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Advanced Electronics Company

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GCC Board Directors Institute

INDEPENDENT DIRECTORS AS FACILITATORS OF EFFECTIVE CORPORATE GOVERNANCE

A WHITE PAPER BY
ADVANCED ELECTRONICS COMPANY AND GCC BOARD DIRECTORS INSTITUTE

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Advanced Electronics Company

Mr. Abdulaziz Al-Duailej
President & Chief Executive Officer
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"This is a part of AEC's CSR initiative to help local companies in Saudi Arabia develop efficient board models. AEC recognises its corporate social responsibility to foster transparency in processes through appointment of independent directors.

The development of sustainable organisations largely depends on their commitment to ethical conduct and social responsibility. Independent directors have emerged as advocates of corporate governance who drive companies towards operational efficiency and internal harmony.''

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Foreword
GCC Board Directors Institute

Mr. Mohammed Al Shroogi
Chairman
GCC Board Directors Institute

"GCC Board Director's Institute (GCC BDI) is delighted to contribute to this white paper on independent directors. We are strong proponents of the benefits of appointing such individuals, who have the power to transform the boards on which they sit, bringing independent thought and diversity to the board room.

By having no material relationship with the company, the value of independent directors is in their objectivity, clarity of thought and external perspective which they can consequently bring to the board."

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Executive Summary

Boardrooms across the globe are making corporate governance a top priority, as they realise it is critical to the long-term value creation, sustainability and investment attractiveness of their companies. Boards are a strategic asset and leading boards understand they play a key role in the success of the company, setting the strategic direction, challenging management assumptions, overseeing risk management, ensuring succession planning and creating the right tone at the top, which translates into a positive ethical business culture. Independent directors perform a valuable function and can help a company to adopt best practices in corporate governance.

Independent directors facilitate objective decision-making and can intermediate in conflicts, help scrutinise management, encourage ethical conduct and guard stakeholder rights. This in turn, promotes good governance and facilitates a healthy organisational culture. Consequently, there has been an upward trend in the inclusion of independent directors within traditional board structures.

This report focuses on a variety of issues relating to the appointment of independent directors, such as their roles and responsibilities, induction processes and emerging trends in this area, among others.

Transforming Boards through Independent Directorship

Globally, boards are beginning to acknowledge the advantages of independent thought and objectivity. This realisation has led to the evolution of board structures –developing a model whereby effective separation of board and management, and the inclusion of independent directors, are key. Independent directors can enhance ethical governance and help create more efficient and resilient boards.

	2000	2018
S&P 1500 Companies* with Independent Board Leadership Model [2]	10%	92%
S&P 1500 Companies* with Independent Directors [2]	65%	83%

* The S&P Composite 1500® is a stock market index of US stocks developed by Standard & Poor's. It covers approx. 90% of U.S. market capitalization, and is a combination of three leading indices namely, the S&P 500®, the S&P MidCap 400®, and the S&P SmallCap 600®. [20]

Korn Ferry (2012) note the following key skills and attributes sought by companies in independent directors: [8]

- Ownership Mindset; Strategic Perspective
- Financial Literacy; Understanding of Latest Technologies
- Effective Interpersonal & Communication skills
- Integrity; High Ethical standards; Leadership Experience
- Specialist Knowledge in a Specific Area
- Commitment to Improve Business; Ability to Devote Required Time

What are Independent Directors?

The standard structure for boards comprises of executive members (such as CEO, CFO etc.), non-executive members and independent directors. The latter are those non-executive members who do not have any material relationship with the company.

According to the KSA Ministry of Commerce and Investment Corporate Governance Regulations for Non-listed Companies, an independent director is a "non-executive member of the Board who enjoys complete independence in his/her position and decisions and none of the independence affecting issues stipulated in Article 20 of these Regulations apply to him/her". *[1]*

Article 20: Issues Affecting Independence

1. **"An Independent Director shall be able to perform his/her duties, express his/her opinions and vote on decisions objectively with no bias in order to help the Board make correct decisions that contribute to achieving the interests of the Company.**
2. **The Board shall annually evaluate the extent of the member's independence and ensure that there are no relationships or circumstances that affect or may affect his/her independence.**
3. **By way of example, the following negate the independence requirement for an independent director:**

a. If he/she holds (5%) five per cent or more of the shares of the Company or any other company within its group; or is a relative of who owns such percentage.

b. If he/she is a representative of a legal person that holds (5%) five per cent or more of the shares of the Company or any company within its group;

c. If he/she is a Board member of any company within the group of the Company for which he/she is nominated to be a Board member.

d. If he/she is an employee or used to be an employee, during the preceding two years, of the Company, of any party dealing with the Company or any company within its group, such as auditors or main suppliers; or if he/she, during the preceding two years, held a controlling interest in any such parties;

e. If he/she has a direct or indirect interest in the businesses and contracts executed for the Company's account;

f. If the member of the Board receives financial consideration from the Company in addition to the remuneration for his/her membership of the Board or any of its committees;

g. If he/she engages in a business where he competes with the Company, or conducting businesses in any of the company's activities."

What are the Responsibilities of Independent Directors?

Boardrooms across the globe recognise the value of independent thought and this has led them to recruit independent directors for their board.

While the role, fiduciary duty and liabilities of an independent director are no different to any other director on the board, because of their objectivity they can have additional responsibilities and these can broadly be grouped into the following categories:

01

PERFORMANCE APPRAISAL OF THE CHAIRPERSON
Assessment of the chairperson is one of the main duties of independent directors. They are accountable to lead the annual evaluation of the chairperson's performance. Apart from the annual meeting, they can conduct additional meetings with non-executive directors or shareholders to gauge the chairperson's commitment to duties. [3]

02

NEUTRAL ADVISORY ROLE
Executives often fail to reach a consensus regarding managerial decisions. On such occasions, independent directors can provide valuable unprejudiced opinions. The neutrality associated with their position allows them to steer discussions along objective lines. [3] And if conflicts arise between management and the board or the board and shareholders, independent directors can be called on to resolve such conflicts because of their impartiality.

03

PROTECTING COMPANY'S INTERESTS
An organisation's larger vision can be neglected in the pursuit of monetary means or appeasement of top leadership. Independent directors' ethical duties and objective guidance enables them to garner focus on a company's larger vision. This prevents executives from forsaking the company's principles. [4] Independent directors can help to balance these conflicts of interest, enhancing shareholder and stakeholder confidence.

04

GUARDIAN OF STAKEHOLDERS
Lack of any material relationship with the company allows independent directors to better protect all shareholders and stakeholders. They can be vigilant watchdogs ensuring checks and balances are in place and being applied.

05

CHAIRING BOARD COMMITTEES
Again because of their independence and objectivity, independent directors are better placed to chair the board committees.

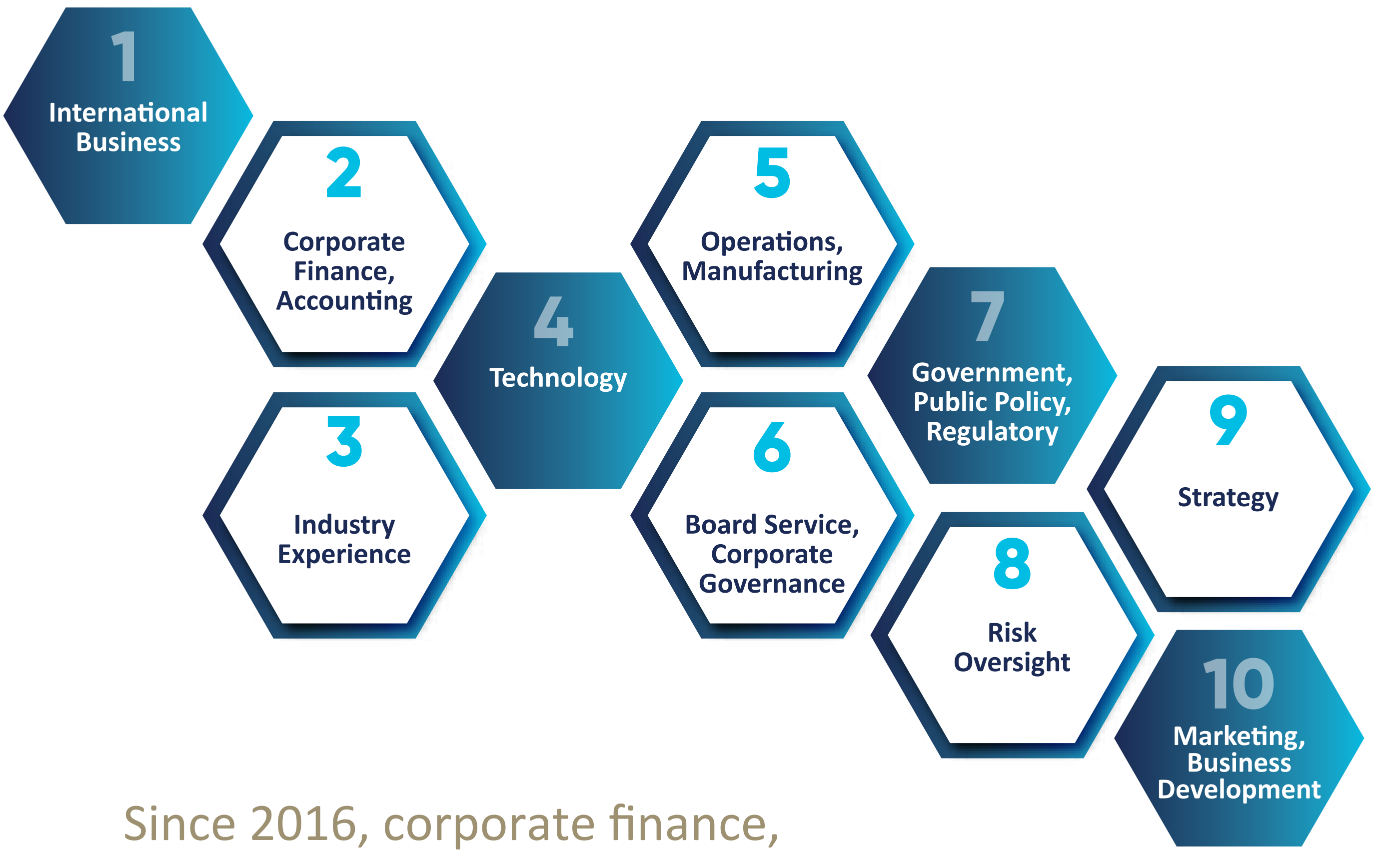
06

MENTOR AND COACH
Independent directors also make good mentors for management and other board directors.

Emerging Trends in Independent Directorship

Skills in Demand

Appointing individuals from wide-ranging backgrounds can add a variety of skills in the board's overall leadership. For 2018, the top-10 areas of expertise were [6] :



Since 2016, corporate finance, accounting, and international business have consistently been the most coveted director qualifications cited by companies.

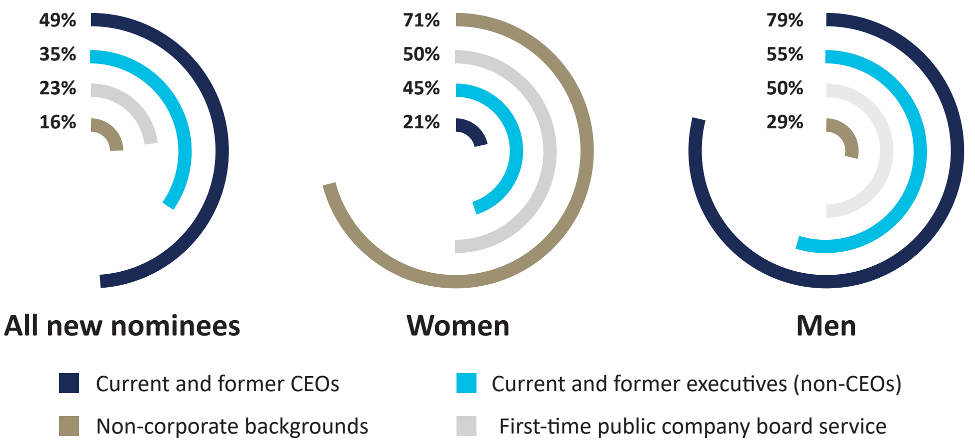
Emerging Trends in Independent Directorship

Career & Gender Diversity

Progressive organisations are building social credibility and promoting investor confidence through appointing director candidates who represent different ethnicities, skill-sets and genders. Diversity brings diversity of thought, innovation and new insights which are all valuable qualities in the boardroom and consequently improve performance.

Professional Backgrounds of Independent Director Nominees :

[6]



Greater gender balance is being reflected in non-CEO board candidates. Women lead in directors with non-corporate backgrounds, while men lead in directors with traditional backgrounds (CEOs).

40% **of the Incoming Independent Directors of S&P 500 Companies are female.** [21]

Why Do Companies Need Independent Directors?

The sustainability, longevity and reputation of companies strongly depends on the board's leadership. In this respect, listed below are some of the benefits that independent directors bring to organisations.

INTEREST OF MINORITY STAKEHOLDERS

Controlling shareholders can often influence directors to favour them which discourages equitable treatment of all shareholders. Independent directors can safeguard the rights of minority shareholders by paving the way for discussions on a level playing field. [4]

IMPROVED PERFORMANCE

There is a general consensus that independent directors add value and improve company performance because of their independent judgement on strategy, performance management, risk oversight, resources, key appointments, company health and operations. The introduction of independent directors significantly improves board leadership and overall organisational health.

CORPORATE GOVERNANCE

Independent directors can act as independent custodians of corporate governance principles. They can improve credibility and governance standards, and they can ensure the company's vision and code of conduct are duly adhered to by the management. [18]

CONFLICT RESOLUTION

As independent directors offer an outsider's perspective, members can discuss and resolve a range of matters with them. This can prevent the development of trivial issues into more wide-ranging organisational conflict. [7]

DIVERSITY AND EXPERTISE

Diversity in skills, experience, perspectives, gender and ethnicity, enable companies with independent directors to gain a competitive edge over others. [7] Independent directors can bring a wide range of expertise, new perspectives, industry knowledge, and ethnic-gender representation to foster board's diversity. They can bring specific expertise from different sectors, geographies and personal experience and are therefore an important element in board succession planning.

Percentage of corporate board members who believe business disputes impact [22] :

Time Management	Core Business Priorities	Trust Levels amongst Board Members
49.3%	44.9%	42.8%

95% of business leaders agree that boards need more candidates with diverse skills. [23]

How to Find Independent Board Directors?

Due diligence in the appointment of independent directors is crucial.

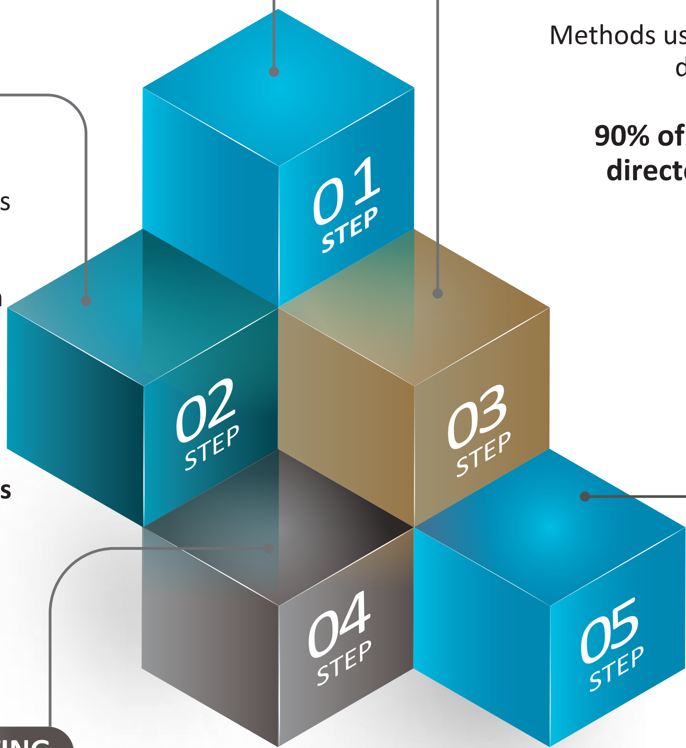
NEEDS ANALYSIS

Companies should assess their current board composition from a size and diversity perspective. They can then subsequently determine gaps in capability which could be strengthened via independent directors.

DEVELOP A COMPETENCY PROFILE

Taking into account the needs analysis above, as well as their core vision and future strategy, companies can then formulate a list of the skills, expertise, and attributes required in an independent director.

79% of mid-cap organisations use a board skills matrix [23]



SEARCH

Boards can widen their search for candidates through internal recommendations, professional firms, or via advertising.

Methods used by organisations to recruit director candidates include: [23]

90% of companies rely on current directors' recommendations and 79% use a recruiting firm.

SELECTION & SHORTLISTING

Selected candidates can be shortlisted after comparing their skills against the agreed competency profile, number of directorships held, and the level of independence they can assume in the boardroom.

NOMINATION AND APPOINTMENT

Potential candidates can be recommended to the board, followed by an election conducted by the shareholders.

Policies for Appointing Independent Directors: Implications and Vulnerabilities

The selection of independent directors requires transparency, conformity to processes, and the recruitment of individuals who fully understand their responsibility and can add value. There is a greater risk of incorporating incompetent directors if the aforementioned factors are neglected. Threats associated with adhering to substandard selection criteria are included below.

BIASED BOARDS

The absence of transparency during nominations can lead to biased appointments. This can defeat the core purpose of independent directorship i.e. to instil balance and to safeguard stakeholder trust. Hence, transparency is fundamental to the process of the appointment of independent directors [10]

INEFFICIENCY AGAINST FINANCIAL FRAUD

Nominees for independent directors should have adequate financial knowledge, irrespective of professional backgrounds. An inability to understand company financials can lead to failure to uncover manifest or hidden financial fraud. During the recruitment process, boards should ensure that the selected candidates are financially literate. [11]

DEPARTURE IN CRISIS

In times of crisis, independent directors are susceptible to resigning early in order to escape an excessive workload, or to maintain their reputation. Recently in India, the independent directors of Punjab National Bank, Jet Airways, Tata Global Beverages, and YES Bank resigned mid-term when these firms faced corporate unrest. Companies should therefore ensure they appropriately judge a candidate's level of commitment to the organisation during the recruitment process. [12]

Strengthening Corporate Governance via Independent Directors

Numerous companies across the globe have identified the benefits of independent directors and appointed them to their boards.

Global Benchmarks

SONY

- Sony Corporation aimed to grow sustainably by bolstering company's governance.
- By 2005, the majority of Sony's board attained independence.
- The largely independent Board focuses on separation of management from directorship, effective oversight, and maintenance of transparency. [13]

Infosys

- Infosys's corporate governance framework ensures due disclosure of company affairs.
- The Board consists of nine members out of which six are independent.
- Each Board committee is chaired by an independent director.
- Provision of Lead Independent Director. [14]

Microsoft

- Since 2000, the roles of CEO and Chairperson of the Board have been segregated.
- Nine out of eleven directors are independent.
- The Chairperson is annually appointed by independent directors.
- Each committee, as well as the Compensation Consultant, is independent.
- Independent directors conduct executive sessions in management's absence. [15]

Nestlé

- Since 2015, seven independent directors with diverse skills & backgrounds appointed.
- Regular in-camera meetings of independent directors without the CEO and Chairperson.
- The Lead Independent Director chairs the Nomination and Sustainability Committee.
- The Audit Committee is chaired by an independent, non-executive Board member. [17]

Independent Director Regulations in the GCC

The countries of the Gulf Cooperation Council have made substantial efforts to introduce independent directors into their respective organisations' boards. Set out below are some of the key regulations in this respect:

Emirates Securities & Commodities Authority, UAE

- "Independent members of the board have no relationship with the Company, any of its Senior Executive Management persons, auditor, mother company, subsidiaries, sister company, or affiliate company that could lead to financial or moral benefit which may affect his decisions."
- Their duty includes "Constantly verifying independence of independent Board members"

Corporate Governance Code, Bahrain

- Every independent director should bring independent judgment to bear in decision-making.
- No individual or group of directors should dominate the board's decision making.
- Non-executive directors should be fully independent of management and should constructively scrutinize and challenge management including the management performance of executive directors.
- Executive directors should provide the board with all relevant business and financial information within their cognizance.
- To facilitate free and open communication among independent directors, each board meeting should be preceded or followed by a session at which only independent directors are present.
- No one individual should have unfettered powers of decision.

In companies with a controlling shareholder, at least one-third of the board should be of independent directors.

Minority shareholders should generally look to independent directors for their interests.

Capital Market Authority Corporate Governance Regulations, KSA

- Independent directors of the Board shall "effectively participate" as follows:
  - Expressing opinions in respect of strategic issues and the Company's policies and performance and appointing members of the Executive Management.
  - Ensuring that the interest of the Company and its shareholders are taken into account and given priority in case of any conflicts of interest.
  - Overseeing the development of the Company's Corporate Governance rules, and monitoring the implementation of the rules by the Executive Management.

"The number of Independent directors shall not be less than two members or one-third of the Board members, whichever is greater."

SAMA, KSA

- **Independent directors should be "neutral and objective in decision making and without undue influence from management or from external entities."**
- **"At least two board members must be independent."**
- **"The Board should determine whether a Director is independent and assess his ability to judge things, and if there are any relationships or circumstances which might affect their independence."**

Code of Corporate Governance, Oman

- "Independent director: means the director who is independent and has experience, proficiency enabling him to support the decision-making process and company management to serve its purposes and objects."
- The percentage of independent directors to the total number of board members "shall not be less than one third, with a minimum of two independent directors".

Independence in this context means two things:

- "pecuniary or financial independence".
- "independence of opinion engendered and nurtured by experience, expertise, proficiency or knowhow in the fields of the company's business, its industry or related industry".
- Independence of thought is "aimed to enable the independent director to support the board's decision-making process and the company's purposes and objectives".

Conclusion

Independent directors have emerged as champions of good governance, due to the neutrality and objectivity associated with their position. The presence of such directors can facilitate impartial judgements and curb any conflicts and inefficiencies within the board's leadership fabric.

In addition to enhancing corporate governance, independent directors can aid in fulfilling the global push for incorporating diversity in organisations and particularly at board level. Recently, gender, ethnic, and professional diversity concerns have shaped the demand for independent directors in corporate environments. Their multifaceted role as a leader and mentor can drive corporates towards improved performance and efficiency.

Thus, organisations seek to improve the quality of their decision-making via independent directorship. Such directors can indirectly help to support, sustain and revive consumer and public trust in the corporate sector. All these aspects have encouraged various industries to add independent directors to their board.

About Advanced Electronics Company

Established in 1988, AEC has emerged as a national leader in the field of modern electronics, manufacturing capabilities, and repair and maintenance services. Ever since its inception, AEC has been a renowned force in the electronics industry. It has now evolved into a core ally of the Government of Saudi Arabia, channelizing its capacities towards meeting the benchmarks rolled out under the Kingdom's Vision 2030 Program.

We envision being recognized as the leading technology solutions provider in the region and to demonstrate unrivaled leadership across all aspects of our business. To this end, we are committed to localizing military manufacturing, deploying smart technologies, and accelerating industrial and commercial growth.

Our mission is to continuously improve and diversify our offerings by aligning our business strategies with end customers' priorities, creating long-term partnerships, harnessing opportunities, acquiring new capabilities, creating job opportunities, and investing in our people and community at large.

Website: www.aecl.com

About GCC Board Directors Institute

Launched in 2007, GCC BDI is a not-for-profit entity that guides board directors of organisations, from family-owned businesses to state-owned and listed companies, to acquire the know-how and tools to reach and sustain effective governance.

GCC BDI was founded by eight leading regional corporations and professional services firms: Saudi Aramco; SABIC; Emirates NBD; Investcorp; McKinsey & Company; Allen & Overy; Heidrick & Struggles; and PwC. Whilst GCC BDI is a completely independent company, representatives from these entities continue to sit on our board of governors today.

We are also supported by the regional regulatory authorities, including the Capital Market Authorities of Saudi Arabia, Kuwait and Oman, the Emirates Securities & Commodities Authority and the Central Bank of Bahrain.

Our mission is to enhance board member capabilities, create a strong and influential regional network of board members and disseminate high quality corporate governance knowledge, leading the regional debate on emerging best governance practices. We aim to accomplish these goals through a combination of effective practice and experience sharing, access to global knowledge and interaction with regional and international counterparts.

Over the last 12 years, GCC BDI has grown to become the leading organisation in the region for board directors. We have delivered over 190 programmes and forums to top-tier companies in the Gulf and now comprise over 1500 members, each with extensive knowledge and experience of operating at the most senior levels of business in the GCC.

Website: www.gccbdi.org

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