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Review

A Review on administrative requirement, corporate administration and business sector responses

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The past decades witnessed the massive growth of literature on corporate governance. Various perspectives of corporate governance mechanisms were widely documented. However, studies on corporate governance from the regulatory perspective receive relatively little attention. Majority review papers focus largely on internal and external corporate governance mechanism literatures. This paper intends to give an overview on the literatures on the second generation of corporate governance research as suggested by Denis and McConnell. Literatures on legal and regulatory mechanism are reviewed. In addition, this paper highlighted the roles and importance of regulatory investor protection, regulatory enforcement and compliance behavior. The consequences of corporate misconduct and stock market reactions followed by identification of research gap and suggestions for future research are discussed.

Key words: Corporate governance, regulatory enforcement, market reaction, agency problem.

INTRODUCTION

The Asian Financial Crisis in 1997/1998 followed by a series of high profile corporate collapses in the last decades has spawned much interest and research in corporate governance. Numerous researches have emerged to investigate the role of corporate governance in mitigating the conflict of interest resulted from separation of ownership and control in agent-principal relationship.

According to Jensen and Meckling (1976), agency theory describes a principal-agent relationship between shareholders and management, where managers act as agents for shareholders to manage the daily operations of the company. A firm can thus be seen as a contract relationship established between the shareholders and manager. Based on the theory, managers are driven by self-interest and opportunistic behavior and would generally seek to maximize their own benefits such as consumption of excessive perquisite. This line of reasoning stems not only from separation of ownership but also the presence of asymmetry information and moral hazard. Managers' personal interests thus do not naturally align with the shareholders' interest. The conflict of interest is termed as "agency problem" (Jensen and Meckling, 1976).

Fama and Jensen (1983) propose that firms need a system that can separate decision management from decision control. Adoption of governance mechanisms to align manager and shareholder interests is essential to curb the conflict. However, costs associated with resolving these conflicts would arise (Eisenhardt, 1989; Jensen and Meckling, 1976). Jensen and Meckling (1976) suggested that monitoring and oversight of management by the board can alleviate agency problem by countering the agent's propensity to engage in opportunistic activities. In another words, shareholders must be able to control the top management. Governance mechanisms such as board size (Cheng et al., 2008; Del Guercio et al., 2003; Jensen, 1993; Yermack, 1996), role duality (Baliga et al., 1996; Brickley et al., 1997; Core et al., 1999; Elsayed, 2007; Rechner and Dalton, 1991), audit com-mittee presence (Carcello and Neal, 2000; Klein, 2002; Rezaee et al., 2003; Xie et al., 2003) and ownership structure (Chen et al., 2006; Chen, 2001; Darren, 2010;

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Singh and Davidson, 2003; Xu and Wang, 1999) have been identified in academic literatures as potential means to mitigate agency problem.

Corporate governance may be seen as such a system in mitigating agency problem between managers and shareholders. It is also widely documented that governance practices limit a manager's ability to deviate from investors' interest. Fama and Jensen (1983), Williamson (1988) and Shleifer and Vishny (1997) contend that the managerial opportunistic behavior can be constrained by corporate governance mechanisms. Jensen (1993) categorized corporate governance mechanism into four groups (Denis, 2001). As listed in Denis (2001), they are legal and regulatory mechanisms; internal control mechanisms; external control corporate governance mechanisms and; product market competition.

Recent years has seen the growth of literature on corporate governance. Various perspective of corporate governance mechanisms were studied however, majority focused largely on internal and external corporate governance mechanism. Studies on the relationship between internal corporate governance mechanism and its impact on firm's performance and valuation are vast. Agency problem is expected to be reduced via governance mechanism thus firms with better governance should have higher valuation (Bai et al., 2004; Beiner et al., 2006; Brown and Caylor, 2006). Recent empirical evidence finds that better governance enables firms to have lower cost of capital (Bradley and Chen, 2011; Byun et al., 2008; Chen et al., 2009), improved liquidity (Chung et al., 2010), and higher stock valuation (Gompers et al., 2003). Several other studies focus on the association between corporate governance mechanisms and firm performance (Bauer et al., 2008; Bhagat and Bolton, 2008; Coles et al., 2001; Mashayekhi and Bazaz, 2008; Sami et al., 2011).

With the massive growth of studies on corporate governance, review on related literature is not new. One of the recent reviews done by Brown et al. (2011) highlighted several prominent corporate governance review papers which cover various issues on corporate governance (Bebchuk and Weisbach, 2010; Bushman and Smith, 2001; Claessens and Fan, 2002; Denis and McConnell, 2003; Gillan, 2006; Shleifer and Vishny, 1997). In addition, Young et al. (2008) investigate principal–principal conflicts in emerging economies while Letza et al. (2004) presented a comprehensive review on major current theories on corporate governance.

As highlighted by Denis (2001), legal and regulatory mechanism is the most basic corporate governance mechanism. However, it received relatively little attention in corporate governance field. The study on the association between corporate governance and regulations gained gradual prominence in recent years. Some notable researches such as La Porta et al. (1998, 2000), Shleifer and Vishny (1997), Denis and McConnell (2003) and Gillan (2006) highlighted and reviewed related literatures on the role and importance of regulatory and legal system with relation to corporate governance. Denis and McConnell (2003) did a comprehensive review on literature on corporate governance. They reviewed and divided corporate governance literatures into two generations. The first generation researches focus mainly on internal governance mechanism (for example, board characteristics, executive compensation, ownership structure, etc.) while the second generation corporate governance research takes into account the influence of legal system, investor protection and with focus on external governance mechanism.

This paper focuses mainly on the second generation corporate governance research, where legal and regulatory mechanisms are reviewed. Unlike Denis and McConnell (2003), this paper intends to give a review on the role of regulatory enforcement on corporate governance which was not widely reviewed previously. The roles and importance of investor protection, regulatory enforcement and compliance behavior will be discussed subsequently. Literatures on consequences from corporate misconduct and stock market reactions are reviewed. Finally, some thoughts on the potential research gap, suggestions on future research directions and conclusions are provided.

REGULATORY ENFORCEMENT

Enforcement roles and importance

Regulation is aimed at improving market efficiency and well- functioned securities market. Strong securities law and investor protection helps instill confidence in the stock market. However, empirical studies show that regulations without proper enforcement will be in vain.

Investor protection is defined as "the extent of the laws that protect investors' rights and the strength of the legal institutions that facilitate law enforcement" (Defond and Hung, 2004). The protection of investors' rights is thus achieved through the enforcement of regulations and laws.

DeJong et al. (2005) conducted an event study to investigate the effectiveness of self-regulation of corporate governance practices in The Netherlands. Their result shows that regulation without enforcement fails to achieve the objective. Enforcement is generally viewed as a tool to secure compliance with regulations. It plays an important role in reducing violations of standards. Prior studies find that the strength of investor protection and enforcement regulatory enforcement is positively associated with financial market development (Defond and Hung, 2004; Frost et al., 2006; Jackson and Roe, 2009; Shleifer and Wolfenzon, 2002). Association between investor protection and corporate governance and subsequent high valuation were detected in past studies (Klapper and Love, 2004; La Porta et al., 2000). In addition, effective enforcement is linked to enhanced

investor protection; financial market development; improved market performance and valuation premiums.

Investor protection and financial market development

Previous studies reveal the importance of securities regulation enforcement and corporate governance. Strong investor protection is often associated with effective corporate governance. According to La Porta et al. (2000: 24), "strong investor protection is associated with effective corporate governance, as reflected in valuable and broad financial markets, dispersed ownership of shares, and efficient allocation of capital across firms". Thus investor protection provides useful insights in understanding corporate governance. Unlike Stigler (1964) which states that financial market regulation is not necessary with the presence of financial contracting, La Porta et al. (2000) argue that legal enforcement by court, government agencies and market participants are crucial. Result shows that in the absence of effective enforcement, managers may not behave in the best interest of shareholders.

Securities law facilitates stock market development (La Porta et al., 1997, 2006). The effect of investor protection and securities laws on capital market development were found significant in several studies. For instance, La Porta et al. (1997) find strong evidence that the securities law has large impact on the size and breadth of both debt and equity markets across 49 countries. Countries with strong legal protection have more valuable stock markets. They conclude that securities laws do really matter. Similarly, Shleifer and Wolfenzon (2002) also find that investor protection enhance stock market development. Investor protection is associated with high number of listed firms and capital valuation (Claessens and Fan, 2002; La Porta et al., 2002).

Some other researches had been done to investigate the impact of regulation towards efficiency of the market. According to Comerton-Forde and Rydge (2006), market efficiency refers "to the ability of investors to transact easily at low cost". They defined market integrity as "the ability of investors to transact in a fair and informed market where prices reflect information". Thus, maintaining and enhancing market integrity is a central objective of exchanges worldwide. Comerton-Forde and Rydge (2006) provide some evidence from Australian Stock Exchange (ASX) that market surveillance is able to enhance integrity.

Investor protection and market performance

Daouk et al. (2006) examines the relationship between capital market governance (CMG) and market performance measures such as the cost of capital, market liquidity, and pricing efficiency. Their result indicates that increased enforcement of securities law leads to improvement on CMG.

Investor protection is also associated to economic growth. Ibrahim (2009) find that economic growth is more pronounced in countries with high level of investor protection. His result shows that GDP growth of a country is influenced by country-level legal protection of investors where countries with stronger protections tend to grow faster than those with poorer ones.

The effects of investor protection on the cost of external finance were examined in recent years. Chen et al. (2009) find lower cost of equity in capital market with strong legal protection of investors. They argue that institutional investors are willing to pay a higher premium for shares in firms with good corporate governance. On the other hand, Lambert et al. (2007) show that stronger securities law, accounting rules and stricter enforcement mechanisms lower firm's cost of capital.

"Market-supportive laws, regulations, and enforcement, give rise to an investor protection environment that is conducive to the supply of liquidity by minimizing information costs" (Brockman and Chung, 2003). Some studies reveal that enhance investor protection and well governed company will lead to better liquidity. For instance, Brockman and Chung (2003) investigate the relation between investor protection and firm- level liquidity in Hong Kong stock market. The empirical result shows there is a negative relationship between quality investor protection and liquidity costs.

In addition, Chung (2006) investigates the relationship between firm liquidity and the level of protection provided to investors using American Depository Receipt (ADR). It was argued that weak investor protection leads to higher liquidity costs and bid-ask spreads resulted from higher agency costs. The empirical results show that the liquidity costs of poor investor protection were more prominent during Asian financial crisis when the expected agency costs were particularly severe. In a more recent paper, Chen (2011) investigates the association between securities laws and corporate liquidity with the presence of corruption. A sample of 47 countries from 1996 to 2007 was studied. The finding suggests that corporate liquidity is lower in countries with more effective securities laws or higher control of corruption.

Likewise, Christensen et al. (2011) examines the capital market effects of changes in securities regulation in 27 EU countries and 27 non-EU countries from 2001 to 2009. They analyze two key capital market directives in the European Union (EU) that tightened market abuse and transparency regulation. Focus was especially given with respect to the enforcement. The results show that stronger securities regulation can have significant economic benefits especially on market liquidity and firms' cost of capital. The effects of regulation depend on proper enforcement.

Enforcement and compliance

The role of enforcement in inducing compliance behavior

could be best explained by Rational Choice Theory. According to this theory, individuals will choose to obey or violate the law based on evaluation of utility. The individual will choose to decide to risk violating the law after considering his or her own personal situation and expected consequences. Therefore, individuals will engage in misconduct if the expected utility exceeds that derived from lawful behavior (Becker, 1968; Grasmick and Bursik, 1990).

Fearnley et al. (2002) noted that it is important to cultivate compliance culture and “have enforcement and oversight mechanisms in place which deter non-compliance and deal swiftly and effectively with abuse”. Sanctioning seeks to coerce compliance where the social control of formal, legal deterrence is imposed by detecting, prosecuting, convicting and penalizing violators (Beyleveld, 1979).

The theory thus reveals the importance of enforcement actions. Enforcement system is aimed to deter potential misconduct and violation of law. Therefore, the effectiveness of the enforcement actions lies on how well certain unlawful behavior is deterred. “Enforcement systems can achieve an optimal level of deterrence by setting the expected sanction for misconduct at the level of the total social costs caused by the misconduct, discounted by the probability of detection” (Oded, in press). It is important to consider the relevant enforcement costs, which are the cost of enforcement actions associated with the specific misconduct.

STOCK MARKET REACTIONS ON NON COMPLIANCE

Investors generally are risk averse. They are willing to bear higher risk without sufficient risk premium for risky investment. Previous findings show that there is significant association between governance mechanism and firm performance. Gompers et al. (2003) thus suggest that the value of a company with poor corporate governance mechanisms should be lower than those who have proper mechanism in place.

Involvement in corporate misconduct such as fraud, corporate crime, fraudulent financial statement, etc., reflect noncompliant behaviour. Enforcement actions such as reprimand, fines, sanctions and litigation will follow subsequently. Agency cost resulted from poor internal governance is identified as one of the major determinants for non compliance (Haat et al., 2006). Referring to the Rational Choice Theory discussed earlier, effective enforcement action will deter unlawful behaviour. The effectiveness of enforcement thus could be identified from the impact of deterrent actions to the offender firms. It could be examined from the consequences borne by the firm from reputational, market reactions to the damages suffered by the firm itself. Furthermore, changes on share prices can be a good indicator for the enforcement effect (Nourayi, 1994).

Aftermath of corporate misconduct

Several studies have been carried out in recent years to investigate the impact of financial market law violation on the companies’ share price and performance. Literature findings suggest that stronger enforcement have significant impact on firm valuation. In one of the studies, Karpoff and Lott (1993) study firms in the U.S. that had been alleged and convicted for corporate fraud. Alleged firms were found to suffer lower firm valuation over the announcement period. They suggest that the decrease in firm value is mainly explained by the loss in reputation. Similarly, Baucus and Baucus (1997) find lower Return on Asset (ROA) and Return on Sales (ROS) for firms which are involved in corporate illegalities. Convicted firms are most likely experience immediate and prolonged decrease in revenues resulted from stakeholders exit.

Goncharov et al. (2006) showed that there is an association between the degree of compliance and pricing effect among German companies. They examine a sample of large public listed German companies in the DAX 30 and MDAX. Their result indicates that high compliant firms enjoyed higher premium in terms of share price.

Bhagat et al. (1998) study the stock price reactions to filings and settlements of lawsuits towards a firm. One of the interesting findings is regardless of who files the lawsuit, the defendant companies would experience significant wealth losses, both statistically and economically. The findings reveal overall decline of average of 0.97% in market value of the defendant firm. On the other hand, in Cloninger and Waller (2000), there were no definite results on the impact of disclosure of alleged corporate misconduct on systematic risk of a security.

In an early study, Kellogg (1984) analysed class action lawsuits of misrepresentations in a company’s financial statements from 1967 to 1976 in the U.S. market. Their finding reveal a decline in stock share value of 3.9% on the day of the announcement was made in majority of the firms for disclosing misleading financial statements. Significant negative statistic returns were also noticed in the subsequent day. Francis et al. (1994) also conducted a similar study. The authors also detect share price effects on companies announced misleading financial statements. Findings show negative market responses of 17.2% averagely followed by the announcement. Another study to examine the impact of announcement effect was undertaken by Cox and Weirich (2002). The authors studied on the impact of fraudulent financial reporting on the capital markets in the United States among large corporation. The result shows that the announcement impact negatively on the capital market both before and on the day of the event.

Impact of enforcement action

Past literatures find that stock market reacts negatively to

news about enforcement actions. Feroz et al. (1991) conducted a study on the abnormal returns for 58 companies which were under investigation by the Securities and Exchange Commission (SEC) from year 1982 to 1989 in the U.S market. Their findings show that the market reacted negatively on the first two events, where negative abnormal returns of 12.9 and 6% were observed by the time of the announcement of reporting violations and investigation of the violation respectively.

Nourayi (1994) examines the SEC's violations. Stock price for alleged firms are negatively impacted subsequent to the enforcement action. The stock price was found to correspond directly with the severity of the enforcement actions. Similarly, Ferris et al. (1992) also observe negative stock price resulted from "SEC-ordered suspensions" of stock trading.

Studies on the impact of enforcement actions in Asia are slowly emerging in recent years. Chen et al. (2005) provide some empirical evidence on the impact of the China Securities Regulatory Commission (CSRC)'s enforcement actions on stock prices. They find that enforcement actions have a negative impact on stock prices. They concluded CSRC indeed has "teeth" in terms of credibility. They observe negative stock returns and the costly economic consequences for alleged firms. Similarly, Kwan and Kwan (2011) documented negative price effect as a result of public reprimand imposed in Malaysian stock market for violation of listing requirements.

Economic consequences and effects of trading suspension (Frino et al., 2011; Obeua, 1997) and class actions lawsuits (Amoah and Tang, 2010; McTier and Wald, 2011; Paul, 2006; Robert, 1984) were also documented in governance literatures. For instance, Wu (1998) find that mandatory suspensions are more effective compared to voluntary suspensions in disseminating information in Hong Kong. Align with the prediction of related researches, the findings show that there are significant negative returns during trading suspensions.

CONCLUSION AND FUTURE RESEARCH DIRECTIONS

Researches in the area of corporate governance are vast. Majority of the research examine the impact of corporate governance towards firm performance and valuation. Despite a large body of literatures on corporate governance mechanisms, reviews on the researches done on the legal and regulatory perspectives are lacking. This paper reviews related literatures in the hope to shed light on the issues of regulatory enforcement and good governance. The importance and role of regulatory enforcement in corporate governance is highlighted.

As highlighted by Denis and McConell (2003), the second generation of corporate governance research has emerged with focus on legal and regulatory perspective. It creates an avenue for further research to investigate if enforcement coupled with corporate governance attributes strengthens the relations between other fraud antecedents and corporate misconduct.

A common theme in prior studies is the belief that effective corporate governance and enforcement may assist in promoting good conduct. Therefore, it is expected to restrain the incidence of violation/ non-compliance/ corporate misconduct. Although quite a number of studies had been conducted to test the significance of the impact of enforcement on governance, the result remains rather vague. On top of that, not many studies were done in finding the potential link of attributed towards the propensity to commit fraud.

Given the relatively scarce corporate governance literatures from the regulatory perspective, there is a need to undertake related research based on this direction. It would be interesting to examine not only the financial impact of violation but also to predict corporate behaviors. More focus could also be given to the role of stock exchange in inducing compliance behavior. In addition, the effectiveness of enforcement actions and the aftermath of misconduct outside U.S. especially in the emerging market is to be explored.

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