A CRITICAL ANALYSIS OF THE ROLE OF DISCLOSURE IN
STRENGTHENING CORPORATE GOVERNANCE AND ACCOUNTABILITY
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CONTENTS

<table>
<thead>
<tr>
<th>CONTENTS</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT</td>
<td>5</td>
</tr>
<tr>
<td>STATEMENT</td>
<td>7</td>
</tr>
</tbody>
</table>

CHAPTER 1: INTRODUCTION

1.1 Statement of Problem 8
1.2 Methodology 9
1.3 An Overview of the Dissertation 9
1.4 Corporate Governance Defined 11
1.5 Background to Corporate Governance 17
1.6 Current Trends in Corporate Governance 22
1.7 Conclusion 27

CHAPTER 2: DEFINING THE ROLE OF DISCLOSURE IN STRENGTHENING CORPORATE GOVERNANCE AND ACCOUNTABILITY

2.1 Introduction 29
2.2 An Evaluation of the Forces that are Causing the Re-examination of Disclosure Practice 29
2.3 The Nature and Form of Information that Should be Disclosed: Mandatory versus Voluntary Disclosure 33
2.4 Conclusion 41
### CHAPTER 3: A LEGISLATIVE SURVEY OF APPLICABLE DISCLOSURE PROVISIONS IN SUPPORT OF KING II, KING III (FROM A SHAREHOLDER VERSUS STAKEHOLDER PERSPECTIVE) AND AN ANALYSIS OF DISCLOSURE PRACTICE IN RELATION TO CORPORATE SOCIAL RESPONSIBILITY

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Introduction</td>
<td>43</td>
</tr>
<tr>
<td>3.2</td>
<td>Shareholder Theory of Corporate Practice and Disclosure</td>
<td>44</td>
</tr>
<tr>
<td>3.3</td>
<td>Stakeholder Theory of Corporate Practice and Disclosure</td>
<td>52</td>
</tr>
<tr>
<td>3.4</td>
<td>Corporate Social Responsibility and Corporate Citizenship</td>
<td>56</td>
</tr>
<tr>
<td>3.5</td>
<td>Applicable Legislation</td>
<td>59</td>
</tr>
<tr>
<td>3.6</td>
<td>Conclusion</td>
<td>64</td>
</tr>
</tbody>
</table>

### CHAPTER 4: A CRITICAL ANALYSIS OF THE VEHICLES FOR DISCLOSURE AVAILABLE TO SHAREHOLDERS TO ENSURE THE ACCOUNTABILITY OF DIRECTORS

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1</td>
<td>Introduction</td>
<td>66</td>
</tr>
<tr>
<td>4.2</td>
<td>What are the information needs of a shareholder and what remedies are open to shareholders to safeguard these rights</td>
<td>67</td>
</tr>
<tr>
<td>4.3</td>
<td>Role and Responsibilities of Directors</td>
<td>79</td>
</tr>
<tr>
<td>4.4</td>
<td>Conclusion</td>
<td>88</td>
</tr>
</tbody>
</table>

### CHAPTER 5: DOES DISCLOSURE LEAD TO THE EFFECTIVE IMPLEMENTATION OF CORPORATE GOVERNANCE POLICIES

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1</td>
<td>Introduction</td>
<td>90</td>
</tr>
<tr>
<td>5.2</td>
<td>Fidentia</td>
<td>91</td>
</tr>
<tr>
<td>5.3</td>
<td>Enron and Worldcom</td>
<td>98</td>
</tr>
<tr>
<td>5.4</td>
<td>Financial Crisis</td>
<td>103</td>
</tr>
</tbody>
</table>
5.5 Conclusion

CHAPTER 6: CONCLUSION AND RECOMMENDATIONS

6.1 Recommendations as to how corporate governance practices can be improved in respect of disclosure

6.2 Recommendations for Public Policy Determinants: The Balance between Governmental Regulation and Market Based Regulation through Disclosure.

7. BIBLIOGRAPHY

7.1 Legislation

7.2 Reports

7.3 Books

7.4 Articles

7.5 Case Law

7.6 Websites

8. ACKNOWLEDGEMENTS
ABSTRACT

This dissertation critically analyses the role of disclosure in strengthening corporate
governance and accountability to determine whether a prescriptive system of disclosure is
of greater efficacy than a voluntary regime. The research undertaken has been done on a
qualitative and theory building basis. The purpose of the study is to examine how current
and future legal reform can curb corporate governance shortcomings and contribute to a
new more dependable mode of corporate governance.

This requires a comparative analysis of the South African and English models which are voluntary (‘comply or explain’) regimes compared to the prescriptive American model of
corporate governance (‘comply or else’). The foundational basis, definition and
jurisdictional evolution of corporate governance is examined and analysed to ascertain
the role of disclosure in relation to good governance. To facilitate this investigation a
critical review of the legislative framework and reforms enacted locally (and offshore
where applicable) is also undertaken.

Disclosure as a concept is probed in terms of both a mandatory disclosure and voluntary
disclosure regime to determine the more prudent mode of dissemination and how it
impacts the efficacy of corporate governance and accountability.

To ensure a holistic view of the role of disclosure is comprehensively critiqued its
influence on corporate social responsibility is embarked upon. It is contextualized against
the shareholder (contractarian) theory of governance versus that of the stakeholder
(communitarian) theory of governance. This will involve a study of the competing
requirements of disclosure in terms of these two theories and its impact on securing
accountability.

The tenuous relationship between shareholders and directors is considered to determine
whether corporate governance regimes safeguard shareholder rights and how these
measures contribute to strengthening governance. The codified role of directors in
enhancing disclosure to shareholders is also undertaken. To examine the interplay between these concepts corporate governance failures are dissected to determine the shortcomings of disclosure practice.

The recommendation of this dissertation is that a mandatory disclosure regime is of greater efficacy in strengthening corporate governance and accountability but to remedy recurring corporate governance shortcomings a disclosure regime that is holistic and principles based is required. It should also be supported by a dedicated and empowered regulatory system with sufficient penal measures to curb fraudulent behaviour but sufficient flexibility so as not to curtail industrial fortitude.
Dissertation presented by Lynelle Bagwandeën in partial fulfillment of the requirements for the degree of Master of Laws (LLM) in the Faculty of Law, University of Kwa-Zulu Natal.
CHAPTER 1: INTRODUCTION

1.1 Statement of Problem

What has emerged via the highly publicized international debate on the topic of corporate governance and disclosure is that a theoretical commitment to the principles of transparency and accountability is not sufficient to provide legitimacy to a corporation nor does it emphatically diminish a company’s vulnerability to a financial and concomitant legal crisis.¹ This dissertation will therefore seek to analyze the role of disclosure in strengthening corporate governance and accountability and seek to determine whether a prescriptive system of disclosure is of greater efficacy than a voluntary regime.

This will essentially involve a comparative analysis of the South African and English models of governance to the American model of corporate governance. It shall also seek to critically examine and analyze the current legislative reforms being enacted both locally and offshore to strengthen the existing framework of disclosure controls; so as to determine whether a prudent disclosure regime is the panacea it is intended to be.

The integrity and relevance of information released by corporate entities will also be critically examined in terms of the role of the board of directors and their accountability to shareholders. To achieve the latter an evaluation of the role of non-executive directors in promoting disclosure will also be pursued. Moreover the role of disclosure as a regulatory measure in promoting a more explanatory transparency of executive remuneration will be considered.

The epicenter of corporate governance is corporate social responsibility. An evaluation of the role of disclosure in strengthening corporate social responsibility and ipso facto corporate governance will also be embarked on. It will however, be contextualized against the shareholder (contractarian) theory of governance versus that of the stakeholder (communitarian) theory of governance. This will involve an analysis of the competing requirements of disclosure in terms of these two theories and its impact on securing accountability.

1.2 Methodology

The methodology employed in undertaking this research has consisted of referral to textbooks, published articles and case law pertinent to the issues of corporate governance. This has been the main source of data collection. Thus a qualitative and theory building approach has been adopted. It was decided to use the latter as it is a descriptive and interpretative approach. Furthermore it is holistic in nature as it aims to understand the processed legal systems to control the release of information thereby identifying the gaps and limitations in an attempt to propose a workable solution.

The purpose of this research is to propose a new model of corporate governance that is holistic incorporating meaningful, credible disclosure across legal, regulatory, ethical and sociological frameworks.

1.3 An overview of the dissertation

The dissertation consists of six chapters.

In chapter one an overview of the dissertation and the foundational basis and definition of corporate governance is presented. Thereafter the current trends that typify corporate

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governance are considered and the various forms of reform currently underway, which is accompanied by a critical slant on disclosure as a whole.

Chapter two comprises an analysis of disclosure as a concept and an in depth analysis of both the mandatory disclosure and voluntary disclosure regimes is scrutinized on a jurisdiction specific basis. The research seeks to critically determine which is a more cogent and productive mode of disclosure and more importantly how it impacts on the efficacy of corporate governance and accountability.

Chapter three embarks on an analysis of the epicenter of corporate governance which is the accountable and verifiable implementation of corporate social responsibility. The implementation of corporate social responsibility warrants a study of the shareholder focused approach of governance versus the stakeholder centric theory of corporate governance practice. As such chapter three will probe the disclosure practice associated with the aforementioned competing ideologies.

Chapter four focuses on the nucleus of corporate governance which is the relationship of directors and shareholders and their role as conduits of disclosure for the benefit of the company. It asserts that the quality of financial disclosure depends significantly on the robustness of the financial reporting standards adopted by the company and the role of the board of directors in enriching the usefulness of disclosure to shareholders by providing further explanation and intellectual enhancement. To ascertain the accuracy of this assumption a critical analysis of the role and responsibilities of directors is undertaken in securing disclosure and whether their function in strengthening corporate governance could be enhanced by the codification of their duties.

Chapter five presents a breakdown of modern day examples of corporate governance failures to ascertain whether disclosure can in fact lead to the effective implementation of governance policies. This involves an analysis of Fidentia, Enron, Worldcom, recent corporate governance fiascos and the current financial crisis.
Chapter six concludes the research by proposing how governance practice can be improved in respect of disclosure.

The intent is to assess the mandatory disclosure regime in securing diligent governance and whether a prescriptive process can in fact secure good practice. Each chapter seeks to juxtapose American jurisprudence pertaining to corporate governance against the South African corporate governance model with due and relevant regard to the English model of governance.

1.4 Corporate Governance Defined

Corporate governance has been established as an important component of the international financial architecture but ironically the term ‘corporate governance’ did not exist in the English language until twenty years ago despite being a concept that has been practiced since the incorporation of corporate entities.\(^4\) It has become a popular catch phrase in the last two decades and as such corporate governance\(^5\) issues have become important not only in academic literature but also in public policy debates\(^6\) and more recently in terms of international and local law reforms which seek to refine disclosure regimes.\(^7\)

The latter has culminated in the new Companies Act\(^8\) (the new Act) which was signed into law by the President on 8 April 2009 and will come into force on a date to be proclaimed in the Gazette which may not be earlier than a year after its enactment. The

\(^5\) The etymology of ‘governance’ comes from the Latin words *gubernare* and *gubernator* which refer to the steering of a ship and to the steerer or captain of a ship. The word governance has a rather archaic ring to it. It stems from the French word ‘gouvernance’ and means control and the state of being governed.
\(^6\) A Berle & G Means *The Modern Corporation and Private Property* 3ed (1932) 56.
\(^7\) Chapter 2 defines and analyses disclosure as a means of strengthening corporate governance and Chapter 3 discusses legislative provisions pertaining to disclosure.
\(^8\) Act 71 of 2008.
new Act has not defined ‘corporate governance’ but has sought to address the concepts of governance and transparency in terms of the purpose of the new Act.⁹

So what exactly is corporate governance? The definition of corporate governance stems from its organic link to the entire gamut of activities having direct or indirect influence on the financial health of corporate entities. The Nobel Prize winning economist, Milton Freidman, who has undoubtedly played a dramatic role in establishing the economic psyche of twentieth century America, expounded the following definition:

‘corporate governance is to conduct business in accordance with owner or shareholder desires which generally will be to make as much money as possible while conforming to the basic rules of the society embodied in law and local customs.’¹⁰

The concept of corporate governance and numerous definitions relevant to the concept have expanded over time as a result of a wide spectrum of economic phenomena and expanding corporate culture. As such, the foregoing discussion clearly underpins the notion that the term ‘corporate governance’ does not have a universally accepted definition.¹¹ While some experts say that corporate governance means doing everything better, to improve relations between companies and their shareholders,¹² the former president of the World Bank, James Wolfensohn, said that ‘corporate governance is about promoting fairness, transparency and accountability.’¹³

The often quoted statement by the esteemed James Wolfensohn is that ‘the governance of the corporation is as important to the world economy as the governance of countries’¹⁴ because modern cross border corporations are often larger than governments in terms of

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⁹ Ibid Section 7 (b) (iii).
¹⁴ Ibid.
economic power. Thus the quality of their governance has become a high level issue of social and political concern. This is consistent with the definition postulated by Shleifer and Vishny\textsuperscript{15} that corporate governance deals with the ways in which suppliers of finance to corporations assure themselves a return on their investment.

The single overriding concern of these experts is in the words of the Hampel Committee,\textsuperscript{16} namely: 'the preservation and the greatest practicable enhancement over time of shareholders investments.'\textsuperscript{17} Thus if the latter is to be taken as a comprehensive definition of corporate governance as used in relation to corporate governance reforms, it is clear that the performance of directors in a company will only be measured by the benefits that accrue to shareholders.\textsuperscript{18} This is a narrow definition in terms of which directors ignore the interests of other stakeholders when exercising their corporate rationale. This is not consistent with the definition espoused by the King Code of Corporate Practices and Conduct as contained in the King Report on Corporate Governance for South Africa dated March 2002 (King II).\textsuperscript{19} This advocates taking into account the interests of a wide range of stakeholders.\textsuperscript{20}

The definition advocated by King II\textsuperscript{21} would infer that a company's success is directly correlated to the interests of all stakeholders in the business such as suppliers, employees

\textsuperscript{15} A Shleifer & R Vishny 'Management Entrenchment: The Case of Manager Specific Assets'(1989) 25 Journal of Finance 123, 140.

\textsuperscript{16} Hampel Committee on Corporate Governance (1998) was intended to be a revision of the corporate governance system in the United Kingdom (UK). The committee was to review the code laid down by the Cadbury Report (now found in the Combined Code). (See Chapter 1.5 and Chapter 1.6) It asked whether the code's original purpose was being achieved. Hampel found that there was no need for an overhaul of the UK corporate governance system. The report aimed to combine, harmonize and clarify the finding of earlier recommendations.

\textsuperscript{17} Hampel Committee on Corporate Governance (1998) Final Report Paragraph 1.17.


\textsuperscript{19} The King Code of Corporate Practices and Conduct (2002) Paragraph 5.2.

\textsuperscript{20} D Wood 'Whom Should Business Serve?' 2002 Australian Journal of Corporate Law 5, 10. It must be noted that the term 'stakeholder' is one that has been plagued by controversy. Critics of the stakeholder theory highlight the breadth in the definition of a 'stakeholder' that is any person or group of persons who can affect or is affected by the activities of a company. A stakeholder may have different interests that may be weighed differently and can be ascribed multiple roles.

\textsuperscript{21} The King Code of Corporate Practices and Conduct (2002) Paragraph 5.2.
and society at large.\textsuperscript{22} This is the so called ‘triple bottom line’ school of thought as opposed to the purist ‘bottom line’ school of thought.\textsuperscript{23} This is significant in South Africa in context of our socio-political history. Moreover it is commensurate and consistent with modern corporate law which inculcates the ideals of responsible and accountable management.\textsuperscript{24} This wider approach therefore focuses on the entire network of formal and informal relations that determine how control is exercised within companies and how the risks and returns from corporate activities are allocated.\textsuperscript{25} This stakeholder centric approach has been further entrenched in the Report on Governance for South Africa issued in its final version on 1 September 2009\textsuperscript{26} (King III). The report and the code highlight sustainability, ethics and stakeholder relationships emphasizing its inclusive nature. King III will come into effect on 1 March 2010.

A more comprehensive definition of corporate governance has come from the Organization of Economic Co-Operation and Development (OECD):

‘as the system by which business corporations are directed and responsibilities among different participants in the corporation, such as the board of directors, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs.’\textsuperscript{27}

\textsuperscript{25} BR Cheffins ‘Corporate Governance Reform, Britain as an Exporter, Corporate Governance and Reform of Company Law’ \textit{Hume Papers on Public Policy} 8 (2000) 10, 28.
\textsuperscript{27} http://www.oecd.org (Last visited on 27 November 2009).
By doing this, not only does corporate governance provide the structure through which the company objectives are set, it also provides the means of attaining these objectives and monitoring performance.  

These two approaches can be construed as the modern ‘definition’ of corporate governance. Both approaches propound the value of corporate governance on a conscious level but do not focus on the practical imperatives that are required for its realization. A functional component would be disclosure of pertinent information by companies through their board to shareholders. In the absence of disclosure, transparency, accountability and fairness remains just a well intended objective. Corporate governance should also focus on the internal means by which corporations are operated and controlled. A more inclusive definition would be the internal processes to help directors discharge their duties and responsibilities as imposed by statute and the common law. This would encapsulate the balancing of interests coupled with additional initiatives like appropriate disclosure regimes and accountable conduct. The definition of corporate governance should be inextricably linked to a compliance regime. In fact King III states that it is wholly inappropriate to unhinge governance from the law yet the key tenets to its functioning remain largely undefined.

It would follow that in ascertaining the manner, means and method of whether corporate governance has been implemented disclosure of key governance issues remains of paramount importance. Disclosure would also be relevant in ascertaining whether or not the interests of stakeholders and shareholders have been fully considered.  

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28 Toronto Stock Exchange Committee on Corporate Governance in Canada ‘Where Were the Directors?’ Guidelines for improved Corporate Governance in Canada, Guideline (12) (i), 1994 (Dey Report).
Disclosure can therefore be identified as an integral and definitive element in correctly defining corporate governance and in ascertaining the principles of responsibility and accountability.\textsuperscript{33}

The King Committee endorses this reasoning as it attempts in King II\textsuperscript{34} and King III\textsuperscript{35} to comprehensively deal with the responsibility of companies to deal with financial non-financial reporting which is based on the interests of stakeholders including shareholders.\textsuperscript{36}

The aforementioned discussion confirms that there is no single, universally appropriate, model of corporate governance. This principle has been recognized in King II, which reiterates that:

‘companies are governed within the framework of the laws and regulations of the country in which they operate. Communities and countries differ in their culture, regulation, law and generally the way business is done.’\textsuperscript{37}

Consequently, as the World Bank has pointed out, there can be no one, applicable corporate governance model.\textsuperscript{38} Yet there are international standards that no country can ignore in the era of the global investor. Thus, international guidelines have been developed by the OECD, the International Corporate Governance Network and the Commonwealth Association for Corporate Governance. The four primary pillars of fairness, accountability, responsibility, disclosure and transparency are fundamental to all the international guidelines of corporate governance.\textsuperscript{39} It would therefore be more productive to define, elaborate and amplify the central pillar of disclosure than to attempt

\textsuperscript{34} King Code on Corporate Governance (2002) Section 5 Chapter 2.
\textsuperscript{37} King Code on Corporate Governance (2002) Section 5 Chapter 2.
\textsuperscript{38} \url{http://www.worldbank.org} (Last visited on 21 October 2009).
\textsuperscript{39} \url{http://www.worldbank.org} (Last visited on 21 October 2009).
to ascribe a hard and fast definition to a concept like governance.\textsuperscript{40} The other key issue is whether the definition or prescription of disclosure would be best achieved by a voluntary regime or a regulatory structure that is monitored and enforced. The guiding principle is that there are no degrees of corporate governance. A company either applies the principles of corporate governance or it does not. If one unties all the mental knots and ignores all the peripheral issues it is about doing the right thing at the right time for the right reason.\textsuperscript{41} This contemplates accountable and ethical conduct\textsuperscript{42} that supports both a prescriptive and a voluntary approach towards governance and disclosure. The evolution and success of these legal models are considered hereunder.

1.5 Background to Corporate Governance

As aforementioned disclosure, accountability and transparency are vital cogs of governance in terms of both a stakeholder and shareholder approach. Notwithstanding this assertion the ever lengthening litany of corporate malpractice scandals indicates something seriously defective in the functioning of disclosure, transparency and accurate financial reporting, the pillars of good corporate governance.\textsuperscript{43} These scandals have led to a loss of credibility in financial reporting and legal structures.\textsuperscript{44} It is vital to restore credibility as reduced confidence in financial information and corporate disclosure produce an investor retreat and a reduction in the productivity of the economy.\textsuperscript{45}

The prima facie explanation for this has been the extensive deregulation in financial systems which allowed market forces to flourish.\textsuperscript{46} This ensured corporate governance was catapulted to the top of business and political agendas and proved to be a stimulus to

\textsuperscript{41} This view recognizes that corporate governance is not only about procedural aspects, but also about mindset and moral attitude, which includes recognition by moral persons of the need to balance their own interests with the interests of others and reaching the conclusion that pursuing their own goals at the expense of others, is wrong.
\textsuperscript{43} AG Monks & N Minow Corporate Governance 2 ed (2003) 2.
\textsuperscript{44} http://www.kpmg.co.uk (Last visited on 29 October 2009).
legislative and non legislative reform across the globe. As a result the deregulation

trend was quickly followed by extensive regulation in the financial and legal system.

Since 1999 there have been at least forty new sets of principles or codes that have been
published globally. These codes vary at one extreme from suggested practices whose
adoption is entirely voluntary to rigid legal requirements wherein non-compliance and
quantified breaches incur civil and criminal penalties.

Implementing change and meaningful disclosure is a constant struggle because corporate
governance is a vital ingredient not only for financial entities but for all entities
particularly large conglomerates whose governance failure can have dire macroeconomic
and sociological implications as evidenced by the demise of Enron, Worldcom and
the recent financial crisis.

Globally all corporate governance codes, guidelines and statutes share a number of
common themes and vary more in the matter they emphasize rather than in principle. A
snapshot of corporate governance regimes in 2009 are as follows: the Anglo-American
Model is a dichotomy of ‘explain or comply’ in terms of the English Model and a strict
legislative response (‘apply or else’) in terms of the American model. The former is

48 Ibid.
50 JP Hawley & AT Williams The Rise of Fiduciary Capitalism: How Institutional Investors can make
America more Democratic 2 ed (2000) 34.
52 L W Jeter Disconnected: Deceit and Betrayal at Worldcom 1ed (2003) 156.
banking crisis (March 2009). ‘Financial Crisis’ is a reference to the collapse and collective drop in share
prices of Banks and Financial Institutions commencing September 2007 and the effects are still evident in
2010. It has caused a global recession that has had a global impact and commentators have conceded that it
can in part be attributed to the failure of corporate governance practices. It is discussed in detail in Chapter
5.4.
54 Ibid.
55 http://www.pwc.com (Last visited on 26 November 2009).
characterized by the Cadbury Report\textsuperscript{56} and the Greenbury Report\textsuperscript{57} (collectively referred to as the Combined Code).\textsuperscript{58} The modus operandi underlying this code is that society is increasingly expecting higher standards of behaviour from companies and highlights the accountability of the board of directors and obligations on them to remain fully appraised of all issues peculiar to the company.\textsuperscript{59}

The cumulative effect of these reports was the assertion that disclosure is a foundational element of a corporate governance framework because it provides all the stakeholders with the information necessary to judge whether their interests are being taken care of.\textsuperscript{60} The issue though is whether stakeholders or shareholders (given the corporate fiascos detailed in Chapter 5) can in fact rely on the disclosure made as a means of strengthening corporate governance and insuring accountability.

The last effective and substantive corporate governance overhaul in the United Kingdom culminated in the Higgs Review\textsuperscript{61} in 2003 which focused on the issues of meritocracy

\textsuperscript{56} A Cadbury ‘Report of the Committee on the Financial Aspects of Corporate Governance’ (1992). The Cadbury Report sought to review aspects of corporate governance specifically related to financial reporting and accountability in the United Kingdom and was the ‘discussion document’ for King I.

\textsuperscript{57} The Greenbury Report (1995) sought to review and build on the principles outlined in the Cadbury Report with specific emphasis on executive remuneration.

\textsuperscript{58} The Combined Code on Corporate Governance (1998) sets out standards of good practice in relation to issues such as board composition and development, remuneration, accountability, audit and relations with shareholders. All companies incorporated in the United Kingdom and listed on the Main Market of the London Stock Exchange are required under the London Stock Exchange Listing Rules to report on how they have applied the Combined Code in their annual report and accounts. The Combined Code is updated at regular intervals the most recent being 29 June 2008. Note the UK governance regime as it applies to all corporate and listed entities remains unchanged but is under review as discussed in Chapter 1.4-1.6. This has culminated in the final report on the Combined Code review and consultation document of the revised UK Corporate Governance Code released for comments on 1 December 2009.

\textsuperscript{59} The Turnbull Report (1999) was produced at the instance of the London Stock Exchange to provide further guidance for directors with regard to maintaining efficient "internal controls" in their companies, by way of audits and checks to ensure the quality of financial reporting and to detect fraud.

\textsuperscript{60} http://www.rbi.org.in (Last visited 12 January 2009) Inaugural address delivered on 5 July 2003 by Shri Vepa Kamesan, Deputy-Governor, Reserve Bank of India, at the National Convention of Urban Cooperative Banks.

\textsuperscript{61} The Higgs review (2003) was a report on corporate governance that reviewed the role and effectiveness of non-executive directors and of the audit committee, aiming at improving and strengthening the existing Combined Code. Note the UK governance regime as it applies to all corporate and listed entities remains unchanged but is under review as discussed in Chapter 1.6. This has culminated in the final report on the combined code review and consultation document of the revised UK Corporate Governance Code released for comments on 1 December 2009. The current review is the Walker Review on Corporate Governance as
and diversity in English boardrooms and the vital role of the audit committee as espoused in the Smith Report. Derek Higgs rejected a legislative approach and recommended building on the aforementioned legacy of codified developments that embody the current framework of the English corporate governance regime which can be summarized as ‘comply or explain’. Of significant relevance is the prescribed business review which has been included in all operating reports of companies since July 2007. It is a mechanism to motivate companies to disclose information more innovatively and informatively.

American reform commenced with the Blue Ribbon Committee (BRC) on improving the effectiveness of corporate audit committees. Its recommendations that corporations should strive to be a viable attraction for capital, by ensuring disclosure and transparency of the company’s true financial performance as well as its governance practices were largely adopted by the US Securities Exchange Commission (SEC).

Notwithstanding these reforms, the American legislature responded even more decisively in terms of a legislative overhaul with the enactment of the Sarbanes-Oxley Act in 2002 (SOX or Sarbanes-Oxley). SOX is aimed at increasing corporate responsibility by improving the accuracy and reliability of corporate disclosures underscored by a strict regulatory and disclosure regime for accounting firms that audit public companies.

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62 The Smith Report (2003) was a report on corporate governance that focused on concerns with the independence of auditors in the wake of the Enron scandal in the US in 2002. Its recommendations now form part of the Combined Code on corporate governance, applicable through the Listing Rules for the London Stock Exchange. It highlighted the duties of an auditor which include evaluating a company’s corporate governance structure so as to provide safeguards to preserve an auditor’s own independence.


64 http://www.nasdaq.com (Last Visited on 21 November 2009) Blue Ribbon Committee (BRC) Report and Recommendations of the Blue Ribbon Committee (1999) on improving the effectiveness of Corporate Audit Committees as issued by the NYSE and Nasdaq.


66 The Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745) was enacted on July 30, 2002. It is also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and is a United States (U.S) federal law. The Act does not apply to privately held companies. The Act contains 11 titles, or sections, ranging from additional corporate board responsibilities to criminal penalties, and requires SEC to implement rulings on requirements to comply with the new law. The Act establishes a new quasi-public agency, the Public Company Accounting Oversight Board, or PCAOB, which is charged with overseeing, regulating, inspecting, and disciplining accounting firms in their roles as auditors of public companies.
Undoubtedly the corporate governance structures that we have today have been shaped by generations and centuries of legal, financial and social development.\textsuperscript{67} While this rich background enables different approaches to be considered and examined, much of the most recent developments have been to formalize and create specific reporting and disclosure structures.\textsuperscript{68}

The more stringent requirements of the American model represent a clear challenge to the ‘light touch’ regulation in London and the principles-based approach advocated by the King Committee in South Africa.\textsuperscript{69} This formed the impetus for corporate governance reform substantiated by King II and now King III.\textsuperscript{70} King III has not deviated from this methodology but has expanded its ambit in that it now applies to all entities as opposed to listed companies.\textsuperscript{71} Its implementation will be enhanced and supported by the new Act.\textsuperscript{72}

The central difference lies in the dilemma between those who see the company as a means to economic ends alone and those who see the company as a social actor. These tensions also result in varying degrees of disclosure. The challenge for meaningful corporate governance change is the achievement of an appropriate balance between the conformance and performance of the board. This should not only underscore the principle as to whether their companies comply with corporate governance principles but also to ensure greater performance of the company in a frank and transparent fashion while still being cognizant of all relevant shareholder and stakeholder interests.\textsuperscript{73}

\textsuperscript{67} See Chapter 1.6.
\textsuperscript{68} Ibid.
\textsuperscript{70} The King Report on Corporate Governance (1994); The King Report on Corporate Governance (2002); The King Report on Corporate Governance (2009).
\textsuperscript{72} Section 7 (b) (iii) and Section 66 of Act 71 of 2008 (see also Chapter 1.6).
\textsuperscript{73} T Mongalo ‘South Africanising Company Law for a Modern Competitive Global Economy’ (2004) 121 SALJ 104, 107.

As Mongalo notes, merely concentrating on conformance will result in a box ticking mentality and as a result, the value of corporate governance reforms will be drastically reduced. Furthermore, a conformance predominated approach may lead to a lack of innovation on the part of a company’s board of directors.
Given the past and current economic ignominies this could be construed as a seemingly insurmountable task notwithstanding burgeoning corporate governance reform. This assertion is based on the recurring corporate collapses worldwide which consistently point to inaccurate disclosure and clouded transparency.

1.6 Current Trends in Corporate Governance

It is self evident that corporate governance is widely held as a vital corporate and strategic imperative. This has been affirmed by the plethora of global reform in the arena of corporate governance as such 2010 heralds a new dawn in this area of law.

These new and innovative reforms with disclosure at its epicentre have been driven by global pressure for convergence in financial regulation and corporate governance. This is a particularly salient issue in emerging markets attempting to compete with established markets in developed countries. It is apparent from the aforementioned discussion that the ‘one size fits all’ attitude to corporate governance is not suitable and instead an understanding of the socio-political and legal context of corporate governance is important to ensure cohesive regime change and transformation. This is because each of the jurisdiction specific codes is intended to be a definitive guide for the intended audience. Taken together, however, the countless and varying approaches are anything but definitive. The findings of numerous separate nations and separate organizations, has culminated in a myriad of codes which in turn has inspired a vigorous and multifaceted discussion. The most pertinent aspect of such a discussion has been the tireless debate between the two opposing views of corporate governance.

One is the need for diversity in business and the other is the push for stronger regulation. The regulatory approach tends to be prescriptive and reactive in nature, advising on solutions to situations after the crisis has occurred as clearly illustrated by the American

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76 Ibid 67.
model. The South African governance regime will be fortified by the new Act which asserts that corporate governance must be taken into account in managing the affairs of a company and the recommendations of King III. This indicates the forceful gravitation towards more regulation and mandatory disclosure.

In light of the financial crisis, the pendulum will inevitably swing too far towards regulation, which will be as bad as too much deregulation. The reasons cited for such a crisis to date has been the degree of complexity associated with the various securitization transactions coupled with great opacity. Equally unsurprising has been the questions as to the role and responsibility of the board of directors of these banking and financial institutions.

In its report to the United Kingdom (UK) parliament entitled ‘The Run on the Rock’, the Treasury Committee categorically pinpointed the directors of Northern Rock Plc as ‘the principal authors of the difficulties that the company has faced since August 2007.’ The report went on to state that ‘the directors pursued a reckless business model which was excessively reliant on wholesale funding’ this was followed by the strongly worded statement by the United Kingdom Financial Services Board that ‘it is the responsibility of the board to test and challenge risky proposals from management’.

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78 Section 7 (b) (iii) and Section 66 of Act 71 of 2008. There must also be disclosure of all information by the company and its directors that is material to the business of the company.

79 *King Report on Corporate Governance* (2009) Chapter 2 and 9 which includes extensive obligations on the Board of Directors in terms of the combined assurance model and integrated reporting.

80 Sections 29, 30, 31, 122 of Act 71 of 2008.

81 See Chapter 5.3.


84 *Australia Daniels v Anderson AWA* (1995) (27) N.S.W.L.R 438 Directors are under a continuing obligation to keep informed about the activities of the corporation, but this requires general monitoring of corporate affairs and policies rather than a detailed inspection of day-to-day activities. This was affirmed in the *United Kingdom Official Receiver v Ireland* (2001) 1 B.C.L.C 547 Each director owes duties to the company to inform himself about its affairs and to join with his co-directors in supervising and controlling them, a proper degree of delegation and division of responsibility is permissible and often necessary, but not a total abrogation of duties.
Thus a very prevalent trend in current corporate governance reform will be role of directors, more specifically that of non-executive directors, adequate monitoring of their independent status\(^{85}\) and disclosure of their contributory role in strengthening corporate governance.\(^{86}\) In February 2009, Sir David Walker was requested by the Prime Minister to review (Walker Review) corporate governance in United Kingdom banks in the light of the banking system failure and the ensuing financial crisis. This culminated in a consultative document dated 26 July 2009 and a final version was produced on 26 November 2009.\(^{87}\)

Walker's fundamental analysis is that the financial crisis was not a failure of regulation but a failure of behaviour and the collective application of corporate governance. His recommendations are focused on the role of the board and directors in ensuring transparency and meaningful disclosure of relevant information pertaining to their decision making and remuneration policies.\(^{88}\) A central theme bolstering this review is the recommendation that regulation is needed to re-enforce governance practice and disclosure methodology.\(^{89}\)

In response to the Walker Review, the Financial Reporting Council (FRC) also initiated a review of the Combined Code. The FRC confirms that: ‘Many of Walker’s recommendations complement the work the Financial Services Authority (FSA) and FRC is already carrying out and will publish a further consultation paper on governance which shall pre-empt the revised Combined Code in 2010.’\(^{90}\)

\(^{85}\) See Chapter 4.2.
\(^{86}\) P Armstrong ‘Directorship, the way we govern now!’ 2003 *Institute of Directorship* 46, 47.
\(^{88}\) Ibid Recommendation 6 and 14.
\(^{89}\) Ibid Page 10 and 11.
\(^{90}\) Review of the Combined Code: Final Report (December 2009) Note it states that ‘as important as governance; is the key determinant to poor governance which is the behaviour of boards.’ Page 6 Downloaded from [http://www.hm treasury.gov.uk](http://www.hm treasury.gov.uk) (Last visited on 4 December 2009).
The final report of the review of the Combined Code (2008) was released on 1 December 2009. It key findings was that the Combined Code should be referred as the ‘UK Governance Code’ to make clearer its status as the UK’s recognized governance standards, introduction of new ‘comply or explain’ provisions relating to risk mitigation strategy to be implemented by the board and whether the ‘apply or explain regimes’ is sufficiently adequate and efficient. It reported that although this regime was suitable for the UK market it was necessary to supplement this regime on the basis proposed by the Walker Review.

It has culminated in a consultation document on the revised UK Corporate Governance Code which requires commentary by May 2010. The aforementioned Walker Review confirms the commonly held view that the global business climate will become more risk averse as over-regulation of companies will stifle people’s creativity. Corporate governance should be less about enforcing rules and more about encouraging the right attitude toward the rules. What is needed is to strike the right balance between implementing hard rules in some areas and allowing flexibility in others.

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91 Ibid.
92 Ibid Page 3.
93 Ibid Page 2 Note that the Walker Review recommends stricter regulation which has culminated in the Financial Services Bill (2009).
94 Consultation On Revised Corporate Governance Code (December 2009) Downloaded from http://www.hm-treasury.gov.uk (Last visited on 4 December 2009). It seeks to consult on governance in the UK based on the Walker Review with committees established to deliberate on whether the proposals made by the Walker Review should extend to all Listed Companies as opposed to just banks and financial institutions. A final report for deliberation will be circulated in May 2010.
The Walker Review proposes a culture and behavioural change in boardrooms that warrants more disclosure in the interests of shareholders and stakeholders like bank customers. 99

With the increasing reliance on market forces and by definition freer enterprise around the world, the quality of corporate governance and the nature of corporate responsibility will become even more important in building and sustaining public confidence in the legitimacy of commerce and industry.

The current trend of the public policy focus is to maintain strong internal controls coupled with independent testing and reporting by external auditors. This encapsulates the intent of section 404 of Sarbanes-Oxley. 100 It also sets out the current public policy directives. 101 High standards of objectivity, rigor and transparency in accounting standards and financial reporting are essential to good corporate governance and investor confidence. Unambiguous corporate financial reporting must be done to ensure full and complete compliance with the requirements of the relevant accounting standards and the applicable legislation pertaining to corporations. Effective enforcement of corporate law is essential under the auspices of an adequately resourced, independent single national corporate enforcement agency responsible for all aspects of corporate governance and law.

In relation to the legal mechanisms aimed at improving corporate governance La Porta 102 has shown that the United States (US or USA) shareholders and creditors are among the

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100 Sarbanes-Oxley Act of 2002 (note that there has been no governance reform in the US save for the recent Emergency Economic Stabilization Act of 2008 (EESA) which established The Troubled Asset Relief Program, commonly referred to as TARP a program of the United States government to purchase assets and equity from financial institutions to strengthen its financial sector. It is the largest component of the government's measures in 2008 to address the financial crisis. It is a reactive measure to a corporate governance crisis rather than corporate governance reform per se and has since been replaced by the American Recovery and Reinvestment Act of 2009 (ARRA)).


best protected in the world.\textsuperscript{103} Notwithstanding this and stringent legal reform the financial crisis has proved devastating on global liquidity and the global economy. It has resulted in monumental losses for banks and financial institutions.\textsuperscript{104}

Once again, it has been followed by the predictable and anguished cry for more regulation as evidenced after the global debt crisis of the eighties, the savings and loan debacle in the US, the Asian debt crisis of 1987\textsuperscript{105} and the sovereign bond defaults in 1999.\textsuperscript{106} Each crisis occurred despite regulations. These corporate catastrophes revealed certain weaknesses in corporate governance, disclosure practice and related aspects of the legal and regulatory foundations of our markets.\textsuperscript{107}

1.7 Conclusion

Corporate governance issues have moved to centre stage in the financial policy deliberation of most states and countries. Countries with deep capital markets were seen as robust and capable of dealing with their own problems with little official interference. This confident view of differential corporate governance definitions is being re-examined as indicated in terms of Chapter 1.6. The majority of corporate governance deliberations involve the closer examination of the role that market discipline, transparency and more stringent disclosure can and should play in strengthening corporate governance. The prima facie view is that disclosure constitutes a vast and feral concept which is best governed by a mandatory regime.

This is most evident in the strides made globally to govern verifiable disclosure of information relevant to shareholders and stakeholders. The issue remains is whether

\textsuperscript{103} This has been further strengthened by the passing of the Sarbanes-Oxley Act 2002. The South African corporate and insolvency regime is pro creditor. This will change, following the effective implementation of the Consumer Protection Act 68 of 2008 and the Companies Act 71 of 2008.
\textsuperscript{104} Turner Review: A regulatory response to the global banking crisis (March 2009).
\textsuperscript{106} Ibid.
prescribed and monitored disclosure as advocated by new governance codes and legislative inputs will strengthen accountability and governance. The prescriptive American model has not guaranteed good corporate governance in fact the compliance costs associated with this regime has stifled meaningful and substantive disclosure.\textsuperscript{108} Similarly voluntary governance regimes have fallen foul to boiler plate, unsubstantiated and vague explanations for non application of governance codes.\textsuperscript{109} As such the role of disclosure in strengthening corporate governance and accountability although a central feature is not a guarantee to obviating governance failure. This can be attributed to the weaknesses in the models of governance under review, the porous and unreliable disclosure made by companies or a combination of both.

Legal reform should seek to refine the mandatory model by incorporating a definitive ethics regime. This means responsible leadership and doing business ethically rather than merely being satisfied with legal and regulatory compliance.\textsuperscript{110} The integrity of the information will in turn be positively impacted. Practically this would translate to supplementing existing governance regimes with controls like ethics policies, director training and penal measures for non compliance to ensure the gaps in the flow of information to shareholders and stakeholders alike are correctly bridged. Disclosure of information is not enough, the nature of information released needs to independently verified. Finally the ownership of this disclosure and concomitant responsibility should vest with the board of directors. The accountability of directors should be supported by appropriate legislation that is simple, accessible and easily enforceable. These assertions will be fortified in the ensuing chapters.

CHAPTER 2: DEFINING THE ROLE OF DISCLOSURE IN STRENGTHENING CORPORATE GOVERNANCE AND ACCOUNTABILITY

\textsuperscript{109} A Review of corporate governance in UK banks and other financial industries 26 November 2009 Page 15.
2.1 Introduction

Disclosure is a broad and multifaceted component of any regulatory regime. This chapter seeks to analyze the merits of a mandatory regime of disclosure against the purported prudence of a voluntary regime of disclosure. The focal point of the analysis is to determine which regime obviates corporate abuse with greater efficacy thereby strengthening corporate governance and accountability. This is best achieved by analysing the American and English corporate governance models to determine the best suited model for South Africa. The jurisdictions chosen are on the basis of a pure legislative approach in America ('comply or else') as opposed to the 'apply or explain' flexibility of the English model of governance. It allows a juxtaposition of two different approaches and the option for South Africa to cherry pick options that best suits its corporate landscape. The forgoing evaluation of disclosure practice seeks to analyse and ascertain what is best suited to South Africa.

2.2 An evaluation of the forces that are causing the re-examination of disclosure practice

Section 195 (1) (f) and (g) of the Constitution of the Republic of South Africa emphasizes the fact that public administration must be fostered by providing the public with timely, accessible and accurate information.

This is commensurate with the doctrine propounded by King II which states that stakeholders such as the community in which a company and government operate, its customers, its employees and its suppliers need to be considered when developing the strategy of a company. However, in terms of section 15A of the Companies Act 61 of 1973, the registrar of companies has the power to condone non-disclosure if it was done for strategic reasons. It became a useful provision for disguising bad business

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112 Act 108 of 1996.
performances and led to lack of transparency. This is in obvious conflict with the primary focus of corporate governance which is disclosure and accountability. The main principle behind accountability and disclosure is that directors should present a balanced and understandable assessment of the company’s financial position and its future prospects.\textsuperscript{115}

There is no equivalent section in the new Act\textsuperscript{116} and in fact section 29 of the new Act\textsuperscript{117} fortifies transparency and accountability of companies and the authenticity of financial statements filed. This is supplemented by the integrated reporting requirements of King III which seeks to ensure that the board makes full disclosure of both sustainability and financial information\textsuperscript{118} and that the board complies with applicable laws and considers adherence to non binding rules, codes and standards.\textsuperscript{119}

The value of disclosure depends on the independent verification of data and the detail of information being disclosed. A corporate governance commentator aptly described this phenomenon as: ‘delivering information is easy but delivering credible information is hard.’\textsuperscript{120}

In general, information being disclosed comprises two typologies, namely: accounting and non-accounting information.\textsuperscript{121}

From an accounting perspective the company’s financial reports which encapsulate the company’s financial position, meet narrow technical requirements. They provide a glimpse of the company’s past performance, little is said of the future and hardly any


\textsuperscript{116} Act 71 of 2008.

\textsuperscript{117} Ibid.


\textsuperscript{119} Ibid Principle 2.9.


\textsuperscript{121} Ibid 129.
information pertaining to the firm’s capacity to innovate, train and enrich its human capital resources, or initiatives to enhance its corporate governance are mentioned.\(^\text{122}\)

All these intangible assets, if reported at all, appear in a non-comparable format and are often in an inconsistent form. This is the reality even though the markets clearly signal the growing importance of such intangibles or non-accounting information as critical enhancements of value in the market place.\(^\text{123}\)

The long term sustainability of corporations rests on a complex balance of factors. While financial viability is clearly vital so too are elements such as the ability to adapt in a changing market.\(^\text{124}\) This is starting to change as many corporations seek ways of measuring their so-called eco-efficiency performance.\(^\text{125}\) Moreover, it enables management to anticipate and exploit opportunities to strengthen the firm’s market competitiveness and boost corporate transparency.\(^\text{126}\)

Sustainability is one of the key themes of King III\(^\text{127}\) it is emphasized throughout the report and the integrity of sustainability reporting vests in the board. The board must ensure that stakeholders and shareholders can make an informed assessment of the company’s economic value and future value creation.\(^\text{128}\)

A strong disclosure regime is a pivotal feature of market-based monitoring of companies, which enhances the relationship between corporate governance and transparency. The latter goes directly to the market’s ability to observe a corporation’s performance. Without effective disclosure of financial performance existing shareholders cannot

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\(^{126}\) Ibid 87.


evaluate management’s past performance and prospective investors cannot forecast the corporation’s future cash flow.\textsuperscript{129}

Shareholders and potential investors require access to regular reliable and comparable information in sufficient detail for them to access the stewardship of management and make informed decisions about the valuation, ownership and voting of shares.\textsuperscript{130} A significant driver behind disclosure practice would be disclosure of concentrated control blocs within a company.\textsuperscript{131} This is to ensure that related party transactions are avoided or adequately disclosed. While not all related party transactions are harmful, abuse does occur.\textsuperscript{132} A pertinent example of a control bloc situation is family controlled public companies wherein policy and form are influenced by majority shareholders. As such explicit disclosure of shareholding is imperative.\textsuperscript{133}

The idea then that information and prompt, accurate disclosure of this information play a central role in our society is certainly not new and mechanisms are constantly being created to transfer this information to the public domain.\textsuperscript{134}

Such periodic disclosure, however, has at least two flaws. First, there is a time lag between the date as of when disclosure documents (typically the firm's financial statements) are prepared and when they are actually disclosed. For instance, an annual report must be prepared and become public after the closing of the company's fiscal year.

\footnotesize{\textsuperscript{129} C Himmelberg \& RG Hubbard ‘Understanding the Determinants of Managerial Ownership and the Link between Ownership and Performance’ (1999) 53 \textit{Journal of Financial Economics} 353, 357. \\
\textsuperscript{130} Ibid 358. \\
\textsuperscript{132} Section 226 of Act 61 of 1973 which requires disclosure of all loans to directors and properly authorised transactions to be replaced by Section 45 of Act 71 of 2008 which pertains to \textit{Loans or other Financial Assistance to Directors}. This section applies not only to loans or financial assistance to directors or other officers or related parties, but also to \textit{‘a related or inter-related company or corporation’} (section 45(2)). In terms of section 45(5) (a), certain disclosure requirements are triggered when specified loans to directors and other prescribed officials exceed 0.1% of the company's ‘net worth’. \\
\textsuperscript{133} R LaPorta et al ‘Corporate Ownership Around the World’ (1999) 54 \textit{Journal of Finance} 471, 517. \\
\textsuperscript{134} A Florini \textit{The Coming Democracy: New Rules for Running a New World} 2 ed (1980) 67.}

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There is a potential three to six month hiatus.\textsuperscript{135} Second, there is no obligation for the company to update the information supplied in the financial statements even if something happens after they are prepared and become public. There is an exception that certain important events must be disclosed in a special report (known as an ‘8-K’ report in the US)\textsuperscript{136} but this exception is not comprehensive. To rectify these flaws there must be a supplemental scheme. In this vein, stock exchanges and other self-regulatory bodies usually require timely disclosure by which the company is required to divulge pertinent information more often and sometimes in more detail than is required by law.\textsuperscript{137}

2.3 The nature and form of information that should be disclosed: mandatory versus voluntary disclosure.

From a corporate governance perspective, disclosure alone may not be enough. Other legal infrastructures are equally important for corporate governance to be pertinent. One must examine the mechanics behind the disclosure procedure, i.e., wholly voluntary, wholly mandatory disclosure or a compromise governance regime.\textsuperscript{138}

Some commentators postulate that the most potent means of protecting investors is mandatory disclosure wherein a guarantee is elicited that companies will implement the reforms necessary to provide investors with adequate checks on shareholder issues, directors and board control.\textsuperscript{139}

\footnotesize{\textsuperscript{135} RA Dye ‘Mandatory versus Voluntary Disclosures The cases of Financial Real Externalities’ 65 (1990) \textit{Accounting Review} 24, 32.}

\footnotesize{\textsuperscript{136} http://www.sec.com (Last visited on 19 November 2009) Form 8-K is a report required to be filed by public companies with the United States Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934, as amended. After a significant event or change a public company generally must file a current report on Form 8-K within four business days to provide an update to previously filed quarterly reports on Form 10-Q and/or Annual Reports on Form 10-K. Form 8-K is a very broad form used to notify investors of any unscheduled material event that is important to shareholders or the SEC. This is one of the most common types of forms filed with the SEC.}

\footnotesize{\textsuperscript{137} Raghu Ram, R & Zingales, L ‘Finance Dependence and Growth’ (1998) 88 \textit{Economic Review} 529, 559.}

\footnotesize{\textsuperscript{138} www.theeconomist.com (Last visited on 19 November 2009) ‘World Investment Prospects Comparing Environments across the world’ (2001).}

\footnotesize{\textsuperscript{139} RA Dye ‘Mandatory versus Voluntary Disclosures The cases of Financial Real Externalities Accounting Review’ (1990) 65 24, 28.}
The optimal governance regime is perhaps a hybrid regime in which the adoption of best practice guidelines is voluntary but disclosure of corporate governance practices is mandatory. Such a regime is optimal since it balances the benefits and costs to all stakeholders.\(^{140}\)

The South African regime of corporate governance is self-regulatory. It may even be regarded as ‘soft-law’, as there is no legal basis for enforcement. The regime is underpinned by the philosophy of ‘comply or explain’.\(^{141}\) Affected companies\(^{142}\) are required to comply with the Code of Corporate Practices and Conduct.\(^{143}\) Compliance with these guidelines is voluntary but companies listed on the Johannesburg Securities Exchange, South Africa (JSE) are required to include in their annual report a disclosure statement.\(^{144}\) This statement explains how the public companies apply the principles of corporate governance or explain why it does not comply.\(^{145}\) King III and the new Act have not deviated from this principle but King III has increased the ambit and scope on what a company must report on in the form of the Integrated Report.\(^{146}\) King III has failed to provide definitive guidelines on how this should be achieved\(^{147}\) and the new Act has focused purely on mandating the disclosure of financial information.\(^{148}\)


\(^{141}\) King Report on Corporate Governance (2009) Page 5 introduces the wording change of ‘apply or explain.’ Commentators like Lindie Engelbrecht explain this as being less prescriptive and more commensurate with a voluntary regime and will hopefully encourage more expansive and substantive explanations as opposed to conformance based explanations. http://www.iodsa.co.za (Last visited on 29 November 2009).

\(^{142}\) Includes listed companies, banks, financial and insurance entities and public sector enterprises that fall under the Public Finance Management Act 1 of 1999. See also Introduction and Background of King Report, 2002.

\(^{143}\) T Mongalo ‘South Africanising Company Law’ (2004) 121 SALJ 104, 106. While the Code is the document that companies must endeavour to comply with, the King Report assists in understanding the provisions of the Code. King III endorses this viewpoint.

\(^{144}\) Section 3.84 JSE Listing Requirements.

\(^{145}\) Section 8.63 (a) JSE Listing Requirements.

\(^{146}\) King Report on Corporate Governance (2009) Principle 9.1 prescribes the Integrated Report which seeks to present a holistic and integrated representation of a company’s finances and sustainability.

\(^{147}\) King Report on Corporate Governance (2009) Chapter 9 provides substantive recommendations.

\(^{148}\) Sections 28, 29 and 30 of Act 71 of 2008.
The American Model has been criticised for being overly prescriptive but has in fact imposed a degree of extra-territorial harmonisation precisely because many off-shore companies are listed on the New York Stock Exchange (NYSE) and National Association of Securities Dealers Automated Quotations (NASDAQ). This is referred to as ‘piggy backing’. Similarly, the principle of complying or explaining as embodied in the UK Combined Code has gained prominence as the code to emulate because companies from a host of countries are listed on the London Stock Exchange (LSE). Notwithstanding, this proclivity each country has its unique domestic requirements.

While this concept may be construed as being progressive nonetheless it does not supersede the domestic requirement for corporate governance developments. As highlighted in Chapter 1.6 the revised Combined Code remains subject to further review and consultation and has raised jurisprudential deliberations that could impact the ‘explain and comply’ regime. Developments in corporate governance have been included in the Financial Services Bill which seeks to entrench the Walker Review recommendations pertaining to disclosure of executive remuneration and risk mitigation strategy. This restates the trend towards a mandatory disclosure regime as an effort to enhance corporate governance and accountability.

The mandatory system of disclosure has societal benefits largely due to the primary incentive of compliance which is the avoidance of penalties that are generally onerous. This is the so called ‘command and control’ structure. The main benefit alluded to above is that regimes with strong investor protection will lead to healthy capital markets. La

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152 http://www.hm treasury.gov.uk (Last visited on 27 November 2009) The Financial Services Bill and an impact analysis was released for commentary on 19 November 2009.
Porta\textsuperscript{154} has found that countries with better legal protection for investors have financial markets that are more developed.

The other benefit to a command and control system is broad based compliance.\textsuperscript{155} Compliance is one of the most significant weaknesses of voluntary disclosure regimes. If the state establishes a set of guidelines or best practices to be followed there are no assurances that the market actors will abide by them since they are not mandatory and thus no penalty attaches to those who fail to comply. While voluntary regimes are less direct, they nevertheless can encourage compliance over time. As more and more companies and organizations adopt corporate governance practices over time, these voluntary practices will become the norm among a majority of firms. This can be termed the so-called 'snowball effect'.\textsuperscript{156}

The regime in South Africa is to a large extent a hybrid model comprising voluntary compliance with King II (and King III as of 1 March 2010) and mandatory compliance with applicable legislation. However, good corporate governance practice will no doubt have an escalating snowball effect over the next few years accentuated by the enactment of the new Act.\textsuperscript{157} The new Act is a step in the right direction as it adds significant governance requirements for public companies and it seeks to establish a commission to enforce compliance with new governance rules.\textsuperscript{158}

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\item \textsuperscript{154} R La Porta et al 'Corporate Ownership around the World' (1999) 54 Journal of Finance 471, 510.
\item \textsuperscript{155} R La Porta et al 'Legal Determinants of External Finance' (1997) 52 Journal of Finance 1131, 1140.
\item \textsuperscript{156} \url{http://www.corporategovernancealliance.com} (Last visited on 27 November 2009).
\item \textsuperscript{157} Act 71 of 2008.
\item \textsuperscript{158} Section 203 of Act 71 of 2008. This was initially analysed in the Department of Trade and Industry Paper: South African Company Law for the 21\textsuperscript{st} Century – Guidelines for Corporate Law Reform, (2004). The Draft Regulations of the Companies Act were released for public comment on 22 December 2009. Regulations 153 to 170 makes no mention of a regulator per se and as such has failed to initiate a regulatory body of any substance. Regulation 143 does afford the Commission the right to commence investigations and has supporting Regulations in the form of Regulations 139 to 141 to assist with these investigations which are tantamount to the powers afforded to the SEC. This will no doubt be the basis of much debate and commentary as there is not recommended formulation as to how this will be implemented in practice. It is nevertheless a step in the right direction to initiate a mandatory regime of compliance.
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The latter will thus compel companies to subscribe to a stricter ethos of disclosure. There is a lucid movement to more mandatory disclosure to ensure compliance and competitiveness in a global arena. This is a commendable feature as developing economies and countries require as much global clout as they can muster and this is clearly in the form of international standardized corporate governance norms.

The optimal governance structure is a partially mandatory regime in which compliance with a code of governance practices is voluntary but disclosure regarding the extent of compliance is mandatory. Of course, optimality, in the corporate governance context is an elusive term with precision about costs and benefits impossible to achieve. However, despite a certain level of ambiguity and possibly equivocation from some companies, we can say that an optimal regime is one that balances the benefits and costs to all stakeholders particularly firms and investors.

The United Kingdom’s (UK) Combined Code places some responsibility for good corporate governance on institutional shareholders by devoting a section to them. The Combined Code suggests that shareholders must evaluate the company’s statements and urge them to do so carefully with common sense and by giving due consideration to all relevant circumstances. The Combined Code also warns shareholders that while they ‘have every right to challenge companies’ explanations if they are unconvincing, they should not be evaluated in a mechanistic way and departures from the code should not be automatically treated as a breach’. In having a section devoted to shareholder responsibility in the Combined Code, as well as warnings of this sort, it presents a fine balance between investor objectives and the interests of a firm in governance matters. While good governance is surely a matter of responsibility for the board and management there may be valid explanations for their departures from voluntary governance practices.

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160 Ibid 446.
162 The Combined Code (2008) Section D Relations with Shareholders. See also Rule 12.43 A (b) of UK Listing Rules.
In the absence of a highly vigilant board and stringent internal controls as is evidenced in the English regime this governance model would be vulnerable to abuse.

The South African system is in stark contrast to the corporate governance regime in the United States (US). In the US, disclosure is mandatory save for disclosure as to whether the company has a code of ethics for senior financial officers. If there is no compliance with the latter, detailed explanation must be provided for the waiver of the code of ethics.\textsuperscript{164} In addition disclosure of whether there is a financial expert on the audit committee must be provided alternatively a suitable explanation must be provided for explicit non compliance must be made.\textsuperscript{165}

The last two elements contain the ‘if not, why not’ approach of the English and South African regime. However, their presence does not permit the American regime to be classified as partially mandatory. The majority of elements of SOX in conjunction with the NYSE rules justify the US regime as being described as purely mandatory.

The new rules added to the existing NYSE governance regime include the following:

- majority of independent directors;
- disclosure of determinations of director independence;
- regularly scheduled executive sessions of non-management directors of each company;
- nominating committee and compensation committee composed entirely of independent directors, with a written charter addressing purpose and

\textsuperscript{164} \url{http://www.nyse.com} (Last Visited on 5 December 2009) NYSE Listing Rules, Section 303A 10. Note corporate governance rules of the New York Stock Exchange approved by the SEC on November 4, 2003, and amended on November 3, 2004, other than Section 303A.08, which was filed separately and approved by the SEC on June 30, 2003. These rules are codified in Section 303A of the NYSE’s Listed Company Manual.

\textsuperscript{165} Ibid Section 303 A 06.
responsibilities of each committee and an annual performance evaluation of each of the committees that meets the requirements of Rule 10A-3 of the SEC;\textsuperscript{166} shareholder voting to approve equity compensation plans\textsuperscript{167} and adopt and disclose corporate governance guidelines and a code of business conduct and ethics for directors and officers and employees.\textsuperscript{168}

Commentators on SOX and the American model of governance have criticized its implementation as rendering the US market uncompetitive, costly and prescriptive. The cumulative result is a counterproductive model of governance.\textsuperscript{169} The efficacy of any model of governance should be evaluated on a cost and conferred benefits basis but should also be tempered with long term gains. The costs to avert wide scale economic failure far outweigh the implementation costs of regulation. This fortifies the opinion that mandatory disclosure is required as market influences are insufficient to encourage voluntary action.

As such jurisdictions are moving towards some form of mandatory disclosure.\textsuperscript{170} Thus the seeming popularity of the mandatory structure leads one to question why jurisdictions

\textsuperscript{166} \url{http://www.sec.gov} (Last visited on 17 November 2009) Sec Rule 10A-3 relates to the audit committee members meeting a heightened standard for independence. The rule implements the requirements of Section 10A(m)(1) of the Securities Exchange Act of 1934, as added by Section 301 of the Sarbanes-Oxley Act of 2002.

\textsuperscript{167} Ibíd. The Securities and Exchange Commission SEC's proxy rules require that domestic public companies prepare a ‘compensation discussion and analysis’ (CD&A) including extensive tabular and narrative disclosure of compensation paid to their most senior and highly compensated executives. This is filed with the SEC which means officer liability for material errors and omissions. The CD&A covers the basis, motivations and relevant information considering for remuneration including that of Non Executive Directors. Once the compensation committee recommends to the Board of Directors that the CD&A be included in Form 10-K and proxy statement it is as mentioned filed with the SEC.

\textsuperscript{168} \url{http://www.nyse.com} Section 303 A 02-05. The NYSE Rules do exempt the following types of companies from specific requirements: controlled companies limited partnerships and companies in bankruptcy closed-end and open-end funds, passive business organizations in the form of trusts derivatives and special purpose securities and foreign private issuers. The exemptions from which these types of companies benefit usually reflect the already onerous requirements that the companies face from other regulators.


\textsuperscript{170} F Easterbrook & D Fischel The Economic Structure of Corporate Law led (1991) 156.
have adopted a hybrid corporate governance regime and, in particular, the benefits of such a regime.\textsuperscript{171}

A latent assumption in academic literature is that there is a causal relationship between corporate governance and firm performance.\textsuperscript{172} However recent research belies this theory. For example, Dalton\textsuperscript{173} has found little evidence to support any relationship between governance and performance. Why then do regulators, investors and public interest groups lobby for higher standards of corporate governance? There are reasons other than positive effects on firm performance as to why investors advocate and regulators support enhancements to corporate governance rules or practices. The received benefits of a comprehensive governance regime include greater accountability to investors by such mechanisms as an independent board, an independent and financially literate audit committee and increased disclosure.\textsuperscript{174}

Research also shows that investors from all over the world indicate that they will pay large premiums for companies with effective corporate governance. One such study conducted by The McKinsey Quarterly\textsuperscript{175} found that institutional investors in emerging market companies would be willing to pay as much as 30 percent more for shares in companies with good governance. Furthermore, it showed that companies with better corporate governance had higher price-to-book ratios, demonstrating that investors do indeed reward good governance.\textsuperscript{176}

The regulatory view is that greater accountability is necessary in order to inspire and maintain investor confidence and to ensure the efficacy of disclosed information.

\textsuperscript{175} http://www.mckinseyquarterly.com (Last visited on 19 November 2009).
\textsuperscript{176} Ibid. (Last visited on 19 November 2009).
Investors care about governance regardless of a firm’s ultimate performance; they want to make sure that they are not disadvantaged by a firm’s corporate governance structure.\textsuperscript{177}

To try and reconcile all the differences in the various markets around the world in the search for a global set of rules is fraught with difficulty. But the principle of ‘comply or explain’ has been gathering increasing acceptance as a flexible, evolutionary way for governance practices to develop. If business leaders prefer to comply or explain, it will be essential to ensure that every explanation is articulated in a full and convincing manner to ensure investor confidence.

As such it would be more beneficial to focus on developing adherence to international accounting standards to promote global literacy of financial information. This would enhance the accessibility and efficacy of information. Moreover, it would be of vital importance to embrace the imperative role disclosure plays in corporate governance which in turn is a prerequisite to a vigorous equity market. Furthermore, transparency and disclosure are essential and critical cogs of corporate governance. Whether these mechanics are voluntary or by way of mandatory prescription remains an ineluctable and necessary condition to accountability.

2.4 Conclusion

According to a report compiled by Credit Lyonnais Securities Asia (CLSA)\textsuperscript{178} pertaining to the latest emerging markets survey South Africa ranked in the top eleven emerging markets in terms of corporate governance, but it ranked poorly in terms of disclosure and transparency which indicates the ‘comply or explain’ regime encompassed by King II (and the less prescriptive ‘apply or explain’ regime of King III)\textsuperscript{179} although laudatory has not been completely successful. To ensure that South Africa is internationally competitive it must visibly demonstrate impeccable governance standards in all sectors of

\textsuperscript{178} http://www.clsa.com (Last visited on 17 November 2009).
\textsuperscript{179} King Code on Corporate Governance (2002) and King Report on Corporate Governance (2009).
commercial activity, not only in principle but in practice as well. The question posed is whether this would be best achieved via a mandatory regime as opposed to a voluntary governance model. The mandatory American model of governance has been examined and it has garnered significant criticism based firstly on the costs associated with its implementation which is simply not commensurate with an emerging economy and a company law regime analogous to English Law. Also the ‘comply or else’ regime has illustrated that disclosure for the sake of compliance (as evidenced by the financial crisis) does not guarantee transparency and accountable governance compounded by the fact that it is devoid of the ‘principles based’ mould that characterizes King II and King III. The alternate English model and the accrued benefits of the ‘comply and explain’ regime to South Africa have also been examined. This is certainly not an ideal regime and can result in disparate disclosure.

This has initiated a complete review of the Combined Code and has been the catalyst of governance legislation in the UK which denotes a deviation from a pure voluntary perspective of governance to a hybrid model. The hybrid model denotes a coupling of ‘apply or explain’ principles with legislative assistance. King III read with the new Act will seek to embody this model. King III cautions against additional legislation this assertion is partly correct if the mandatory model considered is the American option for the reasons stated above but the South African corporate landscape would be best served by definitive disclosure provisions as it relates to non financial information and the risk strategies adopted by boards. The Walker Review states that increased disclosure will

180 King Report on Corporate Governance (2009) Page 6 which highlights the fact that the total cost to the American economy of complying with its ‘comply or else’ regime is considered to amount to more than the total write-off of Enron, Worldcom and Tyco combined.
184 Section (7) (b) (iii), 92 and 94 of Act 71 of 2008.
186 Section 76 and 77 of Act 71 of 2008 has amplified the importance of directors applying their minds and voicing their opinions to ensure their discordance with potentially negative decision taking is minuted to avoid personal liability but remains silent on integrated reporting, sustainability and risk strategy which if viewed holistically will ensure accountable corporate governance and negate the effect of devastating
not guarantee the recurrence of governance failures but seeks to render them less likely and less devastating as the failure of regulation will be mitigated by principled and controlled decision making of directors.\textsuperscript{187} Thus corporate abuse in South Africa would be best curbed by a mandatory regime of disclosure mirroring UK governance developments as opposed to the hybrid model proposed for implementation in 2010. The key issues underpinning the enhanced disclosure relates to the ‘corporate conscience’ which is cognizant of social imperatives as opposed to short term economic gain. This speaks squarely to the stakeholder theory and sustainability initiatives which remain unlegislated and which is considered in the foregoing chapter as a key disclosure imperative in improving governance, accountability and ethical leadership.

CHAPTER 3: A LEGISLATIVE SURVEY OF APPLICABLE DISCLOSURE PROVISIONS IN SUPPORT OF KING II, KING III (FROM A SHAREHOLDER VERSUS STAKEHOLDER PERSPECTIVE) AND AN ANALYSIS OF DISCLOSURE PRACTICE IN RELATION TO CORPORATE SOCIAL RESPONSIBILITY

3.1 Introduction

Modern corporate governance has as its central theme the commitment to corporate social responsibility.\textsuperscript{188} The competing classical view is that the focus of a corporate entity is the interests of its shareholders. The merits of these divergent schools of thought will be considered in this chapter but the recognition that companies interact with stakeholders and not just shareholders has heightened the accountability problem.\textsuperscript{189}

\textsuperscript{189} L Moir ‘What Do We Mean by Corporate Social Responsibility?’ (2001) 1 Corporate Governance 16, 22.
This chapter seeks to analyze these competing rights in respect of disclosure and the issue of accountability. In respect to shareholders, accountability is analyzed in respect of disclosure of financial information and incumbent positive results are a testament of good governance. This is a very insular perception which chapter 3.2 will seek to amplify.

The interests of stakeholders are analyzed with particular emphasis on legal compliance with stakeholder legislation, corporate citizenship, transformation and sustainability. Disclosure in respect of each of these facets is of central importance primarily in terms of the annual report but preferably in terms of tangible delivery. Critical to the stakeholder theory of governance is whether such disclosure is best procured on a mandatory or a voluntary basis.

In summary the purpose of this chapter is to analyze the competing disclosure requirements of stakeholders and shareholders and whether the current disclosure regime contributes to strengthening corporate governance and accountability for their individual and joint betterment.

3.2 Shareholder Theory of Corporate Practice and Disclosure

The history of the social responsibility of a company was articulated by Lionel Hodes who proposed the following principle: that if a company is desirous to pursue a charitable purpose it could be purported to extend its mandate beyond its primary obligation of profit maximization and its purpose as outlined in its articles of association and memorandum. Such conduct, notwithstanding its charitable intent, would be deemed as ultra vires in terms of section 36 of the Companies Act.

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194 Act 61 of 1973. Section 15 (1) (b) of Act 71 of 2008 is the equivalent section and has not deviated from the position outlined in Act 61 of 1973.
This is consistent with the common law as enunciated in the English case of *Hutton v West Cork Railway* that directors are under an obligation to act in the best interests of the company as a whole, with no ulterior motives. Consequently any corporate activity, whether charitable or otherwise, must be incidental to the execution of the company’s business for benefit of the company.\(^{195}\) This dictum was confirmed in the American case of *Dodge v Ford Motor Co*\(^{196}\) which pertained to the retention of a shareholder dividend with the intent of directing the retained funds into the construction of a hospital for the benefit of Ford employees. This constituted an act, although commendable, that was firstly not incidental to the business of the company and secondly not in the best interests of the company which was to promote future profits. It could also have been argued that the retention of the dividend was ultra vires.

Thus the traditional concepts of corporate governance had to be relied upon in ascertaining a company’s social responsibility, namely: the company’s memorandum, articles of association as outlined in Section 59 of the Companies Act\(^ {197}\) and the common law. These were the fundamental tenets of disclosure. The interests of various parties cumulatively referred as ‘stakeholders’ could only be taken into account by the directors to ensure that the company would prosper. The interests of stakeholders were therefore not recognized as a standalone objective. Decisions affecting them would simply be an incidental by-product of advancing the interests of shareholders.\(^ {198}\)

It is self-evident that shareholder interests, directed towards profit maximization\(^ {199}\) have historically been prioritized over and above other stakeholders including for example

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\(^{195}\) *Hutton v West Cork Railway* (1883) 23 Ch D 654 See also HR Hahlo *Company Law through the Cases* 6 ed (1999) 279.

\(^{196}\) *Dodge v Ford Motor Co* (1919) 204 Mich 459 170 NW 668.

\(^{197}\) Act 61 of 1973. Section 15 of Act 71 of 2008 addresses the Memorandum of Incorporation (which is the new cumulative reference to Memorandum and Articles of Association).


\(^{199}\) *Coronation Syndicate v Lillenfeld and the New Fortuna Co. Ltd* (1903) TS 489.
employees. This position was succinctly confirmed in *Hall Parke v Daily News Ltd* 200 wherein the court held that:

‘ex gratia payments of corporate funds by sympathetic directors to redundant employees without taking into account the interest of shareholders was an exercise in philanthropy which was unlawful, being ultra vires and a breach of a directors fiduciary duty.’ 201

There are additional theoretical assertions that support this theory. The most sagacious and practically sound conceptualization is the importance of the economic success of a company, which by its presence alone will confer social benefits to various stakeholders which would not be delivered if the company was a financial failure. Milton Friedman’s sentiment 202 was confirmed by academics like Professor Adolf Berle who stated emphatically that ‘all powers granted to a corporation or to the management of a corporation are necessarily and at all times exercisable for the rateable benefit of all shareholders.’ 203

A commensurate rationale was perpetuated by the Hampel Committee when it concluded that:

‘the single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation of and greatest practicable enhancement over time of their shareholder’s investment.’ 204

203 A A Berle & G C Means *The Modern Corporation and Private Property* 3ed (1932) 56.
204 Hampel Committee (1998) on Corporate Governance (Final Report).
The monitoring and disclosure of a shareholder-centric commitment translates practically to the filing of glowing financials. The previous chapter outlined that this is not always simple or accurate and in fact could be the source of manipulation. \(^{205}\)

Shareholders do have to rely on financials, the duties of directors and the provisions of the Companies Act \(^{206}\) quite extensively. In terms of the Companies Act it is a legal requirement for every company in South Africa to appoint an auditor. \(^{207}\) The primary role of an external auditor is to report to shareholders on whether the company’s financial statements fairly represent the company’s financial position and the results of its operations in all material respects. \(^{208}\) In addition, the Public Finance Management Act prescribes more stringent provisions for reporting and accountability by adopting an approach to financial management in government that focuses on outputs and responsibilities rather than the rule driven approach under previous legislation. The ambit and operation of the Act seeks to secure transparent, accountable and sound management of public revenue. \(^{209}\)

Disclosure of financials notwithstanding statutory provisions can be manipulated often emanating from management’s self serving behaviour. \(^{210}\) Disclosures of this nature weaken corporate governance and clouds accountability issues as such regulations should be enacted to counter such unethical conduct. King II has advocated the internal audit function \(^{211}\) and audit committees. \(^{212}\) The latter seeks to ensure and safeguard shareholders and company interests by advocating communication between the board and the external auditor. King III has enhanced the function of the audit committee function by proposing an effective and independent audit committee. \(^{213}\) King III augments the function of the

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\(^{205}\) See Chapter 2.2.

\(^{206}\) Act 61 of 1973 and See Chapter 4.2 and Chapter 4.3.

\(^{207}\) Section 279 of Act 61 of 1973. Section 90 of Act 71 of 2008 is the equivalent section.

\(^{208}\) Section 301 of Act 61 of 1973. Section 93 of Act 71 of 2008 is the equivalent section.

\(^{209}\) Section 1 of Act 1 of 1999.

\(^{210}\) PM Healy ‘The effect of bonus schemes on Accounting Decisions’ (2006) 7 Journal of Accounting and Economics 85, 87. See also Chapter 4.2.


\(^{212}\) King Report (2002) Section 5 Chapter 1 Paragraph 5.8.

internal audit committee in terms of a practice note that ensures internal audit assurance is provided (applying the Standards for the Professional Practice of Internal Auditing and the Code of Ethics of the Institute of Internal Auditors). The combined assurance model outlined in King III requires assurance coverage to be obtained from management and internal assurance providers on risk areas facing the company. This process is fortified by section 94 of the new Act.

Studies by McMullen have found that companies with an audit committee are less likely to experience errors, irregularities and other indicators of unreliable financial reporting. Financial reporting is also enhanced by audit committee independence which is consistent with the recommendations of King II and King III. Cumulatively these are efforts to safeguard a shareholder-centric means of disclosure as a mechanism to strengthen corporate governance for their benefit.

This has been enhanced by the Corporate Laws Amendment which has amended the Companies Act by promulgating the rotation of the designated auditors (individual partner as opposed to the actual firm) every five years as well the right of the auditor to access all company and accounting records. The rotation of auditors remains a key feature in King III and the new Act.

In addition, the audit committee must be satisfied with the auditor’s independence. The auditor’s rights also extend to the right to: receive notification of and attend shareholders’

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214 Ibid Internal Audit Charter Practice Note.
215 Ibid Principle 3.5.
216 Act 71 of 2008.
222 Insertion of Section 270 (A) into Act 61 of 1973.
224 Section 92 of Act 71 of 2008.
225 Insertion of Section 270 (A) into Act 61 of 1973 which advocates an independence test. Section 94 (b) of Act 71 of 2008 is the equivalent section.
meetings. To ensure proper preparation the auditor has the right to interview and meet with parties like the company secretary, chairman and investor relations prior to the meeting to ensure that any potential risk to shareholders is properly managed. The auditor’s function is further supplemented by their right to approach a court for an order that is just and reasonable in the event that the auditor’s duties are wilfully and intentionally frustrated by a director.\textsuperscript{226}

Thus the Corporate Laws Amendment Act\textsuperscript{227} has given effect to, inter alia, the corporate governance principles formulated in King II by the implementation of a uniform set of accounting standards and the imposition of various obligations on companies aimed at ensuring auditor independence and greater regulation of the auditing profession. This is analogous to the legislative imports made by the Auditing Professions Act.\textsuperscript{228} The position advocated by King III\textsuperscript{229} and the new Act\textsuperscript{230} does not deviate from this standpoint and in fact mirrors this position.

The historic nature of financials perpetuates inherent inaccuracies in implementing share value as the sole means of valuing a company or to ascertain whether best practice is being employed by a corporation. The recent spate of market flexes and share price depreciation is a clear indication of this anomaly and the fact that the shareholder theory has not prevented directors from acting in their self interest. Furthermore, the disclosure practice endorsed by shareholder theory protagonists in fact erode their profits from a compliance costs perspective and thus runs counter to the argument of profit maximisation.

\textsuperscript{226} Insertion of Section 270 (A) into Act 61 of 1973. Section 93 (2) of Act 71 of 2008 is the equivalent section.

\textsuperscript{227} Insertion of Sections 270 A and Section 275 A into Act 61 of 1973.

\textsuperscript{228} Act 26 of 2005.

\textsuperscript{229} King Report on Corporate Governance (2009) Principle 3.9 Recommendation 81 which advocates that the board should develop a process to ensure that the audit committee receives notice of reportable irregularities (as defined in the Auditing Professions Act 26 of 2005) that have been reported by the external auditor to the Independent Regulatory Board for Auditors. When the auditor’s report has been modified as a result of a reportable irregularity, the audit committee should review the completeness and accuracy of the disclosure of such matters in the financial statements.

\textsuperscript{230} Section 94 of Act 71 of 2008.
S440AA (1) of Sarbanes-Oxley\textsuperscript{231} states that:

'Any person who has reason to believe that a financial report of a widely held company failed to comply with a financial reporting standard may refer the matter to the executive officer of the Panel for investigation.'

The effect of this enactment has had far reaching cost implications and a source of discourse for mandatory reporting protagonists.\textsuperscript{232} The new Act\textsuperscript{233} however, has assumed a more progressive codified approach to corporate governance in terms of its purpose clause\textsuperscript{234} and the key governance provision that 'the business and affairs of a company must be managed by and under the direction of its board.'\textsuperscript{235} This is consistent with the inclusive approach envisioned by King II. This is a balanced approach to governance which would curb the imposition of onerous costs associated with rigorous reporting. King III requires additional reporting in the form of integrated reporting\textsuperscript{236} and a combined assurance model\textsuperscript{237} which the new Act\textsuperscript{238} remains silent on. The new Act\textsuperscript{239} has failed to incorporate a 'principles based' mandatory reporting system and is therefore short sighted in its approach.

The audit committee\textsuperscript{240} requirement of a designated number of independent directors\textsuperscript{241} with prescribed financial qualifications coupled with an auditor firm (designated partner) rotation every five years\textsuperscript{242} will prove more problematic in the South African context given the shortage of auditing skills. Thus the importation of these Anglo-American

\begin{footnotesize}
\begin{enumerate}
\item Sarbanes-Oxley Act 2002.
\item L. Sneller & H Langendijk ‘Sarbanes-Oxley Section 404 Costs of Compliance: a case study’ (2007) 15 Corporate Governance 101, 111.
\item Act 71 of 2008 which based its drafting on King II recommendations and global company law reform to collate company law practice with internationally accepted standards of corporate governance.
\item Section 7 (b) (iii) of Act 71 of 2008.
\item Act 66 of Section 71 of 2008.
\item Ibid Principle 3.5.
\item Act 71 of 2008.
\item Ibid.
\item Ibid Section 94.
\item Ibid Section 66.
\item Ibid Section 92.
\end{enumerate}
\end{footnotesize}
rationales will align South Africa to international norms but will prove a costly and a practically rigorous exercise.

Contrary to previous practice endorsed by King II and the JSE Listing Requirements the audit committee will no longer be reported on in the corporate governance insert of the annual report but will constitute a separate report for inclusion in the financial statements describing the audit committee function and the manner and means in which it carried out its delegated duties.\textsuperscript{243}

This would include a report on accounting policies, financial controls and any other related matter to the governance of the company, and would include the endorsement of the appointment of an independent auditor and could potentially include stakeholder related information. A further extension of the audit committee’s powers, which was once reserved for that of the board, is the procurement of external independent advice which would be paid for by the company to the extent that it is reasonable.\textsuperscript{244}

Conferring such powers and duties on the audit committee\textsuperscript{245} raises the perception that the audit committee seems more powerful than the board. The amendments are indicative of the importance of accurate verifiable disclosures to the viability of companies. As aforementioned the Integrated Report\textsuperscript{246} the integrity of which must be signed off by the board and the audit committee further escalates the function of the audit committee.

The Corporate Laws Amendment\textsuperscript{247} mirrored by amendments in the new Act\textsuperscript{248} pays homage to corporate governance initiatives by expanding on the accountability and the reporting requirements of companies. Collectively these legislative instruments represent disclosure requirements that are shareholder centric. The mandatory disclosure provisions

\textsuperscript{243} Ibid Section 100.
\textsuperscript{244} King Report on Corporate Governance (2009) Chapter 4.
\textsuperscript{245} Ibid Section 94 (4).
\textsuperscript{247} Act 24 of 2006.
\textsuperscript{248} Act 71 of 2008.
will constitute credible governance efforts and the penalties that flow from non compliance enhance accountability. This is coupled with auditors who now have a greater ambit of powers which hopefully they will adumbrate to fulfil their functions.

It is accordingly self evident that the traditional purist shareholder theory is supported by the common law and mandated disclosure practice. This is theoretically sound but unbalanced as a contractarian model of disclosure is inherently oblivious of stakeholder concerns and thus not commensurate with modern corporate governance. The new Act has enhanced and confirmed this position but\textsuperscript{249} has failed to legislate extensively on the stakeholder imperative as endorsed by King III.\textsuperscript{250}

3.3 Stakeholder Theory of Corporate Practice and Disclosure

Shareholder-centric practice was criticised by a stakeholder-centric publication which outlined an academic analysis of the logic of obliging directors to act exclusively for the benefit of the shareholders.\textsuperscript{251} It also sought to answer the vexed question of whether directors were in fact obliged to act in the interests of other stakeholders that were affected by the activities of the company.\textsuperscript{252}

This was the nub of corporate governance reforms and debates which in turn promulgated the stakeholder-centric view of business that highlights modern corporate governance. Corporate governance recommendations have since supported a wider scope of corporate responsibility than was previously the custom or allowed by law.\textsuperscript{253} This is consistent

\textsuperscript{249} See also Chapter 2.3 and Chapter 2.4.
\textsuperscript{250} Sections 20(4) of Act 71 of 2008 which restrains the company from doing anything inconsistent with the Act, Section 31 (3) of Act 71 of 2008 states that though the commission, trade unions must be given access to financial statements for purposes of initiating business rescue proceedings, Section 130 (1) of Act 71 of 2008 entitles an affected person to apply to court to challenge the board’s commencement of business rescue proceedings. Act 71 of 2008 is cognizant of stakeholder interests but not to the extent required to enhance disclosure and governance to the benefit of all stakeholders.

\textsuperscript{251} EM Dodd ‘For Whom are the Corporate Managers Trustees’ 1932 Harvard Law Review 1148.

\textsuperscript{252} Ibid 1148.

with the approach endorsed by King II and King III which champions the practice of coupling social and economic goals in running a company. 254

The stakeholder theory has been described as a matter of ‘taming the harsher aspects of capitalism’. 255 It is far too simplistic in the modern corporate world to reduce the success of a company to the short term nature of profit maximisation. 256 This is in fact the antithesis of the principles enunciated by King II and King III. 257 It is apparent that the operation of the modern company has a direct impact beyond shareholder wealth and must exercise this far reaching effect in a responsible and effective manner to benefit the common concern of both stakeholders and shareholders. This will inevitably result in the holistic prosperity of the company which would include a burgeoning bottom line. 258

The issue then arises: Does a company via its directors have a mandatory obligation to consider the interests of stakeholders in conducting the affairs of the company? Cognisance should be taken of stakeholders on a holistic basis however; the radical model mandates a primary concern for stakeholders. This would translate to negative implications for the accountability of directors as it would infer that directors would be accountable to all stakeholders. This must be rejected for the simple reason that to ask the

254 The King Report (2002) Introduction and Background Paragraph 17 Section 5 Chapter 1 Paragraph 8. It illustrates the triple bottom line reporting in the following manner: The economic aspects involve the well known financial aspects as well as the non-financial ones relevant to a company’s business. The environmental aspects include the effect on the environment of the product or services produced by the company. The social aspects embrace values, ethics and the reciprocal relationships with stakeholders other than just shareholders. King Report on Corporate Governance (2009) reiterates this assertion in terms of Principle 8.1, 8.2 and 8.4 to ensure the equitable treatment of shareholders and to proactively manage stakeholder relationships. This is further amplified by the proposed integrated report which should assert the company’s sustainability initiatives and the fact that the company is to employ alternate dispute resolution as a means to enhance its relationships with stakeholders.


256 See Footnote 254.

257 Ibid.

258 http://www.adlittle.co.uk/insights (Last visited 19 November 2009) which outlines the detailed research conducted to support the business case for corporate citizenship. It cites a host of factors that are enhanced like reputational management which is critical to corporate success, the fact that investor relations are driven by a company's social investment programme and that a company's competitiveness and market positioning is enhanced by sustainable procurement as is its operational efficiency and profitability.
board to be accountable to everyone would result in it being accountable to no one.\textsuperscript{259} This ultimately envisages a situation where the interests of the shareholders would be sacrificed in favour of the interests of other stakeholders. This is considered an unbalanced approach and one that would be untenable to shareholders.

The stakeholder theory would certainly broaden the ambit of accountability and disclosure of a company to a wider constituency. This is certainly the current trend as embodied in the pervasive sustainability provisions of King III coupled with the proposals that govern stakeholder relationships.\textsuperscript{260} This would entitle stakeholders to a right of action if they can establish prejudice due to poor decisions by the board of directors.\textsuperscript{261} In Anglo-American jurisdictions stakeholders are more accustomed to asserting their rights than stakeholders in other jurisdictions.\textsuperscript{262} Currently stakeholders would have to rely on the common law principles of delict to assert their rights or any contractual obligations they may have with the company. From a statutory perspective the Consumer Protection Act\textsuperscript{263} which is an effort to protect consumers against unfair business practice, will enable stakeholders to test their rights with further authority as opposed to relying on the common law which is clearly in favour of stakeholders.\textsuperscript{264}

The stakeholder-centric dictum of King II and King III is not instructive but merely advisory and is supported by limited mandatory disclosure requirements. Companies committed to the stakeholder model of governance would have to ensure that the decisions of their directors are suitably ring-fenced and do not inadvertently cause harm to their related stakeholders. This will change albeit not significantly pursuant to the


\textsuperscript{261} P Buri & T Borak ‘Employees as Corporate Stakeholders’ (2002) 8 \textit{Journal of Corporate Citizenship} 45, 57. See also section 218 of Act 71 of 2008.

\textsuperscript{262} D Milton ‘Communitarians, Contractarians and the Crisis in Corporate Law’ (1993) 50 \textit{Washington and Lee Law Review}.

\textsuperscript{263} Act 68 of 2008.

\textsuperscript{264} Section 218 of Act 71 of 2008. This section allows any party (therefore stakeholder) to initiate a civil action should the new Act be contravened. There is no immediate remedial action for stakeholders nor are there general disclosure provisions in favour of stakeholders as such normal court process will have to be followed nevertheless this section is progressive and will provide interesting test cases.
enactment of the new Act. The new Act simply requires directors to ‘attempt within the law to maximise the interests of shareholders’ which is analogous to the Revlon Standard which expressly forbids management from protecting stakeholder interests at the expense of shareholder interests. Rather any management action benefiting stakeholders must have ancillary shareholder benefits. Thus notwithstanding significant corporate governance reform in the US, very little progress has in made in favour of stakeholders since *Dodge v Ford Motor Co.* Sarbanes-Oxley has not changed the common law and this confirms the assertion that the mandatory model of corporate governance typified by American jurisprudence is not suitable for the South African corporate landscape as it is devoid of stakeholder centric norms. Moreover the new Act has failed to adequately legislate on stakeholder interests and mirror the progressive recommendations of King III.

Corporate governance is about the fine balance between stakeholder and shareholder theories which is intrinsic to implementing a holistic form of governance. Being cognisant of sociological and ethical notions will complement existing governance structure but not in a manner in which share value is not seen as the most important interest. It supports the legal argument and business model that meaningful disclosure and commitment to stakeholder interests can lead to profitability.

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265 Ibid.
266 Section 7 of Act 71 of 2008 which focuses the purpose of the new Act on promoting compliance with the Bill of Rights.
268 *Dodge v Ford Motor Co* (1919) 204 Mich 459 170 NW 668.
269 Sarbanes-Oxley Act 2002.
270 Act 71 of 2008.
271 King Report of Corporate Governance 2009 Chapter 9 which is a holistic approach to governance as opposed to Sarbanes-Oxley which is purely focused on financial information. It is interesting and noteworthy that the Draft Companies Act Regulations issued for comment and review on 22 December 2009 specifically proposes in terms of Regulation 50 (12) (ii) that the social and ethic committee has the function of promoting good corporate citizenship including but not limited to charitable giving and related stakeholder centric issues. This is a pronounced advancement from the current position.
272 [http://www.adlittle.co.uk/insights](http://www.adlittle.co.uk/insights) (Last visited 19 November 2009) which outlines the detailed research conducted to support the business case for corporate citizenship. It cites a host of factors that are enhanced like reputational management which is critical to corporate success, the fact that investor relations are driven by a company’s social investment programme and that a company’s competitiveness and market positioning is enhanced by sustainable procurement as is its operational efficiency.
3.4 Corporate Social Responsibility and Corporate Citizenship

Central to the stakeholder theory of corporate governance is the much popularised issue of corporate social responsibility, as it attempts to broaden the traditional shareholder primacy approach. Practically it translates to the expenditure of corporate funds and thus the sacrifice of profits either by spending money or incurring costs in the manifest belief that the cumulative spending will produce results that are superior to pure profit maximisation.273

Thus corporate governance recommendations have since exposed the country’s chief executives to a wider range of corporate responsibility than was previously their custom.274

King II defines corporate social responsibility (CSR) as follows:

‘A well managed company will be aware of, and respond to, social issues, placing a high priority on ethical standards. A good corporate citizen is increasingly seen as one that is non-discriminatory, non exploitative, and responsible with regard to environmental and human rights issues. A company is likely to experience indirect economic benefits such as improved productivity and corporate reputation by taking those factors into consideration.’275

This can be referred to as the inclusive approach to corporate governance which is advocated as the cornerstone of socially responsible business practice.276

276 Ibid.
King III has expanded on this concept by advocating the concept of sustainable business and the inclusion of corporate initiatives in this regard in terms of the Integrated Report. This is enhanced by the burgeoning spectrum of initiatives geared towards governments and corporations to embrace sustainability to ensure future profitability which is the central tenet of integrated reporting.

This global shift in attitude is indicative of modern corporate governance which has expanded on the pronouncement of the US judgement *AP Smith Manufacturing v Barlow* which held that modern conditions require companies to acknowledge and practise socially responsible behaviour. In the absence of statutory direction and the dictum of the Revlon Standard there remains no legally entrenched penalties for companies who fail to implement CSR initiatives.

The JSE has however endorsed CSR with the promulgation of the JSE Socially Responsibility Index (SRI), which hopes to encourage further participation by listed companies in disclosure of their efforts which meets the base line recommendation of King II. There should be reporting in some form or another on their sustainability policies and practices as per King III. King II states that every company should report annually on the nature and extent of its social, transformation, ethical, safety, health and environmental management policies and practices. A reiteration of the aforementioned argument is that companies suffer no punitive measures if they do not

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278 G Terry *Green* 1ed (2008) 115, 139. See also the Carbon Credits Programme and the Summit on Climate Change to be held in Copenhagen in December 2009.
279 *AP Smith Manufacturing v Barlow* (1953) 39 ALR 2d.
281 Sarbanes-Oxley Act 2002 only provides punitive measures for non-disclosure and misstatement of accounting information.
284 [http://www.beeonline.co.za](http://www.beeonline.co.za) (Last visited March 2009) The reference to ‘social’ would also include empowerment initiatives which is governed strictly by its own industry specific charters, DTI codes and legislation being Broad Based Black Economic Empowerment Act 53 of 2003 and Employment Equity Act 200 of 1993.
participate in this index as such non compelled and non accountable disclosure does not strengthen corporate governance.

Moreover organisations equate good CSR with in-depth sustainability reports, believing disclosure on this basis is one and the same thing. Delving into what an organisation does once a year and coming up with a comprehensive report is not of itself, evidence of CSR practice. This is the incorrect approach. In addition there is no verification of disclosure in the annual reports of CSR commitments. It is tantamount to declaring that an organisation is financially sound simply on the basis that it produces a financial report.\(^{286}\)

This has nevertheless been a prevalent trend by listed companies. The London Stock Exchange has made efforts to make corporate responsibility more transparent and accessible. This led to the launch of an online CSR reporting portal. It consists of a single survey designed to allow companies to maintain and disclose the most influential codes and rating systems.\(^{287}\) These moves have been motivated by the growing body of empirical research that demonstrates the bottom line benefits of socially responsible behaviour. Klaasen and McLaughlin\(^ {288}\) indicate that good environmental conduct significantly enhances a company’s performance. So efforts by a company to improve its commitment to stakeholders is ultimately a testament to the shareholder-centric theory, or better stated ‘the enlightened shareholder value approach’ which implies that stakeholder interests may only be achieved if shareholder concerns remain the primary objective.\(^ {289}\)

It is also motivated by addressing the legal, ethical, commercial and other expectations society has for business and in making decisions that fairly balances the claims of all key stakeholders. Acting in a company’s best interests would also warrant safeguarding its


\(^{287}\) International Guidelines consist of FTSE4GOOD Index, Dow Jones Sustainability Index, Global Reporting Initiative, Sigma Guidelines, AA 1000 Series, SA 100 Series and Global Impact.


reputation. Reputational risk and the incumbent costs could be devastating to a company’s bottom line. In the global environment there are many jurisdictions that companies can employ to best advantage in terms of relaxed environmental and labour laws. Those companies that ignore the bugle call for sound corporate governance and the need for sustainable development do so at their own peril. Claims in delict against listed companies like Exxon, Mobile and Shell regarding the forced labour on pipelines in Myanmar is a good example of this. The diminished effect it can have on its brand value is a key component in the success of a company. The cumulative effect of corporate social responsibility is to fortify the ethical conduct of directors in running a business which is integral to a principles based model of governance. However, corporate governance codes and legislation have failed to address CSR and related stakeholder issues substantively so what other recourse do stakeholders have? This question is addressed in Chapter 3.5 below.

3.5 Applicable Legislation

In July 2000, the Pension Funds Act 1995 in the UK was amended, significantly affecting the world of investment. Pension fund trustees must now state the extent to which they take social, environmental and ethical considerations into account when they invest money.

There is a clear reconciliation of the shareholder centric view with that of the shareholder view to the extent that amendments to foreign jurisdiction company law statutes have been made to facilitate directors to formally take cognisance of stakeholders. This was

\[290\] http://www.corporatewatch.org (Last visited on 24 November 2009).

\[291\] G Terry Green ed (2008) 147 which confirms that a brand is that intangible, but valuable mixture of associations and expectations that all successful products carry. Nike brand image was diminished due to its negative labour practices. This can be juxtaposed against Coca Cola whose brand was further fortified due its efforts to replenish water supplies which enhanced its commitment to the environment.

\[292\] A public company on the London Stock Exchange, Prudential Assurance Company, announced that it was introducing a review of all companies invested in to ensure that they met minimum environmental and social policies.
also confirmed in *State Tax Commission v Aldrich*\(^{293}\) which held that the ‘classical theory of the director’s duty must yield to modern life in considering the interests of employees it cannot be said that they have not considered the bona fide interests of the shareholders.’ Cognitive awareness is not enough; there must be a direct compulsion by way of legislative enactment for companies to act in the interests of all stakeholders which would include shareholders, failing which the threshold for compliance and disclosure is too low as such stakeholders have to rely on alternate legislation to procure compliance.\(^{294}\) The following discussion of ‘stakeholder’ legislation underscores this assertion.

Reference can be made to the Securities Services Act\(^ {295}\) which is aimed at shareholder protection. It protects the shareholder (and indirectly stakeholders) from insider trading by prohibiting inappropriate disclosure and tipping off.\(^ {296}\)

The Labour Relations Act\(^ {297}\) prevents companies from flagrantly disregarding employees’ rights and needs in conducting the business of the company. The latter ensures accountability of the company and is supplemented by the Basic Conditions of Employment Act\(^ {298}\) the cumulative effect of which addresses empowerment, fair labour practices, development of human capital and the impact of Human Immunodeficiency Virus / Acquired Immunodeficiency Syndrome (HIV/Aids) on any company. Accurate verifiable disclosure must be provided in terms of the aforementioned Acts.

Thus the far reaching recommendations of King I and King II have in large been superseded and expanded by the promulgation of legislation that requires mandatory compliance and disclosure.\(^ {299}\) This is evidenced by the National Environmental

\(^{293}\) *State Tax Commission v Aldrich* et al (1942) 316 U.S 174 at 192 (U.S. Sup Ct).

\(^{294}\) M Havenga ‘Fiduciary duties under our new corporate law regime’ 1997 *SA Merc LJ* 310.

\(^{295}\) Act 36 of 2004.

\(^{296}\) Ibid Sections 2, 20 and 71.

\(^{297}\) Act 66 of 1995.

\(^{298}\) Act 66 of 1965.

Management Act\textsuperscript{300} imposes strict liability on directors of companies who perpetrate offences by non compliance with its provisions.\textsuperscript{301} King III reinforces this notion in terms of Chapter 6 which requires the board to ensure that companies are compliant with all laws, codes and principles.\textsuperscript{302}

Environmental sustainability recognizes that South Africa has a rich and critical resource base which should be wisely used if it is to provide sustainable support to the development of South Africa, its people and its resources. As such companies need to measure and monitor their environmental impact and implement mechanisms ensuring sustainable uses of resources. The cumulative efforts of the National Water Act\textsuperscript{303} and the Occupational Health and Safety Act\textsuperscript{304} underscore good environmental practice and stewardship pertaining to advancement of environmental sustainability.

It is interesting to note that the majority of legislation related to this contention was enacted post the first King Report. This legislation seeks to supplement the recommendations of King II and King III.\textsuperscript{305} The stakeholder specific legislation is an endorsement of the mandatory system of disclosure and compliance and should have provided the motivation for stricter covenants in the new Act.\textsuperscript{306} The new Act\textsuperscript{307} has failed in entrenching disclosure provisions relating to sustainability and therefore cannot be viewed as an inclusive legislative vehicle for corporate governance. It has however included a requirement that boards constitute ethics and social committees.\textsuperscript{308} The Draft Regulations on the Companies Act\textsuperscript{309} has introduced Regulation 50 which addresses the function and constitution of these ethics and social committees. It prescribes the reference

\textsuperscript{300} Act 107 of 1998.
\textsuperscript{301} National Environmental Management Act 107 of 1998, Section 37.
\textsuperscript{303} Act 36 of 1998.
\textsuperscript{304} Act 85 of 1993.
\textsuperscript{305} King Code on Corporate Governance (2002) and King Report on Corporate Governance (2009).
\textsuperscript{306} Act 71 of 2008.
\textsuperscript{307} Ibid.
\textsuperscript{308} Section 72 (4) of Act 71 of 2008.
\textsuperscript{309} Pertaining to Act 71 of 2008 released for comment and review on 22 December 2009.
to international codes of best practice like the OECD,\textsuperscript{310} the monitoring of company activity with regard to good corporate citizenship\textsuperscript{311} and designated stakeholders.\textsuperscript{312} Although in draft it is a commendable step in the right direction of safeguarding stakeholders and epitomising the values inculcated by King III albeit in a monitoring as opposed to a mandatory function. The vacuous aspect of Regulation 50 is that it fails to entrench and or advance the reform required for ethical disclosure by directors.

There are still practical difficulties associated with the stakeholder theory and its implementation. Of fundamental relevance is the issue of accountability which is a pivotal tenet of any corporate governance system. The key problem is the broadened scope of a director’s duties to a company and the concomitant justification to follow a particular course of action, namely, stakeholder interests. This is commonly referred to as the ‘multiple master debate’ which has resulted in the stakeholder theory being viewed with a degree of scepticism.\textsuperscript{313}

King II has drawn the distinction between accountable and responsible:\textsuperscript{314}

‘One is liable to render an account when one is accountable and one is liable to be called to account when one is responsible. In governance terms one is accountable at common law and by statute to the company if a director, and one is responsible to the stakeholders identified as relevant to the business of the company’

In ascertaining the most productive modus operandi one can argue that accountability and responsibility are ultimately in the best interests of the company. This will always fall at the feet of the board of directors.\textsuperscript{315}

\textsuperscript{310} Regulation 50 (12) (bb) of Draft Regulations of Companies Act 22 December 2009. The OECD has had a history of progressive inclusive regulations that remain focused and geared towards sustainable economic growth and responsible corporate behaviour see: \url{http://www.oecd.org} (Last visited on 18 January 2010).

\textsuperscript{311} Ibid Regulation 50 (12) (ii).

\textsuperscript{312} Ibid Regulation 50 (12) (iii) and (iv) and (v).


\textsuperscript{314} King II (2002) Introduction Paragraph 5.

\textsuperscript{315} See Chapter 4.3.
In running a company directors have been privy to the traditional shareholder model, the stakeholder model and finally the pluralist views which postulate that stakeholder interests should be balanced against the interests of shareholders.\textsuperscript{316} The corollary of this theory could present the practical situation when shareholder interests and thus profitability could be a secondary pursuit as companies focus their efforts on stakeholders’ welfare. This altruistic view is not commensurate with best business practice and presents an unfounded argument against formally legislating on sustainability and CSR.\textsuperscript{317}

In furtherance of this assertion it is evident that CSR and environmental reporting by a clique of companies is being seen less and less as voluntary initiatives or as an endeavour to comply with the ethos and spirit of the King II and King III as it is an effort on the part of the company to be compliant with stakeholder related regulation.

The punitive measures incumbent on directors and companies for non-compliance specifically in relation to environmental issues is particularly onerous. So disclosure of their compliance is most critical.\textsuperscript{318} For example, mining houses run the risk of having their mining licences revoked in addition to strict liability of directors as such environmental reports are filed and are synonymous with all and every listing document.\textsuperscript{319} This position will be solidified if more punitive measures were implemented against companies who misrepresented their CSR initiatives in annual reports and failed to exhibit tangible evidence of CSR initiatives alluded to.

\begin{footnotesize}
\begin{enumerate}
\item[319] Section 103 of Act 71 of 2008.
\end{enumerate}
\end{footnotesize}
In furtherance of the debate of mandatory versus voluntary disclosure it is clear from the polemics that the South African corporate governance regime is best suited to one of mandatory disclosure.

3.6 Conclusion

In the wake of King III there is an optimistic sense that new measures pertaining to disclosure will be made specifically in relation to corporate citizenship which will seek to further entrench the stakeholder inclusive approach. The integrated report exemplifies this sentiment.\(^\text{320}\) This is supported by the board’s obligation to report to its shareholders and other stakeholders on the company’s economic, social and environmental performance in a transparent fashion.\(^\text{321}\) The disclosure provisions of King III take cognizance of stakeholders and prescribe disclosure in every instance. It has a commensurate approach to shareholders\(^\text{322}\) but their position is fortified by the new Act.\(^\text{323}\) This mandatory approach towards disclosure has strengthened corporate governance. It has however failed to entrench mandatory disclosure and adherence to corporate social responsibility by companies which is integral to strengthening corporate governance.\(^\text{324}\) As such it has failed to fortify the definition of corporate citizenship as advocated by Mervyn King.\(^\text{325}\)


\(^{321}\) Ibid Chapter 1 and Chapter 8 which deals with stakeholder relationships.

\(^{322}\) Ibid Chapter 2 and 4.

\(^{323}\) Act 71 of 2008 which is further advanced by Regulation 50 of the Draft Regulations of the Companies Act issued for review and comment on 22 December 2009.

\(^{324}\) This is amplified by Regulation 50 of the Draft Regulations of Companies Act issued for review and comment on 22 December 2009 but not to the extent required to ensure mandatory compliance as it encompasses a monitoring function.

\(^{325}\) M King Corporate Citizen 1ed (2006) 8. Note Regulation 50 (12) of the Draft Regulations of Companies Act issued for review and comment on 22 December 2009 requires monitoring and cognizance of good corporate citizenship issues and as such remains non mandatory.
companies today affect all aspects of our lives, they in fact link us to the communities in which we live and create mutual rights and obligations in society to the extent that a company is as much a citizen as an individual.’

This stresses the holistic and integrated approach a company must adopt in respect of its conduct to ensure sustainable development. This is the crux of CSR, the tangible actions of a company as opposed to pontificating in a report, which creates the perception of what a company will be doing or should be doing. Good corporate citizenship is the raison d’etre of authentic disclosure as it reflects the pillars of accountability and transparency as the company delivers on its promises. The aforementioned statement is made in context of the fact that sustainability reporting is prone to corporate ‘green washing’ and public relations ‘spin’ as companies have a tendency to over inflate corporate achievements and are often not part of the company reports that are verifiable by the company’s auditors.

The current disclosure regime in the South African context albeit effective clearly favour shareholders as opposed to stakeholders.

The holistic approach should be adopted by directors wherein they understand the rationale that ethical compliance with applicable rules pertaining to both stakeholders and shareholders can positively contribute to their bottom line. This draws the attention to the key role player in governance: directors, their roles, responsibilities and interactions with shareholders which are considered in the following chapter.

CHAPTER 4: A CRITICAL ANALYSIS OF THE VEHICLES FOR DISCLOSURE AND REMEDIES AVAILABLE TO SHAREHOLDERS TO ENSURE THE ACCOUNTABILITY OF DIRECTORS

4.1 Introduction

The effectiveness of boards of directors and their obligations to shareholders has been a global concern. The board is meant to oversee the management and check for any wrong doings. It is the engine room of a company and the architect of governance policies. All disclosure pertaining to a company flows from the board.\(^{330}\) The diminished quality of disclosure erodes the strength of a company’s corporate governance policies and director’s accountability to shareholders. Thus there must be a collaborative effort between shareholders and directors underlined by increased accountability and transparency.\(^{331}\)

Legal reform has been initiated to enhance duties and obligations of directors to shareholders. This will be critically analysed in chapter 4.2 to determine whether such reform positively contributes to disclosure, accountability and strengthened corporate governance. With regards to shareholders an examination of the remedies available to shareholders to ensure directors’ accountability pursuant to poor disclosure and concomitant losses is warranted. The elementary principle of the composition of a company board is one that is balanced, comprising both executive and non-executive directors.\(^{332}\) Shareholders depend on non-executive directors to ensure credible disclosure and cement governance practice. This necessitates a critical evaluation of the role of non-executive directors.

\(^{330}\) King Code on Corporate Governance (2002) Chapter 2 and Chapter 3.


Shareholders should and can also use their rights to ensure that the remuneration committee and the like are properly constituted in terms of statutory recommendations and codes of good practice. This level of pro activeness is often referred to as shareholder activism. It can be argued to be traversing the role and ambit of director’s duties but any interested party including a shareholder should have the right to examine and question the information disclosed. Shareholder activism is a symptom of the malady of director accountability and the self interested unmonitored behaviour of directors. This has been the impetus for the statutory reform pertaining to executive remuneration and the legal duties and obligations pertaining to directors. These topics will be analysed to determine whether shareholders can rely on directors to disclose information voluntarily or are they best served by a mandatory regime of disclosure fortified by explicit duties and obligations.

4.2 What are the information needs of a shareholder and what remedies are open to shareholders to safeguard these rights.

Shareholders are providers of capital to a company and possess the right to participate in a dividend. As such shareholders require reliable, relevant and timely disclosure of financial information to help them make informed investment decisions linked to the company’s future income streams.

Their information needs are of a financial nature and would include annual financial statements that satisfy the prescribed financial standards, the maintenance of accurate and

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333 King Report on Corporate Governance (2009) Principle 2.25 requires the board (with the assistance of the remuneration committee) to put forward a policy of remuneration to shareholders for their approval in general meetings.
334 Ibid.
335 Bligh v Brent (1837) 2Y and C Ex. 268.
complete accounting records by directors, auditor’s reports, director’s report on the state
of business and profit of a company and disclosure on director’s remuneration. 337

Shareholders rely on directors and the board to deliver these information requirements
and the nature of the relationship between shareholders and directors remains the
foundation of modern day practice of corporate governance as it has a direct influence on
accountability. 338

Accurate disclosure of information stems from diligent management of a company and
shareholders rely on directors in running their companies as citizens rely on government
in running their country. 339 In terms of recent trends shareholders would be well advised
to take note of company’s risk oversight and investment strategy. 340

However, directors and shareholders do not have the same interest and incentives 341
which directly influences the flow of information made by directors to shareholders. This
is what is referred to as the ‘agency costs’ problem 342 imposed by directors on companies
for example, their remuneration 343 which if implemented in a self serving manner can
erode shareholders’ returns on their investments. 344 To counter this erosion it is essential

337 Section 30, 31, 32 and 33 of Act 71 of 2008. Note in term of King III there is also the issue of the
integrated report which covers the involvement of companies in non-financial issues in terms of it asserting
its role and footprint as a good corporate citizen but traditionally shareholder’s primary information needs
have always been of a financial nature.
338 A Berle & G Means The Modern Corporation and Private Property 3ed (1932) 56 encapsulated the
seminal study on the concept of separation of ownership and management (shareholders and directors) as
they have competing needs and is central to the examination of corporate governance.
339 T Mongalo Corporate Law and Corporate Governance: A Global Picture of Business Undertakings in
340 A Review of corporate governance in UK banks and other financial industries (26 November 2009)
Page 9.
342 M Jensen & W Meckling ‘Theory of the Firm : Managerial Behaviour, agency costs and ownership’
343 Section 30 (4) and Section 30 (6) of Act 71 of 2008 which requires enhanced disclosure of executive
remuneration dealt with extensively in Chapter 4.2. This provision is analogous to the current Section 297
344 A Review of corporate governance in UK banks and other financial industries (26 November 2009)
Page 15 which has asserted that the exorbitant pay packages of executives were the contributing factor to
the financial crisis by sparking high risk business decisions for personal short term gain. The global
imperative is to ensure adequate disclosure of executive remuneration is enclosed in financial statements

68
that directors make accurate and meaningful disclosure to shareholders specifically in relation to executive remuneration as a means of strengthening corporate governance.\(^{345}\)

Executive remuneration remains a contentious issue and is a debate that shareholders and directors engage in with mixed success.\(^{346}\) The principle motivating executive remuneration reform is that there should be an alignment between remuneration and performance-based incentives.\(^{347}\) Shareholders react adversely when they perceive that such incentives are not commensurate with the company’s performance and their returns.\(^{348}\)

The unhealthy preoccupation with short-term profit and excessive risk taking in pursuit of better remuneration leads to value destruction. As such shareholders are demanding more disclosure and accountability from directors in respect of remuneration packages as evidenced by the recommendations of the Walker Review.\(^{349}\) Shareholders require confirmation that companies implement Long Term Incentive Plan (LTIP). This strategic plan ensures that executives are rewarded after several years rather than simply on a year on year basis. It is not devoid of its deficiencies as LTIP entitles participation after designated periods\(^{350}\) without linking the long term performance of the director to the company.\(^{351}\) This can be countered by ‘claw back’ provisions as contained in the Walker Review\(^{352}\) which has been supported by legislative proposals in the form of the Financial...
Services Bill. The new Act requires disclosure of remuneration including salaries, bonuses and performance related schemes.

The South African model is clearly endorsing a mandatory regime of disclosure in terms of company law reform which enhances disclosure but does not obviate convoluted remuneration packages designed to benefit executives whilst remaining technically compliant with applicable rules.

There is referred to as ‘stealth compensation’ a term postulated by Harvard law academic, Lucien Berchuk. It refers to pension and retirement packages, the design and process of which are intentionally not transparent. It is against this background of negative perceptions that the SEC voted unanimously to change the rules for reporting executive remuneration through compensation committees.

Sarbanes-Oxley does not address compensation committees. The SEC advocates a ‘compensation discussion and analysis’ pertaining to compensation paid to executives.
It marks a significant progression from its common law position\(^{361}\) but the disclosure prescribed is sufficient to secure and safeguard shareholder interests. In fact failure to reflect information accurately in the compensation discussion and analysis statement could attract liability by directors.\(^{362}\) The Walker Review has questioned the legitimacy of incentivisation and has made the most progressive recommendations on executive remuneration disclosure regimes to date. This approach has endorsed the mandatory model of disclosure and has in principle been approved by the FSA and its chairman Christopher Hogg who stated that to protect shareholders and “progress disclosure on remuneration you have to make it mandatory.”\(^{363}\)

It is evident that disclosure of a remuneration package in terms of a voluntary regime is less efficient in safeguarding the interests of shareholders than a mandatory regime and the latter must be supplemented by provisions requiring a detailed analysis of remuneration packages by directors to effectively strengthen corporate governance.

Shareholders have recourse to other remedies but in terms of the current dispensation these are limited. Reference can be made to section 32 of the Constitution of the Republic of South Africa\(^{364}\) and the Promotion of Access to Information.\(^{365}\) A shareholder tested these provisions specifically in terms of section 78 (2) (d) of the latter statute in *Davis v Clutchco.*\(^{366}\) The case went on appeal and the Supreme Court of Appeal in South Africa decisively stated that:

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\(^{361}\) *Guinness Plc v Saunders* (1990) 2 AC 663. This case addressed exorbitant executive remuneration on technical compliance as opposed to shareholder interests the plaintiff raised the defence that due process and procedure was not followed by the board of directors. The court held that directors’ remuneration was to be made by the board of directors and not an ancillary committee intimating that the board could not delegate its powers without proper resolution and as such the executive remuneration was invalid. *Levin v Field and Tweeds Ltd* (1951) 2 SA 401(A) 414 it is not part of the business of a court of Justice to determine the wisdom of a course adopted by a company in the management of its own affairs.

\(^{362}\) See Footnote 359.

\(^{363}\) [http://www.timeslive.co.za/news/world/] (Last visited on 1 December 2009). Note Section 66 (9) of Act 71 of 2008 mandates a special shareholder resolution at annual general meetings to approve compensation plans offered to executives and non-executives, this is pronounced endorsement of shareholder activism.

\(^{364}\) Act 108 of 1996.

\(^{365}\) Act 2 of 2000 Section 78 (2) d.

\(^{366}\) *Davis v Clutchco (Pty) Ltd* (2004) (1) SA 74 (C).
company law provided shareholders with extensive protection with regard to accounting records and annual financial statements. This included the important role played by auditors. Parliament could not have intended that the books of a company, great or small, should be thrown open to members on a whiff of impropriety or on the ground that relatively minor errors or irregularities have occurred.\textsuperscript{367}

The attitude is that despite supplementary legislation shareholders should have immediate recourse to the rights afforded to them in terms of the Companies Act.\textsuperscript{368}

The principal remedy available to South African (minority) shareholders is known as the derivative action as enshrined in section 266 of the Companies Act.\textsuperscript{369} The common law has had a much less sympathetic view in the form of \textit{Foss v Harbottle}\textsuperscript{370} wherein the court held that only a company by ‘its proper organ’ can initiate proceedings for a wrong done to the company. The so called ‘proper organ’ the court was referring to applied to a company’s board of directors.

Thus the majority rule sentiment of \textit{Foss v Harbottle} in essence obviated the rights of minority shareholders to bring actions against alleged misconduct if that misconduct was in law capable of ratification by an ordinary resolution of the company. This presented a manifestly unfair situation which left minority shareholders at the mercy of majority shareholders. The majority of shareholders could in fact bring an action but this in itself was a practical hurdle to overcome if there is disparate ownership.\textsuperscript{371}

The so called derivative action by way of the common law arose as an exception to the dictum of \textit{Foss v Harbottle}\textsuperscript{372} and could be evoked if a wrong was perpetuated against the

\textsuperscript{367} Ibid.
\textsuperscript{368} Act 61 of 1973. (or Act 71 of 2008 when effective).
\textsuperscript{369} Act 61 of 1973.
\textsuperscript{370} \textit{Foss v Harbottle} (1843) 2 Hare 461.
\textsuperscript{371} With concentrated ownership comes the danger of managerial entrenchment or the expropriation of minority investors, since large shareholders have the ability to select directors and resist proxy contests and tender holders.
\textsuperscript{372} \textit{Foss v Harbottle} (1843) 2 Hare 461.

72
company and the company would not or could not pursue a remedy against the perpetrator. This common law right is deficient and ineffectual as confirmed in the Van Wyk De Vries Commission\textsuperscript{373} due largely to the fact that the minority shareholder must prove that the wrongdoers are in control of the company. Moreover the minority shareholder runs the risk of bearing the costs of the application which is a discouraging factor. Statutory relief is found in the form of section 266 read with sections 267 and 268 of the Companies Act.\textsuperscript{374}

The latter sections can be evoked where a company has suffered a delict or a breach of trust committed by a director or past director and where the company has not instituted action to redress the wrong. However according to Henochsberg and in terms of practical implementation the provisions are ‘circumscribed and of limited operation’.\textsuperscript{375}

The reasons advanced for this are as follows: the losses contemplated are that caused by the directors specifically and does not contemplate any wrongdoing by an outsider. It has been criticized as a difficult provision to implement, offering little comfort to shareholders and remedying none of the uncertainties and deficiencies caused by the common law derivative action.\textsuperscript{376}

The new Act\textsuperscript{377} attempts to do away with the common law derivative action and the vacuous operation of the current section 266.\textsuperscript{378} It states that:

> ‘any right at common law of a person other than a company to bring or prosecute any legal proceedings on behalf of that company is abolished, and the rights in this section are in substitution for any such abolished right’\textsuperscript{379}

\textsuperscript{373} C Freeman ‘Remedying Shareholder Remedies’ 2008 Without Prejudice 7.
\textsuperscript{374} Act 61 of 1973.
\textsuperscript{375} P M Meskin \textit{et al} Henochsberg on the Companies Act 4ed (1999) 511.
\textsuperscript{376} Ibid.
\textsuperscript{377} Section 165 of Act 71 of 2008.
\textsuperscript{378} Act 61 of 1973.
\textsuperscript{379} Ibid.
The ambit of this section is clearly wider without limiting the action to who must have committed the act causing the loss to the company. The new Act\textsuperscript{380} provides a more streamlined process of derivative actions and thus confirms the corporate governance reforms geared towards enhancing shareholder activism. It is anticipated that the revised legislation will procure greater accountability to shareholders by directors.\textsuperscript{381}

One of the most significant avenues open to shareholders is to initiate steps to procure the removal of a director who is guilty of misconduct. Section 220 of the Companies Act\textsuperscript{382} enables a company to remove directors by ordinary resolution before the expiry of their term of office. While the process afforded to shareholders in terms of this provision is of comfort it is often necessary to remove directors on far shorter periods of time.\textsuperscript{383}

The equivalent provision in the new Act is section 162\textsuperscript{384} which promulgated the maintenance of a register of delinquent directors. The new Act also protects shareholders by ensuring that corruption and collusion between companies, directors and shareholders is minimised. Section 2 (1) (d) of the new Act, however, casts the net widely.\textsuperscript{385} As a result persons far removed from one another may be considered related parties. If this provision is read with section 75 (6) of the new Act\textsuperscript{386} which compels a director to disclose the fact that a person ‘related’ to him/her has acquired a financial interest in the company of which he/she is a director it is clear that the concept of independence and

\textsuperscript{380} Act 71 of 2008
\textsuperscript{381} Viener \textit{v} Jacobs (2003) 834 A 2d 546 is an American case that examined this issued and stated that ‘it is axiomatic that majority shareholders have a duty not to use their power in such a way to exclude minority shareholders from their proper share of benefits accruing from the enterprise’ asserting further that while it is understandable that they will act in their own interests, it must also be in the best interests of all shareholders and the corporation. Furthermore, the business judgement rule was rejected as a means of insulating the defendant from liability, as the court reasoned quite correctly that the rule only applies to decisions made in good faith and where the director is not interested in the subject matter of the business judgement rule A foreign law concept incorporated into South African law through Section 76 (3) of Act 71 of 2008 and which is discussed in detail in Chapter 4.3.
\textsuperscript{382} Act 61 of 1973.
\textsuperscript{383} D Walker ‘The Revival of Shareholder Democracy’ 2006 \textit{Institute of Directorship} 20, 22.
\textsuperscript{384} Section 162 of Act 71 of 2008.
\textsuperscript{385} Act 71 of 2008.
\textsuperscript{386} Ibid.
arms length transacting is endorsed which is a very commendable feature of the new Act.\textsuperscript{387}

This assertion is sustained by Section 161 of the new Act\textsuperscript{388} which entitles shareholders to apply to court for an order to protect their rights and rectify any harm stemming from a contravention which coupled with Section 164\textsuperscript{389} affords shareholders relief from oppressive conduct. Another feature of the new Act is the introduction of ‘appraisal rights’\textsuperscript{390} for shareholders. Appraisal rights ensure that dissenting shareholders can require the company to repurchase the dissenting shareholder’s share at fair value irrespective of the majority percentage approval obtained by the company. The collective impacts of these provisions are increased rights for shareholders which should translate to greater accountability and transparency by directors and other entities with which they interact.\textsuperscript{391} It is also a clear endorsement of mandatory provisions designed to enhance the South African corporate governance model and will be far more efficient in ensuring the information and governance needs of shareholders are met.

Shareholders, especially institutional shareholders, impact corporate governance practices as they become more active in monitoring performance of companies they invest in. They are also exerting enormous pressure on boards for performance, transparency, accountability, safeguarding of company assets and increase in return on shareholder investments. The most obvious example of how the complexion of corporate boards has been influenced by shareholder activism has been by one of the largest institutional investors in the US called the California Public Employees Retirement System (CalPERS). CalPERS publishes an annual list of target usually non-performing listed companies, which it will monitor. Through activism leading public companies in which

\begin{itemize}
\item[Ibid.]
\item[Ibid.]
\item[Ibid.]
\item[Ibid Section 164.]
\item[The King Report on Corporate Governance (2009) endorses the implementation of alternate dispute resolution in terms of Principle 8.6 Recommendation 39 which will enhance the remedies available to stakeholders and shareholders.]
\end{itemize}
CalPERS has invested, have been forced to make major corporate governance changes. This has become known as the ‘CalPERS effect’ in US.  

In terms of the Combined Code the main principle underlying the relationships with shareholders is a mutual understanding of objectives. The board has the responsibility to ensure that a satisfactory dialogue with shareholders takes place. This dialogue must be substantiated by access to information if and when required. The latest review on corporate governance in the UK also postulated more active shareholder engagement supported by a meaningful disclosure of the company’s business model. The Financial Services Bill will seek to entrench this principle.

There is clearly a changing ideology and practice of shareholders from a passive state to a more active state. Shareholders bolster the efficacy of all corporate governance reform as a practical means of strengthening accountability as it closes the gap between ownership and managerial control. Their activism is also instrumental in mandating more disclosure from directors which ultimately strengthens corporate governance. It cements the notion that the threat of accountability will always mandate better disclosure because if directors are not monitored, there is a risk that they may act in pursuit of their own interests to the detriment of the company. If shareholders adopt a more robust approach of monitoring the board and the directors it will definitely enhance the quality of disclosure. Shareholders who have exercised their rights to claim transparency of processes have contributed to the strengthening of corporate governance and the

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395 Financial Services Bill. (Released for comment on 19 November 2009) Downloaded from http://www.hm treasury.gov.uk (Last visited on 24 November 2009).
396 T Wixley & G Everingham Corporate Governance 2ed (2005) 22.

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disclosure procedures and practice directors use. It is clear that these rights are best served by mandatory and legislatively entrenched provisions.

The rights of shareholders are enhanced by the presence of independent directors. Globally, reforms have elevated the issue of ‘independence’ to the forefront of the corporate governance debate. At the core of reforms worldwide is the focus on increasing independence within the boards of publicly listed companies. In practical terms independence suggests that directors are free of inappropriate entanglements with the management of the companies on whose boards they serve so they monitor matters objectively and will deter fraud, arbitrariness and misappropriation of funds. This has been confirmed in terms of CLAA and the new Act.

The law makes no distinction between executive and non-executive directors in far as principles of liability are concerned. Once persons accept an appointment as directors (including independent non-executive positions) they become fiduciary in relation to the company and are obliged to display the utmost good faith towards the company and in their dealings on its behalf. Furthermore non-involvement in the company’s affairs forms the basis of attaching liability for a breach of their duty of skill and care. Nevertheless director’s independence is eroded by the insidious problem of ‘back scratching’ and the empathy and collegiality shared by directors. So independence which understandably

399 The Higgs review (2003) was a report on corporate governance that reviewed the role and effectiveness of non-executive directors and of the audit committee, aiming at improving and strengthening the existing Combined Code. In terms of the Combined Code A.3.1 the definition of independence is asserted and the role of independent directors highlighted. Section 301 of Sarbanes-Oxley Oxley imposes the independent requirement on audit committees and the definition of ‘independent’ excludes any affiliation to the board of directors or role as a professional advisor. Regulation 104 (5) of the Draft Companies Act Regulations issued for comment and review on 22 December 2009 seeks to clarify the conduct of non-independent directors by insisting that there is a recusal from deliberations of the board of directors.
403 Section 94(4) (b) of Act 71 of 2008.
404 Howard v Herrigel and Another (1991) 2 SA 660.
should be a fundamentally objective criterion becomes in fact a subjective one in terms of disclosure and accountability. The case Beam ex rel Martha Stewart Living Omnimedia Inc v Stewart\textsuperscript{407} questioned the ability of independent directors to fulfil their fiduciary duties when a structural bias existed as a result of the director's friendship and interaction. This case restated the importance of adequate disclosure, as disclosure stemming from a board that lacks independence is worthless and has proved repeatedly that it obviates credible governance.\textsuperscript{408}

The board is ultimately the focal point and custodian for corporate governance.\textsuperscript{409} The aforementioned discussion on shareholders, remedies, and shareholder activism ensure that the board always acts in the best interests of the company. This factor has been statutorily entrenched in terms of the new Act\textsuperscript{410} which states that the business and affairs of the company must be managed by and under the direction of its board. The current legislative reform in South Africa is commensurate with global reforms to diminish unhealthy board room practice by firstly holding directors accountable for their corporate actions, secondly ensuring that they actively question management,\textsuperscript{411} thereby taking a less benign approach to business proposals\textsuperscript{412} and thirdly to ensure they remain cognizant of shareholder and stakeholder interests.\textsuperscript{413}

4.3 Role and Responsibilities of Directors

\textsuperscript{407} Beam ex rel Martha Stewart Living Omnimedia Inc v Stewart (2003) 845 A 2d 1040, 1044.
\textsuperscript{408} E Armour 'How Boards can Improve the odds off Merger and Acquisition Success' (2002) 30 Strategy and Leadership 55, 59. See also Regulation 104 (5) of the Draft Companies Act Regulations issued for comment and review on 22 December 2009.
\textsuperscript{410} Section 66 of Act 71 of 2008.
\textsuperscript{413} T Wixley & G Everingham Corporate Governance 2ed (2005) 32.
As Monks and Minow\textsuperscript{414} averred, corporate law provides the legal basis for one of the most important institutions organizing global economies, indeed company law is central to a country’s economy and its prosperity for wealth creation and social renewal.\textsuperscript{415} When issues of corporate governance are considered, the emphasis is on the role played by executive directors since they make managerial decisions. The reason why they are being subjected to increasingly exacting and assiduous scrutiny is that companies contribute enormously to the economic and social well-being of our society. It is therefore inconceivable to ignore the way and manner in which they are managed.

Directors are the persons who direct the affairs of the company.\textsuperscript{416}

Section 208 of the Companies Act\textsuperscript{417} provides for the appointment of directors and requires every public company to have at least two directors and every private company to have at least one director. A director is defined in the Companies Act as follows:

‘Director’ includes any person occupying the position of director or alternate director of a company by whatever name he may be designated.\textsuperscript{418}

The new Act defines a director\textsuperscript{419} as a person being a member of the board of a company, as contemplated in section 66\textsuperscript{420} or an alternate director of a company and includes any person occupying the position of a director or alternate director.

The latter definition seeks to remedy the concept of a ‘shadow director’ which could see a person escaping liability as a director if he or she was not formally appointed as a

\textsuperscript{415} Ibid 17.
\textsuperscript{416} HR Hahlo \textit{South African Company Law Through the Cases} 6 ed (1999) 327. See also section 66 of Act 71 of 2008.
\textsuperscript{417} Act 61 of 1973.
\textsuperscript{418} Section 1 of Act 61 of 1973.
\textsuperscript{419} Section 1 of Act 71 of 2008.
\textsuperscript{420} Act 71 of 2008.
member of the board. This could be implemented with minimum success under the proposed regime as section 66 accounts for management who may not be formally appointed as directors but who control and direct the business affairs of the company. However, due to the broad drafting of this clause it could also imply that senior management who were involved in high level business decisions could also face shareholder and stakeholder wrath should those business decisions be found to be financially detrimental.

In South Africa, director’s duties may be imposed contractually, or in terms of the company’s Articles of Association and Memorandum. In addition, directors have statutory and common law imposed obligations. However, the Companies Act is silent on the explicit duties and responsibilities of directors.

How do shareholders and stakeholders ensure that directors act responsibly, make credible disclosure and remain accountable for their actions? The duty of directors, individually and collectively, to exercise their powers in the best interests of the company is of defining importance. This is commonly referred to as a fiduciary duty towards the company. Fiduciary duties are imposed on directors to ensure that they exercise their powers for the purposes for which they are given and are enforced by statute and by the courts. Likewise directors have a duty to act in good faith and in the interests of the company.

A director may not place himself in a position in which there is a personal interest or a

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421 This is the case individuals prohibited in terms of Act 61 of 1973 of being appointed as a director still managed and directed companies but did not formalise the process by completing CM27 and CM 29 forms. This perpetuated negative and often fraudulent practice but were never charged or sued as it was the corporate entity that was contracting thereby manipulating the legal concept of the ‘corporate veil’.

422 Act 71 of 2008.

423 Ibid Section 66 read with Section 77.

424 Section 20 and Section 218 of Act 71 of 2008.


426 Ibid.

427 Ibid.

428 Section 75, 76 and 77 of Act 71 of 2008 is direct contrast to Act 61 of 1973 by legislating on the duties and responsibilities of directors thereby codifying the common law duties and responsibilities of directors

429 Treasure Trove Diamond Ltd v Hyman (1928) AD 464.

duty which conflicts with duties to the company. Directors of companies are precluded from dealing on behalf of the company with themselves and from entering into contracts in which they have a personal interest conflicting with the interests of the company. This rule was endorsed in *Aberdeen Rly Co v Blaikie Bros* and is strictly relevant to the issues pertaining to conflict of interests and related party transactions. It is explicit in its directive that no extraneous evidence will be entertained.

A company is also entitled to the independent and unbiased judgement of each of its directors. Directors should always apply their mind to the issues at hand using such skill and judgement that they possess. They should never be a puppet or at the will and mercy of others as they would be breaching their fiduciary duty. Moreover if directors follow the knowledge of another who is acting illegally they too will be shrouded in the legal knowledge and shall accordingly be liable.

Although a director may lawfully be elected by a shareholder to represent shareholder interest and may even be a servant or agent of the shareholder, they may not blindly follow that shareholder’s instructions. Nor should a director remain inactive when the interest of the company conflicts with the interest of that shareholder.

The common law thus endorses the idea that the director owes a duty to the company as a whole and not to individual members as the common law does not endorse a stakeholder view of director’s duties. This is an evolving concept which was recognised in *Lonrho Limited v Shell Petroleum Co Ltd* Lord Diplock recognised more expansive duties where the obligation or prohibition was imposed for the benefit or protection of a

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430 *Aberdeen Rly Co v Blaikie Bros* (1854) 1 Macq 461.
431 *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W) 163.
432 *Gray v Lewis* (1873) 8 Ch App 1033.
433 *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W) 163.
434 *Scottish Co-operative Wholesale Society Ltd v Meyer* (1959) AC 324.
435 *Percival v Wright* (1902) 2 Ch 421.
436 *Lonrho Limited v Shell Petroleum Co Ltd* (1981) All ER 456. This case is an exception to dictum of Lord Tenterden CJ in *Doe d Bishop of Rochester v Bridges* (1831) 1 B&Ad 847, 859 which laid down the general rule that 'where an Act creates an obligation, and enforces the performance in a specified manner that performance cannot be enforced in any other manner.'
particular class of individuals, or where the statute creates a public right and an individual member of the public suffers 'particular damage'. This argument can be extrapolated to the financial damages lost by shareholders and societal damage in the form of stakeholders if they are affected by the poor management and conduct of directors in running a company. This could be construed as casting the net of liability too far. This is probably the reason for the circumscribed approach of the new Act\(^\text{437}\) towards stakeholders\(^\text{438}\) whereas a more progressive approach was adopted towards shareholders. It is nevertheless a progressive approach but not to the extent mandated by King III.\(^\text{439}\)

The duty of care and skill was also limited and circumscribed as outlined in the *Fisheries* case\(^\text{440}\) and in the *In re City Equitable Fire* case\(^\text{441}\) which stated emphatically that directors are not liable for mere errors of judgement\(^\text{442}\) nor are they bound to examine entries in the company's books. This position has changed significantly as corporate governance reforms demand that directors give continuous attention to the affairs of the company and failure to do so renders directors liable to a breach of their duty of care and skill which would include irresponsible disclosure or reliance on information that has not been verified.\(^\text{443}\)

In the event that directors breach their common law duties they run the risk of personal liability for losses incurred by the company as a result of such breach. This could encompass the obligation to restore to the company the property lost or to account to the company for profits lost. Concerned parties can rely on select company law provisions to

\(^{437}\) Act 71 of 2008.

\(^{438}\) Section 31 (3) Act 71 of 2008 whereby trade unions are entitled to financial statements so as to initiate business rescue provisions and Section 162 wherein an interested party can apply to court to declare a director a delinquent. Section 20 (4) restrains the company from doing anything inconsistent with the Act and affords shareholders a right of action. Section 159 (4) as it pertains to whistle blowers provisions (This is more expansively addressed in terms of Chapter 5.2 and Chapter 5.3) See also King Report on Corporate Governance (2009) Chapter 8.

\(^{439}\) King Report on Corporate Governance (2009) which addresses the importance of the board in interacting with stakeholders as outlined in terms of Chapter 8 and by employing alternate dispute resolution as a means of resolving disputes with shareholders.

\(^{440}\) *Fisheries Development Corporation of SA Ltd v Jorgensen* 1980 (4) SA 156 (W) 163.

\(^{441}\) *In re City Equitable Fire Insurance Company* (1925) 1 Ch 407.

\(^{442}\) Ibid 460.

\(^{443}\) Section 77 (3) (d) of Act 71 of 2008.
redress aberrant behaviour. Such relief may be evoked in terms of section 424 which establishes a punitive remedy in which a director can be held personally liable for all of the liabilities of the company for reckless and negligent conduct. The import of this section was considered by the Supreme Court of Appeal in the matter of Philotex (Pty) Ltd and Others v Snyman and Others. In its ordinary meaning, 'recklessly' does not connote mere negligence but, at the very least, gross negligence. The test for recklessness is objective insofar as the directors' actions are measured against the standard of conduct of the notional reasonable person, but subjective insofar as one has to postulate that notional being as belonging to the same group or class as a director, moving in the same circles, and having the same knowledge or means to acquire knowledge.

The case of Kalinko v Nisbert, is of relevance, wherein the presiding judge stated that directors who drive companies into liquidation through reckless and or fraudulent trading may soon be forced to reimburse shareholders for losses. Kalinko was afforded leave to sue the directors for losses. This would indeed prevent directors from evoking the corporate veil to avoid fiduciary accountability and liability to shareholders. This is consistent with Anglo-American jurisprudence and highlights the role of disclosure coupled with shareholder activism in strengthening corporate governance. Shareholders will curb nefarious conduct by actively seeking information and disclosure.

The criticisms leveled at the practical problems with these sections have been widespread and have prompted a call for greater accountability of directors who transgress their fiduciary duties. The Leisurenet case was a pertinent example of corporate aberrancy where due to the mismanagement of the company it was rendered insolvent with liabilities in excess of one billion rand. Notwithstanding, the overwhelming evidence of mala fides and poor governance the applicants withdrew their application in terms of

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445 Cooper v SA Mutual Life Ass Society and Others 2001 (1) SA 967 (SCA).
446 Philotex (Pty) Ltd and Others v Snyman and Others 1998 (2) SA 138 (SCA).
448 Salomon v Salomon and Co Ltd (1897) AC 22 HL.
449 http://www.wbs.ac.za (Last visited on 18 November 2009).
section 424 of the Companies\textsuperscript{450} and instead settled in terms of the director’s insurance company as per section 247 of the Companies Act.\textsuperscript{451}

Directors are increasingly coming under pressure with regard to the manner in which they exercise their fiduciary responsibilities. Shareholders are also becoming more demanding of directors as are stakeholders. The cumulative effect consequently would require that the net of liability of directors be spread a lot further when corporate decision-making is done.

The new Act\textsuperscript{452} seeks to ensure a more accountable and disclosure orientated governance regime that remains commensurate with international best practice, whilst enabling management’s ability to run companies profitably.\textsuperscript{453} This is the basis of governance as advocated by King 11: a balanced board both in representation and in terms of commitment to performance versus conformance.\textsuperscript{454}

Legislation need not curb performance by a commitment to conformance and in fact states that performance and accountability is enhanced by supporting regulation. The very nature of accountability is implementing penalties for poorly considered actions and the foregoing discussion on codified duties of directors supports this assertion. The codification of duties enhances disclosure as mandatory disclosure is intrinsically more credible than voluntary disclosure. Section 76 of the new Act\textsuperscript{455} seeks to codify the common law duties with specific reference to director’s fiduciary duty and the duty of reasonable care and skills. The section does not exclude the common law; therefore the common law duties as discussed are not expressly amended.\textsuperscript{456} In dealing with the duty of good faith the new Act provides that a director has a ‘second fiduciary duty to act

\textsuperscript{450} Act 71 of 2008.
\textsuperscript{451} Ibid.
\textsuperscript{452} Ibid.
\textsuperscript{453} D Davies ‘Codifying Directors Duties’ 2007 Institute of Directorship 15.
\textsuperscript{454} Ibid 15.
\textsuperscript{455} Act 71 of 2008.
honestly and in good faith and in a manner that the director reasonably believes to be in the best interests of and for the benefit of the company.\footnote{457}{Section 76 (3) (b) of Act 71 of 2008.}

The proposed codification has met with a contentious reception. The proponents of a voluntary regime and the existing common law framework of disclosure have castigated the proposed amendments, stating that the three conjunctives used in section 76 (3) of the new Act\footnote{458}{Ibid.} are instructive and thus denote a highly prescriptive and limiting regime. It has also been criticized for being vague as ‘acting in the best interests of the company’ is different to acting for ‘the benefit of the company’.\footnote{459}{E Van de Vyver \& S Shandu ‘Company Duties’ 2007 \textit{Without Prejudice} 34.} The import and intent of the clause seeks to introduce a broader band of ethics to the duties of directors which in turn will enhance the quality of disclosure made and should be commended.\footnote{460}{Companies Bill, 2007 discussion forum.} Another important provision is found in section 76 (2) of the new Act.\footnote{461}{Act 71 of 2008.} The director is under obligation to communicate any information of materiality to the board. This disclosure is of paramount importance in strengthening corporate governance and was intended to enhance previous disclosure practice. However it remains a very broadly drafted provision in terms of the information that should be disseminated and therefore susceptible to manipulation and circumvention.\footnote{462}{P Delport \textit{New Companies Act Manual} 1ed (2009) 60. (Note that the Draft Regulations of the Companies Act released for public comment on 22 December 2009 have not offered any further clarity on this issue and in fact Regulation 46 and 104 makes no reference to this issue at all. This will no doubt form the basis of public commentary to supplement and amend the relevant regulations).}

The director must make disclosure of a personal financial interest in a matter before the board and to the shareholders (if prescribed)\footnote{463}{Section 75 (3) of Act 71 of 2008.} and should not participate in the meeting following disclosure.\footnote{464}{Ibid Section 75 (5) (f).} This is relevant and consistent with global reform that proposes a change in director conduct and behaviour of boards. This is amplified by section 77 (3) (d)\footnote{465}{Ibid.} which requires a director to minute and vote against conduct in contravention of the
new Act\textsuperscript{466} so as to mitigate their personal liability. Therefore directors must diligently apply their minds to a matter. Section 77 of the new Act\textsuperscript{467} is deemed to enhance the operation of governance principles as it renders a director statutory liable 'should a director breach his fiduciary duty and for any loss, damages and costs sustained by the company as a consequence of such breach'.\textsuperscript{468} Disclosure as a means of strengthening corporate governance is fortified by the new Act\textsuperscript{469} as it renders a director liable for financial statements that were false and/or misleading in a material aspect.\textsuperscript{470}

This section is further enhanced by section 218\textsuperscript{471} which relates to the right of shareholders and stakeholders to evoke a civil action (in addition to any other remedy they may have) against the directors for loss and damage suffered by said shareholder or stakeholder as a result of a contravention by a director.\textsuperscript{472} It is not necessary for the contravention or conduct to be fraudulent or carried out with gross negligence. This enhances the rights of shareholders and affords them a better form of recourse against directors.\textsuperscript{473}

The most progressive provision in the new Act\textsuperscript{474} is section 76 (3) (read in conjunction with Section 76 (4) and 76 (5)) commonly referred to as the 'business judgement rule'.

The means and mechanisms of strengthening corporate governance are presented with a double edged sword in the form of this provision. It seeks to ensure more disclosure to the board and shareholders as a whole, thereby embracing a holistic practice of governance. The more onerous argument is that the business judgement rule can be

\textsuperscript{466} Ibid.
\textsuperscript{467} Ibid.
\textsuperscript{468} Ibid Section 77 (2) (a).
\textsuperscript{469} Ibid Section 77 (3) (d).
\textsuperscript{470} This is of relevance in terms of corporate failures due to directors colluding with auditors in terms of misrepresenting their profitability to shareholders and to future investors and is of relevance to shareholders and stakeholders.
\textsuperscript{471} Act 71 of 2008.
\textsuperscript{472} Ibid Section 218 (2).
\textsuperscript{473} Note in terms of Section 20 (6) where shareholders have a claim against directors (or managers) who act in contravention of the Act due to their fraudulent conduct or gross negligence thereby remedying the problems associated with Section 424 of Act 61 of 1973.
\textsuperscript{474} Act 71 of 2008.
implemented to erode accountability by making qualified disclosure to defend
detrimental corporate action on the basis that at the time of making the decision it was in
‘the best interests of the company’. This will cause a tandem diminishment of corporate
governance, accordingly interpretation and consistent implementation of this rule is of
overriding importance. 475

It is argued that this rule constitutes a licence to directors to perpetrate various forms of
self-enrichment to the detriment of the company and their shareholders and stakeholders
at large provided the director when making his decision relied on the competent
employees, legal counsel accountants or other professional persons.476 It is a provision
that has been imported from American jurisprudence and in terms of section 5 (2)477 a
court may have recourse to foreign law in interpreting provisions of the new Act.478

Delaware judgements have misinterpreted the business judgement rule as ‘indemnifying’
directors rather than recognising its original impetus479 which is exercising a duty of care
and skill.480 However, the rule can be abused to exonerate directors from monetary
liability flowing from a breach of their duties if the board can prove they reasonably
delegated their authority and relied on competent persons which renders this provision
ripe for abuse as disclosure made by directors in terms of the business judgement rule can
negate corporate governance practice and secure minimal accountability of directors.481

476 Section 76 (5) (b) of Act 71 of 2008. Also it can be argued that it will obviate the effects of Section 77.
478 Ibid.
479 M M McMurray ‘An Historical Perspective on the Duty of Care, the Duty of Loyalty, and the Business
480 Smith v Gorkom (1985) 488 A2d 858 Del. The directors were held liable for a breach of duty of care as
they failed to obtain all the reasonably available information before voting on a merger which proceeded to
have disastrous financial consequences as a direct result of their flagrant disregard of their duty of care and
skill. See also Litwin v Allen (1940) 25 N.Y.S 2d 667 N.Y Sup. Ct. Litwin v Allen in which Judge Shientag
expressed the two legs of duties owed by directors to companies, namely, the duty of care and the duty of
loyalty. Failure to meet these standards would result in legal liability, but as a general rule the court will not
impose liability if the business judgement exercised by the directors turned out to be wrong or to have
caused the company to incur an unforeseeable cost. See also Re Walt Disney Company Derivative
481 S R Cohn ‘Demise of the Director’s Duty of Care: Judicial Avoidance of Standards and Sanctions
4.4 Conclusion

The role of disclosure in strengthening corporate governance involves a panoramic approach that extends across the landscape of shareholder activism to director’s duties and obligations. Company law reform has solidified the legislative support offered to shareholders to access information and disclosure by the company thereby strengthening corporate governance. This position is further enhanced by the obligations imposed on directors in terms of the new Act.\(^{482}\)

This chapter also analysed the global and local trends to fortify disclosure regarding remuneration and the verification of ‘independence’ of non executive directors which emphasises the governance imperative directing reform towards shareholder safeguards. It also confirms that shareholders are best served by a mandatory regime of governance directed by legislation.

Any criticism levelled at codifying director’s duties, obligations and entrenching shareholder imperatives should be directed to one of the best models of governance and the precursors to current company law reform namely the Banks Act.\(^{483}\) The new Act\(^{484}\) has mirrored the basic tenets of the Banks Act\(^{485}\) namely: more disclosure, stakeholder concerns and a higher standard of stewardship by directors thereby fortifying the foundation of corporate governance. It surpasses the efficacy of the new Act\(^{486}\) by its mandatory adherence to corporate governance.\(^{487}\)

In addition the existing banking regulations seek to elaborate on the duty owed by the directors of a bank to its depositors. Regulation 39 (1) of the Banks Act\(^{488}\) requires every

\(^{482}\) Act 71 of 2008.  
\(^{483}\) Act 94 of 1990.  
\(^{484}\) Act 71 of 2008.  
\(^{485}\) Act 94 of 1990.  
\(^{486}\) Ibid.  
\(^{487}\) Ibid Section 60B.  
\(^{488}\) Ibid.
director of a bank or controlling company to ‘acquire a basic knowledge and understanding of the conduct of the business of a bank and the laws and customs that govern the activities of such institution’. Thus, regulations set a specific standard of skill that is required of all directors whether executive or non-executive.

The nature of banking requires a broader view of corporate governance. This incorporates the pluralist vantage of stakeholders being not just the shareholders but the depositors as well.

The Banks Act also inhibits the short fall associated with disclosure in terms of its heightened internal auditing and risk mitigation function thereby all disclosure is verified. It also represents an astute model of a director-shareholder relationship that is enhanced by the presence of a Regulator. It is a prolific model of corporate governance that has rendered it immune to the financial crisis and governance collapse and draws attention to the efficacy and value of a mandatory disclosure regime that best serves shareholder interests and enhances directors’ duties.

Chapter 5: DOES DISCLOSURE LEAD TO THE EFFECTIVE IMPLEMENTATION OF CORPORATE GOVERNANCE POLICIES?

5.1 Introduction

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489 Ibid Regulation 39 (1).
492 Section 64 and 64A of Act 94 of 1990.
493 Ibid Section 60.
494 Ibid Section 4 and Section 6. See also http://www.reservebank.co.za (Last Visited on 26 November 2009). Also note penalties for non adherence in terms of Section 22 and Section 25 of Act 94 of 1990.
495 The Draft Regulations of the Companies Act released for public comment on 22 December 2009 advocates Regulations 153 to 170. These Regulations makes no mention of a regulator per se and as such has failed to initiate a regulatory body of any substance. Regulation 143 does afford the Commission the right to commence investigations and has supporting Regulations in the form of Regulations 139 to 141 to assist with these investigations which are tantamount to the powers afforded to the SEC. This will no doubt be the basis of much debate and commentary as there is not recommended formulation as to how this will be implemented in practice. It is nevertheless a step in the right direction to initiate a mandatory regime of compliance.
In critically analysing the role of disclosure in strengthening corporate governance an evaluation of corporate governance principles has been done and current corporate governance reform considered. The majority of corporate governance reforms and current regimes have been enacted in the wake of corporate governance failures. The thread of similarity tying these corporate collapses together is the magnitude and scope of failure, the loss of vast sums of money and the fact that all the checks and balances failed collectively. These corporate collapses were also characterized by the convoluted mechanisms used to avoid correct disclosure.

Globally the corporate governance framework\(^{496}\) has been built on a reactive rather than pre-emptive mindset. The issue is whether the current reforms being considered have succeeded in securing a dependable and reliable disclosure regime to diminish the magnitude of failures.\(^{497}\) In evaluating whether current governance reforms and mandatory disclosure as a mechanism of facilitating reform is as important as the proponents of diligent governance profess it to be, a practical evaluation of the governance shortcomings prevalent in key corporate governance failures would be valuable. This appraisal is to determine the governance standards (or lack thereof) in place and how such standards can be best supplemented. The analysis is indispensable in determining whether disclosure and the means to ensure disclosure either through a voluntary or a mandatory regime has been adequately addressed.

5.2 Fidentia

A trio of companies: Fidentia Asset Management (Proprietary) Limited, Fidentia Holdings (Proprietary) Limited and Bramber Alternative (Proprietary) Limited (collectively referred to as Fidentia) came under scrutiny as a result of the mismanagement of an amount in excess of one billion rand of investments of numerous

\(^{496}\) See Chapter 1.5 (Background to Corporate Governance which addresses a snapshot of corporate governance regimes: 2009).

\(^{497}\) See Chapter 1.6 (Current Trends in Corporate Governance which addresses reforms earmarked for 2010).
The biggest investment was a billion rand investment from the Living Hands Umbrella Trust, which pays out money from the mineworkers' provident fund to widows and orphans of workers killed in mining related accidents. In the case of Fidentia the level of independence of the financial officers and the accountability of the board was seen to be highly dubious.

This prompted the Financial Services Board Registrar to apply to the High Court in terms of section 5 of the Financial Institutions (Protection of Funds) Act to have Fidentia placed under curatorship. The issue is how in the face of the stringent legal framework that governs South Africa's corporate and finance sector could this have occurred not to mention the various watchdog bodies peculiar to this industry including but not limited to the South African Reserve Bank, South African Revenue Service, Financial Intelligence Centre, Financial Advisory and Intermediary Service Ombudsman, the Long Term Insurance Ombudsman, the Pension Funds Adjudicator, the Short-term Insurance Ombudsman, the Securities Regulation Panel and the Financial Reporting Standards Council. Hence, notwithstanding all the checks and balances and provisions of disclosure and transparency, the aforementioned regulatory safety net seems to have developed gaping holes.

With regard to Fidentia one of the key pillars of good corporate governance, namely, independent auditing, appear to have in fact been vacuous from both an internal and external perspective. It is the role of the board of directors to question the financials filed. To commit fraud of this magnitude one has to ask the questions: What was the role of the

498 http://www.fsb.co.za (Last visited on 26 November 2009).
499 http://www.persfin.co.za (Last visited on 26 November 2009).
505 http://www.foisombud.co.za (Last visited on 21 November 2009).
risk committee, the audit committee and was there a simile of independence exhibited by the non-executive directors?

Fidentia clearly possessed all the prescribed requirements of governance in the form of the aforementioned committees and in fact bragged about the credentials of some of their high flying independent directors.\textsuperscript{511} What is self evident is that disclosure of credentials and prescribed requirements does not guarantee efficient governance or accountability. The efficacy of governance hinges on the effective monitoring of these committees and on the palpable independence of directors. The independent directors are supposed to bring objectivity to the oversight function of the board and improve its effectiveness.\textsuperscript{512} Stakeholders and shareholders place high expectations on them, such expectations were clearly misplaced with the Fidentia board. It is sincerely hoped that disclosure of independent directors will be accompanied by actual independence on their part. Third party verification of independence is elementary in establishing independence alternatively unambiguous disclosure of relationships between directors on the board or sub committees. Disclosure of this nature should be recorded in formal minutes and annual reports. This would be vital in implementing corporate governance policies and cementing accountability.\textsuperscript{513}

In terms of the new Act\textsuperscript{514} it will be far more difficult given the stricter reporting requirements to perpetuate such fraud.\textsuperscript{515} It is also hoped that the extended ambit of liability associated with dereliction of duties by directors would be a deterrent to such conduct.\textsuperscript{516} In addition it will present an integrated strategy across the board to monitor checks and balances. Furthermore it is anticipated that the revised legislation will remedy the lack of communication between the various role-players. The Fidentia case parallels the detracted uninformed role of non-executive directors in Masterbond and the

\textsuperscript{511} M King 'Corporate Citizen' 1ed (2006) 51.
\textsuperscript{513} Section 77 of Act 71 of 2008 advocates this conduct to avoid personal liability.
\textsuperscript{514} Ibid.
\textsuperscript{515} Ibid Section 30 and Section 94.
\textsuperscript{516} Ibid Section 77.
Leisurenets fiascos. However, considering the Fidentia saga was played out in the wake of King II and extensive company law reform locally and abroad it is indeed a disheartening disregard of corporate governance.

In support of this statement an evaluation of the desideratum that encapsulated the gaping fissures in the governance system of Fidentia shall be considered in the following discussion. Fidentia’s accounts were not initially audited and financial statements were filed with the Financial Services Board late and only upon written demand to comply with filing requirements. Invested funds were allegedly distributed through an accountant’s trust account to directors, shareholders and others. This completely obviates the independence requirements of external auditors.

There were material conflicts of interest that were not disclosed by board members in terms of holding positions on both the Fidentia Board and related companies. This is a patently obvious weakness in maintaining the sacrosanct rule of independent non-executive directors and non-conflicted executive directors.

The Fidentia study may be deemed to be the antithesis of best practices. It also exhibits how poor, non verified disclosure practice erodes corporate governance. Apart from the aforementioned weaknesses in disclosure corporate South Africa also stands exposed in a number of other areas as postulated in the Price Waterhouse Coopers study: ‘Survey of Effective Management of South African Retirement Funds’. The survey found that at least two out of five retirement funds have failed to formally confirm whether the trustees

517 http://www.moneyweb.co.za (Last visited on 21 November 2009).
518 Note in terms of King III the internal audit function as per Chapter 3 is far more regimental and the guidelines stricter in terms of the internal audit practice note coupled with the combined assurance model. This is amplified by Principles 3.1 and 3.5. It has enhanced support from Act 71 of 2008 in terms of Section 94 and the independence of external auditors in addition it is underpinned by the ethics regime proposed by the King Code on Corporate Governance (2009) as per Principle1.1.
519 http://www.fsb.co.za (Last visited on 19 November 2009).
522 The King Report on Corporate Governance (2009) has refined and amplified the requirements for independence. Principle 2.18 Recommendations 76 and 77.
523 http://www.seshego.co.za (Last visited on 19 November 2009).
of the funds have the required knowledge to effectively manage the interests of their members.\textsuperscript{524} Unlike the UK in terms of the Myners Report 2001\textsuperscript{525} which evaluated pension funds and institutional investors there is no legislation in South Africa to enforce satisfactory knowledge levels. Among other issues that beg attention are matters like conflict of interest,\textsuperscript{526} the number of directorships one individual can hold,\textsuperscript{527} enforcing asset declarations by directors and the ability of unskilled and inexperienced trustees to make decisions regarding billions of rand of other people's money. Disclosure of this information was elementary in determining whether non-executive directors are appointed to serve the interests of the company and stakeholders or their fellow executive directors.\textsuperscript{528}

It is therefore essential that the recommendations of the Myner Report are translated into future reform on the South African landscape. The induction, ongoing training and development of directors on an ongoing basis is a key principle of King III.\textsuperscript{529} It is also supported by recommendations of mentorship, industry specific training and the amplification of the role of the company secretary.\textsuperscript{530} Directors should also be able to source external advice if so required within reasonable parameters coupled with the right to delegate their responsibilities to properly constituted committees.\textsuperscript{531}

The issue then is whether we remedy the conduct evidenced in Fidentia with further regulation demanding more disclosure or is it a bigger endemic problem. It is an endemic problem of excess, greed and a complete lack of ethics.\textsuperscript{532} Notwithstanding the series of

\textsuperscript{524} Ibid.
\textsuperscript{526} King Code on Corporate Governance (2009) Paragraph 88.7. With specific reference to the disclosure requirements analysis published by Price Waterhouse Coopers downloaded from http://www.pwc.com (Last visited on 22 November 2009).
\textsuperscript{527} Ibid Paragraph 88.6.
\textsuperscript{528} Note there is a global trend to appoint directors with industry specific knowledge and skills to enhance the meting out of board and director duties as outlined in latest governance codes.
\textsuperscript{529} King Code on Corporate Governance (2009) Principle 2.20.
\textsuperscript{530} Ibid Principle 2.20 Recommendations 91, 92 and Principle 2.21 See also Section 85 of Act 71 of 2008.
\textsuperscript{531} Ibid Principle 2.23.
\textsuperscript{532} Ibid Principle 1.1. See also Section 72 (4) of Act 71 of 2008. In relation to ethics and the importance of an ethical foundation in directing the behaviour of boards. This is a global sentiment re-iterated in the Walker Review and the latest review and consultation documents on the Combined Code. Note the Draft
progressive and ambitious laws South Africa has sought to enact, this endemic problem coupled with a poor enforcement regime renders disclosure of any kind dubious. Accountability is also eroded by an excruciating slow legal system; this was evidenced in the delayed appointment of a curator for Fidentia which enabled the Fidentia directors under investigation to shift funds beyond recovery.

Thus, all future regulation must be supported by a stronger regulatory regime to ensure that disclosure enables meaningful accountability so as to improve audit committee performance and independence. Various studies and empirical research has focused on the relationship between these codes and better corporate governance. Wild\(^{533}\) purports that the firms that establish an audit committee experience an increase in their earnings stressing the notion that companies with such independent, well governed committees will no doubt have improved financial reporting.\(^{534}\)

It was self-evident that in Fidentia none of these aforementioned principles were implemented to best advantage. In fact auditor reports and financials were manipulated with the assistance of a fraudulent auditor. There is a therefore a positive correlation between audit committee independence and financial reporting quality.\(^{535}\) This in turn underpins the importance of the independence of key committees like remuneration, risk and audit committees and its influence on credible disclosure.

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Regulations of the Companies Act was released for public comments and review on 22 December 2009. Regulation 50 has addressed the scope operation and mandate of the proposed social and ethics committee in detail. Of relevance if Regulation 50 (12) which focuses on the function of the committee which refers to international dispensations like the OECD and corporate social investment opportunities. It is silent on the actual ethical conduct and development highlighted by the King Report on Corporate Governance (2009) Principle 1.1. This is grounds for commentary and proposed amendments. It does ensure that shareholder engagement is considered.


\(^{534}\) Section 64A of Banks Act 84 of 1990. Section 94 of Act 71 of 2008.

This was not evidenced to best advantage by Fidentia but one of the recommendations by King II as confirmed by King III\textsuperscript{536} to deal with ethics and fraud is encouraging whistle-blowing which is an effective form of regulation. If we inculcate a culture of whistle-blowing the devastating effects of Fidentia could have been diminished. Although legislation has been enacted to protect whistle-blowers in the form of the Protected Disclosures Act.\textsuperscript{537} The implementation of this Act in a responsible and accountable fashion is key to its success as protection will not be afforded to persons who maliciously make untrue and unfounded disclosures. This Act promotes good corporate governance and exemplifies the manner in which disclosure can be implemented to ensure effective corporate governance policies. In addition the Act is a testament to the institutional activism the King Reports advocates. The new Act has also legislated on this issue to underpin the functioning of disclosure and anti fraud initiatives.\textsuperscript{538}

The greater transparency brought by democracy not only offers opportunities to deal with corruption but offers a sharper focus on the constraints that corruption imposes on development and the quality of governance. This is due to the fact that such conduct runs contrary to accountability and the rule of law.\textsuperscript{539}

Sarbanes-Oxley\textsuperscript{540} provides for whistle-blowing by way of section 806\textsuperscript{541} whereby a whistle-blower is protected if he or she partakes in ‘protected activity’ which would include providing information concerning a protected subject matter. As such retaliation against such an individual on any basis whatsoever is prohibited. This is amplified by section 1107\textsuperscript{542} which imposed criminal penalties on any individual who engages in retaliation tactics.

\textsuperscript{537} Act 26 of 2000. 
\textsuperscript{538} Section 159 (4) of Act 71 of 2008 contains whistle blower provisions. 
\textsuperscript{540} Sarbanes-Oxley Act 2002. 
\textsuperscript{541} Ibid. 
\textsuperscript{542} Ibid.
It is further supplemented by section 301 of Sarbanes-Oxley\textsuperscript{543} which requires audit committees to set up whistle-blowing procedures whereby employees can anonymously submit issues of concern regarding questionable accounting or auditing issues.

Blowing the whistle has become a topical issue in corporate governance as companies seek to curb corruption, abuse of company assets, financial crime and other criminal activities. Whistle-blowing is designed to strengthen internal control mechanisms of a company, is central to the internal auditing function and is the most productive form of disclosure. Companies are taking whistle-blowing seriously and are putting in place infrastructures to ensure that employees report information on suspected criminal activities, violation of company procedures and internal controls, cases of misconduct, abuse of company assets and so on. The idea to whistle-blowing is to stop misconduct before damage is done to the company. It's a deterrent as well as a preventative measure. For whistle-blowing to be effective, they have to be mechanisms within the company for reporting misconduct and violation without fear of being identified or harassed by management. Measures should also be put in place to investigate such matters and for appropriate follow up action. Companies have invested in systems such as hotlines and secured websites in order to facilitate whistle-blowing.\textsuperscript{544}

To date there is no such mechanism for public fund managers, which is indeed disconcerting that the principles are in place but practically it has not been implemented to the full extent. In a country plagued by corruption, fraud of gargantuan proportions it seems erroneous and irresponsible not to be implementing whistle-blowing to the fullest extent. This is a reiteration of an earlier assertion that our theoretic framework of corporate governance laws is sound but all disclosure that flows from it requires the assistance of a meaningful regulatory system\textsuperscript{545} to ensure accountability.

\textsuperscript{543} Ibid.
\textsuperscript{544} King Report on Corporate Governance (2009) Chapter 8 and Section 159 (4) of Act 71 of 2008 recognise the importance of these provisions in enhancing the internal audit function.
\textsuperscript{545} Sections 191 and Section 193 and Section 194 of Act 71 of 2008 refers to the establishment of specialist committees and a tribunal which if regulated and staffed appropriately could assist in the proposed regulatory process.
5.3 Enron and Worldcom

Enron and Worldcom were the world's leading electricity, natural gas, and communications companies respectively. At the end of 2001 and 2002 it was consecutively revealed that the cataclysmic financial condition of both companies were the cumulative result of accounting fraud and corporate mismanagement. Their financial condition was the culmination of creatively planned accounting records attributed to another common element between the companies, their auditors, Arthur Anderson. It ultimately led to the demise of Arthur Andersen and both companies have become a global symbol of willful corporate fraud, corruption and poor corporate governance.

Both Enron and Worldcom successively filed for bankruptcy protection and as such constituted the largest such filings in United States history, this has since been overtaken by the collapse of Lehman Brothers in September 2008 in the wake of the financial crisis.

Enron and Worldcom provided the impetus of corporate governance reform in the US as encapsulated in Sarbanes-Oxley and the SEC amendments. However, both Enron and Worldcom portrayed the veneer of commendable corporate governance and endeavoured to make periodic disclosure of such attributes. For example both companies had independent directors on their financial committee and in both instances a financial expert served as chairperson. Despite compliance with a rule that was subsequently entrenched in Sarbanes-Oxley the audit committees failed to identify and act on financial statements that contained material misstatements. Clearly being independent in name and acting independently in practice are two key aspects in ensuring compliance and

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547 Ibid.
550 Section 404 Sarbanes-Oxley Act 2002.
transparency. O’Kelly noted the importance of being independent in thought and action.\textsuperscript{551}

If management is being dishonest it is still going to be hard to root out the deception notwithstanding the disclosure and filing requirements.\textsuperscript{552} The theoretical discourse on corporate governance is bewildered by the magnitude and scope of the corporate fraud. Analysts lay the blame squarely on the lack of independence of non-executive directors.\textsuperscript{553}

A recent corporate governance scandal to undermine India’s corporate landscape is in the form of Satyam Computer Services Limited (Satyam), a software company that has global presence.\textsuperscript{554} The company has fallen foul of misrepresenting its balance sheet and is in fact on the brink of bankruptcy. Its share price has plummeted rendering investors irate. The off balance sheet shenanigans by Satyam parallel the conduct of Enron. Once again all fingers are pointing at India’s weak law enforcement regime, failure of the independent directors to act independently and poor transparency.\textsuperscript{555}

The recurring theme of a lack of independence presents a dichotomy of policing independent directors while maintaining the independent confidential preserve of the boardroom. This can be achieved by firstly, more clarified disclosure of interests, secondly adequate monetary incentives,\textsuperscript{556} which is to compensate independent directors adequately and lastly the threat of prosecution and the concomitant loss of reputation.

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\textsuperscript{552} C Hymowitz & J Lubin ‘Corporate Reform: the first year: boardrooms under renovation scandals prompted changes, but critics say more is needed to prevent another Enron’ 2003 Wall Street Journal 78, 79.
\textsuperscript{554} http://www.corporatewatch.org (Last visited on 27 November 2009).
\textsuperscript{555} Ibid
\textsuperscript{556} Combined Code (2008) Section B.1.1 Non Executive remuneration in the form of director’s fees is a recognized and acceptable reward. Share options and performance related bonuses are not acceptable. There is a fine line between rewarding a highly qualified and skilled party for their time versus obviating their independence.
\end{flushleft}
The aforementioned examples confirm the fact that corporate governance is about constant vigilance. Each corporate catastrophe highlights a gaping hole in governance that requires a concrete response. The regimental disclosure requirements expected by the American auditors in terms of Sarbanes-Oxley and in term of South Africa’s Auditing Professions are a significant deterrent to such conduct and are an imperative support to corporate governance in both regimes.

Another remedial effect evidenced in Sarbanes-Oxley as highlighted in previous chapter is the prohibition of loans to directors. This prohibitive clause would have prevented the advance of a loan in excess of four hundred million US dollars to the CEO of Worldcom. This was done to circumvent his sale of shares in the company and which ultimately resulted in the company’s downward spiral into bankruptcy.

The issue is that notwithstanding the appearance and disclosure of normalcy, fraud is perpetuated and corporate governance principles obviated. The only means of enforcing accurate disclosure and policing such disclosure are punitive measures and dogged enforcements of regulations. In addition the objective evaluation of board performance, constant evaluation and declaration of independence and whistle-blowing remain essential cogs of a regulatory process.

Time Magazine in 2003 named ‘the whistle-blowers’ as its person of the year and praised Cynthia Cooper, an employee of Worldcom, and Sherron Watkins, an employee of Enron, for their courageous role in reporting the fraudulent and underhanded activities of the companies in the absence of protective legislation. In terms of the practical and factual correlation of the two corporate disasters the much belaboured reforms would have in fact curbed management from perpetuating poor corporate governance and

557 Sarbanes-Oxley Act 2002 Section 404AA.
558 Act 26 of 2005.
560 L W Jeter Disconnected: Deceit and Betrayal at Worldcom 1ed (2003) 156.
561 http://www.time.com (Last visited on 19 November 2009).
disclosing incorrect results. This is of course supposition but better regulated disclosure is an effective means of implementing corporate governance policies. This underpins the contention that disclosure alone does not guarantee accountable governance if it is not accompanied by rigorous enforcement.

This argument is affirmed by an analysis of one of the cornerstones of good corporate governance namely the remuneration of audit committees which must be limited to director’s fees only. One of Enron’s audit committee members was paid a consulting fee which would be disallowed under current regulation. Disclosure of this would have indicated disparate treatment or the so-called self-serving behaviour pronounced upon by Healy.

What is also of significance is the operation of the compensation and the nomination committees of these companies. In terms of the compensation committee both Enron and Worldcom had independent directors serving on their compensation committees. In both corporate misdemeanants the compensation committees recommended exorbitant bonuses based on the attainment of targeted revenue goals that were later proved to be grossly misstated by management. This ultimately leads back to the incorrect disclosure of financial statements which was the result of accounting fraud. But more importantly it also points to the committee’s failure to question the reported revenue figure on which the performance bonuses were based, despite the fact that independent directors and financial experts were represented on the relevant committees.

Accordingly the issue is whether the reforms contained in American corporate governance legislation would in fact have prevented the CEO’s from receiving their large overstated bonuses. Sarbanes-Oxley is silent on remuneration committees but the SEC has stated the importance of correlating compensation and performance and the ambit

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564 The Securities and Exchange Commission SEC ‘s proxy rules require that domestic public companies prepare a ‘compensation discussion and analysis’ (CD&A) including extensive tabular and narrative
of director’s liability for reckless conduct has been significantly expanded. As a result it can be inferred that the directors would not have blindly endorsed the payment additionally the role of independent directors have been elucidated to the extent that this conduct would have been prevented. The issue of independent impartial and unbiased directors is of paramount importance. In all examples cited it was later established that notwithstanding citation of independence all directors in fact had interpersonal relationships that contributed materially to the corrupt decisions perpetuated. The inclusion of independent directors on the board to comply with legislation and the concomitant disclosure of this fact does not contribute to strengthening corporate governance and accountability. It must be accompanied by independent directors who exercise due diligence in meting out their duties and are able to identify signals that indicate unacceptable corporate practice.  

5.4 Financial Crisis

A panoramic analysis of the current financial crisis indicates that the current period of gross uncertainty in which the global economy finds itself in is not new.

The current financial crisis is a culmination of factors, firstly the nature of sub-prime loans are characterized by excessive leverage as loans are advanced to people and entities.

disclosure of compensation paid to their most senior and highly compensated executives. This is filed with the SEC which means officer liability for material errors and omissions. The CD&A covers the basis, motivations and relevant information considering for remuneration including that of Non Executive Directors. Once the compensation committee recommends to the Board of Directors that the CD&A be included in Form 10-K and proxy statement it is filed with the SEC.

565 See Chapter 4.2.

566 The subprime crisis is an ongoing real estate crisis and financial crisis triggered by a dramatic rise in mortgage delinquencies and foreclosures in the United States, with major adverse consequences for banks and financial markets around the globe. The crisis, which has its roots in the closing years of the 20th century, became apparent in 2007 and has exposed pervasive weaknesses in financial industry regulation and the global financial system.
with unstable incomes or low creditworthiness. In South Africa the National Credit Act\textsuperscript{567} was enacted with the primary objective to curb reckless indebtedness and has been accredited with minimizing our exposure to the current financial crisis. Thus disclosure mandated by this Act is a key mechanism of strengthening the South African corporate governance regime.

Secondly, there were clear gaps in regulatory and accounting standards regarding the treatment of ‘off-balance sheet’ financial vehicles and lending practices. Save for publicly listed and traded banks, the operation of Sarbanes-Oxley\textsuperscript{568} and the SEC\textsuperscript{569} did not apply and thus the incumbent rigorous checks associated with audit control were absent. In terms of the South African regime all banks are subject to the regimental checks and balances encapsulated in the Banks Act\textsuperscript{570} and the Auditing Professions Act.\textsuperscript{571}

Thirdly, the opaque and complex nature of the securitization process exacerbated risky sub-prime loans into riskier securities like collateralized debt obligations, asset-backed commercial paper conduits and so on. This highlights the complete lack of transparency and disclosure of the mechanics of securitizations which has since highlighted the creatively incorporated special purpose vehicles that in fact perpetuated synthesized transactions.\textsuperscript{572} South Africa’s under developed securitization market and strict exchange control regulations prevented South African banks from trading in such entities. Banks thus benefited from a highly regularized system of control.

\textsuperscript{567} Act 34 of 2005.
\textsuperscript{568} Sarbanes-Oxley Act 2002.
\textsuperscript{569} \url{http://www.sec.gov} (Last visited on 19 November 2009).
\textsuperscript{570} Act 94 of 1990. See also Section 165 of Act 71 of 2008 which curbs off balance sheet transactions without shareholder approval.
\textsuperscript{571} Act 26 of 2005.
The KPMG audit committee review indicated a clear failure in corporate governance as a precipitating factor in the financial crisis and it is patently obvious that it was a common element in issues discussed above.573

The elevated standard of duties and obligations of directors of a bank have been adumbrated in Chapter 4.4.574 As discussed this is due to the fact that banks play a fundamental role in the flow of capital within global economies. As such the business of banking has a number of intrinsic risks that may jeopardise the entire financial system of an economy. Simply stated the success or failure of banks has more significant external consequences than the success or failure of most other types of firms. This statement has epitomised the global crisis the financial markets are currently embroiled in.575 This can be attributed to the disregard of capital and liquidity requirements prescribed by the Basel Committee on Banking Supervision of the Bank for International Settlements in terms of the Basel II Capital Accord (Basel II) of 2005.576 The seminal purpose of this document is to assist banks globally and their supervisors in the implementation and enforcement of sound corporate governance.577 It also seeks to prescribe minimum capital requirements and enhance transparency and public disclosures by banks. Basel II has been formally incorporated into the South African banking sector in terms of the Banks Amendment Act.578

Basel II fervently advocated adequate disclosure of critical information to ensure market discipline. This was completely and utterly ignored. This highlights the role disclosure (in terms of diligently monitored regulation) can play in strengthening the implementation of corporate governance safeguards. This also places us squarely before the following enquiry: what was the role and responsibility of the board of directors of these banking and financial institutions? This inquiry is ultimately the litmus test of the business

573 http://www.kpmg.com (Last visited on 19 November 2009).
574 Regulation 39 of Banks Act 94 of 1990.
576 http://www.bis.org (Last visited on 19 November 2009).
577 Ibid.
judgement rule so as to determine whether directors applied their mind to the assumption of risk or whether the end result was in fact a dereliction of their duties. This has been confirmed by both the Turner Review and the Walker Review which have cited stringent disclosure of adherence capital and liquidity requirements as a key risk mitigation strategy of banks and other financial institutions.

Two recent Singapore cases suggest that the financial crisis as evidenced in that jurisdiction was in fact the result of poor disclosure and an attendant dereliction of director’s duties.

Both cases involve a negligence suit against the auditors for failing to detect and prevent fraud. The defendant audit firms successfully argued that the amount of damages should be reduced as a result of the negligence of the respective boards in failing themselves to spot the warning signs evident in the accounts of the companies. Damages were reduced by fifty percent in both cases. The Singapore Supreme Court of Appeal slated the directors for submitting evidence that they relied on the advice of management and auditors reports. They stated that directors could not dispense with their own duty of stewardship to the company by wholesale delegation.

See also Chapter 4.3.

Turner Review: A regulatory response to the global banking crisis (March 2009). The Turner Review has advised greater regulation of the Banking Sector in the UK and the EU and proposed a central regulator, this recommendation has fallen away but it has supported the assumption of more power for the FSA.

Walker Review of corporate governance in UK banks and other financial industry entities (26 November 2009). Walker asserts that the financial crisis and the collapse of banks has been the result of exorbitant remuneration policies of top end employees which encouraged excessive risk taking. As such the recommendations are risk mitigation focused with expansive disclosure on the bank’s risk plan and risk committees being formed. The other key issue is the recommendation that remuneration policies and the manner in which they are structured should be legislated underpinning the importance of mandatory provisions governing disclosure on key governance issues. As a practical example reference can be made to the financial products unit of American International Group (AIG) which sought to allocate a portion of government aid to pay executive bonuses. These exorbitant bonuses were a key contributor to the insurer’s loss and the potential failure of the company. The Straits Time 31 December 2009. Page B18.


In both cases the court seemed to view the fraud evidenced in the proposed securitization transactions as readily apparent and would have leapt out at anyone making even a cursory examination of the accounts. The two cases suggest a trend by the courts to impose stricter duties of supervision on management by directors and the expectation of such directors to apply their minds more independently. In the Plan Assure case the court stated that the non-executive directors were not entitled to rely solely on the finance manager to ensure that the accounts and business model were in order and it was irrelevant that they (non-executive directors) lacked accounting expertise.

These cases illustrate the importance of directors to ask the requisite questions and to properly consider the risks associated with each new project. In the case of the sub-prime loan crisis and the complexity of the derivative instruments there was a perceived ability to gloss over the risk of default in pursuit of short-term gains. A robust reporting system to monitor whether the projected risk and benefits of projects presented to the board for approval should have been followed in addition to adherence to the various disclosure and verification requirements of Basel II.

The boards of the affected companies should have kept appraised of updated information and disclosed incumbent risks to shareholders. This would have enabled them to take the appropriate measures to reduce exposure in good time. In many cases, although the reasons for this may be complex, banks and financial institutions continued increasing their exposure to sub-prime mortgages which undermined the principles of board responsibility towards proper disclosure. The repercussions of this governance catastrophe will be felt for some time to come. The most palpable has been the failure of the American banking system. It flagrantly disregarded Basel II requirements which manifested in its operational and governance failure. It has also sparked the recent

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584 PlanAssure PAC v Gaelic Innes Pte Ltd 2007 SGCA.
585 This supports the assertions by the Turner Review, Walker Review and King III regarding the training, induction and procurement of directors with specialized skills and knowledge.
586 Examples of poor disclosure and the far reaching ramifications of such practice can be found in the form of Bank of America/Merrill Lynch case wherein a Federal Court Judge rejected the settlement arrangement between Merrill Lynch and the Bank of America based on the SEC’s claims that Merrill Lynch misled shareholders about bonuses and contravened liquidity and capital requirements.
controversial call by President Obama to imposed banking taxes and penalties to ensure the expedient recovery of TARP funds and stricter regulations to govern large banks.

5.5 Conclusion

It is clear that the corporate miscreants examined above, did surprisingly have a large number of corporate governance reforms in place. It is common cause that these were properly disclosed but were in fact not implemented in an accountable and meaningful fashion.

It is naïve to think that disclosure leads to the effective implementation of corporate governance policies yet every policy maker has reiterated the following pronouncements in light of the latest financial crisis that corporations are to be subject to greater disclosure and increased transparency.

It must be accompanied by meaningful regulation so as to assess the performance of the board of directors on a regular basis, albeit indirectly through scrutiny of filings especially if it is a public listed company. It addition law enforcement agencies must endeavour to penalize errant independent and executive directors, if not the present corporate governance structure notwithstanding stricter disclosure mechanisms will remain ineffective. This is clearly evidenced by the planned initiatives of President Obama.

CHAPTER 6: CONCLUSION AND RECOMMENDATIONS

587 Cohen T ‘Proposed new Bank Rules could hurt SA’ 21 January 2010 Business Day. The Emergency Economic Stabilization Act of 2008 (EESA) which established the Troubled Asset Relief Program, commonly referred to as TARP a program of the United States government to purchase assets and equity from financial institutions to strengthen its financial sector. It is the largest component of the government's measures in 2008 to address the financial crisis. It is a reactive measure to a corporate governance crisis rather than corporate governance reform per se and has since been replaced by the American Recovery and Reinvestment Act of 2009 (ARRA). South Africa can distinguish itself from this unenviable position due to its strict adherence to Basel II capital adequacy and liquidity requirements and its highly regularised banking structure

588 Ibid.
6.1 Recommendations as to how corporate governance practices can be improved in respect of disclosure

It is self evident from the research presented and literature review that corporate governance remains an increasingly crucial area of modern legal development. In the wake of the corporate meltdowns, frauds and criminal investigations researchers have signalled the need for 'new theoretical perspectives and models of governance'\(^{589}\).

Also emanating from the research it is clear that disclosure does not unequivocally lead to the strengthening of governance and accountability. This bold statement is based on the analysis that a mandatory regulatory approach, although astute and the most effective means of securing governance, is not a cure all for credible disclosure. The basis for this contention is that, notwithstanding a plethora of legislation, credible disclosure is still not guaranteed as an effective means of strengthening corporate governance and ensuring accountability. The rationale for this is best encapsulated by Groucho Marx who humorously stated that 'The secret of success is honesty and fair dealing. If you can fake these, you've got it made'.\(^{590}\) Ironically this outlines the greatest failing in governance practice which is the appearance of conformance as opposed to a real tangible commitment to meaningful disclosure.

The veneer of compliance precedes corporate collapses consistently: entities are doomed by a combination of employees' greed, lack of oversight and an entrenched and aggressive culture of creative accounting because disclosure also explicitly reinforces the quintessential elements of ethical considerations or lack thereof.\(^{591}\).

In amplification of this voluntary disclosure and compliance with laws diminishes accountability and is a system of governance that would not be commensurate with an

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emerging economy like South Africa.\textsuperscript{592} Therefore a mandatory regulatory regime of disclosure is advocated but one that is honed and enhanced to secure further efficacy. The enhancement is that mandatory compliance should not be implemented mindlessly and implementation should be done in conjunction with alternative measures.\textsuperscript{593}

The alternative measures would extend beyond the regulatory and administrative framework to a more holistic approach. This would involve the adoption of internal and macro perspectives or global perspectives across legal, regulatory, ethical and sociological frameworks to ascertain with greater understandings of why governance failures occur and how best to curb that occurrence.\textsuperscript{594}

Macro perspectives involve the comparative study of different governance systems to assist in the international standardization of minimum standards without the disregard for local practice and requirements. South Africa exemplifies this example by basing its initial governance model on the Cadbury Code. King III\textsuperscript{595} will precede the commencement of the new Act\textsuperscript{596} which is by no means faultless in its proposed enactment of a mandatory system and should take heed of the latest UK corporate governance developments.\textsuperscript{597} This system could be further enhanced by the inclusion of more stringent disciplinary mechanisms for directors. It is proposed that these measures should not be reserved for registered directors alone but the ambit should extend to high profile executives who may not meet the definition of ‘director’.\textsuperscript{598} This would include the CFO and the company secretary who advise the directors. The writer is in no way purporting that directors should not avail themselves of independent advice and fully

\textsuperscript{592} Ibid 230.

\textsuperscript{593} This re-iterates the recommendations of the Combined Codes (2008) and its current review documents to avoid boiler plate reporting but rather endorse substantive reporting.


\textsuperscript{595} King Report on Corporate Governance (2009).

\textsuperscript{596} Act 71 of 2008.

\textsuperscript{597} There is a detailed re-examination of the ‘apply of explain’ model which takes cognizance of the fact that certain provisions require legislative support to ensure compliance.

\textsuperscript{598} P W Moerland ‘Alternative Disciplinary Mechanisms in Different Corporate Systems’ (1995) 26 Journal of Economic Behaviour and Organisation 17, 34. See also Section 66 of Act 71 of 2008 which extends the net of liability to senior management provided they direct, control and manage the business.
appraise themselves of the matters put before the board. Instead individuals who are material in developing and meting out the company’s operational and financial strategy should be held accountable for any mala fides aligned with such strategy. The majority of fraud or negligent conduct is perpetuated with the assistance of middle rung employees who often avoid liability.\footnote{RN Arisham \textit{Fraud in Banks} 1ed (2007) 92 An example is the collapse of Barrings Bank at the purported hands of one rogue trader, Nicholas Leeson when in fact a large portion of the failure and concomitant blame can be allotted to the senior management of the bank who failed to manage the risk and identify the potential disaster, often blindly endorsing the transactions. These senior managers would not constitute the directors that could be prosecuted under SOX or found liable in terms of Section 77 of the new Act 71 of 2008. This is because they would not fall under the ambit and operation of Section 66 of Act 71 of 2008. Moreover although Section 218 is progressive it is not supported by an expedient court system.}

Companies should be incentivized to implement prudent governance policies. From a South African perspective there are indirect economic benefits that flow from expediting transformation policies\footnote{Note in terms of this South Africa this would extend to BEE initiatives as per Broad Based Black Economic Empowerment Act 53 2003.} but sustainability, economic prudence and general CSR initiatives should be rewarded. This will heighten brand development but also improve disclosure practice as more methods to verify disclosure would have to be implemented to ensure the incentivized benefit. The corollary of this is the publication of delinquency lists.\footnote{A Mardjano ‘A Tale of Corporate Governance: Lessons why Firms Fail’ (2005) 20 \textit{Managerial Auditing Journal} 272, 283.}

The mandatory approach must be supported by a stringent regulatory body. To date the Companies Act\footnote{Act 61 of 1973.} has had the Registrar as its watchdog with little to no proactive powers. It was purely reactive in response to reported non compliance or technical shortcomings. The new Act\footnote{Act 71 of 2008. The Draft Regulations of the Companies Act have been released for comment and review on 22 December 2009. The Regulatory Agency function has been addressed but not to the extent anticipated. Moreover the Regulations 137-149 will only reach fruition if supported by an expedient court process.} must be characterized by a stringent body that ensures the requisite checks and balances in respect of accounting, auditing and legal frameworks are.
complied with. All these rules that elevate the importance of disclosure, openness and information will hopefully minimise the opportunistic behaviour of self interested directors.

Trust and ethics should be the backbone of any potential director, but often these character traits are assumed, it is proposed that in addition to the technical training that should accompany the role of director, behavioural training or internal perspectives are endorsed. Directors should be inculcated with the concept of gatekeeper and or guardian roles to ensure they do not fall foul of a lapse in ethics. Also the role of reputation and business ethics, not just in terms of credible disclosure, but ethical conduct from a corporate social responsibility vantage should be highlighted as valuable endeavours and instilled in future directors.

The importance of these macro and internal perspectives has been globally endorsed specifically by the OECD which has advocated pluralism and cultural diversity to reflect on boards and governance.

If this holistic approach is adopted then the qualitative element that is often lost in a prescriptive environment is curbed if not accounted for in total. This is the concern Mervyn King has periodically anguished over. He discusses the concept of intellectual honesty wherein he advocates a quantitative and qualitative endorsement of corporate governance as opposed to the mindless adherence to a set of principles for the sake of compliance and additional credits.

604 King Code of Corporate Governance (2009) Chapter 6 which imposes the compliance with codes, laws and regulations and also underpins the importance of timely relevant and accurate reporting in terms of the IT Governance framework as per Chapter 5 Paragraph 9.
606 G Wood ‘ The Relevance to international Mergers of the Ethical Perspectives of Participants’ (2005) 5 Corporate Governance 39, 40.
He has asserted that directors who belabour under extensive regulatory environments are too preoccupied with compliance to ensure qualitative outputs. The regulation accompanied by tighter punitive measures will safeguard the shareholder and stakeholder on a long term basis if directors act holistically and it will not be a mindless quantitative exercise.  

In view of research presented it can deduced that accountability and transparency are inextricably linked to the critical issue of ‘trust’. As Alan Greenspan argues ‘It is hard to overstate the importance of reputation in a market economy, rules cannot substitute for character.’ When the market loses confidence in the integrity and plausibility of information being produced by a firm, then the markets no longer trust a firm. The negative effects are likely to be dramatic. This is particularly the case for financial institutions for which the loss of reputation can mean the failure of the firm. This has never been more patently apparent than in the case of the financial crisis that has dominated the world stage.

It is therefore advocated that the mandatory disclosure regime we are adopting must be tempered with a shift in attitude. The regulatory approach that has been portrayed by large accountancy firms is target driven and has achieved quantitative as opposed to qualitative compliance. The South African environment responds positively to stringent regulatory measures accompanied by penalties and specific punitive action. Rules pertaining to disclosure keep ‘character’ in check and ensure the strengthening of corporate governance failing which we will be left with nothing but toothless, utopian, corporate ideals dealing with moral niceties which are wholly unrelated to business reality.

6.2 Recommendations for Public Policy Determinants: The Balance between Governmental Regulation and Market Based Regulation through Disclosure.

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610 Sections 20, 77 and 218 of Act 71 of 2008.
611 http://www.bloomberg.com (Last visited on 19 November 2009).
It is evident that market regulation which is tantamount to self regulation or voluntary disclosure is simply not a model for the South African regime let alone the global market. It is archaic and simply not conducive to remedial intervention. In the wake of the financial crisis governmental regulation has embarked on heightened involvement, they will be part and parcel of future governance initiatives as opposed to simply enacting legislation. Regulators will look to well managed and transparent financial systems for blue prints of new regulation. The South African banking system is a prime example complete with an external regulator. This has been initiated already by way of the Alternate Investment Fund Managers Directive which is seeking to apply a banking model on investment managers.

It is evident that market based regulation has had a track record of disasters and governmental regulation which is a ‘bank system’ of governance will parallel the mandatory system of disclosure discussed. The FSA is expected to mandate the assumption of additional powers to increase its sanctions against individuals and firms guilty of market abuse or misconduct. This is an attempt to refine monitoring assessing and mitigating systemic risks.

As asserted in Chapter 4.4 regulation of governance is key in ensuring disclosure strengthens corporate governance as illustrated by the banking industry.

In terms of the new Act there is mention of standalone reporting standards council which would require for maximum efficacy a company regulator. This has not been

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613 S Krige ‘The changing role of the Investment Funds Lawyer’ (2009) 10 Without Prejudice 42 It raises the issue that effects will be less devastating if it is due to a failed regulator that failed regulation.

614 Sections 60 and Section 60A of Act 94 of 1990. See also Chapter 4.4.


616 Section 60A, Sections 24 and Section 35 of Act 94 of 1990. http://www.reservebank.co.za (Last visited it on 6 December 2009) See also Chapter 4.4.

617 Section 204 of Act 71 of 2008.
addressed nor included in the Draft Companies Act Regulations released for comment and review on 22 December 2009. The Regulations which remain very much in draft form have been circumscribed in the powers assigned to the Commission and Tribunal.\textsuperscript{618} It has positively addressed the filing, formulation and management of complaints which in principle is a positive progress\textsuperscript{619} but in practice will need extensive clarification on how the Commission and Tribunal will be staffed and rendered operational.

The latest development is the government backed, managed and designed rescue packages for banks and near bankrupt conglomerates.\textsuperscript{620} It encompasses a government regulated disclosure regime and a corporate governance system that fosters 'sustainable economic growth' which is more palatable and socially acceptable in the modern global corporate world.\textsuperscript{621} It is also supportive of the stakeholder theory which will render the board more accountable and disclosure will be more credible as opposed to the short term, shareholder centric, market based system which has sent the global economy into cataclysmic shock. The governmental based system of regulation is underscored by good corporate citizenship and is also a testament to good ethical business practice the absence of which constitutes the very root of fraudulent self-serving conduct that has led to scores of corporate financial disasters.\textsuperscript{622} As such companies who adopt a negative, defensive stance in relation to corporate governance, and an unambiguous disclosure regime may find the global business goldfish bowl increasingly uninhabitable and unprofitable.

\textsuperscript{618} Regulations 136-146.
\textsuperscript{619} Regulations 147-150.
\textsuperscript{622} See Footnote 587.
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