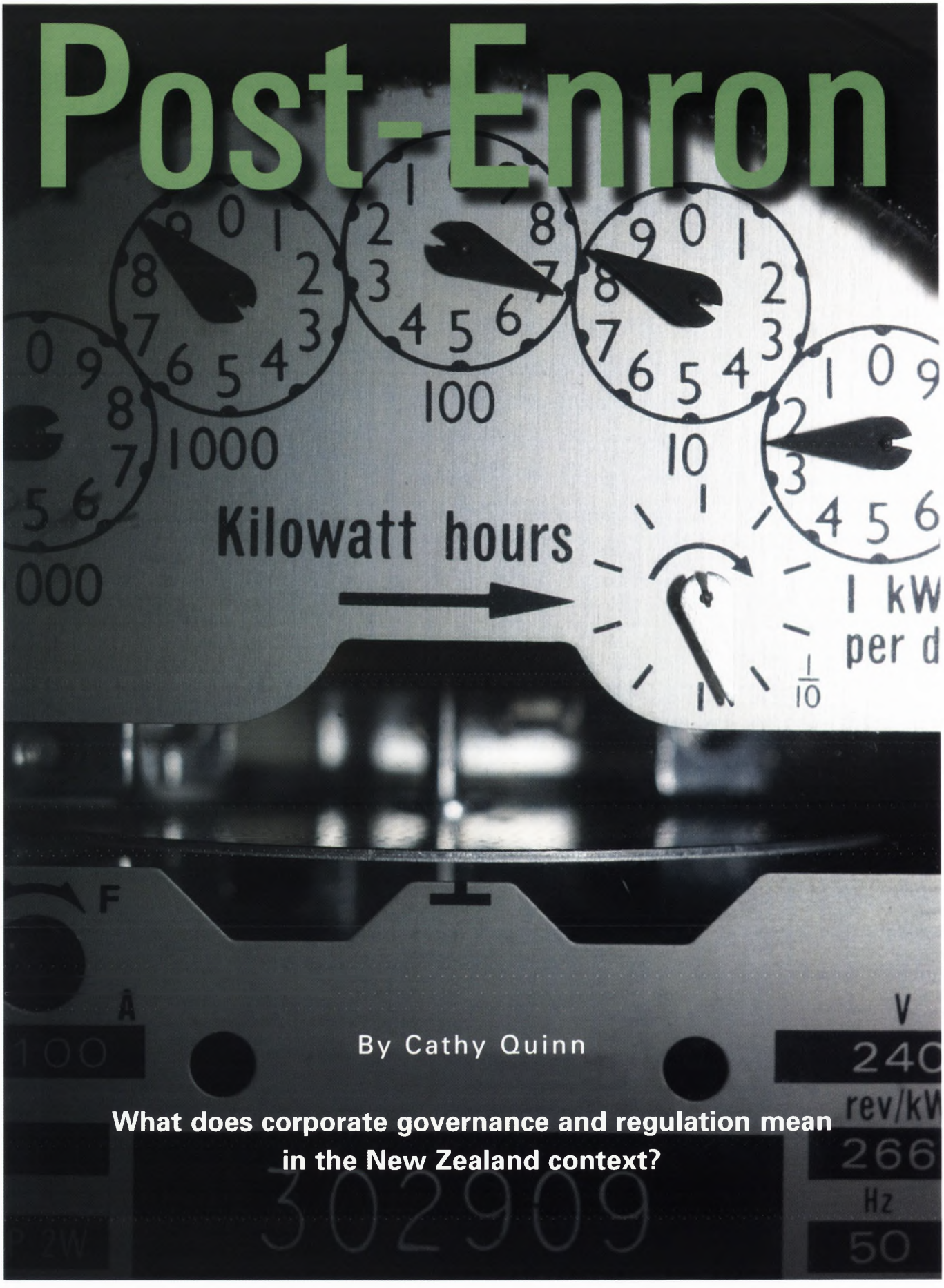
Post-Enron



By Cathy Quinn

What does corporate governance and regulation mean in the New Zealand context?

REGULATORY FRAMEWORK

Like all Organisation for Economic Cooperation and Development (OECD) countries, New Zealand (NZ) has put its own standards of corporate governance and relevant legal frameworks under close scrutiny over the past three years, a fact reflected in various substantial pieces of securities market legislation and the recently passed *Crown Entities Act*. For its part, the NZ Exchange has adopted a Corporate Governance Practice Code in October 2003 – now an appendix to the Listing Rules.

The NZ Securities Commission ('the Commission') has contributed a robust, principles-based framework for good corporate governance across the full spectrum of economic entities in New Zealand, from listed companies to community-owned trusts and Crown entities. The framework is an important piece of work by the Commission – work that drew on a survey of post-Enron regulatory developments in Australia, the US and elsewhere, and on consultation with our own business and governance community in NZ. This made it very clear that the NZ business community favoured a principles-based rather than a more prescriptive rules-based approach. The Commission drafted the principles accordingly.

The Commission takes the standard view that corporate governance is about the way in which entities are directed and controlled within structures that formally separate supervisory and managerial functions and ensure accountability between them, and between the entity and its investors and other external stakeholders.

In a free-market business context, the OECD has recently summed up the corporate governance challenge neatly in these terms:

> 'Good governance helps to bridge the gap between the interests of those that run a company and those that own it, increasing investor confidence and making it easier for companies to raise equity capital and to finance investment.'

The OECD also states that corporate governance should always 'help ensure that a company honours its legal commitments and forms value-adding relations with stakeholders including employees and creditors.' In NZ we see good governance very much in the same terms – accountability, legal compliance, stakeholder relationships, and strong performance by the entity in whatever area it is operating.

NEW ZEALAND APPROACH

The Commission published 'Corporate Governance in New Zealand: Principles and Guidelines' in February 2004, primarily as a tool for boards of directors and others involved in board governance of every kind. Our framework consists of nine high-level statements of principle, each supported by suggestions or guidelines as to how the principle should be implemented.

The principles articulate the need for ethical behaviour; the need for balance in the composition of boards; the role of effective board committees; the critical importance of integrity in reporting; the basics of good remuneration policy; the need for risk-management processes; the imperative of maintaining auditor independence; the importance of constructive shareholder relations; and the potential significance of other stakeholders in a governance context.

The framework, comprehensive as it is, has been very well received, largely because we made a real effort to produce a distinctly NZ approach to promoting high standards.

We started by acknowledging two fundamentally important considerations about NZ and our well-established system of economic management.

First, the standards of governance in any particular entity will inevitably depend on the knowledge, experience and integrity of its directors and managers. These are the people making the critical decisions that drive performance, in financial and other terms. And they are the people best-placed and best-motivated to decide how those decisions are made, within the particular structures and accountability mechanisms of their business. The most effective steps for engaging with shareholders and stakeholders also vary from one entity to another. In short, any securities regulator will be limited in its ability to determine exactly which structures and practices deliver high-standard governance for all entities.

Second, the NZ model of economic management is based squarely on the disciplines of the market, and the ability of interested parties to hold directors and managers accountable. >>

In the banking sector, for instance, we see a strong emphasis on good corporate governance. To quote Reserve Bank Governor, Allan Bollard:

> 'Our supervisory framework is deliberately light-handed in nature, in the sense that we minimise our intrusion into the management of banks' risks and the structure of their operations. Instead, we try to foster robust self-discipline in banks through the corporate governance and disclosure frameworks we have established.'

The central bank has laid down corporate governance and reporting standards, and thereafter looks largely to commercial imperatives and marketplace accountabilities to deliver stability in the banking and payments system. At the Commission, we see parallels with the capital market – stability and performance are served by having companies with sound corporate-governance structures and processes that put a strong emphasis on reporting and on enabling owners to exercise ultimate control.

NZ Guidelines promote formal public certification of awards. So far, only 11 of 116 companies have taken this step.

REGULATORY OPTIONS

Worldwide, a spectrum of regulatory options promote high governance standards – principles-based approaches on one side and rules-based approaches on the other. The *Sarbanes Oxley Act* in the US, a direct legislative response to Enron and Worldcom, has come to be seen as a benchmark in rules-based regulation. It is detailed in its prescription of what boards and executives must do for good governance and is backed by the force of law.

In contrast, a principles-based approach usually gives boards flexibility in deciding how they should implement generally stated requirements for good governance. There are various models along the spectrum. It is fair to say that principles become more prescriptive when written in more detail and accompanied by 'comply or explain' requirements. In Australia, an ASX Corporate Governance Council produced a set of 'comply or explain' principles in 2003.

So, where to locate NZ along the regulatory spectrum? The Commission's consultation during 2003 elicited a clear preference for principles over rules. In any event, we saw some form of principles-based approach as most appropriate to our context, bearing in mind the fundamental considerations already mentioned. We think NZ boards are quite capable of sorting out the best policies and processes for their circumstances, within a broad principles framework of expectations.

The last thing we want in NZ is a 'tick-the-box' compliance mentality on corporate governance. In our view, the purpose of governance is to drive organisational behaviour and performance for the company, shareholders and stakeholders – and that is where board attention should be focused, not on compliance with rules *per se*. For all these reasons, the Commission decided on a relatively flexible principles-based approach.

Indeed, our framework creates a baseline for the behaviour of boards and executives that should help them to ensure that their organisation is complying with its legal obligations. The Principles and Guidelines are obviously also compatible with those legal obligations that bear directly on governance – such as elements of the *Companies Act*, stock exchange listing rules, the *Securities Act* and amendments, and the *Crown Entities Act*.

NEW ZEALAND EXPERIENCE

Reporting and disclosure are obviously critical to the success of a principles-based approach. The Commission wants to see companies and other entities reporting how they achieved each of the nine principles. We want the principles to be discussed and actioned in boardrooms everywhere – and reporting and disclosure to then reflect those discussions and actions. We will see a rising standard of governance when we see more comprehensive and timely reporting and disclosure.

NZ-listed companies have shown a significant improvement in this regard over the past two years. The Commission's own monitoring of 2004 annual reports shows that large corporates have lifted their game and others are definitely starting to wake up to the new expectations being demanded of them. The NZX Listing Rule changes introduced in October 2003 have been a significant contributor to this improvement.

Our monitoring shows that the governance issues most on directors' minds during 2004 were the composition of boards and board committees, along with board nomination processes and directors' remuneration. Well over 90% of the company reports we examined focused on these matters. Half the companies in our monitoring show their board has both a majority of non-executive directors and one-third or more who are 'independent' directors. This is pleasingly in line with the expressed preference of the Commission. As yet, few companies are actually disclosing details of their directors or substantiating their independence case by case. They should be.

Of companies encompassed by the Commission's monitoring of 2004 annual reports, almost half disclose that they have a board audit committee, while a slightly higher number report that they also have remuneration and nomination committees. The NZX Code states that having all three committees is integral to best practice and the Listing Rules require companies without them to report accordingly. The Commission wants to see proactive disclosure on the composition and charter of all board committees, and our Guidelines are very clear on our preferred structure for audit committees in particular.

Listed companies have generally got the message about the

need for reassurance on the integrity of financial reports and other disclosures. This is a central concern in our Principles and Guidelines. Integrity in reporting is a matter both of board process and the inclusion of meaningful information in reporting to shareholders and others.

In our monitoring, around 80% of companies reported on their processes for this during 2004. In many cases, they included specific processes for ensuring compliance with reporting standards and other legal obligations.

2004 SHORTCOMINGS

Our Guidelines promote formal public certification on company accounts by the chief executive and chief financial officer. So far, only 11 out of 116 companies have taken this step, which is a little disappointing.

In other areas, we have found that most companies report on remuneration practices, risk management and auditor independence. In the annual reports, 70% talk about how they maintain independence, with the focus principally on limiting non-audit work by the company's audit firm. A majority of the companies acknowledge the need for a high ethical standard of behaviour right across the company – 40% of the reports in our monitoring project confirm that this concern has been, or will be, embodied in a company code of ethics.

Looking at listed company reports for 2004, there are two areas of distinct disappointment: the importance, or lack of it, attached to fostering constructive relationships with shareholders; and the level of reporting attention given to companies' interaction with other stakeholders. Our Principles and Guidelines address both of these very clearly. We think companies should have plenty of flexibility in how they work with shareholders and stakeholders, but also make more of an effort to report on what they are doing.

Overall, the Commission is pleased with progress both in reporting and in the standards of corporate governance indicated through that reporting. There are some extremely informative reports on listed company governance – Telecom, Air New Zealand and the Warehouse are among the best.

SECURITIES LAW ENFORCEMENT

It is a plain fact that many breaches of the *Securities Act* and Regulations relate to lapses in corporate governance within those companies issuing securities. Often it becomes very clear to the Commission that if the issuer's board had the right focus in its decision-making and was ensuring that the entity followed sound processes, then non-compliance with securities law would not have occurred.

The Commission often finds lapses in the context of investment offerings to the public. Our Enforceable Undertakings regime, in place since late 2002, has provided a stream of examples. One is the case of Prudential Mortgage Limited, a contributory mortgage broker in Christchurch which came to our attention for newspaper advertising that was plainly deficient under Securities Regulations 1983.

The ads offered interests in a contributory mortgage over a property to be purchased by another party, but they failed to state the minimum amount of securities that would have to be held, or minimum term of investment for which the advertised interest rate would apply. The Commission found that the advertising content had not been checked for compliance with the Regulations and that no authorising certificate had been signed.

Furthermore, it transpired that a valuation report provided to contributors had various omissions, putting it in breach of the Contributory Mortgage Regulations.

The Commission secured an enforceable undertaking by the directors of Prudential Mortgage in mid-2004. The directors agreed to ensure that future advertising would be prepared or reviewed by professional advisers, and that the company's employees and marketing agents would be trained in relevant securities law requirements. The directors also agreed to prepare a written compliance plan for future advertising, to be updated annually and subject to compliance checking by auditors. The understandings were satisfactory to the Commission, but the need for them revealed critical gaps in the knowledge of an issuer's directors and staff, and poor performance by a board on matters at the very core of a business under its direction.

Unfortunately, in our experience such circumstances are not uncommon. From time to time the Commission encounters other types of apparent corporate governance failure involving far more serious wrongdoing. Insider trading, and other deceptive or manipulative behaviour >>

Good governance should be predominantly the concern of boards of directors and governors, owners and stakeholders – not lawmakers and securities regulators.

involving securities, can also amount to serious corruption of corporate governance practice. The Commission is on the regulatory frontline against such wrongdoing and, on a case-by-case basis, will use all its powers to call individuals to account before the civil or criminal justice systems.

IOSCO INITIATIVES

The Commission is a keen participant in building a network for international information exchange and enforcement cooperation among securities regulators. Commission Chairman, Jane Diplock, is currently also Chair of the Executive Committee of IOSCO – the International Organisation of Securities Commissions. Through this involvement, NZ has taken a lead role in developing this initiative over the past year. IOSCO members are securities regulators and other relevant national bodies from more than 100 countries, covering more than 90% of the world's securities markets. It has grown substantially in membership and status over the past 30 years, and is now recognised as the leading international standard-setter for securities regulation.

IOSCO promotes regulation that first, protects investors against the misuse of assets, insider trading and other forms of fraud; second, ensures fairness, efficiency and transparency in securities markets; and third, reduces systemic risk.

Following Enron and other high-profile corporate collapses, national regulators like the NZ Commission are looking to IOSCO for more effective cross-border detection and enforcement against corporate wrongdoing.

MMOU

In 2002 the organisation adopted a Multilateral Memorandum Concerning Consultation and Cooperation and the Exchange of Information (the MMOU). New Zealand and Australia were among the early signatories, now numbering 27 regulators worldwide. They agree to exchange information and assist each other in monitoring market activity, and combating fraud and other wrongdoing.

All signatories to the MMOU have the legal powers and organisational capacity for efficient and timely cooperation. It is a major step forward in regulating the fast-growing global capital market and the threats posed by poor corporate governance among companies operating in that market. The NZ Commission has used the MMOU in its enforcement work and its usefulness has certainly been proven.

So important is the MMOU, and its utility to IOSCO members like NZ, that IOSCO now requires all members to become signatories, or be committed to becoming signatories, by January 2010. Jane Diplock was a principal architect of this highly significant outcome of the IOSCO national conference in Sri Lanka in April 2005. There will be seamless cross-border cooperation between an expanding number of securities regulators. The latter will be much better placed to track and curb illegal behaviour in capital markets, and to hold international companies to high standards of corporate governance in a way that Enron and Parmalat never were.

IOSCO Task Force

An IOSCO task force reviewed securities regulation worldwide in the wake of Parmalat and produced a report in February entitled 'Strengthening Capital Markets Against Financial Fraud'. It concluded that core issues of corporate governance were evident in all the major corporate collapses: issues of board conduct; auditor independence and effectiveness; disclosure by securities issuers and market transparency; and behaviour of market intermediaries and analysts. This important report has served to further build consensus on the need for consistent international standards and effective enforcement mechanisms.

CONCLUSION

In the past three years the world, and NZ, have come a long way in their awareness of corporate governance issues and how to promote higher standards. There is a high level of consistency between developments here and internationally, although the Securities Commission and others have made a substantial effort to establish a particular NZ regulation model. Good governance should be predominantly the concern of boards of directors and governors, and of their owners and stakeholders – not lawmakers and securities regulators. That said, the NZ Commission is taking a proactive stance on enforcement where investor protection, market efficiency or systemic risk are at stake. And we are increasingly acting in concert on these matters with our regulatory peers throughout the world. ■

Cathy Quinn *is a member of the New Zealand Securities Commission. This article is based on a talk she gave at the Legal Teachers Forum in Hamilton, New Zealand, in July this year.*