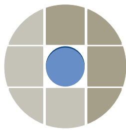
CORPORATE GOVERNANCE CODES AS A TOOL FOR DIALOGUE BETWEEN ISSUERS AND INVESTORS: EXPERIENCE FROM TURKEY AND CROATIA

"The effectiveness of each code's implementation largely depends on how actively the market is monitoring company practices and on the value companies themselves attach to greater transparency and better disclosure."



Corporate governance codes across Europe and, increasingly, the world are implemented mainly according to the principle of "comply or explain".

This approach, first conceived in the United Kingdom in 1992[1] and institutionalised in the European Union (EU) with the adoption of the Accounting Directive,[2] allows listed companies to deviate from the code's recommendations, provided they clearly and publicly disclose the reasons for doing so.

Transparency and external accountability are at the heart of this principle as they encourage companies to reflect on their corporate governance practices and engage in discussions internally and externally with relevant stakeholders about the need for improvement.

While on paper the approach to how companies should implement corporate governance codes seems relatively unified across countries, the actual practice varies greatly. The effectiveness of each code's implementation largely depends on how actively the market is monitoring company practices and on the value companies themselves attach to greater transparency and better disclosure. In other words, pressure, culture and recognition of good corporate governance are crucial for the success of a corporate governance code.

In its determination to raise the quality of listed companies' corporate governance statements and explanations of departures from corporate governance codes, the European Commission (EC)

1

2

3

1
GIAN PIERO CIGNA
ACTING CHIEF COUNSEL, EBRD
CignaG@ebrd.com

2
PAVLE DJURIC
PRINCIPAL COUNSEL, EBRD
DjuricP@ebrd.com

3
MARKUS RENFERT
SENIOR COUNSEL, EBRD
RenferM@ebrd.com

in 2014 issued a Recommendation on the Quality of Corporate Governance Reporting ("comply or explain").

The Recommendation focuses on the quality of information provided in corporate governance statements and elaborates on the elements of an explanation that should be clearly provided for all recommendations of the code that a company has departed from.

Also, because the "comply or explain" approach is essentially a dialogue between companies and the market, it is important to provide feedback on the basis of companies' reporting, which, in turn, requires active monitoring of how a code is applied. The EC Recommendation also supports this by stressing that "efficient monitoring needs to be carried out at a national level, within the framework of the existing monitoring arrangements".

This monitoring role is increasingly undertaken by capital markets regulators (for example, the United Kingdom's Financial Reporting Council, Autorité des Marchés Financiers in France and Comisión Nacional del Mercado de Valores in Spain), which sometimes act as creators or owners of the code. We examine two recent examples from the EBRD's corporate governance work, where projects led by the Legal Transition Programme helped capital markets regulators put in place better monitoring frameworks and introduce new rules for corporate governance codes.

"The EBRD is also promoting good corporate governance when it invests directly in a company. Whether it invests in a listed company or in a private company, the EBRD attaches high value to corporate governance."

MAINTAINING PRESSURE: THE NEW MONITORING FRAMEWORK IN TURKEY

In Turkey, the "comply or explain" approach was introduced in June 2003, when the Capital Markets Board of Turkey (CMB) adopted the Corporate Governance Principles, a set of voluntary recommendations to companies listed on the Istanbul Stock Exchange (ISE). However, the Principles were not effectively implemented and disclosure by listed companies was limited to general descriptions of corporate practices, without specific references to compliance with the Principles or reasons for non-compliance. This approach was revised in 2011, when the CMB identified a number of provisions from the Principles and required companies listed on the ISE to mandatorily comply with them, leaving the remainder of the rules subject to the "comply or explain" mechanism.

In an effort to further improve transparency in Turkey's capital markets, the CMB teamed up with the EBRD to strengthen the implementation of the mandatory Principles and to introduce a more proactive monitoring process with regards to how non-mandatory Principles are applied.

To this end, the Bank helped the CMB to develop a new reporting framework for listed companies: instead of the previous reporting format, which examined compliance with only about 40 per cent of the Principles, the new reporting format covers all Principles and additional information on corporate governance practices that may be significant for the CMB's oversight function. Among the many areas that have been streamlined, there is a focus on the gender diversity of boards, which is part of the EBRD's strategy for the promotion of gender equality.

The framework consists of two reports: the Compliance Report Format (CRF), in which companies report on their compliance status with all non-mandatory Corporate Governance Principles; and the Corporate Governance Information Filings (CGIF), which is used to collect information on current governance practices. The new reporting templates were presented to issuers listed on the ISE in February 2019, along with a manual on how to comply and report compliance with the Principles.

In parallel with the new reports, the Bank is helping the CMB to develop the monitoring framework that will support the CMB's ambitions to start issuing annual monitoring reports. To achieve that, a monitoring manual has been prepared for the CMB, which includes advice on how to:

- review disclosures (including guidance on how to interpret responses from companies and identify red flags)
- transform disclosures into an annual CMB corporate governance monitoring report
- set out its structure and content.

The annual monitoring report shows exactly where the value of a well-developed reporting and monitoring framework lies. The regulator's expectations, coupled with appropriate guidance, can form a solid basis for maintaining pressure on companies to furnish the market with information that goes beyond a box-ticking exercise and provides real meaning and value to stakeholders. The role of the regulator should also make other players more proactive in engaging with companies, all of which should contribute to a more mature governance framework.

The EBRD is also promoting good corporate governance when it invests directly in a company. Whether it invests in a listed company or in a private company, the EBRD attaches high value to corporate governance. In the case of companies on the way to an initial public offering (IPO), corporate governance will be a prominent part of the pre-investment due diligence. Sometimes the EBRD will require a full audit by a reputable corporate governance consultant. In other cases, the audit is performed in-house by the EBRD corporate governance specialists within the Office of the General Counsel. The Corporate Governance Principles will serve as a benchmark when identifying corporate governance deficits of Turkish companies aiming for an IPO. Gaps identified will be part of a roadmap, which the relevant company will implement in the process of raising the IPO. In the case of companies already listed, the EBRD actively engages with the company, so as to maintain good alignment with the Corporate Governance Principles.

ENABLING A SHIFT IN CULTURE: THE NEW CORPORATE GOVERNANCE CODE IN CROATIA

When the collapse of Agrokor Group shook Croatia and some of its neighbouring countries in 2017, the issue of corporate governance quickly came to the fore. Stories of poor management and a lack of oversight within the Group quickly became public knowledge as news platforms reported on one of the biggest corporate scandals in central and eastern Europe.

Yet, even if predicting Agrokor's downfall was difficult, it is not hard to see that the Group did not take corporate governance very seriously. By checking disclosures of the Group's listed subsidiaries from a few years ago, one can easily notice numerous deviations from some of the most important provisions of the Croatian Corporate Governance Code, such as those regarding independent directors, board committees and internal controls. To make matters worse, not only was the Code not being followed, but also the explanations for non-compliance were, in many cases, non-existent or very superficial. However, that did not seem to have raised any flags when the businesses were doing well, so the companies kept repeating the same explanations year after year.

Sadly, many other companies listed on the Zagreb Stock Exchange (ZSE) seemed to follow a similar pattern and, in recent years, the levels of stated compliance with the Code have decreased, while the number of companies providing no or insufficient information to the market has increased.

The Legal Transition Team has been supporting HANFA (the Croatian capital markets regulator) and the ZSE in these revisions since early 2018. Through honest and constructive discussions, we have been able to carry out thorough diagnostic work and benchmark the Code against its latest and most advanced peer European codes. We also took note of the issues related to the old Code's implementation and corporate governance practices raised by both issuers and investors. All of this information was distilled into the final structure and content of the new Code. Once public consultation was completed, the

"The new Croatian Corporate Governance Code was officially adopted by the presidents of the HANFA and ZSE management boards on 15 October 2019."

initiative reached a major milestone on 15 October 2019, when the new Croatian Corporate Governance Code was officially adopted by the presidents of the HANFA and ZSE management boards.

The new Code reflects developments in Croatian and EU law that have occurred since the previous edition was published in 2010. It is also shorter than the previous version and contains many background explanations, the aim of these being to help companies understand the benefits and importance of certain good practices. Since companies will be required to disclose their compliance with the Code according to the "comply or explain" approach, the Code also provides guidance on how to structure explanations in cases of non-compliance.

There are many novelties in the new Code, but perhaps the most important ones are: the clear strategic role of the supervisory board (Section 1); the provision according to which companies should set targets for improving gender diversity across the board and in management structures (Section 3); much clearer expectations in the area of risk management (Section 7); specific references to rules of conduct and whistleblowing mechanisms (Sections 1 and 7); and a section entirely dedicated to "Stakeholders and Corporate Social Responsibility" (Section 10).

As part of the Code's implementation, which is due to start in 2020, companies will be required to disclose their compliance with the Code's provisions or explain why they have not complied.

Similar to the development of the reporting framework in Turkey, the launch of the Code is just the start of the process and not an end in itself. To ensure that information on compliance with the Code (and any issues companies face in that respect) can be processed and fed back to the market in annual monitoring reports by the authorities, we are now starting work on establishing an effective reporting and monitoring process for the Code's implementation. We are also preparing a set of training events for issuers and investors so that they fully understand the value that good corporate governance can bring. We will develop a standing curriculum on corporate governance courses that will be rolled out by the ZSE Training Academy.

These latest regulatory developments in Croatia and Turkey are certainly important, but perhaps more significant than the new Code and reports is the fact that, by taking a leading role in monitoring corporate governance practices, HANFA and CMB are looking to join the ranks of the most advanced European securities regulators in this area and thereby provide a real impetus for the development of local capital markets. This should be instrumental in raising companies' and investors' awareness of the need for good governance and appropriate transparency.

1. The first corporate governance code that included this approach was the Cadbury Code.
2. Directive 2006/46/EC required all companies listed in the EU to "*include a corporate governance statement in its annual report, which shall include (…) an explanation by the company as to which parts of the corporate governance code it departs from and the reasons for doing so*". Also, the revised version of the Accounting Directive (Directive 2013/34/EU) stays true to this approach.