Proposed changes to “Codes” and amendments to “Rules”

An Assessment by
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Highlights of the Proposals

- Most proposals applies to boards and their structure.
  - Expand director duties to enhance accountability.
  - Ensure directors have time to commit.
    - Should there be restriction on number of independent non-executive directorships that individuals can hold? If so, how many?
  - Mandate directors' training (e.g., 8 hours training in law, regulations, and topics relevant to their duties).
  - Require one-third of board be independent non-executive director (INED).

Highlights of the Proposals

- Create remuneration committee.
  - Chaired by INED and majority members are INED. Expand director duties to enhance accountability.
  - Should this committee have authority to determine remuneration or be advisors?
- Mandate a nomination committee.
- Introduce a corporate governance committee.
- Audit committee should meet with external auditor and act as whistle blowers.

Highlights of the Proposals

- Chairman's and CEO's roles and responsibilities should be emphasized, and remuneration should be disclosed.
- Mandate disclosure of shareholders' rights.
- Communications with shareholders should be enhanced.
- Revise rules on company secretary's qualifications, experience, training, roles, and responsibilities.

Selected parallels and comparisons to NYSE listing rules

- *Majority* of directors must be independent.
  - Definition of “independence” is specific.
- Independent directors must meet regularly without executives.
- Nominating and compensation committees must entirely be composed of independent directors.
- Audit committee must also be entirely independent, but must have relevant experience and expertise in finance and accounting and cannot get any consulting feels from firm except for regular director fees.

Selected parallels and comparisons to Sarbanes-Oxley Act rules

- Audit committee must also be entirely independent, and one director on committee must be a financial expert.
- Makes CEO and CFO more accountable (e.g., for appropriateness of financial statements).
- Makes executive and director actions more transparent to shareholders.

Assessment of the proposed changes and amendments

- Overall, they definitely seem like good changes and amendments!
- However, what are the costs of implementation and are they worth it?
- Also, are the benefits real or are they wishful thinking?
- My purpose today will be to provide some findings from academic research that relates to some of these proposals and amendments.
- Specifically, my brief talk speaks to the potential benefits of some of the proposals.

What does academic research say about these issues?

- Busy directors.
- Independent directors.
- Small boards????
- Good for the goose, good for the gander?
- Shareholders' rights.

Directors

- In general, boards have 5 primary functions:
  - Hire, evaluate, and perhaps fire top management.
  - Vote/approve on major operating proposals (e.g., large capital expenditures and acquisitions).
  - Vote/approve on major financial decisions (e.g., securities issuance, dividend payments, stock repurchases)
  - Offer expert advice to management
  - Make sure firm's activities and financial conditions are accurately reported to its shareholders.

Directors

- NOTE: If a board carries out their functions in a satisfactory manner, then the firm value should be enhanced.

Busy Directors

- Directors with multiple board appointments cannot be an effective director?
- Earlier findings from academic research:
  - **Directors of profitable firms get more director appointments.**
  - **These subsequent appointments do <u>not</u> harm any of the firms' values.**
  - **"Busy" directors serve on as many board subcommittees <u>and</u> attend as many meetings as non-busy directors.**
  - **Firms with "busy" directors do not face more lawsuits.**
  - Maybe these findings are <u>not</u> surprising. Only the "best" directors get multiple directorships.
  - So, limiting the number of directorships that a director can have limits the available supply of "good" directors.

Busy Directors

- However, here are some findings from more recent academic research:
  - Firms with "busy" directors have lower profitability.
  - "Busy" directors are less likely to fire CEOs of poor performing firms.
  - When a "busy" director departs, the firm's value increases.
  - So, I'd say that the jury is still out on whether it is wise to limit directorships.
  - HOWEVER, I personally think the findings <u>and</u> arguments of the earlier research has more credence.

Independent Directors

- Are independent directors more likely to fire CEOs after poor firm performance?
  - YES!
- Are independent directors more conservative about compensating CEOs?
  - YES! (Including Japan)
- Do firms with more independent directors have higher firm values?
  - Not clear.

Independent Directors

- Independent boards do NOT lead to higher firm values?
  - Hard to pinpoint.
  - Being effectively reactive doesn't mean they are effectively proactive.
  - Evidence is split.
  - Note also that independent directors may not be expert enough about the firm to make financing and long-term investment decisions.

Independent Directors

- Note also that the “independence” of a director is usually not clear cut.
  - In U.S., an independent director is someone who (including immediate family members) has not worked for the firm or its auditor for last 5 years.
  - Can a cousin or best friend of CEO be considered independent?

Small Boards

- Some exchanges around the world restrict the size of the board.
  - Smaller boards are more engaged and suffer less from the free-rider problem.
  - Smaller boards means more accountability per director.
  - Smaller boards get things done faster.

Small Boards

- Are smaller boards more likely to fire CEOs after poor firm performance?
  - YES!
- Are smaller boards more conservative about compensating CEOs?
  - YES! (Including Japan)
- Do firms with smaller boards have higher firm values?
  - YES! (Including Malaysia and Singapore)
  - And, the evidence is robust!

Good for the goose, good for the gander?

- Would all firms benefit from independent directors and small boards?
  - Young, growth firms usually need <u>inside</u> directors.
  - Firms with unique products/services usually need <u>inside</u> directors.
  - Large firms need <u>more</u> directors.
  - Diversified firms need <u>more</u> directors.
- Board regulations take away flexibility from firms to form boards best for them.

Shareholders' Rights

- Empower <u>shareholders</u> (especially <u>minority</u> shareholders) to affect boards.
  - A novel idea!
  - Especially if we believe…
    - regulations are restrictive and cannot be one-size-fits all;
    - firms do <u>not</u> create boards that are best for minority shareholders.

Shareholders' Rights

- I conducted a study and identified Western European countries where…

  "the legal system favors minority shareholders against managers and dominant shareholders in the corporate decision-making process, including the voting process."

- I find that firms in countries with strong minority shareholder rights have more independent directors (*Journal of Corporate Finance*, 2007).

Conclusion

- Restricting directorships may be a bad idea.
- Having remuneration committees consisting of independent directors is a good idea.
- Imposing a high fraction of independent directors for all firms may be a bad idea.
  - Proposed one-third seems reasonable.
- Consider a cap on board size.
- Consider more ways to empower minority shareholders.