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Subject: **Comment on the Review of the Effectiveness of the Combined Code**

Dear Mr. Hodge,

We have taken notice of your invitation as published in March 2009 to comment on the effectiveness of the Combined Code and fully approve your efforts to test the Code's content and application against the fresh thinking that the financial crisis must provoke. Although we have no experience with the application of the Combined Code as such, we hereby take the liberty of responding to your invitation from a Dutch perspective. In the Netherlands we have a comparable corporate governance code with a 'comply or explain' mechanism since 2004. We would like to share our experiences with the application of the Dutch code against the background of the current financial crisis to contribute to your discussion in the United Kingdom.

The comments below focus on the 'comply or explain' mechanism of the Combined Code (more specific par. 13 to 15 of your invitation to comment) since undersigned conducts PhD research to the application of the 'comply or explain' mechanism in the European Union as supervised by Professor Auke de Bos at the Erasmus University Rotterdam in the Netherlands.

In this comment we want to share our view - as coloured by our Dutch experiences - on the 'comply or explain' approach to contribute to the discussion on its effectiveness and the current concerns. We start below with stressing the significant advantages of and positive developments due to the 'comply or explain' mechanism. Thereafter, we consider its flaws and issues to improve. Information on the experiences with the 'comply or explain' mechanism in the Netherlands is provided for below. But above all, at the end of this comment we emphasize - based on the experiences with its applications in the Netherlands and our own research - several key issues that should receive attention to keep the 'comply or explain' mechanism effective in the current and future timeframe.

#### **Advantages and disadvantages of the 'comply or explain' mechanism**

As almost all EU countries, in the Netherlands we opted for self-regulation with respect to corporate governance. The Dutch Corporate Governance Committee phrases its preference for self-regulation as follows: *"The particular merit of the Code as an instrument of self-regulation lies above all in its influence on the behaviour of management board members, supervisory*

*board members and shareholders. The strength of the Code is proportionate to the extent to which the company's stakeholders endorse it and try to comply with it"* (Preamble 5 of the Dutch Code). We believe that the 'comply or explain' mechanism has some major advantages above compliance reached by hard regulation (as likewise stated in par. 13 of your invitation to comment):

- Codes and the 'comply or explain' mechanism are effective in stimulating discussion about corporate governance issues. They educate the general public and investors about corporate governance practices. Furthermore, they prepare the grounds for changes in company law and securities law where such changes are deemed necessary;
- 'Reputational' and market forces can result in a high level of compliance; the capital market will monitor the compliance and will penalise non-compliance through lowering share prices or accept that non-compliance is justified in the specific circumstances. Improvements in enforcement of and compliance with corporate governance regulation are more often the result of bottom-up approaches (e.g. corporate governance codes), rather than top down efforts (e.g. SOX).<sup>1</sup> Companies do not want lengthy explanations in their annual accounts and therefore they comply except for those few points on which they have strong justification for deviation;
- A major advantage is that the 'comply or explain' mechanism has made corporate governance practices much more transparent: due to the mandatory disclosures by the 'comply or explain' mechanism, the transparency regarding corporate behaviour of the company and its directors has improved significantly.

The above advantages and achievements by the 'comply or explain' mechanism give raise to the belief in its effective functioning.

However, in the current crisis the 'comply or explain' mechanism is being tested to a greater extent than ever before (par. 5 of your invitation to comment). To remain its effective functioning the flaws and the concerns raised on the 'comply or explain' approach (par. 15 of your invitation to comment) should be acknowledged and challenged in the current and future timeframe:

- By all means the 'comply or explain' mechanism improves the formal compliance with corporate governance codes. In their corporate governance chapter/paragraph/charter companies state that they comply with the provisions of the applicable code, but difficult is to verify whether they actually do comply with these provisions in practice. Material compliance with the code is hard to measure and monitor; a problem which is inherent to the chosen model. Nevertheless, constant attention for and supervision on actual material compliance is a necessity to minimize this problem;
- A new development is that in addition to the shareholders, others (such as auditors and securities authorities) obtain a supervisory role regarding the 'comply or explain' mechanism as well. Although the shareholders only can examine compliance with the code ex post, it is argued that this role should be reserved for the shareholders, since they are the ones investing their capital in the company. A growth in supervisors is understandable due

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<sup>1</sup> As studied by Berglöf and Claessen (E. Berglöf and S. Cleassen (2004), Enforcement and Corporate Governance, World Bank Policy Research Working Paper No. 3409) and Coombes and Wong (P. Coombes and S. C. Y. Wong (2004), Why codes of governance work. Corporate governance codes are definitely effective – within limits, The McKinsey Quarterly No. 2 2004: pp. 48-53).

to the lack of supervision on the ‘comply or explain’ mechanism by the shareholders itself. Therefore, awareness of their supervisory role, task and possibilities ought to be created and emphasized, especially in the current circumstances;

- The success of the codes also gives rise to the danger of ‘regulation creep’. New versions of the already existing codes are much lengthier and add more detail. As a result of this, compliance ‘made to measure’ becomes increasingly difficult. The authors of new versions should closely consider the application of the comply or explain principle in practice and from there on decide which additions, modifications or deletions in the new code are necessary to keep the code efficient and feasible to comply with;
- Overemphasis on compliance rather than explanation is a current worry. There is a tendency to ‘comply or breach’; good corporate governance within a company is judged by ticking off boxes instead of a deeper analysis of deviations ‘made to measure’. This threatens the flexibility of the codes, which is one of their fundamental virtues, and can even lead to a ‘one size fits all’ mentality. Companies and board members should be challenged to analyze their actual compliance with the code properly and if necessary give ‘made to measure’ explanations. This responsibility ought to be emphasized<sup>2</sup> in codes and considered as a part of the policy or exercised supervision that directors annually want to be discharged from by their shareholders.

### **Experiences from the Netherlands**

Apart from the key advantages and flaws that need our attention above, several recommendations can be derived from the application of the ‘comply or explain’ mechanism in practice as well. In the Netherlands the Dutch Corporate Governance Code (as effective since 1 January 2004 and recently modified in 2008) incorporates the ‘comply or explain’ mechanism in best practice provision I.1. Additionally the code itself and the ‘comply or explain’ mechanism have gained legal force by special legislation since 1 October 2004 (sec. 391 par. 4 of Book 2 of the Dutch Civil Code and sec. 3 of Staatsblad 747, 2004). The Dutch Monitoring Committee Corporate Governance monitors each year the operation of the Dutch Corporate Governance Code and its implementation. From its monitoring reports can be concluded that there seems to be a general willingness to comply as much as possible with the corporate governance code and companies only deviate/explain when necessary (an average of 5 explanations per company). Certain trends are visible with regard to those parts of the code that are not always complied with. A number of provisions figure constantly in the top 5 deviations, accompanied by a specific set of explanations. The last 4 or 5% of the code seem hard to comply with. Either the provisions are too detailed or other factors are at play. Possibly, these provisions need adjustments or should be transferred to company law or securities law. The committee also drew attention to the rather vague explanations such as the phrase ‘the company has its own regulations’. Although more research is required, the increased standardization of the explanations by deviations with code provisions is not a desirable development.

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<sup>2</sup> Such as in the recently modified Dutch Corporate Governance Code in Principle I: “*The management board and the supervisory board are responsible for the corporate governance structure of the company and for compliance with this code. They are accountable for this to the general meeting and should provide sound reasons for any non-application of the provisions*”.

### **Recommendations**

We believe that the 'comply or explain' mechanism is the most suitable approach for disclosure on corporate governance by listed companies. Nevertheless, we recommend based on the above that the following key issues should receive attention to keep the 'comply or explain' mechanism effective in the current and future timeframe:

- The quality and clarity of explanations due to the 'comply or explain' mechanism need attention to prevent overemphasis on compliance rather than on proper explanation of the code provisions;
- Awareness for, supervision on and prevention of formal compliance whilst no material compliance exists is necessary;
- The authors of new (versions of) corporate governance codes should be aware of overregulation and too many details which make compliance 'made to measure' difficult. Provisions hard to comply with should if necessary be transferred to legislation or gain extra attention from both supervisors as companies and directors the code is applicable to;
- Especially in the harsh economic conditions under which companies are operating currently, the transparency and disclosure on corporate governance practices by the 'comply or explain' mechanism should be closely monitored and promoted to enhance its effectiveness. The mechanism's key strengths - transparent, flexible, 'made to measure', current and to monitor compliance - should equally be embraced and guarded.

To conclude, we hope you will find the above to be a relevant contribution to your efforts and would be happy to provide you with any additional information you may request.

Yours sincerely,

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Assistant Professor Annika Galle