



CONSULTATION PAPER NO. 68

1 MARCH 2010

**ENHANCED CORPORATE GOVERNANCE REGIME FOR REPORTING
ENTITIES**

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Why are we issuing this paper?

1. The DFSA proposes changes to the corporate governance framework applicable to Reporting Entities in the DIFC. This framework needs to recognise that such Reporting Entities may be incorporated outside the DIFC and be subject to the requirements in their home jurisdiction, in addition to the requirements operating here. The proposed changes are part of a wider review of the DFSA Offered Securities Rules ("OSR") currently in progress (which includes corporate governance rules). The framework for corporate governance, however, has been treated as a discrete subject in respect of which some clarificatory amendments are now proposed. In due course a consultation paper setting out additional changes to the OSR will be published. Although reform of the rules relating to the governance of entities is a current topic for debate due to recent events in the global economy, DFSA is not proposing, in the changes in this Consultation Paper, to set out bold new standards for conduct nor to pioneer extensive or prescriptive "black letter" obligations to address deficiencies identified in other markets. Such new standards or obligations, in the event they are enacted, will be reviewed in due course for relevance to the DIFC.
2. This Consultation Paper details proposed changes to the Markets Law 2004 and the Offered Securities Rules.

Who should read this paper?

3. The proposals in this paper would be of interest to:
 - (a) current and prospective Reporting Entities;
 - (b) advisors to Reporting Entities;
 - (c) Authorised Market Institutions operating Official Lists of Securities; and
 - (d) auditors of Reporting Entities.

How is this paper structured?

4. In this paper, we set out:
 - (a) the background to the proposals (paragraphs 10-14);
 - (b) overview of the proposed framework (paragraphs 15-20);
 - (c) explanation for adopting the "comply or explain" model (paragraphs 21-22);

- (d) legislative proposal (paragraphs 23-28); and
 - (e) the specific standards proposed on which comments are sought (paragraphs 29-34).
5. The legislative proposals are contained in the following Annexes:
- (a) Annex A – Markets Law
 - (b) Annex B – OSR new Chapter (mandatory key principles)
 - (c) Annex C – OSR new Appendix (minimum practice standards)

How to provide comments?

6. All comments should be forwarded to the person specified below. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

What happens next?

7. The deadline for providing comments on the proposals is **29 May 2010**. The longer consultation period of 90 days is to allow the DFSA, given current changes in the financial world, to consider developments in the corporate governance arena, and if appropriate, incorporate those into the DIFC corporate governance regime for Reporting Entities.
8. Once we receive your comments, we will consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook and to propose amendments to the Markets Law to the President of the DIFC for enactment. You should not act on these proposals until the relevant changes to the DFSA Rulebook and the Markets Law are made. We will issue a notice on our website telling you when this happens.

Comments to be addressed to:

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Terminology in this paper

9. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in GLO or in the proposed amendments. Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

Background

10. The corporate governance regime under the Markets Law 2004 (the “Law”) and the Offered Securities Rules (“OSR”) as currently drafted requires compliance with five principles prescribed in the Law and thirteen specific Rules in Appendix 4 of OSR (“App4”). App4 also contains detailed Guidance in support of the requirements. This mandatory compliance approach effectively establishes a ‘one size fits all’ corporate governance regime for Reporting Entities with alleviation only by way of waivers and modifications. While it could be argued that in a young jurisdiction, such prescription is justified to establish and foster a corporate governance culture, difficulties have arisen and will continue to arise, in implementing the model given the variety of companies that have, and could potentially, become Reporting Entities in the DIFC.
11. In addition, DFSA considers that it has captured the essence of appropriate corporate governance obligations in its proposed Principles and Standards, since these must also be read in context with the responsibilities and duties of Reporting Entities/directors contained in the OSR (also subject to review). The resulting ‘one size fits all’ regime might thus be too inflexible for Reporting Entities of various sizes and it also appears to be out of step with peer jurisdictions.
12. Additionally, there may be confusion about the extent to which currently the corporate governance requirements are mandatory. There are five separate, references in both the Law and OSR (which may cause some lack of clarity in respect of those requirements) to the following effect:

Provisions requiring or referring to mandatory application

- a. Article 20(1) of the Markets Law requires compliance with the principles in the Law and requirements in OSR Article 20(2) requires explanation of how Reporting Entities apply the principles and Rules in App4;¹
- b. mandatory compliance with the Rules in App4 is required pursuant to OSR 8.4.1;
- c. Guidance 3 of A4.1.1 refers to the requirement in (b) for an explanation of how Reporting Entities apply the principles and Rules in App4;

Provisions allowing for ‘Comply or explain’

- d. under OSR item 14 of A2.1.1 in respect of Shares (and under item 14 of A2.3.1 in respect of Listed Funds), Reporting Entities are required to

¹ See Annex A

make a disclosure in their annual report of how they have applied the principles (or comply with App4 in respect of Listed Funds) and where they have not, provide an explanation.

13. While there are varying views on what regulatory obligations fall within the scope of corporate governance², the regime which DFSA now proposes, as set out in this paper, is based on the way in which authority is exercised and controlled in Reporting Entities and how those in control are held to account³.
14. In respect of the prescription in App4, our recent analysis of the mandatory requirements found that some of them often would not normally come under the ambit of corporate governance (within the scope as set in the paragraph above) and therefore should be made mandatory elsewhere, if at all, in the OSR⁴. We also considered that there should be a clear and justifiable distinction between requirements which should be mandatory in order to meet corporate governance objectives and those that set out the recommended approach on how to meet those objectives.

Overview of the proposed framework

15. The proposed regime lays out a general mandatory framework to meet corporate governance objectives leaving the mechanism open to Reporting Entities on how to meet these objectives. The proposed regime is to prescribe by way of Rules key corporate governance principles (“Key Principles”). Compliance with these Key Principles would be made mandatory.
16. In accordance with the proposed tiered structure, the primary obligation to comply with corporate governance Key Principles under existing Article 20 of the Markets Law will be retained in the Markets Law.
17. The corporate governance principles currently prescribed under Article 21 of the Markets Law will instead be prescribed in the Rules with some relevant enhancements. Prescribing Key Principles by way of Rules instead of in the Markets Law, would give the DFSA greater flexibility in amending such Key Principles to respond to changes in the corporate governance regimes around the world. A clear and justifiable distinction will be maintained between mandatory requirements to meet corporate governance objectives and the recommended approach on how to meet those objectives.
18. For each Key Principle, the DFSA proposes to set out by way of Guidance a number of minimum best practice standards which a Reporting Entity could apply in order to ensure compliance with the Key Principles. Compliance with these standards would be based on a “comply or explain” model thus enabling a Reporting Entity either to apply the relevant practice standard or explain why it has departed from it and what other steps, if any, it has taken to ensure compliance with the Key Principles. This will minimise the difficulties that may arise in implementing the current corporate governance obligations, given the

² The scope of topics covered in various jurisdictions differs and may be covered under wider headings of ‘Risk Management’, ‘Duties of Directors’ and ‘Corporate Governance’.

³ For example, Connected Persons transaction approval requirements could come under the ambit of corporate governance in a wider sense. However this is currently, and will continue to be, captured under ongoing obligations of the Reporting Entity.

⁴ Such matters are not set out in this paper but will be the subject of a separate consultation paper in due course.

variety of companies that have or could potentially become Reporting Entities in the DIFC.

19. In line with the 'comply or explain' model of peer jurisdictions, Reporting Entities will have to make a statement in their annual report⁵ as to the extent they have adopted the best practice standards and where they have not, explain the reasons why.
20. The proposed structure can be summarised as follows:

Location:	Markets Law	Corporate Governance Chapter in OSR	Appendix to the Corporate Governance Chapter in OSR	Corporate Governance Chapter in OSR
Proposal:	Overriding obligation to comply with Corporate Governance objectives and requirements as prescribed in OSR.	Mandatory Corporate Governance Key Principles	Practice standards to achieve Key Principles	Requirement for Reporting Entities to make a statement in their annual report disclosing the extent to which they have followed the practices in the Appendix and where they have not, give an explanation why they were not followed.
Drafting Form:	Art.20 as amended	Rules drafted as Key Principles.	Principle-based practices	Rules
Compliance:	Mandatory	Mandatory	Comply or explain	Mandatory

Why "comply or explain"?

21. While corporate governance objectives in peer jurisdictions are often implemented by way of industry code rather than legislation, the 'comply or explain' model in respect of the recommended practice standards is an effective way of providing a framework which gives the necessary flexibility. Additionally, in a jurisdiction where corporate governance culture is still developing, making the key corporate governance principles mandatory is desirable having regard to the objective of enhancing the international reputation of the DIFC and the region.

⁵ This requirement will be prescribed by way of a Rule which will be consulted upon at a later stage.

22. The DFSA notes that some jurisdictions (for example the US) maintain a more prescriptive approach to the issues DFSA regards as corporate governance. Nevertheless, there are three primary reasons why the 'comply or explain' model in respect of practice standards is considered to be more appropriate for this region:
- (a) while it encourages companies to follow accepted best practice, it recognises that in certain circumstances it may be appropriate for them to achieve good governance by other means ;
 - (b) by allowing a degree of flexibility, the model in practice can set more demanding standards. It can also be more easily adapted to take account of developments in best practice; and
 - (c) it leaves decisions about the appropriateness of a company's governance arrangements in the hands of its board and owners which would be particularly useful in cases of foreign incorporated firms which are subject to different company laws and corresponding corporate governance codes.

Issues for consideration

Comments are sought on whether the combination of mandatory Key Principles and a "comply or explain" model of best practice standards on how to achieve the Key Principles of corporate governance is appropriate for the region?

Legislative proposals

Annex A - The Markets Law

23. Annex A contains proposed amendments to the Markets Law 2004. The primary obligation to comply with corporate governance principles under Article 20 will be retained while selected corporate governance principles under Article 21 will be prescribed in OSR with relevant amendments.

Annex B - OSR – Corporate Governance Chapter

24. Annex B contains new text for the OSR which currently has no equivalent. For the purposes of the Consultation Paper, the new text is styled as a Chapter 1 of the OSR but this is for convenience only as the text will ultimately be located elsewhere in the OSR. In this chapter, the DFSA proposes only six mandatory Key Principles. Three are retained from current Article 21 of the Markets Law, (these are 21(1), 21(3) and 21(4)) with relevant amendments, and the new principles are taken from the UK Combined Code with some minor amendments. These were considered appropriate considering the view that proposed corporate governance regime for Reporting Entities should only relate to the way in which authority is exercised and controlled in Reporting Entities and how those in control are held to account.

Issues for consideration

Are the proposed six principles sufficient, or are more mandatory principles necessary to regulate corporate governance applicable to Reporting Entities?

Annex C - OSR– Appendix to the Corporate Governance Chapter

25. Annex C contains a blend of existing and new text (underlined) that is styled as Appendix 1 of the OSR for convenience only. This text will ultimately replace App4 and may be located in other parts of the OSR.
26. Appendix 1 sets out the corporate governance best practice standards. They are based on the UK Combined Code in so far as they are relevant to the mandatory Key Principles. The purpose of the practice standards in the appendix is to guide Reporting Entities on the best way to meet their corporate governance obligations.

Issues for consideration

1. The DFSA welcomes feedback on whether basing the proposed practice standards on the UK Combined code is appropriate, bearing in mind that the proposed standards will operate within the 'comply or explain' framework.
2. Are there any other specific standards which should be included in the appendix?

OSR– Disclosure of compliance with Appendix 1 to Corporate Governance Chapter 1

27. In addition to mandatory compliance with the Key Principles, Reporting Entities will be required to make a statement in their annual report disclosing the extent to which they have followed the practice standards in Appendix 1 and where they have not, give an explanation as to why they were not followed or what alternative steps, if any, were taken.⁶
28. The DFSA imposes corporate governance obligations only on certain Reporting Entities (i.e. Reporting Entities that have issued certain equity securities and Listed Funds). Accordingly, the annual report of only these Reporting Entities will require the disclosure of compliance with the practice standards.

Issues for consideration

Is the annual report the most appropriate document in which the corporate governance 'comply or explain' statement should be made?

Specific best practice standards identified for comment

29. The DFSA seeks comments on the specific best practice standards listed below.

⁶ This requirement will be prescribed in a Rule which will be consulted upon at a later stage.

30. The DFSA proposes as practice standards:
- (a) that the roles of the chairman and chief executive should not be exercised by the same individual; and
 - (b) that a chief executive should not go on to be the chairman of the same Reporting Entity (see Guidance 32 and 33 Appendix 1).
31. These are measures to ensure a clear and appropriate division of responsibilities amongst senior management and the Governing Body. The DFSA is cognisant, however, that these standards may not be achievable by certain companies, which, by virtue of their business nature and size, have access to a limited directors pool.

Issues for consideration

1. The DFSA seeks views on whether these standards are appropriate.
2. Will the proposed standard that a chief executive should not go on to be the chairman of the same Reporting Entity be unduly burdensome and unnecessarily restrictive on companies from jurisdictions where it is not uncommon for the roles to be combined (e.g. US)?

32. Additionally, a standard has been included relating to the manner in which directors are remunerated. Specifically, it is proposed that the remuneration for non-executive directors should not include share options unless shareholder approval is sought in advance⁷ and any shares acquired by exercise of the options should be held until at least one year after the non-executive director leaves the Governing Body (see proposed Guidance 32 Appendix 1).
33. While this proposed standard is in line with the current requirement under OSR App3 (5) where the granting of share components to the Issuers' Directors or Employees' compensation schemes must be approved by majority vote of the shareholders, the DFSA recognises that this may not be in line with the practices in place in other jurisdictions (specifically, in the US).

Issues for consideration

1. The DFSA seeks views on whether this standard in respect of director's remuneration is appropriate.
2. Will this proposed standard be unduly burdensome on companies from jurisdictions where such a requirement is absent (e.g. US)?
3. Is the requirement to hold Shares acquired by exercise of an option for at least one year after the non-executive director leaves the Governing Body effective in practice? How can the Governing Body monitor such a standard?

⁷ This standard is in line with current OSR Rule A3.1.1 which requires majority consent of shareholders for the granting of Share components to Directors of the Reporting Entity.

34. We also propose that a number of sub-committees of the Governing Body are to be established to ensure there is appropriate discharge of the Governing Body's fiduciary responsibilities. While the underlying principle for the composition of the Nomination, Remuneration and Audit Committees is to ensure a minimum degree of independence, different standards have been set for each namely:
- (a) The Nomination Committee should comprise a majority of independent non-executive directors and should be chaired by an independent non-executive director (Guidance 16 Appendix 1).
 - (b) The Remuneration Committee should comprise at least three independent non-executive directors. The chairman of the Governing Body while eligible to be a member should not chair the committee (Guidance 25 Appendix 1).
 - (c) The Audit Committee should have at least two independent non-executive directors of whom at least one should have financial expertise. The chair of the Committee should be an independent non-executive director (Guidance 40 Appendix 1).

Issues for Consideration

1. Are the proposed standards for ensuring the level of independence for each of the sub-committees of the Governing Body appropriate?
2. Should the Chairman of the Board be restricted from also chairing the Nomination Committee?
3. Would the introduction of a standard which prescribes membership only by independent non-executive directors for all of the sub-committees be unduly burdensome on Reporting Entities?