



nestoradvisors

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“Comply or Explain”

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UK Regulation of Corporate Governance

- Financial Reporting Council (FRC) sets CG standards and monitors overall compliance
 - Develops best practice by agreement with market
 - Encourages implementation of good practice
 - Encourages company-investor dialogue
 - Educates market about benefits of CG
- Financial Services Authority (FSA) requires disclosure of corporate governance in its listing rules
 - On a “comply-or-explain” basis

Enforcement by Investors (1)

“Shareholders should judge effectiveness of governance because they share with the board the objective of creating wealth and achieving sustainable value”

Sir Bryan Nicholson, ex Chairman, FRC

Enforcement by Investors (2)

“The investor weighs up the balance between prudence and value-creation...comply-or-explain offers a better chance of striking the right balance”

Peter Montagnon, ABI

Comply-or-Explain in Practice (1)

“Comply-or-explain is fine in theory but has yet to prove conclusively that it will be increasingly effective in practice”

Sir Christopher Hogg, Chairman, FRC

- 34% FTSE 350 say they fully comply with Combined Code. In fact only 10% fully comply say Grant Thornton.

Comply-or-Explain in Practice (2)

Issues

- Box-ticking
- Default to compliance
- Boilerplate disclosures
- Investor commitment to dialogue
- Media attention
- Shareholder rights

Issues for Investors

- Commitment to engagement necessary
 - Consider disclosures on their merits
 - Avoid box-ticking
 - Use dialogue constructively
- Reward best companies
- Use legal rights where necessary
- Short v long-term pressures

Swot Analysis

Strengths:

- Flexibility
- Principles based
- Enforced by shareholders
- Supported by market

Weaknesses:

- Few sanctions
- Needs investor engagement
- Companies must be serious
- Difficult for small companies

Opportunities:

- Incremental improvements
- Model can be exported

Threats:

- Regulatory burden
- Major scandal
- Complacency
- Box-ticking

Current Issues

- Is comply-or-explain working effectively
 - Box-ticking
 - Time required to explain
 - Time required to evaluate explanations

Views of Chairmen

FTSE 100

- Comply-or-explain is reasonable provided Code's principles taken seriously
- Investors usually support explanations, but
- Investors not committed to dialogue
- Anxious about shareholder activism and short-termism

FTSE 250

- Concern about pressure to comply
- Lack of investor experience in corporate governance functions
- Concern about box-ticking
- Identity of investors – hedge funds and stock lending