European Corporate Governance:

Comply-or-explain:
An Explanation

Master thesis

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Preface

This thesis represents the final chapter of my education at the Tilburg University. I would like to use this opportunity to express my appreciations to all the people who helped me conduct my research or otherwise supported my endeavors.

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And finally to my lovely fiancée Carona, for being the source of my inspiration and ambitions. I might not even have tried getting my master degree if it wasn’t for her, and I definitely couldn’t have done it without her.
List of abbreviations

ECGI - The European Corporate Governance Institute
EC - The European Commission
ECJ - The Court of Justice of the European Union
EU - The European Union
EP - The European Parliament
FMA - Financial Market Authorities
HR - Hoge Raad (High Council of the Netherlands)
ISA - International Standard on Accounting
OECD - The Organization for Economic Cooperation and Development
OK - Ondernemingskamer (Chamber of Commerce of the Netherlands)
SE - Societas Europæa (European Public Company)
SoX - The Sarbanes-Oxley Act of 2002
SPE - Societas Privata Europæa (European Private Company)
TFEU - The Treaty on the Functioning of the European Union of 2008
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Chapter 1: Introduction

Corporate governance, often described as the system by which companies are governed, has become an important topic for legislation, practice and academia throughout the world. Recent economic crises once again sparked debates on this topic. The legislative results of these debates vary from country to country. There have been attempts to harmonize corporate governance in Europe, but this process still has many obstacles to overcome. With the ongoing and growing economic crisis in Europe in particular, the question rises if the need for more harmonization in Europe is necessary. In April 2011 the EC released Green Paper: The EU corporate governance framework, to spark a new debate on Corporate Governance in Europe. This paper inspired this research into this topic. It raises several questions, two of which inspired this research:

(24) “Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?”

(25) “Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?”

This paper will answer both questions, focusing on the explanations provided in companies’ corporate governance statements, what they should look like and how they should be monitored. The comply-or-explain system allows companies to be flexible with corporate governance regulations as long as they explain the reasons behind it. This explanation is aimed at the shareholders who are the only ones who have some form of controlling function in this matter. Though the system has some strong benefits, the Green Paper offers two suggestions on improving it. Both suggestions shall be discussed followed by a recommendation on further steps to improving the comply-or-explain system in Europe.

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1 Green Paper 2011, p. 18-20
§ 1.1 Research
The goal of this thesis is to determine what steps can be taken in the EU on improving corporate governance, in particularly the comply-or-explain principle. Therefore I have formulated the following main questions:

Does Europe need to institute monitoring bodies to check the informative quality of explanations in corporate governance statements? If so, in what form should the European Union implement measures to improve corporate governance statements?

§ 1.2 Methodology
This research has been limited to corporate governance in Europe. Because this is a broad legal field, this research is focused towards one of its main principles; the principle of comply and explain. Because it is a common principle in most European countries and because it faces the same difficulties everywhere, sources from many European legal systems have been used. This is in line with most of the previous research done on this topic.

Amongst the used legal sources are included: various corporate governance codes, verdicts by the ECJ and local courts, EU directives and corporate law statutes from various Member States. Besides studying previous research I have also studied policymaking documents on future developments by the EC and other competent institutions on Member State level. To get a glimpse of the political aspects involved, various newspaper articles and other main stream media sources have been studied, because any European solution is only possible if there is wide support. Finally, recent annual reports and corporate governance statements by European companies were studied and compared to identify real life consequences of the comply-or-explain principle as it functions today. Comparisons have been made between annual reports from three different countries and a comparison has been made between companies from the same sector but from different countries.

This thesis has been written in English to be consistent with most other research done in this field. It is aimed at an academic audience, meaning that the reader is presumed to have general legal knowledge particularly on the subject of corporate governance.
§ 1.3 Structure
To answer these questions, first the recent history of corporate governance will be reviewed in chapter two to place this research into context. This step is necessary to introduce the comply-or-explain principle and place it in the right context within the corporate governance field. It will consist of a short summary of the recent developments in the field of corporate governance.

The third chapter will discuss the questions raised in the Green Paper, identifying if explanations in corporate governance should be improved, and if that is the case, how that can be achieved. I will formulate four key elements that should be present in any explanation; these elements will be clarified using examples from explanations currently found in annual reports. This chapter will also explore what role national authorities could play in monitoring these explanations.

To find out if there is a role for the EU in promoting or implementing rules concerning the comply-or-explain principle, the fourth chapter will analyze current and future developments on corporate law in the EU. I will review the different attempts at harmonizing corporate governance in the EU, and suggest what steps the EC could take to implement the suggestions from the second chapter. To illustrate both the necessity and difficulties of EU action, three different Member States and their system of corporate governance will be analyzed.

The final chapter will give a short summary of the most important findings from the previous chapters and will answer the main questions in this thesis, followed by recommendations on possible future steps for Europe.
Chapter 2: State of the art

The concept of corporate governance was first discussed in the United States and spread to Europe via the UK and later the rest of the world. However, issues of corporate governance already affected the world’s first listed company, The Dutch East India Company in the 17th century. Started in 1995, the European Corporate Governance Network, which is now known as the European Corporate Governance Institute based in Luxembourg, has been the main center for the corporate governance debate in Europe. The main focus in these debates surrounds enterprises in practice. Ever since the debate first started, continuous reforms have taken place and are still underway.

However much is debated about Corporate Governance, it is hard to find a single definition for the concept. As mentioned earlier, it is often described as the system by which companies are governed. It consists of laws, regulations, institutions, markets, contracts, corporate policies and procedures that direct and influence company decision making.

The need for corporate governance stems from the phenomenon that the interests of those who have effective control over a firm, can differ from the interest of those who provide it with capital. This is also called the principle-agent conflict, which in short stands for the conflict between the shareholders (principle) and managers (agent) of corporations. This theory also includes conflict between controlling and non-controlling shareholders and the conflict between shareholders and other stakeholder’s interests. Even though Corporate Governance has a long history and has already been shaped by scandals and crises, it has become a particularly hot topic since the beginning of the financial crisis in 2008.

All countries around the world have experienced and experience scandals and crises, but that does not mean that the nature of these problems are identical. This also means the necessary

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3 Van Daelen 2010, p. 57
4 For more information on ECGI, see www.ecgi.org
5 Brickley and Zimmerman 2010
6 Learmount 2002, p. 6
answers and reforms can be very different. This leads to each country having a unique economic, legal and social structure. However, legislators and regulators often imitate other similar countries hoping these responses can benefit their own system. Therefore I will first analyze the basic building blocks of corporate governance, before analyzing how we can move forward in developing Corporate Governance in Europe.

§2.1 Capital Market Law, Corporate Law and self-regulation

In most countries, corporate governance has been the domain of corporate law and stock exchange law, but next to formal law there is also a lot of self-regulation. In its nature, self-regulation was mostly aimed towards shareholders, traders and other investors. Because most stock exchanges began to require observance of good corporate governance for listed companies, this form of self-regulation became more or less mandatory for these listed companies. However, the widely endorsed practice of comply-or-explain still provides companies with freedom on corporate governance.

Today, most countries have a national Corporate Governance code. The EC recommended that all Member States designate a national corporate governance code for listed companies. In the Netherlands this code is known as the Code Frijns, with the first example being the Combined Code of the Cadbury Committee 1992. These codes are referred to as soft-law, as they are not laws and do not have binding force. These codes can come from different sources like governmental committees or stock exchanges.

The contents of these codes are very different from country to country. The content of these codes depend on the traditions and institutes in each country. The corporate governance codes focus on internal corporate governance, regulating the board and its committees or its two tiers. They often also contain regulations concerning stakeholders and auditing. Because these

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7 Hopt 2011, p10
8 Hopt 2011, p11
9 European Commission’s Plan to Move Forward 2003, p 15
10 The Corporate Governance Code Monitoring Committee, Dutch Corporate Governance Code, for more info see http://commissiecorporategovernance.nl/Corporate_Governance_Code
11 Hopt 2011, p11
12 Hopt 2011, p12
codes are used by a large percentage of corporations and their contents and means of enforcement are very different in Europe, the question remains if more harmonization is necessary.

§ 2.2 International influence on national law.

Foreign law plays a major role in corporate governance because a lot of companies applying these codes are internationally active. The most well-known foreign law having a large influence in Europe is the US Sarbanes-Oxley Act (SOX). The term corporate governance itself is an American term that is not translatable in a lot of other languages. The European Union has not managed to harmonize corporate law, and so corporate governance is for a large part regulated at Member State level. There has been some tension between EU plans to harmonize corporate law and Member States wanting to maintain their individuality. Currently, further plans to harmonize company law have come to a halt, with the European Union trying to accommodate the development of corporate governance on Member State level. This does not mean that corporate governance is no longer an international topic, as companies are still part of the Single Market of the EU.

While the Member States have taken upon themselves to develop their corporate governance systems as they see fit, they are still heavily influenced by each other and European developments. Even though Member States can have great differences, they are faced with similar challenges. While Member States seek solutions that fit their unique background and their political believes, they also continuously look to each other for inspiration on how to deal with these challenges. Combined with the EU’s efforts to harmonize corporate law, this has led to the current situation where there are some universal principles and ideas that have formed corporate governance systems in the Member States, but widely different approaches as to how these principles are put in practice and how they should be developed.

§ 2.3 Comply or explain

The principle of comply-or-explain is one of these widely used principles in corporate governance systems and is mostly viewed as the appropriate tool for corporate governance. To avoid a one size fits all solution, comply-or-explain allows companies to choose between following a specific rule, or explain why they are not compliant. Usually, the code’s provisions are seen as best practice; companies should strive to apply them all. However, as company’s and their situation can be very different, it is likely that a rule could have a
positive effect on one company, but have a negative impact for another company. Following the best practices should not be a goal on its own, the system is designed to be flexible for a reason. As corporate governance is a means of empowering investors, it is ultimately up to them to decide if they agree with the company's decision to comply or explain.

These explanations are part of the corporate governance statement which companies are required to disclose in the EC directive 2006/46.\textsuperscript{13} However, there is little more regulation regarding these explanations. At this point it is up to investors alone to judge these explanations and react accordingly, with advice from invested or hired financial institutions or rating agencies.

Major crises often lead to calls for better regulation, as is true with the recent financial crisis. As there is little to no regulations regarding these explanations, and thus a potential lack of information for investors and other market parties, it makes sense that developing such regulations is due. These regulations should empower investors to judge explanations accordingly, not take away their role as main enforcers of corporate governance.

Comply-or-explain comes in numerous forms. It should be noted that in fact both answers are compliant; it is in line with the law to choose the explain option instead of complying.
Secondly, there is a distinction between deviating from a strict rule-based approach while still complying with underlining principles or deviating completely from set rules and principles. In other words, there are various degrees of compliance, affected by the regulators choice between a rule-based or principle-based approach.

The comply-or-explain principle, especially the lack of clear guidelines and control surrounding these explanations, is one of the focal points of international debate. Because, even though the term ‘soft-law’ suggest more flexibility compared to ‘hard-law’, it is law nonetheless and it should not be ignored unless there is a good reason. Soft-law is not legally binding, so implementation by companies only happens out of goodwill or if it serves them a concrete purpose. This leads to a small percentage of companies that are fully compliant to

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\textsuperscript{13} Directive 2006/46/EC issued on June the 14\textsuperscript{th} 2006 by the European Parliament and the Council, Article 46a(b)
applicable Corporate Governance Codes.\(^{14}\) It could be a need for concern that companies seem to decide mostly out of self-interested reasons, which is expressed by the European Commission in its Green paper on the corporate governance framework.\(^{15}\)

**§ 2.4 From best practice to formal requirement**

Compliance to Corporate Governance Codes is viewed as a form of best practice, meaning it is a method that is expected to have the best results, but it is not mandatory to follow them. However, in most European countries it does have a legal basis, for example paragraph 161 of the German Stock Corporation Act, in the Netherlands article 391 paragraph 4 of book 2 BW, in Italy art.123 bis Consolidated Law on Finance or in the listing rules like in the UK Listing Rule 9.8.6(6). In these nations, (listed) companies are obligated to refer to their compliance to a Corporate Governance Code as part of their annual reporting. This means that while the provisions which are part of the Code are voluntary, properly explaining deviations can be considered mandatory.

It would be a logical step to accept proper explaining is becoming a mandatory requirement, instead of just a form of best practice. This is a similar development as other corporate governance concepts underwent in the past, like the audit committee. The concept of an audit committee was introduced as a best practice by the New York Stock Exchange in 1939 and is now a formal requirement in a lot of legal systems around the world. Perhaps properly explaining deviations from a corporate governance code can undergo a similar development.

In some Member States there is already a debate concerning the legal status of Corporate Governance Codes, which has not been settled yet. In the Netherlands there has been a case in which judges have actively applied provision from the Corporate Governance Code, denying the comply-or-explain principle\(^ {16}\). Though this verdict has later been overruled\(^ {17}\), it shows the delicate relationship between soft-law and hard-law. The result was that applying the Code is

\(^{14}\) Siedl and Sanderson 2009  
\(^{15}\) Green Paper 2011, p. 19  
\(^{16}\) OK 5 July 2009, *LJN* BJ4688 (ASMI)  
\(^{17}\) HR 9 July 2010, *LJN* BM0976 (ASMI)
different from following every individual provision of the code.\textsuperscript{18} There is a legal requirement to apply the code, but non-compliance to a provision on its own is not against the law. The Code forms a guideline on applying the law, but is not a law on its own.

In Germany there is a similar discussion which is particularly vivid.\textsuperscript{19} This is probably a result of lack of experience with soft-law, which is much more common in for example the UK. The problem lies in the fact that any interference to the freedom of professional occupation requires a legal basis in the constitution (art. 12 Grundgesetz). This legal basis can be an act of parliament or secondary legislation. The Corporate Governance Code lacks such a legal basis, though the duty to deliver a corporate governance statement does seem to meet this requirement. Some scholars see this as an “erosion of parliamentarianism”.\textsuperscript{20}

However, the recommendations of the code themselves are supposed to be considered soft-law and shall be enforced by the comply-or-explain principle. This indirect effect could be viewed as a violation of the legal basis requirement and thus seems to prevent a legitimate role for the Code under German law. This results in illegitimate soft-law being enforced as though it was law, as the Code limits the freedom of companies, which is in violation of Art. 12 Grundgesetz. Even though reference is made to the Code in formal law (Art. 161 Aktiengesetz), the provisions of the Code itself do not have a proper legal basis.

This debate has not settled, though there seems to be a majority of authors who assume that the Code does not infringe the constitution as it is in itself not legally binding.\textsuperscript{21} A parallel could be made with other private instruments with indirect legal effects, for example the technical standards like the ISO standards or sector wide codes of conducts that are common in sectors like media or telecom. It is assumed that the Code has similar influence, for example liability for a director acting against his own corporate governance statement. This problem is solved in that liability can only be triggered by a breach of law and not just a breach of code. However, if an incorrect corporate governance statement leads to liability, it seems only a matter of time before judges have to decide if the statement is incorrect by

\textsuperscript{18} HR 9 July 2010, \textit{LJN} BM0976 (ASMI), r.o. 3.4.25
\textsuperscript{19} Du Plessis 2012, p 47
\textsuperscript{20} Wolf 2002, p. 60
\textsuperscript{21} Goulding, Miles and Schall 2005, p. 47
European Corporate Governance: Comply-or-explain: An Explanation

applying the relevant Code. In some cases the code has already been referenced.\textsuperscript{22} Both seem to refer to the Code as an expert view in the application of actual formal law, making sure it is not judged as actual law while having a high indirect effect. These rulings were followed by the legislator by turning some provisions of the code into hard-law with the Disclosure of Management Board Remuneration Act of 2005 and the Adequacy of Management Board Compensation Act of 2009. It seemed that the comply-or-explain principle had been overruled by lawmakers. While politicians still emphasized that they believed in the soft-law approach, this debate might make the concept of comply-or-explain obsolete.\textsuperscript{23}

The results of the debate in Germany could have an effect on all Member States that have introduced codes based on the comply-or-explain principle. The tension between practical use for companies and the principle approach that law should come from the legislator seems to be present in every Member State. The debate does make clear that the comply-or-explain principle is far from perfect; it needs to be further developed if it is to survive.

An alternative approach is to find ways to stimulate investors to pay more attention to the explanations. This approach seems to be unsuccessful at this point, but perhaps methods can be found to improve explanations in this way. It will be difficult to motivate smaller non-controlling shareholders to spend time and money on monitoring, as accompanied costs can be high for non-institutional investors.

Broadening interests of shareholders to include more than just the pricing of their shares and the dividend they will receive seems difficult. Shareholder’s interests are by nature different from the interests of the company and its stakeholders. Investors cannot be forced to be competent supervisors, investing money and monitoring a company are just different roles. Unless a whole new binding legal framework is formed, but that would go against the self-regulating nature of corporate governance.

\textsuperscript{22} OLG Schleswig Holstein 19 September 2002, NZG 2003, 176, 179 (Mobilcom AG I) paragraph 4.2.3 and paragraph 5.4.5. LG München 25 April 2004, IBR 2004, 312 (Hypovereinsbank AG)

\textsuperscript{23} Mallin 2011, p. 55
Because of these reasons I have decided that alternative ways to improve explanations and monitoring explanations by other parties are a more feasible option, the stimulating of investors to monitor companies more thoroughly is therefore beyond the scope of this paper. Investors cannot be forced to act differently, but stimulating companies to improve their explanations would have the same effect, namely better monitoring of corporate governance by investors.
Chapter 3: Monitoring corporate governance statements

There is currently no formal monitoring of corporate governance statements in Europe on EU level, while Member States are also hesitant to implement national forms of monitoring. It is up to investors themselves to judge these statements, but in most Member States it is very uncommon for them to take action. Market authorities or stock exchanges have developed different practices and legislative frameworks dealing with corporate governance statements, but their formal role is mostly limited to verifying that such a statement has been published. A few Member States have actually instituted specialized authorities to perform a more thorough check to judge if the provided information is complete.

§ 3.1 Requirements for good explanations

To determine if better monitoring is necessary, it has to establish what should be required from a good explanation. There is currently little known about what defines a satisfying explanation, which means that they are in practice often incomplete or vague\(^\text{24}\). There is empirical evidence which also suggests that explanations should be improved\(^\text{25}\).

Obviously, explanations should be factually correct, but information should also provide a complete impression of the company’s motives. Though it is sometimes assumed companies provide explanations out of self-interests\(^\text{26}\), this is often not the case.\(^\text{27}\) Though the ‘comply and explain’ approach is applied by nearly all Member States, the way it is applied can be very different. However, four different elements that are common in many systems of corporate governance can be identified to define a good explanation.

1. Identifying which particular provision has been deviated from.

The first step should be identifying exactly what rules are not being applied. Explanations should be specific, identifying each individual instance of noncompliance and providing

\(^{24}\) McCahery and Vermeulen 2009, p. 2

\(^{25}\) Andersson 2011, p. 2

\(^{26}\) Ringleb 2004

\(^{27}\) Seidl and Sanderson 2007, p. 26
separate explanations. It should be as clear as possible what rules the company is not following, and by not mentioning a certain applicable rule it is implied that said rule is applied. Research shows that this first step is often the only information provided by companies.  

A good example can be found in the explanation on corporate management in accordance with Section 289a HGB published by Carl Zeiss Meditec AG as part of its annual report 2010/2011:

“The Management Board and Supervisory Board of Carl Zeiss Meditec AG declare that they conform to the recommendations of the Government Commission on the German Corporate Governance Code […], with just one exception.

The following exception applies: Section 5.4.1 of the German Corporate Governance Code stipulates that the Supervisory Board shall set specific targets in terms of its composition, which – taking the company-specific situation into account – shall consider the international activities of the Company, potential conflicts of interest, an age limit to be defined for Supervisory Board members, and diversity. These targets should also, in particular, include a reasonable proportion of women.

The Supervisory Board of Carl Zeiss Meditec is of the opinion that the composition of the Supervisory Board should, first and foremost, be geared to the interests of the Company, and must ensure efficient consulting with and monitoring of the Management Board. When appointing the Supervisory Board of Carl Zeiss Meditec AG, the priority shall therefore be to ensure that the members have the necessary abilities, skills and specialist qualifications to properly fulfill their duties. […]  

The management clearly states which provisions they do follow and which individual provision they do not follow. While this gives a clear and correct view of the current situation,

28 For example, the German Corporate Governance Code does not require anything but a pure disclosure in the corporate governance statement.

29 Carl Zeiss Meditec AG Annual Report 2010/2011, p 185
they do not provide a real argument for deviating from the provision, other than a general comment on the qualifications necessary for board members. Thus investors and other stakeholders cannot really judge their motives and the possible consequences.

2. Explaining why the company has not followed the rule.

The Code of Austria has a limited description of the comply-or-explain principle; “The company shall prepare a Corporate Governance Report that contains at least the following information: […] If the company decides not to adhere to a code, then the reason why.”

Probably the most important part of the explanation is that it must actually explain the deviation. Though this seems obvious, a large text qualified as an explanation does not mean anything is explained, as the following example clarifies. One of the more common problems with explanations is that they fail to identify the specific reasons for deviating.

“III.5.11 The remuneration committee shall not be chaired by the chairman of the supervisory board […]"

*Given the strategic importance of the selection and retention of senior management for the long-term success of the company, Randstad has opted for a combined nomination & compensation committee. Randstad considers it vital that the chairman of the supervisory board is also closely involved in the attraction and retention of current and future senior management, as well as the longer-term succession planning for the executive board, which is reflected through his appointment as chairman of the nomination & compensation committee.*

The above explanation contains a short example of a logical argument. While it still provides limited information, there are two arguments provided for the deviation. Though it still provides limited information, a statement like this one would provide a good start for a discussion with critical investors. A good explanation consists of one or more factual correct

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30 Austrian Code of Corporate Governance 2012, p.37
31 Arcot, Bruno and Grimaud 2005, p. 2
32 Randstad Holding NV Corporate Governance Report 2008
arguments, and the deviation must be a logical result of these arguments. It must also give a complete picture; it must not hide important counter arguments.

Currently, companies can use any argument they would like as to why they can or will not follow a rule, assuming that they acknowledge that comply-or-explain demands an explanation other than noting the board has decided to deviate from the rules. That should not be sufficient, investors and other stakeholders should be aware of all relevant motives, particularly when there is no obvious necessity to deviate from the rules, as is the case with the Randstad example above. To formulate a simple principle to decide if a given explanation is satisfying, it could be a good idea if the information provided in explanations is in line with the business judgment rule, to allow companies to govern themselves as they see fit while still trying to prevent reckless behavior. From the explanation must follow that the directors have made the decision on an informed basis, in good faith and in the honest belief that their actions are in the corporation’s best interest. In those Member States who have opted for a stakeholder orientated model, the stakeholder’s interest should also be taken into account.

This principle also implies a moral obligation to deviate from rules if it is in the companies’ best interest, which I think is well in line with the self-regulating nature of corporate governance rules. However, when deviating from rules, directors should keep in mind, as the UK Combined Code states: “While it is expected that listed companies will comply with the Code’s provisions most of the time, it is recognized that departure from the provisions of the code may be justified in particular circumstances.”33 In other words; companies should comply with rules unless there are circumstantial reasons not to do so. Therefore, explanations should take into account the unique position a company is in. Though the Belgian Code provides only limited guidelines for proper explanations, it also states that explanations should refer to the company’s specific situation leading to the deviation.34 Deviating should not be taken too lightly, and should not be done out of laziness or for marginal benefits.

The compliance statement provided as part of the Annual Report 2011 of VINCI SA provides a decent description of the reasons for deviating.

33 Financial reporting council: UK Combined Code 2006, p. 1
34 Belgian Corporate Governance Code 2009, preamble.
“Code provision:
A Director is not considered independent if he/she has held his/her position for more than 12 years.

Reason for deviation
The Group’s significant assets relate to multi-year contracts that are in effect over a long period of time, sometimes several decades (concessions and public-private partnerships). Board members must have sufficient perspective on these activities. The individuals affected by this criterion are fully independent in their judgement.”\(^{35}\)

Reference is made to the company’s specific circumstances; the argument is made that having a long experience within the company could even be seen as necessary. Though the conclusion might not be correct that their independency is not affected, it could be a logical decision to prefer an experienced board member over a completely independent director. It is up to investors to decide whether they agree with this decision. One could imagine that they might accept this view in this case, but perhaps would like to see additional safeguards put in place for guaranteeing independent behavior.

3. Detailed description of the alternative chosen and why it was chosen

When a company chooses to be incompliant, their explanation should not be limited to why they made this choice, but also contain a description of what alternative they choose, and why they choose that option. The Danish Code specifically mentions this as followed: “If a company fails to comply with a recommendation, it must explain why and specify its different approach.”\(^{36}\)

This part of the explanation should contain all the necessary information to help investors to properly determine its effects. Some common deviations come from conflicting regulations, industry standards, implementing difficulties or transitional circumstances. Most of the time

\(^{35}\) VINCI SA Corporate Governance Code Compliance Statement 2011, p. 161

\(^{36}\) Recommendations on Corporate Governance by the Danish Committee on Corporate Governance 2011, p. 4
these are reasonable or unavoidable, but that does not mean that they should not be properly explained, including clear and correct arguments. Explanations should also show that they are still acting in the spirit of underlying principles of good corporate governance, because these underlying principles are by nature not voluntary, as is mentioned in the Italian Code\textsuperscript{37}.

“Code provision:
5.4.6 Compensation of the members of the Supervisory Board is specified by resolution of the General Meeting or in the Articles of Association. It takes into account the responsibilities and scope of tasks of the members of the Supervisory Board as well as the economic situation and performance of the enterprise. Also to be considered here shall be the exercising of the Chair and Deputy Chair positions in the Supervisory Board as well as the chair and membership in committees.

2. Remuneration of the Supervisory Board (Code Clause 5.4.6, Paragraph 2, Sentence 1). The members of the Supervisory Board of Daimler AG receive adequate remuneration that contains fixed and function-related elements as well as attendance fees. The Articles of Incorporation provide for a base annual fee for each Member of the Supervisory Board. This base annual fee increases in line with the respective area of responsibility if a member exercises additional functions within the Supervisory Board such as membership or the chair of a committee or the Chair or Deputy Chair of the Supervisory Board. If a member of the Supervisory Board exercises several of the aforementioned functions, he or she is paid an annual fee solely for the function exercised with the highest remuneration. We believe that a function-related remuneration system is more appropriate for the oversight role of Supervisory Board members than performance-related remuneration because it eliminates any potential conflicting interests with possible effects on performance criteria that might arise from decisions of the Supervisory Board. The Supervisory Board therefore does not receive performance-related remuneration.”\textsuperscript{38}

\textsuperscript{37} Italian Corporate Governance Codes and Principles 2011, p. 22
\textsuperscript{38} Daimler AG. Declaration of Compliance with the German Corporate Governance Code 2009
Provided that this information is complete, and details concerning remuneration are provided when necessary. This provides an excellent view of the chosen alternative. They also provide a limited explanation why they feel this option is more suitable, appealing to the principles related to the independence of Supervisory Board members.

4. Transitional

Finally, explanations should contain a timetable depicting if the company is planning to comply in the future and if so, when. This should allow for monitoring of the process the company makes and help judge the effects it will have on future results. Currently, companies often stick with the same explanation until they directly jump to compliance\(^{39}\), while perhaps it would be better if the statement would reflect what progress the company is making towards compliance and what direction it tends to take in the future. This would also mean that it would have to be disclosed if a company has not made any progress whatsoever, including the reasons for doing so. While no mention of progress already implies the lack of progress, specifically mentioning it would probably trigger investors to pay more attention to this deviation.

Simply copying last year’s explanation could be seen as disregarding the underlying spirit of the code, as it is meant to motivate the management to consider their corporate governance, making sure that they are actively continuously aware of the importance of good governance and working on improving its implementation. It should also reflect on changing circumstances, a good explanation today might not be as good a couple of years later. It appears that the Code is often only thought of when the next corporate governance report is due\(^ {40}\), while the flexibility of the Codes allows for continuous development. Currently, only around 5% of explanations in Europe include some form of indication of future developments regarding the application of the Code.\(^ {41}\)

Example of a temporary deviation in the Corporate Governance Statement provided by Shire plc in 2010.

\(^{39}\) Arcot, Bruno and Grimaud 2005, p. 3
\(^{40}\) Siedl and Sanderson 2010, p.22
\(^{41}\) Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, p. 84
“Although the 2010 Governance Code only applies to the Company with effect from January 1, 2011, the Board is of the opinion that the Company complied with the provisions set out in the new Code, with the exception of:
(i) the new provision in Schedule A relating to the claw back of performance-related remuneration following a restatement of financial results or misconduct, which will be considered by the Remuneration Committee in 2011”

The statement provides a reason for deviating, as it is a new provision. The reasons for postponement are not clear, but the timeline for implementing is. The Annual Report of 2011 notes that they are now fully compliant.

The current system of corporate governance in most Member States accepts the right of companies to explain as they see fit, improvement of explanations can only be a result of pressure by investors. As there seems to be limited interest by investors to do so, companies have every right not to properly explain why they deviate. As long as this is the case, the comply-or-explain approach can never properly function. There should be self-regulation, but if companies can easily ignore these regulations without proper motive, there might as well be no regulation at all. Improving the quality of information would be a necessary step in maturing the comply-or-explain principle.

As there is no sign of investors successfully pressuring companies to improve explanations, it is time for a different approach. It would also help investors to compare companies, as it already seems unlikely they would successfully pressure a single company to better explain itself, it seems even more unlikely they would successfully pressure multiple companies to do so. Implementing guidelines for explanations could achieve better explanations and will allow for easy comparing.

Ireland is one of the first nations to include guidelines for explanations in its corporate governance code. They have included most of the observations stated above in one of their

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42 Shire plc Annual Report 2010, p. 45
43 Shire plc Annual Report 2011, p. 48
44 Irish Stock Exchange Main Securities Market Listing Rules, December 2011, chapter 1
codes, which proves that at least some Member States see the benefits of such guidelines. As it is only recently implemented, it is currently impossible to determine the exact effect of these provisions. There seems to be no good reason not to stimulate better explanations this way. An alternative solution can be found in the Swedish corporate governance code, requiring companies to state clear reasons for each case of non-compliance and describing their solution. Though this is a step in the right direction, it remains a vague and abstract rule. In my opinion, companies must at least be made aware of how such an explanation should look like, as stated in the code.

§ 3.2 Monitoring institutions

In its Green Paper 2011, the EC concludes that the overall quality of explanations given in corporate governance statements by European companies’ is unsatisfactory. Over 60% of companies do not provide sufficient explanations when they choose not to comply. Having concluded that monitoring by investors and internal bodies is insufficient, leads to the conclusion that it is up to external monitoring bodies to fill that void. Though their roles vary greatly from Member State to Member State, three kinds of market-wide monitoring bodies can be identified.

1) Financial market authorities (FMA’s)

Member States that require companies to produce a corporate governance statement through law usually mandate a specialized governing authority like FMA to survey and enforce compliance. Possible penalties could include a public letter, a fine or other administrative measures. Examples include the AFM in the Netherlands, CNMV in Spain, FMA in the UK and the FMA in Austria.

2) Specialized public institutions

Corporate governance is a part of financial reporting, and therefor often monitored by FMA’s. However, most countries have also seen the need for a specialized government sanctioned institution, geared towards monitoring the corporate governance framework. Their focus is

45 The Swedish Corporate Governance Code 2010, art. 10.1
46 Green Paper 2011, p. 8
47 Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, p. 84
48 Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States, p. 59
usually on monitoring market-wide developments and stimulating the correct application of national corporate governance codes, rather than monitoring and reporting on individual companies. Examples of such institutions are CGC in Belgium and SCGB in Sweden.

3) Stock exchanges
If companies are required by listing rules to disclose corporate governance statements, the stock exchange itself is entitled to supervise compliance. Depending on the listing rules, sanctions can include reprimands or fines, and in severe cases delisting.

Most corporate governance systems in EU include some form of monitoring by one or more of these institutions. As concluded earlier, investors are themselves responsible for monitoring corporate governance in companies they invest in. They can already act in order to protect their interests, but lack the interest or information to do so. Stock exchanges also focus on the interests of investors; because they have a strong incentive to accommodate investors to attract capital to their market, they are already assumed to protect investors’ interests to a point which is sufficient in the eyes of investors. Investors also have the option to choose between companies listed in regimes with heavy monitoring or in other, less regulated markets. It fits the self-regulating nature of stock exchanges if they can decide for themselves how to monitor the listed companies. Therefore there is no need for Member States of the EU to force them to take a more comprehensive monitoring role, though some stock exchanges might choose to do so themselves.

In some Member States there is already a role for the national FMA in monitoring and enforcing corporate governance, including corporate governance statements. Some have argued that they are already well equipped to do so, as they often already play a significant

49 An example of a company that was fined for breaking the listing rules in the UK is Exillon Energy plc, after being found guilty of related party transactions. See http://www.fsa.gov.uk/static/pubs/final/exillon-energy.pdf
50 An example of company that was delisted for breaking the listing rules in Sweden is The Global Gaming Factory X AB, after being found guilty of misleading. See AktieTorget Market Notice 152/09
51 For example The Spanish Securities Agency (Comisión Nacional del Mercado de Valores) is mandated to check Code compliance.
role in the information disclosure process.\textsuperscript{52} The proposal for amending Directive 2004/109/EC also aims for national authorities to be more involved in monitoring individual companies, including handing them the means to sanction them.

There seems to be no interest in forming an EU level institution that will monitor individual companies in the Member States. While such a move could promote the single market by applying a uniform policy, it is not a realistic option. While there seems to be a consensus that explanations should be improved, the difference between Member States makes such an institution both practically impossible and unwanted. The role of the EU should be to guide the process to improve the corporate governance framework on Member State level.

\textbf{§ 3.3 Scope of monitoring}

There is a clear distinction between the informative quality of statements and the quality of the judgments made by the company. It has to be avoided that supervision judges the decisions of the management. This happened for example in the Dutch case of HBG, in which the investors had lost faith in the management. Because of a lack of clear rules, the court ended up judging the business decisions of the board as though they were investors.\textsuperscript{53}

The aim should be to have better informative quality of statements to all stakeholders, particularly investors. Supervising institutions should only judge if information is accurate and sufficiently informative, it should be up to the investors to decide how the react to deviations of code requirements. Misleading of investors must be prevented, investors and companies should remain empowered to do business as they see fit, as it is not the job of monitoring institutions to judge a business decision. Making corporate governance codes too extensive and making them formal law, limits the flexibility that the system was meant to have. A new balance must be found when introducing monitoring of corporate governance statements.

There are three kinds of checks that are already used in some Member States with various degrees of involvement of the monitoring institution.

\textsuperscript{52} For example The Portuguese Securities Market Commission (Comissão do Mercado de Valores Mobiliários) in its official view in regard to the Green Paper 2011, p 15

\textsuperscript{53} OK 21 January 2002, \textit{LJN} AD8368 (HBG NV vs. VEB) paragraph 3.5
Availability

Monitoring institutions will verify whether companies have formally declared adherence to a Code, and if they publish a corporate governance statement declaring which provisions they have not followed. It would mean simply verifying if the information is available, without any regards for its quality. This is already a common procedure in some Member States.

Accuracy

The accuracy check will determine whether code provisions have been followed and if explanations for deviations provide accurate and correct information. Though it does not judge the decisions taken by the board, it does check if the facts provided to support the decision are correct. This greatly increases the workload for monitoring institutions and could possibly be hard to bring into practice.

Informative quality

This check determines if statements of compliance and explanations of deviations provide sufficient information to enable investors to make informed judgment’s about the company, taking into account the four requirements mentioned in paragraph 1 of this chapter. This check could be done without actually performing an accuracy check.

§ 3.5 Role of the independent auditor

The independent auditor already functions as an agent for the investors, he already has a role in the governance of a companies. Extensive involvement of a qualified and independent auditor could improve the quality of corporate governance reports. It could also improve the degree of confidence investors have in these reports. The EU directives and ISA720 already require some form of consistency check of corporate governance statements with the financial statements. In case the corporate governance statement is part of the Annual Report, article 46a(1) of the Fourth Directive requires the Auditor to perform a consistency check. Alternatively, Article 46a(2) of the Fourth Directive and Article 36(2) of the Seventh Directive state that such a consistency check must also be performed if the corporate
governance statement is issued separately. The auditor must also check if such a report is issued.

There are basically two forms of reporting that an auditor could probably perform with regards to the corporate governance statement. The auditor can provide a factual check of the given data, or it could be a form of assurance, where the auditor expresses an opinion based on certain criteria.\(^\text{54}\) An example of a factual check would be checking the number of appointed independent directors, while judging if they are actually independent is an example of assurance.

The Fourth and Seventh Directives do not mention a comprehensive role for the auditor in corporate governance of companies, unless Member States have developed further requirements. It does not require an auditor to check if the information provided is complete or correct, it only mentions checking if the information is consistent with the financial information. There is also an ethical provision that accounts should not be associated with information that they believe might be false or misleading.\(^\text{55}\) But as there are no formal requirements to the amount of work an auditor has to perform into checking the corporate governance statement, he is not obligated to investigate them. He will only be alarmed when he is coincidentally is confronted with information that is flagrantly incorrect.

Whether or not the role of the auditor needs to be expanded is a difficult question. This research has not revealed a trust issue between investors and the board regarding the explanations. There have also been no reported cases in which the board has deliberately tried to mislead investors in these explanations. The main problem with explanations does not lie with the accuracy of the information provided, but with the informative quality of the information. Even if auditors are suited to judge this aspect, it would be a costly undertaking, though it might also safe investors’ money as they do not have to do these checks themselves. It would probably have an adverse effect: instead of investors actively monitoring the explanations and challenging the board to improve their compliance, they might just accept the opinion of the auditor. This could mean in practice that monitoring is taken away from

\(^{54}\) Discussion Paper: Auditor’s Role Regarding Assurance on Corporate Governance Statements 2009, p. 7

\(^{55}\) IFAC Code of Ethics for Professional Accountants section 110.
investors and is done by the auditors, which would undermine the whole concept of corporate
governance. This concern has already led to some Member States to specifically state that the
auditor is not required to have an opinion on the corporate governance report besides doing a
consistency check.\textsuperscript{56}

\textbf{§ 3.5 Finding the right combination}

Many different combinations are possible between which bodies monitor and check corporate
governance statements, and to what degree they are monitored. At this point each Member
State has applied its own views on monitoring these statements. It is not realistic to find a one
size fits all solution; there is no single “right” as to the desirable level of monitoring. It would
be best to allow room for the Member States themselves to choose between different regimes
of checking the corporate governance statements. A directive should provide Member States
with goals to improve corporate governance statements, but whether they will achieve these
goals by actively intervening in markets is something each Member State can determine on
their own.

However, it seems that an availability check is the least to be expected from these government
agencies, and it should be possible to realize relatively easily. Such a check should be adopted
by any Member State if they have not done so already. The accuracy of statements is already
implied, all Member States have rules that prohibit companies to provide misinformation.
Checking this information on forehand is very labor intensive and often difficult in practice,
which means the benefits might not outweigh the costs. Most Member States will probably
choose to let investors deal with cases of misinformation afterwards, but can choose to
monitor themselves if they feel it is necessary.

Finally the question that remains is if the informative quality should be more closely
monitored. The Green Paper 2011 suggests that monitoring bodies should be authorized to
check the informative quality of the explanations.\textsuperscript{57} Though research has shown that the
comply-or-explain principle does not seem to be very effective in improving compliance to
codes, that alone does not mean we should completely abandon the self-regulating nature of

\textsuperscript{56} Danmark for example has stated this in Danish Auditing Standard 585

\textsuperscript{57} Green Paper 2011, p. 18-19
codes. It does not seem that there is sufficient support amongst Member States to completely change how the system works\textsuperscript{58}.

It is hard to form an objective and complete view on something which is by nature arbitrary. At best, monitoring institutions could judge the effort of companies to provide a sufficient informative explanation. Stricter requirements could lead to monitoring bodies dictating explanations. For example in Spain, the financial market authority CNMV can require companies to clarify, correct or complete reports.\textsuperscript{59} There is a risk of companies writing what monitoring bodies want to hear, instead of providing their real motives.

Finally one must remember that a lot of codes are joined voluntarily. Putting too much legal burden on them would prevent companies from joining the code, meaning that it is impossible that the Code is effective at realizing its goals. In these circumstances I do feel that they can be required to provide explanations, and thus an availability check is recommended, but any more requirements would be counterproductive.

A logical next step would be to set clear guidelines on what a good explanation should look like. These guidelines should be aimed at both the boards who formulate the explanations and the investors judging them. The approach is pioneered by the Irish and Swedish corporate governance codes, though still not very specific. The four elements of paragraph 1 could be a good basis from which these guidelines could be formulated.

§ 3.6 Differences between Member States
All Member States have codes or are planning to introduce codes soon, which are based on the ‘comply-or-explain’ principle. There is however a big difference in how it is monitored and enforced. In the UK, the FSA has declared that is it solely the responsibility of investors

\textsuperscript{58} For example, the Dutch and Belgian Committee’s clearly oppose these kinds of monitoring.

to check if the corporate governance statement is accurate and adequate. 60 They do have the power to apply ‘naming and shaming,’ but unlike France and other southern Member States they hardly ever apply this measure and are certainly not using it regarding explanations in corporate governance statements.

This is just one example of a current phenomenon in corporate governance, namely that there is a strong world-wide formal convergence, but there still seems to be a lot of differences in the practical implementation. 61 Each Member State has their own legal history and culture, which not only effects the implementation and enforcement by government institutions, but also how individual companies and investors look towards corporate governance codes 62. In a country like the UK, which has lots of experience using self-regulation in various other areas, such an approach has whole other practical implications compared to Germany which has no such history and a strong cultural and legal tendency to use formal law. In southern Member States there is a stronger call for government regulation, opposed to other nations who have much more faith in the capital markets. This follows from different ownership structures, in countries where companies with dominant shareholders are more common, there is probably more need for protection of minority shareholders by public institutions. Especially in family dominated firms there is often little interest in corporate governance. 63 Finally there are recently joined Member States that have only recently started to pay attention to corporate governance, that now have lots of companies that joined corporate governance codes completely voluntary, opposed to other states where there is a legal requirement for companies to do so.

Through several international institutions a set of best practices are promoted that find their way to virtually all corporate governance codes in the EU. This is also true for the comply-or-explain principle. While some interpret this as ‘comply or disclose’, all countries face the same problem regarding explanations. Countries like Sweden and Ireland have opted for an indirect approach, taking steps to make managers and investors aware of how good explanations should look like. On the other hand there are Italy and Spain, where the financial

60 Hopt 2011, p. 67
61 Bebchukand and Hamdani 2009
62 Matoussi and Jardak 2009, p. 5-10
63 Siedl and Sanderson 2010, p. 22
market authorities have started actively monitoring and judging individual companies, trying to force better explanations. Then there are countries that might move away from self-regulation, making large parts of what are now considered best practices mandatory.

§ 3.7 United Kingdom, Sweden and Italy
To illustrate the difference between Member States a short comparison between three completely different Member States has been made. While the formal requirements in their respective corporate governance codes are very similar and all three Member States apply to comply-or-explain principle, small differences in their legal framework lead to big practical differences.

The United Kingdom has lots of experience with forms of self-regulation and companies and monitoring institutions are comfortable with the current state of affairs. The UK prides itself as being a role model for other Member States in many aspects of corporate governance. The FRC recently published a study on the workings of the comply-or-explain principle. It notes that about 50% of listed companies are fully compliant. Those who are not compliant always provide an explanation, though investors feel that the quality of explanations needs to be improved. Investors have taken it upon themselves to provide guidelines for explanations.

After reviewing ten random compliance reports from different companies, I have found none of them will meet the standards of chapter two. The problem with investigating these explanations was that relatively few companies publish their corporate governance statements in the United Kingdom. A few examples include Trifast plc Annual report 2011 mentioning appointing a non-independent Executive chairman, simply stating that he was right for the job despite the requirements of the Code. UK Power Networks only refers in general terms to non-compliance, not mentioning the specific sections to which they are incompliant.

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64 Revised Italian Corporate Governance Code 2006, p. 1
65 FRC, What constitutes an explanation under comply-or-explain?, p.2
66 FRC, What constitutes an explanation under comply-or-explain?, p. 8
67 Trifast plc Annual report 2011, p. 56
68 UK Power Networks Annual Report 2011, p. 16
Generally speaking it seems that while the comply-or-explain principle does not provide many perfect explanations as of yet, companies and investors in the UK seem to be aware of that fact and are moving to improve them by themselves. It will be interesting to see if explanations improve in the coming years.

Another country that will be reviewed is Sweden. Sweden is unique in both its legal history and because Sweden was one of the first countries to have actually formulated guidelines for proper explanations in their corporate governance code. Sweden is, like other Scandinavian countries, historically known for its low power distance, collective responsibility, egalitarianism and cooperation.\(^{69}\) A result of this cultural tradition is that Swedish companies tend to have a strong general shareholders meeting.\(^{70}\) This leads to greater trust in management opposed to for example in the UK. A result of this is that Sweden has a great trust in the comply-or-explain principle and is a forerunner in developing it; Sweden has been one of the first Member States to try and improve explanations. There is much less tendency to develop formal rules as there is in the UK and Italy.

Most Swedish companies only publish Annual Reports and Corporate Governance Statements in their native language. When companies do not publish any explanation at all it is possible it could lead to disciplinary action is taken by a financial market authority. Regarding the quality of the explanations I have to refer to secondary sources, for example the Swedish Investment Fund Association, which feels that Swedish attempts at requiring better explanations have been successful.\(^{71}\)

Italy is an interesting case by itself. After studying all corporate governance statements that have been published in English by the companies traded at the Italian main index, the FTSE MIB, it seems that all of them claim to be fully compliant. The same goes for 95% of all Italian companies.\(^{72}\) Extensive corporate governance reports are published by most companies, but none of them publish clear explanations for deviations, as they claim to be

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\(^{69}\) Lubatkin 2005, p. 880  
\(^{70}\) Lubatkin 2005, p. 800  
\(^{71}\) Lena Falk, Acting General Counsel, official reaction to the Green Paper, as published on their website.  
\(^{72}\) Corporate Governance in Italy: Compliance with the CG Code and Related Party Transactions Year 2011, p. 9  
Available at: http://www.assonime.it/AssonimeWeb2/statuto.jsp?id=235032
compliant. This could be an effect of the extensive monitoring implemented in Italy. Such a high level of compliance seems unlikely, but assuming it is true it seems that the flexibility of the system is not working as it should, which seems to be proven by research showing that actual compliance is significantly lower than reported\textsuperscript{73}. As mentioned earlier, a high level of compliance is not a goal on its own, the system was designed to be flexible and companies should profit from this if necessary, provided they explain why the deviate.

\textbf{§ 3.8 Case study: explanations in the contracting industry}

After making a comparison on Member State level which showed great differences between Member States in how they view corporate governance, comparing explanations from similar companies from different Member States might illustrate the differences even better. Because the contracting industry is an industry that is present in all Member States and because there are a lot of publicly listed construction firms in Europe, this industry is a perfect candidate for comparison. Based on the CE-100 2011 Toplist the 10 largest contractors that publish corporate governance reports, including explanations for deviating, have been selected and compared.\textsuperscript{74}

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<tr>
<th>Contractor</th>
<th>Member State</th>
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<td>Grupo ACS SA</td>
<td>Spain</td>
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<td>Aker Solutions ASA</td>
<td>Norway</td>
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<td>BAM Group NV</td>
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<td>Belfinger Berger SE</td>
<td>Germany</td>
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<td>Bouygues’ Construction Divisions S.A</td>
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<td>Fomento de Construcciones y Contratas, S.A.</td>
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<td>Ferrovial, S.A</td>
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\textsuperscript{73} Bianchi, Ciavarella, and Novembre 2011, p. 118

\textsuperscript{74} CE-100 2011 Toplist, p.2-3
Spain is represented by three companies, France and Germany by two companies, Sweden, Norway, Italy and the Netherlands are represented by one company.

The first remarkable difference can be seen in the style of reporting. In Spain, there is a standardized format to be used by companies in which they have to tick a box indicating if they are compliant next to every provision of the Code. This form does provide a clear overview as it is easy to navigate through the report and find deviations, though it does seem to stimulate box ticking behavior opposed to stimulating companies to develop their own corporate governance systems. By having to include a long list in the corporate governance report including all provisions they do follow, it seems that information is not provided in the clearest way possible. Only separately mentioning the deviations seems clearer, as is done by the companies from Germany and France. In Norway, Sweden, Italy and the Netherlands companies have provided an extensive Corporate Governance report in which all aspects of their corporate governance codes are discussed. This approach might give a complete picture and does stimulate companies to work on their corporate governance systems, but it does not necessary provide a better explanations of the deviations as a lot of effort is put in the form and not the content. This formal approach gives companies much less room to present their corporate governance statement as they see fit. It focuses on the individual rules and not on the complete picture, which might be of more interest to investors.

Though companies in Spain have to clearly indicate which provisions they deviate from and have to provide explanations when they tick the explain box, the explanations themselves seem far from adequate.

The picture above shows a part of the template used for filling corporate governance statements in Spain with an example of a poor explanation. Though it is very clear what section of the Code they deviate from, it is unclear what kind of alternative they have

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75 Grupo ACS Annual Report 2011, p.60
implemented and why that alternative is necessary, nor does it show any intention working towards compliance. As their major shareholders are mentioned in the explanation, they are probably involved in this decision. The question is if minor shareholders are interested in this deviation and if they have the ability to influence it in practice.

There are also some similarities amongst the companies. Nine companies have one or more deviations regarding the independency of directors, while six companies deviate regarding remunerations. Not a single company has explanations that are completely in line with the recommendations of paragraph 3.1. A few examples of explanations from different companies will be analyzed further.

“Provision: Remuneration comprising the delivery of shares in the company or other companies in the group, share options or other share-based instruments, payments linked to the company’s performance or membership of pension schemes should be confined to executive directors.

Explanation: The company has had a system of mandatory investment in company shares since 2003. At present, it consists of the obligation of devoting just one of the three components of board remuneration that is received in cash upon purchase of Company shares. This commitment to invest part of the remuneration in Ferrovial shares applies to all the members of the Board of Directors; directors may thus acquire shares prior to leaving their position and provided that three full mandates have elapsed since the mandate in which the purchase occurred.”

The above provision aims to improve and maintain the independency of independent directors and deals with their remuneration. The explanation is clear on what provision they deviate from, and is also clear on its alternative. However, other than the fact that the company has been working like this for ten years, the explanation does not provide a single argument for doing so, nor does it disclose any plans on working towards compliance. This is a typical explanation for the Spanish companies; they provide the absolute minimum so they can complete the checklist, but no effort is made to provide a complete picture. Corporate Governance should be about presenting the necessary information, not just the required

76 Ferrovial Annual Report 2011, p. 66
information. The company seems unmotivated to provide information on its own initiative. It is also typical for construction firms that the independency of board members is not a priority, because it is one of the most common deviations.

“ASSESSING DIRECTOR INDEPENDENCE
Provision: The director has not been a director of the company for more than 12 years, on the understanding that independent status expires at the end of the term of office during which the 12-year threshold is exceeded.
[...]
In accordance with this provision, the Bouygues Board of Directors considers that being a director for more than twelve years does not automatically result in the loss of independent director status. At the conclusion of the term in which this twelveyear period ends, it decides whether the director shall retain or lose this status by taking into consideration his/her particular situation.
[...]
Patricia Barbizet, Pierre Barberis, François- Henri Pinault and Jean Peyrelevade have been directors for more than twelve years, but after examining their situation in accordance with Article 8.3 of the Afep/Medef code, the Board took the view that these directors had kept their independent status.”

This example from a French company shows the most common reason for deviating, namely that the experience a board member has outweighs his lack of independence. This in itself could be a valid argument, but that does not mean this is a sufficient explanation. First of all, no details of the examination are mentioned, it is unclear how the Board reached this conclusion. It is quite possible they have valid arguments, but the fact that they are not mentioned is suspicious. They also did not disclose other measures to insure their independency. They could have also tried to insure the experience of these directors was not lost to the company without deviating from the Code, for example by appointing new independent directors and finding alternative positions for the former directors ones.

77 Bouygues Annual Report 2011, p 175.
The Dutch company BAM provides an example of deviations regarding director remunerations. The deviations are part of an extended corporate governance report. The specific provisions that the company deviates from are mentioned in the introduction to the corporate governance report. The alternative chosen and the explanations are hidden in the report. One of the deviations regards article II.2.13 of the Dutch Corporate Governance Code, which deals with the flexible parts of directors remunerations. This article is divided in ten subparagraphs, but the corporate governance report is unclear which exact paragraphs the company deviates from. Eventually it becomes clear the deviations regard the information provided on the remuneration of directors, parts of which are not disclosed for competitive considerations.  

The way this lack of transparency is hidden in the corporate governance report shows that the company is currently not very transparent regarding corporate governance. Though it seems that BAM has an extensive and well thought out system of corporate governance, it is unnecessary difficult to judge. The Corporate Governance Report of Aker Solutions from Norway follows a similar approach, with similar results.

After analyzing only three different Member States and explanations used in one industry it can be concluded that even though the Codes are very similar, their application varies immensely. Similar problems arise in all Member States, but different solutions are found. At this point, no solution seems to provide high standards of explanations. This once again proves the difficulties it would bring to harmonize corporate governance in Europe. Though based on a common principle, countries are finding different solutions to put this in practice. The results of these more recent measures are unclear at this point.

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78 BAM Corporate Governance Report 2011, p. 3
Chapter 4: Means of implementation of requirements for explanations

This chapter will analyze how current corporate governance systems in Europe are implemented and how a new form of regulation could be implemented.

§ 4.1 Single market
The creation and development of a single market remains the most important goal of the EU. Supranational actions like harmonization and jurisprudential extensions have already removed a lot of barriers in the creation of a single market, but on corporate law, differences are still large and fundamental, leading to competition between Member States. In the current financial crisis, the differences between Member States are even more noticeable, leading to less confidence from the capital markets. The role of corporate governance could be to increase confidence in the capital markets, particularly in weaker and less developed economies.

§ 4.2 The functioning of national Corporate Governance Codes
Different national codes can be seen to enforce the single market by maintaining confidence in domestic equity markets. While the codes are mostly voluntary by nature, they can provide investors with certain expectations.

Though the codes vary greatly, they all share a similar aim. They aim to strengthen the position of investors and encourage them to play a part in the governance of the company and they aim to regulate and strengthen the boardrooms influence. 79

Each code has different mechanisms, 80 but there are common criteria. Reporting standards to stimulate transparency, structure of ownership, functioning in the general meeting, remuneration and nomination committees, board appraisal, training and composition of the

79 Gregory 2002, p. 22
80 Gregory 2002, from p. 28
board and the role of independent or second tier directors. There are even more codes than there are Member States, all these variations form barriers in forming a single market.

These different codes partition the market and Member States hesitate to improve their codes, as Member States compete which each other. Companies are able to choose and pick listing venues for their stock based on favorable regulation. This is the result of the principle of mutual recognition and recent verdicts by the ECJ in the case of Centros and Überseering.

§ 4.3 Mutual recognition vs. Harmonization

The principle of mutual recognition comes from the interpretation of the market freedom principle by the ECJ in the Cassis de Dijon case. In short it stated that if goods or services conform to the regulations of their home state, they can be marketed in all other Member States, with exceptions such as concerns of public order and public health (now art. 36 TFEU). It is one of the main principles on which the Single Market is constructed.

Building on this principle is the principle of freedom of establishment. In the Centros case, the ECJ ruled that a company that exercises its freedom of establishment, Member States are prohibited from discriminating against this company on the ground that it was formed in accordance with the law of another state in which it has an office, even when it does not do any business in that country. Also it is prohibited to restrict the freedom of establishment on the grounds of protecting creditors or preventing fraud, assuming there are other ways to prevent them. In the Überseering case these conclusions are confirmed, Member States are required to recognize a company established in another Member State as a foreign company.

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81 For an overview see Gregory 2002, Annex V
82 ECJ 9 Marche 1999, ECR I-1459, Case 212/97 Centros Ltd v Erhvervs-og Selskabsstyrelsen
83 ECJ 5 November 2002, ECR I-9919, Case 208/00, Überseering BV and Nordic Constriction Company Baumanagement
84 ECJ 20 February 1979, ECR 3795, Case 120/78 Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein (Cassis de Dijon)
85 Schmidt 2007, p. 670
86 ECJ 9 Marche 1999, ECR I-1459, Case 212/97 Centros Ltd v Erhvervs-og Selskabsstyrelsen, paragraph 20-22
87 ECJ 9 Marche 1999, ECR I-1459, Case 212/97 Centros Ltd v Erhvervs-og Selskabsstyrelsen, paragraph 23-27
Mutual recognition allowed the creation of a single market even though the EU failed to complete the process of harmonization. It also marked the beginning of competition between regulatory standards in Member States as they could no longer effectively protect their national markets as they could do in a regime of national treatment, where each foreign branch is subject to the host’s legal system. Instead of agreeing on a single common regulatory system by harmonizing, countries agreed to work on a complicated patchwork to strive for equivalent national rules. The fourteenth directive attempts to harmonize corporate mobility further, but as the mentioned ECJ rulings have already taken down most of these barriers, the directive is often seen as obsolete and might never be realized.\footnote{Van der Sangen 2008, p. 102} The introduction of the SE and SPE could also render the fourteenth directive redundant.

Harmonization would have high initial costs for the Member States, as they have to negotiate and implement the new harmonized laws. This would however be much more efficient for the company’s operation within the European Union. To limit these costs, companies will choose between Member States, thus possibly creating competition between the Member States.

\section*{4.4 Political motive for harmonization}

One of the main challenges facing the EU lies within the differences between Member States and the will to overcome those differences. The dominant view amongst the political elite in the EU seems to be that (institutional) harmonization is the best road to a more dynamic and prosperous Europe.\footnote{Marinescu 2007, p.1} However, the Eurocrisis of 2011 shows that while the EU is working towards harmonization, there is no harmony amongst Member States. A relatively small problem in a single nation could grow towards a threatening catastrophe because political leaders could not agree on a common solution.\footnote{S. Eijffinger and E. Mujagi, ‘Laat de eurocrisis niet tevergeefs zijn’, in: De Volkskrant, 20 August 2011} If they cannot resolve an urgent crisis together, how can they be expected to transfer more sovereignty on any other subject?

One of the criticisms on Corporate Governance is that soft-law lacks the democratic base any good law needs. Corporate governance can only be effective when it is based on a democratic
foundation, a morality and mutual respect. Rules of laws get respected based on the method by which a law is established. In a democratic society laws should arise through an open debate in and outside the institutions of democracy. Though continuous effort is being put in democratizing the EU institutions by enforcing the EP, it is unlikely European citizens, companies and governments will feel as strong of a moral obligation to comply with a transnational code as they feel with existing codes. Besides, it seems uncertain the people will vote for more harmonization. Harmonization is seen as just another word for unification, and the question is if the citizens of the EU are ready for that.

There is however another way to look at this political question. Using the principle of mutual recognition, Member States have already forfeited some of their sovereignty. But, instead of conceding it to a transnational body like the EU, it now resides with other Member States. This means Member States have no direct influence whatsoever, while harmonization means you have direct influence even if it is shared with everybody else. Though this seems a valid argument pro harmonization, it is doubtful it has any real weight in the debate. As the EU is not just an economical union, but also a political one, other non-economic feelings should also be taken into account.

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91 Macy 1999
92 Weber 1947
93 Marinescu 2007, p.2
Characteristics of the three different principles of market integration

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§ 4.5 Regulatory competition?

One of the reasons to promote harmonization is to prevent competition between Member States. Companies could choose to reincorporate to Member States with a more suitable system of law. This could have negative effects for Member States losing such a competition and could result in a “race to the bottom”. This effect refers to the situation where countries continuously loosen their rules to be a more attractive host for companies. One such example would be lowering taxes, but it could also apply for weakening Corporate Governance regulations.

The other school of thought argues that there will be a race to the top, because companies would seek maximum shareholder value, and therefor would cooperate in the country which imposes the highest standards. Hägg suggests that the unique differences between Member States can be seen as different experiments, with countries learning from each other’s successes and mistakes. Harmonization would prevent such experiments, and thus could be

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94 Adapted from Schmidt 2007, p. 674
95 Schmidt 2007, p. 671
96 Fluck and Mayer 2005, p. 1
counterproductive in the field of corporate governance.\textsuperscript{97} This is perhaps true in general, but self-regulation, while important, has its limits. Regarding the issue of explanations there is a consensus that they need to improve, while there seems no pressure from the markets themselves to do so.

Perhaps neither is true and there isn’t much actual competition between states. In the US, one of the most popular States for companies is Delaware, because they have developed administrative and legal expertise that strongly encourages companies to choose to adopt their legislation. This also prevents other States from competing with them\textsuperscript{98}. However, this situation does not apply in the EU, as there is no EU variant to Delaware and there is no federal legislation comparable to SOX in the US.

Though regulatory competition is a real possibility in the EU, studies show it has only a marginal effect, if any.\textsuperscript{99} Probable reasons are that companies choose a system of law they already know, in a familiar language and administrate duties and taxes they already know. When setting up a new business, the logical thing to do is to do it in your home country and changing the seat is something that only legal experts would think about. Harmonization projects, like introducing the SE, seem to have no effect to that regard, because this pan-European legal entity is still for a large part subject to national law.\textsuperscript{100}

Any new harmonization measure should take into account the possible consequences for the current balance between Member States. Using directives rather than regulations allows Member States to find their own solutions to achieving certain goals, while their legal system maintains its identity and possibilities to compete amongst Member States remain intact.

\textbf{§ 4.6 Necessity}

The previous paragraphs show various arguments pro and con harmonizing Corporate Governance Codes. Another question concerns the necessity; if the codes are sufficiently divergent, do we still need harmonization?

\begin{itemize}
\item[\textsuperscript{97}] Hägg 2011
\item[\textsuperscript{98}] Fluck and Mayer 2005, p.1
\item[\textsuperscript{99}] Bratton, McCAhery and Vermeulen 2008, p. 31
\item[\textsuperscript{100}] Van der Sangen 2008, p.104
\end{itemize}
The Comparative Study notes that the codes share a remarkable similarity and previous recommendations serve as a strong converging force. In that case, harmonizing should be easy but unnecessary. The EC notes that convergence is mainly market driven, if the direction the markets take is the right one and if the EC should influence that direction could be debated.

Harmonization and convergence are not the same. Convergence is a much looser term then harmonization and applies to a looser set of ideals, instead of clear regulations. It makes sense these ideals show a lot of common principles as most Corporate Governance Codes are drafted face similar challenges and reach for similar goals. Because of the comply-or-explain principle, compliance to these national codes will always be an issue. The differences in compliance to Corporate Governance between individual companies are often as great within countries as they are between them. Therefor the question remains if convergence in National Codes has actually led to smaller differences between companies within the EU. One study amongst over sixty countries concluded there was “robust evidence of de jure convergence at the country level” but “virtually no evidence of de facto convergence.”

The EC also noted that a Unified Code would necessitate numerous national derogations and would fail to overcome divergence in national company law. Both the EC and the Member States prefer national solutions.

In the beginning of 2009, at the beginning of the current financial and economic crisis, the European Commission sanctioned De Larosière report concluded on corporate governance “This is one of the most important failures of the present crisis” While it is impossible to

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101 Gregory 2002, p. 3  
102 COM/2003/0284, p.16  
103 Atkins 2003, p. 28  
104 Cadbury 2000, p. 7  
105 Atkins 2003, p. 28  
106 Palepu, Khanna and Kogan 2002, p. 20  
107 COM/2003/0284, p.7  
108 De Larosière 2009, p. 29
determine to what extend corporate governance regulations contributed to the crisis, it shows that the corporate governance framework of today is in no sense completed. De Larosière comments that one of the main problems is that the regulatory framework in Europa lacks cohesiveness. This fundamental problem comes from a lack of harmonization, which he states comes from the fact that directives have always included a range of national options or were suspect to diverse interpretations.

The Report of the Reflection Group on the Future of EU Company Law recommends against large scale harmonization in general. Their conclusion is primarily based on an earlier report from 2002, before the current crisis, in which a consensus was reached amongst experts that more harmonization was unnecessary and not feasible. There are three main arguments against more harmonization in corporate governance codes. First of all it was concluded that the benefit of such codes would be limited to none. The main goal to reach full and uniform information for investors would not be reached, because national company laws are still widely divergent. Some experts noted that the remaining differences between corporate law in Member States come from fundamental differences in national attitudes and are therefore hard, if not impossible to change. There was also the more principle matter that these codes should come from the market and market participants themselves.

A study done by Bruno and Claessens focusing on companies in 23 different nations also warns for too much or too strict corporate governance restrictions. They analyzed it from a costs viewpoint, stating “A straight-jacket of many corporate governance rules can, besides being costly in terms of direct outlays, impose indirect costs, limit managerial freedom of initiative, and thereby negatively affect the efficiency of investments and companies’ cost of capital.” Companies often complain about the costs of corporate governance, particularly in the USA.

109 De Larosière 2009, p. 27
111 Report by the High Level Group of Company Law Experts, Brussels, 4 November 2002, from p. 77
112 Gregory 2002, p. 8
113 Bruno and Claessens 2010, p. 481
114 Stanwick 2008, p. 63
In summary, there seems to be much opposition against sanctioning of new corporate governance rules by the EU. Developments are necessary, but they should come from within the markets and be facilitated by company law on Member State level. Since it remains such an international topic where developments are necessary, the EU should play a coordinating role, but implementing new rules in the form of a regulation is ineffective and unwanted.

§ 4.7 EU sanctioned measures in corporate governance

Corporate governance issues have traditionally been addressed at Member State level, with limited rule-making at Community level based on the harmonization clause related to the freedom of establishment, article 50 paragraph 2 (g) TFEU. This is in line with the principle of subsidiarity laid down in Article 5 TFEU. Article 114 paragraph 1 TFEU grants the EU the right to take measures to create and improve the single internal market.

The EC’s Green Paper suggests improving monitoring of corporate governance statements by defining it as regulated information within the meaning of art. 2 paragraph 1 (k) of directive 2004/109/EC. This would mean that national authorities are enabled to exercise their power to enhance the quality of given information if necessary. This would mean to simply broaden the responsibilities of existing competent national authorities to include corporate governance statements. A directive would be the appropriate measure to implementing new corporate governance regulations, as Member States prefer the room to implement corporate law as they see fit. It would not interfere with national ideas on corporate law and not really defy the lack of political will to harmonize, which means a regulation is out of the question. In its proposal to amending Directive 004/109/EC it is also stated that a modification of the Transparency Directive is the most viable solution. Though a directive is part of mandatory law, it will not mean an end to self-regulation, it would merely define what self-regulation should look like. It would not take away the possibility for companies to deviate and thus self-regulate, it only affects how they explain it. It also does not touch the freedom of Member States to implement corporate governance rules as they see fit, as long as their companies clearly explain the deviations. When Member States implement clear rules and companies clearly explain where the deviate, it becomes possible for investors to judge and compare companies on the same basis in different Member States.

As established earlier, self-regulation has not lead to the necessary changes. Some Member States have already taken it upon themselves to improve corporate governance statements, following recent debates, thus issuing another recommendation or green paper is redundant. The Green Paper 2011 has sparked the debate, the direction of the debate seems clear, steering the Member States in the same direction using a directive would be the easiest and most effective, if possible.
Chapter 5: Conclusions and recommendations

This chapter will discuss the conclusions of this thesis, followed by recommendations that follow from these conclusions.

§ 5.1 Inventory of reactions to the Green Paper

In November of 2011, a feedback statement was published by the EC to provide a summary of the reactions to the Green Paper. It concludes that there is a large majority in favor of requiring companies to provide better explanations.\(^\text{116}\) Clearly, responders feel that the explanations provided by companies are in need of improvement. However, little is concluded on how this should be achieved, other than referring to the Swedish model.

There is also a majority against authorizing monitoring bodies to check informative quality of explanations. Most important argument lies in the fact that there already are control mechanisms in place. It seems to me that this argument conflicts with the previous conclusion that the explanations needed to be improved. I do agree that such forms of monitoring should be avoided, but only because of practical difficulties as discussed in the previous chapter. I do feel that the “comply or explain” principle can only work if proper explanations are provided, and as there currently seems to be a consensus that the explanations are insufficient, steps must be taken to improve them.

While we are awaiting the results of countries which are experimenting with informative value monitoring, steps could already be taken to help improving the explanations. Some have recommended implementing the Swedish solution. I would take this a bit further; corporate governance codes should include guidelines for explanations and national authorities should begin to implement programs to help directors and investors improving explanations.


In accordance with the reactions the EC received on its Green Paper, the EC has decided to not include corporate governance statements in its proposed amendment to the Transparency

\(^{116}\)Feedback Statement 2011, p. 17
Directive.\textsuperscript{117} At this point it is unclear if the EC plans to take further actions as a result of its Green Paper or if it has decided to let the market run its course and leave it up to the Member States to decide how to proceed. The EC seems to recognize that harmonization is not an end in itself and there is little political will to take steps in that direction. However, the EC must continue to strive to remove distortions to the single market, ensuring a level playing field. No regulations regarding the explanations in corporate governance statements could be seen as a possible obstacle to this process, meaning the EC should not completely step down.

Usually four reasons are given to justify regulating reporting and disclosure activities: the existence of externalities, market-wide cost savings, costs related to fraud and agency conflicts that could have been prevented by proper disclosure and insufficient private sanctions.\textsuperscript{118} The last issue is obviously present in this case, with investors not forcing proper explanations. Though at this point a theoretical option, fraud is also a risk as long as comply-or-explain does not include proper explanations. Finally, externalities like public pressure following recent scandals, seems a motive for more regulation in the field of corporate governance. Even though Coase already theorized that private contracting and competition can deal with market failures as well\textsuperscript{119}, there is no indication the market will deal with the problem concerning explanations any time soon.

Though it is currently not possible to improve explanations by amending existing directives or creating new ones, the EC should act upon a clear need to improve explanations in comply or explain regimes. It is a shame that the EC has not taken the opportunity to include at least some mention of explanations in its proposed amendment to the Transparency Directive, setting minimum standards for explanations.

\section*{§ 5.3 Recommendations}

It seems there is a general consensus that European rulemaking should be kept at a fundamental level only, allowing for Member States to embrace the spirit of a regulation and allowing them to adapt it to their own model of corporate governance. It is my opinion that

\textsuperscript{117} Proposal of a Directive modifying the Transparency Directive 2004/109/EC
\textsuperscript{118} Luez 2010, p. 5
\textsuperscript{119} Coase 1960, p. 2-44
comply-or-explain can only properly work if those at whom the explanation is addressed can hold the issuer accountable. When that is not possible or when there is no motive to do so, only then should governmental sanctions be taken.

Both the comply-or-explain principle and the problems associated with it are common in the EU. Though a fundamental debate like in Germany could eventually lead to the end of comply-or-explain principle in some nation, this does not seem likely. However, it shows once again its uncertain place within the different legal systems of the Member States, which can be very different. This has led to Member States applying different solutions or no solution at all, with as a possible consequence that the formation of a Single Market is at threatened. Investors often operate internationally and should be able to properly compare information provided by companies from different legal backgrounds.

It is clear that there can be no new EU wide monitoring institution charged with monitoring explanations. There is no political will and the differences between countries are too large for such an institution to be effective. Most Member States feel that actively monitoring explanations from individual companies is already a step too far, leaving it up to investors to enforce good explanations. This approach seems ineffective at this time, but other steps are being taken to motivate companies and investors to improve the explanations.

It is however unclear what the ultimate goal is of these different steps. There is a role for the EU in setting a standard for explanations, to which every Member State can work in their own way. An amendment to the Transparency Directive would be a logical step, making explanations part of the legal framework motivating Member States to take steps to improve the explanations. While the comply-or-explain principle facilitates self-regulation and flexibility, it is my view that the explain part should be taken out of the context of soft-law and be part of mandatory rules. The explanations must be improved to prevent this practice from losing its credibility. If that does not happen, it seems only a matter of time before lawmakers convert it to formal law completely.

Steps on EU level to improve explanations would enhance the Single Market, as investors can more easily compare companies from different Member States. It also lower barriers for investors willing to invest in other countries, but are afraid of customs or regulations they are
not aware of. By implementing a directive, it can be assured that all explanations have a minimum quality, so even investors that are not completely aware of local practices can rely on them.

It also gives investors new strong arguments when discussing with directors. They can point to the directive, even if it is not legally implemented in their Member State, when they feel that explanations are not good enough. Backed up by upcoming legislation, there concerns will have to be taken more seriously.

An amendment to the exiting directive would include a duty for listed corporations to refer to a Corporate Governance Code in their Annual Report or Corporate Governance Statement. It would also contain guidelines on how to apply the comply-or-explain principle and what elements should be contained in a given explanation. Member States should work to a system which produces explanations of a high quality. To specify guidelines to what defines a good explanations, the four elements of chapter three would be defined, namely:

1) Identifying which particular provision has been deviated from.
2) Explaining why the company has not followed that rule, including:
   a. Clear arguments.
   b. The information must be factual correct and complete.
   c. There must be a logical connection between the arguments and the outcome.
3) Detailed description of chosen alternative, including:
   a. What benefits the company has from deviating.
   b. How underlying principles are still protected.
4) A timeframe mentioning if the company is working towards compliance and when it is expected to achieve it.

Another element that should be made clear is the definition of best practices. There has been a lot of criticism on this term. In the context of corporate governance the practices that are often considered best practices are widely assumed to be best practices, no proper research has shown that they are in fact best practices in practice. They are more political decisions rather than the result of scientific research. The term is also misleading because as discussed in chapter 3 paragraph 1, directors are sometimes morally obligated to deviate when it is in the best interest of the company or their stakeholders. Perhaps a new term or a new definition is
required to deal with this issue. One solution would be to have best practices only refer to a few core underlying principles, while the actual Code provisions are called recommended practices.

As Article 288 of the TFEU states; “A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods.” A number of options are making explanations part of formal law or take action to make it part of for example Corporate Governance Codes or Listing Rules. Some Member States might choose to actively enforce good explanations, while others might want to provide better tools for investors to do so.

In the end, the current state of affairs regarding corporate governance codes and the comply-or-explain principle asks for the EU setting guidelines and pointing the way forwards, while the Member States can apply these directions on their own situations. The fact that the same goes for companies applying a corporate governance Code might be more than just a remarkable coincidence.
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