

# **Why adopt codes of good governance? A comparison of institutional and efficiency perspectives**

## **Abstract**

Given the global diffusion and the relevance of codes of good governance, the aim of this article is to investigate if the main reason behind their proliferation in civil law countries is (i) the determination to improve the efficiency of the national governance system, or (ii) the will to “legitimize” domestic companies in the global financial market without radically improving the governance practices. We collected corporate governance codes developed worldwide at the end of 2005 and classified them according to the country’s legal system (common law or civil law). Then, we made a comparative analysis of the scope, coverage, and strictness of recommendations of the codes. We tested differences between common law and civil law countries using t-tests and probit models. Our findings suggest that the issuance of codes in civil law countries is prompted more by legitimation reasons than by the determination to improve the governance practices of national companies. The study contributes to enriching our knowledge on (i) the process of reinvention characterizing the diffusion of new practices, and (ii) the interplay between law and codes’ recommendations in corporate governance practices.

**Keywords:** corporate governance, codes of good governance, board of directors

# **Why adopt codes of good governance? A comparison of institutional and efficiency perspectives**

## **Introduction**

The separation between ownership and control in large companies leads to the need for corporate governance (Berle and Means, 1932), i.e. a set of complementary mechanisms built on one another and aimed at protecting investors' rights and reducing managerial opportunism (Shleifer and Vishny, 1997). Corporate governance practices vary across institutional environments (e.g. Aguilera and Jackson, 2003; Crouch and Streek, 1997; Gordon and Roe, 2004; Hall and Soskice, 2001; Weimer and Pape, 1999). Governance practices reflect, in fact, differences in culture, traditional financing options, corporate ownership patterns, and legal origin.

The characteristics of governance practices within a given country are the result of both forces aimed at increasing their efficiency, and legitimization effects due to path dependence (Gordon and Roe, 2004). Concerning the efficiency forces, product and capital market pressures arising from globalization force the convergence of local governance practices towards the dominant international model (e.g. Becht et al., 2002; Cuervo, 2002; Davis and Steil, 2001; Hansmann and Kraakman, 2004; Mallin, 2002; Whitley, 1999). The integration of financial markets and the pressure from Anglo-Saxon institutional investors shape the corporate governance of large companies in any country. This in turn increases the protection of shareholders' rights, encourages the creation of a more independent and active board of directors, and favors the development of more transparent and efficient financial markets (Monks and Minow, 2004; Van den Berghe, 2002). Furthermore, the forces of globalization create competition among governance systems and increase the anxiety of the political elite

concerning the effectiveness of the national governance model (Gordon and Roe, 2004). Finally, corporate scandals which occurred in many countries at the beginning of the new century (e.g. Enron, Worldcom, Global Crossing in the US; Parmalat and Cirio in Italy; Ahold in the Netherlands; etc.) have forced politicians, national stock exchanges, financial authorities, and supranational organizations (such as EU, OECD or IMF) to search for more effective governance practices (e.g. Coffee, 2005; Hill, 2005).

Despite the benefits of effective governance practices and the pressure from globalization forces, changing governance models is not easy because they are embedded in the national institutional environment (Aoki, 2001; North, 1990; Whitley, 1999). The high complementarity among governance practices may hinder convergence because: i) altering one mechanism without changing the others may dissipate the benefits arising from their interaction; ii) it is difficult to transform many institutions at the same time and in a coordinated way (e.g. Bebchuk and Roe, 1999; Schmidt and Spindler, 2002). Furthermore, modifying governance practices often requires amending laws and therefore agreement between the political and corporate elite on the governance model to adopt (Gordon and Roe, 2004). Initial governance practices have, in fact, distributional effects and create interest groups supporting the status quo. The domestic elite may resist external pressure to adopt more effective governance practices if they undermine the private benefits of control of this group (e.g. Bebchuk and Roe, 1999; Rhodes and van Apeldoorn, 1998).

That being said, this article focuses on the diffusion of new governance practices with the aim of extending the existing empirical evidence (Aguilera and Cuervo-Cazurra, 2004; Cuervo Cazurra and Aguilera, 2004) on the reasons behind the adoption of codes of good governance. Codes of good governance are a set of best practices

recommendations regarding boards issued to address deficiencies in a country's governance systems. These deficiencies are strictly related to the legal tradition of a country (La Porta et al., 1997, 1998, and 1999), and existing evidence shows that common law countries grant better protection to investors' rights than civil law countries (e.g. La Porta et al., 1998; Djankov et al., 2006).

The adoption of new practices within a social system may be explained referring to two main theoretical sources: efficiency (or rational) accounts and social legitimation (DiMaggio and Powell, 1983; Strang and Macy 2001; Tolbert and Zucker 1983). The former points to the efficiency gains following innovation or the adoption of a practice. The latter suggests that practices are adopted because of their growing taken-for-grantedness which makes adoption socially expected. Following these two rationales, if efficiency reasons prevail, civil law countries will develop codes before common law countries and their codes will have stricter recommendations. If legitimation reasons prevail, civil law countries will develop codes later than common law countries and their codes will have weaker recommendations.

To investigate reasons behind codes' adoption, we collected data on the diffusion of codes of good governance until 2005. We also collected the good governance codes developed worldwide at the end of 2005 and classified them according to the legal tradition of their country (common law or civil law). For each code we analyzed the scope (i.e. listed or also non-listed companies), the coverage (i.e. the number of issues addressed), and the strictness (i.e. the presence of clear and stringent recommendations versus vague and elastic ones). We employed difference-of-means and probit models to compare codes in common law and civil law systems.

Both legitimation and efficiency reasons seem to explain the diffusion of good governance codes. On the efficiency side, civil law countries extend code recommendations to non-listed companies more often than common law countries do. On the legitimation side, civil law countries adopt codes later, issue a lower number of codes, and state more ambiguous and lenient recommendations. Taken together, our findings suggest that the issuance of codes in civil law countries is prompted more by legitimation reasons than by the determination to dramatically improve the governance practices of national companies.

This article contributes to both management and legal literature. In particular, it provides further knowledge on (i) the process of reinvention that usually characterizes the diffusion of new practices, and (ii) the interplay between hard and soft law in governance practices.

## **Theoretical development**

### *The diffusion of new practices*

The decision to issue a code of good governance can be assimilated to the adoption of new practices in an existing corporate governance system (Aguilera and Cuervo-Cazurra, 2004). Codes of good governance are, in fact, best practice recommendations regarding the characteristics of the board of directors and other governance mechanisms. They provide a voluntary means for innovation and improvement of governance practices.

A diffused practice can be defined as an innovation within a social system, although the innovation does not necessarily entail an “improvement”, but rather a change in the current state (Strang and Macy, 2001). Many scholars explain the

adoption of new practices and their homogeneity within a social system by referring to two main theoretical approaches: efficiency theory and institutional theory (DiMaggio and Powell, 1983; Strang and Soule, 1998; Strang and Macy, 2001; Tolbert and Zucker, 1983; Westphal et al., 1997). Reasons of efficiency and legitimation both compete with and complement each other (Scott, 2001). The two approaches are not necessarily incompatible because organizations may adopt practices for different reasons (Tolbert and Zucker, 1983). There is evidence suggesting that both efficiency and legitimation reasons may lead to the adoption of new practices (e.g. Aguilera and Cuervo-Cazurra, 2004; Tolbert and Zucker, 1983).

The first theoretical approach views organizations as rational actors, albeit in a complex environment, and points to the gains in efficiency or effectiveness that may follow innovation or the adoption of a practice (Blau and Schoenherr, 1971; Thompson, 1967). Some examples of adoption motivated by technical or rational needs are the adoption of the multidivisional form (Chandler, 1962), the creation of professional programs by failing liberal arts schools (Kraatz and Zajac, 1996), or the introduction of conventions into the broadcasting field (Leblebici et al., 1991).

Conversely, the second theoretical approach views organizations as captives of the institutional environment in which they exist and suggests that practices are adopted because of their growing taken-for-grantedness improving qualities which make adoption socially expected (Meyer and Rowan, 1977; Zucker, 1983). Tolbert and Zucker (1983) in their study on civil service reform in US municipalities illustrated that early adopters were driven to change by technical-competitive reasons and late adopters were driven to conform to what had become best practice. They argued that the early adopters of civil service reforms provided the legitimacy for innovation and other

organizations were then under pressure to adopt the reforms for fear of losing legitimacy. Tolbert and Zucker (1983: 25) defined institutionalization as “the process through which components of formal structure become widely accepted, as both appropriate and necessary, and serve to legitimate organizations.” If practices become institutionalized, their adoption brings legitimation to the adopting organizations or social systems even if sometimes these practices fulfill symbolic rather than task-related requirements.

The process of homogenization is called *isomorphism* and defined as a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions (Hawley, 1968). There are two types of isomorphism: competitive and institutional (DiMaggio and Powell, 1983). Competitive isomorphism assumes a system rationality that emphasizes market competition, niche change and fitness measures. A common view is that this type of isomorphism is relevant for fields in which free and open competition exists and may apply to early adoption of innovation. However, this does not present an entirely adequate picture of the modern world of organizations. To do so, it must be supplemented by an institutional view of isomorphism, according to which organizations compete not just for resources and customers but for political power and institutional legitimacy, and for social as well as economic fitness (DiMaggio and Powell, 1983).

The large majority of contributions on the diffusion of new practices focused on the mechanisms facilitating or inhibiting the transmission process. These studies imply a binary approach of adoption/non-adoption for the most part, and treat the practices themselves as relatively unchanging and uniform. However, innovation diffusion is a dynamic process and diffusing practices may be modified or “reinvented” by adopters

(e.g. Rogers, 1995; Tornatzky et al. 1983). Reinvention is likely to be the rule, not the exception and researchers call for further study on the factors explaining changes in practice content (e.g. Campbell, 2005; Cool et al., 1997).

Finally, institutional theorists highlight that organizations may resist conforming to external pressures due to inertial effects and firm history (e.g. Tolbert and Zucker, 1983). North (1990) affirms that institutions are shaped by historical factors limiting the range of options available to decision makers. Matthews (1986) argues that inertia plays an important role in institutional persistence. Old institutionalists (e.g. Selznick, 1949) highlight the role of politics in shaping formal structures, and focus their analysis on group conflict due to diverging interests. New institutionalists devote less attention on 'how incumbents maintain their dominant positions' (DiMaggio and Powell, 1991: 30). However, DiMaggio and Powell acknowledge that 'actors in key institutions realize considerable gains from the maintenance of those institutions' (1991: 30) and that 'the acquisition and maintenance of power within organizational fields requires that dominant organizations continually enact strategies of control' (1991: 30-31).

### *The good governance codes*

Codes of good governance can be considered a set of best practices regarding the board of directors and other governance mechanisms. Such codes have been designed to address deficiencies in the corporate governance system by recommending a set of norms aimed at improving transparency and accountability among top managers and directors (Fernandez-Rodriguez et al., 2004).

Aguilera and Cuervo-Cazurra (2004) found that codes of good governance were issued mainly by the stock market or by managers' associations. Directors' associations,



investors' associations, and the government did not play a large role in developing national governance practices. This evidence runs counter to the popular claim that institutional investors are the primary triggers of good governance, though these investors may have pressured stock-exchange commissions and private associations to improve governance practices at country level.

In most legal systems, codes of good governance have no specific legal basis and are not legally binding (Wymeersch, 2006). Enforcement is generally left to the effectiveness of internal corporate bodies (i.e. the board of directors) and of external market forces. Only in a few countries (e.g. Germany and the Netherlands in Europe) the law attaches explicit legal consequences to the code or even to its provisions (Wymeersch, 2005).

Even if compliance with code recommendations is traditionally voluntary and based on the "comply or explain" rule, empirical evidence shows that publicly traded companies tend to respond to the main code recommendations (e.g. Conyon and Mallin, 1997; Gregory and Simmelkjaer, 2002). Furthermore, a previous study (Fernandez-Rodriguez et al., 2004) suggests that the market reacts positively to announcements of compliance with the code. In brief, codes of best practices exert major influence on the corporate governance of listed companies, at least formally (Werder et al., 2005).

The content of codes has been strongly influenced by corporate governance studies and practices. Codes touch fundamental governance issues such as fairness to all shareholders, clear accountability by directors and managers, transparency in financial and non-financial reporting, the composition and structure of boards, and the responsibility for stakeholders' interests and for complying with the law (Coombes and Chiu-Yin Wong, 2004; Gregory and Simmelkjaer, 2002).

The core of codes of good governance lies in the recommendations on the board of directors. Following the dominant agency theory (e.g. Alchian and Demsetz, 1972; Fama and Jensen, 1983; Jensen and Meckling, 1976), governance codes encourage the board of directors to play an active and independent role in controlling the behavior of top management. In particular, scholars and practitioners (e.g. Charan, 1998; Conger et al., 1998; Demb and Neubauer, 1992; Lorsch and MacIver, 1989) recommend the quest for an increasing number of non-executive and independent directors, the splitting of Chairman and CEO roles, the creation of board committees (nomination, remuneration, and the audit committee) made up of non-executive independent directors, and the development of an evaluation procedure for the board. The introduction of these practices is considered a necessary factor in order to avoid governance problems and to increase board and firm performance.

*The reasons behind the diffusion of good governance codes*

An open question, which has still not been extensively studied, is whether codes of good governance have been adopted to pursue efficiency or for institutional (i.e. legitimation) reasons (Aguilera and Cuervo-Cazurra, 2004).

*The efficiency rationale.* The main function of codes of good governance is to compensate for deficiencies in the legal system regarding investor protection. In countries with weak protection of investors' rights, the potential benefits for the economic system associated with the reinforcement of good governance practices are greater than in countries with strong protection of investors' rights. Increasing the efficiency of governance practices can, in fact, encourage global institutional investors

to invest more money in domestic companies (e.g. Brancato, 1997; Gordon and Roe, 2004).

Previous studies (La Porta et al., 1997; La Porta et al., 1998 and 1999) showed that deficiencies in the corporate governance systems are linked to the legal tradition of a country, and that common law countries provide stronger investor protection than civil law countries. The anti-director rights index and the distinction between common law and civil law countries (La Porta et al., 1997 and 1998) have been routinely used as measures of legal shareholder protection in cross-country quantitative studies.

The “law matters” approach and its original anti-director index have been criticized for mistakes in coding, conceptual ambiguity in the definitions of some components, and the over-generalization of findings (e.g. Pagano and Volpin, 2005; Roe, 2006; Spamann, 2005). Prompted by the critics, Djankov et al. (2006) constructed a more robust index, measuring the strength of minority shareholder protection against self-dealing by the controlling shareholder. After a robust revision of the methodology used to measure investor protection around the world, Djankov et al. (2006) conclude that strong and significant differences exist between common law and civil law countries in terms of investor protection and several financial measures (i.e. valuable stock markets, more initial public offerings, and lower benefits of control).

Summing up, in countries with weak investor protection, the size of private benefits, measured as the observed size of the voting premium, is higher than in other countries (Zingales, 1994). Due to the absence of strong shareholders’ rights, top managers and controlling shareholders can use a large variety of mechanisms to extract value from the company at the expense of minority shareholders (Morck and Yeung, 2003). In these conditions, the adoption of codes of good governance with a large

coverage and strict recommendations may dramatically increase firm efficiency and reduce the cost of capital (Brancato, 1997). In summary, if efficiency reasons prevail, we would expect the following relationships to hold:

*Hypothesis 1a: civil law countries will issue codes before common law countries.*

*Hypothesis 2a: civil law countries will be more prone to develop codes than common law countries.*

*Hypothesis 3a: codes developed by civil law countries will have a larger scope than codes developed by common law countries.*

*Hypothesis 4a: codes developed by civil law countries will have a larger coverage than codes developed by common law countries.*

*Hypothesis 5a: codes developed by civil law countries will have more stringent recommendations than codes developed by common law countries.*

*The institutional (legitimation) rationale.* The development of codes of good governance aims to increase not only the efficiency of governance rules, but also the legitimation of national companies in the global financial market. Competition among countries in the global economy generates coercive or normative imitation, i.e. mimetic isomorphism (Guler et al., 2002). Countries more exposed to other national economic systems experience greater pressure to harmonize and legitimate their governance practices. A previous study (Aguilera and Cuervo-Cazurra, 2004) supports this idea, showing that codes of good governance are more likely to be issued in countries where there are high government liberalization and a strong presence of foreign institutional investors.

Under the pressure of external forces, the national stock exchanges, the domestic associations and the governments may be forced to change governance practices in the country not only to increase the efficiency of domestic companies, but also to harmonize the national corporate governance system with international best practices. Avoiding adherence to governance principles developed at an international level means, in fact, running the risk of not attracting global investors and increasing the weighted average cost of capital for national companies (e.g. Brancato, 1997; Davis and Steil, 2001).

The effects of the institutional forces producing isomorphic behaviour among firms located in different countries are not irresistible. A recent study provides findings that “run against the conventional wisdom that globalization is an inexorable, uniform, and homogeneous process tending toward unmitigated isomorphism across countries, at least in the adoption of organizational practices” (Guler et al., 2002: 227). Furthermore, it shows that “discernible cross-national patterns in rates of diffusion exist, and they shed light on the forces driving the process” (Guler et al., 2002: 227).

Two sorts of path dependence may slow down the change in governance practices (Bebchuk and Roe, 1999). First, governance practices are mutually complementary mechanisms, so modifying one of them – without changing the others – may eliminate the benefits arising from their interaction (Bebchuk and Roe, 1999; Schmidt and Spindler, 2002). Second, the corporate elite may resist the introduction of better governance practices, because such a change may reduce their power to extract private benefits of control from the firm’s assets (e.g. Bebchuk and Roe, 1999; Collier and Zaman, 2005; Morck and Yeung, 2003; Rhodes and van Apeldoorn, 1998; Zattoni, 1999).

Summing up, in countries with weak protection of investors' rights there would be a strong urgency to issue codes of good governance and to adopt strict governance practices to increase transparency and efficiency of the financial markets. However, two sorts of rule-driven path dependence (based on efficiency and rent-seeking) may oppose the introduction of such codes because of complementarities among governance practices and the will to extract private benefits of control from company's assets (Bebchuk and Roe, 1999). These forces cannot avoid the introduction of good governance codes, but they can slow down their development and limit the changes in national governance systems. In summary, if legitimation reasons prevail we would expect the following relationships to hold:

*Hypothesis 1b: civil law countries will issue codes later than common law countries.*

*Hypothesis 2b: civil law countries will be less prone to develop codes than common law countries.*

*Hypothesis 3b: codes developed by civil law countries will have a narrower or the same scope than codes developed by common law countries.*

*Hypothesis 4b: codes developed by civil law countries will have a narrower or the same coverage than codes developed by common law countries.*

*Hypothesis 5b: codes developed by civil law countries will have less stringent recommendations than codes developed by common law countries.*

## **Research design**

### *Sample*

Our sample includes 60 countries: the 49 countries contained in the data set of La Porta et al. (1998) and all EU member States at the end of 2005. By that time, 44 out of the 60

countries issued at least one code of good governance. Table 1 summarizes the most recent worldwide codes categorized by country legal system, year and issuer.

To classify codes according to their legal system, we relied on previous studies that identified two principal secular legal traditions: civil law and common law (La Porta et al., 1998; Reynolds and Flores, 1989). Our sample contains 29 civil law countries (13 with French, 12 with German, and 4 with Scandinavian civil law) and 15 common law countries. We assigned a dummy variable to each code for the legal systems: 0 for civil law, and 1 for common law.

(Insert here Table 1)

#### *Data collection*

We collected archival data on the diffusion and the content of codes. In particular, for each country, we collected data about (i) the year of issuance of the first code and the number of codes issued until 2005, and (ii) the scope, the coverage, and the strictness of recommendations of each most recent code (at the end of 2005).

Concerning the diffusion of codes, for each country we recorded the year of issuance of the first code and the number of codes issued until 2005. We then calculated the distance between the year of issuance of the first code in the sample (1992) and the year of issuance of the first code in each country to measure the delay in code adoption.

Concerning the content of codes, we built a comprehensive database of the most recent codes of good governance developed worldwide at the end of 2005. Our main sources of information are the “Comparative study of corporate governance codes relevant to the European Union and its member states” (Gregory and Simmelkjaer,

2002), the “Survey of corporate governance developments in OECD countries” (OECD, 2003), and the “Code and principles” section on the European Corporate Governance Institute web site ([www.ecgi.org](http://www.ecgi.org)). For reasons of consistency, our database includes only codes of good corporate governance. We excluded laws and legal regulations, reports on compliance with codes already issued, codes on the behavior of top management, consulting firm reports, and individual or specific company codes.

Our study focuses on analyzing the content of the most recent codes instead of first codes for the following reasons. First, the diffusion of codes across countries did not follow a linear path (Aguilera and Cuervo-Cazurra, 2004). Though some countries issued their first code at the beginning of the ‘90s, codes of good governance became widely diffused only at the end of the ‘90s and the beginning of the new millennium. Second, in the last decades the debate on good governance has dramatically evolved and the “ideal” or “recommended” model today is very different from the one designed in the early ‘90s (Tricker, 2000). Third, recent corporate scandals have created a discontinuity in the history of corporate governance and many countries dramatically changed corporate law to strengthen shareholders’ and investors’ rights (Gordon and Roe, 2004).

For each code we collected data on scope, coverage and strictness of recommendations. We use the term “scope” to mean the types of companies considered by the code. Codes of good governance primarily describe practices for publicly traded companies, but some codes extend their principles to non-listed companies as well. We created a dummy variable to measure the scope of each code: 0 only listed companies, 1 otherwise.



We use the term “coverage” to mean the number of principles of good governance covered by each code. Codes have similar contents, but they may also differ in some principles. So we analyzed codes to see if they cover the following items (Gregory and Simmelkjaer, 2002): shareholders’ rights, employees’ role, board meeting and agenda, separation of Chairman and CEO, board composition and independence, board directorship, deontology for directors, conflict of interest, election term/term limits/mandatory retirement, evaluating board performance, directors’ remuneration, remuneration committee, nomination committee and audit committee (see Table 2). We created a dummy variable for each principle: 0 not covered, 1 covered.

(Insert here Table 2)

Finally, we collected detailed notes on the codes’ recommendations regarding the board of directors (i.e. the separation of Chairman and CEO, the board composition and independence, evaluating board performance, the composition of remuneration, nomination, and audit committees). These principles can be considered the core of good governance codes. The strictness of recommendations may vary from objective and strict on the one hand, and vague and loose on the other hand. Subsequent readings of the collected data focused on identifying the differences among codes. After comparing and contrasting data numerous times (Maxwell, 1996), we classified recommendations as (i) “strong” when they contained objectively strong and quantitatively rigid rules, (ii) “semi-strong” when they contained objectively semi-strong and quantitatively rigid rules, (iii) “weak” when they didn’t contain objective and quantitatively rigid rules, but only vague and general ones, and (iv) “not covered” when the topic wasn’t covered by

the code (see Table 3 for the final categorization). We assigned a number to each recommendation: 3 for strong recommendations, 2 for semi-strong, 1 for weak, and 0 for not covered. We also measured the strictness of all codes' recommendations on the board of directors using a variable (i.e. the overall strength of the code) calculated as the number of strong recommendations on boards included in each code.

(Insert here Table 3)

### *Data analysis*

Data analysis of the content of codes followed generic prescriptions for analyzing qualitative data and involved various applications of sorting, organizing and coding data (Lee, 1999). This was done through the use of theoretical memos (Maxwell, 1996).

We started collecting information on the governance systems of countries considered in the study to understand the main peculiarities of national corporate governance systems. We collected information from different sources, such as books and articles presenting or comparing national governance systems (e.g. Charkham, 1994; Gugler, 2001; Hopt et al., 1998; Reynolds and Flores, 1989; etc.). We also analyzed literature on codes (e.g. Aguilera and Cuervo-Cazurra, 2004; Gregory and Simmelkjaer, 2002; etc.) to set up an initial coding scheme.

Then we started coding two codes from each country-origin legal system: the UK and the US code for English origin legal systems, the Norwegian and the Swedish code for Scandinavian origin legal system, the German and the Japanese code for German origin, and the French and the Italian code for France origin. Both scholars rated independently all items. After this test of the coding system, we measured consistency

among coders and we defined coding rules according to the differences encountered. Then the entire coding process has been repeated for all codes of good governance.

Each code was independently analyzed in detail by the researchers and was interpreted on a continual and evolving basis in order to decompose and reduce data (Coffey and Atkinson, 1996). Following the prescription for qualitative research, we analyzed collected data quantitatively using nominal and categorical variables (Marshall and Rossman, 1995). At the end of the independent analysis, we matched the two sets of data and we found a high overlap: only 14 out of 264 measures of the strictness of codes' recommendations were differently coded by researchers. We measured inter-rater reliability using both percent agreement and Cohen's Kappa (e.g. Cohen, 1968; Dewey, 1983). The results of the analysis of inter-rater reliability are high, and above appropriate minimum acceptable level of reliability. The percent agreement equals to .946 and the Cohen's kappa to .929.

Then, we identified the few cases that were the subject of disagreement and we analyzed them to find a solution. We organized a few meetings to discuss disagreed-on cases. Disagreements were mostly caused by misinterpretation of the meaning of codes' recommendations due to differences among national systems of governance. To reconcile disagreements we analyzed in detail the information collected on the national governance systems. Then we read again the code of good governance, and we discussed non-matched cases. The deeper knowledge of countries' governance practices allowed us to reach an agreement without a long discussion.

To compare codes' diffusion, scope, and coverage between common law and civil law legal systems we used t-test for difference-of-means. To examine the recommendations at a board level, we used probit models with the strictness of the

recommendations as a dependent variable, and the country of origin legal system as an independent variable. We also controlled for two country level variables: the log of GDP (2005), measuring the size of the economic system, and the market capitalization as a percentage of the GDP (2005), measuring the relevance of the stock exchange in the national economy. Both country variables were collected from the World Bank's database of World Development Indicators.

## **Results**

### *The diffusion of codes*

The first code included in our sample is the Cadbury code, issued in the UK in 1992. After that time, the diffusion of codes started slowly – until 1998, only 13 countries had issued a code – but accelerated at the end of the decade – 23 countries issued their first code after 2000. Moreover, 95 out of 144 codes developed around the world until 2005 were issued between 2000 and 2005 (see figure 1).

(Insert here Figure 1)

We tested differences between common law and civil law countries in the year of issue of the first code and in the number of codes issued until 2005 using a t-test (see Table 4). Our results show that civil law countries issued codes of good governance later than common law countries. The average distance in years from 1992 is significantly different in the two groups ( $p < .05$ ): 6.4 years for common law countries versus 8.2 years for civil law countries. Moreover, common law countries are more prone to issue codes than civil law countries. The number of codes issued is

significantly different in the two groups ( $p < .05$ ): 5.9 codes for common law countries versus 2.9 codes for civil law countries. Our results support hypothesis 1b and 2b.

(Insert here Table 4)

#### *The scope of codes*

The majority of codes contain recommendations for companies listed on the national stock exchange. However, 20 codes (out of 44) extend their recommendations to include non-listed companies.

We tested differences between common law and civil law countries in the scope of codes using a t-test (see Table 4). Our results show that codes of good governance extend their recommendations to non-listed companies more often in civil law than in common law countries. The mean between the two groups is significantly different ( $p < .05$ ): 0.27 for common law countries compared to 0.55 for civil law countries. Our results support hypothesis 3a.

#### *The coverage of codes*

All codes of good governance contain principles on “board composition and independence” and a large number of codes cover almost all other items; the only exceptions are “employees’ role”, “conflict of interest”, “deontology for directors”, and “board directorships”.

We tested differences between common law and civil law countries in the coverage of codes using a t-test (see Table 5). Our findings show that the mean of the

total number of items covered by common law and civil law codes is not significantly different. Our results support hypothesis 4b.

However, we found significant differences in terms of coverage of single items. Codes covers principles on “separation of Chairman and CEO”, “board directorship”, and “evaluating board performance” more often in common law than in civil law countries. The mean between the two groups is significantly different: “separation of Chairman and CEO” (0.93 versus 0.52;  $p < .01$ ), “board directorship” (0.47 versus 0.24;  $p < .10$ ), “evaluating board performance” (0.67 versus 0.38;  $p < .05$ ).

Furthermore, our results show that codes of good governance cover principles on “shareholder’s rights”, “employees’ role”, and “conflict of interest” more often in civil law than in common law countries. The mean between the two groups is significantly different: “shareholders’ rights” (0.86 versus 0.53;  $p < .01$ ), “employees’ role” (0.21 versus 0;  $p < .05$ ), and “conflict of interest” (0.59 versus 0.27;  $p < .05$ ).

There are not significant differences between codes issued in common law and in civil law countries concerning any other item (i.e. “board meeting and agenda”, “board composition and independence”, “deontology for directors”, “election term/term limits/mandatory retirement”, “directors’ remuneration”, and “board committees”).

(Insert here Table 5)

#### *The strictness of code recommendations*

We have seen that principles related to board of directors (i.e. “separation of Chairman and CEO”, “board composition and independence”, “evaluating board performance”, and all committees) are the core of corporate governance and are traditionally covered

by all codes. So, lastly we investigated if the strictness of these recommendations differs between common law and civil law countries.

Table 6 shows the results of the analysis of the influence of common law systems, market capitalization as percentage of GDP, and log of GDP on the likelihood of the strictness of code recommendations on boards in a given country. The probit models reveal that codes in common law countries are significantly more likely than codes in civil law countries to issue stricter recommendations on the “separation between Chairman and CEO” ( $p < .01$ ) and the “audit committee” ( $p < .05$ ). Furthermore, the results show that codes in common law countries are significantly more likely to issue stricter recommendations on boards of directors than their civil law counterparts ( $p < .01$ ). Our results support hypothesis 5b.

(Insert here Table 6)

## **Discussion**

This study focuses on the diffusion and content of codes of good governance to extend the existing empirical evidence on the topic (Aguilera and Cuervo-Cazurra, 2004; Enrione et al., 2006; Hermes et al., 2006). The article contributes to management and legal studies on codes of good governance providing further knowledge on i) the process of reinvention characterizing the diffusion of new practices; ii) the interplay between hard and soft law in governance practices.

*The process of reinvention in the diffusion of governance codes.* Our results support the view that diffusing practices are usually modified or “reinvented” by adopters (e.g. Rogers, 1995; Tornatzky et al., 1983). Our findings show, in fact, that

there are significant differences between common law and civil law countries as regards the diffusion, scope, coverage and strictness of recommendations of codes.

Both legitimation and efficiency reasons seem to explain the adoption of good governance codes. On the efficiency side, civil law countries extend code recommendations to non-listed companies more often than common law countries do. On the legitimation side, civil law countries adopt codes later, issue a lower number of codes, and state more ambiguous and lenient recommendations<sup>1</sup>. Taken together our results suggest that the issuance of codes in civil law countries is prompted more by legitimation reasons than by the determination to dramatically improve the governance practices of national companies.

Our findings also support the idea that early adopters are driven to change by efficiency reasons, while late adopters are driven to conform to widely-accepted practices (Tolbert and Zucker, 1983). The common law countries as early adopters of codes of good governance provided the legitimacy for innovation; civil law countries as late adopters were then under pressure to implement the reforms for fear of losing legitimacy. In other words, as codes of good governance become institutionalized, their adoption brings legitimation to the adopting countries.

Finally, our findings are consistent with a symbolic perspective on corporate governance (e.g. Westphal and Zajac, 1998). According to this view symbolic actions (i.e. the introduction of new governance practices) can engender significant positive stockholder reactions and deter other more substantive governance reforms. In coherence with a symbolic perspective, our evidence suggest that civil law countries adopt codes of good governance later and issue codes with more lenient recommendations than common law countries do.



*The interplay between hard and soft law in governance practices.* Our results show that codes of good governance issued by common law and civil law countries cover a slightly different range of principles. In particular, codes issued by common law countries more often contain recommendations related to board of directors (e.g. “separation between Chairman and CEO”, “board directorship”, and “evaluating board performance”), while codes issued by civil law countries more often cover principles related to “shareholders’ rights”, “employees’ role”, and “conflict of interest”.

These differences may be explained considering the peculiarities of both governance systems and corporate law. The principle on “employees’ role” is, in fact, covered by codes developed in countries (such as Austria, Germany, Norway, and Sweden) where corporate codes of domestic companies grant employees the right to elect members to the board. On the other hand, the principle on “conflict of interest” is covered more often in countries (such as Austria, Germany, and France) where the ownership structure of domestic companies includes some industrial companies or financial institutions which are both company shareholders and trading partners.

Summing up, our results support the idea that the characteristics of the national corporate governance system and law explain the main differences among the coverage of codes (e.g. Gregory and Simmelkjaer, 2002). This conclusion supports the existence of a strong interplay between hard and soft law, which is manifest in two respects: i) judges use the principles of codes as yardsticks to measure the specific conduct of directors; and ii) often jurisdictions take the content of soft law (e.g. code recommendations) and include it in corporate law (Wymeersch, 2005 and 2006).

Before concluding, we acknowledge that our study has some limitations. First, we classify countries according to their legal origin. The origin of a country’s legal system

is considered a powerful antecedent of investors' rights (La Porta et al., 1998), ownership structure (La Porta et al., 1999), and the size and breadth of capital markets (La Porta et al., 1997). This variable has been used as a proxy of investors' protection in many comparative studies (e.g. Aguilera and Cuervo-Cazurra, 2004). Despite this fact, it has also received some criticism (e.g. Pagano and Volpin, 2005; Roe, 2006; Spamann, 2005). Given the persistence of differences among national governance systems (due to differences in culture, traditional financing options, corporate ownership patterns), future studies should develop a clearer picture of the interplay between hard and soft law at a country level.

Second, we collected and analyzed only the most recent codes in each country. This means that we did not consider the dynamics of governance recommendations over time (e.g. Collier and Zaman, 2005), but focused instead on the governance practices at the end of 2005. This choice may have a bias towards efficiency in those (typically common law) countries with the longest tradition of codes. Future studies should be aimed at extending our conclusions through the analysis of the political process leading to the development of codes, in order to understand the interplay of the forces favoring and contrasting the introduction of codes and stringent code recommendations.

Third, our study did not investigate the process of code enforcement. This may be a limitation, because of the existing differences between common law and civil law legal systems. While the intrinsic characteristics of the former facilitate the enforcement of codes of good governance, in the latter the development of good governance codes does not automatically provide additional mechanisms to protect investors' rights (Cuervo, 2002). The enforcement of governance codes is a complex matter

(Wymeersch, 2005 and 2006) and future studies should be aimed at analyzing the effect of different code enforcement mechanisms on governance practices at a country level.

## **Conclusion**

Our research investigated the reasons behind the adoption of codes of good governance in civil law countries. Evidence from our study show that both efficiency and legitimation reasons explain the codes' diffusion. On the efficiency side, civil law countries extend code recommendations to non-listed companies more often than common law countries do. On the legitimation side, civil law countries adopt codes later, issue a lower number of codes, and state more ambiguous and lenient recommendations. In this sense, our results support the idea that the issuance of codes in civil law countries is prompted more by legitimation reasons than by the determination to improve the governance practices. These findings expand traditional understandings of the diffusion of governance practices and provide further support to the idea that symbolic actions can deter other more substantive governance reforms. Finally, our results support the idea that the characteristics of both the national governance system and the corporate law explain the main differences among issues covered by the codes.

## **Notes**

1. It might be argued that vagueness and generality of civil law codes are needed for the very reason that they cover a broad corporate spectrum, including both listed and non-listed companies. However, we do not consider this to be the case because: i) the “comply or explain” tradition of codes of good governance does not force companies to adhere to codes' recommendations; ii) a detailed analysis of codes content

showed that almost all codes of good governance do not discriminate their recommendations for different types of companies.

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Figure 1. The diffusion of codes of good governance (1992-2005)

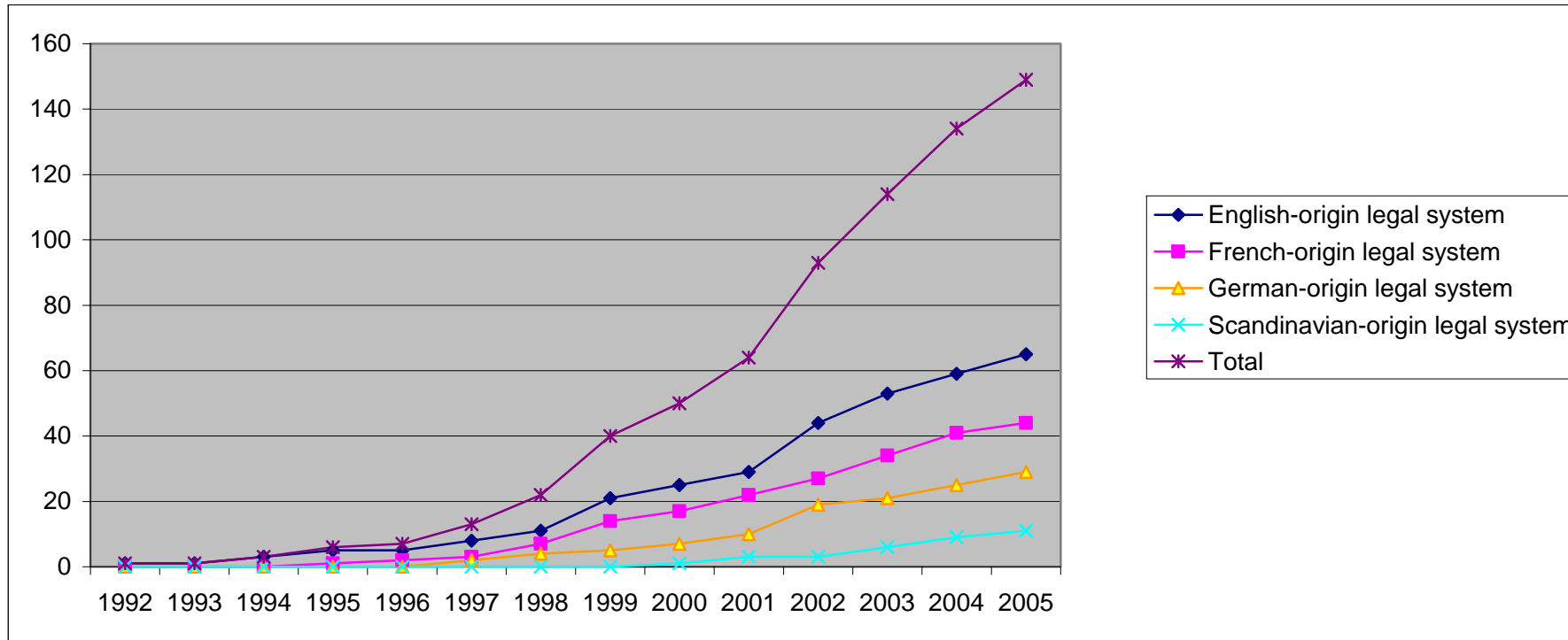


Table 1. Country origin legal system, year and issuer of most recent worldwide codes

Country origin legal system	Year of last code	Issuer of last code	Last code
<b>English</b>			
Cyprus	2002	The Cyprus Stock Exchange	Corporate governance code
Ireland	1999	Irish Association of Investment Managers	Corporate Governance, Share Option and Other Incentive Schemes
Australia	2003	ASX Corporate governance council	Principles of good corporate governance and best practice recommendations
Canada	2002	Toronto Stock Exchange	Corporate governance policy-proposed new disclosure requirement and amended guidelines
Hong Kong	2004	Stock Exchange of Hong Kong	Hong Kong code of corporate governance
India	2000	Securities and exchange board of India	Report of the Kumar Mangalam Birla Committee on corporate governance
Kenya	2002	Private sector of corporate governance trust	Principles of corporate governance
Malaysia	2000	Securities commission Malaysia	Malaysian Code on corporate governance
Pakistan	2002	The securities and exchange commission	Code of corporate governance (revised)
Singapore	2005	Council on corporate disclosure and governance	Code of corporate governance
South Africa	2002	Institute of directors in Southern Africa	King report on corporate governance for South Africa 2002 (King II Report)
New Zealand	2004	Securities Commission	Corporate governance in New Zealand: principles and guidelines
Thailand	2002	Stock Exchange of Thailand	Code of best practice for directors of listed companies
USA	2003	New York Stock Exchange	Final NYSE Corporate governance rules
UK	2003	The Financial Reporting Council	The combined code on corporate governance
<b>French</b>			
Belgium	2004	Corporate governance committee	Belgian corporate governance code
France	2003	Association Française des Entreprises Privées	The corporate governance of listed corporations
Greece	2001	Federation of Greek Industries	Principles of good governance
Brazil	2004	Instituto Brasileiro de governanca corporativa	Code of best practice of corporate governance
Indonesia	2001	The national committee on corporate governance	Code for good corporate governance
Mexico	1999	Mexican Stock Exchange	Codigo de mejores practicas corporativas
Perù	2002	National Supervisory commission of companies and securities	Principios de buen gobierno para las sociedades
Italy	2002	Committee for the corporate governance	Corporate governance code
Malta	2005	Malta Financial Services Authority	Principles of Good Corporate Governance
Portugal	2003	Comissão do Mercado de Valores Mobiliários	Recommendations on Corporate Governance
Spain	2004	Instituto de Consejeros-Administradores	Principles of good corporate governance
Turkey	2003	Capital markets board of Turkey	Corporate governance principles
The Netherlands	2003	Corporate Governance Committee	The Dutch corporate governance code
<b>German</b>			
Austria	2002	Austrian Working Group for Corporate Governance	Austrian code of corporate governance
Czech Republic	2004	Czech Securities Commission	Corporate governance code
Germany	2003	Government Commission German Corporate Governance Code	The Cromme Code
Korea	1999	Committee on corporate governance	Code of best practice for corporate governance
Japan	2004	Tokyo Stock Exchange	Principles of corporate governance for listed companies
Taiwan	2002	Taiwan Stock Exchange	Taiwan corporate governance best-practice principles
Switzerland	2002	Swiss business federation	Swiss code of best practice for corporate governance
Hungary	2002	Budapest Stock Exchange	Corporate governance recommendations
Lithuania	2003	Lithuania stock exchange	The corporate governance code
Poland	2004	The Best Practices Committee of the Warsaw Stock Exchange in association with the Corporate Governance Forum	Best practices in public companies
Slovakia	2002	Bratislava Stock Exchange	Corporate governance code
Slovenia	2005	Ljubljana Stock Exchange, Managers' Association of Slovenia, Association of the Supervisory Board Members of Slovenia	Corporate governance code
<b>Scandinavian</b>			
Denmark	2003	Copenhagen Stock Exchange Committee on Corporate Governance	Report on Corporate governance in Denmark
Finland	2003	HEX Plc, Central Chamber of Commerce of Finland Confederation of Finnish Industry and Employers	Corporate governance recommendation for listed companies
Sweden	2004	The codes group	Swedish code of corporate governance. Report of the code group
Norway	2005	Norwegian Corporate governance Board	The Norwegian Code of Practice for Corporate Governance

Table 2. Items considered in the analysis of codes' coverage

<i>Items</i>	<i>Description</i>
<i>Shareholders' rights</i>	Treatment of shareholders in term of one share/one vote, protection from controlling shareholders' abuse, general meeting participation and proxy voting
<i>Employees' role</i>	Role of employees in corporate governance in term of right to elect some members of the board
<i>Board meeting and agenda</i>	Frequency of board meetings per year and agenda
<i>Separation of Chairman and CEO</i>	Separation between the role of chairman and chief executive officer
<i>Board composition and independence</i>	Board recommendations in term of minimum size, composition, mix of inside and outside directors, qualification, and membership criteria such as experience, personal characteristics, independence, core competencies and availability
<i>Board directorship</i>	Directorship recommendations in term of number and kind of positions that each director should have in other companies
<i>Deontology for directors</i>	Specific director's criteria
<i>Conflict of interest</i>	Non competition obligations and specific principles to avoid conflict of interest for board's members
<i>Election term/term limits/ mandatory retirement</i>	Specific election term criteria such as age, appoint term and re-election term
<i>Evaluating board performance</i>	Boards evaluation procedures
<i>Directors' remuneration</i>	A specific set of remuneration principles for directors both executive and non-executive and managers in term of shares, share-price incentives, share option schemes and limit to vest shares and to exercise options
<i>Remuneration committee</i>	A specific set of criteria about roles, size, composition, membership criteria such as experience, personal characteristics, independence, core competencies and availability, and schemes of remuneration
<i>Nomination committee</i>	A specific set of criteria about roles, size, composition, and membership criteria such as experience, personal characteristics, independence, core competencies and availability
<i>Audit committee</i>	A specific set of criteria about roles, size, composition, and membership criteria such as experience, personal characteristics, independence, core competencies and availability



Table 3. Classification of codes' recommendations on board of directors

<i>Description</i>	<i>Definition</i>
<i>Separation of Chairman and CEO</i>	<ul style="list-style-type: none"> <li>• Strong: separation between Chairman and CEO, in case of CEO duality appointment of a lead independent director or public disclosure of the reasons behind the choice</li> <li>• Semi-strong: separation between Chairman's and CEO's roles</li> <li>• Weak: not objective and quantitative rigid rules but only general recommendations about the relationship between Chairman and CEO</li> </ul>
<i>Board composition and independence</i>	<ul style="list-style-type: none"> <li>• Strong: the majority of board members should be independent non-executive directors</li> <li>• Semi-strong: less than half, but at least one-third of board members should be independent non-executive directors</li> <li>• Weak: less than one-third of board members should be non-executive directors and not all of them should be independent; not objective and quantitative rigid rules but only general recommendations</li> </ul>
<i>Evaluating board performance</i>	<ul style="list-style-type: none"> <li>• Strong: self evaluation at least once a year</li> <li>• Semi-strong: self evaluation less than once a year</li> <li>• Weak: not objective and quantitative rigid rules, but only general recommendations</li> </ul>
<i>Remuneration committee</i>	<ul style="list-style-type: none"> <li>• Strong: all members should be independent non-executive directors</li> <li>• Semi-strong: all members should be non-executive directors, and the majority of them should be independent</li> <li>• Weak: less than the majority of its members should be independent; not objective and quantitative rigid rules (i.e. the board should establish a remuneration committee)</li> </ul>
<i>Nomination committee</i>	<ul style="list-style-type: none"> <li>• Strong: all members should be non-executive directors, and at least the majority of them should be independent</li> <li>• Semi-strong: less than the majority of its members should be independent non-executive directors, and separation between the chairman of the committee and the chairman of the board</li> <li>• Weak: not independence recommendations, not objective and quantitative rigid rules but only general recommendations (i.e. the board should establish a nomination committee)</li> </ul>
<i>Audit committee</i>	<ul style="list-style-type: none"> <li>• Strong: at least the majority of members and the chairman should be independent non-executive directors</li> <li>• Semi-strong: all members should be non-executive directors, and the majority of them should be independent</li> <li>• Weak: less than the majority of its members should be independent non-executive directors, not objective and quantitative rigid rules but only general recommendations (i.e. the board should establish an audit committee)</li> </ul>

Table 4. T-tests for difference-of-means on diffusion and scope of codes of good governance

	Common law countries	Civil law countries
Years of distance of first code	6.4* (.88)	8.2 (.44)
Number of codes issued	5.86* (2.0)	2.89 (.38)
Code's scope	0.27* (.12)	0.55 (.09)
Number of observations	15	29

†  $p < .10$ ; \*  $p < .05$ ; \*\*  $p < .01$ ; \*\*\*  $p < .001$ . Standard error in parentheses.

Table 5. T-tests for difference-of-means on the coverage of good governance codes

	Common law countries	Civil law countries
Shareholder's rights	0.53** (.13)	0.86 (.06)
Employee's role	0* (0)	0.21 (.08)
Board meeting and agenda	0.73 (.12)	0.79 (.08)
Separation of Chairman and CEO	0.93** (.07)	0.52 (.09)
Board composition and independence	1 (0)	1 (0)
Board directorship	0.47 <sup>†</sup> (.13)	0.24 (.08)
Conflict of interest	0.27* (.12)	0.59 (.09)
Deontology for director's	0 (0)	0.07 (.05)
Election term/term limits/mandatory retirement	0.6 (.13)	0.48 (.09)
Evaluating board performance	0.67* (.13)	0.38 (.09)
Remuneration	1 (0)	0.90 (.06)
Remuneration committee	0.87 (.09)	0.90 (.06)
Nomination committee	0.87 (.09)	0.79 (.08)
Audit committee	1 (0)	0.93 (.05)
All items	8.93 (.34)	8.72 (.39)
Number of observations	15	29

<sup>†</sup>  $p < .10$ ; \*  $p < .05$ ; \*\*  $p < .01$ ; \*\*\*  $p < .001$ . Standard error in parentheses.

Table 6. Probit models on the strictness of recommendations of codes of good governance

	<i>Separation of chairman and CEO</i>	<i>Board composition and independence</i>	<i>Evaluating board performance</i>	<i>Remuneration Committee</i>	<i>Nomination committee</i>	<i>Audit committee</i>	<i>Overall strength</i>
<i>Common law countries</i>	1.231** (0.418)	0.094 (0.401)	0.644 (0.400)	0.044 (0.366)	0.495 (0.395)	1.057* (0.422)	0.966** (0.369)
<i>Market capitalization % GDP</i>	0.001 (0.002)	0.00 (0.002)	-0.00 (0.002)	0.002 (0.002)	0.006 (0.004)	0.004 (0.003)	0.001 (0.002)
<i>Log GDP</i>	-0.264* (0.126)	0.207 <sup>†</sup> (0.124)	0.179 (0.129)	0.057 (0.109)	-0.014 (0.119)	0.242 <sup>†</sup> (0.128)	0.085 (0.107)
<i>Log likelihood</i>	-47.745	-46.221	-47.439	-53.067	-50.133	-43.593	-73.70
<i>LR <math>\chi^2</math></i>	15.56**	2.98	4.52	1.51	7.10 <sup>†</sup>	16.22***	9.24*
<i>Pseudo R<sup>2</sup></i>	0.140	0.031	0.045	0.014	0.066	0.156	0.059
<i>Number of observations</i>	44	44	44	44	44	44	44

<sup>†</sup>  $p < .10$ ; \*  $p < .05$ ; \*\*  $p < .01$ ; \*\*\*  $p < .001$ . Standard error in parentheses.