

**FLEXIBLE OR NOT? THE COMPLY-OR- EXPLAIN PRINCIPLE IN
UK AND GERMAN CORPORATE GOVERNANCE**

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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 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 domain. 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 of codes 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.

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1. 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 of governance 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, Sanderson & Roberts (2009) 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, Sanderson & Roberts (2009), 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 *Priifungsausschuss* (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 the compliance statement in its 2005 annual report, 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.'

2. 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, Sanderson & Roberts (2009). 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).

3.The UK and German Codes of Corporate Governance

Codes of corporate governance have been 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 but could instead rely 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 key 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 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 which the rules apply. Many interviewees felt excluded from the process of code development, particularly those working for smaller capitalised companies - those from the mid to 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 expressed 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, pronouncements 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 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:

“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 soft law is, of course, only one element in the Cromme code alongside statute law 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.

4.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 although this

difference is accounted for mainly by the incorporation of statute law elements and guidance into the latter (see Seidl & Sanderson 2009).

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 – recognition that monitoring was 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 actually a 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 no 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 already 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 for many years directors’ salary arrangements have been published in the accounts section of the annual report of public companies as part of the financial reporting requirements. 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.

5. 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 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 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 [and] will then 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)

Notwithstanding the differences in board structure between the UK (single) and Germany (dual) there were few major differences in the way equivalent German interviewees perceived the process. In Germany the executive board usually takes the lead on corporate governance. 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. (...) 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.” (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 spend five minutes on it in the meeting of the supervisory board. We spend 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.

6.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 regulatory strategy have long histories in the UK, and in particular in the City of London. There is a what might be termed 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 [...] 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’ test.” (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 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?” (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 a company’s experience of codes that do not incorporate comply-or-explain in other areas of its business can affect its approach where such flexibility exists. 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.” (U)

Thus for many the default behaviour, the norm, is to comply fully, wherever possible :

“What we feel at the moment is that sometimes we are being backed into a corner slightly. [...] 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.” (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. (...) [I]t’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 saw the Code as offering very little opportunity for flexibility from which one may conclude that the code contents are 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 non-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, 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 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)

The German interviewees did seem to speak of the code as a form of law, something less evident in the UK where regulation seems 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 [compliance] statement and 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)

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)

And, as in the UK, the pressure to conform to norms could be quite strong:

“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)

and:

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 the way that compliance *rates* are highlighted:

“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. [...] Comply-or-explain in Germany is immediately changed into 'comply and don't bother

us with explanations'. 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:

“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, Sanderson & Roberts (2009) 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 thus 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.

7.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 development 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 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 own conformance at all.
- Both sets of interviewees felt considerable pressure towards full conformance rather than engagement 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 also relates to the length of time the two codes have been in force and the extent to which they 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 to conform fully 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.

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