NEWSLETTER MARCH 2011

Critique of the Nigerian Code of Corporate Governance

Content:

INTRODUCTION

The Nigerian Securities and Exchange Commission ("SEC Nigeria") recently published a Code of Corporate Governance for public companies including, those whose securities are listed on a recognized exchange in Nigeria, as well as companies seeking to raise funds from the Nigerian capital market. The main objective of the Code of Corporate Governance for Public Companies 2011 (the "Code" ", "2011 Code" or "Nigerian Code") is to promote good corporate governance practices in public companies in Nigeria and align the Code with international best practices.

This Newsletter examines the provisions of the Code, benchmarking same with similar practices in the United Kingdom (UK) and United States (US)', and outlines the principles laid down by the Basel Committee.[1]

CORPORATE GOVERNANCE REFORMS IN NIGERIA

In 2008, a national committee was inaugurated by SEC Nigeria to address the weaknesses posed by the 2003 Code of Best Practice on Corporate Governance ("the 2003 Code"), improve mechanisms for enforcement, and align the Code with international best practices. The report of the national committee resulted in the 2011 Code. The 2003 Code was applicable to both public quoted companies and all other companies with multiple stakeholders in Nigeria. Similarly, the 2011 Code applies to all public companies, including those whose securities are listed on a recognised exchange in Nigeria. Furthermore, it applies to companies seeking to raise funds from the capital market through issuance of securities or listing by introduction.

[1] The Basel Committee on Banking Supervision.

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From the foregoing, it would appear that the 2011 Code, like its predecessor,[2] applies to all listed companies in Nigeria, including banks. This interpretation, however, is not without complications, as banks are regulated by the Central Bank of Nigeria's (CBN) Code of Corporate Governance for Banks in Nigeria – Post Consolidation 2006 ("CBN Code"). The 2011 Code made no reference to the CBN Code. In fact, save for the provisions of section 1.3(g) of the 2011 Code, one may be tempted to assume that the CBN Code is no longer applicable. Providentially, section 1.3(g) of the 2011 Code states that in the event of a conflict between the Code and any other code to which a company is exposed, the code with stricter provisions will apply. Section 1.7 of the CBN Code makes it mandatory for banks to comply with its provisions. It would appear, therefore, that banks in Nigeria are required to adopt the provisions of the two codes, provided that they comply with the CBN Code where there is a conflict between the two.

Aside from the 2011 Code which is mostly voluntary,[3] other corporate governance provisions in Nigeria are mandatory. The mandatory corporate governance provisions for companies and banks in Nigeria are contained in the Companies and Allied Matters Act (CAMA) 2004,[4] the Banks and Other Financial Institutions Act 2004,[5] the Investment and Securities Act 2007,[6] as well the CBN Code.

Code of Corporate Governance for Banks in Nigeria

Some provisions of the CBN Code are quite distinct from the 2011 Code. It is therefore necessary to point out areas of distinction that may pose conflict.

Induction: Banks must institutionalize and budget for regular training and education of board members on issues concerning their oversight functions.[7]

Composition: There should be a maximum board size of 20 directors,[8] most of whom should be non-executive directors with at least two of the non-executive directors serving as independent directors.[9] Such non-executive directors are allowed to hold office continuously for a maximum of 12 years (i.e. 3 terms of 4 years each). The compensation for the non-executive directors is limited to sitting allowance, director's fee and reimbursement for travel and hotel expenses.

Effectiveness: Banks are mandated to engage external consultants to carry out annual

[2] The Code of Best Practices on Corporate Governance 2003.

[3] See section 1.3(a) of the Code, which gives states that the Code is only intended to serve as a guide for sound corporate governance practices and behavior.

[4] Cap C20 Laws of the Federation of Nigeria (LFN), 2004; Part XI, Section 342 which requires directors to sign the balance sheet for each financial year representing a fair view of the financial affairs of the company, and section 359(3) and (4).

[5] Cap B 3 LFN, 2004: section 28 which requires directors to prepare financial statements for each accounting year that give a true and fair view of the financial affairs of the bank.

[6] Part B

[7] The 2011 Code only makes it mandatory for directors to participate in periodic professional training to update their skills and knowledge.

[8] This is unlike the Code, which only requires that the membership of the Board should be no less than five.

[9] This provision is certainly more restrictive than the Code, which merely requires every public company to have a minimum of one independent director on its board.

performance appraisals of the board performance. The report of each appraisal should be presented to the AGM and a copy sent to the CBN.

Accountability: The CBN Code permits persons or entities related to members of the board to provide services to the bank upon full disclosure to the CBN. CEOs and Chief Financial Officers of banks must certify that the returns of their banks represent the true and fair view of the bank. Sanctions for false statement in the return include fines.[10] The CBN may also suspend or remove CEOs of such banks for false return. The officers may also face disciplinary actions from relevant professional bodies.

The CBN Code also requires approval by the Credit Committee of the board of all applications for credit applications by directors of banks. It also prohibits directors whose facilities have been non-performing for more than one year from sitting on the board of banks. Such directors may also be estopped from sitting on the board of any other bank in Nigeria.

The CBN Code gives the Chief Compliance Officer of each bank the responsibility of monitoring the bank's compliance with the code and making monthly reports of any breach, as well as report of whistle-blowing to the CBN.

CODE OF CORPORATE GOVERNANCE FOR PUBLIC COMPANIES

The provisions of the 2011 Code were highlighted in the February edition of our newsletter, which analyzed relevant provisions including the composition and independence of the board, committees of the board, disclosure requirements and relations with shareholders and stakeholders.

Critique of the Code

The main objective of the 2011 Code is to ensure highest standards of transparency, accountability and good corporate governance, without unduly inhibiting enterprise and innovation. This section examines the implications of some of the provisions of the Code.

Composition of the Board: The Code stipulates that the Board should be of a sufficient size relative to the scale and complexity of the company's operations and composed in such a way as to ensure diversity of experience without compromising independence, compatibility, integrity and availability of members to attend meetings. The minimum number of board membership was placed at five. This number is quite minimal even for small public companies and may have negative implications where companies decide to adopt the minimum requirement. Agreed, board sizes should not be so large as to be unwieldy. However, companies should be encouraged to maintain numbers that can withstand changes to the board and committee composition without undue disruptions.

Board Committees: The Code creates three committees as follows: Risk Management Committee, Audit Committee and Governance/Remuneration Committee. It failed to create a nomination committee to lead the process of new appointments and make recommendations to the larger board, as only a nomination committee can appropriately evaluate the balance of skills of the board before making recommendation to the larger board for appointments. Similarly, the Code combined the

[10] The 2011 Code failed to include any such sanction for false statements in a company's return.

Governance and Remuneration Committees into a Governance/Remuneration Committee. This committee should be split for effectiveness.

Definition of independent directors: The Code requires an independent director to be free of any relationship with the company or its management which may impair or appear to impair his ability to make independent judgments.[11] This definition seems quite strict and all encompassing, and discourages qualified professionals from serving on the board for fear of conflict even when they can effectively separate any interests they may have. Lawyers and Accountants for instance, who ordinarily would be qualified candidates for such positions, would not be able to serve. Even though section 5.5(a)(viii) of the Code makes room for partners or executives of the company's audit firm, internal audit, legal or other consulting firm, who has not acted in that capacity for 3 years prior to their appointment to act as non-executive directors, it still does not give these professionals and others not mentioned, the ability to serve where they are able to so do without conflict.

Furthermore, the Code requires that an independent non-executive director must not be a member of the "immediate family" of a serving or former executive of the company or its group, employed within three years prior to the appointment. No definition is given on what constitutes the "immediate family" of a non-executive director.

Number of Independent Directors: The Code stipulates that every public company must have at least one independent director on its board who should be a non-executive director. This seems quite minimal if the intention is for them to provide necessary checks on managerial excesses. If large companies decide to adopt the minimum requirement of one independent director on their board, it would be difficult for such an independent director to fulfill this role.

Family and Interlocking Directorship: The Code stipulates that no more than two members of the same family shall sit on the board of a company at the same time. Once again, the Code failed to define what constitutes "members of the same family." A similar provision in the CBN Code prohibits any two members of the same "extended family" from occupying the position of Chairman and CEO or Executive Director at the same time. The term "extended family" as used in the CBN Code refers to members of a nuclear family comprising the husband, wife and their siblings plus parents and brothers/sisters of both the husband and wife.[12] While banks who are also required to comply with the CBN Code as explained above can adopt this definition, there is no definition to guide other companies in relation to the term.

Joint Chairman/CEO: The Code requires that the position of the Chairman and CEO be separate and held by different individuals. Having a separate Chairman and CEO may be standard practice in some companies in Nigeria, but not all. In fact, the common practice is to have the same person act as Chairman/CEO of companies in Nigeria. It may therefore be difficult to get these companies to create separate roles for the two. If mandated to do so, the companies may at best create figure heads for one or the other of the roles with no real separation. In jurisdictions like the UK where separation of roles is standard practice, this would not create problems. However, in the US where regulators have recently required a

[11] Section 5.5(b)

[12] Section 5.2.3 of the CBN Code; footnote 1.

separation of the two roles, they made it optional for companies to adopt and where they cannot create separate roles, explain why they think having a single person act as Chairman and CEO is appropriate. SEC Nigeria could adopt a provision similar to section 31 of the Code, which allows companies to establish a risk-based internal audit function or give sufficient reasons why they cannot.

Multiple Directorships: The Code places no limit on the number of concurrent directorships a director may hold. It however requires full disclosure of the number of directorships to enable the board and shareholders assess the suitability of appointment of the director to the board. Serving directors must also notify the board of prospective appointments on other boards. This seems quite broad. Failure to restrict the number of directorships may cause a director to neglect his responsibilities to some companies. There ought to be some restriction on the number of directorships executive directors or those who have full time jobs in a company should hold or the nature of outside directorship they may hold. For instance, the Chairman of a board of company should not be allowed to act as Chairman of the board in another company.

Remuneration: The Code stipulates that the level of remuneration paid to directors should be sufficient to attract and retain skilled and qualified persons needed to run the company successfully. This provision is commendable as it would encourage qualified persons to serve on the board of companies. However, it may be necessary to require the company to avoid paying more than is necessary for the purpose.

Relations with shareholders: The Code requires the board to ensure that shareholders are treated fairly. It stipulates that the venue of general meetings should be accessible to shareholders. It requires that shareholders should play a key role in corporate governance and that institutional shareholders should demand compliance with the Code or seek explanations for non-compliance. It assumes that shareholders have the power to influence the decisions of management.

The Companies and Allied Matters Act require companies to act through three organs: the shareholders,[13] the board or officers[14] or agents.[15] Where authorized by the articles, the board is not bound to obey the directions or instructions of the shareholders and may act contrary to the instructions even if reached in the general meeting.[16] The only avenues for shareholders to check board excesses is to institute legal proceedings requiring the board to act, take steps to amend the article to alter the powers of the directors or remove the directors. However, no alterations shall invalidate prior acts of the board.[17] Until recently, Nigerian shareholders were not known for activism and most times only have two options to address any wrongs done by the directors. The first of those options, which is to remove the directors may not be effective as the directors may have committed the wrong before it is discovered, leaving one option, which is to institute court proceedings. Even then, it may take a long time for the case to be decided, defeating the purpose of the suit.

Prior to the privatization of industries in Nigeria, individual shareholdings in public companies were so dispersed that it would have been difficult for shareholders to exert any influence

[13] Described as members in general meeting
[14] Managing Director
[15] Section 63 CAMA.
[16] Section 63(4) CAMA
[17] Section 63(6) CAMA

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over company management. Privatization paved the way for dominant shareholders to emerge. Institutional shareholders have also become a common feature in Nigeria. Even at that, Nigerian shareholders still have the same apathy towards company management as they had a long time ago. A greater percentage of them still do not attend meetings. Even when they do some have no knowledge of how the company operates, while the few who do, do not receive full information to enable them make informed decisions. In 2006, the case of Cadbury Nigeria Plc illustrated that companies sometimes deliberately overstate their financial position to induce shareholder's vote. Therefore, unless shareholders receive full and accurate information, they may not have the ability to effectively demand board compliance with the Code.

Relations with Stakeholders; Corporate Social Responsibility (CSR) Reporting: The Code encourages transparency with stakeholders and in companies' dealings. It encourages annual reports of environmental, social, ethical, health and safety policies and practices. It also encourages disclosure and stakeholder engagement in companies' CSR strategy which is commendable. It is however necessary to establish mechanisms to enable outsiders confirm company's account of CSR performance.

Whistle-blowing Policy: The Code requires companies to have a whistle-blowing policy and gives the board the responsibility of implementing such policy and establishing mechanisms for reporting unethical behaviors. Interestingly, the Code details mechanisms for reporting such behaviors and merely made a cursory comment in the second part of section 32.2 requiring the board to "continually affirm its support for and commitment to the company's whistleblower protection mechanism."[18] If all the board is required to do is affirm its support and commitment to whistleblower protection, then there is nothing to guarantee companies' responsiveness to voluntary whistle-blowing. Nor did the Code make provisions requiring the board to put in place mechanisms to prevent retaliations against whistleblowers or remedies against those who suffered retaliations. Unless SEC Nigeria takes steps to effectively protect whistleblowers, the provisions of section 32.2 of the Code would make no meaningful impact in Nigerian corporate governance.

COMPARISON WITH US AND UK REFORMS

The UK and US have diverse corporate governance systems that ordinarily require no comparison, save for a few similarities. An evaluation of key provisions from the two jurisdictions, however, would provide insights into the Nigerian 2011 Code. Following the global financial crisis and the failure of world corporate governance systems, the UK adopted the UK Corporate Governance Code 2010 ("UK Code") to replace the Combined Code of Corporate Governance, while the US Securities and Exchange Commission ("US SEC") recently adopted Final Rules, in response to the Dodd Frank Act 2010. Below are key areas of reforms in the UK and US systems in comparison to the Nigerian system.

"Comply or explain"

UK: The "comply or explain approach" is the trademark of UK corporate governance and is still used in corporate governance regulation in the UK.

[18]Emphasis ours

US: The US corporate governance approach on the other hand is based on defined set of rules requiring strict compliance.

Nigeria: The Nigerian corporate governance approach is slightly in between the two. On one hand, the Code stipulates flexible adoption as companies deem necessary to facilitate sound corporate governance practices. On the other, it requires strict application.[19] Yet on another, it adopts the UK 'comply or explain approach,' requiring directors to comply with the Code or provide explanations to shareholders for non-compliance.

Definition of Independent Directors

UK: The UK Code describes an independent director as one who is independent in character and judgment and has no relationships or circumstances which are likely to affect or appear to affect his judgment. This leaves no room for professionals who are able to separate their interests from the affairs of the company to serve on the board. The UK Code requires at least half of the board to be independent non-executive directors for larger companies and at least two independent non-executive directors for smaller companies.

US: US legislation describes an independent director as one who does not have family, or other significant economic or personal relations to the corporation. Factors considered in determining independence of directors include compensation, fees, relationships with subsidiaries and other conflict of interest. The Dodd Frank Act requires that compensation committees must be independent.

Nigeria: The definition of independent directors in the Nigerian Code is similar to the UK description in many respects, in that it prohibits directors who have relationships or circumstances with the company from serving on the board. However, the Nigerian Code makes room for partners or executives of a law firm or accounting firm to serve after three years of acting of acting in that position. The Nigerian code requires at least one independent non-executive director.

Separate Roles for Chairman and CEO

UK: The UK Code requires that the roles of the Chairman and CEO be separate and exercised by different individuals.

US: The Dodd Frank Act[20] amends section 14B of the Exchange Act requiring the US SEC to issue rules to require issuer to disclose in their annual proxy to investors the reasons why it has chosen the same individual or different individuals to serve as Chairman and CEO. This means that once appropriate disclosures are made, a corporation can have one or two different individuals serving as Chairman and CEO.

Nigeria: The Nigerian Code is similar to the UK provision. It requires the roles of the Chairman and CEO be separate and exercised by different persons.

Integrity of Financial Statements

UK: Section 393 of the UK Companies Act 2006 requires directors to approve accounts only when they are satisfied that they give a true and fair view of the company's assets, liabilities, financial position and profit or loss. The UK Code gives the audit committee the responsibility of monitoring the integrity of the financial statements of the company.

[19] See sections 12, 14, 15 of the Code.

[20] Section 972

US: The US laws require financial statements to fairly represent the financial position of the company. It also mandates the CEO and Chief Financial Officer of every company to certify that the financial statement and related information fairly presents the financial condition and the results in all material respects.[21]

Nigeria: The Nigerian Code, like the UK provision requires accounts of companies to present a true and fair view of the financial position of the company. However, just like the US provision, it requires the CEO and Head of Finance of every company to certify the financial statement.

Whistleblower Program

UK: The UK does not have provisions similar to the US whistleblower program. The UK Proceeds of Crime Act 2002, however, is slightly similar to the US whistle-blowing provisions in that it requires designated officer to reports cases of money laundering. Failure to make the necessary reports attracts severe penalty. In addition, the UK Money Laundering Regulation 2007 requires strict compliance with the requirement for designation of reporting officers.

US: Section 21 of the US Securities and Exchange Act 1934 (Exchange Act) contains detailed provisions on whistle-blowing, including requiring that whistleblowers be rewarded. Section 922 of the Dodd Frank Act 2010 has recently amended the Exchange Act by adding a section 21F, which creates a whistleblower program titled "Securities Whistleblower Incentives and Protection.[22] It also requires annual report of the whistleblower award program from US SEC to Congress.[23]

Nigeria: SEC Nigeria recently included a whistle-blowing program in the Code of Corporate Governance requiring directors to establish mechanisms for implementation of the program. The Code, however, made no provision for protection or reward of whistleblowers.

Remuneration

UK: The UK Code requires that the level of remuneration paid to directors should be sufficient to attract and retain skilled and qualified persons needed to run the company successfully, but that companies should avoid paying more than is necessary for the purpose. Non-executive directors may be granted share options upon shareholders' approval and shares purchased in exercise of such options must be held at least until one year after the non-executive director leaves the board.

US: Section 951 of the Dodd Frank Act amends section 14A of the Exchange Act allowing shareholders to have a "say on pay". The amendment requires the board to send proxy or consent or authorization at least every 3 years for an annual or other meeting of the corporation. The board must enclose a separate resolution made subject to shareholder vote, wherein the shareholder shall vote whether or not to approve compensation for the corporation's executives. The shareholders can determine the frequency of vote and can elect to have "say on pay" annually or once every two or three years.

Nigeria: Similar to the UK Code, the Nigerian Code requires that the level of remuneration paid to directors should be sufficient to attract

[21] Section 303 of Sarbanes-Oxley Act 2002

[22] Available at http://www.sec.gov/news/studies/2010/whistleblower_report_to_congress.pdf, last assessed 8/4/2011.

[23] Section 21F(g)(5) of the Exchange Act.

and retain skilled and qualified persons needed to run the company successfully. However, it does not limit payment for necessary purpose. The Nigerian Code also permits all directors including, non-executive directors to take up share options on approval by the shareholders, but stipulates that the option can only be exercised one year after the non-executive director leaves office.

BASEL COMMITTEE'S PRINCIPLES OF CORPORATE GOVERNANCE

As noted above, the Nigerian Code of Corporate Governance applies to banks, as well as other companies. As a result, this section highlights the core principles of corporate governance as laid down by the Basel Committee on Banking Supervision in its document titled "Principles for enhancing corporate governance."[24] The principles set out the best practice for banking organizations and are outlined below.

Board Practices: This requires that the board actively carry out its overall responsibility to the bank and provide effective oversight of senior management.

Senior management: Senior management should be under the direction of the board. They should ensure that the bank's activities are consistent with its business strategy, risk tolerance/appetite and policies approved by the board.

Risk management and internal controls: The Committee directs that banks should have risk management functions, compliance and internal control functions, each with sufficient authority, stature, independence, resources and access to the board.

Compensation: The Committee also requires that banks should fully implement the Financial Stability Board's "Principles for Sound Compensation Practices and Accompanying Implementation Standards."

Complex or opaque corporate structures: The board and senior management are expected to know and guide the bank's overall corporate structure to avoid undue complexity. They must also be on hand to address the risks any structure may pose

Disclosure and transparency: Effective disclosure and transparency should be adopted to ensure good corporate governance.

CONCLUSION

This newsletter discussed the implications of the Nigerian Code of Corporate Governance and drew comparisons with the UK and US rules. It pointed out areas requiring clarifications or amendment to ensure good corporate governance. For some, SEC Nigeria may need to take immediate steps to amend, including the minimum number of independent directors, the power of shareholders to demand compliance, and the provision on multiple directorships.

The Basel Committee's principles for enhancing good corporate governance, though not relevant to companies other than banks, was highlighted to show other measures to further enhance corporate governance practices in Nigerian banks. It is hoped that steps would be taken to adopt relevant principles in the Nigerian system.

[24] October 2010; available at http://www.bis.org/publ/bcbs176.pdf, last assessed 8/4/2011.

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