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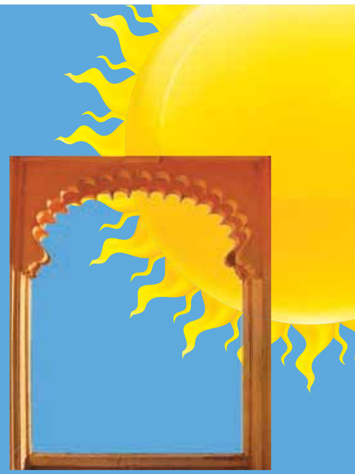

COMPLY OR EXPLAIN - AN ALTERNATE APPROACH TO CORPORATE GOVERNANCE

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Executive Summary

The traditional approach to corporate governance has been a ‘mandatory approach’ where the norms are stated in the form of fixed rules, and the regulators are entrusted with monitoring the compliance of these rules. An alternate to this one-size-fits-all approach has emerged in the form of ‘comply or explain’ (or CorEx), which defines codes (or practices) in line with certain specified principles and any deviations from these practices are required to be publicly explained by the companies. It is expected that the market would react adversely if the explanations are unjustified or inadequate and would act thereby as a disciplining factor for the companies. Originating in the UK, this approach has become popular in other countries too -- mainly because of its inherent flexibility. Because India has had only limited success with the mandatory approach, it may be worthwhile exploring the possibility of transiting to this new, flexible approach. The pre-conditions for the success of the CorEx, however, are largely non-existent in India, although there have been some encouraging trends in the recent past. In view of the same, it is both feasible and desirable to start the transition in some ‘aspirational’ governance norms and proceed to the ‘core’ norms in a calibrated manner later, as the conditions in India become more suitable.

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The concept and its origin

Countries worldwide have traditionally adopted a 'mandatory approach' to implement the corporate governance norms. Under this approach, the authorities in the respective countries prescribe a set of rules, which the corporates are bound to abide by. If they do not comply, they are liable to be penalized by the authorities. The Sarbanes-Oxley Act in the U.S. is a classic example of the 'mandatory approach' to corporate governance. India and many other countries in the world follow this approach.

In contrast, some countries (notably the UK, Germany, Australia and Canada) have adopted a 'comply or explain' approach to corporate governance. Under this approach, the authorities establish for the listed companies a code of governance, compliance with which is *not* mandatory. However, in case a company decides to deviate from any provision in the 'code of governance', it is bound to disclose the same and is also mandated to explain *publicly* why it is deviating. The market is expected to penalize the companies that provide unjustifiable or inadequate explanations (explained later). UK was the first country to introduce the concept in the form of 'UK Governance Code' in 1992, which was the outcome of a recommendation of the Cadbury Committee Report on Corporate Governance.

CorEx: A principle-based approach

Unlike the mandatory approach, which is based on rules, 'Comply or explain' (CorEx) is a principle-based approach. It recognises that the business situations for companies can vary widely (depending on the size and complexity of the company and the nature of the risks and challenges it faces), which makes it inefficient to have a fixed set of rules. It believes therefore that instead of binding rules, a set of general and overarching principles, which are suitable for most, if not all companies, and are essential for good governance, should be set. Together with these principles, a set of practices that foster these principles are also prescribed. For example, the principle that the Chairman is responsible for ensuring the Board's effectiveness requires that Chairman be independent in judgement, which in turn entails a code provision (practice) that the CEO should not ascend to Chairmanship (See Box 1).

Box 1: An example of principles and provisions of U.K. Governance Code

The Chairman

Main Principle

The chairman is responsible for the leadership of the board and for ensuring its effectiveness on all aspects of its role.

Supporting Principle

…The chairman should … promote a culture of openness and debate by facilitating the effective contribution of non-executive directors in particular and ensuring constructive relations between executive and non-executive directors. The chairman is responsible for ensuring that the directors receive accurate, timely and clear information.

Code Provisions

The chairman should on appointment meet the independence criteria…A chief executive should not go on to be chairman of the same company.

Source: The UK Corporate Governance Code, 2012

However, because there might be situations where compliance with a given code provision (practice) may not achieve the fundamental objective of the company, departure from it can be permitted if an explanation is given by the company (See Box 2).

Box 2: An example of 'comply or explain'

During the reporting period of 2012-13, the SABMiller Plc. decided to appoint its incumbent Chief Executive Officer (CEO) to the role of Chairman. This was perhaps one of the most high profile departures from the Code, which requires that the outgoing CEOs leave the company rather than ascend to the chairmanship. The outgoing Chairman gave the following explanation as the criteria under which the board had approached the succession process:

"In selecting my successor, the board carefully considered the requirements of the job in the context of the group's size and geographic spread. We agreed that the new Chairman must be able to provide stability and continuity, must understand both the global brewing industry and the particular challenges of the emerging markets in which we operate, must be familiar with our ways of working and able to enhance our corporate culture and operational performance and must be competent to oversee the completion of the business capability programme currently under way."

Prior to reporting of this formal explanation, the company had clarified these issues in more detail during its meetings with shareholders. Besides, the company justified its decision in the context of the overall succession plan (as it had already identified its long-term replacement CEO) and clarified the need for a calibrated handover of responsibilities given the global complexities of the business.

Source: Association of British Insurers, 2012

Who is responsible for monitoring compliance?

While it is the authorities who are responsible for monitoring compliance with governance norms under the 'mandatory approach', this role in case of 'CorEx approach' is largely left to the investors. The regulator merely requires companies to report compliance or explanation (in case of non-compliance) to shareholders rather than to the regulators, and thereby ensures that the decision on whether a company's governance level is adequate is taken by shareholders. In case of noncompliance, if investors find the explanation to such noncompliance inadequate or unacceptable, it is expected that they would dump the shares, which could hurt the company. Clearly, it is a case of 'market sanction' rather than a 'legal sanction'.

Advantages of CorEx

Given its structure, the CorEx has certain advantages over the traditional mandatory approach, significantly:

i It abandons the one-size-fits-all regime and provides the companies the much desired flexibility to comply or not, depending on their nature, size and circumstances.

ii It encourages innovation. Companies that do not meet the code's provisions have the freedom to think outside the box and develop and adapt practices which may deviate from the code provisions, but are in line with the main principles.

iii It gives shareholders an opportunity to play a key role in holding the Boards to account. This is more effective in disciplining the companies than making the boards solely accountable to the regulators.

Another study finds some companies in UK which did not comply with the provisions of the Code, but provided justified explanation for the same, were not considered badly governed by the market; in fact, they performed exceptionally well. On the other hand, in case of certain other companies, mere mechanical adherence to provisions did not guarantee better stock price performance. One can clearly infer that the 'CorEx approach', by not committing companies to a one-size-fits-all regime, diminishes the risk of companies complying with only the 'letter' rather than the 'spirit' of the governance code. (Arcot and Bruno, 2006)

The Indian approach

India follows a rule-based approach like the US. Unlike in the US, however, where the governance code is provided by law (Sarbanes Oxley Act), the corporate governance rules for listed companies in India are incorporated in the agreements between those companies and the stock exchanges in Clause 49 of the agreement. This agreement contains a combination of mandatory and non-mandatory *rules*. The stock exchanges in India are required to monitor compliance with the mandatory rules and take action in case of non-compliance. (It may be noted, however, that when companies do not comply with non-mandatory rules, no action is taken; also, the companies are not required to provide any explanation.)

While corporate governance norms in India have been strengthened over the years, weak enforcement of these norms has remained a major issue, which has prompted the authorities to search for alternatives. Recently, many of the clause 49 provisions, with a few modifications, have been incorporated in the Companies Act, 2013. Consequently, India has moved even further towards the 'mandatory approach'. (Curiously, the new Companies Act has used CorEx in exhorting companies to practise corporate philanthropy. Section 135 requires companies to annually spend 2 percent of their net profits on philanthropic activities *or "specify the reasons" for failing to do so*.)

Pre-requisites for CorEx to succeed

For corporate governance based on the CorEx approach to succeed, the following conditions are considered necessary.

- First, there must be a general conviction among those charged with the governance of corporations that better governance standards are desirable for the company. While CorEx may never beat criminal intent, it contributes "guidance to the inexperienced, focus to the ambivalent and control over the adventurous" (20th Anniversary of the UK Corporate Governance Code, 2012). None of them however would heed this guidance unless they have a conviction that good governance is in their self interest.
- Second, should departures from the code be necessary, they have to be honestly reported and clearly explained.
- Finally, there must be substantial activism by shareholders, particularly by the institutional shareholders, since they can both exert pressure on boards and managements as also carry a credible threat of affecting the market price adversely, should there be an unjustified departure from the norms.

Is India ready to embrace CorEx?

Whether India is in a position to adopt CorEx depends to what extent the above conditions are prevalent in India.

The first requirement for CorEx to succeed is a general desire among company managements and boards to have improved governance, which entails respect for the rights of those stakeholders who do not have a voice in the board room. This 'respect' however is missing in several Indian companies. This is not surprising, given that in the Indian society, the 'powerful few' expect (and are expected by their "subjects") to have privileges which are denied to the vast majority, even where many of those are at the cost of that very majority!

These features of a feudal society have seemingly permeated to the Board culture of many Indian companies. Directors and managers brought up in such an environment typically tend to behave as though their primary responsibility is to enrich the controlling shareholder, no matter at what cost. Governance practices and rules that thwart this purpose are either totally avoided or are lip-serviced. Under the circumstances, it would be naïve to expect non-mandatory codes of good conduct such as CorEx to work.

The second condition of honest reporting is also missing in India. The Indian experience of the quality of financial statement disclosures is generally poor. Notes to the financial statements rarely explain the matter they deal with. This is despite the fact that the statements are subject to several external checks including by auditors, Further, the corporate governance report required to be incorporated in every annual corporate report often contains no information that could explain the quality of governance and has standard statements that are repeated each year.

Third, for CorEx to be successful, the institutional investors have to effectively monitor compliance (or deviation), and examine the veracity of the companies' disclosures. Unlike in the U.K., the level of institutional shareholder activism in India remains far from desired. (Varottil, 2010). Some encouraging trends however have begun to emerge:

- First, there has been some evidence of activism by institutional investors in the recent years.
- Second, the establishment of proxy advisory firms is increasingly throwing light on the bad practices of listed companies.
- Finally, the new Companies Act, which makes it incumbent upon companies to safeguard the interests of all stakeholders, may give the NGOs a legal means to enforce the same.

Conclusion

The Indian experience with its rule-based, mandatory approach to corporate governance has had a very limited success. The norms are practised more as rituals in religion than as a genuine pursuit of good governance, raising questions about their desirability. Indeed, the mandatory practice of norms as rituals often results in an unnecessary cost on corporations and also, focuses the attention of managements and boards on the form at the cost of the substance.

Theoretically, the 'CorEx approach' to corporate governance, because of its inherent flexibility and reliance on market forces as a disciplining factor, has a distinct advantage over the 'mandatory approach'. In practice too, there is evidence to suggest that 'Comply or explain' approach is a viable approach. But its success depends on the existence of certain pre-conditions such as (a) a general conviction among companies that improved standards are desirable, (b) honest and clear explanation by companies when they deviate from the norms and (c) the existence of shareholder activism. These conditions are largely non-existent in India. Perhaps in recognition of this, the newly enacted Companies Act has pushed the Indian framework further toward the traditional 'mandatory approach'.

While it is not clear whether the Companies Act would achieve its objective of improving governance, India is still not ready for a full-fledged transition to CorEx approach. It is, however, both feasible and desirable to start the transition in some areas and proceed to new areas in a calibrated manner, as Indian companies evolve towards a more stakeholder-focussed form of governance. A useful strategy would be to first bring the aspirational governance norms (such as some of the provisions of Voluntary Guidelines, 2009) under the CorEx regime and cover the core, non-negotiable norms in future, when the conditions become more suitable.

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About NSE CECG

Recognizing the important role that stock exchanges play in enhancing corporate governance (CG) standards, NSE has continually endeavored to organize new initiatives relating to CG. To encourage best standards of CG among the Indian corporates and to keep them abreast of the emerging and existing issues, NSE has set up a Centre for Excellence in Corporate Governance (NSE CECG), which is an independent expert advisory body comprising eminent domain experts, academics and practitioners. The 'Quarterly Briefing' which offers an analysis of emerging CG issues, is brought out by the NSE CECG as a tool for dissemination, particularly among the Directors of the listed companies.