

EMBARGOED UNTIL 3.00 PM TUESDAY 24 JUNE 2003

**NEW ZEALAND SHAREHOLDERS ASSOCIATION
ANNUAL GENERAL MEETING**

**REFLECTIONS ON CORPORATE
GOVERNANCE**

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**AUCKLAND
24 JUNE 2003**

REFLECTIONS ON CORPORATE GOVERNANCE

I am very pleased to have this opportunity to speak to you today. The Business Roundtable welcomed the establishment of the New Zealand Shareholders Association. In an article in the *Herald*, our executive director Roger Kerr endorsed the role that professionally run shareholder associations can play in the wider corporate governance process.

Our starting point is that companies are owned by shareholders. We argue that shareholders should have the dominant say in how their companies are governed and run. Directors are their agents and shareholders have every right to set the terms of directors' employment, monitor their performance and hold them to account. Most of the issues in corporate governance revolve around the problem of ensuring that boards and managements running firms make decisions that are in the interests of their shareholder-owners. We don't want agents making decisions that reflect just their own interests and not those of their principals.

A useful book *Corporate Governance and Wealth Creation in New Zealand* by Joseph Healy was published last year. Healy emphasised that corporate governance is about using the resources of a business to create sustainable shareholder value. He rightly criticised so-called 'triple bottom line' notions, pointing out that "competing or conflicting objectives will simply confuse and provide excuses for poor management." A focus on shareholder value, pursued in ethically, socially and environmentally responsible ways, benefits both shareholders and the wider community.

Besides the exercise of shareholders' own rights there are a range of mechanisms that assist in controlling companies and ensuring they act in shareholders' interests. The most powerful disciplines on public companies are obviously the daily verdict of investors in capital markets, the roles of fund managers, analysts and rating agencies, and the ultimate threat of takeover. The Business Roundtable sees open and competitive markets for capital, labour, goods and services, and corporate control as best serving the interests of shareholders and the public as a whole. Behind these market mechanisms

we need good company and securities market laws, well-run stock exchanges and competent market regulators. Shareholders need to be conscious of the full array of factors that affect the relationship between shareholders and those who run their companies.

The caveat that I mentioned about shareholder associations is that they are professionally run. They need to do their homework. Robust debate is fine but grandstanding, ill-informed arguments and pandering to populist prejudices are a waste of everybody's time. Often the most constructive initiatives, at least in the first instance, are in private with company chairs and managements, to establish the facts of an issue and see whether particular arguments have been taken on board. Shareholders and the directors of their companies should be on the same side – why would you want an adversarial relationship with your employees? But given proper investigation and proper process, I have no difficulty with more vigorous behaviour from time to time. After all, the Shareholders Association is a watchdog and recalcitrant parties that are in the wrong deserve to get bitten. You won't get any argument from the Business Roundtable on that.

I haven't followed all the activities of the Shareholders Association but my impression is that, by and large, your representatives, and your chairman in particular, have played a responsible, constructive and effective role. Most business people I have spoken to see the Association as a welcome addition to the corporate landscape.

As a business organisation, the Business Roundtable seeks to promote the role of business in New Zealand and defend it from unwarranted attacks. I would like to think the Shareholders Association sees a similar role for itself. Statements by politicians and others about New Zealand being "the last frontier of the Wild West" are grossly irresponsible. They damage the interests of all investors and the community at large. New Zealand has never had a 'Wild West' business environment. We could ignore such comments as just silly or ill-informed were it not for the fact that they influence public opinion towards business. We all know that New Zealand does not have a strong pro-business and enterprise culture and recent research confirms New Zealanders seldom

identify the role business plays in creating a well-performing economy. If New Zealand is to get better economic growth and the social benefits that go with it, more people need to explain the role of business and rebut mindless criticisms.

Of course New Zealand business is not free from blemishes – businesses, governments and other human institutions never will be – but its record stands up well against others. Comparative research indicates that New Zealand is one of the least corrupt countries in the world; that it ranks highly for its legal system; and that it scores well for protection of investors, shareholders and creditors. There is no credible evidence of a lack of confidence in New Zealand's markets. Politicians and others who suggest otherwise to advance their own agendas should be condemned.

There has also been a good deal of mindless criticism of the performance of the New Zealand business sector as a whole. Some have linked it to what they see as the under-performance of the sharemarket and others have gone so far as to blame business for perceived inadequacies in the economy's growth performance.

The Business Roundtable has put a good deal of effort into countering these misperceptions. The reality is that the majority of New Zealand firms have generated competitive returns for investors. Aggregate measures of economic value added and market value added are in line with comparable data for other countries and with what you would expect in competitive markets. Many critics of sharemarket performance failed to focus on gross returns (including dividends) and they have recently gone rather quiet as our market has held up while over-hyped world sharemarkets have fallen. An elementary understanding of markets should have suggested that with no barriers to capital flows, New Zealand returns, adjusted for risk, will not vary widely from returns elsewhere over the long run. And it is now apparent to most that the New Zealand economy has performed reasonably well over the past 10 years, although it could have performed better if pro-growth policies had been maintained and not undermined. We would like to see the Shareholders Association joining us in making these kinds of points.

It is quite true – and this is the next point that needs to be made – that large amounts of shareholder value have been destroyed in New Zealand in the last 10 years. However, the losses in economic value terms have been concentrated in four companies – Fletcher Challenge alone accounted for around \$9 billion of them. Here I think it is fair to look for evidence of failures of management and corporate governance, as well as the impact of events outside the control of managers. Clearly mistakes were made but these should be kept in perspective and should not be used, as some have done, to brand New Zealand business managers in general as incompetent.

Many issues need to be weighed in the balance. First, business is always risky, and wrong decisions will always be made. Secondly, losses as well as profits are a normal and indeed healthy part of a competitive enterprise system; they are a signal that competitive forces are at work and that resources should be switched to more socially valuable uses. Thirdly, there is nothing dishonourable about many loss-making situations: a firm may have been beaten by a better competitor, a market may have turned against it, a new technology may have wiped out an old one, or the firm may have been hit by government rule changes. Fourthly, there have been massive losses of shareholder value by companies in Australia, the United States and elsewhere in recent years.

Armchair critics should consider such factors in making a balanced assessment. At the end of the day, if they think firms are incompetent there is usually nothing to stop them combining with others, putting their money where their mouth is, and setting up in competition in the marketplace. Moreover, no one is forcing them to make risky business investments in the first place. Only in the case of government-owned businesses are we exposed to such risks whether we like it or not. And we know that, on average and over time, state-owned enterprises under-perform privately owned ones.

The focus on the poor performance of a small number of New Zealand firms does, however, have one merit. It highlights the point that in the New Zealand context the

key problem is one of performance, not wrongdoing. Unlike the United States and indeed Australia, New Zealand has not had Enron-type problems in its publicly listed companies. Certainly we should guard against such risks but we should not set about fixing things that aren't obviously broke.

Partly as a result of lessons learned during the 1980s, the vast majority of New Zealand companies have put in place what are now conventionally regarded as good corporate governance practices. For many years it has been the norm, for example, for companies to separate the roles of chairman and chief executive, to have a majority of independent directors and to have an audit committee. In the wake of Enron, some have modified aspects of their financial reporting and some accounting firms have reviewed their auditing and accounting practices. I venture to suggest that there would not be one board of any sizeable company in the country that has not deliberated long and hard about its corporate governance practices and become more sensitised to risks. These are sensible, voluntary responses to lessons arising from overseas corporate scandals. They need to be ongoing: good corporate governance practice, like good accounting practice, is dynamic, not static. There should be no automatic assumption that more regulation is needed: markets often self-correct long before regulators arrive on the scene.

In the United States, on the other hand, one of the major responses was the Sarbanes-Oxley Act. Many commentators have pointed out that features of this legislation are not in shareholders' interests: it will be costly to comply with, induce unwarranted complacency that the problems have been solved, and create the risk of focusing boards on avoiding breaches of rules rather than on creating value for shareholders. Other commentators have made the point that Sarbanes-Oxley overlooks problems that led to some of the excesses, such as tax laws that distorted remuneration incentives and regulations that made hostile takeovers more difficult.

In my view one of the best comments on the post-Enron debates on corporate governance was recently made by Graeme Samuel, the recently appointed acting

chairman of the Australian Competition and Consumer Commission (the equivalent of our Commerce Commission). Samuel pointed out that:

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

Samuel went on to say:

The reason for this fixation on prescriptive rules is clear. They are visible, compliance is easily measured, and non-compliance is easily penalised. And our regulators and corporate directors can rest easy that they have done all that is necessary to deal with the failings revealed by recent scandals ...

Yet I venture to suggest that if those rules, as canvassed, were tested against the structure of the boards and audit committees of the likes of FAI, HIH or Harris Scarfe, or perhaps more pertinently, the other more establishment but less publicised failures or partial failures of companies of the ilk of Pacific Dunlop, Pasminco, AMP and NRMA, most, if not all, would have satisfied the prescriptive rules of board and audit committee composition being contemplated.

Conversely, News Corporation, Westfield and Harvey Norman all fail at least one of the prescriptive corporate governance rules. I know where I would rather have my money invested ...

Samuel also made the point that:

We need to remember that all the prescriptive rules will not prevent deliberate fraud, misleading and deceptive conduct, and material non-disclosure by management when dealing with its board of directors. I defy the best legal minds to produce a set of rules that will compensate for negligence, ignorance, apathy or the many characteristics that will render a board of directors dysfunctional. Nor will a plethora of prescriptive rules relating to the relationship of auditors to their audit clients overcome negligence (involuntary or culpable) by audit partners,

or a culture within an audit firm that provides a fertile breeding ground for incompetent audit practices ...

Finally, Samuel remarked:

No process of box ticking will overcome fundamental dysfunctionality of a board of directors flowing from inadequate expertise on the part of directors, an over-compliant board, an excessively dominant chairman or CEO, or a board that is permitted (indeed sometimes encouraged) to factionalise. Functionality of a board cannot be achieved solely through prescriptive rules, but requires the right mixture of personalities, expertise, commitment and leadership.¹

To date, New Zealand has largely escaped knee-jerk regulatory responses of the Sarbanes-Oxley type. We have seen moves toward international accounting standards and continuous disclosure by listed companies. I have reservations about going too far even in these areas. They involve cost – one Australian company, MIM Holdings, has said it will cost it more than \$1 million a year to comply with international accounting standards² – and shareholders' interests will not necessarily be served by making commercially valuable information public knowledge.

There are other proposals being canvassed whose costs seem likely to clearly outweigh their benefits. The New Zealand Exchange is proposing a set of prescriptive rules for corporate governance of the sort that Graeme Samuel warned against. There are an endless number of corporate governance policies which most of us would regard today as good practice. Besides those proposed by the Exchange, the idea that a director should not sit on too many boards and that a chief executive should not go on to become the chair of the same company would be two of them.

But it is one thing to commend certain practices as a desirable norm; it is quite another to mandate them on all companies. I suggest most of us in this room would think it is generally a good idea for the roles of the chairman and the CEO of a company to be separate. But if this was so obviously always in the interests of shareholders, 90 percent of US companies would not combine these roles, as they do, and the New York Stock

¹ Graeme Samuel, *Australian Financial Review*, 21 May, 2003.

² 'New international accounting standards add to costs', *Australian Financial Review*, 27 March 2003.

Exchange and Nasdaq would have rules prohibiting the practice, which they don't. So why should New Zealand mandate such a rule and prevent, say, the founder of a firm remaining chairman and CEO for a period after listing? Warren Buffett's company Berkshire Hathaway breaks practically every corporate governance rule in the book including this one, but how many of us wish we had put \$1000 into the firm when it first listed and were multi-millionaires as a result today?

Buffett is one of many who have spoken out against prescriptive rules and called for boards, chief executives and institutional shareholders to clean up their own act – for example by "withholding their votes for directors who were tolerating odious behaviour." Federal Reserve chairman Alan Greenspan has made similar comments: he has emphasised the importance of integrity, trust, reputation and honest dealing in the rise of American business and lamented the extent to which regulations have diminished the value of such attributes.

I agree with these views. We need to recall some of the old maxims in business that some have lost sight of. One is the market value of trust and personal reputation. Another is that you can't legislate for honesty: it has to be inculcated, cultivated, demonstrated and lived. And another is the importance of *caveat emptor*: buyers of investment products should look at what they are buying, not take irresponsible risks, and – in the absence of wrongdoing – not blame others if things go wrong.

Finally, and consistent with these remarks, I believe we should rely more on shareholder rights and shareholder choice, and less on regulations and regulators, to ensure boards focus on their prime tasks of creating value for shareholders and maintaining good corporate stewardship.

Shareholders are not dumb and powerless. In the recent past we have seen shareholders in a New Zealand company (Telecom) support the decision of a board that its chief executive should go on to become its chairman while shareholders in an Australian company (Mayne) rejected the same decision and forced its board to backtrack.

Shareholders know that a general rule does not fit all circumstances, and they are able to discriminate. They showed that ability in the decisions they made on the takeover options previously available in the stock exchange's listing rules – options which have unfortunately now been suppressed by regulation.

So I think that the Securities Commission is on the right track in looking at broad principles of corporate governance which would provide guidance on good practice for public companies, private companies, cooperatives and state-owned enterprises but would not be mandatory for any of them. The only proviso is that the aim should be to produce a short document focused on core issues, not an elaborate 80-page manual like the ASX Corporate Governance Council has come out with. I think the Shareholders Association is on the right track in putting pressure on large shareholders to vote their shares in appropriate circumstances, as you recently did with the Accident Compensation Corporation. I also think the Institute of Chartered Accountants of New Zealand did a generally good job in its report on corporate transparency; it asked whether there was any real evidence of problems that needed fixing, and kept the focus firmly on company performance.

In contrast, I think the New Zealand Exchange is on the wrong track in expanding the scope of its mandatory listing rules on corporate governance and I think the Institute of Directors is on the wrong track in requiring that its members must take a course and be accredited to sit on company boards. When someone can become a prime minister and run a government but not become a director of a small public company without a specified qualification, something is surely amiss. Shareholders don't need to be patronised. They should be able to determine who they want as directors of their companies and the nature of their company constitutions, just as voters choose who to elect to parliament and the nature of our democratic constitution.

So I hope the Business Roundtable can count on the Shareholders Association taking an active and well-considered interest in these important issues of corporate governance. We will not be defensive about criticism of business when it is well deserved. You will

not hear us defending inflated salaries and bonuses for executives in companies that have under-performed. Equally, we hope you will help defend proper rewards for high performance and rebut sweeping and unfounded criticisms of New Zealand business as a whole.

When perceptions do not match the reality, we should correct the perceptions not acquiesce in proposals for more unnecessary regulation and prescriptive rules. Perceptions that New Zealand does not have generally sound laws and good corporate governance practices do not match reality. Business organisations, journalists, politicians, government officials and regulators all have a responsibility to dispel misperceptions. It is not always easy to stand up to populist bandwagons and insist on principled debate. Too often people who should know better turn into surrender monkeys. But your chairman has never shown a lack of courage in putting on a helmet and going into battle. I hope we can look forward to seeing you in the fray when needed, and on the right side of the arguments.