CORPORATE GOVERNANCE POST-ENRON

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I. INTRODUCTION

'Corporate governance is a topic close to the heart of anyone engaged in securities market regulation — and by now, 'Enron' is obviously a byword for the worst kind of corporate governance.'[1]

After Enron's collapse in 2001, a United States Senate inquiry concluded that there had been 'systemic and catastrophic' failure by everyone who should have been protecting the shareholders of the former energy markets high flyer. It was the biggest corporate bankruptcy in American history. And of course, it pulled down the international audit firm of Arthur Andersen and tarnished reputations far and wide.

Since then, there have been other large international corporate failures — Worldcom and Italy's Parmalat to name just two — and an intense focus on corporate governance and on corporate governance regulation around the globe. The Enron collapse was a wake-up call for law makers and for securities regulators everywhere. Today we are, indeed, living in the post-Enron world.

I want to discuss what that means in the New Zealand context. And I want to give a perspective on the international efforts of regulators, including our Securities Commission (hereafter referred to as Commission), to raise standards and strengthen their ability to deal effectively with bad corporate governance as it impacts on securities markets.

II. REGULATORY FRAMEWORK

Like all OECD countries, New Zealand has put its own standards of corporate governance and relevant legal frameworks under close scrutiny over the past three years. We have seen that reflected in various substantial pieces of securities market legislation and the recently-passed Crown Entities Act 2004. For its part, the New Zealand Exchange adopted a Corporate Governance Best Practice Code in October 2003 — now forming an appendix to the NZX Listing Rules.[2]

As many will know, 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, to Crown entities. The framework is an important piece of work by the Commission — work that drew on a survey of post-Enron regulatory

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1 C Quinn 'Corporate Governance Post-Enron' New Zealand Securities Commission - Legal Teachers Forum (8 July 2005), available <www.sec-com.govt.nz>.

2 NZX, 'NZX Listing Rules' (29 October 2003) is available <www.nzx.com/>.

developments in Australia, the United States, and elsewhere, and on diligent consultation with our own business and governance community in New Zealand. This consultation made it very clear that the New Zealand business community favoured a principles-based rather than a more prescriptive rules-based approach. We listened and the Commission drafted the Principles accordingly.[3]

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 that ensure accountability between these, 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 interest 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 New Zealand 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.

III. The New Zealand Approach

The Commission published 'Corporate Governance in New Zealand: Principles and Guidelines'[4] 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. I think this is largely because we made a real effort to come down with a distinctly New Zealand approach to promoting high standards of governance. We started by acknowledging two fundamentally important considerations about New Zealand and our well established system of economic management. First, the standards of governance in any particular entity will depend inevitably 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 engagement 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 standards governance for all entities. The second consideration is that the

3 New Zealand Securities Commission, 'Corporate Governance in New Zealand: Principles and Guidelines' (18 February 2004) available <www.sec-com.govt.nz>.

4 Ibid.

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

In the banking sector, for instance, we see a strong emphasis on good corporate governance. To quote the 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.[5]

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.

IV. Regulatory Options

Worldwide, there is a spectrum of regulatory options for promoting high governance standards — principles-based approaches on one side and rules-based approaches on the other. The Sarbanes-Oxley Act of 2002 in the United States, a direct legislative response to Enron and Worldcom, has come to be seen as a benchmark in rules-based regulation — detailed in its prescription of what boards and executives must do for good governance and 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.[6]

So, where to locate New Zealand along the regulatory spectrum? The Commission's consultation during 2003, as I have stated, 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 I mentioned before. We think New Zealand 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 this country 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 drive performance and, at the same time, help them to ensure that their organisation is

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5 A Bollard, 'Corporate Governance in the Financial Sector: An Address to The Annual Meeting of the Institute of Directors in New Zealand' (7 April 2003) available <www.rbnz.govt.nz> (last visited on 8 December 2005).

6 ASX Corporate Governance Council, 'Principles of Good Corporate Governance and Best Practice Recommendations' (March 2003) <www.shareholder.com/>.

complying with its legal obligations. The Principles and Guidelines are obviously also compatible with those legal obligations that bear directly on governance — elements of the Companies Act 1993, Stock Exchange Listing Rules, the Securities Act 1978 and Amendments, the Crown Entities Act 2004 and so on.

Reporting and disclosure are obviously critical to ensure a principles-based approach works. 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 all see a rising standard of governance when we see more comprehensive and timely reporting and disclosure.

Among New Zealand listed companies, we do see a significant step up in this regard over the past two years. The Commission's own monitoring of 2004 company annual reports show that large corporates have lifted their game, and others are definitely starting to wake up to the new expectations on them. The NZX Listing Rule changes introduced in October 2003 have been a significant contributor. 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 per cent of company reports examined put a focus on these matters. Half of 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 on 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 have also have remuneration and nomination committees. The NZX Code states that having all three committees is part of 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 — and of course this is a central concern in our Principles and Guidelines. Integrity in reporting is a matter of both board process and the inclusion of meaningful information in reporting to shareholders and others.

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

Our Guidelines promote the idea of formal public certification on company accounts by the Chief Executive and Chief Financial Officer. So far, we have found only 11 out of 116 companies that take this step — this 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 per cent of the companies 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 per cent 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. One is the importance, or lack of it, attached to fostering constructive relationships with shareholders. The other is 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 NZ Ltd, Air New Zealand Ltd and The Warehouse Ltd are among the best. Our monitoring will continue and we are looking for progress across the board.

V. Commission Enforcement

Let me turn now to other areas of focus for the Commission that also have critical bearings on corporate governance, especially among issuers of securities in the New Zealand market. First, securities law enforcement. It is a plain fact that many breaches of the Securities Act 1978 and regulations relate back to lapses in corporate governance within the issuer concerned. Often, it becomes very clear to the Commission that if the issuer's board had the right focus in its decision making and was really ensuring that the entity followed sound processes, then non-compliance with securities law would not have occurred.

The Commission finds lapses often 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 example is Prudential Mortgage Ltd, a contributory mortgage broker in Christchurch which came to our attention for newspaper advertising that was plainly deficient under Securities Regulations 1983. The advertisements 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 the advertised interest rate to 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 making it in breach of the Securities Act (Contributory Mortgage) Regulations 1988. We secured an Enforceable Undertaking by the directors of Prudential Mortgage in the middle of last year. They 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, this plan 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, such circumstances are not uncommon in our experience. 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 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, we will use all our powers to call individuals to account before the civil or criminal justice systems.

VI. IOSCO Initiatives

This brings me to another area of Commission focus — our keen participation in building a network for international information exchange and enforcement cooperation among securities regulators. Currently, I am also Chair of the Executive Committee of IOSCO — the International Organisation of Securities Commissions, and New Zealand has taken a lead role in developing this initiative over the past year. IOSCO and its expanding network for cooperation makes an important contribution to promoting corporate governance standards in local and global securities markets.

For those not familiar with IOSCO, some background is offered[7]. Its members are securities regulators and other relevant national bodies from more than 100 countries, and its organisational coverage is more than 90 per cent of the world's securities markets. It has grown substantially in membership and status over the past 30 years, and is now being recognised as the leading international standard-setter for securities regulation.

IOSCO promotes regulation that: protects investors against the misuse of assets, insider trading and other forms of fraud; that ensures fairness, efficiency and transparency in securities markets; and reduces systemic risk. Corporate governance is a central theme across much of IOSCO's broad agenda — and over the past three years, Enron and other high profile corporate collapses have added huge impetus to this forum. In particular, national regulators like the Commission are looking to IOSCO for stronger, more effective cross-border detection and enforcement against corporate wrong-doing.

In 2002, the organisation adopted a Multilateral Memorandum Concerning Consultation and Cooperation and the Exchange of Information — in IOSCO, they simply refer to the MMOU.[8] New Zealand, and Australia, were among the early signatories, who now number 27 regulators worldwide. They agree to exchange information and otherwise assist each other in monitoring market activity, and in combating fraud and other wrongdoing. All signatories to the MMOU have the legal powers and organisational capabilities necessary for efficient and timely cooperation. It is a major step forward in regulation of the fast growing global capital market and of the threats posed by poor corporate governance among companies operating in that market. Our Commission has used the MMOU in its enforcement work and its usefulness has certainly been proved to us.

So important is the MMOU, and its utility to IOSCO members like New Zealand, that the organisation has this year committed itself to requiring all members to become signatories, or be committed to becoming signatories, by January 2010. This was a high significant outcome of the IOSCO national conference in Sri Lanka in April. 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.

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7 For further information visit <www.iosco.org/>.

8 OICU – IOSCO, 'Multilateral Memorandum Concerning Consultation and Cooperation and the Exchange of Information' (May 2002) <www.iosco.org/>.

An IOSCO Task Force reviewed securities regulation worldwide in the wake of Parmalat and came back with a report.[9] It concluded that core issues of corporate governance were evident in all the major corporate collapses: issues of board conduct, of auditor independence and effectiveness, of disclosure by securities issuers and market transparency, and of behaviour by market intermediaries and analysts. This important report has served to further build consensus on the need for consistent international standards and effective enforcement mechanisms.

VII. Conclusion

Looking back over the past three years, the world — and New Zealand — has come a long way in their awareness of corporate governance issues and of how to promote higher standards. There is a high level of consistency between developments here and internationally, although the Commission and others made a substantial effort to establish a particular New Zealand model for corporate governance regulation. We think good governance should be predominantly the concern of boards of directors and governors, and of their owners and stakeholders — not law makers and securities regulators. That said, the 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.

9 OICU-IOSCO, 'Strengthening Capital Markets Against Financial Fraud' (February 2005). <www.cmvm.pt/> (last visited on 8 December 2005).