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Corporate governance reform in Malaysia: Board size, independence and monitoring

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ABSTRACT

Boards of directors and corporate governance have gained much attention in recent years. Many reforms have been made, especially on board composition to ensure that boards of directors are effective, in order to improve corporate governance. The Malaysian Code on Corporate Governance codified the best practices of good governance and described optimal corporate governance structures. However, due to a different context for business practices and the nature of the business environment in emerging markets, we expect that the determinants of board structure will differ from those in developed markets. Our study investigates the determinants of board structure for Malaysian firms from 2000 to 2007. We also examine trends in corporate board structure and the level of compliance of boards of directors in Malaysia with the requirements of the Malaysian Code on Corporate Governance. Overall, we find that after an increase at the beginning of the study period, and then a decrease, board size remained globally stable over the period studied while board independence has shown an upward trend in recent years.

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Our results also suggest that board size and board independence are correlated with the operation level of the firms. Unlike most findings in the US market, we find no evidence that the measures under the monitoring hypothesis are related to board independence, which requires further investigation on the monitoring role played by Malaysian boards.

1. Introduction

Much attention has been focused on the role of boards of directors in improving corporate governance in recent years. Many reforms have been made to ensure that boards of directors are effective in carrying out their role. In general, the codes of good governance in many countries, including both developed and developing markets (e.g. US, UK, Australia, German, Japan, India, and Brazil) call for more independent directors on boards.

In Malaysia specifically, the Malaysian Code on Corporate Governance (the *Code*), which was first issued in March 2000, sets out the principles and best practices of good governance and describes optimal corporate governance structures and internal processes. The *Code*, together with the establishment of Corporate Governance Guidelines in various countries – such as the US (Sarbanes-Oxley Act), the UK (Cadbury Report, Hampel Report), and Australia (Bosch Report) at about the same time – all attempt to achieve an optimal framework for governance. However, even if board structure can be determined by the firms' specific factors to maximize its effectiveness, the imposed regulation may be a burden to the firm. As a result, much attention has been focused in recent studies on understanding the determinants of board structure.

Nonetheless, most of the theoretical and empirical papers that discuss the determinants of board structure are mainly focused on the US and UK markets and much less on emerging markets. Guest (2008) suggests that the examination of the situation in other countries provides better knowledge of what determines board structure. He further argues that even for the US and UK governance practices, which have many similar features, the determinants of UK board structure are arguably different due to different regulations, different roles of institutional investors and the nature of governance reforms. Further, Vafeas and Theodorou (1998) point out that the value of various governance structures should be investigated separately as each country's regulatory framework, economic environment, strength of markets and governance practices are different. This paper contributes to the literature by examining trends in board structure and changing determinants following a regulatory reform in an emerging market.

The purpose of this study is to examine trends and identify the determinants for board structure in Malaysia, given the different business environment in emerging markets, specifically for a period after the reforms. Our study empirically tests the determinants for board structure for Malaysian companies. A similar methodology was used in other papers, such as Linck, Netter, and Yang (2008) and Boone, Field, Karpoff, and Raheja (2007). The major contribution of this study is to use a data set different from the developed market. The expected findings should facilitate a comparison on board structure determinants between developed western markets and the Malaysian market. At the same time, we also examine the level to which boards of directors in Malaysia comply with the requirements of the Malaysian Code on Corporate Governance. Since the global crisis, Malaysia has undergone a series of legislative reforms[2] to regain investor confidence. The Malaysian Code on Corporate Governance, issued in March 2000, codified best practice for good governance and described optimal corporate governance structures and internal processes. It has now become essential to study the trend in board

[2] The High level Finance Committee on Corporate Governance was formed in March 1998, and its report was released a year later in March 1999. Based on the report, the Finance Committee considered that rules and laws are necessary to address corporate governance issues and it thus proposed to develop a Malaysian Code of best practices on corporate governance.