LAWYERS FOR CLIMATE ACTION NZ INC.

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NZX Policy
NZX Limited

By email: policy@nzx.com

Submission on NZX Corporate Governance Code Review – Initial Discussion Document, November 2021

Introduction

1. Lawyers for Climate Action NZ Incorporated (**LCANZI**) is a non-profit organisation comprising over 350 lawyers and other non-lawyer associate members. We advocate for legislation and policies to ensure New Zealand meets or exceeds its commitments under the Paris Agreement and achieves net zero emissions as soon as possible and no later than 2050. More information about us can be found on our website: https://www.lawyersforclimateaction.nz/.

2. We welcome the opportunity to provide submissions in response to the NZX Corporate Governance Code Review. We see this review as an opportunity for NZX to update and strengthen its climate change related guidance, and to assist NZX issuers to become leaders of New Zealand's decarbonisation efforts.

Executive Summary

3. **Context and Focus on Climate Change:** Climate change is the most pressing issue of our time. Without aggressive action, the impacts (including on New Zealand business and society) will be disastrous. However, New Zealand is not on track to meet the targets in the Paris Agreement and its other commitments. Public issuers will be particularly vulnerable to changing shareholder and customer attitudes and, long term, entities with clear strategies for carbon reduction will fare best in the climate crisis. Accordingly, it is vital that the NZX Corporate Governance Code (**Code**) addresses the issues below.

4. **ESG Reporting:** LCANZI recommends that the Code should encourage all NZX issuers to provide regular climate related disclosure, whether or not they are climate reporting entities under Part7A of the Financial Markets Conduct Act 2013 (**NZ CRD regime**) introduced by the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021. We also encourage NZX to consider incorporating the concept of "double materiality", which requires an assessment of both the impact of ESG factors on an entity and the entity's impact on people and the environment, into the Code.

5. **Remuneration and incentives:** It is clear that remuneration practices strongly influence decision making by executives, and therefore corporate behaviours. LCANZI supports NZX

expanding its guidance on executive remuneration to encourage linking remuneration to Environmental, Social and Governance (**ESG**) objectives and practices that support long-term and sustainable value creation. For some issuers, climate change will become an increasingly integral element of strategy setting and, in these cases, remuneration policies should reflect this.

6. **Climate Change Guidance Note:** We welcome NZX's openness to run a parallel review of the ESG Guidance Note. LCANZI agrees that, at a minimum, the ESG Guidance Note should be updated to reflect legislative requirements for reporting LCANZI also recommends the introduction of a Climate Change Guidance Note for NZX issuers, to sit alongside the existing ESG Guidance Note.

7. **NZX Corporate Governance Institute:** LCANZI supports the establishment of the NZX Corporate Governance Institute as a means for NZX guidance and standards to quickly respond and adapt to international best practice in corporate governance. This is of particular importance in relation to climate change and other ESG matters where regulation and governance practices are constantly developing. LCANZI supports both the inclusion of a diverse range of stakeholders representing key governance issues (such as climate change), and consultation with and reference to external experts where appropriate to support guidance and standards.

Context and Focus on Climate Change

8. Climate change is the most pressing issue of our time, with climate-related catastrophes such as bush fires, drought, continuing deforestation, rising sea levels and flooding frequently making the news and affecting business. In addition to these physical effects, the transitional effects (eg as a result of governmental action, changing customer and investor preferences) and shifting business models are having effect even more rapidly.

9. The Intergovernmental Panel on Climate Change (**IPCC**)'s AR6 report of August 2021 shows that these impacts are accelerating and that immediate and large-scale reductions in global emissions are required to limit global warming to 1.5°C or 2°C, the target set by the 2015 Paris Agreement. This follows the IPCC's finding in 2018 that limiting global warming to 1.5°C requires around a 50% reduction in net emissions from 2010 levels by 2030.[1]

10. The IPCC's report's moderate emissions scenario, which features little change from today's global-development patterns, projects that average global temperatures will rise by 2.1–3.5 ° That would be disastrous in terms of its impacts (including on New Zealand business and society). Even in a scenario in which governments aggressively cut their greenhouse-gas emissions, the IPCC report projects that global temperatures are likely to surpass the 1.5 °C threshold in the coming years, before dropping back below it towards

[1] See the IPCC *Special Report on Global Warming of 1.5ºC*, 2018. https://www.ipcc.ch/2018/10/08/summary-for-policymakers-of-ipcc-special-report-on-global-warming-of-1-5c-approved-by-governments/

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the end of the century. It is still possible to limit global warming to 1.5°C. But unless there are immediate, rapid and large-scale reductions of all greenhouse gases, limiting global warming to 1.5 °C will be beyond reach.

11. New Zealand is not on track to meet the targets in the Paris Agreement. While 34 out of the 45 Annex 1 countries (i.e. developed countries) under the UN Framework Convention on Climate Change have reduced their emissions between 1990 and 2019, New Zealand's annual net CO_2 emissions increased by 34% during this period, the fourth highest increase of all the Annex 1 countries, behind only Canada, Cyprus and Turkey.[2] New Zealand's gross emissions rose by 25% in the same period and New Zealand now has one of the highest per capita emissions levels in the world.[3] There is a real risk that New Zealand's poor performance on climate change will start to affect its international standing, access to markets, and the desirability of its products and services.

12. New Zealand has recently increased its "nationally determined contribution" under the Paris Agreement to a headline target of a 50% reduction of net emissions below our gross 2005 level by 2030.[4] A portion of this is expected to be met by purchasing offshore mitigation, but significant domestic policy interventions will also be required to achieve the necessary reductions. Therefore, further climate change-related regulation can be expected in the near future, which will undoubtedly have a range of effects on listed issuers, including in relation to energy use, carbon costs, access to credit, and governance. It is essential for our economy and our financial markets that issuers understand the risks and opportunities that they face and that they are not only in a position to respond but can lead the way in decarbonising our economy.

13. Societal expectations are also changing, and the status quo is no longer accepted. Sustainability measures are beginning to be seen as part of a company's licence to operate, and measures such as green or sustainable finance are becoming more commonplace. Internationally, governance practices are rapidly adjusting to this shifting context even in the absence of regulatory change. Stakeholders are increasingly holding boards accountable for companies' action or inaction to address impending climate-related risks. Public issuers will be particularly vulnerable to changing shareholder attitudes and, long term, entities with clear strategies for carbon reduction will fare best in the climate crisis.

[2] Data compiled by the Secretariat of the United Nations Framework Convention on Climate Change, available at https://di.unfccc.int/time_series

[3] Ibid.

[4] Submission under the Paris Agreement of New Zealand's first Nationally Determined Contribution, updated 4 November 2021.
https://www4.unfccc.int/sites/ndcstaging/PublishedDocuments/New%20Zealand%20First/New%20Zealand%20NDC%20November%202021.pdf

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ESG Reporting

14. The Code recommends consideration of material ESG factors and practices and inclusion of this in issuers' non-financial reporting disclosures on at least an annual basis. LCANZI strongly supports an update to the Code to include a specific recommendation for issuers to provide climate change reporting on a regular basis, separate from general performance reporting. Climate change reporting will of course become mandatory for large issuers under the NZ CRD regime. However, the stakeholders of smaller NZX issuers have just as pressing a need to know that those companies have taken steps to understand the impending impact of climate change on their business, and how the companies are preparing to manage those impacts. In our view, the Code should recommend that all NZX issuers provide such reporting as a matter of good governance and transparency.

15. From a risk management perspective, climate change creates material risks for all business activities, be it in relation to the availability of credit, market or operational factors or reputational risk, in addition to the (often financial) consequences of non-compliance with climate change laws and regulations. It is important that corporate governance practice includes a focus on identifying and mitigating those risks (and reporting on them appropriately).

16. ESG information, just like financial reporting, needs to be trusted. Other jurisdictions are increasingly adopting policies aimed at expanding external assurance requirements. For example, the European Commission's Corporate Sustainability Reporting Directive (**CSRD**) (adopted on 21 April 2021) will require large and listed EU companies to report in line with mandatory EU sustainability reporting standards and provide external assurance of sustainability information. To improve the quality of ESG disclosures and prevent misreporting of ESG factors, LCANZI recommends that the Code should explicitly outline the benefits of assurance on sustainability information and encourage issuers to seek assurance over their material ESG metrics.

17. Furthermore, to align with the requirements of the XRB's climate-related disclosures standard which will be issued under the NZ CRD regime, the Code should also explicitly outline the requirement under the New Zealand climate reporting regime introduced by the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Act 2021for listed issuers with a market capitalisation of more than $60 million to ensure that aspects of their climate statements that disclose Greenhouse Gas Emissions are the subject of an assurance engagement.

18. In addition, LCANZI recommends that the Code should strongly encourage entities that are not captured by the mandatory disclosure requirements of the NZ CRD regime and the climate standards to be published by the XRB, to still disclose in line with the disclosure framework if they can. This would help to improve the consistency of climate-related disclosures from a wide range of entities across all sectors of the economy. It is important for stakeholders to be able to assess the climate risk of the counterparties they

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deal with, irrespective of the market capitalisation of the entity, and also to help those businesses themselves understand the impacts they are going to be subject to, as a result of climate change.

19. Importantly, the definition of a Climate Reporting Entity (**CRE**) under the NZ CRD regime is expected to be expanded in future so encouragement from the NZX for listed entities not currently covered by the CRE definition will support the embedding of climate-related issues into an entity's strategy and support better decision making. As noted by the XRB in the Governance and Risk Management Consultation Document, this will result in more informed capital allocation decisions, both within an entity and by investors into an entity.

20. LCANZI strongly supports ESG reporting carried out in line with leading international standards. LCANZI notes that the commentary to Code recommendation 4.3 states that "if an issuer chooses a formal framework to report on ESG factors, that it should report against a recognised international reporting initiative such as the GRI guidelines or Integrated Reporting framework".

21. LCANZI recommends that the Code take note of the International Financial Reporting Standards Foundation announcement at COP26, of the formation of the International Sustainability Standards Board (**ISSB**) to develop a comprehensive global baseline of high-quality sustainability disclosure standards to meet investors' information needs and the publication of prototype disclosure requirements. In future, the Code should align with the ISSB prototype disclosure requirements to help improve consistency with international best practice and drive high-quality ESG disclosures.

22. LCANZI notes that the Code recommendation 6.1 "suggests that issuers should report on the material risks facing the business and how they are being managed". This is a traditional financial materiality view. International reporting obligations are increasingly shifting towards "double materiality" reporting, which requires an assessment of both the impact of ESG factors on an entity and the entity's impact on people and the environment. For example, the European Commission's CSRD strengthens the existing rules introduced by the Non-Financial Reporting Directive (**NFRD**), and lifts sustainability reporting to be on par with financial reporting.

23. The EU's adoption of the CSRD clarifies that "double materiality" reporting is required and:

    (a) extends the scope to all large companies and all companies listed on regulated markets (except listed micro-enterprises);

    (b) requires the audit (assurance) of reported information;

    (c) introduces more detailed reporting requirements, and a requirement to report according to mandatory EU sustainability reporting standards; and

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(d) requires companies to digitally 'tag' the reported information, so it is machine readable and feeds into the European single access point envisaged in the capital markets union action plan.

24. As stated in our submissions to the Economic Development, Science and Innovation Committee on the Financial Sector (Climate-related Disclosures and Other Matters) Amendment Bill (which proposed the NZ CRD regime), LCANZI supports the double materiality approach to reporting. LCANZI recommends that the NZX consider incorporating the concept of "double materiality" into the Code.

25. With respect to the location of ESG and climate change reporting, LCANZI strongly supports a level of integration between the annual report and issuer websites. LCANZI endorses the introduction of a climate change policy as a key governance document of issuers, to be published on the issuer's website alongside ethics, diversity and other continuous disclosure policies. Detailed reporting, including measurable and a review of the issuer's performance against its climate change policy, should be included in an annual report.

Remuneration and incentives

26. The Code currently focuses on director and executive remuneration being transparent, fair and reasonable. We agree that remuneration practices strongly influence decision making by executives, and therefore corporate behaviours. It has become apparent in recent times (for example in the Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in Australia) that remuneration is a key incentive that has driven unethical behaviours and a focus on short-term profits at the expense of society, stakeholders, and the long-term interests of the company. LCANZI supports increased guidance on the substance of remuneration policy. This is consistent with NZX's aim to promote good governance practices that support the generation of long-term benefits for issuers' shareholders and other stakeholders, and contribute to a sustainable and productive economy for New Zealand.[5]

27. LCANZI recommends that NZX guidance provides that issuer's remunerations frameworks should promote long-term and *sustainable* value creation for shareholders. When devising remuneration and incentive schemes, boards should seek to ensure that the pursuit of growth and success is not accompanied by rewarding conduct contrary to the values or risk appetite of the issuer or harmful to stakeholder interests.

28. LCANZI also supports a greater focus in the guidance on non-financial performance measures. The right mix of financial and non-financial performance measures is likely to increase the likelihood that listed companies will deliver on long-term and sustainable value in line with company strategies. While non-financial performance can be difficult to measure compared to quantifiable financial results, experience and expertise in non-

[5] NZX Corporate Governance Code Review – Initial discussion document, p 6.

financial performance measures are increasing and should be encouraged given the consequences of relying heavily on financial performance measures.

29. Guidance on sustainable remunerations policies can be developed further in the ESG guidance note and/or the suggested climate change guidance note discussed further below. For certain issuers, ESG and climate change related matters will become integral to their strategies and governance frameworks. Where this is the case, issuers should be encouraged to reflect this in remuneration policies. More generally this may become an area of interest for all listed companies, with several international reports[6] having recognised disclosure and publication of a more sustainable remuneration policy as contributing towards improved company reputation and brand value.

Climate Change Guidance Note

30. We welcome NZX's openness to run a parallel review of the ESG Guidance Note. Given that the Note was last updated in 2017, and the rapidly changing political and regulatory context, LCANZI believes it is appropriate to undertake a 'deep-dive' of ESG and climate change guidance.

31. LCANZI agrees that, at a minimum, the ESG Guidance Note should be updated to reflect legislative requirements for reporting under the NZ CRD regime for CRE.

32. Furthermore, LCANZI strongly supports the introduction of a specific Climate Change Guidance Note by NZX, to sit alongside the existing ESG Guidance Note. This is consistent with the approach taken by NZX's international counterparts. With the increasing attention climate change is attracting in the corporate governance space, we believe that focus and guidance on this issue would be welcomed by issuers.

33. A global survey of board directors carried out by INSEAD in late 2021[7] recorded responses to a number of questions in relation to the board knowledge of climate change and the risks it poses to their companies. 75% of respondents said that climate change is "very or entirely important to the strategic success of their companies". Despite this, 85% said that their board needs to increase its climate knowledge and – importantly – 74% said that climate change is not at all or only slightly integrated into executive performance metrics. While this study was carried out globally, we can reasonably assume that the statistics for NZX issuers are similar if not more concerning.

34. Guidance and standards on climate change-related governance will help to set expectations for directors of listed companies and clarify best practice which will encourage implementation of climate change governance frameworks. As noted above,

[6] Task Force on Climate-Related Financial Disclosures *2019 Status Report*, June 2019; Edmans, Alex, Gosling, Tom and Jenter, Dirk, *CEO Compensation: Evidence From the Field,* June 30, 2021, European Corporate Governance Institute – Finance Working Paper No. 771/2021.

[7] INSEAD Corporate Governance Centre and Heidrick & Struggles *Changing the Climate in the Boardroom*, December 2021.

matters such as remunerations policies, climate-related reporting requirements and assurance practices can be included in a separate guidance note which is updated regularly as best practice and regulation develops.

NZX Corporate Governance Institute

35. LCANZI supports the introduction of the NZX Corporate Governance Institute (**Institute**). Internationally, corporate governance practices and regulation, especially in relation to climate and ESG practices, are developing quickly. The establishment of the Institute would enable NZX and New Zealand companies to be guided by and to respond efficiently to developments in best practice, with a view to becoming a leader in this area.

36. LCANZI agrees that the Institute should act as an advisory body to NZX and, similarly to the Australian Corporate Governance Council and the UK Financial Reporting Council should be responsible for developing principles and guidance for NZX listed companies on governance matters. We note that guidance and policy development of climate change and ESG governance are high on the agenda of international equivalents and should be a specific focus of the Institute.

37. The stakeholder groups comprising the Institute should be diverse with a range of specialisations and should not be limited to institutional investor groups. Stakeholder expertise should reflect the matters on which the Institute is advising, with reference to and consultation with external experts where appropriate. With the increasing urgency for New Zealand companies to focus on climate and ESG matters, it is essential that input should be sought from stakeholders with experience in climate change and ESG governance. Where such experience is difficult to obtain, the Institute should seek to work with outside experts to help develop this expertise.

38. The INSEAD survey (referred to above) found that 85% of respondents said that their board needs to increase its climate knowledge, and nearly half said that their board has insufficient or no knowledge of climate change's implications for financial performance. It is recognised that climate change experience is lacking at board level, and an Institute provides the opportunity for to set clear standards and guidance for directors developed by experienced stakeholders and industry experts.

Final comments

39. We thank NZX for the opportunity to provide submissions in response to the NZX Corporate Governance Code Review. If NZX would like to further discuss any aspect of our submissions, please contact:

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