The Director

Regulation Overdose

Will prescriptive regulations kill good corporate governance?

Boards are only as good as the directors who serve on them. And our boards are under increasing regulatory and shareholder pressures to perform. But New Zealand's pool of good director talent isn't deep enough. So are our boards in shape to cope with the future and to handle a more prescriptive regulatory environment? Mark Story talked to five of our highest profile directors.

New Zealand should not follow the United States' lead and heap more governance and prescriptive reporting regulations on our largest corporations according to five of our highest profile directors.

New Zealand directors, like their British and Australian counterparts, favour less rules-bound codes of practice ahead of the US model enshrined in the Sarbanes-Oxley Act of 2002. The "form" of corporate governance won't of itself improve company performance, make directors any more honest or prevent another collapse like Enron, or closer to home, like HIH Insurance, they argue.

An even more regulatory approach, including the proposals advanced last month by the New Zealand Stock Exchange, won't remove the core drivers of excess. More regulation might well force corporate legal advisers to get more clever at working within the letter as opposed to the spirit of prescriptive frameworks.

Integrity overlooked
Sir Dryden Spring, currently chairman of Fletcher Challenge Forests, is convinced that New Zealand's corporate landscape requires a completely different set of checks and balances (to the US). The legislators have, he says, overlooked the reality that good corporate governance is all about integrity, ethics and leadership. "If you hire directors with these qualities, you'll be three quarters of the way towards good compliance."

Sir Dryden argues that while New Zealand has had its "fair share" of corporate failures, unlike recent US examples, it wasn't necessarily greed that destroyed them. Also unlike the US, and more recently across the Tasman, New Zealand doesn't have a tradition of boards receiving disproportionate financial reward. He argues that excess, greed, egomania, recklessness and apparent stupidity, symptomatic of corporate collapses elsewhere, just isn't part of the Kiwi business culture.

And when it comes to conflicts of interest within US companies, most roads lead to the practice of chief executives playing the dual role of CEO/chairman. This is a "no no" in listed Kiwi companies. Instead of exterminating the executive director/chairman beast, the Sarbanes-Oxley Act attempts to address conflicts of interest by buttressing-up on the compliance front.

It has also been well-established practice in most New Zealand companies to transfer responsibility for audit issues from the board to the audit committee and to have a majority of mostly independent directors on a board to protect the interests of minorities. In the US the chair usually picks his or her own directors.

Kiwi boards better

New Zealand companies – particularly listed ones – are, according to the directors The Director spoke to, perceived to already exceed new corporate governance provisions being implemented globally. Assuming that's true, where has the fallout from the global corporate scandals left us?

With Sarbanes-Oxley only impacting directly on companies with dual listings in the US, few directors we spoke to had an intimate knowledge of the new US corporate governance framework. But with listings in the US, Australia and New Zealand, Telecom must not only comply with Sarbanes-Oxley but with the NZSE's proposed new listing requirements, Australian (ASX) and New York (NYSE) stock exchanges. But from chairman Dr Roderick Deane's perspective, with mandated provisions such as independent directors and audit committees already in place, Telecom hasn't had to make major changes to comply.

However, Telecom does not comply with the recommendations of the UK Higgs Report that forbids individuals from chairing more than one major company. Deane's direct move from CEO to chairman flies in the face of Higgs and other corporate governance reports that criticise chief executives moving up to the chairman's job.

Key signals

The important local fall-out from Sarbanes-Oxley is the impact it has had on local stock exchanges and their reaction to tighten up on reporting requirements. NZSE handed down its first discussion draft last month (see panel on page 11 and comment from Simpson Grierson's senior partner, Shelley Cave page 13).

The dilemma, says Deane, is that we're left with a more prescriptive framework, even though in reality, the fundamental principles haven't changed. An increasingly costly compliance environment looks inevitable. Directors will need to regularly check detail to ensure they haven't missed the wood for the trees.

According to Deane the risks are twofold; boards will spend more time on compliance than ensuring the company performs better and, engaging both accountants and lawyers to complete audits will significantly compound compliance costs.

Grappling with disclosure

Directors are already bureaucracy-bound, overworked and underpaid, says Air New Zealand managing director Ralph Norris. He thinks added compliances will scare good people off from seeking board appointments. And New Zealand's pool of high quality director talent is desperately tiny.

Of all the NZSE changes up for review, which ones are boards spending most time thinking about?

Correct or not, many boards claim to follow, albeit informally, best-practice corporate governance. Therefore, provision for making a third of the board independent of management and including financial experts on audit committees, looks far from onerous.

Norris thinks continuous disclosure is the big issue, especially in relation to profit forecasts and (contingent) liabilities. "Everyone is currently grappling with that."

Companies currently provide little or no disclosure between quarterly or half-yearly announcements. They will be required to notify the exchange on significant good and bad news as it arises. "Too much disclosure can be as bad as too little. What we're trying to do is put out as much information on operating statistics and our hedging dbo. That way the market can draw a trend-line on market performance on a monthly basis," says Norris.

Detail overload

The new listing rules will provide a good practice checklist for some companies but others will have to front up to the changes, according to Restaurant Brands' chairman Bill Falconer. There are, he says, major doubts over whether the market has always been sufficiently briefed or briefed early enough, especially with stocks like Tranz Rail and Air New Zealand.

"Proposed disclosure rules are a wake-up call that listed companies must take a more pro-active stance. I agree in principle that management should represent that there's nothing misleading. But I question whether the level of detail soon to be required is necessary," he adds.

Sir Dryden predicts the incremental swelling of board sizes as another by-product of a more prescriptive, rules-based framework. Board numbers have moved from 12 to six or seven, but he expects them to increase by two and to meet more regularly.

According to Norris, in the past it was relatively easy for individuals to hide within larger boards. "With smaller boards there's less opportunity for one or two people to drive all the decisions and for the others to simply go along for the ride."

Limited director pool

More prescriptive frameworks undoubtedly make boards and directors more accountable. Good directors, therefore, are increasingly more sought after. But they are a scarce commodity.

The New Zealand Institute of Directors (IoD) is well regarded for providing basic training and helping boards keep up with compliance. But with only half the directors of listed companies currently members of the IoD, how does the other half keep informed?

Sir Dryden thinks the best incubator for future directors is a chief executive or other senior management role in decent-sized companies. Problem is New Zealand is progressively becoming a branch operations economy. The pool of talent to choose from is drying up.

Business schools are also starting to provide training programmes, and Sheffield's Academy of Corporate Governance has been created in part to meet this need, but he says they're likely to struggle to have relevance unless directors throughout the country are actively involved.

Blooding new talent

What's likely to widen the pool of available talent, according to Falconer, is the growing use of recruiters within the board appointment process. "Until five years ago, boards shoulder-tapped people they either knew or had seen in action elsewhere. Now companies approach board appointments like any other vacancy, and engage head hunters."

Dunedin-based Ian Farrant thinks that unless boards are prepared to "blood" new directors, they risk reverting to the days when some directors – like him – sat on

15 (or more) boards. “Look around the market place and it’s hard to identify an obvious board choice. Natural intuition, personality and technical competencies all make a good director. I’m surprised Fonterra is trying to pick future directors so early through its Shareholder Council leadership training programme,” says Farrant, currently NZ Refining Company chairman.

He’s not a fan of directors sitting simultaneously on too many boards but he admits that having a good portfolio of directorships can add to any single board’s cerebral firepower. Depending on the nature of the board, he suggests full-time directors set their limit at 10 directorships. “With a full book, you’re less inclined to get too close to any single company. To be effective, directors must know what questions to ask, and where to go to get advice – that comes through networking with other directors.”

How boards rate

How do New Zealand boards rate internationally? Farrant believes our boards were generally of a higher standard 20 years ago than they are now. That said, he cautions that outstanding individuals didn’t necessarily guarantee great company performance. “When you reflect on the talent within boards like Fletcher Challenge or Brierley Investments, the results should have been fantastic.”

NZSE calls for a quota of independent directors on boards and addresses the issue of what constitutes independence and how independent directors contribute. And shareholders too are increasingly interested in how so-called independent directors behave.

True independence

The prevailing view of what independent means, according to Sir Dryden, is that they are not executives of the company, and their own business doesn’t have any significant dependence on the company.

The NZSE says a director who is a substantial security holder or a representative of a substantial shareholder (an individual or party that holds five percent or more) is not independent.

Under the strict definition of the NYSE, Higgs and NZSE reports, Warehouse chairman Keith Smith and director John Avery, both partners in professional firms paid fees of $130,000 and $395,000 respectively last year, would struggle to prove their independence. Similarly, under the proposed NZSE code, Stephen Tindall’s independence is questioned due to his substantial shareholding.

Boards should overwhelmingly comprise independent directors, says Sir Dryden. “The numbers of independent directors can only ever be about right. With 12 member boards, I’d like to see 10 independents. On boards half that size, the only non-independent member should be the managing director.”

A hallmark of good governance is the spread of powers. Where this spread gets cloudy, according to Norris, is where directors – regarded as independent because they’re non-executives – are subsequently found to be linked to majority shareholders. In other words, the assumption that independent directors always act in the best interests of all shareholders can be naive.

Acid test

A tighter regulatory regime will make directors more proactive. Directors welcome rules that ensure a balance between the basic legislative framework and the vigilance of individual companies. The acid test, says Falconer, is whether more reporting standards will deliver better outcomes. While most boards won’t have to make major changes to comply, the costs and time it will take to do so will escalate. This point concerns boards the most.

But, says Falconer, what New Zealand shareholders are really asking on the back of the global corporate scandals is: can we really trust boards? Our boards pride themselves on being in better shape than their Northern Hemisphere counterparts. But it's no longer sufficient to simply meet reporting obligations. Robust systems force boards to prove they're doing so. "It's good that boards have to prove that they've thought things through. I'm not convinced that within a New Zealand environment it will deliver better results."

NZSE-proposed corporate governance framework
The proposed new corporate governance rules and regulatory framework NZSE has developed for listed issuers incorporates rules that set minimum standards designed to enhance investor confidence, and a set of principles that provides listed issuers with flexibility to establish their own corporate governance practices, according to the NZSE statement released with the final draft of proposed new rules last month.

Key Listing Rule changes:

- The minimum number of independent directors is two, or one-third.
- A director may not simultaneously hold the positions of CEO and chairman.
- Directors should complete an appropriate director certification course.
- Issuers are required to establish an Audit Committee, with a minimum of three directors, a majority of independent directors, and at least one with an accounting or financial background.
- The external auditor or lead partner should be changed every five years.

The final proposal is now with the Securities Commission for review and will go to the Minister for approval once the review has been complete.

The new framework will consist of a simplified structure made up of three groups:

- NZSE Compliance and Enforcement – an in-house team of NZSE personnel to deal with both broker and issuer compliance. This team will be responsible for market surveillance, initial investigations and referrals of suspected non-compliance to NZSE Discipline, the Broker Audit Programme, risk assessment, applications for waivers and rulings, compilation of guidance notes and dealings with new listing applications, amongst other things;
- NZSE Discipline – a 20-person board comprised of both external (75 percent) and internal (25 percent) experts to investigate suspected cases of non-compliance, or hear charges brought before it, make findings, and impose sanctions or penalties where appropriate; and
- NZSE Special Division – a three-person independent panel taken from NZSE Discipline, specifically designed to regulate NZSE Limited once listed. Provision for this panel was made at the time NZSE demutualised and this division, and the new construct, will ensure the integrity of the market is preserved.

For details: www.nzse.co.nz

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