

## **Quest for Independent Directors: Special Reference to their Legal Position in the United Kingdom**

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### **ABSTRACT**

The purpose of this research is to analyse current legislation and policies in relation to the appointment of independent directors in Malaysia and to compare their position with that of independent directors in the United Kingdom. Although a board of directors may have a good mix of executive and independent non-executive directors, its independent non-executive directors are often seen to be clearly ineffective, highlighting the fact that ensuring 'independence' of directors is a continuous process and a director's categorisation as 'independent' does not ensure that he is actually independent. The existing literature does not demonstrate a definitive relationship between board composition and corporate performance. This research employs qualitative research methodology, and the authors have conducted a comparative study by referring to the legal position of independent directors in the United Kingdom to determine whether the existing definition of independent director as applicable in Malaysia needs review. The hypothesis of this research is that there is lack of clear definition of what constitutes an 'independent director' in Malaysia. This paper finds that the definition of 'independent director' in Malaysia can be considered at par with that of independent directors in the UK at the current time.

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### **INTRODUCTION**

The balance between executive and independent directors on the boards of publicly listed companies is a key aspect of the corporate governance debate (Nariman & Bidin, 2008). Independent directors are those who are not involved in the full-time management of a company and are not

employees of the company. The proposition that directors should “act independently of management, through a thoughtful and diligent decision-making process,” has been a major preoccupation of corporate governance scholars for several decades.

In Malaysia, the reform of the corporate governance commenced after the economic crisis in the late 1990s. The government adopted an integrated approach to strengthen the country’s corporate governance framework and, as a result, the corporate governance environment in Malaysia has improved significantly since the Asian financial crisis in 1997. The corporate governance movement first gained momentum in California only in the mid 1980s, and the United Kingdom (‘UK’) caught up with the idea soon after. Anglo-American corporate governance then became the popular model of governance outside the USA and the UK. Non-Anglo-American companies believe that unless they align their governance practices to the Anglo-American model, they will not be able to stay competitive in the market for capital. This article seeks to compare the legislation and policies between Malaysia and the United Kingdom in relation to independent directors. This article is divided into several parts.

### Definition

**Malaysia.** Firstly, the newly gazetted Malaysian Companies Act 2016 (the Act) does not define ‘independent director’ except for the meaning of ‘director’ itself. Section 4 of the Act defines a director

as “includes any person occupying the position of director of a corporation by whatever name called and includes a person in accordance with whose directions or instructions the directors of a corporation are accustomed to act and an alternate or substitute director”. Furthermore, Bursa Listing Requirements defines ‘independent director’ as a director who is independent of management and free from any business or other relationship which could interfere with the exercise of independent judgement or the ability to act in the best interests of an applicant or a listed issuer.<sup>1</sup> It further explains, without limiting the generality, a person is independent who is:-

- a) not an executive director of the company or related to any of the companies within the group; and
- b) not employed with the company for two years prior to the listing (except as a non-executive director) and was not a major shareholder of the company, not a family member of any executive director, officer of major shareholder of the company, never engaged in any advisory work with the company (as a partner or director except as non-executive director) and never engaged in any transaction with the company as a partner, director or major shareholder.
- c) not a major shareholder of the said Corporation;

<sup>1</sup>Para 1.01 of the Bursa Malaysia Listing Requirement

- d) not a family member of any executive director, officer or major shareholder of the said Corporation;
- e) not acting as a nominee or representative of any executive director or major shareholder of the said Corporation;
- f) not nor has been engaged as an adviser by the said Corporation under such circumstances as prescribed by the Exchange or is not presently a partner, director (except as an independent director) or major shareholder, as the case may be, of a firm or corporation that provides professional advisory services to the said Corporation under such circumstances as prescribed by the Exchange; or
- g) not nor has engaged in any transaction with the said Corporation under such circumstances as prescribed by the Exchange or is not presently a partner, director or major shareholder, as the case may be, of a firm or corporation (other than subsidiaries of the applicant or listed issuer) which has engaged in any transaction with the said Corporation under such circumstances as prescribed by the Exchange.

In addition, Para (g) of the Practice Note 13 of 2003 states that a person is disqualified from being an independent director if he had engaged personally in transactions with the said corporation (other than for board services as a non-executive director) within the last two years or he is presently a partner, director or a major shareholder of an entity

which has engaged in transactions with the said corporation within the last two years. This further strengthens the notion that an independent director should be free from any relationship with the company. This is in line with the Cadbury Report 1992 where it was suggested that an essential quality that non-executive directors should bring to the board's deliberations is that of independence of judgement. Apart from their directors' fee and shareholdings, they should be independent of management and free from any businesses or other relationship which could materially interfere with the exercise of their independent judgement.

An executive director is a person who is both a director and full-time employee of the company. Meanwhile, the non-executive director is not a full-time employee and is not involved in day-to-day management of the company. Usually, his attendance at board meetings is required to give an independent view for the benefit of the company.

From the above, it can be concluded that in Malaysia an independent director is a member of the board who does not hold any office in the company, has no management responsibility and has no interest in the company before his appointment. Furthermore, he is someone, who, apart from receiving his fee as a director, has no other pecuniary or material interest in the company or its management, dealings, promoters, subsidiaries or in anything else that the company's board finds might otherwise impede such a director's judgement.

**United Kingdom.** Meanwhile, in the United Kingdom, the Companies Act 2006 is silent on the legal distinction between executive and non-executive directors. Section 250 defines ‘director’ as including any person occupying the position of director, by whatever name called. Any person can be a director as a matter of law without bearing that title. An independent director is also referred to as a non-executive director. The law does not make any distinction between executive and non-executive directors (NEDs).

NEDs are directors for all purposes of legislation. Furthermore, Section 251 defines ‘shadow director’ as “a person by whose directions or instructions the director of the company is accustomed to act.” Para B.1.1 of the UK Corporate Governance Code (UK Code) further states the test to determine the independence of a non-executive director, whereby the board should be able to determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgement.

It is interesting to note that under the UK Code there is also a term known as ‘independent non-executive directors’. The Code makes a distinction between non-executives who are independent and those who are not. To qualify for the former category, an individual must not only have the necessary independence of character and judgement but also be free of any

connections that may lead to conflicts of interest. To determine whether an individual is not independent, the code has laid down these criteria:<sup>2</sup>

- they have been an employee of the group within the previous five years;
- they have a ‘material business relationship’ with the company or have had one within the previous three years, including an indirect relationship as a partner, director, senior employee or shareholder of an adviser or major customer or supplier (this would prevent a partner from, for example, the company’s audit firm moving on to the board after retirement);
- they receive remuneration from the company in addition to a director’s fee, or they participate in the company’s share option or performance-related pay schemes, or they are members of the pension scheme;
- they have close family ties with any of the company’s advisers, directors or senior employees;
- they hold cross-directorships or have significant links with other directors through involvement in other companies or bodies;
- they represent a significant shareholder;
- they have served on the board for more than nine years.

<sup>2</sup>Para B.1.1 of the UK Code

### Composition of the Board

**Malaysia.** The underlying philosophy is that 'independent directors' will bring independent and objective judgement to bear upon the board, it being that such directors will not, at least in theory, be coloured by conflicting interests or financial dependence upon the company when making judgements pertaining to the affairs of the company (Cheang, 2002, p. 504).

It is submitted that a balanced board composition is important for the board to function effectively. In 1998, the Malaysian Finance Committee on Corporate Governance was formed to identify the weaknesses arising from the economic crisis and to propose a recommendation to improvise the corporate governance in Malaysia at that time. A balanced board means such composition is not dominated by board members with executive power and consists of members who are independent of the management and shareholders (Shamsul Nahar, 2001).

Para 15.02 of the Malaysian Listing Requirements states that at least two directors or one third of the board, whichever is higher, must be independent directors. Should there be a vacancy in the position of independent director, the company must find a replacement within three months. Also, Recommendation 3.5 of the Malaysian Code of Corporate Governance 2012 (MCCG 2012) stipulates that the board must comprise a majority of independent directors where the chairman of the board is not an independent director. According to the commentary section

in MCCG 2012, a chairman who is an independent director can provide strong leadership if he is an objective member of the board. Alternatively, if the chairman is not independent, then the majority of the board must include an independent director to ensure balance and authority of the board.

It is interesting to note that the Bursa Listing Requirements also stipulate that a director of a public company is not allowed to hold directorship in more than up to five companies at any one time.<sup>3</sup>

**United Kingdom.** Meanwhile, the United Kingdom requires an appropriate combination of executive and non-executive directors and a higher number of NEDs where Para B.1.2 of the UK Code states that except for smaller companies, at least half of the board, excluding the chairman, should comprise NEDs determined by the board to be independent. For the smaller company, it is recommended that the board should comprise at least two NEDs. The code also requires that the audit committee and remuneration committee should comprise at least three non-executive directors; the exact number will vary between three and more than three if a larger number is required to ensure compliance with this provision. It is worth to be noted that the Code requires none of the executive directors to take on more than one non-executive directorship in a FTSE100 company or the chairmanship of a company as per Para B.3.3 of the UK Code.

<sup>3</sup>Para 15.06 of Bursa Listing Requirement

### **Appointment and Tenure**

**Malaysia.** For a public company in Malaysia, the appointment of directors is made by members in the company's general meeting as stated in Section 201(1) of the Act. Also, Section 201(1) states that a person shall not be appointed as a director unless he has consented in writing and made a declaration that he is not disqualified from holding position as a director of the company.

According to Para 7.26 of the Bursa Listing Requirements, all directors shall retire once at least every three years, but they are eligible for re-election. Furthermore, Recommendation 2.2 of the Malaysian Code of Corporate Governance states that the Nomination Committee should develop and maintain and review the criteria to be used in the recruitment process and annual assessment of directors.

According to Recommendation 3.2 of the MCCG 2012, independent directors in Malaysia are recommended to hold office not exceeding the cumulative term of nine years. Upon the ninth year, an independent director may continue to serve on the board subject to the director's re-designation as a non-independent director.

**United Kingdom.** Main Principle B.2 of the UK Code states that there should be a formal, rigorous and transparent procedure for the appointment of new directors to the board. Meanwhile, under Para B.2.1 of the UK Code, it is stipulated that the Nomination Committee should recommend to the board on the potential candidates. It is also

required that the Nomination Committee must comprise of a majority of NEDs. The chairman of the nomination committee should be appointed from among the NED. Para B.2.1 of the UK Code also requires that the nomination committee should evaluate the balance of skills, experience, independence and knowledge of the board and, in the light of this evaluation, prepare a description of the role and capabilities required for a particular appointment.

The NED should also be appointed for a period not exceeding six years. Any term beyond that should be subjected to a rigorous review and the need for progressive refreshing of the board should be considered. The company is required to state in its annual report how the appointment procedures were implemented. In fact, the company is required to state its policy on diversity, gender or any measurable objectives that it has in implementation.

### **Role of Independent Director**

**Malaysia.** One of the main functions of the director is to ensure loyalty to the company. Generally, the duty of a director is to manage or supervise the management of the business of the company (Nariman & Bidin, 2008). The role of independent director is not clearly regulated, but we may refer to Practice Note 13 of 2002 where more clarity on the requirements relating to the role of independent director is provided. Apart from acting honestly and using reasonable diligence in discharging his duties, an independent director must give effect to the spirit, intention and purpose of the

said definition. 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.

The board should establish a Nominating Committee (NC) that should comprise exclusively of non-executive directors, a majority of whom must be independent.<sup>4</sup> Furthermore, it is incumbent for the committee to develop, maintain and review the appointment criteria. In the NC, where the majority of its members are independent directors, it must be ensured that Board composition meets the needs of the company. In fact, the chair of the committee should be a senior independent director.

Furthermore, in the Audit Committee (AC), all the members must be non-executive with a majority of them being independent directors. The role of the committee is, among others, to review and report to the board on matters such as internal audit or any related party transactions on conflict of interest within the company. In short, the committee exerts a check-and-balance mechanism on management so as to safeguard the organisation from management incompetence and corporate fraud (Abdul & Salim, 2010). Their role fits the criteria of an audit committee, which requires a fully independent and functional independent director.

<sup>4</sup>Recommendation 2.1. of the Malaysian Code of Corporate Governance

MCCG 2012 recommends that the composition of the Remuneration Committee be made up wholly or mainly of non-executive directors. Interestingly, the term 'independent directors' is absent from this, implying that independent directors are not required to sit on this committee. It is submitted that the independent director could be considered a non-executive director by virtue of his appointment as the company does not employ him. The significance of this committee is to determine the remuneration package for directors and to provide a safeguard against an excessive salary scheme that is inconsistent with the interest of the company or its shareholders. It is submitted that the independent director should ensure the compensation packages for the executive directors are assessed by formal, transparent and fair criteria to ensure that it is commensurate with the performance of the directors.

**United Kingdom.** Under the UK Code, the NEDs have a role to play as members of a unitary board, whereby the NEDs should constructively challenge and help develop proposals on strategy. As a member of the board, it is expected that NEDs should play a supporting role whereby they should scrutinise the performance of management in meeting agreed on goals and objectives and monitor the reporting of performance. They should satisfy themselves on the integrity of financial information and that financial controls and systems of risk management are robust and defensible. They are responsible for determining appropriate

levels of remuneration of executive directors and have a prime role in appointing and, where necessary, removing executive directors, and in succession planning.<sup>5</sup> The UK Code also requires that the board should establish an audit committee of at least three, or in the case of smaller companies, two independent non-executive directors. The function of this committee, among others, is to monitor the integrity of the financial statement of the company and to monitor the company's internal audit function. These are similar to the Malaysian position of providing a check-and-balance mechanism within the company. In relation to remuneration, similar composition criteria are also required in the remuneration committee.

### **Brief Legal Analysis of Legal Transplant Theory in Malaysia**

The impacts of globalisation motivate developed countries to think about regional trade blocs and harmonisation of laws (Farrar, 2001). However, how far is this theory effective in upholding the practice of good corporate governance? Admittedly, legal transplant is a major source of legal development. Historically, laws have been transplanted either forcefully or voluntarily. The imposition of colonial laws is an example of forced transplant, while borrowing laws for the purpose of legal harmonisation is an example of voluntary transplant (Abdul Rahman & Salim, 2010). This theory was

first introduced by Alan Watson when he promoted the idea that legal transplant plays a very important role in developing the law by exporting the laws to other jurisdictions because he claimed that laws were usually borrowed from elsewhere, so that laws often operated in societies and in places very differently from the places where they had initially been developed (Watson, 1993). The sceptics such as Pierre Legrand argued that such a theory is impossible because the law cannot be separated from society and thus it is impossible to simply apply it to another society (Legrand, 1997). In the Malaysian context, it has been argued that both the views of Watson and Legrand are exaggerated and it has been emphasised that what matters the most is how the imported legal rules have been effective in serving the purpose for which they were transplanted (Salim & Lawton, 2007).

Malaysia, or Malaya as it then was called, traced its origin of legal transplant to *adat* and Sharia law. *Adat* law or customary law is further defined as a rule in a particular family or in a particular district that has from long usage obtained the force of law.<sup>6</sup> Customary law such as *Adat Temenggung* and *Adat Perpatih* were practised alongside Sharia law. Sharia law, also known as 'Mohamedan law' was primarily applied for personal matters such as marriage or estate governance. They had been in practice long before occupation by the Dutch and British in the 17<sup>th</sup> and 18<sup>th</sup> century, respectively (Salim, 2006). After Independence Day,

<sup>5</sup>Para A.4 of UK Code

<sup>6</sup>*Low Bee Hoe (w) v. Morsalim and Goh Tien Lim v. Lee Ang Chin [1947] MLJ 3*



Malaya adopted the British legal system by enactment of the Civil Law Ordinance 1956, which provided for the assimilation of common law principles, rules of equity and statutes of general application subject to certain cut-off dates.

With respect to company law, Malaya followed the British companies law. The first codified law was the Straits Settlement Companies Ordinance 1889. Later, many laws were passed and adopted by the Federated and Unfederated Malay States that were substantively similar to the British companies law. The current Companies Act 1965 was enacted in 1966, and resembles the UK Companies Act 1948. For example, the provision on shareholders' remedies in Section 181(1)(a) resembles the old Section 210 of the UK Companies Act 1948. However, effective from 31 January, 2017, the new Companies Act 2016 will replace the 1965 Act, which it substantially revamped.

In terms of a corporate governance framework, Malaysia started to view good corporate governance practice seriously after the 1997 economic crisis. The Malaysian Government formed the High-Level Finance Committee on Corporate Governance in 1998 with the intention to improve the standards of corporate governance practice in Malaysia (Salim, 2006). The committee came up with the Report on Corporate Governance in 1999 and proposed several measures to enhance the standard. To date, the Malaysian regulator, the Securities Commission, has issued a Code of Corporate Governance in 2000, 2007 and 2012, all of

which were modelled on foreign codes of corporate governance such as those of the UK and Hong Kong. Recently, the Securities Commission issued a draft of the Code of Corporate Governance 2016 for the public to scrutinise and comment upon. From a glance at it, it can be seen that the draft requires companies to apply or explain an alternative approach as opposed to the approach under the previous code, the 'comply or explain approach'. It appears that the draft code follows the trend taken by some developed countries in their approach to corporate governance. These countries include the United Kingdom, Australia, Canada, Germany, Hong Kong and Singapore.

In the authors' opinion, adopting the legal transplant theory in addressing corporate governance issues could enhance the standard, but it may not be effective. This is due to the fact that the nature and needs of each society varies one from the other. What could be successful in foreign countries may not be so in Malaysia. UK corporations mainly adopt the dispersed ownership structure. However, most Malaysian corporations concentrate on shareholding, especially in family-owned businesses or government-linked companies. In the MWSG's survey of the top 100 Malaysian companies in Malaysia in 2014, it was revealed that most of the companies retained independent directors for more than nine years. MWSG has stated that in 300 annual general meetings attended by MWSG in 2015, companies had failed to table the resolution to re-appoint

INEDs who had served for more than nine years for shareholders' approval. This non-compliance showed that there is a problem in ensuring that companies in Malaysia adopt MCCG 2012, which is based on the UK Code.

## RESULTS

Having discussed the above, a question that needs to be asked is whether our current legal framework could reflect the independence of a director by comparing it with that of the UK? It is submitted that there is no clear and conclusive mechanism to assess the independence of a director except by looking at the legal framework that governs his appointment, duties and roles.

The definition of 'independent director' is clearly spelt out in many rules and codes in Malaysia. The MCCG 2012 and Bursa Listing Requirements provide a clear definition of it. However, the UK Code has further divided 'independent director' into two categories: non-executive directors and independent non-executive directors. Such a division, however, is not defined anywhere in MCCG 2012 or the Bursa Listing rules.

As for the composition of the board, the authors find that Malaysian legislation does not adopt the recognised principle that the majority of the board shall comprise independent directors as practised in the UK. Malaysian legislation requires a smaller number of independent directors on the board of companies, but UK jurisdiction requires at least half of the board to be

independent. Malaysian laws, in fact, allow the independent director to hold not more than five (5) directorships in several public companies, while UK jurisdiction limits it to only one (1) directorship in FTSE 100 companies. In the authors' opinion, the Malaysian position is acceptable because Malaysian companies have the problem of a smaller pool of capable directors to choose from. In Malaysia, the number of public-listed companies is only about 919,<sup>7</sup> but in the UK it is 2,426.<sup>8</sup>

It is submitted that the appointment mechanism in Malaysia enjoys similar standards as that of the UK. A separate Nomination Committee is established pursuant to MCCG 2012; the authors are of the opinion that the mechanism to appoint independent directors in Malaysia and UK is similar and in tandem with the practice of other jurisdictions. The existence of a separate body to appoint independent directors is essential for balancing between transparency and business needs. The externalisation of the Nominating Committee is to ensure that necessary guards are in place. According to a survey, 19% of respondents agreed that NEDs lack independence for involvement in the corporate governance of the companies (Hairul, 2012). This is because NEDs were chosen to be on the board either by the

<sup>7</sup><http://www.bursamalaysia.com/market/listed-companies/list-of-companies/main-market/>

<sup>8</sup><http://www.londonstockexchange.com/statistics/companies-and-issuers/companies-and-issuers.htm>

majority shareholders or the CEOs and because of this, their independence is only in name.

According to Recommendation 3.1 of the MCCG 2012, the board should undertake an assessment of its independent directors annually. In fact, in its commentary section therein, it remarks that the existence of independent directors on the board itself does not ensure the exercise of independent and objective judgement as judgment can be compromised by many factors including familiarity or close relationship with other board members. As such, when assessing independence, the board should focus beyond the independent directors' background, economic status and family relationship to consider whether the independent director can continue to bring independent and objective judgement to the board's deliberations. However, according to the Minority Shareholders Watchdog Group in its 2013 report, only 52 companies or 6% disclosed their criteria for board assessment. This raises the question of how independent a director can be upon his appointment to the board.

The nine-year cap for the appointment is also deemed as one of the mechanisms to determine independence. This works on the reasoning that long tenure as an independent director can impair independence. Upon completion of the nine years, directors can be re-designated as non-independent directors or in exceptional circumstances, the shareholders may decide that an independent director can remain in that capacity. The board should provide strong

justification to the shareholders in such exceptional circumstances. However, it is the authors' opinion that imposing such a restriction is challenging in its implementation because of the small pool of truly independent professional directors in Malaysia. This is further compounded by Bursa Malaysia rules that limit directorships to a total number of five at a time. Hairul acknowledged that the problem of finding a totally independent director is probably due to the dearth of such executives in the country (Hairul, 2012).

## CONCLUSION

It can be concluded that, after comparing between the two jurisdictions, it appears that Malaysia has met the high standard set by its UK counterpart. This is because, despite the fact that Malaysia does not have many guidelines or any report on corporate governance, the country has rigorously adopted good corporate governance practices from the UK in its legal framework. Our findings reveal that Malaysia lacks in clearer regulations on independent directors except for the Bursa Listing Requirements and the MCCG 2012, which provide only general reference. However, it is submitted that there is no 'one size that fits all' mechanism in any legal framework anywhere in the world. This is supported by several scholars who have reported on the effectiveness of the legal transplant theory in importing foreign law into local settings. What could be the best corporate practice in the UK may not be so in other jurisdictions. However, credit must be given to our regulators, such as the

Securities Commission and Bursa Malaysia, for striving to meet the best corporate governance practice possible.

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