Regulatory impact and disposition to comply: Regulatees’ perceptions of the legitimacy of flexible regulatory codes

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Assessing the impact of regulation
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Impact of regulation ↔ compliance ↔ disposition to comply

• Project:
  – Soft Regulation? Conforming with the Principle of 'Comply or Explain,' ESRC (RES-000-23-1501)

• Comparative qualitative research
  – UK: common law, liberalism (self regulation tradition), equity finance, dispersed shareholdings with concentrated institutional control.
  – Germany: civil law, corporatism, bank finance, family blockholdings but similar codes of corporate governance including comply-or-explain, i.e. similar regulatory regimes

• Data
  – Analyse 260 companies Corporate governance statements
  – Interviews with directors, CG managers, legal counsel etc.

• Outputs
  – Sanderson, P., Seidl, D. & Roberts, J., 2015e. Disposition to comply with flexible regulation: regulatees’ perceptions of the legitimacy of codes and the comply-or-explain principle. Regulation & Governance, accepted, under revision
Rationale for soft (flexible) regulation

(i) the volume of risks that the public expects to be regulated has risen and continues to increase beyond, some have argued, the capacity of governments to respond, leading potentially to a ‘legitimation crisis’ (Beck 1992, Habermas & McCarthy 1976);

(ii) relatedly, pressure on national budgets has increased which has contributed to the rise of risk based regulatory regimes that require regulators to focus their efforts on those organizations and actions where the magnitude of potential harms is greatest (Black 2005, Hood et al. 2001);

(iii) the notion that intervention in markets should be kept to a minimum if economic growth is to be maximized has led to policy preferences in favour of flexible principle-based rather than rule-based forms of regulation in order to optimize compliance, i.e. without significantly inhibiting innovation (Black 2008, Financial Services Authority 2007).
Flexible regulation: our case: 
Corporate governance codes and ‘comply-or-explain’

- This raises a number of questions for regulation and governance scholars including what determines how regulatees view compliance with flexible regulation and thus their disposition to comply (on which see Frank & Lombness 1988, Grabosky & Braithwaite 1986)?
- We address this question by examining how senior executives, company secretaries and legal counsel of large companies in the UK and Germany perceive their respective corporate governance codes.
- Both countries incorporate the principle of comply-or-explain to maximise flexibility – one size fits all. Regulatees have the option to (i) comply with a rule or (ii) explain why they choose not to comply.
Flexible regulation (for example Bennear & Coglianese 2013) especially in the context of soft law or self-regulation.

Most authors have focused on the risk of non-compliance from the regulator’s perspective (see for example Black 2005, Black & Baldwin 2012a, Black & Baldwin 2012b).

Compliance per se, again from regulator’s perspective, has also received much attention over the years in a host of different contexts including corporate governance (see for example Fairman & Yapp 2005, Hooghiemstra & van Ees 2011, Murphy et al. 2009, Seidl et al. 2013, von Werder et al. 2005).


On the specific use of codes in the business arena there are numerous studies of levels of compliance with codes of practice (for example Dawson & Dunn 2006, Ellis & Higgins 2006) or business ethics (for example Helin & Sandström 2010, Zolingen & Honders 2010).
Theoretical frame: **Legitimacy:** regulatory codes as institutions

- Legitimacy theory has widely been used in studies of corporate decision-making and in particular, governance codes. Most studies on the latter have been concerned with the legitimacy of regulatees’ actions.
- Corporate governance codes are typically treated as representing institutionalized expectations with which corporations seek to conform in order to preserve their own legitimacy (Enrione et al. 2006, Hooghiemstra & van Ees 2011, Seidl et al. 2013).
- Compliance is explained with reference to the organization’s concerns for legitimacy.
- Few studies have in any way addressed the legitimacy of corporate governance codes themselves.
- Yet, as Kelly (2011) points out, “**Legitimacy matters from a normative and practical perspective. All institutions that establish norms, whether those norms develop into soft law, hard law, or no law at all, face legitimacy challenges.**”
Legitimacy (organisational)

• “Assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions” (Suchman 1995: 574).

• Code regimes are considered legitimate to the extent they are “congruent” (Mathews 1993) with the values, norm, and expectations of the social system of which they are a part. It is thus not the content or the structures of the code regime alone which determine their legitimacy.

• Note: Mathews (1993) speaks of ‘congruent’ rather than identical values. Legitimacy is dependent on the values and norms exhibited being compatible but not necessarily identical. i.e. the regulatory system has to be understood.
Categorising legitimacy:

• Pragmatic, moral and cognitive Aldrich and Fiol (1994) further developed by Suchman (1995)
Operationalising Pragmatic legitimacy

- **Pragmatic legitimacy** is based on the self-interested calculations of the respective audiences (Suchman 1995: 578). That is, legitimacy arises from a specific benefit conferred on the legitimacy-seeking entity.

- Code regimes would be considered pragmatically legitimate by regulatees to the extent they believe they can benefit from it.

- From this perspective a key challenge in maximising regime legitimacy is to address the interests of the regulatees and to persuade them of the usefulness of the code (cf. Palazzo and Scherer 2006; Scherer et al 2013; Ashforth and Gibbs, 1990).

- For example, compliance with corporate governance codes can be said to increase a firm’s valuation and accordingly decrease their cost of capital, by assuring potential investors that the firm is properly governed (Beiner et al. 2006, Drobetz et al. 2004, Goncharov et al. 2006).
Operationalising Moral legitimacy

• Suchman explains, such normative evaluation “reflects a prosocial logic that differs fundamentally from narrow self-interest” (1995: 579) in that benefits flow to others.

• Palazzo and Scherer (2006: 73) argue that such “moral concerns to some extent prove resistant to self-interested manipulations and to purely pragmatic considerations.”

• Accordingly, code regimes could be considered legitimate to the extent that they are perceived as morally acceptable, i.e. “the ‘right thing to do’” (Suchman 1995: 579).

• e.g. best practice?
Operationalising Cognitive legitimacy

• Cognitive legitimacy is based on the **familiarity** of the audience with the particular structures or actions in question. Something is granted cognitive legitimacy if it fits into the established and accepted schemata.

• Unlike instrumental and moral legitimacy, cognitive legitimacy does not involve conscious evaluation but operates “mainly at the **subconscious** level” (Palazzo & Scherer 2006: 72).
  – rests on the fact that the particular structures and actions are comprehensible, i.e. they fit with pre-existing mental models, and
  – that the particular structures and actions are to some extent taken-for-granted.

• In extremis this takes the form that “for things to be otherwise is literally unthinkable” (Suchman 1995: 583).

• **Code regimes would be cognitively legitimate to the extent that the use of codes fits into regulatees’ existing cognitive schemata and thus are considered ‘natural’ or ‘normal.’**
Findings: Pragmatic legitimacy

• Private benefits from complying with the code. A significant number of our German interviewees highlighted such benefits:
  – “The real purpose of the German corporate governance code is to advertise Germany as a capital market - the two-tier board system is hard to explain to the Americans and English. I think the code has fulfilled this task very, very well for our corporate governance system.”

• That both single and dual board systems can be accommodated within a one-size-fits-all code is seen as a means of reassuring foreign investors that the two serve very similar purposes and diminishes perceptions of difference between them. It enables German companies to retain their traditional board structure and is thus:
  – “worthwhile in order not to have to take on board every idiocy from the Anglo-Saxons such as the one tier board structure.” By demonstrating such equivalence the code engenders what Suchman (1995) called ‘exchange legitimacy.’

• There was less of a sense of the code having primarily pragmatic legitimacy amongst UK interviewees, but they did express their preference for regulation by code rather than statute so in that sense the flexibility inherent in the code could be argued to confer private benefits by way of lower compliance costs: “Boards get quite cross about having to comply with rules that are senseless in their view.
  – “You can see that investors and others are expecting you to adhere to but having the flexibility to explain why an aspect might not be appropriate for you, I think is a really good place to be.”

• But perhaps the main private benefit identified by UK interviewees was the gain made by having to comply with a single code. One interviewee, recalling the situation immediately prior to the Cadbury Report (1992) commented:
  – “there were a plethora of codes coming out and every major institutional shareholder felt that it ought to have its own statement of principles or code and therefore measure the report against that.”

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  - “there were a plethora of codes coming out and every major institutional shareholder felt that it ought to have its own statement of principles or code and therefore measure the report against that.”
Findings: Moral legitimacy

• The main example identified, best practice, may appear pragmatic but it is likely also by
definition to be considered ‘the right thing to do’ and there is a clear sense in which it is
prosocial. Whether arising internally or externally the practices valued by a company and
delineated as best practice are by such delineation made available to others to be used as
benchmarks to assess their own practices (Wareham & Gerrits 1999).
• Many of our UK interviewees considered the code embodied best practice and had, therefore,
moral legitimacy:
  – “The beauty of the Code is it does follow best practice.” Its origins were understood to lie in
    “experienced City operators collaborating over what were the sort of elements that made companies
    operate well and effectively, trying to capture what until that time had actually been complicit in good
    management, and saying what are the signs of good management and how can we encapsulate that in
    a best practice guide as to how you should do something”
• To some extent our German interviewees agreed on best practice but the origins of the code
were a concern – whose best practice do they embody? The perception in the UK that the
rules were derived endogenously contrasts markedly with the responses from Germany. While
not many would concur with the view of one German interviewee that the code originated
with:
  – “some professors of whom you don't know whether they ever have seen a company from the inside”
most would agree that “the topic of corporate governance started in the Anglo-Saxon sphere,” and
many would also concur with the comment that “in Germany matters of corporate governance are
much more regulated than in the Anglo-Saxon world - insofar as there was a need for more regulation
it was in the Anglo-Saxon world rather than us.”
• In other words while the code might represent UK best practice it lacked moral legitimacy in
this regard in Germany.
Findings: Cognitive legitimacy

• For some, but not all, German interviewees the code completely lacks this ‘taken-for-grantedness’ (Suchman 1995: 575):
  – “The attempt to find regulations that determine how all companies can be managed is doomed to fail.”

• However, by contrast, almost all UK interviewees seemed confident they understood the concept of codes in general and the comply-or-explain principle in particular. While the objectives of the fixed rule US system were not perceived to be markedly different from those of the UK the flexibility offered by using a comply-or-explain code was considered superior by UK interviewees:
  – “It is not like criminal law where something is obviously wrong and something is obviously right. It is a consensus as to this is the way we think things should be done but we are prepared to accept that for some companies it may be different and provided your explanation is adequate then you know you can carry your shareholders with you.”

• Indeed, some UK interviewees even considered comply-or-explain codes offered the opportunity for superior compliance as well, because:
  – “you comply with the spirit as well as the letter - so in some ways they can be more onerous because if you are applying that sort of spirit test, that sometimes does drive you to some harder choices than the letter of the law test.”

• Again, this contrasted with some German interviewees who found the concept of comply-or-explain simply alien:
  – “The fact is that if the lawmakers want something done they should make a law – they do anyway - there is enough law around. And if they do not want this, they should stay clear of it. But these recommendations – 'should', 'could' – what do I get out of it? Nothing!” [... ] Either there is law or there is no law.”

• However, notwithstanding their enthusiasm for this form of rule, UK interviewees did identify a major issue with the comply-or-explain principle. Arguably, the more a comply-or-explain code is taken-for-granted and the more it is seen as a natural but flexible substitute for hard law, the more monitors expect regulatees to comply as though it were hard law:
  – “It is not a comply-or-explain in reality. It is not equal weighting comply or explain. It’s thou shalt comply and at the periphery you can explain away.”
Findings: summary & paradoxes

- Almost all UK interviewees and many of their German counterparts saw their respective code as embodying best practice and thus possessing moral legitimacy, although a substantial minority in German considered the whole idea of rule by code to be alien, a political instrument imposed from outside, from the ‘Anglo-Saxon’ world.
- The code was considered generally to possess greater pragmatic legitimacy by our German interviewees than their UK counterparts, although a few in the UK did mention that a single one-size-fits-all code serves to lower transaction costs.
- Given the UK tradition of voluntaristic self-regulation, it is not surprising that rule by code is more ‘taken-for-granted’ and so possesses greater cognitive legitimacy in the UK than in Germany.

Paradox 1. For the majority of code provisions, any perceived flexibility offered by comply-or-explain was illusory. Regulatees considered this ‘mimetic isomorphism ‘ (DiMaggio & Powell 1983) to be driven by key monitors, although institutional shareholders interviewed to provide background and context for the research denied this was the case.
- Paradox 2. relatedly, the more a code is perceived as a success, i.e. a substitute for hard law, the more pressure there is not to deviate.
Explaining variations

• The UK code was established earlier than the German code so there has been more opportunity to reform any questionable provisions (one of the advantages of flexible codes over statute law).

• Isomorphic pressures tend to come from the media, the public and government who may hold different views on the purpose of codes of corporate governance and their capacity to prevent sub-optimal corporate decisions, negligence and criminality.

• This pressure can lead to ‘symbolic responses’ (Selznick 1949) where regulatees resort to ticking boxes rather than engaging positively with the code and consequently threatening the legitimacy of the code with external monitors.
• The ‘magic’ of codes is in their capacity to serve as **partial substitutes** for hard law. Once they are perceived to be perfect substitutes from which deviation within acceptable limits is inconceivable, they lose their purpose.

• The purpose of codes and enabling mechanisms such as comply-or-explain is to help correctly position regulatees in relation to wider society such that performance is optimized (in the sense of outcomes for both the regulated company and the wider society). Thus those who demand full conformance with the rules misunderstand the efficiency gains to be made by using flexible forms of regulation.
Lessons for regulators

- Regulatee buy-in is critical. Involving regulatees in design, implementation and evaluation will maximize the legitimacy of codes.
  - Moral and pragmatic legitimacy – for example, embedding accepted best practice and making an effort to identify and disseminate the tangible business benefits of compliance for regulatees - are both relatively straightforward and achievable with careful regulatory design.
  - Cognitive legitimacy is more problematic. It is emergent. It is derived from the social context in which the individual is embedded and determines how we know and understand the world around us. Understanding the process by which a code works, and how and when it is acceptable to explain rather than comply – to the point where any other means of rule seems unthinkable - takes time (see Suchman 1995, Zucker 1991).
  - Indeed, in a culture where certainty is prized the idea that compliance is discursively constructed and can be a contested concept may never become the norm.
Countering resistance to flexible codes

• Under conditions of uncertainty procedural fairness is key – in other words regulators need to focus on ensuring regulatees have confidence their actions will be assessed using fair and agreed procedures and criteria (see for example Blader 2007, Herian et al. 2012, van den Bos & Lind 2002).

• The legitimacy of a code, particularly one incorporating comply-or-explain will be enhanced if it includes in its provisions the procedures and criteria by which compliance will be assessed.
Multiple monitors issue

• Faced with multiple monitors, regulatees may be best advised to opt for hard law with its fixed rules in order to reduce uncertainty or, when faced with soft law in the form of flexible codes of regulation, opt for full conformance.

• Interestingly, there is also evidence that when conditions are uncertain regulatees converge towards full conformance in part to defend the legitimacy of the prevailing (and known) regulatory system (see Vainio 2011), irrespective of any inherent flexibility. In this way, and less pessimistically, potentially outcome-optimizing mechanisms such as comply-or-explain can be preserved, to be drawn upon again when conditions are more certain – when monitors ‘allow’.
Conclusion

• Positive impacts (disposition to comply) arise in part from the perceptions of regulatees on the legitimacy of the code. In practical terms that means flexible regulatory codes are most effective when:
  – (i) regulatees are involved in code design,
  – (ii) the code embodies existing best practice, and
  – (iii) the benefits to regulatees are clearly demonstrated, but:
  – (iv) regulation by flexible code must already be the norm or at least not inconsistent with existing traditions and practices.