NEW ZEALAND BUSINESS ROUNDTABLE

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

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1.0 Introduction

1.1 This submission is made on behalf of 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.

1.2 In September 2002 the NZBR made a submission on the earlier proposals by the New Zealand Stock Exchange (NZX) for modifying its Listing Rules on corporate governance (CG). This submission:

- recognised the importance of good corporate governance practices for public companies and listed issuers;
- pointed to a lack of evidence that current New Zealand practices are unsatisfactory;
- emphasised that the aim of good corporate governance should be to improve business performance, not simply ensure conformance with rules;
- argued that more prescriptive rules are not the right response to issues of poor performance; and
- noted that there was no evidence that more rules would enhance the credibility of the NZX or confidence in New Zealand's capital markets.

1.3 The NZX released a final proposal on 6 May 2003 and invited further public comment. This submission sets out our comments on:

- the process of consultation;
- the fact that no empirical or academic evidence has yet been cited in support of proposals for prescriptive governance rules;

- the proposed rules, which we continue to believe are not justified; and
- recommendations in the Code on matters which are not yet generally regarded as best practice and should be separately reviewed.

1.4 A core issue in relation to all the proposals is whether or to what extent the NZX and the government (directly or via the Securities Commission) should prescribe corporate governance rules or whether they should be the business of shareholders who invest in listed companies. Ideally, competing stock exchanges could determine their own rules, independently of regulators, and companies would choose where to list. With the moves to greater regulation of New Zealand's capital markets, which we regard as generally ill-advised, the likelihood of domestic competition with the NZX is reducing, so the main options open to companies if regulations and costs become onerous will be to not list (ie to stay or go private), or to list on an overseas exchange.

1.5 In order to avoid such outcomes, and to make listing on the NZX attractive to issuers, we remain of the view that shareholders should have the maximum freedom of choice in determining their own corporate governance rules. Evidence has not been presented of general corporate governance malpractice or mischief in New Zealand. The NZX already has requirements on corporate governance in its Listing Rules which we believe are reasonable and well accepted. These cover issues which directly affect boards, such as the appointment and rotation of directors, the powers of directors and directors' remuneration. The Listing Rules also cover areas of broader corporate governance on such matters as self-dealing by directors, unequal treatment of shareholders and abuse of minorities. These include disclosure requirements, restrictions on related party or material transactions without shareholder approval, enforcing interest group voting and applying voting restrictions. On top of these general governance rules have come recent government regulation of takeovers and legislation for continuous disclosure – measures which add compliance costs for companies and reduce the freedom of shareholders to choose how their listed companies are governed. Our starting point is thus that very good arguments need to be made for adding further to these requirements, and the onus of proof is on those advocating change.

2.0 Changes in NZX proposal

2.1 The release on the NZX website talks of final recommendations developed after "extensive consultation with industry participants." However, despite important objections to the recommendations being raised, the current proposals contain no changes of substance from the earlier proposals and no explanation is given for rejecting criticisms. The proposed rules have been tidied up, some inconsistencies removed and wording changed or moved. We note that the changes include:

- the requirement that new directors must attend an NZX "approved" course, rather than a course run by the NZX. (Also a member of an audit committee may be deemed to have adequate accounting or financial background if he or she has completed a course approved by the NZX for audit committee membership.);
- the replacement of the earlier Code requirement that audit firms not provide other financial services by the requirement that the board should "address" the issue; and
- the shifting of the footnote that NZX50 companies should provide quarterly reports to include it in the Corporate Governance Best Practice Code in Appendix 15, where it has the status of a recommendation.

3.0 The consultation process

3.1 The Conduct Rules of a Registered Exchange now have the status of government approval (or non-veto) and the endorsement of the Securities Commission. In the absence of immediate competition with the NZX or effective alternatives for many listed issuers, they are imposed rather than freely chosen. In other words, they have effect as regulations, are tied in to the constitutions of companies, and listed issuers must comply with them.

3.2 Before proposing changed or new corporate governance rules, we would have expected the NZX to have first consulted organisations representing listed companies and other interested parties to identify if there were weaknesses in

current practices in New Zealand, whether these had led to actual problems, and whether there was a need for any changes. If such a need was identified and changes were considered justified, a well-formulated proposal could then have been distributed for comments. The next stage should have been to publish all submissions received (on the NZX website) so that interested parties could be well informed and benefit from one another's views. (This practice was followed by the Institute of Chartered Accountants of New Zealand with its study on Corporate Transparency. The ICANZ working group also met with submitters, including ourselves.) The NZX could then have provided a reasoned response to points of substance in the submissions received. Finally, any justified changes could be promulgated.

3.3 Even though there has been no real interaction to date, such an engagement is still desirable. In its absence we see no sound basis for changes to the NZX's existing rules.

4.0 The drawbacks of prescriptive rules

4.1 In our earlier submission we set out reasons for not favouring a prescriptive approach to corporate governance. We think it is a good idea for a professional organisation such as the Institute of Directors to produce and maintain a suggested corporate governance code as a guide to good practice, but its adoption by companies should be a matter of voluntary choice.

4.2 We take this position because we are unaware of evidence that prescriptive rules have benefits outweighing their costs. This is recognised by leading exchanges that have adopted a governance regime of guidelines, with required disclosure. Cases like Enron demonstrate that a culture of competence, good conduct and transparency is more important than complying with rules on the structure and composition of the board.

4.3 It is apparent that most New Zealand listed companies could readily comply with most of the proposed rules, or already do so. That indicates that they see the benefits for shareholders of adopting recognised governance practices. However, what is good practice in the majority of cases does not apply to all companies. It does not justify removing shareholders' freedom (and

responsibility) to make their own decisions, or imposing the additional cost burden of compliance checks.

4.4 A serious (moral hazard) risk with prescriptive regulation is that directors may think that if they have complied with the letter of the rules they have discharged their responsibilities to shareholders. In turn shareholders may think that because the company is complying with the rules it is focused on its basic task of creating shareholder value and that they do not have to worry either about its performance or about its integrity. These are perverse incentives. Both directors and shareholders should have incentives to be more responsible and accountable for corporate governance.

4.5 The term 'expectations gap' has been used in relation to unrealistic expectations that auditors can unfailingly pick up false or misleading financial reporting. It would be unfortunate if another 'expectations gap' about what can be achieved with corporate governance was opened up. In successful, dynamic economies firms routinely fail; losses as well as profits are a normal feature of a competitive market. And no amount of rule-making and enforcing will root out all the opportunism that is part of human nature; the realistic aim is to minimise it, not eradicate it completely.

5.0 Problems with the NZX proposals

5.1 In our earlier submission we took the position that there should be no prescriptive rules for the number of independent directors (either on the board or on the audit committee), the separation of the chairman/CEO roles, or the definition of independence that is applied to independent directors. We also said that:

- there should be no prescribed requirements for qualifications or experience for director positions;

- the NZX could provide courses for directors and should encourage continuing director education, but should not require attendance at NZX-approved courses; and

- the Exchange should encourage, develop and support good governance practice, including disclosure by listed issuers of their governance policies and practices.

5.2 We note the NZX has retreated from the position that its Code represents "the full universe of CG best practice" to a position where its "corporate governance rules set minimum standards which the Exchange believes will enhance confidence in the processes adopted by issuers". The proposed NZX Code is still labelled "Best Practice".

5.3 However, 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. A search of governance websites reveals the extent to which interpretations differ. For example, the European Corporate Governance Institute website lists some 115 corporate governance studies or Codes, across 39 countries and cross-national groups, most of which were published in the second half of the 1990s. Best corporate governance practice is an evolving concept, like best accounting or auditing practice, and subject to extensive variation, including the influence (for better or worse) of political and business interests.

Chairman/CEO separation

5.4 We noted in our earlier submission that we were quite sympathetic, as a general rule, to the propositions that the roles of chairman and chief executive should be separate and that there should be a majority of independent directors on boards. Such practices are often desirable in non-commercial organisations as well; for example the combination of chairman and CEO roles at the Securities Commission is arguably not good practice. However, we do not believe that what may generally be regarded as good practice should be made mandatory. We are unaware of evidence in the finance literature that such features of board structure affect the financial performance of listed companies on average and over time, or can be referred to as best practice.

5.5 On the chairman/CEO issue, we noted that these roles are combined in 90 percent of US companies. Bill Gates was chairman and CEO of Microsoft at a

time when it became the world's most highly valued company. Should Microsoft have been prevented from adopting this practice? Neither the New York Stock Exchange nor Nasdaq, two of the world's leading exchanges, have moved to require their listed companies to separate the roles of chairman and CEO. Why should New Zealand adopt a different model from the world's most successful economy? Combined roles are rare in New Zealand, but why should they be excluded? To give one illustration, it is easy to imagine that the founder of a company that has grown to the point where it wishes to list might wish to remain both chairman and CEO for a period after listing. Bill Gates may well have been a case in point. The NZX could deny itself listing opportunities by applying a blanket rule.

Independent directors

5.6 Similar comments apply to the issue of independent directors. We noted in our earlier submission that executive directors make up 60 percent of the total membership of boards in the United Kingdom. GPG is a company which would not satisfy the Exchange's proposed rule that the minimum number of independent directors on a board should be two, or one third, unless Sir Ron Brierley as chairman is counted as an independent. Why should a company which has been highly successful and whose governance arrangements have been sanctioned by its shareholders be obliged to change them? Doing so could carry a cost in terms of performance. We consider this decision should be a matter for shareholders, not the Exchange, and again the Exchange could lose listing opportunities by imposing it.

Director certification

5.7 In the same vein, shareholders in New Zealand companies have seen fit to elect to company boards thousands of directors who have not completed director certification courses. Why should shareholders be deprived of the right to do so in future? There are likely to be many talented people willing to be appointed to boards who have not, and do not wish to, become certified. Some may even fail an academic test. It would be absurd if a New Zealand company wanted to invite a reputable overseas director to join its board but was obliged

to ask the person to sit a course on being a director. Boards and shareholders should be left to determine whether to require certification.

5.8 Further, moral hazard, as identified in paragraph 4.4 above, is a significant risk of director certification. As has been pointed out by the chief executive of the Institute of Directors, accreditation of itself will not address issues of unethical behaviour and greed. Shareholders should take little if any additional assurance from a director having met the limited accreditation requirements proposed. In our view, listed companies should not be diverted into promoting accreditation for directors at the expense of achieving the complementary balance of skills most needed to grow shareholder wealth.

Audit committee

5.9 The great majority of large public companies have an audit committee. However, it may make little sense for a small listed company with a small board to handle audit matters via a committee rather than the whole board. Australia is to mandate audit committees for large issuers only and the United Kingdom and Canada do not mandate audit committees at all. They do, however, require companies to disclose whether they have an audit committee and, if so, to provide information on its composition, role and functions. We think this is a superior approach.

Independent directors' remuneration

5.10 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.

5.11 Given the extent to which financial incentives are seen by some as contributing to the poor performance of some executives and auditors in disclosing information for investors in the United States, we question whether the NZX should recommend stock remuneration for independent directors as a best practice.

Quarterly reporting

5.12 The recommendation that NZX50 companies report more frequently (quarterly) is, in principle, inconsistent with current requirements for continuous disclosure. Under a continuous disclosure regime, in general quarterly reports cannot contain any material information that has not already been disclosed. Companies may choose to produce quarterly reports to comply with requirements in overseas jurisdictions, but risk breaching continuous disclosure rules locally if they delay material information in order to produce consolidated quarterly reports.

5.13 Under continuous disclosure, periodic reporting is still needed as a matter of record and for production and comparison of consistent historical information. However, we do not consider quarterly reporting can be regarded as best practice under continuous disclosure without further research to support that view, since it clearly imposes additional costs on a company. Continuous disclosure is itself already imposing significant costs and we have yet to see a convincing case that it produces commensurate benefits.

6.0 ICANZ approach

6.1 If any modifications to the existing NZX Listing Rules on CG are warranted, we believe a superior approach has been developed by the Institute of Chartered Accountants of New Zealand as part of its report on corporate transparency. In our view the Institute approached this exercise in a thoroughly professional, open and consultative way. The NZX and Securities Commission will now have the opportunity to study its report *Improving Corporate Reporting: A Shared Responsibility*. In essence its approach to corporate governance builds on the *OECD Principles of Corporate Governance* and recommends disclosure by issuers of their corporate governance practice against the OECD or similar principles. The merit of this approach is that it focuses on what corporate governance is primarily intended to achieve, namely:

- increasing shareholder wealth;
- aligning the interests of boards, managements and shareholders; and

- providing timely and accurate information to facilitate accountability and investor decisions.

Issuers would be required to disclose their approach to meeting principles-based objectives in a corporate governance statement in the annual report. Reference might be made to conformance with appropriate codes (eg that of the Institute of Directors) and the reporting would be at a level of detail appropriate to the nature of the company and its investors' preferences. Such an approach also reduces the risk that listed companies might become locked into practices that are inappropriate to their circumstances and to their shareholders' preferences, and is less likely to constrain the ongoing improvements in corporate governance practice that are a feature of a dynamic economy.

6.2 This approach has the great advantage of keeping the focus of corporate governance on company performance rather than conformance, and of avoiding the moral hazard problem of prescriptive rules.

6.3 As part of its work the Institute investigated the frequently made claim that New Zealand must adopt the key elements of measures taken by other countries – on corporate governance and other areas of regulation – if it is to continue to attract and retain overseas investment. It commissioned Professor Neil Quigley of the University of Victoria to report on this issue. Professor Quigley's key findings were:

- Differences in regulation and the associated transaction costs of learning about them are unlikely to be a key determinant of foreign investor participation in New Zealand capital markets.

- Regulatory approaches and laws from the larger OECD countries cannot be applied to New Zealand without significant risk of setting standards or imposing industry structures that are inefficient in the context of the small and isolated markets of New Zealand.

- In most cases the benefits from harmonisation *per se* are unlikely to be large enough to drive the adoption of overseas legal and regulatory frameworks.[1]

6.4 We have studied Professor Quigley's report and concur with his findings. We believe they apply in respect of corporate governance rules.

7.0 Conclusion

7.1 The corporate governance arrangements that work best for a company are a complex interaction of people, processes, culture and institutional arrangements. Their prime focus should be on company performance. The crucial question is what arrangements best serve the interests of company shareholders. Monitoring and enforcing prescriptive rules can increase costs without providing offsetting benefits. There is no crisis of director conduct or ethics in New Zealand. Given the local market dominance of the NZX, it is particularly important that any rule changes have the explicit support not only of brokers but of issuers and shareholders as well.

7.2 Graeme Samuel, president of the National Competition Council in Australia and acting chairman-designate of the Australian Competition and Consumer Commission, has recently summed up many of the arguments in this submission in the following terms:

> It is inevitable that in the wake of corporate governance scandals, regulators and corporations will rush to institute visible changes in board and sub-committee composition and structure – encompassing requirements as to a minimum number of independent directors, the separate roles of chairman and CEO, the existence and composition of board audit, remuneration, and corporate governance committees, etc. These are all focusing on things visible from the outside but they lead to an obsession with the structure, a belief in the proposition that "one size fits all", and an overwhelming faith in the effectiveness of dogmatic fixed rules. The drive to more tightly regulate the membership and functions of boards is encouraging companies to view governance as a legal challenge rather than a way to improve performance.

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1 See Institute of Chartered Accountants of New Zealand, *Improving Corporate Reporting: A Shared Responsibility*, paragraph 26.

> The reason for this fixation on prescriptive rules is clear. They are visible, compliance is easily measured, and non-compliance is easily penalised. And our regulators and corporate directors can rest easy that they have done all that is necessary to deal with the failings revealed by recent scandals …
>
> Yet I venture to suggest that if those rules, as canvassed, were tested against the structure of the boards and audit committees of the likes of FAI, HIH or Harris Scarfe, or perhaps more pertinently, the other more establishment but less publicised failures or partial failures of companies of the ilk of Pacific Dunlop, Pasminco, AMP and NRMA, most, if not all, would have satisfied the prescriptive rules of board and audit committee composition being contemplated.
>
> Conversely, News Corporation, Westfield and Harvey Norman all fail at least one of the prescriptive corporate governance rules. I know where I would rather have my money invested …
>
> We need to remember that all the prescriptive rules will not prevent deliberate fraud, misleading and deceptive conduct, and material non-disclosure by management when dealing with its board of directors. I defy the best legal minds to produce a set of rules that will compensate for negligence, ignorance, apathy or the many characteristics that will render a board of directors dysfunctional. Nor will a plethora of prescriptive rules relating to the relationship of auditors to their audit clients overcome negligence (involuntary or culpable) by audit partners, or a culture within an audit firm that provides a fertile breeding ground for incompetent audit practices …
>
> No process of box ticking will overcome fundamental dysfunctionality of a board of directors flowing from inadequate expertise on the part of directors, an over-compliant board, an excessively dominant chairman or CEO, or a board that is permitted (indeed sometimes encouraged) to factionalise. Functionality of a board cannot be achieved solely through prescriptive rules, but requires the right mixture of personalties, expertise, commitment and leadership.[2]

7.3 In the absence of a sounder rationale for the proposals and widespread support from all relevant stakeholders, we do not see a case for the proposed changes to the NZX's existing rules on corporate governance.

7.4 We do not favour the NZX proposals for prescriptive rules for chairman/CEO role separation, independent directors, director certification and audit

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2 Graeme Samuel, *Australian Financial Review*, 21 May, 2003.

committees, and its recommendations for independent directors' remuneration and quarterly reporting.

7.5 If, contrary to our current assessment, modifications to the existing NZX are demonstrated to be justified, we support a principles-based rather than rules-based approach, as recommended by the Institute of Chartered Accountants of New Zealand.

7.6 We support the development by professional bodies of guidelines on corporate governance 'good practice' for companies to consider adopting on a voluntary basis. Organisations such as the NZX, ICANZ, the Listed Companies Association and the Business Roundtable should cooperate with the Institute of Directors in periodic reviews of existing guidelines. Account should be taken of the evolution of thinking on corporate governance in Australia and other countries, and companies (particularly dual listed companies) should be free to report compliance with alternative guidelines or codes.

7.7 As outlined in section 3 of this submission, we ask that the NZX and the Securities Commission engage in further consultations on the NZX proposals, and we would like the opportunity to take part in them.