CORPORATE GOVERNANCE CODES IN AUSTRALIA AND NEW ZEALAND: PROPRIETY AND PROSPERITY

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I INTRODUCTION

Corporate governance is a concept very much in vogue. For corporate lawyers, the government, market analysts, and those actually involved in the running of companies, the issues surrounding the management and control of companies is of intense practical and theoretical interest. This interest has, moreover, been enlivened in recent years by the increasing globalisation of business and spectacular corporate failures, of which Enron, Tyco and OneTel are merely the latest.

One manifestation of this interest is the development in various countries of codes of corporate governance. The objective of these codes is to indicate what best practice in the area of corporate governance is, and to act as practical guidelines. Recently, both Australia and New Zealand have seen such codes promulgated. In March 2003, the ASX Corporate Governance Council released its *Principles of Good Corporate Governance and Best Practice Recommendations*.[1] These principles were endorsed by the Implementation Review Group of the Council in March 2004.[2] In New Zealand, in February 2004 the Securities Commission released its *Corporate Governance in New Zealand: Principles and Guidelines*.[3] While the two codes differ in some respects, their similarities are far more notable than their differences. In particular, both codes implicitly identify the same central issue. That is, the so-called 'agency cost problem': the tendency of senior management to act self-interestedly. The solution in both codes is the creation of an independent board to monitor management closely and an extensive, robust regime of financial reporting.

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[1] Australian Stock Exchange Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations* (2003) Australian Stock Exchange <http://www.shareholder.com/shared/dynamicdoc/ASX/364/ASXRecommendations.pdf> at 19 May 2004 ('ASX code').

[2] Implementation Review Group of the Australian Stock Exchange Corporate Governance Council, *Principles of Good Corporate Governance and Best Practice Recommendations: Report to the ASX Corporate Governance Council* (31 March 2004) Australian Stock Exchange <http://www.asx.com.au/about/pdf/IRG%20Report%20to%20ASX%20CGC%20final.pdf> at 19 May 2004 ('IRG report').

[3] New Zealand Securities Commission, *Corporate Governance in New Zealand: Principles and Guidelines* (2004) New Zealand Securities Commission <http://www.sec-com.govt.nz/publications/documents/governance-principles/corporate-governance-in-new-zealand.pdf> at 19 May 2004 (NZSC code).

The purpose of this note is to outline the central features of these proposals and to pose, by way of a critique, three questions. First, do the codes address the right problem? While the agency problem has been recognised as of central concern in jurisdictions such as the United States and the United Kingdom, the Australasian corporate economy is different in many respects and may give rise to a different set of issues. Secondly, are the solutions of independence and disclosure conceptually and practically viable? Thirdly, in responding to the perception of dishonesty and self-dealing arising out of recent corporate collapses, do the codes pay sufficient attention to that aspect of corporate governance that is concerned with wealth creation?

II THE CENTRAL FEATURES OF THE GOVERNANCE CODES

The principal objective of both codes is to define best practice in the governance of companies. To this end, the codes set out a series of principles, nine in the Securities Commission's code and ten in the ASX code, each supplemented by a series of guidelines. The purpose of these guidelines is to set out structures and processes to help companies achieve the standards required by each principle. In setting out the principles and guidelines, there is a remarkable degree of commonality between the two codes. All nine of the principles set out in the Securities Commission's code are contained in one form or another in the ASX code.[4]

In broad terms, there are six recommendations common to the two codes. First, both codes recommend that the board should have independent directors.[5] The definition of independent differs slightly between the codes, but in broad terms it excludes those employed by the company and those having direct business links with the company.[6] Second, it is recommended that the board should be composed of individuals having a mix of skills and knowledge, to enable the board to discharge its duties.[7] Third, the codes suggest that there should be subcommittees of the board to deal with matters such as audit[8] and remuneration.[9] Fourth, the company is required to put in place robust procedures for reporting financial and governance information.[10] The board is also required to adopt procedures and policies to ensure the integrity and accuracy of that information.[11] Fifth, it is recommended that the remuneration of the board should be fair and reasonable and should be the result of transparent procedures.[12] In particular, both codes recommend that board

[4] The ASX code, above n 1, also contains a principle (Principle 8) relating to the review and evaluation of the performance of management.
[5] ASX code, above n 1, 19-20; NZSC code, above n 3, 15-18.
[6] ASX code, above n 1, 20; NZSC code, above n 3, 17.
[7] ASX code, above n 1, 19; NZSC code, above n 3, 15.
[8] In the IRG Report, above n 2, 15, some concern was expressed about the need for all companies to have full audit committees. This concern seems to rest on the burden of having such committees on smaller listed companies.
[9] ASX code, above n 1, 21-22, 29-30; NZSC code, above n 3, 19-20.
[10] ASX code, above n 1, 35-37; NZSC code, above n 3, 21-23.
[11] ASX code, above n 1, 29-32; NZSC code, above n 3, 21-23, 28-30.
[12] ASX code, above n 1, 51-57; NZSC code, above n 3, 24-25.

remuneration should be linked to the performance of the company.[13] Sixth, the board is enjoined to observe the highest standards of ethical behaviour and to adopt a code of ethics against which the behaviour of directors might be measured.[14]

While the recommendations in the codes are substantially similar, they do nevertheless differ in three major respects. First, the ASX Code is limited in its application to listed companies.[15] In contrast, while the Securities Commission's code is intended to apply principally to listed companies, it is not limited to such companies.[16] Second, the ASX rules are more prescriptive.[17] The approach of the ASX is that all companies to which its code applies should conform, unless there are good reasons for not doing so. Companies that do not conform must disclose this fact as part of their reporting obligations and explain the departure.[18] Third, Principle 8 of the ASX Code, which has no counterpart in the Securities Commission's code, recommends that the board adopt procedures to review systematically the performance of directors and other senior executives.[19] This is the only direct recommendation in either code aimed at improving the managerial and business performance and decision-making of a company's senior management.

The central problem identified by the codes is how to monitor more effectively senior management and thereby make them accountable where their actions are motivated by self-interest rather than the corporate interest. The solution to this problem in both codes is, in broad terms, the establishment of the board as a quasi-external body that is able and willing to monitor management. In theoretical terms, the concern to establish structures and systems to monitor senior management reflects what is commonly referred to as the agency cost problem.[20] The relationship between those who own the enterprise and those who manage it is described in terms of agency. The central assumption of this agency theory is that the interests of the owners and managers will diverge. This divergence represents a cost on the activities of the enterprise. This cost is comprised of the reduced return to the owners due to managers pursuing their own objectives and the costs incurred by owners in monitoring management. Agency cost theory assumed particular prominence in analyses of the company because of the rise of the large publicly owned company in the early 20th century. The dispersed nature of the shareholding in such companies greatly exacerbated the agency cost problem because no individual shareholder had a sufficiently large stake to make it worth their while to

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[13] The NZSC code is more equivocal on this. The guidelines recommend that pay and performance be linked, but it was noted that in the consultation process leading up to the development of the code that opinion was divided (see NZSC code, above n 3, 24).
[14] ASX code, above n 1, 25; NZSC code, above n 3, 12.
[15] ASX code, above n 1, *Foreword.*
[16] NZSC code, above n 3, 5.
[17] This is a major source of concern in the IRG Report, above n 2, 6-7.
[18] ASX code, above n 1, 5.
[19] ASX code, above n 1, 47.
[20] Michael Jensen and William Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305.

take an active monitoring role over management. If a shareholder was unhappy with the way the company was being run, it was cheaper simply to sell the investment.

The codes developed by the ASX and Securities Commission are, therefore, an attempt to minimise agency costs. The combined effect of the recommendations is to create a board that is independent of the company's management and whose own interests are tied more closely to the interests of shareholders, by measures such as performance-linked remuneration. This independent group, which has access to the fullest possible amount of information about the company, is thus able and incentivised to exercise the oversight and review of management that the shareholders are either unable or unwilling to do. In this way, the board, established as a quasi-external body, acts as a proxy for the company's owners, the shareholders. The scope for management to pursue their own agenda is thus limited and agency costs are reduced.

III Three Questions

The identification of the agency cost problem as the central obstacle to good governance, and the solutions articulated by the ASX and Securities Commission to overcome this obstacle, are consistent with international trends, particularly those in the United States. Thus, the *Sarbanes-Oxley Act 2002* has fundamentally overhauled the reporting of corporate financial information, and both the *Listed Company Manual* of the New York Stock Exchange and the American Law Institute's *Principles of Corporate Governance* recommend that listed companies have a majority of independent directors.[21] While the ASX's and Securities Commission's proposals accord with steps taken elsewhere, the emphasis on board independence and reporting in codes intended for application in Australia and New Zealand nevertheless gives rise to three closely related questions.

A *Have the Codes Identified the Right Problem for Australia and New Zealand?*

The strategy of board independence and robust financial disclosure was originally developed in the US. The US economy is characterised by very large companies with highly dispersed shareholdings, with a large and liquid share market. However, while the US economy was the basis from which the principal theoretical models were derived, it is nevertheless unique. Most western economies are like those of Australia and New Zealand. These economies are characterised by a small and fairly thin share market and by listed companies that are relatively small by global standards. Most importantly, the shareholding in these companies reflects a high degree of concentration. Thus, over one-third of Australian companies have a substantial shareholder holding of 30 percent or more, while in New Zealand 30 percent of the top 40 listed companies are under majority control with a further 57 percent being under minority control.[22]

[21] American Law Institute, *Principles of Corporate Governance* (1992) 1 [3A.01].
[22] John Farrar, *Corporate Governance in Australia and New Zealand* (2001) 470.

The importance to the overall economy of the publicly owned company as opposed to privately held companies, the so-called SME, is also much less than in the US. Indeed, Farrar cites figures derived from the Australian Bureau of Statistics that SMEs account for 97 percent of all private sector business and more than 50 percent of all private sector employment.[23]

For present purposes, the important implication of the fundamental differences in the structure of corporate ownership between the US on the one hand, and Australia and New Zealand on the other is that there is much less separation of ownership and control in the latter. This in turn suggests that the central governance concern in Australia and New Zealand is not the agency cost problem. Rather, it suggests that the more serious issue is that of the conflict between shareholders and, in particular, the potential for abuse of a minority by a majority. Thus, speaking of Canada, which like Australia and New Zealand is characterised by high degrees of ownership concentration, Daniels and MacIntosh note:[24] 'As compared to the United States ... the focal axis of agency problems in Canada is thus likely to be inter-investor conflicts, rather than investor-manager conflicts.'

When viewed from the perspective of the particular features of the Australian and New Zealand economies, one may therefore justifiably ask whether the codes have addressed the right question. In focusing on listed companies to the exclusion of privately owned companies, and in following initiatives and solutions developed in and for the US, the codes have proffered solutions to a problem that for Australia and New Zealand may not be the central or most pressing concern. This in turn raises the issue of convergence in corporate governance.

It has been suggested that corporate governance systems worldwide are converging to a single model, and that that model is the one currently operating in the US. The supremacy of the US model is presented in evolutionary terms: this model is inherently more efficient and is the 'logical winner of a Darwinian struggle between different forms of corporate structure'. [25] From this premise, it follows that all countries should seek to move to the US model as soon as possible to secure the advantages of that system. It also follows that the focus in the ASX's and Securities Commission's codes on this model is, therefore, justified. The difficultly with such an approach, however, is that evolutionary arguments are necessarily contingent. Until history truly ends,[26] we can never be sure who has really won. In the meantime, we are left with a less than superior 'one-size fits all' solution.

[23] Ibid.

[24] Ronald Daniels and Jeffrey MacInstosh, 'Toward a Distinctive Canadian Corporate Law Regime' (1991) 29 *Osgoode Hall Law Journal* 863, 886-887.

[25] Brian Cheffins, 'Corporate Law and Ownership Structure: A Darwinian Link?' (2002) 25 *University of New South Wales Law Journal* 346, 348.

[26] Henry Hansmann and Reinier Kraakman, 'The End of History for Corporate Law' (2001) 89 *Georgetown Law Journal* 439.

B *Will the Recommendations Work to Improve Governance?*

The proposals adopted by the ASX and Securities Commission to improve governance rest on a system of external oversight of the company's affairs. This model assumes that the board is a quasi-external body at arms' length from management, who acts in the interests of shareholders and the wider economic community. In seeking to evaluate the likely success of these proposals in improving governance, there are two related issues worthy of note.

First, there is cause for scepticism about the practicality of having truly independent directors. Those persons most likely to fill the position of independent director are those with full-time positions as senior executives of other firms. While such people will have expertise in corporate management, this very fact compromises the ability of independent directors to monitor actively the board in a number of ways. Independent directors will be unlikely to have detailed knowledge of the nature of the company's business and will necessarily be reliant upon senior management for advice on and interpretation of the company's position. While the codes have sought to address this by ensuring information flows to the board, often the issue is not too little information, but too much. The directors are simply unable to digest the volume of information they receive and thus end up taking management's word for what it all means.[27] Independent directors are also naturally pre-disposed to a hands-off management style by the board. As senior executives of other firms, this will be exactly how they would want the boards of their own firms to behave. This in turn is reinforced by the central role played by management in the selection of independent directors.[28] The independent director is thus to an extent beholden to management for his or her position.

Secondly, as part-time directors, independent director may devote insufficient attention to the company's affairs to effect any real oversight. It has been suggested that on average an independent director may devote as little as 125 hours per year to the company's affairs.[29] The part-time nature of the independent director also calls into question the motivation of such directors to be active in monitoring management. As Monks and Minow note: '"Independence" can also mean "indifference".'[30] Thus, the willingness of an independent director to provide any real check on management will turn on the individual's own sense of propriety and professionalism. However, as the ASX notes, 'personal integrity cannot be regulated'. [31]

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[27] Colin Carter and Jay Lorsch, *Back to the Drawing Board: Designing Corporate Boards for a Complex World* (2004) 150.
[28] G P Stapledon and Jeffrey Lawrence, 'Board Composition, Structure and Independence in Australia's Largest Listed Companies' (1997) 21 *Melbourne University Law Review* 150, 158; Saleem Sheikh, 'Non-executive Directors: Self-regulation or Codification?' (2002) 23 *Company Lawyer* 296, 298.
[29] Carter and Lorsch, above n 27, 22.
[30] Robert Monks and Nell Minow, *Corporate Governance* (2nd ed, 2001) 191.
[31] ASX code, n 1 above, 25.

C *Have the Codes Sacrificed Value Creation for Accountability?*

The phrase 'corporate governance' has at least two meanings. The first is concerned with the accountability of those responsible for the operation of the company and how that accountability can be made more effective. The phrase 'corporate governance', however, also refers to the mechanisms and strategies designed to make the company a more efficient and effective means of wealth creation. The focus of both the ASX's and Securities Commission's codes is on corporate governance in the first sense. While the ASX does refer to wealth creation, when viewed at the level of the actual measures recommended, this clearly takes a back seat to accountability. The Securities Commission's report is even more closely focused on accountability. Indeed, the words 'wealth' and 'value' do not appear in the report.

A focus on propriety in the management of companies is obviously not an inappropriate one. It is clearly important in both a moral and practical sense that companies are, and are perceived to be, managed honestly. However, the almost exclusive focus on propriety in the management of companies may be questioned in two respects. First, as an objective of corporate regulation, enhancing the capacity of the corporate form as a vehicle for wealth creation is surely just as important as ensuring an absence of fraud and impropriety. The economic rationale of the company underpins the recent CLERP reforms in Australia[32] and is expressly recognised in New Zealand in the Long Title to the *Companies Act 1993* (NZ). The criticism that can be levelled at the codes, therefore, is that they fail almost completely to address the principal economic justification for the corporate form. The absence of impropriety in the management of companies is no guarantee of economic success.

Second, and perhaps more importantly, the measures adopted in the codes to ensure propriety may actually work against improving the quality of decision-making and the role of the company as a vehicle for wealth creation. Thus, for example, the codes recommend that the board be independent of management. While independence will go some way to ensuring propriety and establishing the board as a quasi-external body to monitor management in the interests of shareholders, independence can have considerable negative side effects on the quality of the business decisions made by the board. Directors who have no other relationship with the company will be unlikely to know much about the company, or about its particular line of business. Therefore, in making strategic decisions about the company's business, the board effectively is reliant either upon management or is making 'best-guess' decisions from an inadequate knowledge base. Neither outcome bodes well for the goal of wealth creation. It is thus not surprising that empirical studies of the effect of independent directors on company performance

[32] H A J Ford, R P Austin and I M Ramsay, *An Introduction to the CLERP Act 1999* (2000) 2.

have been unable to show any positive correlation.[33] The idea of the board as a quasi-external monitor of management also ignores the role that the board should play in setting the strategic direction of the company. While it is clear that the board should exercise control over management, the board also has an important role in determining the direction of the company's business and in making strategic business decisions. However, if the idea of board independence is to be taken seriously, as the codes suggest it should, then the board must remain distant from such decisions: the board cannot fulfil its oversight role if it has had a hand in the decisions it must review. The company is thereby denied the benefit of the skills and business acumen that presumably resides in the board.

IV CONCLUSION

A recent central concern of corporate governance reform is accountability. However, accountability is only one aspect of good governance. In addition, corporate governance is also concerned with the quality of decision making and enhancing the company as a vehicle for the creation of wealth. The recommendations of the ASX and Securities Commission, as with many such codes, seem overly concerned with corporate scandal and with rooting out corruption. While propriety in the management of companies may be a prerequisite for the health of the corporate sector, the mere absence of fraud cannot be an end unto itself. The principal justification for the existence of companies is the creation of wealth and prosperity. It is a pity that the Securities Commission, and to a lesser extent the ASX, did not devote more attention to this aspect of corporate governance.

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[33] Jeffrey Lawrence and Geof Stapledon, *Do Independent Directors Add Value?* (1999) University of Melbourne <http://cclsr.law.unimelb.edu.au/research-papers/Monograph%20Series/Independent%20Directors%20Report.pdf> at 19 May 2004.