Corporate Governance- "Comply or Explain"

Market based approach to good governance

Syed Asad Ali Shah

What I would cover

- Regulator's perspective: why good Corporate Governance?
- **Corp. Governance Journey in last 18 yrs**
- **What is missing in the Code / Regulatons**
- **Outcomes : of 2007 IFC survey & PICG 2019 survey**
- **Why Comply or Explain is the right approach?**
- **Way forward**

Regulator's perspective: why good Corporate Governance?

- **Good corporate governance is not an end in itself. It is a means to create an environment of market confidence and business integrity that supports capital market development and corporate access to equity capital for long-term productive investments.**

- **The quality of a country's corporate governance framework is therefore of decisive importance for the dynamics and the competitiveness of its business sector, for improving the business performance and economy.**

Balancing two objectives of Corp Governance

Broadly two objectives have to be considered:

- **Performance**
  - ***conduct its business so as to enhance corporate profit and long-term shareholder value.***
- **Public interest : Accountability & reporting to shareholders & market participants to ensure market confidence**

Corporate Governance- journey

- Started as rule based, as part of listing rules of stock exchanges in 2002
- Updated in 2012 with some additional requirements
- Enforced through regulations under company law in 2017
- Modified to a hybrid framework, six mandatory and remaining "Comply or explain" 2019

What are the outcomes till now?

- Results of Survey
  - 2007 IFC Survey
  - 2019 PICG Survey

IFC survey 2007- chairman of a local listed company

- *Not corp. governance but the Code of Corp. Governance is important.*
- *I have to follow each and every word of the Code. I do not understand why independent directors, audit committees, internal audit and company secretaries are important but the Code wants them and I need to have them.*
- *For me the profitability of the company is important. I think the Code has not increased the profitability of my company even though we do have four meetings of the board, we have non-exec directors, we follow the Code but having all this has decreased my profits, not increased my profits.*
- *When I should be concentrating on business matters, I am concentrating on internal audit reports. So why do I follow the Code? Because I am the owner of a listed company and because the SECP wants us to follow the Code.*

IFC survey – Company Sectry of local listed company

- *Corporate governance is important because we have to follow the Code of Corporate Governance… benefits like the ones outlined by you relating to access to foreign capital, institutional investors, increased reputation of the business, all this does not matter to my company.* ***What matters to the company is the survival of the business and we need money for that. We can take a loan from the bank at any time and they are not worried about our corporate governance practices so why do we need to think of foreign capital or increased reputation or better governance?***
- ***I only consider corporate governance important because the SECP wants me to consider it important.***

IFC survey – Board Practices (CFO of a listed company)

- *We follow the Code of Corp. Governance in terms of board composition and our board of directors do all that the Code requires…we have to do this.*
- *We have board meetings, we have a separate CEO and chairman. We have non-executive directors who may be considered independent but there is no compulsion to have non-executive directors…**The Code wants the board to approve annual reports, remuneration, strategy, etc. Thus most of the board's time is spent in approvals. The board hardly gets any time to think of vision, succession planning, long-term strategy, new business opportunities, going global.***
- ***The board has human beings not robots who can comply with the Code and also think of succession planning and vision. The Code is more important than anything else.***

IFC survey – Benefits of Corporate Governance

- **For an overwhelming majority (82%) of the respondents, the most important benefit of adoption of corporate governance practices was compliance with legal and regulatory requirements.**
- **There was no sufficient evidence of appreciation or comprehension of other significant benefits, such as protecting shareholders' rights; building/enhancing the company's/bank's reputation; improving strategic decision making; gaining better access to external capital …….**

IFC survey – Role of Institutional shareholders

- It was observed from the interviews that key executives of responding companies were unhappy with the duties and functions performed by institutional investors as members of the board of directors.
- They asserted that representatives of institutional investors are overworked because each one is on more than ten different boards and they do not generally come prepared for board meetings.
- The SECP should incorporate in the Code a section on a revised role for institutional investors. This is essential to make the institutional investors aware of their duties and responsibilities. It may also be helpful in ensuring that the institutional investors and their nominee directors play a pivotal role in effective implementation of corporate governance practices.

What is still missing

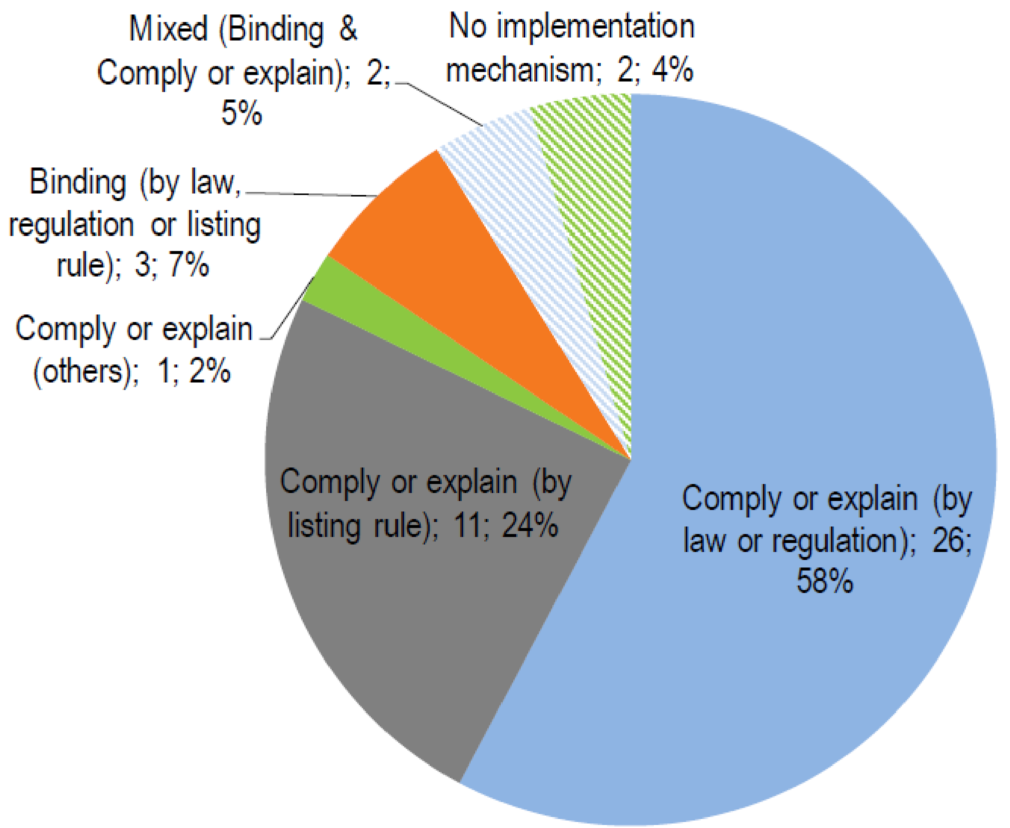
- Elaboration of board's role to achieve enhanced performance.
- Guidance on Board and Committee evaluations.
- Emphasis & guidance on Board's own annual evaluation, evaluation of CEO's performance & holding the CEO accountable.
- Lack of requirement on Nominating / Governance Committee to ensure right appointments on the board
- Incorporating sustainability in governance, strategy & reporting

What is still missing

- Reporting on Internal Control effectiveness by the board should be based on review of int. contrl system.
- Confirmation of directors, which the board considers to be independent.
- Elaboration of responsibilities of Chairman of the Board and the CEO.
- Requirement to have executive sessions of the Board (without the presence of management / CEO)
- Role of Institutional Investors in the Corporate Governance
- Guidance / requirements on shareholder communications, holding effective general meetings and robust disclosure.

Comply or Explain Vs Rule Based

- **84% jurisdictions have "comply or explain" approach**



Comply or Explain Vs Rule Based

- Jurisdictions with Binding requirements:
  - India, China and US
- Jurisdications with C or E
  - UK
  - Germany, Netherlands, almost all EU
  - Singapore
  - South Africa
  - Japan
  - Hong Kong

Why Comply or explain

- Clear evidence from surveys / experience that it is largely a box ticking exercise
- Clear evidence : most jurisdictions have comply or explain approach
- Corp Govnce needs to be promoted for its own reasons: for success of company, not for compliance
- Market is stronger than regulations
- Create demand for good govnance from investors
- Role of institutional shareholders / front line regulator / other stakeholders to promote governance

Way forward

- Once size does not fit all
- Corp governance should not be confined to reqrts of the Code, rather should be “beyond compliance” aimed at enhancing long-term viability
- Code reqrnts should be considered as minimum.
- Learning and improvement is continuous process
- Demand based Corp. Governance, mainly driven by institutional investors / lenders rather than regulators.
- Regulator’s role : Build an echo system that promotes demand, enhance learning, culture of good corporate governce

Thank You