Technical guide on good practices for the application of the "comply or explain" principle

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1.Introduction

This Technical Guide is published in the exercise of the powers granted under article 21 (3) of the consolidated text of the Securities Market Law, adopted under Royal Legislative Decree 4/2015 of 29 October.[1] The Guide provides guidance to help listed companies to comply with the corporate governance laws, regulations and standards that apply to them, specifically, to help them fill out section G *Degree of compliance with corporate governance recommendations* of the annual corporate governance statement required under Circular 5/2013 of 12 June.[2]

In Spain, there is a long tradition in the application of the "comply or explain" principle, beginning in January 2003 when the report of the Special Commission to foster transparency[3] introduced that principle to Spanish practice. The principle has survived and even been strengthened in the subsequent corporate governance codes that have been approved since.

The "comply or explain" principle became part of statute law under the *Law 26/2003*,[4] which amended Law 24/1988, of 24 July, the Securities Market Law, by introducing for the first time in Spain, under article 116 (now repealed), a duty to publish an annual corporate governance statement (hereinafter, "IAGC" *informe anual de gobierno corporativo*,), reporting on the degree of compliance with corporate governance recommendations and, where appropriate, explaining any departure from such recommendations.

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[1] *Royal Legislative Decree 4/2015, of 23 October, which approves the consolidated text of the Securities Market Law.*

[2] *Circular 5/2013, of 12 June, of the Comisión Nacional del Mercado de Valores*, which introduces annual corporate governance forms for listed companies, savings banks and other institutions that issue securities admitted to trading on organised securities markets.

[3] Report of the Special Commission to foster transparency and security in the markets and in listed companies ("Aldama Report"), 8 January 2003.

[4] *Law 26/2003, of 17 July, which amends Law 24/1988, of 28 July, the Securities Market Law, and the consolidated text of the Companies Law, approved by* Royal Legislative Decree *1564/1989, of 22 December*, with the purpose of enhancing the transparency of listed companies.

At present, article 540 (4) (g) of the Companies Law, in line with that same principle, places Spanish listed companies under a duty to disclose in their annual corporate governance statement *the degree of compliance with corporate governance recommendations or, as the case may be, explain any departure from such recommendations.*

The "comply or explain" principle is widely supported by companies, investors and regulators as an appropriate tool in corporate governance. Yet, as mentioned in the annual reports produced by CNMV on listed companies' IAGCs, in the 2011 Green Paper on the EU corporate governance framework, and in other reports also produced at the prompting of the European Commission, it appears that there are some shortcomings in the way the principle is applied in practice, in particular as regards the quality of explanations provided by companies when departing from corporate governance codes.

Since 2008, the CNMV includes in its annual report on IAGCs an assessment of the explanations set out by companies in their statements on the ten recommendations of the corporate governance code that are most often departed from. No significant improvement in the quality of such explanations has been seen since that time.

The purpose of this Guide is to help rectify these shortcomings by providing listed companies with guidance on how to present explanations in their corporate governance statements in the event of departure from the recommendations of the Good Governance Code of Listed Companies ("the Code").

For that same purpose, the European Commission ("the Commission") produced its *Recommendation of 9 April 2014 on the quality of corporate governance reporting ("comply or explain")*, which is discussed in the following section. This Guide is intended to enhance awareness of the Recommendation among company boards and, given its practical significance, among shareholders and other stakeholders, so as to encourage companies to draft higher-quality explanations in events of departure from recommendations, as suggested by the Commission Recommendation.

This Guide aims to promote a change in the way in which listed companies and their boards address their corporate governance practices. It should be widely accepted that it is inadequate to address the degree of compliance with recommendations by means of a mechanical *ex post* exercise, i.e., when filling out section G of the corporate governance statement, considering only at that time the question of how to justify – in the absence of an *ex ante* assessment – the fact that certain company practices depart from one or more specific recommendations.

Rather, this Guide aims to buttress one of the fundamental general principles underpinning the philosophy of good governance codes and the present Code in particular: a legitimate expectation that the company and its directors should bear the recommendations in mind in all significant governance practices, such that they ought to consider in each specific case whether the most suitable course of action should, or should not, fully comply with the applicable Code recommendations.

Therefore, there should be a prior assessment of whether the practice being followed or which is intended to be followed at a given time, or the decision that is intended to be adopted, is compliant with Code recommendations, and, if not, the company must be in a position to explain not only the reasons why a given recommendation has been departed from, but also how the company, by means of the practices or decisions finally adopted, follows the principles of the Code, remains consistent with company interests and at the same time adequately mitigates its risk exposure.

Finally, at the end of this Guide there is attached an Annex containing examples of explanations that do not completely follow the guidance laid down in the Guide. The examples have been drawn from corporate governance statements filed by companies with the CNMV, and are intended only as a sample in aid of avoiding those earlier mistakes.

2. Commission Recommendation of 9 April 2014 on the quality of corporate governance reporting ("comply or explain")

The key considerations underlying the Commission Recommendation are:

- High quality disclosure on companies' corporate governance arrangements offers useful information to investors and facilitates their investment decisions. It also gives investors more confidence in the companies they invest in. Increased transparency to the market can also bring, more generally, reputational benefits for companies and more legitimacy in the eyes of stakeholders and society as a whole.

- The 'comply or explain' principle laid down in Article 20 of Directive 2013/34/EU is a key feature of European corporate governance. According to this principle, companies that depart from the relevant corporate governancecode are required to explain in their corporate governance statement which parts of the code they depart from and the reasons for doing so.

- While full compliance with a code can send a positive message to the market, it may not always be the best approach for a company from a corporate governance perspective. Departing from a provision in the code could in some cases allow a company to govern itself more effectively. The 'comply or explain' approach provides companies with flexibility by allowing them to adapt their corporate governance to their size, shareholding structure or sectoral specificities. At the same time, it promotes a culture of accountability, encouraging companies to reflect more on corporate governance arrangements.

- In its resolution of 29 March 2012, the European Parliament considered the 'comply or explain' approach a useful tool for corporate governance. In particular, it was in favour of compulsory adherence to a relevant code by the company and requiring meaningful explanations for departures from a code, which should include a description of the alternative measure taken.

- The purpose of the Commission Recommendation is to provide guidance for companies and to assist them in improving the quality of their corporate governance reporting. Given the diversity of legal traditions and approaches, the Commission Recommendation offers a general framework, which can be further developed and adapted to the specific national context.

- Appropriate disclosure of departures from the relevant codes and of the reasons for such departures is very important to ensure that stakeholders can make informed decisions about companies. Such disclosure reduces the information asymmetry between the company directors and its shareholders, and therefore, decreases the monitoring costs for the latter. Companies should clearly indicate which recommendations of the code they have departed from and, for each instance provide an explanation regarding: the manner in which the company has departed, the reasons for the departure, the way in which the decision to depart from a recommendation has been arrived at, the timeframe of the departure and the measures taken to ensure that the company action remains consistent with the objectives of the recommendation, and of the code.

- In providing this information, companies should avoid using standardised language and should focus on the specific company context that explains the departure from a recommendation. The explanations should be structured and presented in such a way that they can be easily understood and used. This will make it easier for shareholders to engage in a constructive dialogue with the company.

  The purpose of the Recommendation is to provide guidance to Member States, bodies responsible for national corporate governance codes, companies and other parties concerned. The guidance aims to improve the overall quality of corporate governance statements published by companies in accordance with Article 20 of Directive 2013/34/EU and, specifically, the quality of explanations provided by companies in case of departure from the recommendations of the relevant corporate governance code.

In that context, the provisions of the Commission Recommendation on the quality of explanations in case of departure from a Code or from any of its recommendations are as follows:

SECTION III

Quality of explanations in case of departure from a code

7. Article 20(1) of Directive 2013/34/EU requires listed companies to provide explanations in case of departure from the recommendations of the code to which they are subject or which they have voluntarily decided to apply.

8. For the purpose of paragraph 7, companies should clearly state which specific recommendations they have departed from and, for each departure from an individual recommendation:

(a) explain in what manner the company has departed from a recommendation;

(b) describe the reasons for the departure;

(c) describe how the decision to depart from the recommendation was taken within the company;

(d) where the departure is limited in time, explain when the company envisages complying with a particular recommendation;

(e) where applicable, describe the measure taken instead of compliance and explain how that measure achieves the underlying objective of the specific recommendation or of the code as a whole, or clarify how it contributes to good corporate governance of the company.

9. The information referred to in paragraph 8 should be sufficiently clear, accurate and comprehensive to enable shareholders, investors and other stakeholders to assess the consequences arising from the departure from a particularrecommendation. It should also refer to the specific characteristics and situation of the company, such as size, company structure or ownership or any other relevant features.

3. Additional considerations for appropriate adaptation of the Commission Recommendation to the corporate governance framework in Spain

As a supplement to the Commission Recommendation, discussed in the preceding section, we believe it appropriate to engage in an overall reflection and set out a number of additional considerations – further specified below – so as to support more effective application of the Recommendation and highlight some of the special features of the Good Corporate Governance Code of Listed Companies adopted by the Board of the Comisión Nacional del Mercado de Valores [Spain's securities market regulator, CNMV] on 18 February 2015.

When a company and its board takes a decision that may attract application of the Code, they ought to consider ***ex ante*** whether or not that decision is consistent with Code recommendations and, as appropriate, assess its effects and be in a position to provide appropriate explanations in line with the guidance in this Guide.

In relation to the recommendation set out in Section III, paragraph 8 of the Commission Recommendation, companies should:

a) Describe the reasons and specific circumstances that, in the directors' view, justify departure from a recommendation, explaining the extent to which such departure achieves the objectives that flow from the respective principle[5] of the Code underlying that specific recommendation.

   Moreover, reasons should be given for the claim that the departure is consistent with the company's interests and with the spirit of the Code, supporting the performance, survival and sustainability of the business over the long term and leading to improved and more effective governance.

   The explanations should also be sufficiently specific, disclosing particular features of the company's affairs and showing the reasons why, in these circumstances, the company has decided not to follow the recommendation.

b) Express mention should be made, where appropriate, of the specific procedure followed by the company to take the decision to depart from the recommendation (company body making the proposal, company body making the final decision, involvement of external advisers or experts, etc).

[5] The 25 principles that the Good Governance Code of Listed Companies sets out in section II, which provide the underpinnings of the 64 specific recommendations in section III.

ANNEX

Examples of explanations which are inconsistent with the European Commission Recommendation

It bears repeating that in some cases departure from a Code recommendation may in fact lead to more effective governance of the company. In such cases, a clear and comprehensive explanation must be supplied. This can be achieved only by having regard to the spirit of the Commission Recommendation of 9 April 2014 and by providing the information recommended in Section III of the Recommendation and in section 3 of this Guide.

In some cases, however, the information given by listed companies in their corporate governance statements to explain departures from recommendations is not clear or specific enough for the market to evaluate it appropriately.

The examples supplied below display some of the shortcomings most often identified in practice. They show case explanations that are not specific enough and do not reflect the particular circumstances of the company. These defective explanations, in line with a generally accepted classification, can be characterised as:

- Redundant: the statement merely points out that the recommendation has been departed from, wholly or in part.

- Overly broad: the statement evinces broad disagreement with the recommendation, but does not set out the specific reasons for non-compliance in the light of the specific context of the company.

- Alternative: the statement does not disclose the specific reasons why the company departs from the recommendation, but includes some additional information about various alternative criteria which the company has decided to follow.

- Transitional: the company expresses a commitment to take the necessary steps to comply with the recommendation in future, but does not disclose the specific reasons, in the light of the actual circumstances of the company, why the recommendation has not been followed so far, nor does it specify a date as from which compliance will take place. We recommend that companies should first explain the specific circumstances justifying departure at the present time and, secondly, clearly indicate the time at which it is believed that a change in such circumstances will allow for full compliance.

The fact that a company departs from a specific recommendation of the Code because it has decided to follow procedures, measures or criteria other than those proposed in the recommendation might be entirely acceptable, but in this case specific explanations should be provided of that course of action, in a full and clear statement.

The following examples, based on real extracts from corporate governance statements filed by listed companies, are provided by way of illustration only and do not exhaust the range of explanations that might be inconsistent with the guidance in this Guide for an explanation to be regarded as adequate and complete. Hence these examples are a mere sample of the forms of explanation most often found in practice that fall short of providing sufficient and specific information on departures from a recommendation.

Recommendation

The board of directors should have an optimal size to promote its efficient functioning and maximise participation. The recommended range is accordingly between five and fifteen members.

Example 1

There are three legal-person directors, represented by natural persons, and one independent expert.

Example 2

The board comprises 3 independent directors, a non-executive proprietary director who is also the chairman, and a non-director secretary.

Recommendation

Proprietary and independent directors should constitute an ample majority on the board of directors, while the number of executive directors should be the minimum practical bearing in mind the complexity of the corporate group and the ownership interests they control.

Example 1

The board of the company comprises: Four executive directors. One independent director. One proprietary director. Three other non-executive directors.

Example 2

The board of the company comprises 3 executive directors, 1 proprietary director and 1 independent director.

Recommendation

The percentage of proprietary directors out of all non-executive directors should be no greater than the proportion between the ownership stake of the shareholders they represent and the remainder of the company's capital.

This criterion can be relaxed:

a) In large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings.

b) In companies with a plurality of shareholders represented on the board but not otherwise related.

Example 1

At present the company has two independent directors, accounting for two-sevenths of the total board membership.

Example 2

Proprietary directors account for 55.55% of the board.

Example 3

The proportion referred to under this heading as to non-executive directors is not complied with.

Example 4

The board of 14 members comprises 1 executive director, 2 independent directors and 11 proprietary directors appointed by the controlling shareholder, who holds a stake of 69.832%.

Example 5

The company believes that it is unnecessary to comply with this recommendation because its purpose is achieved by virtue of the legal duties and obligations to which directors are subject, such as diligent management, loyalty and the protection of the interests of the company and of all its shareholders above any other circumstance.

Recommendation

Independent directors should be at least half of all board members.

However, when the company does not have a large market capitalisation, or when a large cap company has shareholders individually or concertedly controlling over 30 percent of capital, independent directors should occupy, at least, a third of board places.

Example 1

Independent directors account for 25% of the total.

Example 2

Independent directors account for 14.28 % of the total.

Example 3

Excluding the other non-executive director, independent directors account for 28.858% of the total.

Example 4

Without prejudice to the proportionality that may exist on the board as to proprietary directors, it is believed that the presence of more independent directors is unnecessary.

Example 5

The Board has three independent directors out of a total of 14 directors, but there is a plurality of external proprietary directors on the Board who represent the majority of the share capital which belongs to shareholders with no relation to one another. This plurality of proprietary directors allows them to act with complete independence from other directors, with the objective of defending the company's interests. As correctly stated in the Code, this encourages a culture of mutual oversight that benefits all shareholders (free float).

Example 6

The development of the board has meant that the percentage of independent directors is now somewhat lower than recommended (25% versus 33.33%). However, the board and the nomination and remuneration committee are working to ensure that upcoming director replacements are covered by independent directors.

Example 7

It is planned that one or more non-executive directors will become independents.

Recommendation

The nomination committee should ensure that non-executive directors have sufficient time available to discharge their responsibilities effectively.

The board of directors regulations should lay down the maximum number of company boards on which directors can serve.

Example 1

The company does not lay down rules about the number of directorships their board members can hold.

Recommendation

Companies should disclose the following director particulars on their websites and keep them regularly updated:

a) Background and professional experience.

b) Directorships held in other companies, listed or otherwise, and other paid activities they engage in, of whatever nature.

c) Statement of the director class to which they belong, in the case of proprietary directors indicating the shareholder they represent or have links with.

d) Dates of their first appointment as a board member and subsequent re-elections.

e) Shares held in the company, and any options on the same.

Example 1

In our view the references made in the corporate governance statement (available at all times on the company website) already adequately keep updated the necessary information on directors in line with the disclosure requested in this recommendation.

Recommendation

The board of directors should not propose the removal of independent directors before the expiry of their tenure as mandated by the bylaws, except where they find just cause, based on a proposal from the nomination committee. In particular, just cause will be presumed when directors take up new posts or responsibilities that prevent them allocating sufficient time to the work of a board member, or are in breach of their fiduciary duties or come under one of the disqualifying grounds for classification as independent enumerated in the applicable legislation.

The removal of independent directors may also be proposed when a takeover bid, merger or similar corporate transaction alters the company's capital structure, provided the changes in board membership ensue from the proportionality criterion set out in recommendation 16.

Example 1

It was not thought appropriate to follow this recommendation in the bylaws or in the rules and regulations of the board, on the view that the status of an independent director is equivalent to that of the rest of directors, insofar as any director must resign in the event of breach of the duties that bind all directors regardless of their class (proprietary, executive or independent).

Recommendation

The percentage of proprietary directors out of all non-executive directors should be no greater than the proportion between the ownership stake of the shareholders they represent and the remainder of the company's capital.

This criterion can be relaxed:

a) In large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings.

b) In companies with a plurality of shareholders represented on the board but not otherwise related.

Example 1

The company believes that it is unnecessary to comply with this recommendation because its purpose is achieved by virtue of the legal duties and obligations to which directors are subject, such as diligent management, loyalty and the protection of the interests of the company and of all its shareholders above any other circumstance.

Recommendation

Listed companies should have a unit in charge of the internal audit function, under the supervision of the audit committee, to monitor the effectiveness of reporting and control systems. This unit should report functionally to the board's non-executive chairman or the chairman of the audit committee.

Example 1

The internal audit function is still at the implementation phase.

Examples of degree of compliance with recommendations

If a company does not fully comply with a Code recommendation, then in its annual corporate governance statement it must indicate the degree of its compliance.

Of the 64 recommendations currently contained in the Code, 19 of them allow for four options as to the degree of compliance: *"compliant", "partially compliant", "explain", "not applicable".*

35 of the recommendations do not allow for the "not applicable" response, because these are not practices that require that a given circumstance be present; finally, 10 recommendations only allow for the "compliant" or "explain" responses. These latter recommendations only cover a single good governance practice, so they may be either followed or not, but partial compliance is not possible.

Where a recommendation covers several good governance practices, compliance with one or more of them – but not all – implies partial compliance.

To aid a proper understanding of the four possible response options referred to above, we provide some examples of recommendations that allow for all the response options:

Recommendation 34

When a lead independent director has been appointed, the bylaws or board of directors regulations should grant him or her the following powers over and above those conferred by law: chair the board of directors in the absence of the chairman or vice chairmen; give voice to the concerns of non-executive directors; maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company's corporate governance; and coordinate the chairman's succession plan.

Compliant: The chairman of the board performs management duties. The bylaws entrust the lead independent director with the following functions: chair the board of directors in the absence of the chairman or vice chairmen; give voice to the concerns of non-executive directors; maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company's corporate governance; and coordinate the chairman's succession plan.

Partially compliant: The chairman of the board performs management duties. The bylaws entrust the lead independent director with the following functions: chair the board of directors in the absence of the chairman or vice chairmen; give voice to the concerns of non-executive directors; maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company's corporate governance.

The bylaws do not entrust the lead independent director with the function of coordinating the chairman's succession plan.

Explain: The chairman of the board performs management duties. The bylaws do not entrust the lead independent director with any of the following functions: chair the board of directors in the absence of the chairman or vice chairmen; give voice to the concerns of non-executive directors; maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company's corporate governance; and coordinate the chairman's succession plan.

Not applicable: The chairman of the board does not perform management duties.

Recommendation 37

When an executive committee exists, its membership mix by director classshould resemble that of the board. The secretary of the board should also actas secretary to the executive committee.

Compliant: The company has created an executive committee. Its membership mix by director class resembles that of the board. The secretary of the board also acts as secretary to the executive committee.

Partially compliant: The company has created an executive committee. Its membership mix by director class resembles that of the board, but the secretary of the board does not also act as secretary to the executive committee.

Explain: The company has created an executive committee. Its membership mix by director class does not resemble that of the board, and the secretary of the board does not also act as secretary to the executive committee.

Not applicable: The company has not created an executive committee.

Recommendation 41

The head of the unit handling the internal audit function should present an annual work programme to the audit committee, inform it directly of any incidents arising during its implementation and submit an activities report at the end of each year.

Compliant: There is in place a unit handling the internal audit function, and its head officer presents an annual work programme to the audit committee, informs it directly of any incidents arising during its implementation and submits an activities report at the end of each year.

Partially compliant: There is in place a unit handling the internal audit function, and its head officer presents an annual work programme to the audit committee, and informs it directly of any incidents arising during its implementation. However, he or she does not submit an activities report at the end of each year.

Explain: There is in place a unit handling the internal audit function; its head officer does not present an annual work programme to the audit committee, does not inform it directly of any incidents arising during its implementation and does not submit an activities report at the end of each year.

Not applicable: There is no unit in existence handling the internal audit function.

Recommendation 44

The audit committee should be informed of any fundamental changes or corporate transactions the company is planning, so the committee can analyse the operation and report to the board beforehand on its economic conditions and accounting impact and, when applicable, the exchange ratio proposed.

Compliant: The company has carried out or is planning fundamental changes or corporate transactions, the audit committee has been informed so that it can analyse the operation and report to the board beforehand on its economic conditions and accounting impact and, when applicable, the exchange ratio proposed.

Partially compliant: The company has carried out or is planning fundamental changes or corporate transactions and the audit committee has been informed, but it does not analyse the operation nor report to the board beforehand on its economic conditions and accounting impact and, in particular, when applicable, the exchange ratio proposed - the report is produced *ex post*.

Explain: The company has carried out or is planning fundamental changes or corporate transactions but the audit committee has not been informed.

Not applicable: The company has not carried out nor is it planning fundamental changes or corporate transactions. In these cases, this is the response option to be selected, even where the bylaws or the rules and regulations of the board expressly provide that the audit committee must be informed about such transactions for analysis and prior reporting to the board when such transactions are intended to take place.

Recommendation 59

A major part of variable remuneration components should be deferred for a long enough period to ensure that predetermined performance criteria have effectively been met.

Compliant: The remuneration schemes envisage variable remuneration, and a major part of variable remuneration is deferred for a long enough period to ensure that predetermined performance criteria have effectively been met.

Partially compliant: The remuneration schemes envisage variable remuneration, and a part of variable remuneration, but not a major part or a negligible part, is deferred for a long enough period to ensure that predetermined performance criteria have effectively been met.

Explain: Remuneration schemes envisage variable remuneration, but payment is not deferred, or the amount deferred is clearly negligible.

Not applicable: The remuneration schemes do not envisage variable remuneration.