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Revisions to the FMA Corporate Governance Handbook

The Institute of Directors (IoD) appreciates the opportunity to comment on the proposed revisions to the *FMA Corporate Governance Handbook* (the handbook).

We welcome the FMA's initiative to revise the handbook to ensure it is up to date with developments and trends in corporate governance. The handbook plays an important part in improving corporate governance in New Zealand and assisting directors in carrying out their roles and responsibilities.

Since the handbook was last updated in 2014, the NZX Corporate Governance Code (NZX Code) has been significantly revised. In the light of this, the FMA has refocused the handbook to apply to non-listed and public sector entities. The FMA encourages listed issuers to refer to the NZX Code for corporate governance obligations and has removed references to listed issuers in the handbook. We support this reorientation and the general alignment of content with the NZX Code. This will result in a reduction in fragmentation, duplication and inconsistencies in the various corporate governance reporting regimes in New Zealand. It will also support companies that list in the future to transition to the public operating environment.

Our submission focuses on some of the key revisions to the handbook and other matters the FMA may wish to include.

About the Institute of Directors

The IoD is a non-partisan voluntary membership organisation committed to driving excellence in governance. We represent a diverse membership of over 8,500 members drawn from listed issuers, large private organisations, small and medium enterprises, public sector organisations, not-for-profits and charities.

The IoD's *Code of Practice for Directors* (IoD's Code) provides guidance to directors to assist them in carrying out their duties and responsibilities with high professional standards. All IoD members must sign up to the Code.

Our Chartered Membership pathway aims to raise the bar for director professionalism in New Zealand, including through continuing professional development to support good corporate governance.

Overview of the handbook and revisions

The handbook is aimed at assisting directors, executives and advisors to apply corporate governance principles to their entities. There are 8 high-level corporate governance principles in the handbook, reduced from 9 in the 2014 edition (Principle 9 (stakeholder interests) has been merged with Principle 8 (shareholder relations)). The principles are largely the same as those in the NZX Code. There are also guidelines and commentary in the handbook. Boards are asked to *explain* how they comply with each principle, rather than 'comply or explain why not' (as per the NZX Code). This allows for flexibility and meaningful reporting. We agree with the principles as expressed subject to some minor comments later in our submission.

Key revisions
The handbook has been revised in the light of developments in corporate governance, including around non-financial reporting, director and executive remuneration, and auditors.

Now that the NZX Code has been updated for listed issuers, the handbook has been reoriented towards companies or entities with an economic impact in New Zealand and/or that are accountable to the public because of their involvement in our financial markets, including:

- companies wanting to raise capital and/or list on the NZX in the future
- companies providing financial services
- state-owned enterprises
- community trusts
- public sector entities
- other companies.

The broad scope of the handbook should help improve corporate governance across different sectors and especially entities seeking to raise capital or list on the NZX. However, we suggest the FMA further clarify the scope, for example the handbook's application to Māori and iwi owned entities, and large NGOs, NFPs or charities.

The FMA has asked whether more guidance is needed for entities seeking to grow and possibly raise capital and/or list in the future. We support further guidance from the FMA about the various ways entities can raise funds which would be a useful resource for boards. However, this would be better in a separate publication.

The IoD's Code and *The Four Pillars of Governance Best Practice* are listed as useful references in the handbook and we welcome this.

Principle 1: Ethical Standards

Directors should set high standards of ethical behaviour, model this behaviour and hold management accountable for delivering these standards throughout the organisation.

Ethical practice underpins sustainable success and should be fundamental to all boards and directors. The IoD's Code provides that directors should lead a culture of high ethical standards.

The guidelines to Principle 1 set out specific matters that an entity's code of ethics should cover including conflicts of interest. Conflicts of interest are perhaps the most commonly unidentified or overlooked risk for directors. They can be challenging to manage and can give rise to significant public scrutiny. The FMA may wish to consider conflicts in more detail in the handbook. For more information see the IoD's *Conflicts of Interest Practice Guide*.

Principle 2: Board composition and performance

To ensure an effective board, there should be a balance of independence, skills, knowledge, experience and perspectives.

Board composition is a major consideration for the effectiveness and performance of the board. A balanced board needs a broad mix of skills and experience and boards are at their best when they are distinguished by diversity of thought. A board with a variety of perspectives is likely to ask a wider range of questions when presented with options. Introducing diversity is about fresh thinking and appropriate challenge to board decision-making and the culture of the board.

The guidelines to Principle 2 provide that directors should be selected and appointed through rigorous, formal processes designed to give the board a range of relevant skills and experience. The commentary adds that each director should have skills, knowledge and experience relevant to the affairs of the entity. The commentary also adds that an effective board requires a range and balance of relevant attributes among its members. This will include consideration of gender, ethnicity, cultural background, age and specific relevant skills.

NZX has recognised the importance of diversity at a governance level. For example, it has required listed companies to report on the gender breakdown of directors and officers in their annual reports since 2013, and the NZX Code now recommends issuers set measurable objectives for achieving diversity (gender at a minimum) and assess and report on progress in achieving the objectives. In our view, the handbook should include similar guidelines whereby organisations are encouraged to adopt a diversity policy, establish measureable objectives, and track and report progress in achieving them. For more information see the IoD's guide *Getting on board with diversity*.

CEO succeeding to chair

The FMA says in the commentary to Principle 2 that, in general, the CEO should not become the chair. This is particularly relevant to listed issuers and we note that it is generally considered to be good practice to have a sufficient interval between the roles. However, in private entities, it is not uncommon for a CEO to become the chair, for instance, where a founding CEO transitions as part of a succession plan. Given the reorientation of the handbook away from listed issuers, the FMA may wish to address this matter in more detail and explain the reasons why it is generally not best practice for a CEO to become the chair (eg how the entity and the CEO/chair relationship may be impacted as a result).

Principle 3: Board committees

The board should use committees where this will enhance its effectiveness in key areas, while still retaining board responsibility.

Board committees, such as audit and risk, can aid the board by giving greater scrutiny to specific aspects of the board's duties and responsibilities.

Audit committee chair and audit firm relationship

The FMA has updated the guidelines to Principle 3 saying that the chairperson of the audit committee should not have a long-standing association with the external audit firm as either a current or retired audit partner or senior manager within the firm. We support this revision, however we suggest this should be subject to an appropriate timeframe (eg of three years) and that the audit committee chair should not have an ongoing/residual financial relationship with the audit firm.

Director attendance at committee meetings

The handbook outlines the composition of committees but it does not address attendance of other (non-executive) directors at committee meetings.

The IoD's Code states (at 3.18) that "any non-executive director should be invited to attend meetings of any board committee should they so wish, whether appointed to that committee or not, provided the director is not excluded by reason of conflict of interest".

Directors who are not members of committees should be able to attend committees. This is because directors (the board) remain liable under the Companies Act 1993 for actions of committees (except in limited circumstances). Activities of committees are generally restricted to making recommendations for the board's approval, rather than the committee being empowered to make decisions in its name or on the board's behalf.

We suggest including in the commentary that non-executive directors should have a standing invitation to attend all committee meetings (provided they do not have a conflict of interests) and that employees (including executive directors) may attend committee meetings at the invitation of committees.

Principles 4: Reporting and disclosure

The board should demand integrity in financial reporting and in the timeliness and balance of corporate disclosures.

Transparency and a level of consistency in corporate governance reporting are important to the market, shareholders and stakeholders. Good governance practice expects reporting that is open and meaningful – that goes beyond 'tick box compliance'. This is supported by providing appropriate context and explanation.

The FMA has updated the guidelines and commentary in the light of developments around non-financial reporting and disclosure. We support these and suggest the FMA also update the Principle 4 description to refer to financial and *non-financial* reporting to provide more balance and emphasis. This will also align with the equivalent principle in the NZX Code.

Demand for greater transparency about corporate activities and for more holistic reporting is gaining global traction. Financial information alone does not tell the whole story, and scrutiny is extending beyond the bottom-line to examine what businesses are doing, how they are doing it, and their impact on the environment and society. Many different types of entities are already reporting non-financial information, including using established frameworks such as the international Global Reporting Initiative or Integrated Reporting. We expect entities will increasingly adopt these frameworks in the near future.

Principles 5: Remuneration

The remuneration of directors and executives should be transparent, fair and reasonable.

Effective communication about remuneration information with shareholders and the wider public helps build trust and confidence in companies.

CEO remuneration
Executive pay is increasingly in the spotlight in New Zealand and companies can expect greater scrutiny and debate about it and income disparities in the future. Given this, the FMA may wish to give more prominence and stronger guidance about it in the commentary. This may cover, for instance, what meaningful disclosure looks like, eg how executive pay is comprised and how it aligns with organisational strategy and performance. The FMA may also wish to consider including commentary about further disclosure on organisational remuneration policies and practices, for example on the gender pay gap and worker remuneration.

Director remuneration
We support the guidelines and commentary around the disclosure of director remuneration. The commentary could also add that the report on director remuneration should include a breakdown of remuneration for committee roles and for fees and benefits for any other services. The IoD has developed a *framework* (available on our website) for disclosing director remuneration in annual reports which may be helpful to companies and entities subject to the handbook. Using the framework will enable a more open and consistent approach to disclosure in annual reporting.

We note that the FMA has deleted from the guidelines "no non-executive director should receive a retirement payment unless eligibility for such payment has been agreed by shareholders and publicly disclosed during his or her term of board service". We think it is important to have a guideline around retirement payments. We suggest clarifying that the payment of retirement allowances to directors is not good practice, and that director remuneration should be based on their services rather than their duration of service.

Principle 6: Risk management

Directors should have a sound understanding of the key risks faced by the business, and should regularly verify there are appropriate processes to identify and manage these.

Risk management is a critical element of the board's role. The FMA's revisions include guidelines and commentary on governing environmental, social, and governance risks. We support this additional material in the handbook to provide more fulsome and clear communication about organisational risks. Greater transparency in this area is consistent with international trends and underpins good governance. We note that much of the guidance and commentary aligns with recent updates to the NZX Code and we support this alignment, which will be especially helpful to companies deciding to list.

The NZX Code includes references to health and safety risks as part of a more holistic approach to risk management and corporate reporting. This highlights the importance of health and safety in organisations following the introduction of the Health and Safety at Work Act 2015. We suggest the FMA consider including similar coverage and take the opportunity to highlight other key risks such as cybersecurity, and ethical behaviour and conduct risk.

Principles 7: Auditors

The board should ensure the quality and independence of the external audit process.

The IoD's Code recognises the importance of auditors and the need for independence.

The FMA has added into the guidelines that boards should approve audit fees, and any other services provided by their auditor, and should not delegate this function to management. We suggest the guidelines also recognise audit committees can approve fees (this is consistent with the requirements in the NZX Code). That is, the guidelines could state that "the board or audit committee if there is one" should approve fees.

The FMA has updated its commentary on non-audit work. It now says when considering independence, the audit committee should take into account what a reasonable and informed third party would be likely to conclude regarding the audit firm's independence. The fees paid for non-audit work will be a factor in determining independence. We support the FMA's commentary about improving the disclosure in financial statements regarding non-audit work to ensure investors can get an informed view of the auditor's independence.

Principle 8: Shareholder relations and stakeholder interests

The board should foster constructive relationships with shareholders and stakeholders. Shareholders should be encouraged to engage with the entity.

The IoD's Code provides that directors should adopt policies governing the management of relationships with key stakeholders that are consistent with the nature of the company, its mission or purpose and interests of shareholders. Companies should recognise and respect the legitimate interests of stakeholders. Engagement with key stakeholders should assist directors to act in the best interests of the company.

As noted above, the FMA's 9 principles for corporate governance in the 2014 edition of the handbook have been reduced to 8 (to align with the NZX Code), with the principles on shareholder relations and stakeholder interests being combined. Stakeholder considerations have also been included in other principles.

Stakeholder interests are gaining greater importance in today's operating environment and we support the retention of stakeholder interests as a principle (albeit with shareholder relations).

Conclusion

We reiterate our support for updating the handbook to raise corporate governance standards in New Zealand. It is appropriate that the handbook has been refocused, away from listed issuers now that the NZX Code is in place. The alignment of content where appropriate with the NZX Code is welcome and will result in a reduction in fragmentation, duplication and inconsistencies in the various corporate governance reporting regimes in New Zealand. We encourage the FMA to make enhancements outlined in our submission to help reflect good corporate governance.

We appreciate the opportunity to comment on behalf of our members and would be happy to discuss this submission with you.

Yours sincerely

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