ICSA

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THE IMPORTANCE OF "COMPLY OR EXPLAIN" IN THE EU BUSINESS ENVIRONMENT

Feedback to the EU Commission from the ICSA Corporate Governance Summit held in Brussels in October 2008

The Institute of Chartered Secretaries and Administrators (ICSA) is the qualifying body for company secretaries and a leading global authority on corporate governance. A well remunerated board-level role, company secretaries oversee the smooth running of businesses: directing shareholder and pension schemes, advising senior colleagues on areas such as governance, corporate law and risk and influencing the direction of corporate strategy. Chartered Secretaries work across all industries, operate in public and private sectors and run their own companies providing company secretarial services. The ICSA has 36,000 members worldwide and is represented in over 70 countries

This report provides a detailed overview of the issues in the debate over the value of 'comply or explain' as a principle of corporate governance in the European business environment. The views and conclusions that it contains derive from a corporate governance summit which ICSA held in Brussels in early October 2008. The object of the summit was to create feedback which could act as input to the European Commission's study on 'comply and explain'. ICSA welcomes the chance to contribute to the debate at an EU level on 'comply and explain' and how it is currently working in the EU. ICSA also welcomed the chance to have prior discussions on the initiative with the European Commission and appreciated their assistance in identifying appropriate questions for consideration at the summit. It is in the same spirit of co-operation that ICSA now offers the thoughts and conclusions detailed in this report as a contribution to the debate.

Delegates to the summit were placed in four break-out groups to discuss the series of questions which ICSA had previously agreed with the European Commission as part of their programme to explore a range of methodologies for embedding the corporate governance principle of 'comply or explain' across the EU. The four broad topics for discussion were directors' remuneration, the quality of 'comply or explain' explanations, the advantages of 'comply or explain' over legislation, and the extent to which the 'comply or explain' framework enhances company value. The groups were made up of delegates from across the EU and were from a wide range of business contexts. This report details the questions debated and the views and conclusions which resulted.

QUESTION ONE:
DIRECTORS' REMUNERATION

The first of the break-out groups was asked to deal with the 'comply or explain' issues involved in the area of directors' remuneration. They were asked to look at how shareholder engagement had worked when it came to directors' remuneration and discuss specific examples. They also considered whether issues of directors' remuneration should be dealt with by legislation rather than by 'comply or explain'. This was felt to be topical with legislation on contractual terms for directors pending in France, Belgium and Holland. The group considered whether the legislative route was the correct solution to the problem and whether other member states should think about following suit. Finally they were asked to discuss whether legislation in other related areas should be considered.

DISCUSSION AND CONCLUSIONS

The group discussed the issues and effects which had grown in importance in the UK as a result of the 'comply and explain' regime. It was felt that the experience of shareholder engagement on remuneration varied. Some shareholders still did not communicate or engage with companies at all. Others provided inflexible directions of what they wanted but left no room for alternatives. The third, and most positive category, provided proper guidance on what information they did and didn't require and what they would like more of. It was agreed that the latter category was the one most likely to open up a proper and useful dialogue.

It was agreed that one of the most important factors was the point in the reporting cycle at which companies engaged with shareholders. It was felt that, for maximum value, the first proper contact should be made at least three months before the annual general meeting. Engagement was going to be less effective if it was initiated before the guidance given by the voting issue services of institutional investors had been shaped or decided. It was felt that a policy of trying to avoid surprises was a key factor. If companies were to engage in well-timed dialogue about intentions then the process would be much smoother.

The group noted examples where lack of engagement had caused real problems. In particular they discussed the case where the pharmaceutical giant, GlaxoSmithKline, (GSK), had suffered a 76% advisory vote against proposed remuneration packages. On that occasion the threat of potential and actual damage to GSK's reputation had changed its thinking and practice on remuneration. This was seen as an example of how shareholder action could change corporate behaviour much faster than the use of legislation.

The UK climate was felt to have changed considerably since the introduction of 'comply or explain' to this area of corporate behaviour. Boards of directors should take note of even low advisory votes against remuneration, and where there is a significant advisory vote they should

seriously consider whether they implement their intentions. The advisory votes do have a real impact on investment decisions to buy or sell a company's stock.

As a result of this change in culture, advisory voting and public opinion have had a moderating effect on corporate behaviour. The issue of severance is now looked at in an increasingly disciplined way with most contracts now prescribing one-year notice periods, rather than the old practice of longer notice periods, and the practice of granting stock options has become more restrained, with grants typically being made on a phased basis.

The group considered how practices might change in the current, volatile economic climate. It was agreed that the market would decide how far bonus schemes and other remuneration issues which might give rise to 'reward-for failure' concerns would be curtailed. Increased transparency, it was felt, would help the process. One downside which the group identified as being a likely consequence of the outrage communicated by both politicians and media would be that fewer people would wish to take up appointments as non-executive directors, (NEDs), and that there would be a shortage of experienced NEDs in the future.

The group also considered how far remuneration policy could be seen to encourage inappropriate risk taking. It concluded that remuneration policy was only a part of a very complex process. They cited the examples of Société Générale and Barings. The subsequent collapses were due to traders ignoring internal control procedures but the motivations were not only simple greed or a desire to increase the banks' profitability. The group concluded that, despite the complexity of the corporate culture, it was obvious that incentives still encouraged inappropriate behaviour.

One barrier to the value of 'comply or explain' across Europe that the group identified is the lack of visibility of underlying shareholders. It was also felt that investors needed to be encouraged to engage in participatory or advisory votes. The group considered that in mainland Europe the restraint and control of directors' remuneration needed to depend much more on the sort of greater shareholder discipline which could come from the UK model. It was felt that if the UK model were to be used in developing EU-wide practice then issuers would be able to identify their shareholders.

The group noted that the influence of shareholders and especially supervisory boards had led to constraints on remuneration. It also drew attention to the failings of the UK remuneration disclosure regime which covers directors, but not other highly paid employees. In Australia, for example, annual reports show both the salary of the CEO and a table of other employees' levels of pay.

QUESTION TWO:

THE QUALITY OF "COMPLY OR EXPLAIN" EXPLANATIONS

The second of the break-out sessions was asked to deal with the issue of the quality of explanations provided by organisations as a response to the 'comply or explain' framework, both in their annual statements and throughout the year. The group considered how the explanations could be improved, whether they were sufficiently detailed and tailored to the situation and whether there was sufficient consultation and engagement with shareholders. They also examined how 'comply or explain' is regulated and enforced by shareholders and regulators and how the regulation and enforcement regime affects the quality of the statements.

DISCUSSIONS AND CONCLUSIONS

There was an overall view that not enough detail or useful information was emerging from the process. Boards of directors were playing safe and preferring to stay with what lawyers recommended they should say rather than giving an open picture of the situation. The group felt that the key to making 'comply or explain' work was transparency and this was lacking in some areas.

The quality of explanations was thought, at best, to be variable. They tended to follow legalistic, or 'boilerplate', formats. Processes were simply being described as 'rigorous' or 'formal' rather than providing a genuine explanation. Boards of directors were thought to be taking the easy option rather than giving fuller and genuine explanations. It was felt that in many cases boards of directors were signing off reports without having examined them in any great depth and that investors, for their part, were not putting a great deal of effort into reading and understanding them before giving their approval.

The group felt that more pressure should be applied to investors to fulfil their duty to review the reports received and then vote appropriately. Investors receive and read many reports, including explanations of non-compliance. The group believed that investors needed to review those reports thoroughly and engage in dialogue with the companies that issue them.

The group stressed that it takes resources and competence to understand company reports and to make informed decisions on the acceptability of the explanations which boards of directors were giving. It warned that if investors were not careful and did not take the time to understand a business properly they might be led to believe that any deviation from compliance was acceptable because it was somehow an exception. On the other hand, they might be unwilling to accept explanations that sought to justify an entirely appropriate departure by a company from a best practice provision.

The group urged organisations, such as the ICSA in the UK and similar organisations overseas, to do more to publicise the quality of explanations which were being given. But it recognised that such strictures would be more effective if the initiative came directly from investors. It also suggested that people had to understand the limitations on how great an understanding could be achieved and how much detail could be reported.

The group concluded that the potential improvements to the explanations given were related to the detail provided. Often companies feel that they cannot give too much detail in a report but they are happy to have discussions verbally, over the telephone for example, and explain matters in greater detail that way. Where this has happened, investors should make it public that they have had such discussions on particular issues. It was recognised that confidentially is important to companies, which was often why they did not provide much detail in their publicly available explanations, particularly where they were dealing with executive remuneration.

It was thought that more prescription of what was expected in reports might help improve the quality of the explanations. It was felt that this would be most effective if the initiative came from the investors themselves. One improvement would be if the various investment organisations, for example PIRC, Morley, NAPF and ABI in the UK, pooled their efforts to provide more coherent market-led guidance. This would make it simpler and easier for companies.

The group suggested that regulators, like the Financial Reporting Council in the UK, for example, and its European counterparts, could take the lead in bringing the parties together. The group thought it possible that such initiatives could be led by the European Union itself but that this would not be ideal. The group felt that the key issue was quality, rather than quantity, of disclosure and this was something on which more guidance could be given. It also felt that an associated problem was that boards often did not know who their investors actually were and therefore the nature of the information they would want.

It should also be possible, the group recommended, for companies to provide a checklist of their corporate governance code compliance. This could be available online all year round and readers could be directed to it in the annual report. This would enable investors and other interested parties to obtain that specific information as and when they needed it rather than having to wait for the reporting season.

The group concluded that there was plenty of engagement and consultation with investors generally but not enough on governance issues specifically. They criticised shareholders for often waiting too long before raising a governance issue with a company. Engagement had to come from both shareholders and companies for the process to work well. It also thought that institutional investors' duties could be widened further, for example, by a requirement to disclose how they exercised their voting rights on a specific issue and why they made the particular decision they did. Some countries in the EU, like France and Holland, for example,

require that level of disclosure although it does raise practical issues about the timing of extraordinary general meetings and dates for posting of notices of meetings

It was agreed that it would also help to have a more joined-up approach between fund managers and investors' governance teams. Tension is often created by the different parties involved failing to agree on what precisely it is that they want.

The group concluded that, by and large, the concept of 'comply or explain' is neither regulated nor enforced as effectively by shareholders and regulators as it should be. The group felt that corporate governance and 'comply and explain' did work but that they needed to be improved. This could only come about with regular dialogue and enforcement of what 'comply or explain' meant to shareholders. The UK's Combined Code of Corporate Governance talks of the need for regular dialogue and the constructive use of the annual general meeting. But making this work is left almost completely to the shareholders themselves with the regulator, the FRC, appearing to be reluctant to get involved, or to tell shareholders what they should be doing. It was felt that the onus should be on the regulators to do this, though the group recognised that shareholders have engaged with companies on some of these ideas, such as remuneration, but on other issues, like risk management, the dialogue is rare, if it is taking place at all. The result is that without regulatory intervention investor bodies are increasingly on their own in taking the responsibility for holding companies to account.

The group felt that ultimately it was not the regulatory regime which affected the quality of the explanations but the litigation regime. The fear of litigation meant that companies were increasingly reluctant to spell things out explicitly. That said they reported that there were some companies, like Cable & Wireless, for example, which had been able to talk openly in their reports about the risks they faced. This suggested that it can be done without compromising confidentiality. The group recommended that investors should reward companies that were prepared to enter into dialogue. Equally investors should draw attention to companies which did not.

QUESTION THREE:
THE ADVANTAGE OF "COMPLY OR EXPLAIN" OVER LEGISLATION

The third of the break-out groups was asked to deal with the advantages of 'comply or explain' over legislation. In particular they were asked if they agreed that certain minimum standards should be set by legislation and that it is not desirable to leave everything to the market. Assuming the answer to that question was yes, the group questioned what would be the minimum standards to be enforced by legislation. They might include, for example, the establishment of an audit committee, the annual corporate governance statement and

the measures required by the shareholders' rights directive, all of which have recently been introduced into EU legislation. The group was also asked what further matters, if any, should be introduced into legislation and what were the advantages of leaving other matters to the 'comply or explain' regime. To assist in their consideration the group initially decided on some definitions and clarifications to focus their task. They decided that the term 'minimum standards' meant minimum corporate governance standards and that legislation in this context meant a Directive rather than a Recommendation.

DISCUSSION AND CONCLUSIONS

The group started by noting that all corporate governance codes are already applied against a background of legislation and regulation which is particular to each member state. Legislation and regulation may already contain particular provisions, for example in relation to the length of directors' contracts, which may also be relevant to a corporate governance code.

The group decided that minimum standards, if they are to be applied at all, should be principles based. A minimum standard might be applied, for example, in relation to a requirement for a company to disclose its approach to board functions and the balance on the board between executive and non-executive directors in general terms, or reinforce the board's responsibility for independent audit. But it should not be applied in the form of, for example, the detail of board composition or the specific number of independent directors. The key point was the operational flexibility of companies. Minimum default standards might be acceptable in principle as long as operational flexibility was retained. Minimum standards would also have to take account of the difference in company size and complexity.

The group also felt that the feasibility or desirability of minimum standards would vary depending on which aspect of corporate governance was under discussion. Transparency should always be the key principle. For example, disclosure requirements could apply to remuneration but they would not be appropriate for any legislation dealing with board performance issues. The group also felt that if remuneration were to come under specific legislative requirements the emphasis should be on the highest paid individuals within companies rather than simply concentrating on members of the board of directors. The group pointed out that in Australia, for example, disclosure requirements were based on the top five earners in a company.

The group warned of a fundamental problem in setting minimum standards. With inevitable differences between the existing legal requirements of member states, the setting of minimum standards might result in the standards being set simply to achieve a consensus. That could result in a Directive which sets lower compliance criteria than the existing codes in some countries. Companies might then be less willing to strive to reach the higher standards set out in the code and more legislation might simply result in more box-ticking and boilerplate disclosure.

The group issued a warning of the risk of political interference in legislation at member state level at the stage of national implementation. This could result in the 'gold-plating' of some requirements.

The group also emphasised the problem of the inflexibility of legislation. Codes of practice always offered the opportunity to adapt and change more easily and quickly than is possible with legislation.

Aside from remuneration disclosure, the group proposed other areas which the Commission might usefully consider, though not necessarily to pursue the case of further legislation. Firstly, the group urged more focus on minimum standards for institutional investors to ensure that they are engaged in promoting good corporate governance. It was noted that shareholders already face problems in some member states if they meet to discuss certain actions, for example, to remove directors. In some cases this can be seen as 'acting in concert' which can have unwelcome consequences including, at worst, an obligation to make a full takeover offer for the company in question. Secondly, the group endorsed the measures on shareholder protection as already outlined in the Shareholder Rights Directive and the various practical initiatives to ensure that shareholders can make sure their votes can be cast at general meetings. Thirdly, the group urged the Commission to consider problems of intermediaries and shareholder identification and provide a better capability for companies to identify their actual owners. It was noted that record dates set too long in advance of meetings do not help here. There was a concern about the ability of shareholders to sell their shares after a record date or divest themselves of the economic interest in shares which results in their having a vote when they have no long-term interest in the company.

The group concluded by stressing that it is a company's owners not legislators who are the key interested parties in the success of companies. The role of corporate governance should be to provide structures for handling potential conflicts of interest and to encourage the spread of best practice. The group's fundamental conclusion was that the benefits of 'comply or explain' outweighed the potential disadvantages of legislation in this area.

QUESTION FOUR:

TO WHAT EXTENT DOES THE "COMPLY OR EXPLAIN" FRAMEWORK ENHANCE COMPANY VALUE ?

The fourth of the break-out groups was asked to investigate to what extent the 'comply or explain' framework enhances company value. To reach conclusions on this question the group looked at whether 'comply or explain' could enhance the value of EU companies, whether it made them more competitive in the global market, whether it promoted better

company performance by allowing a flexible approach, and what effect it can have on a company's reputation and standing. The group also looked at whether the position would be different under a rules-based system rather than 'comply or explain' and examined the key advantages 'comply or explain' brought to companies.

DISCUSSION AND CONCLUSIONS

The group decided that a 'comply or explain' framework could enhance value if it was applied effectively. To achieve this there needed to be honest and full disclosures by companies, sound governance practice embedded throughout the organisation, effective engagement by shareholders and an understanding by boards of their responsibilities.

The group took the issue of board responsibility further by focussing on the review of internal control that a board is required to conduct every year and on which the board is required to make a statement in the annual report. It considered the likely differences in practice as to the extent to which boards review the effectiveness of internal control and the level of understanding that some boards may have in respect of the risk appetite of the company and the risk identification and management processes in place. It questioned whether there should be a legal underpinning of the review. For example there could be a requirement to include in the annual report a statement along the lines of that required by the UK Companies Act disclosure requirement confirming the adequacy of information supplied to the auditors. The group felt this would focus the minds of company directors when carrying out the assessment of internal control to ensure that it had been conducted with the right degree of diligence.

On the wider questions the group felt that evidence showed that 'comply or explain' did enhance the value of companies. It referred to a research paper, (Governance and Performance in Corporate Britain), published by the UK Association of British Insurers, (ABI), which found a strong correlation between sound governance and shareholder value and also found that those companies which had sound governance in place experienced less share price volatility. The group also felt that increased disclosure and appropriate explanations, promoted by the 'comply or explain' principle, would drive a better understanding of the company by investors who may then be more supportive of companies in times of adversity.

On the question of whether the principle of 'comply or explain' made companies more competitive in the global market the group came to several conclusions. It recognised that compliance with governance codes under 'comply or explain' principles was less expensive for companies than compliance under a regulatory framework such as the Sarbanes-Oxley legislation in the US. It felt that 'comply or explain' promoted a more flexible approach which meant that companies could adapt to change more quickly and that should result in increased competitiveness. There was also a general belief that well governed companies, which perform

well and have greater engagement with shareholders, should have a lower cost of capital as a result and therefore improved competitiveness. The group also felt that companies based in less developed economies see 'comply or explain' as a quick and easy route to embracing best governance practice, regardless of the framework of local law. This attraction of a 'comply or explain' approach should improve the competitiveness of Europe's capital markets over alternative markets.

The group emphasized that the more flexible approach created by a 'comply and explain' system allowed companies to tailor governance to their specific and changing needs and allowed a greater speed of response to changing circumstances. It felt that an appropriate approach to governance and an understanding of it by the investor should lead to improved performance.

The group agreed strongly that a 'comply and explain' framework had a large effect on companies' reputation and standing. It emphasized that sound governance and transparency could improve a company's reputation, although getting it wrong could also have a serious adverse effect. For example, the group pointed out that the UK retailer, Marks & Spencer, suffered significant damage as a result of the announcement that their chief executive was to be appointed executive chairman. This was noted by the group to have been regarded by some investors and sections of the press as a miscalculation by the company, made worse by the absence of any prior dialogue with major shareholders. The group also cited the pharmaceutical company Novartis as an example of a company which had enhanced its reputation because of its strong governance fully embedded throughout its organisation coupled with full disclosure to shareholders.

The group concluded that under a rigidly rules- based system all the benefits of comply or explain would be lost. The result would be less informative explanations driven by a 'box ticking' mentality in order to comply with the letter of the law rather than the spirit of applying principles. It would force companies into a 'one size fits all' framework of governance and result in increased costs of compliance. Governance would become more process driven and would lack a business sense. The group also noted that the European model of governance, based on the 'comply or explain' principle, had greatly assisted emerging markets to develop their governance standards and dovetail with their existing legal structures both effectively and quickly.

The group concluded that the key advantages to companies of a 'comply or explain' system were that governance practice could be tailored to meet a company's' specific requirements; that it allows for considered explanations and a move away from comparatively uninformative 'box ticking'; that it should promote a better understanding of companies by investors; and finally that it should promote increased dialogue between companies and their investors.

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