Review questions:

What constitutes compliance?

What are the determinants/ predictors of compliance with corporate governance codes?

Gulnaz Khamidullina
Regulatory compliance researchers distinguish two types of empirical research examining the impact of regulation: research explaining the causes or predictors of compliance and research examining the effects of compliance (Parker and Nielsen, 2009).
Background

Benefits:

1. In order to understand what constitutes ‘good explanations’ one needs to understand what circumstances justify diversions from code requirements in each particular case.

2. Understanding factors that condition the degree and nature of companies’ responses to governance codes could help in understanding performance studies.

3. Inform future policy changes.
Systematic review – inclusion criteria

Inclusion criteria:

1. Flexible governance regulation
   and

2. Factors explaining compliance behavior
Systematic review

Excluded were:

- papers that looked at degrees of compliance/quality of compliance without suggesting any explanations of what drives compliance
- papers that looked at market responses to CG practices
- papers that analyzed the role of CG practices in other types of compliance or disclosure
- papers that looked at determinants of compliance with hard governance regulation (e.g. SOX)
## Profile of papers

<table>
<thead>
<tr>
<th>Country</th>
<th>N = 40</th>
</tr>
</thead>
<tbody>
<tr>
<td>UK</td>
<td>9</td>
</tr>
<tr>
<td>Germany</td>
<td>7</td>
</tr>
<tr>
<td>Netherlands</td>
<td>3</td>
</tr>
<tr>
<td>Multi-country (EU, Asia, Australia+Canada, Germany +UK )</td>
<td>5</td>
</tr>
<tr>
<td>Canada</td>
<td>3</td>
</tr>
<tr>
<td>Poland, Slovenia, France, Italy, Greece, Cyprus, Russia, Denmark, Brazil, South Africa, Ireland, Korea</td>
<td>13 (1 each country)</td>
</tr>
</tbody>
</table>

2 papers studied compliance among SMEs (companies listed on the Alternative Investment Market)
Researchers define compliance in many different ways, use different measures of compliance.
Compliance = strict observance of the code

- Any deviation from the code constitutes non-compliance
- Compliance is measured as a strict observance of code provisions (e.g. majority of NEDs on board constitutes compliance, if not, then non-compliance).
- These researchers do not analyse explanations for deviations.
Compliance measures

- “We rely on the ROB index published by the Globe and Mail to measure corporate governance practices” (Bozec and Dia, 2010). The index comprises 4 categories: Board composition, Compensation, Shareholder rights, Disclosure

- The ratings on the disclosure on corporate governance come from a private rating agency, Deminor Rating (Bauwhede and Willikens, 2008)

- “A broad CG compliance and disclosure index containing 50 CG provisions” (Ntim et al, 2012)

- “Compliance is the board’s level of conformance to Canadian regulations on the board of directors (30-points index)” (Khemakhem and Dicko, 2013)

- “The QCA Corporate Governance Guidelines for AIM companies (2005) were used as the basis for constructing a corporate governance disclosure score” (Mallin and Ow-Yong, 2012)
# Quality of explanations

<table>
<thead>
<tr>
<th>Reference</th>
<th>Quality of explanations measure:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hooghiemstra, 2012</td>
<td>Score based on (i) No explanation (1 point); (ii) Generic explanation (2 points); (iii) Firm-specific explanation (4 points)</td>
</tr>
<tr>
<td>Arcot et al, 2010</td>
<td>(i) No explanation; (ii) General explanation; (iii) Specific explanation</td>
</tr>
<tr>
<td>Arcot and Bruno, 2011</td>
<td>Classify the explanations on a Type 0 to 5 scale, from the least (absence of any explanation) to the most (unique and specific) informative</td>
</tr>
<tr>
<td>Seidl et al, 2013</td>
<td>Deficient justification, context-specific justification, principled justification</td>
</tr>
<tr>
<td>Hooghiemstra, 2011</td>
<td>9 types of explanations for non-compliance</td>
</tr>
<tr>
<td>Pass, 2006*</td>
<td>Separate criteria of acceptable/unacceptable explanations for each code principle</td>
</tr>
<tr>
<td>Shrives and Brennan, 2015*</td>
<td>Comprehensive typology comprising seven components</td>
</tr>
</tbody>
</table>
Aguilera (2005):

- One of the problems with codes of good governance is that it is hard to assess whether or not codes are simply a box-ticking corporate governance tool decoupled from a transformation in the firm’s corporate governance culture.
## Substantive compliance

<table>
<thead>
<tr>
<th>Reference</th>
<th>Quality of explanations measure:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mulgrew et al, 2014</td>
<td>Use three perspectives on NEDs independence <em>(authors’ perspective, CG guidance perspective and company’s perspective)</em> to identify the extent of substantive compliance</td>
</tr>
<tr>
<td>Bianchi et al, 2011</td>
<td>Developed an index based on best practice recommendations (voluntary in nature) on implementing the code principles</td>
</tr>
<tr>
<td>Hooghiemstra, 2012; Okhamotvskiy and David, 2012</td>
<td>Gauge substantive compliance from content analysis of compliance statements: uninformative superficial explanations are an indication of symbolic compliance</td>
</tr>
</tbody>
</table>
## Patterns of compliance

<table>
<thead>
<tr>
<th>Reference</th>
<th>Independent variable</th>
<th>Compliance measures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Holm and Scholer, 2010</td>
<td>Ownership dispersion, exposure toward the international capital market</td>
<td>Transparency, Board independence</td>
</tr>
<tr>
<td>Hooghiemstra and van Ees, 2011</td>
<td>Visible, invisible firms</td>
<td>Typology of explanations</td>
</tr>
<tr>
<td>Dedman, 2000</td>
<td>CEO ownership, size, prior performance, institutional ownership</td>
<td>Board independence, duality</td>
</tr>
<tr>
<td>Talaulicar and Werder, 2008</td>
<td>Board size, sales, number of employees</td>
<td>Factor analysis, 7 measures</td>
</tr>
</tbody>
</table>
Patterns of compliance

- **Holm and Scholer, 2010** CG practices have a different relevance to companies with different characteristics. Transparency proved to be more relevant for companies with exposure to the international capital market. Board independence was more critical for companies with dispersed ownership structure.

- **Dedman (2000)** finds that firm’s leverage is positively and significantly associated with compliance on board duality, but not board independence.

- **Talaulicar and Werder (2008)** used factor analysis and principal component analysis to identify 8 patterns of CG code compliance. Authors claim that companies of the same size that “comply with the recommendations of the GCGC [German CG Code] to a very similar degree, can still feature different patterns of Code compliance”.

# Firm-level compliance predictors

<table>
<thead>
<tr>
<th>Theoretical framework</th>
<th>Independent variable</th>
<th>Impact on compliance (more likely)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Size</strong></td>
<td>Size</td>
<td>+</td>
</tr>
<tr>
<td>Political costs, implementation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>costs, reputation costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ownership</strong></td>
<td>Ownership concentration</td>
<td>-</td>
</tr>
<tr>
<td>Information asymmetry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency costs, information</td>
<td>Institutional ownership</td>
<td>inconclusive</td>
</tr>
<tr>
<td>asymmetry</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency and moral hazard</td>
<td>State ownership</td>
<td>+</td>
</tr>
<tr>
<td><strong>Capital structure</strong></td>
<td>Leverage</td>
<td>inconclusive</td>
</tr>
<tr>
<td>Agency, monitoring costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Board</strong></td>
<td>Directors’ ownership,</td>
<td>-</td>
</tr>
<tr>
<td>Agency theory, information</td>
<td></td>
<td></td>
</tr>
<tr>
<td>asymmetry, monitoring costs</td>
<td>Board independence</td>
<td>inconclusive</td>
</tr>
<tr>
<td>Resource-based view</td>
<td>Social networks</td>
<td>no relationship</td>
</tr>
<tr>
<td><strong>Prior performance</strong></td>
<td>Prior performance</td>
<td>inconclusive</td>
</tr>
<tr>
<td>Agency theory, monitoring costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Company lifecycle</strong></td>
<td>Firm growth</td>
<td>inconclusive</td>
</tr>
<tr>
<td>Agency theory, monitoring costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Exposure to international capital</strong></td>
<td>Exposure to international capital markets</td>
<td>+</td>
</tr>
<tr>
<td>markets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agency theory</td>
<td></td>
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</tbody>
</table>
Size

- The firm size was measured as: book value of assets, market value of equity, sales value and number of employees, listing ranking
- Larger firms adopt new CG standards faster and report less deviations from the code
- The most obvious explanations are related to political costs, reputational costs and implementation costs of (non)compliance
Ownership concentration

- Often measured as percentage of ownership exceeding 5% or 3%.
- – ve correlation: better access to information reduces the need for increased disclosure and compliance with CG code recommendations becomes a less pressing issue.
- +ve correlation: “managers are reluctant to comply with codes of good governance as their “freedom” declines… strong external shareholders are necessary to enforce code compliance” (Rapp et al, 2011).
- Most studies find that ownership concentration and compliance are negatively linked.
- Three papers find a non-linear relationship between the two variables.
Ownership type

Institutional investors

- Research findings linking institutional ownership and compliance are inconclusive.

State ownership

- Two studies examined the link between compliance and state/government ownership.
Capital structure

+ve link: Companies should be motivated to voluntarily disclose more in order to reduce the costs of borrowing (Hooghiemstra, 2012; Black et al, 2006; Ntim et al, 2012; Bauwhede and Willikens, 2008).

-ve link: Companies with higher levels of debt are less reliant on equity financing and are less motivated to demonstrate good CG to equity investors. Debtholders’ interests are secured by covenants and the level of disclosure is less critical for debtholders (Hooghiemstra, 2012; Black et al, 2006; Duhamel et al, 2012).
Board characteristics

- Managerial ownership: –ve link
- Board independence: no link, positive when members of audit committees or appointed by minority shareholders
- Directors’ relational network and political connections on compliance:
  - board members’ political connections have little effect on compliance (Khemakhem and Dicko, 2013)
  - directors’ embeddedness in the business network (interlocking directorship, membership in Dutch CG Committee) on compliance. No significant relationship was found between these variables. (Hooghiemstra and van Ees, 2011)
Prior performance

- Chizema (2008) finds that company’s performance (measured as return on assets) is positively related to voluntary disclosure of executive compensation (best practice requirement of the German code) and early adoption of the CG reform. Chizema (2008) suggests that signalling theory predicts the results: financially stable companies are motivated to disclose more to demonstrate their investment attractiveness.
Prior performance

- Ntim et al (2012) find that company’s profitability is linked to voluntary CG disclosure. Authors suggest that directors of financially successful companies would be motivated to disclose more to justify higher pay.

- Dedman (2000) hypothesises that poorly performing companies receive more attention from institutional shareholders and are under more pressure to improve CG practices. The findings do not support the hypothesis (no significant link).
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Prior performance

- Black et al (2006) however report a negative link between long-term profitability and Korean CG index and insignificant link for the short-term profitability. Researchers suggest that more profitable companies are less dependent on external financing and are less motivated to invest in governance reform.
Company’s lifecycle and compliance

Firm age

- Chizema (2008) finds that older companies are less likely to disclose executive compensation.
- Arcot and Bruno (2011) in a UK based study find that “older companies are more likely to comply less and explain little”.
- On the contrary Nowak et al (2006) in a study of compliance with a German CG code find that older companies demonstrate higher level of compliance.
- Black et al (2006) suggest that older companies should demonstrate higher compliance, since they have more experience and time to improve their CG practices. The study however does not find a significant link between company’s age and CG measure.
Company’s lifecycle and compliance

Firm growth

- Prediction: High-growth companies are more motivated to be compliant since they require more financing and would aim to reduce information asymmetry (Ntim et al, 2012).
- Growth opportunities were measured as market to book ratio or sales increase.
- Nowak et al (2006) and Ntim et al (2012) do not find the evidence that high growth companies are better or worse at compliance.
- Arcot and Bruno (2011) find that companies with growth opportunities are less likely to have independent board committees, more likely to deviate from code requirements.
- Durnev and Kim (2005) in a multi-country study find that growth opportunities are positively linked with the level of CG disclosure and the relation is stronger in weaker legal regimes.
Exposure to international capital markets

- A number of researchers (Khemakhem and Dicko, 2013; Bozec and Dia, 2012; Ntim et al, 2012) find that cross-listing on foreign stock markets are important determinants of compliance.

- Measured as the existence of American Depositary Receipts (ADRs), Global Depository Receipts (GDRs), extent of foreign shareholding or cross-listing on foreign stock markets) has a positive impact on compliance.

- Companies willing to trade shares in foreign exchanges are looking to raise capital and should be interested to “demonstrate commitment to good corporate governance” (Okhmatovskiy and David, 2012).

- Ntim et al (2012): cross-listed companies have to meet additional disclosure and CG requirements of two or more jurisdictions and thus “will invariably be expected to disclose more”.

- Duhamel et al (2012) find that French companies with more international exposure exceeded national requirements. Zeidan (2014) suggests that this factor is more relevant for developing countries.
Part 2: research questions

How institutional investors in the UK conceptualize *compliance with best governance practice*?

How listed companies conceptualize *compliance with best governance practice*?
Research method

- Repertory grid + semi structured interviews
- Rationale:

  “the grid is perhaps best seen as a catalyst within a conversation between investigator and the individual” (Pope and Keen, 1981)
Interview 1

Profile:

- Investment fund, is in top 100 by size (measured as worldwide asset under management)
- Corporate Governance Executive
- Elements in the grid: 2 FTSE 100; 4 FTSE 250
Interview 1

Findings:
Process – get involved at “maintenance” stage (risk prevention and mitigation)

Criteria for assessing CG:

1. Strong chair vs weak chair (defined as the ability of the chairman to control the board and to influence executive management in the way that is right for minority shareholders)
2. Board size – look for extremes (too small too large more than 14) Why? Ability to act quickly, quick decision making
3. “We do not like NEDs to sit on many boards”
4. Remuneration: “Alignment between what will drive shareholder returns and what managers are incentivized to achieve”
5. Justifiable non-compliance vs non-justifiable – case by case
6. Companies lifecycle, e.g. major shareholder reducing their stake, less influence, disproportionate power on board, we would expect the board structure to be dominated by NEDs…
7. Fully independent AC is a strict requirement. RC and NC are not as vulnerable…
8. Reliance on proxy advisors for reviews, but not voting recommendations.
I have an example of a company, which is a very good company, but it wouldn’t fit with any typical governance structures of the guidelines, because historically it is run in a very different way.