SOCIETY FOR CORPORATE GOVERNANCE NIGERIA

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THE ROLES OF INDEPENDENT DIRECTORS IN PROMOTING BEST CORPORATE GOVERNANCE PRACTICES

ABSTRACT

The importance of having individuals with no financial, personal, or material attachments, as directors of the company stemmed primarily from the proverb, "whomever pays the piper dictates the tune." As each board director represented various interests, ranging from institutional investors, shareholders with large holdings, venture capitalists, the CEO amongst others which may supersede the interests of the company and the shareholders.

Therefore, the need for a director bearing impartiality and objectivity to the board brought forth the 'independent director' who would, occupy a unique position to dissect through the core issues and find a neutral position where issues arises in the boardroom; being a bridge builder in difficult conversations; bring in a specific expertise to the board and utilize his or her networking abilities and other resources to enhance the company's portfolio. This article therefore seeks to examine who an independent director is, the difference from non-executive directors, the roles of independent directors, frameworks imposing the inclusion of independent directors as well as the evaluation of independence and its application in Nigeria, while juxtaposing it with other countries.

[1] Chioma Mordi (Mrs.), Uzodinma Okeke and Rachel Ogidan– Research team of the Society for Corporate Governance Nigeria
[2] Curled from Singh Cassidy, founder of the Boardlist, available online at https://medium.com/@theBoardlist/five-reasons-you-need-an-independent-director-on-your-board-dc300f668a41 (accessed 2 March 2020)

1.0 INTRODUCTION

Principle 1 of the Nigerian Code of Corporate Governance 2018 accentuates the importance of an effective board in ensuring the sustenance of the prosperity of the company. The board of a company is vital to the proper management of the company, and consequently an effectively functioning board is the prerequisite of a successful corporate governance model.

For the purpose of effective management of the company, the board of directors are classified into executive and non-executive directors. While the Companies and Allied Matters Act does not draw a distinction between the two categories, the Nigeria Code of Corporate Governance 2018 sets a distinction between the executive and non- executive directors. In addition to the aforementioned, the Code requires the appointment of an Independent Non-Executive Director, which is now considered as a primary requirement and an epitome of good corporate governance.

Independent directors have been rightly described as the cornerstones of good corporate governance. They are entrusted with the responsibility to provide an unbiased, independent, varied, out-of-the-box, and experienced perspective to the board. According to Jeffrey Sonnenfeld's "*what makes great boards great"* article, good-governance advocates and stock exchange heavyweights alike have argued that boards with too many insiders are less clean and less accountable. According to the article, Tyco International Scandal of 2002 might have been less likely if their boards hadn't been dominated by insiders. The reason behind the clamor for more independent directors rests on the premise that persons who are unfettered by possible conflicts of interest will bring the rigor and critical analysis required to limit recurrences of the debacles we have seen, and restore investor confidence.

[1] Nigeria Code of Corporate Governance, 2018, available online at https://nambnigeria.org/Nig_Code_of_Corp._Governance_2018.pdf (accessed 5 February 2020)
[2] Ajit Kaushal, "*Independent Directorship: A Panacea of Agency Problem*", available online at https://poseidon01.ssrn.com/delivery.php?ID=1080650930650900890 1112706407902406703203701704108602502308601306508308306410001103005709910012200600410511209400800207812206911603800001504510008410006909309210308900405502211211206509607500811908206812109606602411210910307211709106911809810208809608 5&EXT=pdf February 2020) [3]Supra note 1 [4] Ibid. principle 7
[5] D.K Derri, A.Y. Abdullahi, "*The role of independent directors in the corporate governance of Nigerian banks*", InternationalJournal of Law, Volume 3; Issue 4; July 2017; Page No. 98 106, available online at http://www.lawjournals.org/download/159/3 4-25-890.pdf (accessed 5 February 2020)

[6] S. Prabakaran, "Business Ethics and Corporate Governance" Excel Books: India, 2009. Page 117
[7] J.A., Sonnenfeld "*What makes great boards great"* available online at https://hbr.org/2002/09/what-makes-great-boards-great (accessed on February 20 2020)

2.0 DISTINGUISHING BETWEEN NON-EXECUTIVE DIRECTORS AND INDPENDENT DIRECTORS

Over the past decade, board composition has been one of the main aspects of the corporate governance debate. Corporate governance guidelines – whether published by an institutional investor organisation, a multinational corporation, a company directors' association or a stock exchange – consistently recommend independent directors.

These guidelines recommend amongst others the establishment of various board committees, such as an audit committee, a remuneration committee, a risk management committee and a nomination committee. Furthermore, these guidelines usually recommend that independent directors make up a certain proportion of each committee.

In defining an independent director, it is important to enunciate that all independent directors are non-executive directors. However, this does not imply that all non-executive directors are independent directors, as a non-executive director might not necessarily be an independent director. This reasoning is usually taken one step further, because there is a crystal distinction between those non-executive directors who are, and those who are not, independent of the executive management and free from any business or other relationship with the company that could compromise their autonomy.

In Nigeria, the requirement of Independent Non-Executive Directors in achieving board effectiveness has been enshrined in virtually all the instruments and codes of Corporate Governance, notably the Nigerian Code of Corporate Governance 2018, the Securities and Exchange Commission's Code of Corporate Governance for Public Companies, CBN Guidelines on the appointment of Independent Directors inter alia. The various instruments proffer congruent definitions of an independent director.

In defining an independent director, principle 7.2 of the Nigeria Code of Corporate Governance 2018, highlights non-exhaustive features of the same, including a non-executive director who does not possess a shareholding in the company the value of which is material to the holder, such as will impair his independence or in excess of 0.01% of the paid up capital of the Company; is not a representative of a shareholder that has the ability to control or significantly influence Management among other things.

Similarly, the Securities and Exchange Commission's CG Code defines an independent director as a director who is not a substantial shareholder of the Company (holds less than 0.1%); is not a representative of a shareholder who has the ability to control Management; had not previously been employed by the Company inter alia.

The two definitions provided above define the independent directors by providing a non-exhaustive list of the criteria of an independent director. Unlike the forenamed codes, the CBN guidelines on the appointment of independent directors provides an overarching definition as follows:

"a person with no direct material relationship with the Bank or any of its officers, major shareholders, subsidiaries and affiliates; a relationship which may impair the director's ability to make independent judgments or compromise the Director's objectivity in line with Corporate Governance best practices."

[10] Barry Reiter and Nicole Rosenberg " *Meeting the information needs of Independent directors",* available online at https://iveybusinessjournal.com/publication/meeting-the-information-needs-of-independent-directors/ (accessed 12 February 2020)

[11] Lawrence, Jeffrey, and Stapledon, Geof, " *Do Independent Directors Add Value?"* (Centre for Corporate Law and Securities Regulation, 1999) pg. vi

3.0 RATIONALE FOR THE APPOINTMENT OF INDEPENDENT DIRECTORS

The primary rational for having non-executive directors, and independent directors is the protection of shareholders' interest. For the most part, they serve as a check on management in the interests of shareholders, as they are the trustees of the shareholders. To further aid the dispensation of their duties, such directors require among other things, an essential amount of independence from the management. This remains the core of the proliferation of the requirements of independent directors on the company boards across various jurisdictions.

The use of independent directors to monitor the performance of the executive management is one element of a broader tapestry of monitoring devices and rules which serve to reduce the divergence between the interests of shareholders and management.

Other parts of this 'tapestry' where independent directors add value to the company include the following:

- Independent directors ensure that the takeover process of the company is not detrimental to the shareholders. As directors are perceived as maximising shareholder wealth, it may pay a company's shareholders to ensure that the board comprises a majority of independent directors as this perception may well result in a higher share price, thus creating a self-fulfilling prophecy.
- Executive remuneration was cited by the Cadbury Committee as a specific area where independent directors could add value.
- Several studies have found a relationship between board composition and the quality of financial disclosure. One particular study found significant correlations between two measures of financial reporting quality and the composition of companies' board audit committees. The two measures of financial reporting quality employed in the study were: (i) analysts' published evaluations of each sample company's disclosure practices; and (ii) the existence of a Securities and Exchange Commission (U.S.A) Accounting and Auditing Enforcement Release against the company or its auditors. The results demonstrated that higher analyst ratings of disclosure practices were associated with firms having lower percentages of affiliated non-executive directors on their audit committees.

It appears that those who advocate an increase in the proportion of independent directors on company boards are implicitly, if not explicitly, suggesting that such a development would bring about a net reduction in agency costs.

[15]Supra note 9

[16]J. A, Brickley, J. L, Coles, and R. L, Terry, 1994, " *Outside Directors and the Adoption of Poison Pills* ", (Journal of Financial Economics, 35, pp 371-390.)

[17]Cadbury Committee (Committee on theFinancial Aspects of Corporate Governance (Sir Adrian Cadbury, chair)), 1992,*Report,* Gee & Co: London.

A related – but subtly different – rationale for independent directors has emerged from the Organisation for Economic Co-operation and Development's (OECD) project of preparing corporate governance guidelines aimed particularly at developing countries. The OECD advocates "good" corporate governance structures and practices, such as including independent directors on the board, on the basis of access to international capital markets. Hence, the addition of independent directors on the board is an allure to foreign investors.

Conclusively, the purpose of identifying and appointing independent directors is to ensure that the board includes directors who can effectively exercise their best judgment for the exclusive benefit of the company, judgement that is not clouded by real or perceived conflicts of interest.

The continuous independence of the Independent directors remains immensely indispensable to the protection of shareholders' interests, and as such, Principle 7.4 of the Nigeria Code of Corporate Governance compels the board to annually ascertain and confirm the continued independence of each Independent Director of the Company.

In compliance with the requirements of relevant codes of corporate governance, many public and even private organizations have appointed independent directors on the board. It thus raises the question of the roles and importance of the independent directors, particularly as the relevant codes are silent on the subject.

[18]D.W. Wright "*Evidence on the Relation between Corporate Governance Characteristics and the Quality of Financial Reporting*", Working Paper, Business School, University of Michigan.
[19]Organisation for Economic Co-operation and Development (OECD), 1998,"*Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, A Report to the OECD by the Business Sector Advisory Group on Corporate Governance (Ira Millstein, chair")*, OECD: Paris
[20] Jagbir Singh Kadyan " *Independent directors Role and Responsibility in Corporate Governance in India"* accessed online https://www.academia.edu/11852068/Independent_Directors_Role_and_Responsibility_in_Corporate_Governance_in_India (accessed 12 February 2020)
[21]"Corporate Governance Reporting in Nigeria: A review of the thirty most capitalized companies on the Nigerian Stock Exchange", Society for Corporate Governance Nigeria, November 2019

4.0 EVALUATING THE INDEPENDENCE OF THE INDEPENDENT DIRECTOR

Beyond his fiduciary duty, the independent director owes a special duty to shareholders, particularly the minority shareholders, who look to them to provide transparency in respect of the disclosures in the working of the company.

This special duty raises the question of the independence of the independent director in light of the relativity of the concept. This has been a subject of academic debate globally, particularly as appointments are made by the companies. The mode of appointment has thus made the concept more mythical than pragmatic.

In spite of the above, the Nigeria Code of Corporate Governance compels the board to annually ascertain and confirm the continued independence of each independent director of the Company. This provision addresses the issues surrounding independent directors becoming partial and compromised thus affecting their ability to proffer unbiased judgments. The Code however fails to address the fluidity of independence, as an independent director might be independent on one subject and might not be independent during the consideration of another issue even during the same board meeting.

Notwithstanding the shortcomings of the concept, particularly in codes of corporate governance in Nigeria, the value of independent directors on companies' board cannot be overemphasized.

5.0 TERMS AND CONDITIONS OF APPOINTMENT OF INDEPENDENT DIRECTORS

Prior to the issuance of the Code of Corporate Governance in 2018, various sectors in response to challenges in their respective sectors developed codes of corporate governance stipulating various terms and conditions for the appointment of independent directors. The terms and conditions for the appointment of independent directors as contained in the Code would be adopted, as the non-restrictive code was issued for companies of varying sizes and complexities across various industries.

[22] Companies and Allied Matters Act, Chapter 59, Laws of the Federal Republic of Nigeria 1990, Part IX, Section 279, available online at http://www.nigerialaw.org/CompaniesAndAlliedMattersActPartIXX.htm#Directors%20and%20Secretaries%20of%20the%20company (accessed 5 February 2020)

[23] Role of The Independent Director In Corporate Governance, available online at https://blog.dcsl.com.ng/blog/2015/09/21/role-of-the-independent-director-in-corporate-governance/ (accessed 5 February 2020)

[24] Anon. (2016) available online at https://blog.ipleaders.in/roles-independent-directors-corporate-governance/ (accessed 6 February 2020)

5.1 TERMS OF APPOINTMENT

1. He must not possess a shareholding in the Company, the value of which is material to the holder such as will impair his independence or in excess of 0.01% of the paid-up capital of the Company.
2. He must not be a representative of a shareholder that has the ability to control or significantly influence Management.
3. He must not, or has not been an employee of the Company or group within the last five years.
4. He must not be a close family member of any of the Company's advisers, Directors, senior employees, consultants, auditors, creditors, suppliers, customers or substantial shareholders.
5. He must not and has not had within the last five years, a material business relationship with the Company either directly, or as a partner, shareholder, Director or senior employee of a body that has, or has had, such a relationship with the Company.
6. He must not have served at directorate level or above at the Company's regulator within the last three years.
7. He must not render any professional, consultancy or other advisory services to the Company or the group, other than in the capacity of a Director.
8. He must not receive, and has not received additional remuneration from the Company apart from a Director's fee and allowances; does not participate in the Company's share option or a performance-related pay scheme, and is not a member of the Company's pension scheme.
9. He must not have served on the Board for more than nine years from the date of his first election.

5.2 RESIGNATION

The Code or Corporate governance fails to provide for the procedure for the resignation of the independent directors.

[25]R. Anand "*How to get truly independent directors*" available online at https://www.thehindubusinessline.com/opinion/how-to-get-truly-independent-directors/article29459974.ece# (accessed 12 February 2020)
[26]ibid
[27]Supra note 7

5.3 MINIMUM NUMBER OF INDEPENDENT DIRECTORS REQUIRED

Similarly, the Code fails to expressly stipulate the number of independent directors required, the Security and Exchange Commission Code on Corporate Governance which regulates public companies, however recommends a minimum of one independent director on each company's board.

6.0 INDEPENDENT DIRECTORS AND GLOBAL PRACTICES

It must be pointed out that while there is a global clamour for inclusion of independent directors, the definition of an independent director varies from jurisdiction to jurisdiction.
The International Corporate Governance Network in its report- ICGN Global Governance Principles addresses the importance of independence in the leadership of companies. It provides as follows:

"The board of a widely-held company should comprise a majority of independent non-executive directors. Controlled companies should preferably have a majority of independent non-executive directors, or at least, three (or one-third) independent directors, on the board."

In the same light, the document explicitly provides for the criteria for independent directors and imposes a duty on the board to disclose in the annual report, the names of directors being considered by the board to be independent, as well as reasons for such consideration.

The international standards of board independence continue to evolve, and developed as well as developing countries persistently amend their relevant codes to accommodate these changes. The rate of change remains robust, as the corporate governance codes are constantly revised to ensure the independence of the board. While the requirements may vary by level of market maturity and

ownership structures, majority of the economies require independent directors on the board of companies, in accordance with best practices of corporate governance.

[28]Principle 7.4 of the Nigerian Code of Corporate Governance 2018
[29]Supra note 6

However, the standards are noticeably higher in the developed states and half of the European markets have adopted board independence standards requiring that either half or a majority of the board members are independent directors. Notably is the United Kingdom, which is moving from a fifty-percent independence requirement (excluding the chairman) to a majority requirement (including the chairman). The figure however remains lower in developing economies, especially in Nigeria, where a 2019 report of the thirty most capitalised public companies in Nigeria by the Society for Corporate Governance Nigeria illustrates that many of the capitalized companies on the Nigeria Stock Exchange continue to operate without independent directors, and the limited companies with independent directors have an insignificant number, thus threatening the true independence of the board.

An examination of some of the highest ranked companies globally by market value indicates that compliance with corporate governance best practices, notably inclusion of independent directors has played a large role in the effective running of such corporations.
Independent directorship is a major criterion for Microsoft Corporation, a major leading multinational technology company. Their Corporate Governance Guidelines provides that a substantial majority of their directors will be independent. Their Board of Directors have adopted Director Independence Guidelines to assist in determining each director's independence. Annually, each director completes a detailed questionnaire that provides information about relationships that might affect their determination as independent.
Similarly, independent directorship is key for Apple Incorporation and the company incorporates a standard that includes a board occupied by a majority of independent directors in compliance with the requirements laid down by the Nasdaq Stock Market.

Conclusively, while the board independence standards vary from country to country, global best practices as examined above are an indication of the requirement of independent directors in substantial amount to ensure the smooth running of companies.

INDEPENDENT DIRECTORS AND GLOBAL PRACTICES

[29]Supra note 11
[30] ICGN Global Governance Principles, 5th Edition, November 2017, available online: http://icgn.flpbks.com/icgn_global_governance_principles/ICGN_Global_Governance_Principles.pdf(accessed 5 February 2020)
[31]Ibid. paragraph 2.5

5.3 RECOMMENDATIONS

Independent Directors are charged with the mandate of bringing objectivity to the oversight function of the board and critical in the performance evaluation of the board and management, and the inclusion of the appointment of the same in the various codes of corporate governance in Nigeria is laudable.

Nonetheless, the various Nigerian Corporate Governance Codes have shortcomings as highlighted above, noteworthy is the question of the true independence of the independent directors, as well as the failure of the Nigeria Code of Corporate Governance which extends to private companies to provide an encompassing definition of an independent director.

These lacunae despite affecting the implementation of the respective codes are not insurmountable, and cue can be taken from developed countries as well as global best practices in ensuring the inclusion of independent directors as stipulated by the Nigerian Codes of Corporate Governance.
For, whilst there is no absolute formula in determining a perfect composition of independent directors, boards with a balanced or higher proportion of independent directors would certainly go a long way in alleviating boardroom dominance, stereotype discussions and complacency.

Practically speaking, it is difficult to tease out the factors that make one board, an effective team and another, equally talented group of people a dysfunctional one. Some scholars and corporate governance gurus have pointed to a number of factors; one being identifying well-governing boards with certain process representatives which can be used to indicate monitoring performance. The process representatives allude to independent board leadership whether through a non-executive chairperson or a "lead" independent director.

[1] I.M. Millstein and P.W. MacAvoy, "*The Active Board of Directors and Performance of the Large Publicly Traded Corporation"* (Columbia Law Review, 1998) pp 1283-1321