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MINOR DISSERTATION

**THE RESPONSIBILITIES OF THE BOARD OF DIRECTORS IN
PROMOTING THE PRINCIPLES OF CORPORATE
GOVERNANCE**

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Plagiarism

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DEDICATION

I dedicate this work to my parents, Pearlene and Gordon Parry for always being there for me and always supporting me throughout my studies.

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I gratefully acknowledge and express my sincere gratitude to my supervisor Adv. Kathy Idensohn for her guidance, support and helpful comments for this dissertation, however the usual *caveat* applies.

I would also like to thank my parents, for their encouragement and supporting during my studies. For without them, I would not have this opportunity.

I thank our Lord and saviour for giving me the strength and perseverance to complete this dissertation. “I can do all things through Christ who strengthens me” – (*Philippians 4:13*)

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ABSTRACT

Corporate governance is an important aspect of the way in which companies do business. It regulates the conduct of those in control of the corporation. An important aspect of corporate governance is the establishment of structures and processes that enable directors to discharge their legal responsibilities.

The global financial crisis raised many corporate governance issues and this led to many reviews and changes to corporate governance systems worldwide. This is the main reason for this research. This dissertation will focus on these reviews and changes in the corporate governance systems of South Africa and the United Kingdom.

The recent collapses of high profile companies, for example, Enron and WorldCom in America, Parmalat in Italy and Masterbond, Saambou and Fidentia in South Africa have resulted in the actions, skill and diligence of directors to again come under strict inspection. Companies and especially directors have to realise that they do not act independently but that their actions and decisions impact on the societies and environment in which they operate. This is the main problem in this dissertation.

The new Companies Act 71 of 2008 incorporates into statute for the first time issues of corporate governance. Company law sets the framework in which the company operates and the recommended practices set out in the King Report on Governance for South Africa 2009 ('the King III Report') and the King Code of Governance for South Africa 2009 ('the Code') provide guidance for directors as to how they should direct the business of the company and make decisions on behalf of the company. In this sense, the Companies Act of 2008 and the King III Report and the Code complement each other.

The King III Report and the Code deal broadly with the responsibilities of the board of directors. The Report confirms that it is for the board of directors to act as the focal point and custodian of corporate governance.

This dissertation is in essence an examination of the responsibilities of the board of directors to promote the principles of corporate governance and recommendations in terms of the King III Report and the Code.

KEY WORDS

Board of directors, Cadbury Report, Corporate governance; Enforcement, Governance, JSE listing requirements, King III Code, King III Report, Regulations.

LIST OF ABBREVIATIONS

AD	Appellate Division
ALL SA	All South African Law Reports
BOD	Board of Directors
CEO	Chief Executive Officer
Ch	Law Reports, Chancery
DTI	Department of Trade and Industry
SA	South African Law Reports
SALJ	South African Law Journal
SA Merc LJ	South African Mercantile Law Journal
SCA	Supreme Court of Appeal
SOX	Sarbanes-Oxley Act of 2002
W	Witwatersrand Local Division

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CHAPTER 1

GENERAL INTRODUCTION

Due to international changes in the field of corporate governance and company law reform in South Africa, corporate governance has become an important aspect of the way in which companies do business. Corporate governance is the collection of law and practices that is grounded in the fiduciary duties of directors. It regulates the conduct of those in control of the company. An important feature of corporate governance is the establishment of structures and processes that enable directors to discharge their legal responsibilities.¹

The Companies Act 71 of 2008 incorporates into statute for the first time provisions dealing with corporate governance. Company law (the Act and the common law) sets the framework in which the company operates and the recommended practices set out in the King Report on Governance for South Africa 2009 and the King Code of Governance for South Africa 2009 provide guidance for directors as to how they should direct the business of the company and make decisions on behalf of the company. In this sense, the Act, the King III Report and the Code mirror each other.²

The Companies Act 61 of 1973 did not have a clear set of laws regarding the duties and the liabilities of directors and corporate governance.³ An analysis of the duties and the liabilities of directors fall outside the scope of this dissertation.⁴

This dissertation deals with the responsibilities of the board of directors to promote the principles of corporate governance and recommendations in terms of the King III Report and the Code. The King III Report and the Code deal broadly with the responsibilities of the board of directors. The King III Report confirms that it is for the board of directors to act as the focal point and custodian of corporate governance.⁵

¹ Monray Marsellus Botha 'The Role and Duties of Directors in the Promotion of Corporate Governance: A South African Perspective' 2009 (30) *Obiter* 702. In this analysis Botha investigates corporate governance principles in South Africa and explores the importance of the role and duties of directors in the promotion of corporate governance principles.

² Mervyn King 'The Synergies and Interaction between King III and the Companies Act 71 of 2008' *Acta Juridica* 446.

³ Botha op cit note (1) 706.

⁴ For a detailed discussion of the duties and the liabilities of directors, see Farouk HI Cassim, Maleka Femida Cassim, Rehana Cassim, Richard Jooste, Joanne Shev and Jacqueline Yeats *Contemporary Company Law* 2ed (2012) 505-594.

⁵ King III Report, Principle 1.1, para 1. See para 4.3 below for the responsibilities of the board of directors in terms of King III. Available at: <http://www.library.up.ac.za/law/docs/king111report.pdf> [accessed 28 January 2014].

The court in *South African Broadcasting Corporation Ltd v Mpopu*⁶ stated:

‘In state-owned enterprises, like other organisations, good corporate governance is ultimately about effective leadership.’ Jajbhay J further stressed, ‘integrity is the key principle underpinning good corporate governance, and that good corporate governance is based on a clear code of ethical behaviour and personal integrity exercised by the board, where communications are shared openly’.⁷

1.1 BACKGROUND TO RESEARCH

Corporate governance became one of the crucial issues of the 1990’s as a result of a number of well-publicised corporate problems and scandals in the late 1980’s. Due to issues ranging from questionable earnings to outright fraud, businesses came under increasing scrutiny from shareholders and regulators alike. Corporate problems of the 1980’s involved creative accounting, spectacular business failures, the apparent ease of unscrupulous directors in expropriating other stakeholders’ funds, the limited role of auditors, and the claimed weak link between executive compensation and company performance. Press comment on these issues has been prolific over the last few years, giving widespread publicity to the concerns being raised on how companies were being directed and controlled. In order to address these problems, the South African and British stock exchanges and interested bodies undertook a major review of corporate law, which included the consideration of corporate governance.⁸

Furthermore, the global financial crisis of 2007 to 2008 is considered by many economists as the worst financial crisis. It resulted in the threat of total collapse of large financial institutions, the bailout of banks by national governments, and downturns in stock markets around the world. Economies worldwide slowed during this period, as credit tightened and international trade declined. Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion and institutional bailouts.⁹

The main reason for this research is because the global financial crisis raised many corporate governance issues and this led to many reviews and changes to corporate governance systems worldwide.¹⁰

⁶ [2009] 4 ALL SA 169 (GSJ) para 60.

⁷ Ibid para 64.

⁸ Tshepo Mongalo ‘The Emergence of Corporate Governance as a Fundamental Research Topic in South Africa’ (2003) 120 *SALJ* 174.

⁹ http://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932008 [accessed 25 January 2014].

¹⁰ John Birds, Bryan Clark, Iain MacNeil, Gerard McCormack, Christian Twigg-Flesner, Charlotte Villiers and A J Boyle *Boyle and Birds’ Company law* 8ed (2011) 363.

It is my interpretation that the ultimate goal of the reviews and changes in corporate governance regimes worldwide is to maintain investor confidence in the markets and to secure the economic growth of countries.

1.2 PROBLEM STATEMENT

The recent collapses of high profile companies, for example, Enron¹¹ and WorldCom in America, Parmalat in Italy and Masterbond, Saambou and Fidentia in South Africa have resulted in the actions, skill and diligence of directors to again come under strict inspection. Companies and especially directors have to realise that they do not act independently but that their actions and decisions impact on the societies and environment in which they operate. In a report conducted by an international institutional investor, South Africa ranked amongst the top 25 emerging markets in terms of corporate governance, but it rated poorly in terms of disclosure and transparency. While South Africa may thus offer some of the best investment returns for emerging global market investors, it must still demonstrate high standards of corporate governance to retain such investors. If there is a lack of corporate governance, capital will be invested elsewhere. Good governance pays not only for the company and interested parties but also ensures that a company becomes a magnet for global capital. Thus, for South Africa to be competitive in the international investment market, it has to have an excellent reputation of good governance.¹²

1.3 AIMS OF RESEARCH

The aim of this research is to analyse the responsibilities of the board of directors to promote the principles of corporate governance and recommendations in terms of the King III Report and the Code. Such an analysis therefore requires research into the nature of corporate governance, the enforceability and efficacy of the King III Report and the Code, the links between the Companies Act of 2008 and the extent to which the directors' responsibilities under the King III Report and the Code constitute legal duties.

¹¹ In only 15 years, Enron Corporation grew to be America's seventh largest company, with annual revenues exceeding \$100 billion and over 21 000 staff in more than 40 countries. However, its top executives had engaged in accounting manipulations in an effort to boost the company's stock price. The Enron scandal, revealed in October 2001, eventually led to the bankruptcy of the Enron Corporation. As a result of the scandal, new regulations and legislation were enacted to expand the accuracy of financial reporting for public companies. The collapse of Enron led to the enactment of the Sarbanes-Oxley Act of 2002, (SOX) on 30 July 2002.

¹² Mildred Bekink 'An Historical Overview of the Director's Duty of Care and Skill: From the Nineteenth Century to the Companies Bill of 2007' (2008) 20 *SA Merc LJ* 95-96. This is linked to para 2.4 below, which provides for the importance of good corporate governance.

A comparative study of the law in the United Kingdom will be undertaken with the aim to find an answer to the problem in this dissertation. The reason for a comparative study is because company law and corporate governance principles in the United Kingdom are fairly similar to that of South African company law.¹³

1.4 STRUCTURE OF DISSERTATION

A general introduction to the problem is given in Chapter 1. This chapter will deal with the proposal to examine the responsibilities of the board of directors in terms of the King III Report and the Code. The reason for this examination is because many reviews and changes to the corporate governance system have been made and the Companies Act 71 of 2008 incorporates into statute for the first time provisions dealing with corporate governance. The introduction summarises what will be discussed in the preceding chapters.

Chapter 2 provides a general overview of corporate governance and it also explains the regulatory framework of corporate governance in South Africa. The purpose of this chapter is to determine the nature of corporate governance. Once the nature of corporate governance is determined, the directors' legal responsibilities can be ascertained. The definition and the importance of corporate governance are also analysed. Lastly, the impetus for new corporate governance legislation is analysed. This is necessary in order to fully appreciate the reasons for all the changes in the new Act. The main aim of this analysis is to point out the shortcomings in the old Act and to determine the reasons why the legislature decided to reform the old Act.

Chapter 3 analyses the legal and regulatory framework of corporate governance in the South Africa. The main aim of this analysis is to determine the legal and regulatory requirements that companies have to comply with and the penalties for non-compliance.

Chapter 4 examines the legal enforceability of King III. Such an examination therefore requires research into the enforceability and efficacy of King III. It is therefore also necessary to examine the responsibilities of the board of directors in terms of the King III and to determine the relationship between King III and the Companies Act 71 of 2008.

Chapter 5 discusses the background and development of corporate governance in the United Kingdom. The different committees and reports are therefore distinguished.

¹³ For a study of the various purposes and objectives of comparative research, see DH van Zyl *Beginsels van Regsvergelyking* (1981) 17-34 and F Venter, AJ van der Walt, CFC van der Walt, NJJ Olivier, GJ Pienaar and LM du Plessis *Regsnavorsing Metode en Publikasie* (1990) 207-217.

The aim is to point out the similarities and important differences between the two countries legal and regulatory framework and ultimately to find an answer to the main problem in this dissertation.

Chapter 6 summarises the main arguments of this dissertation and recommendations are made for the legislature and policy makers to improve corporate governance practices in South Africa.

1.5 RESEARCH METHODOLOGY

The proposed research involves an examination of the relevant South African and foreign legislation with regard to the responsibilities of the board of directors in promoting the principles of corporate governance. Case law, books, articles and research reports will be used to amplify the research. A comparative study of the law in the United Kingdom will also be carried out. The main purpose of the comparative study is to find a solution to the problem in this dissertation.

In general, a comparative study involves a systematic examination designed to explain similarities and differences between nations or regions. The comparative method compels us to identify similarities and differences, and then to account for them. In comparative law, a deep understanding of different legal systems could lead to lessons to be learned from each system that could influence the development of law and possibly lead to emulation and practical attempts to unify or harmonise law.¹⁴

Furthermore, a comparative study seems to be particularly important as section 5(2) of the Companies Act 71 of 2008 provides that: '[t]o the extent appropriate, a court interpreting or applying this Act may consider foreign company law'. This is complimentary to section 5(1), which directs that the Act 'must be interpreted and applied in a manner that gives effect to the purpose of section 7'. Section 7(e) states that one of the purposes of the Act is to 'continue to provide for the creation and the use of companies, in a manner that enhances the economic welfare of South Africa as a partner in the global economy'.

¹⁴ Phillip C Aka 'Corporate Governance in South Africa: Analyzing the Dynamics of Corporate Governance Reforms in the Rainbow Nation' (2007) 33 *North Carolina Journal of International Law and Commercial Regulation* 254-255. In this analysis Aka provides an overview, *inter alia* of South Africa and the scholarship on the law of comparative corporate governance. He further provides that the comparative corporate governance scholarship seeks to understand and illuminate approaches governments in various regions of the world take relating to the regulation of the corporation, with specific attention to the origins and durability of the differences between countries or regions.

CHAPTER 2

CORPORATE GOVERNANCE IN SOUTH AFRICA

2.1 INTRODUCTION

This chapter provides a general overview of corporate governance in South Africa. The main purpose of this chapter is to determine the nature of corporate governance. Once the nature of corporate governance is determined, the board of directors' legal responsibilities can be established. An attempt is made to define corporate governance and the importance for companies to practice good corporate governance is established. Moreover, an analysis on the need for new corporate governance legislation in South Africa is also provided. The main objective of this analysis is to point out the shortcomings in the 1973 Act and to determine the legislatures' reasons for reforming the 1973 Act.

Corporate governance in South Africa was first institutionalised with the publication of the first King Report on Corporate governance in 1994 (King I). This was followed in 2002 by the second King Report on Corporate Governance for South Africa (King II), placing South Africa at the forefront of countries regulating in favour of superior governance standards. The release of King II brought about increasing recognition of the fact that company law and codes of good governance practice are mutually dependent and that, in many respects the out-dated company law regime imposed by the 1973 Act hindered rather than advanced economic activity in the company. In 2004, the South African Department of Trade and Industry (DTI) published a policy paper, *South African Company Law for the 21st Century*¹⁵, proposing a new company law regime aimed at promoting the development of a fertile environment for economic activity. The aim was, ultimately, to repeal the 1973 Act and to replace it with a consolidated hub of company legislation which would simplify the law relating to the formation of corporate entities; encourage entrepreneurship and investment by rationalising the process and costs associated with the administration of companies; encourage greater transparency, efficiency and accountability by companies and their directors and make our company law regime consistent with best practice jurisdictions internationally.¹⁶ The overhaul of South Africa's corporate law regime follows similar processes in Australia (2004), Ireland and the UK (2006), the Channel Islands (2008),

¹⁵ The Department of Trade and Industry (DTI) policy paper *South African Company Law for the 21st Century: Guidelines for Corporate Law Reform* (General Notice 1182 in *Government Gazette* 26493 of 23 June 2004). Available at <http://www.pmg.org.za/bills/040715companydraftpolicy.pdf> [accessed 28 January 2014].

¹⁶ *Ibid* para 12.

certain European countries (notably Italy and Switzerland in 2008) and China. The Companies Act 71 of 2008 was signed into law in April 2009 and the third King Report on Corporate Governance for South Africa (King III) was released on 1 September 2009.¹⁷

2.2 THE NATURE OF CORPORATE GOVERNANCE

The key to a proper understanding of the concept of corporate governance is to understand two terms: corporate law and corporate finance. Corporate law recognises, as a formal matter, three different groups: shareholders, directors, and officers. Corporate law gives each of these groups certain rights and imposes certain obligations with respect to the operation of the enterprise. It also regulates the distribution of rights and duties between the three groups. Corporate law is essentially concerned with creation and or availability of the corporate form for two primary purposes, namely: (1) to facilitate and regulate the process of raising capital for the business operations of a company (corporate finance), and (2) to impose controls on persons whose power is derived from the finance that the use of the corporate form has put at their disposal or regulating organs concerned with the governance of a company (corporate governance).¹⁸

Corporate finance law deals with the way in which a company raises money for its business operations and how the company deals with its finances generally. By comparison, corporate governance focuses mainly on the systems by which companies are directed and controlled. It is the collection of law and practices, grounded in fiduciary duties and their application, that regulates the conduct of those in control of a corporation, and the means through which a variety of countries provide a legal basis for corporations while preserving, to some extent, authority to control abuses of these business organisations. Issues involved in the law and study of corporate governance include formation and dissolution of companies, financing, structures such as board of directors and shareholders, the importance of the corporate constitution, duties and responsibilities of those controlling companies, the importance of company meetings, protection of minorities within companies, and insider trading and its importance in corporate governance.¹⁹

The two key elements of governance concern supervising or monitoring management performance, and ensuring accountability of management to shareholders

¹⁷ Ramani Naidoo Corporate Governance: An Essential Guide for South African Companies 2ed (2009) 1-2.

¹⁸ Aka op cit note (14) 238.

¹⁹ Ibid 238-239.

and other stakeholders. The reference to other stakeholders makes the important point that the role of corporations in society has evolved from one where its responsibilities were seen as being exclusively to shareholders, to one where other stakeholders, such as employees and suppliers, is acknowledged. Furthermore, many corporations are of such size that their influence pervade society as a whole and the general public can be regarded as a stakeholder, albeit and indirect one. There is therefore a fundamental debate²⁰ as to the relationship between the company and its stakeholders, which will affect the way in which corporate governance is viewed.²¹

From the above it is apparent that corporate law and corporate finance are two totally distinct concepts. It is also apparent that corporate law contains an element of corporate finance; however, corporate finance does not. Corporate finance deals mainly with the financial aspects of the business. It is therefore my understanding that you cannot have corporate law without corporate finance. Corporate law also contains an element of corporate governance, at which an attempt is made to provide a definition on this subject.

2.3 DEFINITION OF CORPORATE GOVERNANCE

There is no set definition as to what corporate governance means. Critics often speak of corporate governance as an indefinable term, something - like love and happiness – which we essentially know the nature of, but for which words do not provide an accurate picture. Academics²² have attempted to lay down a working definition of corporate governance, yet one definition varies from the other, and this often leads to confusion.²³

Corporate governance is concerned with the structures and processes associated with management, decision-making and control in organisations.²⁴ The most authoritative definition of corporate governance in the United Kingdom was provided by

²⁰ See Jean Jacques du Plessis, James McConvill, Mirko Bagaric *Principles of Contemporary Corporate Governance* (2007) 3-6 for a discussion on the origins of the corporate governance debate and the stakeholder debate and for analysis on the protection of different stakeholders by directors when they manage a company, with specific reference to the stakeholder provisions in King III, see Irene-Marié Esser ‘The Protection of Stakeholder Interests in Terms of the South African *King III Report on Corporate Governance: An Improvement on King II?*’ (2009) 21 *SA Merc LJ* 188-201 and also see I Esser and JJ Du Plessis ‘The Stakeholder Debate and Directors’ Fiduciary Duties’ (2007) 19 *SA Merc LJ* 346-363 for a comparative analysis of the stakeholder debate and directors’ fiduciary duties’ in the United Kingdom and in South Africa.

²¹ Tom Wixley and Geoff Everingham *Corporate Governance* 3ed (2010) 2.

²² There is however no general definition of corporate governance, for an analysis of the concept ‘corporate governance’, essential corporate governance principles and the meaning of corporate governance, see Du Plessis op cit note (19) 1-13.

²³ Ibid 1.

²⁴ Wixley and Everingham op cit note (21) 1.

the Cadbury Committee, which reported on the *Financial Aspects of Corporate Governance* in 1992.²⁵ The Cadbury Committee's report defined corporate governance as 'the system by which companies are directed and controlled'.

The Cadbury Committee further expanded on this definition²⁶:

'Boards of directors are responsible for the governance of their companies [**emphasis added**]. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting up the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board's actions are subject to laws, regulations and the shareholders in general meeting.'

In this relationship, responsibility rests with directors to establish the company's policies and to supervise how the company is managed. The directors are, in turn, accountable to the shareholders. Auditors have a role of acting as a representative for the shareholders collectively by guarding against financial irregularities and aiming for the directors to provide a 'true and fair view' of the company's performance. As the shareholders supply equity capital to the company, they seek maximisation of their financial return from the company, so that the single overriding objective shared by all listed companies, whatever their size or type of business, is the preservation and the greatest practicable enhancement over time of their shareholders' investment.²⁷

2.4 THE IMPORTANCE OF GOOD CORPORATE GOVERNANCE

The major advantages of good corporate governance lie in the increased ability of properly governed companies to attract institutional and foreign investment, to implement sustainable growth, and to identify and manage their business and other risks within pre-determined parameters, thereby limiting their potential liability. In the contest for scarce skills and human talent, properly governed companies with a reputation for being good corporate citizens are also more easily able to attract better calibre employees.²⁸

²⁵ Committee on the Financial Aspects of Corporate Governance, *Report of the Committee on the Financial Aspects of Corporate Governance* (Sir Adrian Cadbury, Chair) (1992) para 2.5. Available at <http://www.ecgi.org/codes/documents/cadbury.pdf> [accessed on 28 January 2014].

²⁶ Ibid.

²⁷ Boyle and Birds' op cit note (10) 366.

²⁸ Naidoo op cit note (17) 10.

The inability to access capital at competitive rates remains a major inhibitor to the growth of many companies, both public and private, and indeed of many developing countries, and where once corporate governance may have been regarded as a 'soft issue', the quality of potential investee company's corporate governance is now ranked alongside its returns on investment ratios in determining whether a potential investor will invest in that particular company. A country's reputation regarding governance issues is a collage of its legal and regulatory approach to corporate governance and the conduct of individual players in its economy.²⁹

'Markets exist by the grace of investors ... No market has a divine right to investors' capital ... If the country does not have a reputation for strong corporate governance practices, capital will flow elsewhere. If investors are not confident with the level of disclosure, capital will flow elsewhere. If a country opts for lax accounting and reporting standards, capital will flow elsewhere. All enterprises in that country – regardless of how steadfast a particular company's practices may be – suffer the consequences.' – Arthur Levitt³⁰

The Stanford Law School conducted a study to examine the relationship between a company's corporate governance behaviour and its market value. It showed that institutions looking to invest in emerging economies were much more likely to invest money in companies that had sound corporate governance practices. With the release of King III in 2009, South Africa has undeniably one of the best corporate governance frameworks worldwide, but this country, and indeed much of Africa, still lag far behind other emerging markets in its ability to attract foreign direct investment.³¹

Bribery is recognised by the World Bank as the single greatest obstacle to economic and social development, and there is an abundance of empirical data to support the view that corruption pushes up the price of doing business in a country. Investors are warned to adhere to the Constitution of South Africa, 1996 and environment legislation in South Africa, such as the National Environmental Management Act 107 of 1998 which defines our environment rights as South Africans, and establishes a clear liability and duty of care on any party who, directly or indirectly, contributes to the transgression of those rights.³²

Public interest in corporate governance has amplified with the increase, in the last decade, of high corporate scams resulting in huge losses. Companies that took decades to build had to be all but nationalised and bailed out by government loans or, left unaided, fell into ruin, and billions have been lost through the unbridled greed of management and the gross negligence of boards. In the bull market, the approach of

²⁹ Ibid 10-11.

³⁰ Ibid 11.

³¹ Ibid.

³² Ibid 18-20.

investors is normally far more *laissez-fairre*, with ‘the soothing sound of share prices constantly ticking upwards’ tending to lull investors into worrying less about the management of their investments and integrity of the company’s directors. However, in tough economic times, investors and public tend to keep a more watchful eye on the way companies are being run and, spurred by shareholder activists and the media, are increasingly demanding greater accountability and better corporate citizenship from companies. When the dust of the most recent spate of corporate implosions has eventually settled, investors will again be lulled into complacency until the next governance glitch happens. Nevertheless, for now, issues of proper corporate governance, transparency and accountability remain at the center-stage and are fundamental to a company for a sustainable future.³³

Institutional shareholders are demanding greater accountability from companies they own, not the general public. It has been said that good corporate governance matters more in times of crisis, as it helps companies withstand economic shock.³⁴

To some extent, bankruptcies are a cynical occurrence, and all corporate failures can be laid at the door of poor corporate governance. Other factors such as unexpected interest-rate hikes, currency and demand fluctuations, natural disasters, and health issues such as the HIV/AIDS pandemic may sometimes force an adequately run company out of business. In light of the recent governance failures, shareholders, banks and investors are becoming increasingly selective about the companies with which they do business. The majority of recent corporate failures can clearly be attributed to bad business plans, poor management decisions, fraud, under-capitalisation and the failure to anticipate and mitigate risk.³⁵

2.5 THE IMPETUS FOR NEW CORPORATE GOVERNANCE LEGISLATION IN SOUTH AFRICA

The economy and commercial activity are impacted significantly by company law. Company law can encourage and facilitate commercial enterprises and economic growth or it can restrict and retard it. It is therefore of fundamental importance for company law to be comprehensible, certain and accessible. The previous company law regime was criticised as being bulky, complex and full of inconsistency in its underlying philosophy and policy. The 1973 Act was amended about forty-two times in the thirty-seven years of its existence. This sort of pieced together and piecemeal reform led to conflict in the

³³ Ibid 20.

³⁴ Ibid 20-21.

³⁵ Ibid 21-22.

policy and objectives underpinning the previous company law regime. The 1973 Act was too cumbersome, complex, archaic and excessively technical.³⁶

Moreover, during the thirty-seven years of existence of the 1973 Act, both the domestic and global environment has radically changed. Several of the traditional company law doctrines and concepts inherited from nineteenth-century English law have been abandoned or substantially modified. New company law concepts have been developed, such as the solvency and liquidity test, delinquent directors, corporate governance, new standards of accountability and transparency, market manipulation, and new ideas and approaches to corporate rescue, mergers and amalgamations and shareholder appraisal rights. The underpinning principle is that legislation (such as the 1973 Act) that has outlived its usefulness and that is stifling the development of the economy must be repealed.³⁷

The DTI³⁸ likewise state that:

‘We live in a world of greater globalisation, increased electronic communication, greater sensitivity to social and ethical concerns, greater competition for capital, goods and services, and increased mobility of international capital that emphasises the importance of investor-friendly domestic laws’.

Over and above all this, there has been dramatic socio-political and economic change in South Africa as well as a new constitutional dispensation. Apart from an investor friendly-corporate law regime, the DTI emphasises, as major themes of corporate law reform programme, the importance of a corporate law system that is flexible, simplified, modernised and transparent.³⁹

The DTI articulated three interrelated impetuses that collectively form the need for the overhaul of the law of corporate governance in South Africa. The DTI seeks to accomplish: (1) a changing environment, (2) a new constitutional dispensation, and (3) the imperativeness of modernisation.⁴⁰

Regarding the first impetus, the policy paper enumerated issues within and outside South Africa that have contributed to fundamental changes in the environment in which business operates, and highlighted the need for domestic laws to be investor friendly and competitive within the international trends. These issues include greater globalisation, increased electronic communication, greater sensitivity to social and

³⁶ Cassim op cit note (4) 3.

³⁷ Ibid.

³⁸ DTI policy paper op cit note (15).

³⁹ Ibid 3-4.

⁴⁰ Aka op cit note (18) 245.

ethical concerns, fast changing markets, greater competition for capital, goods and services, and mobility of international capital.⁴¹

The second impetus is mainly concerned with the adoption of the post-apartheid Constitution of 1996. Chapter 2 of the Constitution provides for the ‘Bill of Rights’ which enshrines the rights of all people in the country and affirms the democratic values of human dignity, equality and freedom. It forms a cornerstone of democracy in South Africa. The Constitution and the principles it promotes are then reflected in the policies and legislative programs that have taken place since 1994, such as environmental regulation and affirmative action laws, like the BEE Act (now Broad-Based Black Economic Empowerment Act 53 of 2003), designed to promote inclusion for blacks.⁴²

The third impetus focuses on the necessity for modernisation of the current corporate law regime that includes companies. The aim is a company law, which is up-to-date, competitive and designed for a modern company that is not only a domestic institution operating in a new environment but also an international competitor, with careful consideration paid to developments and best practices internationally, while keeping also in mind the local context and peculiarities of South Africa.⁴³

This last impetus is directed at two main problems. The first is that the 1973 Act is full of highly formalistic and economically unrealistic rules that make it burdensome and costly to form and manage an enterprise. These rules may also, encourage sham compliance with provisions. This needs to be changed to afford South African businesses the flexibility they need to raise capital in a global environment that requires responsiveness and innovation. Certain areas of importance which necessitates attention include the rules governing the duties and liabilities of directors now largely left to common law and Codes of Corporate Practice, and the administration of corporate governance rules, under the current law marked by a lack of enforcement and recourse.⁴⁴

The second main problem is that, no comprehensive reform of the out-dated and unfashionable legal framework built on foundations, which were put in place in Victorian England in the middle of the nineteenth century, has taken place, when a broad range of countries or jurisdictions within and beyond Africa, including Australia, Botswana, Canada, Hong Kong, and the United Kingdom, have undertaken extensive reviews of their domestic company law. Indeed, during the same period, a series of spectacular corporate failures have focused attention upon the need for improved corporate governance in many countries. South Africa has also had its own share of failures represented by the collapse of companies like Leisurennet and Regal Bank. The

⁴¹ Ibid 245-246.

⁴² Ibid 246-247.

⁴³ Ibid 247.

⁴⁴ Ibid.

net effect of such occurrences has been that investor confidence around the world, and particularly in the U.S., has been badly shaken by events at Enron, WorldCom, Tyco, Adelphia, Vivendi and Parmalat. The actions of a small number of people have had immense repercussions on the whole business community.⁴⁵

The most important factor around which, for the DTI, these various factors combine is the importance of good corporate governance for the South African economy. Corporations, in various forms, are central to the country's economy and its prosperity, in that they are tools for wealth creation and social renewal. A company law regime that is clear, facilitating, predictable and consistently enforced can create a protective and fertile environment for economic activity.⁴⁶

Therefore, the DTI prescribes the five steps, summarised in the policy paper that it designed to promote the competitiveness and development of the South African economy using company law. The contribution of corporate governance to economic development becomes particularly urgent considering the fact that despite the vision of the government and the magnificent strides achieved in the post-apartheid period, one review on the first ten years of majority rule found that the country continues to be saddled by two economies.⁴⁷

King I was released in 1994 and broke new ground in corporate governance at the time it was published: it formalised the need for companies to recognise they no longer operated independently from the societies in which they operate by advocating an integrated approach to good governance that includes principles of good social, ethical and environmental practice. Thereafter, King II was published in 2002/3 and built on the changes in corporate governance that the 1994 report introduced by acknowledging a shift away from the single bottom line to a triple bottom line. This means that companies should consider economic interests along with social and environmental factors in their corporate decision making, all the while keeping in mind that they are ultimately accountable to the company or body of shareholders. King II tracked the findings of an important study conducted in South Africa from 2001-2002 that demonstrated that shareholders and other investors attach importance to corporate governance and are willing to pay a premium for the shares of a well-governed company over a poorly managed company with a comparable financial record.⁴⁸

The Code of Corporate Practices and Conduct imposed a requirement on companies to comply or explain. Under this Code regime, affected corporations, such as listed companies, banks, financial and insurance institutions, and certain categories of

⁴⁵ Ibid 248.

⁴⁶ Ibid 248-249.

⁴⁷ Ibid 249.

⁴⁸ Ibid 249-250. See para 3.7 below for a summary of the King Reports.

public sector enterprises, must comply with provisions in the Code. If they fail to comply, they must justify their non-compliance in their annual reports.⁴⁹

Although unveiled in the wake of corporate failures in both South Africa and abroad, it is interesting that the United States and South Africa took different approaches to dealing with the problem: the United States achieved compliance through the threat of legal sanctions represented in the Sarbanes-Oxley Act of 2002, while South Africa applied a self-censoring technique.⁵⁰

Mongalo⁵¹ appears to share the view of the DTI that the occurrence of fundamental changes in the business environment in which businesses operate is necessary in reforming corporate governance principles. He commented that because we live in an era where investment can be moved from one part of the world to another with the click of a mouse, the main objective of a reformed company law should be the encouragement of foreign direct investment. Mongalo also wants serious note to be taken of the fact that corporate law is becoming increasingly globalised, where all countries are fighting for investor capital. Along with the DTI, Mongalo embraces the impetus relating to a new constitutional dispensation dictating a move away from conventional corporate governance principles. In justifying this wholly integrated approach to corporate governance, Mongalo, like the DTI, pointed to South Africa's post-apartheid constitution whose provisions, including its supremacy clause, and stated that it mandated a more harmonious balancing of shareholder investor interests and those of the public or other stakeholders and counselled dispensation with the most exclusive principles of conventional governance law.⁵²

Mongalo and the DTI believes South African corporate governance law to be sorely out-dated and in dire need of modernisation. As a result of the increased globalisation of the South African economy in a number of areas, the current framework of corporate governance in the country is holding back, rather than facilitating competitiveness, growth and investment. The embedment of South Africa's law of corporate governance in English law and the law's lag in modernisation have led to unfortunate consequences, at a substantial cost to businesses and the economy. The DTI and Mongalo advocate the imperativeness of good corporate governance for the South African economy.⁵³

Foreign direct investment from all quarters of the globe is crucial to South Africa's economic growth. Given this occurrence, a good system of corporate

⁴⁹ Ibid 250.

⁵⁰ Ibid 251. The UK also took a similar self-regulatory approach, see Chapter 5 below.

⁵¹ Tshepo Mongalo 'South Africanizing Company Law for a Modern Global Economy' (2004) 121 *SALJ* 93.

⁵² Aka op cit note (40) 251-252.

⁵³ Ibid 252.

governance must be in place. Mongalo agrees that there are many reasons why businesses fail that have little or nothing to do with how they are managed, but insisted that most of the classic collapses during the past decades can be attributed to the failure of conventional corporate governance principles (I concur).⁵⁴

Lastly, in some respects, Mongalo's recommendations for change parallel that of the proposals DTI made for promoting the competitiveness and development of South Africa's economy through company law, but in other respects, his recommendations exceed those of DTI, for example, Mongalo advised that a balance be struck between self-regulation and state intervention. A framework of company law that is too interventionist, may have the opposite effect of chasing away the investment necessary for economic development. Mongalo recommended the codification or regulation by legislation of directors' duties to correct the present situation characterised by so many sources of duties of directors, namely, the common law, statute, and codes of good practice, which all operate in tandem. However, principles only suitable for certain businesses, like listed companies, should be left as codes of good practice, given that these codes have the advantage of flexibility in the sense that individual companies can apply them in a way that best fits their own circumstances and, compared to statutes, the codes are easier to update.⁵⁵

In reforming the United Kingdom company law, it was pointed out that the intention of the corporate law reform of the United Kingdom was to encourage companies to take an appropriate long-term perspective to develop productive relationships with employees and in the supply chain and to take seriously their ethical, social and environmental responsibilities.⁵⁶

2.6 SUMMARY

This chapter has analysed the nature and definition of corporate governance, which is very much linked to each other. It is accordingly submitted that there is no general definition of corporate governance. Corporate governance refers to a system whereby companies can be directed and controlled. This is the most authoritative definition of corporate governance according to Sir Adrian Cadbury.

⁵⁴ Ibid 252-253.

⁵⁵ Ibid 253-254.

⁵⁶ King op cit note (2) 453. It is submitted that an application of the new Act and King III will achieve the intent of the United Kingdom corporate reform in South Africa.

From the above it is clear that the impetus for the good corporate governance in companies is mainly because of the series of corporate collapses worldwide and the need to restore investor confidence in the market. Financial objectives, *inter alia* are expressed to be the driving factor underpinning contemporary corporate governance regulation. Furthermore, the previous South African corporate law regime was out-dated and in need of modernisation. It is submitted that the need for reforming the corporate governance principles occurred as a result of fundamental changes in the commercial environment in which businesses operate.

Consequently, the above recommendations submitted by the DTI for the overhaul of corporate governance law in South Africa were imperative for business to succeed in the modern society. I strongly concur with the DTI and Mongalo's recommendation that good corporate governance is imperative for the South African economy.

The many corporate collapses of companies' world-wide and in South Africa are confirmation that the past corporate governance practices were in-effective and is evidence of a need for reform. It is my view that, if the DTI did not take such steps above, South African company law would be out-dated, un-competitive, un-fit for the modern business world and would ultimately result in more corporate collapses and stifled economic growth in South Africa.

CHAPTER 3

THE LEGAL AND REGULATORY FRAMEWORK OF CORPORATE GOVERNANCE IN SOUTH AFRICA

3.1 INTRODUCTION

In this chapter, the regulatory framework of corporate governance in South Africa is analysed. The main goal of this analysis is to determine the legal and regulatory requirements that companies have to comply with and the penalties for non-compliance.

Corporate governance must be considered against the background of a country's broader legal context. Companies exist within a governance framework which is set by the law, regulations, codes of best practice such as the King Reports, the company's own constitutional structure provided by its memorandum of incorporation and the policies adopted by its board of directors to guide its day-to-day operations. The efficiency with which the governance framework in a country operates depends on how effective the legal and regulatory environment is, the level of shareholder awareness and activism which exists, and the approach of funders and institutional investors to the companies in which they invest. The value of a robust legal framework – based on the principles of an unassailable constitution, an independent judiciary and due process of the law – in providing an effective context within which companies can be governed cannot be over-emphasised (emphasis added).⁵⁷

3.2 THE COMPANIES ACT 71 OF 2008

The Companies Act of 2008 was signed into law on 8 April 2009. The Act came into effect on 1 May 2011 after substantial amendment by the Companies Amendment Act 3 of 2011. It consists of a mere 225 sections and five schedules coupled with 179 regulations and three annexures.⁵⁸ It is indeed a succinct piece of legislation.⁵⁹

The Act not only sets out how a company acquires legal personality and raises funds, but incorporates into statute for the first time provisions dealing with corporate

⁵⁷ Naidoo op cit note (35) 27.

⁵⁸ Compared to the Australian Corporations Act 2001, which consists of approximately 1516 sections and schedules and the most recently modernised United Kingdom Companies Act 2006, which is the longest statute ever passed by the UK parliament. The UK Act however, is clear and its legislation is comprehensible, which is of far greater importance than the brevity such of South Africa's Companies Act 71 of 2008. See para 5.2 below for the background and development of the corporate governance regime in the UK.

⁵⁹ Cassim op cit note (36) 2.

governance since the limited liability company was introduced in South Africa by the Joint Stock Companies Limited Liability Act 23 of 1861 in the Cape.⁶⁰

The Act provides the legal structure in terms of which companies are created and empowered. Companies are creatures of statute, and cannot exist unless they are created in terms of the law and given certain powers in terms of the memorandum of incorporation (section 15). Companies, in particular state owned entities, may also be created in terms of their own founding legislation, for example the Broadcasting Act 4 of 1999 in respect of the South African Broadcasting Corporation. Company law defines the manner in which companies come into existence; it defines their objects, authorities, rights and obligations as separate legal entities; the offences of which they are capable and the penalties applicable to those offences. Overall, compliance with all applicable legislation remains the accountability of the company's board of directors, although the day-to-day responsibility for this function is usually delegated to executive management with the board exercising an oversight role.⁶¹

Section 66(1) provides that:

‘The business affairs of a company must be managed by or under the direction of its board of directors, which has the authority to exercise all the powers and perform any of the functions of the company, except to the extent that the Act or the company's memorandum of incorporation provides otherwise.’

This provision is highly significant in that, for the first time in our Companies Act, the board of directors has been assigned the legal duty and responsibility of managing the affairs of a company. Section 66(1) of the Act is a concession to reality by acknowledging that the *raison d'être* for the appointment of the board of directors is the management of the company's business. But, notably, the board's powers may be curtailed by the Act or by the company's memorandum of incorporation.⁶²

Section 66(2) provides that a private company has to have at least one director and a public company at least three directors. In the governance of a company, its business is managed by senior management under the direction of the board. In this regard, two of the board's main functions are the appointment of the company's chief executive, to lead the management team, and the approval of the strategic direction of the company, in both the short and the long term.⁶³

⁶⁰ King op cit note (56) 446. The old Act did not deal with matters of corporate governance. Since 1994, corporate governance has been dealt with exclusively on a voluntary basis under the Code of Corporate Practices and Conduct formulated by the King Committee (King I), which was replaced in 2002 (King II) and since 1 March 2010 listed companies have to comply with (King III).

⁶¹ Naidoo op cit note (57) 28.

⁶² Cassim op cit note (59) 403.

⁶³ King op cit note (60) 449.

Chapter 2, Part F of the Act provides for ‘Governance of Companies’. The two main organs of a company are the board of directors and the shareholders in a shareholders’ meeting. The Act sets out procedural rules relating to the convening of shareholders’ meetings⁶⁴, the provision of notice of meetings⁶⁵, attendance at meetings⁶⁶, the conduct of meetings⁶⁷, the passing of resolutions⁶⁸ and voting⁶⁹ at meetings. It is essential that these formalities be complied with so that the business transacted at a shareholders’ meeting is not open to being expunged on the grounds of non-compliance, or because of irregularities in the proceedings – albeit that in some instances compliance with some formalities is not required.⁷⁰

For the first time in our company law regime, the common-law fiduciary duties of directors⁷¹ are set out in the Act. It is a ‘one size fits all’ approach and thus a disadvantage. The object of this partial codification of the fiduciary duties of directors was to ensure that directors are easily made aware of their fiduciary duties and that the fiduciary duties are easily accessible to directors.⁷²

The Act sets out rules relating to the appointment of directors⁷³, grounds of ineligibility and disqualification of persons to be directors⁷⁴, the removal of directors⁷⁵, the procedure to declare directors delinquent or under a probation order⁷⁶, board committees⁷⁷, board meetings⁷⁸, resolutions of directors⁷⁹, remuneration of directors⁸⁰, and provision of loans and other financial assistance⁸¹ to directors.⁸²

⁶⁴ Section 61(1) provides that the board of director of a company, or any other person specified in the company’s memorandum of incorporation or rules, may call a shareholders meeting at any time.

⁶⁵ Section 62(2).

⁶⁶ Section 63(1).

⁶⁷ See section 63(1).

⁶⁸ Section 65(1) provides that every resolution of shareholders is either an ordinary resolution or a special resolution.

⁶⁹ Section 1 of the Act defines ‘voting power’, with respect to any matter to be decided by a company, as meaning the voting rights that may be exercised in connection with that matter by a particular person, as a percentage of all such voting rights.

⁷⁰ Cassim op cit note (62) 335.

⁷¹ See sections 75, 76, 77, 78 of the Act.

⁷² Cassim op cit note (70) 19-20.

⁷³ Section 66(4) provides that a director may be appointed and removed by a person named in, or determined in terms of, the memorandum of incorporation.

⁷⁴ Section 69 provides for the grounds of ineligibility and disqualification of directors.

⁷⁵ See section 71.

⁷⁶ Section 162(5) sets out the grounds of delinquency.

⁷⁷ Section 72(1) provides that except to the extent that the memorandum of incorporation of a company provides otherwise, the board of a company may— (a) appoint any number of committees of directors; and (b) delegate to any committee any of the authority of the board.

⁷⁸ See section 73(1).

⁷⁹ See section 73(6).

⁸⁰ See section 66(8).

⁸¹ See section 45.

⁸² Cassim op cit note (72) 403.

Section 73(1) provides that a director authorised by the board may call a board meeting at any time and a meeting must be called if required by at least 25 per cent of the directors where the board has 12 or more members or by at least two directors where the board has fewer than 12 members.⁸³

Section 73(3) provides that board meeting may be conducted electronically.⁸⁴ Given modern technological advances, it is now possible to hold a meeting without all members being physically present in the same room, as they can electronically ‘be in the presence’ of one another through web-based or video-conferencing facilities.⁸⁵

Chapter 3 of the Act is titled ‘Enhanced Accountability and Transparency’, which provides that every public company and state-owned company must have a company secretary⁸⁶ and an audit committee⁸⁷, as well as having an external auditor.

The duties of a company secretary are set out in section 88 and they must provide, *inter alia*, guidance to directors as to their duties and responsibilities and ensure that minutes are kept of all shareholders’ and board meetings. In regard to the appointment of auditors, the individual acting as the designated auditor of the external audit team cannot be appointed for more than five consecutive financial years. Members of the audit committee must be directors of the company, but not involved in the day-to-day management of the company, or full time employment of the company or being a material supplier or customer of the company, nor be related to any person who falls within any of the criteria set out above. While no qualifications for members of the audit committee are set out in the new Act, the Minister may prescribe minimum qualification requirements for members. The Act provides that the audit committee of a company has to nominate for appointment a registered auditor of the company, who is, in the opinion of the audit committee, independent. The audit committee has to determine the fees of the auditor and the nature and extent of any non-audit services that the auditor may provide to the company. The audit committee must prepare a report, which has to be included in the annual financial statements, describing how the audit committee has carried out its functions and commenting on the accounting practices and the internal financial controls of the company.⁸⁸

In addition to the provisions of the Companies Act of 2008, common law and King III, all companies incorporated in South Africa are required to comply with a

⁸³ Ibid 462.

⁸⁴ Section 1 of the Act provides that ‘electronic communication’ has the meaning as set out in section 1 of the Electronic Communications and Transactions Act 25 of 2002.

⁸⁵ Naidoo op cit note (61) 59.

⁸⁶ See section 86.

⁸⁷ See section 90.

⁸⁸ King op cit note (63) 450-451.

number of other laws which impose, albeit indirectly, certain governance obligations on the company and its directors.⁸⁹

The enforcement of the Act is of vital importance.⁹⁰ The Act has decriminalised much of the conduct that was considered criminal under the 1973 Act. The object of decriminalising company law is not to trivialise the importance of effective sanctions for non-compliance, but to ensure more effective enforcement. However, the Act is not entirely without criminal penalties and attempts to keep criminal penalties to a minimum. It relies on an amalgamation of criminal penalties, civil remedies and administrative fines for enforcement. Overall responsibility of compliance with the Act is placed on the Companies and Intellectual Property Commission ('the Companies Commission'). It may investigate alleged contraventions of the Act and if it is found that a company has contravened its provisions, the Companies Commission may, *inter alia* decide to terminate the matter, refer the matter to the National Prosecuting authority or other regulatory authority, or resolve to issue a compliance notice. Failure to comply with a compliance notice may result in an administrative fine being levied by the court, which may not exceed the greater of 10 per cent of the company's turnover during the period that the company failed to comply with the compliance notice, and the maximum fine of R1 million.⁹¹

From the above, it is clear that the intention of the legislatures was to produce an Act that up to date with the modern corporation. The issue of corporate governance mainly applies to the board of directors and shareholders of a company. It is my understanding that should the board of directors or shareholders act contrary to the provisions of the act, this would result in non-compliance and a penalty would thus be incurred.

3.3 THE COMMON LAW

In addition to statutory duties prescribed by the Companies Act of 2008, there are certain common law duties incumbent on the directors and officers of a company. Common law is law which is not written in the statute books of a country but which, nevertheless, through custom, usage and court decisions, has gained force of law. Although several provisions of common law have been incorporated into the Act, the promulgation of Act does not replace the common law; in other words, the new Act

⁸⁹ Ibid. For example, the Public Finance Management Act 1 of 1999 (as amended by Act 29 of 1999) imposes stringent reporting and financial accountability provisions in respect of governmental departments and state owned entities. See 34-36 for more examples and a brief summary of the other applicable Acts.

⁹⁰ The enforceability of the Act is in contrast with enforceability of King III, see para 4.4.

⁹¹ Cassim op cit note (82) 26 and 833-837 for a full discussion on the Companies Commission.

reflects rather than replaces the common law. This is contrary to the position in the UK, where the enactment of the new UK Companies Act in 2006 specifically repealed and replaced the common law relating to companies.⁹²

3.4 LEGAL PRECEDENT

Legal and judicial precedent is a body of decisions which establishes a particular legal principle. In deciding subsequent cases with similar issues or facts, a court must consider, in addition to the law laid down by statute, the body of precedent on the issue. In certain circumstances, for instance where a decision has been handed down by a higher court such as the court of appeal, such precedent is considered mandatory precedent and must be followed by the lower court. Legal precedent, once established, forms part of common law. The 2008 Act codifies much of what has become accepted in our legal system through judicial precedent and common law. In interpreting the provisions of the Act, it is specifically contemplated in section 5 of the Act that, to the extent appropriate, the courts may consider foreign company law and the requirements of economic development and entrepreneurship as set out in section 7 of the Act. The clear intention of the drafters of the 2008 Act is therefore that it should continue to remain relevant to the South African business environment by being flexible and adaptive to changing circumstances.⁹³

In reflection, there is value to Act's provision that allows the courts to consider foreign company law. Seeing to it that the economy, business and regulatory environment in South Africa and around the world is constantly changing, it is therefore imperative to stay up-to-date with contemporary commercial practices, in addition to judicial precedent and the common law.

3.5 REGULATIONS

Regulations exist to assist the primary legislative process. In other words, primary legislation such as the Companies Act 71 of 2008 contains provisions which allow certain bodies established under the law to make regulations, in term of defined processes, on a range of matters within their areas of responsibility. This allows the law to be applied more effectively and with more flexibility having regard to the changing circumstances. Regulations therefore involve the prescripts of government agencies and

⁹² Naidoo op cit note (85) 31.

⁹³ Ibid 31-32.

regulatory bodies put in place by the state for the governance of companies and the protection of investors.⁹⁴

The Act establishes one new institution and adapts and transforms three existing ones. The three transformed regulatory agencies are the Companies Commission, the Takeover Regulation Panel, which was formerly the Securities Regulation Panel, and the Financial Reporting Standards Council, while the entirely new regulatory agency is the Companies Tribunal.⁹⁵

3.6 THE JOHANNESBURG STOCK EXCHANGE (JSE) LISTING REQUIREMENTS

Securities exchange regulations such as the JSE listing requirements⁹⁶ determine the requirements that companies must fulfil in order to have their shares listed on the stock exchange. The listing requirements regulate the conduct of listed entities and companies planning to list their shares.⁹⁷

Paragraph 1.2 of the JSE listing requirements provides that listings are granted subject to compliance with the listings requirements and new applicants and their directors must comply with the listings requirements. In addition, the JSE may grant a listing subject to any additional condition(s) that it considers appropriate, in which event the new applicant will be informed of, and will be required to comply with, any such condition(s).

Paragraph 1.11 provides that where the issuer has failed to comply with the listing requirements and it is in the best interest for listing to be terminated, the JSE may suspend or terminate a listing.

Furthermore, paragraph 3.62 provides that all directors of listed companies are bound by and must comply with the listings requirements, as amended from time to time, in their capacities as directors and in their personal capacities.

Paragraph 3.84 provides that issuers must comply with the specific requirements concerning corporate governance and must disclose their compliance therewith in their annual report.

⁹⁴ Ibid.

⁹⁵ Ibid 825.

⁹⁶ The most recent issue (service issue 17) of the JSE listing requirements as of 13 November 2013 is available at <http://www.jse.co.za/How-To-List/Listing-requirements/JSE-listing-requirements.aspx> [accessed on 30 January 2014].

⁹⁷ Naidoo op cit note (92) 28.

Paragraph 8.63(a) read with paragraph 3.84 provides that issuers are required to disclose in the annual report and in the annual financial statements:

‘(a) the King Code:

(i) a narrative statement of how it has applied the principles set out in the King Code, providing explanation(s) that enable(s) its shareholders to evaluate how the principles have been applied; and

(ii) a statement addressing the extent of the company’s compliance with the King Code and the reasons for non-compliance with any of the principles in the King Code, specifying whether or not the company has complied throughout the accounting period with all the provisions of the King Code and indicating for what part of the period any non-compliance occurred.’

It is submitted that the listing requirements, which are consistent with international best practice, greatly increase the discretionary powers of the JSE-listed entities. Listed companies are required to comply with the provisions of the King Code and state in their annual reports the extent and the reasons for any non-compliance.⁹⁸

3.7 THE CODES OF GOOD GOVERNANCE: THE KING REPORTS ON CORPORATE GOVERNANCE

The King Committee was formed in 1992 by the Institute of Directors of Southern Africa. The King Committee was led by former judge Mervyn King to consider, *inter alia*, issues of financial reporting and accountability, good practice concerning the responsibilities of directors and auditors, and a code of ethical conduct for South African enterprises. The King Committee was similar in concept to the Cadbury Committee which was disbanded on completion of its mandate and was succeeded, in time, by various other committees such as the Turnbury and Higgs Committees, the core of the King Committee continued to function to guide the evolution of South African corporate governance. The work of the King Committee remains the definitive South African standard on corporate governance.⁹⁹

The 1994 Report of the King Committee on Corporate Governance (King I) codified the standards of governance applicable to companies and other defined entities. For the first time in South Africa, the governance standards of companies listed on the main boards of the JSE Securities Exchange, large public entities as defined in the Public Entities Act 93 of 1992 (for example Telkom and Eskom), banks, financial and insurance companies and large unlisted public corporations (companies with

⁹⁸ Ibid 36.

⁹⁹ Ibid 32.

shareholders' equity over R50 million) were regulated by more than just legislation. In March 2002, the King Committee published the second King Report on Corporate Governance for South Africa (King II). Following the release of King II in 2002, the JSE reviewed its listing requirements to make the application of the King Code mandatory for listed companies. Several of the recommendations contained in King I and II have been superseded by or incorporated into legislation, some of the more significant being the Labour Relations Act 66 of 1995, the Basic Conditions of Employment Act 75 of 1997, the Employment Equity Act 55 of 1998, the Corporate Laws Amendment Act 24 of 2006 and most recently the Companies Act of 71 of 2008.¹⁰⁰

A third report on Corporate Governance was required because of changes in the company law regime (brought about by the Companies Act 71 of 2008) as well as the need to ensure alignment with international governance trends. In a fundamental move away from the approach in King II (which applied to affected companies only), the new King Report sets out aspirational best practice governance standards for all companies and corporate entities. Underlying the shift away from the 'comply or explain' approach of King II – an approach which suggested an element of enforcement and sanctions attaching to non-compliance – is the recognition that there is no 'one-size-fits all' approach to governance.¹⁰¹

3.8 THE ROLE OF MARKET FORCES

Market forces is another source of influence, and perhaps control, over internal arrangements and management of the company, but does not sit comfortably under any of the classifications of regulation above. The significant role of market forces in contributing to good corporate governance and strong corporate performance has been emphasised in economic literature on corporation and company law. In fact, many consider the influence of market forces to be an effective substitute for formal legal regulation.¹⁰²

It is therefore submitted that market forces, although categorised as 'soft law', due to it constituting a form of corporate control, but control arising without any form of threat of direct legal sanction – are most significant than legal rules.¹⁰³

Most corporate governance codes are based on a 'comply or explain' approach. If companies adhere voluntarily because they consider that an elaborate corporate

¹⁰⁰ Ibid 32-33.

¹⁰¹ Ibid 34.

¹⁰² Du Plessis op cit note (20) 122.

¹⁰³ Ibid 123.

governance statement is in their interests for creating confidence in the markets, third parties-especially investors, but also creditors are entitled to rely on the honest and complete nature of the statements. The ‘comply or explain’ technique therefore builds further on the idea of market enforcement.¹⁰⁴

3.9 SUMMARY

From the above, it is clear that companies in South Africa have to comply with many legal and regulatory requirements.¹⁰⁵ Legislation, the common law, legal precedent, regulations, listing requirements, the Codes of good governance and market forces all impact on the manner in which companies do business.

It is submitted that:

‘corporate governance has been viewed by some as becoming increasingly prescriptive and more difficult to comply with, and, in a number of companies, governance has been relegated to an annual “form-ticking” exercise to which management, directors, and some even company’s auditors, pay mere lip-service’¹⁰⁶

However, I disagree, because based on history of company collapses and the archaic company law regime, there clearly was a lack of proper corporate governance regulation.

It is my opinion, if companies do not adhere to all the legal and regulatory framework of corporate governance, they would collapse, they will not be able to contend with larger companies on the JSE, they would not restore investor confidence in the markets and these companies would not be financially sustainable in the future.

¹⁰⁴ E Wymeersch ‘The Enforcement of Corporate Governance Codes’ (2006) 6 *Journal for Corporate Law Studies* 121 and for an analysis of the framework to help understand when which corporate governance rules are (not) enforced and what can be done to improve corporate governance mechanisms in a weak enforcement environment, see E Berglof and S Claessens, *Corporate Governance and Enforcement*, World Bank Policy Research Working Paper No 3409, September 2004.

¹⁰⁵ See para 2.3 above.

¹⁰⁶ See Naidoo op cit note (97) 22-24 on ‘the cost of compliance’. It has been estimated that the total cost to the American economy of complying with the SOX exceeds the combined write-offs from Enron, WorldCom and Tyco. American companies are reported to have spent some \$265 billion complying with section 404 of the SOX (which requires the verification of a company’s internal controls), and the cumulative cost to UK businesses of complying with 19 new laws and regulations passed since 2007 to increase accountability has risen by more than 10 billion Euros from roughly 65 billion Euros to a 76, 81 billion Euros in 2008, according to the British Chamber of Commerce’s 2009 Burden Barometer. Above all, there is little empirical evidence that the onerous costs of compliance have brought any real and measurable improvement in the overall quality of governance. It is now widely accepted, perhaps almost everywhere else except in the US, that the SOX was an ill-conceived, panic-induced piece of legislation that had little chance of yielding any lasting improvement in the quality of governance of US corporations.

CHAPTER 4

THE LEGAL ENFORCEABILITY OF KING III

4.1 INTRODUCTION

In this Chapter, the legal enforceability of King III is examined. Such an examination therefore requires research into the enforceability and efficacy of King III. It is therefore also necessary to examine the responsibilities of the board of directors in terms of the King III and to determine the relationship between King III and the Companies Act 71 of 2008.

King III comprises of a Code of principles founded on an ‘apply or explain’ basis, a Report which amplifies the principles in the Code and contains the King Committee’s recommendations on governance best practice. Where practices are mandatory in terms of legislation, the Code uses the peremptory ‘must’ to distinguish these. Principles which are a requirement of good governance are differentiated by permissive ‘should’. In other words, a company *must*, in terms of the Companies Act 71 of 2008 prepare annual financial statements for which the directors *must* accept responsibility; it *should*, in addition, indicate in its sustainability report the positive and negative impact of its operations on the environment. In contrast to the approach in King II, practical implementation guidelines are not included as part of the Code, but will be issued intermittently by the Institute of Directors in the form of Practice Notes. This will help ensure that King III remains current and relevant.¹⁰⁷

4.2 THE RELATIONSHIP BETWEEN KING III AND THE COMPANIES ACT 71 OF 2008

Section 7 of the Act provides that the purpose of the new Act is to promote compliance with the Bill of Rights, as provided for in the Constitution of the Republic of South Africa, 1996 in the application of company law. It is also designed to promote entrepreneurship, flexibility and simplicity in the formation and maintenance of companies and to encourage transparency and high standards of corporate governance. This statement in turn encourages an interaction between King III and the Act.¹⁰⁸

There is always a link between good governance and compliance with law. Good governance is not something that exists separately from the law and it is entirely inappropriate to unhinge governance from the law. The starting point of any analysis on this topic is the duty of directors and officers to discharge their legal duties. These duties

¹⁰⁷ Cassim op cit note (91) 34.

¹⁰⁸ King op cit note (88) 447.

are grouped into two categories, namely: the duty of care, skill and diligence, and the fiduciary duties. As far as the body of legislation that applies to a company is concerned, corporate governance mainly involves the establishment of structures and processes, with appropriate checks and balances that enable directors to discharge their legal responsibilities, and oversee compliance with legislation.¹⁰⁹

In addition to compliance with legislation, the criteria of good governance, governance codes and guidelines will be relevant to determine what is regarded as an appropriate standard of conduct for directors. The more established certain governance practices become, the more likely a court would regard conduct that conforms with these practices as meeting the required standard of care. Corporate governance practices, codes and guidelines therefore lift the bar of what are regarded as appropriate standards of conduct. Consequently, any failure to meet a recognised standard of governance, albeit not legislated, may render a board or individual director liable at law. Around the world hybrid systems are developing. In other words, some of the principles of good governance are being legislated in addition to a voluntary code of good governance practice. In an ‘apply or explain’ approach, principles override specific recommended practices. However, some principles and recommended practices have been legislated and there must be compliance with the letter of the law.¹¹⁰ This does not leave room for interpretation. Also, what was contained in the common law is being restated in statutes. In this regard, the most important change is the incorporation of the common law duties of directors in the Act.¹¹¹

4.3 THE RESPONSIBILITIES OF THE BOARD OF DIRECTORS IN TERMS OF KING III

The King III Report requires the board of directors to provide effective leadership based on an ethical foundation.¹¹² An ethical corporate culture means more than social philanthropy or charitable donations.¹¹³ The rationale for ensuring that the company is

¹⁰⁹ King III Report, Introduction and Background, para 4. This is the link between governance principles and the law. These responsibilities of the board of directors’ under King III are in essence, legal duties that directors have to apply or explain if they deviate from King III.

¹¹⁰ For example, section 30(1) provides that each year a company must prepare annual financial statements. A company is generally permitted to provide financial assistance for the purchase or subscription of its shares (section 44) and to make loans to directors (section 45), subject to certain conditions such as solvency and liquidity in terms section 4.

¹¹¹ King III Report, Introduction and Background, at para 4. South Africa simply follows the trend set in the UK and other common law jurisdictions such as Australia, New Zealand, Ghana, Malaysia and Singapore.

¹¹² Principle 1.1.

¹¹³ King III Report, Introduction and Background, para 9.

run ethically is that it would earn the necessary approval from those affected by and affecting its operations.¹¹⁴

The board must ensure that the company's ethical performance is assessed, monitored, reported and disclosed,¹¹⁵ enabling users of ethics reports to form opinions and make decisions based on disclosed and verified information.¹¹⁶

As far as sustainability is concerned, it is a primary moral and economic imperative of the 21st century¹¹⁷ and sustainability considerations are rooted in the Constitution of the Republic of South Africa, 1996, which imposes responsibilities upon individuals and juristic persons for the realisation of the most fundamental rights.¹¹⁸

The board should ensure that the company is, and is seen to be, a responsible corporate citizen¹¹⁹ which implies an ethical¹²⁰ relationship of responsibility¹²¹ between the company and the society in which it operates.¹²² It is responsible for the strategic direction and control of the company.¹²³ So the board should not only consider the financial performance of the company, but also the impact of the company's operations and the environment.¹²⁴

¹¹⁴ King III Report, Introduction and Background, para 12. Section 72 (4) of the Act requires every listed company and every state-owned company to appoint a social and ethics committee, unless the company is a subsidiary of a holding company that already has a social and ethics committee that would perform the prescribed functions on behalf of the subsidiary company, or it is exempted by the Companies Tribunal from the requirement to appoint a social and ethics committee. The functions of the social and ethics committee is to monitor the company's activities, having regard to any relevant legislation, such as the Broad-Based Black Economic Empowerment Act 53 of 2003, or prevailing codes of best practice, such as the United Nations Global Compact Principles and recommendations of the Organisation for Economic Co-operation and Development on corruption.

¹¹⁵ King III Code, para 1.3.8.

¹¹⁶ King III Report, Principle 1.2, para 53.

¹¹⁷ King III Report, Introduction and Background, para 8.

¹¹⁸ Ibid.

¹¹⁹ King III Report, Principle 1.2,

¹²⁰ King III Report, Principle 1.1.

¹²¹ The case of *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd & Others* (2006 (5) SA 333 (W)) involved an attempt to ensure that a company and its directors could not ignore its environmental obligations with impunity by the mass resignation of directors. Hussain J emphasised that the director's fiduciary obligation to act *bona fide* in the best interests of the company is a duty that must be taken into account whenever directors act, (par 16.6 at 350). Hussain J concluded that the directors had breached this duty because they had not 'acted in good faith upon reasonable grounds' when they all suddenly resigned (ibid). Highlighting the social responsibility of a company, Hussain J (par 16.7 at 351) emphasised the King Report on Corporate Governance for South Africa (2002) ('King II') (para 2.1.1), which states that the board of directors is the center of good corporate governance and is responsible for managing the company properly. For an analysis of this case, see Stephanie Luizand Zuené Taljaard 'Mass Resignation of the Board and Social Responsibility of the Company: *Minister of Water Affairs and Forestry v Stilfontein Gold Mining Co Ltd*' (2009) 21 *SA Merc LJ* 420-425.

¹²² King III Report, para 19.

¹²³ King III Report, Principle 1.1, para 7.

¹²⁴ King III Code, para 1.2.1.

The board should draw up a code of conduct.¹²⁵ The board should ensure that its conduct and that of management aligns to the set values and is adhered to in all aspects of its business.¹²⁶ The board should ensure that all decisions and actions are based on values underpinning good corporate governance, namely responsibility, accountability, fairness and transparency.¹²⁷

The board of directors should act as the focal point and custodian of corporate governance.¹²⁸ Furthermore, the board of directors should act in the best interests of the company.¹²⁹ The Report recommends that every board should have a charter setting out its responsibilities and should meet as often as required to fulfil its duties, but preferably at least four times per year.¹³⁰

The board of directors has the responsibility to elect as a chairperson someone who is an independent non-executive director. The CEO of the company should not also fulfil the role of chairperson of the board.¹³¹ In addition, the board should appoint a CEO and establish a framework for the delegation of authority.¹³² The board should comprise a balance of power, with a majority of independent non-executive directors.¹³³ Directors should be appointed through formal process.¹³⁴

The board of directors should strive to achieve the appropriate balance between its various stakeholder groupings, and is urged to take into account, as far as possible, the legitimate interests and expectations of its stakeholders when making decisions in the best interests of the company.¹³⁵

The board should ensure the integrity of the company's integrated report, which should be prepared annually and should convey adequate information regarding the

¹²⁵ King III Code, para 1.1.7.

¹²⁶ King III Code, para 1.1.8.

¹²⁷ King III Report, Principle 1.1, para 1.

¹²⁸ King III Report, Principle 2.1 of the King III Report. The court in *South African Broadcasting Corporation Ltd v Mpofo* [2009] 4 ALL SA 169 (GSJ) para 60, stressed, good corporate governance (particularly in state-owned enterprises) is ultimately about effective leadership. The court stressed further that an organisation depends on its board of directors to provide it with direction.

¹²⁹ King III Report, Principle 2.14.

¹³⁰ King III Report, Principle 2.1, para 1.

¹³¹ King III Report, Principle 2.16.

¹³² King III Report, Principle 2.17.

¹³³ King III Report, Principle 2.18.

¹³⁴ King III Report, Principle 2.19. These principles are similar to the Act, which also sets out rules relating to the appointment of directors, grounds of ineligibility and disqualification of persons to be directors, the removal of directors, the procedure to declare directors delinquent or under a probation order, board committees, board meetings, resolutions of directors, remuneration of directors, and provision of loans and other financial assistance to directors, see Cassim op cit note (106) 403 and para 3.2 above.

¹³⁵ King III Report, Principle 8.3. In addition, Principle 2.14 provides that the board and its directors should act in the best interests of the company.

company's financial and sustainability performance.¹³⁶ Integrated reporting enables stakeholders to better assess the value of a company. The board should furthermore ensure that the company complies with applicable laws and that it also considers adherence to non-binding rules, codes and standards.¹³⁷

The board should be responsible for the governance of both risk¹³⁸ and information technology,¹³⁹ and should ensure that there is an effective risk-based internal audit.¹⁴⁰

Furthermore, the board should be responsible for dispute resolution and should ensure that disputes are resolved as effectively, efficiently and expeditiously as possible.¹⁴¹

Directors should be aware of the practicalities of business rescue proceedings.¹⁴² In addition, the board and individual directors should be aware of and understand their duties during the business rescue proceedings, as well as the duties and powers of the business rescue practitioner.¹⁴³

The board should ensure that the company complies with applicable laws and considers adherence to non-binding rules, codes and standards.¹⁴⁴ The board and each individual director should have a working understanding of the effect of the applicable laws, rules, codes and standards on the company and its business.¹⁴⁵

4.4 THE ENFORCEABILITY AND EFFICACY OF KING III

As stated above, King III is drafted on an 'apply or explain' basis. In following the 'apply or explain' approach, the board of directors, in its collective decision making,

¹³⁶ King III Report, Principle 9.1.

¹³⁷ King III Report, Principle 6.1.

¹³⁸ King III Report, Principle 4.1.

¹³⁹ King III Report, Principle 5.1.

¹⁴⁰ King III Report, Principle 2.10.

¹⁴¹ King III Report, Principle 8.6.

¹⁴² King III Report, Introduction and Background, para 11. King II Report, Principle 2.15 states that the board should consider business rescue proceedings or other turnaround mechanisms as soon as the company is financially distressed as defined in the Act. The Act has introduced provisions of business rescue proceedings, which are aimed at rescuing economically viable companies in financial distress, see Cassim op cit note (133), 481-482 and Chapter 8 of the Act for an analysis on the business rescue proceedings.

¹⁴³ King III Report, Principle 2.15.

¹⁴⁴ King III Report, Principle 6.1.

¹⁴⁵ King III Report, Principle 6.2 read with Code 6.2.2 which provides that directors should sufficiently familiarise themselves with the general content of applicable laws, rules, codes and standards to discharge their legal duties (i.e., fiduciary duties and their duty of care, skill and diligence in the best interests of the company).

could conclude that to follow a recommendation would not, in the particular circumstances, be in the best interests of the company.¹⁴⁶ The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of the overarching corporate governance principles of fairness, accountability, responsibility and transparency. Explaining how the principles and recommendations were applied, or if not applied, the reasons, results in compliance.¹⁴⁷

However, its principles are not legally binding on these companies, unless their shares are listed on the JSE, in which case they are subject to the JSE listing requirements. On the other hand, companies whose shares are not listed on the JSE do not have to comply with King III.

From the above, it is my understanding that King III is mandatory for companies who want list their shares on the JSE. In addition to King III, these companies also have to comply with the JSE listing requirements. The board of directors of listed companies are required to comply with the provisions of the King Code and state in their annual reports the extent and the reasons for any non-compliance.

In addition, the board of directors of listed companies also still have to comply with the provisions of the Companies Act, which is mandatory for the board of directors of all companies and also contains various elements of corporate governance. Companies may, on a voluntary basis, choose whether it wants to list their shares on the JSE and comply with King III. It is therefore submitted that King III, the JSE listing requirements and the Companies Act, mirror each other.

Moreover, market forces¹⁴⁸, even though it is not considered part of the legal regulation of corporate governance, has significant influence on the management, internal arrangement of a company and contribution to good corporate governance.

¹⁴⁶ The common-law principle that a director must act in the best interest of the company is codified in section 76(3)(b). Section 76(3)(b) of the Act requires a director to act in the best interests of the company. The wording of this provision removes any doubt that the directors of a company owe their duty to the company and the company alone. This duty is the fundamental and paramount or overarching duty of company directors – to act *bona fide* in what they consider – not what the court may consider – to be in the interests of the company as a whole, and not for a collateral purpose, see *Re Smith & Fawcett Ltd* [1942] Ch 306 (CA); *Robinson v Randfontein Estates Gold Mining Co Ltd* 1921 AD 168; *S v De Jager & Another* 1965 (2) SA 616 (A); *Fisheries Development Corporation of SA v Jorgensen; Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W); *Howard v Herrigel NO* 1991 (2) SA 660 (A) and *Phillips v Fieldstone Africa (Pty) Ltd* 2004 (3) SA 465 (SCA).

¹⁴⁷ King III Report, Introduction and Background, para 3.

¹⁴⁸ See para 3.8 above.

4.5 SUMMARY

In summary, corporate governance mainly involves the establishment of structures and processes, with appropriate checks and balances that enable directors to discharge their legal responsibilities, and oversee compliance with legislation. This is the link between governance principles and the law. Stated differently, these responsibilities of the board of directors' under King III constitute legal duties.

It is my understanding that King III is not enforced through legislation; it relies on self-regulation. There is no regulatory agency that is mandated to enforce King III and there is no sanction for non-compliance. However, enforcement takes place according to the JSE listing requirements. Listed companies are contractually bound to comply with King III and failure to follow the JSE listing requirements would amount to a breach of the listing requirements. Listed companies will have to comply with King III or be the JSE may suspend or terminate the listing.

Furthermore, the board of directors has the responsibility to promote the principles of corporate governance in terms of King III. Since King III is drafted on an 'apply or explain' basis, the board of directors, in its collective decision making, could conclude that to follow a recommendation would not, in the particular circumstances, be in the best interests of the company. The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of the overarching corporate governance principles of fairness, accountability, responsibility and transparency.

In the above analysis, it is evident that King III governs all the critical areas a company. It therefore submitted that King III impacts and changes the way a company normally conduct business. It is also submitted that although King III is voluntary for all companies and all companies should still strive to apply its principles as it would only benefit such company's.

In my view, King III is enforceable, but only to a certain degree. However, if King III is not strictly applied, the board of directors still have to prove that they were acting in the best interests of the company and explain their reasoning for deviating from its principles. This leaves the board of directors with all the power.

CHAPTER 5

COMPARATIVE ANALYSIS: UNITED KINGDOM

5.1 INTRODUCTION

In this chapter the background and development of corporate governance in the United Kingdom is discussed. It is therefore necessary to distinguish between the different UK committees and reports, since the goal is to point out the similarities and important differences between the South Africa and the United Kingdom's regulatory framework and ultimately to find an answer to the problem in this dissertation.

In the UK, concern about standards of financial reporting and accountability, heightened by a series of major corporate closes and a controversy over directors' pay brought corporate governance to the center of attention. The global financial crisis raised many corporate governance issues and led to many reviews and changes to the corporate governance system in the UK and abroad. Notably, the Walker Review led to changes in the financial regulation and the Financial Reporting Council (FRC) replaced the Combined Code on Corporate Governance with the new UK Corporate Governance Code in 2010.¹⁴⁹

5.2 BACKGROUND AND DEVELOPMENT OF THE CORPORATE GOVERNANCE REGIME IN THE UNITED KINGDOM

The main impetus for better practices in corporate governance began in the UK in the late 1980's.¹⁵⁰ The development of better corporate governance practices came as a result of a series of corporate collapses and scandals in the late 1980's and early 1990's.

Since the beginning of the 1990's the corporate governance debate has been shaped to a large degree by the work of the Cadbury, Greenbury, Hampel and the Turnbull Committee. The collapse of ENRON and other companies in the United States and Western Europe also led to further moves to strengthen the protections afforded by the corporate governance regime. The financial crisis also gave impetus to further reforms to the corporate governance system, many of which have implemented by and are overseen by the Financial Reporting Council.¹⁵¹

¹⁴⁹ Boyle and Birds' op cit note (27) 363.

¹⁵⁰ Peter Loose, Michael Griffiths and David Impey *The Company Director: Powers, Duties and Liabilities* 11ed (2011) 692.

¹⁵¹ Boyle and Birds' op cit note (149) 370.

In the UK, companies are incorporated at country level and have to abide by the Companies Act 2006.¹⁵² In 1992, the UK produced the world's first corporate governance report, leading to a formal corporate governance code. Subsequently, the UK has published more reports than any other country.¹⁵³

The *Cadbury Report* (1992) was produced by a committee chaired by Sir Adrian Cadbury. It was titled '*The Financial Aspects of Corporate Governance*', and was not intended to be a comprehensive review of the subject. The code was discretionary: UK listed companies were required to report that they had complied with the code or, if they had not, they had to state reasons for non-compliance.¹⁵⁴

The Cadbury, Greenbury and Hampel committees were set up by the City of London institutions – that is, by the UK's financial sector. The codes were essential voluntary and applied principally to listed companies, although it was suggested that many of the recommendations could be applied to private companies. In 1998, the Combined Code consolidated the Cadbury, Greenbury, and Hampel proposals, and was incorporated into the London Stock Exchange's listing rules. The Combined Code set out standards of good practice on matters such as board composition, director remuneration, accountability, and audit in relation to shareholders. In these reports, companies had to confirm that they had complied with the Code's provisions or, if they had not, provide explanations of why not. Although the code had no legislative basis and enforcement, failure to meet its requirements could lead to delisting from the London Stock Exchange. Formal de-listing, however, would tend to disadvantage the very shareholders whom the corporate governance codes were designed to protect, so delisting was a last resort.¹⁵⁵

The Combined Code¹⁵⁶ was revised in 2003 and again in 2006. In this later edition, the corporate governance requirements were grouped under four headings:

¹⁵² This is the primary source of legislation relating to companies in the UK. An analysis of the UK Act falls outside the scope of this dissertation, because the 2008 Act is very similar to the UK Act and the provisions dealing with corporate governance have been dealt with in para 3.2 above. The UK Act is the largest statute on the statute book. The Act contains 47 Parts with 1300 sections and is followed by sixteen Schedules. There are also over 70 statutory instruments made under the Act. It is clear that the UK Act is indeed a massive piece of legislation. It is considerably more comprehensive and has incorporated a substantial amount of case law in the Act. The aim of this incorporation would clearly be to clarify the law. It is submitted that the drafters of the 2008 Act should have perhaps done the same and not have taken the less detailed route, since there are many sections in the 2008 Act which are still unclear. Available at http://www.legislation.gov.uk/ukpga/2006/46/pdfs/ukpga_20060046_en.pdf [accessed 29 January 2014].

¹⁵³ Bob Tricker *Corporate Governance: Principles, Policies and Practices* 2ed (2011) 119.

¹⁵⁴ *Ibid.* The most important distinguishing characteristic about the *Cadbury Report* was its reliance on self-regulation.

¹⁵⁵ *Ibid.* 121.

¹⁵⁶ The Combined Code on Corporate Governance was a result of an amalgamation of the *Cadbury* and *Greenbury Reports* which were brought together in 1998 in United Kingdom.

independence; diligence; professional development; board performance evaluation. These editions of the Combined Code were published by the FRC, which is the UK's independent regulator responsible for promoting high-quality corporate governance, and which had by this time taken over regulatory responsibility from the London Stock Exchange. The FRC also regulates the UK professional accountancy bodies. Following the global financial crisis, beginning in 2008, the FRC reviewed the Combined Code, and renamed it the Corporate Governance Code (2010). This code sets out the standards of good practice in relation to board leadership and effectiveness, remuneration, accountability, and relations with shareholders. The Corporate Governance Code contains broad principles, plus some more specific provisions.¹⁵⁷

Similar to the Combined Code the Corporate Governance Code (2010) focuses on directors, remuneration of directors, accountability and audit and relations with stakeholders. The aim of the Code is to allow companies to create and establish their own governance policies in the light of the main and supporting principles. This seeks to offer flexibility for companies in order to take account of their diversity but within a broad framework of requirements. The listing rules require listed companies to describe their corporate governance in their annual report and accounts from two points of view. First, the company must report on how it applies and adheres to the Code's principles. Again, it is for the companies to define and explain their own governance policies in the light of the principles, including any special circumstances applying to them which have led to a particular approach. It is for their shareholders and others to evaluate this part of the company's statement. The company must confirm where it complies with the Code's provisions. From the second point of view the company must describe its non-compliance with any of the Code's provisions. The comply or explain approach adopted in the Code is favoured as having been in operation since the Code's beginnings in 1992 and for the flexibility it offers which 'is strongly supported by both companies and shareholders and has been widely admired and imitated internationally.'¹⁵⁸

In 2012 the FRC reviewed the 2010 version of the Corporate Governance Code. The new edition of the Code (Corporate Governance Code (2012)¹⁵⁹) was published in September 2012 and applies to reporting periods beginning on or after 1 October 2012.¹⁶⁰ Companies reporting on reporting periods beginning before 1 October 2012 should continue to report against the June 2010 edition of the Code, although they are

¹⁵⁷ Ibid 122. These principles are similar to King III.

¹⁵⁸ Ibid 373.

¹⁵⁹ Available at <http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf> [accessed on 29 January 2014].

¹⁶⁰ *Corporate Governance Code* (2012).

encouraged to consider whether it would be beneficial to adopt some or all of the new provisions in the revised code earlier than formally expected.¹⁶¹

The Corporate Governance Code sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. All companies with a premium listing of equity shares in the UK are required under the listing rules to report on how they have applied the Code in their annual report and accounts. The Code contains broad principles and more specific provisions. Again, listed companies are required to report on how they have applied the main principles of the Code, and either to confirm that they have complied with the Code's provisions or - where they have not - to provide an explanation. Some of the provisions of the Code require disclosures to be made in order to comply with them.¹⁶²

Together with the Corporate Governance Code (2010) the Stewardship Code (2010) was published in July 2010 and is to be applied on a 'comply or explain' basis. The Code 'aims to enhance the quality of the engagement between institutional investors and companies to help improve long term returns to shareholders and efficient exercise of governance responsibilities'.¹⁶³ The Code however, does not require any dialogue between the shareholders and any other stakeholders.¹⁶⁴

5.3 SUMMARY

There are many new regulatory developments in the UK since the 1990's. The first being the *Cadbury Report* and after the global financial crisis in 2008, the FRC reviewed the *Combined Code* and renamed it the *Corporate Governance Code* (2010). This Code is however replaced with the 2012 version which applies to reporting periods beginning on or after 1 October 2012.

From the above, it is clear that according to the 2010 and 2012 Codes, listed companies in the UK are governed on a 'comply or explain' basis. The 'comply or explain' approach first set out by the *Cadbury Report* has been retained in the all the Codes and Reports set up in the UK. Listed companies must comply with the Code's provisions or confirm that they have complied with the Code's provisions or provide an

¹⁶¹ <https://frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx> [accessed 20 January 2014].

¹⁶² Ibid.

¹⁶³ John Lowry and Arad Reisberg *Pettet's Company Law: Company Law and Corporate Finance* 4ed (2012) 225-226.

¹⁶⁴ Ibid 228. This is in contrast with the approach taken in South Africa where relationships and dialogue between all stakeholders is required, see para 4.3 above. This is reflected in King III, Chapter 8 requires management to formulate a strategy and formulate policies for the management of relationships with each stakeholder groupings.

explanation when they do not. Non-compliance with the provisions of the Code is not a breach of the Code, but failure is.

It is submitted that the chief distinguishing feature of the UK Reports is its reliance mainly on self-regulation. It is also interesting to note that, all the UK Reports deal with specific aspects of corporate governance, in contrast to that of South Africa, which covers all the issues of corporate governance in King III.

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 CONCLUSION

The discussion above examines the responsibilities of the board of directors to promote the principles of corporate governance. The research has revealed that companies have to comply with many legal and regulatory requirements of corporate governance in the South Africa and in United Kingdom.

After following a comparative methodology, it is submitted that the South African legal and regulatory framework with regard to corporate governance is very similar to that of the United Kingdom's, however there are many differences as well.

The reason for the legal and regulatory requirements was because of the global financial crisis, high profile corporate collapses and the previous corporate law regime was considered outdated and in need of modernisation. This has led to the DTI policy paper which articulated three interrelated impetuses that collectively form the need for the overhaul of the law of corporate governance in South Africa. It is submitted that the DTI have accomplished what it has set out to do.

In addition, a new innovation of the Act is the incorporation corporate governance issues. Company law sets the framework in which the company operates and the recommended practices set out in the King III provides guidance for directors as to how they should direct the business of the company and make decisions on behalf of the company. It is submitted that the Act and King III complement each other.

The Companies Act 71 of 2008 contains provisions which allow certain bodies established under the law to make regulations. Furthermore, securities exchange regulations such as the JSE listing requirements determine the requirements that companies must fulfil in order to have their shares listed on the stock exchange. Listed companies in South Africa, have to comply with many legal and regulatory requirements.¹⁶⁵

It is submitted that the link between governance principles and the law is stated in King III and these duties of the board of directors under King III constitute legal duties.¹⁶⁶

The fact that King III operate on an 'apply or explain' basis and in the 'apply or explain' approach, the board of directors, in its collective decision making, could

¹⁶⁵ See para 3.6.

¹⁶⁶ See para 4.2.

conclude that to follow a recommendation would not, in the particular circumstances, be in the best interests of the company. The board could decide to apply the recommendation differently or apply another practice and still achieve the objective of the overarching corporate governance principles of fairness, accountability, responsibility and transparency. Explaining how the principles and recommendations were applied, or if not applied, the reasons, results in compliance.

It is therefore submitted that these principles does not suit or apply or fulfil a specific company's need, it could be amended or left out. The one size fits all approach is heavily criticised.¹⁶⁷

Furthermore, the global financial crisis has raised many corporate governance issues and this has led to many reviews and changes to the corporate governance system in the UK.¹⁶⁸ The Corporate governance Code contains broad principles and more specific provisions. Listed companies are required to report on how they have applied the main principles of the Code. They must either confirm that they have complied with the Code's provisions or they must provide an explanation for non-compliance.¹⁶⁹

The UK and South Africa have reformed their corporate governance regimes. The only logical conclusion that can be drawn from the above developments is the fact that both countries have shown that they strive for better corporate governance practices. This is evident from the different codes, reports, regulatory agencies, legislation and committees that have been established and developed over the past 20 years.

¹⁶⁷ See para 4.4 for the enforceability and efficacy under King III and its principles.

¹⁶⁸ See para 5.1.

¹⁶⁹ See para 5.2.

6.2 RECOMMENDATIONS

In light of the summaries and conclusion above, the most important recommendations arising from this research are as follows:

In South Africa, compliance with King III is mandatory for companies listed on the JSE, but for all other entities there is no statutory obligation to comply with King III Report and the Code. It is recommended that King III should be a mandatory code of best practice and should apply to all business entities and not just companies listed on the JSE.

The DTI and Mongalo¹⁷⁰ advocates for the imperativeness of good corporate governance for the South African economy. I strongly agree and recommend that all companies should strive for good corporate governance.

It is submitted that corporate governance is becoming too prescriptive, more difficult for companies to comply with and the high cost of compliance is becoming a problem.¹⁷¹ It is therefore recommended that the legislature and policy makers provide financial assistance to smaller companies for costs associated with compliance and reimburse such companies if it applied with all King III principles. In so doing, it encourages and provides incentive for other companies to adhere to King III.

Stakeholder interests have received no formal legal recognition under the Companies Act 71 of 2008. The Code strongly emphasises the importance of stakeholder interests and the triple bottom line or integrated approach that requires companies to have regard to social, economic and environmental concerns. It is recommended that the stakeholder's interests should receive formal recognition under the Act.

¹⁷⁰ See para 2.5.

¹⁷¹ See para 3.9 (n 106).

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