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## **Explaining "Comply or Explain"**

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The approach to regulating for good corporate governance differs in various jurisdictions. The United States, for example, has the Sarbanes-Oxley Act, a highly technical set of corporate governance rules that all its public companies must adopt. These rules are seen as highly prescriptive.

In contrast, many other countries, particularly in the Commonwealth, have adopted codes of corporate governance. Singapore's Code of Corporate Governance (the Code) was first established in 2001 and last revised in 2012.

These codes are based on a "comply or explain" approach – which, plainly put, means that companies either comply with the principles and guidelines set out or explain why they have not.

### **Rationale**

"Comply or explain" has been criticised for not being clear about whether a rule should be applied or not. However, there are clear benefits to a "comply or explain" regime where the principles and guidelines in the code are developed to reflect generic best practices in corporate governance.

For one thing, it avoids the disadvantages of a "one size fits all" mandate that is not appropriate when companies are different in size, maturity, pedigree and industry.

It allows the regulator to not impose requirements that are excessively burdensome and costly especially for smaller companies. These companies just need to argue their case as to why they are unable to comply.

Second, it sets goals for companies not yet able to comply. These companies can pace themselves to learn from others, while explaining that they are progressing towards achieving compliance.

In fact, "comply or explain" enables innovation by supporting new ideas. It recognises that alternative approaches are justifiable if they achieve good governance in a transparent way; it enables companies to achieve conformance with a governance principle in a way that is appropriate to that company.

It is this thinking through how best to address the principles of the Code that will help companies internalise the principles and perform better than if they are just required to follow a set of prescriptive rules.

### **Misunderstandings**

However, in the implementation of the Code, there have been some misunderstandings about how "comply or explain" should work.

The first misunderstanding is that the Code is a "voluntary" one. This arises from contrasting the "comply or explain" approach with the SGX Listing Rules and legislation which are, of course, mandatory in nature.

SGX Listing Rule 710 requires a company to describe its corporate governance practices with specific reference to the principles of the Code, and to provide an appropriate explanation for any deviations from the Code in its annual report. In other words, while it is true that a company has a choice to comply, it is, in fact, mandated to make a choice.

And if its choice is not to comply, then it has to explain – adequately – the reasons why it has not. This is where there have been many shortcomings in practice. For example, it is all too common for listed companies with independent directors who have served for more than nine years to be described in the annual report as still being independent without adequate reference or explanation as to the "particularly rigorous review" that should have been conducted with respect to their independence.

Another misunderstanding by some companies is that it is better to have the appearance of having complied than to have to explain any deviation. This attitude can result in token compliance and a "ticking the box" approach to the Code.

Witness, for instance, the general and generic descriptions found in many annual reports of the search process that is undertaken by the boards for new candidates to be appointed as directors, the orientation programmes new directors undergo, and the types of annual training that have been designed for the board.

Yet another misunderstanding is that the responsibility for effective governance of the "comply or explain" approach lies with the companies and their boards only. On the contrary, it also depends on other stakeholders, including the regulators, the shareholders and industry watchers, for the approach to work.

These other stakeholders are required to monitor compliance with the Code, and institute dialogue and enforcement action when companies fail to adequately explain their non-compliance with the Code.

Shareholders can raise questions and make their votes felt at general meetings. Regulators can investigate and take regulatory action especially when there is persistent non-compliance. Investment advisers and industry watchers can factor in the level of compliance and adequacy of explanations for non-compliance in their assessment and ratings of these companies. All these actions by stakeholders will incentivise companies towards better governance practices.

### **Trust**

That said, the "comply or explain" regime works best when there is trust. All stakeholders need to be able to trust a listed company's commitment to good governance. Companies, in turn, must trust that their explanations will be considered in the right context. When this mutual trust exists, "comply or explain" will provide market-based, even innovative, solutions that are worked out by companies and their stakeholders without the need for regulatory action.

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