ABSTRACT

In the aftermath of the recent US corporate scandals a lively debate has emerged regarding the relative merits of the "principles" and the "rules" based approaches to corporate governance. I examine the relevance of this debate for the effectiveness of a corporate governance structure. JEL Classification: Corporate Governance-Finance-and-Governance; - General (G300)

"Rules" Versus "Principles"

The Search For Transparency In Corporate Governance

Dr. Rajeeva Sinha

INTRODUCTION

Two distinct approaches to corporate governance reform can be observed in the literature. In the first approach broadly referred to as "rules" based corporate governance requirements in the corporate governance structure and disclosure standards are mandated that can be observed by outsiders as indicators of good or bad corporate governance. In these measures there is a significant downplaying of the value of communication from a corporate board regarding its corporate governance practices. For example, the *Sarbanes-Oxley Act*, passed by the US Congress earlier, incorporates several measures aimed at public accounting reform and investor protection. It will serve as a check list of all things that the top management is expected to do as a signal of good corporate governance practice[1]. As opposed to a "rules" based approach

[1] For information on recent "rules" based initiatives in the US and in particular the report of the Corporate Accountability and Listing Standards Committee on corporate governance in the New York Stock Exchange visit http://www.nyse.com/about/report.html

to corporate governance, there is a contending viewpoint in support of what has been termed as a "principles" based approach to corporate governance. In the "principles" based approach, companies have the freedom to choose between various alternatives and structures in corporate governance. The board is expected to explain any departure from expected norms and practices. There is value attached to communication and deliberation between shareholders and managers in this approach to corporate governance. The approach does not obviate the need for standards in the corporate governance structure. However, it is flexible in its interpretation of deviations from the standard. This interpretation is dependent on communication between shareholders and managers. Examples of such approaches to corporate governance are the recommendations of the Hampel Committee (1992) report in the United Kingdom[2].

The pressure for a "rules" based corporate governance system has increased as shares of some of the larger companies are listed and traded in a number of countries. This has led to demands for harmonization of corporate governance standards. In this era of globalization large companies with listings in a number of countries would prefer to deal with a uniform set of standards rather than coping with a variety of corporate governance regimes. Given the pre-eminence of the US capital markets there is a natural preference for the harmonization of corporate governance requirements in different countries with the corporate governance listing requirements of the New York Stock exchange[3]. There is also a strong belief held by large investors that a "rules" based approach will lead
corporate governance[4].

There is increasing disquiet that the pendulum
to the other extreme in terms of prescriptive "ru
corporate governance. Sonnenfield (2002) artic
view of corporate governance in a recent art
Harvard Business Review. I quote:

"We will be fighting the wrong wars if we simply
rules for the boards and ignore their more pressi
be strong, high functioning work groups whos
trust each other challenge one another and eng
with senior managers on critical issu
corporations" (Sonnenfield 2002, p.106)

Supporters of the "principles" based approach
the *Sarbanes-Oxley Act* and similar legislatio
countries will in effect impose a set of legislate
for corporate governance. This has the dange
the corporate governance ethos into a st
limiting the aspirational aspect. There w
motivation left to go beyond the minimum requ
the rules. On the contrary, an attempt would
search for loopholes. There is a real danger th
encourage a value system that if there is no rule
an action then it is not illegal and hence ac

OBJECTIVE & MOTIVATION

In this paper I propose that the goal of good
governance cannot be achieved by structural re
but by considering the broader theoreti
underpinning corporate governance. Structu
have to be evaluated in the context of th
controversy regarding the role of "rules" versus '
in corporate governance. In this article I will sh

[2] Over the last couple of decades several committees and working groups have explored issues relating to corporate governance in the United Kingdom. The work of two committees,
Committee (Cadbury, 1992) and the Hampel Committee (Hampel, 1998) is of relevance to our discussion here. There is a notable difference in the emphasis of the recommendations o
committee in comparison to the recommendations of the Cadbury Committee. The Hampel Committee pleaded for a case by case approach to corporate governance as opposed to the
of board characteristics like the percentage of independent directors, separation of the posts of chairman and the CEO, etc., as requirements for good governance. The Cadbury Comm
statements by directors and auditors on the effectiveness of internal controls, reduced the element of discretion which corporations can exercise on corporate governance (Section 4.5 o
Committee Report; Cadbury, 1992) Hampel Committee in its report was less inclined to accept such requirements and certification by the directors and auditors (Section 6.12 of the Ha
Report).

The Hampel Committee took a critical view of a 'tick in the box' approach adopted in the implementation of the recommendations of the Cadbury Committee. The Hampel C
recommended that shareholders should take into account '...the diversity of circumstances and experience among companies,' in their interpretation of matters relating to corporate go
1.13). The Committee argued that good governance needs to be agreed between companies and their shareholders on a case-by-case basis, 'shareholders and others should show flexi
interpretation of the code and should listen to directors' explanations and judge them on their merit ...' (Section 1.11).

[3] For example, the chairman of the Ontario Securities Commission in Canada, in a recent public lecture commented that ".....it makes sense to harmonize with the US iniatives unless t
reasons for not doing so."

[4] The Toronto's 'Globe and Mail's' Report on Business team ran an excellent set of reports on the state of corporate governance in Canada. Pronouncements by prominent institutional
Canada like the Ontario Teachers Pension Plan Board suggest that there is strong support for a "rules" based approach to corporate governance. See Globe and Mail October 7 11, 200

[5] The implications of a "rules" based approach is illustrated by the controversy surrounding the compensation package of the New York Stock exchange (NYSE) Chief Mr. Richa
led to his subsequent resignation. Post-Enron the NYSE has taken a very proactive approach towards corporate governance by trying to embed good corporate gover
the listing requirements in the companies' listing requirements (see the website in footnote 1). Mr. Richard Grasso did not break any rules when he awarded himself a
package of 140 million (reportedly greater than the net earnings of the NYSE - a non-profit organization). It was the manner the compensation packages were being de
the investors. The reaction to this one more episode in the corporate governance breakdown has been typical. On the one hand there is an acknowledgement that we a
needs to be rectified, while on the other there is a rush to introduce some more structural reforms in the corporate governance framework. Consider the following abs
BBC website reporting on this NYSE controversy:

- "It has to be fixed. There is obviously something wrong," said David E. Robbins, a former director of compliance for the American Stock Exchange.
- "It's not just the payment to the chairman and the CEO. It's the way they regulate themselves and serve their members."
- Measures under consideration include splitting the NYSE's chief executive and chairman's roles, and ditching its regulatory role altogether.
(Http://news.bbc.co.uk/2/hi/business/3122508.stm)

"principles" approach is a logical and superior view of corporate governance as opposed to a "rules" based approach. Given the scope of the agency problem between shareholders and managers, incentive structures have to be designed such that managers promote shareholder value. The difficulty in the design of these incentive structures is that the contracts between managers are not complete. The relationship between shareholders and managers are characterised by incomplete contracts (Hart, 1995). There are three reasons why the contracts between shareholders and managers will be incomplete:

a. Cost of thinking and planning all the different eventualities
b. Cost of negotiation
c. Cost of writing down the contract

Incomplete contracts between managers and shareholders require the use of corporate governance mechanism to bridge the gaps in contracts. The mechanism comprising the corporate governance structure provides the institutional basis for the interpretation of the unspecified component of the contract. These are the channels for communication of the expectations and obligations of the shareholders and the managers on a continuing basis.

WHY DO WE NEED CORPORATE GOVERNANCE?

Installing corporate governance mechanisms like the board or insisting on its structural characteristics like the separation of the posts of the chairman and the CEO may not be enough to ensure communication required for the interpretation of the incomplete contracts between shareholders and managers. There should be a willingness to communicate and engage in deliberation between shareholders and managers. Communication and deliberation will not take place if the framework for corporate governance is based on "rules" and listing requirements, the mere satisfaction of which is indicative of good governance. If the managers do not perceive any value attached to deliberation and communication in investor relations the quality of communication and deliberation will be poor. If satisfying the requirements necessitated by the "rules" is a signal of good corporate governance then there will be attempts to distort and doctor information so that requirements of the "rules" are met.

This may have been a major factor that led to the recent spate of corporate scandals. Dishonesty of top level CEOs or auditors in the recent past is a symptom not the cause. Too much was at stake in conforming to "rules" like 'high share prices' and too little was to be gained and possibly a lot to loose (in the form of poor value of executive stock options) in being honest about performance and prospects for the companies in their charge. The shareholders had simple 'rules' like the granting of executive stock options to align the managerial objective function with the shareholder objective of wealth maximization. Similarly, it may not be enough to have a separation of the posts of CEO and the Chair of a corporate board. This separation may be a good standard for corporate governance but this does not automatically guarantee good corporate governance if in the interpretation of managerial performance, poor value is attached to communication and deliberation.

'Culture of dissent and a climate of trust and candor' - how to make it happen?

Sonnenfeld (2002) in his paper is in effect arguing for the need to view corporate governance as a process. He lists a number of standards like board member age, board size, etc. for bringing about 'a culture of dissent' and creating a 'climate of trust and candor'. To be able to develop a corporate governance framework that recognises it as a process and not a mere requirement that has to be met in terms of its structural characteristics, a distinction has to be made between two types of rationality - 'procedural' and 'substantive' (Simon, 1976:130-32).

Behaviour is substantially rational when it is appropriate to the achievement of given goals within the limits imposed by given conditions and constraints. The implicit assumption in the use of substantive rationality is that there is sufficient information available regarding the characteristics of the environment and the goal of decision making. In the corporate governance context substantive rationality is translated into goals like an efficient (low cost) corporate governance structures and shareholder wealth maximisation. Tools like stock options or the market for corporate control contribute to the efficiency of corporate governance structures as they minimise the costs of information production, assimilation and renegotiation of contracts. Behaviour is procedurally rational when it is the outcome of appropriate deliberation. Procedural rationality is usually studied in problem situations in which the subject must gather information of various kinds and process it in different ways in order to arrive at a reasonable course of action, a solution to the problem. Simon [1976] notes that procedural rationality is appropriate when the task is non trivial, that is a substantially rational response is not instantly obvious. Procedural rationality will involve identification of processes that promote mechanisms of learning and knowledge production and also accounts for the motivations of shareholders and managers in the production, assimilation of information and the renegotiation of contracts. In corporate governance because of incomplete contracts in shareholder management relations the basis for corporate governance design should be procedural rationality and not substantive rationality.

A corporate governance framework based on procedural rationality will require deliberation that is communication between shareholders and managers. Facilitating communication between shareholders and managers is a challenge because of the unorthodox location of shareholders in the organizational space. In the information processing perspective the firm is an organization that collects analyses and distributes information as a public good within the firm. Shareholders have a claim over this information as it affects the value of

the corporate assets they own. However, shareholders are located outside the boundary of the firm as subscribers to the firm's equity capital that are traded freely in the stock market. The challenge is to design communication protocols that allow for information publicly available within the boundaries of the firm to cross over and become available to shareholders without compromising the value of the firm's future cash flow and the shareholders right to trade in the firm's equity. The communication protocol will have to ensure that it is cost effective, not susceptible to 'influence activities' and non-discriminatory in its availability to all subscribers of the firm's equity capital. Such a communication protocol will require a decision on the mix, periodicity and intensity of exchange of information.

Communication between shareholders and managers can be of two types, viz., structured and unstructured. Examples of structured information flows are company financial reports. Unstructured information exchange can be through general body meetings of shareholders, board meetings, board committees, social exchanges, professional gatherings and the internet. Unstructured information exchange between shareholders and managers is termed as deliberation. Structured communication will be through what Kreps (1988) refers to as 'focal points' such as financial performance indicators or standards in corporate governance that have been identified in advance. An example of a 'focal point' is the requirement that posts of chairman and the CEO should not be held by the posts of the CEO and chairman of the board. The form of communication is standardised and simplified to be universally understood and is independent of firm specific norms and practices (Kreps, 1988). Unstructured communication on the other hand, will be informal and not in a predetermined form. It will comprise idiosyncratic information about organisation specific norms or what Keeps (1988) refers to as organisational 'culture'. A requirement for procedural rationality between shareholders and managers will be that their communication should not be limited to "focal" points or "rules" based information but also encompass unstructured information exchanges as envisaged in a "principles" based approaches to corporate governance.

From the discussion so far we can draw the following inferences:

A. The contracts between shareholders and managers are incomplete
B. Corporate governance mechanisms are required to bridge the gap in incomplete contracts
C. Procedural rationality should be the basis of the working of these corporate governance mechanisms because of incomplete contracts, as opposed to substantive rationality
D. Procedural rationality requires the use deliberation and exchange of unstructured information to bridge the gaps in the incomplete contracts between shareholders.
E. Deliberation and exchange of unstructured information will not take place or will be of a poor q[illegible] a "rules" based approach to corporate goverr ance[illegible] exchange can only take place in a "principles" [illegible] approach to corporate governance.

Needed: An effective communication prot[illegible]

From the standpoint of procedural rationality, g[illegible] incomplete contracts, a communication protoc[illegible] required between shareholders and manag[illegible] protocol should satisfy some attributes to e[illegible] effectiveness. These attributes are:

A. There should be scope and value atta[illegible] unstructured communication or deliberatior[illegible]
B. Structured communication should be usec[illegible] alarms'
C. The protocol should account for the scope of 'i[illegible] activities' in the flow of communication
D. Communication flows specifically unstructur[illegible] communication should be 'non-discrim[illegible] between small and large shareholders.

Deliberation

Deliberation is important in the context of the in[illegible] contract between shareholders and managers. [illegible] deliberation is a cognitive pro ess in which the [illegible] maker engages as the decision is framed, as goals a[illegible] are adopted or rejected, and as implement[illegible] monitored, and plans and goals are retained or re[illegible] light of progress. This conception of learning iden[illegible] sources of deliberation as the decision-mak[illegible] knowledge of the organisation; suggestions of [illegible] persons, examples offered by outsiders, and exist[illegible] and regulations (Beach, Mitchell, Palucowski & [illegible] 1992 p.184). With deliberation, managers will ha[illegible] information on the mixed and variable motives [illegible] shareholders. A decision-making environment b[illegible] unstructured information exchange will not onl[illegible] the agency problem but also improve the q[illegible] decisions, as it will provide the basis for volun[illegible] operation. Voluntary co-operation implies going [illegible] the call of duty, wherein individuals exert effort, en[illegible] initiative to the best of their abilities on beha[illegible] organisation (Kim & Maurborgne 1998 p.323). [illegible] operative behaviour is important in the co[illegible] incomplete contracts between shareholders and m[illegible] Deliberation between shareholders and mana[illegible] promote the 'feeling of entity' and reduce the s[illegible] opportunistic behaviour.

Fire Alarms

Company accounts have been the traditional st[illegible] channel of communication used by managers [illegible] strategic co-operation with shareholders. Such [illegible] information have to be simple and standardise[illegible] understood and interpreted by all concerne[illegible] standardised information are termed as 'focal [illegible] (Kreps, 1988). There are two possible uses of 'focal p[illegible]

the shareholders if they are not ignored. Shareholders can use 'focal points' for an arms length sale and purchase of shares, or they could be used as 'fire alarms'. It is not advisable to ignore focal points. The gathering and communication of information serves a ritualistic purpose indicating to the contracting parties that proper attitude about decision-making exists (Feldman & March, 1981). Information is not simply a basis for action but a representation of competence. Thus, the gathering of simple and universal information is a reflection of credible decisions and will contribute positively towards perceptions of procedural rationality.

The use of 'focal points' as 'triggers' to buy and sell ownership will be contrary to the requirements of procedural rationality. Shareholders will in effect adopt a dominant strategy. There is no reciprocity in the exchange of messages. Shareholders will not need to communicate with managers except in the form of sale and purchase of shares. This leads to greater ambiguity as shareholders have mixed and varying motives for sale and purchase of shares. Such use of focal points will lead to a strong perception of unfairness and a lack of faith in the authority of the shareholder. This will induce opportunism and exacerbate the agency problem between shareholders and managers.

Empirical studies on the relative significance of financial (structured) and non-financial (unstructured) information show that the use of the former alone leads to undervaluation of company securities. Healy and Palepu (1995) examined investor communication in the case of a marketing firm and found that it was difficult to convince investors only through financial reports. Investor communication through financial reports led to stock mis-valuation over an extended period. Amir and Lev (1996) in a study of the wireless communication industry found that on stand-alone basis financial information are largely irrelevant for the valuation of cellular companies. However when this information is combined with non-financial information the financial information contributes to the explanation of stock prices.

The downside of the use of unstructured information or deliberation is that it is a costly exercise. On a continuous scale, deliberation is defined as the flow, assimilation and evaluation of unstructured information and can increase from no exchange to high intensity exchange. However, high intensity deliberation cannot be sustained for long. It could amount to the replication of all managerial functions. A cost-effective alternative will be the use of focal points as 'fire alarms' as signals for initiating high intensity deliberation. If 'focal points' or structured information indicate poor performance then this would be a signal for an increase in the intensity of deliberation or unstructured communication.

However, low-level continuous deliberation has to be a feature of shareholder management relations. Given incomplete contracts, the characteristics of the messages and their interpretation cannot be identified in advance. The shareholders will need to gather information that may not have any immediate consequences. The varying and implicit nature of expectations and obligations imply that there is a need to scan the environment for gathering what is termed as 'gossip' (Feldman and March,1981). Focal points can function as 'fire alarms' only when shareholders have some deliberation on a continuous basis. The level of these deliberations need not be intensive but there is a need for continuous communication.

A low-key continuous deliberation also helps in a quick response to 'fire-alarms'. Outside intervention at the board level can be quickly effected and will have a steep learning curve if there is a 'live' database available as a result of continuous low key deliberation. Therefore, the framework for information exchange proposed is one of the low key continuous deliberation with financial information as 'fire alarms' signalling the need for more intensive deliberation.

Influence Activities

There is also the issue of reliability of information. Even if we set aside the recent dramatic instances of top management malfeasance there is evidence that financial reporting will be susceptible to what Milgrom & Roberts. (1988) term 'influence activities'. Most information is not innocent and suffers from misrepresentation as it is gathered and communicated in the context of conflict of interest and with consciousness of decision consequences. Dechow, Sloan & Sweeny (1995), provide evidence on the manipulation of earnings information by managers with the objective of inducing shareholders to take decisions favourable to managers. Studies also show managerial bias for investments and mergers and acquisitions that enhance the significance of the incumbent management team (Amihud & Lev, 1981; Shleifer & Vishny, 1989; Stiglitz & Edlin, 1992).

Deliberation or unstructured communication will have a role in minimising the scope for 'influence activities'. The gathering and communication of information serves a ritualistic purpose indicating to the contracting parties that proper attitude about decision-making exists (Feldman & March, 1981). Information is not simply a basis for action but a representation of competence. This will have a deterrent effect on the possible use of 'influence activities' in the communication of structured information.

Similarly, non-financial communication can also be susceptible to 'influence activities'. Financial information has an important role to play in the credibility of non-financial disclosure. There can be validation of prior voluntary non-financial disclosures through required financial reporting of actual realizations (Healy and Palepu 2001 Hutton Miller & Skinner 2000) also report that good news forecasts are only informative for valuation purposes if they are accompanied by verifiable forward looking statements.

Non-Discriminatory Communication

It is now well documented that the ultimate corporate ownership around the world is highly concentrated and in

many countries is controlled by families (La Porta et al, 1999, Claessens et al 2000 and Faccio et al 2002). As a consequence it is feared that large shareholders will use the corporate assets of the firm to generate private benefits that are not shared by minority shareholders (Shleifer and Vishny 1997). It is therefore important that the communication protocol account for the possibility that minority shareholders may be disadvantaged in their access to unstructured communication. Reporting requirements for structured information have been the subject of regulatory concern. Similarly, regulators should focus on communication protocols for the flow of unstructured information. The regulators should actively examine the potential of the IT frontier for the design of such protocols. The internet can serve as an effective tool for ensuring access. The internet holds the promise of a tremendous resource in the flow and cross validation of financial and non-financial information between shareholders and managers. A good example of similar low key continuous communication is the use of e-mail alerts by publishers regarding their publications and journal contents.

Ball in the institutional investors' court - agents watching agents

Procedural rationality requires unstructured communication between shareholders and managers in a "principles" based approach to corporate governance. The vision of a corporate governance framework that emerges from this analysis is one where corporate governance standards are laid out and any departures from governance standards become the subject of dialogue between shareholders and top management. Large block shareholders, typically institutional shareholders and pension funds will have the primary responsibility and incentive to engage top management. Studies show that institutional investors and large outside block shareholders can be monitored and shall improve firm performance (Holderness and Sheehan, 2000; Woidtke, 2001). However, these institutional may have their own agency conflicts or conflicts with other shareholders particularly minority shareholders. Existing laws on insider trading and disclosure may also come in the way of effective unstructured communication between institutional investors and shareholders.

THE INTERNET AND DELIBERATION

There is a growing realisation of the potential represented by the internet as a communication tool in corporate governance[6]. The Sarbanes-Oxley Act has several provisions regarding auditing, reporting and record retention that will encourage the use of information technology and specialist reporting tools like the XBRL (extensible business reporting language). The Act will reduce the cycles for data collection, validation and analysis. However, the measures in the Act cannot be considered as a communication protocol that would encourage the flow of information between shareholders and managers. The focus of the Act is on the availability of authentic and timely structured information. It does not provide for the potential use of Inte deliberation.

Reform of information disclosure policy cannot bee if it continues to focus only on structured or stand information. Studies cited in the secti communication protocol have clearly demonstra value and interdependence of financial and non-fir information in valuation. Information disclosure has to take on the board the potential for unstru communication that has been demonstrated by cha and web based proxy voting. At present there a provisions to regulate the use of these chat rooms solicitation of proxy votes. Often the use of Inter corporate governance purposes becomes the sub litigation as they are seen to contravene legi designed for in- person face-to face communication times to perpetrate misinformation. Examples potential that Internet represents for inc deliberation between shareholders and with manag are the chat rooms of institutional investors like Ca and AFL-CFO. These websites offer the minority inve platform to exercise their proxy votes and to expres views on important corporate governance issues executive compensation. Thus the Internet could tu fact of concentrated institutional ownership into a m place where major institutional investors could co for proxy motions and attention for their view important corporate governance issues concernin companies in which they have stakes.

CONCLUSION

The analysis presented in this paper demonstrates the for a shift in the focus of corporate governance reform a principal agent incentive based paradigm that is ins by a preoccupation with substantive rationality paradigm that views corporate governance as a proces draws its recommendations from consideratio procedural rationality. The agenda for investigation reform in corporate governance should be to identif conditions that will promote the willingnes shareholders (primarily institutions and high net w individuals or HNWI) and managers to participate in process of deliberation and exchange of information use of Internet as a tool for communication should als promoted in shareholder management relations. In light three issues need to be examined and have to b focus of reform measures to promote effective corpo governance:

A. What are the agency conflicts and incentive struct of the money management industry?
B. What are the potential incentive conflicts betw large institutional block holders/mutual funds and minority shareholders/individual investors?
C. How can laws on insider trading disclosure reflec realities of modern (institutional/HNWI) corpo ownership and Internet as a communication tool?

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