will also receive fees as a member of a particular committee, and if he is a chairman (of the company or a committee), that fee

will be higher than as a mere member. Again, the fees are measured against established rates, and are generally safe and uncontroversial. Additionally, there are some companies in Singapore who pay an attendance fee to Directors per Board meeting attended, and possibly a higher attendance fee if the Director is required to travel to attend the Board meeting. Generally also, companies pay their Directors' remuneration either wholly or mainly in cash.

Despite all these attempts at being fair, many directors in Singapore feel that directors' fees in Singapore are on the low side. They cite the heavy responsibilities (particularly post-Enron), heavy demands on time for reading the thick files for each meeting, and the long hours of the meeting itself.

If one were to apply a simple division of the fees against the actual time spent, these complaints look rather petty. But in all fairness, fees for directors cannot be measured by time alone. Up to 10 years' ago, some companies were still paying their directors solely by the number of meetings they attended. So if the attendance fee for each meeting was, say \$1,000 per meeting and there were 4 meetings a year, and you skipped one, then your fees for the year would be \$3,000 and not \$4,000. Such companies, as you can imagine, were rather unpopular with directors, and being a director of such a company was a matter of sufferance.

I believe we should move away from a totally fixed rate for directors' fees. There is no reason not to offer directors an additional fee based on the profitability of the company. I accept that the independent directors (even the best independent directors) have rather less of a role to play in the profits of a company than an excellent CEO supported by an excellent management team; but a board which has done its job probably would have been responsible for ensuring the appointment of that excellent CEO and his key members in the first place, for supervising the management team and keeping it honest and ensuring that the management team keeps up its performance and is properly accountable.

So I would advocate that directors be paid a fixed fee plus an additional fee based on the profitability of the company they serve in, but that there be a cap on such performance-based fees. I do not believe in over-compensation in the event of freak financial results. I also have another concern regarding over-compensation, hence my asking at the beginning of this sub-section if fees can be excessive. Yes, they can be. I think it would be an unwelcome situation when an independent director is so dependent on the fees received that he will not wish to jeopardize his position by taking on the CEO, or the majority shareholders. He must not be beholden, either directly or indirectly, to the company, the majority shareholders or the CEO, as a result of the fees he receives. So I leave this issue with you: Would you prefer your directors to be underpaid or overpaid? Perhaps the issue of overpayment can be resolved by paying Directors based on individual performance. The Code provides for individual Director's performance to be evaluated, in addition to collective Board performance. But will it cause division within the Board? And how do you evaluate yourself, and your peers?

Tapping the Directors' Potential

This is a difficult and complicated issue and can form a separate paper on its own. I will therefore discuss only one major aspect of this topic. I believe that no director can fully or properly discharge his obligation without "accurate, relevant and timely information" - to use the language of OECD.

If you look at the failures of companies, and then scrutinize the conduct of the directors in these failed companies, you will see that the directors generally did not know the full story. Yes, you can blame the directors for their sloppiness and carelessness and you can even impose more rules on the directors (which is what some jurisdictions are doing). But that is not the solution.

In my view, the best way to ensure that the directors will discharge their duties is to provide a proper regime for them to receive "accurate, relevant and timely information". I do not believe that it is sufficient to do that by mere declarations. I see very little in

existing rules and guidelines which will effectively ensure the passing of "accurate, relevant and timely information" to directors. I do recognise that to some extent it is up to a director to seek out information he needs to make properly considered decisions, but the cooperation of Management is necessary in order for him to obtain the information he requires.

Imposing more responsibilities and rules on the directors will not help. Obviously directors cannot do more if they do not have the requisite information. You need to have at least a whiff of bad smell before you begin a thorough investigation. After all if external auditors say that they are ordinarily only watchdogs, and not bloodhounds; and only bloodhounds if they see some drops of blood, I think the directors would be right to say that the same applies to them. The crucial difference would of course be that the auditors are watchdogs outside the house, while the directors are watchdogs within the house. Obviously the directors should not be mere poodles, but even a watchdog within the house would need to smell something first.

So I think it is time to look at the role of the CFO, and spell out clearly his responsibilities to ensure that he will provide the necessary information to the Board. Mr Ken Lay claimed that he was not familiar with the financial figures of his company. Most people laughed at that, and did not believe him. But there may be some truth in that, especially in companies where the CEO is an untrained entrepreneur who has just listed his company. That the CEO is an untrained or unschooled entrepreneur is of course a poor defence in law at the end of the day but the reality is that it exists.

So I would welcome rules to establish a proper regime for the delivery of accurate, relevant and timely information to directors and with attendant rules as to the role of the CFO within this regime.

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