

14 October 2016

Hamish Macdonald
Head of Policy & Legal
NZX Limited
Level 7, Zurich House
21 Queen Street
Auckland 1010

Dear Hamish

Submission to review of NZX Corporate Governance Code within the NZX Main Board Listing Rules.

Thank you for the opportunity to make a submission to the review of NZX Corporate Governance Code (NZX Code).

The Forum is committed to promoting good corporate governance in New Zealand companies for the long-term health of the New Zealand capital market. The Forum's members are institutional investors with significant investment in NZ listed companies. The Forum members believe that good governance improves company performance and increases shareholder value, and is key to promoting investor confidence in our market.

The Forum welcomes NZX's review of the NZX Corporate Governance Code. The quality of stock exchange rules and regulations is an important element of listed market corporate governance frameworks. The NZX, therefore, has a unique role in producing this best practice "Comply or Explain" Code for issuers and investors.

The draft Code makes a good improvement on the current code in the following areas in particular:

- introduction of *principles* including on shareholder rights, risk, and non-financial reporting
- strengthening of guidance and comply or explain requirements on remuneration
- further improvements on diversity policy and reporting
- recommendations to have formal board committee charters, and director agreements

We commend the NZX on these improvements.

However, there are important areas of weakness, and some omissions from the existing code. A number of the Recommendations are too generic to be meaningful, important points of governance have been downgraded to commentary, compared to, for example, the ASX Corporate Governance Code, and the use of conditional wording undermines the rigour of the code as currently drafted.

We strongly advise that the NZX makes recommendations which provide better clarity and substance in the following areas:

- Principle 2 – Board composition and performance , in particular independence, skills and succession planning.
- Principle 3 (4) – Reporting and Disclosure, including disclosure of actual risks.
- Principle 8 - Respect for shareholders rights

In our submission, our recommendations below are proposed as additions to those in the Code as currently drafted, unless stated otherwise.

Yours sincerely



Anne-Maree O'Connor
Chair
New Zealand Corporate Governance Forum

Feedback on the NZX Corporate Governance Code within the NZX Main Board Listing Rules.

A. Purpose

The draft NZX Code is currently missing a Purpose Statement. Accountability to shareholders should be central to the purpose of the Corporate Governance Code. We recommend that the Purpose Statement – when written – should include the following statement:

“The board recognizes its responsibility to shareholders to maximize long-term shareholder value”.

B. Principles & Comply or Explain Recommendations

Our submission concentrates on feedback to the Principles and “Comply or Explain” Recommendations in the draft NZX Code (Code). The “Comply or Explain” tier should provide the basis for good governance.

The Code as drafted relies too heavily on the commentary section. The commentary should not be used as a substitute for clear and meaningful Recommendations. The Recommendations are non-binding on companies (unless covered by legislation elsewhere) and therefore provide sufficient flexibility to issuers.

For commentary, the Code can make further use of links to other guidance, including from the FMA, NZCGF, and IOD, and in this way keep the focus of the code on the Comply or Explain tier.

For a ‘comply or explain’ regime to be effective it is essential that both the Recommendations and explanations are meaningful for companies and investors. The ASX offers such guidance. We recommend the NZX Code provides similar guidance.

C. Accountability to Shareholders

Including respect for shareholder rights in the principles (Principle 8) is a fundamental improvement. However, the recommendations themselves do little to support this – focusing as they do on communications which may be better dealt with in the section on reporting and disclosure.

Accountability of issuers to their shareholders should be central to the Code, and currently is not.

For example, the Code is silent on shareholders rights regarding material transactions such as dilution, or material changes to the nature of the business. The Listing Rules set out some of the legal requirements for issuers on these matters, but the Code itself must include recommendations on the fundamental shareholder rights which underpin such rule making.

For example, whilst shareholders want Boards to have the flexibility to raise capital efficiently, this has to be balanced against existing shareholder rights. Material transactions have the potential to inequitably transfer, or destroy, shareholder value. They are also points where there is an increased potential for conflicts of interest between shareholders and the executives and their advisors. The Board is accountable to shareholders and has responsibilities to manage these issues.

The Code also does not provide recommendations for protecting the proper exercising of shareholder rights at Annual or (Special) Extraordinary Shareholder meetings.

We are disappointed our submission to the earlier consultation on this section has largely been ignored, both in the Recommendations and the commentary.

The **Recommendations should include:**

1. Accountability to shareholders

- The NZX Code should explicitly recognise that Boards and management are accountable to the company and its shareholders.
- The Board's written role description should include a statement on responsibilities and accountability to shareholders.
- A listed entity should respect the rights of its security holders by providing them with appropriate information and facilities to allow them to exercise those rights effectively.

2. Major transactions

The Board has a responsibility to ensure that major transactions are conducted with respect for existing shareholder' interests.

- Shareholders, as owners of the business, should have rights to:
 - i) approve material changes to the nature of the business, and*
 - ii) approve material non pro-rata dilution of their ownership.*
- Boards should provide a clear explanation to shareholders of major capital allocation decisions, the scope of any related independent report and the process for selection of the advisor.

3. Shareholder voting

Mechanisms should be in place to facilitate participation in shareholder meetings, in particular to enable shareholders to effectively exercise their voting rights.

- Clear meaningful information about the matters to be addressed at the meetings should be included in the Notice of Meeting which should be posted on the company's website with sufficient notice in advance, and preferably at least 28 days prior to the meeting taking place.
- Boards should support the principle of one share/one vote in the voting process and as such count votes according to poll rather than a show of hands, should not bundle resolutions and only allow voting on resolutions that have been included in the Notice of Meetings.
- Shareholders should be able to vote electronically without appointing a proxy, usually the Chair, to attend the meeting in person. Votes should be properly counted, recorded and results fully published.

D. Board Composition & Board Committees

The Code makes good improvements in recommending formal role descriptions and board and committee charters.

Shareholders elect the Board's non-executive directors and require the right information on the board, nominees and nomination processes to do so. Shareholders will consider Board composition, skills, independence, experience, diversity, work-load, and succession planning.

The staggered board election cycle gives stability to a board and its directors, but it also makes it more difficult to refresh the Board compared to markets such as the UK where shareholders re-elect directors annually. A good balance in the NZ market would be for succession plans to include annual re-election for directors with a tenure of over nine years.

Independence

Independence plays an important role in protecting shareholder interests and managing agency risks.

The review of the Code pre-empts the Listing Rule Review where NZX will consider the issue of independence in the Listing Rules. To be a credible good practice code, the NZX Code must provide strong guidance on independence when it is launched. This does not prevent the Rules being updated on independence requirements post the launch of the new Code.

The Recommendations should include:

- The chairperson of a publicly owned entity should be independent. No director of a publicly owned entity should simultaneously hold the roles of board chairperson and chief executive (or equivalent). The Chief Executive should not go on to be the Chairperson, unless exceptional circumstances apply.
- Boards should be majority independent, unless this is not achievable due to the company's shareholder structure. Executives should not be a member of the Remuneration, Nomination or Audit Committees, and should only attend meetings by invite. Explanation should be given for the presence of the executives on the Board other than the CEO.
- A listed entity should have and disclose a board skills matrix setting out the mix of skills and diversity that the board currently has or is looking to achieve in its membership. (ASX Code 2.2)
- Board succession should occur on a planned and ongoing basis. Non-executive directors who have served longer than nine years should be subject to annual re-election in order to facilitate board independence and refreshment.
- Boards should disclose the processes it employs to nominate candidates to the Board and the process for shareholders to nominate candidates.

A listed entity should:

- a) Undertake appropriate checks before appointing a person, or putting forward to security holders a candidate for election, as a director; (ASX 1.2 a) and
- b) Provide security holders with all material information in its possession relevant to a decision on whether or not to elect or re-elect a director. (ASX Code 1.2 b.) This should include other current or relevant past directorships.

Takeover Committees:

- The board should establish appropriate protocols, that set out the procedure to be followed if there is a takeover offer for the company including any communication between insiders and the bidder. It should disclose the scope of independent advisory reports to shareholders. This may include the option to set up a takeovers committee.

E. Reporting and Disclosure

In order to make investment decisions, investors need to understand the company's strategy, how the strategy will deliver long-term value to its shareholders, and the company's means and ability to execute it. Investors should understand the company's risks, significant environmental, social and governance issues, stakeholder relationships that are core to the business and how these are managed. Shareholders should be kept abreast of important changes in the strategy.

The Recommendations should include:

- An issuer should provide financial and non-financial disclosure, including on environmental social and governance issues, and should indicate how financial and non-financial targets are measured. (Italics edit current recommendation in Code).
- Companies should communicate a balanced and understandable assessment of the company's performance, business model, strategic objectives and progress against meeting them. Changes in financial disclosure should be explained and allow comparison with historical performance.

(In commentary) **Company reporting should:**

- a) be linked to the company's business model;
- b) be genuinely informative and include forward-looking elements where this will enhance understanding;
- c) describe the company's strategy, and associated risks and opportunities, and explain the board's role in assessing and overseeing strategy and the management of risks and opportunities;
- d) be accessible and appropriately integrated with other information that enables shareholders to obtain a picture of the whole company;
- e) use key performance indicators that are linked to strategy and facilitate comparisons;
- f) use objective metrics where they apply and evidence-based estimates where they do not.

F. Independent Audit**The Recommendations should include:**

The annual report should describe the work of the audit committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process.

G. Other

Smaller Issuers

Smaller issuers recognise the value of good corporate governance, and also want to know what is important to their shareholders. Shareholders recognise that size and stage of development will be reasonable explanations in many cases for not meeting the Code's recommendations.

H. Recommendations removed from current Code that should be retained:

In drafting the Code some important clauses have been lost. The following should be reinstated:

- The separation of the CEO and Chairman. (current NZX Code 2.1). This has been removed without comments and is surely an oversight.
- Under Auditor – the word “independence” has been removed from the clause 4.2 (a) - *“to ensure that the ability and independence of the auditors...”* and should be reinstated.
- Under clause 3.5 retain – *“The Audit Committee should also address issues of auditor independence”*.
- Under Ethical Standards it is important to retain 1.2 : *“The code of ethics should address ethical issues, establish compliance standards and procedures, provide mechanisms to report unethical behaviour and ensure disciplinary measures are in place for any violations”* and 1.3 (d) *“ Directors giving proper attention to the matters before them”*.

For additional guidance for recommendations and commentary please see:

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NZCGF previous submission to NZX and our guidelines <http://www.nzcgf.org.nz>

Please see in Appendix 1 our answers to NZX review questions.

Appendix 1 NZX Questions to submitters

1. ***Do stakeholders agree that a more detailed recommendation about ethics is useful?***

Yes

The Ethical Standards Recommendation could adopt the similar FMA guideline on Code of Ethics in full. It should include:

- i) reference to facilitation payments and anti-bribery, and
- ii) the Board and management should ensure there is not a misalignment between incentive structures and its Code of Ethics.

It is important under Ethical Standards to retain 1.2 : *“The code of ethics should address ethical issues, establish compliance standards and procedures, provide mechanisms to report unethical behaviour and ensure disciplinary measures are in place for any violations”* and 1.3 (d) to consider *“Directors giving proper attention to the matters before them”*.

2. ***Is there anything further that should be recommended in the code of ethics or discussed in commentary?***

The Ethical Standards section has been repositioned to emphasise personal responsibility of employees and Directors. Whilst personal conduct is at the heart of a Code of Ethics, the Board and Management have a responsibility to ensure that strategic objectives, incentives and expectations placed on employees are not misaligned with the company’s ethical standards. The Code of Ethics should include how to conduct relationships with suppliers, contractors or business partners.

3. ***Are there any further matters in relation to board composition that stakeholders would like covered?***

Please see recommendations in section D. above under Board Composition.

4. ***Do stakeholders consider a recommendation that directors undertake training to be important?***

Yes.

5. ***Do stakeholders consider that the board should establish a formal procedure to regularly assess director, board and committee performance?***

Yes.

6. ***Do stakeholders consider it is still appropriate to include a recommendation that directors who are not members of the audit committee, and employees, should only attend audit committee meetings at the invitation of the audit committee? Alternatively, is this something that would be better as commentary?***

This should sit in the Recommendations but be reworded to apply only to Executive Directors and employees who should only be able to attend by invitation, and should not be members of the Audit Committee.

7. ***Do you consider that the level of overlap between the mandatory Listing Rules and the Code is appropriate? Would submitters prefer some other committee related matters to be covered in the NZX Code as opposed to the mandatory Listing Rules? Note that this would have the impact of making these requirements non-mandatory.***

The Committee Related matters in the mandatory Listing Rules should remain as mandatory rules.

8. ***Reporting: Do you agree with the proposed recommendations?***

Agree with 4.1, and 4.2 (which is already covered by Rule 10.4.5).

Recommendation 4.3 lacks meaning because “*non-financial*” is not defined. Instead edit as follows “*An issuer should provide both financial and non-financial disclosure, including on environmental, social and governance issues, and indicate how non-financial targets are measured*”.

9. ***Do you agree with the proposal to address ESG reporting within commentary?***

ESG reporting needs to be in Recommendation. And expanded on in the Commentary.

10. ***Do you agree NZX should develop its own ESG reporting guidance based on the SSEI’s model guidance or alternatively allow for issuers to use the GRI framework?***

The SSEI’s model guidance is to help stock exchanges address this issue within their rules and guidance documents.

The NZX should produce a short guide explaining:

- why ESG reporting is important,
- how to approach ESG reporting, including if you are a small issuer,
- provide a list and links to the key reporting frameworks (which would include GRI) and other relevant resources.

Then let companies decide which framework best works for them.

11. ***Remuneration: Do you agree with the proposals?***

Yes. There should also be an emphasis on Remuneration Policy.

It is important that Board describes how the remuneration policy is aligned with the company’s long-term strategic objectives.

12. ***Do you agree that it is appropriate to require heightened disclosure in respect of CEO remuneration as proposed?***

Yes.

We support heightened CEO remuneration disclosure given the significance of this to delivering a successful strategy. It is also in line with global best practice and it is good to see NZX recognising this.

Performance measurement should integrate risk considerations so there are no rewards for taking inappropriate risks at the expense of the company and its shareholders.

The company should disclose annually how awards granted to senior management and the CEO were determined and deemed appropriate when reconciled with KPIs and in the context of the company's underlying performance.

13. ***Are there any other risk concerns you think should be specifically addressed in the commentary?***

The Code should adopt the FMA guidelines that issuers should report at least annually to investors and stakeholders on risk identification, risk management and relevant internal controls. This could also be included as a Recommendation under the reporting section.

The board is responsible for determining the nature and extent of the principal business risks it is willing to take in achieving its strategic objectives.

14. ***Are there any other concerns you think should be specifically addressed in commentary about audit requirements.***

See Recommendation F. above.

15. ***Shareholder rights & relations: Do you have any concerns about principle 8 and 9 being merged into a single recommendation regarding shareholder interests?***

We do have concerns. Firstly, these have not been merged, and it is not appropriate to do so. There are a range of stakeholders that are materially to the success of a company's business, but with very different relationships and requirements than investors and shareholders.

Principle 9 from the FMA Code should be retained – but the Recommendation could be more concise.

Companies should include a description of key stakeholder relationships that are significant to the success of the company.

For shareholders, the company's stakeholder relations is important particularly with those key stakeholders that are material to the business. For example, regulators or employee relations may be vital for business success in one business, whereas community buy-in may be the focus of another company's stakeholder management. It was important for shareholders to understand these significant relationships.

16. ***Are there any other concerns you think should be specifically addressed in relation to shareholder rights and relations?***

Yes.

Shareholder Rights are only addressed in the Principle. They are not addressed in the Recommendations or Commentary. This is a fundamental flaw in the code as drafted. See Recommendations in section E above.