"Across the Board"

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COMMENT

¶121 Comply or explain — will it work?

Alan Cameron is the chairman of Cameron Ralph Pty Ltd, a privately held business aimed at assisting boards to improve their performance. He was formerly the chairman of ASIC.

The new Australian Stock Exchange (ASX) Principles of Good Corporate Governance and Best Practice Recommendations released at the end of March continue the "comply or explain" model of their predecessor in the Listing Rules. This was also the approach originally adopted by the Cadbury Committee in England in the early 1990s. It has the undoubted attraction of appearing to allow companies to adopt practices which match their own needs, rather than having to follow a structural model which may not be appropriate to their circumstances.

However the model is now under attack from both ends of the spectrum. In Australia, the Labor Party wants more prescription. In the United Kingdom, where an even more specific set of guidelines is looming as a result of the Higgs Report, there is strong opposition, from the chairmen of listed companies in particular, because the rules are seen as likely to become prescriptive. Higgs himself has said that his proposed reforms were meant to avoid pushing companies into "mindless compliance" and that if shareholders take an over zealous or pedantic approach "comply or explain" could become comply or breach and result in a "creeping regulatory capitalism".

What are the prospects for "mindless compliance" here? Quite good, if the experience of one, small listed company is any guide. That company discovered a year or so ago that it was off the list of permitted investments for various funds because it had been reported as not complying with a guideline requiring companies to have nomination committees — that requirement was, of course, to have one or say why not. It said that it did not have one because the remuneration committee performed the role. Not good enough (or not noticed?) by the box tickers — failed. Off the investment list. Next year they re-named the committee as the remuneration and nomination committee — pass with honours.

Comply or explain worked reasonably well (subject to that kind of mindless reaction) when all that was required was a statement of what a company did or did not do in a particular area, such as whether or not the company had an audit committee. It will not work so well when the so-called best practice recommendations are far more detailed and explanations for non-compliance will be common. The result may well be that the new guidelines will be a fizzer, or counterproductive.

The approach only works to "penalise" bad or unreasonable corporate governance behaviour if the non-compliance is visible. If the bulk of Australia's 1,500 listed entities have some element of non-compliance, as is quite likely, then the non-compliance we should be worried about will be much harder to spot. If 26 of the ASX top 200 have executive chairmen and 20 do not even have a majority of non-executives on their boards (without looking at the independence of the non-executives), how much more non-compliance will there be below the top 200?

Nor will there be a great incentive to change arrangements to avoid having to give an explanation, if the majority of companies are having to do so, especially if that group includes respected market leaders. Further, a company which cannot comply in one respect

may see no reason to bother to comply in other respects, which are awkward but not impossible, if that unavoidable non-compliance means that they will be marked down as having "failed" in any event.

I do not wish this outcome to occur. Like the ASX, I would not welcome prescriptive legislation in Australia like the Sarbanes Oxley Act in the United States. It may be that I am wrong in predicting that large numbers of companies will find it difficult to comply. However the awkwardness of this result could be avoided if highly specific rules, for example on the composition of boards or audit committees, were replaced by statements of principle, such as every board should have sufficient independent directors to enable it to discharge its monitoring roles.

Perhaps what this analysis indicates is some difficulty with the concept of reporting against "best practice", when claimed best practice has jumped somewhat ahead of where the majority of companies have any desire to go, or any real chance of being. It is the credibility of the recommendations themselves as "best practice" that will be in jeopardy if too few companies are willing or able to comply with them.

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