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Independence and Boards of Directors: An International Governance Regime Perspective

Lisa Barnes *

Corporate Governance is not a new concept. But, the spate of recent large scale corporate collapses has been a catalyst for popularising the prescription of governance regimes by international stock exchanges. This study analyses the listing rules of nine international stock exchanges in order to clarify the definition of independence, and to contribute to an *International Governance Regime (IGR)* by initiating four governance strategies all supported by the stock exchanges.These initiatives include the use of *Independent Governance* of directors on boards, an independent chairperson, separation of the roles of CEO and Chair, and the encouragement of the use of nomination committees to encourage further use of independent directors. These four initiatives are the stepping stone for creating an International Governance Regime, supported by stock exchanges all over the world, creating an efficient and orderly international commercial environment.

Field of Research**:** Corporate Governance, International Governance Regime, Independent Governance.

1. Introduction: Best Practice on an International Scale.

The current financial crisis has seen many companies of high reputation crumble amongst the pressures of sub-prime market challenges, falling property prices, and relaxed regulation particularly in the US. Since the late 1990s the US Clinton lead government in the effort to boost the level of home ownership among minorities and low income earners, has amended an act originally created in the 1970s to loosen lending requirements

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* Lisa Barnes is a Lecturer in Accounting at the School of Business and Management, University of Newcastle, Australia. Address for correspondence: Lisa.Barnes@newcastle.edu.au PO Box 127 Ourimbah, NSW Australia, Ph 0061 2 43484157 Fax 0061 2 4348 4101

. This allowed such companies as Fannie Mae to make loans to people with no income, no assets and no job. The fallout of the sub-prime mortgage market has seen looses suffered by such high profile companies as Merrill Lynch, Credit Suisse, Bears Stearns and Citigroup. The governance of such companies has come to the forefront. How are these board structured to add value, and why did they fail?

Corporate Governance it seems is the new buzz word of governments, institutional investors and of course business. With the recent history of corporate collapse, and injury to various stakeholders, governments and international organizations have rushed to regulate and legislate, recommend and prescribe, governance regimes to protect the rights of stakeholders, in an effort to help maintain an orderly commercial environment, within global economies.

The exploration of the make up of boards of directors and particularly the use of independent directors is an area of research that has seen many gaps in its findings. It is the nature and scope of this paper to explore and compare different boards of directors and indeed different governance regimes in which this listed companies operate, in each of their various countries, to add value to the governance debate regarding what is good international governance.

This papers objective is to explore and compare international governance codes specifically in relation to the definition of "independence" of directors in Australia, Canada, Germany, Japan, the United Kingdom, Singapore, Hong Kong, the United States and Sweden. The identified gaps in the literature will formulate the research question, and pose recommendations on its findings. This study also analyses the listing rules of nine international stock exchanges in order to contribute to an *International Governance Regime (IGR)* by initiating four governance strategies all supported by the stock exchanges.

The research questions investigated are then:
1/ Can the term "independence" in relation to directors be clarified on an international level?
2/ Can an *International Governance Regime* (IGR) be supported by similarities in stock exchange listing rules?

2. Governance: The Literature

2.1 Corporate Governance

Clearly the overriding common objective of governance regimes is to create and maintain an orderly commercial environment, for the benefit of the public interest, to avoid such situations as the world is currently in, by way of controlling and monitoring board performance. Corporate governance itself has a long history, although the term was not used by such economists as Smith (1776) and

Spencer (1862) - the idea that the running of a corporation ethically would bring profits to the corporation and by default economic benefit to society underpinned their discussions. Indeed, Drutman and Cray (2004) note that corporations were perceived originally to be 'arms of the state'. Viewing corporate America following the merger and trust movements at the end of the nineteenth century, Berle and Means (1932) popularised the idea that whereas entrepreneurs were good with ideas, specialist managers should run businesses. And that in any event because of the emerging corporate structure, professional managers had to be engaged. Thus, by the early 1930s the notion of the potential problems associated with the separation of ownership from control were firmly embedded in the corporate regulatory literature; as an ultimate consequence of what Bryers (1993) labelled the *socialization of capital*.

Those potential problems underpin Jenson and Meckling's (1976) discussion of the costs associated with agency monitoring initiatives. Agents' propensities to not always act for the benefit of their principles in preference to gaining a personal benefit, created an ethical dilemma provoking and justifying the development of legislative and other impositions of corporate governance principles. It has also been noted that a generalisation is set in the specific context of publicly listed companies in which shareholders are typically divorced from any active association in or with management.

2.2 Boards of Directors

2.2.1 Directors

The role of the Directors is clearly defined to be "the management role undertaken by directors requires that in the exercise of power they act honestly and in the best interests of shareholders and creditors" (Hinchy & McDermott, 2006, p.121). Whereas in the past, some boards of directors were made up of members elected because they knew someone on the board, they are now elected for their skills and their ability to add value to the board and by default the business. Board of directors for entities must exhibit as much of their fiduciary duties as they would to a corporation, as they are still under Corporations Law (2001) legislation in the carrying out of these duties.

2.2.2 Independent Directors

The Joint code of professional conduct defines independence as being free, in fact and appearance of any interest which might be regarded, whatever its actual effect as being incompatible with integrity and objectivity (Section B.4 Dellaportas, Gibson, Alagiah, Hutchinson, Leung and Van Homrigh 2005). "The field of corporate governance is concerned with the rules and principles that regulate the power relationship among owners (shareholders), directors and managers" (Goodman and Schwartz, 2004).

International Corporate Governance Network (ICGN, 2009) Statement on Global Corporate Governance Principles state that "corporate boards should be independent". Corporate Governance rating organization such as Glass and Lewis and Co. (2009) looks at economic consequences of corporate governance such as board independence. Some advocate that a majority of boards be independent and that in particular the chair be an independent director.

The New York Stock Exchange Corporate Governance Rules: Section 303A state that there

1. "must have a majority of independent directors and have
2. tests of independence if no material relationship with the listed company"

www.nyse.com/pdfs/finalcorpgovrules.pdf.

SEC (2003) and CII definitions of independence include the following in the last five years:
1/ employed by the company, director or affiliate
2/ employee or director or >20% ownership of an affiliate, advisor or consultant
3/ paid advisor or consultant to an executive officer of the company and receives at least $50,000 revenue for advisory services.
4/ employed by has 5%> ownership interest in 3rd party to the company (1% consolidated annual revenue)
5/ employee or director or organization that receives grants ($100,000 or 1 percent of total grants).

2.2.3 Duality of Roles of CEO and Chair

To avoid a board room that exhibits too much control, the roles of Chairperson and the CEO are encouraged to be different (Hong Kong Exchanges and Clearing House (2004) and the Australian Securities Exchange (2007). This is particularly true for family owned and run companies (such as those in Europe and the Nordic regions), used to a family member controlling the board. International evidence suggests that this duality wields too much power and control to one board member, and the separation of the roles encourages the corporation to enable the input of all board members to enable them to add value to the decisions made by the board, without one person being given the power to make decisions.

2.2.4 Nomination Committee

The use of a nomination committee enables the board to independently assess the value of a potential new board member (Swedish Corporate Governance Board,2006). It can be made up of a sub-committee of the board, but does not usually include the chair or the CEO. The use of the Nomination committee is to allow for a true assessment of a potential board member based on their experience, merit and industry or other skills that they can offer to the board.

2.3 United States Corporate Governance (2002)

In the US the Sarbanes Oxley Act (SOX) 2002 is just one of many sets of corporate governance principles recommended to corporations, according to the Securities and Exchange Commission (SEC). It is legislation with which all registered corporations in the United States must comply with, or risk prosecution for failure of compliance. SOX was designed to improve investor confidence in the financial markets.

US corporate governance is agency theory based ie trying to align interests of Shareholders to management. European is more about protection of stakeholders, particularly shareholders. The NYSE, the Nasdaq and AMEX all require a majority of directors to be independent. CII (2008) “An independent director is someone whose only nontrivial professional, familial, or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.”

2.4 Combined Code UK (2003)

In the United Kingdom (UK) the Combined Code on Corporate Governance (Combined Code) was released in 2003 after the Hampel Committee on Corporate Governance in June 1998. The *Hampel Committee* was set up to review current corporate governance arrangements on an international level, make recommendations and design a code specifically for listed companies – *The Combined Code*. It is applicable for all registered companies and applied after 1 November 2003, requiring under listing rules all listed corporations to make disclosures.

2.5 Swedish Code of Corporate Governance (SE 2005)

Based on the Swedish Companies Act (1975), it is largely self regulated, and was written due to the large portion of Swedish people owning shares in companies (SE 2005). It is aimed at listed companies, particular the large listed companies (A-List), under the “comply or explain” principles. It encourages companies to comply with the code in a cost-effective manner, and to encourage implementation of systems and procedures for governance mechanisms. During the first year of the code the Annual Report of the Swedish Corporate Governance Board (2006) found that 153 companies or 60% discussed governance on their websites and 102 stated if they intended to apply the code or not. Of the 76 companies obliged to apply the code due to their size, only 25 did not provide information.

2.6 Hong Kong Code on Corporate Governance Practices (2004)

The Hong Kong Exchanges and Clearing Limited (HKEx), which is the holding company of Stock Exchange of Hong Kong (SEHK) has issued a Corporate Governance Practices Code (2004), and this become compulsory on the 1st January 2005 for all listed companies on the SEHK. Modeled on the Combined Code of the UK (2003) it is an 'if not, why not' explanation of any deviations of the prescribed corporate governance practices.

2.7 Toronto Stock Exchange Corporate Governance Policy (2002)

In Canada, the Toronta Stock Exchanges Proposed New Disclosure Requirement and Amended Guidelines were issued in 2002. They came from initiatives of the Joint Committee on Corporate Governance, Beyond Compliance :Building a Governance Culture (2001), and the institute of corporate directors and Toronto Stock Exchange Report on Corporate Governance, 1999 – Five years to the Day.

2.8 Japans New Corporate Governance Principles (2006)

These were issued by the Japan Corporate Governance Forum (JCGF), by Revision Principles working Group of the JCGF, in 2006. The notion behind the governance principles is to "academically and practically, *with* the social roles of the company, help build healthy relationships between the company and society" (JCGF, p.1, 2006).

2.9 Singapore Ministry of Finance Code of Corporate Governance (2001)

Issued by the Corporate Governance Committee, and compulsory for listed firms under Rule 710 of the listing manual, it refers to the need to enhance corporate performance and accountability, but also maintaining healthy relationships with stakeholders. It takes a balanced approach to the compliance with governance codes similar to that taken by Canada and the UK.

2.10 German Corporate Governance Code (2002)

Issued by the Government Commission appointed by the Justice Minister, its aim is to make "rules transparent for both national and international investors, thus strengthening confidence in the management of German corporations" (GCGC, 2001, p.1). It was part of amendments made to the Transparency and Disclosure Law, 2002, and has a legal basis.

2.11 ASX Corporate Governance Principles (2007)

Corporate Governance received explicit ASX acknowledgement through the changes in its Listing Rules with the introduction of ASX Listing Rule 4.10. Listed

companies are required to explain the reasons why they have not adopted the "Principles of Good Corporate Governance and Best Practice Recommendations" which was written by the ASX Corporate Governance Council (2003), based on the OECD (1999) corporate governance principles. It was then reviewed from ten principles down to eight principles in 2007, and the name to drop "Best Practice" from the title.

3. Method of Enquiry

The decision to target the particular countries was based on how they could be best analysed (Krippendorff, 1980) in terms of content, convenience sampling in terms of availability, and the fact that the stock exchanges listing rules were important documents for disclosures (Uneman, 2000), and were used by a large number of stakeholders. The archival data was collected from publicly available sources, such as organisations web-sites and reports of various international Stock Exchanges. The information was collated and compared in order to find differences and similarities. Whilst it is noted that recommendations made can be applied to different organizations, it is the object of this analysis to find if any, best practices can be made that will apply to the majority of entities in the majority of stock exchanges or international organizations.

4. Data Analysis

The data was analysed from archival data. The first part of the research was to compare and analyse (a) if the relevant stock exchange encouraged the use of independent directors (and to what extent), and (b) to compare the various definitions of what the exchanges meant by the term independent. The countries initially analysed include Australia (ASX 2007), Hong Kong (HK2005), The United Kingdom (UK 2003) and Sweden (2005). These countries were chosen for their very detailed analysis of the definition of independent directors.

Table One: Definitions of Independence (Australia, Hong Kong, UK and Sweden).

ASX CG (2003)	HK (2005)	CC UK (2003)	Sweden (2005)
Majority of Board to be Independent	At least 3 (three) independent directors	At least half the board to be Independent	Majority of board to be Independent
Independent if:			
Not Substantial SH (Sec 9 Companies Act 2001)	Hold less than 1% issued capital	They are a significant SH	Not more than 10% of shares or votes
No Previous employment less than 3 years	Not be employed within 2 years	Have been employed within the last 5 years	Have been employed within the last 3 years
Not be a Material consultant within 3 years	Not within last year part of professional advisers	No significant links with advisers or directors	No significant remuneration for advise
			Not in last 3 years been employed by audit firm
Not have Material relationship eg customer, supplier	Not have Material relationship eg customer, supplier	Not have Material relationship eg customer, supplier in last 3 years	Not have Material relationship eg customer, supplier
Not have Material contractual relationship other than director	Received financial assistance other than wage	Additional remuneration, share options or pension plan	Not be managing director in last 5 years
	Not be on board to protect other companies SH		Not be on a board with another director
	No connection to board or substantial SH within last 2 years	Not have close family ties with advisers or directors	Not have close family ties with advisers or directors
	Not be financially dependent on company		
	Not be director for more than 9 years	Not be a director for more than 9 years	Not be a director for more than 12 years

The data was then analysed to include information on a) to what extent independence within the board in encouraged, b) if the chair is encouraged to be also independent, c) if duality of CEO and chair positions were encouraged on the boards and d) if nomination committees were present on boards. The definitions then of independence were compared in terms of shareholding, employment, materiality (eg consultancy, business or contractual), time as a director, family ties and presence on other boards. Again the countries of Australia, Hong Kong, the UK and Sweden were analysed for these purposes.

Table Two: Comparison of Independence Principles (Australia, Hong Kong, UK and Sweden).

Principle	**ASX CG (2003)**	**HK (2005)**	**CC UK (2003)**	**Sweden (2005)**
Number of Independent Director on Board	Majority	At least 3	Majority	Majority
Independence of Chair	Yes		Yes	
Duality of CEO and Chair	No	No	No	No
Nomination Committee	Yes	Yes	Yes	Yes
Independent if:				
Substantial SH	Sec 9 Co. Act not Substantial	Hold less than 1% Issued Capital	Not a substantial SH	Not more than 10% of shares or votes
Employment	Last 3 years	Last 2 years	Last 5 years	Last 3 years Employed by audit firm last 3 years
Material Consultant	Last 3 years	Last year	Presently	Presently
Material Business	Presently	Presently	In last 3 years	Presently
Material Contractual relationship	None	No financial assistance	No extra remuneration or shares	Not be managing director in last 5 years
Time as director	No Limit	Not > 9 years	Not > 9 years	Not > 12 years
Family Ties		No connection to board or SH within last 2 years	Not have close family ties with directors	Not have close family ties with advisers or directors
Board and Other Directors		Not on board to protect other companies SH		Not be on a board with another director

The countries of Canada, Germany, Japan, Singapore and the United States were then added to the research and compared against the four criteria of a) number of independent directors, b) independent chair, c) duality of CEO and Chair and d) use of nomination committees.

Table Three: Comparison of Board Characteristics of 9 countries

Principle	ASX	HK	UK	Sweden	Canada	Germany	Japan	Singapore	US
Independent Directors	> 50%	At least 3	> 50%	> 50%	> 50%	Per Management Board	Encouraged not required	Encouraged	> 50 %
Independent Chair	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Duality of CEO and Chair	No	No	No	No	No	No	No	No	No
Nomination Committee	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes

5. Comment on the Findings

5.1 Independence of Board members

The analysis shows that the use of independent board members is a governance mechanism supported by stock exchanges all over the world. Although the number of independent directors varies from a majority, to encourage but not required, it is still seen as one mechanism in which companies are able to demonstrate the use of governance techniques to encourage long-term survival.

The definitions of independence is varied however amongst the stock exchanges, based on the following:

- Previous employment time limits (2 years to 5 years)
- Relationship with affiliates (eg employment, ownership, family ties)
- Consultancy relationship, (eg not material or significant in manner, capped fees)
- Share ownership in entity (eg not material, not significant, 5% ownership, 10% votes)
- Business Partnership (eg material transactions with entity).
- Time limit as a director (eg more than 9 – 12 years would erode independent status).

5.2 Independence of Chairperson

Again well supported by international stock exchanges it states the obvious – that the Chairperson will be able to do their job better if they exhibit true independence – that is no other engagement with the company apart from their roles on the board. This allows the Chair to run the meeting without any links to either the company, the Chief Executive Officer (CEO) or other Board members. It is encouraged to promote ethical conduct amongst board members, and allow for decisions to be made truly in the companies' interests.

5.3 Duality of Roles of CEO and Chair

Seen to be a mechanism in the board room that exhibits too much control, the roles of Chairperson and the CEO are encouraged to be different. This is slowly changing, particularly for family owned and run companies (such as those in Europe and the Nordic regions), used to a family member controlling the board, international evidence suggests that this duality wields too much power and control to one board member. The separation of the roles encourages the corporation to enable the input of all board members to enable them to add value to the decisions made by the board, without one person being given the power to make decisions.

5.4 Nomination Committee

Whereas in the past, some boards of directors were made up of members elected because they knew someone on the board, they are now elected for their skills and their ability to add value to the board and by default the business. The Nomination Committee then is set to be an important corporate governance mechanism.

6 Recommendations

The significance of this study is to attempt to create an International Governance Regime, similar to that used by International Accounting bodies in its International Financial Reporting Standards (IFRS). The findings of this study make the following recommendations for an International Governance Regime (IGR).

- Use of independent directors
- Independent Chairperson
- No Duality of Chairperson and CEO roles
- Instigation of a Nomination Committee

To truly retain independent the following is put forward as mechanisms to maintain true independence of directors – coined *Independent Governance (IG)*.

1. No previous employment in the entity
2. No material consultancy, trading or ownership based on audit rules of 10% of turnover as the basis for valuation.
3. No share ownership or voting rights greater than 10% of shares
4. Directorships expire at 10 years of continued service.

This proposed Independence Governance is a compilation of the nine governance regimes examined. The four characteristics would need to be maintained in order to retain independence. Should directors continue to work with the organization after 10 years or when a material relationship is identified, they would then be classified as not independent, and the Nomination Committee would be responsible for their continued work as part of the board of directors of the entity.

7. Conclusion

To answer the research question "1/ Can the term "independence" in relation to directors be clarified on an international level?" the four characteristics of independence would include no previous employment, no material involvement, no share ownership or voting rights and less than 10 years as a director.

To answer the research question "2/ Can an *International Governance Regime* (IGR) be supported by similarities in stock exchange listing rules?" the overall response would be that international stock exchanges are already encouraging similar governance mechanisms. Not only do they encourage directors who are independent, but they are also encouraging an independent chairperson, a separation of the roles of CEO and Chair and recommending a Nomination Committee on the appointment of directors to encourage further independence.

Further research needs to be done on the issue of corporate governance rules by other countries not researched in this paper, and other international organisations such as the World Bank and International Monetary Fund. The creation of one international standard would maintain the governance of companies across boarders and this in turn will contribute to an orderly international commercial environment.

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