Codes of Corporate Governance: Germany and Britain

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Background:
Codes as a popular means of regulation

1978 "The Role and Composition of the Board of Directors of Large Publicly Owned Corporations" (Business Roundtable, USA)

1989 "Code of Best Practice, Listing Rules" (Hong Kong Stock Exchange)

1991 "Statement of Best Practice on the Role and Responsibility of Directors of Publicly Listed Companies (Irish Association of Investment Managers)

1992 "Cadbury Committee Report: Financial Aspects of Corporate Governance" (Cadbury Commission, UK)

2002 ‘The German Corporate Governance Code’ (‘Cromme Code’)

By 2005: CGCs in over 40 countries, additionally several transnational codes (e.g. OECD)
Examples

• ‘The roles of chairman and chief executive should not be exercised by the same individual’ (Combined Code A.2.1)

• ‘The Supervisory Board should set up an Audit Committee’ (Cromme Code 5.1.2)

• ‘The overall compensation of the members of the Management Board shall comprise a fixed and a variable component’ (Cromme Code 4.2.3)

• ‘The Supervisory Board shall examine the efficiency of its activities on a regular basis’ (Cromme Code 5.6)
1. Codes as standards (Brunsson et al 2000):
   - Voluntary rules that try to persuade others to follow them and/or
   - third parties to evaluate others according to whether they have followed them

2. Codes as socially constructed
   - “Best practice” is a social construct
   - Meaning of the code provisions is socially constructed
The “comply-or-explain rule”

Companies have to “state in their report and accounts whether they comply with the Code and identify and give reasons for any areas of non-compliance”
(Cadbury Committee 1992: 17)

“The Committee recognises that smaller listed companies may initially have difficulty in complying with some aspects of the code. … The boards of smaller listed companies who cannot, for the time being, comply with parts of the Code should note that they may instead give their reasons for non-compliance”
(Cadbury 1992, No. 3.15).

“It is for shareholders and others to evaluate the company’s statement”
(Combined Code 2003: 1)
Five basic ideas behind code regulation

1. Formal voluntariness (Comply-or-explain rule)
   - Issuers are “experts” describing “best practice”
2. Legitimacy
3. Acceptability
4. Responsiveness re. idiosyncrasies of company
5. Responsiveness re. beneficiary of the codes
6. Complexity reduction of the rule regime

CBR Summit: Innovation and Governance 29-30 March 2006
The **normative** model of the code regime

- **Code Issuer**
  - Provision of code as a schema for mutual observation

- **Corporation** *(2nd order observer)*
  - Observation of the corporation on the basis of the code
  - Observation of the capital market’s observation of the company

- **Capital Market** *(1st order observer)*
Does the capital market really enforce the code?

**Empirical evidence**

So far no evidence for any connection between compliance statement and share price

**Fund managers and analysts**

Mostly don’t really care about compliance rates unless extreme case of non-compliance:

- There is no real evidence for the relevance of particular corporate governance issues for financial performance

- Difficulty of “measuring” corporate governance (“corporate governance score card”)

- “Lack of incentive for managers to intervene in a company, if they feel the key issue for their client is the next quarter’s performance figures” (Myners 2001 Institutional Investment in the United Kingdom: A Review.)

- “We have to pay a bit of lip service to corporate governance, particularly [with] this current government, but actually for us, our clients aren’t giving us the money to say make Britain a better place. They’re saying, ‘give us the best return for a risk level,’ and they don’t want you to get on your high horse and keep holding the shares just so you can vote against something. If it’s bad for the share price then just sell it. “ (UK Fund Manager)
Evidence from Germany (1): Compliance depends on how and by whom one thinks one is being observed

**Fear of potential relevance to shareholders**
Most directors (in Germany) don’t know what relevance compliance has for their shareholders. They think it might not have any relevance but they nevertheless fear it could be relevant.

**Indirect peer pressure**
Most directors (in Germany) compare their own compliance rates with that of their peers. They don’t want to stick out as negative examples, but they also don’t necessarily want to be one of the best.

→ e.g. “As a DAX 30 company you can’t really afford having more than three deviations in your compliance statement” (company director)

**Other stakeholders**
Decisions on compliance are considered in light of the general image of the organization

Company directors (in Germany) mostly prefer to comply in order to evade having to answer questions about non-compliance.
Evidence from Germany (2): Corporate governance codes require additional interpretation

**Code provisions often refer only to an abstract practice**
e.g. ‘An age limit for members of the management board shall be specified’ (Cromme Code)

**Code provision often extremely vague**
e.g. ‘…the supervisory board shall include what it considers an adequate number of independent members’ (Cromme Code)

**“Justified” deviations not specified in the code**
CG codes cannot provide criteria for evaluating deviations from the code

**Conformance of compliance statement and actual practice not regulated**
CG codes cannot provide observational schemas for judging whether compliance statement accords with the actual practices

- Directors try to interpret how their external observers interpret the codes
The emergence of shared interpretations

There is a natural trend toward shared interpretations (the example of Germany):

- **Competition between different commentaries on the code:** they try to establish themselves as “official” commentary

- **Imitation between companies:** many directors scan systematically the compliance statements of other companies and discuss their actual practices with each other.

- **Observation intermediaries:**
  - Directors/company secretaries read the same studies on corporate governance to see how they interpret the code and the compliance statements
  - Directors/company secretaries observe how they are being evaluated in comparison to their peers (“we don’t want to be at the bottom of the list, but the middle is fine”)
“Comply-or-explain rule” in Britain vs. “Comply-or-disclose” in Germany

Different types of explanation:

1. Pure disclosure of non-compliance

2. Disclosure of non-compliance plus description of deviating practice

3. Disclosure of non-compliance plus description of deviating practice plus justification
   a) “Empty” justification
   b) Justification on the basis that particular code provision is generally “bad practice”
   c) Company or industry specific reason
German compliance statements (160 companies)

Germany: Percentage of different types of “explanation”
British compliance statements (initial 30 companies)

Britain: (Tentative) Numbers of different types of explanations given in FTSE (30 largest)

- pure disclosure
- with description
- empty justification
- provision not suitable
- company specific reasons
CBR Research Project (ESRC funded 2006-8)
Soft Regulation: Conforming with Comply or Explain
John Roberts, Paul Sanderson, David Seidl

Aim: Examine the way that the boards and senior managers of major UK and German companies treat compliance with codes of corporate governance, in particular the way they apply the principle of 'comply or explain'.

Rationale:
• Governments advocate flexible regulation to encourage innovation/growth
• Effectiveness depends on regulatees' attitudes to compliance.

Objective:
• Improve understanding of bases on which compliance decisions are made.
• Reasons for non/conformance e.g. maintain confidence of investors

Questions: e.g., To what extent are such decisions:
(a) Internal and strategic, (b) Externally grounded in local culture & traditions

Method:
• Interview, and compare responses of, senior managers in UK and Germany (similar CG codes, different political/legal traditions and corporate structures.)