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Are Codes Fostering Convergence in Corporate Governance? An Institutional Perspective

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Introduction

This chapter discusses the role of corporate governance codes[1] in the context of pressures for corporate governance convergence across countries. We show that there is a diverging convergence as corporate governance practices continually evolve. Further, given that codes are non-mandatory in most countries, firms can cherry pick to adopt those practices that best fit their interests. This is consistent with the view that firms as agents have some degree of freedom in creating their corporate governance portfolio even though they are embedded in a given national or institutional environment (Aguilera and Jackson, 2003; Aguilera, Desender, and Castro-Kabbach, 2011). In this chapter, we seek to address the following questions posed in this book through the lenses of corporate governance codes:

What are the institutional drivers that propel firms in different nations towards convergence in corporate governance?
What are the major impediments that stand in the way of convergence?
What empirical evidence suggests that we are moving towards or away from convergence?

To begin with, we discuss the salience of codes within the corporate governance field and argue why this approach is appropriate in the discussion of corporate governance convergence. First, codes are considered worldwide as the main regulatory instrument with respect to shaping the direction of some crucial corporate governance-related issues. For instance, compliance studies in several countries find that

codes have an effect on the structure and functioning of the board of directors (Alves and Mendez, 2004), reduce the agency cost of managerial entrenchment and enhance board oversight (Dedman, 2000, 2002), and positively impact the stock price since markets react positively to announcements of compliance with the code (Chizema, 2008). However, unlike 'hard' law regulation, for example, the Sarbanes-Oxley Act of 2002, which led to increased delisting and reduced efficiency due to high costs of compliance, codes may not lead to the optimal corporate governance; that is, they merely reduce the worst corporate behavior but do not foster the best practices through strict compliance.[2]

Second, corporate governance as 'an institutional framework' encompasses not only the internal structure of the corporation, but also its external environment, including capital market and government policies (Williamson, 2000). Hence, the study of corporate governance should encompass a multitude of issues in order to determine the extent of convergence. Codes, as a set of best practices designed to address deficiencies in the formal contracts and institutions, allow an exemplary exploration of cross-national institutions and their possible convergence or continuing divergence.

Third, the term corporate governance institution has quite an extensive scope; it stretches from higher- to lower-order institutions (Williamson, 2000), from formal national and international institutions (Coffee, 1999) to national and firm practices (Chizema, 2008), from institutional actors to business elites and individual managers at firm level (Maclean, Harvey, and Press, 2006). Corporate governance institutions are present in all countries around the world with varying configurations (Gregory, 2001; OECD, 2002). The same conclusion could be drawn on corporate governance practices in general and codes in particular (Aguilera and Cuervo-Cazurra, 2009; Haxhi, 2010). Codes are designed at three hierarchical levels: at the international level, such as the OECD Code (2004); at the national level, including all the codes that are within the scope of this study; and at the individual firm level, for example the General Motors Board of Directors Corporate Governance Guidelines on Significant Corporate Governance Issues (1994).

One approach to studying convergence proposed by Yoshikawa and Rasheed (2009) involves identifying specific drivers and impediments of convergence and examining their role at the national and firm level. Since the Cadbury Code (1992), 82 nations worldwide had issued their own code(s), and new codes continue to emerge in different countries (ECGI, 2011). This gives us an opportunity to study to what extent codes serve as drivers and impediments of convergence

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of institutions at national level, and convergence of practices at the firm level.

Fourth, as to a global convergence process, if we observe important differences between the codes in one country and a variety of other countries, what can we conclude from such differences? Either governance configurations are the result of universally applicable economic rationales, in which case same or similar configurations should result in all countries, or specific national contexts lead to the emergence of different configurations in different countries. This makes it quite pertinent to examine codes in a discussion of institutional diversity and convergence.

The organization of this chapter is as follows. We first explore the theories of institutional diversity and convergence. Second, we describe codes and their main issuers. Third, we discuss whether codes are fostering convergence in corporate governance and what empirical evidence we have. Finally, we discuss the prospects for future convergence and offer our concluding remarks.

Theories of institutional diversity and convergence

All institutional theories (e.g., Scott, 1995; Williamson, 2000) focus on the relationship between institutions and how organizations operate, particularly the importance of fit between organizational practice and the characteristics of the institutional context in which they operate. Wider national institutional configurations affect the organizational structures (e.g., corporate governance structures) and national regulatory practices (e.g., self-regulatory practices as exemplified in codes).

In the new institutional economics model of Williamson (2000), four hierarchical institutional levels of social institutions are distinguished. In this perspective, the top level of informal institutions, such as norms and cultural values, and the second level of the formal institutional environment, that is, the law and property rights, will affect the corporate governance structures, which are at a lower level. Furthermore, institutional theory can be applied to address the process of embedding corporate governance institutions in a nexus of higher-order formal and informal rules (e.g., Aoki, 2001; North, 1991). Therefore, the link between higher- and lower-level institutions is omnipresent in the contemporary literature on institutional diversity and diffusion of institutional (organizational) practices. Here, we make a clear distinction between formal (e.g., legal and capital market) and informal (e.g., national culture) institutions, and will further discuss separately the effect that each of these contextual sources may have as the drivers of convergence.

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Local institutional framework and transnational convergence processes

The existing literature on institutional diversity and convergence of institutional (organizational) practices is directly related to the concepts of cross-national diversity and global convergence; that is, the perspective of societal effects (Sorge, 1996) and national business system (Whitley, 1992), and the perspective of new institutionalism (DiMaggio and Powell, 1983). New institutionalism focuses on the influence of the societal or cultural environment on global institutionalization of organizational forms or practices; whereas, according to the societal effects and national business system approaches, features of national business and organizations that dominate different national environments are closely associated with distinct configurations of general societal national features. Here, the emphasis is on the persistence of non-identical business practices and forms of organization in different national/institutional contexts, which can be as effective as their counterparts in other contexts. Hence, the national business system approach focuses on the regulative pillar of institutions (Scott, 1995) and deals foremost with social structural carriers, conducting analysis at the societal level (Maurice and Sorge, 2000), whereas the new institutionalism that addresses isomorphism in institutional fields focuses on the normative and cognitive pillars and deals with culture and routine as major institution carriers, conducting analysis at the intermediate level of organizational fields.

However, as the two main streams in the diffusion of organizational practices, these approaches express opposite views concerning the mechanisms they identify as promoting the emergence of such practices. New institutionalism tends to emphasize the global diffusion of practices and their adoption through isomorphism, but pays little attention to how such practices are created locally (it is unclear whether there is diffusion of a common practice or whether practices themselves become more alike globally). On the other hand, the national business systems approach highlights how business, through the reproduction of tightly linked institutions and business systems, continues to be influenced by the national institutional frameworks (as impediments), but tends to neglect the effects of transnational institutional pressures towards convergence (it provides no clear mechanism for recognizing the impact of transnational context) of national practices (Tempel and Walgenbach, 2007).

Combining a business systems approach with other institutional arguments, Djelic and Sahlin-Andersson (2006) and Ansari, Fiss, and Zajac (2010) show how national institutional systems are increasingly nested

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within transnational, higher-order institutional frames. For instance, regarding the diffusion of codes, to what extent can we observe regulatory practices that are the dominant source of a transnational (isomorphic) convergence process? As Scott (2001) emphasizes, the jurisdiction of cultural belief systems, the nature of governance systems, and the structuring of organizational fields are factors that influence the extent of isomorphic institutional change. However, this change does not necessarily mean greater convergence in governance system, but rather increasing variety. Strang and Meyer (1993) argue that the generality and abstraction of regulatory concepts increases the likelihood of their diffusion, thus convergence. In the case of codes, will the similarity in these cross-country characteristics increase the likelihood of isomorphic converging pressures on their worldwide diffusion? In our view, the combination of both global and local alternatives may provide a more informative and comprehensive picture of such converging processes.

Cross-cultural psychology approach: focus on informal institutions

As discussed above, in the new institutional model of Williamson (2000), informal institutions such as norms and cultural values occupy the top hierarchical level of social institutions. Culture has been described by Hofstede (2003) as the collective programming of the mind that distinguishes the members of one human group from another. According to Hofstede (1997), the impact of national culture on organizational practices (e.g., codes) is profound and can be captured by dimensions that reflect business and work-related values. Culture is considered an essential element for understanding how social systems change because of cultural influences, namely the norms and the values of such systems, and the behavior of groups in their interactions within and across systems. In line with this discussion, later on in this chapter, we will propose to add the cross-cultural psychology approach to the literature on convergence of corporate governance best practices.

Corporate governance codes and convergence

Codes and their issuance

Despite the specificity and diversity in corporate governance practices, the wave of corporate scandals at the end of the 1980s and the low confidence of shareholders fostered (primarily in the US and the UK) the emergence of new modes of corporate governance regulations and codes. Codes are a set of best practices designed to address deficiencies

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in the formal contracts and institutions by suggesting normative guidelines, for example, on the preferred role and composition of the board of directors, relationships between shareholders and top management, the independence of non-executive directors, auditing and information disclosure, and the remuneration and dismissal of directors (Cadbury Code, 1992). Although the contents of codes vary across countries, regarded as instruments of self-regulation all codes share remarkable similarities related to the objectives of corporate governance. The two main goals of every code are: (1) improving the quality of companies' governance and (2) increasing the accountability of companies to shareholders while maximizing shareholder or stakeholder value (Aguilera and Cuervo-Cazurra, 2009).

Codes can be distinguished from other modes of regulation in that they are formally non-binding and *voluntary in nature*, issued by *multi-actor* committees, *flexible* in their application, built on the market mechanism for *evaluation of deviations*, and *evolutionary in nature* (Haxhi, 2010; Seidl, 2007). The *voluntary and self-regulatory nature* of codes, as a characteristic of regulating corporate governance, is exemplified in the widely used comply-or-explain principle. This principle implies that while compliance with code provisions is voluntary, the disclosure of non-compliance is mandatory (ECGF, 2006). The comply-or-explain principle prevails in most European countries, although enforcement regulations differ by country. The mandatory disclosure of (non)compliance information is separately legitimized, for instance by law in the Netherlands and Germany or by incorporation in the listing requirements in the UK (Haxhi and van Manen, 2010; Voogsgeerd, 2006).

Moreover, the *flexibility* of the comply-or-explain principle is considered an important advantage of the so-called 'soft law' over the 'hard law', for example, the US Sarbanes-Oxley (SOX) Act (2002). Companies are allowed flexibility in applying best practices, which reflects the tolerance for company particularities, such as ownership structures and actor (shareholder, board, and management) characteristics. Similarly, the *evaluation of possible deviations* and code compliance is generally left to the capital market, which again emphasizes the voluntary enforcement of the code's best practices[3] (Goncharov, Werner, and Zimmermann, 2006).

In addition, codes are developed by *multi-actor institutional issuers* organized around committees of experts, with actors in the field using the code as an instrument of assessment of corporate governance practices. As a result, the code issuance by multi-actor committees reproduces the societal debate about corporate business practices (Haxhi and van Ees, 2010).

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Finally, a deviation from the code does not necessarily constitute a breach of a rule, but can imply the initiation of (new) code creation or adjustment (update) in a country. For instance, in the UK, since Cadbury Code (1992), there have been around 12 directly related updates of codes and guidelines until the latest UK Corporate Governance Code (2010). Both (non)compliance with the code's provisions and its evaluation by the investor community provide the inputs for subsequent restructuring and reformulation of the existing codes, hence the *evolutionary nature* of corporate governance regulation through codes (Haxhi, 2010).

Several scholars consider the Cadbury Code (1992) as the original corporate code, although similar codes had already been created in the late 1970s, triggered by the conglomerate merger movement, the managers' hostile takeover behavior, and the shareholder rights movement in the US at that time. The Business Roundtable report (1978), chaired by Coca-Cola's CEO at the time, turned out to be a claim for legitimacy of private power and the enforcement of accountability (Aguliera and Cuervo-Cazurra, 2009). Following the example of the New York Stock Exchange, which has continued to issue codes since the late 1970s, other stock exchanges, for example, Hong Kong Stock Exchange, 1989, or investors' organizations, for example, Irish Association of Investment Managers, 1991, issued their own codes. The Cadbury Code (1992) was issued because of concern regarding 'the perceived low level of confidence both in financial reporting and in the ability of auditors to provide the safeguard which the users of the company reports sought and expected' (Aguliera and Cuervo-Cazurra, 2004).

Since Cadbury Code, codes have proliferated in the last two decades such that today about 82 nations worldwide have issued their own code(s), and new codes have emerged in very different countries (ECGI, 2011). Codes emanate from nations with diverse cultures (Hofstede, 1997), financing traditions (Coffee, 1999), ownership structures and legal origins (La Porta et al., 1998), historical legacies (North, 1991), and industrial and business structures (Whitley, 1992; Hall and Soskice, 2001). Most of the previous studies about codes either describe code diffusion from a global perspective (e.g., Aguliera and Cuervo-Cazurra, 2004; Atkins, 2004; van den Berghe, 2002; Collier and Zaman, 2005; Cuervo, 2002; Haxhi and van Ees, 2010; Learmount, 2002; Zattoni and Cuomo, 2008), document the differences and similarities between national codes (e.g., CACG, 1999; Gregory, 2001; Gregory and Simmelkjaer, 2002; Ow-Yong and Kooi Guan, 2000; Reid, 2003) or explain the rates of compliance with the national code within a single country (e.g., Akkermans et al., 2007; Alves and Mendes,

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2004; Berglöf and Pajuste, 2005; Chizema, 2008; Conyon and Mallin, 1997; Dedman, 2000, 2002; Fernández-Rodríguez et al., 2004; Weir and Laing, 2000). Although these studies provide useful descriptions, they neither address the underlying factors or characteristics that facilitate or impede the worldwide convergence of such codes, nor provide explanations as to whether codes are fostering convergence in corporate governance.

Codes and their convergence

Examining the existing literature, it is unclear whether we are indeed moving towards governance convergence. Hence, it is important to move the debate beyond the convergence/divergence dichotomy and pay more attention to the national culture and institutions, as well as the global transnational issuers of codes as driving forces and actors fostering convergence in corporate governance. As pointed out by Aguilera and Cuervo-Cazurra (2009), there are several transnational entities enabling the creation and diffusion of codes, such as the World Bank or the OECD. These transnational issuers, by promoting a common set of practices regardless of country characteristics, may indirectly be contributing to the achievement of convergence across national governance practices. In other words, they are not moving corporate governance toward a particular model (e.g., Anglo-Saxon or Continental European) but toward a more general global model.

Another important influencing factor is the salience of external factors pushing towards harmonization of best practices as the world becomes increasingly internationalized, at least in the industrialized world. Both Cuervo (2002) and Reid (2003) argue that external forces, such as globalization, market liberalization, emergence of powerful foreign investors, and recommendations on global best practices by transnational organizations, appear to facilitate increasing confluence.

Moreover, with respect to the national cultures, Haxhi and van Ees (2010) find that the dimensions of culture that reflect norms and beliefs in society about the integration of individuals with groups, the equality and the distribution of power, and the tolerance for uncertainty correlate with the issuance of codes and the identity of the issuing organizations. Individualist cultures have a stronger tendency to develop codes. In cultures with high receptivity to power differences, there is a higher probability that the first issuers are from the government, directors, and professional associations; while in the case of countries with low receptivity, the stock exchange and investors' groups are more likely to initiate the first code.

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Regarding the global diffusion of codes and their possible convergence, it can be observed that Anglo-Saxon regulatory practices are the dominant source of diffusion. Haxhi and van Ees's (2010) analysis reveals that formally non-binding codes develop more easily within similarly individualistic national cultures. Using the metaphor of institutional contagion, these codes diffuse internationally largely through imitation (Oxelheim and Randøy, 2005). The extent of contagion will depend on the level of immunity of the national business systems. Considering that Anglo-Saxon business practices are the source of a transnational process, there may be isomorphic pressures that stretch beyond the nation state, thereby suggesting the possibility of the emergence of a transnational or converging community (Morgan, 2001). As Scott (2001) emphasizes, the influence of cultural belief systems, the nature of governance systems, and the structuring of organizational fields are factors that influence the extent of isomorphism – the resemblance in these cross-country characteristics will likely increase the probability of isomorphic pressures in the worldwide diffusion of corporate governance best practices, thus, their convergence. Since abstraction and ambiguity are essential in imitation processes (Strang and Meyer, 1993), the generality and abstraction of regulatory concepts increases the likelihood of their diffusion, and consequently greater convergence. However, by revealing a tension between existing national business cultures and practices, and the adoption of new regulatory modes that originate from other business contexts, it may strengthen the resistance to convergence of corporate governance best practices (Haxhi and van Ees, 2010). Therefore, convergence of corporate governance practices is not a straightforward process.

Future convergence: The Dodd-Frank Act

There is new hard law regulation in the US in response to the 2008 financial crisis. It is interesting to note that this regulation does not speak at all to the philosophy or principles in codes, which are based on the idea that 'not one size fits all.' The Dodd-Frank Wall Street Reform and Consumer Protection Act, signed into law on 21 July 2010, dramatically increases the degree of government supervision over large financial institutions and establishes new consumer financial protections in direct response to the 2008 financial crisis. Enormous and far-reaching, the Act spans more than a thousand pages, with thousands of additional pages in rules anticipated. We point out here only a few of its most notable provisions, which it would be interesting to compare with existing codes or how current country codes will react to this new US hard law. The Act

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creates a new 'super regulator,' the Financial Stability Oversight Council (FSOC), to oversee the financial industry and address future financial crises. The Council has the power to identify firms that threaten stability and subject them to stricter oversight by the Federal Reserve. The Federal Reserve and the Council can break up firms that have not responded to stricter oversight measures and continue to pose a threat.

It is clear that the 2008 Financial Crisis also prompted Congress to expand the federal government's involvement in corporate governance. Whereas SOX regulated the composition and responsibilities of audit committees, the Dodd-Frank Act requires a broad range of financial institutions to have a risk committee as well. The risk committee will be responsible for overseeing the firm's risk management practices, and the committee must have at least one risk management expert having experience with similar firms. The Federal Reserve is empowered to decide how many independent directors must serve on the committee. The SEC, the Federal Reserve, and a number of other federal regulators are further required to 'jointly prescribe regulations or guidelines' for large financial institutions that will prohibit incentive-based executive compensation arrangements that encourage inappropriate risks or that could lead to material financial loss. The Act includes a number of broad executive compensation reforms that are not limited to financial institutions, including a requirement that US public companies provide shareholders with a non-binding say-on-pay vote. The SEC is also required to instruct the stock exchanges to adopt new listing standards imposing enhanced independence requirements for board compensation committees. It will be interesting to see how other countries will react to these new rules enacted in the US.

Concluding remarks

According to Yoshikawa and Rasheed (2009), the global integration of product and capital markets is leading to changes in corporate governance across the globe. However, to date there is no substantive evidence that such an observable evolution would constitute factual convergence. These obvious governance changes are related to a search for greater efficiency in governance and improved legitimacy in financial markets. In addition, local drivers such as institutional embeddedness, cultural attributes, and politics can impede these governance changes or initiate the issuance of 'hybrid' practices (Haxhi and van Ees, 2010; Yoshikawa, Tsui-Auch, and McGuire, 2007; Yoshikawa and Rasheed, 2009).

As an example, the practice of regulating corporate governance through formally non-binding codes or the comply-or-explain principle (ECGF,

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2006), a regulatory mechanism originating from the UK, is supposed to be the same throughout all the EU countries. However, the meaning of this regulatory mechanism differs substantially between countries. In the Netherlands, the comply-or-explain principle is amended by law (Voogsgeerd, 2006). Similarly, German firms are also required by Article 161 of the Stock Corporation Act to fill in the 'declaration of conformity.' Nevertheless, in the statement of (non)compliance no motivation is required (Cromme, 2005) and, thus, it can be seen more as a 'comply-or-disclose' principle (Wooldridge and Pannier, 2005). In the UK, meanwhile, the stock exchange forces the code implementation (MacNeil and Li, 2006). One can ask to what extent the comply-or-explain principle is 'global', that is, a not contextually embedded element facilitating convergence, compared to the way it is 'locally' interpreted or applied (e.g., in Germany some practices fall under this regime, whereas others do not), impeding the convergence of a more uniform corporate governance regulatory practice (Haxhi and Aguilera, 2011). Therefore, 'the extent to which any novel practice … is diffused and applied in a societal (cultural and institutional) context in which it did not originate, is a function of its mutual adaptation with regard to practice that predate its introduction' (Sorge, 2004: 138). Here, we have acknowledged dialectic tensions (complementarily or mutual affinity of opposites) between culture and institutions, actors and systems, but dynamics do not boil down to everything changing in an unpredictable fashion (Haxhi, 2010). Next to change there is continuity, and the two are ingeniously intertwined, thus, a diverging convergence is likely as corporate governance practices continually evolve.

Notes

1. For consistency reasons, we will refer to corporate governance codes, as the most commonly used term; however, both terms, codes of good governance and corporate governance codes are used interchangeably in the literature.
2. The Chicago view claims that a market economy can achieve efficient corporate governance without government intervention and there is no need for statutory rules. In fact, statutory rules are almost certain to be counterproductive since they will limit the founders' ability to tailor corporate governance to their own individual circumstances; while the self-regulatory approach is trying to educate and persuade companies to make changes in corporate governance institutions (Hart, 1995).
3. The negative share-price reaction should be perceived as a sanction to unexplained deviations from the code provisions, assuming that shareholders will take the level of compliance into account while engaging a buying, selling, holding, or voting action.

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