NEW ZEALAND'S EXCHANGE
TE PAEHOKO O AOTEAROA

Director Independence

Second Consultation Paper

May 2024

CONTENTS

This Consultation Paper has been prepared by NZX to seek comment on the proposals contained in the paper, with a view to ensuring that the proposals will enable NZX to operate its markets on a fair, orderly and transparent basis. The proposals set out in this paper do not reflect NZX's concluded views of the matters raised. Capitalised terms which are not defined in this Consultation Paper have the same meanings given to them in the NZX Listing Rules.

Context for the review

Why are we reviewing the director independence settings?

We are reviewing the settings contained in the NZX Listing Rules (**Rules**) and NZX Corporate Governance Code (**Code**), because of stakeholder feedback (particularly from the investor community) that NZX's current regulatory settings relating to director independence should be enhanced. These stakeholders considered that NZX should provide a clearer articulation of the purpose of the requirements, and that NZX should undertake a review of the adequacy of the existing settings to protect the interests of minority shareholders.

While some issuer and legal firms questioned the need for this review through the initial consultation process, suggesting that there was no problem to solve, NZX considers it appropriate to proceed with the review in light of broader stakeholder and submitter feedback.

NZX wishes to ensure that its regulatory settings continue to support the operation of NZX's markets on a fair, orderly and transparent basis, by promoting good governance and acknowledging that an effective board should include a balance of independence, skills, knowledge, experience, and perspectives, as reflected in Principle 2 of the Code.

Objectives of the review

NZX is undertaking this review, with the objectives of ensuring that NZX's regulatory settings:

- appropriately articulate the purpose of the director independence requirements,
- are correctly calibrated to appropriately manage the inherent conflict of interest that they are designed to address, in the context of the relative value of independence as a performance factor,
- enable access for investors and other stakeholders to information about issuers'[1] corporate governance practices relating to director independence to facilitate efficient allocation of capital, and
- promote good governance practices that support the generation of long-term benefits for issuers' shareholders.

These objectives have been designed to enable NZX to enhance the operation of its markets on a fair, orderly, and transparent basis, consistent with NZX's obligations under the Financial Markets Conduct Act 2013.

[1] The requirements for director independence and reporting obligations against the Code do not apply to issuers with only quoted debt securities or quoted fund securities. The reference to an 'issuer' in this paper is to a listed issuer of quoted equity securities.

Introduction

Background to this consultation

The review of NZX's director independence settings was foreshadowed in the 2022 Code review. NZX commenced consultation in relation to this review in May 2023, with the release of an initial consultation paper that sought in principle feedback from submitters to assist NZX in designing specific proposals for further consultation.

NZX received excellent engagement through the first round of consultation, receiving 20 submissions in total from law firms, investor organisations, issuers, individuals, Chartered Accountants Australia, and New Zealand (**CAANZ**), the New Zealand Shareholders' Association (**NZSA**), the New Zealand Corporate Governance Forum (**NZCGF**), the Institute of Directors (**IoD**), the Listed Companies' Association (**LCA**), and proxy advisor CGI Glass Lewis.

NZX established the NZX Corporate Governance Institute (**NZX CGI**) in late 2022. The NZX CGI is comprised of a broad cross-section of members representing institutional and retail investors, board directors, a cross-over member from the ASX Corporate Governance Council, legal advisors, and academics. This review was one of two core projects for the NZX CGI in 2023. The NZX CGI provided extremely valuable insights and assisted NZX in the design of the proposals described in this consultation paper. This paper outlines the views of the NZX CGI in relation to the proposals, including in relation to the need for NZX to enhance its protections for minority shareholders in relation to director independence, where there were differing views among NZX CGI members.

One of NZX's objectives in the development of its regulatory policy is to ensure that it is evidence based. As one of the inputs to this review the NZX CGI commissioned research from Dr. Griffin Geng at Victoria University, which provided valuable analysis and was also used to inform the development of the proposals. We have published Dr. Geng's research alongside this paper. In addition, NZX has validated its proposals by benchmarking the practices adopted by comparable international exchanges in relation to certain proposals contained in this paper.

How can I contribute to this consultation?

Provide a submission

We invite interested parties to provide their views on the proposals described in this consultation paper, and that are contained in the Exposure Draft of the Rules and Code by emailing NZX Policy. We are interested in general feedback in relation to the proposals, and have raised specific consultation questions to prompt feedback in certain areas.

Alternatively, if you would prefer to provide a verbal submission, please email NZX Policy to arrange a time to speak with us.

You can contact NZX Policy at: policy@nzx.com

The closing date for submissions is **14 June 2024.**

NZX may publish the submissions it receives, so please clearly indicate in your submission if you do not wish for your submission to be published, or identify any part of your submission which contains confidential information.

Participate in one of our workshops

We intend to hold workshops in relation to certain aspects of this consultation in late May 2024 and early June 2024.

If you have previously provided us with a submission as part of the initial discussion document, or are part of NZX Policy's distribution list, we will automatically invite you to participate in these sessions. If you would like to be added to our contact list for these sessions, please email us at policy@nzx.com.

If you have any queries in relation to the review, please contact:

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Executive Summary

NZX is proposing amendments to the Code and Rules which are contained in the accompanying Exposure Drafts of those documents. It is intended that any amendments to the Code that are implemented as a result of the review, will take effect for a listed entity's first full financial year commencing on or after 31 December 2024.

The key proposals are:

- the inclusion of a statement as to the purpose of the director independence requirements in the Code, to better articulate why the requirements are needed, including because of the unique features of listed rather than private entities due to the spread and composition of a listed issuer's shareholder base.
- no change to the "Disqualifying Relationship" definition contained in the Rules.
- the retention of the board composition settings relating to director independence, and changes to the Code recommendations relating to the composition of an issuer's Audit and Risk Committee, and Nominations Committee.
- additional requirements relating to the information to be included in notices of meeting, and announcements of a board's determination of a director's independence.
- not to introduce additional minority shareholder protections to provide minority shareholders with greater control over the appointment of independent directors.

Consultation questions are included with the discussion of each of these proposals. In addition, NZX welcomes submitters' more general views relating to the director independence settings. We have included a summary of the current settings relating to director independence as an Appendix to this paper.

Director Residency

We are also including within this review new proposals relating to director residency. Rule 2.1.1 requires that an issuer's board includes two directors who are ordinarily resident in New Zealand. We are consulting on whether this requirement should be amended such that an issuer is required to have:

- two directors who are ordinarily resident in New Zealand or Australia, or
- one director who is ordinarily resident in New Zealand.

This proposal is discussed further in section 6 of this paper.

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Consultation Snapshot

As there are a number of discrete proposals contained in this consultation. we have set out in the table below a snapshot of the proposed changes to NZX's regulatory policy relating to director independence and residency. The table identifies where the proposal is contained in this paper, and the Exposure Draft of the Rules and Code that accompany this paper.

Consultation Proposal	Consultation Paper	Exposure Draft
Purpose		
Inclusion of a purpose statement for director independence in the Code	Section 1.1 and 1.2	Code Commentary (recommendation 2.4)
Independence Assessment and Code factors		
SPH: Change the Code factor relating to substantial product holdings from 5% to 10%	Section 2.2	Code factor 6 (recommendation 2.4)
Personal Wealth: *New Code factor- shareholdings representing a significant portion of a director's personal wealth (preliminary feedback sought).*	Section 2.2	
Tenure: *New Code commentary to encourage long-tenured directors to stand for annual re-election (preliminary feedback sought).*	Section 2.3	
Process: Clarify expectations for issuers to obtain information relating to a director's interests and relationships.	Section 2.4	Code Commentary (recommendation 2.4) Rule 2.6.5
Process: Disqualifying Relationship director self-attestation	Section 2.5	
Composition settings		
Audit Committee: Code recommendation that one member to be an independent director and have an accounting or financial background.	Section 3.2	Code recommendation 3.1

Consultation Proposal	Consultation Paper	Exposure Draft
Nomination Committee: Code recommendation that all members be independent directors.	Section 3.4	Code recommendation 3.4
Takeover Committee: Code commentary clarification that members do not need to be independent directors but should be independent from the bidder and holders who have accepted the offer.	Section 3.5	Code commentary (recommendation 3.6)
Disclosures		
Notice of meeting: disclose identity of a shareholder who has nominated a director candidate.	Section 4.1	Rule 7.8.3
Notice of meeting: greater disclosure of independence assessment when Code factor applies.	Section 4.1	Rule 7.8.3
Market announcement: greater disclosure of independence assessment when Code factor applies.	Section 4.2	Rule 2.6.4 (new)
Director residency		
Ordinarily resident: *Develop guidance as to the interpretation of "ordinarily resident" based on the Carr decision (preliminary feedback sought).*	Section 6	
Composition: *Amend the director residency requirements to 2 directors who are domiciled in Australia or NZ; or* *Amend the director residency requirements so only 1 director must be domiciled in NZ.(preliminary).*	Section 6	

1 Purpose of the Requirements

1.1 Inclusion of a Purpose Statement

Development of the proposal

Stakeholders have noted that neither the Code nor the Rules clearly articulate the purpose of the director independence requirements. In the initial consultation paper, NZX consulted on whether it was appropriate to clarify the purpose of the director independence requirements, noting NZX's preliminary view supporting a purpose statement.

In the initial consultation some issuer and law firm submitters expressed concern that including a purpose statement may cause further ambiguity and confusion in the Rules, and reinforce the negative stigma associated with non-independence. However, the NZX CGI, LCA, certain legal advisors and the investor and broader stakeholder pool supported the inclusion of a purpose statement. NZX considers that concerns regarding the inclusion of a purpose statement causing complexity and confusion can be addressed through a careful articulation of the purpose statement.

Proposal

NZX therefore intends to include a statement as to the purpose of the director independence requirements in the commentary to the Code, to provide further guidance to issuers when interpreting the Rule and Code settings.

1.2 Nature of the Purpose Statement

Development of the proposal

In the initial consultation, NZX consulted on an appropriate articulation of a purpose statement. We also sought submitters' feedback on the nature of the conflicts that the director independence settings were intended to address.

Issuers, their legal advisers, and NZICA generally considered that the purpose of the requirements was to ensure that independent directors can bring independent challenge to the board, and to ensure that independent directors have independence of mind. These submitters generally considered that the independence requirements had a different purpose to the 'conflict of interest' protections in the Companies Act 1993 (**Companies Act**) and the Rules. Some legal adviser submitters noted that the independence requirements were designed to promote robust corporate governance and further an issuer's long-term sustainability, through a focus on acting in the best interests of the company, this view was also supported by some investor submitters.

Investor groups generally had a different perspective, and considered that the key role of the director independence requirements was to ensure that the conflicts between management and the board were adequately addressed to reduce shareholder agency costs. These submitters also felt strongly that the independence settings should enable a board to address conflicts between shareholders with different interests (particularly dominant shareholders). Some of these submitters also acknowledged that the

requirements supported confidence for the markets and greater thought diversity and effectiveness in decision-making.

The NZX CGI considers that the two different views of the purpose of the requirements are not necessarily inconsistent with one another. The NZX CGI acknowledges that directors' duties require a director to consider the best interests of all shareholders, and that these duties apply to both independent and non-independent directors.

NZX considers that publicly listed companies have unique features which are distinct from those of private companies, which arise from the spread and composition of an issuer's shareholder base. This creates a greater potential for shareholder agency risk[2], and for competing interests to arise between minority and majority shareholder groups. Some examples of scenarios in which these conflicts may manifest are included in the research paper that has been provided by Dr. Geng, including in relation to the consideration of CEO compensation, and corporate acquisitions.

While we have not identified an express purpose statement included in the requirements in the settings of other international exchanges, most of the exchanges we have reviewed[3] include reference to the concept that an independent director may bring independent judgment to the consideration of the issues before the board. NZX considers that non-independent directors are also able to bring an independent view when making decisions, as these directors are required to discharge their legal duties in the interests of all shareholders, even where they have a relationship or interest that triggers the Disqualifying Relationship definition.

NZX considers that part of the rationale for the director independence requirements is also to ensure that there are a sufficient number of directors who are unlikely to have relationships that could cause the conflict-of-interest provisions of the Rules and legislation to be triggered (noting that those requirements are transactional in nature) or could result in a perception that they are unable to exercise independent judgment.

Proposal

NZX is proposing amendments to the Code commentary that are designed to better articulate the purpose of the director independence requirements. The inclusion of this commentary does not create any additional obligation or reporting obligation (noting the Code operates on a 'comply or explain' basis) on issuers. It is intended to act as additional guidance to assist issuers in better understanding the rationale for the requirements, particularly to assist issuers when considering the application of the Disqualifying Relationship test (include the Code factors) to a director.

The proposed amendments are designed to reflect both perspectives, that the purpose of the requirements is to ensure that there are a sufficient number of directors on an issuer's board who do not have relationships or interests that would reasonably cause them to be, or perceived to be, aligned in a material way with management or a particular shareholder group. The requirements are also designed to provide comfort that an issuer's board is comprised of members who do not have interests or relationships that could reasonably

[2] As noted by Dr.Geng, a fundamental conflict arises from the separation of ownership (shareholder) and control (managers). Directors who are elected by shareholders to represent and protect their interests play a vital role in balancing the principal-agent dynamic.

[3] Including ASX and SGX.

be considered (or could reasonably be perceived) to materially affect their capacity to bring an independent perspective to board decision making.

We intend to specifically recognise that both independent and non-independent directors are subject to duties to act in the best interests of the company which are owed equally to all shareholders, and that non-independent directors are also able to bring an independent view when making decisions.

1.3 Disqualifying Relationship Definition

Development of the proposal

We also consulted on the extent to which amendments should be made to the definition of 'Disqualifying Relationship' contained in the Rules.

The current definition is set out below:

> **Disqualifying Relationship**
>
> means any direct or indirect interest, position, association or relationship that could reasonably influence, or could reasonably be perceived to influence in a material way the Director's capacity to:
>
> (a) bring an independent view to decisions in relation to the issuer,
>
> (b) act in the best interests of the issuer, and
>
> (c) represent the interests of the issuer's financial product holders generally,
>
> including having regard to the factors described in the NZX Corporate Governance Code that may impact director independence, if applicable.

In the initial consultation, we asked whether the definition should be more aligned to the purpose of the requirements, by either: being expanded to refer to the ability for a director to conduct themselves and exercise judgment in an independent manner; or to provide more focus on ensuring independence from management and shareholders.

Most issuer and law firm submitters did not support expanding the Disqualifying Relationship test to include 'independent manner and judgment', noting that this was likely to cause confusion by suggesting that a non-independent director might not be able to conduct themselves in an independent manner. While some law firms' views, NZSA, and CGI Glass Lewis, supported the inclusion of 'independent manner and judgment' which was regarded as encouraging a less 'bright-line' approach to the application of the Code factors, and to better reflect the core principle of independence of thought. The NZSA also noted that it would be difficult for shareholders to assess for themselves and validate directors' statements as to whether a director can act in an independent manner and exercise an independent judgment.

ACC and the NZCGF supported narrowing the Disqualifying Relationship test so that it was more focused around the potential for agency risk and the potential ability for a director to represent minority holders. These submitters considered that the perspective

from which to assess whether there was a perceived conflict was from that of the non-conflicted financial product holders.

Proposal

NZX does not propose any changes to the definition of Disqualifying Relationship as set out in the Rules, in light of the proposal to provide further guidance as to the purpose of the requirements through amendments to the Code commentary.

NZX considers that it is important to recognise that the focus of the definition is on the material *influence* of a relationship or interest on the Director's *capacity* to act in a manner outlined in limbs (a) to (c). This differs from a determination that a relationship or interest will, in fact, prevent a director from bringing an independent view to decisions in relation to the issuer, acting in the best interests of the issuer, or representing the interests of the issuer's financial product holders generally, as this would give rise to a situation where an issuer's board was in effect determining that a director was unable to fulfil directors' duties[4]. This is important because it ensures that a broader group of interests and relationships will cause a director to have a Disqualifying Relationship, and because it is consistent with NZX's views that non-Independent Directors may also bring an independent view to decision-making.

NZX agrees with the views of submitters that it could be confusing if the concept of the ability for a director to exercise judgment in an independent manner is brought within the definition of Disqualifying Relationship, for example by taking the approach in Singapore that "an independent director is one who is independent in conduct, character and judgment"[5]. We consider that it would be difficult for a board to assess this at the time a director was appointed (as this would appear to require consideration of the director's actual decision making). We also consider that limb (a) of the definition sufficiently encapsulates the concept that a director does not have interests or relationships that could be perceived to affect the director's capacity to bring an independent view.

In our view, narrowing the definition so that it is more focused on interests or relationships that give rise to a perception of alignment with majority holders is unnecessary as this is sufficiently addressed through limb (c) of the definition, and the Code factors (which include factors designed to identify relationships with substantial holders).

We do not consider that retaining limb (a) of the definition is inconsistent with these considerations, noting our proposal around the inclusion of a purpose statement in the Code commentary, and the approach taken by international exchanges which generally includes consideration of relationships and interests that may materially affect a director's ability to bring an independent view to decision making.

[4] This is consistent with the approach taken in the Financial Reporting Council's UK Corporate Governance Code 2024 which focuses on interests or relationships that are likely or could impair a director's independence.

[5] Provision 2.1 of the SGX Code of Corporate Governance, January 2023.

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')?

2 Independence assessment and Code factors

The review also includes consideration of the test for independence and how it should be applied by listed issuers, including the nature of the factors relating to Code recommendation 2.4 that may impact director independence.

2.1 Code factor – cross directorships

Development of the proposal

In response to the initial consultation paper, certain submitters provided their views as to whether cross-directorships should be included as a factor in the Code that may indicate a lack of independence.

Two legal adviser submitters did not support the inclusion of a factor relating to cross-directorships as an indicator of a lack of independence, noting frequency of this practice in New Zealand, and that cross-directorships can foster open and frank dialogue. LCA did not support the inclusion of cross-directorships as a Code factor, and the IoD also considered that conflicts arising from cross-directorships were best addressed through the conflict-of interest provisions.

Proposal

NZX understands that while the UK Financial Reporting Council includes cross-directorships within its Corporate Governance Code[6], that it is not common for international exchanges to refer to cross-directorships as factors that may indicate a lack of independence. NZX notes that a new factor was introduced into the Code as a result of the 2022 review which relates to close personal relationships (including close social or business connections) which may somewhat address the concern that cross-directorships may affect a director's capacity to bring an independent view to decision-making where a director has formed a close personal relationship with another director resulting in "group-think".

NZX also considers that cross-directorships go beyond the management of matters which the director independence requirements are primarily proposed to address (agency risk and ensuring a director is not aligned with a particular shareholder group), as described in more detail above. We consider that concerns about cross-directorships, above those which are addressed through the close personal relationship Code factor, primarily relate to the time that a director has available to perform a directorship, rather than independence.

We do not propose to introduce cross-directorships as a Code factor that may indicate the presence of a Disqualifying Relationship.

[6] Provision 10, UK Financial Reporting Council, Corporate Governance Code 2024.

2.2 Code factor – director shareholdings

Development of the proposal

The Code currently includes substantial product holdings as a factor which the board of an issuer should consider when assessing whether a director has a Disqualifying Relationship. NZX interprets the threshold at which a director has a substantial product holding as 5% of a class of quoted voting products of an issuer, which is consistent with the treatment contained in the Financial Markets Conduct Act 2013 (**FMC Act**).

In our initial consultation paper, we consulted on whether the 5% threshold should be increased.

Submitters had mixed views as to whether the consideration of the level of a director's shareholding was relevant to concerns around agency risk being created due to the holding's relevance to the director's personal wealth causing horizon span issues, or whether the level of a director's shareholding was an indication of a relationship that might affect the director's capacity to represent the interests of all shareholders (including minority holders).

Several law firms suggested raising the threshold from 5% to 10% to align with the Rule requirements for Related Party transactions. Some of these submitters noted that a director's shareholding was more likely to align the interests of the director with shareholders (including minority shareholders). The LCA supported increasing the threshold from 5% to 15% on the basis that this level of shareholding would reflect a level of interest whereby the director might be perceived to be more aligned with majority shareholders. CGI Glass Lewis also supported increasing the threshold, and ACC considered that the existing 5% threshold was too low.

The NZCGF generally considered that 5% remained an appropriate threshold at which a board should start to actively consider the effect of the shareholding on a director's independence and noted that in general, the interests of minority shareholders will not be completely congruent with the interests of substantial shareholders.

NZX notes that the ASX is currently consulting on a proposal to include a 10% holding rather than a substantial product holding with the ASX Corporate Governance Code as a factor that may be relevant to the assessment of a director's independence.

Proposal

We propose to increase the threshold at which a director's shareholding in an issuer may indicate a Disqualifying Relationship from 5% to 10%. NZX considers that the primary reason the Code contemplates a director's shareholding in an issuer as an interest that should be considered by a board when assessing a director's independence, is to ensure that there is consideration of the effect of that interest on the director's capacity to represent different shareholder groups, and that 10% is a more appropriate threshold in this context.

NZX notes that the factors in the Code are not an exhaustive list of the interests, positions, and relationships that a board should consider when assessing the independence of a director, and that in all cases the materiality of the interest, position or

relationship should be assessed when determining whether a director has a Disqualifying Relationship.

The Code also contains a separate factor relating to whether a director is currently, or has within the last 12 months, derived a substantial portion of annual revenue from the issuer. This factor is more closely aligned with horizon span issues and agency risk. This factor could be expanded to include shareholdings that represent a significant proportion (suggested by one submitter to be 5%) of a director's personal wealth, however interests that a director has acquired through personal investment do not necessarily indicate an increased agency risk through a close relationship with management. In addition, the conflict-of-interest requirements under the Rules and Companies Act should operate to appropriately manage conflicts in relation to specific transactions. We are interested in further views from submitters relating to the inclusion of an additional Code factor relating to a director's personal wealth exposure to an issuer.

2.3 Code factor – tenure

Development of the proposal

In our initial consultation, we consulted on how the benefits of long tenure should be weighed against the effects of long tenure on a director's independence. We noted that NZX had recently amended Code factor 8 to clarify that NZX considers long tenure to be tenure of 12 years or more, as an outcome of the 2022 review of the Code.

The majority law firm and issuer view was that long tenured directors bring significant benefits to the operation of a board. One submitter considered a director could be both long tenured and independent, however the majority view was that at some point tenure did result in a lack of independence. This is consistent with the benchmarking of academic research that was conducted by Dr. Geng which cites a 2018 study which found that while an increase in board tenure correlates with a rise in firm value up to a certain threshold, beyond this point, it negatively impacts firm value, which the research attributed to the trade-off between the accumulation of firm-specific knowledge and the preservation of board independence[7].

Two submitters suggested mirroring the approach taken in Australia, to include commentary in the Code that independence should be regularly assessed when a director's tenure exceeds ten years.

The LCA and two law firms supported a flexible approach to tenure. They noted that an issuer's corporate and management structure could result in different levels of tenure affecting a director's independence status and that the rotation requirements in the Rules provide shareholders with a mechanism to remove a long tenured director.

ACC noted the value of a long tenured director to board performance but did not regard these benefits as relevant when assessing whether tenure caused a director to be non-independent. ACC considered that long tenure increased perceived agency risk and should give rise to a determination of a lack of independence. The NZCGF noted its support for a 9 - 10 year period after which a director should be considered long tenured,

[7] Huang, S., & Hilary, G. (2018). Zombie board: Board tenure and firm performance. Journal of Accounting Research, 56(4), 1285-1329.

noting that the consequence of long tenure and a determination of independence, was that a disclosure requirement was triggered for an issuer to explain why despite an director's long tenure the board considered the director to be independent.

The NZSA noted that it does not consider tenure to be a barrier to independence but rather a factor to be considered when ensuring effective succession planning.

One submitter noted that Rule 2.7 requires a director to rotate every three years, and considered that there would be some merit in requiring more frequent rotation for long tenured directors to ensure that shareholders have the ability to terminate a director's appointment, including in circumstances where shareholders disagree with the board's assessment of the director's independence. NZX is interested in the views of submitters as to whether commentary to this effect should be included in the Code or as a Rules requirement.

Proposal

NZX remains comfortable with the settings in the Code that after a period of 12 years a director should be considered long tenured. NZX agrees with the views of some submitters that the effect of long tenure on a director's independence will depend in part on the agency risk that it creates, which may be affected by other factors relating to the issuer, such as changes in senior management, and is therefore proposing minor amendments to the Code commentary in this regard.

We are interested in submitters' views as to whether the Code commentary or Rules should be amended to note that an issuer may wish to consider ensuring that a director who has had continuous tenure as a director of the issuer for a period of 12 years' or more stand for re-election on an annual basis. We have not included this as a proposal in the Exposure Draft materials.

2.4 Arrangements for updating interests and relationships

Development of the proposal

In our initial consultation paper we asked for feedback as to whether the Rules should require an issuer to have arrangements in place, to ensure that directors provide sufficient information about their interests and relationships that are relevant to the determination of whether a director has a Disqualifying Relationship. This is implicit in Rule 2.6.4 which requires an issuer to be responsible for ensuring that Directors provide sufficient information to enable the board to make a determination under Rule 2.6.1.

The majority of legal advisory and issuer submitters, including LCA, noted that the conflict-of-interest provisions of the Rules and the Companies Act and considered these were sufficient to ensure that boards were provided with updated information in relation to a director's relationships and interests. LCA suggested the Code commentary could reinforce expectations around issuers having arrangements to ensure directors provided up to date information.

The NZSA considered that there should be more obligations to ensure that interests and relationships are disclosed by directors. The NZCGF also supported further requirements for directors to provide greater disclosures around changes in relationships and interests.

Proposal

NZX is proposing amendments to the Code commentary to recommendation 2.4, to note that issuers should have arrangements in place to ensure directors provide up to date information as to interests and relationships that are relevant to the board's assessment of independence, and to note the obligations in current Rule 2.6.3 and 2.6.4. We are also proposing a clarifying amendment to current Rule 2.6.4 (Rule 2.6.5 in the Exposure Draft).

NZX considers that these amendments are appropriate as Section 140 of the Companies Act applies more narrowly to transactions, and Rule 2.10 prevents directors voting on 'matters' in which they are interested adopting the section 139 test (which relates to personal financial interests in transactions). Therefore, the interests and relationships which directors are required to disclose for the purpose of the conflict-of-interest provisions are narrower than those which would indicate a Disqualifying Relationship.

We consider that it is useful to clarify this point, although we understand that in practice many issuers include interests and relationships in their interest registers that are broader than those that are required to be disclosed in order to satisfy the conflict of interest requirements. We consider it more appropriate to reinforce expectations in this area through the Code commentary, rather than creating Rules based obligations.

2.5 Director self-attestation relating to independence

Development of the proposal

One law firm submitter suggested that accountability for ensuring director independence could be enhanced if NZX were to impose a Listing Rule requirement for a director to provide a self-attestation that there is no restriction on the director's ability to conduct themselves in an independent manner and exercise independent judgement. This submitter suggested that such a requirement would encourage independent director candidates to undertake more robust due diligence before accepting appointments.

NZX is not aware of other exchanges' corporate governance codes specifying expectations around the independence assessment process. NZX considers that any obligation or expectation in this area would need to apply to the issuer rather than directly to the director.

Proposal

NZX is further considering whether to amend the Code commentary to suggest that an issuer should consider whether it would be appropriate to include within its independence assessment process, a procedure that a director provide the issuer with a self-attestation in respect of whether that director has a Disqualifying Relationship.

We would like to better understand current market practice and whether this is something that occurs routinely in the market to determine whether such an amendment would be appropriate.

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?

3 Composition settings

3.1 Board composition

Development of the proposal

The Rules currently require an issuer's board to have at all times, at least two Directors who are Independent Directors (excluding alternate Directors). In addition, Code recommendation 2.8 recommends that a majority of an issuer's board should be independent. The current requirements are described in the Appendix to this paper.

In our initial consultation, we sought submitters' views as to the level of independence that is necessary for the board to operate effectively as a whole, noting our expectation that standard conflict management arrangements should ensure that conflicts are appropriately managed in relation to specific matters and transactions.

The majority of legal adviser submitters were comfortable with the existing Board composition settings. Two law firms favoured softening the settings to reflect the approach taken in Australia where there is no requirement for independent directors contained in the Listing Rules (rather the ASX Code recommends a majority of independent directors). Investors expressed a 'sum of the parts' approach as being appropriate when considering the relative importance of the director independence settings and were generally comfortable with the current board composition settings.

Our comparator exchange benchmarking work revealed that SGX requires at least two and one-third of the board be comprised of independent directors[8], TSX requires a minimum of two independent directors[9], and the HKEX Listing Rules require a minimum of three independent non-executive directors who must comprise one-third of the board[10].

In terms of New Zealand market conditions, there appears to be a high proportion of independent directors on boards, reflecting strong voluntary uptake of Code recommendation 2.8. According to data published by Chapman Tripp[11], 77% of the top 75 listed companies by market capitalisation had a majority of independent directors, while 20% of the top 75 listed companies had boards solely comprised of independent directors.

Proposal

NZX does not propose any amendment to the board composition settings contained in the Rules and Code relating to director independence. NZX considers that our current settings are broadly consistent with international peer exchanges and are appropriate in the context of New Zealand's market conditions.

3.2 Audit and Risk Committee composition: financial literacy

Development of the proposal

The Rules require that an Audit Committee of an issuer must have a majority of independent Directors and that at least one member of the Audit Committee has an

[8] SGX Rule 210(5).

[9] TSX Technical Guide to Listing

[10] HKEx Listing Rule 3.10.

[11] New Zealand Corporate Governance – Trends and Insights 2022, Chapman Tripp, May 2022.

accounting or financial background, amongst other requirements. Code recommendation 3.1 also recommends that members of the audit committee should be non-executive directors.

As a response to the initial consultation, NZCGF advocated for a change to Code recommendation 3.1 so that it is recommended that one member of an Audit Committee is both a financial expert and is an Independent Director. ACC proposed a stronger formulation, that the Rules should be amended to impose this setting as an obligation rather than a recommendation.

NZX has undertaken further international benchmarking work, and we understand that TSX requires audit committee members to be both financially literate and independent from the issuer[12]. We also understand that HKEX[13] requires one audit committee member to be both independent and have an appropriate level of accounting or financial literacy. In addition, the SGX Code of Corporate Governance contains a provision that the Chair of the Audit Committee should be both independent and have relevant financial expertise[14]. The ASX Corporate Governance Code recommends that an issuer's audit committee is comprised of a majority of independent directors and that the qualifications and experience of those directors is disclosed[15].

NZ RegCo has noted in its 2023 oversight report[16], that it has recently identified a number of issuers with improperly constituted audit committees, and NZX considers that it is appropriate to further consult on proposed enhancements to the composition settings as described below.

Proposal

NZX is proposing to amend Recommendation 3.1 of the Code to recommend that an issuer's audit committee includes one member who is both an Independent Director and has an accounting or financial background. We consider that this change, which would operate on a 'comply or explain' basis would enhance the composition of Audit Committees, and we are specifically interested in feedback from issuers of the consequences of this proposal.

3.3 Audit Committee composition

Current settings

Rule 2.13.2 requires that the audit committee of an issuer must have a majority of independent Directors, and that at least one member of the audit committee has an accounting or financial background. The Rule also requires that an audit committee is comprised at least of three members who are directors of an issuer.

[12] TSX Technical Guide to Listing

[13] HKEx Listing Rule 3.21

[14] Provision 10.2 of the SGX Corporate Governance Code 2018.

[15] These requirements are mandatory for issuers in the S&P/ ASX 300 Index. Refer to Recommendation 4.1 of the ASX Corporate Governance Code 4th Edition, and ASX Listing Rule 12.7.

[16] NZ RegCo Oversight Report 2023.

Code recommendation 3.1 also recommends that members of the audit committee should be non-executive directors, and that the Chair of the Committee is both an independent director and not the Chair of the issuer's Board.

Feedback on current settings

During 2023, NZ RegCo referred several breaches of the audit committee composition requirements to the NZ Markets Disciplinary Tribunal (**Tribunal**), and also issued a number of infringement notices in relation to breaches of those requirements.

In the course of determining those breaches referred to it, the Tribunal observed that having at least three members is an important component to ensuring a robust Audit Committee, in conjunction with the requirement that all members are Directors, there is a majority of Independent Directors and at least one member has an accounting or financial background.

The Tribunal also noted that the Rules requirement that an Audit Committee have at least three members is intended to ensure that there are sufficient different perspectives to perform an Audit Committee's responsibilities. The Tribunal also commented that the requirements for majority independent director membership, is an important shareholder safeguard, which supports an unbiased and robust audit process, and ensures sufficient separation from an Issuer's management.

NZX's composition settings relating to Audit Committees are broadly comparable with those of peer exchanges, and NZX considers that these long-standing settings remain appropriate for NZX's markets. In light of the significant number of breaches of the requirements in 2023, NZX is interested in the market's views as to the appropriateness of the Audit Committee composition settings.

3.4 Nomination Committee composition

Development of the proposal

As discussed in section 5 of this paper, NZX has carefully considered whether it would be appropriate to consult further on proposals that were put forward by certain submitter groups and certain members of the NZX CGI in relation to enhanced minority shareholder protections.

Investor groups have strongly advocated for enhanced minority shareholder protections and have raised specific examples where they considered that a board's assessment of a director's independence was inappropriate, including in relation to director candidates.

While under the Rules an issuer's board is required to consider whether a director is an Independent Director, the Code recognises that an issuer should establish a nomination committee to recommend director appointments to the board (unless that function is carried out by the whole board). The commentary to Code recommendation 2.2 notes that a board candidate's independence should be considered as part of an issuer's selection procedure which may be administered by an issuer's nomination committee or board.

NZX's current composition settings for an issuer's nomination committee are set out in the Code, which recommends that at least a majority of the nomination committee should be independent directors.

As part of the consideration of the submission feedback relating to the suitability of the director independence settings to ensure that they sufficiently protect minority shareholder interests, we further considered the composition settings relating to an issuer's nomination committee.

Our benchmarking research revealed that the ASX Corporate Governance Code[17] recommends that a majority of the nominations committee should be independent directors, which is also the approach adopted by SGX[18] and the UK Financial Reporting Council[19], while this is required by the HKEX[20] Listing Rules.

We have also considered the research conducted by Dr. Geng, which cited various international academic studies[21] that suggested that management in effect wields considerable influence over the nomination process, and that the list of nominated board candidates frequently favoured management 'often overlooking the interests of minority shareholders.

Proposal

NZX considers that it may be appropriate to change Code recommendation 3.4 to recommend that a nomination committee is comprised *only* of independent directors, although we are interested in the views of submitters as to whether this change is necessary.

The commentary to Code recommendation acknowledges that smaller issuers may elect not to have a separate nomination committee, and that the role of the nomination committee may then be performed by the board or remuneration committee. We have also clarified that where an issuer has only two independent directors that it may not be able to convene a nomination committee comprised solely of independent directors, but that its alternative arrangements should be explained in its annual report.

While the proposed change to the Code recommendation relating to composition would be an outlier setting internationally, it may further ensure that the members of the nomination committee have the capacity to better assess director candidate nominees without relationships or interests (such as an affiliation with a major shareholder), further enhancing their ability to bring an independent view to such decision-making, noting that the responsibility for a determination of independence sits with an issuer's board.

[17] ASX Corporate Governance Code recommendation 2.1.

[18] Provision 4.1 of the SGX Corporate Governance Code.

[19] Provision 17 of the UK Corporate Governance Code.

[20] HKEx Listing Rule 3.27A.

[21] Cai, J., Nguyen, T., & Walkling, R. (2022). Director appointments: It is who you know. The Review of Financial Studies, 35(4), 1933-1982.

3.5 Takeovers

Development of the proposal

Code recommendation 3.6 recommends that an issuer should establish appropriate protocols to be followed if there is a takeover offer, and the commentary that was included as part of the 2022 Code amendments encourages issuers to disclose the composition of its takeover committee at the time the takeover committee is convened in relation to the bid, and to confirm that the committee's members are independent of the bidder.

In our initial round of consultation, we asked submitters for their views of the relative importance of a director being an Independent Director under the Rules (not an Employee and having no Disqualifying Relationship) compared to independence from the bidder.

A majority of legal adviser and issuer submitters considered independence from the bidder was more important than a lack of a Disqualifying Relationship, noting that the Takeovers Code already contained requirements in this area. One submitter acknowledged that the lack of a Disqualifying Relationship could also be important to ensure that a director was not prejudiced by placing undue emphasis on the effects of the takeover on management. The majority of submitters noted that affiliation with a majority holder should not be problematic as all holders are interested in receiving the best price, and some submitters noted that the relevant consideration was whether the director was an Associated Person of a shareholder who had accepted the takeover offer (with one submitter suggesting that this should be reflected in the Code).

The IoD considered that both a lack of a Disqualifying Relationship and independence from the bidder were relevant considerations.

The investor perspective was mixed. NZSA accepted independence from the bidder and a lack of a personal shareholding were the most important aspects relating to independence in the context of a takeover. ACC considered that both the lack of a Disqualifying Relationship and independence from the bidder were critical. NZCGF considered that independence from the bidder was at least equally as important as being an Independent Director.

Proposal

NZX considers that in a takeover context, a director's independence from the bidder is the most important consideration, along with the director's independence in relation to the takeover transaction. We note the relatively small size of the director pool in New Zealand and that it is important to ensure that takeover committees can be convened.

A director who has a Disqualifying Relationship due to an association with a major shareholder should not be excluded from acting on a takeover committee, so long as that shareholder has not committed to accept the offer. The relevant focus for an issuer in convening a takeover committee should be whether the director has a conflict in relation to the takeover transaction, rather than whether the director has a Disqualifying Relationship more broadly. In a takeover context the interests of major and minority shareholders are likely to be aligned in terms of ensuring that all shareholders receive the best price under the offer.

NZX is proposing updates to the Code commentary to recommendation 3.6, to clarify independence expectations in a takeover context, to note that independence from the bidder is appropriate, but that directors do not necessarily need to be 'Independent Directors' under the NZX Listing Rules to be members of a Takeover Committee.

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?

4. Disclosures

NZX has received general feedback from submitters through this review, and the review of the Code that was conducted in 2022, that the quality of issuers' disclosures in relation to the board's assessment of a director's independence could be improved.

As an outcome of the 2022 Code review, Code recommendation 2.4 was amended to recommend that where one of the Code factors applies to a director, and the issuer's board has nevertheless determined that director to be independent – that an issuer's annual report disclosure should include a description of the interest or relationship that triggers the factor, and the board's reasons for determining the director to be independent.

As part of our initial consultation for this review we consulted on whether greater disclosure was needed at the time of a director's appointment or where there is a change in the board's determination of a director's independence status, as NZX has received feedback that this is an area where market practices could be improved.

4.1. Issuer disclosures: notice of meeting requirements

Development of the proposal

We consulted on a proposal that the Rules include a requirement for an issuer to disclose the reasons for its determination of a director candidate's independence when making a disclosure in a notice of meeting to elect or re-elect a director. Rule 7.8.3(a) currently requires only that the board's determination as to whether the candidate is independent is disclosed.

The majority of legal advisory and issuer submitters including LCA, did not support any extension of the requirements (noting that the publication of a director's independent status acted as a confirmation that the board had conducted an assessment process, and that the director biography information included in a notice of meeting and information to meet the requirements of Rule 7.8.3 should provide sufficient information).

NZSA supported better disclosure around the nature of a director's interests and how the board has formed a view that the director can exercise an independent judgement in a notice of meeting, which was also supported by the NZCGF. ACC supported additional disclosure where material conflicts have been identified by shareholders.

Separately, the LCA suggested that the Rules should require the disclosure of the identity of a shareholder who had nominated a candidate for appointment as a director.

In addition, the NZSA suggested that, should an enhanced minority shareholder regime not be adopted (as discussed in section 5 of this paper), that a notice of meeting for the appointment of a director should include separate resolutions relating to whether the director is independent, and whether the director should be appointed. This is also reflected in the NZSA's current consultation on '*NZSA Policy No 7 – Independent Directors'.* The NZSA considers that while the board is best placed to assess a director's independence, that splitting the resolution in this way will 'enhance the clarity of the factors underpinning the status of the individual directors which in turn will enhance the role and credibility of non-independent directors'.

Proposal

NZX is proposing to amend Rule 7.8.3 to include additional requirements relating to the information that is to be included in a notice of meeting relating to the assessment of the independence of a director candidate, along with the identity of any shareholder who has nominated a candidate. NZX considers that this is useful information for shareholders and other stakeholders, including proxy advisors. NZX considers that it is more useful to frame these settings as prescriptive requirements, and that it is relevant that shareholders generally consider this information useful (even where a board does not).

Specifically, NZX is proposing increased disclosure obligations where an issuer has made a disclosure relating to the Board's view of the candidate's independence in a notice of meeting to which Rule 7.8.3 applies, in circumstances where the issuer has determined the director candidate to be independent despite the presence of a Code factor. The issuer would then be required to disclosure the interest or relationship that triggered the Code factor, and why the issuer's board had nevertheless determined the director to have no Disqualifying Relationship. Currently the Code recommends that this information is included in an annual report, but there is no Rule requirement or Code expectation that this information is included within a notice of meeting that contains a resolution to appoint, elect or re-elect a director.

NZX considers that these additional requirements will result in better disclosure in relation to a board's assessment of a director's independence, which will be beneficial for shareholders and other stakeholders.

We have carefully considered the proposal put forward by the NZSA that the resolutions relating to a director's independence and appointment should be tabled as stand-alone resolutions. NZX considers that the additional proposed disclosure obligations described above are likely to provide further clarity to the market. We agree with the NZSA that it is the board, rather than shareholders, who are best placed to determine whether a candidate or director is independent. We do not consider it appropriate for shareholders to be entitled to vote on whether they agree with the board's assessment, as we are mindful that there may be circumstances where factors considered by the board cannot be disclosed, and that shareholders will not have the benefit of being privy to the board's discussions, including in relation to the materiality of relationships and interests to the director. We therefore do not propose to make this change.

4.2. Issuer disclosures: market announcements relating to independence

Development of the proposal

In light of the concerns expressed by certain stakeholders relating to the quality of disclosures relating to a director's independence we also consulted on whether additional disclosures should be required at the time a board releases a market announcement containing an initial disclosure of a director's independence under Rule 2.6.1 or where the board's assessment changes and a disclosure is made under Rule 2.6.3.

The majority of legal advisory and issuer submitters, including LCA, saw little value in increased disclosure where the determination has been that there is no Disqualifying Relationship, as any disclosure was regarded as likely to be formulaic (that the Code factors did not apply), and felt the current settings were appropriate.

Investors broadly supported additional requirements in this area. ACC supported more information about a director's skills and how they relate to the issuer's skill matrix at the time of the director's appointment. NZCGF supported Rule requirements for disclosure of the board's reasons where a change is made to a director's independence status, and a change to Rule 2.6.2 to require a confirmation to be provided by the board that it had considered the Code factors at the time of a director's appointment, along with the reasons for its determination.

The IoD supported Rule 2.6.2 being enhanced to require disclosure of the reasons for the assessment of a director's independence at the time of appointment, and noted the importance of issuers monitoring changes in a director's interests and relationships on an ongoing basis.

Proposal

NZX considers that there is merit in aligning the nature of the information that NZX recommends be provided in an issuer's annual report in relation to the assessment of a director's appointment under Coder recommendation 2.4(c), with the disclosures to be made through a market announcement at the time the board makes an initial determination, or changes its determination, in relation to a director's independence.

We are proposing a new Rule 2.6.4 to require an issuer to disclose the reasons for its independence assessment when a Code factor is present and the board has determined that the director has no Disqualifying Relationship, in the announcement that is made under Rule 2.6.2 or 2.6.3.

Disclosure settings: consultation questions

We are proposing Rule requirements (set out in the Exposure Draft of the Rules) 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 assessment 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.

5. Minority shareholder protections

One of the most controversial aspects of the review has been the consideration of the sufficiency of NZX's current settings relating to director independence from the perspective of minority shareholders.

NZX is aware of strong views from the investor community that NZX's settings should be enhanced, including to provide minority shareholders greater rights in relation to the appointment of independent directors.

5.1. Engaging with minority shareholders – director independence assessment

Development of the Proposal

Rule 2.6 currently requires the assessment of a director's independence is made by the board rather than shareholders. Although shareholders do have rights to vote on the appointment of directors, through the operation of Rule 2.2 and the director rotation requirements contained in Rule 2.7.1, shareholders are not responsible for the assessment of a director's independence.

Through our initial consultation we sought stakeholders' views on whether minority shareholders should have an increased role in relation to the assessment of a director's independence, and the practical implications of such a proposal.

There was a general view from issuers, legal advisers and the LCA that the determination of a director's independence should remain with the board, and that it was not appropriate for minority shareholders to have greater involvement in the assessment, which would be difficult practically. These submitters noted the ability for shareholders to question an issuer at the annual meeting. The NZSA also considered that minority shareholders should not be more involved in the director independence assessment process, noting the practical difficulties that may arise.

In contrast, ACC and NZCGF strongly supported greater engagement with minority shareholders in relation to an independence classification, noting however that it would be unlikely to be effective without greater rights for minority shareholders in relation to the appointment of directors.

Certain members of the NZX CGI noted that many issuers do engage with minority shareholders when assessing a director's independence, in line with recommendation 8.2 of the Code that an issuer should allow investors the ability to easily communicate with an issuer. The NZX CGI had competing views in relation to the practical ability for minority shareholders to have a greater role in relation to the assessment of a director's independence. The NZX CGI acknowledged that company culture was an important driver of the assessment of a director's independence and acknowledged that the there is a lack of data internationally available on the impact of director independence on outcomes for different shareholder groups.

Proposal

NZX does not consider that it is appropriate to change the regulatory settings (including guidance or the Code commentary) to suggest that the board of an issuer further engage with minority shareholders in relation to the assessment of a director's independence. We

consider that this would be practically difficult, and in some cases that it would be inappropriate for a director's personal interests and relationships to be shared more broadly than with the board.

We note the enhancements which were made to recommendation 2.4 as part of the 2022 Code review, which are designed to achieve greater disclosure in relation to a board's assessment of a director's independence in annual reports. We will be undertaking a sample testing review of these disclosures as the annual reports for financial years commencing after 1 April 2023 become available. We also note the other disclosure proposals that are contained in this paper, which we consider will promote greater transparency in relation to the board's assessment of independence, enabling minority shareholders to better challenge a board's assessment.

5.2. Minority shareholder rights in relation to the appointment of independent directors

Development of the Proposal

The most controversial aspect of the review related to whether minority shareholders should be given greater ability to vote on the board's assessment of the independence of the director, with the result that if the resolution was not passed the director could not be determined to be independent.

We received extensive submission feedback on this matter which was also discussed in detail by the NZX CGI.

Issuers and law firms almost unanimously opposed the introduction of a minority shareholder approval or veto regime, noting that such an approach would cut across the fundamental principles of corporate governance, and the equal application of directors' duties, along with limb (c) of the Disqualifying Relationship definition that requires Independent Directors to be able to represent the interests of financial product holders generally. These submitters noted the protections in the Rules (rotation, related party and major transaction requirements) and under statute for minority holders (including derivative action rights), and the conflict of interest provisions in Rule 2.10.1.

These submitters also highlighted the potential unintended consequences such as unconstructive shareholder activism, the time and resource that issuers would need to expend to comply with a minority shareholder regime, and the potential for such a regime to negatively affect market participation more broadly, along with the compliance issues that could arise. One submitter suggested that any change in this area should be delivered through a legislative change. The IoD did not support additional appointment or veto rights and suggesting that these issues were best addressed through disclosure settings.

Investors generally favoured the introduction of some form of a minority shareholder regime which was seen as a remedy to some of the perceived deficiencies in the current director independence settings. NZSA did not support minority shareholders having a specific veto right over the appointment of an independent director but did support the refined proposal that was developed by the NZX CGI which is discussed further below.

The NZX CGI's views were also divided, along the same lines as submitters. The NZX CGI members discussed whether a minority shareholder protection regime was necessary, considering whether there was sufficient evidence to warrant a regulatory change in this area.

The NZX CGI also considered whether the proposal would reduce risk for minority shareholders, and was divided as to whether additional minority shareholder protections relating to the appointment of independent directors would reduce issuers' cost of capital, with investor members considering this to be the case.

Refinement of the Proposal

As part of the detailed consideration given to this issue, the NZX CGI considered a proposal favoured by the NZCGF and NZSA that would apply to 'controlled companies' where there is a majority shareholder who holds (alone or with associates) 30% or more of the voting rights in a listed issuer. NZX has completed analysis that suggests that just over one-third of issuers on the NZX Main Board would fall within this test.

The proposal that was considered by the NZX CGI was whether a new recommendation should be introduced into the Code, that recommended that these companies allow minority (less than 30%) holders the sole right to appoint two independent directors. The recommendation would operate on a 'comply or explain' basis allowing an issuer to disclose why it had elected not to adopt such a practice.

It was identified that there was precedent for this approach in the United Kingdom, and the research provided by Dr. Geng also cited research conducted by Bebchuk and Friedman[22] which had advocated for this approach as a remedy for potential self-dealing transactions.

The NZX CGI again had mixed views on this proposal, and carefully considered whether there appeared to be a sufficient 'problem statement' in that there were systemic examples of situations where investors considered that a lack of independence had disproportionately adversely affected minority shareholders due to the design rather than the application of NZX's settings.

Some members of the NZX CGI also challenged the assumptions put forward by Bebchuk and Friedman that in some instances independent directors serve only at the pleasure of the controlling shareholder, noting that in New Zealand directors' duties require a director to act in the best interests of the company which is a duty owed to all shareholders equally. The NZX CGI also considered the other protections that apply in the New Zealand context, including that all shareholders have the right to nominate a director candidate[23], and the other operative provisions of the Rules which provide shareholder protections (including the related party transaction restrictions).

NZX notes that the UK Financial Conduct Authority (**UK FCA**) has settings relating to minority shareholder rights for appointing independent directors that are similar to those that were considered by the NZX CGI. The UK FCA is currently consulting on a suite of proposals that while retaining those director independence settings, looks to remove shareholder voting on core transactions, for example related party transactions. The removal of these operative protections would increase the role that the independent

[22] Bebchuk, L. A., & Hamdani, A. (2017). Independent directors and controlling shareholders. University of Pennsylvania Law Review, 1271-1315.

[23] Rule 2.3.

directors play in representing shareholders, and would increase the importance of minority shareholders being comfortable with the independence status of the director.

NZX considers that unlike the position in the UK, the Rules provide significant protections for minority shareholders. The research conducted by Bebchuk and Friedman also assumed that independent directors have a particular role in vetting self-dealing transactions, and did not consider the effects of protections that exist under the Rules for shareholders to approve such transactions, or New Zealand's broader legislative and market environment.

NZX's settings include key rights for shareholders to approve Major and Related Party Transactions and certain types of capital raising activity. In 2023 NZX made significant revisions to our Guidance Note in relation to Major and Related Party Transactions to include additional standard waiver conditions that will require non-interested directors to certify why waiver relief is in the best interests of the issuer, and certain groups of shareholders along with the grounds for that opinion, and for these certifications to be released to the market. Similar protections are also captured in the new Guidance Note relating to Capital Raisings, that became effective in January 2024.

Proposal

NZX is not proposing to amend its regulatory settings to provide minority shareholders with additional rights in relation to the appointment of directors.

NZX does not consider that the examples that have been provided of issues in this area demonstrate a systemic behaviour that requires an additional regulatory response. As noted above, NZX has made enhancements in relation to other operative provisions of the Rules that are designed to enhance the protections for minority shareholders, and is proposing additional disclosure obligations to be placed on issuers in relation to a board's assessment of independence through this paper.

We consider that the implementation of the refined proposal would also cause NZX to be an outlier internationally, including in relation to ASX and note that we have not been provided with evidence to suggest that introducing these settings would lower issuers' cost of capital.

NZX considers that the settings that exist currently including that our Code factors already identify that a relationship between a director and a substantial product holder may give rise to a Disqualifying Relationship, the proposed revisions to the Code in relation to the purpose of the regime, along with the board composition settings and operative requirements of the Rules act as appropriate safeguards to protect minority shareholders' interests.

6. Director Residency

NZX considers that it is appropriate to include within this review consideration of the Rule requirements relating to director residency.

Rule 2.1.1 requires that at least two directors of an issuer be 'ordinarily resident in New Zealand'. The purpose of this requirement is to ensure that there are at least two directors who are familiar with the New Zealand financial markets and are able to be held accountable by New Zealand based shareholders and respond to their queries, along with ensuring there is an ability for NZX to take enforcement action in appropriate cases.

Although NZX consulted on these requirements in 2018, NZX considers that it is appropriate to re-engage with the market in relation to these requirements, particularly in light of investor and issuer expectations during the Covid period, and submitter feedback obtained through the director independence review, including in relation to the small director candidate pool in New Zealand.

Background

In April 2018 NZX consulted on changing the composition requirements to require that two directors be ordinarily resident in either New Zealand *or Australia*. In response to investor feedback, NZX retained the requirement that the board of equity issuer be comprised of 2 directors who are ordinarily resident in New Zealand.

In 2022 NZ RegCo declined to grant a ruling to an issuer that the director was ordinarily resident in New Zealand because the director's primary residence was in Australia, although the application was subsequently withdrawn and therefore was not published to the market.

The Rules do not contain a definition of 'ordinarily resident' or provide any factors to guide the interpretation of that term. NZ RegCo has proposed that NZX Policy should develop guidance as to how this term should be interpreted, noting that in 2017 in an unpublished decision NZ RegCo interpreted the term 'ordinarily resident' in line with the *Carr*[24] decision so that factors beyond the test used for tax purposes (physical presence in New Zealand for at least 183 days in a 12 month period) were considered relevant to the assessment as to whether a director was ordinarily resident in New Zealand.

Submission feedback

As part of the current review, NZX received feedback that directors in 'enforcement countries' under the Companies Act Regulations 1994 (currently only Australia) should meet the composition requirements by being regarded as 'ordinarily resident in New Zealand'.

NZX is aware that other jurisdictions do not have any resident director requirements, including Nasdaq Global, Nasdaq Dubai, the New York Stock Exchange and the Tokyo Stock Exchange, (although SGX and HKEX each require there to be two resident directors). NZX considers that it is appropriate to consider our director residency requirements in the context of New Zealand's market environment, including the small director candidate pool in New Zealand.

[24] *Re Carr* [2016] NZHC 1536.

Some members of the NZX CGI broadly supported expanding the director residency requirements to Australia given the proximity and alignment between the NZX and ASX markets. It was also suggested that Singapore could be an appropriate jurisdiction to satisfy the residency requirements.

Proposal

NZX considers that it would be appropriate to develop guidance to inform how the term 'ordinarily resident' should be interpreted to ensure that there is consistent market practice.

We proposed that the guidance would align with NZ RegCo's recent engagement with the market that reflects the *Carr* decision that residency is not solely to be determined using the 183 day rule.

Our preliminary view is that the appropriate factors to consider when assessing whether a director is 'ordinarily resident' would include: (1) the amount of time the director spends in New Zealand, (2) the director's connection to New Zealand, (3) the ties the director has to New Zealand, and (4) the manner in which the director lives in New Zealand.

We do not yet have a preliminary view as to whether amendments should be made to the residency test to include directors domiciled in Australia, or to reduce the requirement so that only one director must be ordinarily resident in New Zealand. We are interested in submitters views on these aspects.

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?

Appendix: Current settings

The Code and Rules contain NZX's current regulatory policy in relation to director independence.

Assessing independence

Rule 2.6.1 requires the board of an issuer[25] to identify which Directors it has determined to be Independent Directors by having regard to the non-exhaustive factors described in the Code which may impact director independence.

An Independent Director is defined in the Rules as a Director who is not an Employee of the Issuer and who has no Disqualifying Relationship.

The term Disqualifying Relationship is defined in the Rules. This is a key definition in defining a director's independence.

Disqualifying Relationship

means any direct or indirect interest, position, association or relationship that could reasonably influence, or could reasonably be perceived to influence in a material way the Director's capacity to:

(a) bring an independent view to decisions in relation to the issuer,

(b) act in the best interests of the issuer, and

(c) represent the interests of the issuer's financial product holders generally

including having regard to the factors described in the NZX Corporate Governance Code that may impact director independence, if applicable.

There are several important points relating to the interpretation of this definition. The first is that the board of an issuer should assess a director's independence by considering all of the director's interests, positions and relationships. Rule 2.6.4 notes that an issuer is responsible for ensuring that a director provides sufficient information to make the independence determination.

The Code[26] contains a number of factors that may indicate a lack of independence. These factors are not exhaustive, and are not the only factors that an issuer should consider when determining a director's independence.

[25] This requirement only applies to issuers of Equity Securities, issuers who solely have Quoted Debt Securities or Quoted Fund Securities do not need to comply with this requirement.

[26] Note this reflects the Code as at 1 April 2023, against which issuers must report for financial years commencing on or after 1 April 2023.

The factors are set out in the table below:

Examples of factors that may cause a board to determine that a director is not independent include that the director:

1. is currently, or was within the last three years, employed in an executive role by the issuer, or any of its subsidiaries;
2. is currently deriving, or within the last 12 months derived a substantial portion of his, her or their annual revenue from the issuer;
3. is currently, or was within the last 12 months, in a senior role in a provider of material professional services (other than an external auditor) to the issuer or any of its subsidiaries;
4. is currently, or was within the last three years, employed by the external auditor to the issuer, or any of its subsidiaries;
5. currently has, or did have within the last three years, a material business relationship (e.g. as a supplier or customer) with the issuer or any of its subsidiaries;
6. is a substantial product holder of the issuer, or a senior manager of, or person otherwise associated with, a substantial product holder of the issuer;
7. is currently, or was within the last three years, in a material contractual relationship with the issuer or any of its subsidiaries, other than as a director;
8. has close family ties or personal relationships (including close social or business connections) with anyone in the categories listed above;
9. has been a director of the entity for a period of 12 years or more.

The Code recommends that where an issuer has determined a director to be independent despite the presence of a factor contained in the Code, that the issuer discloses the reasons for its determination, along with a description of the interest, position or relationship that triggered the application of the Code factor.

The Code operates on a 'comply or explain' basis. Rule 3.8.1(b) requires an issuer[27] to disclose in its annual report which Code recommendations it has not followed along with an explanation of the reasons for not following the recommendation, and the issuer's alternative governance arrangements. Therefore, an issuer could elect not to make the disclosure recommended by recommendation 2.4, so long as the issuer discloses its reasons for doing so.

Rule 2.6 requires a board to determine whether a director is an independent director having had regard to the non-exhaustive factors described in the Code and to announce that determination to the market within 10 business days after a director's initial appointment. An issuer's board must also update the market if its determination as to a director's independence changes.

Board composition requirements

Rule 2.1.1 requires that the Board of an issuer of quoted equity securities must, at all times, have at least two Directors who are Independent Directors (excluding alternate Directors). In

[27] This requirement only applies to issuers of Equity Securities, issuers who solely have Quoted Debt Securities or Quoted Fund Securities do not need to comply with this requirement.

addition, Code recommendation 2.8 recommends that a majority of the board of an equity issuer should be independent. As the Code operates on a 'comply or explain' basis, an issuer may elect not to have a majority of Independent Directors on its board so long as it explains the reasons for not doing so.

Rule 2.1.1 also requires that at least two directors of an issuer be ordinarily resident in New Zealand.

Audit Committee composition requirements

Rule 2.13.2 requires that the audit committee of an issuer must have a majority of independent Directors and that at least one member of the audit committee has an accounting or financial background. The Rule also requires that an audit committee is comprised of at least three members who are directors of an issuer.

Code recommendation 3.1 also recommends that members of the audit committee should be non-executive directors, and that the Chair of the Committee is both an independent director and not the Chair of the issuer's Board.

Nomination Committee composition settings

Code recommendation 3.4 recommends that a majority of the nomination committee should be independent directors. The commentary to that recommendation acknowledges that for smaller issuers the remuneration committee may perform the functions of the nomination committee.

Takeover Committee composition settings

Code recommendation 3.6 recommends that the board of an issuer should establish appropriate protocols that set out the procedure to be followed if there is a takeover offer for the issuer including the option of establishing an independent takeover committee and the likely composition and implementation of an independent takeover committee. As part of the amendments that were made to the Code commentary to that recommendation as part of the recent 2022 review, the commentary encourages issuers to disclose the composition of its takeover committee at the time the takeover committee is convened in relation to the bid and to confirm that the committee's members are independent of the bidder.

Independent director obligations

The Rules do not create specific obligations on Independent Directors[28] (although voting restrictions do apply to certain resolutions in which a director is interested). However, it is a standard condition of certain waiver decisions granted by NZ RegCo that Independent Directors provide certifications in support of the waiver application (for example: as to the arm's length nature of a transaction).

[28] It is noted that Rule 5.2.2(e) provides an exception from the Related Party requirements where the Independent Directors approve employment contracts or contracts for personal services with Related Parties, in certain circumstances.