

Securities Law Review
Investment Law Team
Ministry of Economic Development
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DRAFT FINANCIAL MARKETS CONDUCT BILL

SUBMISSION OF THE INSTITUTE OF DIRECTORS

About the Institute of Directors

The Institute of Directors in New Zealand (IoD) is a non-partisan voluntary membership organisation committed to raising governance standards in New Zealand. The IoD aims to help business and businesses understand governance and how skilled and experienced directors with vision and independence of thought can work with management to achieve better business performance.

The IoD represents a diverse membership of over 5,000 members drawn from NZX listed corporations, unlisted companies, private, closely held companies, small to medium enterprises, public sector organisations, not-for-profits and charities.

Introduction

The IoD supports any legislation that is likely to result in a more efficient market economy and functional and performing financial markets that investors can have confidence in. We therefore support the central purposes of the draft Financial Markets Conduct Bill ("the Bill") which are to:

- promote the confident and informed participation of businesses, investors, and consumers in the financial markets, and;
- promote and facilitate the development of fair, efficient, and transparent financial markets.

We are also vitally interested in ensuring that any legislation that affects Directors and Directors' responsibilities:

- promotes improved standards of governance and better decision making;
- is not designed to prevent business failure *per se*, but permit an appropriate degree of risk taking;
- does not invoke criminal sanctions for the legitimate exercise of business discretion, but only where *mens rea* (criminal intent) is present;
- does not place such a burden on directors that the risk/reward equation results in a significant reduction in the director talent pool.

On our understanding of the published material to date, the MED and government also largely share these objectives.

'Re-regulation' of the financial supervision regime requires a balanced approach

The process of 're-regulation' and introduction of re-designed prudential standards in the economy is a natural outcome of severe economic risk events, such as the global financial crisis. However, the design and application of new laws must be balanced and focused on the long term. The IoD notes concerns from many of our stakeholders of a direct correlation between enhanced sanctions for directors and the risk that business people may be deterred from becoming directors or taking reasonable business risks.

The IoD supports the proposition that regulation and enforcement regimes should not only encourage appropriate behaviour but also avail people of remedies in the event of contravention. This must be balanced with the desire to attract and retain talented directors who are free to take reasonable business risks. Acknowledgement of, and full assumption of, director duties are a critical part of achieving this balance. The concern that heavy-handed regulation will lead to excessive risk aversion is legitimate and real. While sometimes dismissed as alarmist, the risk that New Zealand's relatively small cohort of experienced directors is diminished by regulatory intervention is a legitimate concern.

The report of the United Kingdom's Hampel Committee on Corporate Governance¹ (a successor to the Cadbury report) was critical that previous investigations into governance matters concentrated too much on compliance as the solution without looking at good corporate governance itself:

*"Both the Cadbury and Greenbury reports were responses to things which were perceived to have gone wrong ... Understandably, both concentrated largely on the prevention of abuse. We are equally concerned with the positive contribution which good corporate governance can make."*²

The IoD considers that rules and regulation can only be a partial solution to improving governance. The reality is that inputs such as New Zealand's level of financial literacy and the inherent risks of business cannot be ameliorated by increasing regulation of professions to the point where the risk/reward balance makes participation unattractive. The importance of regulation and well managed oversight of commerce is indisputable but compliance must be a facet of a wider corporate culture that values ethical behaviour. A commitment to continuous improvement and best practice is as equally important as the well justified attempts to prevent abuse.

The IoD is committed to working with the MED, FMA and other government agencies in promoting this second leg of the improvement equation; indeed it is the primary reason for our existence.

IoD Comments on the Bill

The IoD makes the following selective comments on the Bill. We note that many of the matters covered by the Bill are outside the IoD's expertise and ambit, and we leave commentary on those matters to others.

For clarity, the absence of adverse comment by the IoD should not be taken as support for any particular provision, and we reserve our right to comment on any matter as the legislative process unfolds.

Criminality

The IoD stated it was cautiously supportive of the appropriate extension of enforcement powers into criminal matters in its 2010 submission to the MED.

There have been well-publicised instances of directors believed to have behaved inappropriately and illegally, e.g. some directors of failed finance companies. However, this must be balanced against the fact that many companies (and therefore by implication directors) do add shareholder value. In the experience of the IoD, there are directors whose performance standards need to be raised in order to maximise their value proposition but in general, New Zealand business is well served by capable and committed directors.

The IoD supports the public enforcement of director duties, however we are considerably more cautious about the imposition of criminal sanctions on directors where there is a breach of those duties. The stigma associated with criminal proceedings in New Zealand is such that any director facing criminal charges is likely to suffer material reputational damage, even when there is no intention to mislead, or acquittal results. Where criminal offences are considered appropriate there should be an element of criminal dishonesty required in all cases.

We note that the proposed element of recklessness (for tier 3 and 4 offences) is subjective and is always assessed with the benefit of hindsight without the benefit of the context in which the relevant

¹ Committee on Corporate Governance, Final Report' (London 1998), para 1.7

² ibid

actions occurred. To create a criminal offence from activities that in the minds of directors were legitimate business risks would be, in the view of the IoD, a step too far. We therefore do not support criminalising recklessness on its own – there must always be an element of dishonesty, deception or fraud. .

Proportionality and Predictability

Two key concepts for the IoD in respect of the new criminal offences lie in the principles of *proportionality* and *predictability*.

With respect to *proportionality*, the IoD considers there is no reason the FMA and the courts will not continue to treat matters judiciously and with the degree of seriousness commensurate with the wrongdoing in each case. The key is to ensure that judgement is in proportion to the degree of aberration in the relevant actions or omissions.

Enforcement must also be *predictable*. For the legislation to be effective and successful it must have a high degree of *ex ante* predictability that gives certainty to those operating in the marketplace. Unpredictable or inconsistent *ex post* application of the legislation will have a significant impact on directors and by extension the successful operation of New Zealand business.

We therefore strongly recommend that the government provide clear examples or guidelines of the type of conduct that would fall into each tier of sanction, perhaps with reference to past events or conduct which these new sanctions are intended to deter. It would also aid understanding for the government to clarify whether these new sanctions are intended to result in different outcomes or penalties in relation to recent court cases (such as *Feltex*³ or *Nathans*⁴) and to conduct which has not been prosecuted under existing legislation but would likely be prosecuted under the provisions of the proposed Bill.

Sanctions

The IoD endorses a simple and clear framework for accountability, and to this end we see the four-tiered public enforcement framework as an improvement over previously published multi-tiered proposals. In particular, the use of so-called “speeding tickets” for tier 1 administrative offences helps cost-effectively encourage the good conduct of market processes.

We are pleased to see that sentences for tiers 2-4, where a custodial sentence is available, are based on elements of criminal intent:

- wilful disobedience of a regulatory order intended to promote the good conduct of the market (in the case of many tier 2 offences);
- knowingly making defective disclosures (in the case of tier 3 and tier 4 offences).

As discussed above, the IoD does not believe that recklessness on its own is a sufficient basis for a criminal sanction, due to the inherent subjectivity of the term and the dangers involved in a potential “rewriting of history” with a retrospective assessment of risk. We therefore do not support 478.a.iv and 479.a.iii as currently formulated. Instead, we propose that factors such as recklessness and negligence be a factor that the Court takes into account in determining the severity of punishment once criminal intent has been established.

Civil Remedies and Prohibitions on Insurance

The IoD is still considering the application of the civil remedies regime and its interaction with the prohibitions on indemnity and insurance in both the Bill and the Companies Act 1993. We expect to make further submissions on these areas as the legislative process unfolds.

We note that section 490 of the Bill appears to encourage settlement, by allowing insurances and indemnities to cover costs where proceedings are discontinued. It is not clear to us whether this was the policy intent.

³ *Feltex: Ministry of Economic Development v Feeney and Ors* (District Court, Auckland CRI-2008-044-29199, 2 August 2010)

⁴ *R v Moses* HC AK CRI 2009-004-1388 [8 July 2011]

Regardless, the enforcement regime unquestionably places directors at greater risk, which we believe will likely result in upwards pressure on insurance premiums, on the back of historically high increases. Also, as discussed elsewhere in our submission, this increased risk may deter competent directors from continuing in their roles.

Changes to Directors responsibilities

The IoD notes that the government intends to change Directors Duties by inserting new s138A into the Companies Act 1993, either through the Bill or through another enactment.

While the inclusions appear to be broadly consistent with the intent of the wider reforms, we note that the terms “seriously detrimental to a company’s interests” (138A.1) and “serious loss to the company’s creditors” (138A.2) are new formulations and are inherently subjective, creating uncertainty as to their application.

As discussed above there is a need for the new enforcement regime to have a high degree of *ex ante* predictability. In our view there is a need to be very clear about the intended impact of the proposed changes and how they are intended to influence directors’ conduct. Again, we urge the government to provide clear examples or guidelines.

Director and Management bans

The IoD acknowledges that the provisions in the Bill relating to Management and Director bans are generally consistent with proposals in the June 2010 Discussion document, and are in part a response to public concerns over conduct that led to collapses in the finance sector.

We note that a lifetime ban is a very harsh sanction, which should only be applied in the most extreme cases. To our knowledge this sanction has never been imposed in Australia despite being available during some of Australia’s most high profile corporate collapses. As with our other comments on predictability, we encourage the government to clarify the circumstances under which they intend such a sanction to be imposed.

The IoD is still considering whether it supports these changed thresholds, and we expect to make further submissions as the legislative provisions unfold.

Legislative Review

Given that the sanctions introduced by the Bill are new, and given the current level of uncertainty as to how they will be applied in practice the IoD recommends that the government commits to a formal review within a defined time frame, say 5 years. Such a review should encompass not just the matters covered by the Bill, but all of the recent legislation directed at updating and improving the conduct of financial markets. Ideally, the commitment to such a review would be included in legislation.

I would welcome an early opportunity to discuss the issues we have raised in this submission.

Yours sincerely,



Ralph Chivers
Chief Executive Officer
Institute of Directors in New Zealand (Inc)