

# The Role of Independent Directors in Monitoring Related Party Transaction (RPT) in Malaysia, Thailand and Singapore

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**Keywords:** ASEAN, concentrated ownership, transaction, independent director.

**Abstract:** Related-party transaction (RPT) represents a potential “self-dealing” between the company and its directors, material owners, officers, and investees and as such most countries require some form of additional monitoring over it. In dispersed ownership countries, such as the United States (US) or United Kingdom (UK), the companies are expected to adhere to the high standard of corporate governance as the owners and managers are separate. However, such expectation is challenging in concentrated companies such as in family-owned companies and government-linked companies that are common in selected ASEAN countries such as Malaysia, Thailand and Singapore. The objective of this paper is to analyse the role of independent directors in concentrated companies. Despite having several laws and policies governing RPT which are based on the Anglo-Saxon framework, the dynamics of Asian companies’ structure may render them ineffective at the expense of the minority shareholders. The author employed doctrinal analysis of data from both primary and secondary legal sources from Malaysia, Thailand and Singapore. It is suggested these countries should review the existing regulatory framework for RPT by strengthening the role of the independent director. This paper will contribute to the existing literature by discussing the necessity of strengthening the role of independent director in monitoring RPT.

## 1 INTRODUCTION

Related-party transaction (RPT) represents a potential self-dealing between the company and its directors, material owners, officers, and shareholders. It may include activities such as the selling and purchasing of assets, guaranteeing of loans, and exchanging of assets with different qualities.

Previous literature mainly focuses on the controlling shareholder in the US and UK, which is based on dispersed company ownership and not within the in a concentrated company environment which has different agency problem. In a dispersed ownership structure, the key agency problem is the outside directors and managers can misuse their powers to pursue their personal interest at the expense of the shareholders. Meanwhile, in concentrated ownership jurisdictions, the key agency issue is the act of shifting the resources out of a company to its controlling shareholders or known as tunnelling.

Therefore, this paper seeks to fill the gap by critically analysing the existing RPT regulations in Malaysia, Thailand and Singapore. These countries are chosen because they are the participating

members to the ASEAN Disclosure Standards, which allow cross-listing initial public offerings among the member states. This paper is divided into several parts, starting with Section 2 on theories on RPT, followed with Section 3 that discusses the laws and regulations in Malaysia, Thailand and Singapore on RPT and appointment of independent directors, Section 4 on the analysis of the role of independent director in RPT and finally Section 5 concludes.

## 2 THEORIES ON RELATED PARTY TRANSACTION

### 2.1 Conflict of Interest

The theory views the transaction as undermining directors’ fiduciary responsibility to the company and the monitoring function of the board on behalf of the shareholders as a whole (Farrar & Watson, 2011). Others such as earning management (a purposeful intervention in the external financial reporting process)(Marchini, Mazza, & Medioli, 2018), with the

intent of obtaining some private gain), tunneling (Cheung, Rau, & Stouraitis, 2006) or transferring wealth out of the company by the controlling shareholders, excessive compensation to directors who are a related party and misleading financial statement. These drawbacks are consistent with the agency issues in a dispersed ownership company where it was argued that due to the outside shareholders' conflict with the managers, there was a tendency for the managers to appropriate the firm's resources for personal consumption (Berle & Means, 1933; Fama & Jensen, 1983). The managers are not holding significant number of shares in the company, and this led to weak incentive to act appropriately. As a result, they could be simply incompetent and ignorant by abusing their power at the expense of the minority shareholders (Kraakman et al., 2006).

## 2.2 Efficiency Hypothesis

On the other hand, the efficient hypothesis theory does not view RPT as harmful to shareholders, but in fact, beneficial. Proponents provided an alternative view that RPT is an efficient transaction that rationally fulfils other economic demands of a company such as securing in-depth skills and expertise between participants with private information or providing an alternative form of compensation (Gordon, Henry, & Palia, 2004). It would be more cost efficient for the company to engage a related party than an outsider. There would be better coordination between the contracting related parties because the information is reliable and this could mitigate the hold-up problem contracting process (Ryngaert & Thomas, 2007). It could also be argued that RPT is inevitable if the market is inefficient and incomplete information (Pizzo, 2013a). The argument put forward by these proponents of efficiency theory is this that the minority shareholders are not prejudiced because the efficiency of RPT is benefitting them in long-term (Balsam, Gifford, & Puthenpurackal, 2017). However, these arguments could unreasonably be used to justify the abusive RPT practices including tunnelling. It was reported that abusive RPT, whether in the form of one-off material expropriation of wealth or the slow expropriation of wealth via continuous operational transactions, are one of the biggest corporate governance challenges facing Asian businesses (OECD, 2009).

## 2.3 Contingency Perspective Theory

The literature on the above theories (conflict of interest and efficiency) have been inconsistent and

unable to cope with different situations. For example, in certain jurisdiction in ASEAN where there is a higher concentration of ownership in a company (as opposed to dispersed ownership in the US or UK), both theories are unable to reconcile with the intricacies of concentrated ownership issue especially in ASEAN.

Under this theory, the effectiveness of a corporate governance structure is mediated by interdependencies between organizations and their environments; namely (i) costs, (ii) contingencies and (iii) complementarities. Cost refers to the value of inputs to corporate governance, contingencies refers to how corporate governance interrelates with variations in internal and external strategic resources that share a firm's interdependence with market, sectoral, regulatory or institutional environments and last but not least, complementarities refers to the overall bundles of practices that are aligned to mutually enhance the ability to achieve effective corporate governance (Aguilera, Filatotchev, Gospel, & Jackson, 2008). In relation to corporate governance, this theory holds that universal best practices should be rejected because its effectiveness varies upon the internal or external contingent factors.

Pizzo supported the idea that it is necessary to interpret them bearing in mind contingency factors, such as specific organisational contexts and institutional environments, and to take into account the influence of complementarity/substitution between governance factors (Pizzo, 2013b). E.g., we could consider the possibility of viability when applying the legal transplant from foreign jurisdictions into another jurisdiction due to a different type of ownership like USA and Asia. Increased monitoring and the roles of independent directors as being done in the US, which is to address the agency perspective in dispersed ownership, may not be effective in Asian jurisdiction where the latter is known for the prevalent of concentrated ownership.

### **3 LAWS AND REGULATIONS IN MALAYSIA, THAILAND AND SINGAPORE ON RPT AND APPOINTMENT OF INDEPENDENT DIRECTORS**

#### **3.1 Malaysia**

##### **3.1.1 Companies Act 2016 (CA 2016)**

The terms “related party” and “transaction” carry different meanings depending on the regulation. Section 7 states that, a corporation is deemed to be “related” to each other if:

- a) It is a holding company of another corporation;
- b) It is a subsidiary of another corporation; or
- c) It is a subsidiary of the holding company of another corporation.

Section 221 of CA 2016 states that a director must declare his material interest in the proposed contract with the company. Furthermore, the section above excludes the director concerned from disclosing any information despite him being the member or creditor of the company ‘if the interest of the director may be regarded as not being a material interest.’ Section 222 also provides that a director who is anyway whether directly or not, interested in a contract entered into with the company, shall not participate in the discussion when the contract is being considered and shall not vote on the contract or proposed contract. Section 228 prohibits the company from entering or carrying into any effect any arrangement or transaction where a director or a substantial shareholder of the company or its holding company or its subsidiary, or a person connected with a director or substantial shareholder.

##### **3.1.2 Bursa Malaysia Listing Requirements (BMLR)**

BMLR defines RPT as “a transaction entered into by the listed issuer or its subsidiaries that involves the interest, direct or indirect, of a related party”. Meanwhile, “related party” in related to a corporation, means a director, major shareholder, or person connected with such a director or major shareholder.

In addition to that, Para 10.08(7) disallows interested directors, substantial shareholders and those connected to them from voting when shareholder approval is sought from the general meeting. Depending on certain percentage threshold, BMLR also require disinterested shareholders’

approval in a general meeting. The advice from an independent adviser is required to provide an opinion as to whether the proposed RPT is fair and reasonable and whether such a transaction is to the detriment to the minority shareholders.

Every RPT must be reviewed by the audit committee where all members are must be non-executive with a majority of them are independent. They are also required under Paragraph 15.12 to review the proposed RPT or any conflict of interest situation that may arise that could affect the company’s management integrity.

##### **3.1.3 Code of Corporate Governance 2018 (CGG 2018)**

CGG 2018 is “apply and explain an alternative approach” in nature. If the company intends not to follow the recommendation under the code, it has to explain any alternative measures to compensate the non-compliance.

In relation to the appointment of independent director, the code recommends half of the board must be from independent directors or for a large company, majority of the board must be independent. The tenure of the independent directors is up to nine years and if the company intends to retain the director exceeding that period, shareholders’ approval must be obtained. The code also require if the independent directors’ tenure has exceeded twelve years, two-tier approval is required. Under the two-tier voting process, shareholders’ votes will be cast in the following manner at the same shareholders meeting:

- Tier 1: Only the Large Shareholder(s) of the company votes; and
- Tier 2: Shareholders other than Large Shareholders votes

#### **3.2 Thailand**

##### **3.2.1 Securities and Exchange Act B.E. 2535 (1992)**

Thailand legal system is a hybrid by combining civil and common law legal system. Publicly listed companies are also subject to the provisions of the Securities and Exchange Act BE 2535 (1992) (SEC Act), and regulations issued under the SEC Act, as well as coming under the supervision of the Office of the Securities and Exchange Commission (SEC) and the Stock Exchange of Thailand (SET).. According to the Disclosure of Information and Other Acts of Listed Companies Concerning the Connected Transactions S.E. (2003), connected transactions

refers means any transaction between a listed company or a subsidiary company and the listed company's connected persons; or any transaction between a subsidiary company and its connected persons (Thailand, 2003). Connected person includes directors, executive, major shareholders, controlling person, proxy, spouse and any juristic person (legal entity) with a major shareholding in the company.

The act also state that a related person refers to spouse, underage children, business partners, partnership where spouse or underage children are partners with unlimited liability with 30% control, limited company or public company where either spouse, underage children, ordinary partners, or any one of these persons hold at least 30% share in limited or public company or any juristic person authorized to represent another juristic person under.

As for the disclosure and approval process, it depends on the categories and transaction size where the approval is concerned. For example, a small normal business transaction, regardless of the value, does not require any disclosure to SET, board's approval or shareholders' approval for that matter. However, for financial assistance transaction where the value is less than 100 million baht or 3% of net asset tangible value, the company must disclose the transaction to SET and to seek board approval. For a transaction exceeding this threshold, the company must convene a meeting to acquire the shareholders' approval by giving at least fourteen days notice (14) to the shareholders and to SET by disclosing certain material information such as the identity of the connected persons, the business company and its operation, any recent inter-transactions as well as summary of financial statement for the past three (3) years as laid down in Clause 20 of Information and Other Acts of Listed Companies Concerning the Connected Transactions, 2003.

The law also requires the opinion from the independent financial advisor (IFA) as to the rationality and benefits of the transactions to the company, the fairness of the transaction and the reasoning whether the shareholders should approve or reject the transaction. Finally, for the transaction to be approved, at least three-fourths (3/4) of the shareholders (excluding interested shareholders) must agree. Similar to Malaysia, independent directors must be a member of the audit committee and required to review the proposed transaction before it can be approved by the board (Thailand, 2015).

### 3.3 Singapore

#### 3.3.1 SGX Mainboard Rules

Rule 904 of the Mainboard Rules define interested person transaction as a transaction between an entity at risk and an "interested person". Interested person is defined as :

- (i) a director, chief executive officer, or controlling shareholder of the issuer; or
- (ii) an associate of any such director, chief executive officer or controlling shareholder.

Under Chapter 9 of the Listing Manual, subject to certain exceptions, all other interested person transaction must be either be announced immediately or approved by the shareholders. The interested transaction is defined as a transaction between an entity at risk and an interested person. Such transactions must be announced if it reaches certain threshold amount.

According to Rule 905, if the transaction is equivalent to three percent (3%) of the listed company's net tangible asset (NAT) according to its latest audited accounts. The second threshold that requires announcement is when the amount is equivalent to five percent (5%) of the listed company's NAT according to its latest audited accounts. Furthermore, if the transaction is below than SGD100, 000.00, it will be exempted from the announcement. Therefore, the announcement can only be made if the amount is within the 3-5 percent threshold. The announcement must contain the following information:

- (a) the details of the interested person and the nature of the interest of the interested person;
- (b) details of the transaction including the relevant terms and the bases on which the terms were arrived at;
- (c) the rationale and benefit to, the entity at risk;
- (d) a statement as to whether or not the audit committee is of the view that the transaction is on normal commercial terms and is not prejudicial to the interest of the listed company and its minority shareholders, or that the audit committee is obtaining an opinion from an independent financial adviser before forming its view, which will be announced subsequently; and
- (e) the current total for the financial year of all transactions with the interests persona and the current total of all interested person transactions.

### 3.3.2 Code of Corporate Governance 2018

The Singaporean Code of Corporate Governance 2018 is 'comply and explain' in nature. It is stated that an independent director is one who is independent in conduct, character and judgement, and has no relationship with the company, its related corporations, its substantial shareholders or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement in the best interests of the company.

The code also stipulates that the audit committee must comprise of at least three non-executive directors and the chairman who is also an independent director. The committee's scope of work includes reviewing 'significant financial reporting issues' which may also covers interested person transaction.

## 4 ANALYSING THE ROLE OF INDEPENDENT DIRECTORS IN RPT

It is well documented that independent directors monitor management more in the interests of shareholders than inside directors do (Liu, Uchida, & Yang, 2012). By having independent directors' monitoring the RPT, it could send a signal to investors that there is monitoring in place (Kohlbeck, Mayhew, Lafond, & Warfield, 2004).

Under the OECD Guide to Fighting Abusive RPT published in 1999, among recommendations is to have a coherent regulatory system dealing with RPT, particularly on disclosure, board oversight and shareholders' approval in each jurisdiction. There is a notion that corporate governance is poor in concentrated companies, and therefore it is crucial to monitor the RPT/connected transaction/interested party transaction at ASEAN level could be introduced to strengthen the corporate governance. There is already a monitoring mechanism by independent director in moderating the effect of the transaction. In Malaysia, Thailand and Singapore, the independent directors who are also in the audit committee members must review the RPT and its impacts to the company.

The OECD principles, which are based on corporate governance model from the US and UK have been transplanted in the Asian region since the financial crisis in 1997 (Chen, Wan, & Zhang, 2018). The model was to ensure that higher level of independence could address the tunnelling or

expropriation by the controlling shareholders in concentrated companies in Asia. This is because, one of the factors contributing to the crisis was poor governance in highly concentrated companies where there was no check and balance in the board then.

For years, scholars and regulators have been searching the right mechanism in minimising the effects of the agency. The US and UK might be successful in implementing many good corporate governance practices but would they be effective in the other part of the world? In short, they have been successful in empowering the dispersed shareholders and became a model of a 'successful good corporate governance' to the world (Puchniak, 2014). Emerging economies like ASEAN requires a different approach as most of the companies in the region are family-owned via a complex pyramid structure, state-owned or large controlling shareholders (Juliarto, 2012; Lemmon & Lins, 2009). Questions like how the independent directors can play their monitoring role when their appointment is at the behest of the controlling shareholders? There are many scholars (Farrar & Watson, 2011) have expressed their concern on the independence level of the non-executive directors because of social and economic factors (Le Mire & Gilligan, 2013).

Despite the extant of literatures on the advantages of having the independent directors approval, it is also acknowledged that the quality of 'independence' is questionable. This is because the appointment is still being done by the executive directors who usually nominate their trusted business associate to be an independent director (Ferrarini & Filippelli, 2014). This idea should be supported provided that there is genuine independence, a clear procedure and the interested person is prohibited from voting (Farrar & Watson, 2011).

Ultimately, the process of approval lies in the hand of the disinterested shareholders. It is a general rule that, in any conflict transaction, the directors or shareholders concerned is not allowed to vote. However, the disinterested shareholders (who are also the minority) still tend to approve the RPT because the presence of the interested directors or controlling shareholders during the voting process (despite not allowed to vote) .It is not common that the minority shareholders will vote against the proposed RPT especially when the majority shareholders are the founder/family members of the company or politically-connected shareholders (like Genting Group or CIMB Group)(Chan, 2010; Rachagan, 2011). Being a minority has always been intimidating, more so if the proposed RPT could be 'disguised' as beneficial to the company.

## 5 CONCLUSION

In conclusion, this paper recognises that there is a legitimate concern as to the effectiveness of the independent directors within the existing regulatory framework on RPT in these countries. The nature of concentrated ownership in the region requires a different approach in addressing the key agency issue; tunnelling.

The test that can be applied is whether the said director can exercise independent judgement and act in the best interests of the company (listed issuer). When an independent director is appointed to the board, he is expected to lend his views without any restriction or biases (Abdul Razak, Adam, & Mahali, 2017). This remains a debate until today.

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