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Submission on the exposure draft of the NZX Listing Rules

The Institute of Directors (IoD) appreciates the opportunity to comment on the exposure draft of the NZX Listing Rules, with reference to the questions set out in the consultation paper dated 11 April 2018. We also comment on the related exposure draft of the NZX Corporate Governance Code.

We reiterate our comments in our submission dated 1 December 2017 endorsing the review and setting out our position on specific issues. Our feedback in this submission mainly focuses on director-related matters.

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 8,700 members drawn from listed issuers, large private organisations, small and medium enterprises, state sector organisations, not-for-profits and charities.

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

Summary of submission

Proposed extension of the continuous disclosure rules

The IoD strongly opposes the proposal to extend the continuous disclosure rules to include constructive knowledge of directors and officers for the following reasons:

- the continuous disclosure regime appears to have been working well on the whole
- we expect the 2017 NZX Corporate Governance Code will raise corporate governance standards in New Zealand, including around continuous disclosure and risk management
- there is a significant risk of hindsight bias under the proposed test (as to *what* information directors and officers ought reasonably to have known and disclosed, and *when*)
- the growing regulatory burden for directors means they are spending disproportionately more time on conformance rather than performance. The proposed change will add to this and may:
    - have adverse effects with internal reporting
    - lead to boards becoming more risk adverse, ultimately impacting business success and shareholder value

- directors of listed issuers are exposed to significant legal liability and this is increasing over time. The proposed change may deter directors from serving on boards of listed issuers
- costs will increase for issuers, and directors and officers under the proposed change
- we believe the policy intent won't be achieved because of the above factors having a more negative than positive impact on directors and issuers.

Independent director requirements
The requirements for boards of equity issuers in the Listing Rules have been reformulated under the draft Listing Rules and we support:

- the requirement for boards to have a minimum of three directors and at least two independent directors
- a new general rotation rule (ie a director must not hold office (without re-election) past the third annual meeting following the director's appointment or three years, whichever is longer)
- a new recommendation in the NZX Corporate Governance Code (on a 'comply or explain' basis) that a majority of the board should be independent directors
- a new principles-based test for determining independence.

We strongly recommend that there should be a minimum of *two* resident directors (of New Zealand or Australia) on boards of listed issuers, and not one as proposed.

Overview of proposed changes

NZX is proposing to combine the NZAX and the NXT with the Main Board for equity issuers and funds. Debt will remain on the Debt Market. Other key proposals include:

- introducing new eligibility rules for listing (ie requirements for 300 financial product holders, 20% free-float and a minimum market capitalisation of $15 million)
- a NZX Foreign Exempt Regime to facilitate the listing of overseas companies
- extending the continuous disclosure obligations to include constructive knowledge of directors and officers (to include situations when issuers ought reasonably to have come into possession of material information)
- a requirement for shareholder approval for transactions that significantly change the nature or scale of an issuer's business (in addition to the current major transactions rules)
- a requirement to publish preliminary half-year financial statements (and removing the requirement to publish a separate half-year report)
- a new test for determining independent directors (and new recommendations and commentary in the NZX Corporate Governance Code).

We discuss the proposals on continuous disclosure and independent directors below.

NZX has indicated that the Listing Rules will be finalised this year. It is proposed that the new regime will take effect from 1 January 2019 with a six month transition period (ie issuers will need to be compliant by 1 July 2019). Six months is not enough time for issuers to make constitutional and other necessary changes. It can take considerable time, for instance, to recruit new directors (eg where directors have resigned because they don't meet the independence requirements or in light of other changes to the rules). Some issuers are very complex and operate across various jurisdictions and will take longer to embed the rules than others. Accordingly, we strongly recommend that the transition period be extended.

We also note that while alignment with ASX Listing Rules is desirable in some cases, this is not always possible or appropriate given New Zealand's legal and regulatory environment is significantly different to Australia's, as are our markets and economy.

Proposed extension of the continuous disclosure rules

Continuous disclosure is a disclosure framework which seeks to ensure the timely release of material information by issuers listed on the NZX. NZX's 2017 *Guidance Note on Continuous Disclosure* states that continuous disclosure:

- is essential to maintaining the integrity of the market
- ensures that the market is informed of relevant information in a timely manner
- promotes equality of access to information so that investors can make informed investment decisions
- plays a critical role in promoting fair, orderly and transparent markets.

New Zealand's mandatory continuous disclosure framework has been in place since 2002. It is modelled on ASX's continuous disclosure rules which were introduced in 1994.

Continuous disclosure is a fundamental obligation of issuers and boards. The current NZX Listing Rules provide that an issuer must disclose material information immediately to NZX when it becomes aware of the information. For the purposes of the rules, an issuer becomes *aware* of information if a director or executive officer has *come into possession* of the information in the course of the performance of their duties.

NZX is proposing to extend the definition of *aware* to include constructive knowledge of directors and senior executives (in addition to actual knowledge). That is, a director or senior executive will be deemed to be aware of information when they *ought reasonably to have come into possession of it* in the course of the performance of their duties. This would be a significant change if introduced.

We understand that the Financial Markets Authority supports the proposed change in the light of some continuous disclosure inquiries. The proposed change is aimed at ensuring issuers have sufficient governance frameworks in place for material information to be identified and disclosed to the market (eg adequate procedures, systems and controls to keep boards fully informed).

IoD commentary

The proposal to include constructive knowledge was not raised in the first round of consultation on the review of the Listing Rules. We note that NZX stakeholders who submitted in the first round generally considered that the continuous disclosure regime was working well. The NZX 2017 Thematic Review on Continuous Disclosure also found that "on the whole, NZXR is satisfied that issuers are well prepared to meet their continuous disclosure obligations. In particular, it appears that the issuers surveyed have good processes in place to escalate and manage information internally, and are undertaking appropriate monitoring of their external environments to ensure they can respond to information in a timely manner". While it is necessary to have appropriate frameworks in place, this will not guarantee boards are up to date with *all* matters and it will not eliminate risk.

The extent of the problem that needs to be remedied is not clear to us from information that is available to the public. Continuous disclosure has been in place for over 15 years and appears to have been working well on the whole. Recent issues should not drive extensive change for all issuers, in particular as negative impacts will outweigh expected benefits.

The NZX Corporate Governance Code (the Code) for issuers listed on the NZX Main Board was published in May 2017. It was the first substantial update to the Code since 2003 and it applies for reporting periods from 31 December 2017. The Code represents a significant step forward for corporate governance reporting requirements and brings New Zealand more in line with global trends. It comprises new material including on continuous disclosure and risk management. While the Code is not mandatory, issuers have been revisiting their processes and practices, and we expect it will help raise governance standards when it has had time to be fully embraced.

There is a growing global trend from stakeholders and investors for greater transparency about corporate activities. This is driving better reporting and stakeholder engagement. Recent, high profile, corporate governance failures and incidents in New Zealand and overseas have also highlighted key issues for boards. We are aware that directors and boards are discussing these issues in the context of their organisations.

Directors take their continuous disclosure obligations seriously. The Thematic Review showed that all but one issuer surveyed had continuous disclosure as a standing item on each board meeting agenda and some had standing disclosure committees. The consequences of breaching the continuous disclosure obligations can be severe under the NZ Markets Disciplinary Tribunal Rules and the Financial Markets Conduct Act 2013, and there is the potential for costly class actions by shareholders.

Hindsight bias

Compliance with the continuous disclosure rules can often be complex and challenging, especially for larger issuers. The proposed change is likely to further complicate the rules. The nature of the proposed test also means that there is a risk of *hindsight bias* in determining liability and we are very concerned about this. There are several dimensions to this including when a court or regulator considers *what* directors or officers ought reasonably to have known and disclosed, and *when*. It is important for issuers to balance timely disclosure of material information and prevent premature disclosure of incomplete or indefinite matters. This will often involve waiting for facts and evidence (and may include delays where information is coming from international operations). Premature disclosure may result in a false market and in some cases severely prejudice an issuer.

Deterring directors from serving on boards of listed issuers

Directors can be exposed to significant liability in their positions and this is increasing over time (across legislative and regulatory regimes). This is particularly high for directors of listed issuers, when compared with directors of other entities. We are concerned about the proposed change because this may deter directors from serving on boards of listed issuers. We are already aware of many directors who favour serving on boards of private companies because of the lower risk profile. It is critical that issuers on the NZX Main Board attract high performing, effective, and progressive directors to help raise the standard of governance in issuers, and trust and confidence in business in New Zealand.

Conformance and risk adverse boards

Boards have a fundamental role in setting, driving and overseeing strategy. They must be continually engaged in strategic matters to ensure the long-term sustainability of their organisations. This is particularly important in today's complex and challenging operating environment for many organisations, especially listed issuers. They also have a responsibility to set risk appetite and oversee and monitor risk management.

The impact of increased director liability adds to boards' growing regulatory burden and means they can spend disproportionally more time on conformance rather than performance. Our 2017 Director Sentiment Survey found that 72% of directors were spending more time on compliance related activities in the last 12 months. Boards receive much of their information on an organisation's position and progress from management. The proposed change may have adverse effects, for example it may:

- mean boards are given far more information from management to cover off issues, at the cost of boards scrutinising more important issues
- make directors and officers vulnerable to information obscured or concealed by other staff.

We are also very concerned that the proposed change will lead to boards becoming more risk adverse (ie not taking appropriate business risks). This could ultimately impact business success and shareholder value.

Cost burden on issuers and directors
The proposed change will result in an increase in costs for issuers and directors and officers. Issuers and directors are likely to be impacted by compliance costs as they seek to minimise risk (eg by seeking professional advice more frequently to ensure they are compliant with the rules). Issuers are also likely to spend considerably more time and resources on internal audit and other compliance functions.

Insurance premiums for directors and officers may also increase. D&O insurance costs in Australia have risen more than 200 percent in the last 12 to 18 months[1] and we are seeing costs increase in New Zealand.

There are other ways for the NZX and FMA to ensure that issuers have sufficient governance frameworks in place without deferring to greater regulation, and given the likely impact on directors and issuers, we strongly oppose the proposed extension of the continuous disclosure obligations and the policy intent.

Independent director requirements

NZX has reformulated its governance requirements for boards of equity issuers mandating:

- a minimum of three directors
- at least one director must be ordinarily resident in New Zealand or Australia
- at least two independent directors.

We agree that boards should have a minimum of three directors and at least two independent directors. NZX may need to allow some flexibility for smaller issuers to transition to two independent directors.

We reiterate our concern in our earlier submission around having only one director that is ordinarily resident in New Zealand or Australia. There are strong reasons why there should be a minimum of two and we request NZX reconsider this requirement.

Proposed changes to the director rotation requirements include the general rule that a director must not hold office (without re-election) past the third annual meeting following the director's appointment or three years, whichever is longer. This aligns with ASX and we support this change.

A new recommendation is proposed in the Code that a majority of the board should be independent directors. While there may be some issues with this in the New Zealand market, we support it given it applies on a *comply or explain* basis. This also aligns with the ASX.

Independent directors
The rules and definitions concerning independent directors have been overhauled and now cross-reference to the Code. We have set out below the proposed approach which a board must follow in identifying which directors it has determined to be independent directors.

For the purposes of the draft Listing Rules, *independent director* means a director who is not an employee of the issuer and who has no disqualifying relationship. *Disqualifying relationship* "means any direct or indirect interest, position, association or relationship that might influence, or could

[1] Australian Law Commission Reform, *Inquiry into Class Action Proceedings and Third-Party Litigation Funders* (June 2018).

reasonably be perceived to influence, in a material way, the director's capacity to bring an independent view to decisions in relation to the issuer and to act in the best interests of the issuer and its financial product holders generally (see the factors described in the NZX Corporate Governance Code that may impact director independence)".

The commentary on independence in the Code provides:
"'independent' status should not be determined without careful consideration of all relevant factors and interests. An issuer must consider the definition of an 'independent director' when making such determinations. An issuer may also wish to establish and publish clear criteria for determining independent directors in accordance with the overarching test within the Listing Rules.

Factors that may impact director independence are:

- recently being employed in an executive role by the issuer or any of its subsidiaries
- recently holding a senior role in a provider of material professional services to the issuer or any of its subsidiaries
- a recent or current material business relationship (eg as a supplier or customer) with the issuer or any of its subsidiaries
- a substantial product holder of the issuer, or an officer of, or person otherwise associated with, a substantial product holder of the issuer
- a recent or current contractual relationship with the issuer or any of its subsidiaries, other than as a director
- having close family ties with anyone in the categories listed above
- having been a director of the entity for a length of time that may compromise independence.

In each case, the materiality of the interest, position, association or relationship needs to be assessed to determine whether it might interfere, or might reasonably be seen to interfere, with the director's capacity to bring an independent judgment to bear on issues before the board and to act in the best interests of the issuer and its security holders generally."

IoD comment
We support this principles-based approach to determining independence, in line with our earlier submission. The proposed approach is clearer than the current rules and should be easier to apply in practice. Boards should be able to stand back in making an assessment and consider the factors that may taint independence but not be restricted by them. The factors are largely the same as those in the Financial Markets Authority's Corporate Governance Handbook 2018 and there is some alignment with ASX. This would introduce a new level of consistency around independence across corporate governance codes relevant to New Zealand entities.

Conclusion

It is encouraging to see the progress made on the review of the Listing Rules. We generally support the director related reforms discussed above, subject to our comments. However, we strongly oppose the proposed extension of the continuous disclosure rules to include constructive knowledge. We also strongly recommend increasing the transition period for issuers.

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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