DETERMINANTS OF NOMINATION COMMITTEE: NEW ZEALAND EVIDENCE

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Abstract

A sizable volume of corporate governance literature documents that an independent and competent board of directors matter for organizational success. In order to function effectively, board comprises of different sub-committees and the three most common sub-committees are audit committees, compensation committees and nomination committees. Surprisingly, there is a paucity of research in understanding the determinants of nomination committee notwithstanding the importance of an independent nomination committee in board selection process. We contribute to the nomination committee literature by investigating the factors associated with the determination of nomination committees in New Zealand. We find that cross-sectional variation in the firm-specific characteristics affect the existence of nomination committees. This finding casts doubt on the 'one-size-fits all' approach of corporate governance. Our logistic regression of the nomination committee determinants indicates that firm size, governance regulation and busy directors are positively associated with the existence of nomination committees, whereas firm leverage, controlling shareholders, and director independence are negatively related to the formation of nomination committees.

Keywords: Corporate Governance Best Practice Code, Nomination Committee, Board Busyness, Controlled Ownership, New Zealand

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1. Introduction

This paper contributes to the corporate governance literature by documenting the firm-specific and regulatory determinants of nomination committees in New Zealand. The well documented information asymmetry problem between managers and outside directors give rise to corporate governance mechanisms to protect shareholders interest. The academic literature is replete with studies on the board of directors as the primary governance mechanism (Hermalin and Weisbach, 1998, 2003; Adams, Hermalin and Weisbach, 2010). In order to function effectively, the board comprises of different sub-committees and the three most common sub-committees are audit committees, compensation committees and nomination committees. Although audit committee as a corporate governance mechanism has been extensively researched (see Bedard and Gendron 2010, for a recent review of the literature), nomination committee and to a certain extent compensation committee has received scant research attention (Ruigrok, Peck, Techeva, Greve, and Hu, 2006).

Such a scant attention towards the nomination committee is surprising given that this committee serves an important purpose in ensuring that right people are appointed to monitor management behavior. Archival research indicates that selection of board members through the nomination committee ensures relatively better judgment of new appointee which reduces agency problem and increases quality of board (Vafeas, 1999). Vafeas (1999) examined the effect of managerial ownership and different attributes of board qualities on the establishment of nomination committees using data from period when the formation of nomination committees was voluntary. A separate nomination committee can pay attention on specific task of selecting the appropriate Chief Executive Officer (CEO) (Bosch, 1995), and hence contributes towards the implementation of a successful corporate governance regime (Corporate Governance in New

Zealand: principle and guidelines, 2004). Additionally, nomination committee significantly influences the process of evaluating board candidates (Corporate Governance Best Practice Code, 2004, hereafter the code).

Should the formation of separate nomination committees be mandated by regulation in light of the advantages associated with such committees? We examine this question in New Zealand where a regulatory reform started soon after the major corporate collapses in the US and elsewhere, and resulted in the passage of the Code in 2004. A simple 'one- size- fits-all' regulation focused mainly on the board independence. Principle two of the Code prescribes that "…there should be a balance of independence, skills, knowledge, experience and perspective among directors so that the board works effectively." Nomination committee in New Zealand works within and subject to the framework of the Companies Act 1993, the company's constitutions and (where applicable) the Code, and New Zealand Stock Exchange (NZX) Listing Rules. The Code prescribed that every company should have a nomination committee with majority of independent directors aimed at recommending the appointment of the directors to the board. The committee should also have a written charter and meet in regular intervals to review board of director's performance against the charter.

However, the practice of establishing nomination committee is comparatively new in New Zealand (Sharma, 2007) for several reasons. First, the formation of nomination committee is a recommended practice, not a legal requirement. Second, the regulatory guidelines on the process and operation of the nomination are very narrow. Third, the guidelines do not preclude the involvement of CEO in the nomination committee activities. Yet at the same time the importance of nomination committees in New Zealand is underscored by the absence of a lack of qualified independent directors (Goldfinch, 2004). Therefore, dominance of the CEO and the risk of nominating independent directors who are in fact affiliated with CEOs are a significant concern in New Zealand. A separate nomination committee, therefore, seems like a reasonable choice for New Zealand listed companies. We investigate the effect of regulatory reform and other firm-specific characteristics on the composition of nominating committees in NZ. The reporting environment of NZ is characterized with a 'comply or explain' environment where firms are encouraged to form nomination committees as a code of best practice or explain the absence thereof. This study will, therefore, provide evidence on the attitude of firm towards the governance regulation.

The guidelines on forming nomination committee in the major industrialized countries are mixed. For example, listing requirements with respect to nomination committee in the NYSE, NASDAQ and AMEX are concerned with the fully independent nomination committee with no CEO involvement in the selection process. In UK, Higgs report suggests that the majority of the nomination committee members should be independent non-executive directors and the chairman of the committee must be independent but Cadbury Report suggests that selection of non-executive director is the matter of whole board (Jones & pollitt, 2004). Australian Stock Exchange Listing Rule requires that the nomination committee should consist of at least three members with majority independent director. Some European countries such as Sweden have nomination committees made up with the representatives of owners who are accountable and required to provide reports at the AGM (Carlsson, 2007).

The paper proceeds as follows. Section 2 provides a conceptual argument for the necessity of nomination committees and reviews the related literature. Section 3 develops testable hypotheses. Section 4 describes the research design choice, sample selection procedures, and empirical results. Section 5 concludes the paper.

2. Theory and related literature

The separation of ownership and control gives rise to information asymmetry that managers could use to exploit outside atomistic shareholders for their private benefits (Berle & means, 1932; Jensen & Meckling 1976). Outsiders demand strong corporate governance mechanisms to be enforced by the corporate managers to ensure that the managerial objectives are aligned with that of the shareholders. The board of directors is the primary internal governance mechanism established to ensure that the alignment takes place. The board is interested in the long-run net firm value and is able to reduce the CEO's ability to bias the earnings report through costly monitoring. The bias introduced into the report therefore not only depends on the CEO's choice of manipulation but also on the board's choice of monitoring. The board has an incentive to engage in monitoring because oversight lowers the CEO's excess compensation and hence increases the net terminal firm value. However, monitoring is costly which could lower the board's incentive to grant CEOs a powerful incentive scheme (Laux and Laux 2008). They argue that this situation can be best handled with board sub-committees with each committee having separate board functions.

In order to function effectively, boards consist mainly of three different sub-committees. Audit committees oversee the audit scope and the adequacy of the independent public accountants' audit plans and results, review and monitor the annual and quarterly financial statements and other financial reports, and evaluate and monitor the internal accounting controls. Compensation committee is responsible for to setting appropriate and supportable pay programs that are in the organization's best interests and aligned with its business mission and strategy. Finally, nomination committee is entrusted with the responsibility of selecting appropriate board members consistent with the organizational strategy.

Theoretically the board of director is appointed by the shareholder. But a significant literature shows that shareholders simply ratify the director candidates selected by the board itself (Vafeas, 1999). Rosenstenin and Wyatt (1990) describes US firms director selection process where existing board members appoint new directors to be formally ratified at the shareholders annual meeting. Selection process is affected by three different parties namely shareholders, corporate managers, and sponsors who share conflicting interests. Shareholders prefer active directors, whereas executive directors prefer passive directors and create power conflict (Hermalin & Weishach, 1998). In the absence of a an independent nomination committee CEOs could get involved in the director selection process leading to a high number of grey directors (Shivdasani & Yermack, 1997) and a greater risk that a director appears independent without being independent in fact (Carcello, Neal, Palmrose, and Scholz, 2011). The presence of nomination committee helps to bring a more objective approach to the selection of board members (Bostock, 1995) since management inherently dominates boards through control of the nomination and election of directors (Patton & Baker, 1987; Carson, 2002). Nomination committee can guard against nepotism (Bostock, 1995), reduce power battle between CEO and incumbent directors (Eminet & Guedri, 2010; Zajac & Westphal, 1996), and pay careful attention to shareholder interest of long-term value maximization by appointing the right mix of directors (Ruigrok et al. 2006). Moreover, it establishes a professionalize selection process which overcomes the CEO involvement problem in selection. However, Bebchuk and Fried (2004) argue that nomination committee hardly appoints any director without the consent of CEO and CEO preference for a particular candidate is prioritized. Fund sponsors want to ensure their involvement in the director selection process to enhance their power but critics argues that the independent directors selected by fund sponsors are obliged to them and unlikely to perform an oversight role (Varma, 2003).

The precondition of a good nomination committee practice is the presence of a good board of directors mix (Vafeas, 1999). Using 600 large US public firms in 1994, Vafeas found that although the nomination committee could not influence the number of outside directors to be appointed to the board, the committee could influence the decision to appoint a majority of independent directors. However, existence of nomination committee varied inversely with inside ownership suggesting that firms with high inside ownership can avoid the independent monitoring of nomination committees leading to managerial entrenchment. Carson (2002) found that nomination committee is being formed for board efficacy and for mitigating e agency costs of debt. She reveals that board size and firm leverage are the most significant determinants of nomination committee existence.

Whether the formation of nomination committee brings out desired benefits has not been convincingly answered. For example Calleja (1999) claims that companies have higher shareholders return in the absence of board committees. However, using Australian sample, Christensen, Kent and Stewart (2010) reveal that nomination committees enhance monitoring process and increase firm performance. Cotter and Silvester (2003) find that existence of board committees[11] does not increase firm value at all. Similarly, Osma & Noguier (2007) reveal that the existence of nomination committee increases earnings manipulation by constraining the effective workings of independent directors. Taken together it is not ex-ante clear as to whether all companies should form nomination committees. We, therefore, investigate the determinants of nomination committee formation in New Zealand.

[11] They considered only audit committee and remuneration committee. They argued that nomination committee does not have any distinctive monitoring role and nomination committee does not have legal or institutional base to comply.

3. Hypothesis Development

We develop the following testable hypotheses for examining the possible determinants of the formation of nomination committees in New Zealand.

Adoption of the CODE

Adoption of corporate governance best practice code 2004 became one of the primary criteria for listing on the NZX. The motive of adopting best practice code was to increase the compliance of governance including formation of nomination committee, as it will increase the accountability of director selection process. The following hypothesis is therefore proposed:

H_1 : *There is a positive association between the CODE and the formation of nomination committees.*

Board of director size (BOD)

The structure of board in a firm such as board size and board composition influences the nature of board committee (Jiraporn, Sing, and Lee, 2009). Firms operating with a large board will increase the possibility of forming different supervisory committees (Florou & Galarniotis, 2007; Hilb, 2005) and decrease the overlap of authority. Accordingly, the following hypothesis is focused on board size:

H_2 : *There is a positive association between the board size and existence of nomination committees.*

Board independence (BIND)

One of the vital qualities of the board is the strong presence of independent director in the board (Vafeas, 1999). Outside directors stand to lose a lot in terms of their reputational capital if they collude with management. However, the likelihood of nominating independent directors will depend to a great extent on the nomination process. Self-interested nomination by insiders would destroy firm value. Conversely, nominating committees are expected to exercise better control of the nomination process by appointing more outside directors (Vafeas, 199, p.203). Nowland (2008) posits that companies formed with independent smaller boards find it easier to agree on implementing nomination committee regulation. However, Kapardis and Psaros (2006) found that the presence of nomination committee is not the effect of independent board instead a compliance with corporate governance code[12]. Similar finding is reported by Carson (2002). Given the conflicting nature of the evidence, we develop the following hypothesis in the null form:

H_3 : *There is no association between the board independence and existence of nomination committees.*

Multiple directorships (BODBUSY)

Since the directors' reputation capital increases with the number of directorships they hold, collusion with management becomes relatively costlier as directorships increase, and the benefits of effective monitoring become higher. Consistent with that, outside directors nominated by a separate nominating committee are expected to hold multi-directorships compared to directors nominated otherwise.

H_4 : *There is a positive association between the between the average number of directorships by outside directors and the existence of nomination committees.*

Control shareholding (CONTSHR)

[12] Charkham (1994) expressed deep concern about the true independence of nomination process as CEOs might have implied dominance over the sub-committees.

Corporate governance literature has postulated two competing hypothesis regarding the governance function of controlling shareholders. On the one hand, controlling shareholders could entrench themselves by wielding significant control over corporate decisions. If controlling shareholders pursue to make private benefits at the cost of minority shareholders, then they will resist forming nomination committees. On the other hand, the monitoring hypothesis, could also imply a negative association between controlling shareholdings and formation of nomination committees. Since companies with controlled shareholding face less information asymmetry problem, the demand for governance mechanisms including independent nomination committee is relatively weak.

H_5 : *There is a negative association between the control ownership and existence of nomination committee.*

4. Research Methodology

4.1. Research Design

We adopt a logistic regression approach to examine the firm specific determinants of nomination committee existence. The following regression is estimated over the 2000-07 sample period.

$$NCDUM = \alpha_0 + \alpha_1 CODE_{it} + \alpha_2 BOD_{it} + \alpha_3 BIND_{it} + \alpha_4 BODBUSY_{it} + \alpha_5 CONTSHR_{it} + \alpha_6 LEV_{it} + \alpha_7 SIZE_{it} + \varepsilon_{it} \;\ldots\ldots\ldots\ldots(1)$$

Where, *NCDUM* is a dummy variable coded 1 if the firm has nomination committee and 0 otherwise. *CODE* is a dummy variable taking the value of 1 for observations from 2004 to 2007 sample period and zero otherwise. *BOD* is board size measured as the total number of directors in the board during the operating year. *BIND* is the percentage of independent directors in the board calculated as the ratio of independent directors to total number of directors. Controlling shareholdings, *CONTSHR* is a dummy variable taking a value of one when a single or individual entity holds more than fifty percent of outstanding shares during the financial year. *LEV* is firm leverage and is defined as the ratio of total liability to total assets. Finally firm size is proxied by log of *TOTASSET*.

4.2 Sample Selection

The research was based on NZX and New Zealand Alternative Exchange (NZAX) listed companies over the period of 2000 to 2007. NZSE is the main board of New Zealand stock market which includes premium securities. NZAX listed companies are fast growing where issued companies gain low cost and easier access of more information. All the financial institutes were excluded from the sample because organization structure, governance practice and regulations are different compared to their non-financial counterparts. This procedure yields a final usable sample of 70 companies from 14 different industrial sectors. Financial data were collected from DATASTREAM and corporate governance data were collected manually from NZX deep archived annual report.

4.3 Results

Descriptive statistics and correlation analysis

Table 1 Panel A shows that about 60% of the sample observations are characterized to have a nomination committee in existence. This figure is substantially higher than Australia (29.36% as reported by Christensen et al., 2010) but less than the UK (85% as reported in Mcknight & Weir, 2009). Average board size is 6 with approximately 67% of the directors are independent directors. The board holds on average 26 outside directorships. On average 27% of the sample observations are characterized to have controlling ownership.

Table 1. Descriptive Analysis

Panel A:

Variables	Mean	Median	Maximum	Minimum	Std. Dev.
NCDUM	0.60	1.00	100	0.00	0.49
REGDUM	0.50	1.00	1.00	0.00	0.50
BOD	6.23	6.00	13.00	3.00	1.58
INDDIR	3.83	4.00	12.00	0.00	1.55
BODBUSY	25.80	23.50	108.00	7.00	13.11
CONTSHR	0.27	0.00	1.00	0.00	0.45
LEV	0.29	0.25	4.57	0.03	0.33
SIZE	1.73	1.66	3.63	1.50	6.02

Panel B:

Correlation Analysis

Variables	1	2	3	4	5	6	7	8
NCDUM (1)	1							
CODE (2)	0.11***	1						
BOD (3)	0.25***	0.07*	1					
BDIND (4)	0.14***	0.06	0.56***	1				
BODBUSY (5)	0.31***	0.07*	0.49***	0.45***	1			
CONTSHR (6)	-0.11**	0.03	-0.08*	0.04	0.10**	1		
LEV (7)	-0.08*	-0.06	0.06	0.10**	0.01	-3.61***	1	
SIZE (8)	0.39***	0.07*	0.51***	0.43***	0.37***	-0.09**	0.11**	1

PANEL: C

Univariate Analysis

Independent variables	NC=1	NC=0	Difference in mean
BDSIZE	6.56	5.75	-0.81***
BDIND	4.01	3.57	-0.44***
BDBUSY	29.07	20.89	-8.17***
CONTSHR	0.24	0.33	-0.10**
LEV	0.32	0.27	-0.05*
SIZE	4.79	5.54	-0.75***

Variable definitions:

NCDUM = a dummy variable coded 1 if the firm has nomination committee and 0 otherwise.
CODE = a regulation dummy coded 1 for sample period 2004 to 2007 when the best practice code could be complied with and zero otherwise.
BOD = board size measured as that indicates total number of directors in the board during the operating year.
BDIND = percentage of independent directors calculated as the ratio of independent director to total number of directors.
CONTSHR is a dummy variable taking a value of one when a single or individual entity holds more than 50% of share in the financial year
LEV = the ratio of total liability to total assets.
TOTASSET = the proxy variable of firm size and calculated as log of total assets;

Significance level: ***, **,* indicates significance at 1%, 5% and 10% level respectively.

Table 1, Panel B presents the correlation analysis, which reveals that the nomination committee existence increases with the board size, board independence and the initiation of best practice code. The probability of having nomination committees reduces with an increase in firm leverage and controlling shareholdings.

Univariate analysis

Panel C of Table 1 presents a univariate analysis of the difference in mean of the independent variables partitioned on the basis of the existence of nomination committees or absence thereof. The percentage of sample observations having nomination committee increased from 55% in the pre-reform period to 65% in the post-reform period. This difference in mean is statistically significant at the 1% level. Firms having nomination committees are smaller in size, have higher leverage, and lower controlling shareholdings compared to their ‘no nomination committee’ counterparts. Additionally firms having nomination committees have significantly larger number of independent directors, and busy directors.

Multivariate analysis

Although univariate analysis provides findings consistent with the hypotheses, such analysis does not control for other known determinants of nomination committee existence. Therefore we provide a logistic regression analysis in Table 2. The primary independent variable of interest is *CODE* which captures the effect of the passage of governance code in 2004 on firm’s propensity to form nomination committeesThe coefficient on *CODE* is significant at better than the 5% level indicating that firms’ propensity to establish nomination committees increased after the passage of the governance regulation. H_1, therefore, is supported. It must, however, be emphasized that such a finding does not necessarily imply that regulation helped in bringing out desired benefits for outsiders because firms could comply with regulation in form but not in substance.

Table 2. Logistic Regression

$$NCDUM = \alpha_0 + \alpha_1 CODE_{it} + \alpha_2 BOD_{it} + \alpha_3 BIND_{it} + \alpha_4 BODBUSY_{it} + \alpha_5 CONTSHR_{it} + \alpha_6 LEV_{it} + \alpha_7 SIZE_{it} + \varepsilon_{it} \ldots\ldots\ldots\ldots(1)$$

Variables	Total Sample		Pre-Regulation Sample		Post-Regulation Sample	
	Z - stat	P-value	Z - stat	P-value	Z - stat	P-value
Constant	-5.14	-7.55***	-4.47	-4.88***	-3.67	-5.90***
CODE	0.40	2.02**	-	-	-	-
BDSIZE	-0.02	-0.18	0.08	0.61	-0.10	1.38
BDIND	-0.15	-1.88*	-0.09	-0.81	-0.23	-2.95***
BODBUSY	0.06	5.23***	0.06	3.97***	0.04	3.73***
CONTSHR	-0.76	-3.21***	-0.84	-2.44**	-0.43	-2.01**
LEV	-1.59	-3.05***	-0.15	-0.20	-2.24	-4.01***
SIZE	1.03	6.97***	0.66	3.58***	1.06	6.67***
Log likelihood		-301.65	-161.72		-129.08	
Restricted log likelihood		-376.88	-192.87		-180.66	
LR statistics		150.45	62.28		103.16	
Probability (LR)		0.00	0.00		0.00	
McFadden R-sqr		0.20	0.16		0.28	

Variable definitions:

NCDUM = a dummy variable coded 1 if the firm has nomination committee and 0 otherwise.
CODE = a regulation dummy coded 1 for sample period 2004 to 2007 when the best practice code could be complied with and zero otherwise.
BOD = board size measured as that indicates total number of directors in the board during the operating year.

BDIND = percentage of independent directors calculated as the ratio of independent director to total number of directors.
CONTSHR is a dummy variable taking a value of one when a single or individual entity holds more than 50% of share in the financial year
LEV = the ratio of total liability to total assets.
TOTASSET = the proxy variable of firm size and calculated as log of total assets;

Significance level: ***, **,* indicates significance at 1%, 5% and 10% level respectively.

****, **,* indicates significance at 1%, 5% and 10% level*

The coefficient on *BDSIZE* is positive but insignificant for the full sample while negative in the post-regulation sample. Therefore H_2 is not supported. The coefficient on *BDIND* is negative and statistically significant (coefficient value -0.15, t-statistics, -1.88). This evidence is contrary to the expectation of a positive association between *BDIND* and existence of a nomination committee. It indicates that a director may appear independent without being independent in fact and hence oppose the establishment of a nomination committee (Carcello et al. 2011). Moreover a personal and or social relation may exist which drives more support to CEO rather than independently monitoring (Westphal & Zajac, 1995)[13]. Hwang and Kim (2009) show that the probability of turnover decreases by an average of 3.7% for firms with boards that are conventionally independent but not socially independent. They define a director to be socially dependent on the CEO if the director and the CEO have two or more of the following in common: (i) served in the military; (ii) graduated from the same university (and were born no more than three years apart); (iii) born in the same US region or the same non-US country; (iv) have the same academic discipline; (v) have the same industry of primary employment; or (vi) share a third- party connection through another director on whom each is directly dependent.

The coefficient on board 'busyness' is positive and statistically significant implying that the probability of establishing nomination committee is higher in companies with boards holding multiple directorships (Vafeas, 1999 or Ruigrok, 2006). Jiraporn et al. (2009) document that busy directors serve on fewer board committees. They provided two competing arguments for the likely association between director busyness and serving in board committees. The 'reputation' hypothesis predicts that directors holding multiple directorships will serve in more board committees because multiple directorships allow them to learn about different management styles. Because of their competence and extensive experience they are more likely to serve on a larger number of board committees including nomination committee, than those not holding multiple directorships. The 'busyness' hypothesis, on the other hand, predicts a negative association between multiple directorship and serving on board committees because busy directors will have less time to spend on board committees. Our empirical finding seems to support the reputation hypothesis, which is plausible in New Zealand given the shortage of company directors. The coefficient on ' Control shareholding' is negative and significant suggesting that the probability of forming nomination committees goes down with an increase in controlling shareholding. Firms operating under control shareholding status reduce the effectiveness of board and therefore individual entity involved more on selection process and reduces the importance of monitoring mechanism (Rediker & Seth, 1995).

Finally regression result reveals that firm leverage and firm size are positively associated with the probability of nomination committee existence. In the agency literature, firm leverage represents agency cost of debt. Managers in an effort to reduce this cost, deploy governance mechanisms including independent nomination committee to send signal particularly to lenders of greater managerial oversight. Firms operating with large scale of assets indicate higher monitoring of directorial role (Eminet & Guedri, 2010) and higher compliance of governance regulation. Therefore we expect a positive relation between existence of nomination committee and firm size proxied by total assets. The regression model has an R^2 of about 22% and the model fit is significant at the 1% level with an LR statistic of 169.27.

[13] US listing requirement changed the formal involvement of CEOs in the board member selection process. Exchange regulations now require NYSE-listed companies to have a nomination committee comprising solely of independent directors, and the NASDAQs revised listing provisions required director nominees to be recommended or selected by either a nomination committee comprising solely independent director or by the independent member of the full board of directors. (Carcello et al., 2011; Bebchuk & Fried, 2004)

5. Conclusion

The study has empirically examined whether the formation of nomination committees increased after the passage of the governance code in 2004. We provide evidence supporting a positive effect of regulation on firms' propensity to form nomination committees. We also find that firms that are larger in size, have more complex operations, have a higher percentage of non-controlling shareholders, and have directors with multiple directorships are more likely to form nomination committees. We document a negative and significant association between board independence and the formation of nomination committees which is different from earlier studies. We offer two possible explanations for the conflicting results. First, New Zealand labor market is badly suffering for efficient professional director and therefore, director who appointed as independent director may not be truly independent. Second, we argue that the social ties between the CEO and independent directors could compromise actual independence.

The study has only investigated the determinants of nomination committees. An important extension of this research would be to see the effectiveness of nomination committee and the impact of effective nomination committee on financial reporting quality in New Zealand.

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