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19, С-блогы, 306-каб.,тел.: 8(7172)26-61-22
www.zqai.kz, E-mail: instzak-kz@mail.ru
institutzakonodatelstva@gmail.com

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блок С, каб. 306, тел.: 8 (7172) 26-61-22
www.zqai.kz, E-mail: instzak-kz@mail.ru
institutzakonodatelstva@gmail.com

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www.zqai.kz, e-mail: instzak-kz@mail.ru
institutzakonodatelstva@gmail.com

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HOW CAN THE EFFECTIVENESS OF THE «COMPLY OR EXPLAIN» PRINCIPLE IN THE UK CORPORATE GOVERNANCE CODE BE IMPROVED?

Jangarashev Rolan Maratovich
Deputy Director of the Institute of Legislation
and Legal Information of the Republic of Kazakhstan,
Republic of Kazakhstan, Nur-Sultan; e-mail: dzhangarashev.r@zqai.kz

Abstract. *The article considers features of corporate government established by the UK Corporate governance code and the increasing necessity in the improvement of corporate governance. The author identifies key problems and analyzes basic models of modern corporate management. Main factors of the increase of enterprises' corporate management efficiency identified by the author comprise academic novelty and practical value of the article. The article considers advantages of the "comply or explain" principle, which consists in adaptation of management rules to specific characteristics of individual companies. It is believed that this principle leads to better corporate governance outcomes than the «one size fits all» approach. However, the effectiveness of "comply or explain" approach depends on the existence of several crucial condition, such as quality of the explanation part of the principle. As it has been identified poor quality explanations can affect among others to the accountability and transparency of companies financial operations, the effectiveness of stock markets, the ability of shareholders to evaluate corporate behavior. Author analyses the corporate practice of some European countries, which implement the corporate practice of controlling companies' explanations of inapplicable principle by establishing an independent monitoring body. However, it seems that such practice has some flows and such practice needs thorough evaluation before its implementation. The author also mentions Kazakhstani experience and contemplates on the future perspectives of the development of a corporate governance code in Kazakhstan.*

Key words: *comply or explain; corporate governance; financial regulation, voluntariness, efficiency.*

БІРІККЕН КОРОЛЬДІКТІҢ КОРПОРАТИВТІК БАСҚАРУ КОДЕКСІНДЕ «САҚТА НЕМЕСЕ ТҮСІНДІР» ҚАҒИДАТЫНЫҢ ТИІМДІЛІГІН ҚАЛАЙ АРТТЫРУҒА БОЛАДЫ?

Ролан Маратұлы Джанғарашев
Қазақстан Республикасының Заңнама және құқықтық ақпарат
институтының директорының орынбасары,
Қазақстан Республикасы, Нұр-Сұлтан қ.; e-mail: dzhangarashev.r@zqai.kz

Аннотация. *Мақалада Ұлыбританияның корпоративтік басқару кодексінде белгіленген корпоративтік басқарудың ерекшеліктері қарастырылған. Корпоративтік басқаруды жетілдірудің өскелең өзектілігі қарастырылды. Негізгі проблемалар анықталып, қазіргі заманғы корпоративтік басқарудың негізгі модельдері талданды. Мақаланың ғылыми жаңалығы мен практикалық құндылығы автордың кәсіпорындарды корпоративтік басқарудың тиімділігін арттырудың негізгі факторларын анықтайтындығында. Мақалада басқару ережелерін жеке компаниялардың ерекшеліктеріне бейімдеуден тұратын «сақтау немесе түсіндіру» қағидатының артықшылықтары қарастырылады. Бұл прин-*

цип «бір өлшем бәріне сәйкес келеді» тәсілінен гөрі корпоративті басқарудың тиімді нәтижелеріне әкеледі деп саналады. Алайда, сақтауға немесе түсіндіруге негізделген тәсілдің тиімділігі кейбір маңызды шарттардың болуына байланысты. Осындай шарттардың бірі – принциптің түсіндірме бөлігінің сапасы. Анықталғандай, сапасыз түсініктемелер, басқалармен қатар, компаниялардың қаржылық операцияларының есептілігі мен ашықтығына, қор нарықтарының тиімділігіне, акционерлердің корпоративтік мінез-құлықты бағалау қабілетіне әсер етуі мүмкін. Автор тәуелсіз бақылаушы орган құру арқылы бақылаушы компанияларды қағидатқа қолданылмайтын түсіндірудің корпоративтік практикасы енгізілетін кейбір Еуропа елдерінің қолданыстағы корпоративтік практикасын талдайды. Алайда, мұндай тәжірибенің кейбір кемшіліктері бар және мұндай тәжірибені енгізер алдында мұқият бағалау керектігін қатарстырған. Сондай-ақ, автор корпоративтік басқару кодексін әзірлеудегі қазақстандық тәжірибенің болашақ перспективаларына назар аударған.

Түйін сөздер: *сақтау немесе түсіндіру; корпоративтік басқару; қаржылық реттеу, еріктілік, тиімділік.*

КАКИМ ОБРАЗОМ МОЖНО ПОВЫСИТЬ ЭФФЕКТИВНОСТЬ ПРИНЦИПА «СОБЛЮДАЙ ИЛИ РАЗЪЯСНЯЙ» В КОДЕКСЕ КОРПОРАТИВНОГО УПРАВЛЕНИЯ СОЕДИНЕННОГО КОРОЛЕВСТВА

Джангарашев Ролан Маратович
Заместитель директор Института законодательства и правовой информации Республики Казахстан, Республика Казахстан, г. Нур-Султан; e-mail: dzhangarashev.r@zqai.kz

Аннотация. *В статье рассматриваются особенности корпоративного управления, установленные Кодексом корпоративного управления Великобритании. Рассмотрена возрастающая безотлагательность улучшения корпоративного управления. Выявлены ключевые проблемы и проанализированы основные модели современного корпоративного управления. Научная новизна и практическая ценность статьи заключается в том, что автор выделяет основные факторы повышения эффективности корпоративного управления предприятиями. В статье рассматриваются преимущества принципа «соблюдай или объясняй», заключающегося в адаптации правил управления к специфике отдельных компаний. Считается, что этот принцип приводит к лучшим результатам корпоративного управления, чем подход «единый для всех». Однако эффективность подхода соблюдения или объяснения зависит от наличия некоторых важных условий. Одним из таких условий является качество пояснительной части принципа. Как было установлено, некачественные объяснения могут повлиять среди прочего на подотчетность и прозрачность финансовых операций компаний, эффективность фондовых рынков, способность акционеров оценивать корпоративное поведение. Автор анализирует существующую корпоративную практику некоторых европейских стран, в которых внедряется корпоративная практика разъяснения контролирующими компаниями неприменимого принципа путем создания независимого контрольного органа. Вместе с тем такая практика, как представляется, имеет определенную динамику, и такую практику следует тщательно проанализировать до ее внедрения. Автор также обратил внимание на практику и рассмотрел будущие перспективы казахстанского опыта разработки кодекса корпоративного управления.*

Ключевые слова: *соблюдать или объяснять; корпоративное управление; финансовое регулирование, добровольность, эффективность,*

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Introduction

The UK Corporate Governance Code, formerly known as the Consolidated Code, is considered one of the most influential corporate governance codes worldwide. Its main characteristic, and what makes it different from the Sarbanes-Oxley Act in the United States, is the flexibility, which it offers to companies. The voluntariness and flexibility of the Code is conceptualized in the «comply or explain» principle, which is applied not only in the UK, but at the EU level and beyond as well.

The «comply or explain» principle is used to inform investors and public through a statement of compliance with the best corporate practice, or otherwise explain why that practice is inapplicable.

The concept was first introduced in the UK following the recommendations of the 1992 Cadbury Report[1]. The «comply or explain» principle currently forms the basis of the European code-based approach to corporate governance.

Thus, some national European bodies have established a set of good corporate governance practices that are expected to be adopted. In fact, these national codes of corporate governance set out rules or guidelines that are not binding, but companies must either comply with them or publicly explain why they do not comply with some of their provisions.

A compliance-based approach can be particularly important in emerging market economies where the organizational structure, ownership and control of companies are complex and where optimal governance arrangements are evolving to maximize companies' value.

Despite the wide popularity of the «Comply or explain» principle, there is an increasing concern around its practical effectiveness. A number of studies suggest that this principle does not work properly. Seidl D., Sanderson P. & Roberts J. [1] argue that there are few deeply detailed studies conducted on the «comply or explain» approach, which could explore its better practical use.

Nevertheless, this paper will describe the current practical use of the «comply or explain» approach, outline some of the main problems, including poor quality of explanations and inappropriate corporate performance, provide and evaluate the solution of implementation of an independent monitoring authority from international experience and shortly examine Kazakhstan's experience. It seems to be true that «comply or explain» principle should have more sophisticated regulatory mechanisms in the Code, and more research should be done on this matter.

Materials and methods

In order to achieve the research goal, the universal dialectical method of cognition was used, as well as private scientific and special research methods based on it: comparative legal, systemic, formal legal, methods of legal modeling.

Discussion and results

The corporate governance, as a part of the company law, aims to create effective management mechanisms in order to provide the security of the shareholders welfare and companies successful development. The Cadbury Committee[2] had conceptualized the definition of corporate governance as a system by which companies are directed and controlled. According to Mallin [1] the majority of the European countries adopted corporate governance codes in order to increase investors' confidence in the company and create accountable and transparent management system.

In the UK, the Corporate Governance Code is a collection of the best practices and recommendations, including leadership, effectiveness, accountability, and relations with shareholders, which have been promoted for private companies by Financial Reporting Council[3]. It is an independent regulator responsible for improvement of the corporate governance in the UK.

Notably, successful development of the corporate governance in the UK became possible due to the operation of the «Comply or Explain» principle as the main concept of the Code [2]. The core idea of this concept is the principle of flexibility. This means that private companies can choose whether to agree with the Code recommendations or not. Today, the

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[1] *Cadbury A. (1992). Report of the Committee on the Governance. Financial Aspects of Corporate London, Gee. (22.04.2022)*
[2] *Ibid.*
[3] *Financial Reporting Council (2011) Response European Commission Green Paper on the EU corporate governance framework // https://www.frc.org.uk/Our-%20corporat.pdf (20.04.2022).*

Code is perceived as a leading international trademark for the best corporate governance practice in both theory and praxis [3].

It is necessary to give an explanation on how the comply or explain principle works. Despite the fact that the idea of the principle is quite simple, scholars define it differently. Perhaps, the most extensive definition of the «comply or explain» principle is:

characterized by voluntary compliance with the recommended provisions and mandatory disclosure: companies have to state in their annual reports whether they comply with the Code provisions, identify any areas of non-compliance, and explain the reasons in light of their own particular circumstances [3].

In other words, private companies are independent to agree or disagree with any of the Code recommendations. If a company accepts the Code's provisions, it will «comply» with them. If it does not comply, it has to «explain» why. These simple procedures seem to be an effective mechanism for private companies' excellent corporate performance.

However, there are some practical limitations of the «comply or explain» principle such as increasing number of explanations for non-compliance with the Code provisions. It has been found that in 2004 the percentage of the companies, which are completely opposed to the given provisions, was less than 10 [3]. This tendency has been deteriorating in the following years. According to Shrives and Brennan roughly half of the private companies between 2011 and 2012 have not complied with the Code recommendations. Perhaps, fundamental reason for this growth is that the Code does not provide explicit guidance on how to construct explanations for non-compliance. As a result, companies might provide inadequate and meaningless explanations. Surprisingly, none of authors does not have a distinct definition for such explanations, which makes them difficult to distinguish. Therefore, it seems that growing number of explanations can have a detrimental effect on the «explain» part of the principle and challenge the whole premise of the «comply or explain» approach and its practical effectiveness.

As a result of growing number of private companies' explanations on unaccepted recommendations, it may have certain negative consequences. Particularly, they might have a negative impact on the quality of explanations, which can result in to inappropriate corporate performance.

As mentioned before, if companies do not comply with the Code provisions, they are required to provide well-reasoned explanations for such departures. There are several studies suggesting that an increasing quantity of non-compliance cases might result in corresponding numbers of poor quality explanations [5]. Difficulties, however, in analysing these studies arise from the fact that they do not have a clear definition of «explanation quality».

Nevertheless, fairly straightforward reasons for poor quality explanation were suggested by Shrives and Brennan [6]. First, companies might consider the Code as a mandatory act, which they are obliged to comply. Consequently, under its pressure, they can draft more generalized rather than specific explanations [6]. This means that companies may craft expected, but not necessarily appropriate explanations. Next, they might duplicate other companies' explanations by partly copying the structure which does not necessarily fit in to a company's own circumstances. Finally, if a company uncertain about how to draft correct deviations, they may fully copy other companies' original explanations. In other words, departures will have identical characteristics even if they do not match the company's own circumstances. All three reasons for such explanations can be estimated as companies' patterned act which lead to poor quality explanations.

As a consequence of a failure to provide substantive reasons for deviations from the Code, companies may have inappropriate corporate performance. Existing literature does not provide particular instances of companies such performance which makes it nearly impossible to examine. Nonetheless, example of Morrison Company can highlight the importance of providing valuable explanations for non-compliance which are directly connected to the companies' successful performance. According to Arcot, Bruno and Faure-Grimaud [3] Morisons Company mostly was not compliant with the code recommendations and provided explanations for non-compliance claimed to be of poor quality. Shareholders were not genuinely concerned by this fact as long as performance of the company was satisfactory. In 2004 it announced profit warning for the first time in a hundred years of operation and disclosed inability to estimate its financial position for the next year. Ultimately, in 2005 Morisons lost 30% of its market value. Arcot, Bruno and Faure-Grimaud [3] emphasise that poor quality explanations usually become noticeable after a period of company's inappropriate performance. Despite the absence of actual examples in the literature, many companies have similar features with the example of Morisons.

It seems that growing tendency of an inferior quality of explanations and poor management requires several decisive actions, aimed to improve a proper functioning of the «comply or explain» principle. The UK authors highlight the possibility of creating a separate independent organisation responsible for examining the quality of explanations. This organisation might improve such explanations which can have a positive effect on companies' corporate governance and improve the «comply or explain» principle.

According to Keay [2], the UK does not have an independent regulatory entity. It has been suggested that such body could have better likelihoods of detection of a poor quality explanations than investors have. In order to create this independent monitoring body, Britain could adopt some of the best international practices. Keay [2], determines three European countries, which have an empowered monitoring body. First, in Spain a relevant institute is authorised to verify the fact that companies provided satisfactory information explaining the reasons for the departures. Furthermore, the institute publishes its findings on explanations for shareholders judgement. These publications can be used as a basis for the best practices. Second, the regulatory authority in Slovenia correspond to the code recommendations and if so, checks whether such deviations are accurate and adequate. Dutch experience slightly deviates from previously mentioned countries. There is no a separate regulatory body in the Netherlands. Alternatively, there is a community with the assigned function to ensure that its Corporate Governance Code meets actual and practical requirements. Additionally, the European Commission in its Green Paper[4] suggested that an independent monitoring body can sophisticate the corporate governance practice. Presumably, separate regulatory authority might better detect poor quality of non-compliance.

Conceivably, an implementation of these practices in the UK can be an effective way to enhance the practical use of the «comply or explain» concept. The increase in the number of meaningful and valid explanations by creating an external body might prevent the risk of failure in a company's equity and develop the «comply or explain» principle's mechanism.

However, this postulated solution of delegating monitoring functions to an external body might not successfully operate in the UK. Keay [2] stresses that there is no assurance or warranty that the regulatory authority will cultivate the «comply or explain» approach in terms of improving quality of explanations or ameliorating corporate performance. On the contrary, there is an abundant evidence showing the failure of these regulatory entities operation in Europe. In Spain, for instance, authority of the regulatory body was abrogated in 2006 due to problematic issues with delegating regulatory roles [2]. Clearly, at this point, introducing this type of regulatory body may create grounds for conflict of interests between different organizations willing to undertake this role. It appears that there is a certain difficulty in choosing the right regulatory authority, to whom delegate monitoring authority. It can be either private or government body. Most surprisingly, Spanish regulatory entity did not actually examine a single companies' explanation for departures during its authority period.

In response to suggestions of the European Commission's Green Paper, the FRC opposed the necessity to have regulator, because it is shareholders' responsibility to evaluate whether explanations are acceptable or not [2]. Inconvenience of those suggestions has been highlighted with the fact that regulators may encroach on investors' rights to examine non-compliances which is contrary to the «comply or explain» principle. It seems that international practices cannot improve practical mechanisms of the principle without disregarding its major doctrine throughout establishing an external body. Therefore, it may be difficult to adopt these experiences from other countries in which they do not properly operate.

A compliance-based approach can be particularly important for the emerging market of Kazakhstan where the organizational structure, ownership and control of companies, which are considered to be at its emerging and complex development. In an attempt to cope with these matters Kazakhstan has only developed the draft of the National Code of Corporate Governance and it is uncertain whether it will be adopted.

Moreover, considering that in Kazakhstan corporate sector has either government or private owned companies, it requires careful

[4] *Work/Publications/Corporate-Governance/FRC-response-fo-the-Green-Paper-on-the-EU- The European Commission (2011). Green paper The EU corporate governance framework http://ec.curopa.eu/internal_market/company/docs/modern/com2011-164_en.pdf#pagc=2 (24.04.2022).*

consideration and evaluation prior to an implementation of an internal body that will supervise companies compliance with corporate code. Another sensitive issue is whether such body should be an independent or state controlled. These matters might have various effects to the implementation of «comply or explain» principle into Kazakhstan's corporate practice and development.

Thus, as international practice shows, first, the adoption of an appropriate corporate governance code based on «comply or explain» principle can enhance sustainable corporate development in Kazakhstan. Second, carefully considered pros and cons of the implementation of the «comply or explain» concept into the Kazakhstan's corporate traditions. Finally, Kazakhstan need careful and balanced introduction of an entity that monitor companies, either private o government owned, compliance or explanations with corporate code.

Conclusion

In conclusion, this paper has focused on the growing trend of increased uninformative explanations provided by private companies for non-compliance to the UK's Corporate Governance Code provisions towards the «comply or explain» principle. An identified negligence of private companies to this principle can have a detrimental effect on the quality of explanations and corporate governance performance. Looking towards implementation of international experience, namely, creation of sovereign authority, it has been concluded that this practice cannot be adopted in the UK due to its practical limitations and flowed mechanisms.

It can be concluded that there is an undoubted necessity in carrying out more research, which will contribute to development of sound solutions for the practical usage of the «comply or explain» principle along with retaining its originality. Particularly, academics in cooperation with the experts of the FRC should give a clear definition of «explanation quality». Expanding some of the literature results in terms of real examples of companies' corporate governance failure due to provided poor quality explanations would constitute to the understanding the nature of the issue and generate better solutions.

In relation to Kazakhstan, adoption of national corporate code based on UK's corporate governance approach, particularly on «comply or explain» principle will be a major achievement at the national level, contributing to the further development of the regulatory environment, improvement of the quality of corporate governance and increase the investment attractiveness of domestic private and government owned companies.

Additionally, as existing international practice shows, allocation of special monitoring body should carefully consider domestic characteristics of a corporate sector. Therefore, more research should be carried out in these matters with deep internal market evaluation prior to allocation of such entity.

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