

INTERNATIONAL JOURNAL OF LEGAL STUDIES AND SOCIAL SCIENCES [IJLSSS]

ISSN: 2584-1513 (Online)

Volume 3 | Issue 2 [2025] | Page 461 - 469

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COMPLY OR EXPLAIN IN PRACTICE: A CRITICAL ASSESSMENT OF UK CORPORATE GOVERNANCE

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ABSTRACT

Internationally praised for its unique "comply or explain" method, the corporate governance framework of the United Kingdom allows listed firms flexibility to stray from the UK Corporate Governance Code if they provide a logical justification. Seeking to reconcile regulatory scrutiny with company independence, this principle-based approach strives to promote transparency, accountability, and investor confidence without imposing strict legal requirements. Still, doubts about its actual efficacy remain, especially in light of prominent corporate collapses and growing stakeholder interest. Whether the "comply or explain" strategy is meeting its intended goals is thoroughly investigated in this paper. Using theoretical analysis and legal changes especially from FTSE 350 firms, this study evaluates the quality and content of corporate justifications for non-compliance. It also investigates how investors, regulators, and proxy advisors react to these disclosures and whether they apply significant pressure for higher standards of governance. This study adds fuel to the continuing discussion over the future of UK corporate governance and if a stronger, legally enforceable model is needed to protect stakeholder interests.

INTRODUCTION

The UK Combined Code of Corporate Governance ("the Code") is generally considered an international standard for effective corporate governance practices. The option it provides to companies, allowing them to either adhere to its principles or clarify their reasons for non-compliance, sharply contrasts with compulsory frameworks (e.g., Sarbanes-Oxley Act in the US). The benefits of this flexibility are believed to stem from its capability to motivate companies to embrace the essence of the Code, instead of strictly adhering to its specifics, while a more rigid statutory framework would promote a box-ticking mentality that would not permit reasonable exceptions to the rule and would not enhance investors' confidence. Consequently, the Comply or Explain model is expected to result in improved governance, and its fundamental concept has been embraced by numerous other nations, both advanced and emerging. This article reviews the successes of the Combined Code in the UK; specifically, it assesses the ways in which the different recommendations are overseen and enforced, how the Code has been understood and utilized

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over time, and if the Code has resulted in a different outcome compared to a more statutory approach.

ORIGINS AND FRAMEWORK OF “COMPLY OR EXPLAIN”

The "comply or explain" strategy is a defining feature of the corporate governance system in the United Kingdom, embodying a unique approach to regulating corporate actions through adaptable standards instead of strict regulations. This framework was initially described in the influential Cadbury Report of 1992, which was commissioned in reaction to a number of financial scandals that occurred in the late 1980s and early 1990s, including the failures of Polly Peck and the Maxwell Group.¹ The Cadbury Committee suggested that companies should either conform to a set of best practice principles or offer a well-reasoned justification for any non-compliance, thus promoting transparency and accountability without enforcing obligatory legal standards.²

Following the Cadbury Report, corporate governance in the UK continued to evolve through a series of influential reviews. The Greenbury Report (1995) addressed directors' remuneration, while the Hampel Report (1998) sought to consolidate earlier recommendations into a more cohesive framework.³ These efforts culminated in the Combined Code on Corporate Governance, first issued in 1998, which formalised the "comply or explain" mechanism across a broader spectrum of governance practices.⁴

Today, the principal instrument embodying the "comply or explain" principle is the UK Corporate Governance Code, administered by the Financial Reporting Council (FRC).⁵ The Code applies primarily to companies with a premium listing on the London Stock Exchange, requiring them to report on how they have complied with its provisions in their annual reports. Where a company chooses not to comply with a specific provision, it must provide a clear and meaningful explanation to its shareholders.⁶ The underlying rationale is that market discipline—through investor engagement and scrutiny—should incentivise adherence to governance best practices.

¹ Committee on the Financial Aspects of Corporate Governance, *The Financial Aspects of Corporate Governance* (Gee 1992) [Cadbury Report].

² *Ibid.*, 14-15.

³ Paul L Davies, *Principles of Modern Company Law* (10th edn, Sweet & Maxwell 2022) 708.

⁴ Financial Services Authority, *The Combined Code: Principles of Good Governance and Code of Best Practice* (1998).

⁵ Financial Reporting Council, *UK Corporate Governance Code* (July 2018)

<https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code> accessed 27 April 2025.

⁶ Financial Conduct Authority, *Listing Rules*, LR 9.8.6R(6).

Importantly, the "comply or explain" model operates within a "soft law" framework.⁷ Unlike statutory rules that impose fixed obligations, the Code's provisions are not legally binding in themselves; rather, they derive force through the Listing Rules, which mandate disclosure of compliance or reasons for deviation.⁸ This flexible approach aims to accommodate the diverse circumstances of listed companies, recognising that a one-size-fits-all model would be inappropriate in a dynamic corporate environment.

Despite its non-statutory nature, the "comply or explain" principle has profoundly shaped corporate behaviour in the UK and influenced governance frameworks internationally. Countries such as Germany, the Netherlands, and South Africa have incorporated similar models into their regulatory structures.⁹ As a result, the UK's approach is often cited as a successful example of balancing regulatory objectives with corporate autonomy, though, as will be discussed in subsequent sections, its effectiveness is not without limitations.

ADVANTAGES OF THE “COMPLY AND EXPLAIN” APPROACH

The "comply or explain" approach offers a number of distinct advantages that have contributed to its success and resilience within the UK's corporate governance framework. Chief among these is its **flexibility**, which allows companies to tailor governance practices to their particular circumstances. Unlike prescriptive regulatory regimes, the UK Corporate Governance Code acknowledges that effective governance cannot be reduced to a rigid checklist.¹⁰ This flexibility is particularly valuable given the wide diversity of companies listed on the London Stock Exchange, ranging from multinational conglomerates to smaller, domestically focused firms.

A second significant advantage of the model is that it promotes meaningful engagement with governance principles instead of mere superficial compliance. Since companies are allowed to diverge from the Code's stipulations, as long as they provide a convincing rationale, boards are encouraged to reflect thoughtfully on their corporate governance frameworks and to express their

⁷ Brian R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 503.

⁸ *Ibid.*

⁹ Klaus J Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' (2011) 59 *Am J Comp L* 1, 25–27.

¹⁰ Paul L Davies and Sarah Worthington, *Gower and Davies: Principles of Modern Company Law* (11th edn, Sweet & Maxwell 2022) 728.

justifications to shareholders.¹¹ This interaction cultivates a culture of accountability and thoughtful discussion, rather than mechanical following of regulations.

Moreover, the "comply or explain" mechanism encourages transparency and market discipline. By mandating companies to reveal either their compliance or their rationale, the system enables shareholders and prospective investors to evaluate the governance quality independently.¹² Investors can subsequently make educated choices regarding whether to invest in, continue holding, or divest from companies based on their governance practices. In theory, companies that consistently provide inadequate or unpersuasive justifications may encounter reputational harm, diminished investor trust, or a lower share price, thereby motivating good governance.¹³

The UK's "comply or explain" approach has also had a significant **international influence**. Jurisdictions such as the Netherlands (through the Dutch Corporate Governance Code), Germany (via the German Corporate Governance Code), and South Africa (through the King Reports) have all adopted governance models that similarly balance compliance with flexible reporting.¹⁴ This global diffusion of the principle testifies to its perceived effectiveness in reconciling regulatory oversight with corporate autonomy.

Case studies demonstrate these advantages in practice. For instance, *Marks and Spencer plc* has historically provided detailed and thoughtful explanations where it chose to deviate from particular Code provisions, demonstrating that deviations can coexist with strong investor confidence when transparently justified.¹⁵ Conversely, companies like *Rolls-Royce Holdings plc* have been cited as examples where robust compliance with governance principles contributed to the restoration of market trust following periods of reputational damage.¹⁶

Overall, the "comply or explain" model's emphasis on flexibility, transparency, and shareholder empowerment represents a pragmatic alternative to rigid, rules-based systems. It seeks to foster a

¹¹ Marc T Moore and Martin Petrin, *Corporate Governance: Law, Regulation and Theory* (Palgrave Macmillan 2017) 112.

¹² Financial Reporting Council, *UK Corporate Governance Code* (July 2018) 3.

¹³ Brian R Cheffins, *Company Law: Theory, Structure and Operation* (Clarendon Press 1997) 505.

¹⁴ Klaus J Hopt, 'Comparative Corporate Governance: The State of the Art and International Regulation' (2011) 59 *Am J Comp L* 1, 27–30.

¹⁵ Financial Reporting Council, *Developments in Corporate Governance and Stewardship 2017* (January 2018) 20–21 <https://www.frc.org.uk> accessed 27 April 2025.

¹⁶ Rolls-Royce Holdings plc, *Annual Report 2021* (2022) 45–50 <https://www.rolls-royce.com/investors.aspx> accessed 27 April 2025.

genuine commitment to governance principles, thereby enhancing the legitimacy and competitiveness of UK capital markets.

CRITICISMS AND CHALLENGES

While the "comply or explain" approach offers significant advantages, it has not been immune to criticism. One of the most persistent challenges is the **variable quality of corporate explanations** provided by companies that choose not to comply with the UK Corporate Governance Code. Numerous empirical studies have revealed that companies often offer vague, superficial, or "boilerplate" explanations that fail to provide meaningful insight into their governance decisions.¹⁷ Such explanations undermine the system's integrity by frustrating the ability of shareholders to assess whether non-compliance is justified.

Compounding this issue is the problem of **shareholder passivity**. Although the "comply or explain" model relies heavily on investors to scrutinise explanations and hold companies to account, in practice, many institutional investors lack either the incentive or the resources to monitor governance disclosures actively.¹⁸ This inertia weakens the intended market-based enforcement mechanism, allowing poor governance practices to persist relatively unchecked.

The case of *Sports Direct International plc* (now rebranded as Frasers Group) offers a notable illustration of these problems. In 2016, Sports Direct was heavily criticised for its governance failings, including weak oversight of working conditions at its warehouses and poor board-level accountability.¹⁹ The company routinely provided minimalistic explanations for its departures from best practice, which were seen as inadequate by many shareholders and governance bodies. Moreover, despite significant public controversy, many institutional investors were slow to respond forcefully, reflecting the broader issue of shareholder disengagement. The Sports Direct case highlighted the risks inherent in a regime that lacks strong enforcement mechanisms and depends heavily on investor activism to ensure compliance.

Another concern is that **the system favours form over substance**. In some instances, companies may comply with the letter of the Code while neglecting its spirit, engaging in "box-ticking" behaviours that satisfy formal requirements without achieving genuine governance improvements.

¹⁷ Alexis Thomsen and Konstantinos Sergakis, 'Quality of Explanations under the Comply or Explain Regime: Evidence from FTSE 350 Companies' (2018) 19 *European Business Organization Law Review* 577, 590.

¹⁸ Paul L Davies, *Corporate Boards in Europe – Accountability and Convergence* (OUP 2013) 22.

¹⁹ House of Commons Business, Innovation and Skills Committee, *Working Practices at Sports Direct* (Fourth Report of Session 2016–17, HC 219) 3–5.

Such superficial compliance diminishes the credibility of the model and can create a false impression of good governance.

Critics have also questioned the adequacy of **regulatory oversight**. Although the Financial Reporting Council (FRC) issues periodic reports on corporate governance compliance, its ability to sanction companies for inadequate explanations is limited. This weakens the deterrent effect and contributes to the persistence of poor-quality disclosures.

Finally, there is a growing view that **increased complexity** in governance requirements, particularly with the rise of Environmental, Social, and Governance (ESG) factors, may outstrip the "comply or explain" model's capacity for effective regulation.²⁰ As governance expectations evolve, there is a risk that the model's flexibility could become a liability, enabling companies to sidestep emerging standards under the guise of providing explanations. Thus, while the "comply or explain" approach remains a valuable feature of UK corporate governance, its effectiveness ultimately hinges on the quality of corporate disclosures, the vigilance of investors, and the strength of regulatory oversight. Without meaningful reform and reinforcement, the system risks erosion of trust and credibility.

REFORMS AND CURRENT DEVELOPMENTS

Recognising the challenges faced by the "comply or explain" model, significant reforms and policy initiatives have been introduced in recent years to strengthen corporate governance standards in the United Kingdom. The Financial Reporting Council (FRC), as the principal body overseeing corporate governance, has been at the forefront of efforts to improve the quality of explanations and reinforce accountability mechanisms.

One major development was the **revised UK Corporate Governance Code of 2018**, which placed a greater emphasis on long-term value creation, company purpose, and corporate culture.²¹ The updated Code explicitly encourages companies to move beyond formulaic compliance and to articulate how their governance structures support sustainable success. This shift reflects a growing recognition that corporate governance must address not only shareholder interests but also broader stakeholder concerns.

²⁰ Simon Witney, *Corporate Governance and ESG: How Directors Are Adapting to New Expectations* (2022) 5 *Journal of Corporate Law Studies* 103, 114.

²¹ Financial Reporting Council, *UK Corporate Governance Code* (July 2018) 1–3 <https://www.frc.org.uk/directors/corporate-governance-and-stewardship/uk-corporate-governance-code> accessed 28 April 2025.

In tandem with this, the FRC has issued **annual reviews of corporate governance reporting**, identifying good practices and highlighting areas for improvement.²² In particular, the FRC has stressed the need for explanations to be specific, company-tailored, and sufficiently detailed to enable shareholders to evaluate the justifications for non-compliance.²³ These reports are intended to foster a market of informed investors who can exercise effective oversight, thereby strengthening the market-based enforcement of the "comply or explain" regime.

Reforms have also addressed the institutional framework itself. Following the recommendations of Sir John Kingman's Independent Review in 2018,²⁴ the government announced that the FRC would be replaced by a stronger regulator, the **Audit, Reporting and Governance Authority (ARGA)**.²⁵ ARGA is intended to have enhanced powers, including the ability to direct changes in company reporting and to impose sanctions where reporting is inadequate. This reform represents an important step towards reinforcing the credibility and enforcement capacity of the UK's corporate governance system.

Another key development has been the growing integration of **Environmental, Social, and Governance (ESG)** factors into corporate governance expectations. Investors and regulators increasingly expect companies to disclose how their governance frameworks address issues such as climate risk, diversity, and social responsibility. The 2018 Code reflects this trend by requiring companies to report on how their policies and practices contribute to broader societal outcomes. This evolution poses both opportunities and challenges for the "comply or explain" model, as it demands a broader conception of what constitutes good governance and meaningful explanation.

Finally, the FRC has sought to encourage **greater shareholder engagement** through the **UK Stewardship Code 2020**, which sets out best practice principles for institutional investors.²⁶ By promoting more active stewardship, the FRC aims to address concerns about shareholder passivity and to enhance the monitoring function that underpins the "comply or explain" approach.

In sum, recent reforms reflect an ongoing effort to revitalise and adapt the "comply or explain" model to contemporary governance challenges. While these measures represent significant

²² Financial Reporting Council, *Annual Review of Corporate Governance Reporting 2020* (November 2020) 6.

²³ *Ibid*, 7-8.

²⁴ John Kingman, *Independent Review of the Financial Reporting Council* (December 2018)

<https://www.gov.uk/government/publications/independent-review-of-the-financial-reporting-council> accessed 28 April 2025.

²⁵ Department for Business, Energy and Industrial Strategy (BEIS), *Restoring Trust in Audit and Corporate Governance* (White Paper, March 2021) 13.

²⁶ Financial Reporting Council, *UK Stewardship Code 2020* (January 2020) <https://www.frc.org.uk/investors/uk-stewardship-code> accessed 28 April 2025.

progress, their ultimate success will depend on their effective implementation and on cultural shifts within both companies and investors.

CONCLUSION AND SUGGESTIONS

The "comply or explain" approach remains a cornerstone of UK corporate governance, embodying a commitment to flexibility, transparency, and market-based accountability. Its strengths lie in its capacity to accommodate diverse corporate contexts, promote thoughtful governance practices, and empower shareholders to play an active role in monitoring corporate conduct. However, the model's effectiveness has been increasingly tested by practical challenges, including the prevalence of poor-quality explanations, shareholder passivity, and the rising complexity of governance expectations in the modern corporate environment.

A critical analysis of the regime reveals that while flexibility is a virtue, it can also serve as a shield for weak governance practices when not accompanied by robust oversight and investor engagement. The Sports Direct case starkly demonstrates how insufficiently explained deviations from governance standards can persist when shareholder activism is lacking and regulatory enforcement is weak.²⁷ Such instances risk eroding trust in the overall system and suggest that flexibility must be counterbalanced by credible mechanisms of accountability.

Recent reforms, notably the enhancement of the UK Corporate Governance Code, the establishment of ARGA, and the increased emphasis on ESG factors, reflect a concerted effort to address these shortcomings. These developments are encouraging, particularly the move towards a regulatory framework that combines flexibility with clearer expectations and greater enforcement capability. Nevertheless, reform efforts must continue to evolve to ensure that the "comply or explain" model remains fit for purpose.

Based on this analysis, several suggestions emerge:

First, there should be a more explicit regulatory expectation that explanations must meet a minimum standard of quality, including clear articulation of the rationale for non-compliance, the alternative governance measures adopted, and how these measures serve the company's long-term interests.²⁸ This could be operationalised through formal FRC or ARGA guidance, accompanied by the threat of public censure for persistently inadequate disclosures.

²⁷ House of Commons Business, Innovation and Skills Committee, *Working Practices at Sports Direct* (Fourth Report of Session 2016–17, HC 219) 5.

²⁸ Financial Reporting Council, *Annual Review of Corporate Governance Reporting 2020* (November 2020) 7–8.

Second, investor education and empowerment must be strengthened. Institutional investors, particularly asset managers and pension funds, should be encouraged, if not required, to adopt stewardship practices that prioritise active engagement with governance disclosures.²⁹ The revised UK Stewardship Code represents a positive step, but its principles should be integrated more directly into investors' fiduciary duties.

Third, a differentiated regulatory approach could be considered, whereby companies with persistently poor explanations or governance failures are subject to greater scrutiny or additional reporting obligations. This would maintain the general flexibility of the model while targeting enforcement resources where they are most needed.

Fourth, as ESG considerations become more central to governance expectations, the "comply or explain" model must be adapted to ensure that explanations relating to sustainability and social responsibility are subjected to the same rigour as traditional governance issues.³⁰ Without such adaptation, there is a risk that ESG disclosures will follow the same pattern of boilerplate reporting that has afflicted other areas of governance.

In conclusion, the "comply or explain" model remains fundamentally sound but cannot afford complacency. Its future legitimacy depends on ensuring that flexibility does not come at the expense of meaningful accountability. Through continuous reform, vigilant regulatory oversight, and stronger investor engagement, the UK can preserve the virtues of the model while addressing its vulnerabilities, thereby sustaining the credibility and competitiveness of its corporate governance framework in an evolving global environment.

²⁹ Financial Reporting Council, *UK Stewardship Code 2020* (January 2020) Principle 6.

³⁰ FRC, *Climate Thematic: Review of Corporate Governance Reporting* (2022) 6.