

Director independence: NZX consultation paper May 2023

Purpose of the requirements

Consultation paper question	IoD response
1. Do you consider that a clearer articulation of the purpose of the director independence requirements would assist issuers in assessing a director's independence?	<p>Yes. A clear purpose for the requirements is vital to ensure that they are fit for purpose. Clarity is also required in the link between the requirements and how they achieve a specific purpose.</p> <p>The matters outlined are not just about managing conflict. Independence is one important element of good governance by boards, their dynamics and sound collective decision-making in the interests of the company.</p>
2. What do you consider an appropriate purpose statement to be?	<p>We think that there is a link between purpose and benefits/outcomes (see below) that director independence is seeking to achieve.</p> <p>Not “wordsmithing” the purpose(s), there could be several, based on research and good practice (including the 4 Pillars of Governance Best Practice):</p> <ul style="list-style-type: none">• Overall, reinforcing a focus on acting in the best interests of the company (s. 131 of the Companies Act 1993), rather than other related interests and stakeholders• Providing for sufficient challenge, monitoring, accountability and support for the chief executive and company senior leadership• Working with all shareholder groups in a way that ensures timely and effective access to capital• Bringing a range of perspectives and challenge to the board table on major decisions• Ensuring that directors are not conflicted through other roles. We note that this may be better addressed in the conflict of interest / management of interest approach – including under the Companies Act 1993 ss. 189 (company keeping an interest register) and 211 (disclosures in annual report)

Consultation paper question	IoD response
	<ul style="list-style-type: none"> Balancing alignment of interests with the company (e.g. from a shareholding) with a significant personal benefit (e.g. that might come with a significant shareholding and associated income)
<p>3. Are there any disadvantages with including a clearer articulation of the purpose of the requirements in the Code?</p>	<p>Seeing the code as exclusive and covering all circumstances is a potential risk with better articulation of the purpose. The consultation document points to this in how the current independence provisions have been applied.</p> <p>That said, clear caveats about the purposes and the requirements not being exclusive goes some way to addressing this, while achieving most of the benefits of the requirements.</p>
<p>4. Do you agree that the conflicts of interest articulated above reflect the concerns that the director independence settings are designed to address?</p>	<p>Generally, yes. However, the issue related to board membership and/or shareholding in another organisation where a conflict may arise could be better dealt with through interests and conflict disclosures rather than through director independence.</p>
<p>5. Should any of the interests or relationships set out be articulated differently?</p>	<p>The titles of the issues on pages 7 and 8 of the consultation document could better describe the nature of the problem director independence is intended to address. For example, “Management and Board” issue could be framed as “Ensuring effective monitoring and accountability of management by the board”.</p> <p>The “inter-board” title doesn’t sufficiently describe the issue. Again, consider whether this is a director independence issue primarily or is better covered by declaration of interests/conflicts of interest management.</p> <p>There is a useful focus on relationships and the social connections between directors and management and between directors in the paper. From the literature, it is clear that these are as, if not more, important than the obvious connections such as previously holding a management position.</p>

Consultation paper question	IoD response
6. Are there additional purposes that should be reflected in the Code?	Clarity about independence supports board appointment processes, including who should be involved in those processes. The updated Code currently doesn't comment on who should be involved in those appointment processes, beyond recommending, if it is the board as a whole, the majority of the board have to be independent directors. With persuasive executive directors they could potentially appoint "independent" directors with social connections to them (for example), who aren't fully independent.

Benefits of director independence

Consultation paper question	IoD response
1. What benefits do independent directors bring to a board?	<p>In the <i>Four Pillar of Governance Best Practice</i> we note that benefits of independent directors include:</p> <ul style="list-style-type: none"> • A fresh and independent viewpoint on issues before the board • Accessing specific expertise and experience • Accessing networks and relationships with other organisations. <p>Research on director independence has tended to investigate benefits in relation to:</p> <ul style="list-style-type: none"> • Representing all shareholder interests • Providing third party advice and oversight • Not acting with undue management influence • Driving improved shareholder/firm value and financial performance in the short and medium-term • Takeover value • Chief Executive compensation

Consultation paper question	IoD response
	<ul style="list-style-type: none"> • Compliance behaviour, including fraud detection • Governance quality¹ <p>It is also worth noting that the benefits and whether they are achieved may also relate to the size and circumstances (e.g. performance when independent directors were appointed).</p>
<p>2. How important do you consider a director's independence is to enable the director to fulfil the director's duties, compared to other factors?</p>	<p>Director independence is one factor among many that influence standards of corporate governance.</p> <p>On one hand, the legal duty of a director to act in what they consider to be the best interests of the company means that all directors, independent or not, have to act in the company's interests, not their own.</p> <p>The existence of director independence requirements in many stock exchanges suggests that director independence requirements are necessary, but not sufficient to deliver good governance and performance outcomes. This indicates that delivering these practices and outcomes in the absence of independent directors, is more limited. Put simply, it is easier to wear one director "hat" than wearing two (management and director).</p> <p>Board dynamics also play a critical role in relation to independence.</p> <p>A single independent director might still be a "voice in the wilderness", irrespective of their independence, capability and experience.</p> <p>Hearing that voice and acting on it, in conjunction with other directors as part of a collective, is an important role for the board chair. Inclusion is key to this, both for the voice of independent directors, as well as those who add more generally to board diversity.</p>

¹ Larker, DF, and Tayan B, Independent and Outside Directors: Research Spotlight, Corporate Governance Research Initiative, Stanford Graduate School of Business, May 2022 see [Research Spotlight | Independent and Outside Directors \(stanford.edu\)](https://stanford.edu/research-spotlight/independent-and-outside-directors)

Consultation paper question	IoD response
	<p>A further element is any “information gap”, and how easily and quickly an independent director can bridge them. A 2010 study (Duchin, Matsuaka and Ozbas) finds that with low costs of acquiring information by independent directors, then firm financial performance improves. If it is high, then it deteriorates.²</p> <p>There is also a link to director review and board evaluation processes. These could focus on the extent to which directors, particularly but not limited to independent directors, have acted independently, including independently of their other interests, even if these do not conflict. (See also answer to “Nature of director independence”, question 1 below).</p>
<p>3. In what specific circumstances is the independence status of a director particularly important (for example, consideration of takeover proposals, of the determination of a particular offer structure)?</p>	<p>Director independence appears to be particularly important in several circumstances:</p> <ul style="list-style-type: none"> • Takeovers. Some of the research suggests that takeover premiums are higher with independent directors • Acquisitions and mergers. Some research suggests that there is more rational merger activity with acquisitions and mergers • Share issues: There is some suggestion in the research that independent directors are more able to represent the interests of all shareholders <p>The evidence appears more mixed on the impact of director independence on the everyday delivery of financial performance and returns, although small firms and those with historically poorer financial performance may benefit most.³</p>

² Ran Duchin, John G. Matsusaka, and Oguzhan Ozbas (2010), When are Outside Directors Effective?, Journal of Financial Economics. See https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1480772_code84406.pdf?abstractid=1026488&mirid=1

³ Range of studies referenced in Larker, DF, and Tayan B, Independent and Outside Directors: Research Spotlight, Corporate Governance Research Initiative, Stanford Graduate School of Business, May 2022 see [Research Spotlight | Independent and Outside Directors \(stanford.edu\)](#)

Consultation paper question	IoD response
<p>4. In relation to the consideration of takeovers, what is the importance of a director being an Independent Director under the Rules (i.e. not an employee and having no Disqualifying Relationship) compared to independence from the bidder?</p>	<p>The answer is both, based on the Takeovers Code and guidance on it. Guidance on the Code prepared by the Takeovers Panel and IoD points to an obligation on directors of organisations covered by the Code to: “A company’s directors who are independent from the parties to the proposed transaction are required to oversee the Code-regulated transaction and ensure compliance with all of their company’s obligations under the Code.” This extends to obligations to appoint an independent advisor to prepare a report for shareholders on the merits of the transaction.⁴</p>
<p>5. What are your views as to the necessary levels of director independence to enable a board to operate effectively? Are these levels affected by the size and complexity of the issuer (e.g. for issuers in the S&P / NZX 20 Index, or the S&P / NZX 50 Index)?</p>	<p>As noted above, board effectiveness is not solely a function of the number or presence of independent directors, although available evidence in general suggests that there are benefits from boards having a critical mass of independent directors. Increasing organisational complexity may make the “information gap” referred to above worse and the ability to bridge this gap more difficult in the absence of a majority of independent directors. Having more independent directors with the ability to seek and get the required information, would enable the board to operate more effectively.</p>

⁴ See [Takeovers' code guide | IoD NZ](#) (2020)

Consultation paper question	IoD response
6. Do you consider that issuers whose boards have a larger number of independent directors perform better?	<p>We have not seen evidence to answer this question definitively and would like to see the research commissioned by NZX address this. The available general evidence on financial performance about organisations with boards with independent directors is mixed.⁵ However, this belies differences in results for smaller firms and those with historically poor financial performance.</p> <p>In addition, as noted above, it is possible that more independent directors on the boards of larger, more complex companies may also be able to address information gaps more effectively.</p>
7. Do you consider that the benefits of independent directors are affected by the size and complexity of an issuer (e.g. for issuers in the NZX 20, or NZX 50)	Potentially, for the reasons discussed in responses to earlier questions in this section.
8. Do you consider the current hybrid regulatory model to be appropriate whereby the Rules contain mandatory director independence requirements, and the Code contains settings which issuers may elect to adopt on a voluntary basis?	The hybrid model permits rules for director independence where the benefits of those requirements are clearest with the strongest evidence and voluntary (comply or explain) requirements for those that only apply to some firms. The evidence of the benefits of director independence is less certain in the areas of director independence that are less able to be defined and require consideration and judgment by boards (e.g. the social connection between a director and management or between directors).

⁵ Larker, DF, and Tayan B, Independent and Outside Directors: Research Spotlight, Corporate Governance Research Initiative, Stanford Graduate School of Business, May 2022 see [Research Spotlight | Independent and Outside Directors \(stanford.edu\)](https://stanford.edu/research-spotlight/independent-and-outside-directors)

Nature of director independence

Consultation paper question	IoD response
<p>1. Do you consider that the definition of an Independent Director should be expanded to include a director who is able to conduct themselves in an independent manner and exercise an independent judgment, as well as having no Employee relationship or Disqualifying Relationship?</p>	<p>Changing expectations in this way may be useful.</p> <p>It could also help in selection and review/board evaluation processes.</p> <p>However, it could equally apply to non-independent directors, particularly to discharge the duty to act in what they believe to be in the best interests of the company.</p>
<p>2. How would the change to the definition of Independent Director referred to in question 1 change the manner in which the board of an issuer assesses a director's independence?</p>	<p>It would focus more on independence capability selection and performance assessments on the board. It puts more weight on these, notably recommendations 2.2 (procedure for the nomination and appointment of directors to the board) and 2.7 (director performance) of the current NZX Corporate Governance Code. These would need to be amended if the definition of director independence was broadened.</p>
<p>3. Do you consider that the purpose of the requirements needs to be better reflected in the definition of an Independent Director in the Rules, for example by referring to independence from the interests of management and substantial holders?</p>	<p>Yes. This reflects the response to questions about the purpose and benefits of director independence requirements. It should help understanding the requirements and the reasons for them.</p>

Consultation paper question	IoD response
<p>4. Do you have any comments around the advantages and disadvantages of tailoring the director independence composition settings so that an assessment of a director's independence is tied to the conflict of interest that a factor indicates?</p>	<p>The consultation document refers to the difficulties of high levels of tailoring of the requirements to practical implementation of them. In principle, the requirements should be tailored as much as possible to the situations where director independence contributes most to improved outcomes/biggest benefits based on the available evidence (outlined above and in footnotes). This has to be assessed against the ability to draft the requirements clearly and the compliance costs involved.</p>
<p>5. Should a director's shareholding in an issuer be considered as a factor that indicates non-independence? If so, what level of shareholding or relevant interest in shares should trigger this as a consideration?</p>	<p>As noted in the consultation document, directors having a shareholding in an issuer can have benefits in aligning the financial interests of a director with the financial performance and maximising value of a firm. There is no "magic" level of shareholding above which this alignment transforms a directors interests to the extent that the director holding those shares is no longer independent.</p> <p>However, even smaller holdings could have a detrimental impact, including a focus on driving shorter-term value maximisation rather than a longer-term perspective. This might be the basis for a director outwardly claiming to act in the company's best interests, when it is really enhancing their own interests, (and not necessarily in the best interests of the company in the longer term). This contrasts with start-up companies where shares may be the basis for remuneration instead of cash (with the associated risk) and a basis for alignment with company direction and fortunes.</p> <p>Larger holdings are more likely to at least be perceived as that director governing for their own interests or a grouping of shareholders' interests, rather than those of the company generally and, therefore, all shareholders' interests.</p>

Consultation paper question	IoD response
6. How do you consider the benefits of long tenure should be weighted against the effects of long tenure on a director's independence, when considering the effects on board and director performance?	Some thinking suggests that longer tenure diminishes director independence from management and, if there are other long serving directors, other directors. There is some research that supports this proposition, although the focus of this work is predominantly on very long tenure (i.e. more than 20 years board service) ⁶ . Equally, this question turns on the actual tenure of independent directors. We note that a 2016 study on director tenure in the United States suggested average tenure was 8.5 years (i.e. around three, three-year terms). ⁷
7. Are there any additional matters that should be considered in relation to the definition of director independence?	No

⁶ See for example, Vafeas, N (2003), Length of Board Tenure and Outside Director Independence, Journal of Business Finance and Accounting 30(7-8): 1043-1046 at: https://www.researchgate.net/publication/4991440_Length_of_Board_Tenure_and_Outside_Director_Independence

⁷ Katz, D. and McIntosh, L. ,(2016) Director Tenure Remains a Focus of Investors and Activists on Harvard Law School Forum on Corporate Governance at: [Director Tenure Remains a Focus of Investors and Activists \(harvard.edu\)](http://www.harvard.edu)

Minority shareholder interests

Consultation paper question	IoD response
<p>1. Do you consider that the current director independence requirements do not appropriately protect the role of minority shareholders?</p>	<p>A clearer purpose, identification of benefits and a wider definition of director independence and ongoing focus on directors meeting their duty to act in the best interests of the company and following the NZX Corporate Governance Code requirements should ensure minority shareholder interests are protected. Available research about independent directors and takeovers, for example, bears this out.</p>
<p>2. Should issuers be encouraged to engage with minority shareholders in relation to the assessment of a director's independence?</p>	<p>There should be a high level of transparency about director independence with a range of stakeholders, along with ongoing transparency on interests and conflicts.</p>
<p>3. What benefits and disadvantages would arise if minority shareholders were able to veto a board's assessment as to the independence of a director?</p>	<p>Director independence should not be the sole domain of minority shareholders. Based on the other research outlined in this submission, there are benefits to a wider group of stakeholders. It would be better to rely on transparency and other requirements, rather than a veto power.</p>

Consultation paper question	IoD response
4. Are there alternative or additional changes that you consider should be made to the director independence settings that more appropriately address the conflicts between majority and minority shareholders?	A strong focus on all directors acting in the best interests of the company and being seen to do so would augment the director independence requirements. IoD has suggested that the board tabling a statement of what they believe to be the best interests of the company at every second Annual General Meeting would help all shareholders understand how they are upholding their duties and assist them to consider the extent and nature of their shareholdings. This could be added to the NZX Corporate Governance Code, alongside clarifying director independence requirements.

Disclosure

Consultation paper question	IoD response
1. Do you consider that there are changes to the Rules or the Code that should be made to enhance the quality of director independence assessment disclosures?	In addition to the matters outlined in the answers to previous questions, it may be beneficial to consider appropriately framed disclosures of the social and other relationships between directors and management, and between directors.
2. Should further disclosures be required by Rule 2.6.2 within 10 business days of a director's initial appointment, beyond the determination of a director's independence?	Yes. However, it is also important that there is ongoing monitoring of director independence because director circumstances can change consistent with the purposes of director independence outlined above and the circumstances of the firm. The timing of any review of each director's independence will depend to some extent on how any new requirements are tailored.

Consultation paper question	IoD response
3. Should the Rules require an issuer to disclose the reasons for its assessment of a director's independence in a notice of meeting that contains a resolution to elect or re-elect a director?	Yes. However, this should be part of a wider recommendation for election or re-election, of which independence is only one factor, alongside experience, capability and approach to governance.
4. Should the Rules place more direct obligations on issuers to ensure that directors provide updated information in relation to changes to interests and relationships that are relevant to an assessment of whether the director has a Disqualifying Relationship?	Yes. See answer to questions 2. Note that this depends, however, on the speed with which circumstances can change and/or the nature of the interests which should be recorded on the interests register which might have a bearing on director independence.
5. Should the Rules place more direct obligations on issuers to re-assess a director's independence when the issuer becomes aware that a director's interests or relationships that relate to the independence assessment have changed?	Yes. For the reasons outlined in the answers to questions 2 and 4. This, however, relies on a process and approach, such as the interests register, that allows this to happen. Given the Companies Act 1993 requirement to maintain an interest register and practice to review this at each Board meeting, a step to consider both conflicts and independence should be straightforward.