

**REGULATING ORGANIZATIONS THROUGH CODES OF
CORPORATE GOVERNANCE**

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by

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Abstract

Although codes of corporate governance have come to be widely used as a mode of regulating corporations, our understanding of how they function is still rather limited. In this paper we describe the design of such code regimes and propose a theoretical framework for studying their effects. On the basis of an observation-theoretical approach, codes are conceptualized as schemas of observation that determine the way we evaluate corporations. On the one hand, the effect of a code depends on the extent to which it becomes integrated into recursive cycles of mutual observation between the corporation and the various actors in the field. On the other hand, it also depends on how the code relates to other observational schemas in the field. The paper concludes with some guidelines for empirical research on code regimes.

Keywords: Codes, Corporate Governance, Ecology, Field, Observation, Rules

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Introduction

In the wake of corporate scandals like Polly Peck (UK), BCCI (UK), British & Commonwealth (UK), Maxwell (UK), Mirror Group (UK), Enron (US), World Com (US), Holzmann (Germany), Metallgesellschaft (Germany), Bayerische Hypo- und Vereinsbank (Germany) there have been increasing calls for more effective regulation of corporate behavior in general and the actions of company directors in particular. In response to that, various laws on issues of corporate governance have been passed in several countries around the world. In addition, in recent years there has been a strong trend towards the adoption of ‘soft law’ (Mörth, 2004) or ‘soft regulation’ (Sahlin-Andersson, 2004) in the form of *codes of corporate governance*. A code of corporate governance can be defined generally as ‘a non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations’ (Weil *et al.*, 2003). The first serious code of this kind was the so-called Cadbury Report, which was issued in the UK in 1992 by a committee set up by the London Stock Exchange and the Financial Reporting Council.¹ It contained a set of rules addressed to the boards of directors of all listed companies registered in the UK. One of the rules, for example, stated: ‘The roles of chairman and chief executive should not be exercised by the same individual’ (Cadbury Committee, 1992: A.2.1). While adherence to the individual rules of the code itself was voluntary, the listed companies were required by the Listing Rules to publicly ‘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). Thus, the voluntary codes were combined with obligatory disclosure of the degree of compliance (‘comply-or-explain’ rule).

The Cadbury code as a mode of regulation for the corporate sector was subsequently imitated by many countries around the world (Van den Bergh and De Ridder, 1999; Iskander and Chamlou, 2000; Weil and Manges, 2002; Aguilera and Cuervo-Cazurra, 2004). Up to now similar codes have been implemented more than fifty countries. These codes were variously issued by stock-exchange-related bodies, associations of directors, various types of investor groups, business and industry associations, and governmental commissions (Wymeersch, 2005). Most of them refer to companies listed on the respective national stock exchanges. Apart from these national initiatives there are also some transnational initiatives like the ‘OECD Principles of Corporate Governance’, which are not so much directed at companies as such, but are primarily meant as ‘guidelines for legislative and regulatory initiatives in both OECD and non OECD countries’ (OECD, 2004: 3). Other transnational initiatives have not developed codes themselves, but propagate the development

of national codes. Within the EU the use of governance codes as a mode of regulation has been endorsed by the High Level Group of Company Law Experts. In their report to the European Union they write:

Each Member State should designate one particular corporate governance code as the code with which companies subject to their jurisdiction have to comply or by reference to which they have to explain how and why their practices are different (Weil and Manges, 2002: 77).

Thus, the national code initiatives ought to be regarded as embedded in a wider context of transnational initiatives that both call for codes as a form of regulation and partly provide guidelines on the content of such codes (see Jacobsson and Sahlin-Andersson, 2006).

To the extent that the national codes of corporate governance refer to a domain that could also be regulated by national law, we can also speak of codes as a form of ‘regulated regulation’ (Knill and Lehmkuhl, 2002) or ‘responsive regulation’ (Ayres and Braithwaite, 1992). That is, the law has left a regulatory space for code initiatives which could, however, be replaced by legal directives. In the UK, for example, the Cadbury Committee and subsequent committees were set up privately because business law had left large areas of corporate practice unregulated. In Germany, by contrast, it was explicitly decided which areas of corporate practice to regulate by law and which ones by codes (Baums, 2001). In this sense, the code initiatives are embedded in a legal framework that could take over part of the domain covered by the code. In Germany, one of the code provisions that required the individual disclosure of the directors’ remuneration was recently replaced by a relevant law due to low levels of compliance with the code provision.

In view of the pervasiveness of codes of corporate governance and the propagation of code regulation by transnational actors there is surprisingly little research on their underlying mechanisms. Our understanding of the dynamics of soft regulation in general is still rather limited, since it is only in the last few years that it has been made a prominent point on the regulatory research agenda (e.g. Brunsson and Jacobsson, 2000; Mörth, 2004; Kerwer, 2005; Djelic and Sahlin-Andersson, 2006). On codes of corporate governance in particular there is hardly any research. There are merely some generally descriptive studies of corporate governance code compliance (e.g. Pellens *et al.*, 2001; Oser *et al.*, 2003; Von Werder *et al.*, 2003; Von Werder *et al.*, 2004; Von Werder *et al.*, 2005), as well as comparisons of different code contents (Weil and Manges, 2002; Weil and Manges, 2003) and analyses of the rationale for the adoption of

code regulation by nation states (Aguilera and Cuervo-Cacurra, 2004; Cuervo-Cacurra and Aguilera, 2004). However, in order to understand the code mechanism we need to go beyond analyses of individual elements of code regulation and study the interactions between its different elements; we need to approach code regulation as a ‘regime’, as a dynamic system of interrelated parts. In this paper we will take a first step towards developing a framework for such an analysis.

The argument will proceed as follows: in the first section we will describe the particularities of corporate governance codes and how code regulation is *meant* to function. Drawing on observation theory, in the second section we will develop a theoretical perspective for studying code regimes in practice. According to this view, codes of corporate governance are conceptualized as schemas of observation. In the third section we will argue that the introduction of codes establishes an observational field of mutual observations. Depending on the particular constellation of mutual observations between the observers in the field, codes might become institutionalized as observational schemas. In the fourth section we will distinguish different types of code provisions representing different types of observational schemas. We will show how all of these schemas are in some way or other incomplete. These incompletenesses are filled by coupling to other observational schemas. Depending on the particular schemas that it connects to the code has different effects. We conclude with a brief reflection on the contribution of the paper and provide some rough guidelines for empirical research on the basis of this framework.

1. The basic ideas behind code regulation – the normative model

In comparison with directives, codes of corporate governance are characterized by five points: (1) they are formally voluntary, (2) they are issued by ‘experts’ describing ‘best practice’, (3) they are designed to be applied flexibly, (4) they build on the market mechanism for evaluating deviations and for enforcing the code and (5) they are evolutionary in nature. In the following we will elaborate on each of these points.

First, the individual code provisions contained in the code are not formally binding. The official commentary to the German Cromme Code, for example, says explicitly: ‘The code itself refers to the code provisions [...] as non-binding. If companies wish to deviate from the code provisions [...] they may do that’ (Ringleb *et al.*, 2004, my translation). This voluntariness provides *legitimacy* to the code issuer (e.g. Ringleb *et al.*, 2004: 51–65). Code issuers are

usually not democratically elected and thus cannot claim any democratic legitimacy. Instead, they emphasize the voluntariness of the code, arguing that anyone can issue rules as long as they are not binding. This is in line with other research on soft regulation, which observes that in the absence of a democratic decision process, by which rules are introduced, formal voluntariness serves as a principal argument for their legitimacy (Brunsson, 2000); or put differently, ‘without coercion, there is no authority in need of legitimacy’ (Kerwer, 2005: 620).² While the code provisions themselves are formally voluntary, they are sometimes (not always) combined with a requirement for obligatory disclosure of the level of compliance (‘comply or explain’). That is to say, companies are formally obliged to disclose any deviations from the code provisions. This coercive element, however, is usually separately legitimized. In Germany, for example, the so called ‘comply-or-explain’ rule was passed by the German parliament and incorporated into the German Stock Corporation Act (§ 161), whereas in other countries, e.g. the UK, the ‘comply-or-explain’ rule is incorporated in the listing requirements.

Second, codes are usually issued by committees that claim particular ‘expertise’. In contrast to other areas of soft law the claim of expertise does not rest primarily on scientific knowledge (Jacobsson, 2000; Jacobsson and Sahlin-Andersson, 2006) but on practical experience. Code-issuing bodies are usually composed predominantly of prominent practitioners: company directors, institutional investors, shareholder representatives, lawyers, accountants etc. This practical expertise is typically symbolized by the chairpersons of the code committees. In the UK the various code committees were chaired by well-known businessmen, such as Sir Adrian Cadbury, Sir Ronald Hampel and Sir Derek Higgs, after whom the respective codes were named; similarly, in Germany the code commission was chaired by the widely respected former CEO of ThyssenKrupp, Dr. Gerhard Cromme. In line with the emphasis on practical expertise, codes are explicitly meant to describe so-called ‘best practice’, which implies that they describe practices that have proven successful *in practice*. In this sense these codes are also referred to as ‘codes of best practice’. The original idea is that the practices of certain exemplary companies can be diffused throughout the corporate sector.³ This reference to the expertise of the members of the code commission and the description of the code provisions as ‘best practice’ is generally seen as the primary means of raising the *acceptance* of the code amongst the addressees of the code (see Ringleb *et al.*, 2004: 9–16. On soft regulation generally, see Jacobsson, 2000 and Kerwer, 2005: 618).

Third, codes are *meant* to be applied flexibly. It is not intended that all companies to which the code is addressed follow all code provisions. Rather, where individual rules do not fit the particular organizational setting, companies are *expected* to deviate. In contrast to the principle of voluntariness, the idea of flexibility refers to the possibility of deviation in cases where particularities of the industry or the company oppose the application of the code provisions. Baums gives as examples: size; ownership structures, international ownership, and requirements of the capital markets of other countries (Baums, 2003: 7). In the Combined Code it says: '[D]epartures from the Code should not be automatically treated as breaches' (Financial Reporting Council, 2006: 7); put differently, this means that it is possible to conform to the code even when deviating from it. In the official commentary on the German Cromme Code, for example, it says: 'Flexibility, as [one of the] guiding idea[s] of the code, is meant to prevent companies affected by the code from being corseted into too inflexible regulations. Companies should rather have the possibility of tailoring the modalities of corporate governance to their individual situations and of optimizing them with regard to efficiency criteria' (Ringleb *et al.*, 2004: 89; my translation). This flexibility is primarily generated through the 'comply-or-explain' rule, which expects companies to deviate from unsuitable provisions and to provide an explanation for the deviation.⁴ In the British Combined Code, for example, it says: 'While it is expected that listed companies will comply with the Code's provisions most of the time, it is recognised that departure from the provisions of the code may be justified in particular circumstances. Every company must review each provision carefully and give a considered explanation if it departs from the Code provisions' (Financial Reporting Council, 2006: 5). The flexibility of the code serves as a means of increasing the *responsiveness* of the code with regard to the differences of the affected companies. This means that the differences do not have to be accounted for in the code provisions themselves, and that the complexity of the codes is thus reduced – even to the extent that some code committees issue code provisions that they know some companies cannot comply with. The Cadbury Committee, for example, writes in the respective code: '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: 3.15). In addition to that, such flexibility allows for an 'authentic' responsiveness towards idiosyncrasies. It is not the code issuer who has to assess the applicability of the code provisions *on behalf* of the affected companies – the companies assess it for themselves from within the concrete situation. In this

way, flexibility provides in principle the possibility of an authentic assessment of the situation.

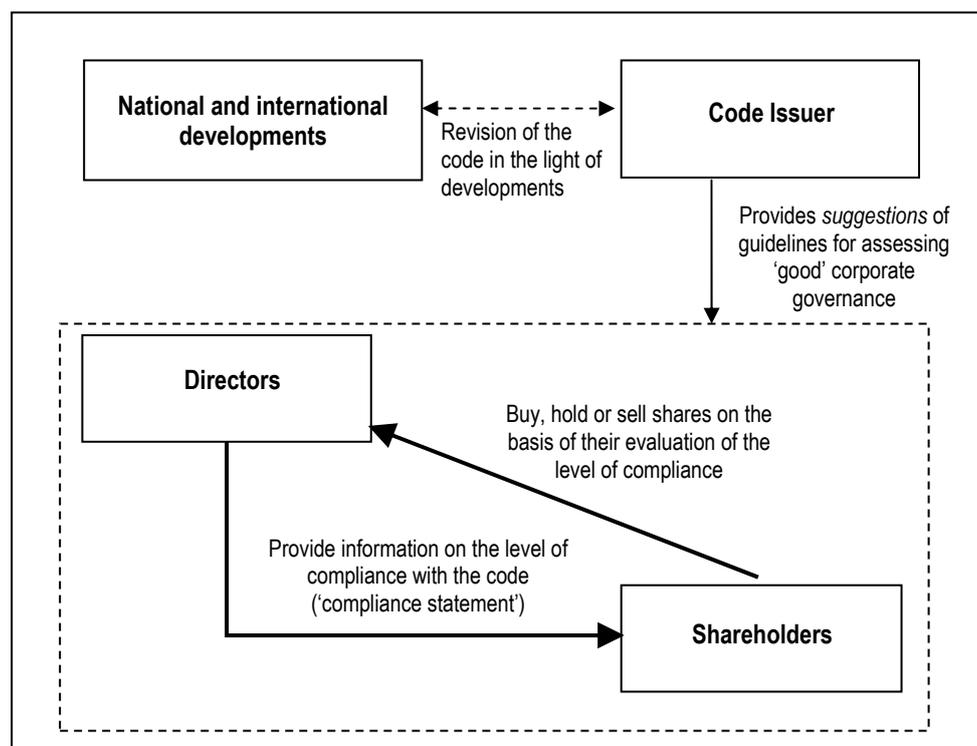
Fourth, regulation by a code builds on the market mechanism, which is supposed to serve two functions: evaluation of possible deviations and enforcement of the code as such. Whether or not a deviation from the code by a specific company is justified and how significant unjustified deviations are, is meant to be evaluated by the members of the capital market, who are also the ones the code is meant to protect primarily.⁵ In the Combined Code it says: ‘It is for shareholders and others to evaluate the company’s statement’ (Financial Reporting Council, 2006: 4). Similarly, Baums writes about the German code: ‘It is left to the capital market to evaluate the equivalence of any deviations [to the code provisions]’ (Baums, 2001: 10). As in the case of the third principle discussed above, here too, the evaluation by those affected means that no particular institutional arrangements have to be made for this purpose. It thus reduces the complexity of the regulatory design. Additionally, it allows in principle for an authentic evaluation by those affected by the deviations, as opposed to an evaluation carried out by external institutions on behalf of the affected parties.

An additional function of the integration of the market mechanism is the enforcement of code compliance by those affected by potential deviations. Unjustified deviations from the code provisions are expected to be ‘sanctioned’ through negative share-price reactions. As Schüppen writes: ‘The influence of compliance on the share price is the idea behind the [comply-or-explain rule]’ (Schüppen, 2002: 1273; my translation). It is assumed that shareholders will take the level of compliance into consideration when they make a decision to buy, sell, hold, or vote. Accordingly, unjustified deviations from code provisions that appear significant to shareholders are expected to result in lower share prices (Weil and Manges, 2002: 68–69). In this context researchers often cite the study by McKinsey and Company (2002), which found that fund managers were prepared to pay an average premium of 14% for well-governed European and North American companies and even more in emerging markets. Since company directors are interested in high share prices, this mechanism is assumed to work as an enforcement mechanism (for similar studies see e.g. Gompers *et al.*, 2003; Bauer *et al.*, 2004). As in the two previous points, here too the integration of the capital market reduces the complexity of the design of the code system, since no separate enforcement mechanism has to be set up.

Fifth, codes are evolutionary by their very nature. They are meant to be revised on a continuous basis in the light of current developments. In the Cadbury Code, for example, it says explicitly: ‘It is essential [...] that the Code [...] is kept up to date’ (Cadbury, 1992: 3.11). Code initiatives are consequently designed in such a way that they allow for a continuous development of the code content. This means that changes to the code are normally fast and unbureaucratic procedures, in contrast to laws, whose ‘adaptation to changed circumstances is mostly cumbersome and leads to negative delays’ (Baums, 2001: 1; my translation; see also Ringleb *et al.*, 2004: 1645). In accordance with this idea, some countries, such as Germany, have a standing committee that regularly reviews the code in the light of national and international developments in corporate governance (Wymeersch, 2005).

Although we described the five features of the code system separately above, they very much build on each other. Code issuers assume a particular system of interrelations between different actors, which we have reconstructed in Figure 1.

Figure 1: The assumed mechanism of the code system



At the top of the code regime is the code issuer, who provides the capital market with *suggestions* for assessing ‘good’ corporate governance in the form of the code. By reference to its expertise it tries to convince the capital market to *accept* the code as useful guidelines of ‘good’ governance. Only if the code is accepted can it become effective. This is the first hurdle the code regime has to overcome. After that, the main mechanism of the code regime is the feedback loop between the company and the shareholders. The shareholder is expected to assess the company’s displayed compliance with the code and on that basis make his or her decision on buying, holding or selling company stocks. The directors of the company, on the other hand, are aware that their compliance rate affects the shareholders’ decisions and, thus, ultimately the share price. Because of that, directors will try to comply with the code and only deviate if they can provide justifications.

So far we have examined the *normative* model of the code regime describing how it is meant to function. In order to assess how the code regime functions in reality we need to analyze the code-related processes in their wider societal context.

2. Codes of corporate governance as schemas of observation

In order to develop a conceptual approach for studying the code regime it is probably useful to take the code itself as a starting point, since it is the code around which the entire system is built. In its most basic sense a code of governance can be conceptualized as a *schema of observation* – in the sense that it provides distinctions for assessing the corporate governance of companies. Taking this as a starting point we can proceed to observation theory, according to which we would also conceptualize the actors involved as observers and their interactions as mutual observations. The concept of observation as a unit of analysis has the advantage that it is so basic that (almost) all social phenomena can be described as a result of it. In this sense the concept of observation is more basic than that of ‘norm’ or ‘institution’ (Spencer Brown, 1979).

The theory of observation does not constitute a clearly defined field of research; it is rather a loosely bound complex of theoretical strands. Regarding our research question there is one strand, exemplified by the works of George Spencer Brown (1969), Heinz von Foerster (1981) and Niklas Luhmann (2002), that seems particularly promising. The central idea of all three authors is that every observation is based on a distinction that creates the object of observation. In other words, every observation is a construction that is based on a particular

distinction; depending on his or her distinctions, the observer observes the world differently. Codes of corporate governance, in this sense, can be conceptualized as observational distinctions that create a particular reality for the observers using them for observing the governance of corporations. These schemas of observation make the observer see something as relevant to corporate governance which otherwise would not be observed as such. Put differently, it is the observational schema that makes something ‘a difference that makes a difference’ (Bateson, 1972: 315). For example, the German Cromme Code (Cromme Code: 5.4.6) distinguishes between staggered and non-staggered boards (i.e. re-election of members at different dates and for different periods of office), suggesting that under normal circumstances staggered boards represent better corporate governance. Before the code came into effect, staggered boards were not an issue; this was a difference that did not make a difference in the assessment of corporate governance. Interestingly enough, in other countries the same difference makes the opposite difference, so to speak, in the sense that staggered boards are considered bad practice. This brief example should make clear that it is the particular distinctions used that determine what we observe as (good) corporate governance.

In the context of this observation-theoretical approach, code regimes can be conceptualized as networks of interrelated observers that observe each other on the basis of the codes. Thus, in order to study a code regime one has to identify the different observers involved, analyze which observer is observing which other observers, examine the particular observational schemas contained in the code, and, finally, analyze how the code is complemented by, or competes with, other observational schemas (e.g. financial performance indicators). In the following section we will start off with an analysis of the interplay between the different observers involved in the code regime.

3. The code as creating a field of mutual observations

The functioning of a code of corporate governance depends on the dynamic interaction of many different actors. Already the normative model that we reconstructed above addressed the interplay between the individual corporation and its shareholders. However, beyond that there is a wide set of other actors that are of relevance if one wants to study the functioning of such a regulation mechanism (Engwall, 2006). In order to account for that, we suggest that codes be conceived as constituting a ‘field’ of interaction of many different players (Hedmo *et al.*, 2006, speak in a similar context of a ‘regulatory field’). This field is made up of all actors that interact with each other *with regard* to the

code; in this sense one could speak of an issue-based field (Hoffman, 1999). On the basis of our observation-theoretical approach this field can be conceptualized as an observational field which consists of all actors (observers) that use the code as a schema in their mutual observations. This field is essentially dynamic: first, the boundaries of the field are open to new observers entering it. This is the case when actors start using the codes as schemas of observation and are themselves being observed on that basis. For example, rating agencies might start using the codes in their credit ratings. However, actors might also leave the field, which would be the case if they stopped using the code as an observational schema and were themselves no longer being observed on that basis. For example, when the Cromme Code was first introduced in Germany a lot of consultants entered the field offering general advice on the implementation of the code, most of whom have left the scene in the meantime. Second, the way in which the codes are used in the mutual observations changes over time as new observers enter or leave the field and as other schemas of observation are introduced. In addition to that, the recursiveness of observations between the observers possesses itself a dynamic element which might lead to changes in the use of the codes.

For a code to become effective it is necessary that an observational field develops around it. Company directors have to observe that they are being observed on that basis. Without this observational loop the chances of the code being taken into account by the directors are relatively small. Initially, such a code is just *one* observational schema on offer, which competes with many other observational schemas on corporate governance; there are, for example, numerous books describing how good governance or other potential codes of governance are supposed to be structured: in some countries there are competing codes of Corporate Governance; in Germany, for example, there were initially the ‘German Code of Corporate Governance’ by the *Berliner Initiativkreis* (2000) and also the ‘Frankfurter Grundsätze’ by the *Grundsatzkommission Corporate Governance* (2000), until the Cromme Code came into effect. These offers have to be taken up if they are to have an effect. Beyond that, it is necessary that this observation be coupled with decisions that are considered relevant by the directors. The normative model, for example, assumes that the level of compliance will influence the shareholders’ decisions on buying, holding and selling shares. Apart from that, there are also other decisions on which it could have an influence, e.g. the granting of loans, or juridical decisions about liability claims due to negligence (Birkner and Hasenauer, 2004).

We may distinguish between primary and secondary reasons (or better: observations) for using a code as a schema of observation. *Primary reasons* have to do with the content of the code itself. Actors might use a code because they have analyzed the individual code provisions and they appear justified to them. This may be either because the observer is convinced of the usefulness of the particular code provisions as such, or because the observer has found substantiations for them – either while discussing the issue with other observers, or in other texts (e.g. the Baums Report of 2001 explained why it suggested particular code provisions or other texts which dealt with corporate governance rules). *Secondary reasons*, in contrast, have to do with the observation of other actors in the field. First, one might observe that the code issuers describe themselves, and are described by others, as ‘experts’ on corporate governance. Hence one might consider the code to represent expert knowledge that can be accepted without further examination (Jacobsson, 2000). Second, one might observe that other actors in the field are *using* the code as an observational schema – for example other shareholders, analysts, lawyers. This might motivate one to use the code oneself: (1) if other actors who are considered sophisticated (e.g. analysts) are using the code one might take this as confirmation of the quality of the code; (2) if actors who are generally considered successful are seen to be using the code, one might imitate this behavior in order to partake in this success; (3) the fact that other actors are using the code might have concrete effects on companies (e.g. reactions to company share prices, or the risk of being held liable for particular behaviors). This in turn might make it sensible for other observers to use the code as a schema of observation. These second types of secondary reasons, i.e. the observation of others *using* the code, might result in a self-reinforcing cycle: *the use of the code leads to further use of the code*. We could also speak of a process of institutionalization in the sense of a ‘self-activating social process’ (Jepperson, 1991: 145). In the following we want to look at potential self-activating mechanisms in more detail. For this purpose we want to focus on three exemplary self-reinforcing cycles of mutual observation.

(1) Mutual observations between shareholders

Mutual observations amongst shareholders provide a particularly conspicuous basis for self-reinforcing cycles of code use. If shareholders observe that other (‘successful’) shareholders use the code to assess the governance of corporations they too might follow this practice. The fact that their peers use the code might serve as motivation to use the code themselves. There are two potential reasons for this. First, the effects of different governance practices on company performance are (at least to date) unclear. For the investor who has to

make an investment decision this constitutes an area of uncertainty, in the sense that the relation between means and ends is not clear (March and Olsen, 1976). Drawing on DiMaggio and Powell's concept of mimetic isomorphism (1991) one would expect that if successful shareholders are seen to be using the code to assess a company, other investors are likely to perceive the code as a solution to their assessment problem. This is supported by the literature on herd behavior amongst analysts (Welch, 2000; Phillips and Zuckermann, 2001; Rao *et al.*, 2001). The second potential reason is the classic rationalistic one that has already been described by Keynes (1936). According to Keynes, investors judge assets on the basis of how they think *other* investors might judge them (and of their belief that others judge them in a particular way, who in their turn believe that others judge them ... and so on), since the share price is ultimately just a reflection of such beliefs. Applied to our specific context, this implies that if shareholders see (a substantial number of) other shareholders use the code in their investment decisions they can expect code compliance to have an influence on the share price. Under such circumstances it would be rational to base one's own investment decision on the code as well.

Apart from that, shareholders might observe observation intermediaries, i.e. observers who observe organizations on behalf of other actors; e.g. analysts, shareholder associations, corporate governance rating agencies. These groups are particularly important not least due to the salience of their observations. Because of that, one would expect their use of the code – codes are often explicitly addressed to such intermediaries (see e.g. Ringleb *et al.*, 2004: 351) – to have a particular influence on the tendency of investors either to use the code themselves or to rely on the results of the observations of the intermediaries (i.e. an indirect use of the code). Particularly influential in this respect might be the publication of so-called 'turkey-lists' or 'black-lists', in which observational intermediaries put down the names of companies with bad compliance rates. In addition to that, there are also so-called 'Corporate Governance Quality Awards', which are handed out to the companies with the best compliance rates.

These intermediaries combine several of the aspects that we have already referred to above. They present themselves as 'experts' in the field, which means that their use of the code would enhance the code's legitimacy. As a secondary result of that, such intermediaries are likely to be imitated, especially where uncertainty prevails, as in the situation described further up. And finally, given the potential of intermediaries to influence the way investors evaluate a corporation, and thus indirectly affect the share price (see the Keynes argument above), it would be rational for shareholders to orient their own judgment to the evaluations of those intermediaries. To spell out the self-reinforcing cycle: if

intermediaries observe shareholders using the code in their investment decisions, they might themselves use the code to assess the resulting share price reactions, which then again might be observed by other shareholders leading them also to use the code; which again is observed by the intermediaries and so on.

(2) Mutual observations between companies and their external observers

A further central group of observers comprises the focal companies that are – or are not – assessed on the basis of the code. As outlined in the normative model above, companies are assumed to observe that they are being evaluated by shareholders on the basis of the code. To the extent that this is the case, corporations inevitably fear negative consequences on their share price if they deviate without justification from code provisions. Apart from the shareholders themselves, they might observe the observation intermediaries (e.g. analysts). As already pointed out above, such codes are often explicitly meant to be used by intermediaries. Companies may also observe that the use of the code by intermediaries increases the likelihood that shareholders will use it, as they might observe the described self-reinforcing cycle of code usage by investors and intermediaries.

Besides the observers that the code itself mentions, there are the ‘other stakeholders’ or the ‘general public’. Although the general public is unlikely to take a direct interest in compliance rates, the reports of intermediaries, like the shareholder associations, might catch its attention. A prominent example of this was the *public* debate on the deviation of several DAX-30 companies from the recommendation to disclose the compensation components of the individual board members. Shareholder associations stated explicitly that they ‘use’ the mass media strategically in order to put such issues on the public agenda. For companies, this might have negative effects on their reputation with possible implications for their sales figures (particularly in the case of banks and similar companies where trust plays a special role), their share price, the value of the directors on the market for managers, the attractiveness of the company as an employer and so on.

Since the external observers’ assessment of a company is also to some extent relative to the assessment of other companies, the companies are likely not only to observe their external observers but also the compliance rates of their peers. That is to say, if companies observe that the majority of other companies do not comply with a particular code provision, the external observers are less likely to expect compliance on this particular point and will consequently be less critical

of the particular deviation – and vice versa. Hence the self-reinforcing cycle: the more companies comply with the code, the more will the external observers expect compliance, and the more companies will be motivated to comply. But this also works the other way around: the fewer companies comply, the less will the external observers expect compliance, and the less will other companies be motivated to comply.

(3) Mutual observations between companies and lawyers

A further important group of external observers that we have not discussed yet are company lawyers. They might combine the observational schemas of the corporate governance code with legal schemas on due diligence in liability claims. Wymeersch writes: ‘As with other soft law instruments, the legal system has a tendency to incorporate the standards of the codes as the normal benchmark against which conduct in a specific case will be measured. In terms of liability, of interpretation of contract clauses, and so on, it does not seem unlikely that the rules as adopted in the code will be considered the standard’ (Wymeersch, 2005: 418. See also Birkner and Hasenauer, 2004; Kieser *et al.*, 2002). Some representatives of shareholder associations have indicated that they intend to use the code in this way. In that case, if companies are not in compliance with the code provisions, they might have to prove that their deviating practice is at least as good; in other words, this might lead to a shifting of the burden of proof from the prosecutor to the prosecuted company. The use of the code in this legal context may be justified on the basis of two secondary reasons (i.e. secondary observations): first, company lawyers might observe the code issuers as ‘experts’ on corporate governance and, hence, the code as the outcome of ‘expert’ judgment on ‘best practice’ of corporate governance (Ringleb *et al.*, 2004: 1624). The second justification is based on the observation of other companies. If a large number of companies comply with the code, lawyers may justify the use of the code by referring to it as ‘common practice’ amongst corporations (Ringleb *et al.*, 2004: 1625). Companies observing that lawyers use such codes in this way might comply with those codes in order to lower the risk of liability claims. This might set off a self-reinforcing cycle where companies comply with the code in order to avoid liability claims, and lawyers use the fact that a majority of companies comply with the code as a basis for liability claims, which motivates companies to comply with the code, and so on.

With these three examples we have tried to show the potential for an institutionalization process. Whether or not these self-reinforcing cycles are started and, if started, how strong the self-reinforcing element would be or

whether it would be counteracted by other forces, is an empirical question that has to be analyzed in each individual case. Apart from that, the observational field is a dynamic one with new observers constantly entering or exiting it and various observational schemas being introduced or eliminated. Because of that, such cycles have to be studied in the context of the development of the field; they might start at some point and end at a different point. In the following we shall take a closer look at the types of observational schemas contained within the code and their relation to other schemas of observation existing in the field.

4. Codes of corporate governance in the ecology of observational schemas

With regard to codes of corporate governance we can distinguish three types of observational schemas. We will illustrate them with examples from the German Cromme Code. The first one refers to the disclosure or non-disclosure of particular information. Sometimes this is just to inform the shareholder, e.g. by means of the publication of a ‘financial calendar’ (Cromme Code: 6.7). In most cases, however, this is meant to provide the external observer with an informational basis for evaluating the company. For example: ‘Compensation of the members of the management board shall be reported in the Notes of the Consolidated Financial Statements subdivided according to fixed, performance-related and long-term incentive components. The figures shall be individualized’ (Cromme Code: 4.2.4) or ‘In its report, the Supervisory Board shall inform the General Meeting of any conflicts of interest that have occurred together with their treatment’ (Cromme Code: 5.5.3). The suggested schema of observation here is merely concerned with whether the relevant information is disclosed or not.

The second type of observational schema refers to the application of particular (abstract) procedures without specification of their concrete content. For example,

‘An age limit for members of the management board shall be specified’ (Cromme Code: 5.1.2). The observational distinction here is whether or not a particular procedure is put in place, i.e. whether or not an age limit has been decided upon. However, the question of a specific age limit is not addressed.

The third type of observational schema refers to the appropriateness of particular practices or structures. For example, ‘The Management Board shall be comprised of several persons’ (Cromme Code: 4.2.1); or ‘[The Chairman of the Supervisory Board] should not be Chairman of the Audit Committee’ (Cromme Code: 5.2). In contrast to the previous type of code provision, this one

addresses the *content* of the structure or procedure, i.e. not only the selection process but what should or should not be selected.

All three types of observational schemas are not self-sufficient. They are ‘incomplete’ in that they tend to call for additional observational schemas to complement them. This is most obvious in the case of the first two types of code provisions. In the first case, the provided information in most cases calls for further analysis according to a different schema. In the example above, the code provision concerned with the disclosure of management compensation does not say anything about the appropriateness of the level and structure of the disclosed compensation. However, it is the level and nature of the compensation, not the disclosure as such, that was the issue in devising this provision (in contrast, for example, to code provisions requiring the publication of the ‘financial calendar’, where it is the publication of the dates themselves that is of relevance; it is not a question of whether these are good or bad dates). Thus, both for the external observer and for the corporation itself this particular type of code provision on its own does not allow the assessment of the appropriateness of the particular practice or structure.

A similar kind of incompleteness is connected with the second type of code provisions. Here the code provision addresses the intended issue, as in the example above: age makes a difference, but a further distinction is required to specify the particular content of the provision. The question here is: what age limit does make the difference? Hence, it is necessary to complement the code provision with further observational schemas distinguishing appropriate from inappropriate age limits. The code itself neither contains these additional schemas nor does it indicate where they can be found.

In addition to these instances of incompleteness we want to point out three further ones which are fundamental to more or less all code provisions. The first one concerns the interpretation of the code: how are the code provisions to be interpreted – both generally and with regard to the individual organization in particular? The code itself does not contain observational schemas for interpreting the code or for distinguishing ‘adequate’ from ‘inadequate’ interpretations. This problem is not specific to codes but is inherent to any text. No text can control the way it is being interpreted. This phenomenon is generally known as ‘difference’ (Derrida, 1978; for an application to rules, see Derrida, 1994). Beyond this it has been noted that ‘soft laws’ are often left ambiguous by design (Sahlin-Andersson, 2004). An example of this is the code provision on the independence of the supervisory board in the Cromme Code, which requires that ‘the Supervisory Board shall include *what it considers* an

adequate number of independent members’ (Cromme Code, 2005: 5.4.1; emphasis added). Cromme, the Chairman of the code-issuing commission, said: ‘[This code provision] has been criticised by many people for not being particularly precise. [...] I can tell you that this has been exactly our purpose: we wanted to choose a frame as broad as possible, a definition as broad as possible, which would allow the respective companies in their specific situation to find appropriate solutions with regard to the definition of independence and also the number [of independent directors]’ (speech at the Third Conference on the German Corporate Governance Code in Berlin, 2005; my translation; spoken version). Thus, in order to interpret the code provisions one has to rely again on schemas external to the code.

The second fundamental incompleteness concerns the assessment of deviations from individual code provisions and the provided explanations for them. While codes explicitly speak of the possibility of *justified* deviations from individual code provisions, they do not specify in what cases deviations are justified. In other words, the codes do not include a schema for observing justified, as compared to unjustified, deviations. This again is an unavoidable incompleteness; already Kant and Wittgenstein pointed out that no rule can regulate (comprehensively) the exceptions from itself. This is also known as the ‘paradox of rule and exception’ (Ortmann, 2003a). Thus, if a director wants to use the code provisions as an observational schema for assessing and devising his or her company’s governance structures this director will have to ‘supplement’ the observational schemas of the code with additional schemas external to the code. Similarly, shareholders or other external observers need to use additional schemas for assessing whether or not a given explanation for the deviation is justified or not. And even if this has been decided and a deviation is perceived as unjustified, they need yet a further observational schema to assess how important the particular deviation is. In this respect the codes themselves do not distinguish between the relevance of different code provisions. It is more or less left open where the additional schemas might come from.

The third fundamental incompleteness has to do with the compliance statement. The normative model of the code regime assumes that the external observers are informed about the company’s level of compliance through the compliance statement. The code itself, however, does not specify any schemas (or procedures) for assessing the congruence between the stated compliance and the actual structures and practices in the corporation. In other words, the code leaves it up to the observer to decide about the ‘accuracy’ of the statement of compliance. (For a summary of all the different types of incompleteness see Table 1.)

Table 1: Summary of types of incompleteness

Type of code provision	Incompleteness
1. Provision requiring merely the disclosure of information	No schemas for evaluating the disclosed information
2. Provisions requiring a particular (abstract) procedure without specifying the content	No schema for distinguishing appropriate from inappropriate content
3. All code provisions	No schema for distinguishing appropriate from inappropriate interpretations of the code
4. All code provisions ('comply-or-explain' rule)	No schema for evaluating deviations and the explanations provided for the deviations
5. All code provisions	No schema for judging whether the compliance statement accords with the actual practices

For understanding the functioning of a code regime it is now important to study what happens to these instances of incompleteness. It makes a great difference what other observational schemas the code and its individual provisions are combined with. In other words, one needs to analyze the code in the wider context of other observational schemas and study its various relations to them.

When new codes are issued they become embedded into networks of already existing observational schemas. Some of these schemas might form links with the code, completing some of its incomplete points, and in this way determining how it is used. At the same time the code might itself be used to complement other observational schemas. It might, for example, complement legal rules by serving as a benchmark for assessing liability claims (Wymeersch, 2005: 418). In addition to that, the code might stand in different relations of competition with other observational schemas, e.g. alternative schemas for assessing the attractiveness of corporations for potential investors. Hence, one would expect that through the introduction of the code, existing schemas are variously modified, emphasized, or suppressed. In addition to the existing schemas the introduction of the code is also likely to give rise to new observational schemas, e.g. various commentaries on the code or schemas that allow the conversion of compliance rates into numerical figures – so-called scorecards (e.g. Strenger, 2004). These existing and new observational schemas are undoubtedly influenced by the introduction of the code; however the code itself is influenced in its turn by these schemas. In order to account for the dynamic interaction between these observational schemas in the observational field we can also

speak of an *ecology* of observational schemas (see Vickers, 1968; Bateson, 1972; Seidl, forthcoming). Viewed in terms of ecology, the different observational schemas cannot be studied independently of each other. Rather, every observational schema is affected by other schemas and vice versa. With every new observational schema that is added or erased the ecology is changed. In the following we want to analyze some of the constellations formed by the code and other observational schemas.

With regard to the various types of incompleteness of the code that we outlined above we can distinguish several possible developments. First, the various actors who want to assess companies on the basis of the code might use their own observational schemas for completing the codes. However, to the extent that the code itself gets institutionalized, i.e. locked into self-reinforcing cycles, it is likely that a particular set of supplementary schemas becomes institutionalized as well (see Edelman, 1992). The process of institutionalization might be embedded in the way the actors in the observational field copy supplementary schemas that other actors use, or in the way some actors explicitly propose certain supplementary schemas, e.g. in the form of a commentary to the code (e.g. Ringleb, *et al.*, 2004; Pfitzer and Oser, 2003; Huckle and Ammann, 2003; Stock *et al.*, 1999). These supplementary schemas might then become stabilized in the same self-reinforcing cycles that we described above. For example, with regard to the code provision requiring the supervisory board to have an ‘adequate number of independent members’, which we already referred to above, we would expect various actors to put forward supplementary schemas that define what an ‘adequate number’ and ‘independence’ are. Depending on the particular supplementary schema chosen, the board would consequently be considered either to be or not to be independent, and thus the company to be, or not to be, in compliance with the code provision. Thus, the supplementary schema can have an extreme effect on what is being observed on the basis of the code. In the course of mutual observations some of the definitions might then become stabilized while others might disappear again.

Second, the various incomplete elements might remain so because they go unnoticed or because it is assumed that other observers will complete them instead. In some cases the original sense of incompleteness might get lost in the course of the mutual observations. In the first two cases of incompleteness, i.e. where code provisions require the disclosure of particular information (e.g. disclosing the directors’ level of income) or where they require a particular abstract procedure without specifying its content (e.g. setting *any* age limit for directors), it might be that no supplementary schemas are used at all. The actors

in the field might simply observe whether or not the information is provided and behave as if this were the actual issue. The information itself might not be analyzed any further. Similarly, actors might simply observe whether a particular procedure is put in place, regardless of the concrete content. In our example, they might check *that* an age limit is determined but not *what* age limit in particular. By leaving such points incomplete, the meaning of the code thus shifts from a particular content to particular (empty) procedures or structures (see Power, 1997).

In some cases these original instances of incompleteness are obscured by the use of derivative schemas; that is, schemas that are derived from the code and are used as a substitute for the code. Such substitutive schemas provide simplified versions of the code or transform the code into numbers. An example of such a substitutive schema is a checklist, which transforms the code provisions into a list of yes-or-no questions. Although many actors in the field, particularly the code issuers, have warned against the ‘tick-box mentality’ such checklists are widely propagated – ironically even the official commentary on the Cromme Code contains itself a checklist in its appendix (Ringleb *et al.*, 2004: 351–367). Another substitutive schema is the so-called corporate governance scorecard (e.g. DVFA, 2003; Strenger, 2004). Such scorecards are similar to checklists but they also calculate a score for corporate governance. This score is itself a derivative schema that might be taken as a substitute for the code; in other words, instead of evaluating a company’s corporate governance by going through the code, one might just be provided with a score prepared by somebody else. Another potential substitutive schema is the compliance statement that companies have to provide. That is, actors in the field might not use the code as such but only look at the compliance statement. Such a use of the compliance statement has variously been propagated:

‘The compliance statement makes it possible for investors to assess without spending much time or money [...] whether certain standards of good governance are met.’ (Seibt, 2002: 250; my translation)

Such substitutive schemas tend to decrease awareness for the two original cases of incompleteness as the necessity of additional observational schemas does not show up anymore. For example, a score card result of 100 % or a compliance statement stating ‘full compliance’ seems to imply good governance. There is no indication that further observations are necessary to assess governance.

The fifth instance of incompleteness discussed above referred to the congruence between the compliance statement and the actual structures and practices in place in the focal corporation. The code itself does not provide any schemas (or procedures) for assessing such congruence. The problem with this point is also that the actual structures and practices are often shielded from external observation. In order to observe them one either has to enter the organization or try to gather information by different means (Wymeersch, 2005). While there are some actors who actively investigate the level of congruence, in most cases the official declaration is likely to be taken at face value. Even Baums, chairman of Government Panel on Corporate Governance, writes: ‘One can presume the compliance statement by management board and supervisory board to be true’ (Baums, 2001: 12; my translation). The main reason for that is some kind of institutional trust (Meyer and Rowan, 1977; Zucker, 1986). As long as the actors in the field observe that the entire system is functioning well on the whole, they assume that they can trust declarations to be correct on the whole. To the extent that directors are aware of this we can expect to find instances of ‘creative compliance’ (McBarnet and Whelan, 1991) and decoupling between declared formal procedures and actual activities in the company (Meyer and Rowan, 1977).

A particularly interesting instance of incompleteness concerns the ‘comply-or-explain’ rule. The code itself does not provide any schemas for evaluating disclosed deviations and the relevant explanations offered. The normative model described above assumes that shareholders base their assessments on their personal criteria. The problem, however, is that there is uncertainty about the effects of any deviations. As a consequence, external observers might just use a rule of thumb, by which they just count the number of deviations, with a high number representing a negative assessment and a low number a positive one. This form of evaluation can be widely observed: everyone speaks about the number of deviations as if they were all to be considered of equal importance (e.g. Von Werder *et al.*, 2005). Individual explanations for deviations also tend not to receive much attention. Although they are easily accessible it might be difficult to evaluate whether a specific explanation is justified. This is likely to be the case especially for observers who are not familiar with the particular practices in a particular industry or market (e.g. foreign investors). Apart from that, the evaluation of explanations takes time and effort which some observers might not be prepared to invest. As a consequence, deviations might be automatically evaluated negatively without the relevant explanations being taken into account. This is more so when one uses substitutive schemas that do not allow the observation of explanations. Many checklists, for example, only distinguish between compliance and deviation. Because of that, justified and

unjustified deviations would be observed in the same way. Many practitioners have warned against this tendency (e.g. Coombes and Wong, 2004); the code issuers themselves have tried to encourage people not to dismiss explanations without having looked at them first. In the British Combined Code, for example, it says: ‘Whilst shareholders have every right to challenge companies’ explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the Code should not be automatically treated as breaches’ (Financial Reporting Council, 2006: 7). However, even the code issuers often do not pay such explanations much attention. For example, the official commentary on the Cromme Code contains a checklist that does not distinguish between justified and unjustified deviations. Neither do the yearly ‘official’ reports on the Cromme Code differentiate between them (Von Werder *et al.*, 2003; Von Werder *et al.*, 2004; Von Werder *et al.*, 2005). Interestingly enough, the commentary on the Cromme Code even recommends that such explanations be not incorporated in the compliance statement but in a separate document, the so-called corporate governance report (Ringleb *et al.*, 2004: 1556). Thus, external observers who only read the compliance statement cannot distinguish between explained and unexplained deviations.

If directors observe a tendency among external observers not to take explanations into account, they are unlikely to make use of the ‘comply-or-explain’ rule. Instead they will interpret their options as ‘comply or breach’ (Coombes and Wong, 2004), which removes the principle of flexibility, on which the idea of the code is based. This might also be the reason why so many companies do not provide any explanations for their deviations (MacNeil and Li, 2005). An additional problem is that, even if the provided explanations were assessed by the external observers, the directors cannot be sure whether the explanations that appear justified to them would appear so also to the external observer. As MacNeil and Li (2005) write: ‘There remains the risk that the company’s assessment of this issue would not be the same as that of investors, not least because assessments of the costs of compliance are largely subjective’. Thus, companies that do not want to take any risks are likely to try to comply with as many code provisions as possible – even if they think they have justified reasons for deviating.

The effect of codes on mutual observations, however, depends largely also on the way they are integrated into other schemas. For example, only if the shareholders perceive the code to make a difference to their financial interests will they react towards observed non-compliance. So far, however, the relevance of good governance for financial performance has not been proved; the evidence for any connections between governance and performance is very

mixed (e.g. Bassen *et al.*, 2006; Bauer *et al.*, 2004; Drobetz *et al.*, 2004). Another example is the integration of the code into legal schemas of observation. If the code is perceived to define the care and diligence of the board, and is treated as such, legal observers will base their observations of corporations on the code. This might then be observed by the directors as a legal threat for non-compliance (Birkner and Hasenauer, 2004; Wymeersch, 2005).

Apart from the possible integration of the code into other schemas of observation one also needs to analyze the relation of the code to alternative or competing schemas. For example, how are compliance levels evaluated with relation to other financial performance indicators? Can low financial performance be compensated with a high compliance level and vice versa? Or is the compliance level irrelevant as long as the financial performance is positive? MacNeil and Li (2005) suggest that, on the basis of a survey of FTSE 100 serial non-compliers, in Britain there is a strong link between share price performance and investors' tolerance of non-compliance with the Combined Code. In other words, as long as the share price is acceptable, investors are unlikely to take much notice of any deviations from the code. From the perspective of the directors this means that one might deviate from the code without having to fear any negative reaction as long as the company performs well. Thus, the 'comply-or-explain' principle becomes a 'comply-or-perform' principle.

To some extent the introduction of a code also leads to a crowding-out of other observational schemas, since the external actors' 'time and capabilities for attention are limited' (March, 1994: 10). This crowding-out is particularly obvious in cases of similar observational schemas. For example, if there are several corporate governance codes around, people tend to use only one and disregard the other. But also observational schemas that are different to the ones included in the code might get crowded out if they lose out on the competition for attention (March, 1994). This crowding-out tends to increase as a code becomes increasingly institutionalized. The more people use a particular code and the less they refer to alternative schemas of observation (e.g. the less alternative schemas are discussed by analysts) the less will other people be aware of those alternative schemas. The more people use substitutive schemas that do not show the content of the code – e.g. a corporate governance score or the compliance statement – the greater is this tendency likely to be. In these cases one cannot know whether particular schemas are included in the code or not. In addition to that, once the code dominates observation an element of social trust might set in: one trusts that all relevant elements are covered by the code, because otherwise other people would have pointed out that some elements were missing (Luhmann, 1992: 588–589). As a result, the code has a

tendency to focus observation on those aspects that are covered by it while obscuring aspects covered only by alternative schemas.

With these examples of the ways in which a code might become integrated into the ecology of observation we have tried to show how the effect of such a code is determined by its relation to other schemas of observation. Depending on the way in which the code is related to other schemas it results in different observations. Consequently, it also leads to different constellations of mutual observations between the different observers.

Conclusion

In this paper we have tried to contribute to the understanding of code regimes as a particular form for regulating organizations. In order to account for the dynamics involved in such regimes we have suggested that codes should be conceptualized as schemas of observation that mediate the mutual interactions between the various actors involved. To the extent that codes are actually used, an *observational field* is created around them; i.e. a field of observers, who in some way or other refer to the codes in their mutual observations. However, codes are themselves only determined through their relation to other observational schemas around them. On the one hand, codes require complementary schemas in order to become operative – in this respect we have identified several instances of incompleteness. On the other hand, other existing or emerging observational schemas might emphasize, suppress or subvert such codes as observational schemas. Hence, what and how the different observers observe on the basis of the codes depends on how these codes are combined with complementary schemas and compete with conflicting ones. To account for the dynamic interrelation between such schemas, we have suggested the concept of an *ecology of observational schemas*, in which the codes become embedded.

On the basis of this theoretical framework we have identified several constellations between the various actors in the field that lead to self-reinforcing cycles of mutual observations. To the extent that codes are caught in such cycles they become institutionalized as observational schemas. However, whether or not code use is enforced in that way and what implications this has for the interaction between the observers depends on the particular circumstances. We have tried to demonstrate how the relation of the code to other observational schemas determines what observations the code allows for: (1) other schemas might complement a code's incomplete elements; (2) the code's incomplete

elements might remain incomplete; (3) the code as a whole might become integrated into other schemas.

The purpose of this framework is to provide guidelines for studying the effect of codes in their concrete settings. According to this framework an analysis of a particular code regime can be structured around the following questions: (1) what types of observational schemas does a code provide and what types of incompleteness do they entail? (2) who are the observers referring to the code? (3) are there any cycles of mutual observation in which the code is involved? (4) what other schemas of observation exist in the field? (5) how are these schemas related to the code?

Notes

¹ In the USA and Hong Kong there were two precursors to this code in 1978 and 1989 respectively. However, those codes were relatively general and did not receive much attention.

² As an additional means of legitimation, standard-setting committees are often composed of members representing the affected parties (Hommelhoff and Schwab, 2001; Baums, 2001: 16).

³ The original notion of ‘best practice’ as best *existing* practice is, however, not always that clear in the code initiatives.

⁴ It must be noted that there are different versions of the ‘comply-or-explain’ principle. While in Britain, for example, companies are obliged by the listing regulations to provide an explanation for their deviations, in Germany they are only obliged to state that they are not in compliance with the code – the rule is thus sometimes also referred to as ‘comply-or-disclose’. Nevertheless, even in the second case companies are expected by the code issuer to provide explanations out of self-interest.

⁵ While the various codes mostly mention also other actors beyond the shareholders, the code regime is ultimately focused on the shareholder. This can be seen from the way the codes are set up – including the composition of the code committees.

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