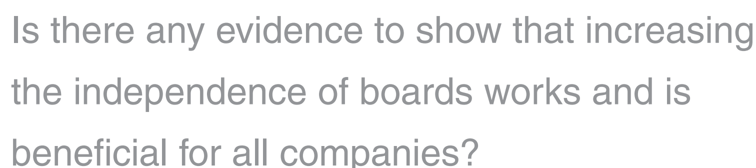
Do the NZSE listing rules destroy value?

By Megan Goldfinch

On October 29, 2003, the New Zealand Stock Exchange implemented changes to its listing rules regarding corporate governance regulation. It is now mandatory for listed companies to have a minimum of two independent directors on the board or to ensure that independent directors make up one-third of the board, whichever is greater. These changes are part of a global reform of corporate governance regulation that has taken place as a result of the recent financial scandals that have rocked the United States economy.

The hypotheses underlying these changes are that, first, the effectiveness of the board in monitoring management is a function of its independence and, secondly, more effective monitoring increases shareholder value. Independent directors are perceived to be able to carry out this monitoring role better than inside directors for two reasons. Firstly, they are not beholden to the CEO or to the company as inside directors are. Additionally, they are motivated to take an active monitoring role in the firm to preserve their reputation in the external labour market (Fama and Jensen, 1983). It is argued,



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therefore, that increasing the proportion of independent directors on the board will strengthen the monitoring capacity of the board and hence improve firm performance.

But is there any evidence to show this will work? The New Zealand approach in making compliance with the listing rules mandatory is similar to the rigid rules-based regime of the United States. This approach has drawn criticism for providing a simple "one size fits all" solution in imposing the same rules on all companies, despite their many differences in size, industry, shareholder composition, culture and performance. In New Zealand, the primary concern of critics of the proposal has been that not enough qualified independent directors are available to fill the positions, which will mean that quality will be sacrificed for independence. This is indeed of concern, but the question we should really be asking is: "Is there any evidence to show that increasing the independence of boards works and is beneficial for all companies?"

This article reviews the empirical literature on the relationship between board independence and firm performance. It should be noted that the empirical evidence is not from New Zealand and, as yet, none is available. This review demonstrates that the empirical tests fail to support the hypotheses that the effectiveness of the board in monitoring management and the resulting performance of the firm is a function of its independence. The results are mixed and some findings are directly at odds with the hypotheses.

In short, the prescriptive regulations that impose particular governance structures on firms, such as the mandatory requirement of two independent directors for firms listed on the NZSE, may not achieve the desired effect. In fact, they may force some firms to adopt suboptimal governance structures or deter some firms that operate in specialised industries and require board members with specific industry knowledge from listing altogether. This will ultimately harm firms' performances and, consequently, the NZSE itself and the New Zealand economy.

THEORY BEHIND PROPOSED CHANGES FOR NZSE LISTING RULES

What is the theory behind increasing boards' independence? The answer to this question involves an examination of why boards exist in the first place. Boards exist because of the "agency" problem that arises due to the separation of ownership and control that occurs in companies. Agency problems occur because of a divergence of interests between the agent and the principal (Milgrom and Roberts, 1992), or, in the case of public companies, the managers and the shareholders. Managers, as the agents, do not bear the full costs of their decisions because their interests are not necessarily in line with those of shareholders (Jensen and Meckling, 1976).

To ensure that managers act in the best interests of shareholders, it is necessary to monitor and oversee their activities. The board is charged with this responsibility as well as making decisions on behalf of the firm. In practice, however, a lot of decision making, particularly in large public companies, is delegated to management. So it becomes even more critical to ensure management is acting appropriately on behalf of shareholders.

When there is a wide distribution of shareholders, it is too costly relative to the expected payoff for any individual shareholder to do this. The board came into existence to carry out this role on behalf of shareholders. It serves an essential role as a market solution in helping to mitigate the agency problem by addressing the divergence of interest between managers and shareholders.

While the board is appointed to act on behalf of shareholders, it is itself comprised of individual agents whose interests are not necessarily in line with those of shareholders. The theoretical underpinning of the proposed NZSE listing rules changes is the belief that the effectiveness of a board's monitoring of management is directly related to its independence. This is because it is argued that only independent directors can be effective monitors.

Independent directors possess two characteristics

that are believed to enable them to fulfil their monitoring function. Firstly, their independence; they are not beholden to the company or management in any way. Secondly, they are concerned to maintain their reputation in the external labour market (Fama and Jensen, 1983). Fama and Jensen argue that outside directors have greater incentives to monitor management effectively to develop their reputation as decision experts and increase the value of their reputational capital. Therefore, their interests are said to be more closely aligned to those of the shareholders[1]. Directors of poorly performing firms, perceived to have done a poor job overseeing management, are less likely to become directors at other firms.

Insider-dominated boards, on the other hand, are seen to be a device for management entrenchment. There is scepticism as to insider directors' ability to appraise managerial performance effectively when they themselves are part of the management team. Additionally, they are not necessarily able to express their independent opinions about the company or management as their careers are tied to that of the CEO. Insider directors may also be motivated by factors other than shareholder wealth maximisation. For instance, they may try to increase the size of the firm beyond its optimal level for the purpose of empire building.

The status and remuneration of top management tends to be tied to the size of the firm rather than its performance so their motivation in expansion may be to increase their private benefits rather than firm value. Or they may be motivated to diversify the firm's portfolio of businesses so as to increase their job security (Jensen, 1986). For these reasons, many believe that a "monitoring board" composed almost entirely of outside directors is an important component of good corporate governance.

Corporate failures are often perceived to be a result of the failure of the board to adequately monitor management. After the widespread corporate failures in the late 1980s and the more recent corporate accounting scandals in the US, there has been criticism that boards are "captured" by management. There is a widespread belief that the optimal board composition has a high proportion of independent directors and that it is a market failure if this does not exist. Having a mandatory number of independent directors is seen as a solution to this market failure in that increasing the independence of boards will strengthen their monitoring capacity, thus making them more effective. This reasoning underlies the proposal for the minimum number of independent directors in the companies listed on the NZSE.

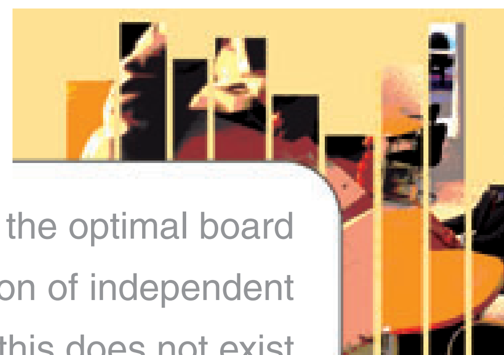
The empirical evidence is presented in the next section and shows that the evidence is far from supportive of the theory.

EMPIRICAL EVIDENCE

Taken as a whole, the empirical evidence does not provide support for proposals to increase the independence of corporate boards. While it is difficult to conclude whether increased independence improves or decreases firm performance either way, the evidence could be interpreted to lean against the theory.

Various methods can be used to test for the existence of a relationship between board composition and firm performance. The direct way is simply to measure performance and see if it is correlated with board composition. The advantage of this method is that it allows examination of the direct effect independent directors have on the firm's "bottom line". Testing for this relationship can be

[1] Kaplan and Reichus (1990) find evidence that is consistent with this argument.



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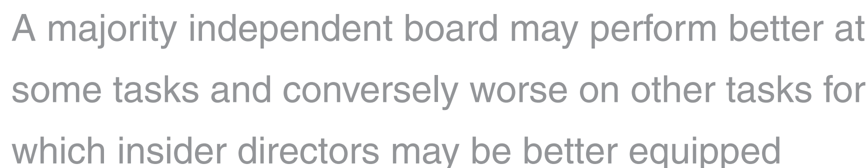


problematic, however, as it involves data gathered over a long period of time.

Researchers have conducted numerous studies testing for a direct relationship between board composition and firms' performance. Both stock-based and accounting-based measures have been used as proxies for firm performance. However, whichever measure is used, the research has produced mixed results[2]. Contrary to what is expected from the theory, some studies actually produce evidence that firms with a high proportion of outside directors may actually perform worse[3].

Another approach in testing for the benefits of independent directors involves examining the relationship between board composition and their performance on discreet tasks such as CEO replacement and executive compensation. The benefit of this method is that it provides more manageable data, which makes it easier to find statistically significant results. This method is, however, unable to determine the net effect of board composition on firm performance. A majority independent board may perform better at some tasks and conversely worse on other tasks for which insider directors may be better equipped. Therefore, while this method can give some indication as to the relationship between board independence and firm performance, it is unable to give conclusive evidence to the overall effect on firm performance.

Studies have also examined the relationship between a board's independence and the quality of its decisions relating to a number of issues such as CEO replacement, executive compensation, takeovers and the relationship between board independence and the incidence of financial fraud. Again the evidence is unclear. It is interesting to note, however, that studies which examined the incidence of financial fraud produced evidence which suggests that independent directors do help deter financial fraud and this interpretation supports the argument for reform. This aspect of the board's function is very topical right now in the wake of the corporate scandals over financial reporting in the US. However, the board of Enron was comprised mostly of independent directors. This shows an independent board is no guarantee against fraud.

Another method of testing for a relationship between board independence and firm performance is to look at the sharemarket reaction to the announcement of the appointment of the various types of directors. The advantage of event studies is that they are not complicated by many of the factors that hinder other methods of analysis. They control for firm-specific effects and test directly for the desired effect. Rosenstein and Wyatt (1990 and 1997), in two separate studies, examine the different stockmarket reactions to the announcement of the appointment, by management, of an independent director and, subsequently, an insider director. They find that the announcement of an outside director is accompanied by a significantly positive reaction, albeit small, of a 0.2 per cent increase in the stock price. This is despite the fact that most boards were dominated by outsiders at the time of the announcement anyway. This can be interpreted as outside directors being appointed in the interests of shareholders. But it may also be a signalling mechanism indicating the company plans to take action to sort out any problems it has. Additionally, this finding does not imply that outside directors are superior to inside directors and it is difficult to identify whether the results imply anything specific about the impact on firm value of adding an inside or outside director to the board.

On the whole, it is difficult to draw any definitive conclusions from these studies. None of the various testing procedures seems to produce conclusive evidence as to the benefits of independent directors. This suggests that the NZSE proposal, which mandates a minimum number of independent directors, lacks empirical support.

Before concluding that no correlation exists

[2] Klein (1998) finds evidence of a significant negative correlation between the change in market value of equity and the number of outside directors, but insignificant results for the return on assets and stockmarket returns.

[3] Early work by Vance (1964) reported a positive correlation between a number of firm performance measures and the number of inside directors on the board; and Bhagat and Black (2002) find evidence of a negative relationship between firm performance and board independence.

between board composition and firm performance, however, the reasons for the mixed empirical evidence relating to the benefits of independent directors should be examined. It may be that a relationship does exist, but is not being detected in the empirical tests.

EXPLANATIONS FOR LACK OF EMPIRICAL SUPPORT FOR RECOMMENDATIONS

Problems with accurately classifying directors as independent or affiliated may be a factor in the lack of empirical support for the theory. The common practice is to categorise directors according to three groups: inside directors who currently work for the firm; affiliated outside directors who do not work for the company, but have ties to the company[4]; and independent outside directors who have no such affiliation.

The possibility remains, however, that directors with affiliations are still being classified as independent. The classification is unable to distinguish directors who may have strong personal ties to the CEO or are beholden to the company in an obscure way. These ties are too subtle to be picked up in these definitions of independence and are probably too difficult to observe. But they may affect the results of empirical tests.

Another factor that may potentially be causing problems in the empirical tests is the direction of causation. That is, is board independence affecting firm performance, or is firm performance affecting board structure? Hermalin and Weisbach (1998) find evidence that poor firm performance may lead to an increase in board independence. In a cross-sectional regression that does not take the possibility of this effect into account, this is likely to make firms with more independent directors look as if they perform worse. This problem could explain the findings of the empirical research that found a negative correlation between the proportion of independent directors and firm performance.

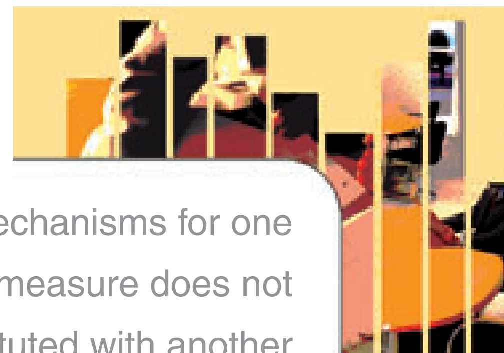
Additionally, there may be an interrelationship between governance mechanisms. This means firms may substitute corporate governance mechanisms for one another so that the absence of a particular measure does not imply bad corporate governance if it is substituted with another. For example, the absence of independent directors, as one corporate governance mechanism may be compensated for by the presence of large institutional shareholders who take an active interest in the monitoring of the company and its managers. As mentioned previously, the theory on boards of directors is relatively underdeveloped empirically. Perhaps a better understanding of the mixed empirical results can be achieved by looking at the role of the board in the broader context of the firm and other mechanisms that can help mitigate agency problems.

The board of directors is not the only mechanism that serves to resolve agency problems. A number of alternative mechanisms can be influential in ensuring management is acting in the best interests of shareholders. These can be either external[5] or internal mechanisms[6]. For instance, the market for corporate control relies on prospective acquirers to monitor managers. Evidence has been found of a substitution effect between independent board representation and block shareholder equity stakes, managerial shareholdings and inside director shareholdings (Rediker and Seth, 1995).

[4] They may be former company officers, relatives of company officers, people who are likely to have business ties with the company, including commercial bankers, lawyers, investment bankers and consultants.

[5] The external mechanisms include the threat of takeover (Grossman and Hart, 1980), leverage, and the managerial labour market (Fama 1980), that all work by having external parties monitor management.

[6] Examples of internal mechanisms include management ownership of equity, large outside owners and institutional owners (Demsetz and Lehn, 1985).



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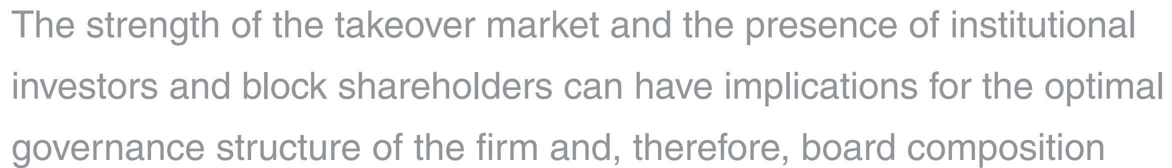


The strength of the takeover market and the presence of institutional investors and block shareholders can have implications for the optimal governance structure of the firm and, therefore, board composition

To the extent that these mechanisms can all minimise or reduce the agency conflict, one may be used as a substitute for another. Alternatively, the mechanisms may be complementary. It is necessary, therefore, to consider the existence of a relationship between the governance mechanisms in understanding the context in which the board of directors exist. To the extent that the governance mechanisms are interrelated, the performance of the firm may be a function of the efficiency of the governance structure of the firm, rather than just the monitoring of the board.

As there is evidence of substitutability between the different governance mechanisms, this makes the interpretation of empirical studies difficult. It may also explain the mixed results from the empirical tests that examined the relationship between firm performance and board composition.

OPTIMAL BOARD COMPOSITION ENDOGENOUSLY DETERMINED

While all the above reasons may explain the mixed empirical results as to the benefits of independent directors, perhaps the most plausible explanation for why empirical results are inconclusive as to the benefits of board independence is that the optimal board composition for each firm is endogenously determined. This means each firm has its own optimal governance structure that is determined by firm-specific factors and the institutional environment the firm faces.

The interrelationship between governance mechanisms means that firms need not rely on boards solely for relieving agency costs. Nor perhaps do some firms need the same degree of monitoring as others. A natural consequence of this is that each firm will have its own optimal board structure. Some firms will benefit from a more independent board, while other firms will perform better with boards that are dominated by insiders.

So what determines a firm's optimal governance structure? Alchian and Woodward (1987) argue that firms with higher costs in monitoring their activities will be organised with substantial owners as managers. Therefore, this governance mechanism may leave only a minor monitoring role for the board. Additionally, firms of this type are commonly in growth industries and which may be very specialised. It may be beneficial, therefore, for such firms to have an insider-dominated board that is then better informed to make strategic decisions for the company.

The industry in which a firm operates may also influence its governance structure. Firms in very specialised or technical industries may benefit from having an insider-dominated board whose members are better informed about the industry and strategic direction the firm should take. Independent directors may lack a comprehensive understanding in this matter. Firms such as these will then employ alternative governance structures to counter agency problems[7].

Institutional forces in the market are also instrumental in shaping firms' optimal governance structure. The strength of the takeover market and the presence of institutional investors and block shareholders can have implications for the optimal governance structure of the firm and, therefore, board composition. The US is said to have an active market for corporate control. This provides an incentive to managers to perform well as they face the threat of losing their job through a takeover if the company is not performing well.

There is evidence that the threat of takeover and the board of directors are substitute governance mechanisms for the monitoring of management (Brickley and James, 1987). Therefore, firms in the US may not require such an independent board. In contrast, the UK, another major international financial market, has a weak disciplinary takeover market (Franks and Mayer, 1996). The substitution hypothesis argues that firms in the UK will employ

[7] In a study of the insurance industry, Mayers, Shivdasani and Smith (1997) find evidence that mutual insurance companies that have weaker external control mechanisms have a higher proportion of independent directors on their boards than stock insurance companies. They also reported that firms which transformed from a mutual ownership structure to stock ownership, reduced the proportion of independent directors on their boards.

alternative governance mechanisms as monitoring devices. This may take the form of a more independent board of directors or they may have more insider ownership. Additionally, block holders and institutional investors, who are prevalent in the UK, could take an active role in monitoring firms.

To the extent that governance mechanisms interrelate, Agrawal and Knoeber (1996) suggest that insider ownership may facilitate an active takeover market. If managers hold an equity stake in the firm, they will be less opposed to a takeover that increases the value of their holdings. Having management on side makes the takeover process much easier. In contrast, block owners can make a takeover much more difficult. They can have the ability to oppose a takeover and raise the offer price which will deter potential acquirers. Therefore, a firm with this type of ownership is less likely to be a target for takeover and so will be less subject to the scrutiny of the market for corporate control.

It is interesting to note that the US has very low ownership concentration by international standards. This may explain the strength of its takeover market.

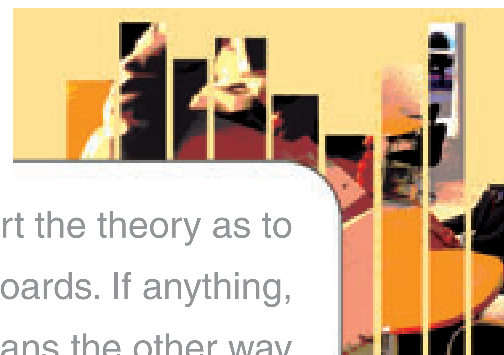
Applying this to the New Zealand context, the higher concentration of equity ownership may mean firms are sheltered from the scrutiny of the market of corporate control. In this case, firms may benefit from more independent boards. Alternatively, other monitoring mechanisms may play a greater role in overseeing the management of firms. The block holders themselves have the ability and incentive to monitor management so a weak takeover market does not necessarily mean the board needs to take a more active monitoring role.

To the extent that institutional features vary across markets and countries, this can mean that firms that are in all other aspects identical yet operate in different markets can have very different optimal governance structures and, correspondingly, board structures.

The mixed results from the empirical testing of the relationship between the composition of the board of directors and firm performance have a number of possible explanations. There may, in fact, be no relationship; it could be argued that a few board meetings a year do very little to affect firm performance. In assuming a relationship exists, however, the most plausible explanation is that governance mechanisms are interrelated and each firm, depending on its specific characteristics and the institutional environment it operates in, will have its own optimal governance structure. Given the cross-sectional variation in firms' capital structures, organisational structures, size and industry, it is naïve to assume otherwise. As one of the governance mechanisms, the optimal composition of the board of directors will thus be determined in this manner.

It is clear that the complexity of the interrelationships of the governance mechanisms along with their interaction with firm-specific factors and the institutional environment mean that it is impossible for an outside observer to prescribe one governance structure that is optimal for all firms.

There is no conclusive evidence to support the theory as to the benefits of independent-dominated boards. If anything, it could be argued that the evidence leans the other way. This implies that prescriptive regulations requiring that all firms' boards have a minimum number of independent directors will impose a suboptimal governance structure on some firms, effectively causing them harm and reducing their values. Despite the evidence, however, it is the horror stories such as Enron and, more recently, Parmalat in Italy that grab the headlines and prompt public cries for reform.



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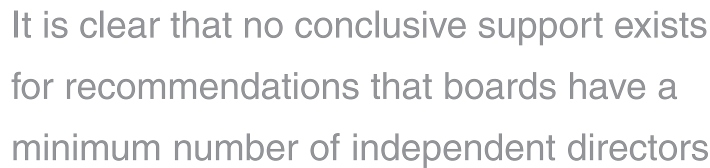

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And it is this that will influence regulators such as the NZSE in an attempt to restore public confidence in the exchange.

CONCLUSION

The collapse of large, high-profile companies in recent times is largely perceived to be a result of the failure of the board of directors to adequately monitor their respective companies. A solution to this is seen to be increasing the number of independent directors on the board and as a result the NZSE now requires firms listed on the exchange to have a minimum of two independent directors on the board of directors.

This article reviews the empirical literature on the correlation between board independence and firm performance with the objective of determining whether there is empirical support as to the benefits of independent directors. On the whole, little evidence is available to suggest that increasing the number of independent directors will lead to improved firm performance. And it could be argued that the bulk of the evidence suggests a negative correlation between increasing proportions of independent directors and firm performance.

It is proposed that the empirical results are mixed because the board of directors is only one of a number of interrelated governance mechanisms that help to mitigate agency problems. Furthermore, the optimal governance structure for a given firm will be endogenously determined with respect to firm-specific factors and the institutional environment the firm faces. Therefore, the optimal composition of the board will also be endogenously determined. Evidence suggests that the composition of the board responds to, among other things, a firm's growth opportunities (Lasfer, 2000), the industry the firm operates in (Mayers, Shivdasani and Smith, 1997) and the market for corporate control (Brickley and James, 1987). Additionally, it is proposed that market forces will provide incentives for firms to adopt their respective optimal governance structures. The key point is that firms will tend toward their own optimal governance structure. Firm-specific factors and institutional forces will determine this, and market forces, if left to their own devices, will lead the firm toward this structure.

It is clear that no conclusive support exists for recommendations that boards have a minimum number of independent directors. Mandatory compliance with these prescriptive requirements may actually impose suboptimal governance structures on some firms. This will, in turn, lead to a negative effect on firm value. While it is acknowledged that the majority of firms listed on the NZSE will not have to alter their board structure to satisfy the new requirements, the new rules may deter some firms from listing in the first place. This is most likely to affect those firms in highly specialised fields that require board members with company and industry-specific knowledge. These are exactly the type of companies the NZSE is supposed to be encouraging in moving New Zealand toward a "knowledge economy". Should the new listing rules have a deterrent effect, this will have serious consequences for the NZSE and the overall New Zealand economy.

Megan Goldfinch
ANALYST
Corporate Finance
Deloitte

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