



ICGN

International Corporate Governance Network

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By email: consultation@nzx.com

Review of the NZX corporate governance best practice code.

Dear Sir,

Thank you for inviting market participants, including the International Corporate Governance Network (“ICGN”), to respond to the Consultation Paper on the review of the NZX Corporate Governance Best Practice Code (“NZX Code”).

Introduction ICGN

ICGN was founded over 20 years ago and is an investor-led membership organisation of more than 650 individuals based in 46 countries from around the world. Our mission is to inspire and promote effective standards of corporate governance to support the sustainable value creation of companies and to advance efficient markets and economies world-wide. Our members represent institutional investors with global assets under management in excess of US\$26 trillion. Accordingly, ICGN's members offer a source of practical knowledge and experience with regard to governance and investment issues. For more information on ICGN, please visit www.icgn.org.

At the ICGN Annual Meeting of 2016, the members adopted ICGN's new Global Stewardship Principles. The ICGN Global Stewardship Principles set out ICGN's view of best practices in relation to investor stewardship obligations, policies and processes. These stewardship principles are linked to the ICGN Global Governance Principles, our primary standard for well governed companies and investors alike, emphasising a shared interest in protecting and generating sustainable corporate value.¹ Both ICGN policy documents are available on our website and serve, amongst other ICGN guidance and commentary, as a basis for this response to your consultation.

Overall comments

We support NZX' key objectives to improve corporate governance practices in New Zealand. The introduction of the 'comply or explain'- approach in New Zealand is

¹ See: <https://www.icgn.org/policy>

important for issuers and investors. Good corporate governance demands some degree of flexibility and customisation at the individual company level; there is no ‘one size fits all’ approach that works for every company. The ‘comply or explain’ principle accordingly provides the board and the shareholders the opportunity to adapt governance practices to the specific characteristics of the business and its own needs. At the same time ICGN believes that there should be clear and bespoke explanations for non-compliance with the NZX Code, not a generic statement.

NZX has chosen to focus on board diversity, ESG and health and safety reporting and remuneration reporting as areas of importance to investors as part of developing the proposed updates. ICGN agrees that these areas are important for NZX and the investor community. ICGN recently published its new Diversity Guidelines and is supportive of NZX’s view that board diversity has to be considered beyond simply gender. This promotes directors with more diverse experience, social backgrounds and competencies to help enable effective board decision-making and leadership. Studies have shown that more diversity on boards can lead to long-term performance that benefits investors.

However, as institutional investors in most cases are minority investors in companies, the protection of minority shareholder rights is one of our fundamental priorities. Concerns can be particularly acute in companies with controlling shareholders—a common theme of ownership around the world. While controlling shareholders in many cases can be strong long-term partners with minority shareholders, there is also the risk that the interests of the controlling shareholder might conflict with those of minority shareholders. These challenges can be particularly difficult in local markets, where enforcement of minority shareholder rights can be challenging. Shareholder rights are critical to ensure that management is not entrenched and working without accountability against the long-term interests of investors and the company and its stakeholders more generally.

This calls for supporting minority shareholder rights and protections, also in the NZX Code. Key areas of focus in this context could include:

1. Differential ownership rights through loyalty shares or dual class shares. ICGN challenges differential structures of this nature for their potential for abuse by controlling shareholders. While *differential voting rights* are viewed by some companies and regulators as a viable way to encourage long-term ownership and thinking by investors, ICGN views this as a flawed tactic. Avoiding mismatches between voting control and economic ownership is an important principle of protecting minority shareholder rights. *Dual class shares* are problematic for minority shareholders for similar reasons and are an area of concern that is building globally. Accordingly, there remains considerable debate as to the benefits and potential abuses of differential rights.
2. Chronic problems relating to the efficient execution of proxy voting also remain unresolved, both in domestic markets and in cross-border applications. This inhibits the most basic of shareholder rights: the ability of shareholders to vote at shareholder meetings and the ability to confirm whether their votes have formally been counted. These voting challenges also

compromise the ability of shareholders to exercise appropriate stewardship in line with their fiduciary duties. There is scope for greater efficiencies across the vote execution chain and for more awareness building and dialogue with intermediaries – custodian banks in particular.

3. A fundamental shareholder right is the right to influence board membership and composition directly. This relates both to voting at shareholder meetings, but also for mechanisms to allow shareholders to put forward director candidates on the ballot; such rights are not universal to all companies and should be an area of focus.

The above-mentioned matters concerning the protection of minority shareholder rights could possibly be addressed as a new best practice under principle 8 or even as a solely new principle because of all the issues directly linked to the protection of minority shareholder rights.

Specific questions

In the consultation paper NZX request input on specific questions. We will highlight some of our policy initiatives and respond to some questions in more detail.

Principle 1: Ethical Standards

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

We think it positive that the New Zealand code begins with a focus on ethical standards. ICGN agrees that ethics and ethical practices are the foundation of good business practices and are fundamental to protecting and generating sustainable value over the long term. Our main focus would be on ensuring boards oversee a culture of integrity, reflected in codes of ethics and conduct. Boards should be aware of how ethical violations are flagged and dealt with; granular disclosure of this nature to the public may be positive, but often not necessary—as long as the board can disclose in general terms how it oversees application of company codes of conduct.

The board may be beholden to the society that supports its business, its products and output, but it must strive over the long term to balance the divergent demands of its stakeholders, including the need to cover the cost of capital for its shareholders.

Companies should be good corporate citizens. They operate within a societal context, with or without a global footprint, through their investment of capital, the payments of taxes and wages to workers, and any philanthropic activity that benefits a local economy. There is interdependency between companies and society.

Investors, particularly institutional investors, seek long-term value creation in the companies in which they invest. It does no good when companies compromise the ability of future generations to meet their own short-term needs. The ICGN Global Governance Principles, Corporate Culture 4.1 state that “[H]igh standards of business ethics should be adopted through codes of conduct/ethics (or similar

instruments) and oversee a culture of integrity, notwithstanding differing ethical norms and legal standards in various countries. This should permeate all aspects of the company's operations, ensuring that its vision, mission, business model and objectives are ethically sound and demonstrative of its values."

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

It might be valuable to point in the commentary or a separate best practice to the ICGN Global Governance Principles Section 1.2, the "board of directors is accountable to investors and relevant stakeholders for protecting and generating sustainable value over the long-term" and should b) "monitor the effectiveness of the company's governance, environmental impacts, and social practices, and adhere to applicable laws." ICGN believes that better reporting on corporate cultural factors, including business ethics, could establish a positive atmosphere for more engagement between stakeholders and a better dialogue between the management, the board and shareholders.

Principle 2: Board composition and performance

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

Standards of independence do not feature prominently in this New Zealand Code, and this is a shortcoming. ICGN believes that the Board should be comprised of a majority of independent directors with the knowledge and experience to discharge the board's responsibilities and the independence of judgment to do so free of any external influences. Therefore, we support the initiative of NZX to strive to incorporate this recommendation in the Listing rules and in the meantime strongly suggest that companies have a majority of independent directors in the board. Companies that does not have such a majority should explain clearly why and take action to reach to the appropriate level of independent directors.

When recruiting non-executive directors, a candidate's skills, experience and fit with the skills and experience the board is seeking should be primary factors for consideration. However, within the skills-based framework, boards should also strive for greater diversity. It is a board's responsibility to ensure that it possesses and maintains the right balance of independence, skills and diversity. As ICGN understands, unfortunately diversity is not part of defined balance in Principle 2. This should be addressed in Principle 2 and also incorporated in best practice 2.2.

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

Yes, best practice 2.6 should address this issue more effectively. The Board should periodically update its skills framework as the company's business and strategy evolve. This strategically positions the company to refresh its director candidate pool to reflect changes in its business approach.

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

Yes. ICGN believes that diversity is a core attribute of a well-functioning board which supports greater long-term value for shareholders and companies. An important best practice which promotes board diversity in general, is the adoption of robust board evaluation processes. Therefore ICGN believes that the scope of best practice 2.7 could be broadened.

Board evaluations should be conducted on an annual basis. Evaluations can be used to assess board group dynamics, identify areas for improvement and highlight gaps between the board skills matrix and director incumbents and nominees. This process can inform the recruitment of prospective board candidates. Board evaluations should be free of insider influences and provide board members with the discretion to identify areas for discussion and improvement. As part of the annual evaluation, the board should include an annual self-assessment of its performance in achieving its board diversity goals.

The Board should periodically update its board member evaluation metrics as the company's business and strategy evolve. This will allow the skills and experience necessary to oversee the company's strategy and risk to develop alongside the company's business.

There should be a board succession plan that addresses prospective retirements, committee chair rotations, non-executive board chair and/or lead director rotations and existing and prospective diversity gaps. New director recruitment should be conducted strategically using the board succession plan and skills matrix as a roadmap. "Overboarding" (namely a director having too many individual board commitments) is also something that should be avoided.

Principle 3: Board committees

The audit committee is an important committee of the board in challenging and supervision of the board. The position and personality of the chair is directly aligned with the impact an audit committee could have in the governance and leadership of a listed company. Therefore the chair of the audit committee should be an independent director, should not be the chair of the Board. ICGN suggests formalizing this in best practice 3.1.

1. 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?

Yes. However, all board members should have a continuous open and standing invitation to the meetings of the audit committee. Executives, employees or their representatives should be invited to attend the meeting if this would benefit the information available and will lead to more in depth discussion and decision-making in the audit committee. The audit committee chair or a majority of the committee

should be able to decide to withdraw any invitation if the other attendees would interfere with the independent and professional functioning of the audit committee.

2. Do you consider that the level of overlap between the mandatory Listing Rules and the Code is appropriate? Would submitters prefer some of the 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.

It is important that boards, shareholders, management, employees and other stakeholders can easily understand which rules apply to companies in certain situations or circumstances. Any doubt or misunderstanding should be avoided. Taken this starting point into account, ICGN believes that a combination of mandatory rules and regulation together with codes and guidance (or 'soft law') driven, drafted and enforced by market participants, could lead to an optimal environment for good governance and a sustainable business and investment opportunities. In New Zealand this suggests scope for some overlap between listing rules and the governance code. But the nature of a governance code is that it can be more expansive or aspirational with regard to proposed best practices than may be relevant for listing rules. So some overlap can be positive, but it need not be 100%.

Principle 4: Reporting and disclosure

1. Do you agree with the proposed recommendations?

We support the recommendations, and support the strong emphasis given to “non-financial” reporting in addition to financial reporting—though we think that “non-financial” can be an inappropriate term as they are effectively long-term risk factors that can have clear financial implications. Disclosure is important for good corporate governance. Relevant and material information should be disclosed on a timely basis so as to allow investors to take into account information which assists in identifying risks and sources of wealth creation. Issues material to investors should be set out succinctly in the annual report, or equivalent disclosures, and approved by the board itself.

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

There is a challenge with syntax when addressing ESG related issues. Rather than look at ESG as an end, companies need to understand and managed ESG related issues as part of their long term value creation strategy. In turn investors should integrate material environmental, social and governance (ESG) factors in stewardship activities to promote the long-term performance and sustainable success of companies. To reach this challenging goal, investors need information (or data) of the company to be able to show active ownership and to start a dialogue with the company on these issues. Hence, the importance of non-financial reporting by listed companies cannot be stressed enough. In the commentary by best practice 4.3, it would be extremely helpful to define what kind of (minimum) information has to be disclosed under the obligation of non-financial disclosure.

If there is no formal ESG requirement in New Zealand, investors will be looking for some form of integrated report that puts historical performance into context and portrays the risks, opportunities and prospects for the company in the future-- helping investors and stakeholders understand a company's strategic objectives and its progress towards meeting them. Such disclosures 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 investors to obtain a picture of the whole company;
- e) include environmental, social and governance related information that is material to the company's strategy and performance;
- f) use key performance indicators that are linked to strategy and facilitate comparisons;
- g) use objective metrics where they apply and evidence-based estimates where they do not; and
- h) be strengthened where possible by independent assurance that is carried out annually having regard to established disclosure standards.

3. *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?*
4. *Do you think another framework should be used instead?*

Overall, it would be valuable for investors that listed companies start with more advanced reporting on ESG. The GRI framework could serve as a good starting point and over time develop certain regional or local aspects that might be slightly different from the global standards.

5. *Do you agree that issuers should make key governance documents available to interested investors and stakeholders?*

Yes. This should be done at a dedicated public section of the company's website and as part of the annual reporting by the company.

Principle 5: Remuneration

1. *Do you agree with the proposals outlined above?*

The broad thrust of the proposals is sensible, but we would question the position on less robust disclosure regarding remuneration. But it is positive to see that the individual terms of CEO pay are subject to disclosure. Well-structured remuneration arrangements should facilitate the creation and sustainability of long-term shareholder value. They should also help to support a culture that is aligned with the company's strategic objectives as well as the company's values. Within the context described, "guaranteed" elements of variable remuneration are inappropriate in a

well-thought out and effective remuneration plan. It is incumbent upon the remuneration committee to ensure that only the necessary level of remuneration is paid and that under-performance is not rewarded.

When reviewing a company's remuneration arrangements, shareholders should be able to clearly understand how management is being incentivised and remunerated to perform and how much this may cost. This should be included in either the best practices 5.2 and 5.3. or in the commentary.

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

Yes. When reviewing a company's remuneration arrangements with executive board members, shareholders should be able to clearly understand how management is being incentivised and remunerated to perform and how much this may cost. Therefore, NZX might consider expanding the heightened disclosure regime to all executive directors.

Principle 6: Risk management

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

As stated in the commentary, it is critical that the board has processes in place to identify and manage the key risks facing its business, particularly to identify those risks that the board is willing to take in order to pursue its strategy and how it will manage these risks.

The commentary could be strengthened. One example thereto is that the board of directors should confirm in the annual report that it has carried out a robust assessment of the state of affairs of the company and any material risks, including to its solvency and liquidity that would threaten its viability. ICGN's Guidance on Corporate Risk Oversight provides further detail on exploring risk management through a corporate governance lens.²

Linking risk management with the audit process, the board should state whether, in its opinion, the company will be able to meet its liabilities as they fall due and continue in operation for the foreseeable future, explaining any supporting assumptions and risks or uncertainties relevant to that and how they are being managed. In particular, disclosure on risk should include a description of:

- a) risk in the context of the company's strategy;
- b) risk to returns expected by investors with a focus on key consequences;
- c) risk oversight approach and processes;
- d) how lessons learnt have been applied to improve future outcomes; and
- e) the principal risks to the company's business model and the achievement of its strategic objectives, including risks that could threaten its viability.

² See http://icgn.flpbks.com/icgn_corp_risk_oversight/ICGN_Corp_Risk_Oversight.pdf

Principle 7: Auditors

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

ICGN supports the recommendations and commentary made related to principle 7. Especially, the obligation for issuers to ensure that their external auditor attends their Annual Meeting and that they are available to answer questions from investors relevant to the audit.

However, ICGN believes that it is for the better functioning of internal control mechanisms that each listed company has an internal auditor. We suggest articulating a new best practice regarding this issue.

Best practice 7.3: The board of directors should oversee the establishment and maintenance of an effective system of internal control which should be measured against internationally accepted standards of internal audit and tested periodically for its adequacy. Where an internal audit function has not been established, full reasons for this should be disclosed in the annual report, as well as an explanation of how adequate assurance of the effectiveness of the system of internal controls has been obtained.

Principle 8: Shareholder rights and relations

1. Do you have any concerns about principle 8 and 9 being merged into a single recommendation regarding shareholder interests?

The best practices and the commentary do not address shareholder rights as such. ICGN believes it is important to list the rights of shareholders if only to make it obvious that these rights have to be acknowledged.

In our general comment we already noted that the protection of minority shareholder rights should be a core of the principles.

Besides the above, ICGN is strongly in favour of shareholder approval in important events within the company's life cycle. A possible best practice to this extend could be drafted in the following wording:

Best practice 8.3: Shareholders should have the right to vote on major decisions which may change the nature of the company in which they have invested.

Commentary: Such rights should be clearly described in the company's governing documents and include:

- a) amendments to governing documents of the company such as articles or by-laws;
- b) company share repurchases (buy-backs);

- c) any new share issues. The board should be mindful of dilution of existing shareholders and provide full explanations where pre-emption rights are not offered;
- d) shareholder rights plans ('poison pills') or other structures that act as anti-takeover mechanisms. Only non-conflicted shareholders should be entitled to vote on such plans and the vote should be binding. Plans should be time limited and put periodically to shareholders for re-approval;
- e) proposals to change the voting rights of different series and classes of shares; and
- f) material and extraordinary transactions such as mergers and acquisitions.

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

Shareholders should have the right to approve significant related party transactions and this should be based on the approval of a majority of disinterested shareholders.

The board should submit the transaction for shareholder approval and disclose (both before concluding the transaction and in the company's annual report):

- a) the identity of the ultimate beneficiaries including, any controlling owner and any party affiliated with the controlling owner with any direct/indirect ownership interest in the company;
- b) other businesses in which the controlling shareholder has a significant interest; and
- c) shareholder agreements (e.g. commitments to related party payments such as licence fees, service agreements and loans).

Closing remark

We hope that these comments and suggestions are useful in your deliberations and the ICGN Policy Director, George Dallas (george.dallas@icgn.org), would be happy to elaborate on any of the points raised in this letter. Thank you for your consideration.

Yours truly,

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