The Value of the "Comply or Explain" Principle
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ABSTRACT
The "comply or explain" approach is basically characterized by voluntary compliance with the recommended code provisions and give explanation in particular circumstances if good governance can be achieved by other means. Although there are many practical obstacles which prevent the existing "comply or explain" approach to function in an optimal fashion, its existence is still of significance value to improve the quality of corporate governance alongside with other statutory rules. Instead of focusing on the compliance rate, more attention should be paid to improving the quality of explanations, and shareholders are encouraged to engage more in monitoring the appropriateness of the deviation of the provisions.

Keywords: Internal governance, The "comply or explain" principle, Optimal performance.

1. INTRODUCTION
The quality of internal governance has been increasingly associated with the potential performance of a company. In order to achieve optimal performance of general companies, there were attempts to provide guidance as a form of legislation. However, in response to the corporate governance failures in 1980s, the UK introduced a new approach known as "comply or explain" as a form of regulation instead of using "one-size-fits-all" statutory measures.1[1] The Cadbury Report is the forerunner of the introduction of the concept of "comply or explain", which is applied widespread thereafter and is considered as the trademark of corporate governance in the UK.2[2] The "comply or explain" approach is basically characterized by voluntary compliance with the recommended code provisions and gives explanation in particular circumstances if good governance can be achieved by other means.3[3] Flexibility is one of the most significant features of this approach because it encourages companies to adopt the spirit of the Code instead of mechanically following the letters of statutory requirements.4[4] However, the increasing compliance rate but poor quality of explanations provided has aroused many criticisms about its effectiveness, and since it is not backed up by statutory sanctions, there are also concerns about the enforceability of the principle-based regime.

This essay will firstly explain the merits of the principle-based approach over other statutory laws, including its flexibility, specifically concentration and its potential role as a communicative method to reduce information asymmetry between company and shareholders. Then the existing problems and concerns about the "comply or explain" approach will be discussed, in particular the problems associated with the quality of explanations provided. Finally, some suggestions to improve the effectiveness of the approach will be given. This essay will argue that although there are many practical obstacles which prevent the existing "comply or explain" approach to function in an optimal fashion, its existence is still of significance value to improve the quality of corporate governance alongside with other statutory rules. Instead of focusing on the compliance rate, more attention should be paid to improving the quality of explanations, and shareholders are encouraged to

2. Hana Horak and Nada Bodiroga-Vukobrat, 'EU Member States’ Explanations with the 'Comply Or Explain' Principle in Corporate Governance' (2011) 7 CYELP 179, 180
3. UK Corporate Governance Code 2014, comply or explain, para 3
engage more in monitoring the appropriateness of the deviation of the provisions.

2. MERITS OF "COMPLY OR EXPLAIN" APPROACH OVER STATUTORY RULES

There are increasing academic debates between soft law and hard law after more and more codes have been introduced. The most significant advantage of hard law may be the high level of certainty and enforceability.[5] However, a purely hard law approach is no longer a suitable response to the constantly changing market and the 'one-size-fits-all' approach cannot provide companies which are different from each other with appropriate guidance.[6] The one-size-fits-all approach is also been criticized for creating undue burden for some of the smaller companies, to whom most of the requirements are not necessary and even burdensome and costly to comply with. 7 [7] Therefore, it is important to strike a balance between the areas where strictly compliance is required and where flexibility is more desirable.8

The combination of both regulation rules and codes and initiatives are more likely to serve the interests of different market participants. The "comply or explain" approach is widely accepted and apprised not only in the UK, but also has been introduced at the European level and imitated widespread in many other countries. 9 [8] The essence of the "comply or explain" approach lays in its flexibility. Firstly, both the establishment and reform of a statutory rule require a long period of time and therefore it is impossible to respond quickly enough to the constantly changing situations and emerging problems in the market.10 While the codes are usually been reviewed every several years to ensure they are consistent with the current markets, and therefore it is the level of flexibility of soft law that is important to keep the governance requirements up to date.11[9] The fact that the UK introduced audit committees through code long before the European Union brought it into the statutory rule is also an example of the flexibility of soft law compared with hard law.12[10] It has been argued by Dr Chris Gibson-Smith that "Part of the strength of the UK's corporate governance regimes is in its constant evolution, which is a sign of its maturity, robustness and adaptability." 13 [11] Therefore, flexibility is considered as the core of the "comply or explain" approach because of its ability to encourage companies to benefit from the spirit of the Code, by giving explanations in circumstances where the purported "best practice" is not consistent with their individual situations, instead of mechanically follow the letter of the rules.14[12]

In addition, since companies differs in their size, areas and special circumstances, the "comply or explain" regime would allow governance to be tailored by companies in accordance with their specific needs without the burden of being penalized by non-compliance with strict regulations.15[13] Therefore companies are able to take into consideration of their specific structures and commercial needs. In a society where diversity is one of the notable features, the significance of being managed and developed by paying attention to specific needs is very important.16 Evidence also demonstrates that companies are so heterogeneous and even similar companies may adopt different strategies and made different decisions. 17 Therefore, the possibility for companies to develop in a situation-specific way is another merit of the "comply or explain" regime.18[14]

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5. Konstantinos Sergakis, EU Corporate Governance: A New Supervisory Mechanism for the 'Comply or Explain' Principle? (2013) ECFR 394, 397
6. Alessandro Zatoni and Francesca Cuomo, Why Adopt Codes of Good Governance? A Comparison of Institutional and Efficiency Perspectives (2008) 16(1) CGAIR 1, 4
7. Miroslav Nedelchev, 'Good Practices in Corporate Governance: One-Size-Fits-All Vs, Comply-or-Explain' (2013) 4 IBA 75, 77
8. ibid 79
9. Andrew Kray, 'Comply or Explain in Corporate Governance Codes: In Need of Greater Regulatory Oversight?' (2014) 34(2) LS 279, 283
10. Nedelchev (n7) 77
14. David Seidl, Paul Sanderson and John Roberts, 'Applying the "Comply-or-Explain" Principle: Discursive Legitimacy Tactics with Regard to Codes of Corporate Governance' (2013) 17(3) JMG 791, 810
15. Yan Luo and Steven E. Salterio, 'Governance Quality in A "Comply or Explain" Governance Disclosure Regime' (2016) 22(6) CGAIR 460, 464
16. Seidl et al. (n15) 812
17. Sridhar et al. (n1) 8
18. Michelle Edkins, 'Comply or Explain' in 20th Anniversary of the UK Corporate Governance Code (Financial Reporting Council, 2012) 18
Moreover, the premise of the "comply or explain" approach is based on the idea that the flexibility will ultimately lead companies to be better governed and make the company more attractive to investors.\textsuperscript{19,15} If the tailoring could be well justified, then a justifiable departure could mean that the endorsed 'best practice' is inefficient and a persuasive explanation could also serve as a way to inform the investors about the specialty of the company and how the company is carefully governed to distinguish itself from other companies.\textsuperscript{20} There are different experiment results as to the potential influence of corporate governance on the performance of the companies.\textsuperscript{21,16} However, although the relationship between governance practice and company performance is not clearly defined, there are many empirical studies which indicate that investors are more likely to invest in companies with good corporate governance.\textsuperscript{22,17} Therefore, under 'comply or explain' regime, a justifiable departure with explanations provided by companies may distinguish themselves by indicating that more careful thoughts have been put into their management, and therefore serve as a communicative method between investors and the company which reflects that the company is well governed and managed.\textsuperscript{23,18}

Last but not the least, although the 'comply or explain' principle is complied based on a voluntary basis, it cannot be said to be self-regulation, therefore it is still backed by certain types of enforcement and is expected to allow flexibility within an acceptable range.\textsuperscript{24,19} There is requirement which makes companies under an obligation to state publicly whether or not to comply with the provisions and give explanations when choose not to comply and also explain how they could meet the governance requirements using their own methods.\textsuperscript{25,20} Shareholders also have some form of sanctions when they are not satisfied with the explanations, and therefore this approach does not allow companies to solely regulate themselves but use some form of regulation to enhance the accountability.\textsuperscript{26} Therefore the flexibility is backed by shareholder enforcement and is expected to perform better than a pure hard law approach.

3. PROBLEMS ASSOCIATED WITH THE "COMPLY OR EXPLAIN" PRINCIPLE

3.1 The "Comply or Comply" Principle

The spirit of the 'comply or explain' regime lays in the possibility for companies to depart from the provisions which are not suitable for their specific situations, and the idea is that companies do not comply but with adequate explanations for non-compliance are more likely to perform well.\textsuperscript{27} However, according to the Corporate Governance Review 2012, 51% of the companies have fully complied with all of the provisions in the Code and the overall compliance with the provisions of the Code reached 97%.\textsuperscript{28} It has also been demonstrated by empirical studies that many investors simply ignore any explanations and treat anything but comply as non-compliant and the non-compliance has been automatically interpreted by investors as a signal of bad corporate governance.\textsuperscript{29,21} Since investors are more willing to invest in companies with good governance, then it results in that there exists a trend for companies towards fully compliance, and most of the companies have increasingly consider the codes as mandatory requirements in order not to lose attractiveness of their companies.\textsuperscript{30} It has been sated by David Mayhew that "comply or explain purports to give companies a choice — in reality it is Hobson's choice since the stigma attaching to the latter route pushes companies, almost rigidly, into the first

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  \item 19. Christian Andres and Erik Theissen, 'Setting A Fox to Keep the Geese — Does the Comply-or-Explain Principle Work?' (2008) 14(3) JCF 289, 291
  \item 20. Luo et al. (n16) 463
  \item 21. Kenneth MacAulay et al. 'The Impact of A Change in Corporate Governance Regulations on Firms in Canada' (2009) QJFA 29, 32
  \item 22. Igor Filatotchev and Brian K. Boyd, 'Taking Stock of Corporate Governance Research While Looking to the Future' (2009) 17(3) CGAIR 257, 259
  \item 23. Melinda Timea Fülöp et al. 'The Implementation Degree of Recommendations Regarding the "Comply or Explain" Statement and Its Efficiency Via Cloud Computing' (2014) 15 PEF 1105, 1107
  \item 26. Financial Report Council (n25)
  \item 27. Keay (n10) 280
  \item 28. Sergakis (n6) 405
  \item 29. David Mayhew, 'Explaining Without Stigma' in in 20th Anniversary of the UK Corporate Governance Code (Financial Reporting Council, 2012) 28
  \item 30. Keay (n10) 283
\end{itemize}
option.' 31 As a consequence of the investors' negative attitudes towards the non-compliance, companies are reluctant to depart from the Code and this will result in a damage of the spirit of the "comply or explain" principle.32

Moreover, it can be seen that codes have become increasingly detailed and more prescriptive, and this makes compliance more like a 'box-ticking' exercise and companies tend to tick the boxes rather than provide explanations.33[22] It has also been showed that if any pressure is put on companies who choose not to comply or who provide less satisfactory explanations, these companies tend to go directly towards fully compliance instead of improving the quality of their explanations.34[23] Fully compliance rather than explanation is usually explained by companies on the basis that the costs to provide high quality and satisfactory explanations outweigh the potential consequence of mismatch between 'best practice' and their circumstances.35 Another problem which also encourages the box-ticking exercise is the excessive use of proxy agencies by institutional investors to inform themselves with the performance of the companies they invest.36[24] Commercial agencies typically qualify the performance of a company using a tick-box methodology by investigating whether certain components and provisions have been satisfied.37[25] Since both the requirements for compliance and explanations become more detailed and more prescriptive, it provides more prescriptions for box-ticking exercise instead of relying on.38 As a consequence, good governance has been increasingly manifested by the number of 'yeses' ticked within a list of uniformed criteria. Therefore, this may ultimately undermine the underlying spirit of the "comply or explain" principle.

3.2 Quality of Explanations Provided

The essence of the "comply or explain" is not to encourage all the companies to fully comply with the provisions provided; however, the significant feature is the "or explain" part of the principle, and therefore a better quality of explanation is a far more important element to assess the effectiveness of the principle rather than the rate of compliance.39[26] The effectiveness of the principle is not measured by fully compliance with all the provisions but the quality of the explanations which distinguish a well-governed company from a badly governed one.40[27] The statements are intended to act as a communicative method between the company and the investors and make sure investors are well informed of the information upon which could enable them to make decisions.41 However, as a recent report by the Financial Reporting Council (FRC) demonstrated that one of the issues that influence the effectiveness of the approach is that the statements provided by many companies are 'frustratingly large quantities of predictably standard statements'. 42 There are several problematic aspects relating to the explanations which damage the spirit of the 'comply or explain' approach.

The first problem arises from the inadequate definition of a satisfactory explanation and as a consequence, perfunctory and boilerplate explanations are usually provided.43[28] Companies are said to be faced with objective difficulties to satisfy all investors with precise and adequate explanations because the standard of a meaningful and satisfactory explanation is not obvious.44 Investors are also complaining about the poor quality of explanations they receive, which are thought to offer no help in measuring the performance of the company. As a result of the

31. Mayhew (n30) 27
32. ibid
35. Luo et al. (n16) 466
38. Shrives (n37) 97
40. Lynsey Sheridan, Edward Jones and Claire Marston, ‘Corporate Governance Codes and the Supply of Corporate Information In the UK’ (2006) 14(5) CGAIR 497, 502
41. Moreno (n34) 31
42. Arcot et al. (n35) 200
43. Marc T. Moore, ‘Whispering Sweet Nothings: The Limitations of Informal Conformance In UK Corporate Governance’ (2009) 9(1) Journal of Corporate Law Studies 95, 125
44. Sergakis (n6) 406
increasing complaints from both explanation providers and receivers, the FRC organized a consultation process meeting with both companies and investors and having a discussion about the notion of a ‘meaningful explanation’. There are three elements were proposed to constitute a meaningful explanation:

"It should set the context and historical background, should give a convincing rationale for the action it was taking, and describe mitigating action to address any additional risk and to maintain conformity with the relevant provisions. Also the explanation should indicate whether the deviation from the Code's provisions was limited in time and when the company intended to return to conformity with the Code’s provisions."[29]

However, since the circumstances for different companies vary a lot from each other, even with the above provided guidance, it is not necessarily easy to decide whether an explanation constitutes a meaningful one, and this also lead to a further problem that the measurement of an explanation will also become a box-ticking exercise.[30] The guidance from different entities becomes more detailed and prescriptive, then companies start to tick the boxes to ensure that they fulfill all the requirements to be considered as having provided a good explanation.[31] There has appeared a wide use of boilerplate statements by companies, which could mechanically cover all the three elements required above for a meaningful explanation but are still so generic and non-specific and therefore provide little useful information. Sridhar Arcot and Valentina Bruno demonstrated that many companies do not modify the explanation according to the changing situations and provide the same explanation for non-compliance every year before jumping directly to compliance.[30] Companies also do not provide explanations when they jump from non-compliance to fully compliance. Some companies claimed that they are under too much burden when providing explanations since there are too many prescriptive requirements provided by different entities that explain what should be included as a satisfactory explanation, and as a result companies tend to tick the boxes to comply rather than tick the boxes to explain since there also have other bad implications for non-compliance.[32] Therefore, the lack of precise definition for a meaningful explanation may impose difficulties on companies, while a definitive uniformed standard would also arise with problems that may lead companies to tick boxes.

Moreover, there are also concerns about who should be responsible for assessing the quality of the explanations, and if the answer is shareholders, then there exists a problem of shareholders’ lacking of attention on the explanations. [33] It has been argues that the market forces could discipline the firms and response to low quality explanations and performance with lower share prices. However, there are questions about whether the market will actively react and whether it could be a reliable indicator. There are studies showing that the markets are not concerned about the explanations, and the non-compliance without explanations is considered acceptable as long as the financial performance is good and there are profits. [34] Therefore, the market is not a reliable tool to assess the quality of explanations. The monitors of the current regime are shareholders and particularly in the form of institutional investors in the UK, and they should determine the appropriateness and quality of the explanations provided. Therefore, the market forces could discipline the firms and response to low quality explanations. Then there exists a problem of shareholders’ lacking of attention on the explanations. Therefore, the market is not a reliable tool to assess the quality of explanations. The monitors of the current regime are shareholders and particularly in the form of institutional investors in the UK, and they should determine the appropriateness and quality of the explanations provided. The fact that the very existence of codes in the market is primarily intended to maximum shareholders’ value also explains why shareholders are appropriate monitors. However, an empirical study which

45. ibid 407
47. Bjoën Fasterling, ‘Development of Norms Through Compliance Disclosure’ (2012) 106(1) JBE 73, 75
49. Keay (n10) 290
50. Arcot et al. (n35) 193

51. ibid
54. Luo et al. (n16) 465
55. ibid
57. Seidl et al. (n15) 794
is conducted with 245 UK companies has demonstrated that the shareholders, and especially in companies with dispersed ownership, do not pay much attention to the quality of the explanations that are provided. Similar studies also suggested that shareholders and more generally, market participants do not take time to think about the quality of the explanations. This problem is even more notable in recent decades because the ownership has been increasingly dispersed and there are increasing number of foreign investors who invest in the UK market. The failure to engage is perhaps engendered partly by the costs and time shareholders have to sacrifice in order to work collaboratively to be qualified monitors. Therefore, it has been argued that British institutional shareholders tend to sell their shares to exit rather than be involved in monitoring the performance of the company. However, the premise of disclosure requirement is intended to act as a way to bring dialogues between companies and their investors and it could not function to its optimal fashion unless shareholders and other potential information receivers pay attention to the explanations provided.

Another area which also drew attention is the enforceability of the "comply or explain" regime. It is usually been argued that the lack of penalties as a way of enforcement is one of the factors that makes voluntary law system ineffective. The Code requires explanations to be provided but it is entirely silent as to the consequence of non-explanation. It is the shareholders who can determine the appropriateness of the explanations, and if they find they are not satisfied with the explanations, there are, in theory, some options from which shareholders could choose from to exert their powers. For example, shareholders can simply sell the shares or they could exert pressure on the board by exerting their voting rights, and they could also bring a derivative action against directors who breach their duties. Therefore the enforceability of the "comply or explain" principle depends to some extent on the existence and practical application of shareholder rights. The Company Act 2006 contains various provisions to help shareholders to exert their rights, such as the right to vote the right to require directors to call general meeting the right to require circulation of statements and the ultimate power to remove director. However, these rights were not usually utilized by shareholders not only because shareholders' reluctance to engage in monitoring, but also because the costs and obstacles shareholders have to bear when using these rights. Where shareholdings become very dispersed, which is the case in the UK, it may be very difficult for shareholders to coordinate sufficiently to make use these mechanisms valuable. Therefore, the lac of scrutiny and enforcement undermine the shareholders' ability to monitor the company and therefore there are doubts about the enforceability of the 'comply or explain' principle.

4. SUGGESTIONS TO IMPROVE THE EFFECTIVENESS OF THE "COMPLY OR EXPLAIN" PRINCIPLE

Although many criticisms have been made about the effectiveness of the "comply or explain" principle, its flexibility is essential to support the development of corporate governance regime. The reason to highlight the existing problems is not to minimize its importance but to find ways to improve its effectiveness. The following suggestions are provided in order to improve the effectiveness of the 'comply or explain' principle and lead the regime to function to its optimal fashion.

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59. Keay (n10) 292
60. Sridhar et al. (n1) 4
61. Standard Life Investments, 'Comply or Explain: Can It Survive In A Global Market place?'
62. Keay (n10) 285
63. Arcot et al. (n35) 201
64. Eva Parum, Corporate Governance and Corporate Identity (2006) 14(6) CGAIR 558, 563
66. Shirves (n37) 86
67. Keay (n10) 286
68. Horak et al. (n2) 191
69. Company Act 2006, s284
70. Company Act 2006, s303
71. Company Act 2006, s314
72. Company Act 2006, s168
73. Aidan O'Dwyer, Corporate Governance After the Financial Crisis: The Role of Shareholders in Monitoring the Activities of the Board (2014) 5 ASLR 112,117
4.1 Adherence to the Spirit of the "Comply or Explain" Principle

Companies will not choose to derive from the provisions unless the benefits to do so outweigh the costs. However, many companies claim that the non-compliance has negative impact on their market reputation and companies are still criticized by not obtaining fully compliance. As a consequence, the 'comply or explain' concept is sometimes interpreted as 'comply or breach' or 'comply or be damned', which may damage the spirit of the principle. Therefore, unless companies can diverge from the requirements and provide explanations without any stigma, the spirit of the 'comply or explain' principle cannot be fully appreciated. The change of culture and market behaviour is not easy and it requires time and engagement from both companies and investors. In order to encourage market participants to appreciate the spirit of the principle, the following suggestions should be applied as a whole. Since if the explanation providers are able to provide good quality information and explanation receivers engage enough to assess the information and there exist adequate enforcement tools, then these suggestions as a whole may lead to more appreciations of the spirit of the 'comply or explain' principle and as a result largely improve the effectiveness of the principle.

4.2 Improving Shareholder Engagement

A method could not be said to be successful if whom it is intended to benefit to dose not take the method seriously and does not bother to make use of it, and it could not function effectively unless all parties take part in as they are expected to do. The disclosure requirement is intended to provide shareholders with adequate information to assist their decision making. It also helps to reduce costs since the disclosure could help to solve information asymmetry problem. The explanations provided is expected to serve as a basis for investors to be based on to make their decisions on whether to buy or sell their investments. The existence of massive institutional investors in the UK — in particularly UK insurance companies and pension funds, which owned nearly 50% of the market when the 'comply or explain' approach was introduced, was considered as an important feature which make the approach successful, because of the collectiveness and the willingness for them to engage in monitoring of the companies. However, the increasing number of foreign investors in the UK is considered as a hindrance to encourage shareholders to engage in the monitoring of the companies. The reluctance of many investors is primarily because of the active engagement requires both time and money and most investors today prefer a more liquid and diversified portfolio instead of confining themselves into a single investment. It has been demonstrated that the institutional investors often employ a 'box-ticking' way towards engagement and no real efforts have been made to effectively assess the performance of the company. The effects of such a trend have drawn public attention, and therefore the FRC issued the UK Stewardship Code in 2010 and seek to rebuild investors with long-term engagement and monitoring. The Stewardship Code is purported to "assist institutional shareholders better exercise their stewardship responsibilities, which in turn gives force to the 'comply or explain' system." Under the principle 3 in of the Stewardship Code, it specifically stated that:

"Institutional investors should consider carefully explanations given for departure from the UK Corporate Governance Code and make reasoned judgments in each case. They should give a timely explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position."

Shareholders are encouraged to take time to carefully monitor the explanations provided and enter into dialogues with companies if they are not satisfied with the explanations. However, the Stewardship Code itself also is applied on a 'comply or explain' basis, and therefore this may be a problem which lessens the likelihood to

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76. Arcot el al. (n53) 7
77. ibid
78. Mayhew (n30) 29
79. Keay (n10) 292
80. Heidi Vander Baumwede and Marleen Willekens, 'Disclosure on Corporate Governance in the European Union' (2008) 16(2) CGAIR 101,105
81. Horak et al. (n2) 186
82. Seidl el al. (n15) 793
83. O'dwyer (n74) 115
84. ibid 120
85. The UK Stewardship Code Stewardship, para 1
86. The UK Stewardship Code, para 3
87. The UK Stewardship Code, Principle 3
effectively increase the shareholder engagement.\textsuperscript{88} There are also concerns about the effectiveness of the Stewardship Code as to encourage foreign investors.\textsuperscript{89} Therefore the possible positive influence the Stewardship Code could exert will need more time to be tested. If shareholders could be encouraged to take their role as monitors, then it may contribute to the development of both the companies and the effectiveness of the 'comply or explain' principle.

4.3 Improving the Quality of Explanations

It has already been mentioned that the effectiveness of the 'comply or explain' regime is not determined by the high rate of compliance but more importantly is the quality of reasons for non-compliance. The three elements provided by the FRC may provide companies with a bottom line as to what aspects should be considered to form an explanation. However, companies are heterogeneous and therefore it is difficult to assess the quality of an explanation using a uniformed standard. The Green Paper suggested subjecting the corporate governance statements to the meaning of Article 2(1) (k) of the Transparency Directive (2004/109/EC) and allowing state regulators to investigate the quality of the statements.\textsuperscript{90} This would enable regulators to intervene if the explanations are considered to be inadequate by state regulators. For instance, in Canada, the TSX and securities regulators are able to review the firm governance disclosures and if the disclosures are found to be inadequate, then the regulators could trigger enforcement proceedings.\textsuperscript{91} However, this may encourage the box-ticking exercises as the companies will be more concerned about whether the explanations are satisfied with every requirement and seek comfort by ticking all the 'Yes' boxes before submitting the explanations. As a consequence, the costs for providing qualified explanations are more likely to outweigh the foreseeable benefits and therefore it may result in more companies choose to comply instead of spending time and money to ensure all the boxes are ticked. The FRC also vented its opposition to introduce state regulators to monitor the quality of explanations because they consider the regulators would be 'usurping the right of shareholders to assess the acceptability of explanations which is an essential pillar of the comply-or-explain concept.\textsuperscript{92} Therefore shareholders are still considered to be the suitable monitors of the quality of the explanations.

Since it is the shareholders to determine the quality of explanations and they could know what constitute a good explanation in relation to their specific circumstance, it could be suggested that shareholders could provide samples and guidance as to what they consider as an adequate explanation.\textsuperscript{93} This would allow companies to provide more specific information according to their own companies, and even if companies are still exercise in a box-ticking way to satisfy the requirements shareholders have listed, the information would also be more valuable because the 'boxes' are more firm specific and are concentrated on what is required by shareholders instead of required by general rules that could apply to all the companies. In addition, it was stated in the preface of the UK Corporate Code that:

"Chairmen are encouraged to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the Code) have been applied. Not only will this give investors a clearer picture of the steps taken by boards to operate effectively but also, by providing fuller context, it may make investors more willing to accept explanations when a company chooses to explain rather than to comply with one or more provisions.\textsuperscript{94}"

The chairman's introduction would be of great help to improve the quality of explanations if it is carefully provided. The Association of British Insurers (ABI) demonstrated that the scores are on average 56\% higher for companies which included a chairman's introduction in their statements than those companies who are not.\textsuperscript{95} The results also indicated the significance of the involvement of both shareholders and managers.

There has also been suggested that an independent monitor could be involved in assessing

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\textsuperscript{88} O'dwyer (n74) 123
\textsuperscript{89} Moreno (n34) 31
\textsuperscript{90} Keay (n10) 297
\textsuperscript{91} MacAulay et al. (n22) 33
\textsuperscript{93} Keay (n10) 299
\textsuperscript{94} The UK Corporate Governance Code, Preface, para 7
\end{flushright}
the quality of the explanations. However, this may bring other unnecessary issues. If the independent monitor applies a uniformed measurement to assess different companies, then this will bring companies back to the one-size-fits-all approach. While if the independent monitor is required to measure each company using firm-specific criteria, then it would make this approach even more expensive and time-consuming, and the greater flexibility a company is, it would be harder for an external party which is unfamiliar with the specific circumstances of the company to assess its performance. Therefore the shareholders in each company are considered to be the most appropriate monitors, and it is of significance importance for them to be encouraged and incentivized to engage in monitoring the explanations.

Therefore, in order to encourage the market participants to appreciate and then adherence to the spirit of the 'comply or explain' principle instead of mechanically flowing the words of the requirements, shareholders engagement is significantly important, since they are the most appropriate monitors of the quality of the explanations provided. The quality of the explanations should be improved, and this may be achieved by asking for examples from shareholders and the using of chairman’s introductions. Suggestions to introduce state intervention and regulator monitoring may not be appropriate, because they may undermine the voluntary basis of the 'comply or explain' principle and the flexibility of this regime, both of which are essential part of the 'comply or explain'.

5. CONCLUSION

Since the 'comply or explain' concept was introduced by the Cadbury Report in 1992, it has stood the test of time and has been widely accepted by market participants not only in the UK but also in more than 60 other countries elsewhere. The depth of compliance and more importantly, the quality of explanations provided by companies are the milestone of its effectiveness. Since the inception of the principle-based regime, the compliance rate is relatively high, while it is the quality of the explanations which has aroused public concern and critics. The quality of the explanations have been largely decreased because of the lack of precise standard, lack of monitors' attention and the lack of enforceability as a result of providing low quality explanations. Although there are still many obstacles that grasp the spirit of the approach, the 'comply or explain' approach is considered the right choice at present that marry the commercial freedom with sound governance. Since no approach can be certain to avoid any failure and stigma, and there do not exist a tool to measure the success in preventing failure. It is the approaches which could stand the test of time and introduce behavior changes that should be praised, and the 'comply or explain' principle is thought to be one of them. Therefore, the 'comply or explain' principle may continue to improve the quality of corporate governance generally. Suggestions given above, including increasing the shareholder engagement, improving the quality of explanations and encouraging the appreciation of the spirit of this principle, are intended to improve the effectiveness of the 'comply or explain' principle. It is believed that it is the 'comply or explain' principle, which is the hallmark of the UK governance regime, which has contributed to the attractiveness of UK corporate market, and this principle will continue to function as an impetus in the UK market as well as other countries.

AUTHORS' CONTRIBUTIONS

This paper is independently competed by Wei Lu.

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[3] UK Corporate Governance Code 2014, comply or explain, para 3

97. ibid
98. Marco Becht, ‘Comply or Just Explain?’ in 20th Anniversary of the UK Corporate Governance Code (Financial Reporting Council, 2012) 11


[8] Andrew Keay, 'Comply or Explain in Corporate Governance Codes: In Need of Greater Regulatory Oversight?' (2014) 34(2) LS 279, 283


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