4

Regulation by Law or the Code?

LYN BOXALL

The corporate scandals of the late 1990s and the global financial crisis of 2008 caused governments around the world to identify causes and undertake regulatory action to forestall a recurrence. Against this backdrop, it is interesting to take a look at the different ways the United States and the United Kingdom approach the task of regulating for better corporate governance.

THE UK CODE-BASED APPROACH

The UK first issued its Corporate Governance Code in 1992, following the publication of the *Cadbury Report*. The Code sets out governance principles and guidelines of "best boardroom practices"

for how they should be implemented. Corporations have the option of either complying with the Code or explaining why they have not done so.

Many countries, particularly Commonwealth countries, have adopted the UK's code-based "comply or explain" approach. Singapore did so when it introduced a Code of Corporate Governance in 2001, which became operational in 2003. It has been updated twice since, most recently in 2012.

Of course, these codes are intended to complement and supplement the mandatory and prescriptive provisions of key legislation, such as the Companies Act and the Securities and Futures Act of Singapore, and the listing rules. The codes represent a separate "pillar" of governance that captures best practices, which are higher than baseline standards.

THE US SOX ACT

In the US, the Sarbanes-Oxley Act of 2002 (SOX) was enacted in the aftermath of Enron and other corporate scandals of the late 1990s. It makes the internal control of a corporation a direct responsibility of the board. SOX is regarded to have resulted in considerable improvements in the standard of corporate reporting in the US.

Although SOX-related regulations use the "comply or explain" method in some isolated instances (for example, in relation to whether a company has a "code of ethics" or its audit committee has a "financial expert"), in most other instances, US regulation tends to rely on the legislation and penalties (fines and imprisonment).

It is important to note that the US does not have a single national or authoritative corporate governance code. There are historical and constitutional reasons for this, but without an overarching code, debate over governance in the US typically defaults to appeals for

legislative action and black-letter regulation.

For example, the US response to the global financial crisis has included further legislation, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

WHICH APPROACH?

SOX and the Dodd-Frank Act are examples of a "rules-based" approach to corporate governance in the US. On the other hand, the UK Code is seen as an example of a "principle-based" approach for "best practices" in corporate governance while baseline requirements are ensconced in statutes and listing rules.

One example of how the US and UK approaches differ is in the requirement for CEO/CFO certification of annual/quarterly reports and assurances on the effectiveness of internal controls. This is hard-wired into SOX in the US while it is a best practice item in the UK Code (as is in Singapore).

WHICH APPROACH IS BETTER?

Well, neither of the US and UK approaches to corporate governance prevented the global financial crisis in 2008. Perhaps the fault lies with their implementation. Both approaches require, for example, good governance practices in relation to risk management and accountability to stakeholders – failures in these practices go to the heart of the cause of the global financial crisis.

Regulation by legislation makes compliance mandatory. In that sense, it is effective, and corporations face a level playing field. It may well be the better approach from a liability perspective in a highly litigious environment like the US.

However, the prescriptive approach allows no leeway and less

flexibility in accommodating rapid developments in the modern market-place. In response, new rules and regulations have to be developed and implemented all the time. This means a continual assessment of the adequacy of the rules and the effectiveness of their enforcement where the letter of the law is vital to the setting of standards.

Singapore has adopted the UK's more balanced approach. Core rules are legislated and best practices are embodied in the Code which allow companies to adopt such practices that are appropriate for their circumstances. Standards of practice are encouraged to improve over time in line with community expectations.

One could say that the Singapore approach to corporate governance has worked reasonably well. Singapore topped the recent corporate governance rankings of countries in Asia by the Asian Corporate Governance Association in its report, *CG Watch 2012*.

There is, however, still some way to go. The risk with a "comply or explain" approach is that companies see them as non-binding and fail to comply without giving adequate explanations. This requires the regulators to be vigilant in enforcing the "comply or explain" requirements, and for companies to observe the objectives and spirit of the Code. ■