CORPORATE GOVERNANCE RESEARCH ON NEW ZEALAND LISTED COMPANIES

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I. INTRODUCTION

The purpose of this article is to review and add to approximately fifty years of research on New Zealand listed companies from various disciplines. The main findings are not controversial, as corporate governance standards are high by international standards. To be sure, there has been a rolling set of corporate failures in the finance company sector since the global financial crisis—principally involving nonlisted finance companies issuing debt securities to the public—but these failures have been comprehensively addressed by recent legislative reforms. In this regard, the article will be of interest to corporate governance researchers seeking a topical review of corporate governance in a small, common law jurisdiction. A key commercial context, however, is supplied by the regional free trade agreement between New Zealand and Australia, the recent free trade agreement between Australia and the United States, and the (largely moot) free-trade agreement between New Zealand and the United States. In the event that New Zealand and the United States do enter into a free-trade agreement, it is reasonable to expect that U.S. corporations contemplating investment in New Zealand will take a much closer interest in corporate governance in New Zealand as part of their legal risk assessments.

As stated, this article comprehensively reviews and adds to extant research on corporate governance of New Zealand listed companies.[1] It is cross-disciplinary in nature and considers legal, managerial, and accounting perspectives, as well as literature on corporate governance. Part I of the article provides background information on listed companies in New Zealand and outlines some of the key legal issues relevant to such companies. Part II considers corporate control of New Zealand listed companies. Part III reviews interlocking directorships, while Part IV considers overall board composition including board size, independent directors, board leadership, and diversity on boards. Part V discusses board committees (including audit, remuneration, and nomination committees), and Part VI concludes our review. While the aim of this article is to provide a topical resource on corporate governance in New Zealand listed companies, we also think the article provides some commercial intelligence for U.S. corporations contemplating investment in New Zealand, a matter which will

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1. For a recent overview, see INST. OF DIRS., THE HANDBOOK OF INTERNATIONAL CORPORATE GOVERNANCE § 6.15 (2d ed. 2009). *See generally* Lucian Bebchuk & Michael Weisbach, *The State of Corporate Governance Research*, 23 REV. FIN. STUD. 939 (2010).

come into closer focus if the proposed free-trade agreement between New Zealand and the United States proceeds.[2]

A. "Listed" and "Unlisted" Companies

Generally speaking, there are only two significant types of companies limited by shares in New Zealand: "listed" and "unlisted" companies. When we refer to "listed companies," we mean companies listed on the New Zealand Stock Exchange (NZSX), the most viable board for equity securities of the New Zealand Exchange Limited (NZX).[3] Unlisted companies are companies that are not listed on any registered exchange in New Zealand. Corporate governance matters for all types of companies, but it is most important where a company raises money from the public. In New Zealand, this activity is predominantly carried out by companies listed on the markets operated by the NZX. Unlisted companies are also able to raise money from the public in New Zealand and, as this article will discuss, the corporate governance regime that applies to some of these companies is problematic.[4]

We focus on corporate governance in listed companies that raise money from the public for two related reasons. The first and overarching reason is that

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2. At the Asia-Pacific Economic Cooperation meeting in Singapore in 2009, President Obama announced that a free trade deal with New Zealand would go ahead. On the Closer Economic Relations Agreement between Australia and New Zealand, see Gordon Walker, *The CER Agreement and Trans-Tasman Securities Regulation: Part 1*, 19 J. INT'L. BANK. L. & REG. 390 (2004). *See also* ALAN BENNETT, GUIDE TO THE AUSTRALIA-UNITED STATES FREE TRADE AGREEMENT (2005). Inward investment into New Zealand is governed by the Overseas Investment Act 2005 (NZ) and the Overseas Investment Regulations 2005 (NZ). Partly as a result of the CER Agreement, downstream agreements such as the Memorandum of Understanding on Business Law Co-ordination Between Australia and New Zealand and the mutual recognition of securities offerings regime between Australia and New Zealand, Australia is the principal influence on the corporate governance of New Zealand listed companies (via the Australian Stock Exchange Listing Rules). On the mutual recognition of securities offerings regime, see Press Release, Lianne Dalziel, World First in Comprehensive Mutual Recognition of Securities Offerings, June 13, 2008), *available at* http://www.beehive.govt.nz/release/world-first-comprehensive-mutual-recognition-securities-offerings.

3. The NZX operates three markets: the NZSX, the New Zealand Debt Market (NZDX), and the New Zealand Alternative Market (NZAX). Before demutualization, the NZX was known as the New Zealand Stock Exchange (NZSE). The demutualization of the NZSE is discussed in Gordon Walker, *New Zealand*, *in* 3 INTERNATIONAL SECURITIES REGULATION: PACIFIC RIM (Gordon Walker ed., 2011). Until May 2011, the Securities Commission was the chief co-regulator of listed companies. In May 2011, the Securities Commission was disestablished and its role taken over by the Financial Markets Authority.

4. For an overview of the issues, see VICTORIA STACE, SECURITIES LAW IN NEW ZEALAND ch. 30 (2010).

good corporate governance supports investor protection.[5] Indeed, investor protection and the prevention of fraud are the historical reasons for prospectus disclosure. The second reason is a modern restatement of the first reason, with the emphasis on protection of minority shareholders. This reason is best framed as a question: how do the outside investors get a return on their investment and their money back?[6]

Because of the so-called "agency problem," corporate-governance issues always assume importance where there is a significant separation of ownership and control.[7] Such separation occurs in listed companies in New Zealand. By contrast, corporate governance issues are of little or no importance to a single-shareholder/single-director company, where the director is the sole shareholder and there is no fundraising from the public. According to the New Zealand Companies Office database, the overwhelming majority (over 95%) of all New Zealand registered companies are small or medium-sized enterprises.[8] If there is any separation of ownership and control in such companies, minority shareholders typically have the ability to stipulate the terms upon which they will become shareholders and invest capital. Hence, incoming minority shareholders can negotiate amendments to the company's constitution and shareholders' agreement if they so desire. This process is called "private ordering."[9] Following this logic, we assume that listed companies face the biggest challenges with respect to corporate governance.

The assumption that listed companies matter most for corporate governance issues generally holds quite well. Where this assumption does not hold up so well is when a majority-controlled unlisted company in New Zealand is

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5. Governance mechanisms also influence the finance policies of public listed companies (i.e., decisions about reliance on debt versus equity). A study of New Zealand firms from 2004 to 2008 demonstrates that those listed firms with weak governance mechanisms tend to be more reliant on leverage than firms with strong governance mechanisms. *See* Hardjo Koerniadi & Alireza Tourani Rad, *Corporate Governance, Financing Patterns and the Cost of Capital: Evidence from New Zealand Companies* 1 (2012 Fin. Mkts. & Corporate Governance Conference Paper, 2011), *available at* http://ssrn.com/abstract=1969584.

6. *See* Andrei Shleifer & Robert Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 738 (1997) (expressing this article's view of corporate governance from a straightforward agency perspective, with the key question being: "We want to know how investors get the managers to give them back their money."). For a literature review of this line of research up to 2002, see Gordon Walker, *Corporate Governance in East Asia: Prospects for Reform, in* CORPORATE GOVERNANCE: AN ASIA-PACIFIC CRITIQUE 575–77 (Low Chee Keong ed., 2002).

7. On the agency problem, see MICHAEL JENSEN, A THEORY OF THE FIRM 85–87 (2003).

8. *See* GORDON WALKER ET AL., COMMERCIAL APPLICATIONS OF COMPANY LAW IN NEW ZEALAND 7 (4th ed. 2012).

9. *See generally* Harm-Jan de Kluiver, *Private Ordering and Buy-Out Remedies Within Private Company Law: Towards a New Balance Between Fairness and Welfare?* 8 EUR. BUS. ORG. L. REV. 103 (2007).

an "issuer."[10] An issuer may be an unlisted company that has allotted securities pursuant to an offer that requires the issuance of some type of disclosure document as specified in the Securities Act 1978 or the Securities Regulations 2009.[11] As it turns out, majority-controlled, unlisted issuers of debt securities are the key corporate governance problem in New Zealand.[12] The raft of finance company failures in New Zealand during the global financial crisis provides evidence for this proposition.[13] Unlisted finance companies raised money from

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10. *See* JOSEPH HEALY, NEW ZEALAND CAPITAL MARKETS 4 (2001), *available at* http://web.archive.org/web/20100522013822/http://www.med.govt.nz/upload/18163/healy.pdf (noting that "[w]hen large shareholders effectively control firms, their policies may result in the expropriation of minority shareholders and reduced managerial initiative"); *see also* Shleifer & Vishny, *supra* note 6, at 759 (arguing that "as ownership gets beyond a certain point, the large owners gain nearly full control and are wealthy enough to prefer to use firms to generate private benefits of control that are not shared by minority shareholders. Thus there are costs associated with high ownership and entrenchment, as well as with exceptionally dispersed ownership.").

11. Securities Act 1978 cl 33(1); *see also* Securities Regulations, SR 2009/230, reg 5(1).

12. Mark Peart, *Finance Company Collapses – A Sign of Poor Corporate Governance?* DIRECTOR, Apr. 2008, at 71.

13. *See* STACE, *supra* note 4; COMMERCE COMM., H.R., 49th Parl., INQUIRY INTO FINANCE COMPANY FAILURES (2011) (NZ) [hereinafter COMPANY FAILURES INQUIRY], *available at* http://www.parliament.nz/NR/rdonlyres/57E84344-829E-45EB-9F99-E1F8E38DF2C1/204528/DBSCH_SCR_5335_Inquiryintofinancecompanyfailuresl1.pdf; *see also* COMMERCE COMM., 2007/08 FINANCIAL REVIEW OF THE MINISTRY OF ECONOMIC DEVELOPMENT (2009) (NZ) [hereinafter FINANCIAL REVIEW], *available at* http://www.parliament.nz/NR/rdonlyres/16F22058-8DD8-4541-B9A9-064848076239/100892/DBSCH_SCR_4272_6521.pdf; COMMERCE COMM., BRIEFING ON FINANCE COMPANY FAILURES (2009) (NZ) [hereinafter COMPANY FAILURES BRIEFING], *available at* http://www.parliament.nz/NR/rdonlyres/88FE4F52-55C3-42C0-8451-81EFE5CF2DEB/113426/DBSCH_SCR_4483_Briefingonfinancecompanyfailures_69.pdf; Sophie Gladwell & Dilmun Leach, *Corporate Governance in the Credit Crisis*, NZLAWYER, July 10, 2009, at 22; Darise Bennington, *Honest Bridgecorp Directors Prohibition Upheld by High Court*, NZLAWYER, Sept. 17, 2010, at 1; Maria Collet-Beavan, *A Brand New Regime*, NZLAWYER, Oct. 15, 2010, at 13; James Weir, *We Stood Back and Did Nothing*, SOUTHLAND TIMES (New Zealand), Nov. 26, 2010, at 18; Press Release, N.Z. Sec. Comm'n, Commission Releases Information on Finance Company Investigations (Dec. 3, 2010); W. Wilson et al., *Best Practice Corporate Governance? The Failure of Bridgecorp* (Fin. & Corporate Governance Conference Paper, Nov. 24, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1714663. Failures of corporate governance played a role in the global financial crisis. A National Commission set up to investigate the financial crisis in the USA commented, "The Commission concludes that some large investment banks, bank holding companies, and insurance companies, including Merrill Lynch, Citigroup, and AIG, experienced massive losses related to the subprime mortgage market because of significant failures of corporate governance, including risk management. Executive and employee compensation systems at these institutions disproportionally rewarded short-term risk taking. The regulators (the former Securities and Exchange Commission for the large investment banks and the banking supervisors for the bank holding companies and AIG)

the public by way of debt securities, but these companies were not subject to the discipline of the New Zealand Exchange Listing Rules. In particular, such issuers were not subject to the continuous disclosure regime that applies to listed companies.[14] The inapplicability of the Listing Rules, combined with significant weaknesses in the Companies Act 1993 (for example, weak related-party transaction rules) and the securities regulation regime (as far as unlisted issuers of debt securities were concerned), are among the reasons for the failures of finance companies in recent years.[15]

B. Working Assumptions and Some Initial Observations About Corporate Governance in New Zealand

We now state some generalized working assumptions. We agree with writers such as Susan Watson and Chris Noonan that corporate governance in New Zealand has a statutory base.[16] John Farrar's taxonomy of matters affecting corporate governance also includes "hard soft law," such as stock exchange listing rules and statements of accounting practice.[17] Again, we agree, but go no further. In particular, we do not think that unlisted companies take voluntary codes of conduct, such as the former Securities Commission's Principles and Guidelines, seriously because the companies are not legally compelled to observe them, and there is little evidence they do so voluntarily.[18]

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failed to adequately supervise their safety and soundness, allowing them to take inordinate risk in activities such as nonprime mortgage securitization and over-the-counter (OTC) derivatives dealing and to hold inadequate capital and liquidity." *See* FIN. CRISIS INQUIRY COMM'N, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 279 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

14. The problem was partially addressed in the Securities Amendment Regulations 2007.

15. *See* William R. Wilson et al., *Examination of NZ Finance Company Failures: The Role of Corporate Governance* (Fin. & Corporate Governance Conference Paper, Jan. 14, 2010), *available at* http://ssrn.com/abstract=1536874. For an analysis of the role related party transactions played in the finance company collapses, see Duncan C. Jessep et al., *Related Party Transactions in New Zealand: An Empirical Study of a Flawed System*, 30 COMPANY & SEC. L.J. 110 (2012).

16. Susan Watson & Chris Noonan, *The Foundations of Corporate Governance in New Zealand: A Post-Contractualist View of the Role of Company Directors*, 22 N.Z. U. L. REV. 649 (2007).

17. JOHN FARRAR, CORPORATE GOVERNANCE: THEORIES, PRINCIPLES AND PRACTICE 4 (3d ed. 2008).

18. SEC. COMM'N OF N.Z., CORPORATE GOVERNANCE IN NEW ZEALAND: PRINCIPLES AND GUIDELINES (2004), *available at* http://www.fma.govt.nz/media/178375/corporate-governance-handbook.pdf. The Principles are reviewed in COMPANY AND SECURITIES LAW IN NEW ZEALAND ch. 10 (John Farrar ed., 2008). Generally speaking, unlisted finance company issuers did not observe these principles and guidelines during the global financial crisis. *See* STACE, *supra* note 4.

We view corporate governance as having particular meaning and application for listed companies because of the contractual obligations contained in the relevant NZSX Listing Rules. These obligations can be regarded as default investor protection rules. They are necessary because an investor in a listed company generally does not have the ability to customise the terms upon which he or she invests because the investment occurs on the secondary market. By contrast, shareholders in unlisted companies have the ability to customize their company constitutions and negotiate such corporate governance rules as they see fit as a condition of their shareholding (private ordering).[19]

We also think that listed companies would not undertake many or all of the corporate governance practices demanded by legislation or by the NZSX Listing Rules were they not legally obliged to do so.[20] So, for example, while there is some evidence to support the proposition that good governance translates to superior share price performance,[21] we do not think enlightened corporate self-interest is the key driver of corporate governance practices. Rather, we contend it is the coercive nature of various mandatory and "voluntary" disclosure requirements imposed on listed companies—the legal infrastructure of corporate governance that drives these practices.[22] These requirements represent the modern formulation of a policy of disclosure by companies first articulated in 1844 in the Gladstone Committee Report.[23] Thus, the legal implementation of corporate governance is largely concerned with two types of coercive information disclosure: mandatory and "voluntary" disclosures.

In New Zealand, all companies must comply with certain mandatory rules contained in the Companies Act 1993 and related legislation, such as the Financial Reporting Act 1993. An additional set of mandatory requirements is imposed on listed companies by the Listing Rules. The Listing Rules include so-called "voluntary" rules that require listed companies to "comply or explain" the extent to which they have complied with the NZX Corporate Governance Best

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19. WALKER ET AL., *supra* note 8.

20. FARRAR, *supra* note 17. *See also* Trish Keeper, Codes of Ethics and Corporate Governance: A Study of New Zealand Listed Companies (Oct. 20, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1947113.

21. Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107 (2003). For a recent Australian study, see *Wealth*, AUSTRALIAN, Mar. 31, 2010, at 5 (a study by Goldman Sachs JBWere found that companies that scored highly on governance issues produced a 35% excess return on the index). Another study found that the governance-return correlation existed from 1991 to 1999, but was not evident from 2000 to 2008. *See* Lucian Bebchuk et al., *Learning and the Disappearing Association Between Governance and Returns* (Harvard Law & Discussion Paper No. 667, 2010), *available at* http://ssrn.com/abstract=1589731.

22. This is an argument for the primacy of legal rules (or legal coercion) in corporate governance. It implies that some of the management literature extolling the virtues of good corporate governance is making a virtue of legal necessity.

23. For a discussion of the Gladstone Report, see Gordon Walker, *Securities Regulation, Efficient Markets and Behavioural Finance*, 36 HONG KONG L.J. 481, 488 (2006).

Practice Code that appears in an appendix to the NZSX Listing Rules.[24] To this extent, New Zealand takes a hybrid approach to the corporate governance of listed companies with a mixture of mandatory and voluntary rules. The reasoning underpinning this approach is that the market will make a judgement about the quality of the disclosures, and this will be reflected in the company's share price. Such logic assumes companies are not indifferent to the impact of their disclosure practices on share prices. In normal times, this assumption seems reasonable for the blue chip end of the market; however, it is doubtful whether this assumption is valid for all companies in the market.[25]

Generally speaking, New Zealand listed companies do not suffer from the concerns that are the typical subjects of criticism by those promoting good corporate governance.[26] For example, corporate ownership is relatively concentrated in New Zealand, rather than diffuse (thereby reducing opportunities and incentives for self-serving behaviour by managers at the expense of shareholders). Also, boards are typically of a reasonable size, are led by an independent chairperson, and tend to have independent directors. Finally, interlocking boards (i.e., directors serving on multiple boards) tend to be rare. A major criticism of the boards of New Zealand companies, however, is that their composition is not diverse. Rather, they are "relatively homogenous in terms of gender, age, ethnicity, and functional diversity."[27]

Several studies have contrasted governance systems around the world. Vidhi Chhaochharia and Luc Laeven reviewed governance norms and practices in twenty-three countries. Using data from the Institutional Shareholder Services (ISS) Global Corporate Governance Database, these authors created a governance index based on seventeen governance variables. New Zealand was rated as having the best governance system from 2003 to 2005.[28] Chhaochharia and Laeven also found, across their entire sample, "a modest though not insignificant effect" of governance scores on financial performance and that governance

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24. NZX, LTD., NZSX/NZDX LISTING RULES, r. 10.5.5(h)–(i) (2010) [hereinafter NZSX LISTING RULES], *available at* https://www.nzx.com/files/static/NZSX_NZDX_Listing_Rules.pdf. *See generally* Diane K. Denis & John J. McConnell, *International Corporate Governance* (ECGI – Fin. Working Paper No. 05, 2003), *available at* http://www.ssrn.com/abstract=320121.

25. *See* Damian Reichel, *Continuous Disclosure in Volatile Times*, 28 COMPANY & SEC. L.J. 84 (2010); Gill North, *Continuous Disclosure in Australia: The Empirical Uncertainties*, 28 COMPANY & SEC. L.J. 394 (2011).

26. In September 2010, New Zealand was ranked fifth in the world for corporate governance according to GovernanceMetrics International. *See Proxy Power Questioned*, AUSTL. FIN. REV., Jan. 19, 2011, at 9.

27. N. van der Walt et al., *Board Configuration: Are Diverse Boards Better Boards?*, 6 CORP. GOVERNANCE 129, 142 (2006); *see also* N. van der Walt et al., *Corporate Government Diversity – Does it Make a Better Board?*, N.Z. MGMT., Nov. 2004, at 80.

28. Vidhi Chhaochharia & Luc Laeven, *Corporate Governance Norms and Practices*, 18 J. FIN. INTERMEDIATION 405 (2009) (this conclusion is based on relatively few firms (12 in 2003, 13 in 2004, and 18 in 2005)).

systems that go beyond the norms of their countries' systems have a strong, positive impact on firm value.[29]

The 2010–2011 *Global Competitiveness Report* ranked New Zealand highly in terms of governance practices.[30] New Zealand ranked eighth out of 139 countries on the "efficacy of corporate boards," with a score of 5.5 out of 7.[31] New Zealand also scored highly on the strength of financial and auditing standards (6.2 out of 7; third overall). For protection of minority interests, New Zealand received a 5.6 out of 7 (the fifth highest ranking of all countries). For strength of investor protection, New Zealand scored highest at 9.7 out of 10. Overall, the *Global Competitiveness Report* concludes that New Zealand:

> [P]ossesses some of the best-functioning institutions in the world, ranking 3rd, behind only Singapore and Hong Kong in this pillar. Specifically, it ranks 4th for the quality of public institutions while it retains its leadership in the private institutions component. Overall, the environment is extremely conducive to business, supported by efficient goods (7th) and labour markets (12th) and by one of the soundest banking systems in the world (2nd).[32]

Corporate governance research in New Zealand has been relatively sparse.[33] This is largely due to the small size of the listed corporate sector (with

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29. *Id.* at 414.

30. WORLD ECON. FORUM, THE GLOBAL COMPETITIVENESS REPORT, 2010–2011 (K. Schwab ed., 2010) *available at* http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2010-11.pdf. *See also* Peter Cornelius, *Good Corporate Practices in Poor Corporate Governance Systems*, 5 CORP. GOVERNANCE 12 (2005).

31. A rating of "7" would have indicated that "investors and boards exert strong supervision of management decisions." *See* WORLD ECON. FORUM, *supra* note 30, at 384.

32. *Id.* at 29. However, a study carried out by Morningstar measuring the experiences of mutual fund investors in twenty-two countries scored New Zealand at "D-," the worst. *See* BENJAMIN N. ALPERT & JOHN REKENTHALER, MORNINGSTAR, MORNINGSTAR GLOBAL FUND INVESTOR EXPERIENCE 2011, at 31 (2011), *available at* http://corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf.

33. For a discussion of the characteristics of the New Zealand market, including its small size, openness, and remoteness, see Michal S. Gal, *The Effects of Smallness and Remoteness on Competition Law – The Case of New Zealand*, 14 COMPETITION & CONSUMER L.J. 292 (2007); Terence Arnold et al., *The Structure of New Zealand Industry and Its Implications for Competition Law, in* NEW ZEALAND COMPETITION LAW AT THE TURN OF THE CENTURY 24–60 (Mark Berry & Lewis Evans eds., 2003); GRAHAM T. CROCOMBE ET AL., UPGRADING NEW ZEALAND'S COMPETITIVE ADVANTAGE (1991). For discussion on New Zealand capital markets, see CAPITAL MARKET DEV. TASKFORCE, MINISTRY OF ECON. DEV., CAPITAL MARKETS MATTER: REPORT OF THE CAPITAL MARKET DEV. TASKFORCE (2009) [hereinafter CAPITAL MARKETS MATTER], *available at* http://www.med.govt.nz/business/economic-development/pdf-docs-library/cmd-capital-markets-matter-full-report.pdf.

fewer than 160 companies listed on the main board in early 2011), the relatively small international impact and profile of these companies, and the small size of the academic sector in New Zealand. Some earlier attempts at literature reviews occurred in the mid-1990s and focused mainly on issues of governance and securities regulation.[34] Nonetheless, research on governance in New Zealand has increased substantially over the last fifteen years or so. Most notably, we have seen increasing interest from scholars in the fields of accounting, economics, finance, management, and sociology.

In this article, we review and add to around fifty years of studies on the corporate governance of New Zealand listed companies. We investigate who (generally) controls listed companies and ask how common directorship linkages are between listed entities. We then turn our attention to the characteristics of boards themselves, before focusing on board committees. This article concludes by returning to issues associated with the failure of nonbank financial intermediaries in recent years. While much of the focus of this article is on legal and regulatory issues relating to corporate governance, the nature of the literature we draw upon means that our discussion is informed by interdisciplinary research.

II. CORPORATE CONTROL

Corporate governance in New Zealand largely comprises the mandatory reporting requirements contained in the Companies Act 1993, cognate legislation, and the NZSX Listing Rules, including the voluntary "comply or explain" rule.[35] The NZSX Listing Rules contain a Corporate Governance Best Practice Code in Appendix 16 comprising flexible principles. NZSX listed companies are required by Listing Rule 10.5.5 to "comply or explain" adherence to the Code in a corporate governance statement in the annual report.[36]

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34. Mark A. Fox & Gordon R. Walker, *Sharemarket Ownership and Securities Regulation in New Zealand*, 17 N.Z. U. L. REV. 402 (1997); Mark A. Fox & Gordon R. Walker, *Regulatory Design and Sharemarket Ownership in New Zealand*, 3 ADVANCES IN INT'L BANK. & FIN. 123 (1998); Mark A. Fox & Gordon R. Walker, *Evidence on the Corporate Governance of New Zealand Listed Companies*, 8 OTAGO L. REV. 317 (1995); Mark Fox & Gordon Walker, *New Zealand Sharemarket Ownership*, *in* SECURITIES REGULATION IN AUSTRALIA AND NEW ZEALAND 261–86 (Gordon Walker et al. eds., 2d ed. 1998); Simon Swallow et al., *The New Zealand Stock Exchange and Securities Markets in New Zealand*, *in* SECURITIES REGULATION IN AUSTRALIA AND NEW ZEALAND 214–41 (Gordon Walker et al. eds., 2d ed. 1998). Also, two relatively contemporary books are of relevance: JOHN FARRAR, CORPORATE GOVERNANCE IN AUSTRALIA AND NEW ZEALAND (3d ed. 2008); JOSEPH HEALY, CORPORATE GOVERNANCE AND WEALTH CREATION IN NEW ZEALAND (2003). The Healy book largely ignores the extant research on this very topic.

35. Alma Pekmezovic, *Empirical Studies on Corporate Ownership*, 2007 N.Z. L.J. 275. (2007). For a recent discussion of the NZSX Listing Rules, see Mark Fox, Gordon Walker & Alma Pekmezovic, *Corporate Governance Disclosures*, 2010 N.Z. L.J. 239 (2010).

36. NZSX LISTING RULES, *supra* note 24, r. 10.5.5.

In contrast, the U.S. model of governance takes a more prescriptive approach; for example, Sarbanes-Oxley (a response to various governance failures) provides a mandatory, rules-based regime.[37] Such differences may be (at least in part) due to underlying differences in the ownership and control of companies in various countries.[38] In the United States (and, for that matter, in the United Kingdom) corporate ownership tends to be widely dispersed, with majority shareholders being somewhat rare and markets being relatively liquid. By contrast, New Zealand has a small, less developed, less liquid securities market and fewer widely held companies.[39] Accordingly, there is an argument that strategic regulatory design should be informed by stock market ownership.[40] For example, an understanding of ownership composition makes it easier to more effectively target regulatory funding—something that is particularly critical in New Zealand, where the budget for securities regulation has been limited.[41]

A. Control Classifications and General Governance Issues

There is now almost fifty years of data on the control of New Zealand listed companies, with studies dating back to 1962. These studies generally use a classification scheme devised by Graeme Fogelberg (see Table 1).[42] Under that scheme, at one extreme, majority control represents a situation where there is a major shareholder (or close-knit group of shareholders) that holds an unassailable position in the control of a company. At the other extreme, management control represents a situation where shareholdings are so widely dispersed that no individual shareholder can exercise control in the direction of a company.

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37. *See generally* Nandini Rajagopalan & Yan Zhang, *Recurring Failures in Corporate Governance: A Global Disease?*, 52 BUS. HORIZONS 545 (2009). These authors propose that violations of governance reforms is a function of perceived costs and benefits such that "[t]he higher the costs imposed on the perpetrator and the lower the benefits associated with the fraud, the lower the likelihood that the fraud will be committed." *Id.* at 549.

38. Alma Pekmezovic, *Determinants of Corporate Ownership: The Question of Legal Origin – Part 1*, 18 INT'L COMPANY & COM. L. REV. 97 (2007); Alma Pekmezovic, *Determinants of Corporate Ownership: The Question of Legal Origin – Part 2* INT'L COMPANY & COM. L. REV. 147 (2007).

39. *See generally* Swallow et al., *supra* note 34.

40. *See generally* Fox & Walker, *Regulatory Design*, *supra* note 34.

41. These suggestions are similar to those made by Peter Fitzsimons, who, when commenting on takeover regulation in New Zealand, noted that much debate had misguidedly focused on "evidence and arguments associated with stock markets in which shares are widely held." *See* Peter Fitzsimons, *Takeovers and Efficiency in the Context of Concentrated Shareholdings: The Case of New Zealand*, 15 COMPANY & SEC. L.J. 4, 4 (1997).

42. Graeme Fogelberg, *Ownership and Control in 43 of New Zealand's Largest Companies*, 2 N.Z. J. BUS. 54 (1980).

Classification schemes such as Fogelberg's are based on the premise that diffuse ownership may lead managers to engage in self-interested behaviors that are not in the best interests of shareholders. This creates the so-called "agency problem," whereby managers (agents) may not always act in the best interests of owners (principals). Historically, one of the earliest observations of the agency problem was by Adam Smith. When discussing professional managers, Smith proposed that "being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance" as if they were owner-managers.[43] One extension of such logic is that movement away from owner-controlled companies to management-controlled companies may increase compliance costs and provide more opportunities for managers to behave in ways that do not always serve the best interests of investors. Modern securities regulation laws, accounting standards, and stock-exchange listing requirements attempt to minimize the scope for managerial self-interest. For example, as mentioned earlier, since April 2009, NZSX-listed companies have been required (by Listing Rule 10.5.5) to disclose in their annual reports the extent to which their corporate governance practices differ from the NZSX Corporate Governance Best Practice Code.[44]

TABLE 1
Classification of Control Types

Classification	Deemed to Exist When
Majority	Over 50% of capital held by one holder or a tightly knit group.
Minority	An individual or small cohesive group of shareholders holds sufficient votes to be able to dominate the company through their interest. Exists where there is an important minority interest or family group accounting for between 15% to 50% of votes.
Joint	Minority interest strengthened by a close association with management, or management control enhanced by a sizeable minority interest. One of two situations may apply: • Owning a minority interest of 10% to 15% coupled with board representation, or • Owning or controlling a minority interest of more than 5% with board representation and active management involvement.
Management	Ownership is so widely distributed that no one individual or group has a minority interest that is large enough to allow them to exert dominance over the company's affairs.

43. ADAM SMITH, THE WEALTH OF NATIONS 1776, at 700 (Modern Library, Edwin Cannan ed., 1937). The classic modern formulation of the agency problem is Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

44. NZSX LISTING RULES, *supra* note 24, r. 10.5.5. The NZSX Corporate Governance Best Practice Code is contained in Appendix 16 to the NZSX Listing Rules.

Table 2 contains a summary of the results of studies that use Fogelberg's classification scheme of corporate control.[45] Fogelberg's own study looked at large companies listed in both 1962 and 1974.[46] Fogelberg's data demonstrated that a significant proportion of companies were management controlled in 1962, and this trend continued through to 1974.[47] He attributed increasing firm size as a key contributor to management control, noting:

> [I]t is also apparent that the larger the individual company the more likely it is to be management controlled . . . . The findings support the proposition that once a company reaches a certain size, then, with few exceptions, dominant ownership and control of it is beyond the resources of an individual or small group of shareholders. Control effectively passes to those who manage and direct the company.[48]

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45. Data for 1962 and 1974 are from Fogelberg, *supra* note 42. Data for 1981 are from Richard F. Chandler & Brian D. Henshall, *Corporate Directorship Practices in New Zealand Listed Public Companies* (Dep't of Mgmt. Studies, Working Paper No. 8, Univ. of Auckland, 1982). All other data is from Mark A. Fox & Gordon R. Walker, *Sharemarket Ownership and Securities Regulation in New Zealand*, 17 N.Z. U. L. REV. 402 (1997); Fox & Walker, *Regulatory Design*, *supra* note 34; Mark A. Fox, Gordon R. Walker & Alma Pekmezovic, *Corporate Control of New Zealand Stockmarket (NZSX) Companies: The 2009 Data*, 28 COMPANY & SEC. L.J. 494 (2010). It is not always a straightforward matter to identify the major security holders in New Zealand listed companies. Lloyd Kavanagh, a member of the former Securities Commission observed: "Despite the importance of this disclosure, compliance is not always optimal. High Court remedies have always been available for breaches, and thanks to litigation funding the Commission has been able once again to take serious cases to the Court. The most recent was last year where we obtained interim orders against the manager of the National Property Trust in respect of relevant interests it held in the trust. A shortcoming to date in this law has been the lack of any remedy other than High Court proceedings. This makes it difficult to secure disclosure quickly in cases where material information has not been given to the market." Kavanagh also notes that High Court proceedings constitute an expensive enforcement option. Lloyd Kavanagh, Speech at the Companies and Securities Law Conference, Analysing the New Role of the Securities Commission (May 16, 2005).

46. These were companies with shareholder funds in excess of $2 million.

47. Fogelberg, *supra* note 42. In an earlier publication, Fogelberg looked at the ownership and control of twelve of New Zealand's listed companies in both 1962 and 1974. In both years, only one company was majority controlled. In 1962 four companies were minority controlled, but this number decreased to two companies by 1974. Only two companies were minority controlled in 1962, and none in 1974. The number of management-controlled companies increased from five in 1962 to nine in 1974. In light of these changes, Fogelberg observed, "It is apparent that by the early 1960s, even in New Zealand's largest companies, the movement towards management control was substantial. However, some twelve years later, the movement is almost complete with 75 percent of the companies being classified as management controlled." Graeme Fogelberg, *Ownership and Control of New Zealand's Largest Listed Companies*, ACCOUNTANT'S J., Aug. 1978, at 247; *see also id.* at 245.

48. Fogelberg, *supra* note 42, at 71.

From Table 2 it is clear that movements away from management control and toward majority and minority control took place in the late 1970s and became more pronounced in the early 1980s. Majority control companies increased from 7% in 1974 to 22.1% in 1981, and management control companies decreased from 48.8% to 30.4% over the same period.[49] Subsequently, from the late 1990s through to 2009, management-controlled companies became more commonplace, increasing from 3.7% in 1996 to 29.1% in 2009. From 1996 to 2009, majority controlled companies became less prevalent, decreasing from 46.7% to 19.9%. Over this same time, minority controlled companies also declined, while joint controlled companies increased. Generally, the data in Table 2 indicate that after the mid-1990s, NZSX companies were less likely to be majority controlled and were increasingly more likely to be management controlled.

TABLE 2
Control Types of New Zealand Listed Companies, 1962 to 2009

	1962	**1974**	**1981**	**1985**	**1990**	**1993**
Majority	16.3%	7.0%	22.1%	37.8%	54.5%	50.0%
Minority	32.6	30.2	38.2	48.3	38.8	41.4
Joint	11.6	14.0	9.3	7.0	3.0	6.0
Management	39.5	48.8	30.4	7.0	3.7	2.6
No. of Companies	43	43	204	143	134	116
	1996	**1999**	**2001**	**2003**	**2005**	**2009**
Majority	46.7%	40.0%	35.5%	32.1%	27.9%	19.9%
Minority	44.4	45.2	46.8	39.4	38.3	40.4
Joint	5.2	2.6	3.2	8.8	9.3	10.6
Management	3.7	12.2	14.5	19.7	24.6	29.1
No. of Companies	135	115	124	137	183	141

While there has been a decline in the majority control of New Zealand listed companies in general, ownership of those companies has become increasingly global in nature (see Table 3).[50] Foreign control had risen from 1985

49. Chandler & Henshall, *supra* note 45, at 18. Chandler and Henshall classified Fogelberg's 1962 and 1974 data into one of three ownership categories: "family," "corporate," or "management." They contrasted 1962 and 1974 data with the types of control for the thirty-two companies that remained in 1981 from Fogelberg's original sample. From 1962 to 1981, control by family interests declined by 85%, while management control increased by 35%. Consistent with Fogelberg's observations about management control increasing as firm size increases, Chandler and Henshall propose that their own findings would seem to indicate that "control is related to corporate size, i.e., large companies will be predominantly controlled by management, medium-sized companies will tend to show a spread of control between the controllers, and small companies will tend to be controlled by family interests." *Id.*

50. Data for 1985, 1990, and 1993 is from Mark A. Fox & Matthew R. Roy, *Corporate Control and Foreign Ownership of New Zealand Listed Equities*, 1(2) N.Z. STRATEGIC MGMT. 24 (1994). Data for 1996, 1999, and 2001 is from Mark A. Fox &

to 1996 (from 16.8% to 26.7%); however, by 1999, 38.3% of listed companies were foreign controlled.[51]

Data from the ownership composition of Top 40 listed companies also provides useful insights into the dynamics behind ownership changes (see Table 4).[52] Generally, overseas institutions increased their ownership of Top 40 companies (from 10% in 1989 to 36% in 1998). Overseas corporates also increased ownership from 9% to 21%. At the same time, ownership of the Top 40 companies by local corporate declined from 21% in 1989 to 8% in 1998. Part of this decline may have been due to the divestment of assets by holding companies such as Brierley Investments Limited.[53] Returning to the ideas inherent in agency theory (and implicit in Fogelberg's classification scheme of corporate control), we note there is mixed empirical support for the notion that management control leads to self-serving behavior in New Zealand.[54] For 1985, Mark A. Fox and Robert T. Hamilton found no relationship between the levels of diversification of ninety-six listed companies and their control structure (as defined by Fogelberg).[55] They tentatively observed that diversification was motivated by an (often misguided) attempt to improve financial performance, rather than an attempt to increase firm size (which is typically associated with increased managerial compensation and reduced employment risk for executives).[56] Michael Firth looked at the financial

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Gordon R. Walker, *Ownership and Foreign Control of NZSE Companies*, 20 COMPANY & SEC. L.J. 56 (2002).

51. Chandler and Henshall do not use Fogelberg's definition of control. However, for 204 listed companies in 1981, Chandler and Henshall note that "[t]here are twenty companies in which over 50 percent of the capital was owned by overseas interests and a further six in which 25 to 50 percent of the capital was under overseas control." Chandler & Henshall, *supra* note 45, at 20. Chandler and Henshall conclude that in 1981, around 13% of listed companies were under overseas control (i.e., had 25% or more of voting capital controlled by overseas interests, or were a New Zealand branch of a company that was incorporated overseas). *Id.*

52. Doyle Paterson Brown, Ltd., *Ownership Structure of the New Zealand Stockmarket*, Mar. 1996. *See also* Mark A. Fox & Gordon R. Walker, *Foreign Control of NZSE Companies: New Zealand Evidence*, 18 COMPANY & SEC. L.J. 283 (2000).

53. *Brierley Investments Grounded*, ECONOMIST, Aug. 22, 1998, at 50. Note that in his heyday, Sir Ron Brierley and the companies he led (first BIL and later Industrial Equities Limited) were influential in unlocking hidden shareholder value. A recent article calls Brierley the "scourge of lazy boards" and his retirement "the end of a colourful type of shareholder activism." *See* Tony Boyd, *Exit Sir Ron, Scourge of Lazy Boards*, WEEKEND AUSTL. FIN. REV., Feb. 12–13, 2011, at 64.

54. The focus of much of the research on corporate governance is on how corporate control or board characteristics influence financial performance. Of course, financial performance (or even firm survival) may be undermined through various self-serving activities on the parts of directors, investors, or managers. Some of these actions may constitute corruption. *See* Susan Watson & Rebecca Hirsch, *The Link Between Corporate Governance and Corruption in New Zealand*, 24 N.Z. U. L. REV. 42 (2010).

55. Mark A. Fox & Robert T. Hamilton, *Ownership and Diversification: Agency Theory or Stewardship Theory*, 31 J. MGMT. STUD. 69, 75 (1994).

56. *Id.* at 76.

performance of 149 listed companies from 1986 and concluded that a "manager-controlled firms' profitability behavior is no different from other categories of companies."[57] A subsequent study by Fox examined control structure for 1990 and its impact on average financial performance for 1991 to 1993 and found no correlation between ownership and subsequent financial performance.[58]

TABLE 3
Foreign Control of New Zealand Listed Companies, 1985 to 2001

		1985			**1990**	
	Foreign Controlled Companies	Total Companies	% Foreign Controlled	Foreign Controlled Companies	Total Companies	% Foreign Controlled
Majority	18	54	33.3	21	73	28.8
Minority	6	69	8.7	12	52	23.1
Joint	0	10	0	0	4	0
Management	0	10	0	0	5	0
Totals	24	143	16.8	33	134	24.6
		1993			**1996**	
	Foreign Controlled Companies	Total Companies	% Foreign Controlled	Foreign Controlled Companies	Total Companies	% Foreign Controlled
Majority	31	58	53.4	36	63	57.1
Minority	14	48	29.2	24	60	40
Joint	1	7	14.3	2	7	28.6
Management	0	3	0	1	5	20
Totals	46	116	39.7	63	135	46.7
		1999			**2001**	
	Foreign Controlled Companies	Total Companies	% Foreign Controlled	Foreign Controlled Companies	Total Companies	% Foreign Controlled
Majority	24	46	52.2	15	44	34.1
Minority	15	52	28.9	18	58	31
Joint	1	3	33.3	2	4	50
Management	4	14	28.6	3	18	16.7
Totals	44	115	38.3	38	124	30.6

57. Michael Firth, *Control-type and the Financial Structure and Performance of New Zealand Firms*, 26(1) N.Z. ECON. PAPERS 1, 16–17 (1992). Firms were classified as owner-controlled if there was a single shareholder (or closely associated group) who owned 20% of stock and was thought to exercise some form of control. In contrast, owner-managed firms were those that were not owner-controlled.

58. Mark A. Fox, *Corporate Control and Financial Performance of New Zealand Companies* 6–7 (Dep't of Econ. & Mktg., Discussion Paper No. 14, Lincoln Univ., 1996), *available at* http://researcharchive.lincoln.ac.nz/dspace/bitstream/10182/972/3/cd_dp_14.pdf. (Financial performance was measured by return on assets and return on equity.).

TABLE 4
Top 40 New Zealand Listed Companies, Ownership Changes, 1980 to 1998

Type of Investor	**Dec. 89**	**Mar. 91**	**Aug. 91**	**Mar. 92**	**Dec. 92**	**Mar. 93**	**Sept. 93**
Local Institutions	16	14	12	12	14	15	17
Overseas Institutions	10	17	22	23	24	25	27
Local Corporates	21	15	11	11	10	9	7
ESOPs	4	8	4	4	4	4	3
Overseas Corporates	9	6	20	20	20	19	16
Other	40	40	31	30	28	28	30
Totals							
Institutions	26	31	34	35	38	40	44
Corporates	30	21	31	31	40	28	23
Overseas	19	23	42	43	44	44	43
Type of Investor	**Nov. 94**	**May 95**	**Aug. 95**	**Mar. 96**	**July 96**	**Aug. 97**	**July 98**
Local Institutions	14	13	11	11	10	11	15
Overseas Institutions	31	29	31	32	32	32	36
Local Corporates	9	8	9	8	7	8	8
ESOPs	3	3	3	3	2	1	1
Overseas Corporates	20	25	25	26	29	29	21
Other	23	21	20	20	20	19	19
Totals							
Institutions	45	42	42	42	42	43	51
Corporates	29	33	34	34	36	37	29
Overseas	51	54	56	58	61	61	57

B. Insider Ownership: The Intersection of Owner and Management Control

Ownership by insiders is also commonly thought to cause agency problems. Andrew K. Prevost, Ramesh Rao, and Mahmud Hossain looked at a sample of NZSE firms from 1991 to 1997. Their pooled data showed insider ownership of 6.8% and Top 20 shareholder ownership of 76.3%.[59] Insider ownership had a strong, positive association with performance. Further, their findings suggest "excessive ownership concentration may actually be detrimental to firm performance."[60] However, a study of the Top 50 listed companies from

59. Mahmud Hossain et al., *Corporate Governance in New Zealand: The Effect of the 1993 Companies Act on the Relation Between Board Composition and Firm Performance*, 9 PACIFIC-BASIN FIN. J. 119 (2001). Insider ownership was defined as "proportion of equity beneficially held by all members of the board of directors including top officers of the firm who are members of the board to total shares outstanding." *Id.* at 131.

60. *Id.* at 139. Insider ownership may also play a role in influencing decisions about financial disclosures. Y. T. Mak examined the relationship between insider ownership and voluntary disclosure of forecast information in prospectuses for initial public offerings. He

1999 to 2007 by Krishna Reddy, Stuart Locke, and Frank Scrimgeour found no link between insider ownership (defined as the proportion of ordinary shares held by board members) and financial performance.[61] However, large stock holdings were found to contribute positively to financial performance.[62] This could be because holders of large blocks are more vigilant in protecting their investments than smaller shareholders.[63] Another study also found that concentrated

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proposed that when insider ownership (e.g., by managers and directors) was higher, there would be less need to voluntarily disclose information because insiders and outsiders are already likely to have their interests aligned. However, when looking at a sample of ninety-two prospectuses for 1983 to 1988, he found no relationship between insider ownership and voluntary disclosures. The mean level of insider ownership was 55.2%, when insider ownership consisted of shares allocated to be issued to related companies, promoters, management, staff, and directors. *See* Y. T. Mak, *Corporate Characteristics and the Voluntary Disclosure of Forecast Information: A Study of New Zealand Prospectuses*, 23 BRIT. ACCT. REV. 305 (1991). More recently, Haiyan Jiang and Ahsan Habib looked at the influence of the type of ownership concentration on annual report voluntary disclosures for a sample of listed companies from 2001 to 2005. *See* Haiyan Jiang & Ahsan Habib, *The Impact of Different Types of Ownership Concentration on Annual Report Voluntary Disclosures in New Zealand*, 22 ACCT. RES. J. 275 (2009). A key finding of this study is that "different types of controlling shareholders affect corporate disclosures differently." *Id.* at 299. Companies that were controlled by financial institutions disclosed significantly less when ownership concentration was higher. Among the reasons proffered was lack of financial shareholder activism in New Zealand and lack of physical proximity of many controlling financial institutions. Firms with management-controlled or government-controlled ownership structures disclosed significantly more when ownership concentration was higher. The authors proposed that greater disclosures at higher concentration levels by government-controlled firms may be motivated by concerns for social responsibility and accountability. *Id.*

61. Krishna Reddy, Stuart Locke & Frank Scrimgeour, *The Efficacy of Principle-based Corporate Governance Practices and Firm Financial Performance*, 6(3) INT'L J. MANAGERIAL FIN. 190 (2010). This finding is confirmed by a study of small cap companies. *See* Krishna Reddy et al., *Corporate Governance Practices of Small Cap Companies and Their Financial Performance: An Empirical Study in New Zealand*, 1 INT'L J. BUS. GOVERNANCE & ETHICS 51 (2008). It also appears that insider ownership (typically defined as ownership by directors, divided by total shares outstanding) is higher in smaller companies than in larger ones. A study of fifty large firms from 1999 to 2005 reported mean insider ownership of 14.4%. *See* Krishna Reddy, Abeyratna Gunasekarage, Frank Scrimgeour & Stuart Locke, *Corporate Governance Practices of Large Firms in New Zealand and Firm Performances: An Empirical Investigation* (19th Australian Finance and Banking Conference, Sydney, Dec. 15–19, 2006). This contrasts with a mean insider ownership ratio of 31.3% in the study of small cap firms from 2001 to 2005. Reddy et al., *Small Cap Companies*, *supra*.

62. The mean proportion of stock held by the twenty largest shareholders was 69.3%. Reddy et al., *Small Cap Companies*, *supra* note 61.

63. There are several explanations for this phenomenon. Reddy, Locke & Scrimgeour point out that their findings on insider ownership and financial performance may differ from those of Hossain et al., because of differences in sampling. (The latter study includes both small and large companies, and small companies tend to have a higher

ownership had a positive association with financial performance but that this relationship was strongest for companies whose major investor was a financial institution.[64]

Much of the research discussed above assumes (but by no means confirms) that diffusion of ownership diminishes firm value. However, such a linear relationship has been questioned. For example, based on data for New Zealand listed companies in 1994 to 1998, Gurmeet Singh Bhabra found a curvilinear relationship between insider ownership (defined as beneficial ownership by directors) and firm value.[65] Insider ownership was positively related to firm value for ownership levels below 14% and above 40% (and inversely related between those levels). The rationale for this finding is that market discipline may increase firm value at low levels of managerial ownership, and there is a convergence of interests at high levels of ownership. At intermediate levels, by contrast, managers may become entrenched, and associated agency costs may be higher.[66] In this regard, a study by Prevost, Rao, and Hossain found that insider ownership had a nonlinear impact on financial performance, but "ownership concentration has little systematic effect on firm performance."[67]

C. Institutional Investors

Institutional ownership levels may also play a role in mediating any governance-performance relationship.[68] Institutional shareholders may enhance firm value in a number of ways, including encouraging capital market efficiency and liquidity; monitoring efforts of the companies they invest in, possibly

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proportion of insider ownership.) The conventional legal explanation is that block shareholdings are a response to weak regulation.

64. Nicholas Boone, Sisira Colombage & Abeyratna Gunasekarage, *Block Shareholder Identity and Firm Performance in New Zealand*, 13 PAC. ACCT. REV. 185 (2011).

65. Gurmeet Singh Bhabra, *Insider Ownership and Firm Value in New Zealand*, 17(2) J. MULTINATIONAL FIN. MGMT. 142 (2007).

66. Research from an unpublished thesis also supports the idea of a nonlinear ownership-financial performance relationship. In a study of seventy-nine listed companies, Hannah Maling found that ownership and firm value were positively related when ownership levels were below 16% or above 58%. *See* Hannah Maling, *Managerial Ownership and Firm Value: Evidence from New Zealand* (Feb. 10, 2000) (unpublished Master of Business Research Report, Univ. of Otago).

67. Andrew K. Prevost, Ramesh P. Rao & Mahmud Hossain, *Determinants of Board Composition in New Zealand: A Simultaneous Equations Approach*, 9 J. EMPIRICAL FIN. 373, 394 (2002).

68. Gordon R. Walker & Mark A. Fox, *Securities Regulation and New Zealand Sharemarket Patterns, 1989-1993*, 5 J. BANKING FIN. L. & PRAC. 244 (1994); Gordon R. Walker & Mark A. Fox, *Institutional Investment and Ownership Concentration in New Zealand Listed Companies*, 7 J. BANKING FIN. L. & PRAC. 356 (1996).

affecting significant changes in corporate governance and strategy (or discouraging moves that often harm performance, such as excessive diversification); and taking action to stifle or stop excessive compensation schemes or schemes that show a disconnect between compensation and firm performance.[69]

Farshid Navissi and Vic Naiker's research examined 123 New Zealand listed companies that had at least 5% institutional ownership in 1994.[70] The average institutional shareholding was 22%. However, Navissi and Naiker note that "simply examining the overall shareholding by institutional investors does not consider the level of monitoring exercised by these investors."[71] Accordingly, they categorize institutional investors as either "active" or "passive." Active investors have board representation and passive investors do not. Institutional ownership of up to 30% was found to generally improve firm value (as measured by market-to-book value), and ownership over 30% reduced firm value.[72] Hence, Navissi and Naiker suggest:

> It is possible that institutional investors (similar to corporate insiders) will decrease firm value once their shareholdings exceed a certain level. That is, active monitoring may improve firm value (convergence-of-interest hypothesis) only up to a certain level of shareholding. At higher levels of share ownership, institutional institutions may encourage sub-optimal decisions that could be harmful to the firm (entrenchment hypothesis).[73]

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69. Gordon R. Walker & Mark A. Fox, *Institutional Investors and the Brierley Investments Limited Executive Share Options Scheme*, 13 COMPANY & SEC. L. J. 344 (1995). This article discusses successful efforts by institutional investors to get Brierley Investments Limited to drop a proposed option scheme for directors. The proposed scheme had undemanding performance standards and occurred within the context where several directors were selling down their holdings in the company. *See also* Aik Win Tan & Trish Keeper, *Institutional Investors and Corporate Governance: A New Zealand Perspective* (Center for Accounting, Governance & Taxation Research, Sch. of Accounting & Commercial Law, Victoria Univ. of Wellington, Working Paper No. 65, Oct. 2008), *available at* http://www.victoria.ac.nz/sacl/cagtr/working-papers/WP65.pdf.

70. Farshid Navissi & Vic Naiker, *Institutional Ownership and Corporate Value*, 32 MANAGERIAL FIN. 247 (2006). Note that 1994 was the first year of mandatory disclosure of distribution of equity under the Financial Reporting Act of 1993.

71. *Id.* at 255.

72. These findings are interesting in light of a study of 259 firm year observations from 2000 to 2003 that showed that the top institutional shareholder ratio was negatively associated with firm value, indicating that "a dominating institution may hurt firm value." *See* Jianguo Chen & Dar-Hsin Chen, *Does Institutional Ownership Create Values?: The New Zealand Case* 13 (N.Z. Fin. Colloquium Paper, Oct. 24, 2007), *available at* http://www.nzfc.ac.nz/archives/2008/papers/0810.pdf.

73. Navissi & Naiker, *supra* note 70, at 249.

More generally, some insight into the impact of institutional investors on governance practices is found in a survey of fund managers who invested in New Zealand listed companies.[74] Typically, these fund managers preferred investing in companies with independent board chairs, a majority of independent directors, a majority of independent directors on remuneration committees, and performance-based compensation for executives (they also viewed this as desirable for nonexecutive directors). Nevertheless, fund managers tended to believe that governance guidelines should be applied on a case-by-case basis, with authors Peggy Chiu and John Monin noting that these managers tended to believe that "the corporate governance framework should not be considered as a body of rules that cannot be overridden."[75] This viewpoint is consistent with the notion of strategic governance reform and fits with a model of governance based on a "comply or explain model."[76] Similarly, Andrei Shleifer and Robert W Vishny, in an international review of the literature focusing on the legal protection of investors and ownership concentration, note that they "do not believe that the available evidence tells [them] which one of the successful governance systems is the best."[77] Megan Goldfinch echoes these sentiments with respect to New Zealand Listing Rules: "[E]ach firm has its optimal governance structure that is determined by firm-specific factors and the institutional environment that the firm faces."[78]

D. The Role of Executive Compensation

The impact of corporate control on financial performance is affected by the mediating role of executive compensation. Research on thirty-six New

74. Peggy Chiu & John Monin, *Effective Corporate Governance: From the Perspective of New Zealand Fund Managers*, 11(2) CORP. GOVERNANCE 123 (2003). We also note that fund managers can have conflicts of interest that lead them to behave in ways that are not in the best interests of all shareholders. C.B. Ingley and N.T. van der Walt state that governance concerns arise as "most fund managers are short-term speculators, not long-term owners, and because of the conflicts of interest they incur when fund managers' largest clients are firms that comprise the corporate investment pool." *See* C.B. Ingley & N.T. van der Walt, *Corporate Governance, Institutional Investors and Conflicts of Interest*, 12 CORP. GOVERNANCE: AN INT'L REV. 534, 534 (2004).

75. Chiu & Monin, *supra* note 74, at 129.

76. Brian K. Boyd et al., *Who Wins in Governance Reform?*, *in* STRATEGIC DISCOVERY: COMPETING IN NEW ARENAS 237 (Howard Thomas & Don O'Neal eds., 1997). Brian K. Boyd et al., *International Corporate Governance Reform*, 12 EUR. BUS. J. 116 (2000).

77. Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 J. FIN. 737, 774 (1997). For another useful review of the governance literature, see Diane K. Denis, *Twenty-five Years of Corporate Governance Research . . . and Counting*, 10 REV. FIN. ECON. 191 (2001).

78. Megan Goldfinch, *Do the NZSE Listing Rules Destroy Value?*, 6 U. AUCKLAND BUS. REV. 1, 7 (2004).

Zealand companies from 1998 to 2000 found that total compensation was significantly influenced by present, past, and future financial performance. This supports the view that the negative impact of agency conflicts on firm performance "are minimized when executives become owners of their own firms since executive remuneration becomes tied to the long-term performance of the firm."[79]

Looking at data from 431 listed firm year observations (the sum of observations across all years examined) from 2001 to 2005, Haiyan Jiang, Ahsan Habib, and Clive Smallman observed a nonlinear effect of ownership concentration on the CEO compensation-firm performance relationship.[80] CEO compensation was negatively related to corporate financial performance when ownership concentration was high and positively related when ownership concentration was low. These results indicate that "large controlling shareholders seem dysfunctional in curbing managerial power, evidenced by their support of firm-performance detached CEO compensation scheme."[81] When ownership concentration is lower, by contrast, any individual shareholder has less power and may be less likely to attempt to expropriate firm resources.

III. INTERLOCKING DIRECTORSHIPS

The studies on corporate control discussed in Part II give us some idea of the nature of who holds power over New Zealand's listed companies. Interlocking directorships are another common means of assessing power relations in business that are secondary in influence to ownership.[82] With regard to interlocking directorships, Georgina Murray proposes that "[p]ower, in this context, means having a key member of your board inter-lock with (or sit on) someone else's board, thereby feeding you information from a wide corporate environmental scan about the machinations of inter-firm politics."[83] Another common view of interlocks (known as resource dependence theory) sees them as a means of co-opting resources from the environment.[84] Such a view is not

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79. Abeyratna Gunasekarage & Michael Wilkinson, *CEO Compensation and Firm Performance: A New Zealand Investigation*, 10 INT'L J. BUS. STUD. 45, 52 (2002).

80. Haiyan Jiang, Ahsan Habib & Clive Smallman, *The Effect of Ownership Concentration on CEO Compensation-Firm Performance Relationship in New Zealand*, 21(2) PAC. ACCT. REV. 104 (2009).

81. *Id.* at 124.

82. Georgina Murray, *Interlocks or Ownership: New Zealand Boardroom Power*, 16 N.Z. SOC. 176 (2001).

83. *Id.* at 177. Murray's research examined interlocks among all of the Top 30 New Zealand companies, not just listed companies. *See also* Georgina Murray, New Zealand Corporate Capitalism (1989) (unpublished Ph.D. thesis, University of Auckland), *available at* https://researchspace.auckland.ac.nz/handle/2292/2038.

84. *See generally* Amy J. Hillman et al., *Resource Dependence Theory: A Review*, 35 J. OF MGMT. 1404 (2009). The importance of co-opting resources is given credence by Graeme Fogelberg and Clinton R. Laurent's study of 160 large listed companies. *See*

inconsistent with Murray's view of interlocks as providing useful information to directors.

There are three major corporate governance issues that arise from directors sitting on multiple boards: (1) directors may face conflicts of interests between their duties to several companies or between the duty to the company and self-interest; (2) directors with several board positions may be unable to gain a satisfactory understanding of each company's business; and (3) multiple directorships may affect a director's independence and thereby impede his or her ability to effectively monitor the company's executive management.[85] However, as we will demonstrate, New Zealand listed companies have had relatively low levels of interlocking directorships in recent years.[86]

Studies of interlocking directorships tend to focus on two types of interlocks: company interlocks and director interlocks. Company interlocks refer to the number of other listed companies with which any given listed company has directors in common. Director interlocks refer to the total number of board positions held on other boards by a given company's own directors.

Historical data on interlocking directorships are presented in Tables 5 and 6.[87] The number of company interlocks has decreased from 7.0 for 1984 to

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Graeme Fogelberg & Clinton R. Laurent, *Interlocking Directorates: A Study of Large Companies in New Zealand*, 3(2) J. BUS. POL'Y 16 (1973). Of all interlocks, 19% were with competitors, 29.2% were with customers, and 22.5% were with finance companies). Further, interlocks with suppliers were commonplace in meat, textile, printing, fertilizer, electrical machinery, and stock and station industries.

85. Jeffrey Lawrence, *Multiple Directorships and Conflicts of Interest: Recent Developments*, 14 COMPANY & SEC. L. J. 513 (1996). *See also* Hon. Justice Tompkins, *Directing the Directors: The Duties of Directors Under the Companies Act 1993*, 2 WAIKATO L. REV. 76 (1995).

86. Erik Devos et al., *Are Interlocked Directors Effective Monitors?*, 38 FIN. MGMT. 861 (2009). Based on a sample of 3,566 U.S. and Canadian firms for the years 2001 to 2003, poorly performing companies were more likely to have interlocked directors on their boards.

> In further analysis, we find that the market reacts negatively to the announcement of director appointments that create interlocked boards. In addition, we find that interlocked directors are associated with lower than optimal pay-performance sensitivity of CEO incentive compensation. Finally, we find evidence that interlocked directors lower the sensitivity of CEO turnover to prior firm performance. Collectively, our results suggest that the presence of interlocked directors is indicative of poorly governed firms. From a public policy perspective, regulatory authorities and activist institutional investors may take these findings into consideration when making recommendations on the optimal structure of corporate boards."

Id. at 862.

87. For data from 1962 and 1970, see Graeme Fogelberg, A Study of the Ownership and Control of Public Companies in New Zealand (1963) (unpublished M.A. thesis,

1.94 for 2009. Similarly, the number of director interlocks has declined from 7.97 for 1984 to 2.20 in 2009. Also, the incidence of directors holding multiple directorships has become less commonplace over time. For 1970, Clinton Laurent found that 566 of 876 (65%) of directors held more than one board position.[88] However, by 2009 only 82 (9.2%) out of 753 directors held more than one board position.[89]

One reason for the decline in interlocks since the 1980s is a decrease in the number of listed companies, meaning there are fewer opportunities for interlocks in the first instance. We suspect the decline is also due to fewer ownership connections between listed entities that have common directors as a means of coordination and control.

Some directors are more likely than others to be on multiple boards. Fogelberg and Laurent found that larger companies tend to have more interlocks, as did companies controlled by a minority (rather than a family) interest.[90] They also found that some industries tended to have more interlocks (meat and beverage; wood, pulp, and paper; printing and publishing; fertilizers; retail; and finance).[91] Subsequently, Roy, Fox, and Hamilton and Firth also found that larger companies tend to have more interlocks and that some industries are more likely than others to have more interlocks.[92] Roy, Fox, and Hamilton found that more interlocks occurred in the insurance, liquor, forestry, finance, and banking industries.

Victoria Univ. of Wellington); Clinton R. Laurent, Interlocking Directorates in New Zealand (1971) (unpublished M.A. thesis, University of Victoria); Fogelberg & Laurent, *supra* note 84. For data from 1972 and 1984, see Michael Firth, *Multiple Directorships and Corporate Interlocks in New Zealand Firms*, 23 AUSTL. & N.Z. J. SOC. 274 (1987). For data from 1981, see Chandler & Henshall, *supra* note 45. For the basis of the 1984 CEO duality figure, which is formed from a sample of 184 companies, see R. Turner, *Board of Directors Leadership*, 7 N.Z. J. BUS. 59 (1985). For data from 1980 and 1985, see Mark A. Fox, Studies of Corporate Governance in New Zealand (1995) (unpublished Ph.D. thesis, Univ. of Canterbury), *available at* http://www.ir.canterbury.ac.nz/handle/10092/4347. For interlocks data from 1987, 1990, and 1993, see Matthew W. Roy, Mark A. Fox & Robert T. Hamilton, *Board Size and Potential Corporate and Director Interlocks in Australasia 1984-1993*, 19 AUSTL. J. MGMT. 201 (1994). For Interlocks data from 1996 and 1999, see Mark A. Fox & Gordon R. Walker, *Multiple Directorships and Interlocks Among New Zealand Stock Exchange Companies, 1996 to 2001*, 19 COMPANY & SEC. L. J. 467 (2001). For interlocks data from 2003 to 2009, see Mark A. Fox, Gordon R. Walker & Alma Pekmezovic, *Interlocking Directorships and Female Directors in New Zealand: The 2009 Data*, 28 COMPANY & SEC. L. J. 496 (2010). For noninterlocks data from 1987 to 2005, see Mark A. Fox & Gordon R. Walker, *Board Composition and New Zealand Stockmarket Companies*, 24 COMPANY & SEC. L. J. (2006); Fox, Walker & Pekmezovic, *supra* note 35.

88. Laurent, *supra* note 87.

89. Fox, Walker & Pekmezovic, *Interlocking Directorships*, *supra* note 87.

90. Fogelberg & Laurent, *supra* note 84.

91. *Id.*

92. Roy, Fox & Hamilton, *supra* note 87; Firth, *supra* note 87.

Fox and Roy found that board chairs and nonexecutives were most likely to be on the boards of other companies.[93] They observed, "[T]here is an 'inner circle' of directors holding the majority of interlocks among the inner circle of directors holding all interlocks."[94] This may be because executive directors have less time to be professional directors, or accepting directorships of other companies may be seen as showing a lack of devotion to their executive roles. Board chairs may be more likely to be on multiple boards as they have greater expertise and experience than other directors. Recent data also indicates that when women are on boards, they are more likely to have interlocks than their male counterparts.[95]

TABLE 5
Characteristics of New Zealand Listed Company Boards, 1962 to 1987

Year	1962	1970	1972	1980	1981	1984	1985	1987
Board Size	7.21	6.96	6.66	7.24	6.95	7.12	7.45	6.14
Mean Directorships Per Director		3.10	1.28			1.38		1.35
Mean Multiple Directorships Held		4.25	2.83			3.00		2.71
No. of Directors		876	1,291			1,143		1,326
No. of Directorships		2,718	1,646			1,574		1,793
Company Interlocks						7.00		4.42
Director Interlocks						7.97		5.59
CEO Duality (%)				17.83		11.14	10.81	17.81
Independent Chairs (%)								
Executive Chairs (%)				20.16			14.19	18.49
Nonexecutive Directors (average #)				5.45	4.9		5.60	4.48
Independent Directors (average #)								
Nonexecutives (%)				75.00	71.50		75.83	72.60
Independent Directors (%)								
Sample	58	160	247	129	208	221	148	292

93. Mark A. Fox & Matthew R. Roy, *Composition of Boards of Directors and Interlocks in New Zealand, 1987 to 1993*, 10 N.Z. Soc. 17 (1995).

94. *Id.*

95. In 2009, female directors held only 59 of the 753 total board positions (7.7%). However, when women are on boards, they tend to have more interlocking directorships than their male counterparts. On average, men held only 1.15 directorships, whereas women held an average of 1.22 directorships. *See* Fox, Walker & Pekmezovic, *Interlocking Directorships*, *supra* note 87.

TABLE 6
Characteristics of New Zealand Listed Company Boards, 1990 to 2009

Year	1990	1993	1996	1999	2001	2003	2005	2009
Board Size	5.69	6.14	6.15	6.40	6.00	6.56	6.43	6.08
Mean directorships per director	1.23	1.22	1.20	1.21	1.25	1.21	1.19	1.15
Mean Multiple Directorships Held	2.39	2.51	2.47	2.55	2.47	2.43	2.48	2.39
No. of Directors	664	666	741	723	749	859	897	753
No. of Directorships	814	815	889	875	934	1041	1066	867
Company Interlocks	2.18	2.60	2.57	2.91	2.78	2.65	2.66	1.94
Director Interlocks	3.01	3.32	3.12	3.58	2.89	2.78	2.69	2.20
CEO Duality (%)	15.38	14.29	8.82	7.38	9.16	4.26	6.03	
Independent Chairs (%)							62.00	71.30
Executive Chairs (%)	17.48	16.54	13.73	9.84	15.27	14.89	12.10	6.30
Nonexecutive Chairs (average #)	4.15	4.57	4.91	5.26	4.78	5.28	5.09	4.90
Independent Directors (average #)							3.69	3.60
Nonexecutives (%)	72.67	74.18	78.00	81.00	78.00	81.00	79.16	80.59
Independent Directors (%)							57.39	59.21
Sample	143	133	145	139	161	166	178	142

IV. OVERALL BOARD COMPOSITION

Boards of directors provide a mechanism through which monitoring of management can occur on behalf of shareholders. The size, leadership, and composition of boards influence their ability to effectively monitor management and to support strategy development. Tables 5 and 6 contain a summary of research findings of these board characteristics.

A. Board Size

The only NZSX requirements regarding board size (mandated in Listing Rule 3.3.1) are that there should be a minimum of three directors (other than alternate directors) of an issuer and at least two directors should ordinarily reside in New Zealand. The typical board size in New Zealand has declined since 1962, when the mean board size was 7.21 directors (see Table 5). In 1985, board size

was around 7.5 directors; since that time, board size has declined to an average of 6.1 directors in 2009.[96]

From a decision-making standpoint, larger boards tend to bring more diverse perspectives to formulating strategy. Executives may also be less able to dominate larger boards or to subvert the ability of boards to monitor executives. Further, resource dependence theory sees directors as linking companies with resources from their external environment.[97] Hence, having a board with more directors may enable organizations to co-opt needed resources more successfully. One way this occurs is through interlocking directorships. However, one concern with larger boards is they tend to have more interlocks with other companies, which might lead to conflicts of interest and anti-competitive behavior.

A global review of the empirical research demonstrates that board size has a positive relationship with corporate financial performance.[98] However, findings on any board size/corporate performance relationship are mixed. For example, Fox found inconsistent evidence of the impact of board size in 1987 and 1990 on subsequent financial performance.[99] In another study, Fox found that board size was not a significant predictor of failure for New Zealand listed companies between 1985 and 1990.[100] For a sample of 633 firm year observations over 1991 to 1997, Prevost, Rao, and Hossain found that larger boards were associated with poorer financial performance.[101] Further, Reddy, Locke, and Scrimgeour, in a study of fifty large listed firms, found no significant relationship between board size and various measures of financial performance.[102] We suspect the lack of clear findings regarding a board size/performance link for New Zealand firms may be due to the relatively small size of listed company boards.

B. Presence of Independent Directors

Listing Rule 3.3.1 stipulates that at least two directors must be independent. Where there are eight or more directors, three or one-third of the total number of directors must be independent. The board must identify which directors are "independent." Independent directors are not executives of the issuer

96. In 2009, all listed companies comprised three or more directors, and 81.7% of boards comprised between three and seven directors. *See* Fox, Walker & Pekmezovic, *supra* note 35.

97. Amy J. Hillman et al., *The Resource Dependence Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change*, 37 J. MGMT. STUD. 235 (2000).

98. Dan R. Dalton et al., *Number of Directors and Financial Performance: A Meta-Analysis*, 42 ACAD. MGMT. J. 674 (1999) (a meta-analytic review of 131 research samples).

99. Fox, *supra* note 87.

100. Mark A. Fox, *Corporate Governance and Corporate Failure* (Dep't of Econ. & Mktg., Discussion Paper No. 41, Lincoln Univ., 1997), *available at* http://researcharchive.lincoln.ac.nz/dspace/handle/10182/874.

101. Hossain et al., *supra* note 59.

102. Reddy, Locke & Scrimgeour, *supra* note 61.

and do not have any disqualifying relationships (for example, being a substantial security holder).

Research on listed companies for 1991 to 1995 by Prevost, Rao, and Hossain finds that higher ownership by insiders (that is, ownership by management and directors) is associated with a smaller proportion of outsiders on boards.[103] This indicates that independent directors and insider equity ownership can operate as substitute governance mechanisms.[104] In another study, covering listed companies for 1991 to 1997, Prevost, Rao, and Hossain found:

> [O]utside directors may function as a substitute in corporate governance for lower levels of inside ownership. [Also] very high levels of inside ownership are associated with higher outside directors. This suggests that firms increase their use of outside directors in order to mitigate the potential negative entrenchment effect brought about by high inside ownership.[105]

Prevost, Rao, and Hossain consider that highly concentrated share ownership in New Zealand may "imply that outside takeovers are not a viable disciplining mechanism thus making the presence of outsiders on the board a pivotal element in controlling agency problems."[106] By 2009, 59% of NZSX listed company directors were independent (see Table 6). Nonexecutive directors had risen from around 73% in 1987 to 81% in 2009 (see Tables 5 and 6).

It is often proposed that executives and other nonindependent directors cannot be relied on to impartially monitor their own performance because of an inherent conflict of interest. Such conflicts of interest are more likely to occur when executives have little stake in the corporations they manage.[107] While there are compelling arguments in favor of independent directors, there are also arguments in favor of representation by insiders. Independent or nonexecutive directors may not have the time and expertise to perform effectively or understand the complexities of the companies they serve. (This concern may be particularly acute when directors are also CEOs or serve on many boards.) In New Zealand, this argument was made by Megan Goldfinch who, when commenting on Listing Rules that require a minimum of two directors (or make up one-third of a board), observed that research indicated none of the various testing procedures seemed to produce conclusive evidence as to the benefits of independent directors.[108] This suggests the NZSX proposal, which mandates a minimum number of independent directors, lacks empirical support.

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103. Andrew K. Prevost, Ramesh P. Rao & Mahmud Hossain, *Board Composition in New Zealand: An Agency Perspective*, 29 J. BUS. FIN. & ACCT. 731 (2002).

104. *Id.*

105. Prevost, Rao & Hossain, *supra* note 67, at 394.

106. Prevost, Rao & Hossain, *supra* note 103, at 735.

107. *See generally* Michael C. Jensen, *Self-Interest, Altruism, Incentives, and Agency Theory*, 7 J. APPLIED CORP. FIN. 40 (1994).

108. Goldfinch, *supra* note 78, at 3.

Despite popular wisdom extolling the benefits of independent or outside directors, the evidence on the impact of outsiders on financial performance is equivocal. A survey of 159 samples of board composition/financial performance studies from around the world found that board composition has virtually no effect on firm performance.[109] The findings in New Zealand are mixed. Prevost, Rao, and Hossain found that firm performance was positively influenced by the proportion of outsiders on boards.[110] Reddy, Locke, and Scrimgeour found no significant relationship between board independence and various measures of financial performance for fifty large, listed firms.[111] They thought this could be because companies already have good governance structures or that such directors may lack the detailed company-specific knowledge of internal candidates.[112] Abeyratna Gunasekarage and Debra K. Reed looked at the impact on share prices of 463 director appointments from July 1999 to June 2004.[113] The appointment of outsiders did not lead, per se, to abnormal stock returns. In the New Zealand context, it also appears that companies with a majority of outsiders on their boards may be more likely to fail.[114]

Ahmed, Hossain, and Adams examined data for nonfinancial listed companies for 604 firm year observations from 1991 to 1997.[115] They observed that outside directors increased from 52% in 1991–94 to 62% in 1995–97. Since board size remained relatively stable, the authors speculated the increase "is a measured response by listed corporations to the reform package that was passed."[116] The 1993 Companies Act had made it possible for investors to bring

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109. Dan R. Dalton et al., *Meta-analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269 (1998).

110. Hossain et al., *supra* note 59.

111. Reddy, Locke & Scrimgeour, *supra* note 61.

112. *Id.*

113. Abeyratna Gunasekarage & Debra K. Reed, *The Market Reaction to the Appointment of Outside Directors: An Analysis of the Interaction Between the Agency Problem and the Affiliation of Directors*, 4 INT'L J. MANAGERIAL FIN. 259 (2008).

114. Fox, *supra* note 87. This research suggests it is desirable that the balance of power on boards should *not* rest with outsiders. There are several reasons why this may be the case: outsiders as a whole may lack the insight into the activities of a firm and its environment that those involved in the company on a day-to-day basis possess. These attributes may be particularly pertinent to ensuring corporate survival. As Fox observes, "It appears that boards dominated by outsiders may, in effect, hamstring executives from the pursuit and implementation of those strategies which best ensure the very survival of their company." *Id.* at 74. However, the measure of outsiders used in the study is somewhat restrictive and may not adequately capture independence. Hence, the findings should be regarded as indicative only.

115. Kamran Ahmed, Mahmud Hossain & Mike B. Adams et al., *The Effects of Board Composition and Board Size on the Informativeness of Annual Accounting Earnings*, 14 CORP. GOVERNANCE: AN INT'L REV. 418 (2006).

116. *Id.* at 428 (also lending support to the notion that smaller boards are more effective than large boards in monitoring earnings quality, although the proportion of outsiders on boards was not significantly associated with earnings informativeness).

direct legal action against a director alleging breach of duty of care.[117] Hence, one concern regarding outside directors relates to risk. Alastair Marsden and Andrew K. Prevost looked at the impact of the Companies Act 1993 on the use of derivatives by listed companies. Using data from listed companies in 1994 (ninety-four companies) and 1997 (ninety-one companies), these authors observed that higher growth companies with boards that comprised a greater proportion of outside directors were less likely to use derivative contracts.[118] They proposed this was "consistent with the view that outside directors become more cautious as a result of the perception of their increased risk brought about by the new legislation . . . ."[119]

For a sample of sixty-nine firms that were continually listed from 1992 to 1995, Stephen F. Cahan and Brett R. Wilkinson observed that the percentage of outside directors increased by 5.1% in the period after the passage of the Companies Act 1993 (which came into force on July 1, 1994).[120]

Hossain, Cahan, and Adams conducted cross-sectional research for seventy-seven companies as of December 2005 and concluded that high growth rates and the use of outside directors were related.[121] The mean proportion of outsiders was 52%. The proportion of outside directors on boards was significantly and positively related to firms' investment opportunity set, leverage, and the number of board meetings and was significantly negatively related to low levels of insider ownership and firm size.[122]

C. Board Leadership

According to Rule 2.1 of the Corporate Governance Best Practice Code, a director should not simultaneously hold the positions of Chief Executive and

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117. John H. Farrar, *Duty of Care of Company Directors in Australia and New Zealand*, *in* CORPORATE GOVERNANCE AND THE DUTIES OF COMPANY DIRECTORS 81–91 (Ian Ramsay ed., 1997).

118. Alastair Marsden & Andrew K. Prevost, *Derivatives Use, Corporate Governance, and Legislative Change: An Empirical Analysis of New Zealand Listed Companies*, 32 J. BUS. FIN. & ACCT. 253, 291 (2005).

119. *Id.* The authors also found that outside directors increased from 41.8% in 1994 to 51.7% in 1997. This is consistent with findings from Prevost, Rao & Hossain, *supra* note 67, who also observed an increase in outsider director representation following the passage of the Companies Act 1993. They also found that the percentage of shares held by stockholders with 5% or more of outstanding equity was around 54% in both years. Inside ownership (the percentage of shares beneficially and nonbeneficially owned by top managers and directors) decreased from 37.8% in 1994 to 20.4% in 1997.

120. Stephen F. Cahan & Brett R. Wilkinson, *Board Composition and Regulatory Change: Evidence from the Enactment of New Companies Legislation in New Zealand*, 28 FIN. MGMT. 32 (1999).

121. M. Hossain et al., *The Investment Opportunity Set and the Voluntary Use of Outside Directors: New Zealand Evidence*, 30 ACCT. & BUS. RES. 263 (2000).

122. *Id.*

Chairman of the Board.[123] Holding both positions is known as CEO duality. The Listing Rules do not preclude an executive who is not the CEO from being a chairman. By international standards, NZSX companies have low levels of CEO duality and of having executive chairpersons.

A study of 184 New Zealand listed companies in 1984 found that 11.14% had a CEO who was also board chair.[124] This was down somewhat from the 1980 figure of 17.83%.[125] Independent board chairs have become more commonplace in recent years, with the incidence of these increasing from 62% in 2005 to 72% in 2009.[126]

Arguments in favor of CEO duality propose it leads to increased organizational effectiveness and is reflected in improved company performance.[127] In this regard, CEO duality is seen to result in a situation where there is one clear leader, with no doubt as to who has authority or responsibility over company matters.

Compelling arguments have also been made against CEO duality. CEO duality may lead to a situation where the governance role of boards is compromised. When a chairman is also the CEO, the resultant concentration of power makes it more difficult for the board as a whole to effectively evaluate the performance of the CEO and of other executives. Hirsch and Watson go so far as to propose a link between CEO duality and corruption:

> As the chairman has significant influence within the board, he or she can impair the board's decisions and the way in which the board monitors management's conduct. Such an increase in influence without any superior or balancing level of effective control can induce an exploitation of that position, which can lead to corruption. Additionally, performing two functions with partially opposed duties raises a conflict of interests, which can foster poor corporate governance.[128]

If we adopt an agency theory perspective, separating the roles of CEO and chairman may reduce the ability of the CEO and executives in general to

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123. NZSX Corporate Governance Best Practice Code, r. 2.1, [hereinafter NZSX Best Practice Code] *available at* https://www.nzx.com/files/static/NZSX_NZDX_Listing_Rule_Appendices.pdf.

124. Turner, *supra* note 87.

125. Fox, *supra* note 87.

126. Fox & Walker, *Board Composition and New Zealand Stockmarket Companies*, *supra* note 87; Fox, Walker & Pekmezovic, *supra* note 35.

127. These positive views of CEO duality tend to be consistent with what is known as stewardship theory. *See* James H. Davis et al., *Toward a Stewardship Theory of Management*, 22 ACAD. MGMT. REV. 20 (1997); Lex Donaldson & James H. Davis, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, 16 AUSTL. J. MGMT. 49 (1991).

128. Watson & Hirsch, *supra* note 54, at 61–62.

engage in self-serving behavior. The roles of the chairman and CEO can be seen as encompassing different domains that may not be complementary, particularly if one of the roles of the chair is as a mentor and reality check for the CEO, and as a focal point for providing information to the board as a whole.

Despite concerns about CEO duality, a review of sixty-nine studies from around the world provides no support for a link between board leadership and financial performance, either positive or negative.[129] Equivocal research findings are also found in New Zealand. Mark A. Fox and Peter Cammock examined the impact of CEO duality (and of having executive chairpersons) for New Zealand listed companies in 1990 on financial performance (averaged for 1990 to 1993). They found no evidence of an impact of board leadership on financial performance.[130] Also, Prevost, Rao, and Hossain found that CEO duality did not explain board performance.[131] Finally, a study of corporate failure in New Zealand listed companies from 1985 to 1990 found no relationship between CEO duality and the propensity that firms will fail.

Given the lack of consistent findings on CEO duality, it may well be the case that "researchers investigating corporate governance [should] recognize that CEOs and boards do not always have different interests. Such research should consider the circumstances in which board vigilance, firm performance, and informal CEO power interact and the role these factors play in the governance equation."[132]

These views are consistent with the idea of strategic governance reform, that the best governance practices are situational and depend on the nature of firms themselves and the environments in which they operate.[133]

D. Diversity on Boards

While efforts to improve the diversity of boards in general have gained increasing global attention, the representation of women is usually the primary

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129. Dalton et al., *supra* note 109.

130. Mark A. Fox & Peter C. Cammock, *Leadership of Boards of Directors and Financial Performance in New Zealand, 1990–93*, 18 N.Z. J. BUS. 143 (1996).

131. Hossain et al., *supra* note 59.

132. Sydney Finkelstein & Richard A. D'Aveni, *CEO Duality as a Double-Edged Sword: How Boards of Directors Balance Entrenchment Avoidance and Unity of Command*, 37 ACAD. MGMT. J. 1079, 1103 (1994).

133. For a recent study that also formulates a model that considers both financial and nonfinancial aspects of director performance, see Deryl Northcott & Janine Smith, *Managing Performance at the Top: A Balanced Scorecard for Boards of Directors*, 7 J. ACCT. & ORG. CHANGE 33 (2011). *See also* James C. Lockhart, *Revisiting the Black Box: Reflections on Governance Activities, Governance Research and the Prescription for Best Practice* (Massey Univ. Coll. of Bus., Research Paper No. 18, Oct. 1, 2010), *available at* http://ssrn.com/abstract=1686035.

focus.[134] This is largely because the paucity of women on boards is one of the more obvious shortcomings in terms of board diversity. A Korn/Ferry Institute report shows that women directors are more commonplace in large U.S. companies, with 85% of Fortune 1000 companies having at least one female director.[135] In Australia, the proportion of female directors of Top 200 companies is now at 9.8%.[136] This percentage is similar to Britain, where women make up 7.8% of the members of the boards of FTSE 250 companies, and 12.5% of the board members of FTSE 100 companies.[137] In the United States, however, it is thought that about 15% of all directors are women.[138] Korn/Ferry reports that Sweden and Norway are the only countries to have made real progress in women's representation on boards.[139] In New Zealand, the Chairman of the former Securities Commission, Jane Diplock, noted the "dismal progress for women in reaching the boardrooms of New Zealand listed companies."[140]

Research findings support these assertions. A New Zealand study looked at diversity of fifty-nine listed company boards from 1997 to 2001.[141] Over this period, the number of women directors rose from 4.1% to 5.7%.[142] More recently,

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134. Van der Walt and Ingley create a taxonomy of diversity and note that this construct can include factors such as age, gender, ethnicity, discipline, independence, culture, industry background, and religion. *See* Nicholas van der Walt & Coral Ingley, *Board Dynamics and the Influence of Professional Background, Gender and Ethnic Diversity of Directors*, 11 CORP. GOVERNANCE 218 (2003). Another study by van der Walt et al., *Board Configuration, supra* note 27, mentions board diversity, including board size, independence, number of directorships per director, and relative experience.

135. KORN/FERRY INST., 34TH ANNUAL BOARD OF DIRECTORS STUDY 2007, at 6, *available at* http://www.kornferryinstitute.com/files/pdf1/Board_Study07_LoRez_FINAL.pdf.

136. Kate Lahey, *Women Make Inroads in the Boardroom*, AGE (Melbourne), Aug. 11, 2010, Business 5. *See also* Peter Wilson, *Gender Equity: Don't Be Left Behind*, WEEKEND FIN. REV., Jan. 22–23, 2011, 62; Glenda Korporaal, *Time Is Short for Firms to Lift Equality for Women*, WEEKEND AUSTRALIAN, Mar. 26–27, 2011, at 28.

137. E. MERVYN DAVIES ET AL., WOMEN ON BOARDS 7 (2011), *available at* http://www.bis.gov.uk/assets/biscore/business-law/docs/w/11-745-women-on-boards.pdf.; *see also* EUROPEAN COMMISSION, WOMEN IN ECONOMIC DECISION-MAKING IN THE EU: PROGRESS REPORT 9–12 (2012), *available at* http://ec.europa.eu/justice/gender-equality/files/women-on-boards_en.pdf.

138. KORN/FERRY INSTITUTE, *supra* note 135.

139. *Id.*

140. Jane Diplock, Chairman, New Zealand Securities Commission, Address at the Wellington Branch of the Institute of Directors (Apr. 6, 2006).

141. Van der Walt et al., *Board Configuration, supra* note 27.

142. *Id.* The numerical increase was from 16 out of 395 (for 1997) to 23 out of 404 (for 2001). Based on a composite measure of diversity that included elements of gender, ethnicity, age, board size, director independence, and the number of directorships per director. The findings suggest that "a relatively high level of board diversity is associated with increased profitability, whereas the converse is true where there is a relatively high level of strategic complexity." *Id.* at 142. The authors caution that these findings are *not* based on looking at the lagged impact of changes in diversity. *Id.*

a 2008 study of women's participation on boards showed that women held only 8.7% of directorships in the Top 100 listed companies, as measured by market capitalization.[143] In a 2009 survey of 753 listed company directors only fifty-nine (7.7%) were women.[144] Women are also infrequently board chairs, with only six NZSX companies having female board chairs in 2009.[145] However, as mentioned earlier, women directors tend to have more interlocking directorships with other companies than their male counterparts.[146]

Data on women's representation elsewhere in the economy indicates that women are particularly underrepresented on the boards of listed companies. For 2005, Jacqui Shilton, Judy McGregor, and Marianne Tremaine compared the representation of women on the boards of fifty-four Crown (i.e., government-owned) companies and Top 40 listed companies.[147] For Crown companies, women comprised 19.7% of all directors; 85.2% of these companies had at least one or more female directors on their boards. In contrast, female directors comprised only 3.9% of all directors for corporate companies. However, 28.2% of listed companies had one or more female directors.[148] It has been reported that women comprised 35% of directors on Crown companies, 17% of top legal partnerships, and 24% of judges.[149]

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143. HUMAN RIGHTS COMM'N, NEW ZEALAND CENSUS OF WOMEN'S PARTICIPATION 2008 (2008), *available at* http://www.hrc.co.nz/hrc_new/hrc/cms/ files/documents/28-Mar-2008_12-59-39_2008_Census_of_Womens_Participation.pdf. Also, Judy McGregor reports on data from 166 of the 200 top companies in New Zealand; 28.3% of these companies had some female representation on their boards, but women comprised only 4.4% of all directors. That data also indicates that women who did become directors tended to be middle-aged and highly educated, but one imagines the same could be said of men. McGregor also discusses the use of a training program designed to enhance skills. *See* Judy McGregor, *The New Zealand Experiment – Training to Be on Board as a Director*, *in* WOMEN IN MANAGEMENT: INTERNATIONAL CHALLENGES AND OPPORTUNITIES 129 (Ronald J. Burke & Mary C. Mattis eds., 2000).

144. Mark A. Fox, Gordon R. Walker & Alma Pekmezovic, *Women Directors on NZSX Company Boards*, 28 COMPANY & SEC. L.J. 577 (2010).

145. *Id.*

146. This issue is also mentioned by van der Walt et al., who note that in their 1997 to 2001 sample, "the same few women directors tended to serve on multiple boards." Van der Walt et al., *Board Configuration*, *supra* note 27, at 142.

147. Jacqui Shilton, Judy McGregor & Marianne Tremaine, *Feminizing the Boardroom: A Study of the Effects of Corporatization on the Number and Status of Women Directors in New Zealand Companies*, 11 WOMEN MGMT. REV. 20 (1996).

148. *See id.* at 23 (proposing that the greater representation of women on the boards of Crown companies is partly a reflection of several factors; namely, the public sector being more responsive to such concerns, the impact of equal opportunity legislation, the "climate and culture of public sector organizations which has made the representation of women seem both more urgent and desirable as well as more appropriate," and the proactive role of the Crown Company Monitoring Unit).

149. *See* Judy McGregor, *Gender Equality Lacking in New Zealand Boardrooms*, SUNDAY STAR TIMES (Auckland) (Mar. 30, 2008), http://www.stuff.co.nz/business/338351.

In a 2006 speech, Diplock argued that it makes good business sense to have women directors.[150] Likewise, Judy McGregor, the New Zealand Equal Employment Opportunities Commissioner, stated that "the lockout of women from corporate governance is mystifying at a time when corporate social responsibility and the value of diversity are popular talking points. In other countries, there is much greater recognition of business benefits of women on boards."[151]

Shilton, McGregor, and Tremaine also note the market power of women as consumers and their level of investment in companies suggests that corporations could benefit their competitive position by recruiting women directors.[152] The logic here is that if boards look more like the markets they serve, they will be more likely to make decisions that better serve the customers that their businesses serve.[153] Some credence for this proposition is found in a study of Fortune 500 companies by Catalyst, which shows over a four-year period companies with the highest proportion of women on their boards had significantly higher profitability than boards having the lowest proportions of women.[154] In New Zealand, a sample of the Top 50 listed companies from 1997 to 2007 also found gender representation had a positive effect on financial performance.[155] Also, a New Zealand study of 355 firm year observations for small cap listed firms from 2001 to 2005 found that female representation on boards has a positive effect on financial performance.[156]

The above research (particularly regarding independent directors, board size, and CEO duality) indicates that there are no established links between board characteristics and the financial performance of New Zealand listed companies. As a consequence, strategic governance reforms based on a "comply or explain" model that recognize the possible pitfalls of some governance structures, while allowing for deviations from these, appear to be optimal. In essence, then, the research findings for New Zealand indicate that optimal governance practices are situational and depend on the nature of firms themselves and the environments in which they operate.

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150. Diplock, *supra* note 140.

151. HUMAN RIGHTS COMM'N, EEO COMMISSIONER: WOMEN LOCKED OUT OF BOARDROOM, (Mar. 30, 2008), *available at* http://www.hrc.co.nz/2008/eeo-commissioner-women-locked-out-of-boardroom.

152. Shilton et al., *supra* note 147.

153. *See, e.g.*, TOM PETERS ONLINE EDITION, http://www.tompeters.com/dispatches/010021.php (last visited Sept. 2, 2012). For a conceptual discussion on the benefits of diversity, including gender diversity, see van der Walt & Ingley, *supra* note 134.

154. Jessica Marquez, *Firms with More Women on Boards Perform Better than Those that Don't*, WORKFORCE, Sept. 30, 2007, http://www.workforce.com/article/20070930/NEWS01/309309999.

155. Krishna Reddy, The Relationship Between Corporate Governance Practices and Financial Performance in New Zealand: An Empirical Investigation (2010) (unpublished Ph.D. thesis, University of Waikato), *available at* http://researchcommons.waikato.ac.nz/handle/10289/4367.

156. Reddy et al., *Small Cap Companies, supra* note 61.

V. BOARD COMMITTEES

One historical criticism of corporate governance research is that it has largely focused on the board of directors as a whole, rather than on the key committees where (particularly on larger boards) decisions are often made.[157] The NZSX Listing Rules focus on the audit, remuneration, and nomination committees. While audit committees are required, remuneration and nominations committees are not strictly necessary if a company is constrained by having a small board.

A. Audit Committees

The Code of Corporate Governance Best Practices Rule 3.1 states that audit committees should be comprised of only nonexecutive directors.[158] This rule is presumably intended to protect the integrity of financial reporting and ensure that such reporting is not tainted by self-interest on the part of executive directors. The Best Practice Code goes into further detail about the requirements of an audit committee. Rule 3.6.1 of the Code requires each issuer to establish an audit committee that shall be comprised solely of directors of the issuer, have a minimum of three members, have a majority of members that are independent directors, and have at least one member with an accounting or financial background.[159] Rule 3.6.3 sets out the responsibilities of an issuer's audit committee.[160] These responsibilities include ensuring that processes are in place, recommending the appointment and removal of the independent auditor, meeting regularly to monitor and review the independent and internal auditing practices, having direct communication with any internal auditors, reviewing financial reports, advising directors on compliance matters, and ensuring the external auditor or lead audit partner is changed at least every five years. A member of the audit committee will be deemed to have adequate accounting or financial background if he or she is a member of the Institute of Chartered Accountants of New Zealand, has held a CFO position at an issuer for more than twenty-four

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157. Focusing on boards as a whole, without consideration of board committees "may actually distort perceptions of corporate boards, their functions, and the roles of directors." *See* Idalene Kesner, *Directors' Characteristics and Committee Membership: An Investigation of Type, Occupation, Tenure, and Gender*, 31 ACAD. MGMT. J. 66, 66 (1988). In New Zealand, Chandler and Henshall observe that "[t]he presence of committees is a definite indication of corporate size, perhaps not so much because of their increased propensity to deal with complexity, but because large companies tend to have large boards which by necessity and expedition must delegate to committees." Chandler & Henshall, *supra* note 45, at 33.

158. NZSX Best Practice Code, *supra* note 123, r. 3.1.

159. *Id.* r. 3.6.1.

160. *Id.* r. 3.6.3.

months, has completed a NZX course for Audit Committee members, has experience and/or qualifications deemed satisfactory by the board.[161]

The prevalence of audit committees in New Zealand listed firms has grown markedly over the last thirty years. In 1982, only around 15% of listed companies had audit committees.[162] Michael E. Bradbury looked at the choice to voluntarily establish audit committees.[163] Of 135 New Zealand firms listed in 1981, only twenty had an audit committee (at this time listed companies could choose whether or not to have an audit committee). Bradbury observed that the formation of audit committees was not related to agency concerns arising from the separation of ownership and control.[164] However, a relationship was found between each of board size and intercorporate ownership (another company owning at least 10% of the shareholding) and the voluntary formation of audit committees.[165] Bradbury proposed that larger boards might form audit committees as an efficient means of reviewing audited financial statements and implementing accounting controls.[166] This may be because larger boards typically comprise more independent directors than smaller boards, and independent directors may be concerned with documenting that they are showing "due care." Bradbury also observed the low rate of voluntary audit committee formation may have been due to low litigation rates, together with a lack of contingency-based legal fees and class action privileges.[167]

Subsequently, by 1989 around 22% of listed companies had audit committees.[168] Audit committees became more common following the 1987 sharemarket crash, and the 1989 requirement that CEOs and CFOs "of most public sector entities to acknowledge, in the financial statements, their responsibility for those statements and for maintaining an effective system of internal control."[169] By 1993, 63% of listed companies had audit committees,

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161. NZSX LISTING RULES, *supra* note 24, r. 3.6.3.

162. Richard F. Chandler, *The Audit Committee: Awaiting Discovery in New Zealand*, 61 ACCT. J. 201 (1982).

163. Michael E. Bradbury, *The Incentives for Voluntary Audit Committee Formation*, 9 J. ACCT. & PUB. POL'Y 19 (1990).

164. *Id.* at 32.

165. *Id.* at 33.

166. *Id.*

167. *Id.* at 34.

168. M. Lukkassen, An Investigation into the Use of, and Attitudes to, Audit Committees by Chief Accountants of New Zealand Listed Public Companies (1989) (unpublished research report, Dep't of Accountancy, Massey Univ.) (on file with authors).

169. Brenda A. Porter & Philip J. Gendall, *Audit Committees in Private and Public Sector Corporates in New Zealand: An Empirical Investigation*, 2 INT'L J. AUDITING 49, 50 (1998). For a discussion of the responsibility of auditors to nonclients for negligence in New Zealand (contrasted with several other common law countries, Canada, the United States, the United Kingdom, and Australia), see Carl Pacini et al., *At the Interface of Law and Accounting: An Examination of a Trend Toward a Reduction in the Scope of Auditor Liability to Third Parties in Common Law Countries*, 37 AM. BUS. L.J. 171 (2000); *see also* Janne Chunga et al., *Auditor Liability to Third Parties After Sarbanes-Oxley: An*

compared with 58% of private companies, with two-thirds of audit committees having been established in the prior four years.[170] The major reasons for establishing audit committees were as good practice in general, and to facilitate examining internal controls and the effective examination of external financial reports.[171] A 1996 survey comprising fifty-six listed companies showed that 77% had audit committees.[172] By 1996, the typical audit committee met 3.3 times per year and comprised 3.5 members, 2.9 of whom were nonexecutives.[173]

Several studies provide further insight into the composition of audit committees. Elizabeth Rainsbury looked at thirty-one large listed companies for 1999, comprising 227 directors.[174] Forty-three percent of these directors were members of audit committees, and 32% were members of remuneration committees. Nonexecutive directors and those directors with financial expertise were more likely to be members of audit committees. Audit committee members were also likely to be on remuneration committees.[175] This may be because financial expertise is useful for serving on both committees.

In a sample of New Zealand listed companies for 2004 and 2005, Vineeta Sharma, Vic Naiker, and Barry Lee found that the average audit committee comprised 3.46 members, that 78% of audit committees had an independent chair, and that 67% had at least one accounting expert.[176] They noted that audit committees met more frequently when managerial ownership was higher, leading

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International Comparison of Regulatory and Legal Reforms, 19 J. ACCT., AUDITING & TAX'N 66 (2010); Carl Pacini et al., *Auditor Liability to Third Parties: An International Focus*, 15 MANAGERIAL AUDITING J. 394 (2000); Susan M. Watson, *The Application of 'Common Sense' Liability of Auditors in New Zealand*, 43 J. BUS. L. 286 (1999); Susan Watson, *Liability of Auditors to Third Parties in New Zealand, Clarification at Last*, 44 J. BUS. L. 52 (2000).

170. Porter & Gendall, *supra* note 169.

171. *Id.*

172. Mark A. Fox & Gordon R. Walker, *Corporate Governance and the Company Secretary*, 2(4) CORP. GOVERNANCE Q. 4 (1996). This rate was notably lower than for Australian and UK companies. *See* Mark A. Fox & Gordon R. Walker, *Boards of Directors and Board Committees in New Zealand: International Comparisons*, 10 BOND L.REV. 341 (1998). Mark A. Fox, *Board Structure of New Zealand Listed Companies: An International Comparative Study* (Dep't of Econ. & Mktg., Discussion Paper No. 20, Lincoln Univ., 1996), http://www.researcharchive.lincoln.ac.nz/dspace/bitstream/10182/958/3/cd_dp_20.pdf.

173. Fox & Walker, *Corporate Governance*, *supra* note 172.

174. Elizabeth Rainsbury, *Audit Committee Membership – A New Zealand Perspective*, 16 PAC. ACCT. REV. 45 (2004).

175. *Id.* Rainsbury suggests that "[t]his may reflect the limited pool of independent directors available for board committees or the power and influence these directors have on the board." *Id.* at 64. Given the prevalence of independent directors on New Zealand listed companies' boards, we suggest that it is not independence per se that may be the influencing factor, but directors with financial expertise.

176. Sharma, Vineeta, Vic, Naiker, Barry & Lee, *Determinants of Audit Committee Meeting Frequency: Evidence from a Voluntary Governance System*, 23 ACCT. HORIZONS 245 (2009).

them to propose that "the audit committee may be addressing important agency problems associated with managerial power vesting through greater ownership."[177] Firms with greater institutional ownership had audit committees that tended to meet more frequently. This was seen as a sign that institutional investors were demanding more effective governance practices. Audit committees also met less frequently when there were more multiple directorships. Sharma, Naiker, and Lee went so far as to suggest that regulators consider limiting the number of directorships held in order to "enhance the quality of financial oversight by the audit committee."[178]

As a related matter, various studies have examined the impact of the Financial Reporting Act 1993. These studies typically focus on the impact of mandatory disclosure requirements. However, the research findings yield mixed results. Stephen Owusu-Ansah and Joanna Yeoh contrasted the disclosure practices of fifty listed companies between the pre- and post-Financial Reporting Act regimes.[179] They found significantly higher disclosure levels after the Financial Reporting Act was in place. Further, Ahsan Habib and Sidney Weil looked at thirty-eight companies and 341 firm year observations from 1990 to 1999.[180] They found no evidence of any significant impact of the 1993 regulatory reform on the value-relevance of accounting information.

B. Remuneration Committees

According to the Code of Corporate Governance Best Practices Rule 3.7, issuers should establish a remuneration committee to recommend compensation packages for directors to shareholders.[181] Issuers should identify the members of the remuneration committee in their Annual Report. The NZSX Code of Best Practice does not prescribe the composition of remuneration committees. The Code is silent on the process for determining director remuneration and the disclosures that should be made in relation to this process. In this regard, information relating to the performance of directors and efforts to benchmark compensation may also be useful. Listing Rule 3.5 deals with directors' remuneration. LR 3.5.1 provides that:

> [N]o remuneration shall be paid to a director in his or her capacity as a director of the issuer or any subsidiary, other than a subsidiary which is listed (including any remuneration paid to

177. *Id.* at 260.

178. *Id.* at 261.

179. Stephen Owusu-Ansah & Joanna Yeoh, *The Effect of Legislation on Corporate Disclosure Practices*, 41 ABACUS 92 (2005).

180. Ahsan Habib & Sidney Weil, *The Impact of Regulatory Reform on the Value-Relevance of Accounting Information: Evidence from New Zealand*, 24 ADVANCES IN ACCT. 227 (2008).

181. NZSX Best Practice Code, *supra* note 123, r. 3.7.

> that director by a subsidiary, other than a subsidiary which is also listed) unless the remuneration has been authorised by an Ordinary Resolution of the Issuer.[182]

The resolution must express directors' remunerations as either a monetary sum per annum payable to all directors of the issuer taken together or a monetary sum per annum payable to any person who from time to time holds office as the director of the issuer. Clause 211(1)(f) of the Companies Act 1993 requires full disclosure in the annual report of the director's remuneration.

Listing Rule 3.5.2 allows an issuer to make a payment to a director or former director of that issuer by way of a lump sum or pension, upon or in connection with the retirement or cessation of office of that director, only if the amount of the payment or the method of calculation of the amount of that payment is authorized by an ordinary resolution of the issuer.[183] Both the nomination and remuneration committees should have a written charter that articulates their authority, duties, responsibilities, and relationships with the board as a whole. The board as a whole should also regularly review these committees in light of their charters.

By 1996, the average remuneration committee of New Zealand listed companies comprised 3.6 members, three of whom were nonexecutive directors.[184] Independent director representation on remuneration committees is intended to reduce bias that may favor executives in compensation decisions and better align compensation with firm performance. A study of seventy-three New Zealand listed firms from 1994 to 1998 found that outside director representation on boards was *not* associated with CEO compensation levels or with the adoption of executive incentive schemes.[185] This is surprising, as one would expect independent directors to be able to better constrain CEO pay. Another study found that around one-third of companies appoint their CEOs to compensation committees.[186] After controlling for variations in firm performance, the annual pay increments of CEOs serving on compensation committees was four percentage points less than those CEOs who did not serve on compensation committees.[187] At least one study, however, indicates that boards are better able

182. NZSX LISTING RULES, *supra* note 24, r. 3.5.1.

183. *Id.* r. 3.5.2.

184. Fox & Walker, *Corporate Governance and the Company Secretary*, *supra* note 172.

185. Fayez A. Elayan et al., *Executive Incentive Compensation Schemes and Their Impact on Corporate Performance: Evidence from New Zealand Since Compensation Disclosure Requirements Became Effective*, 21 STUD. ECON. & FIN. 54 (2003). Outside directors were 71% for seventy-three companies listed in 1998. On average CEOs held only 2.15% of outstanding equity.

186. Glenn Boyle & Helen Roberts, CEO Presence on the Compensation Committee: A Puzzle (July 29, 2010), *available at* http://ssrn.com/abstract=1650826.

187. *Id.*

to constrain CEO pay if they are smaller, do not have the CEO as a member, and are of higher quality generally.[188]

C. Nomination Committees

With regard to overall board composition, the Listing Rules require that every NZSX company should have formal and transparent methods for the nomination and appointment of directors. According to Code Rule 3.10, issuers should establish a nomination committee to recommend director appointments. At least a majority of the nomination committee should comprise independent directors. Issuers should identify in annual reports the members of the nomination committee. These rules are intended to ensure that executive directors do not exert too much influence on the nominations process for new directors. Widening Rule 3.10 to state that the chair of the nominations committee should be an independent director might strengthen this rule.[189]

A survey of 157 directors by Ingley and van der Walt found that the major factors influencing the selection of directors were: the ability to represent shareholder interests, being well respected in their industry, being well respected in the business community, and having recognized strategic capabilities.[190] The compliance aspects of directors' roles were rated highest in terms of the standard of support provided by the board (protecting assets of the firm and representing shareholder interests). Ingley and van der Walt also provide some indication of the strengths and weaknesses of outside directors. Respondents were asked to rate external directors of their companies on thirty-three criteria. The highest ranked items were: record of attending meetings, understanding of governance issues, commercial judgement, quality of contributions at board meetings and their value to the CEO, and access when needed. The lowest ranked items were: the ability to provide leadership to management, ability to assist with introductions, technical competence within the industry, the ability to assist in networking, and technical competence in sales/marketing.

We observed earlier that New Zealand boards are not diverse. In particular, representation by women directors is very low. This gives rise to a key issue for nominations committees (or for the board as a whole, if no such committee is in place); namely, why do women have so little representation on the boards of New Zealand listed companies? Is it a function of an "old boys' network" or of women being less qualified than their male counterparts? There

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188. Steven F. Cahan et al., *Board Structure and Executive Compensation in the Public Sector: New Zealand Evidence*, 21 FIN. ACCOUNTABILITY & MGMT. 437 (2005).

189. NZSX Best Practice Code, *supra* note 123, r. 3.10.

190. Coral B. Ingley & Nicholas T. van der Walt, *The Strategic Board: The Changing Role of Directors in Developing and Maintaining Corporate Capability*, 9 CORP. GOVERNANCE: AN INT'L REV. 174 (2001); Nicholas van der Walt & Coral Ingley, *Evaluating Board Effectiveness in the Changing Context of Strategic Governance*, 1 J. CHANGE MGMT. 313 (2001).

seems to be some credence to the old boys' network argument. One study notes that new directors tend to be recruited through the contacts of existing directors and executives, and, hence, not all new board members are selected solely on the basis of their expertise.[191] This may be due to the informal process that is often followed in recruiting new directors. James Lockhart conducted case study research into the recruitment practices of executives and directors in ten New Zealand listed companies.[192] While the selection of executives followed a structured process, professional directors were typically selected and recruited on an ad hoc, informal basis: "Rarely was any process followed other than the Chairman seeking expressions of interest among colleagues and associates and the selection made on the basis of who may 'fit in best.'"[193]

McGregor's research, based on a survey of women serving on Top 200 company boards, indicates that the reason most commonly given for the lack of women on corporate boards was that "companies did not think that women were qualified for board service" (given as a reason by 69% of respondents).[194] Other concerns expressed by women directors were that companies did not know where to look for qualified women directors (62%) and were not looking to have more women on their boards (59%). Following such logic, the more that nomination committee can conduct a broad, systematic, formalized search for new directors, the more likely they are to recruit directors who are not just associates of incumbent directors.[195]

If boards themselves do not address issues of diversity, there is the risk this will be mandated by legislation. For example, one approach to increasing women's participation on boards is through quota systems. This approach has been adopted in both Norway and Sweden. Norway requires that 40% of public company directors be women, and Sweden requires 25%.[196] Critics of such proposals worry of government interference in business prerogatives and perceive that there may be an insufficient number of women who are qualified to be

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191. TOWARDS EFFECTIVE GOVERNANCE: A NEW ZEALAND-WIDE REVIEW OF GOVERNANCE 2007, at 6 (2007), *available at* http://www.directionsgovernance.com/07DirFinalReport.pdf.

192. James Lockhart, *What Really Happens Inside the Boardroom and How It May Shed Light on Corporate Success and Failure*, 31 J. GENERAL MGMT. 29 (2006).

193. *Id.* at 36.

194. McGregor, *supra* note 143.

195. For a discussion of various initiatives to encourage women directors, including efforts by the Institute of Directors, see Rosanne Hawarden & Ralph E. Stablein, *New Zealand Women Directors: Many Aspire But Few Succeed*, *in* WOMEN ON CORPORATE BOARDS OF DIRECTORS: INTERNATIONAL RESEARCH AND PRACTICE 57 (Susan Vinicombe et al. eds., 2008). One initiative to improve the representation of women on boards is that of the Auckland Chamber of Commerce. However, their focus is mainly on small and medium-sized enterprises. They view this as a starting point for women to leverage their experience onto the boards of larger organizations.

196. KORN/FERRY INST., *supra* note 135.

directors.[197] It would appear to be axiomatic that merit should trump diversity.[198] At the basic corporate level, quota systems may erode the fundamental right of shareholders to appoint and remove directors unless that right has been removed by the constitution. In addition, there is the danger that gender (or other diversity) targets may breach discrimination laws.[199]

VI. CONCLUSIONS

The preceding section reviewed extant research on corporate governance in New Zealand. We now turn to examine the role of corporate governance in New Zealand in the context of the global financial crisis. We conclude that while corporate governance of listed companies was good, the same cannot be said for nonlisted issuers of debt securities. Here, poor corporate governance and supervisory failures were causal in the failure of nonlisted finance companies.

The Organisation for Economic Co-operation and Development (OECD) considered the role of corporate governance in the recent global financial crisis.[200] It concluded that "the financial crisis can be to an important extent attributed to

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197. For a discussion of arguments for and against quotas for women on boards, see Elizabeth Broderick, Getting on Board: Quotas and Gender Equality, Speech at Third Women on Boards Conference (Apr. 29, 2011), *available at* http://www.humanrights.gov.au/about/media/speeches/sex_discrim/2011/20110429_women_boards.html.

198. Concerns about tokenism were raised by Brierley Investments Limited when a Wellington woman, Joanne Copland, sought to become a director of that company. Copland was head of the economics department at a major girls college, qualified as an accountant, and a private company director. The chairman of Brierley informed shareholders that "the board cannot have sympathy with, and rejects, the concept of tokenism in board membership in any form, no matter how well intentioned. It would be quite improper for any board or individual director to seek to represent any one group of shareholders on the basis of size of shareholding, race or gender." *See* N. Stride, *BIL Chief Against Woman's Board Bid*, N.Z. HERALD, Nov. 10, 1994, sec. 3 at 1.

199. *See* P. Durkin, *ASX Gender Targets Raise Legal Danger*, AUSTL. FIN. REV., July 5, 2010, at 5. We should note that it appears unlikely that legislation will mandate representation by women directors for listed companies in New Zealand. "I challenge you to examine just how actively you encourage board diversity—at the personal day-to-day level, and through the institute. People like you hold a powerful position as opinion leaders, and here you have a chance to take the lead. Not just, as I said, because women are your employees, your investors and your customers, and social justice demands it, but also because the evidence is that more women on boards is good for business." *See* Jane Diplock, Chairman, Securities Commission New Zealand & Executive Committee, International Organization of Securities Commission, Corporate Governance and You, Speech to Institute of Directors (Nov. 24, 2010).

200. GRANT KIRKPATRICK, OECD STEERING GROUP ON CORPORATE GOVERNANCE, THE CORPORATE GOVERNANCE LESSONS FROM THE FINANCIAL CRISIS (2009), *available at* http://www.oecd.org/dataoecd/32/1/42229620.pdf.

failures and weaknesses in corporate governance arrangements."[201] A subsequent OECD report identified effective implementation of already agreed upon standards as an "urgent challenge."[202] A third report addressed this point by noting that:

> It is important for jurisdictions to regularly review whether their supervisory, regulatory and enforcement authorities are sufficiently resourced, independent and empowered to deal with corporate governance weaknesses that have become apparent. This should include an assessment of inter-agency as well as internal communication and decision making systems.[203]

The above line of analysis requires qualification. As Brian Cheffins pointed out, a "striking aspect of the stock market meltdown of 2008 is that it occurred despite the strengthening of U.S. corporate governance over the past few decades and a reorientation toward the promotion of shareholder value."[204] Cheffins found little evidence of corporate governance problems except for those in the financial sector. We have reached the same conclusion.

As we have seen, New Zealand ranks well overall in assessments of its corporate governance. The main corporate governance weakness that emerged in New Zealand as a result of the global financial crisis concerned nonbank financial intermediaries (sometimes called nonbank deposit takers or nonbank deposit taking financial institutions and generally described as finance companies). Between 2006 and 2010, over fifty New Zealand finance companies went into liquidation, receivership, or suspended payments.[205] The president of the New Zealand Institute of Directors was reported as stating that up to $8.5 billion of investors' money had been lost or frozen.[206] One report, in 2008, attributes these collapses to a range of corporate practices, including borrowing short and lending long,[207] providing high commissions to financial advisers,[208] inadequate risk

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201. *Id.* at 2.

202. OECD STEERING GROUP ON CORPORATE GOVERNANCE, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: KEY FINDINGS AND MAIN MESSAGES 7 (2009), *available at* http://www.oecd.org/dataoecd/3/10/43056196.pdf.

203. OECD STEERING GROUP ON CORPORATE GOVERNANCE, CORPORATE GOVERNANCE AND THE FINANCIAL CRISIS: CONCLUSIONS AND EMERGING GOOD PRACTICES TO ENHANCE IMPLEMENTATION OF THE PRINCIPLES 6 (2010), *available at,* http://www.oecd.org/dataoecd/53/62/44679170.pdf.

204. Brian Cheffins, *Did Corporate Governance "Fail" During the 2008 Stockmarket Meltdown? The Case of the S&P 500*, 65 BUS. L. 1, 2 (2009). *See also* N.Y. STOCK EXCH., REPORT OF THE NEW YORK STOCK EXCHANGE COMMISSION ON CORPORATE GOVERNANCE (2010), *available at* http://www.ecgi.org/codes/documents/nyse_cgreport_23sep2010_en.pdf (reaching a similar conclusion).

205. COMPANY FAILURES INQUIRY, *supra* note 13.

206. Weir, *supra* note 13.

207. Peart, *supra* note 12, at 75.

208. *Id.* at 72.

management,[209] having no independent directors,[210] and conducting related party transactions.[211] Later reports point to a similar effect.[212]

Potential problems in the nonbank financial intermediary sector had been identified as early as July 2005.[213] Broadly speaking, two (partly related) sets of problems were apparent. The first set of identified problems related to unlisted issuers of debt securities. Here, the suggested remedy was enhanced disclosure and improvements to trustee arrangements.[214] A second, overlapping set of problems was related to nonbank deposit takers. Here, the identified problems were more extensive.[215] In any event, all of the problems identified by the Ministry of Economic Development were realized in the financial crisis. To this extent, the finance company collapses in the financial crisis were preventable and can be partly attributed to, in the words of the OECD report, "failures and weaknesses in corporate governance arrangements."[216]

Somewhat surprisingly, there is not a great deal of literature on this issue; however, two reports by the New Zealand Commerce Committee are notable. First, in August 2009, the Commerce Committee initiated an inquiry into finance company failures.[217] The final report was released in October 2011.[218] A key finding of the final report was that poor governance was causal in the collapses. Second, the 2007–2008 financial review of the Ministry of Economic Development contained two appendices on finance company failures.[219] Appendix B of the review comprised observations from the Registrar of Companies on the finance company failures. The Registrar's report noted that the finance companies were largely mezzanine financiers to the property market.[220] It

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209. *Id.*

210. *Id.* at 73.

211. *Id.*

212. *See* COMPANY FAILURES INQUIRY, *supra* note 13; STACE, *supra* note 4; Gladwell & Leach, *supra* note 13; Maria Collett-Bevan, *A Brand New Regime*, N.Z. LAWYER, Oct. 15, 2010, at 14; Wilson et al., *supra* note 13.

213. MINISTRY OF ECON. DEV., REVIEW OF FINANCIAL PRODUCTS AND PROVIDERS – STAGE ONE: FRAMEWORK, PROBLEM IDENTIFICATION AND GENERAL DIRECTIONS FOR REFORM – REPORT TO MINISTER OF COMMERCE (2005), *available at* http://www.med.govt.nz/business/business-law/pdf-docs-library/past-work-and-older-topics-pdfs/review-of-financial-products/framework-problem-identification-and-general-directions-for-reform-report-to-minister-of-commerce-29-july-2005.pdf.

214. *Id.* para. 24.

215. *Id.* para. 25 ("Current supervisory arrangements via trust deeds do not provide an adequate protection to depositors . . . . [B]ecause there are currently no minimum prudential standards for trust deeds . . . the supervisory practices of trustee corporations vary and do not anchor to minimum standards . . . .").

216. KIRKPATRICK, *supra* note 200, at 2.

217. COMPANY FAILURES BRIEFING, *supra* note 13.

218. COMPANY FAILURES INQUIRY, *supra* note 13.

219. FINANCIAL REVIEW, *supra* note 13. This report is reviewed by STACE, *supra* note 4.

220. *Id.* at 8. These finance companies were the successors to the contributory mortgage companies of the 1980s, which collapsed in similar circumstances.

listed factors and outstanding issues of concern in the finance company collapses. These included: poor corporate governance,[221] treatment of nonperforming loans (NPLs),[222] lending practices,[223] repayment issues (characteristics of Ponzi schemes), the trustee supervisory model,[224] auditors (problematic audits by second-tier accounting firms), disclosure (no continuous disclosure), and application of Securities Act 1978 (some transactions designed to avoid reach of the legislation and inadequate regulatory moratoria).

The legislative response to the bulk of these issues was dramatic. First, the (now repealed) Securities Regulations 1983 were amended by the Securities Regulations 2009 to provide additional clauses deemed to be included in the trust deeds of finance companies.[225] The finance companies affected were issuers that continuously offered debt securities to the public. Later, an additional layer of regulation was provided by the Securities Trustees and Statutory Supervisors Act 2011. Second, in September 2008, Parliament passed the Reserve Bank of New Zealand Amendment Act 2008 to address the problems associated with nonbank deposit takers.[226] This was accomplished by introducing Part 5D into the principal Act. Thus, section 157C(1)(a) of the Reserve Bank Act 1989 now contains a definition of a "deposit taker" that includes a person who offers debt securities to the public in New Zealand and carries on the business of borrowing or providing financial services and imposes obligations on such persons.[227] Part 5D of the principal Act will be enhanced when the Non-bank Deposit Takers Bill 2011 comes into force in June 2013. This Bill introduces licensing requirements and strengthens the Reserve Bank's powers.

The amendments to the Reserve Bank Act 1989 in 2008 addressed the majority of the problems associated with finance companies. They did not, however, address the general problem of nonlisted issuers raising funds from the public. This area required comprehensive reform. Here, the Capital Market Development Taskforce recommended the creation of a new market regulator—the Financial Markets Authority—with the ability to monitor all public securities,

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221. Examples of perceived poor governance include: CEO/board chair duality, lack of independent directors, lack of skills, etc.

222. Examples include "roll ups" by way of capitalization of interest of nonperforming loans and misleading disclosures in relation thereto.

223. Examples include related-party lending and concentration of loan risk at the speculative end of the property market.

224. That is, performance of trustee companies rated low especially in relation to breaches of Trust Deeds.

225. *See* Securities Regulations 2009, SR 2009/230, pt. 5.

226. *See, e.g.*, [2008] 649 NZPD 17963; *see also* [2008] 649 NZPD 18210. For a discussion of the Reserve Bank of New Zealand Amendment Act 2008, see STACE, *supra* note 4, ch. 30.

227. Deposit takers must now: have a current credit rating, have at least two independent directors, have and comply with a risk management program, comply with any regulations on minimum capital requirements, comply with any regulations on capital ratio, comply with regulations on related party transactions, and comply with regulations on liquidity requirements. Reserve Bank of New Zealand Act 1989.

whether listed or not, and this body was established on May 1, 2011.[228] In any event, importing key requirements of the NZSX Listing Rules into the Companies Act 1993 and making them applicable to nonlisted issuers seems desirable.[229]

In conclusion, we view the "comply or explain" basis of the NZSX Listing Rules as supported by New Zealand and international evidence, which indicates there is no one best approach to corporate governance practices, hence the need for strategic governance reforms. This proposition gathers strength when we consider that a key concern of increasingly strict governance regulations is that they may hinder boards from being more entrepreneurial and, instead, focus their attention on minimizing risk.[230] The notion that boards should play a role that is primarily supportive of management (particularly as a strategic asset) is supported by a four-country study of the United States, Canada, Australia, and New Zealand.[231] In that study, around 60% of the forty-one directors surveyed indicated that changes in governance regulations had caused boards to focus more on preventing downside risk.[232] If that finding holds true for New Zealand, the key variable will be the enforcement policy of the new Financial Markets Authority (FMA) since it can reasonably be assumed that a strong regulator will ensure a focus on downside risks such as incarceration.

As a generalization, the predecessor of the FMA (the former Securities Commission) did not have a good track record on enforcement. One key reason appears to have been lack of funding. Although the precise details of the funding of the new FMA have not been announced, some form of industry levy is likely to be the prime means of funding the new body along with governmental subvention.

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228. CAPITAL MARKET DEVELOPMENT TASKFORCE, *supra* note 33. *See also* Philipp Maume & Gordon Walker, *Capital Markets Matter: A New Era in New Zealand Securities Regulation*, 29 COMPANY & SEC. L.J. 184 (2011); Philipp Maume & Gordon Walker, *Goodbye to All That: A New Financial Markets Authority for New Zealand*, 29 COMPANY & SEC. L.J. 239 (2011).

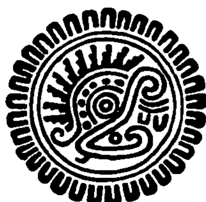
229. "Unlisted issuers are not subjected to a continuous disclosure regime and in most cases a prospectus is only filed (and renewed) with the Registrar twice a year. Where funds have been raised from the public, there is a view that some form of continuous disclosure model should apply to the issuing entity." FINANCIAL REVIEW, *supra* note 13, app. B.

230. David W. Anderson et al., *The Evolution of Corporate Governance: Power Redistribution Brings Boards to Life*, 15 CORP. GOVERNANCE: AN INT'L REV. 780 (2007). In New Zealand, Ingley and van der Walt propose that "[a] gap exists between international prescriptive guidelines for best practices in risk management and actual board practices, processes, and capabilities for effective risk oversight. We conclude from the results that even though these directors acknowledge the importance of risk management as an issue for their organizations, they perceive it in a traditional manner as an operational activity rather than a specific responsibility of the board and are not actively involved in the risk-management process." Coral Ingley & Nick van der Walt, *Risk Management and Board Effectiveness*, 38 INT'L STUD. MGMT. & ORG. 43, 66 (2008).

231. Anderson et al., *supra* note 230.

232. *Id.*

The FMA has announced its enforcement policy.[233] It has stated, inter alia, that it will actively enforce compliance with the new licensing regime for trustees and statutory supervisors from October 2011.[234] There are good reasons to think this will be the case because of the FMA's prosecution of the finance company cases arising before the new regime came into effect in October 2011. A mix of criminal and civil proceedings had been instituted against the directors of seven finance companies as of October 26, 2011.[235] A further seventeen investigations were continuing; charges were laid against another eleven companies; and twenty-four cases had been referred to another regulator, had concluded with another enforcement option, or had been closed.[236]



233. *See FMA Enforcement Policy*, FIN. MARKETS AUTHORITY, http://www.fma.govt.nz/laws-we-enforce/enforcement/fma-enforcement-policy/ (last visited Sept. 2, 2012).

234. *Id.*

235. *See Finance Company Cases Before the Court*, FIN. MARKETS AUTHORITY, http://www.fma.govt.nz/laws-we-enforce/enforcement/prosecutions-and-proceedings/finance-company-cases-before-the-court/ (last visited Sept. 2, 2012).

236. *See Status of Investigations into Failed Finance Companies (Non-Bank Deposit Takers)*, FIN. MARKETS AUTHORITY, http://www.fma.govt.nz/laws-we-enforce/enforcement/prosecutions-and-proceedings (last visited Sept. 2, 2012).

CARBON TAXES AND THE WTO: A CARBON CHARGE WITHOUT TRADE CONCERNS?

Keith Kendall*

I. INTRODUCTION

Anthropogenic climate change is a rare example of a truly global problem. While pollution may be seen to have had transnational effects, these problems could be limited to neighboring states or countries in the same region (such as in the case of pollution in rivers that cross national boundaries). Climate change, by contrast, represents a situation in which the actions of a country in, say, northern Europe, may have an eventual effect on communities in the Pacific Ocean or South America.

In considering the appropriate means to address climate change, specific responses can be grouped into three broad categories: taxes (often described as carbon taxes),[1] emissions trading schemes (ETS),[2] and command-and-control (or direct regulation).[3]

Notwithstanding the variety of policy responses available, very little serious discussion of the relative merits has occurred, especially in the legal literature. This may be partly explained by the seemingly unanimous global support for an ETS as the preferred policy among nations seeking to address climate change in recent years (at least through a market mechanism).[4] However, the stalling of the ETS in the United States and the lack of concrete outcomes

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1. *See, e.g.*, Keith Kendall, *Exports and Imports under a Carbon Tax in* 7 CRITICAL ISSUES IN ENVIRONMENTAL TAXATION: INTERNATIONAL AND COMPARATIVE PERSPECTIVES 477 (Lin-Heng Lye et al. eds., 2009).

2. Also often referred to as cap-and-trade schemes; *see, e.g.*, Janet E. Milne, *Carbon Taxes Versus Cap-and-Trade: The Relative Burdens and Risks of Market-Based Administration in* 7 CRITICAL ISSUES IN ENVIRONMENTAL TAXATION: INTERNATIONAL AND COMPARATIVE PERSPECTIVES, *supra* note 1, at 445.

3. For an overview of these three broad categories, see EBAN S. GOODSTEIN, ECONOMICS AND THE ENVIRONMENT (6th ed. 2011), particularly chapters 16 and 17.

4. As of September 2012, the European Union and New Zealand had introduced emissions trading schemes (via Council Directive 2003/87, 2003 O.J. (L. 275) 32 (EC) and the Climate Change Response (Emissions Trading) Act 2008 (N.Z.)). The Australian Government has also implemented a price on emissions effective from July 1, 2012, which will convert to a full ETS in 2015 (*Clean Energy Act 2011* (Cth) and related legislation). A proposal for an ETS in the United States passed the House of Representatives but not the Senate. *See* American Clean Energy and Security Act 2009, H.R. 2454, 111th Cong. (2009).

from the Copenhagen,[5] Cancun,[6] and Durban[7] Climate Change Summits demonstrate that any such unanimity is illusory at best.[8]

This paper seeks to address some of the gaps in the legal literature dealing with climate change policy alternatives. The overall premise presented is that a carbon tax is the economic instrument that can be designed most readily in conformity with international trade obligations imposed under the World Trade Organization (WTO), so most of the broad discussion focuses on carbon tax. The economic principles described, however, are common to most alternatives, particularly an ETS. Only some of the specific elements of these alternatives require a different frame of discussion.

Section II provides a basic overview of the economics involved with a carbon tax, written for an audience with no training in economics. Such information is readily available in economics literature, although the material tends to be presented in a manner consistent with the assumption that the reader has had formal economics training. Section III then discusses the main policy responses to climate change, including those already identified (a carbon tax, an ETS, and command-and-control policies). This discussion addresses a shortcoming in the legal literature; specifically, the literature often assumes the reader is aware of the various policy alternatives and their functions. Some advantages and disadvantages of the relevant policies are canvassed, with the conclusion that a carbon tax is the preferable alternative.

One of the primary concerns surrounding any new charge by a domestic political policy is the loss of international competitiveness that domestic industry is likely to suffer. Such unilateral imposition of a charge (which will occur under both a carbon tax and an ETS) results in domestic producers facing additional costs not also borne by their foreign competitors.[9] This loss of competitiveness can be addressed through a border tax adjustment (BTA) similar to that operating under most goods and services/value added tax systems around the world. Under this mechanism, exports have the tax rebated, so they enter the world market free of the carbon charge, with imports being subjected to the same impost as domestically produced goods. In this way, the domestic policy has a neutral effect on a domestic industry's international competitiveness.

Section IV provides a brief overview of the mechanics of a BTA. Section V deals with the legitimacy of such a mechanism as assessed under the WTO requirements. This section also forms the primary thrust of this paper, with

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5. 2009 U.N. Climate Change Conference (Dec. 7–18, 2009).

6. 2010 U.N. Climate Change Conference (Nov. 29–Dec.10, 2010).

7. 2011 U.N. Climate Change Conference (Nov. 28–Dec. 9, 2011).

8. In addition, Congress debated two bills for a carbon tax as well as a separate bill for an ETS in the 110th Congress, demonstrating that support exists in the United States for models other than that presented to the Senate. *See* Milne, *supra* note 2, at 446.

9. Jan McDonald, *Environmental Taxes and International Competitiveness: Do WTO Border Adjustment Rules Constrain Policy Choices?*, *in* 2 CRITICAL ISSUES IN ENVIRONMENTAL TAXATION: INTERNATIONAL AND COMPARATIVE PERSPECTIVES 273, 273 (Hope Ashiabor et al. eds., 2005).