Corporate Governance White Paper

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1. Introduction

The challenges for those engaged in corporate governance have continued since early 2009, when Minter Ellison Rudd Watts re-published its White Paper on Corporate Governance in New Zealand. Businesses have continued to have to operate in difficult and turbulent conditions.

Regulators have responded to investor and public sentiment and have taken enforcement action against directors of entities that raised money from the public. Many of those proceedings have resulted in judgments and sanctions against the directors of those public issuer entities, including jail terms. Civil proceedings are now following in several instances. The cases have heightened directors' awareness of their responsibilities and potential personal liability.

These factors continue to emphasise the need for strong corporate governance. Poor corporate governance has been found to play its part in the global financial crisis as well as our own finance company collapses.[1]

The Chief Executive of the Financial Markets Authority and the former Chair of the New Zealand Securities Commission have also stated that they believe that failures in corporate governance played a part in causing a number of the finance company collapses.[2]

While better corporate governance practices will not eliminate corporate failure or destruction in shareholder value, they should, if implemented, monitored and updated regularly, reduce corporate failure and assist in maximising shareholder wealth. As was said in the Higgs Report:[3]

> *"Good corporate governance must be an aid to productivity, not an impediment. It is an integral part of ensuring successful corporate performance, but of course only a part. It remains the case that successful entrepreneurs and strong managers, held properly to account and supported by effective boards, drive wealth creation."*

Certainly, we can say that those boards which do not work well together or with management, who do not maintain deserved trust, or who do not remain alert to a rapidly changing, challenging business environment, will be at substantially greater risk of failure.

In both of our earlier versions of this paper, we recommended boards resist adopting a tick the boxes mentality, i.e. so long as a company has met accepted corporate governance principles (e.g. "x" number of independent

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1 Grant Kirkpatrick, "The Corporate Governance Lessons from the Financial Crisis", 11 February 2009 ("OECD Report") (for the remaining papers in the trilogy, see: http://www.oecd.org/daf/corporateaffairs/corporategovernanceprinciples/corporategovernanceandthefinancialcrisis.htm). See also comments by Heath J in *R v Moses, Doolan and Young* and Miller J in *Davidson v Registrar of Companies*.

2 See the presentation by Sean Hughes, Chief Executive of the Financial Markets Authority to the Institute of Directors on 19 March 2012. He said "I think we can say that the finance company failures were at least in part a failure of corporate governance." See also Sean Hughes, "Finance firm debacle shows light touch failed," New Zealand Herald, 2 January 2012. Sean Hughes states "we've said that the finance company failures were largely a failure of corporate governance." See the speech given by Jane Diplock AO, chairperson of the New Zealand Securities Commission, on 3 September 2008. Poor governance was "at least partially attributable" to most cases of corporate failure.

3 Derek Higgs, "Review of the role and effectiveness of non-executive directors", January 2003 ("Higgs Report").

directors), then all will be well. We noted that it would not be sufficient for directors to simply adopt the structural elements of these principles. The behavioural elements are of equal or greater importance. They also need to be implemented, acted on and monitored regularly. We have been asked by members of the business community to "update" our paper in light of recent case law in New Zealand and Australia.

This paper is intended to do that. We consider that the good governance principles and practices highlighted in our earlier papers, continue to be the relevant ones. They should lead to better corporate governance if properly implemented. In developing our views in this regard, we have considered international developments and relied upon our own experiences as advisers to companies and boards of directors. We have also had regard to discussions we have had with a number of leading directors and senior executives. We have not attempted to summarise the various reports or recommendations around the world, which we have reviewed in the course of preparing this paper. Generally, they are all worthy documents which are well written, considered and useful reference points.[4]

As a general principle we continue to support the principle of "comply or disclose" as recommended in the Higgs Report, by the ASX, the NZX and the New Zealand Financial Markets Authority. We believe this approach acknowledges that "one size does not fit all."

2. What is meant by corporate governance?

The "Principles of Good Corporate Governance and Best Practice Recommendations" published by the ASX Corporate Governance Council ("ASX Report") included a simple summary of what is meant by corporate governance. It states:

> *Corporate governance is "the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations." It encompasses the mechanisms by which companies, and those in control, are held to account. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised.*
>
> *Effective corporate governance structures encourage companies to create value (through entrepreneurialism, innovation, development and exploration) and provide accountability and control systems commensurate with the risks involved.*

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4 Papers include the Higgs Report, the Cadbury Report, Recommendations of the Royal Commission on HIH; ASX Corporate Governance Council, "Corporate Governance Principles and Recommendations with 2010 Amendments", 2nd edition, June 2010 ("ASX Report"); the Sarbanes Oxley Act; changes to the NZX Listing Rules; the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (Australia); New Zealand Securities Commission "Statement on Corporate Governance", 28 November 2002("NZSC 2002 Paper"), "Corporate Governance in New Zealand Consultation on Issues and Principles", 5 September 2003 ("NZSC 2003 Paper"), "Corporate Governance in New Zealand Principles and Guidelines", 16 March 2004, reprinted February 2011 ("NZSC Principles"), and "Securities Commission principles of Corporate Governance – Update", 29 November 2006 ("NZSC 2006 Update"); the initial ICANZ Report on Corporate Governance, "Corporate Transparency, Making Markets Work Better", August 2002; the ICANZ report to the Minister of Commerce on Corporate Reporting, "Improving Corporate Reporting: A Shared Responsibility", May 2003 ("ICANZ Report"); OECD, "Board Practices: Incentives and Governing Risks", 2011 ("OECD 2011 Report") Financial Reporting Council, "Guidance on Board Effectiveness", March 2011; New Zealand Securities Commission, "Review of Corporate Governance Disclosure by Selected Issuers, July 2010.

We consider this definition a useful description of "corporate governance".

3. Summary of Minter Ellison Rudd Watts' recommendations on best practice principles and practices for good corporate governance

We set out below a summary of our views of best practice principles for achieving good corporate governance. In recognition of our view that one size does not fit all, we continue to support the Australian and English approach of "if not, why not". I.e. if a company does not adopt the recommendations, then it should explain to shareholders why not. On many occasions, there may be good reason for not following these best practice recommendations.

The recommendations fall into two categories – essentially "behavioural" and "structural" issues. We consider the behavioural aspects of equal or greater importance to the structural.

In summary, we recommend the following "behavioural" principles be considered for adoption to enhance corporate governance (a more detailed explanation and discussion follows below):

- each director of a board (especially non-executive directors) needs to ensure they both deeply understand the business of the entity they are governing, and the risks inherent in that business, while at the same time bringing to the table an alertness to threats and opportunities in the external environment which may not always be apparent to management. It is inappropriate to rely on fellow directors for business or financial understanding or for directors to only be able to contribute in a narrow area of expertise. Further, directors must be financially literate particularly in relation to public issuers;

- while directors must retain objectivity from management and be willing to engage in constructive and rigorous debate, directors and senior management should endeavour to work as a team with a common objective – the success and sustainability of the business;

- directors must be prepared to engage in constructive and rigorous debate with one another and management – challenging status quo thinking matters, especially in times of turbulence;

- directors must commit the necessary time to fulfil the role – generally more is required than attendance at monthly board meetings and information overload is not an excuse;

- boards should focus on the priorities of the business for its success and sustainability – compliance should not be a primary focus of the board;

- the chief executive and senior management (e.g. CFO) must have the well-placed trust and confidence of the board, otherwise the chief executive should be replaced or the board resign;

- in times of crisis or challenge, boards must act with urgency and should seek appropriate "heavyweight advice". Boards also need to bear in mind that advisers only advise. Their advice is only as good as the information provided to them. Directors need to read, consider and seek to understand advice. If a director does not understand the advice or has any reason to doubt it, he or she should seek clarification or understanding from the adviser. Reliance on advisers only assists a board as a defence to an accusation of a failure by a director to meet the standard of care expected of directors. It is axiomatic that it is far better not to be in the position of having to establish a defence on the basis that directors relied on advice;

- boards should be satisfied that the remuneration packages of senior executives and directors are appropriate and create incentives aligned with the company's long term best interests. The balance between fixed and at risk remuneration needs to be carefully struck – a significant difference can encourage short termism;

- boards should seek to persuade shareholders to support directors being remunerated at a level that better reflects the responsibility and risk directors assume;

- conflicts of interest need to be recognised and managed seriously and openly. Perceptions of conflict are nearly as important as actual conflicts;

- the chairperson has the primary role in leading the board and in fostering a constructive and open relationship with management, particularly with the chief executive. The chairperson should develop a relationship with other senior executives, as well as the chief executive, so that he/she is given a heads up on issues if the chief executive is keeping information from the board;

- The chairperson is not just a figurehead. The chairperson's role involves leadership. The chairperson has the primary obligation of ensuring the agenda for board meetings is properly formulated, for guiding decisions and ensuring meetings are conducted efficiently and effectively;

- while board committees are a useful means for the board to carry out certain areas of its work load, we caution against heavy use of board committees (recognising that the audit committee has a particularly heavy role). Board committees should not result in an abdication of responsibilities by board members not on those committees. Where entities are offering securities to the public, particular care needs to be taken that any committee overseeing the securities offering process does not fetter the right and obligation of each individual director to provide a meaningful review and give feedback on the offering documents. Even beyond offer documents, all directors need to understand and be across key risk areas for the business and understand them. Directors cannot avoid responsibility by overreliance on sub-committees;

- continuous disclosure should be embraced by companies;

- the board should review its mix of directors from time to time and make changes to allow for new blood and new skills if that is required;

- candidates should undertake due diligence on the company and their potential board members;

- non-executive directors should meet regularly without the presence of management so as to provide a forum for discussion of issues that may not be aired in the presence of management;

- adoption by boards of a Code of Ethics can be useful if it is constantly used as a reference point for decision making;

- boards should avoid 'spin'. Don't represent to investors and other stakeholders that you observe good corporate governance standards or meet best practice if you do not. Only represent what you actually do;

- shareholders should use their powers to demand better corporate governance; and

- investors should not overly rely on external credit ratings when making investment decisions.

In summary, we recommend the following "structural" practices and principles be considered for adoption to enhance corporate governance (a more detailed explanation and discussion follows):

- the requirement for a specified number of independent non-executive directors is a sound principle but will not necessarily result in better corporate governance or enhanced performance. However, independent non-executive directors can play a useful role where there is a major shareholder;

- clear delegations should be in place between the board and management. These should be monitored and reviewed regularly. Similarly, if the board has adopted a policy, it can leave implementation of that to management. However, the board must take steps to see that management implements the board's policy. Boards should be prepared to question the basis of an assurance from management – i.e. the board cannot do its job simply by relying on assurances from management;

- disestablish board committees that do not meet;

- boards should avoid acceptance of 'oral reports' from management, insist on written reports and that the board have sufficient time to read and consider them prior to board meetings or being asked to make decisions in respect of them;

- boards should engage in regular reviews of the board and individual directors' performance;

- a board should have an appropriate mix of skills and experience for its stage of development;

- the chief executive should be a member of the board of directors;

- the chief executive and the chairperson should not be the same person;

- a chief executive of a company should not go on to become chairperson of the same company;

- boards should have an audit committee made up of non-executive directors, chaired by someone other than the chairperson of the board and include members with strong financial skills;

- audit partners should rotate every five years from a client;

- auditors should be constrained from undertaking non-audit work for an audit client;

- there should be cooling off periods between audit partners and senior audit staff of an auditor joining an audit client as employees or directors;

- the chief executive officer and chief financial officer should be required to sign off on financial statements;
- companies should outline their corporate governance policies and report on them in their annual report to shareholders. Companies' policies and reports should also be made available on their websites;
- quarterly reporting is not required under an effective continuous disclosure regime and where material information is revealed in quarterly reports this can lead to suggestions that it should have been disclosed earlier;
- consideration should be given to providing protection for whistle blowers in corporates who report bad corporate governance to regulators; and
- care needs to be taken where credit rating agencies are involved that any conflicts of interest are identified and managed.

4. Key corporate governance principles – Behavioural issues

4.1 Boards must deeply understand the business they are in, and be alert to external threats and opportunities not always apparent to management

From the global financial crisis originating from the sub-prime issues in the United States, and the contagion that followed from exposure to Collateralised Debt Obligations ("CDO") and Credit Default Swaps, we have been surprised to learn that directors of some the world's leading financial organisations, as well as the regulators who supervised them, did not understand deeply enough the business their institution was in, and the risks inherent in the business model chosen. Closer to home, we have seen non-executive directors held liable in circumstances where it seems that they did not understand the risks the business was exposed to, and the potential second and third order consequences of those risks. While in a time of stability, it may be possible to survive without that deep understanding; in turbulent times, it creates serious exposure. In our view, directors both at the time of their appointment (see below), and subsequently, need to take whatever steps are necessary to ensure they understand the business' operations and strategy.[5]

The finance company cases in New Zealand and the Centro case in Australia make it absolutely clear that all directors must understand the fundamentals

[5] Similarly, the OECD principles on corporate governance suggests that "board members acquire appropriate skills upon appointment, and thereafter remain abreast of relevant laws, regulations and changing risks through in-house training and external courses." See also para [6.2] of OECD, "Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles", 24 February 2010 ("OECD 2010 Report") recommending that this recommendation be made more explicit in the OECD principles rather than as a footnote. In some sectors having the requisite qualifications and experience is mandated: the fit and proper person test for a person to be a director of a licensed insurer requires this (http://www.rbnz.govt.nz/finstab/insurance/4434500.pdf).

of the business, monitor performance and review financial statements regularly. Justice Heath said in the Nathans Finance case:[6]

> *"Directors need to have the characteristics, skills and experience to ... enable the fortunes of the company to be guided and for the management of the company to be monitored. Those obligations are cast upon all categories of directors, not just executive directors."*

Justice Heath also said:[7]

> *"It is axiomatic that a director of a finance company will be assumed to have the ability to read and understand financial statements and the way in which assets and liabilities are classified. … Without those skills, it would not be possible for directors to monitor and guide the finance company's business."*

While Justice Heath made his comments regarding financial literacy in respect of a finance company, we expect the courts will require all directors of public issuer entities to be able to read and understand the financial statements of their entities.

Directors (especially independent directors) should also bring to the table an alertness to threats and opportunities in the external environment which may not always be apparent to management. The reality of a full time executive's life is that they become deeply involved in and committed to the company's business strategy and operations. Often the most successful managers do this with a singular focus and passion, which drives the business forward. At the same time, this, in itself, can create a risk if they do not have ability to detect external threats and opportunities early. Directors whose involvement in the business is part-time, and who have a broader perspective (for example, from other sectors) have a key role in sharing those insights and assisting the board to identify emerging trends early, so that the company can respond.

The OECD Report noted that the financial crisis had highlighted "severe shortcomings in practices both in internal management and in the role of the board in overseeing risk management systems" in relation to a number of the large international financial sector companies that were the focus of their review. That was the case despite the importance attached to risk management by regulators and corporate governance principles. This was in part due to a lack of understanding of the business by the directors. For example, they observed that boards of many financial institutions lacked directors with specialist experience in, or deep knowledge of, current practices in the industry. The same directors sat on highly technical board committees, including those related to audit and risk.[8] Other factors such as remuneration policies and communication between management and the board also contributed. We address these issues below.

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6 *R v Moses, Doolan & Young* High Court, Auckland, CRI-2009-004-1388, 8 July 2011 ("Nathans Finance"), at para [85].

7 Ibid, at paras [83]-[84].

8 See OECD Report, page 22.

4.2 The board and senior management team must have a constructive relationship and endeavour to operate as a team

In the debate on corporate governance in New Zealand, we have observed a degree of distrust between boards of directors and management. We believe that issue remains live. Successful corporate governance will, of course, require both directors and managers to work together positively (along with others who are influential in the process, such as advisers). This is particularly important when the external environment creates stress and pressure. In our experience, this requires some good old basic values to be alive and well between the two groups – trust, mutual respect, openness, a willingness to engage in robust debate, integrity, independence, courage and honesty. While few directors or senior managers would suggest that these values do not exist in their own organisations, our observation remains that they are not always as prevalent as is desirable.

If there is distrust between these two key groups, there will not be an atmosphere conducive to openness and honesty between senior management and the board. Trust is a critical ingredient, along with mutual respect. Boards need to foster an environment in which senior management will engage with directors about ideas and problems early, so that constructive debate can occur and solutions be developed. A distrustful atmosphere will lead to senior managers only willing to engage with boards if they feel they know all the answers to every angle of an issue. The risk from that is that boards may be deprived of the opportunity to offer their wisdom, experience and judgement.

This is not only a New Zealand problem. Congressional hearings, held during 2008 in the United States to investigate the financial crisis, revealed distrust and disrespect between management and the board in many of the failed financial companies in the States.[9] There was a lack of effective communication of risk throughout the organisations examined – delays in reporting risk exposure resulted in the companies taking on excessive risk for prolonged periods of time.[10] Interestingly, the OECD Report found that firms that avoided these problems "demonstrated a comprehensive approach to viewing firm-wide exposures and risk, sharing quantitative and qualitative information more efficiently across the firm and engaging in more effective dialogue across the management team."[11]

Here, one experienced senior executive commented to us that it is important in the corporate governance debate that the board and management remember that they are a team with a single goal – the best interests of the company over the long term. Another experienced director said to us that, while the board and management can be regarded as a team, it is important that both groups understand their different roles and that some distance is retained, so that the board maintains its objectivity and is willing to engage in constructive and rigorous debate. We believe both these views can be reconciled. A good team can be one where competent people work to achieve a shared vision and engage in constructive and rigorous debate when required. That debate also requires

9 See for example the hearing on 7 March 2008 on "CEO Pay and the Mortgage Crisis", available at http://oversight.house.gov/story.asp?ID=2011. The hearings examined the compensation and retirement packages granted to former CEOs of Countrywide, Merrill Lynch and Citigroup.

10 For example, UBS senior management only became aware of the company's risk exposure half a year after their group risk management body was alerted to the risks. See also para [5.3] of the OECD 2010 Report regarding risk disclosure.

11 See OECD Report, page 8.

open sharing of the information required for the debate to be informed. Both aspects require mutual trust. We believe that is an environment in which superior performance should be able to be achieved.

4.3 Directors must engage in constructive and rigorous debate with each other and management

But trust alone is not enough. At the same time as maintaining a positive relationship and endeavouring to work as a team, directors must be prepared to engage in constructive and rigorous debate with each other and senior management. At times, this requires a degree of courage to pursue a line of thought which may challenge the collective wisdom around the table, as well as the sensitivity to be able to do so in a way which is not misinterpreted as a personal conflict. It also requires an ability to accept challenge of one's own ideas, without feeling personally threatened – and an awareness that no-one has an exclusive monopoly on understanding reality. In particular, management should understand that it is an inherent part of the non-executive director's role to question and challenge. Doing so does not imply a lack of trust – it is simply part of the job. The ability to achieve this balance depends in large part on the personalities of directors as well as their skills, commitment of time, and relationship with management.

We believe that the chairperson has a critical role in fostering an environment that encourages both working as a team, as well as challenge and debate. This is not easy to achieve, but is a significant contribution to good governance. Justice Heath made it clear in the Nathans Finance case that "a chairman is not just a figurehead. His or her role involves leadership."[12] We comment further on the responsibilities of the chairperson below.

4.4 Directors must commit the time necessary to fulfil their role

We recognise that the deep understanding and external awareness referred to above requires significant time and effort to obtain and maintain. With the increasing complexity of business in today's environment, the increased expectations of directors by the community and, in our view, the likelihood of courts expecting more of directors, along with calls by some regulators for increased responsibilities for directors, it is critical that directors devote the necessary time to the role.

In this regard we note that information overload is not an excuse, especially for important documents. In the Centro case, Justice Middleton said:[13]

> *"A board can control the information it receives. If there was an information overload, it could have been prevented. If there was a huge amount of information, then more time may need to be taken to read and understand it. The complexity and volume of information cannot be an excuse for failing to properly read and understand the financial statements. It may be for less significant documents, but not for financial statements."*

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[12] Nathans Finance, at para [399].

[13] *ASIC v Healey* [2011] FCA 717, at para [229].

Further in *Gold Ribbon (Accountants) Pty Ltd (in liq) v Sheers & Ors*, Williams noted the consequences of not devoting sufficient time to a director's responsibilities:[14]

> *"a director who absents himself from attendance at meetings is obviously likely to disable himself or herself from adequately performing the obligation to keep informed about the company's activities so as to contribute to the collective management of the company's affairs, or from performing the obligation to monitor the company's affairs and policies."*

To be effective, and to adequately meet their responsibilities, directors need to do more than simply read board papers and attend regular board meetings. They need to take the time to understand the company's business and the environment it operates in, confer with one another, and participate in appropriate ways to support the company, including committing significant amounts of time when issues the company is dealing with require this. Undoubtedly these expectations will limit the number of companies for which a director can accept directorships. At the same time, it is undoubtedly helpful for non-executive directors to be on more than one board at a time, as they can bring different insights to issues and trends, and corporate cultures to bear.

This factor, together with the increased demands on directors, continues to justify, in our view, a significant lift in directors' fees in New Zealand. New Zealand directors' fees continue to be significantly below those generally paid in Australia. The issue of increasing directors' fees in light of proposed responses to corporate governance has received consideration internationally.[15]

4.5 The board should focus on the priorities of the business

It has been put to us that, with the turbulent external environment and an increased focus on director performance and potential director liability etc, it is natural and reasonable for boards to focus on "compliance". Indeed, adoption of good corporate governance principles requires some monitoring of compliance with those principles.

However, there is a tension between boards being satisfied they are meeting their miscellaneous legal obligations and the need to really focus on the business, so that the business meets its business objectives and is successful and sustainable. There is a real danger that a company can become overly internally focussed and that financial performance, and therefore the long term sustainability of the business itself, may be threatened if board meetings are primarily focussed on compliance and personal legal risk avoidance.

One experienced senior executive put it to us that the board should agree with senior management the priorities for the business and make reporting on these the focus of board meetings. Compliance should be a feature of board meetings but not the dominant purpose. We agree with that view. A balance is required, and it is important that compliance is seen as an important part of the process, but not an end in itself.

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[14] [2006] QCA 335, [223].

[15] See, for example, the Higgs Report and the OECD 2011 Report.

In the current context, government, regulators and the business community need to ensure that the balance referred to above is maintained. In the wake of corporate failures, there is often a popular expectation that "someone must be held accountable" and a call for company law responsibilities to be tightened. We have seen this occur since the last update. While this may be justified in some cases, there is a risk that inappropriate legislative or regulatory intervention may simply increase a systemic focus on compliance at the expense of sustainable business performance, with obvious implications for New Zealand's long run economic performance. The Financial Markets Authority's power to enforce directors' duties further adds to the focus of boards on compliance (see further at 5.14 below) as do the proposals to criminalise breaches of the duties to act in the best interests of the company and to avoid reckless trading.[16]

4.6 It is critical that the board have the right chief executive for the company's stage of development and that he or she has the trust and confidence of the board

In all of the discussions we have had with directors, they have all consistently stated that they believe the appointment of the chief executive is the most important decision the board makes. We agree with that view and would add that ongoing performance is also very important. If the board does not have confidence in that person, there is little likelihood of the principles of constructive debate, teamwork between the board and management etc. operating. If there is not a relationship of mutual trust and confidence, then change needs to occur – either the board or the chief executive must be replaced.

In *Davidson v Registrar of Companies*, Justice Miller made it clear that it is dangerous for a board to continue to rely upon an executive who fails to "immediately comply" with a request or direction of the board. His Honour concluded that, if a board finds itself in the position that it cannot rely on the trustworthiness of the chief executive, and cannot remove them for any reason (e.g. because they are the major shareholder) the right course of action is for the board to resign.

There are differences of view amongst directors as to the extent to which the board should engage directly with senior management reporting to the CEO and seek a similar level of trust and confidence. Our view is that the board should respect the chain of authority within the company. However, it is not inconsistent with that approach for the board to ensure it is satisfied that the CEO is supported by senior management in whom the board has confidence. This is particularly the case in relation to the chief financial officer, given the importance to the board in undertaking its monitoring role of receiving reliable, appropriate financial information.

4.7 Boards should engage appropriate "heavyweight" advice on critical issues but recognise they cannot abdicate their decision making role to advisers

The Centro case in Australia and the finance company cases in New Zealand emphasise to us that when the going gets tough or on key issues involving

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16 See the Companies and Limited Partnerships Amendment Bill.

risk, boards should invest in obtaining quality 'heavyweight' advice. Directors must remember however that advice is just that advice. Directors must still make the relevant decisions having taken into account that advice. As Justice Heath said in *Nathans*:[17]

> *"Clients instruct; advisers advise. The quality of any advice is only as good as the information provided to the professional, on the basis of which he or she is asked to advise. In considering the extent to which directors are entitled to rely on external advice, some assessment must be made of the prime information on which the adviser acted and whether he or she was on inquiry as to the accuracy of that information."*

4.8 Boards should be satisfied that the remuneration packages of senior executives and the chief executive officer or managing director, in particular, are appropriate and in the company's best interests

One of the themes of various corporate failures (including massive reduction in shareholder wealth which has not resulted in a total collapse of the company) has been that remuneration packages for senior executives have contributed to short term thinking and, in some cases, undesirable behaviour. This has been the case since before our 2003 report, and continues. It has frequently been raised as a major contributor to the international financial sector failures.

It has been put to us that, unless carefully designed, packages where the difference between the "fixed" component of remuneration and the "at risk" or performance aspect is significant (which is now common in New Zealand and internationally) can lead, and commonly do lead, to a focus on taking whatever steps are necessary to achieve that bonus or at risk sum (or a significant part of it). At the extreme, this can lead to risks being taken that result in the total loss of shareholders' equity and collapse. We accept that overseas, especially in North America, remuneration practices have gone far beyond what is typically seen in New Zealand. We also agree that a totally fixed package may not reward or encourage exceptional performance; it may in itself give rise to inappropriate incentives including complacency and loss of competitive advantage over the long term, which can also undermine corporate sustainability. However, we believe it is critical to ensure that there is an appropriate balance between fixed and at risk remuneration, and that packages do not encourage "short termism" to the detriment of the long term performance of the company.[18]

Our comments regarding bonuses and at risk portions of remuneration packages are equally applicable to option schemes.

The NZX recommends[19] that directors should be remunerated partially under a performance-based equity security compensation plan, or

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17 Nathans Finance, at para [100].

18 The UK Corporate Governance Code (2012) for example lists as a supporting principle that the performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company.

19 See para [2.7] of Appendix 16, Corporate Governance Best Practice Code of the NZX Listing Rules which is based on the NZX's proposals in May 2003 ("NZX Best Practices Code"). See also rules

alternatively, by investing in equity securities (such as options) in the company. In 2009 in response to the global financial crisis, the NZX recommended that boards accept part of their remuneration in shares in lieu of cash – with a view to assisting cash constrained entities and to display a signal by directors to "share the pain" and invest in the company for the longer term. We support that sentiment. There are contrary views as to whether this is positive for good corporate governance. It can lead, just like non-fixed senior executive remuneration, to a short term focus.[20] We accept there is a contrary view, that if directors hold equity in the company they have a real economic incentive to see it perform (we believe that the potential liability and reputational risk is as much as an incentive as holding equity). If a director holds a large equity stake, that can also raise issues as to whether the director remains independent. This is not necessarily a problem in itself; however, it may impact upon whether a company has the required number of independent non-executive directors.

We note that this remains a live issue – a study conducted by Nestor Associates and cited in the OECD Report indicates that financial institutions that remunerated senior management with high stock holdings at multiples of the base salary, had high rates of collapse in the global financial crisis in the United States.[21]

More recently, the OECD 2011 Report paid particular regard to a board's ability to effectively oversee executive remuneration. The report considers, at some length, the challenges of how to encompass remuneration and incentive arrangements with the longer term interests of the company. In that report, the OECD said:[22]

> *"The key challenge for boards is to understand how risk flows through the structure of remuneration and, as importantly, the remuneration metrics. This is not an easy process since there will be a certain degree of information asymmetry between the board and executives, with the latter having a greater understanding of the drivers of chosen remuneration metrics. In terms of process, this suggests a number of steps that boards could take to improve remuneration arrangements: i) a better integration between risk management and compensation/incentive setting such as by cross membership of risk/audit committees and compensation committees; ii) adopting formal processes for mapping risk tolerance with incentive structure; and iii) extending the duration of performance targets and factor in greater ex-post flexibility including clawbacks."*

We expect that the approach to executive remuneration will continue to evolve as boards experience, in practice, what does and does not work. Invariably, these perspectives are learnt with the benefit of hindsight.

We note that the ASX Report focused heavily on disclosure of remuneration policy and actual remuneration to key executives (as well as directors) as an

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3.5.1 and 7.3.7 of the NZX Listing Rules, which allows entities to pay directors in stock where the director so elects and it is approved by shareholders.

20 As recognised by the New Zealand Securities Commission in the NZSC Principles and in the NZSC 2003 Paper.

21 See OECD Report, page 14.

22 OECD 2011 Report, page 8.

important corporate governance principle.[23] Indeed the Financial Markets Authority also regards it as important to achieving good corporate governance.[24] While not objecting to the requirement for disclosure, we believe the more critical issue is that directors are satisfied that the policies in place give the appropriate signals the company needs, bearing in mind its stage and development.

Some senior executives we have spoken to have noted that a regime of disclosure of actual remuneration of key executives can lead to shareholders focussing on that issue to a greater extent than other important issues for a company (such as the company's strategy) at general meetings. Ultimately, how shareholders derive value from shareholder meetings is over to them.

Director retirement allowances or termination payments to retiring chief executives do not appear to have been a significant issue in New Zealand compared to other jurisdictions.

We believe it would be undesirable if the practices which have occurred in other jurisdictions (such as in Australia) were be repeated here. Indeed the payments made to some departing directors of companies in Australia which have failed or destroyed shareholder value have been described as obscene.[25]

The OECD 2011 report found that:

> *"the most common approach among OECD countries is for the legislation to provide some degree of prescription as to how the process of remuneration setting is governed, normally in terms of assigning responsibilities amongst company organs and, less frequently, by mandating certain criteria for independence. In relation to the former, Principle II.C.3 recommends that "shareholders should be able to make their views known on the remuneration policy for board members and key executives. The equity component of compensation schemes for board members and employees should be subject to shareholder approval". Thus, the principle has two separate components: i) some form of shareholder engagement on remuneration policy for both boards and executives and ii) explicit approval of any share based schemes."*[26]

Fundamentally, we believe shareholders are best placed to approve director remuneration, and the Board should approve executive remuneration. We support the approach of Rule 3.5.1 of the NZX Listing Rules which requires directors' remuneration to be approved by an ordinary resolution of shareholders. We also recommend that such an approach be considered as part of the governance of widely held companies which are not listed. We note that such a requirement does not apply globally. In the United Kingdom for example, shareholders of listed UK incorporated companies at present have a mandatory but non-binding vote by ordinary resolution to

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23 These policies have now been enacted in section 300A of the Corporations Act 2001 (Australia) ("Corporations Act").

24 See http://www.fma.govt.nz/keep-updated/newsroom/releases-from-the-old-securities-commission/2010/issuers-could-improve-corporate-governance-reporting/.

25 In the Report of the HIH Royal Commission, the Commissioner states that, "the scale of remuneration and also retirement benefits in some cases seems obscene to many in the community and gives rise to understandable outrage when there is a gap between apparent performance and the magnitude of the payment." See further OECD 2011 Report, page 16.

26 OECD 2011 Report, page 20.

approve directors' remuneration. However, in March 2012 the Department for Business Innovation & Skills put out a consultation paper proposing, amongst other things, a binding shareholder vote on remuneration annually, unless it remains unchanged in which case it is every three years.[27]

Recently in Australia, legislation was passed to put in place the "two strikes" rule for approval of directors' and executives' remuneration by the shareholders of listed companies. If, at the annual general meeting, at least 25% of the votes were cast against the remuneration proposal put forward by the board, the directors' report for the next annual general meeting must specify what the board's actions were in response, or the reasons for inaction. At the next annual general meeting, if 25% of votes are again cast against the remuneration proposal, there must be put to the vote a resolution that a meeting be held within 90 days to re-elect all of the directors. These developments give real voice to minority shareholders in remuneration issues and will push boards to have an active discourse over the remuneration proposal.

While there have been issues overseas regarding excessive director remuneration, we do not believe there is any issue in New Zealand. Indeed, we think if anything there is an issue with director remuneration being too low. See our comments at 4.5 above.

We agree that a remuneration committee can be a useful tool at increasing accountability to shareholders for remuneration decisions. But we do not believe there should be a hard and fast rule requiring a committee. In some cases, the size and scale of a company will justify establishing such a committee, in other cases it will not. We agree with the Royal Commissioner of the HIH Royal Commission when he said that:[28]

> *"The creation by a board of a remuneration committee to consider matters of this kind may be useful, especially if it facilitates their consideration by the non-executive directors. But again I mention the need for flexibility. There is not much point in demanding that a company with three directors should have a separate (or any) remuneration committee. In the end the board itself has to take responsibility for its decisions."*

Nevertheless, we believe that executive directors should not sit in, or participate in, discussions on their own remuneration.

4.9 Boards should seek to persuade shareholders to remunerate directors at a level that better reflects the responsibilities and risks that the position reflects

We consider that directors' fees in New Zealand have been low and there is a case for directors receiving fees more consistent with the risk of the position and the increased time commitment expected. There have been occasions in New Zealand where boards have sought to increase directors' fees and have backed down following investor or media pressure. We think boards should be more robust with shareholders about the need for

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27 See: http://www.bis.gov.uk/assets/biscore/business-law/docs/e/12-639-executive-pay-shareholder-voting-rights-consultation.pdf. The proposal would be made by way of the Enterprise and Regulatory Reform Bill amending the Companies Act 2006 (UK).

28 Report of the HIH Royal Commission, at para [6.2.9].

directors' fees to better reflect the skills, time and risks associated with the position.

Board remuneration of government controlled companies or organisations tends to be lower than that of comparative commercial entities. We do not think that is appropriate. It relies upon quality directors being prepared to accept that in part they are doing "public service". Given the increased time commitment the courts and regulators now expect of directors, as well as the increased risk of personal liability under the proposed Financial Markets Conduct Bill, we encourage government to remunerate directors of government entities to better reflect these factors.

4.10 Conflicts of interest should be recognised and dealt with seriously and openly

Conflicts of interest and perceived conflicts of interest need to be recognised and should be dealt with seriously and transparently.

Directors should actively disclose to the board all potential and actual conflicts of interest.

In our view, despite the fact that the Companies Act 1993 allows an interested director to participate in discussions and vote on matters in respect of which he or she has an interest, best practice is that directors should not do so (this is consistent with the NZX Listing Rules which generally prohibit voting by an interested director).

The issue of "conflict of interest" has been a significant one in a number of major corporate failures in history, including recent history. Some recent examples have illustrated that conflicts were not properly disclosed or, once disclosed, were overlooked.[29] Conflicts were overlooked in the sense that, despite the conflict and its disclosure, directors or senior executives participated in decisions in respect of which they had a conflict even if that involved promotion of their own interests.

4.11 The chairperson's primary roles are to lead the board, facilitate an effective contribution by directors and have the key relationship between the board and the chief executive

There are numerous writings on the topic of the role of the chairperson,[30] and different approaches are taken in different jurisdictions. In the United States, for example, it remains common in listed companies for one person to be both chief executive and chairman of the board. In the United Kingdom, Australia and New Zealand, this is not the norm, and in some cases the chief executive is not a director.

We consider that separation of the roles of chairman and chief executive is very important for good governance. The themes which emerge from the

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29 See Enron and HIH, for example.

30 Including the Cadbury Report, the Higgs Report, the ASX Corporate Governance and Best Practice Recommendations, comments in the Onetel decision (*ASIC v Rich* [2003] NSWSC 85), *Whitlam v ASIC* [2003] NSWCA 183, the HIH Royal Commission and recently comments by Heath J in the Nathans Finance case at paras [399] – [400] citing the Institute of Directors Code of Practice for Directors.

literature referred to above (and with which we agree) are that the chair is responsible for:

- leading the board;
- monitoring the effectiveness of the board;
- setting the board agenda;
- chairing all shareholder meetings;
- supporting the chief executive and being available as a "sounding board";
- arranging the regular evaluation of the board, its committees and executive directors;
- facilitating effective contribution of non-executive directors;
- facilitating a constructive relationship around the board table which supports rigorous and constructive debate;
- ensuring that management clearly understands the board's expectations of them; and
- ensuring that all directors receive sufficient and timely information to enable them to be effective board members.

These are different responsibilities from those of the chief executive in leading the management team and running the business in a day to day sense. Combining the roles risks the governance responsibilities described above not receiving the priority required.

Some of the various reports have also suggested that, amongst other matters, it should also be the chairperson's responsibility to:

- require management to provide the board with accurate, timely and clear information;
- foster a constructive relationship between the board and management;
- ensure board meetings allow sufficient time (and indeed time prior to the board meeting to prepare) for adequate discussion, consideration of issues and constructive debate; and
- ensure that board meetings do not simply "go through the motions".

In our view, while the chairperson has an important role in ensuring the above are achieved, all directors should contribute to their attainment, as well as being a sounding board to the chief executive (particularly on matters in which a director has a particular interest or experience). Recent case law affirms this. All directors are required to guide and monitor the business of the company; they cannot discharge this duty if they have not ensured that they have adequate control over the same and effective lines of communication to the board from management.

It has been put to us by a number of directors that, while it is important for the chairperson to be accessible to the chief executive and act as a sounding board, it is important that that relationship does not become too close. Similarly, it is important that the chairperson listen at board meetings to views contrary to those of the chief executive's view.

The recent finance company cases also highlighted the importance of the chairman having a good relationship with all members of the senior management team so that if a chief executive withholds information from the board it is more likely that a member of senior management will give the chairman a 'heads up' personally on a confidential basis.

The Australian **OneTel** decision (*ASIC v Rich*)[31] caused concern in 2003 that the law may now impose additional responsibilities and expect more of the chairperson of companies than was generally regarded as the case. In that decision, in determining the standard of care required of the chairperson, the Court had regard to current corporate governance literature. This was relied upon to establish that at the relevant time the chairperson was subject to responsibilities and, ultimately, legal duties never before set out in statute or by judicial decision.

The Court found that directors were under a duty to be generally familiar with the business and financial condition of a company and that a director is under a continuing obligation to keep informed about the activities of a corporation, in particular, its financial status. The Court concluded then, that if the duty to keep themselves informed exists for all company directors, it must be a duty imposed on the company chairperson, whose "responsibilities" may be enhanced.[32]

We note that, under the Companies Act 1993, in determining the standard of care expected of a director, regard is had to "the position of the director and the nature of the responsibilities undertaken by him or her."

More recently, the finance company cases in New Zealand have made it clear that the chairperson of a board has additional responsibilities.[33]

4.12 Use of other committees should not result in an abdication of the board's responsibility

In addition to an audit committee, we note that it is now reasonably common in New Zealand for boards to have various other subcommittees which undertake certain work for the board. These include a nominations committee in relation to director appointments and a remuneration committee. Indeed, both the Higgs Report and the ASX Report recommend the use of these committees as a means to assisting in achieving good corporate governance. The Higgs Report says this:[34]

> *"The increased use of board committees on audit, remuneration and nomination has played an important role in raising standards of corporate governance. Although the board retains ultimate responsibility, these committees give assurance that important board duties are being rigorously discharged …"*

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31 [2003] NSWSC 85.

32 Shortly after *ASIC v Rich* was pronounced, *Whitlam v ASIC* [2003] NSWCA 183 seemed to take a step backwards from the suggested increase in chairperson responsibilities, in relation to chairpersons acting as a proxy on behalf of shareholders. In *Whitlam*, the New South Wales Court of Appeal overturned the lower court's finding that in failing to vote as directed by the shareholders, the chairperson-proxy was in breach of his duties as a director. It was held that the chairperson only owed duties as a proxy to the members who appointed him (i.e. under an agency relationship), and not to the company as a director. The chairperson's superior knowledge and expertise did not increase his obligations as an agent. See also *Motor Trades Association of Australia Superannuation Fund Pty Ltd v Rickus (No.3)* [2008] FCA 1986 at paras [52]-[53].

33 See generally the Nathans Finance case.

34 Higgs Report, at page 59.

Higgs went on to recommend that no one individual be appointed to all three board committees to avoid any one person having too much influence.

The NZX's Listing Rules recommend separate board remuneration and nomination committees.[35]

Most writings recommend committees adopt a charter setting out their role, responsibilities and the principles that will guide them.

Board committees can be useful and reduce the amount of time required of the full board to discuss the detail of the work involved. However, whether the use of these committees is the best way for the boards to undertake their business will, in our view, depend on the nature of the company and its stage of development. If committees are used, given that the board itself remains ultimately responsible, we consider it important that it be briefed regularly on the committee's work and any important issues which have been deliberated. Board members not forming part of the committee should not be inhibited by the existence and operation of the committee to probe and ask whatever questions, or seek whatever assurances, they deem necessary.

In our view, the Centro case in Australia and the finance company cases in New Zealand have made it clear that, in relation to public offer documents and financial statements, each director has a non-delegable duty to satisfy themselves that such documents are not misleading. This is a personal duty. Directors need to take care in relation to public offer documents and financial statements that the use of due diligence committees does not compromise non-committee board members' ability to contribute meaningfully to and assess the content of those documents. More generally boards need to be careful that they do not over rely on committees especially when the committee is tasked with oversight of a core business risk area.

4.13 Companies should strongly embrace the continuous disclosure principle

We support the continuous disclosure regime. We consider that a requirement to constantly keep the market informed of material issues is fair and will ultimately improve corporate governance. Companies should not be able to withhold "bad news" with a view to propping up their share price. Similarly, by requiring companies to also disclose the "good news", the risk of those in the know using that information for their own advantage is minimised. Investors should be entitled to know the material "good" and "bad" news in deciding whether, and how much, to invest in a company.

The continuous disclosure regime has now become an important part of the functionality of our market, and boards seem relatively comfortable with it. We consider that the disclosure practice is continuing to improve and strengthen as the market becomes more demanding in its expectations. We recognise that difficult issues arise from time to time as the line between material information that is required to be disclosed and information that does not need to be disclosed (whether because it is not material or one of the exceptions to disclosure applies) is not always clear.

We have observed a heightened awareness and sensitivity by boards and issuers to continuous disclosure compliance post the Securities Commission

[35] See paras [3.7] and [3.10] of the NZX Best Practices Code.

issuing civil proceedings against Nuplex and its directors in April 2010 in relation to alleged breaches of continuous disclosure laws.

4.14 Tenure of directors – the board should review its mix regularly and be satisfied it is appropriate for the company's stage of development

The board should review its mix from time to time and be satisfied that it is appropriate for its stage of development. A company may require a board with different skill sets at different times of its life.

The Higgs Report recommended that non-executive directors be appointed for an initial term of three years and, subject to satisfactory performance, a second term of three years. He suggested that after six years, it is probably appropriate for a non-executive director to retire and allow someone with fresh thinking to come in. He suggested a maximum total term of nine years for non-executive directors.

While we can see that there is always the potential for people to become "stale" and that new blood can bring fresh thinking, we are not convinced there should be black and white rules around the issue. We believe that what is important is that the board apply their minds to the issue of whether change is required. The issue of whether directors continue to add "value" should be addressed in director and board evaluations of performance. We certainly do not believe that a majority shareholder should be required to change its nominees.

4.15 Potential candidates for a directorship of a company should undertake a thorough due diligence of the company they are being invited to join whatever its size

Given the increased focus by shareholders and regulators on company performance (and directors' responsibility for that) and the reputational damage when companies fail or directors preside over a reduction in shareholder value, potential directors should take care in undertaking appropriate due diligence on the company whose Board they are asked to join.

We have seen companies with high standing in the market place fall from grace relatively quickly. Regrettably, despite our continuous disclosure laws, people should not assume, based on market place perception, that all is well.

Candidates should be satisfied that the board they are joining has sound corporate governance policies and practices, that its board members are persons of integrity, have experience, wisdom, judgement and are "independent thinkers". Similarly, they should be satisfied with the company's financial position and strategy for its future success.

The due diligence process is also an opportunity to begin to build the deep understanding of the company's business which, as noted above, is essential for a director to have. That level of knowledge then needs to be built on and improved continuously throughout the term of the directorship.

4.16 Non-executive directors should meet regularly without the presence of management

The Higgs Report recommended that non-executive directors meet at least once a year without the presence of the chairperson and management. The UK Corporate Governance Code (2012) now reflects this.

The New York Stock Exchange Rules require independent directors to meet regularly without the presence of management. The theory behind scheduling meetings regularly is to avoid any negative inference being drawn from the fact that the independent directors are meeting together.

We believe there is real merit in non-executive directors meeting together regularly. In 2003, we proposed that this should be at least once every 6 months. With the increasing pace of change and developments, greater frequency may be justified – e.g. three monthly. Some Boards make it a practice to have a short, non-executive session at the beginning of all Board meetings. We consider the chairperson should also participate in those meetings.

At least one director of a company that had gotten into difficulties in the past as a result of fraud by a senior executive, commented to us that he believed that the non-executive directors might have been able to identify the issue before it became too late if they had met together on occasions. As it transpired, he said they had each had some misgivings over a period but could not quite put their finger on what was causing them concern. In his view, had they met on occasions, he believed that each of their individual concerns about the particular executive, put together, may have resulted in some action being taken before it was too late.

Another experienced director commented to us that non-executive directors should always feel free to request a meeting to be convened without the presence of executive directors. We agree that non-executive directors should feel free to do so and should not feel constrained to wait for a scheduled six monthly meeting of non-executive directors. However, we believe scheduling regular meetings has value, as it avoids any negative inference being drawn from the mere fact of calling a meeting without the presence of the chief executive.

We do not consider it appropriate to exclude the chairperson, as a non-executive director, from these meetings.

4.17 Boards should avoid ‘spin’ when describing their approach to corporate governance

In a number of the finance company cases in New Zealand, the Courts concluded that statements made by companies and their boards about their corporate governance standards were materially misleading. In the Nathan’s Finance case such statements were made in Nathan’s investment statement, prospectus and certain letters to investors. The statements in the prospectus and investment statement were:

> *“Nathans’ robust credit assessment and corporate governance processes have ensured that the Company has retained its unblemished nil bad debt record for the period ending 30 June 2006.”*
>
> and:

> *"Advances to VTL [Nathan's parent company] and its subsidiaries have been made on a commercial arms length basis."*

These statements created the impression that strong corporate governance was in place including because loans to VTL were said to be made on an arm's length basis. However, the Court concluded that this was not the case.

His Honour found that the emphasis on good corporate governance and robust credit management processes in a business focussed on commercial lending created a false impression of the nature of Nathans' business at that time.[36] His Honour also said that strong corporate governance does not involve the delegation of strategic decisions about a company's business to its parent.[37]

In our view, the recent finance company cases make it clear that the Courts will not tolerate 'spin' about a company's corporate governance standards. Boards should not, themselves or allow PR people to, represent particular standards will be met if they are not prepared to ensure that such standards are met.

4.18 Adoption of a Code of Ethics by a board

Both the NZX's Corporate Governance Best Practice Code ("NZX Best Practices Code"),[38] and the Securities Commission's "Corporate Governance in New Zealand, Principles and Guidelines" ("NZSC Principles") recommend that an issuer formulate a Code of Ethics to govern its conduct. We support boards doing so. Such Codes represent a useful touchstone to refer to when challenging issues arise, and a constant benchmark for directors and management. Our only caution is that companies which do adopt an Ethics Code should not thereafter regard themselves as "having done ethics". All board and company decisions should be judged against ethical standards, and it is the constant application of ethical principles to novel circumstances that constantly arise which is the challenge.

4.19 Shareholders should use their powers to demand better corporate governance and performance

At the time of our paper in 2003, there had been debate in Australia and elsewhere on the role of institutional investors, superannuation schemes and managed funds as shareholders.

At that time, we were told that it was common for investors of this nature to be relatively passive, e.g. by not voting at annual meetings.

There has been a move then, both in Australia and New Zealand, for these sorts of investors to be more active with a view to enhancing good corporate governance and performance. We think it likely that this trend will continue and intensify.[39]

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36 Nathans Finance, para [250] and see also para [265].

37 Nathans Finance, paras [191], [196], [207 (d)] and [218]-[219].

38 See Appendix 16 of the NZX Listing Rules.

39 In this context consider the UK Stewardship Code which encourages engagement between institutional investors and the company.

Susan Ryan AO commented at a conference we attended in 2003 that, in Australia, superannuation trustees have become more active shareholders. By way of example, she indicated that this group had started to demand to know what corporate governance practices an entity had prior to investing and, if the entity did not have any or if they thought those in place inadequate, they would not invest in that entity. Similarly, companies that performed poorly could expect to be questioned why, and be asked if strategies were in place to reverse this etc.

In a paper that Susan Ryan presented to that conference, she said:

> *"ASIC is developing its own guidelines for corporate governance and through the educational activities of AIST, this active approach will be disseminated throughout the entire not for profit sector.*
>
> *Reflecting the community, or as a proxy for the community, these funds will act against the practices which are causing the community so much alarm and damage.*
>
> *Targeted practices include excessive director and executive remuneration, the use of options in remuneration packages, the practice of multiple chairmanships, the narrow pool of company directors, the lack of diversity and competence on boards, the lack of independents on boards, the inclusion of service providers, such as lawyers and accountants on boards they have been advising, deceit and concealment of massive contracts for executives and consultants, conflict of interest in many aspects of board and executive structure and behaviour, the hiring and oversight of auditors.*
>
> *As proxies for the community, superfunds in these governance activities are part of a rapidly growing movement insisting on corporate accountability.*
>
> *While government, regulators, business and professional bodies and the media are all a part of this movement, the work of superfunds trustees is pivotal, and will I believe effect desirable change in the long as well as short term."*

More recently, the OECD noted the importance active shareholders can have on encouraging strong monitoring of the role of the board in the remuneration process.

Despite having attended annual meetings where shareholders seem to have focussed on the negative, and have given the Board and executive a torrid time, we believe that well informed shareholders fairly testing those responsible for stewardship of the company will improve good corporate governance and performance. While not wishing to detract from the right of shareholders to exercise their voice at a meeting, we do believe shareholders should seek to be constructive. In the main, directors and executives of New Zealand companies are hard working and focussed on the best possible performance of the company. Unnecessary grandstanding, vitriol and a failure to actually listen have the potential to negatively impact on director and executive performance.

4.20 Investors should not overly rely on credit ratings in making investment decisions

Credit ratings have not been a significant feature of the New Zealand market. They certainly were internationally in the period prior to the global financial crisis. However, since 1 March 2010, as part of the regulation in New Zealand of non-bank deposit takers, all deposit takers above a minimum threshold must have a credit rating. There is a view internationally that credit rating agencies played their role in the creation of the global financial crisis. Investors relied on credit ratings given to complex financial instruments without really understanding those instruments. Investors should not use a credit rating as a total substitute for their own analysis of an investment proposition. They at least need to understand what the ratings mean and the nature of the instruments being rated. Credit ratings can be useful but are no substitute for investors doing the basics.[40]

5. Key corporate governance principles – Structural issues

5.1 The requirement for a specified number of independent non-executive directors is a sound principle, but will not necessarily result in better corporate governance or enhanced performance. However, independent non-executive directors can play a useful role where there is a major shareholder

We believe the two principles set out in paragraphs 4.1 and 4.2 are far more important and more likely to lead to good corporate governance than a focus on the number of "independent" directors on a board and what constitutes "independence".

The Higgs Report, the Sarbanes-Oxley Act (USA) and the ASX Report have all called for boards of directors to comprise a majority of "independent" directors. The NZX Rules mandate that there be a minimum of two or, if there are eight or more directors, three, or one-third independent directors (whichever is the greater number).[41]

Where a particular shareholder has invested sufficient capital to own a majority of the company, we consider it wrong to deprive that shareholder of the right to appoint the majority of directors. Indeed, the existence of a particular majority shareholder can operate as a positive encouragement by minorities to invest in the company. It certainly can be strongly argued that a majority shareholder has the most to gain (given their larger capital at risk) in good corporate governance and performance of the company. In reality, where a particular shareholder is a majority shareholder, minorities invest knowing that a particular shareholder controls appointment of the board of directors and the company.

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40 See also IOSCO, "The Role of Credit Rating Agencies in Structured Finance Markets", May 2008. IOSCO suggests that "there are serious questions whether institutional investors, either through ignorance or lax internal governance and risk management, relied excessively on credit ratings, with little regard or the underlying risks of the financial instruments they bought, sold, and in some cases even designed." Similarly, the OECD Report, page 25, also notes that banks that relied heavily on credit rating reports and failed to establish their own risk analysis fared poorly in the financial crisis. See too http://www.rbnz.govt.nz/finstab/nbdt/creditratings/3914649.pdf and http://www.fma.govt.nz/help-me-invest/getting-the-right-information/credit-ratings/.

41 See 3.3.1(c) of the NZX Listing Rules.

It has also been put to us by a number of experienced senior executives that "independent" directors do not necessarily make the best directors. Involvement of those with real knowledge of the business is critical. It was put to us that what is critical is capability, integrity and values.

We accept that while a majority shareholder and a company's interests will often be aligned, that will not always be the case. Accordingly, we can see value in a board which has a majority shareholder having a number of non-executive independent directors, with a view to those directors seeking to ensure the board focuses on what is in the company's best interests.

We therefore continue to support the NZX Rule of one-third or two directors being "independent" (thus allowing a majority shareholder to still appoint a majority of the directors).

To be regarded as "independent" directors should be free from the influence of a substantial shareholder or of management. The ASX Report includes a definition of independence, which we believe provides useful guidance. The ASX Report defines a director as being an independent director if he or she is not an executive director and:

> ***"Relationships affecting independent status***
>
> *When determining the independent status of a director the Board should consider whether the director:*
>
> - *is a substantial shareholder of the company or an officer of, or otherwise associated directly with, a substantial shareholder of the company;*
> - *is employed, or has previously been employed in an executive capacity by the company or another group member, and there has not been a period of at least three years between ceasing such employment and serving on the Board;*
> - *has within the last three years been a principal of a material professional adviser or a material consultant to the company or another group member, or an employee materially associated with the service provided;*
> - *is a material supplier or customer of the company or other group member, or an officer of or otherwise associated directly or indirectly with a material supplier or customer;*
> - *has a material contractual relationship with the company or another group member other than as a director".*[42]

This definition of independence was an amendment made in 2007 to the earlier ASX Report, to adopt a more flexible approach instead of the 'checklist' type of definition used previously. The above definition now indicates relationships that *may* affect the independence of a director. Similarly, we believe some caution should be taken before adopting a black and white definition of independence. The focus should be "is this person free from the influence of shareholders or management?" We note that the HIH Royal Commission said this about the ASX's previous recommendations in the first edition of its report in relation to independence:

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[42] See page 17 of the ASX Report.

> *"I am concerned that an attempt to be unduly prescriptive might impose undesirable rigidity, and distract attention from the critical issue of freedom from possible influences, many of which may be "subtle" and not susceptible to a 'check-list' approach."*

Indeed, the OECD Report suggests that the negative list approach taken by the Sarbanes-Oxley Act (USA) may have "led to qualifications (i.e. a positive list) or suitability being only of secondary importance," and also unduly limiting the pool from which independent directors with relevant experience may be chosen from. As noted above, the issue is not just "independence and objectivity but also capabilities."[43]

As an aside, we note that great care should be taken in applying US governance solutions in New Zealand, without taking account of differences in the context. For example, New Zealand company law and practice (in common with that of Australia and United Kingdom) gives shareholders much greater rights to approve (or not) executive decisions than is often the case in the United States. There, for example, major transactions and director remuneration often do not require binding shareholder approval, which places a greater emphasis on the role of independent directors.

5.2 The board's delegations to management should be clear, monitored for compliance and reviewed from time to time

The Companies Act 1993 requires that "the business and affairs of the company must be *managed by, or under the direction or supervision* of the Board of the company."[44]

In a number of the high profile finance company collapses the degree of supervision and management by the board of the executive was inadequate. In some instances, "rogue" executives also paid little regard to their boards, kept them poorly informed and pulled the wool over their eyes.

It has been put to us by one experienced company director that one of the board's most important roles (after selection of the chief executive) is to put in place appropriate delegations to management and endeavour to monitor, as best it can, that these are complied with. The New Zealand courts clearly agree with that. In the Nathans Finance case Justice Heath said:[45]

> *"Directors direct. Managers manage. That is the essential difference between governance and management. Directors establish the policy or rules that are to be implemented by management and put systems in place to ensure their instructions are carried out."*

It seems obvious to us that good corporate governance requires a clear understanding between the board and management of their respective roles and authority. Delegations should, in our view, be formal and in writing. It is appropriate to put in place a framework, approved by the directors clearly setting out what types of decision-making power have been delegated to the chief executive, what the financial limits are, and what may be sub-

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43 See also OECD Report, page 23.

44 See section 128 of the Companies Act 1993, emphasis added.

45 Nathans Finance, at para [74].

delegated. It is also appropriate to clearly set out what reporting after the event is required when decisions are made by delegates.

It has also been put to us that it is not always sufficient for directors to be satisfied on compliance issues by simply receiving assurances from management. There are occasions where directors need to go beyond an assurance. The recent finance company cases make this clear. For example in *Davidson v Registrar of Companies*, Justice Miller made it clear that it is inappropriate to provide "latitude" to executive directors in their reporting to the board. Reliance on information provided orally and "volunteered" is not an appropriate substitute for calling for and obtaining written board reports in time for consideration by directors prior to board meetings. Justice Miller said:[46]

> *"There is a large difference between a written report, usually provided some days before a meeting, and an oral report at the meeting. Without the opportunity to prepare, directors are in a poor position to examine critically what they are being told. Without a record of what was reported, they are in a poor position to demand accountability if it turns out that what they were told was wrong."*

In Nathans Finance, Justice Heath said:[47]

> *"Subject to adequate monitoring of management by the directors or anything that may put a director on notice of the need for further inquiry, reliance on information provided by management in their delegated areas of authority will generally be appropriate. But every reliance inquiry will be fact specific, taking in account both the obligations and responsibilities of particular directors and the nature of the tasks delegated to members of the management team."*

Justice Heath went on to say in terms of the reliance defence available to directors under both the Securities Act 1978 and Companies Act 1993:[48]

> *"Both of these provisions envisage the possibility of the need for further inquiry by a director, on the basis of information already held or incomplete information on which further explanation is required. The protections ... will be forfeited if appropriate inquiry is not made."*

The level of delegation is a judgment decision based on the scale and nature of the company's activities, and the respective capabilities of the board and management. On the one hand, the Board should not over-delegate to the extent that it cannot, with confidence, assure itself that the board is discharging its responsibility for the management and supervision of the company's business and affairs. Conversely, the Board needs to consider the risks inherent in insufficient delegation of authority, in relation to the size of the particular business. It should be acknowledged that not delegating authority may mean that the Board has effectively become the management of the company, and therefore loses the independence of thought required. It also may mean that responsiveness is slowed, if decisions that could be dealt with by management need to be held over to the next monthly Board meeting.

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46 *Davidson* v *Registrar of Companies* [2011] 1 NZLR 542, at para [124].

47 Nathans Finance, at para [82].

48 Ibid, at para [86].

However, it is absolutely clear from the recent finance company cases in relation to offering of securities to the public that directors must personally be satisfied that offer documents are not misleading. They have a non-delegable duty in this regard. Every director should read the public offer documents and form an independent assessment based on all the information available to them that the documents are true and not misleading.

5.3 Boards should engage in regular evaluation of the board's and individual directors' performance

Most writings in the area of corporate governance strongly support regular evaluation of the board and individual directors' performance.[49] Similarly, boards should ensure that appropriate processes are in place for the review of the chief executive's performance. In turn, the chief executive should ensure a regular evaluation of other senior management's performance.

We have spoken to a number of directors and chief executives, all of whom strongly endorse regular evaluation of the board and each director (including the chairperson's performance). It was pointed out to us that these systems need to allow for the fact that on occasion, there can be issues in a chairperson's performance, and the system adopted must not allow that to be hidden.

5.4 A Board should contain a mix of skills and talent appropriate for the company's stage and development

Generally, we believe boards are well served by having a mixture of directors with strong financial skills, business and other "life" experience. The particular mix will depend on the company's stage of development at different times.

We note that the Higgs Report considered British boardrooms too "clubby". In our 2003 paper, we suggested there was room in New Zealand to look outside the usual "gene pool". We believe some progress has been made in that regard but the issue has not gone away. We remain of the view that it is important that appointments are based on the skills and attributes that individuals bring to the Board of a particular company.

From our experience (and those experiences which some directors and senior managers have shared with us), a diversity of views around a board table assists in leading to good decision making. It was put to us by one chief executive that constant selection from the same gene pool can lead to group-think when what is useful are independent thinkers. By way of example, it was suggested to us that if a University Council was made up solely of those with PhDs, the University would miss something from the views of others with different experiences. It has been suggested to us that what is important is experience (not necessarily as a director), whether that be business experience or some other experience useful to the particular company. Having said that, and while we support diversity, all Board members must be capable of discharging their responsibilities. The view expressed, which we agree with, is that the boardroom is not a place for

49 See, for example, the ASX Report. Usually these evaluations occur annually. The Code of Ethics proposed by NZX's Code of Corporate Governance Best Practice requires the board of a listed company to establish a formal procedure to regularly assess individual and board performance.

"learners". What is needed from boards are wisdom and judgement that are unlikely to come from learners.

The question of board diversity has been the subject of widespread debate and discussion in recent times in a number of jurisdictions including New Zealand. In March this year, NZX consulted on a proposed Diversity Listing Rule. The Rule is with the Financial Markets Authority for approval. If approved it will require disclosure by an issuer in its annual report on gender diversity and a statement by the board of its evaluation of its performance with respect to its diversity policy.

The argument for gender diversity is that it assists in contributing to prevent "group think". It has also been found that "women have different leadership styles, attend more board meetings and have a positive impact on the collective intelligence of a group." Studies suggest there is a positive correlation between the percentage of women on boards and corporate performance, though for certain the overall impact of women on firm performance is more nuanced.[50]

We are of the view that it is critical that boards have the best people available to them as directors regardless of gender, race, age or any other matter. We do not support gender diversity for diversity's sake. In our view, the boardroom is not a place for training directors. We do not think that a reasonable expectation to put on other directors or owners of enterprises. We consider the ability to bring independent judgment and thought to matters is more important than the gender of the individual.

We do not consider that there should be a mandatory requirement that directors be subject to an accreditation course, as was proposed in 2003. We remain of the view that directors and the boards appointing them should consider whether such a course is appropriate for the individual concerned. Whether there is value will in large part depend on the quality of the course and its content.

This is consistent with our view that the boardroom is not a place for "learners". We query how much value a director accreditation course will actually give likely directors who have the requisite skills of good judgment, integrity and experience.

In our view, a mandatory requirement for director accreditation is an example of a tick-the-boxes mentality.

Boards should, however, ensure that there is an appropriate "induction" programme for new directors so that they can contribute fully as soon as possible.

5.5 The chief executive should be on the board of directors

It has been put to us by one experienced director that the chief executive should also be on the board of directors (but not the chairperson). Surprisingly, this is often not the case in New Zealand, both amongst listed companies and other major widely held businesses, e.g. in the case of the large unlisted co-operatives.

The argument is that this assists in providing the critical link between the board and management – it makes management part of the team – through

50 See the European Commission Green Paper on the EU Corporate Governance Framework, 2011.

the link of the chief executive on the board. As a director, the chief executive obviously also assumes directors' liabilities. It was put to us that this assists in ensuring that the chief executive shares his or her concerns with his or her fellow directors.

The argument against putting the chief executive on the board is that the chief executive's presence can inhibit directors airing concerns at the board regarding management. We believe this issue can be addressed by ensuring that directors feel comfortable calling for discussion without the presence of the chief executive from time to time.

On balance, we consider that it is helpful for governance for the chief executive to also be a director. Certainly that is the prevalent model overseas.

5.6 The chief executive and the chairperson of a company should not be the same person

The practice of the same person performing the two roles has been common in the United States but not in the United Kingdom, Australia or New Zealand.

In our view the two roles should be separated so as to encourage an appropriate degree of objectivity between the board and management.

We note that some statutory regulators in New Zealand and overseas have an executive chairperson. We do not accept that what is necessarily good for business should also apply in relation to regulators or agencies.

5.7 A chief executive of a company should not go on to become chairperson of the same company[51]

Again this has happened infrequently in New Zealand. Generally speaking, we believe it is undesirable. The risks of it include that:

- the chairperson may find it difficult to distance him or herself from the day to day operations of a company;
- the new chief executive officer may not have room to become their own person, or may feel more compelled to defer to the views of the chairperson; and
- given the chairperson's intimate knowledge of the company as a result of being the chief executive officer, he or she may assume the chief executive officer knows various matters and how best to deal with issues, so that the chief executive officer may miss out on the chairperson offering his or her wisdom and judgement on issues.

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51 The international view is that a chief executive officer should not go on to become chairperson of the company. See the Cadbury Report and the Higgs Report in the UK, the HIH Royal Commission Report and the ASX Report in Australia.

5.8 Boards should have an audit committee comprising of non-executive directors, chaired by a non-executive director who is not the chairperson, and with real financial experience

Virtually every writing on the topic of corporate governance post-Enron has recommended that companies have a separate audit committee comprising of non-executive directors, chaired by a non-executive director who is not the chairperson of the board.[52]

Under rule 3.6.2 of the NZX Listing Rules, an audit committee must have a minimum of three members comprised solely of directors, with a majority of the members being independent directors. At least one of the members must have a financial or accounting background.

The Financial Markets Authority, in its own recommendations for corporate governance stated that an audit committee should comprise all non-executive directors, a majority of whom are independent with at least one director who is a chartered accountant, or has another recognised form of financial expertise. The committee should also have a chairperson who is not the chair of the board.[53]

Much has also been written on the role of the audit committee.

The NZX Listing Rules state that the minimum responsibilities of an audit committee include:[54]

- *"ensuring that processes are in place and monitoring those processes so that the board is properly and regularly informed an updated on corporate financial matters; and*
- *recommending the appointment and removal of the independent auditor; and*
- *meeting regularly to monitor and review the independent and internal auditing practices; and*
- *having direct communication with and unrestricted access to the independent auditor and any internal auditors or accountants; and*
- *reviewing the financial reports and advising all directors whether they comply with the appropriate laws and regulations; and*
- *ensuring that the external auditor or lead audit partner is changed at least every five years."*

The Higgs Report also suggested that the audit committee's role should be:

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[52] By way of example, see the Higgs Report, the ASX Report, Sarbanes-Oxley Act, the NZX's corporate governance rules, and the Securities Commission's statement on certain aspects of "Corporate Governance and Financial Reporting, Strengthening Confidence in New Zealand's Capital Markets", 28 November 2002.

[53] Para [3.4], NZSC Principles.

[54] Rule 3.6.3, NZX Listing Rules.

- *"To monitor the integrity of the financial statements of the company, reviewing significant financial reporting judgements;*

- *To review the company's internal financial control system and, unless expressly addressed by a separate risk committee or by the Board itself, risk management systems;*

- *To monitor and review the effectiveness of the company's internal audit function;*

- *To make recommendations to the board in relation to the appointment of the external auditor and to approve the remuneration and terms of engagement of the external auditor;*

- *To monitor and review the external auditor's independence, objectivity and effectiveness, taking into consideration relevant UK professional and regulatory requirements;*

- *To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm."*

We consider the above to be appropriate, but note that the existence of an audit committee does not absolve the full board from responsibility and, accordingly, the audit committee should report fully to the board on all material issues dealt with by it.

The recent case law in relation to finance companies has made it clear that boards cannot "abdicate" responsibility to subcommittees. The full board should insist on being properly briefed by a subcommittee and have an opportunity to provide meaningful input on matters within the subcommittee's remit if they consider that necessary. We do not consider it appropriate to delegate processes around offers of securities to the public to subcommittees. We believe the market should move to involve the full board given the potential liability of directors.

Most writings also endorse the adoption of a charter by the committee, setting out its role and responsibilities. A number of directors have endorsed this approach.

While it will be appropriate for the chief financial officer (and potentially the chief executive officer) to generally attend audit committee meetings so as to be available to discuss issues, the audit committee should also have a practice of meeting regularly with the auditor without the presence of management. The purpose of this is to ensure that there are occasions where the auditor and audit committee can discuss issues without the auditor being influenced by management. The auditor should also have regular meetings with management without the audit committee. We understand that such practices are common in a number of New Zealand companies.

5.9 Requiring audit partner rotation every five years

There also seems to be a general consensus that audit partners should rotate every five to seven years to assist in maintaining auditor independence.[55] We support that view.

There was debate in 2003 as to whether there should be a requirement that audit firms actually rotate every five to seven years. The view taken internationally is not to require this.[56] We note that PricewaterhouseCoopers's survey of directors and senior executives of the top 200 companies in New Zealand (February 2003) found that 86% of respondents disagreed with requiring audit firm rotation. We agree. We do not consider it in a company's best interests to require that it change audit firms regularly. Indeed that could cause practical problems in a small country like New Zealand. Boards and audit committees should monitor the performance of their audit firm regularly and decide if and when it is appropriate to change that firm.

5.10 Limiting conflicts in relation to audit firms

Internationally, the following measures have been taken to assist in the maintenance of auditor independence post-Enron and after other corporate failures:

- limiting the ability of an audit firm to undertake audit and non-audit work for a client; and

- cooling-off periods before audit partners and key audit staff can join a client.

We consider both of these steps appropriate.

5.11 Requiring the chief executive officer and chief financial officer to sign-off on financial statements

It has been suggested to us that if the chief executive officer and chief financial officer were required to sign-off on financial statements, along with the auditor and directors, that would enhance their focus on them. Presumably, it would also act as a deterrent on chief executive officers and chief financial officers putting pressure on auditors to sign-off on the financial statements when that should not be the case.

The Sarbanes-Oxley Act (USA) provides that the chief executive officer and chief financial officer of each issuer shall prepare a statement to accompany the audit to certify the "appropriateness of the financial statements and disclosures fairly present, in material respects, the operations and financial condition of the issuer." In order to incur liability for a breach, the executive must have knowingly and intentionally breached the section.

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55 See the ICANZ Report (ICANZ suggested seven years). PricewaterhouseCoopers have published the independent results of a survey of directors and senior management of the top 200 companies in New Zealand, in which five years was the median period selected. The NZSC Principles recommend five years as providing a balance between cost and efficiency losses and independence gains, and being in line with international best practice.

56 However, see the UK Corporate Governance Code 2012 at page 19. FTSE 350 companies are required to put their audit contract up for tender every ten years.

At least one auditor has suggested to us that they believe requiring chief executive officers and chief financial officers to also sign off on financial statements would act as a good balance to the pressure which management can sometimes put the auditors under.

We believe that the suggestion is a reasonable one. In many corporate collapses and instances of destruction of shareholder value, auditors have been accused of inappropriately signing off on a variety of matters, in the large part due to the express or implied pressure applied to them by executives, i.e. in order to retain a client's business, they have pushed the boundaries too far. We believe that the combined effect of:

- putting an increased focus on auditor independence; and
- requiring chief executive officers and chief financial officers to also sign off stating that to the best of their knowledge and belief, the financial standards comply with the law,

should minimise instances where financial statements do not meet legal and accounting standards because an auditor has pushed the boundaries to maintain a client relationship.

5.12 Requirement to disclose corporate governance policies

The NZX Rules require a listed issuer to state in its annual report its corporate governance practices. To the extent an issuer's rules differ from NZX's Corporate Governance Best Practice Code, the issuer is required to explain in its annual report how its corporate governance principles materially differ from the NZX's code.[57]

The Financial Markets Authority also recommends, in the NZSC Principles, that entities report on how they have achieved the NZSC Principles in their annual reports.

One senior executive expressed some concern about the cost of including information on its corporate governance policies in the annual report. We expect there will be cost in formulating policies (even if simply pulling together various current policies which fall under corporate governance), monitoring and reviewing policies, plus reporting on these to shareholders. However, we believe the benefits should outweigh the detriments. Companies should have good corporate governance policies, investors should know what they are and companies should be required to report on them. The requirement to do this is likely to result in these policies getting at least an annual focus by the board.

5.13 Quarterly reporting not required under an effective continuous disclosure regime

In 2003, there was some debate around whether issuers should have to report quarterly. In the ICANZ draft report in 2003 on "Corporate Transparency, Making Markets Work Better," ICANZ discussed whether New Zealand should move to quarterly reporting.

It noted that quarterly reporting should reduce shocks to the market that may come about through less frequent reporting. ICANZ noted that a

[57] Rule 10.5.5(i) of the NZX Listing Rules.

possible downside was the market becoming overly reliant on a company's financial information, rather than conducting their own analysis, and recommended that quarterly reporting not be considered further.

However, the ICANZ Report noted that a majority of submitters rejected a move to quarterly reporting, citing the risk that it could lead to a short - term view being taken at the expense of the long-term interests of the corporate and its investors.

Companies listed on the ASX are required to report half-yearly and yearly. Australian reforms favour continuous disclosure, including a proposal that the Australian Securities & Investments Commission be allowed to issue on-the-spot fines for breaches of continuous disclosure obligations.

The debate seems to have ended with it being accepted that quarterly reporting should not be a requirement. The latest reports on the state of corporate governance from regulators in Australia, United Kingdom and New Zealand have not proposed quarterly reporting requirements be put in place.[58] We remain of the view that quarterly reporting is unnecessary, given the continuous disclosure regime pursuant to which the market should be kept constantly informed of relevant information. If the continuous disclosure regime is working properly, quarterly reporting should not be necessary as the market should have all material information.

In its 2003 consultation paper,[59] the Securities Commission noted the public view that quarterly reporting keeps shareholders more informed and minimises shocks to the market. The Commission also noted our view that quarterly reporting would be redundant as the continuous disclosure regime achieves the same ends.

Further, we note that the NZX Listing Rules only require mining issuers to report on a quarterly basis.[60]

5.14 Better enforcement of corporate governance principles and related laws

The ICANZ Report in 2003 recommended giving the Securities Commission and Registrar of Companies additional resources to undertake enforcement. We agreed with that recommendation. In our view it was not sufficient merely to rely on companies regulating themselves or the market doing so. We noted the history of the late 80's and 90's (and New Zealand's reputation at that time and subsequently for being a "wild west") showed that approach to have been a failure. We concluded that, human nature being as it is, greater attention to compliance will occur if the market believes the relevant requirements (whether they be accounting standards, rules of the NZX or otherwise) are seen to be enforced.

Sean Hughes, the Chief Executive of the Financial Markets Authority, appears to support this view. In his article published in the New Zealand Herald, he says that the "efficient markets hypothesis" or "light touch

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58 However, see the proposed Kiwisaver (Periodic Disclosure) Regulations 2012 (currently a draft for consultation), which would require the manager of a Kiwisaver Scheme to produce quarterly reports specifying, amongst others, performance and returns, asset allocation and liquidity and liabilities.

59 See the NZSC 2003 Paper.

60 Rule 10.10.4 of the NZX Listing Rules.

regulation" has, in the collapse of finance companies, "been shown to have failed a generation of investors."[61]

We also noticed that if regulatory bodies are asked to take on additional enforcement functions they need to be resourced appropriately to fulfil those functions.

Since our revised paper in 2009 there have been a number of "structural" changes. In particular, the Financial Markets Authority has been created under new legislation. It has broader powers of enforcement than the Securities Commission. The Financial Markets Authority has also been given the power to enforce directors' duties under the Financial Markets Authority Act 2011. In our view it is critical that the Financial Markets Authority exercises this power judiciously. As the courts have long recognised, directors' duties require the exercise of commercial judgment, and it is not generally appropriate for benefit of hindsight views to be substituted for decisions taken honestly and in good faith, in real time. Our observation is that post the finance company collapses and other litigation taken by the Financial Markets Authority and its predecessor that directors are much more cautious. That in itself is not necessarily a bad thing. However, it will not be in shareholders' best interests if directors became too risk averse due to a fear of being second guessed by a regulator down the track.

A further area where we consider it important there should not be an overreaction is the proposal to criminalise breaches of certain directors' duties: to act in the best interests of the company and to avoid reckless trading. In relation to the latter, the section of the Companies Act 1993 headed "Reckless trading" does not actually use that term in the body of the section. Instead it speaks of incurring a "substantial risk" of "serious loss". In our view it is not appropriate to criminalise actions which may genuinely be within the spectrum of activities that a prudent and reasonable director might undertake honestly and in good faith.

5.15 Providing protection to whistleblowers who report actual or potential breaches to the chair of the audit committee and to regulators

There has been some consideration internationally in relation to whether there should be laws to protect "whistleblowers". In the United States, section 806 of the Sarbanes-Oxley Act provides a remedy for employees who face retaliatory action for certain whistleblowing activities and the Dodd-Frank Act, passed in 2010, provides a system where the SEC may award the whistleblower between 10-30% of a court ordered sanction worth more than $1 million. However, it is believed policies that would protect against liability under this section would be similar to the complaints procedures and codes of ethics required by the Sarbanes-Oxley Act.[62]

In New Zealand, the relevant existing legislation is the Protected Disclosures Act 2000. However, that legislation's focus is government owned organisations and not commercial businesses.[63]

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61 Sean Hughes "Finance firm debacle shows light touch failed," New Zealand Herald, 2 January 2012.

62 See, for example, Preston Gates Ellis LLP "Protecting against whistleblower liability under section 806 of Sarbanes-Oxley: Why Companies Need to Adopt Policies *Now*", 5 December 2002.

63 The Financial Markets Conduct Bill also proposes a regime to protect certain limited disclosures by auditors and supervisors (and their employees) of issuer companies.

The NZX's Best Practice Code requires that a listed company's code of ethics provide mechanisms to report unethical behaviour, and ensure that disciplinary measures are in place.[64] This will only work in practice if issuers have an environment where staff are satisfied that their identity and fact of reporting are kept entirely confidential from their superiors. An experienced company director suggested to us that it is good practice to allow staff to raise any issue of concern, in confidence, with the chair of the audit committee. We agree with that.

We noted in 2003 that we had not examined this particular issue in depth, and that the debate internationally has resulted in some diverse views. We remain of the view that it is not a key requirement for good corporate governance. There is risk that legislatively giving whistleblower protection to commercial businesses could result in additional costs for business (e.g. having to persuade a regulator that information passed to them does not have substance). However, given that bad corporate governance does occur (e.g. fraud) and that this is not always brought to light through the existence of a business's processes and policies, it seems difficult to argue against giving a whistleblower protection for disclosure to appropriate regulators (potentially in breach of a duty of confidentiality to their employer).

5.16 Conflicts of interest of credit rating agencies should be clearly identified, explained and highlighted to investors

Various international bodies have suggested that conflicts of interest of credit rating agencies contributed to overly positive ratings of various financial instruments, such as CDO's, that were at the centre of the global financial crisis. Credit ratings agencies are paid by the issuer of the financial instrument. That creates an inherent conflict of interest.[65] Further conflicts arise when the credit rating agency has multiple roles with an issuer and their advisers, as pressure (overt, subtle or implied) can come on to them to give as good a rating as possible in light of the overall financial importance of the relationship with the issuer.[66] We have attended some international conferences where it has been suggested that to deal with this conflict, someone other than the issuer should pay the credit rating agency and that the extent of a credit rating agency's relationship with an issuer should be limited. We do not think it practical or likely for anyone other than an issuer to pay a credit rating agency. We do think that a credit rating agency's role with an issuer it is rating should be limited. In some instances, international credit rating agencies both created the investment product in one division of the agency and rated that instrument in another division. Directors of issuers should not allow credit rating agencies to have multiple roles in relation to instruments they are rating. In our view, that is not appropriate even if disclosed to investors – the conflict is too significant.[67]

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64 Para [1.2], Appendix 16 of the NZX Listing Rules.

65 See Willem Buiter, "Regulating the New Financial Sector" 9 March 2009, available at http://www.voxeu.org/index.php?q=node/3232.

66 See OECD Report, page 25.

67 Consistently with this see Regulation (EC) No 1060/2009 (Article 6 – Independence and avoidance of conflicts of interests), the Dodd-Frank Wall Street Reform and Consumer Protection Act (Subtitle C – Improvements to the regulation of credit rating agencies), the Code of Conduct Fundamentals for Credit Rating Agencies (2 – CRA Independence and avoidance of conflicts of interest) and the United States Government Accountability Office's report "Credit Rating Agencies:

6. Should legislation be implemented to effect corporate governance principles?

The question remains how to effect adoption of good corporate governance principles.

The United Kingdom shied away from a legislative approach.

The United States adopted, via the Sarbanes-Oxley Act, a more prescriptive approach. Sarbanes-Oxley has been criticised for its part in the global financial crisis. Other legislation, such as Dodd-Frank, has been introduced since.

In Australia, the ASX has taken the approach of either following the best practice principles recommended by it, or explaining why not.

Since 2003, the law in Australia has been amended to:

- expand disclosure of director and executive remuneration, and encourage shareholder participation in consideration of director and executive remuneration. The Corporations Act 2001 (Australia) now allows for non-binding shareholders' resolutions on remuneration reports to be passed and requires shareholder approval for certain termination payments;[68]

- establish the Financial Reporting Panel for considering disputes between ASIC and entities in relation to financial reports, and to determine whether financial reports submitted to it by listed or unlisted entities complies with the relevant requirements;[69]

- facilitate communication between companies and shareholders by requiring notices to be worded clearly and concisely, allowing distribution of notices and annual reports by electronic means, and permitting voting by proxy;[70]

- encourage transparency by requiring directors of listed companies to disclose directorships held in other listed companies, and by requiring listed companies to keep a register of information about relevant interests;[71]

- give the ASIC power to impose financial penalties and issue infringement notices on individuals for involvement in an entity's breach of continuous disclosure rules;[72]

Alternative Compensation Models for National Recognized Statistical Rating Organizations", January 2012.

68 See sections 300A(1)(a), (b), (ba), (c), (d) and (e), as well as sections 200B(1), 200F, 250R(2), (3), 249L and 250SA of the Corporations Act.

69 See sections 295A, 298(1A), 299A, 206(2) and Part 13 of the Corporations Act.

70 See sections 249L, 249LA, 249J, 249X, 250A, 250B, 250D, 314 of the Corporations Act.

71 See section 300, 627A, 627C and 627DA of the Corporations Act.

72 See sections 674 and Part 9.4AA of the Corporations Act.

- make it clear that a person may seek compensation for a breach whether or not ASIC issues proceedings[73] and allow damages to be recovered from either the relevant entity or a person involved in the contravention of continuous disclosure provisions;[74]

- require additional disclosures in directors' reports on auditors, establish independence requirements for auditors and require auditor rotation for listed companies;[75]

- allow shareholders to submit questions to auditors who must attend an entity's annual general meeting;[76]

- expand an auditor's duty to inform ASIC of any suspected contraventions of the Corporations Act or of any person attempting to unduly influence, coerce, manipulate or mislead the auditor;[77]

- require auditors to retain their working papers for an audit or review of a financial report;[78]

- extend qualified privilege to auditors under certain circumstances;[79]

- expand the powers of the Financial Reporting Council to include broad oversight powers on accounting and auditing standards;

- setting higher qualification requirements for registration of auditors and allowing the establishment of 'authorised audit companies';[80]

- impose an obligation on Australian Financial Services licensees to make arrangements to manage conflicts of interests;[81]

- allow the ASIC to issue a stop order against any prospectuses and disclosure documents that are not worded and presented in a clear, concise and effective manner;[82]

- establish a framework to streamline Product Disclosure Statements which are required when certain financial products are being offered;[83]

- increase fines, penalties and disqualification periods of directors for contraventions of the Corporations Act, and to introduce a

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73 Sections 1317H, 1317HA and 1317J of the Corporations Act.

74 Ibid.

75 See sections 300, 306, 307 and Part 2M of the Corporations Act.

76 See sections 250PA, 250RA and 250T of the Corporations Act.

77 See sections 311 and 601HG of the Corporations Act.

78 See section 307B of the Corporations Act.

79 Privilege is now extended to registered company auditors, and for certain disclosure requirements, all auditors, see Part 7.8 of the Corporations Act.

80 See Part 9.2A of the Corporations Act.

81 See section 912A(1)(aa) of the Corporations Act.

82 See section 715A and Policy Statement 168 published by the ASIC.

83 See sections 1012DA and 1013FA of the Corporations Act.

'whistleblowers' protection regime for employees reporting to ASIC in good faith on reasonable grounds a suspected breach of the law;[84]

- enact measures to proportion responsibility with regard to liability for misleading conduct between plaintiffs and defendants, and between defendants where there are more than one;[85]

- clarify when provisions apply to officers, senior managers and employees under the Act;

- transfer responsibility for supervision of the financial markets from market operators to ASIC;[86]

- simplify certain financial reporting standards for some parent companies to reduce compliance costs;[87]

- introduce a solvency test similar to the test under the Companies Act 1993 for companies to satisfy before dividends may be paid;[88]

- reverse the effects of the "Sons of Gwalia" decision which decided that claims by shareholders over a company's assets in some cases ranked equally to claims by unsecured creditors;[89]

- impose a regime for shareholder approval of director and executive remuneration whereby 25% of shareholders may (after 'no' votes in consecutive meetings) force directors to stand for re-election (the "two strikes" rule);[90]

- regulate incentive-based remuneration structures relating to provision of financial advice about retail investment products;[91] and

- give enhanced powers to ASIC in respect of auditors, including the ability to "name and shame" non-complying auditors and requiring very active auditors to publish a transparency report.[92]

Since 2003, the law changes which have occurred in New Zealand include:

- the adoption of the Corporate Governance Best Practices Code in the NZX Listing Rules;

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84 See sections 206BA, 1308, 1309 and Part 9.4AAA of the Corporations Act.

85 See sections 1041H of the Corporations Act, section 12DA of the Australian Securities and Investments Commission Act 2001 and section 52 of the Trade Practices Act 1974.

86 See part 7.2A of the Corporations Act.

87 See the Corporations Amendment (Corporate Reporting Reform) Act 2010.

88 See section 254T of the Corporations Act.

89 See section 563A of the Corporations Act.

90 See Division 9 of Part 2G.2 of the Corporations Act.

91 See the Corporations Amendment (Future of Financial Advice) Act 2012.

92 See Part 2M.4A of the Corporations Act and Division 5A of Part 2 of the Australian Securities and Investment Commission Act 2001.

- changes to the disclosure regime for substantial security holders and the introduction of new market manipulation and misconduct provisions, as well as new disclosure requirements for investment advisers and investment brokers;[93]

- the passing of the Financial Advisers Act 2008 which sets out disclosure and conduct obligations for financial advisers, and the Financial Service Providers (Registration and Dispute Resolution) Act 2008 which requires registration of financial service providers on a public register, and entry into a dispute resolution scheme;[94]

- the passing of the Securities (Disclosure) Amendment Act 2009 which allows for a simplified disclosure prospectus to be used that draws on the continuous disclosure regime that issuer companies must comply with;

- the passing of the Auditor Regulation Act 2011 which provides for the licensing, registration and oversight of the auditors of issuer companies by the Financial Markets Authority; and

- the passing of the Financial Markets Authority Act 2011 which gives the Financial Markets Authority the power to enforce directors' duties under the Companies Act 1993.

Since the publication of our original report, the Securities Commission also published a shortened version of "Corporate Governance in New Zealand, Principles and Guidelines" in a handbook form for directors, executives and advisers in 2011.[95]

Two significant pieces of proposed legislation are the Financial Markets Conduct Bill and the Companies and Limited Partnerships Amendment Bill. The Financial Markets Conduct Bill is an ambitious reform of securities law to promote confident and informed participation in the financial markets. It is intended to replace a host of legislation, including the Securities Act 1978, the Securities Markets Act 1988, the Superannuation Schemes Act 1989 and the Unit Trusts Act 1960. The Companies and Limited Partnerships Amendment Bill is an omnibus bill which will tighten requirements around company registration (including requiring companies to have a New Zealand resident agent), criminalising certain directors' duties and other reforms.

7. Conclusion

We remain of the view that an overly legalistic or regulated approach to the corporate governance issue is not the correct approach and the recent case law reflects this. We continue to favour the approach New Zealand adopted in 2003 of comply or explain, rather than requiring every company to follow all principles. That approach allows flexibility.

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93 See the Securities Markets Amendment Act 2006, the Securities Markets (Substantial Securities Holders) Regulations 2007 and the Securities Markets (Investment Advisers and Brokers) Regulations 2007 which came into force on 29 February 2008.

94 The Financial Advisers Amendment Act 2009 further supplements this regime.

95 New Zealand Securities Commission, "Corporate Governance in New Zealand Principles and Guidelines: A Handbook for Directors, Executives and Advisers", 16 March 2004 (reprinted February 2011).

We do not accept the argument that as corporate governance is mostly about ethics, nothing should be done (on the basis that you cannot legislate for ethics).

We do not favour corporate governance becoming a tick-the-box exercise.

We believe it is important that companies embrace the principles, behaviours and practices behind best practices of corporate governance.

The approach taken needs to be constantly reviewed to ensure recommended best practice corporate governance principles are up to date and suitable for the business environment of the day.

Analysis of the causes of the global financial crisis have shown that weak corporate governance practices played a significant part. As we predicted this has resulted in a call for greater regulation. While we appreciated that was justified in relation to parts of the banking and finance sector, we do not believe it justifies any prescriptive approach to corporate governance.

Unlike many jurisdictions, the role of credit rating agencies in New Zealand has been limited. In responding to our own financial crisis, particularly with the finance company area, we need to be careful to learn the lessons from overseas regarding credit rating agencies and that an over reliance on them is inappropriate.

The Financial Markets Authority has a responsibility to exercise its enhanced enforcement powers judiciously including so as to minimise the risk of directors becoming unnecessarily risk averse. That would not be in the interests of shareholders or the wider community.