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EU MEMBER STATES' EXPERIENCES WITH THE 'COMPLY OR EXPLAIN' PRINCIPLE IN CORPORATE GOVERNANCE

Hana Horak* and Nada Bodiřoga-Vukobrat**

Summary: The smooth functioning of the EU internal market entails not only regulatory harmonisation, but also a set of rules which, regardless of the national laws of Member States, uniformly regulates company law and corporate governance at the supranational level. Availability, transparency and disclosure of information in listed companies are of the utmost importance for company law and corporate governance, including capital market law. In company law and corporate governance, they are used as an instrument for the protection of shareholders and to control the activities of management and supervisory boards, while in capital market law their purpose is to ensure reliable and accurate information for the whole capital market.

1. Introduction

The smooth functioning of the EU internal market entails not only regulatory harmonisation, but also a set of rules which, regardless of the national laws of Member States, uniformly regulates company law and corporate governance at the supranational level. Availability, transparency and disclosure of information in listed companies are of the utmost importance for company law and corporate governance, including capital market law. In company law and corporate governance, they are used as an instrument for the protection of shareholders and to control the activities of management and supervisory boards, whereas in capital market law their purpose is to ensure reliable and accurate information for the whole capital market.¹

A comparative analysis of company law and corporate governance in the EU Member States² reveals a number of differences in national laws and the need for uniform company law and corporate governance to the

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¹ G Ferrarini, L Enriques and M Gatti, 'EC Reforms of Corporate Governance and Capital Markets Law: Do they Tackle Insiders' Opportunism?' (2006) Social Science Research Network 13 <<http://ssrn.com/abstract=886345>> accessed 20 April 2009.

² M Adenas and H Wooldridge, *European Comparative Company Law* (CUP 2009).

greatest extent possible. Differences arise from the affiliation of national laws either with the Anglo-Saxon or continental legal system. However, the natural evolution of national systems is not the only cause. Differences have also ensued from external factors, such as the modelling of laws or codes on those previously adopted in another state.

Applying the comply-or-explain principle poses certain questions and difficulties in view of the differentiated approach in Member States.³

Following numerous corporate scandals in the United States and Europe, a need arose for efficient regulation of corporate governance in general and regulation of the activities of members of company bodies in particular, ie corporate behaviour. Apart from the existence of mandatory provisions which extensively regulate the operation of bodies in listed companies, the situation in the United States⁴ and Great Britain, as well as in other EU Member States, necessitated the creation and adoption of various 'soft-law' instruments,⁵ such as corporate governance codes, especially in the 1990s. In 1992, the first code which set the foundation of good corporate governance practice was introduced in Great Britain, under the title the Cadbury Code. It established a novel regulatory concept known as 'comply or explain', or an obligation to declare compliance with a code of corporate governance.⁶ The Cadbury Code served as a regulatory model and was imitated in more than fifty states.⁷

The corporate governance framework for listed companies in the European Union is a combination of legislation and soft law including recommendations and corporate governance codes. While corporate governance codes are adopted at the national level, Directive 2006/46/EC⁸

³ For more on this issue, see H Horak and K Dumančić, 'Usklađivanje u području prava društava RH s pravnom stečevinom EU' (2011) *Pravo i porezi* 5.

⁴ The comply-or-explain approach in Great Britain differs from that in the US, ie the approach adopted in the Sarbanese Oxley Act in the US. Instead of the system in force in Great Britain, this is legislative regulation.

⁵ 'Soft law' is a system of adopting rules regulating social relations outside the traditional method of adoption of legal rules by democratically elected legislative state bodies, whose application is enforced by criminal proceedings and litigations in court (hard law). Soft law is the system of autonomous private regulation by private law parties. For more on soft law, see N Bodiřoga-Vukobrat and H Horak, 'Kodeksi korporativnog upravljanja: instrument socijalno odgovornog gospodarjenja' in N Bodiřoga-Vukobrat and S Barić (eds), *Socijalno odgovorno gospodarjenje* (TIM press 2008) 201.

⁶ Subsequently amended on several occasions: in 2003 under the Combined Code and from 2010 the UK Corporate Governance Code. For more, see <http://www.ecgi.org/codes/all_codes.php> accessed 17 July 2010.

⁷ L Van den Berghe and L DeRidder, *International Standardisation of Good Corporate Governance* (Kluwer 1999); R Aguilera and A Cuervo-Cacurra, 'Codes of Good Governance Worldwide: What is the Trigger?' (2004) 25 *Organization Studies* 425-444.

⁸ Directive 2006/46/EC of the European Parliament and of the Council of 14 June 2006 amending Council Directives 78/660/EEC on the annual accounts of certain types of companies, 83/349/EEC on consolidated accounts, 86/635/EEC on the annual accounts and consolidated account of banks and other financial institutions and 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings, OJ L 224 16/08/2006.

promotes their application by requiring that listed companies refer in their corporate governance statement to a code, and that they report on their application of that code on a comply-or-explain basis.⁹

Corporate governance is traditionally defined as a system by which companies are directed and controlled, and as a set of relationships between the company's management and its stakeholders.

Notwithstanding supranational and national initiatives in the area of corporate governance, one transnational project deserves special attention: the OECD Principles of Corporate Governance¹⁰ of 2004, which are not directly targeted at companies themselves, but rather serve primarily as a guide for legislative and regulatory initiative in both OECD and non-OECD countries.¹¹ The OECD Principles of Corporate Governance are based on a broad interpretation of corporate governance.¹² The principles contain six key areas of corporate governance: an efficient corporate governance framework; the strengthening of shareholder rights; equitable treatment of shareholders;¹³ recognition of the role of stakeholders; disclosure and transparency in companies; and the accountability of the board.

Basic rules for the management of companies are contained in the laws or other regulations of the state concerned.¹⁴ The codes represent systematic compilations of principles, standards, good practice and recommendations on corporate governance, and their application is not legally binding for companies.¹⁵ Corporate governance codes differ also with a view to whether they contain provisions applicable at a national level (national codes) or at the level of an individual company (company-specific corporate governance codes). The application of such codes is voluntary; neither an explicit legal basis nor enforcement provisions exist. The lack of an explicit legal basis does not deprive the codes of legal consequences. As a *soft law* instrument, the code is binding only for the company, prescri-

⁹ Commission, Green Paper 'The EU Corporate Governance Framework' COM (2011) 16. See also Annex 2, 'List of EU measures in the field of corporate governance'.

¹⁰ OECD, 'OECD Principles of Corporate Governance' (2004) <http://www.oecd.org/document/56/0,3343,en_2649_34813_31530865_1_1_1_37439,00.html> accessed 17 July 2010.

¹¹ For more on corporate governance definitions in the codes of the EU Member States, see H Horak, K Dumančić and J Pecotić Kaufman, *Uvod u europsko pravo društava* (Školska knjiga 2010).

¹² 'Corporate governance ... involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined', OECD (n 10) 11.

¹³ Bodiroga-Vukobrat and Horak (n 5) 201.

¹⁴ Bodiroga-Vukobrat and Horak (n 5) 201-206.

¹⁵ For a full list of national corporate governance codes, principles and recommendations, see the European Corporate Governance Institute (ECGI) Index of Codes <http://www.ecgi.org/codes/all_codes.php> accessed 17 July 2010.

bing certain behaviour in its internal organisation. In most legal systems, corporate governance codes at the national level are not mandatory. Their enforcement is left to company administrative and management bodies, especially the board of directors or management.¹⁶ In other cases, there is a specific legal basis and enforcement provisions, but such codes are mostly applicable to companies listed on a regulated market. Companies abide by them voluntarily only because they feel that an elaborate statement on corporate governance is in their best interest and serves the purpose of building confidence in the company's operations.

Additionally, a corporate governance code can be adopted by an association of which a company is a member, and to whose provisions it is thus liable to adhere. Another example is where the provisions of a certain act explicitly mandate compliance with a code, including legal consequences in cases of non-compliance. Consequently, the company's statute would have to contain explicit provisions requiring compliance with a national corporate governance code.¹⁷

Codes of corporate governance are adopted by various collective expert bodies formed by government or non-governmental organisations,¹⁸ such as government bodies, boards or committees nominated by governments, stock exchange bodies, academic, professional and economic associations (chambers), employers' associations (associations of members of management bodies) and various groups of investors.¹⁹ The application of codes of corporate governance is targeted primarily at companies listed on regulated markets, but also at unlisted companies and state-owned companies.

2. Reasons for the comply-or-explain principle

Corporate governance codes are predominantly based on the comply-or-explain principle. Under this principle, listed companies must declare in their annual accounts whether they comply with the recommendations from the code or explain why they are not complying. This statement must be permanently available on the company's website.²⁰ This

¹⁶ The existence of a management or board of directors depends on the choice between monist or dualist governance in a company.

¹⁷ E Wymeersch, 'Enforcement of Corporate Governance Codes' (2005) ECGI Working Paper Series in Law 46/2005.

¹⁸ For more on this subject, see E Wymeersch, 'Implementation of the Corporate Governance Codes' in K Hopt, E Wymeersch, H Kanda and H Baum (eds), *Corporate Governance in Context: Corporations, States and Markets in Europe, Japan and the US* (OUP 2005).

¹⁹ See Bodiroga-Vukobrat and Horak (n 5) 201.

²⁰ European Commission, European Corporate Governance Forum, 'Statement of the European Corporate Governance Forum on the Comply-or-Explain Principle' (2006) and 'Annual Report 2005' (2006) <http://ec.europa.eu/internal_market/company/ecgforum/index_en.htm> accessed 26 March 2007.

approach has proved excellent in practice because it is responsive to company-specific needs. Moreover, efficient application of this principle favours harmonisation of the legislative and regulatory framework of the EU Member States,²¹ given that the published information provides material for conclusions about the practice of companies liable to implement the code. This in turn can lead to possible modifications or regulation of widely accepted practice. The adoption of common principles becomes the foundation for companies' operations at the supranational level.

As explained above, depending on the law of the Member State, the obligation to apply the comply-or-explain principle may be implemented by law, adopted by a regulatory authority or contained in listing rules. The application of recommendations contained in the code ensures a high level of transparency and, notwithstanding mandatory provisions regulating the mechanisms of liability of members of the company's bodies (in both unitary and dual systems),²² fosters the application of the comply-or-explain principle and liability for annual accounts. Thus, the comply-or-explain principle depends on an appropriate regulatory framework and the existence and correct practical application of shareholder rights, as well as abandoning the non-transparent acquisition of company shares.

The role and activities of regulatory authorities should concentrate on monitoring whether the declaration of compliance with the recommendations published in a code exists and taking action in cases of false declarations. One of the outstanding issues with the application of a code is the demarcation of legislative solutions from those regulated in the code. We are more inclined towards a position that the code should continue where the legal act stops.²³ It should contain practical instructions on how to apply legal solutions and how to act when circumstances require taking specific actions to implement the law.

Given the application of the comply-or-explain principle, we should bear in mind the discrepancies resulting from the different legal traditions of the EU Member States. The different structures of capital markets

²¹ This is the conclusion of the European Commission, 'The Action Plan on Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward' COM (2003) 284 final and 'Final Report on the High Level Group of Company Law Experts on a Modern Regulatory Framework for a Company Law in Europe', 4 November 2002 <http://ec.europa.eu/internal_market/company/docs/modern/report_en.pdf> accessed 17 July 2010.

²² See in detail in J Barbić, 'Pregled odredaba Zakona o trgovačkim društvima o monističkom ustroju organa dioničkog društva' (2007) 12 Hrvatska pravna revija 44; V Gorenc, Z Česić, V Buljan and V Brkanić, *Komentar Zakona o trgovačkim društvima* (RRIF, 2008) 545; Horak, Dumančić and Pecotić Kaufman (n 11) 42.

²³ See J Barbić, E Čolaković, B Parać and V Vujić, *Korporativno upravljanje osnove dobre prakse vođenja društava kapitala* (Biblioteka Kaleidoskop, Naklada Ljevak 2008) 93.

and the maturity of the corporate governance tradition in specific states should also be taken into account.

3. The comply-or-explain principle in theory

The central element of almost all codes is the comply-or-explain principle.²⁴ Its first appearance was in the Cadbury Report: companies listed on a regulated market²⁵ had to declare in their annual accounts whether

²⁴ In Croatian legislation, for the purpose of better monitoring of management and supervision in a company, and also the accountability of bodies and directors and the availability of information to all interested external stakeholders under Article 65 of the Act on Amendments to the Companies Act of 19 October 2007, Article 272a of the Companies Act was deleted and a new Article 272p Statement on compliance with the corporate governance code was added under subsection 2B. Unlike, for example, in Great Britain, in Croatian law, the comply-or-explain provision is contained in the act itself, and not in the code. The same goes for s 161 Aktiengesetz. Given the above, the authors in this paper use the formulation in conformity with the Companies Act, which reads as follows:

'(1) The supervisory board or board of directors of a company whose shares are admitted to trading on a regulated market shall ensure that the management, ie executive directors, of the company report in a separate section of the annual report on the company's position at least: a) information on the corporate governance code to which the company is subject and/or the corporate governance code which the company may have voluntarily decided to apply and/or the corporate governance practices applied beyond the requirements under national law as well as information stating where the applicable corporate governance codes or corporate governance practices have been published; b) whether the company deviates from the corporate governance codes mentioned under a) and explanations for areas of deviation; c) a description of the essential features of internal auditing in the company and risk management in relation to financial reporting; d) information on significant direct and indirect shareholders, including indirect shareholders in pyramid structures and cross shareholdings, holders of securities with special control rights and their description, limitations on voting rights such as limitation to a certain percentage or number of votes, temporal limitations for realisation of voting rights or cases in which, in co-operation with the company, financial rights from securities are detached from their holding, rules on appointment and revocation of members of the board of directors, ie executive directors, or supervisory board, and amendments to the statute, and powers of members of the board of directors, ie executive directors, or supervisory board, especially powers to issue company shares or personally acquire shares; e) information on the composition and operations of management, ie executive directors and supervisory board, or the board of directors and their committees.'

²⁵ The term 'regulated market' is defined in Croatian law in Article 3 item 20 of the Capital Market Act (Official Gazette of the Republic of Croatia 88/08, 146/08, 74/09) in accordance with Directive 2004/39/EC. Article 3 item 20 states that a regulated market is a 'multilateral system operated and/or managed by a market operator and which fulfils the following requirements:

a. brings together or facilitates the bringing together of third-party buying and selling interests in financial instruments in the system, pursuant to predetermined unambiguous rules and in a way that results in a contract in respect of the financial instruments admitted to trading under its rules and/or systems;
b. possesses authorisation as a regulated market, and
c. regularly functions in accordance with Part two of this Act.'

The term regulated market is also determined pursuant to the provisions of Articles 308, 309 ff of the Capital Market Act.

they complied with the code, and identify and give reasons for any area of deviation. In theory, the comply-or-explain principle should provide for a flexible code application, ie the application and adjustment of those provisions which are important for a specific company and the method for achieving conformity. Bearing this principle in mind, non-compliance with particular provisions of the code could be justified in certain instances. Each company must carefully weigh each provision and provide a reasonable explanation in the case of non-compliance.²⁶ The informative quality of explanations of non-compliance with the code is of extreme importance, given the potential liability for any given explanation (statement). As far as the *explain* provision is concerned, it is important to highlight that non-compliance *per se* does not imply poor management of the company. Some analyses support this statement by showing that companies which have explained non-compliance with a code in a reasonable manner have an excellent management.²⁷

The underlying idea behind the comply-or-explain principle is to grant flexibility in the application of code provisions, which is precisely one of the features of codes as soft law instruments. In this context, we believe that the intention of codes is not to have all companies apply and adhere to the same provisions. When particular provisions are not suitable for a certain organisational structure, a company is actually expected not to align its operations with them, but to explain why those provisions are not complied with. Organisational structure and other factors having an impact on the company include company size, the structure of shares in the company's equity, the ratio of foreign investment in the company and capital market requirements in a given state.²⁸

The German Corporate Governance Code²⁹ mentions flexibility among the essential features of the code, which is implemented to pro-

²⁶ D Seidl and P Sanderson, 'Applying "Comply or explain": Conformance with Codes of Corporate Governance in the UK and Germany' (2009) Centre for Business Research, University of Cambridge Working Paper No 389, 5 <<http://www.cbr.cam.ac.uk/pdf/WP389.pdf>> accessed 17 July 2010.

²⁷ S Arcot and V Bruno, 'One Size does not Fit All, after All: Evidence from Corporate Governance', 1st Annual Conference on Empirical Legal Studies <<http://ssrn.com/abstract=887947>> accessed 17 July 2010.

²⁸ T Baums, 'Reforming German Corporate Governance: Inside a Law Making Process of a Very New Nature. Interview with Professor Dr Theodore Baums' (2001) 2 German Law Journal <http://www.germanlawjournal.com/past_issues.php?id=43na> accessed 20 July 2010.

²⁹ The German Corporate Governance Code (the so-called Cromme Code) was adopted by the Government Commission for Corporate Governance in 2002. The most recent amendments were in 2010. The Code is available at <<http://www.corporate-governance-code.de/eng/kodex/1.html>> and <www.ebundesanzeiger.de> accessed 17 July 2010. Article 161 of the Shares Act (*Aktiengesetz*) prescribes the obligation to give a statement on compliance or non-compliance with the recommendations in the Code. On the reform of German company law, see T Baums, 'Company Law Reform in Germany' (2003) 3 J Corp L Stud 181.

tect companies subject to it from limitations arising out of and mandated under a legislative framework. Companies should be allowed to adapt corporate governance models to their individual circumstances and optimise them in relation to the efficiency of the set criteria. The fundamental value of the comply-or-explain principle lies in the fact that companies may be entirely aligned with the code, but may also deviate from the code in individually adapted areas to the extent and in the manner compliant with the comply-or-explain principle.

The comply-or-explain principle does not provide leeway to avoid the rules; a company is required to disclose and, in the original British concept of this principle, to provide a public explanation for deviations.³⁰ Comply-or-explain should actually rest on third parties monitoring and implementing compliance with the code. Capital markets and in particular shareholders and all the stakeholders in a company are third parties.³¹

It is in the shareholders' interest to adequately evaluate the significance of deviations. In this sense, the very existence of a code is primarily to protect shareholder interests.³²

The ensuing conclusion is that when an efficient system of regulation exists, investors can act for themselves. It is to be assumed that shareholders will examine the statement on compliance with the corporate governance code with all its requisite contents, ie the declaration whether the company deviates from the corporate governance code and explanations for areas of deviation. In addition, a description of the basic features of the company's internal audit as well as risk management in relation to financial reporting will be considered. Furthermore, there will be information on important direct and indirect shareholders in the company and the composition and operation of the management and supervisory board or board of directors and committees. This will in theory serve as the basis for a decision, depending on the level of compliance and sound management of the company's business, on whether to buy, sell, and keep stocks, ie when voting on certain decisions at the company's general meeting, etc.

³⁰ Seidl and Sanderson (n 26) 5.

³¹ D Kerwer, 'Rules that Many Use: Standards and Global Regulation' (2005) 18 *Governance* 611-632.

³² Kerwer (n 31).

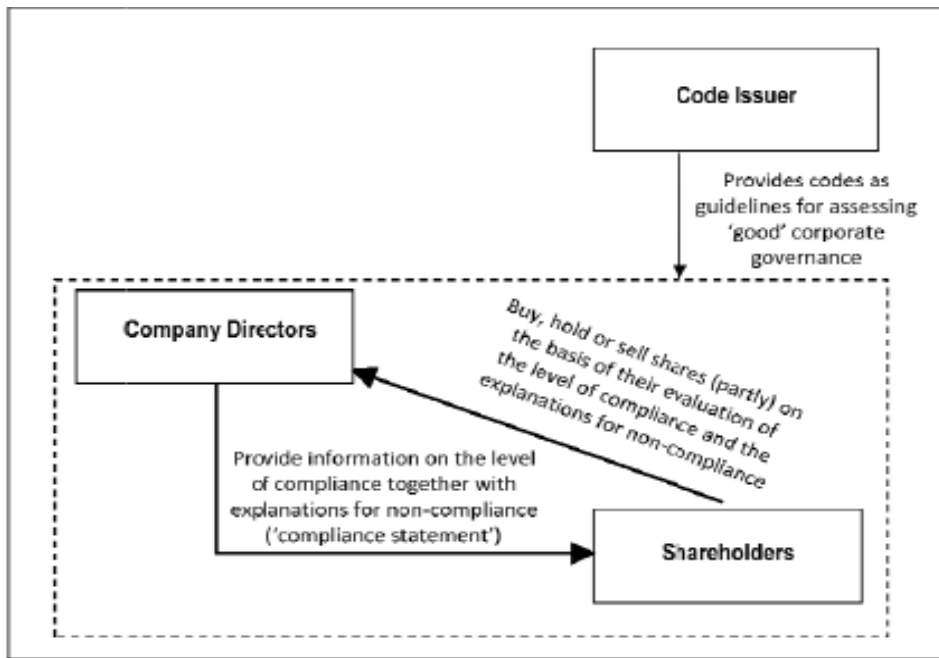


Figure 1: The design of the code regime.

Source: see footnote 26, page 7.

In practice, regrettably, many shareholders do not exercise their right and obligation to monitor compliance and are therefore referred to as ‘absentee landlords’.³³ Given the above, the conclusion is that shareholders have to possess a lot of relevant information to allow them to reach a decision on the corporate governance of the company in which they invest. They have sufficient rights at their disposal to accomplish this (eg the right to appoint members of supervisory or management boards, vote on remuneration policy,³⁴ the right to convene general meetings, etc).

4. Comply-or-explain: experiences from EU Member States

Comply-or-explain at the supranational level was recommended in the EU in 2002 by the High Level Group of Company Law Experts.³⁵ It was formally adopted by the European Commission in 2006 in Directive 2006/46/EC, which introduced the comply-or-explain principle in EU law.

³³ RiskMetrics Group, ‘Study on Monitoring and Enforcement Practices in Corporate Governance in the Member States (2009) <www.riskmetrics.com> accessed 26 June 2010.

³⁴ In Denmark, the Netherlands, Portugal, Sweden and Great Britain, and recently introduced as an option in Germany.

³⁵ ‘Final Report on the High Level Group of Company Law Experts’ (n 21).

Under the provisions of the Directive, all companies whose securities are admitted to trading on a regulated market³⁶ of the EU are required to give a statement on the application of a corporate governance code or to explain why it is not applied. This statement must be included in a specific and clearly identifiable section of the annual report or in a separate report published together with the annual accounts or by means of a reference in the annual report when such a document is publicly available on the company's website.³⁷

The statement must contain key information on the corporate governance practice applicable in the company:

a) information on the method of work and competences of the general shareholder meeting, and a description of shareholder rights and the manner in which they are realised;

b) information on the composition and work of the management and supervisory board, or board of directors and their committees;

c) information on important direct and indirect shareholders, and shareholders with special control rights, and a description of those rights, limitations on the rights and information regarding their contracts with the company;

d) other relations between important shareholders and the company;

e) information regarding contracts concluded with related third parties;

f) the existence and nature of the risk management system;

g) a statement on the application of the national corporate governance code by the company or an explanation and reasons for deviations from the code.

Although the comply-or-explain principle has already been accepted in numerous EU Member States, Directive 2006/46/EC has mandated its application and set the minimum requirements, which had not been harmonised until this time.

Company bodies are required to ensure that the annual accounts, annual reports and corporate governance statement are drawn up and published in accordance with the Directive and international accounting standards. A breach of this duty results in the liability of the members of management bodies towards the company.

³⁶ For more on the definition of a regulated financial market and trading on it, see Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC [2004] OJ L 145/1.

³⁷ Article 1 of Directive 2006/46/EC (n 8) which amends Directive 78/660/EEC by introducing a new Article 46a.

4.1. Outstanding implementation issues in the EU Member States

Bearing the implementation of the Directive in the EU Member States in mind, different approaches to corporate governance codes are observable. Each Member State has its own tradition and, regardless of the provisions of the Directive, each of the codes must be analysed in its unique context. The *first differentiation* between corporate governance codes is based on the initiative for their creation and adoption, since those who create and adopt it are in principle also authorised to monitor its application. Their influence on monitoring instruments for code application is very significant.

Corporate governance codes have been adopted in 25 EU Member States. For the two remaining Member States, other arrangements are in place: in Ireland, the British code of corporate governance applies, whereas in Greece the Corporate Governance Act is in force.³⁸

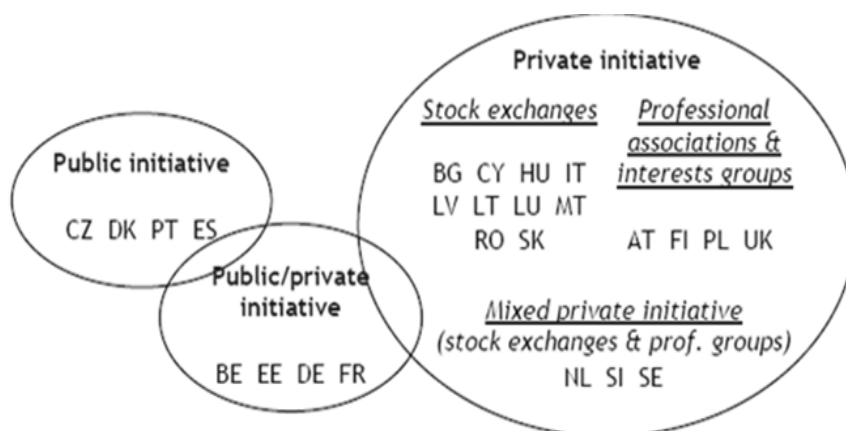


Figure 2: Sources of initiative for the adoption of corporate governance codes.

Adapted from RiskMetrics Group (see footnote 33, page 23).

The next difference in approach arises from the manner in which corporate governance codes are applied in the EU. In this context, the requirement to publish a statement on corporate governance based on the comply-or-explain principle prescribed in Directive 2006/46/EC has been implemented by law in the practice of EU Member States (Austria, Bulgaria, the Czech Republic, France, Hungary, Lithuania, Latvia, the

³⁸ RiskMetrics Group (n 33) 23.

Netherlands, Slovakia, Slovenia and Spain).³⁹ This obligation is also found in securities regulation⁴⁰ (Portugal, Great Britain), listing rules (Denmark, Estonia, Ireland, Italy, Latvia, Poland and Romania) or the comply-or-explain principle is contained in the code itself (Cyprus, Finland, Luxembourg and Sweden). This divergence arises from the fact that the choice of method for implementation of the obligation to apply the comply-or-explain principle under Directive 2006/46/EC is left to the Member States, provided that it is published and accessible. The deadline for transposition of Directive 2006/46/EC was September 2008. By mid-2010, all Member States apart from Greece had reported the complete or partial implementation of Directive 2006/46/EC in national legislation.⁴¹

In conclusion, in the majority of cases where corporate governance codes are created by government institutions (public bodies), the obligation to apply the comply-or-explain principle is stipulated in law or a by-law. Where a code is created by non-governmental institutions (stock exchanges, professional associations and interest groups, etc), the application of the comply-or-explain principle does not necessarily arise from a law or by-law.

4.1.1. Content and structure of the code

Corporate governance codes in the EU Member States also differ in their content and structure. Some codes contain performance guidelines, given the diversity of obligations arising. These codes commonly contain three types of guidelines: general principles, which are usually binding for the companies (typically copied from the law itself) and recommendations, which are based on general principles. Recommendations are applied within the meaning of the comply-or-explain principle. In addition, such codes may contain suggestions, which usually either indicate how to apply recommendations or provide best practice examples. The comply-or-explain principle is not applicable to such suggestions (Belgium, Denmark, Germany,⁴² Hungary, Italy, Luxembourg and Sweden).⁴³ Other Member States follow similar, but less elaborated typologies regarding the use of terms and gradation between general principles, re-

³⁹ RiskMetrics Group (n 33) 28.

⁴⁰ Regulations and other by-laws.

⁴¹ European Commission, 'Transposition of the Accounting Directives as of 19 October 2010' <http://ec.europa.eu/internal_market/accounting/docs/transposition/accounting_dir_transposition_en.pdf> accessed 19 July 2010.

⁴² In relation to the application of recommendations, the German Code contains the words 'should' (*sollte*) and 'can' (*kann*), and companies are allowed to deviate from them, though are obliged to publicly declare this each year. The Recitals to the German Code also point out that the term 'shall' (*soll*) should be understood as a recommendation. For more on this, see Gorenc, Ćesić, Buljan and Brkanić (n 22) 567.

⁴³ See RiskMetrics Group (n 33) 35.

commendations and suggestions. Moreover, codes in certain Member States (Austria, Ireland, Slovakia and Great Britain) make a distinction in application depending on the size of the company or, as in Bulgaria, the code stipulates the obligation to apply recommendations only for companies listed in the highest quotation.⁴⁴

Notwithstanding the above, the content and structure of the code does not automatically determine its quality. Although their content varies from one Member State to another, all codes regulate the same subject matter: authorities, composition and the operation of the company's managing bodies and their committees, directors' remuneration, risk management in relation to financial reporting and internal auditing in the company, as well as other information important for shareholders.⁴⁵ The quality of the code depends on the legal framework in force in each Member State, its practical application, manner of publication, accessibility of information, and active shareholder involvement. In addition, the application of the code entails efficient monitoring.

4.1.2. Corporate governance models

The diversities of national corporate governance codes in the EU Member States arise not only from the fundamental legal aspects, but also from the preferred model of corporate governance. Variations in corporate governance models⁴⁶ exist in relation to ownership structure in joint-stock companies and the method of acquiring capital for the performance of economic activities.

When it comes to ownership structure in joint-stock companies in the EU Member States, listed companies are quite widespread in Great Britain and Ireland, whereas concentration of ownership, ie the existence of one or more majority shareholders with controlling rights over the company is typical in Italy, Austria, Germany and Portugal. Low levels of ownership concentration are characteristic of France and the Netherlands, although not to the extent present in Great Britain. The Nordic states, and also Slovenia and Belgium, hold an intermediate position.

In addition, majority shareholders in listed companies can be individuals, ie families, especially in the Mediterranean countries of the EU and Belgium. Majority shareholders in Belgium and Romania are non-financial institutions, companies and foundations. A mixture of non-financial institutions and families as majority shareholders exists in

⁴⁴ RiskMetrics Group (n 33) 35.

⁴⁵ See, for example, Article 272p (1) of the Companies Act, Official Gazette of the Republic of Croatia 111/93, 34/99, 52/00, 118/03 (Decision of the Constitutional Court of the Republic of Croatia), 107/07, 146/08 and 137/09.

⁴⁶ For more on corporate governance models, see Barbić, Čolaković, Parać and Vujčić (n 23) and Horak, Dumančić and Pecotić Kaufman (n 11) 39-84.

Germany. Financial institutions as majority shareholders are typical in Austria, France and the Netherlands, and particularly in Great Britain. In the countries of Eastern Europe, a considerable share in companies is frequently owned by the state.⁴⁷

5. Harmonisation with the requirements laid down in Directive 2006/46/EC

It is important to remember that the transposition of Directive 2006/46/EC in the EU Member States ensued through a variety of instruments for implementation of the comply-or-explain principle.

- Some Member States did not have to take any action, given a previously existing requirement to refer to a national code and to apply the comply-or-explain principle pursuant to listing rules (Denmark, Ireland and Romania).
- In certain Member States, the listing rules did not need to lay down the application of the comply-or-explain principle, since the code itself mandated its application (Cyprus, Estonia, Ireland, Luxembourg and Sweden).
- In other Member States, the combination of governmental and non-governmental regulation applies. Usually, the stock exchange rules refer to national corporate governance codes (and sometimes lay down the obligation to disclose compliance with the code, without mentioning a particular method), and security market rules provide for the application of the comply-or-explain principle (Austria, Bulgaria, Italy, Latvia, Lithuania, Poland, Slovakia, Slovenia and Great Britain).
- Some Member States have decided to introduce the whole system, which includes referral to the application of the code and its application pursuant to the comply-or-explain principle prescribed by law or a by-law (the Czech Republic, France, Germany, Hungary, the Netherlands, Portugal and Spain).⁴⁸

This may create a situation whereby companies must comply with different requirements for the application of the comply-or-explain principle, particularly where they are not registered or where they are not listed in the Member State of their registered seat.⁴⁹ In the Netherlands,

⁴⁷ See RiskMetrics Group (n 33) 26. See also Federation of European Securities Exchanges, 'Share Ownership Structures in Europe' (2008) <http://www.fese.eu/_lib/files/Share_Ownership_Survey_2007_Final.pdf> accessed 20 July 2010.

⁴⁸ See RiskMetrics Group (n 33) 24.

⁴⁹ For more on real seat and incorporation theories, see D Babić and S Petrović, 'Priznanje stranih trgovačkih društava u Europskoj uniji nakon presude Suda Europskih zajednica u predmetu Centros' (2002) 52 Zbornik Pravnog fakulteta u Zagrebu 376 and Horak, Dumančić and Pecotić Kaufman (n 11).

for example, the comply-or-explain principle is based on a law regarding the Dutch corporate governance code and is mandatory for all Dutch companies listed on a regulated market, regardless of where it is. In contrast, the requirement to apply the comply-or-explain principle in Great Britain, pursuant to the British corporate governance code, is contained in the listing rules and applicable to all companies listed in Great Britain, regardless of their registered seat. Thus, Dutch companies listed only in Great Britain must apply the Dutch code, as the state of its registered seat, as well as the British code, as the state of its listing. Bearing this in mind, a British company listed in the Netherlands, at least in theory, is not obliged to apply either the Dutch or the British code as a result of application of the comply-or-explain principle. The survey conducted by the Riskmetrics Group reveals a small number of 'forum shopping' situations, whereby a company elects provisions from various codes to fit its needs in order to avoid its obligations rather than achieve greater flexibility. In practice, a company with multiple listings, ie in the state of its registered seat and in its strategic market, usually chooses the code of the state of its registration. As a formal solution to these issues, the European Forum for Corporate Governance has proposed the following new provisions:⁵⁰

- if the Member State of the registered seat and the Member State of the primary listing are different, the company should choose to apply the corporate governance code applicable in either the Member State of its registered seat or the Member State of its primary share listing;
- a Member State can require that a company that is either registered in that Member State, or the shares of which are admitted to trading on a regulated market in that Member State, but which applies another Member State's corporate governance code, explain in what significant ways the actual corporate practices of that company deviate from those set out in the Member State's corporate governance code.

All EU Member States regularly update their corporate governance codes either in line with national regulations or with the requirements of EU supranational regulations.⁵¹ According to surveys conducted in 6 EU Member States (Austria, Bulgaria, Germany, the Netherlands, Romania and Great Britain) the procedure for regular updating is formalised. The conducted surveys show that updates are more regular than in countries

⁵⁰ European Corporate Governance Forum, 'Statement of the European Corporate Governance Forum on Cross-border Issues of Corporate Governance Codes' (2009) <http://ec.europa.eu/internal_market/company/docs/ecgforum/ecgf-crossborder_en.pdf> accessed 20 July 2010.

⁵¹ See RiskMetrics Group (n 33) 55.

where such formalised procedures are lacking. In other Member States, the mechanisms for updates and amendments to codes are informal and ad hoc.⁵²

Directive 2006/46/EC sets minimum joint standards for formal monitoring of the application of a code and compliance with its provisions.⁵³ Thus, the Directive prescribes that the board of directors and supervisory board, or the supervisory board and auditor are responsible for ensuring that the company's board of directors or its executive directors issue a statement on compliance with the corporate governance code.⁵⁴

Furthermore, Directive 2006/46/EC requires that the auditors conduct formal supervision of the corporate governance statement, regardless of whether it was published in an annual report or a separate document.⁵⁵

Market-wide monitors, as the analysis shows, actively monitor information by gathering annual reports which contain statements on the application of the comply-or-explain principle. In some cases, they also analyse the informative value of the corporate governance statement and publish the results thereof. Thus, capital market monitors tend to be more actively involved than stock exchanges. The survey shows that the use of standard forms for corporate governance reporting within the EU could raise its quality. However, unprofessional and improperly constructed standard forms may lead to a superficial approach to question answering ('box ticking').⁵⁶

6. Application in the Republic of Croatia

Based on the provisions of the Companies Act, Croatian company law is presently completely aligned with EU company law, including Directive 2006/46/EC.

For all companies whose shares are admitted to trading on a regulated market, Article 272p of the Companies Act prescribes the legal obli-

⁵² See RiskMetrics Group (n 33) 77.

⁵³ Article 1(8) of Directive 2006/46/EC, which amends Directive 78/660/EEC and introduces Article 50c.

⁵⁴ In Croatian company law, Article 272p(1) of the Companies Act prescribes that the 'management and supervisory board, or the board of directors ... shall ensure that the company's management ...'. In this sense, the Companies Act correctly distinguishes between the terms 'ensure' and 'submit', since pursuant to Article 250a of the Companies Act, the management has a duty to submit an annual report, which is in conformity with the formulation of Article 272p of the Companies Act. For more, see Gorenc, Ćesić, Buljan and Brkanić (n 22) 568.

⁵⁵ Article 1(8) of Directive 2006/46/EC, which amends Directive 78/660/EEC and introduces Article 46a(2).

⁵⁶ The Croatian Corporate Governance Code on page 24 also includes an annual questionnaire. For more, see <<http://www.zse.hr/UserDocsImages/legal/Corporate%20Governance%20Code-eng2010.pdf>> accessed 17 July 2010.

gation for administrative, management and supervisory boards to make sure that the board of directors, ie executive directors, include a corporate governance statement in a separate section of the annual report. The purpose of prescribing the content of the statement is to guarantee that all listed joint-stock companies apply the best corporate governance practices and that the statement is not just a formality, but a tool which will enable all interested persons to gain insight into the actual state of governance and business management.

The wording of Article 272p is in conformity with other provisions of the Companies Act. Thus, the board of directors has a duty to submit a written annual report on the state of the company to the general meeting once a year (Article 250a(1)). An integral part of the report of listed joint-stock companies is the declaration of compliance with the corporate governance code in Article 272p of the same Act (Article 250a(4)). The declaration in section 1 of this Article must be publicly accessible (Article 250a(5)).⁵⁷

⁵⁷ Article 403 of the Capital Market Act is consistent with this provision.

‘(1) The issuer of securities shall make public its annual financial report from section 2 of this Article at the latest four months after the end of each financial year and shall ensure that it remains publicly available for at least five years from the date of its publication.

(2) The annual financial report of the issuer shall comprise:

1. the audited annual financial statements;

2. the management report;

3. statements made by the persons responsible for drawing up the annual financial report of the issuer, whose first name, family name, job and functions within the issuer shall be indicated, that, to the best of their knowledge:

- the annual financial statements prepared in accordance with the applicable set of accounting standards give a true and fair view of the assets, liabilities, financial position and profit or loss of the issuer and the undertakings included in the consolidation taken as a whole;
- the management report includes a fair review of the development and performance of the business and the position of the issuer and the undertakings included in the consolidation taken as a whole, together with a description of the principal risks and uncertainties that they face.

(3) The audit report, signed by the persons responsible for auditing the annual financial statements, shall be disclosed in full to the public together with the annual financial report referred to in paragraph 2 of this Article, pursuant to the method and the time period laid down in paragraph 1 of this Article.

(4) The provisions of sections 1, 2 and 3 of this Article shall apply accordingly to an issuer that is required to prepare consolidated accounts.’

Article 404 of the Capital Market Act:

‘(1) Where an issuer has its registered office in the Republic of Croatia, the reports referred to in Article 403 section 2 items (1) and (2) of this Act shall be deemed to be reports drawn up pursuant to regulations on the establishment, structure and business activities of sole traders and companies and regulations governing the accounting of enterprises and the application of financial reporting standards.

(2) If the annual financial statements are not approved by the competent body of the issuer within the time period laid down in Article 403 section 1 of this Act, the issuer shall, within the time period laid down in Article 403 section 1 of this Act, disclose to the public its annual financial statements indicating that the statements have not been approved by its competent body.

(3) In the case referred to in section 2 of this Article, the issuer shall, within 7 days of the approval of annual financial statements by its competent body, disclose to the public the

The provisions of the Companies Act in the Republic of Croatia provide comprehensive legal regulation of the scope of activities of joint-stock company bodies.⁵⁸ Nonetheless, the harmonisation process with EU legislative and regulatory practice has revealed a need to adopt a corporate governance code to regulate where the act stops.

The Corporate Governance Code was first created in 2007 by the Croatian Financial Services Supervisory Agency (HANFA) and Zagreb Stock Exchange.⁵⁹ It was amended to reflect the best corporate governance practices in the EU Member States. Some authors believe that the German code should be used as a model, given the fact that the Croatian Companies Act is closest to the German Akt-G. Although this idea is in principle correct, Croatian particularities, especially those of the Croatian financial market as well as the maturity of the corporate governance tradition in the Republic of Croatia should not be overlooked. Of course, numerous companies in the Republic of Croatia have their own corporate governance codes that can also be included in an annual report within the meaning of Article 272p.

A survey⁶⁰ based on secondary sources from the annual reports of 265 companies listed on the Zagreb Stock Exchange was conducted for the purpose of this paper. The purpose of the survey was to determine whether the companies have their own code, whether it is being applied, and if not, why. The survey shows that out of 265 listed companies,⁶¹ 167 of them apply the Corporate Governance Code.

approved annual financial statements. Where the competent body of the issuer approves the annual financial statements in full, as made public in accordance with section 2 of this Article, it shall be deemed that the issuer has disclosed its approved annual financial statements if it discloses to the public information that the annual financial statements previously disclosed to the public have been approved in full by its competent body.

(4) Along with the annual financial report referred to in Article 403 section 2 of this Act and the auditor's report referred to in Article 403 section 3 of this Act, the issuer shall publish in full the decision of its competent body on approval of the annual financial statements and the decision on the distribution of profit or loss, if the decisions are not an integral part of the annual financial report.

⁵⁸ J Barbić, *Pravo društava kapitala* vol 2 (Organizator 2005); Gorenc, Ćesić, Buljan and Brkanić (n 22).

⁵⁹ The Corporate Governance Code of the Zagreb Stock Exchange (n 56) was adopted in 2007.

⁶⁰ Information retrieved from the annual reports of listed companies and annual questionnaires on the application of codes of corporate governance, published on the websites of the Zagreb Stock Exchange <<http://zse.hr/default.aspx?id=26484>> accessed 17 July 2010 and HANFA <<http://www.ripe.hanfa.hr/hr/publiciranje/izvjesca/>> accessed 17 July 2010.

⁶¹ The Capital Market Act (Official Gazette of the Republic of Croatia 88/08 and 146/08; hereinafter: CMA) lays down the obligations of issuers whose securities are listed on a regulated market managed by the stock exchange, the content of reports and notifications, deadlines for the creation and publication, mode of publication and submission to the official registry of required information. The mentioned obligations of issuers are prescribed under Articles 395-449, 364 and 450-464 CMA.

Figure 3

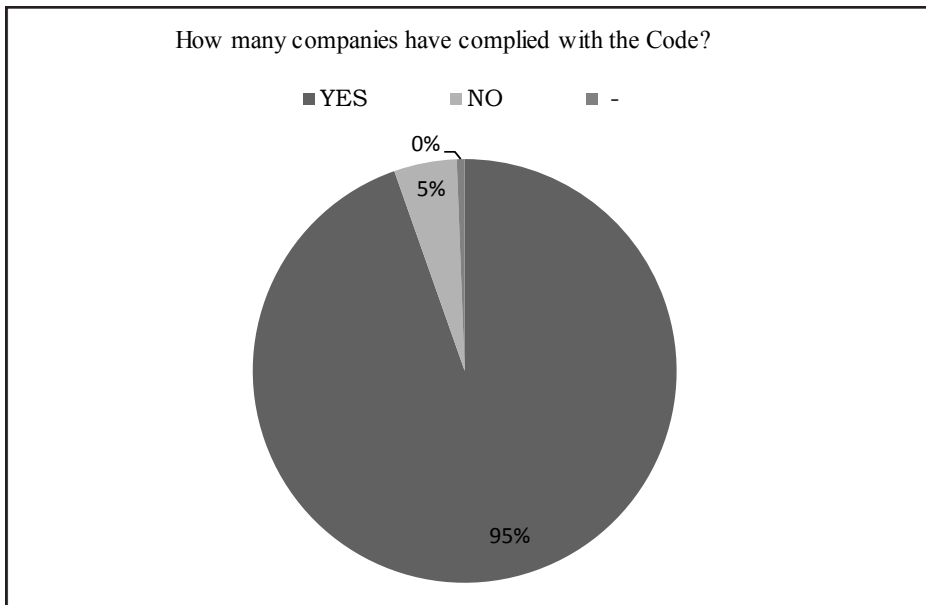
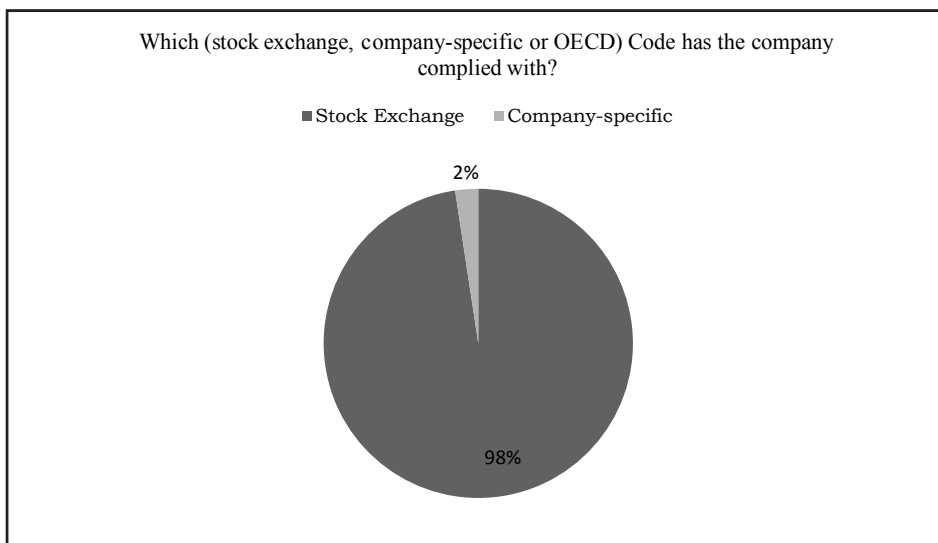
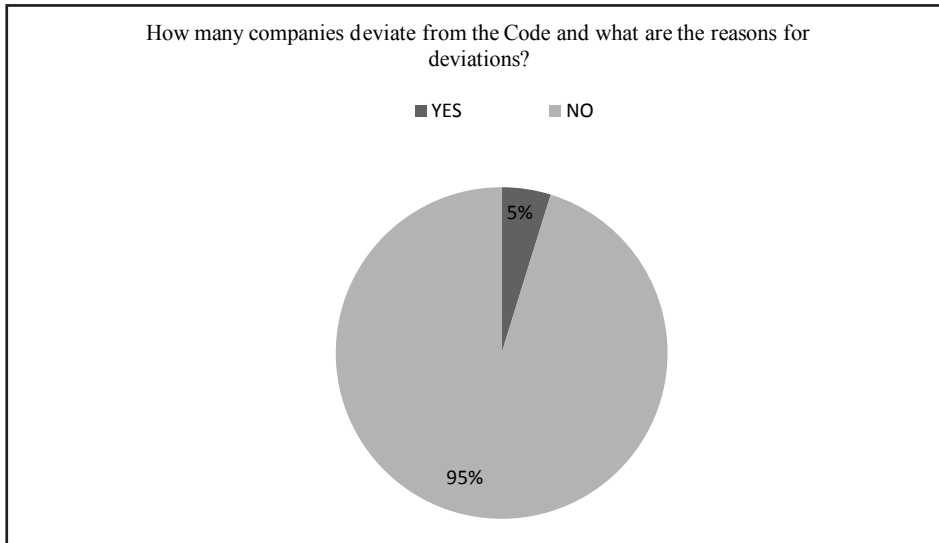


Figure 4



The results of the survey lead to the conclusion that out of 167 joint-stock companies applying a corporate governance code, 163 or 98% apply the Stock Exchange Code, while 4 or 2% use company-specific codes.

Figure 5



The survey also demonstrated that out of 167 joint-stock companies applying a corporate governance code, 8 or 6% deviate from it, while 159 or 95% report full compliance.

The following explanations for deviations from the code are detected:

- pursuant to legal provisions and the statute, the company has assured against abuses of confidential information by persons who have access to it;
- there is no need for compliance with a code;
- there is no legal obligation either in the code or the statute for the company to comply;
- the company has not established mechanisms for compliance with a code.

A potential weakness of the application of the comply-or-explain principle referred to in Article 272p lies in the fact that the obligation to make statements on compliance permanently available (Article 272a) was deleted from the current version of the Act. Consequently, the opinion is that shareholders should have recourse to the general provisions on shareholder rights (Article 250a in particular⁶²). Therefore, without the obligation to make the statement on compliance permanently available, the wording of Article 250a(5) of the Companies Act actually requires that the shareholders actively pursue their right to information (ie by reading through the entire annual report, including the declaration of compliance with the code).

⁶² Gorenc, Ćesić, Buljan and Brkanić (n 22) 570.

As previously stated, the Croatian legislative and regulatory framework is currently characterised by a high level of alignment with the EU legal framework. A significant outstanding issue in business practice is, however, the extremely low level of corporate governance culture. This gap between legal and business practice has recently resulted in numerous corporate abuses which are presently awaiting resolution in court proceedings. Only time will tell whether the outcome of the court proceedings will be able to improve the corporate governance culture or raise awareness of company governance and management for the benefit of the company itself and thus its shareholders as well.

7. Conclusion

The experiences of the EU Member States and developments in legal and business practices in the EU show that, although a legislative and regulatory framework for the application of the comply-or-explain principle exists, the true will of company bodies and all external stakeholders is needed to apply it in practice. In this sense, the quality of explanations in cases of deviation has still not reached a satisfactory level. One of the outstanding issues is low shareholder involvement in monitoring the application of this principle in business practice.

One of the essential factors of efficient implementation of the comply-or-explain principle is the availability and publication of information, which is the task of the management, supervisory board or board of directors. Apart from this, an important role is given to auditors, especially when it comes to information availability and publication, in order to guarantee reporting quality in corporate governance. Surveys show that the comply-or-explain principle could be advanced in business practice by granting wider powers to bodies such as regulatory agencies, stock exchanges and ad hoc committees. Strengthening the independence of regulatory bodies in practice, ie granting wider powers to deal with irregular behaviour, could indisputably further promote this principle.

Following the line of thought presented in this paper, it seems that codes as soft law instruments (whether themselves based on the comply-or-explain principle or in the case of a regulatory framework, containing the same principle based in law) have not proved in practice to be attempts at self-regulation but rather an extension of mandatory regulation, arising out of the necessity to regulate this area through a set of more detailed and supplementary provisions in the codes. Thus, codes supplement regulation where the law stops, and by applying the comply-or-explain principle enable companies to make information on business management and corporate governance publicly available as they see fit and in accordance with the legislative framework.

The comply-or-explain principle is not suitable for application in all markets, given the distinctions and variety of legal frameworks, the development of capital markets and numerous economic and social factors influencing the efficiency of its application.

In business practice, the application of the comply-or-explain principle was obviously not mature enough to prevent the corporate scandals of the 1990s and afterwards. The experiences gained from the financial crisis of 2008 demonstrate that these problems must be regulated through mandatory provisions when it comes to risk management in relation to financial reporting. Lately, information availability has become the crucial requirement for companies. The aim of the obligation to publish information, including statements on compliance with a corporate governance code is to guarantee transparent use of corporate governance control mechanisms. Given this, we are of the opinion⁶³ that the comply-or-explain principle should not be abandoned, but strengthened through all available instruments with the purpose of reinforcing the corporate governance legal framework.

According to the Green Paper of the European Commission, 'The European Union Corporate Governance Framework',

comply-or-explain could work much better if monitoring bodies such as securities regulators, stock exchanges and other authorities were authorised to check whether the available information (in particular, the explanations) is sufficiently informative and comprehensive. The authorities should not, however, interfere with the content of the information disclosed or make business judgements regarding the solution chosen by the company. The authorities could make the monitoring results publicly available in order to highlight best practices and to push companies towards more complete transparency. Use of formal sanctions in the most serious cases of non-compliance could also be envisaged.⁶⁴

One way to improve monitoring could be to define the corporate governance statement as regulated information within the meaning of Article 2(1)(k) of Directive 2004/109/EC, and thus make it subject to the powers of the competent national authorities as laid down in Article 24(4) of the Directive, which is in line with the analysis and conclusion of the authors of this paper.

⁶³ See RiskMetrics Group (n 33) 188.

⁶⁴ Commission (n 9) 20.