**NEW ZEALAND BUSINESS ROUNDTABLE**

# SUBMISSION TO THE NEW ZEALAND STOCK EXCHANGE ON PROPOSED LISTING RULES ON CORPORATE GOVERNANCE

**SEPTEMBER 2002**

## 1.0 Introduction

1.1 This submission on the proposals by the New Zealand Stock Exchange (NZSE) for Listing Rules on corporate governance (CG) is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

## 2.0 Importance of corporate governance

2.1 The NZBR acknowledges and fully endorses the importance of sound CG practices by public companies and listed issuers. However, we do not believe there is any such thing as "the full universe of CG best practice" alluded to in the Foreword. Best practice in CG internationally is recognised as depending on the culture and the business and legal environments of each country and the circumstances of individual companies.[1]

2.2 The main aim of CG is, or should be, to improve the performance of companies. Conformance with rules does not assure performance. Boards have a "responsibility to exercise governance so as to ensure the long-term successful performance of their corporation".[2]

2.3 Boards in New Zealand, like most countries outside Europe, have a unitary structure. There is a strong body of thought in unitary board countries in favour of separating the chief executive/chairman roles and having a majority of independent directors on boards. We are quite sympathetic to that thinking. However, there is no strong evidence in the finance literature that such a board structure has any effect on performance or can be referred to as 'best' practice. Nor is the practice universal: executive directors make up 60 percent of the total membership of British boards, and up to 90 percent of

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1 International Task Force on Corporate Governance of the International Capital Markets Group (ICMG), 'International Corporate Governance: Who holds the Reins?', ICMG, June 1995.

2 The (US) Business Roundtable, 'Corporate Governance and American Competitiveness', March 1990.

US companies combine chairman and chief executive roles.[3] The arguments for the separation of these roles and the use of more independent directors cannot be divorced from the complete set of CG practices followed by a

[3] 'Gloom at the top', *The Bulletin*, September 3, 2002, p 46.

board. Best results appear to come when all directors understand and accept their dual responsibilities: the managerial role – to drive the company forward – and the self-regulatory role – for assuring the right conduct.[4]

2.4 The approach generally favoured in advanced countries is not to be prescriptive about corporate governance rules. Prescriptive regimes may be more appropriate in environments where there is less transparency and accountability – through media and other forms of scrutiny of corporate performance – and less of a culture of ethical conduct. It is not obvious that being prescriptive about the number of independent directors and their degree of independence helps performance, and it will certainly add costs for some companies. The definitions of what constitutes independence can be arbitrary.

2.5 If the NZSE is determined to establish the independence of independent directors, it would be preferable to get companies to disclose the extent of the dependence of directors who have a professional association (eg as lawyers or accountants) with the company. Companies already disclose substantial security holdings and directors' holdings. There are mixed views about whether directors should hold and be rewarded with stock, or are no longer independent if they do so. The evidence that this makes a difference to performance or governance is equivocal. We consider the NZSE might recommend practice in this area, but should not prescribe compliance.

## 3.0 Directors' competence

3.1 Shareholders have the responsibility to appoint directors. In our view it is not for the NZSE to determine the suitability or qualifications of directors. The NZSE may well incur responsibility and liability for the performance of directors if it declares they are suitable by dint of a form of 'licensing' through approved qualifications. Courses on the role and duties of directors are already provided by the Institute of Directors and other organisations and may be valuable for some. Efforts to improve training programmes and to

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4 Francis, Ivor, 'Future Direction: The power of the competitive board', FT Pitman Publishing, Melbourne, 1997.

encourage director education in other ways are to be commended. However, there is no evidence that compulsion is justified. The proposals for certification will add compliance costs and provide no guarantee of improved performance.

## 4.0 Audit

4.1 The requirement for an audit committee reflects standard good practice and should not impose an additional burden on listed issuers. However, the NZSE should not prescribe the qualifications and experience of those who are to perform that role. This would have cost implications that have not been justified, as would prescribing the roles and responsibilities of audit committees. The footnote and Code suggestion that auditors should not also be financial consultants has not been shown to be needed in New Zealand. Where is the evidence that there is a problem? The proposal would have substantial cost implications for some issuers.

4.2 There are practical difficulties in New Zealand with the limited number of major audit firms. Rotation of audit partners rather than firms is less likely to create difficulties or shortages. We also consider it has not been established that New Zealand accounting firms are unable to properly separate their audit responsibilities from their consulting and advisory services businesses where this is necessary. We would prefer solutions to any genuine problems to be implemented voluntarily by individual market participants rather than imposed on all.

## 5.0 More rules and regulations are the wrong response

5.1 The NZBR recently made a submission to the Ministry of Economic Development on proposals to change securities trading legislation (a copy of which was sent to the NZSE). We noted that in the absence of a sound framework for policy analysis, undue weight may be put on ill-examined presumptions, such as the notions that:

- New Zealand will attract more overseas capital with more extensive prescriptive regulation;

- New Zealand will attract more overseas capital from a country if it harmonises its regulations with that country;
- more laws can lift standards of behaviour;
- prices will more accurately track the underlying values of securities if market participants are better informed through mandatory disclosure; and
- New Zealand markets would be 'the last frontier of the Wild West' without the extensive legislation of the last 20 years or more.[5]

5.2 There appear to be presumptions in some quarters that regulations exist in other countries because they produce net social benefits. However, in the words of a major textbook on the economics of regulation, this view "has lacked supporters for several decades" in part because "a large amount of evidence … refutes it".[6] The NZSE should not climb on the bandwagon of regulation and apply the same thinking to its Listing Rules.

5.3 The proponents of more regulations and prescriptive rules have often simply assumed that they will efficiently achieve their stated goals. In many cases, the experience in New Zealand has been that regulations have raised the costs, risks and uncertainties of dealing in markets without producing any obvious or demonstrable gains, or reducing the inexorable pressure to increase those burdens further.

5.4 The small New Zealand market cannot be expected to remain competitive under the burden of intrusive rules and monitoring and enforcement structures that are designed for much larger markets. Offshore regulators have a natural interest in pressuring New Zealand governments to adopt their regimes. There is no hope for the future competitiveness of our capital markets if evidence that we are losing competitiveness is used to justify

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5 Submission to the Ministry of Economic Development on the Reform of Securities Trading Law, August 2002.

6 Viscusi, W Kip, Vernon, John M, and Harrington Jr, Joseph E, *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, 2nd edition, 1995, p 326.

additional regulatory and self-regulatory burdens in order to 'promote confidence'.

5.5 The only safeguard against these debilitating trends is better analysis and a greater sense of constraint in removing shareholder choice and freedom of contract. It is disappointing to find that the commentary on the CG proposals sets out a policy intention rather than the necessary analysis. The NZSE should not weight the responses it gets to its request for submissions on the basis of the numbers in support of particular views but on the quality of the analysis presented.

5.6 We believe shareholders should be free to choose for themselves the regime of governance that is best for their company. If the NZSE is determined to proceed with a prescriptive CG regime, one option we urge for serious consideration is to allow shareholders to opt out of the prescribed regime by resolution at a general meeting.

## 6.0 Actions to improve credibility and confidence

6.1 We note the NZSE's statement in its commentary that its proposals are important "to market credibility and enhancement of market confidence". The proposed note for the Foreword refers to the "value that a strong governance framework brings to capital markets and capital market participants". However, there is no measure of the current level of confidence and no evidence that it is low. Nor is there evidence that the current governance practices of listed issuers are not "strong". No reason is given for believing that further prescriptive rules will raise, rather than lower, the level of market confidence and will add "value". The high weighting of overseas investment in our market rebuts the view that New Zealand has to succumb to pressures from overseas regulators to adopt their rules and regulations in order to maintain market confidence.

6.2 The objective of enhancing confidence *per se* looks *ad hoc* and overly narrow in ignoring the importance of having a competitive capital market. The objective implies that the NZSE would be satisfied if it achieved high confidence in a market that had become so uncompetitive and inefficient as to

be insignificant. Confidence should come from appropriate transparency and disclosure, rather than through any attempt to prescribe a uniform approach.[7] Few would argue that confidence in a market can be increased by imposing unnecessary rules. They generate disrespect for rules and an attitude of non-compliance. This is highly corrosive.

6.3 The performance of stock exchanges reflects the performance of listed issuers. This in turn is influenced by the performance of the economies in which they operate. Growth in the market in general depends ultimately on growth in the economy. Thus, instead of increasing compliance costs for listed issuers, the focus of the NZSE should be on encouraging the government to adopt policies and take actions that will encourage economic growth in New Zealand.

6.4 We are confident the NZSE is serious about promoting the performance of the New Zealand sharemarket and would therefore expect it to:

- discourage the government and media from attacking our market as 'the last frontier of the Wild West';
- argue strongly for the protection of property rights (as in the Vodafone case, the proposed Kyoto measures and the restructuring of the electricity sector by the previous government). Property rights should not be taken without due process and compensation;
- discourage the Securities Commission from attacking major companies or the market in general, perhaps in order to boost its own profile, regulatory powers or budget. (Its impulsive and incorrect attack earlier this year on Telecom New Zealand's accounting standards illustrates our point.);
- remind the government that the 39 percent marginal tax rate creates the impression that it favours higher tax rates on investor income;
- lobby the government to reverse its anti-privatisation stance so that companies like NZ Post, electricity SOEs and local authority trading companies have a chance of being listed on the NZSE;

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7 See ICMG study, *op cit*, p10.

- encourage a reversal of the presumption in favour of the harmonisation of regulatory regimes, recognising that smaller markets have less need for and are less able to sustain the costs of expensive regimes. New Zealand must seek to be more efficient if its capital markets are to compete with Australian exchanges for Australasian business;
- set an example to the government by not proposing changes to its Listing Rules that are not supported by an independent, professionally competent impact statement;
- promote a national strategy for economic growth that is credible in the eyes of investors.

6.5 The current regulatory approach and dynamic seem likely to make New Zealand's capital markets less liquid and less attractive for capital raising. An object lesson for us should be Tasmania, which is subject to the same regulations as the rest of Australia. Its capital markets have no visibility in an Australasian setting. If New Zealand continues to adopt regulations and rules designed for much bigger and more liquid markets, we can expect our capital markets to become increasingly inefficient, insignificant and invisible. The current trend for global investment banks to exit New Zealand should heighten this concern. We suggest that the NZSE should think carefully before introducing inflexible CG rules that do not allow for differences in the size, nature or style of issuer and its governance.

## 7.0 Conclusion: the NZSE's review process

7.1 The case for more regulation of corporate governance is not established. We are not aware of evidence that current New Zealand practices are unsatisfactory or that, generally speaking, there is any harm being done that the NZSE proposals will correct. The commentary associated with the proposals falls well short of a rigorous review:

- It does not establish why the stated aims of "accountability, transparency and certainty" and "enhancement of market confidence" would not be achieved by a reporting approach, ie the disclosure of the CG practices of issuers as required under the current rules (LR 10.5.3.(h)). Why is this

inadequate? A reporting approach is consistent with the commitment to disclosure requirements in paragraph 8 of the Foreword. Shareholders are entitled to regular information about their company's CG practices, performance and prospects. In this regard we would expect the NZSE to respect materiality in the reporting of practices which differ from any recommended Code.

- The prescriptive approach to CG appears to be at odds with the underlying principles of the Listing Rules set out in the Foreword. It represents a form of merit regulation which seems inconsistent with paragraph 2 of the Foreword which advises that such an approach would "offer a spurious assurance to investors".

- The NZSE does not need to make precipitate changes to its Listing Rules. In the wake of the Enron and other scandals, regulators and markets around the world have rushed into more regulation of market practices and conduct. Often sound analysis of the policy and framework of securities market regulation has not been undertaken and further changes may be expected. The same problems have not occurred in New Zealand. We think the NZSE should work with the business community (eg the Institute of Directors) to formulate a voluntary code that meets New Zealand needs. Indeed it is not clear that the existing IOD Code is unsuitable for that purpose.

- The proposals should have academic and empirical support. The NZSE as the dominant market service provider in New Zealand, with a need to establish a reputation for quality, should adopt high standards of analysis. It should publish professionally competent impact statements on the proposed rule changes that would gain the support of New Zealand's leading academics in finance or regulatory economics. Development of suitable local CG codes should involve a process of research, consultation and feedback. We commend the decision to defer implementation of the Listing Rule changes and urge that the consultation process should be extended with the aim of reaching a high level of consensus about desirable changes.