Flexible or not? The comply-or-explain principle in UK and German corporate governance

Source paper 1. Research report and summary – Interview element

Draft - do not quote without permission please.

Paul Sanderson,¹ David Seidl,² Bernhard Krieger,³ John Roberts⁴

Keywords/Panel topics: Comply-or-explain, Corporate governance, Flexible regulation, Soft law, Regulation after the financial crisis

DRAFT: Please do not quote without permission.

Correspondence: Dr Paul Sanderson, Cambridge Centre for Housing and Planning Research, Dept. of Land Economy, University of Cambridge, 19 Silver Street, Cambridge CB3 9EP, UK. ps238@cam.ac.uk

¹ As above plus Centre for Business Research, University of Cambridge, Cambridge, UK
² Institut für Organisation und Unternehmenstheorien, University of Zurich, Switzerland
³ Institut für Ethnologie, Ludwig-Maximilians-Universität, Munich, Germany
⁴ Judge Business School, University of Cambridge, UK

Acknowledgements
1) This report and summary draws on data collected for Soft Regulation?: Conforming with the Principle of 'Comply or Explain,' a research project funded by the UK Economic and Social Research Council (RES-000-23-1501).
2) The authors wish especially to thank the many practitioners who took part in interviews for the project.
When does flexible regulation work?

Applying the comply-or-explain principle in UK and German corporate governance

Abstract

The current financial crisis has given rise to calls to toughen considerably the codes of corporate governance put in place in many countries to regulate corporate behaviour (e.g. the UK Combined Code). These codes vary slightly in form but tend to contain a mix of non-discretionary regulations and discretionary guidance and information. Almost all such codes embody some variation or other of the comply-or-explain principle. Companies should comply with the rules or explain why they do not. In this way the code framers avoid, or perhaps enable, a one-size-fits-all approach. It is this discretion that governments are under pressure to limit, but little is known about how it is used, in what circumstances, and to what effect? In this paper we report the findings of research carried out in the UK and Germany to investigate the extent to which large public companies fully comply with the rules, and the attitudes of company directors and legal counsel to using comply-or-explain. We find that positive conformance with codes depends on factors such as the extent to which regulatees are engaged in the formation and revision of the code, and thus feel a sense of ownership; the existence of interested and relevant monitors; and the extent to which soft regulation is a traditional means of control in a country. We also found that pressure, both internal and external, both real and imagined, can lead to the establishment of a norm of full compliance, with perhaps perverse outcomes, and that in any event the majority of the contents become akin to hard law where deviation is not considered acceptable. There are however a very small number of rules where temporary deviation may be unavoidable from time to time and where non-compliance accompanied by a valid explanation is accepted.
Soft law: comply-or-explain

It is perhaps inevitable that crises lead to calls for better regulation of the actors involved, as can be witnessed in the debate over the global financial crisis. Such systemic crises are however, thankfully rare. On the other hand, corporate failure as the result of wrongdoing is a much more common event. Consider for example Polly Peck, BCCI, and Maxwell in the UK, Enron and World Com in the US, and Holzmann, Metallgesellschaft and Bayerische Hypo- und Vereinsbank in Germany. These corporate scandals have given rise to calls for the establishment or refinement of the codes of corporate governance that are put in place to regulate corporate behaviour in general and the actions of company directors in particular. Such codes are either fully voluntary, e.g. the latest version of the UK the Combined Code (Financial Reporting Council 2008), or contain voluntary and statutory elements, e.g. the latest version of the German code, Regierungskommission 2008 (referred to throughout as the 'Cromme' code after the chair of the code commission). They may thus be considered either instruments of soft law or mixed soft and hard law. Within the code elements the individual rules themselves may be fixed or flexible – a mix of non-discretionary regulations and discretionary guidance and information on, for example, best practice.

Proponents of soft law argue that it has that essential flexibility that hard law lacks and our innate desire to conform with social norms produces genuine compliance. Soft laws have been described as ‘rules of conduct which, in principle, have no legally binding force but which nevertheless may have practical effects’ (Snyder 1993:2). Although regulatees may choose to conform or not conform with soft law there is an assumption that behaviour is more likely to be consistent with codified guidance and statements of best practice than if such guidance and statements are not stated within the framework of a code. In this way non-binding rules can have the same political and social effects and benefits as hard law (Borchardt and Wellens 1989: 268). But, as Cini 2001 notes, because ‘soft law is not legally binding, implementation must rest solely on the goodwill of those agreeing to and affected by it’ and, presumably, where such goodwill is absent, soft law may well result in soft compliance.

Even where goodwill and the desire to conform exist conformance may not be the best option for regulatees. They may determine that the principle underpinning a particular rule or guidance on best practice will, in their case, be best served by non-conformance – or they may be prevented from conforming for reasons outwith their control. This use of discretion to determine conformance or non-conformance can be invaluable, not only for regulatees, but also for regulators. In this way a
code can be both universal - ‘one size fits all’ and particularistic – customised to suit the regulatee’s particular circumstances. The concern of course is that the decision not to conform is made for narrow self-interested reasons that conflict with the principle underpinning the discretionary rule, rather than supporting it, so such decisions must be monitored and a determination made on whether the regulatee’s decision on action is indeed consistent with the regulatory objective.

To enable monitors to function effectively in determining whether the reason given for non-conformance is acceptable regulatees must explain their actions in respect of any rule from which they have deviated. This process has become known as comply-or-explain. It is the cornerstone of modern codes of corporate governance. Statements of the extent of conformance with the code and the reasons for any non-conformance are given in a corporate governance statement, which is contained, in some domains, within the annual report, or in others, published separately. These statements can then be monitored and assessed for validity by the various stakeholders. In the case of larger public companies such monitoring tends to be carried out by their major investors, typically major financial institutions, and by specialist ratings agencies, who tend to provide advice to medium sized investors such as individual pension funds and local governments. It may be expected that one impact of such monitoring is that there is considerable pressure to conform. However in a survey of compliance with codes of corporate governance Seidl and Sanderson 2007 found that just 51% of the 30 largest companies in the UK, and 40% of the 30 largest in Germany fully conformed with the code. This raises two separate but related questions: (i) to what extent do regulatees conform with soft regulation (addressed in Seidl and Sanderson 2007), and (ii) why do they conform – or rather in what circumstances do they choose to conform and in what circumstances do they choose not to conform (addressed herein). Are such decisions common across domains and a function of time and the embeddedness of the code or are there significant differences arising from culture and tradition? Note that both choices, **comply and explain**, are essentially compliant in that the choice not to conform is equally acceptable under the code – subject ultimately to the agreement of monitors – which is why we generally use the terms **conformance and non-conformance** in this paper rather than **compliance and non-compliance**. (Indeed, for greater clarity the Dutch **Tabaksblat Code** (Commissie Tabaksblat 2003)refers to ‘apply or explain,’ a formulation favoured by leading authorities on UK corporate governance such as Ross Goobey 2005.)

‘Comply’ or ‘explain’ can take a number of forms. Conformance, can mean strict adherence to the **letter** of the code or to the underlying principle, or both. For example, the German Cromme code (Regierungskommission 2005) recommends the formation of a **Prüfungsausschuss** (an audit
committee) as oversight of the audit process may be better effected by a smaller group than the whole supervisory board, but where the board is already small, for example in the case of a small company, this makes no sense. The underlying principle is already being met by the whole board overseeing auditing. On the other hand where age limits are required to be set by a code, setting a limit at 99 years might appear somewhat disingenuous.

Non-conformance is generally justified by recourse to firm- or industry-level particularities or against the logic of certain code provisions. On the other hand explanations may simply be 'empty.' For example, in its 2005 annual report HypoVereinsbank AG justified its non-conformance with the code provision requiring that its directors' and officers' (D&O) liability insurance contains a deductible with the bland statement that, ‘responsible action is an understood duty of the members, no deductible is required for that’ (trans.). Similarly, in the UK, Camelot plc, in its compliance statement of 2005, provides the following rather empty justification for four incidents of non-conformance: ‘the exceptions are not viewed by the board to impact the quality of corporate governance, and arise from the unique nature of the company.'

**Empirical approach**

The principal focus in this paper is on the similarities and differences in directors' perceptions of conformance and non-conformance and the factors that influence them. The formal statements regarding deviations and the explanations given are of secondary interest and have been addressed in Seidl and Sanderson 2007. To clarify the extent to which social norms drive decisions on comply or explain we studied the perceptions of company directors and their senior legal advisors on corporate governance issues from amongst the 130 largest listed firms in the two countries, the UK and Germany. These were sourced from FTSE250 in the UK and from the DAX30, MDAX and SDAX in Germany. There are of course a number of similarities and differences between the two countries which have contributed to the development of these norms. The UK is a common law liberal democracy while Germany is perhaps best characterised as a corporatist or social democratic state with a civil law tradition. Their different traditions and histories have resulted in different capital market structures and different legal conceptions of the responsibilities of the corporation. The UK has widely dispersed share ownership, outsider control and a unitary board. Germany has concentrated ownership, control by insider block-holders and a dual board structure which includes employee representatives. As a consequence the former emphasises a company’s responsibilities to
its shareholders while the latter recognises that a company has a duty to consider the interests of a broader set of stakeholders. The two countries do however have broadly similar codes of corporate governance and many of the largest companies in both countries trade globally so the differences may not be quite as significant as they first appear. Perhaps of equal significance is that the UK code was established in 1992, a decade before the German code, so comparing the perceptions of those concerned with discretionary compliance decisions in the two countries will provide a sense of how the use of comply-or-explain has evolved.

The consequences of these differences with respect to the application of the principle of comply-or-explain were explored in a series of 48 interviews held during 2006 and 2007 in both countries. The interviews were semi-structured to allow for local variations in practice but followed common guidelines. The transcripts of the interviews were then analysed and codified using Weft QDA qualitative analysis software. While a majority of the German interviewees were employed by their companies as internal corporate lawyers and legal advisors (syndikus) interviews were also held with senior directors. Similarly, a majority of the British interviewees were employed as company secretaries. To familiarise themselves with the issues the interviewers also met with a number of investment managers, corporate governance advisors and academics - including some of those involved in drafting their respective codes. The extracts below have been anonymised in accordance with assurances given to interviewees. The source country is in most cases obvious from the surrounding text but to ensure clarity the letters U for UK or G for Germany have been appended. Note also that the UK interviews were conducted in English and most of the German interviews in German. Extracts in this paper from the latter are therefore translations. Code conformance was assessed with reference to the relevant version of the codes: The Combined Code 2006 and the Cromme code (Regierungskommission 2005).

The UK and German codes of corporate governance

Codes of corporate governance have be defined as 'non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations' (Weil et al., 2003). The first significant development of such a code arose in the UK in 1992 out of the report of the Cadbury Committee set up by the London Stock Exchange and the UK Financial Reporting Council. The code set out best practice for the directors of companies listed on the London Stock Exchange. Many of these original rules remain in force today, e.g.. 'the roles of
chairman and chief executive should not be exercised by the same individual' (Cadbury 1992: A.2.1). The code and its subsequent elaborations in the Combined Code has been imitated with suitable customizations in around fifty countries (van den Berghe and De Ridder 1999; Iskander et al. 2000; Weil, Gotshal & Manges LLP 2002; Aguilera and Cuervo-Cazurra 2004). Most draw upon either the Combined Code or the OECD ‘Principles of Corporate Governance,' which provide guidelines for both OECD and non OECD countries (OECD 2004). The codes are remarkably similar. Indeed, The High Level Group of Company Law Experts 2002 found sufficient commonalities to recommend to the EU that it did not need to establish its own code of corporate governance an could rely instead on those established in the individual member states.

The codes are typically issued by stock-exchange-related bodies, associations of directors, various types of investor groups, business and industry associations, and governmental commissions (Wymeersch 2005; Aguilera and Cuervo-Cazurra 2004). They are aimed primarily at companies listed on their respective stock exchanges. Membership of such exchanges is generally conditional on observing the relevant code but while this is the only compulsion used in the UK, compliance with the Cromme Code is required under German corporate law (Aktiengesetz). Moreover, whereas the Combined Code, at least formally, is voluntary, the Cromme Code is a mix of rules with different bases: part hard law, part soft principles of best practice (most akin to the Combined Code) and part aspirations for which neither conformance nor explanation is required.

The current version of the Combined Code has developed from the original Cadbury Committee report on internal financial control in 1992, with subsequent contributions from Greenbury 1995 on disclosure of directors’ remuneration, Hampel 1998, consolidating previous provisions and further clarifying the roles of directors and shareholders, Turnbull 1999 on internal control procedures and Higgs 2003 on the role and duties of independent directors. All these took evidence from the actors involved, particularly the directors of major companies. It is unsurprising therefore that many of the UK interviewees perceive the code as a reflection of established practice: 

“In many ways the Code came about from experienced City operators collaborating over what were the sort of elements that made companies operate well and effectively, trying to capture what until that time had actually been complicit in good management, and saying what are the signs of good management and how can we encapsulate that in a best practice guide as to how you should do something? So at the outset, yes, it was linked to previous scandals that had taken place but was as much about providing a useful tool to people (...) So it was built out
of current best practice as opposed to being driven by a particularly political agenda or some other element extraneous to business itself. It came from within rather than from outside.” (U)

The way the code evolved discursively with input from practitioners, rather than by the imposition of rules from outside, was noted by several UK interviewees:

“The way it developed ... there was quite some time and debate before it was agreed that it should be adopted or tagged onto the listing rules and then worked through. Some of these things happen in the opposite direction but this was something that very much evolved.” (U)

However, this does not necessarily mean that regulatees feel they have dominated the development of the code, nor that they have successfully constrained its scope through each iteration:

"I have been around for a long time from, in the early days with very slim corporate governance type rules in the form of listing rules, through to where we are today, where we have got rather more regulation than is easy to cope with.” (U)

Nonetheless, as the Combined Code has developed so has the attention paid to it:

“In the early days of the Code I just read through it and thought, yes that is alright. So nowadays it is more of a process, and it is more carefully considered, because it is taken more seriously by everybody as well.” (U)

... and not just by the company lawyers charged with ensuring compliance:

“I think it is heading in the right direction. I think it has been unfortunate I guess for all of my career that Directors generally, I talk in general terms about Directors of companies, have had to rely on someone like me to tell them what their duties are. They can read them for themselves now.” (U)

This sense of ownership found in the UK contrasts with the development of the German code. The Cromme code is not understood as coming from 'inside'. The process in Germany has been dominated by committees that, while including some industry leaders, appear somewhat detached from the businesses to whom the rules apply. Many interviewees felt excluded from the process of code development, particularly those working for smaller capitalised companies - those from the lower end of the MDAX and SDAX. Many of the interviewees seemed to understand the Cromme Code not as discursively produced but rather as externally imposed An MDAX interviewee expresses a certain lack of awareness about the development of the code:
“At the time all the committees and expert groups met and came up with ideas about what to do with the issue of corporate governance in order to make Germany more attractive as a financial centre, as well as to increase the transparency of our companies. I and the whole company took a step back and waited for what will come. As lawyers my colleagues and I wondered about the novelty they wanted to tell us about with this code. (...) At some point it dawned on us that this is more than just a temporary fad, but something with a regulator, a clear task, announcement and public discussion. When we saw the code in its first draft, we said that we have no choice but to look deeper into it.” (G)

The development of the Cromme Code is seen as being driven by both internal and external factors:

“Obviously [the code] emerged because of the ‘new market’ and developments in other countries, but also in Germany. Failures, changes in the composition of shareholders, excessive option packages for executive board members, etc. - many things got out of balance … shareholders, supervisory board members, executive directors, partners, etc.” (G)

Some of these factors are accepted as valid justifications while others are resented:

“The topic of corporate governance started earlier in the Anglo-Saxon sphere: the Cadbury report and all the rest of it. And then one had the impression in Germany that one had to catch up; also because some investors asked for it. Or the other way round: because there were such initiatives in the Anglo-Saxon world and not around here some had the opinion that things [here] were a bit medieval. And then there was a McKinsey study that claimed that those who subscribed to corporate governance explicitly would have a 10 % higher market capitalisation. ... But you have to take into account that the legal context in diverse countries is quite different. In Germany matters of corporate governance are much more regulated than in the Anglo-Saxon world. Insofar as there was more of a need for regulation it was in the Anglo-Saxon world rather than us.” (G)

The former CEO of a large German bank also focused on the pressure from abroad that led to the development of the code:

“There was an obvious coercion, a necessity to better demonstrate to foreign observers, foreign investors, and at the same time to seize the opportunity to reform a couple of things because one could constantly read in the Anglo-Saxon media – not only in the tabloid press, but also in the academically inspired magazines – that in corporate governance terms [Germany] is a developing country. To oppose this view on the one hand, but also to develop
what we had to develop on the other, were the primary objectives of corporate governance.” (G)

This sense that the code is imposed from outside, that practitioners do not ‘own’ the code is reinforced by a rather formal process of continual development. One of those involved in the process commented:

“It is a living document – it is a continuous government commission – we meet several times during the year and produce an annual update. It is on us whether or not and how often we change things. ... Ideas and propositions are forwarded to an office which works as a kind of clearing house. Either they are collected there for the next meeting or if there is something immediate, they are circulated. ... This will be discussed in detail at the meetings. There are two meetings where things are discussed pretty formally. Nobody is allowed to substitute for you. Either you are there or you are not. And then there is, from time to time, some informal discussion as well where people are asked what they think of this or that but I think the driving force is the central office.” (G)

This was elaborated upon by a different member of the commission:

“The meetings are prepared by the commission staff. If necessary sub-committees are established to examine in detail certain issues and report back at the next meeting. (...) Well, it is a multi-level operation; in the end there are three levels: the commission staff; perhaps sub-committees consisting of several commission members and chaired by one of their number; and lastly the full commission meeting in plenary session.” (G)

The members of the commission were appointed by the German government. Perhaps unsurprisingly the members themselves seemed convinced they constituted a cross-section of the relevant stakeholders. As one said:

“Appointment was ad personam and because of that I think it was necessary to invite members one could expect to draw on considerable experience. To ensure a good balance of interests care was taken to select representatives from banks and the stock exchange on the one hand, and from academia on the other, thirdly from active entrepreneurs from large and smaller publicly listed companies. Overall I think what was achieved was the appointment of a balanced committee about which somebody from the outside could not make allegations that particular interests were favoured.” (G)
Some of the interviewees, however, did express strong criticism about the composition of the commission and indeed about whether the members had the required experience. One questioned the legitimacy of the process, describing it as:

“absolute without democratic control, without any feedback from companies ... by some professors of whom you don’t know whether they ever have seen a company from the inside.”

(G)

Less dramatically those from smaller companies amongst these interviewed tended to perceive the code as being aligned more to the activities of larger companies and saw much of its day to day activities as irrelevant. One of the commission members responded to this point:

“I see the point, however I don’t share the opinion. If we take one step back and ask about the primary rationale for the creation of the corporate governance commission in the first place, then it was certainly about considering the situation of larger companies as their external effects are far more significant than those of smaller ones. From this perspective an emphasis on the actions of the boards of larger companies is entirely justified. I would certainly admit that smaller companies, and in particular family run businesses, get a bit under pressure. On the other hand I would plead for maintaining this pressure as it is crucial for how we appear abroad. As a matter of fact, smaller and family run publicly listed companies are less numerous abroad compared to their larger counterparts.”

(G)

Many of the German participants emphasised the way the Cromme Code serves as a marketing tool to attract, and indeed educate, foreign investors:

“This corporate governance code is a bureaucratic monster. The only good aspect – from my perspective – is that it explains very well the corporate legal structure of German publicly listed companies... the interaction between the annual general meeting, the executive board and the supervisory board. Something like corporate law for dummies - corporate law and German employees' participation for dummies. They achieved this and it is something worthwhile in order not to have to take on board every idiocy from the Anglo-Saxons, such as the one tier board structure. This is a major achievement of the corporate governance code. It is a successful marketing tool that has put many things into perspective and will ultimately assist with convergence of the systems.”

(G)

... and ...

“The real purpose of the German corporate governance code is to advertise Germany as a capital market. And the two-tier board system is hard to explain to the Americans and English.
I think the code has fulfilled this task very, very well for our corporate governance system. Mostly the text simply restates [practice]. The first adaptation of the code was marginally new. It sets out the legal situation in very understandable language, both in German and English. It is a marketing tool for the German capital market.” (G)

Overall the vast majority of UK interviewees perceived the process by which the code was originally developed and subsequently redeveloped to be inclusive and entirely legitimate. None of the interviewees complained their concerns went unheard and unanswered. Engagement was not considered an issue. This stands in contrast to the far more institutionalised process in Germany where self-regulatory codes are less common and the code is, of course, only one element alongside statute and guidance. Additionally the German code was created and put into practice over a comparatively short period and was instigated by government. It is therefore unsurprising that it is perceived more as an imposed set of enforced rules rather than a self-authored document at the heart of a self-regulatory system. This perception is reinforced by the existence of a permanent multi-level bureaucracy to oversee implementation and development of the code. It is easy to understand that such a heavily bureaucratic process can alienate some of the affected actors, particularly when they feel their type of company is under-represented, for example, smaller and family run firms.

Perceptions of the flexibility of the codes and comply-or-explain

These two different historic trajectories and levels of institutionalisation go some way towards explaining the different attitudes reported by UK and German interviewees towards their respective codes, and provides a basis from which to understand the different ways they perceive the comply-or-explain mechanism. In the UK non-conformance and thus explanation will only typically be utilised in respect of a very few code provisions by any one company, and full non-conformance is never considered to be an option – even by smaller companies. In Germany however cases of full non-conformance can be found and the average number of deviations by non-conformers was over 5, compared to 2 in the UK. It is worth noting however that the Combined code contains 48 provisions compared to 82 in the Cromme code (see Seidl & Sanderson 2007).

As a basis for understanding some of the differences in the approach taken to conformance in the two countries, interviewees were asked to reflect on the effectiveness of the code as a means of
regulating the behaviour of companies. Most UK interviewees showed a degree of appreciation for the flexibility of soft law but were also well aware that such flexibility was limited:

"I think it is a success, despite all of what I have said. It is not irrelevant, it isn’t, … [but] …. I don’t know of any people who have really explained on the big issues - you will comply. So it gives you flexibility at the margin but not in the main. I wonder what the margin is, is it 5%, is it 10%? It is flexibility in the trivia in there but the real core of it is not as flexible as comply-or-explain. That is what I am saying. It is comply. You will bloody comply because you will be out there being shot at if you don’t.” (U)

Notwithstanding the perceived boundaries of comply-or-explain the mechanism as a core element of the Combined Code was generally considered to be a success:

"I think it has been a success and I think the comply or explain, or apply or explain, has been a success. If it had been a rigid requirement I think companies would not have enjoyed that. We ourselves may have found that we were being impeded in the way that we wanted to manage our business.” (U)

The way that the code enabled a one size fits all approach was seen as a significant benefit:

"[I]f you have hard law in an area then you are effectively supposing that the same model fits every company and of course even a hard law can have exceptions built into it. But if you use hard law and you put exceptions in, either the exceptions are so wide and discretionary as to negate the point of having the hard law or you have to be sufficiently detailed in your exemptions that you try to cover every particular case - which is equally difficult I think. Having seen it from the outside and now from the inside, I think the soft law actually works much better in this area. It is not like health and safety legislation. It is not like criminal law where something is obviously wrong and something is obviously right. It is a consensus as to this is the way we think things should be done but we are prepared to accept that for some companies it may be different and provided your explanation is adequate then you know you can carry your shareholders with you as it were.” (U)

The reference to the importance of context is significant. Comply-or-explain is not an especially common mechanism. It works in the context of corporate governance because the regulatees are relatively high profile and their actions are monitored by self-interested investors. In the UK these monitors are powerful financial institutions who have both the resources and interest to scrutinize boards’ decisions. They also have sufficient leverage to ensure their concerns are heard and are
addressed. The mechanism is likely to be less effective in domains where monitoring is less intensive. In the Netherlands, for example, the government established a formal monitoring commission to examine explanations of non-conformance with their corporate governance code – perhaps a recognition that monitoring was proving insufficient?

A further benefit of the code and comply-or-explain mentioned by UK interviewees was the way that engagement with decisions on comply-or-explain encouraged a degree of reflexivity which in turn strengthened corporate accountability:

“It is good that management are challenged to demonstrate that what they are doing is the right thing to do, that things they have done have been the right things to do, that they are tested by the appropriate standards rather than just regarding companies as a personal fiefdom. If you are the MD and you also own 51% then that is fine but if, like most managers, you are a professional manager rather than a major shareholder, being held accountable that way is right.” (U)

Some interviewees went as far as to praise the Combined Code as a design template for the governance structures of publicly listed companies.

“I think the Combined Code has been very successful, from a number of perspectives I think. Perhaps at the outset it was looked on as being the standard to aspire towards but now I think it is very much more looked on as being a framework and, if you like, in some sense a minimum that people then operate to. But I think there is much greater recognition that good governance doesn’t spontaneously happen and therefore you need to have an approach which through time, through experience of operating with the Combined Code, has meant that most Boards and Directors and Chairmen now are starting from a much better position than they were before the first version of the Code came out” (U)

Indeed, one of our interviewees described the code as a kind of manual:

“I think it is a success. I think you should look at it as a tool, not a restriction, but a tool of empowerment. If you look at it as something, well actually this is the way we are going to set up our Board, this is the way we are going to effectively manage our business, that should give you comfort that there is a way to do it properly. It doesn’t stop there being a bad apple in the box etc but I think it is workable.” (U)
UK interviewees with dual listing status expressed, for the most part, a preference for the soft law approach found in the UK compared to the statutory approach adopted by the United States, especially since the advent of 'Sarbanes-Oxley':

“*I do think the comply or explain piece is a really valuable valve and I think, as I say, living with both sets of rules, the US rules and the comply or explain premise of the Combined Code, Boards get quite cross about having to comply with rules that are senseless in their view. So to have a best practice world that you can see that investors and others are expecting you to adhere to but having the flexibility to explain why an aspect might not be appropriate for you, I think is a really good place to be.*” (U)

Support for the code, however, is not unconfined. Some thought that the code had become too far-reaching, one interviewee describing it as only:

“*a qualified success probably. I regard it as being over-prescriptive and that is certainly the view round here.*” (U)

Another interviewee mentions that while comply-or-explain is a valuable mechanism the concept and its usage is not understood well by all monitors, some of whom treat non-conformance simply as non-compliance. For this reason the code may have:

“*... to be redrafted because you are never going to get the box tickers who have now got departments full of people box ticking, they can’t take a view, they are incapable of reading the explanation and applying it. You haven’t got intelligent people doing these jobs who are able to say, ah in [this company]’s case, I have read the blurb, yes I agree with that. They are going to come from their position all the time.*” (U)

The institutionalisation of monitoring can also cause regulated companies to increase their monitoring of the monitors, with attendant increase in compliance costs:

“*It is an industry in its own right. I am not sure it adds on a lot of value.*” (U)

Nonetheless, most UK interviewees were content with both the form of regulation (the Combined Code) and the principle and mechanism of comply-or-explain. The situation in Germany however was more complicated. There were some positive evaluations of the code as a whole. The largest German companies, those with international operations, did not appear to find either compliance with the code, or utilising the comply-or-explain mechanism to be problematic:
“comply-or-explain is a actually good method which precisely helps to realise the principles and recommendations. I would not wish lightly to do something as embarrassing as explaining a deviation but if I have a good reason for it I am not worried at all because this is what the code actually wants to achieve. You are allowed to deviate though you have to explain why. Then the audience should decide if the explanation is convincing or not .... From this perspective I do not see it as anything indecent to explain that we want one of our board members to become the chairman of the supervisory board because we have good reasons for it. We stand up for this and we do not perceive this as a flaw. And looking at the movement of our stock price, the audience agrees. (...) 'Explain or comply' is extremely important. People look at it and evaluate the explanation. And this is exactly how it is designed.” (G)

Another interviewee agreed:

"The recommendations ... make perfect sense. And companies have the possibility of deviating if they announce this and explain in the [compliance] statement. I think this is very reasonable. From my perspective there is n reason for a company not to accept the code and apply it using comply-or-explain. This is the reason why we have this sensible book of rules in Germany. It is written in a way that every company can apply it.” (G)

However a number of German interviewees were critical of the code. Some perceived the objectives of the code as either unattainable or irrelevant, or both:

“If you lead your company well in principle you will not be able to achieve good corporate governance. If you lead your company well, with the help of all the tools one uses professionally nowadays, the actions the code prescribes become by-products. ... 90% are unimportant topics.” (G)

This point of view was fairly common, as was the notion that it was possible to comply with the letter of the code while perhaps paying less attention to the intention, the spirit of the code provisions. One interviewer made the point by reference to the Ten Commandments!:

“Well, this is a similar question to whether the Ten Commandments make sense if people don’t stick to them. OK, the minister of course says ‘yes’ because if the Commandments did not exist then everything would be worse. The corporate governance code makes sense by its principles. But what do you understand by principles? Reasonable corporate governance. We subscribe to these principles. I think this makes sense and is not without effect. Nevertheless, I have to say – and this is brought out in the bible – you have to distinguish between being correct to the
letter of law, in a Pharisaical sense, and being right not only to the letter but also to the meaning of the law – really being good. There is a difference. You can comply to the letter of the corporate governance code and everybody says that is ok, but in fact you may not have complied to the meaning of it.” (G)

The extent to which individual decision-makers embrace the spirit rather than merely the letter of the code is, in the end, a reflection of their own sense of responsibility on the matter:

“One of the basic problems of all those corporate governance codes is, and it does not matter whether you take Hampel, Cadbury, Greenbury, Higgs, all the French Guys, Blue Ribbon, and all the rest of them or the Cromme commission: in the end one attempts to increase measurability by increasing the degree of formalisation. In the end, governance is the action of individuals and values of individuals. One has to be aware of that no matter how much you codify.” (G)

The values underpinning the code provisions were not shared by all the German interviewees. One expressed his admiration of the CEO of Porsche, Wendelin Wiedeking, the enfant terrible of German corporate governance:

“I am impressed by Mr. Wiedeking. I like the way he resists complying with the rules. I do not think Mr. Cromme is completely honest. You just have to look at what happened within Volkswagen. There is no mentioning in the code that the board is not allowed to visit a brothel with the employees representatives!”(G)

Quite a few were openly hostile to codes of corporate governance as a whole:

“The attempt to find regulations that determine how all companies can be managed is doomed to fail. If you had told me before about such a project, I would have told you that I knew how this would end up: This would end up in blah blah regulations without any significance.” (G)

As has been noted, a major difference with the UK Combined Code, and a major issue with the German development process, is that the Cromme Code is understood by many medium-sized and smaller public companies as something that has been imposed on them from outside – something over which they feel little sense of ownership and can exercise little influence. It is therefore perceived by some as lacking legitimacy. It is moreover seen as a political project. Critics identified two main specific areas of grievance: the publication of the salaries of board members, and the
whole field of employee representation on the board. The latter has not been seen as an issue in the UK, where there is no right of employee representation and where directors’ salary arrangements have been for some time published in the accounts section of the annual report of public companies as part of the financial reporting rules. However, in Germany in the late 1990s there was a sustained campaign by some news media for disclosure of the remuneration of board members and senior management. This debate became difficult for the Cromme commission to resist and they added remuneration disclosure to the corporate governance code. This has not however been well-received by board members. Many perceive its inclusion as a form of invasion of privacy driven by envy and it reinforces for many the perception that the code lacks the requisite degree of legitimacy it should command from those affected. Some interviewees expressed incomprehension that such a provision should have been included in the code:

“In Germany there is a clear misunderstanding in respect of the disclosure of salaries. The disclosure of salaries is towards the stockholders. Dear stockholder, your board cost this amount. But our discussion is not about what the shareholder should know in order to make an investment decision, but rather to satisfy the curiosity of those who do not own shares. The public does not have such a right. You cannot deduce such a right from anywhere. Why should it have such a right? But in Berlin, the government brings up this topic over and again. If you do not make this public – to the general public – via the corporate governance code, we will impose it by law. This is a perversion. The whole thing about corporate governance is about the trust of the capital market.” (G)

and:

“The obligation to publish [salaries] is absurd because it is not the public's business. This is an internal legal relationship between the owner of a company and their employees, the managers. And if somebody wants to make this public he can request it at the annual general meeting and the annual general meeting can decide on it.” (G)

But, while not necessarily agreeing with disclosure some thought demands for it were understandable:

“You have to see that there are so many other interests at stake. I think as a journalist or a media guy I would demand this strongly because I know that several times a year I can fill a whole page reporting on issues people are interested in.” (G)

and

“[Cromme’s] influence is very strong as the chair of the commission because, in conjunction with the Department of Justice - the commission is an instrument of the Department of Justice
he aimed to press ahead with the reforms as much as possible and as much as necessary. He had to (...) tackle unpleasant topics .... and to propose regulations that would find a large measure of agreement. One could not have left open hot issues such as the remuneration of the board members which rightly or wrongly were fiercely discussed in the public arena. You could not have said that this issue is insignificant. Because of the strong public interest the commission had to propose something.” (G)

In terms of employee representation many interviewees criticised the code for ignoring the issue:

“The law[on employee representation] is from 1976; it is 30 years old. To impose on companies a completely new understanding of corporate governance while ignoring employees’ representation is a design flaw.” (G)

In fact several interviewees expressed their frustration at the fact that the code drafters chose to ignore the paradox that employee representatives could follow their own narrow sectional interests while the code required other members of the board to demonstrate independence and responsibility for the strategic direction of their company:

“[T]he independence of the members of the supervisory board is important. (...) Second, the topic of competence. For instance financial expertise is important in the sense that members of the supervisory board are responsible for the well-being of the company. This is of course important. But what about employee representatives? They are neither independent, nor competent, nor do they feel responsible for the well-being of the company.” (G)

Some blamed the political nature of the Cromme commission for this:

“What is interesting about the corporate governance commission is that the issue of employee participation was and is excluded from discussion. Without any doubt this is a birth defect. We have to thank politics for that because politicians did not want this as an issue of corporate governance – which is a German particularity and needs re-assessing. ... Nonetheless I have always endorsed the presence of the labour unions on the commission. Their contribution is constructive and valuable. It is the case that we have this particular issue of corporate governance in Germany because we have employee representation on the supervisory board. It would be absurd not to let the labour unions take part in discussions on questions of company law.” (G)
Another participant was however less phlegmatic about the presence of labour representatives on the Cromme commission:

"I perceived this of course very awkwardly and bitched about it a little, but the task of the commission was not changeable. It was laid down by the federal government. The commission was not allowed to deal with the issue of employee participation. It is a bit like you are dealing with the topic of hunting but you are not allowed to talk about guns... and this is still the case. That means that labour unions ensure the topic of employees' participation is left out [of discussions]. And I really don't like that." (G)

Overall, the emphasis in the interviews in Germany seemed to focus more on substantive issues of content, both what was included - such as directors' liability insurance and 'staggered' boards - and what was excluded – employee representation - rather than was the case in the UK where most felt the content was acceptable or that comply-or-explain offered sufficient flexibility where it was not. Nonetheless several UK interviewees mentioned substantive issues including the definition of independence of non-executive directors and rules on the composition of sub-committees such as the remuneration committee (which were amended shortly after the interviews took place). Such issues were generally dealt with by use of comply-or-explain, with only minimal criticism from shareholders. In Germany the situation was similar although there was less experience, and therefore less understanding, of self-regulation and comply-or-explain.

**Compliance reporting**

We now turn to the process of compliance reporting. Our interest here is to assess whether there are any significant differences of approach that might impact on the decision to comply or to explain. During the interviews we asked our interviewees about the resources devoted to compliance and compliance reporting. This varied but almost all considered the resources required to be reasonable. Few at board level spent much of their own time on dealing with compliance matters. In both countries lawyers seemed to dominate and indeed own the process internally although the board took ultimate responsibility and senior board members, particularly the CEO and chairman, would often be involved in conversations on governance issues with their company secretary (UK) or legal counsel (Germany).

Much of the process of reporting compliance is entirely routine:
“I will look at last year’s, I am not going to reinvent the wheel, I will look at the criticisms that have been made of last year’s. (...) will then look at it from the point of view, well you obviously look at it from the accuracy point of view but that is just inevitable. Then I am tempted not to make many changes to be honest. I don’t get much feedback on it.” (U)

Another company secretary similarly describes the process as continual. He additionally refers to external actors (auditors and lawyers) being involved in the process:

“I find that at this level Chairmen are relying on their Co Secs to - it is only where you have got problems do Chairmen start to get interested in this area. (...) My previous experience is there are a number of requirements coming from a number of different directions as to what needs to go into a Directors report, not least the Companies Act which obviously is transitioning from the ’85 Act to the 2006 Act, and the listing rules, and Directors remuneration requirements and all this sort of stuff. So there are huge checklists of things that have to go into it. You always start with last year’s and modify accordingly and then tick it off against all the requirements. Obviously you have got lawyers involved as well who look at it, as well as the auditors, and our own people.” (U)

The timing of preparing the corporate governance compliance statement is dictated by the company’s financial year end and is timetabled accordingly. Most companies seemed to follow the same sequential process:

“The initial draft was then obviously prepared and circulated to the Board and the Board members, well internally first through relevant interested parties here from a range of different parts of the organisation. Then through the Board for comment and input and then revised accordingly and then produced for final sign-off by the Board as part of the Annual Report process. We also check it against the auditors obviously, who have to look at it, for their purpose there were certain aspects, and our external lawyers as well from their point of view. The process of drafting it, I would take into account current comment, best practice out in the market, looked to see what others were doing as well in terms of evaluating how people are reporting on some of these things.” (U)

and:

“It is a much more iterative process, I would be aghast if anything came to our Board and they said we had better check the Combined Code on this. Because the way it happens is once a year, at least once a year, and it happens more often in our case, but at least once a year, I present to the Board a whole compendium of our governance arrangements. One of the things
that I do in compiling that, in presenting it, is I set out the Combined Code, and then in another column I set out how we are complying with it and areas where we may or may not need to explain. We do that once a year so the Board has uppermost in its mind what the provisions in the Combined Code are, it is not something that is out there and they never see it. So they see it at least once a year. (...) So there is never any question of putting the cart before the horse here because the Board and the Committees are fully aware of good governance, of what is in the Combined Code. It does influence what decisions they may make but it is only an influence.” (U)

Many also kept a watching brief on the actions of their boards throughout the year:

“Clearly the Board is aware of the Combined Code but it is really my role to remind them as they go through meetings and other issues day to day, for me to remind them that the Combined Code requires us to do certain things. If for any reason we decide to deviate from the Code it would just be made clear that we will have to disclose it, and we will have to explain the reasons, and then the Board will discuss and agree, yes, they are comfortable with the explanation and they feel that the explanation fully justifies it. That will be minuted usually and then obviously when we come to do the review at the end of the year, the corporate governance review, then we would include an explanation at that time. So the Board would be aware of it, the Board will be made aware that it was a deviation.” (U)

There were few major differences in the way equivalent German interviewees perceived these processes. The dual board structure in Germany did however dictate who was involved – the executive board usually taking the lead on corporate governance matters. A supervisory board member described the process insofar as it affected the supervisory board, as minimal:

“Well, this is a topic discussed in the last meeting of the supervisory board (...) and the responsible specialist of the executive board – mostly working in the general secretariat, or whatever you want to call it these days – presents to us where we comply and where we do not. He also reports whether there have been substantive changes – either positive or negative – on the issues we deal with. And then there is normally a very short discussion.” (G)

Asked for his role in the process of reporting compliance another member of a supervisory board replied that:

“... no member of the supervisory board would do that. It is the administration of the supervisory board that takes care of it. The supervisory board takes care of the substance of
the company’s business, but not of the procedural issues. (...) The way to come up with decisions within the supervisory board is that decisions are prepared by the chairman as well as by the executive board. There are draft resolutions. There is not really much to decide anymore. As a member of the supervisory board you get everything prepared and spoon-fed. You don’t have the time to critically discuss issues or to change them in the way one might think from the outside. This is not possible in terms of time because there are so many things to decide upon. (...) You think too much about debating the issues. The supervisory board is a very formalised committee in which very few things are argued about. That might be different in the executive board in the sense that there is more discussion between the members. But the supervisory board is a external control committee of people with limited access to information which only vaguely keeps track of what really happens inside the company and which plays a role mainly in the strategic decision making. This is a supervisory, not an executive board.” (G)

The resources allocated by some executive boards were quite substantial. Some set up a separate office to deal with ensuring compliance and preparing the compliance statement:

“At the beginning the secretariat of the executive board carried it out but then we set up a compliance office. We have outsourced it; it has become a separate, independent department which deals with questions of compliance, also with insider rules and the time frame for buying and selling of [our] stock by the members of the supervisory board. It is responsible for the whole technical aspects of corporate governance and makes sure all processes are undertaken appropriately and looks out if there might be conflicts of interest – already pre-emptively – and contacts the people, etc.” (G)

Family dominated public companies are something of a rarity in the UK but are quite common in Germany. For such companies corporate governance is not a priority, let alone compliance with a code of corporate governance, and may be treated more or less as an irrelevance as one member of a family dominated firm listed on the SDAX recounted:

“I am responsible for the draft of the annual report, generally for the whole communication with shareholders. That means that I have to draft the corporate governance statement. I do this with the lawyer Dr. ----- We look at the deviations, formulate them, give the statement to the supervisory board who then decide upon it. We lose five minutes on it in the meeting of the supervisory board. We lose another hour drafting it. As I said already, I have to admit that this is pretty pointless for us. (...) The [company] is very anti-bureaucratic. [The head of the family]
hates this kind of stuff. I do not think much of this body of regulations and I don’t see why I should stick to these rules.” (G)

In general the administrative overhead arising from the ongoing provision of advice and preparation of the annual corporate governance statement is not considered excessive although the process is more standardized in the UK than in Germany and larger companies have a more formalised process in place while smaller companies tend to rely on external advisers.

To comply or to explain: a stratified code

The addition of comply-or-explain to a code of corporate governance enables a regulated company to (i) demonstrate it has complied directly with the rule; (ii) demonstrate it has complied by some alternative means with the underlying explicit or implicit principle on which the rule is based; (iii) explain why compliance with the rule (and any underlying principle) is not possible or is not in the interests of the shareholders. In order to better understand the drivers for conformance and more especially non-conformance interviewees were engaged in conversation on their practice when dealing with issues of non-conformance, either from their own experience or their understanding of the issues faced by others. One immediate difference in this regard between the UK and Germany is that self-regulation and the use of codes as a regulatory strategy have long histories in the UK, and in particular in the City of London. There is a what might be called a ‘code culture’ to be found in the City which influences the way that business as a whole deals with issues of governance:

“If you look at the way the City has operated since the ’60s when the takeover panel was first really constituted, you know, a uniquely British institution if you like, it is a non-statutory body, there is no law that says it can do this, there is no regulation that says it can do this, but everyone among the great and the good got together and said something must be done. So in our British way we all agreed that this is what we would do and anyone who didn’t want to play by the rules, we wouldn’t play with them.” (U)

Others spoke about the ‘spirit’ of the code, something far less tangible than the letter of the law, and something that required a considerable degree of engagement and reflexivity:

“I think codes, as opposed to legislation, in my view are supposed to have a degree of flexibility built within them which enables people to, one in a strengthening way means that you comply
with the spirit as well as the letter. So in some ways they can be more onerous because if you are applying that sort of spirit test, that sometimes does drive you to some harder choices than the letter of the law.” (U)

Engagement with the ‘spirit’ of the law brings with it responsibility and accountability:

“It is very easy to write down something, thou shalt do this and that, and you won’t do that and the other. If you quote something which is grey it requires interpretation and if you have got latitude, then responsibility and accountability comes with it doesn’t it? I think where there are areas of interpretation we would consider pretty carefully what that interpretation should be. It may well be more onerous and, as I say, it is very easy to say, ok black is black, and white is white, and which side do you fall, but if there is something which is grey, you are left, and I think, a lot of companies would default to the more difficult position sometimes, maybe not always. I think obeying the spirit, it can be relaxing as well but I also think it can bring with it a greater burden.” (U)

However, some of the UK interviewees yet again spoke of the importance of authorship, of making a genuine contribution to the code – not by way of an explicit contribution perhaps but by the way those who drafted and periodically revise the code incorporate best practice within the code provisions:

“I think the Code is following best practice. (...) I don’t think the Code sets best practice, I think that would be wrong. I think the beauty of the Code is it does follow best practice. Who on earth is going to actually prescribe to us what best practice is? The fact that we are allowed to explain, in theory I would imagine, then says to us that it is following best practice. It is not imposing it. If it was imposing perhaps that would be a reason, perhaps it would be imposing what third parties believed to be best practice but we are allowed to explain away.” (U)

Flexibility of the code is seen by some of the UK interviewees as a two way street. Not only can companies use the flexibility of comply-or-explain but if the code is to retain its legitimacy with regulatees then it too must be flexible and adjust to reflect best practice where the code has either failed to capture such practice within its provisions or where best practice itself changes:

“I think a lot of it is best practice anyway. Some of the ridiculous things like you couldn’t have the Chairman sitting on the Remuneration Committee previously, and they got rid of that because actually that was a ridiculous thing. People said well ok we won’t have the Chairman on the Remuneration Committee but for obvious reasons he should be there in attendance and
eventually they changed it because it just wasn’t sensible. Everybody was saying, oh god, the original Higgs Report said the Chairman should not Chair the Nominations Committee which we all thought was daft. If that had have gone through we would have probably had the SID chairing the Nominations Committee but we lobbied hard, along with a lot of other companies, and they got rid of it. So I think that there has been some sort of credence taken of what business thinks about it." (U)

There is a practical side to creating and retaining a sense of ownership of a code - regulatees need to have reasonable access to those carrying out revisions to the code:

“My own experience of codes has been that it is actually very easy to get to the people who draft them so if you want to understand the spirit of them it is actually quite easy. In previous times I have been heavily involved in the drafting of the Banking Code and I found them very accessible. If you want to actually make changes, where you find parts of a code that don’t work so well, because they tend to have a review every 3 years, you can normally get things changed more easily. Somehow they feel more tangible”. (U)

There is also a practical side to a one size fits all code::

“A few years ago there were a plethora of codes coming out and every major institutional shareholder felt that it ought to have its own statement of principles or code and therefore measure the report against that. So you would end up with a pile of codes and you would say, well, they are all trying to get to the same place, and if we don’t meet some of these, people are going to potentially take issue with it, but I think having gone that way I think they have pulled back from that a lot now, or there is different emphasis. Morley [an investment company] may have a particular view on remuneration or types of remuneration plans but generally they are all working under the ambit of the Combined Code and therefore it becomes much more easy to deal with.” (U)

The point was made by several UK interviewees that not only have companies adjusted to the Combined Code and learned to use its flexibility but also the monitors have come to accept the code as the primary standard for corporate governance and are becoming used, over time, to the use of explanation for deviation where this can be demonstrated to have been applied responsibly:

“People did go down the route of saying, the Code is the standard, if you don’t meet the Code then, by definition, you are not meeting the standard and therefore that is a black mark against you. There has been a lot of debate by Higgs and everybody else about trying to get
away from that and I think most serious investors now are away from that. There is not a knee jerk reaction. You may be not complying with the Code but that doesn’t mean that anyone is going to automatically mark you down accordingly. It may be a flag is raised to explain that there may be some discussion round it but it is not going to be a significant problem.” (U)

The same interviewee also emphasised the normative aspect of the combined code:

“I think one’s perception of the Code as being, as we have seen it move from being a guidance document to then being incorporated by reference into the listing rules, it is not directly regulation but it is regulation in a way and therefore you would be expecting people to be complying to that if there is no good reason not to, but I don’t think it loses its value necessarily because of that. (...) I think it is helpful for people to have some clarity around the framework and then they work through the behaviours that are required for it. I think it is because the Code itself is reflective of the general market perception about what is a reasonable framework within which to be operating.” (U)

However, it may be that experience of regulation in other areas of a company’s business can affect its approach to utilising the flexibility of the code. Although this interviewee was at pains to demonstrate that both the Code and hard regulation were treated with equal seriousness, the language used – talk of breach and penalties – would seem to suggest an aversion to any position other than a norm of full compliance:

“In principle, day to day I don’t think people say, oh that is a rule and that is a code and therefore I am going to ignore that. From my experience in compliance, when we had the Mortgage Code and we had the Banking Code and we had the ABI codes prior to some of the more detailed FSA regulation, they were enshrined in our business processes and people adhered to them. I guess if it ever came to a situation where you were thinking, well I can do this or I can do that, clearly the penalties for breach of regulation are greater, and the potential reputational risks are greater, so if you had to, for any reason, prioritise, you would always adhere to regulation first. But certainly from my days in compliance people didn’t ever say, oh that is only a code, I am not going to do it. There may have been some areas where it was more flexible, there was more scope for interpreting the rules” (U)

The default behaviour, the norm, is to fully comply:

“I think it is slightly different. I think there is almost a disappointment that where it is misunderstood that they misunderstand, whereas with the FSA I think it is more clear cut that
if you don’t do something this is the penalty. What we feel at the moment is that sometimes we are being backed into a corner slightly and other times we will just say, we are entitled to explain and we will just explain. Our starting point is always we comply with the Combined Code, and we do fully support it, but if there are situations where we do feel that it is in the interests of the business to do something different then the Board is comfortable with doing something different and then I think they do just get a bit irritated when that is misinterpreted. But it doesn’t actually stop them I guess, is where we are at the moment.” (U)

Others go further and perceive the Code as de facto hard law:

“It is not a comply or explain in reality. It is not equal weighting comply or explain. It’s thou shalt comply and at the periphery you can explain away. (...) It’s comply, you will bloody comply because you will be out there being shot at if you don’t. On that basis it could be codified. It could be really codified and made legal and have no real impact because you probably wouldn’t put into law some of the margin that people explain away because it would just be (...) Yes, so some of that sort of stuff you wouldn’t put into law. But the bits that were put into law, if they said to me tomorrow it was going to become legal to do X, Y and Z, and those are the core, I wouldn’t have a problem because I would never thinking of explaining. Yet you sucker people into this thing that they can comply or explain, and everybody talks about the freedom to comply or explain, peer pressure doesn’t let you explain on the major stuff.” (U)

So for this interviewee the perception of comply-or-explain is just that – a perception. On this reading any sense of code legitimacy based on its potential flexibility may be comforting but is false. He is not alone:

“No, you might get away with minor omissions on a comply or explain basis like you have forgotten to have a meeting of the Non-Execs without the Chairman. Something relatively trivial you could get away with but most of it is I think actually pretty hard law, I don’t think it is a Code at all. (...) We don’t regard it as Code, we regard it as something we have to comply with. (...) I think it has evolved from kind of soft law to hard law for people like us. We actually don’t see it materially different to, the consequences of not complying are a bit different, but I don’t think we necessarily see it any different to the listing rules or the disclosure rules or the Companies Act. It is another lump of stuff we have to comply with.” (U)

Several interviewees then see the Code as offering very little opportunity for flexibility from which one may conclude that the code is becoming ossified:
“So, ok, there is some soft stuff and some encouragements here and there but most of what is in the Combined Code is hard law and a lot of it now, because this is 4 years old, is now taken as motherhood and apple pie. You wouldn’t dream of not having an independent Audit Committee or an independent Remuneration Committee, or a Nomination Committee that isn’t composed of Chairman, NEDs and CEO, which I have a slight issue with. The world has kind of moved on, I think this is now entrenched and most people would not argue with most of it.” (U)

This is seen as being at odds (not necessarily correctly) with the original intentions of the Cadbury Committee:

“It is sort of fine in the sense that it has been in place for a few years now, people sort of understand the nuances, people understand where they can flex and where they can’t, and I think people are now happy with it. There were all sorts of sharp intakes of breath when it was brought in. (...) To the extent we are not allowed to exercise the discretion that the original writers of the Combined Code intended because the market won’t let us.” (U)

Some even fear that the increasing pressure on larger companies to fully comply may lead eventually to the comply-or-explain mechanism falling into disuse:

“I think there probably is a tendency (...) that the FTSE 100 companies have become more and more compliant. My concern, as I keep telling my Company Secretary friends, is don’t comply the whole time because otherwise you will end up losing that right to explain. I think, I really do think that right is valuable and I think particularly with what is happening in Europe, in a way if you can’t see responsible use of the flexibility of comply or explain, I think the trend will be that you will lose it and there will just be rules and I think that will be a huge error. So I keep encouraging my friends not to comply.” (U)

Almost all the UK interviewees reported this movement towards full compliance. In a sense what we can observe is a process of internalisation of rules. Rather than by force of law, the actors on the capital markets are perceived to produce a punitive environment that encourages full compliance as the only acceptable position. It forces companies, particularly large companies, to comply fully with the norms set out within the code:

“I think the principle of comply or explain, it is fair to say it is designed to allow people the flexibility and I think, as I say, depending on your sector, how that sector is perceived, and how
big you are, there is some flexibility. But if you are a FTSE 100 there is no flexibility. You are expected to comply and the institutional investors will put pressure on you if you don’t.” (U)

Others agree:

“...I think for a company like [us], and indeed probably for most other FTSE 100 companies, comply or explain is a bit of a myth because compliance is effectively mandatory. (...) So there are some exceptions but in neither of those cases material exceptions. So I think for a 100 FTSE,... full compliance is effectively required.” (U)

Some even spoke of a 'culture of compliance' among their peers in the FTSE 100. On the other hand, the pressure does not only come from monitors or peers:

“Yes, I suppose it depends to some extent on how the auditors work. I know ours last year certainly worked from a checklist and they went through the Code and if there was anything where you weren’t slap bang in the middle of it they would put, ‘breach.’ It really infuriated me and I spent quite a long time with them trying to explain how the Code worked.” (U)

And the media are seen to contribute to this punitive environment:

“I am quite surprised how reluctant people are [to explain rather than conform] and I guess it is because they have got more experience of the media probably to step out of line. So I think that conformity is quite strong. I guess it comes back to reputation probably, not wanting to stick your head above the parapet unless you absolutely have to.” (U)

However, the extent to which the punitive nature of the environment is real or imagined may be open to question. Institutional investors may be far more accepting of deviations, accompanied by valid explanations, than board members believe. To inform the research a number of institutional investors were interviewed, one of whom put it thus:

“I was astonished that they spent so much time box ticking. That’s how I would describe it. [Board members] didn’t imagine that there was any institutional flexibility, and that really, I couldn’t understand that. They spent a lot of time talking about independence of non-executives, particularly about tenure. You know they were saying, ‘I’ve got a wonderful non-exec, he’s been on the board for nine years, he’s just tremendous and now we’ve got to get rid of him because he’s past nine years and those [institutional investors], they’ve created a rod for their own backs because they’re getting rid of the good people.’ And one by one we were all putting up our hands saying, ‘If he’s good - keep him, that’s fine, and if you have to make
him no-independent then you make him non-independent, but it's not a problem, and if you have a board which is non-independent because of that guy and you don't want to get somebody else in- then fine, just explain’. ‘No, no, no, no [they said], we have to get rid of him.” (U – institutional investor)

Of course there is a transaction cost to be taken into account when explaining rather than conforming:

“It is much better to fall in the pack, and I am talking about companies generally, than to stand out on a trivial point. Why explain something that really doesn’t matter because you are going to devote a lot more management effort to that explanation and defending that position than you are simply to comply.” (U)

Overall, UK interviewees, perhaps incorrectly, felt considerable pressure on them to demonstrate full compliance. While many wish to retain the essential flexibility of the code, their preference for full compliance actually serves to weaken the justification for retaining comply-or-explain. Almost all interviewees treated code compliance with the same diligence as they would hard law - perhaps because they were wary of what they perceived as the punitive environment they inhabited. There is something distinctly Foucauldian about their behaviour – there is little evidence that monitors are actually increasing the pressure for full compliance. In fact some of the interviewees themselves noted increased understanding amongst stakeholders of the responsible use of flexible compliance – in other words that non-conformance is not necessarily considered by monitors to be synonymous with non-compliance. Nonetheless the interviewees seemed to have internalised this need for full compliance and displayed little resistance. It has become for those who have already demonstrated full conformance an habitual value and for those who have not yet attained full conformance, an aspiration. On the other hand if the code really does enshrine contemporary best practice then full conformance ought in any case to be the default position, with a few rare temporary deviations to accommodate unavoidable circumstances such as the unexpected departure of a director. Where the code does not enshrine accepted best practice substantial deviations may occur, to which the monitors may acquiesce (as was seen over the composition of the nomination and remuneration committees). Perhaps the lesson from the UK’s 15 years experience of comply-or-explain is that it provides regulatees with a possibly illusory sense of control over the governance of their companies. The great majority of the contents of the code become akin to hard law. Deviation is simply not acceptable. These form the bedrock of the code. A second smaller stratum of rules may have been or become sub-optimal and following substantial deviation may be amended and amalgamated into
the first lower stratum. The final stratum consists of rules such as board independence where temporary deviation may be unavoidable from time to time.

Turning to the German interviews a number of respondents considered preparing for implementation of the Cromme code was important:

“We try to take the role of early mover (...) From our perspective this is an advantage as one can influence one thing or another. (...) We know no one in the commission, but nevertheless I think that if one undertakes this well in advance you always have a chance to influence...if only because one is perceived as a company that implements things from the very beginning.” (G)

and:

“Yes, we try to anticipate the developments in large part and internally be ready for them and to manifest this inside the company. I think this is better for the company than to run after and implement those things ex post which the lawmakers or commissions set up for companies.” (G)

Another interviewee placed emphasis on consent. According to him this was the precondition for the working of the code itself because only via consent could one create legitimacy:

“A voluntary code lives by to a certain degree by consent. You cannot push something through like one can via law where you have all the sanctions of penal law available.” (G)

While feedback and consent are considered necessary for creating legitimacy, cost was also a major issue for the German interviewees. The increased cost of compliance with a further set of rules can, if monitoring and enforcement is insufficient, lead to lower compliance rates, especially where such rules are considered overly burdensome and/or unnecessary:

“There are plenty of statutory rules. We should not overload this. I think it is good to summon companies to engage in a reasonable dialog with their investors and with the public, but the subject should not be overloaded. We are already challenged with lots of other new regulations which cost time and money and cause a lot of administration.” (G)

Another interviewee mentioned in this context that a period of stability was now needed to enable companies to embed the various changes made to date:

“We should now say – and I am here in tune with colleagues from other companies – that we have a book of rules that we should allow to settle. We do not need any more changes. We have now something reasonable. We should let that settle and not come up with new ideas
every year. We should let it sink into the landscape and in four of five years we should go and look out for possible changes. In particular we should look at how far discussions on the European and international level have advanced and for clues about the changes these might mean for the German corporate governance code." (G)

However, the main question is the extent to which regulatees accept the code and engage with it and understand its inherent flexibility.

"I see some of the rules being very close to law. I don’t believe and don’t see the danger or need that some of them turn into law." (G)

Certainly the inherent flexibility of comply-or-explain, although somewhat novel in Germany, appears to help in this regard:

"Yes, the moment you are allowed to say 'I don’t comply and I explain why' you have reached maximum flexibility. Ok, the maximum would be when you don’t have to do anything. But this is already quite a large amount of discretion, because law is law." (G)

Our German interviewees did seem to speak of the code as a form of law, something less evident in the UK where regulation seemed to be treated as qualitatively different to law. This emphasis on soft law as law does suggest that Borchardt and Wellens (1989) were correct in their observation that non-binding rules can have the same effects as hard law.

However, for others the Cromme code is interesting primarily because it is not statutory law. Notwithstanding the statute elements of the Cromme code there is a sense in which some did not seem to consider it as either law or regulation per se but rather as an extra-legal agreement between interested parties – the company and others with a legitimate interest in its governance:

"[The code] is more flexible and more adaptable. I have the opinion that we don’t have to always call the state and the lawmakers if we want to sort out some stuff between ourselves." (G)

Although flexible regulation may be less common in Germany than in the UK a sense of the importance of voluntarism was expressed by several interviewees:

"Generally the German businesses want to plan and do everything on a voluntary basis, with as few laws as possible. We succeeded somehow on that way and now we should accept that as well. We can do everything by law, but I would question whether this would be better." (G)
and:

“I think of the code has been good for several reasons. One crucial aspect is that because of it we could get away from statutory law. I think that the required statement and a modification to corporate law is right.” (G)

For some, hard law, because of its requisite universality, was unlikely to be able to set more than minimum standards:

“One should not have here statutory law because at the end of the day [the code] could only determine the very basic rules of the game, but the not best practices which exceed the legal minimum. ... [Hard law] is just the minimum of what one has to do but that does not turn you into a good manager.” (G)

But levels of engagement with the code and with its legal form did of course vary:

“Q: So what do you think about this being dealt with by a code, and not by a law?
A: Your questions - I could not care less! You can regulate either way.” (G)

Indeed, a large number of interviewees were far less positive about the Code. In this context, some raised the question of enforcement. For them it was less a matter of whether corporate governance was regulated by soft law or hard law but more to do with whether regulatees would follow the rules:

“You can of course make a thousand laws. Of course there is the question of how much people stick to them and what penalties are imposed. I believe that in the governance of a company the integrity of the management is crucial, as is the integrity of the supervisory board that controls the management. There have been some or many cases of fraud in the past which is the reason, or at least part of the reason, for the corporate governance code - it is there to eliminate those. However I am not sure whether this is a successful endeavour. One can give people the feeling of security but at the end of the day it boils down to the trust you have in the management. It is a code. You can draft a law but I can break a law. The cases of fraud we had were carried out with a certain amount of care. They were not accidental. Whether I break a law or a code, at the end there will always be a corpus delicti.” (G)

Other claimed that the regulation of German corporate governance was already dealt with more than adequately in corporate law:
“In Germany questions of corporate governance are regulated much more precisely in corporate and business law compared to the Anglo-Saxon world. Such a strictly codified corporate governance law is unusual internationally." (G)

Even the flexibility offered by soft law was not apparent to some:

“It is astonishing how much force to regularise such a code has. The bottom line is that there is not much space for individuality.” (G)

Moreover the transaction costs associated with compliance with soft law, raised by some UK interviewees in respect of explaining rather than complying, were also an issue for some German interviewees:

“I think that soft law is the wrong way to ensure best practice. At some point these best practices will cause so much increase in administration, documentation and other costs for companies that people will turn around and say, this is insane!” (G)

Peer pressure also plays a part:

Peer pressure goes to the point that people do less and less where they deviate and where they have to explain. [...] In principle, everybody wants to be the swot. The more companies claim not to deviate the more people question whether it is worth the trouble to say ‘I deviate’ ” (G)

As does pressure from the public, articulated by the media:

“De facto you cannot treat this anymore as flexible. The discussion about the board members’ remuneration showed that. The public sinks its teeth into a subject matter which is not so important after all, hypes it up and pillories those who think that this is rubbish. And voluntariness says good bye.” (G)

The Cromme code commissioners were also identified as exerting pressure towards full compliance by virtue of highlighting compliance rates:
“There is comply or explain – something always slightly abused in Germany. When somebody explains and the stakeholders are happy with it, why is this wrong? […] But the commission runs around and claims that 97% fulfil all points. And I ask myself what is the point? Cromme is even proud of this. There might be lots of good reasons for many companies to not comply to specific points. And the stockholders seem to want that … otherwise they would complain which they don’t do. So don’t claim as the commission to be an extension of the law. No. You provide recommendations of different degrees. But comply-or-explain in Germany is immediately changed into 'comply and don’t bother us with explanations'. And in my opinion this is wrong. This is no longer a voluntary regulation.” (G)

However, the pivotal issue in determining attitudes to comply-or-explain in Germany has been the disclosure of director’s remuneration:

“You can see that high pressure has developed. The fact that one third – absolutely within their rights – decided to explain [not publishing the individual salaries of board members] caused people to say that they were not sticking to the code. Nonsense. Of course they followed the Code.”

In their survey of UK and German corporate governance statements Seidl and Sanderson (2007) examined which rules generated most deviations. In the UK, issues of board independence dominated, mainly because of leavers or joiners or because a director’s status changed from independent to non-independent by virtue of time served. The situation was in many cases temporary with the company assuring its investors in its corporate governance statement of a return to compliance on the issue once a replacement director had been appointed. However, refusing to disclose remuneration, the most common deviation in Germany, is not unavoidable – it speaks of self-interest – which may explain the reaction the explanations received from those monitoring compliance. In fact the pressure from the public on this issue led to the status of remuneration disclosure being modified, from a recommendation to incorporation in statute law:

“[The minister] said that if people did not comply there would be a law … She said you had better comply with the code. She said she would observe what was happening for one more year and if not, there would be a law. And that’s what happened.” (G)

This seemed to increase the sense of lack of ownership and also to increase the perception amongst quite a few interviewees that comply-or-explain was indeed for the most part merely a staging post on the way to full compliance:
“Of course it is a standard. And you don’t want to write every year that you don’t do this or that. At some point they get you and we all do the same rubbish. That’s the case. You don’t have to say much and the statement is much shorter. You know, this is the normative power of the standard. Insofar I would say that comply or explain in merciless. At some point you don’t want to explain anymore and then you comply.” (G)

The tendency towards full compliance was of course also observed in the UK interviews - but there is an important difference. Almost all interviewees in the UK perceived the contents of the Combined Code as embodying best practice which in turn increased their sense of ownership of the Code. Full compliance is thus, in a sense, a perfectly natural part of the endgame for UK companies and the comply-or-explain mechanism enabled companies to conform with the code when circumstances such as mergers, takeovers, new listings and the sudden departure of directors made full compliance temporarily unattainable. For a number of German interviewees the mechanism was little more than a political sop to make the imposition of the code more palatable. At the extremes such attitudes were manifest in full non-conformance. This is not to suggest that such companies deviated from 100% of the rules in the Cromme Code – but rather that they made no effort to assess and publish details of the extent of their discretionary compliance:

“We decided to generally reject it. ... the idea of a code itself is rejected - not what is written in it. As I said, we had done a lot of what is in it before the code. This is ... automatism. .... The fact is that if the lawmakers want something done they should make a law – they do anyway - there is enough law around. And if they do not want this, they should stay clear of it. But these recommendations - 'should', 'could' - what do I get out of it. Nothing. .... I think it is politic to say that I don’t want to follow a code because I follow the law. And if this is not enough for lawmakers then they have to think about changing the law.” (G)

Others also rejected the whole concept of soft law:

“'Could' and 'should' rules - even for a lawyer this is a rather acrobatic art form. And for somebody who does not work with such texts and norms it becomes a nightmare. That’s why this distinction is in my opinion very bad and has done nothing to further either codes or corporate governance. It would be great to shorten the code and get rid of all the recommendations. Get rid of them. Generally I am an opponent of the code. Either there is law or there is no law. I don't think soft law is very helpful.” (G)
The same interviewee also expressed his anger at what he perceived to be the dishonesty of the whole process:

“This has nothing to do with codes. You cannot say one has to comply with the code – otherwise it is law. Go and pass your law. Yes or no. You can spare us this show of pretence that companies have discretion. Just be a bit more honest. Either politicians have the guts or they do not. To be honest, I think these intermediate forms [of law] are not fit for purpose.” (G)

The notion that only hard law ensured compliance with the more contentious rules was not uncommon:

“We provided a template for the executive board. We stated what we need to change and the executive board actioned it. Also the supervisory board was told we are now fully compliant. The only difficulty was the remuneration of the executive board. Because it was just a recommendation at the beginning – a soft regulation – we did not publish. Once it became law, we published however, but with some discomfort on the part of the executive board which did not think this was right.” (G)

and:

“Q: How would this have developed if it had not been put into statute law?”
A: Some would have remained uncompliant. I am sure about that.” (G)

and:

“One would like to do everything that the law prescribes - but nothing beyond that.” (G)

In contrast with their UK counterparts a substantial section of the German interviewees were sceptical about compliance with soft law – both their own need to comply and the likelihood of others complying. This would suggest that monitoring is either absent, because their shares are held by a small number of insiders, or because the monitors themselves do not value the code sufficiently to use it to hold the management to account for their actions. Certainly those who declared full non-compliance would be likely to fall into the first category but further research would be required to address the second. The refusal to engage with the principle of comply-or-explain, another contrast with the evidence from the UK, would seem to be related to the perception that the code has been imposed from outside, although a lack of understanding of systems of self-regulation may also be playing a part.
Summary

- While UK based companies see the code as embodying best practice and so share a sense of ownership of the code with their larger counterparts this is not true to the same extent in Germany where the Cromme code is perceived by quite a few as a political instrument, imposed from outside. This impacts negatively upon its perceived legitimacy. Engagement of regulatees leading to a sense of ownership would seem to be essential for the successful application of soft law.

- However, as some UK interviewees commented positively about the careful consideration given to the inception of the Combined code and the fact that it has become embedded over time German attitudes may well change as the Cromme code itself beds in and becomes just a normal part of the corporate landscape. Against this, the key enduring difference between the UK and Germany is the institutionalised nature of the process of developing and refining the latter's code which may mean that German practitioners never assume a sense of code ownership to the same extent as their UK counterparts.

- Although the reporting processes are almost identical further differences were noted in the intensity of monitoring. The dominance of institutional investors in the UK ensures interested and powerful monitors whereas there are more family owned companies in Germany and a capital market in which bank finance plays a far greater role. While there was strong criticism of those German companies that refused to publish directors' remuneration, this came primarily from outside the business community, strengthening the convictions of those who argued that codes are an alien form of regulation.

- The outcome of the issue of the publication of directors' remuneration (its transference to the statute section of the Cromme code) combined with the sense that the code is an alien imposition contributed to the greater level of scepticism in Germany about the real benefits of comply-or-explain. Moreover while the UK interviewees generally understood that non-binding rules can have the same effects as hard law, a significant number of German interviewees found the concept of soft law nonsensical and either treated the soft elements of the code as hard law or refused to assess their conformance at all.
Both sets of interviewees felt considerable pressure towards full conformance rather than engage with comply-or-explain. This was depicted often as a response to the costs of non-conformance, in terms of both resources and reputation, but is also related to the length of time the two codes have been in force and are considered to articulate best practice. The Combined code has become well embedded over 15 years and has been amended as necessary to reflect accepted best practice. The Cromme code is relatively new so practitioners have less experience of using comply-or-explain and scepticism over soft law in general has been reinforced by the outcome of the remuneration disclosure issue.

The paradox of the sustained nature of the trend towards full conformance in the UK is that, while it ought to be the natural default position if the code really does embody best practice, it may also lead to comply-or-explain falling into disuse, with the concomitant danger that, if and when companies need to avail themselves of the flexibility, monitors will be unused to its deployment and respond unsympathetically. Interestingly, the pressure interviewees felt on them to fully conform may be more perceived than real. Perhaps in contrast to their German counterparts, the UK interviewees seemed to perceive the environment they inhabit as harsher, less forgiving and altogether more punitive than the contextual interviews carried out with institutional shareholders would suggest. This corporate over-focus on potential punishment for deviant behaviour accords with the analysis by Roberts et al. 2006 who drew similar conclusions regarding the disciplinary effects of director-shareholder meetings.

Although there was more enthusiasm for comply-or-explain from UK interviewees than their German counterparts the sense of control over the governance of their companies it seemed to provide may be illusory. The great majority of the contents of the code become akin to hard law, or in the German case may well be hard law. Deviation is simply not acceptable. These rules form the bedrock of the code. A second smaller stratum of rules may have been or become sub-optimal and following substantial deviation may be amended and amalgamated into the first lower stratum. The final thin top layer consists of a very small number of rules such as board independence where temporary deviation may be unavoidable from time to time and it is these, and these only, where a valid explanation is deemed acceptable.
References


Commissie Tabaksblat. (2003) De Nederlandse Corporate Governance Code: The Netherlands:


Regierungskommission. (2005) Deutscher Corporate Governance Kodex: Düsseldorf:

Regierungskommission Deutscher Corporate Governance Kodex.

Regierungskommission. (2008) Deutscher Corporate Governance Kodex: Düsseldorf:
Regierungskommission Deutscher Corporate Governance Kodex


Applying the ‘comply-or-explain’ principle: Conformance with codes of corporate governance in the UK and Germany

Source paper 2. analysis of compliance statements

Draft – under major revision - do not quote without permission please.
Acknowledgements
This paper draws on data collected for Soft Regulation?: Conforming with the Principle of 'Comply or Explain,' a research project funded by the UK Economic and Social Research Council (RES-000-23-1501).
Abstract

The comply-or-explain principle is a central element of most codes of corporate governance. Originally put forward by the Cadbury Committee in the UK as a practical means of establishing a code of corporate governance whilst avoiding an inflexible ‘one size fits all’ approach, it has since been incorporated into code regimes around the world. Despite its wide application very little is known about the ways in which managers apply the principle – in particular, how they make use of the option to ‘explain’ deviations. To address this we analysed the compliance statements and reports of 257 listed companies in the UK and Germany, producing some 708 records of deviations, which we used to generate our empirically derived taxonomy of forms of ‘explanation’. We find these varied forms of ‘explanation’ are based in part on different logics of argumentation. This leads to a broader use of the option to ‘explain’ than envisaged by the Cadbury Committee. In addition our country comparison shows significant divergence in compliance patterns in the UK and Germany which may be explained by differences in experience, culture and legal system. 

Keywords: Corporate Governance; Corporate Governance Codes; Comply-or-explain; Compliance; Compliance Reporting; Compliance Monitoring
1. Introduction

In the wake of corporate scandals like Polly Peck (UK), BCCI (UK), British & Commonwealth (UK), Maxwell (UK), Mirror Group (UK), Enron (US), World Com (US), Holzmann (Germany), Metallgesellschaft (Germany), Bayerische Hypo- und Vereinsbank (Germany) there have been increasing calls for more effective controls on corporate behaviour in general and the actions of company directors in particular. By way of response many countries have introduced new sets of laws and regulations to protect the interests of shareholders, particularly minority shareholders who have few opportunities to influence the actions of the boards of companies in which they invest. These reforms are considered by many to have been successful in encouraging both domestic and foreign investment (Shleifer and Vishny 1997), especially in common-law countries, but also (to a lesser extent) in German and Scandinavian civil-law countries (see Coffee 1998; La Porta et al 1998, 2000).

Irrespective of the form of legal system there has been in recent years a strong trend towards the use of ‘soft law’ (Mörth, 2004) or ‘soft regulation’ (Sahlin-Anderssson, 2004), in this area, in the form of codes of corporate governance. A code of corporate governance can be defined generally as ‘a non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations’ (Weil et al., 2003). The first serious code of this kind arose from the report of the Cadbury Committee in 1992 set up by the London Stock Exchange and the UK Financial Reporting Council. It contained a set of rules addressed to the boards of directors of all listed companies registered in the UK, many of which are still in force today, for example, ‘The roles of chairman and chief executive should not be exercised by the same individual’ (Cadbury Committee, 1992: A.2.1). The Cadbury Code as a mode of regulation for the corporate sector was subsequently imitated in more than fifty countries throughout the world (Van den Berghe and De Ridder, 1999; Iskander and Chamlou, 2000; Weil and Manges, 2002; Aguilera and Cuervo-Cazurra, 2004). These codes were variously issued by stock-exchange-related bodies, associations of directors, various types of investor groups, business and industry associations, and governmental commissions (Wymeersch, 2005; Aguilera and Cuervo-Cazurra, 2004). Most of them refer to companies listed on respective national stock exchanges. Apart from these national initiatives there are also some transnational initiatives like the ‘OECD Principles of Corporate Governance’, which are not so much directed at companies as such, but are primarily meant as ‘guidelines for legislative and regulatory initiatives in both OECD and
non OECD countries’ (OECD, 2004: 3). Within the EU the use of governance codes as a mode of regulation has been endorsed by The High Level Group of Company Law Experts (2002). Nonetheless, many remain sceptical of the use of codes citing, for example, the economic rationalism that underpins them (Bhimani 2008) and the way that this rationality leads to decisions and justifications of action that are outwith the spirit of the codes (Ahrens 2008).

A central element of most national codes is the “comply-or-explain” principle, which was first put forward in the Cadbury Code as a practical means of establishing a single code of corporate governance whilst avoiding an inflexible ‘one size fits all’ approach. Cadbury (1992) required that, “[L]isted companies … should state in the report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance.” This approach received support from The High Level Group of Company Law Experts (2002) which compared and evaluated different code regimes throughout Europe and has since been advocated by the Commission (Communication of the Commission 2003) for use by member states. Theoretically the comply-or-explain mechanism provides both flexibility in the application of the code and a means by which to assess compliance: ‘While it is expected that listed companies will comply with the Code’s provisions most of the time, it is recognized that departure from the provisions of the code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions’ (Financial Reporting Council 2006: 5). However, despite its promotion by various national and supranational organizations, very little research has been carried out on the way that the mechanism functions in practice (see Aguilera and Cuervo-Cazurra 2009). There have been numerous surveys on compliance rates (e.g. Von Werder et al. 2003; 2004; 2005) and correlations between compliance rates and firm performance (e.g. Gompers et al 2003; Goncharov et al 2006; Drobetz et al. 2004), but hardly any systematic research has been conducted on the way in which companies make use of the option to “explain”. An exception to this is the study by MacNeil and Li (2006) which examined whether share price performance explains compliance rates, in the course of which they analysed somewhat unsystematically the contents of compliance statements concluding they were not suitable vehicles for the provision of reasoned explanations. Yet, a closer look at compliance statements shows that some companies do indeed provide good justifications for deviations. Arcot and Bruno (2006) in their working paper show there are substantial qualitative differences between ‘explanations’. Yet, even their analysis of the different forms
of compliance statements is by no means comprehensive. This general deficiency of studies into board members’ use of the option to “explain” deviations has also been recognised by the European Corporate Governance Forum (2006):

“[I]t seems appropriate to have a closer look at the way in which companies comply with the recommendations of the applicable code. In particular, it does not seem sufficient to rely on simple compliance rates. When applying the principle of ‘Comply-or-explain’ more emphasis needs to be put on the quality of the explanations for deviations from the code as a meaningful explanation can fully justify non-compliance. The potential responsibility inherent to a statement of compliance should also be examined.”

In response to the call for more research on the way the explain option is used in practice we examine in this paper the compliance statements and corporate governance reports of 257 listed companies in the UK and Germany. While explanations for deviating are certainly not restricted to published reports and accounts, (companies can also provide explanations verbally at their AGM or via a press statement or in private meetings with shareholders), the formal statements can nonetheless be considered reasonable indicators of the types of explanation given also elsewhere. Analysing 708 individual cases of deviations from individual code provisions and the respective treatment in the compliance statement we derive a taxonomy of forms of “explanation”. It can be shown that different form of “explanation” are based on a different logic of argumentation which is not necessarily in line with the original idea of “comply or explain” as developed by Cadbury. We analyse the distribution of different forms of “explanation” across different companies. Comparing the statements of companies in two countries with different legal cultures, different capital market structures and different experiences of regulatory codes, enables consideration to be given to the extent to which use of the explain option follows a general pattern or is dependent on context.

The rest of this paper is structured into five sections. After this introduction, we will first describe the concept of the ‘comply-or-explain’ principle in more detail. We will then present our empirical approach to examining the way in which managers apply the ‘comply-or-explain’ principle. The following two sections will, then, present our analysis of the compliance patterns in UK and Germany respectively. The final section contains a discussion and explanation of these findings together with our conclusion.
2. What is “comply-or-explain”?  

The basic idea behind comply-or-explain is to allow for some flexibility in the application of the rules set out in the code. The codes are explicitly meant to be applied flexibly. It is not intended that all companies covered by the code should follow all provisions. Rather, where individual rules do not fit the particular organizational setting, companies are expected to deviate. (Baums 2003:7 gives as examples: size; ownership structures, international ownership, and requirements of the capital markets of other countries.) The Combined Code states clearly that: ‘[D]epartures from the Code should not be automatically treated as breaches’ (Financial Reporting Council, 2006: 7), and the official commentary on the German Cromme Code states: ‘Flexibility, as [one of the] guiding idea[s] of the code, is meant to prevent companies affected by the code from being corseted into too inflexible regulations. Companies should rather have the possibility of tailoring the modalities of corporate governance to their individual situations and of optimizing them with regard to efficiency criteria’ (Ringleb et al., 2004: 89; our translation). It is the essential genius of comply-or-explain that companies can be said to be in conformance with the code as a whole whilst deviating from individual rules.

This is not however a free pass for rule avoidance. Companies are required to declare and, in the original British application of the concept, to provide a public explanation for deviations. In the UK the Combined Code warns that: ‘While it is expected that listed companies will comply with the Code’s provisions most of the time, it is recognised that departure from the provisions of the code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions’ (Financial Reporting Council, 2006: 5, emphasis added). The flexibility of the code serves as a means of increasing the responsiveness of the code to individual circumstances. This means that differences in the circumstances of regulatees do not have to be anticipated by rule-makers and the complexity of the codes is kept to a minimum. Indeed, code issuers employing comply-or-explain are well aware from the outset that some regulatees, companies or groups of companies, will have difficulties in complying with certain provisions. The Cadbury Committee, for example, recognized that ‘smaller listed companies may initially have difficulty in complying with some aspects of the code. […] The boards of smaller listed companies who cannot, for the time being, comply with parts of the
Code should note that they may instead give their reasons for non-compliance’ (Cadbury, 1992: 3.15). Regulatees should assess their own positions and provide authentic responses - it is not for the code issuer to assess the applicability of the code provisions on behalf of affected companies nor to assess their response – the companies themselves are responsible for assessing both applicability and the appropriateness of their response.

The authenticity of such assessments is however for others to monitor and judge. The comply-or-explain principle relies upon third parties to provide such monitoring and thus to enforce conformance with the code (Brunsson, et al., 2000; Kerwer, 2005; Seidl 2007). In this case that third party is, at aggregate level, the capital market, in the form of individual shareholders. The market has two functions in this regard: evaluation of possible deviations and enforcement. It is after all in their direct interest to assess the significance of deviations. Indeed, the code exists primarily to protect their interests.iii ‘It is for shareholders and others to evaluate the company’s statement’ (Financial Reporting Council, 2006: 4). Similarly, Baums writes about the German code: ‘It is left to the capital market to evaluate the equivalence of any deviations [to the code provisions]’ (Baums, 2001: 10). Here too, evaluation by those affected means that no particular institutional arrangements have to be made for this purpose. It thus reduces the complexity of the regulatory design. Additionally, it allows in principle for an authentic evaluation by those affected by the deviations, as opposed to an evaluation carried out by external institutions on behalf of the affected parties. As MacNeil and Li (2006: 488-499) write: “The objective of the ‘comply or explain’ approach is to allow investors to make an informed assessment of whether non-compliance is justified in the particular circumstances.”

An additional function of the integration of the market mechanism is the enforcement of code compliance by those affected by potential deviations. Somewhat simplistically, unjustified deviations from the code provisions are expected to be ‘sanctioned’ through negative share-price reactions (Easterbrook and Fischel 1996). As Schüppen writes: ‘The influence of compliance on the share price is the idea behind the [comply-or-explain rule]’ (Schüppen, 2002: 1273; our translation). It is assumed that shareholders will take the level of compliance into consideration when they make a decision to buy, sell, hold, or vote. Accordingly, unjustified deviations from code provisions that appear significant to shareholders are expected to result in lower share prices (Weil and Manges, 2002: 68–69). In this context researchers often cite the study by McKinsey and Company (2002), which found that fund
managers stated they were prepared to pay an average premium of 14% for well-governed European and North American companies and even more in emerging markets. Since company directors are interested in delivering shareholder value through higher share prices, this is assumed to work as an enforcement mechanism.\textsuperscript{iv} Again, integration of the capital market can be seen to reduce the complexity of the design of the code system, since no separate external enforcement mechanism is required. In Figure 1 we have represented the design of the code regimes graphically.

\begin{center}
\begin{tabular}{c}
\textbf{Figure 1: Approximate Here}\n\end{tabular}
\end{center}

3. Empirical approach

A central component of the comply-or-explain principle is the public declaration concerning compliance or non-compliance together with the explanations provided in respect of deviations. In order to better understand the way the comply-or-explain mechanism is applied by company directors we have examined the compliance statements of companies required to observe national codes of corporate governance. As we were interested in the way that deviations were justified we concentrated on those deviations that were publicly declared in the official statements rather than conducting a survey as e.g. Von Werder et al. (2005) did.\textsuperscript{v} We took the position – originally envisioned by the design of the code regime – of the “average” shareholders who try to inform themselves about the level of compliance by studying the official company documents.

As use of the comply-or-explain principle by large companies generally attracts more attention together with comment and controversy we chose to analyse the statements of the 130 largest listed companies listed on the London Stock Exchange and the Frankfurt Stock Exchange respectively (altogether 260 companies). Thus, our data set initially comprised compliance statements of 260 companies in Germany and the UK published in the calendar year 2006, reporting activities to years ending 31 December 2005, 31 March 2006 or 31 December 2006\textsuperscript{vi}. In Germany this includes all companies contained in the Dax30 (30 companies with a market capitalization between €4 bn - €80 bn), the MDax (50 companies with a market capitalization between €0.3 bn and €7 bn) and the SDax (50 companies with a market capitalization of €0.05 bn and €0.5 bn). In the UK this includes all FTSE100 companies and the next largest 30 companies of the FTSE350 – with a market capitalization
ranging from £2 bn to £112 bn (€3 bn - €165 bn). From this initial set of 260 companies three were excluded since they did not provide any compliance statements due to their particular legal status during the period in question. Both sets of companies include all types of industries.

The analysis of our data proceeded in four steps. First, we reviewed the literature on code compliance – particularly the practitioner literature (e.g. Baums 2001) for potential types of explanations that one would expect. This was used to sensitize us as authors for the types and forms of explanations that one might find in the compliance statements and company reports. Second, we identified in the compliance statement and company report of each of the 257 companies those passages referring to individual code provisions, which resulted in a set of 708 stated deviations. Third, we conducted a content analysis of the selected passages (Babbie 2003; Krippendorff 2004; Miles and Huberman 1994; Strauss and Corbin 1998; Weber 1990). The coding of the passages involved several iterative steps. Initially, two of the authors of this paper analysed fifty passages independently of each other. This exercise resulted in two sets of preliminary categories of “explanations” for deviations. These sets were then compared and the differences were discussed. Following that an initial set of agreed categories was extracted from the first two sets. Using these categories, a further one hundred passages were analysed independently by the authors. Again, the results were compared and discussed, which led to the addition of some further categories. At the same time it became clear that there was an overlap between some of the initial categories. The overlapping categories were thus replaced by more general categories. The resulting set was then organized into main categories and subcategories. Based on this set of categories we analysed independently of each other the remaining passages. The discussion of the results of this analysis confirmed that the categories we identified were orthogonal and mutually exclusive (Strauss and Corbin 1998). In this way we generated an empirically derived taxonomy of forms of “explanation” for deviations. In a fourth step we examined the distribution of the different types of declaration of levels of compliance (based on our empirically generated taxonomy) across the different companies. In order to assess the extent to which the use of the explain option follows a general pattern or is dependent on context we compared the distribution of forms of explanation between the two countries. In order to facilitate this comparison we divided the set of companies into similar bands: the German data set was divided along the three main indices – DAX, MDAX and SDAX; the British
data was divided into analogous bands – the thirty largest companies, the next fifty largest companies and the fifty smallest companies in the set.

Table 1 presents our empirically derived taxonomy of forms of “explanation” to which we have added two categories – one for full compliance (in order to account also for those companies that do not deviate from code provisions) and one for full non-compliance, which we did not observe in our set, but which has been described in the literature (Von Werder et al. 2005). The taxonomy itself will be explained in more detail in the following sections together with a description of the distribution of the different types of “explanation” across different companies.

4. The comply-or-explain principle in the British Context

4.1 The integration of the comply-or-explain principle in the Combined Code

The relevant version of the Combined Code (Financial Reporting Council 2006) in the UK comprised 48 code provisions while the German Cromme Code (Cromme Commission 2006) comprised 82 code provisions. These are set out in two sections, the first for companies, the second for institutional shareholders, reflecting the nature of the British capital market. There are also three schedules to the Code that provide guidance on aspects such as performance related remuneration, the liability of non-executive directors, and disclosure of corporate governance arrangements. The main focus of our analysis is on the first section which contains subsections on the duties of Directors, Remuneration, Accountability and Audit, and Relations with Shareholders. A number of issues are addressed within each subsection, each containing a statement of the Main Principle involved. This is followed by more detailed Supporting Principles and finally, Code Provisions.

Observance of the Combined Code is a compulsory element of the listing rules of the London Stock Exchange but it does not cover private companies and some rules do not apply to smaller companies, those outwith the FTSE 350. Foreign owned companies can either comply with the Combined Code or the code applicable in their country of primary listing but if the latter they must state the extent to which they have complied with that code and outline
any significant differences between that code and the Combined Code.

Whilst observance is compulsory the preamble to the Code (2006:2) hints at the high trust basis underpinning the self-regulatory tradition within the City of London, noting that:

Whilst recognising that directors are appointed by shareholders who are the owners of companies, it is important that those concerned with the evaluation of governance should do so with common sense in order to promote partnership and trust, based on mutual understanding. They should pay due regard to companies’ individual circumstances and bear in mind in particular the size and complexity of the company and the nature of the risks and challenges it faces. Whilst shareholders have every right to challenge companies’ explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches. Institutional shareholders and their agents should be careful to respond to the statements from companies in a manner that supports the ‘comply or explain’ principle.

The successful application of the ‘comply-or-explain principle’ thus depends on both the company and the investor acting with integrity, applying the code as far as possible but allowing for deviations where sensible and, where necessary, entering into an authentic dialogue to increase each side’s understanding of the position of the other. To this end a mere statement of deviation from a code provision is insufficient. Companies are required to explain in all cases. Such explanation is also a requirement set out in the listing rules (Para. 9.8.6) Indeed, Schedule C to the Code (2006:23) stipulates the extent of disclosure required: Paragraph 9.8.6 of the Listing Rules states that in the case of a listed company incorporated in the United Kingdom, the following items must be included in its annual report and accounts:
- a statement of how the listed company has applied the principles set out in Section 1 of the Combined Code, in a manner that would enable shareholders to evaluate how the principles have been applied;
- a statement as to whether the listed company has
  - complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code; or
• not complied throughout the accounting period with all relevant provisions set out in Section 1 of the Combined Code and if so, setting out:

(i) those provisions, if any, it has not complied with;
(ii) in the case of provisions whose requirements are of a continuing nature, the period within which, if any, it did not comply with some or all of those provisions; and
(iii) the company's reasons for non-compliance.

Of the 130 UK companies analysed there was just one without valid usable data. Carnival Corporation, formed from a US and a UK company, listed in London under its new identity part way through the relevant year, but its primary listing remained in New York and it did not report on its compliance with the Combined Code for the period we analysed. We thus excluded it and only analysed 129 UK compliance statements. Of the 129 compliance statements analysed 67 companies (51.94%) were fully compliant (see Table 2). The top 30 companies in terms of market capitalization have a slightly higher rate of full compliance than the rest of the sample but in fact there is, perhaps surprisingly, very little difference between the top 30 and the top 80 companies. Full compliance does however fall away towards the bottom of the FTSE 100 and beyond, with the bottom 50 in our sample (those with market capitalization below £4 bn, or €5.92 bn) recording full compliance at just half the rate of the top 80.

The average number of deviations per company for the FTSE 1-30 is 0.60, or 1.80 if one excludes companies reporting full compliance (see Table 3). The average rises steadily as market capitalization decreases, from 0.96 cases for the FTSE 31-80 to 1.49 for the FTSE 81-130 although if one excludes full compliers there is little variation by size of company. There is however a steady increase in the maximum number of deviations that companies seem to be comfortable reporting. (Note that even the smallest company in our sample does not qualify for the dispensations given within the code on grounds of size). This maximum rises from 4 for the top 30 (SABMiller, a holding company with mainly overseas operating subsidiaries) to 7 for the bottom 50 in our sample (Daily Mail & General Trust, essentially still a family controlled firm). But even the least conforming company deviated from less than 15% of the provisions contained in the Code.
However, it would appear to be easier to comply with some provisions than others - or companies are less sanguine about being seen to deviate from some provisions. All companies complied with 20 of the code provisions (41.67% of the code) with the top 30 complying fully with 36 provisions (75.00%). Again, as Table 4 shows, frequency of non-compliance increased inversely with size of company.

The distribution of the number of deviations varies considerably, both amongst the provisions themselves and between the bands we use in our analysis of the top 130 listed companies. As Table 4 and 5 show, amongst the top 30 non-compliance is fairly low, with provision C.3.1 (composition of the audit committee) attracting the largest number of deviating companies at just 3 (10% of the sample).

Table 5 also shows that of the next 50 companies just three provisions, A.3.2 (the requirement for a majority of the board to be independent non-executive directors), B.2.1 (composition of the remuneration committee) and C.3.1 (composition of the audit committee), attracted more than 10% deviations, but for the bottom 50 in the sample the number of deviations per code provision increases, with provisions A.3.2 and B.2.1 attracting more than 20%. Overall, in the entire sample of 129 companies, A.3.2 had the highest rate of deviation at 26 (18.84%), followed by C.3.1 at 19 (13.77%), B.2.1 at 17 (12.32%) and A.4.1 at 10 (7.25%).

High numbers of deviations of code provisions are not necessarily an indication of regulatory failure. As explained previously, a central idea of regulation by codes is the flexibility built into the system, particularly through the comply-or-explain principle. Companies are meant to deviate from individual code provisions in those cases where they seem unsuitable or illogical for their own particular circumstances. Thus instances of deviation, far from illustrating non-compliance, could also be interpreted as indicating that the regulatory regime is working effectively - the flexibility offered by comply-or-explain adding essential
lubricants to the system. One way to assess whether the regulatory regime is functioning well is to analyse the compliance statements and the type of explanations given for any deviations, which we will address in the following section.

The explanations provided for the deviations have been coded according to the taxonomy delineating types of explanation shown in Table 1 above. These ranged from complete non-compliance both with and without explanation (neither of which apply to the UK) to various types of partial non-compliance. The latter are shown in Figure 2 below. Company specific reasons (both temporary and non-temporary) account for a high proportion of the explanations given by the reporting companies. Examples include the Burberry Group's demerger from GUS and numerous occasions when directors or even the chairman left, perhaps for health reasons, without completing a full term, causing the board to become imbalanced or requiring the CEO to serve temporarily in a dual capacity as both CEO and chairman.\textsuperscript{vii}

\begin{figure}
\centering
\caption{Figure 2 Approximately Here}
\end{figure}

The distribution of the different types of explanation between the three segments of the sample is given in Table 6 below.

\begin{table}
\centering
\caption{Table 6 Approximately Here}
\end{table}

This shows that while temporary company specific reasons other than structure or size were given most often overall (23.91% of all explanations given), these featured more prominently amongst the smaller companies in our sample (32.88%) than amongst the larger ones (11.11%). Larger companies were more likely than their smaller counterparts to raise principled objections against the content of particular provisions - 5 cases (27.78%) amongst the top 30 companies compared to just 2 cases (2.74%) amongst the bottom 50 companies.

There was little correlation between type of explanation employed and the code provision on which it was employed - with one exception. Some 11 cases (42.30%) of non-compliance with A.3.2 (board independence - a majority of directors should be independent) were explained by 3.3.7.2 (justification on the basis of temporary company specific reasons other
than size or structure). This represents 33.33\% of all instances of the use of that particular justification in our analysis of UK companies.

5. The comply-or-explain principle in the German Context

5.1 The integration of the comply-or-explain rule in the German Cromme Code

Similar to the British Code, but ten years later, the German Cromme Code was developed by a group consisting (apart from two academics) of practitioners chaired by a well-known corporate figure, in this case, the Chairman and former CEO of ThyssenKrupp Dr. Gerhard Cromme. But, in contrast to Britain the code issuing group was officially set up by the Ministry of Justice as a "Governmental Commission" and the code was also included by the Ministry in the official part of the Bundesanzeiger, the gazette where the details of enacted laws are first published. The first version of the Cromme Code was published in February 2002. Since then it has been reviewed and updated on an annual basis, with two major changes in 2005 and in 2007. In this paper we focus on the 2005 edition, the version in force for the year of our analysis.

Although the Cromme Code was to some extent modelled on to the Cadbury Code and the Combined Code it has a slightly different format. First, apart from the code provisions ("recommendations") to which the comply-or-explain principle applies, the code also reiterates various elements of corporate law. It also contains additional "suggestions" from which companies can deviate without disclosure. In this paper we concentrate only on the recommendations, the equivalent of the content of the UK Combined Code. Altogether, there are 82 code provisions, which are grouped around six topics: shareholders and the general meeting, the management board, the supervisory board, cooperation between the two boards, transparency, and reporting and audit of the annual financial statements. In contrast to the Combined Code the Cromme Code does not distinguish between "principles" and "code provisions" but refers only to "recommendations". These only apply to listed companies located in Germany, i.e. not to foreign domiciled companies that choose to list on the German stock exchange.

An important distinction between Germany and the UK concerns the way the comply-or-explain principle is integrated into the code. There are three main differences. First, the comply-or-explain principle has been incorporated into the German Stock Corporation Act
§ 161 states: "The Management and Executive Boards of the listed company declare every year that they have complied and will comply with the recommendations of the 'Governmental Commission German Corporate Governance Code' […] or declare which recommendations they have not or will not comply with. This declaration must be made available to the shareholders on a permanent basis." (§ 161 AktG, our translation). Second, as the formulation of § 161 makes clear, companies are only required to disclose their deviations from the code provisions, they do not have to give any reasons for the deviation. In this sense the German comply-or-explain principle is sometimes also referred to as "comply-or-disclose". Yet, the code itself contains a provision requiring "explanations" for deviations: "The Management Board and Supervisory Board shall report each year on the enterprise’s Corporate Governance in the Annual Report (Corporate Governance Report). This includes the explanation of possible deviations from the recommendations of this Code." (Cromme Code: 3.10; our emphasis). It is also often assumed that companies will provide explanations out of self-interest (Ringleb et al., 2004). Third, in contrast to their British counterparts German companies are required to publish a separate statement ("Compliance Statement") in which they declare their deviations from the code, apart from an additional Corporate Governance Report in the annual report, in which they can provide further information on their corporate governance. Some authors (e.g. Ringleb et al., 2004) even argue that the Compliance Statement itself should only contain the declaration of compliance or deviations while any explanations for the deviations should go exclusively into the Corporate Governance Report, to enable a fast and easy assessment of levels of compliance.

5.2 Analysis of the compliance statements of companies listed on the Frankfurt Stock Exchange

Altogether we analysed the websites and annual reports of all Dax 30 (30 companies), MDax (50 companies) and SDax companies (50 companies) with regard to their Compliance Statements and Corporate Governance Reports. Apart from two companies valid data on all other companies was found (see Table 7). The two companies that did not publish compliance statements, Highlight Communications AG and EADS, did not do so since being a foreign company they did not fall under the German Stock Corporation Act in which the comply-or-explain principle was contained. In our sample there are however also other foreign companies, e.g. Depfa Bank AG, which did publish compliance statements.

--------------------------------------------------------------------------------------------------

TABLE 7 APPROXIMATELY HERE
Of all the 128 companies 18 declared full compliance (14.06 %). Yet, the number of fully complying companies differs considerably between the different bands (Dax, MDax and SDax). While 40.00 % of companies of the Dax 30 are fully compliant with the code the number is much smaller for the other two indices, at 10.20% and 2.04 % respectively (see Table 8). Amongst the companies included in the study not one deviated from all code provisions. (Interestingly some 5 to 10 small listed companies did declare full non-compliance for the year of analysis, as they are allowed to do under the German system, but they were too small to be included in the three indices analysed here.)

The average number of deviations per company is 4.40 (or 5.16 if one excludes those companies declaring full compliance), shown in Table 9 below. Again, there is a considerable difference between the different indices, with an average number of deviations amongst the Dax 30 companies of 2.63 (resp. 4.31), amongst MDax companies of 4.31 (4.41 resp.) and among SDax companies of 5.88 (resp. 5.78). Amongst the Dax 30 companies Henkel AG has the maximum number of declared deviations with 20 deviations - most of them due to their specific legal form. Amongst the MDax companies Depfa Bank AG has declared the most deviations with 30 deviations and, finally amongst the SDax companies Indus Hodling AG has declared the maximum number of 15 deviations.

Table 10 below shows that, out of all 82 code provisions, 18 (21.95%) were complied with fully by all the companies in our dataset but there was quite a degree of variation between the three indices. Amongst the DAX 30 companies the number is 51 (62.20%) and for the MDax and SDax 35 (42.68 %) and 36 (43.90 %) respectively.

There are however some provisions that have quite low levels of compliance. For example, more than 50 % of all companies in our dataset deviate from code provision 4.2.4S2, which requires the compensation of the Management Board to be disclosed individually. This figure
is even higher when only SDax companies are considered, with almost two-thirds declaring a deviation. Other examples are code provision 3.8, requiring a suitable deductible for the D & O insurance policy to be agreed, and code provision 5.4.7 Para 3S1, requiring the individual disclosure of the compensation of the Supervisory Board Members - with more than 40% of all companies deviating from the former requirement (amongst the SDax the figure is nearly 60%) and more 36% of all companies deviating from the latter (42% for SDax companies). See Table 11 for an overview of the code provisions complied with least.

Table 12 provides an overview of the different "explanations" provided for the deviations. The figures in the four rows represent the frequency (in percent) that a particular type of explanation was used. The number of explanations given is slightly higher than the number of deviations observed as some companies gave multiple justifications for a single deviation. For example, several companies justified their deviation from Code Provision 3.8, which requires a deductible for the D & O insurance policy, by arguing against the code provision as counterproductive (justification 3.3.2) and by pointing out that it conflicted with international practice (3.3.8).

Table 12 provides an overview of the use of different types of explanations for deviations. Interestingly, nearly 30% of all deviations, whether non-temporary (28.32% - 3.1.1) or temporary (1.21% - 3.1.2), are disclosed without any kind of explanation. This is possible in Germany, since the law just requires disclosure, not necessarily justification. Yet, as explained above, it is often assumed that companies will provide justifications, and is indeed recommended in one of the code provisions. In addition to the unjustified disclosures there are a number of what we refer to as "empty" justifications (8.81%). These were presented by companies as explanations but in fact contained no explanatory content. For example, CeWe Color Holding AG 'explained' that they deviated from a code provision "since corporate practice as hitherto […] is to be maintained.". When combined, pure disclosure and empty justifications constitute almost half the deviations analysed here (see Figure 3).
In contrast to pure disclosure and empty justifications, principled justifications against the content of a particular provision (3.3.2) constitute just 19.17% of all deviations. By way of example, Fresenius AG states:

“Disclosure of individual compensation for each member of the Management Board, according to clause 4.2.4, sentence 2, in our view limits the structuring of compensation so that it is differentiated by individual performance and responsibility.” (Fresenius AG)

Over half of all cases of principled justification (53.56%) relate to just three types of code provision: Provisions No 7 (requiring a deductible in case of the D & O insurance policy), Provision No 25 (requiring individual disclosure of the management compensation) and Provision No 41 (requiring an age limit for members of the Supervisory Board), suggesting a feeling that these provisions are not deemed by board members to represent best practice.

In comparison very few companies gave industry-specific reasons (3.3.4.1 and 3.3.4.2) for deviating. Company size or board size (3.3.5), which Cadbury suggested might be a reason for deviating, is given however by just under 10% of the smaller companies in our analysis. Almost all relate to Code Provisions No 36 and No 37, which recommend establishing specialist committees within the Supervisory Board. In their compliance statements smaller companies frequently justify their deviation on the grounds that their Supervisory Boards are simply too small – in many cases they have just three members – so it makes no sense to set up subsidiary committees. In a few cases this explanation is also used (less convincingly) to justify deviations from Code Provisions No 72 and 73 requiring annual and quarterly reports to be made accessible within 90 and 45 days respectively.

Justifications on the basis of company structure (3.3.6.1 and 3.3.6.2) played a significant role in the case of just one single company, Henkel AG, where the particular legal form of the company requires it to have a different board structure. This was given as justification for 15 deviations. In a few other cases companies referred to their complex international structure to justify a delay in the publication of their annual and quarterly report (Provisions No 72 and 73). "Other company-specific reasons" (3.3.7.1 and 3.3.7.2) played only a minor role. "Conflict with international practice (3.3.8) was invoked several times, but almost
exclusively with regard to Code Provision 3.8 requiring a deductible in the D & O insurance policy. Transitional explanations due to the novelty of a code provision (3.3.9.1) or being a new entrant (3.3.9.2) played almost no role. In a very few cases companies also referred to potential conflicts between code provisions and the law (3.3.10). EM TV AG, for example, writes:

"The introduction of performance related payment for members of the Supervisory Board is put on hold, since there are currently concerns regarding the legitimacy of performance related payment." (EM TV AG; our translation)

Finally, in a few cases, the information provided in the compliance statements and/or Corporate Governance Report was unclear, and categorization impossible (category 4 - ambiguous or incomplete information).

6. Discussion and Conclusion

In this last section we discuss our main findings in the two different domains (the UK and Germany) highlighting similarities and differences. A first issue of interest when examining the effectiveness of governance codes as a means of regulation is whether the rules have any effect on the practices of the companies to which they apply. In this respect the declared level of compliance is an important indicator - although the declared practices and structures need not necessarily correspond to actual practices (Meyer and Rowan 1977; Seidl 2007). The declared compliance rates in our study differ considerably. While over 50% of the UK companies analyzed were fully compliant, the respective number in Germany was less than 15%. In both countries compliance levels dropped as company size decreased but there were significant differences. For example, while almost 30% of the smallest 30 companies in the UK top 130 were fully compliant, less than 2% of similar companies in Germany complied fully. Similarly, the average number of deviations of all companies analyzed was about 2 in the UK compared to about 5 in Germany. A similar difference is evident in the number of code provisions from which no deviations were found - more than half in the UK but less than a quarter in Germany, although some of this difference may be accounted for by the different number of provisions in their respective codes (48 in Germany compared to 82 in Germany). In addition, most code provisions in the UK have been in place for more than a decade while the Cromme code only became effective in 2002. Thus, German companies might still be in a process of adapting to a relatively new regulatory regime. Certainly compliance levels have been rising steadily in Germany since inception (see von Werder et
al. 2003; 2004; 2005). Size difference might also be relevant: the top 130 companies in the
UK were capitalized at between €3 bn and €165 bn while their German equivalents ranged
from €0.05 bn to €80 bn.

Of course, analysis of compliance levels provides only a partial insight into the effectiveness
of governance codes. As we have emphasized, deviations from code provisions are not, as
some corporate governance rating agencies would have it, evidence of regulatory or
compliance failure (see Koehn and Ueng, 2005). On the contrary, a high number of
deviations may be nothing more than evidence that comply-or-explain is working as intended
- providing essential flexibility within a single universal set of rules. On the other hand it
could be evidence of boards pursuing their own interests at the expense of their shareholders.
In this respect analysis of the provided "explanations" constitutes a good indicator - bearing
in mind, of course, that the stated reasons may or may not correspond to the "real" reasons for
deviation (Seidl 2007).

Consistent with the logic underpinning comply-or-explain one would expect to find
explanations are primarily situation specific (justification types 3.3.4 to 3.3.9 in Table 1), i.e.
industry specificities, company size, company structure, new entrant etc., but this is not the
case. In the UK they account for around 50% of declared deviations but only around 20% in
Germany. Amongst such explanations "company-specific justifications other than structure
and size" (justification 3.3.7.1 and 3.3.7.2) featured most prominently in both countries. In
the UK transitional justifications from new entrants to the London Stock Exchange were also
fairly frequent, reflecting the relative importance of the exchange - it is the third largest in the
world, and around twice the size of its counterpart in Frankfurt. This, combined with the
longstanding importance of the UK as a financial centre, makes it an attractive place for
companies from outside the UK to obtain a primary listing. In Germany, by contrast, the most
common situation specific explanation given was company and board size (although in our
classification there were actually more companies in the catch-all 'other' category). This may
also be because the average size of German company is smaller. Unsurprisingly size was
more often offered as an explanation for deviation by the smallest 30 companies than the
largest. But perhaps of greater interest, industry-specific reasons, which some writers
expected to be much in evidence (e.g. Baums, 2001), were only rarely cited. A few
companies did refer to the specific characteristics of their industry as a reason for deviating
but such deviations were relatively unimportant. The small number of explicit justifications
drawing on industry specificities also indicates that in this respect one size can indeed fit all.

Most strikingly though, a large number of explanations were clearly not consistent with the
principles underpinning comply-or-explain. (Again, in both countries, this applies more to the
smaller companies surveyed.) Firstly, there were what we have referred to as pure disclosures
(explanation 3.1.1 to 3.1.3, see Table 1) where deviations were simply disclosed without any
reason being given. While these amounted to just below 15% of deviations in the UK the
respective figure for Germany was almost 40% (or about 30% if we exclude those cases
where companies indicated they would comply in future.) The difference between the UK
and German figures might partly be explained by the fact that German companies are not
formally obliged to provide explanations. Secondly, both in the UK and Germany almost
10% of the explanations were what we referred to as "empty" (explanation type 3.3.1) -
varying slightly across the different size bands. Taken together almost 25% of UK deviatio
ns, and almost 50% of German deviations were not properly justified. The number is even higher
if we add those deviations where companies simply described without explanation their
alternative practice (although one might argue that such descriptions implicitly constitute a
form of justification.) This undermines one of the central ideas of the code regulation regime,
i.e. that companies only deviate where they can provide convincing justifications to those
monitoring code compliance, their shareholders. Whether such companies did not have any
convincing justifications for nonconformance or whether they did not wish to publish their
justifications we cannot say but the first would suggest such companies do not perceive their
external audience - defined broadly as the capital market and more narrowly as their
shareholders - to be effective or relevant code monitors while the second implies they do not
consider the compliance statement and/or Corporate Governance Report to be important
forms of communication - they may for instance have communicated their justifications in
other ways, for example in private meetings with their major institutional and/or family
shareholders.

A further interesting finding concerns what we referred to as a "principled justification"
against the content of a particular code provision. Although this might at first appear very
similar to situational explanations in that a "real" reason for the deviation is given, it is
clearly not in line with the original idea of the comply-or-explain principle to provide
essential flexibility in situations in which specific code provisions simply do not fit. This has
also been pointed out by Baums (2001), one of the architects of the German Cromme Code. A principled justification is an implicit criticism of the code drafters. For example, in Germany a number of companies justified their deviation from the code provision requiring a deductible for D&O insurance as a matter of principle, not least because the Cromme commission demanded a ‘reasonable’ deductible be made without specifying what they consider ‘reasonable’ - although presumably there is also a degree of self-interest in managers not paying personally the excess on negligence insurance policies that cover their activities. Both in the UK and Germany this type of explanation was used widely (but for different sorts of deviation). Indeed, it was the most common type of explanation amongst the largest 30 companies, accounting for more than a third of their total deviations. To the extent that these "principled" explanations provide general reflections on individual code provisions they can play another important role in the code regulation regime. They can, together with the justification we refer to as "general problems with the implementation/potential conflict with law" (explanation type 3.3.10), provide feedback to the code issuers about problems with individual code provisions. After all, one important characteristic of soft law codes (cf. hard statute law) is that the former can be more readily changed when required (see Baums 2001; Seidl 2006). In the UK there was a sustained refusal to comply with the rule that denied chairmen the option to sit on their company’s remuneration committee. After consideration it was accepted that this was indeed a proper role for them and the code was amended accordingly.

In general, there appeared to be significant differences in explanations amongst the different indices or size bands (top 30 companies, middle 50 and bottom 50). While this was evident in both countries these differences were more prominent in Germany. To some extent, this has to do directly with size. Smaller companies have less resources than their larger counterparts and some of the code provisions are of less relevance to them. Yet this cannot explain all the differences observed. For a later phase of our research we undertook interviews on code compliance which leads us to speculate that these differences may also be related to levels of exposure, peer pressure and ownership structure (see Sanderson et al 2009). Larger companies (particularly the Dax 30 companies) are more exposed to public scrutiny than their smaller counterparts (in the MDax or SDax). Moreover, companies seem to compare themselves with their own peer group (similar sized companies or companies within the same index.) Thus, in their decisions on compliance, and in their formulation of compliance statements, they tend to refer to precedents set by their peers. Lastly, many companies in the
MDax and SDax have a dominant, private shareholder. Many are "family firms," less dependent on the capital market than their larger counterparts, with a dominant shareholder who may well value privacy over transparency and disclosure.

Our analysis shows that a significant number of companies in both the UK and Germany are not providing full and proper justifications for deviating from code provisions. However, there are marked differences between the two countries. Levels of both full compliance and fully justified nonconformance are considerably higher in the UK than in Germany. (This is not to say that individual companies in the UK and in Germany might not be very similar in terms of board members' attitudes to comply-or-explain.) There are several potential explanations for this difference. Firstly, board members in the two countries have different experiences of the use of regulatory codes and self-regulation in general. The UK (Cadbury) Code of Best Practice was established as far back as 1992, and was predicated on a traditional reliance on self-regulation and the importance of reputation, particularly in the City of London, in which 'chaps would be trusted to behave under the watchful eye of benign authorities … the old world of small, well-defined, interconnecting circles where everyone knew everyone else and deals were done face-to-face' (Augar 2000:46). For their German counterparts used to "hard" regulation, the Cromme code, which had only been in place for very few years, has been more or less their first serious exposure to self-regulation. Board members, especially from smaller domestically oriented companies, may well need time to adjust to the idea of "soft" regulation and its associated obligations. Secondly, behavioural differences may also be explained by differences in the capital market structures in the two countries. In designing the original code the Cadbury Committee took into account UK corporate practice and the structure of the UK capital market where, although share ownership is dispersed, large outsider financial institutions exercise considerable influence on boards. These institutions have both the interest and the resources to monitor and enforce the code provisions. This contrasts sharply with the German context where companies are more likely to be controlled by insider blockholders with networks of cross-shareholdings. There is therefore less pressure to justify publicly deviations from the Cromme Code. It is of no little significance that comply-or-explain has not been adopted as a regulatory mechanism in other economic and social sectors. To be effective it requires powerful external monitors. While the differences in structure and legal tradition in the UK and Germany, and thus differences in their approaches to comply-or-explain may diminish over time - there is the possibility they may not - in which case the Cromme Code will need considerable revision in form if not
content. As Cadbury (2002:28) wisely remarked, "Both statutory and self-regulation have their part to play in corporate governance. The issue is the balance between them and the aspects of governance for which each is appropriate."
References


Wymeersch, E. (2005) “Implementation of the Corporate Governance Codes”, in K. Hopt, E. Wymeersch, H. Kanda and H. Baum (eds.) Corporate Governance in Context:
FIGURES AND TABLES

Figure 1: The design of the code regime
Figure 2. Frequency of type of explanation for non-compliance in the UK

![Frequency of type of explanation for non-compliance in the UK](image-url)

- **Company specific reasons for non-compliance (temporary)**
- **Description of non-compliant alternative practice (permanent)**
- **Pure disclosure of non-compliance (temporary)**
- **Empty justification of alternative practice**
- ** Transitional justification - new entrant**

Explanation (see table for labels)
Figure 3. Frequency of type of explanation for non-conformance (130 largest German companies)
### Table 1: Empirically derived taxonomy of compliance

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Full compliance</td>
</tr>
<tr>
<td>2.</td>
<td>Full non-compliance</td>
</tr>
<tr>
<td>3.</td>
<td>Partial non-compliance</td>
</tr>
<tr>
<td></td>
<td>3.1 Pure disclosure (indication of areas of non-compliance without descriptions of alternative practice or any justification)</td>
</tr>
<tr>
<td></td>
<td>3.1.1 non-temporary deviation</td>
</tr>
<tr>
<td></td>
<td>3.1.2 temporary deviation</td>
</tr>
<tr>
<td></td>
<td>3.1.3 pure indication that future compliance already explicitly decided</td>
</tr>
<tr>
<td></td>
<td>3.2 Disclosure and description of alternative solution without justification</td>
</tr>
<tr>
<td></td>
<td>3.2.1 Non-temporary</td>
</tr>
<tr>
<td></td>
<td>3.2.2 temporary</td>
</tr>
<tr>
<td></td>
<td>3.3 Disclosure with justification</td>
</tr>
<tr>
<td></td>
<td>3.3.1 empty justification</td>
</tr>
<tr>
<td></td>
<td>3.3.2 principled justification against content of particular code provision</td>
</tr>
<tr>
<td></td>
<td>3.3.3 principled justification against code regulation (in contrast e.g. to laws) with regard to a particular provision</td>
</tr>
<tr>
<td></td>
<td>3.3.4 justification on the basis of industry specificities</td>
</tr>
<tr>
<td></td>
<td>3.3.4.1 non-temporary</td>
</tr>
<tr>
<td></td>
<td>3.3.4.2 temporary</td>
</tr>
<tr>
<td></td>
<td>3.3.5 justification on the basis of company size or board size</td>
</tr>
<tr>
<td></td>
<td>3.3.6 justification on the basis of company structure</td>
</tr>
<tr>
<td></td>
<td>3.3.6.1 non-temporary</td>
</tr>
<tr>
<td></td>
<td>3.3.6.2 temporary</td>
</tr>
<tr>
<td></td>
<td>3.3.7 other company-specific reasons</td>
</tr>
<tr>
<td></td>
<td>3.3.7.1 Non-temporary</td>
</tr>
<tr>
<td></td>
<td>3.3.7.2 temporary</td>
</tr>
<tr>
<td></td>
<td>3.3.8 justification on the basis of international practice</td>
</tr>
<tr>
<td></td>
<td>3.3.9 Transitional justification</td>
</tr>
<tr>
<td></td>
<td>3.3.9.1 new entrant to the particular stock market</td>
</tr>
<tr>
<td></td>
<td>3.3.9.2 new code provision</td>
</tr>
<tr>
<td></td>
<td>3.3.10 General (not company-specific or industry-specific) problems with implementation or conflict with legal regulation</td>
</tr>
<tr>
<td>4.</td>
<td>Ambiguous or incomplete information</td>
</tr>
</tbody>
</table>
### Table 2: Number of fully compliant companies in the UK

<table>
<thead>
<tr>
<th>Companies</th>
<th>Companies analysed</th>
<th>Fully compliant</th>
<th>% of full compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE 1-30</td>
<td>30</td>
<td>20</td>
<td>66.67 %</td>
</tr>
<tr>
<td>FTSE 31-80</td>
<td>49</td>
<td>30</td>
<td>61.22 %</td>
</tr>
<tr>
<td>FTSE 81-130</td>
<td>50</td>
<td>17</td>
<td>34.69 %</td>
</tr>
<tr>
<td>Total</td>
<td>129</td>
<td>67</td>
<td>51.94 %</td>
</tr>
</tbody>
</table>

### Table 3: Number of deviations per company in the UK

<table>
<thead>
<tr>
<th>Companies</th>
<th>Average number of deviations</th>
<th>Median number of deviations</th>
<th>Average number of deviations by non-compliers only</th>
<th>Maximum number of deviations by company</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE 1-30</td>
<td>0.60</td>
<td>0</td>
<td>1.80</td>
<td>4</td>
</tr>
<tr>
<td>FTSE 31-80</td>
<td>0.96</td>
<td>0</td>
<td>2.47</td>
<td>6</td>
</tr>
<tr>
<td>FTSE 81-130</td>
<td>1.49</td>
<td>1</td>
<td>2.21</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>1.07</td>
<td>0</td>
<td>2.23</td>
<td>7</td>
</tr>
</tbody>
</table>

### Table 4: Number of code provisions with which all companies comply

<table>
<thead>
<tr>
<th>Companies</th>
<th>No of provisions with which all companies comply</th>
<th>% of code provisions with which all companies comply</th>
</tr>
</thead>
<tbody>
<tr>
<td>FTSE 1-30</td>
<td>36</td>
<td>75.00 %</td>
</tr>
<tr>
<td>FTSE 31-80</td>
<td>31</td>
<td>64.58 %</td>
</tr>
<tr>
<td>FTSE 81-130</td>
<td>27</td>
<td>56.25 %</td>
</tr>
<tr>
<td>All</td>
<td>20</td>
<td>41.67 %</td>
</tr>
</tbody>
</table>
Table 5: List of code provisions of the UK Combined Code with the lowest compliance figures

<table>
<thead>
<tr>
<th>Code Provision</th>
<th>FTSE 1-30</th>
<th>FTSE 31-80</th>
<th>FTSE 81-130</th>
<th>ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>n</td>
<td>%</td>
<td>n</td>
<td>%</td>
</tr>
<tr>
<td>A.2.1 The roles of chairman and chief executive should not be exercised by the same individual. The division of responsibilities between the chairman and chief executive should be clear.</td>
<td>0</td>
<td>0.00</td>
<td>2</td>
<td>4.08</td>
</tr>
<tr>
<td>A.2.2 The chairman should on appointment meet the independence criteria set in the Code. A chief executive should not go on to be chairman of the same company.</td>
<td>1</td>
<td>3.33</td>
<td>4</td>
<td>8.16</td>
</tr>
<tr>
<td>A.3.2 Except for smaller companies, at least half the board, excluding the chairman, should comprise non-executive directors determined by the board to be independent.</td>
<td>2</td>
<td>6.67</td>
<td>7</td>
<td>14.29</td>
</tr>
<tr>
<td>A.3.3 The board should appoint one independent non-executive directors to be the senior independent director. The senior independent director should be available to shareholders.</td>
<td>0</td>
<td>0.00</td>
<td>3</td>
<td>6.12</td>
</tr>
<tr>
<td>A.4.1 There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. A majority should be independent.</td>
<td>1</td>
<td>3.33</td>
<td>3</td>
<td>6.12</td>
</tr>
<tr>
<td>A.6.1 The board should state in the annual report how performance evaluation of the board, its committees and its individual directors has been conducted.</td>
<td>0</td>
<td>0.00</td>
<td>4</td>
<td>8.16</td>
</tr>
<tr>
<td>B.2.1 The board should establish a remuneration committee of at least three independent non-executive directors. In addition the company chairman may also be a member, but not chair.</td>
<td>2</td>
<td>6.67</td>
<td>5</td>
<td>10.12</td>
</tr>
<tr>
<td>C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, members, who should all be independent non-executive directors.</td>
<td>3</td>
<td>10.00</td>
<td>8</td>
<td>16.32</td>
</tr>
<tr>
<td>D.1.1 The chairman should ensure that the views of shareholders are communicated to the board as a whole. The chairman should discuss governance and strategy with major shareholders.</td>
<td>1</td>
<td>3.33</td>
<td>4</td>
<td>8.16</td>
</tr>
</tbody>
</table>
Table 6: Distribution of different types of explanation in the case of partial non-compliance - UK.

<table>
<thead>
<tr>
<th>Type of Explanation</th>
<th>FTSE 1-30 %</th>
<th>FTSE 31-80 %</th>
<th>FTSE 81-130 %</th>
<th>All %</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1.1 Pure disclosure (non-temp.)</td>
<td>0.00</td>
<td>10.64</td>
<td>1.37</td>
<td>4.53</td>
</tr>
<tr>
<td>3.1.2 Pure disclosure (temp.)</td>
<td>5.56</td>
<td>4.26</td>
<td>9.59</td>
<td>7.25</td>
</tr>
<tr>
<td>3.1.3 Pure disclosure - future compliance already decided</td>
<td>0.00</td>
<td>8.51</td>
<td>0.00</td>
<td>2.90</td>
</tr>
<tr>
<td>3.2.1 Disclosure and description of alternative practice (non-temp)</td>
<td>11.11</td>
<td>10.64</td>
<td>12.33</td>
<td>11.59</td>
</tr>
<tr>
<td>3.2.2 Disclosure and description of alternative practice (temp.)</td>
<td>0.00</td>
<td>4.26</td>
<td>6.85</td>
<td>5.07</td>
</tr>
<tr>
<td>3.3.1 Empty justification</td>
<td>16.67</td>
<td>10.64</td>
<td>6.85</td>
<td>9.42</td>
</tr>
<tr>
<td>3.3.2 Principled justification against content</td>
<td>27.78</td>
<td>4.26</td>
<td>2.74</td>
<td>6.52</td>
</tr>
<tr>
<td>3.3.3 Principled justification against code as from regulation</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>3.3.4.1 Justification on the basis of industry specificities (non-temp)</td>
<td>5.56</td>
<td>0.00</td>
<td>0.00</td>
<td>0.72</td>
</tr>
<tr>
<td>3.3.4.2 Justification on the basis of industry specificities (temp.)</td>
<td>0.00</td>
<td>0.00</td>
<td>1.37</td>
<td>0.72</td>
</tr>
<tr>
<td>3.3.5 Justification on basis of company size or board size</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>3.3.6.1 Justification on basis of company structure (non-temp)</td>
<td>5.56</td>
<td>8.51</td>
<td>0.00</td>
<td>3.62</td>
</tr>
<tr>
<td>3.3.6.2 Justification on basis of company structure (temp.)</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>3.3.7.1 Other company-specific reasons (non-temp)</td>
<td>5.56</td>
<td>8.51</td>
<td>6.85</td>
<td>7.25</td>
</tr>
<tr>
<td>3.3.7.2 Other company-specific reasons (temp)</td>
<td>11.11</td>
<td>14.89</td>
<td>32.88</td>
<td>23.91</td>
</tr>
<tr>
<td>3.3.8 Justification - international practice</td>
<td>11.11</td>
<td>0.00</td>
<td>0.00</td>
<td>1.45</td>
</tr>
<tr>
<td>3.3.9.1 Transitional justification - new entrant</td>
<td>0.00</td>
<td>12.77</td>
<td>16.44</td>
<td>13.04</td>
</tr>
<tr>
<td>3.3.9.2 Transitional justification - new provision</td>
<td>0.00</td>
<td>2.13</td>
<td>1.37</td>
<td>1.45</td>
</tr>
<tr>
<td>3.3.10 General problems with the implementation / potential conflict with law</td>
<td>0.00</td>
<td>0.00</td>
<td>1.37</td>
<td>0.72</td>
</tr>
<tr>
<td>4 Ambiguous or missing information</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
</tbody>
</table>
Table 7: Data set on German companies

<table>
<thead>
<tr>
<th>Companies</th>
<th>No of companies</th>
<th>No of compliance statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dax 30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>MDax</td>
<td>50</td>
<td>49</td>
</tr>
<tr>
<td>SDax</td>
<td>50</td>
<td>49</td>
</tr>
<tr>
<td>Total</td>
<td>130</td>
<td>128</td>
</tr>
</tbody>
</table>

Table 8: Number of fully compliant companies in Germany

<table>
<thead>
<tr>
<th>Companies</th>
<th>Fully compliant</th>
<th>% of full compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dax 30</td>
<td>12</td>
<td>40.00 %</td>
</tr>
<tr>
<td>MDax</td>
<td>5</td>
<td>10.20 %</td>
</tr>
<tr>
<td>SDax</td>
<td>1</td>
<td>2.04 %</td>
</tr>
<tr>
<td>Total</td>
<td>18</td>
<td>14.06 %</td>
</tr>
</tbody>
</table>

Table 9: Average number of deviations per company

<table>
<thead>
<tr>
<th>Companies</th>
<th>Average number of deviations</th>
<th>Median number of deviations</th>
<th>Average number of deviations by non-compliers only</th>
<th>Maximum number of deviations by company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dax 30</td>
<td>2.63</td>
<td>1</td>
<td>4.39</td>
<td>20</td>
</tr>
<tr>
<td>MDax</td>
<td>4.31</td>
<td>4</td>
<td>4.41</td>
<td>30</td>
</tr>
<tr>
<td>SDax</td>
<td>5.88</td>
<td>6</td>
<td>5.78</td>
<td>15</td>
</tr>
<tr>
<td>Total</td>
<td>4.40</td>
<td>4</td>
<td>5.16</td>
<td>30</td>
</tr>
</tbody>
</table>
Table 10: Number of code provisions all companies are in compliance with

<table>
<thead>
<tr>
<th>Companies</th>
<th>No of provisions all companies are compliant with</th>
<th>% of code provisions all companies are compliant with</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dax 30</td>
<td>51</td>
<td>62.20%</td>
</tr>
<tr>
<td>MDax</td>
<td>35</td>
<td>42.68%</td>
</tr>
<tr>
<td>SDax</td>
<td>36</td>
<td>43.90%</td>
</tr>
<tr>
<td>All</td>
<td>18</td>
<td>21.95%</td>
</tr>
</tbody>
</table>
Table 11: List of code provisions of the German Cromme Code with the lowest compliance figures

<table>
<thead>
<tr>
<th>Code Provision</th>
<th>DAX 30</th>
<th>MDAX</th>
<th>SDAX</th>
<th>ALL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>n</td>
<td>%</td>
<td>n</td>
<td>%</td>
</tr>
<tr>
<td>3.8 If the company takes out a D&amp;O policy for [its] Board[s], a suitable deductible shall be agreed.</td>
<td>6</td>
<td>20,00</td>
<td>20</td>
<td>40,82</td>
</tr>
<tr>
<td>4.2.2 Para.1(1HS) At the proposal of the committee dealing with Management Board contracts, the full Supervisory Board shall discuss the structure of the Management Board compensation system</td>
<td>6</td>
<td>20,00</td>
<td>2</td>
<td>4,08</td>
</tr>
<tr>
<td>4.2.2Para1(2HS) The full Supervisory Board shall regularly review the structure of the Management Board compensation system</td>
<td>6</td>
<td>20,00</td>
<td>3</td>
<td>6,12</td>
</tr>
<tr>
<td>4.2.4S2 The figures [of the compensation of the members of the Management Board] shall be [reported] individualized [in the Annual Report].</td>
<td>10</td>
<td>33,33</td>
<td>25</td>
<td>57,14</td>
</tr>
<tr>
<td>5.3.1 [...] the Supervisory Board shall form committees with sufficient expertise.</td>
<td>1</td>
<td>3,33</td>
<td>1</td>
<td>2,04</td>
</tr>
<tr>
<td>5.3.2S1 The Supervisory Board shall set up an Audit Committee [...]</td>
<td>2</td>
<td>6,67</td>
<td>6</td>
<td>12,24</td>
</tr>
<tr>
<td>5.4.1S2 The international activities of the enterprise, potential conflicts of interest and an age limit to be specified for the members of the Supervisory Board shall be taken into account.</td>
<td>3</td>
<td>10,00</td>
<td>10</td>
<td>20,41</td>
</tr>
<tr>
<td>5.4.7Para2S1 Members of the Supervisory Board shall receive fixed as well as performance-related compensation.</td>
<td>4</td>
<td>13,33</td>
<td>13</td>
<td>24,49</td>
</tr>
<tr>
<td>5.4.7Para3S1 The compensation of the members of the Supervisory Board shall be reported individually in the Corporate Governance Report, subdivided according to components.</td>
<td>6</td>
<td>20,00</td>
<td>19</td>
<td>40,82</td>
</tr>
<tr>
<td>7.1.2S3(1HS) The Consolidated Financial Statements shall be publicly accessible within 90 days of the end of the financial year;</td>
<td>0</td>
<td>0,00</td>
<td>9</td>
<td>18,37</td>
</tr>
<tr>
<td>7.1.2S3(2HS) interim reports shall be publicly accessible within 45 days of the end of the reporting period.</td>
<td>0</td>
<td>0,00</td>
<td>6</td>
<td>12,24</td>
</tr>
</tbody>
</table>
Table 12: Distribution of different types of "explanation" in the German context

<table>
<thead>
<tr>
<th>Type of &quot;explanation&quot;</th>
<th>Dax 30 %</th>
<th>MDax %</th>
<th>SDax %</th>
<th>All %</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1.1 Pure disclosure (non-temp.)</td>
<td>8.75</td>
<td>30.92</td>
<td>33.21</td>
<td>28.32</td>
</tr>
<tr>
<td>3.1.2 Pure disclosure (temp.)</td>
<td>0.00</td>
<td>0.00</td>
<td>2.50</td>
<td>1.21</td>
</tr>
<tr>
<td>3.1.3 Pure disclosure - future compliance already decided</td>
<td>2.50</td>
<td>10.14</td>
<td>10.36</td>
<td>8.98</td>
</tr>
<tr>
<td>3.2.1 Disclosure and description of alternative practice (non-temp)</td>
<td>13.75</td>
<td>6.76</td>
<td>7.50</td>
<td>7.94</td>
</tr>
<tr>
<td>3.2.2 Disclosure and description of alternative practice (temp.)</td>
<td>1.25</td>
<td>0.00</td>
<td>0.00</td>
<td>0.17</td>
</tr>
<tr>
<td>3.3.1 Empty justification</td>
<td>10.00</td>
<td>13.53</td>
<td>5.36</td>
<td>8.81</td>
</tr>
<tr>
<td>3.3.2 Principled justification against content</td>
<td>26.25</td>
<td>21.74</td>
<td>11.79</td>
<td>19.17</td>
</tr>
<tr>
<td>3.3.3 Principled justification against code as form of regulation</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>3.3.4.1 Justification on basis of industry specificities (non-temp.)</td>
<td>0.00</td>
<td>0.00</td>
<td>0.71</td>
<td>0.35</td>
</tr>
<tr>
<td>3.3.4.2 Justification on basis of industry specificities (temp.)</td>
<td>0.00</td>
<td>0.48</td>
<td>0.00</td>
<td>0.17</td>
</tr>
<tr>
<td>3.3.5 Justification on basis of company or board size</td>
<td>0.00</td>
<td>1.45</td>
<td>9.64</td>
<td>5.18</td>
</tr>
<tr>
<td>3.3.6.1 Justification on basis of company structure (non-temp.)</td>
<td>18.75</td>
<td>0.48</td>
<td>1.43</td>
<td>3.45</td>
</tr>
<tr>
<td>3.3.6.2 Justification on basis of company structure (temp.)</td>
<td>0.00</td>
<td>0.00</td>
<td>0.71</td>
<td>0.35</td>
</tr>
<tr>
<td>3.3.7.1 Other company-specific reasons (non-temp.)</td>
<td>1.25</td>
<td>7.73</td>
<td>10.36</td>
<td>7.94</td>
</tr>
<tr>
<td>3.3.7.2 Other company-specific reasons (temp.)</td>
<td>1.25</td>
<td>1.45</td>
<td>2.14</td>
<td>1.73</td>
</tr>
<tr>
<td>3.3.8 Justification on basis of international practice</td>
<td>6.25</td>
<td>2.42</td>
<td>1.07</td>
<td>2.25</td>
</tr>
<tr>
<td>3.3.9.1 Transitional justification - new entrant</td>
<td>0.00</td>
<td>0.48</td>
<td>0.00</td>
<td>0.17</td>
</tr>
<tr>
<td>3.3.9.2 Transitional justification - new provision</td>
<td>5.00</td>
<td>0.00</td>
<td>0.00</td>
<td>0.69</td>
</tr>
<tr>
<td>3.3.10 General problems with the implementation / potential conflict with law</td>
<td>3.75</td>
<td>2.42</td>
<td>1.43</td>
<td>2.07</td>
</tr>
<tr>
<td>4 Ambiguous or missing information</td>
<td>1.25</td>
<td>0.00</td>
<td>1.79</td>
<td>1.04</td>
</tr>
</tbody>
</table>
Endnotes

1 The extent to which this leads to ‘convergence’ as countries seek to emulate the Anglo-Saxon world is a matter of some debate, with prominent critics arguing that traditional ownership structures are of more importance. See, for example, Bebchuk and Roe (1999) on ‘path dependence.’

2 In the USA and Hong Kong there were two precursors to this code in 1978 and 1989 respectively. However, those codes were relatively general and did not receive much attention.

3 While the various codes mostly mention also other actors beyond the shareholders, the code regime is ultimately focused on the shareholder. This can be seen from the way the codes are set up – including the composition of many code committees.

4 On the other hand de Jong et al (2005) found no correlation between firm value before and after instatement of corporate governance reforms in the Netherlands.

5 Other than Von Werder et al (2005) we also did not follow up on potential undeclared consecutive deviations as this was of no immediate interest to our study.

6 There were minor changes made to the UK Combined Code published in June 2006 for use in reporting years commencing after 01 November 2006. However, depending on their reporting period, some British companies used the 2003 version, some, particularly those that conformed fully (without deviation), used the 2006 version in anticipation, some used one but referred in explanation to the other. For consistency we illustrate the latest 2006 version but in our analysis employed whichever version the reporting company used. It is after all the explanation and use of comply-or-explain with which we are concerned here – not the specific rules themselves. But in fact most changes were minor in the sense that they slightly amended existing provisions rather than making wholesale deletions and insertions, e.g. the restriction on the company Chairman serving on the remuneration committee was removed to enable him or her to do so where considered independent on appointment as Chairman (although it is still recommended that he or she should not also chair the committee).

7 Moore (2008) provides a fascinating analysis of CEO-chairman duality in the case of Marks and Spencer.

8 Andres and Theissen (2008) provide evidence that compliance on this issue is correlated with firm size, levels of remuneration and ownership concentration.