14 June 2024

NZX Policy

Submission on the Second Consultation Paper on Director Independence

Glass Lewis appreciates the opportunity to comment on the aforementioned Consultation Paper, which relates to proposed amendments to the NZX Listing Rules and NZX Corporate Governance Code.

Founded in 2003, Glass Lewis is a leading, independent provider of global governance services that provides proxy research and vote management services to more than 1,300 clients throughout the world. While, for the most part, institutional investor clients use Glass Lewis research to help them make proxy voting decisions, they also use Glass Lewis research when engaging with companies before and after shareholder meetings.

Through Glass Lewis' web-based vote management system, Viewpoint, Glass Lewis also provides investor clients with the means to receive, reconcile and vote ballots according to custom voting guidelines and record, audit and disclose their proxy votes.

We have used the NZX Corporate Governance Code to inform our own Glass Lewis voting policy guidelines, which in turn informs our proxy voting research. We view the NZX Corporate Governance Code as a useful authority for informing the market as to local governance best practices and norms and see the periodic updates to the document as a seminal piece of work.

The responses provided below are not meant to be exhaustive but are designed to address what Glass Lewis sees as the main issues and concerns raised in the Consultation Paper. Thank you in advance for your consideration and please do not hesitate to contact us if you would like to discuss any aspect of our submission in more detail.

Respectfully submitted,

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Purpose: consultation questions

1. Do you have any comments in relation to the proposed amendments to the Code commentary in relation to the purpose of the director independence requirements?
2. Do you consider that any amendments should be made to the definition of the term 'Disqualifying Relationship' in light of the proposed purpose statement?
3. Do you consider that there would be merit in re-naming the definition of 'Disqualifying Relationship' to better reflect that non-independent directors are able to act in the best interests of an issuer? If so, do you have a preferred term (e.g. 'Restricting Relationship', 'Constraining Relationship')?

Our Response to Question 1

We support the proposed amendment in relation to the purpose of the director independence requirements.

Independence in mind and perception can be challenged in a myriad of ways and the examples listed in the Code do not provide an exhaustive list of all possibilities. It is also not practical for the Code to provide such an exhaustive definitive list. We view the purpose statement as facilitating discussion and consideration of director conflicts that are not explicitly listed and therefore allowing a broader consideration of director independence.

However the closing sentence of the amendment *''noting that both independent and non-independent directors are subject to dutites to act in the best interests of the company which are owed equally to all shareholders''* is unnecessary in our view and slightly undermines the importance of independence purpose statement.

Our Response to Question 2

The rationale provided by the Consultation Paper is reasonable and the 'Disqualifying Relationship' statement as it is appears fit for purpose. This is particularly the case given the inclusion of the purpose statement already provides for a broadening of independence considerations.

Our Response to Question 3

We do not have a strong view on the appropriateness of the term 'Disqualifying Relationship'. The term appears fit for purpose from our perspective, though the examples mentioned above are similarly fit.

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Independence assessment: consultation questions

1. Do you consider that a factor relating to a director's personal financial exposure to an issuer, such as an investment exposure should be included in the Code, noting that Code factor 2 addresses revenue derived from an issuer?
2. Should we propose a Rule requirement or include in the Code that long tenured (12 years or more) directors stand for re-election on an annual basis? Should this only apply to directors who have been determined to have no Disqualifying Relationship?
3. Is it a common practice for issuers to seek a self-attestation from directors, or director candidates, in relation to whether or not the director or director candidate has a Disqualifying Relationship?

Correction of Record – and expanding commentary

Page 16 of the Consultation Paper misrepresents a previous verbal submission we made.

With regard to the threshold at which a director's shareholding is considered an independence consideration, the Consultation Paper states *''CGI Glass Lewis also supported increasing the threshold, and* [a third party] *considered that the existing 5% threshold was too low.''.* We highlight this as a misrepresentation. We did not support the increase in the threshold in our previous submission. Instead we provided our view that expressing materiality in a percentage of shares has limitations and that a 1% shareholding of a large cap NZX-listed company would be much more material to the individual than a 5% (or 10%) shareholding of a micro cap.

Expanding on that commentary, we take a view that a 5% shareholding in any ASX50 entity will be a material holding impacting director independence in most cases. We additionally assert that a 5% shareholding is large enough to be the deciding vote in a significant number of special resolution proposals.

The risks to independence are therefore already high for a 5% shareholder, particularly when considering an acquisition that would lead them to exit their position. Given this view, raising the reference percentage beyond 5% appears excessive.

Our Response to Question 1

We view a director's personal financial exposure as a reasonable addition to the code as a factor in determining independence. Material financial exposure can impair independence in many ways, though most obviously when considering a corporate transaction that would lead a director to exit their shareholding.

We do not view the inclusion of ''revenue derived'' as a catch all for the financial exposure given that it is unclear whether this captures unrealized capital gains – which may well be the primary financial goal for a shareholding in any given year.

Our Response to Question 2

We have no strong view on the proposal to require annual re-election for longer tenured directors. On one hand, we are generally supportive of all director terms being shortened to one year to enhance accountability to shareholders. However, on the other, we do not see why directors should necessarily be elected on unequal terms from one another based on tenure. Imposing different re-election requirements based on tenure could create inconsistency in governance practices and may inadvertently suggest that all longer-serving directors are less effective or trustworthy than their shorter-serving counterparts. Having a mix of tenures can provide a balance of fresh perspectives and corporate knowledge.

Our Response to Question 3

Not applicable – the question is directed to issuers.

Composition settings: consultation questions

1. What would the benefits be to the integrity of an Audit Committee if the member who has an accounting or financial background, was also an independent director rather than a non-independent director?
2. How difficult would it be for issuers to adopt the amended recommendation 3.1 so that one member was both an independent director and had an accounting or financial background, noting this would operate on a 'comply or explain' basis?
3. Do you consider that NZX's current audit committee composition settings are appropriate from a market integrity perspective?
4. Are there any changes that you would propose to NZX's current audit committee composition settings? If so, how would those changes support market integrity, and enable greater compliance?
5. What would the benefits be to the integrity of the director appointment and independence assessment process if the Code recommended that an issuer's Nomination Committee was solely comprised of independent directors?
6. What are the difficulties that would be faced by issuers in adopting a recommendation that the Nominations Committee was comprised solely of independent directors?
7. Do you agree with the proposed changes to the Code commentary to recommendation 3.6 relating to the composition of takeover committees?

Our Response to Question 1

We support this change, as we believe that combining independence with the necessary expertise provides for a better oversight of the company's accounting policies and financial reporting. Independent directors are more likely to provide unbiased oversight, challenge assumptions and decisions made by management and other board members, and scrutinise financial decisions and policies without undue influence.

However, we recognise that, depending on the business's complexity, the collective experience of the committee may compensate for the absence of an independent member with an accounting or financial background. Therefore, we agree that this recommendation should follow a 'comply or explain' approach rather than being mandatory.

Additionally, we suggest that companies should disclose the specific qualifications and experience of directors classified as financial and accounting experts. Currently, there is no guidance on what constitutes financial and accounting expertise, leaving significant room for interpretation. In our practice, Glass Lewis typically classifies directors as audit and financial reporting experts if they are chartered accountants, certified practicing accountants, or current or former CFOs.

Our Response to Question 2

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We do not see any particular difficulty here though defer to the issuer community to represent themselves on this question. However, we suggest that this could be implemented through a regular board renewal process. Companies without an independent director with audit or financial expertise could clearly state addressing this gap as an objective in the next round of board renewal.

Our Response to Questions 3 and 4

We find the current NZX's audit committee composition settings generally appropriate and in line with best practices. However, we note that in the current setting, executive directors are allowed to sit on the committee, provided it remains majority independent. As the audit committee's primary role is to oversee the company's accounting policy and financial reporting, including the work of executives, having a member of senior management on the committee can present significant conflicts. Therefore, we suggest recommending that audit committees be comprised solely of non-executive directors.

Regarding non-compliance, we acknowledge that forming a majority independent audit committee with three members may not be feasible for less complex businesses with smaller boards. Allowing more flexibility in the composition requirements based on the size and complexity of the business and the board would likely facilitate greater compliance. For companies with three or four directors, it may be reasonable to permit two-person committees, provided both members are independent directors.

Our Response to Questions 5 and 6

We understand the rationale behind the proposed changed and recognise the potential benefits it my offer in providing better protection against the risks highlighted by the research conducted by Dr. Geng. In theory, a fully independent nomination committee could be more resistant to management's influence over the nomination process. However, we are not aware of any evidence to suggest that a material, additional value woud be gained above what is achieved by a majority-independent nomination committee.

The benefits of an all-independent committee would significantly hinge on the overall composition of the board and the company's shareholder base. There may be scenarios where implementing this requirement does not automatically lead to a more impartial nomination committee. For example, where a substantial shareholder nominee is constructively challenging the board and management but prohibited from the committee, or where the independent element of the board is most heavily influenced by a dominant CEO notwithstanding an absence of a Disqualifying Relationship. We believe that excluding substantial shareholders from engaging in the nomination process could be detrimental in certain cases.

The consultation paper rightly acknowledges the potential challenges faced by smaller issuers, which we find to be valid concerns. In such situations, it may be more beneficial to

opt for a majority-independent nomination committee, rather than having only two members on the committee or having no committee at all.

Overall, we believe that this change requires some further consideration.

Our Response to Question 7

We agree that a director's independence from the bidder and in relation to the proposed transaction is of utmost importance in the context of a takeover.

Additionally, we believe that a director's personal financial exposure can impact their independence in a transaction leading them to exit their position. While all shareholders seek the best price on exit, a director's personal circumstances can skew their risk and return tolerance versus diversified minority shareholders and also influence their preferred timing on exiting an investment. This risk is higher if their shareholding represents a significant portion of their personal wealth.

The proposed changes reflective of the emphaisis on independence from the bidder, but do not address our concern around personal financial exposure.

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Disclosure settings: consultation questions

Context: NZX are proposing Rule requirements that would require an issuer to disclose the reasons why the board has determined a director or director candidate to have no Disqualifying Relationship, if one of the Code factors contained in table 2.4 of the Code is present, along with the nature of the interest or relationship that triggered the factor:

- in a notice of meeting relating to the appointment, election or re-election of that director, and
- in a market announcement relating to a director's independence status.

1. Are there any practical concerns about this proposal from an issuer's perspective. What, if any, changes to existing processes and practices would issuers need to make in order to comply with the increased proposed disclosure obligations?
2. Are there any practical concerns from a director or candidate perspective around the proposals to include greater disclosure requirements on issuers in relation to the ssessment of a director's independence as described above?
3. If NZX introduces requirements for greater disclosure as set out above, for notices of meetings and market announcements, should Recommendation 2.4(c) be elevated to a Rule requirement to require this information also to be included in a notice of meeting, rather than reported against on a 'comply-or-explain' basis which is the current setting.

Our Response to Question 1
Not applicable – the question is directed to issuers.

Our Response to Question 2
Not applicable – the question is directed to directors and nominees.

Our Response to Question 3

We highly value detailed disclosures related to specific nominees in the notice of meeting. Best practice involves providing comprehensive information about the board's assessment of a director's independence, as well as the relevant skills and expertise the nominee brings to the board.

While this information may already be available in other documents such as the annual report or market announcements, reiterating it in the notice of meeting is beneficial. This approach ensures the information reaches a wide range of shareholders, enhancing transparency in the director (re-)election process. Providing more detailed disclosures in the notice of meeting will help shareholders make well-informed decisions with minimal additional cost to companies.

Therefore, we support elevating this recommendation to a requirement.

Director residence: consultation questions

1. Do you consider that it would be helpful for NZX to develop additional guidance as to how the term 'ordinarily resident' should be interpreted? If so, do you consider the proposed factors to be appropriate?
2. Do you consider that the residency requirements should be amended so that an issuer is required to have two directors who are resident in New Zealand or Australia?
3. Do you consider that the residency requirements should be amended so that an issuer is required to have only one director who is ordinarily resident in New Zealand?

Our Response to Questions 1, 2 and 3

As we are based in Australia we do not view ourselves as best placed to provide responses to these questions.

We note the primary purpose of the director residency includes being accountable to New Zealand based shareholders and response to those shareholders enquiries and therefore view New Zealand-resident stakeholder views are the relevant views on these matters.