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# Towards Good Corporate Governance in South Africa: Private Enforcement versus Public Enforcement

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## **ABSTRACT**

This research paper investigates whether South Africa should opt for private enforcement as opposed to public enforcement to entrench good corporate governance. In so doing, the paper goes on to develop a framework for determining the suitability of an enforcement strategy.

It is submitted that to derive a sound enforcement strategy a three-pronged analysis is required. This analysis can be captured as follows:

1. Determining whether a country has good laws, principles and rules as it relates to corporate governance;
2. Evaluating the suitability of the enforcement framework of the country; and
3. Identifying prevailing corporate governance challenge(s).

The application of this analysis to the South African context reveals that South Africa has good laws, principles and rules as it relates to corporate governance. It also reveals that the enforcement framework is capable of assuring investors that their investments will be protected and hence suitable. As far as corporate governance challenges are concerned, it is reasoned that South Africa, as a leading emerging country, experiences corporate governance problems common to both developed and developing countries. South Africa would therefore be better equipped, if it had a balanced enforcement framework; recognising no priori winner between the two categories of enforcement. This is aligned with the latest empirical evidence, which holds that the 'multiple mechanisms' approach is evident in developed countries with strong financial markets.

Furthermore, it is also submitted that the establishment of good corporate governance is too important for emerging and developing countries to gamble with favouring one enforcement category over the other.

The adoption of this hypothesis, rules out the World Bank's provocative recommendation that private enforcement should be favoured over public enforcement at all costs.

## **PART A**

'Enforcement more than regulations, laws-on-the-books or voluntary codes is key to effective corporate governance, at least in transition and developing countries. Corporate governance and enforcement mechanisms are intimately linked as they affect firms' ability to commit towards their stakeholders, in particular towards external investors.'<sup>1</sup>

Erik Berglöf and Stijn Claessens

### **1. INTRODUCTION**

#### 1.1 Background: Corporate Law Reform

For the past six and half years a great deal of attention has been devoted to the reform of South African company law. The reform process commenced in September 2003, when the Department of Trade and Industry (DTI) initiated a reform programme that included a review of existing securities regulation and, of corporate structures and practices in the area of corporate governance. Subsequently, in March 2004 (and updated in June 2004) the DTI published a policy document on corporate law reform entitled 'South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform'. This policy paper explained that company law in South Africa would be reviewed and modernised. The objectives of the reform process were to align it with international trends and to accommodate the economic and legislative changes that have taken place in South Africa since the advent of democracy in 1994. The policy paper also explained that this reform process would occur in two stages. Firstly, urgent interim changes would be brought by the Corporate Law Amendment Act No 24 of 2006. The Act provided for, amongst others, assistance to acquire shares and greater protection of minority shareholders in respect of takeovers. The Act came into effect on 14 December 2007. Secondly, the new Companies Act will repeal and replace the entire Companies Act No 61 of 1973, when it becomes operational.

The promulgation of the new Companies Act No 71 of 2008 signalled the completion of a comprehensive overhaul of company law in South Africa. This Act is less bulky and complicated than its predecessor and it incorporates certain common law principles relating to companies,

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<sup>1</sup> Erik Berglöf and Stijn Claessens *Corporate Governance and Enforcement* (2003) at i.

directors and shareholders. Moreover, it was modelled on similar legislation in operation in New Zealand, Australia, Canada and United States (Maryland). Despite this ‘comprehensive’ exercise in reforming South African company law, particularly in respect of ‘laws on books’, the importance of enforcement should not be underestimated. Enforcement is regarded as being pivotal for the overall effectiveness of corporate governance. It is against this backdrop that this thesis focuses on enforcement strategies in relation to good corporate governance.

## 1.2. Research question

The research question to be addressed by this study is whether South Africa should favour private enforcement as opposed to public enforcement to entrench good corporate governance.

## 1.3 Scope of the study

The departure point of this research paper is that ‘statutory regulations, laws-on-books or voluntary codes’ are not by themselves adequate to address the issue of good corporate governance.<sup>2</sup> There is a need for enforcement to be looked at critically.

The research paper seeks to critically analyse whether South Africa should favour private enforcement as opposed to public enforcement to entrench good corporate governance. This analysis involves a two-pronged approach. Firstly, it aims to ascertain whether South Africa has in place the enforcement framework that assures public investors that their assets will be protected. This discussion will focus on the Companies Act No. 71 of 2008 and King III, specifically highlighting the corporate governance developments. The second part of the research paper will proceed to consider whether South Africa should favour private enforcement as opposed to public enforcement. In executing this objective, empirical work undertaken in securities law will be relied upon.

It is important to note that the Companies Act No. 71 of 2008 (hereafter referred to as the new Companies Act) was promulgated in April 2009 and is not yet in operation. Stakeholders

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<sup>2</sup> Supra at 1.

anticipate a commencement dated of 1 July 2010; however, this date seems unlikely after an editorial process was initiated to address mistakes that occurred during the processing of the Bill. Similarly, King III was finalised on 1 September 2009 and comes into operation on 1 March 2010. Despite their current status, this research paper will use both the new Companies Act and King III as its main source documents.

#### 1.4 Structure of the paper

To address the research question, the paper commences with a brief background of the company law reform process that has unfolded in South Africa in part A. This is followed with an overview of corporate governance. This discussion focuses on two main issues, namely: ‘what is corporate governance and why corporate governance’. This overview also includes an evaluation of the enforcement framework in South Africa as it relates to corporate governance. This discussion will include a high-level comparison between South Africa and United Kingdom in respect of the dominant enforcement tools available in both countries. United Kingdom has been selected for comparison primarily because of the available empirical evidence and since it is also a common law country. This comparison, however, is not without its shortcomings. It is recognised that the corporate governance challenges differ between developed and developing countries. Notwithstanding this, it will still be useful to be aware of the dominant enforcement tools available in a highly developed stock market such as the United Kingdom. The developments in United Kingdom could serve as lessons for South Africa. This section, part B, concludes by highlighting the relationship between corporate governance and enforcement.

The next section, part C, commences with an overview of enforcement. The discussion focuses on two elements, namely: ‘why enforcement and what is enforcement’ in relation to corporate governance. In so doing, a rudimentary framework of enforcement mechanisms is developed and an overview of literature on private enforcement versus public enforcement is provided. The discussion also highlights some of the important elements needed for enforcement. After establishing an understanding of enforcement it focuses on whether private enforcement should be favoured over public enforcement and vice versa. In part D, the paper summarises the discussion, highlights recommendations and proposes an analysis for assessing the viability of enforcement strategies.

## 1.5 Objectives of the research paper

This paper aims to –

- highlight the developments of the Company Law reform that has unfolded in South Africa, particularly focusing on developments relating to corporate governance;
- provide an overview of corporate governance;
- evaluate the enforcement framework as it relates to corporate governance with the aim of ascertaining whether it is capable of protecting providers of capital finance;
- determine whether South Africa should favour private enforcement as opposed to public enforcement to entrench good corporate governance; and
- make recommendations where necessary.

## 1.6 Methodology

The envisaged research is not of an empirical nature, but involves a literature study of books, journal articles, legislation and so forth. The study aims to critically analyse the various relevant empirical studies that has been conducted. This approach, however, is not without its shortcomings. The obvious limitation is that it only focuses on one aspect of corporate governance, namely: the protection of shareholders. The other is the reliance on empirical evidence of developed countries. Nevertheless, the approach serves as a good departure point to unveil and further the debate around good corporate governance in South Africa.

## **PART B**

### **2. GOOD CORPORATE GOVERNANCE**

‘As demand for investment funds increases in developed and developing nations, and barriers to the free flow of capital fall, policy makers have come to recognise that corporate governance is relevant to the ability to attract capital’ Holly J. Gregory and Marsha E. Simms<sup>3</sup>

As indicated in part A and in the quotation above, good corporate governance assures providers of corporate finance that their investments will be protected. Before an investigation can be launched into enforcement strategies and more specifically whether South Africa should favour private enforcement as opposed to public enforcement, it is necessary to ascertain whether South Africa has the enforcement framework that assures public investors that their assets will be protected.

#### 2.1 Overview corporate governance

Corporate governance has emerged as an important subject. The importance of the subject is recognised globally and has been spurred on by, amongst others, a series of high-profile business scandals, globalisation and the recent financial crisis.<sup>4</sup>

The concept of corporate governance was born out of the conflict of interests between a company’s owners and its hired managers. This conflict arose when the ownership of companies became separated from the control of the company, which meant that the firm’s owners (principals) no longer managed the company, since the responsibility to manage the company was shifted to the managers (agents) of the company. The agency problem<sup>5</sup> gave rise to a

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<sup>3</sup> Gregory and Simms *Corporate Governance: What it is and Why it matters* (1999) at 1.

<sup>4</sup> Tshepo Mongalo *The Emergence of Corporate Governance as a fundamental research topic in South Africa* (2003) at 175-178.

<sup>5</sup> In its most basic sense an agency-problem is a term adopted to depict a situation where the well-being of one person (the principal) depends upon the actions of another person (the agent).

situation where the managers of companies could abuse their control function to the detriment of the owners.<sup>6</sup>

Corporate governance was consequently introduced to provide meaningful protection to the principals by guarding against opportunistic behaviour by some agents. This protection was essentially introduced to ensure that agents control companies in ways that will serve the interests of their principals.<sup>7</sup>

Despite the prominence of corporate governance in the modern world, the concept is not new.<sup>8</sup> The principles underlying corporate governance are as old as company law itself and can thus be traced back to the 17<sup>th</sup> Century – a case in point is the incorporation of the Dutch-East Indian Company (the VOC). The incorporation of the VOC saw the first issue of shares to members of the public. Consequently, giving rise to the agency problem where ownership of the company was separated from the control of the company. Pursuant to this occurrence, the buying and selling of shares became a popular practice.<sup>9</sup>

Despite its long history, new corporate governance principles are still being incorporated into the system. This is primarily as a consequence of reforms. To highlight the distinction between the new corporate governance principles and the established corporate governance principles, Mongalo (2003) categorizes these principles as belonging to either the self-regulatory regime or the traditional corporate governance regime. This traditional corporate governance regime (also referred to as the conventional regime) generally refers to established principles that have long been provided for in common law or company legislation. As a result, these principles of corporate governance are generally backed by legal enforcement. These include: fiduciary duties of directors, requirements for special resolutions, the role of shareholders and company meetings. It is important to highlight that even though the traditional corporate governance regime is backed by legal enforcement it does not necessarily mean that the enforcement is effective. On the other hand, self-regulatory regime refers

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<sup>6</sup> John Armour, Henry Hansmann and Reinier Kraakman *The Anatomy of Corporate Law: A Comparative and Functional Approach* (2009) at 3.

<sup>7</sup> Ibid.

<sup>8</sup> Tshepo Mongalo *The Emergence of Corporate Governance as a fundamental research topic in South Africa* (2003) at 178-179.

<sup>9</sup> Frentrop *A History of Corporate Governance* (2003) at 60-64.

to the new corporate governance principles that are concerned with, amongst others, the improvement of the rules and principles of company direction; and development of stricter checks and balances to alleviate wrongdoings of those engaged in corporate decision making. The objective of these principles is to equip companies to operate in the modern environment. This corporate governance regime is backed by codes of good practice.<sup>10</sup> This matter will be expanded upon later under item 2.2.

### 2.1.1 What is corporate governance?

Corporate governance has a number of interpretations.<sup>11</sup> Experts in the area prescribe the boundaries of the subject in different ways and therefore are unable to agree on a universal definition. For the purpose of the research paper, two approaches to corporate governance will be highlighted, which are essentially regarded as the ‘modern views’ of corporate governance.<sup>12</sup>

Some experts, including Sir Adrian Cadbury, define corporate governance as ‘the system by which companies are directed and controlled’.<sup>13</sup> In terms of this definition, the main objective of corporate governance is to ensure that the investments of those who supply a company with finances are increased exponentially. A number of consequences flow from adopting this definition of corporate governance. Firstly, it would mean that a director’s performance will be dependant on the rate of return which the investor receives. In other words, if the investor receives a significant return on his or her investment then a director has automatically performed well. Conversely, if the return is negative or insignificant then it implies that the director has failed to perform. Secondly, when a director engages in corporate decision making, the director is only obliged to consider the interest of shareholders, disregarding the interest of other

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<sup>10</sup> Tshepo Mongalo *Self Regulation versus Statutory codification: Should the new regime of corporate governance be accorded statutory backing?* (2004) at 267.

<sup>11</sup> “[C]orporate governance is one of those fundamental yet nebulous concepts which may claim to understand and implement but which few can define comprehensively or even succinctly.” Horrigan *Fault lines in the intersection between corporate governance and social responsibility* (2002) at 515.

<sup>12</sup> Tshepo Mongalo *Self Regulation versus Statutory codification: Should the new regime of corporate governance be accorded statutory backing?* (2004) at 265.

<sup>13</sup> *Committee on the Financial Aspects of Corporate Governance (Chairperson: Sir Adrian Cadbury) Final Report and Code of Best Practice* (December 1992) (“Cadbury Report”) at par 2.5.

stakeholders, which include employees and suppliers. This approach to corporate governance is considered to be the narrow approach to corporate governance.<sup>14</sup>

The 'broad approach' to corporate governance views corporate governance as being mainly concerned with reaching a balance between economic and social goals. This 'balancing act' is viewed as the basis for governing and controlling a company. Accepting this view of corporate governance infers that the company should be run as a community having regard to all stakeholders. Unlike the narrow view of corporate governance, this approach considers the interest of all stakeholders. Therefore a company's success is dependant on reaching a state of equilibrium between the interests of all stakeholders. These approaches to corporate governance become essential when stakeholders issues are considered.<sup>15</sup>

Berglöf (2006) contends that irrespective of the preferred approach, corporate governance is primarily a means by which a company can assure investors that it is a well-run institution to which investors and lenders can confidently commit their funds.<sup>16</sup>

Now that the approaches to corporate governance have been outlined, the discussion will focus on what is meant by good corporate governance. The Organisation for Economic Cooperation and Development (OECD) has identified four 'core standards' of good corporate governance. These include:

- Fairness;
- Transparency;
- Accountability; and
- Responsibility.<sup>17</sup>

Spurred on by the Asian financial crisis, the Business Sector Advisory Group recommended that the OECD promote and further articulate these four core standards of corporate governance.

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<sup>14</sup> Tshepo Mongalo *Self Regulation versus Statutory codification: Should the new regime of corporate governance be accorded statutory backing?* (2004) at 265-266.

<sup>15</sup> *Supra* at 266.

<sup>16</sup> Erik Berglöf *A Note on Corporate Governance and Development* (2006) at 2.

<sup>17</sup> OECD *Principles of Corporate Governance* (2004) at 17.

Subsequently, in April 1999 a set of corporate governance principles were developed. These principles are non-binding and provide guidance on the implementation of good corporate governance.<sup>18</sup> They include:

- **Fairness:** The concept of fairness can be broken down into two principles. The first principle states that: ‘The corporate governance framework should protect shareholders rights.’<sup>19</sup> Unpacking this principle, it is evident that it considers shareholders as property owners. As such, shareholders have a right to hold and convey their interest in the company. Therefore to establish good corporate governance requires laws, procedures and practices that protect this property right and ‘ensure secure methods of ownership, registration and free transferability of shares.’<sup>20</sup> This principle also recognises that shareholders have participatory rights on key corporate decisions. These include: election of directors, the approval of mergers and acquisitions, using of proxies for voting. Principle II states that: ‘The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.’<sup>21</sup> This principle refers to the protection of minority shareholders against misappropriation of assets or self dealing by controlling shareholders, managers or directors. This protection can be achieved by rules that impose fiduciary duties or regulate transaction by corporate insiders and mechanisms that enforce these rules. An example of such a mechanism is a derivative action.<sup>22</sup>
- **Transparency:** Principle IV states that : ‘The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company.’<sup>23</sup> This principle recognises that stakeholders, which include shareholders and investors, need information on the company’s financial performance, corporate

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<sup>18</sup> OECD Principles of Corporate Governance (2004) at 4.

<sup>19</sup> *Supra* t 17.

<sup>20</sup> Gregory and Simms *Corporate Governance: What it is and why it matters* (1999) at 8.

<sup>21</sup> OECD Principles of Corporate Governance (2004) at 17.

<sup>22</sup> Gregory and Simms *Corporate Governance: What it is and why it matters* (1999) at 8.

<sup>23</sup> OECD Principles of Corporate Governance (2004) at 22.

governance practices and corporate ownership. Having access to relevant information timeously serve as a critical tool to keep the company's managers and directors in check.<sup>24</sup>

- **Accountability:** Principle V states that: 'The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board and the board's accountability to the company and the shareholders.'<sup>25</sup> This principle encapsulates directors' legal duties, which they owe to the company and its shareholders. Furthermore, the principle recognises that the board is responsible for monitoring managers and holding them accountable for the use of the company's assets.
- **Responsibility:** Principle III states that: 'The corporate governance framework should recognise the rights of stakeholders as established by law and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and sustainability of financially sound enterprises.'<sup>26</sup> This principle recognises that a company must comply with the laws and regulations of the country within which it operates.<sup>27</sup>

It is also important to note that corporate governance practices vary across nations. This is as a consequence of 'distinct societal values, different ownership structures, business circumstances and competitive conditions'.<sup>28</sup> Good corporate governance therefore has a unique meaning for a specific country. Good corporate governance is impacted by the 'strength and enforceability of contracts, the political standing of shareholders and debt holders, and the development and enforcement capacity of the legal system'.<sup>29</sup> Furthermore, there are also distinct differences in the corporate governance challenges faced by developed, developing and emerging countries.<sup>30</sup> In emerging and developing countries the corporate governance challenge generally involves 'balancing incentives for controlling shareholders and protecting minority rights against actions

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<sup>24</sup> Gregory and Simms *Corporate Governance: What it is and why it matters* (1999) at 8.

<sup>25</sup> OECD Principles of Corporate Governance (2004) at 22.

<sup>26</sup> *Supra* at 21.

<sup>27</sup> Available on [http://www.oecd.org/document/49/0,3343,en\\_2649\\_34813\\_31530865\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,3343,en_2649_34813_31530865_1_1_1_1,00.html).

<sup>28</sup> Gregory and Simms *Corporate Governance: What it is and why it matters* (1999) at 6.

<sup>29</sup> *Ibid.*

<sup>30</sup> Erik Berglöf and Stijn Claessens *Corporate Governance and Enforcement* (2003) at 20.

by insider shareholders’<sup>31</sup> whereas the corporate governance challenge in developed countries relates to rendering managers accountable to shareholders.<sup>32</sup>

It follows that understanding what constitutes good corporate governance must therefore consider the legal environment and cultural values of a specific country. As such, establishing good corporate governance is largely a matter to be considered by the specific nation and the private sector that operates within that society.

### 2.1.2 Why corporate governance?

‘The governance of the corporation is now as important in the world economy as the government of countries.’  
James D. Wolfensohn, the ex President of the World Bank<sup>33</sup>

This quotation encapsulates the importance of implementing good corporate governance. There are a number of reasons why good corporate governance is a prerequisite for a well-run company. The first reason for implementing good corporate governance is to enhance the ability of companies to attract lower-cost investment capital. Corporate governance achieves this by improving both local and international investor confidence. In other words, good corporate governance assures investors that their assets will be used as agreed upon. This benefit of corporate governance was affirmed in a study conducted by McKinsey and Company in June 2000, where it was shown using empirical evidence that effective corporate governance attracts investors.<sup>34</sup> The study concluded that 80% of shareholders in the United Kingdom were prepared to pay a premium price for shares in a company that has established good corporate governance. This study also found that 75% of investors equated financial performance with good board practices. These results were confirmed by McKinsey and Company whilst conducting a similar survey in 2002.<sup>35</sup>

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<sup>31</sup> Ibid.

<sup>32</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* at 1.

<sup>33</sup> James D Wolfensohn *A Battle for Corporate Honesty* (1999) at 38.

<sup>34</sup> McKinsey and Company *Investor Opinion Survey on Corporate Governance (June 2000)*.

<sup>35</sup> McKinsey and Company *Global Investor Opinion Survey (July 2002)*.

Secondly, implementing good corporate governance relates to the maximisation of wealth. This is achieved by promoting the efficient use of resources both within the company and the larger economy. Improving the efficiency of the company's assets in turn results in the improvement of the company's performance.<sup>36</sup>

Societies are relying on companies to play a key role in economic growth and development. In this regard, good corporate governance also enhances a firm's ability to meet societal expectations. Society expects company's to play a role in alleviating poverty and improving the standards of living.<sup>37</sup>

Fourthly, implementing good corporate governance plays a pivotal role in protecting investors. It is reasoned that when good corporate governance is implemented it facilitates oversight and holds the board and management accountable for the management of the corporation. This oversight and accountability together with the efficient use of resources, improved access to lower-cost capital and increased responsiveness to societal needs and expectations – should ensure improved corporate performance. It is noted that good corporate governance may not guarantee a company improved corporate performance but it can improve a company's chance of survival. Moreover, a well-run company is less susceptible to takeover, mergers or bankruptcy. The empirical evidence that has been undertaken to link good corporate governance to corporate performance has revealed contradictory findings. Experts in the field have argued that the link between good corporate governance and corporate finance makes intuitive sense.<sup>38</sup> It is also worth noting that the evidence collected from recent corporate failures, which include Enron, WorldCom and Leisurennet indicates that corporate failure was as a consequence of ineffective corporate governance.<sup>39</sup>

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<sup>36</sup> Gregory and Simms *Corporate Governance: What it is and why it matters* (1999) at 4.

<sup>37</sup> *Supra* at 3-4.

<sup>38</sup> *Supra* at 5.

<sup>39</sup> Segal *Corporate Governance: substance over form* (2002) at 320.

Another reason to implement good corporate governance is to reduce the likelihood of corruption in business dealings. Even though good corporate governance cannot prevent corruption, it does allow for the early detection of corrupt practices.<sup>40</sup>

These benefits of good corporate governance are ensured by, amongst others, –

- demanding that directors adhere to their fiduciary duties; namely: good faith, care, skill and diligence;<sup>41</sup>
- adopting standards for transparency, particularly regulating the interaction between the company and the investors or creditors;
- insisting on transparency in corporate transactions, in accounting and auditing procedures, in all individual business transactions; and
- developing sound company strategy and ensuring that mergers and acquisitions are executed for sound business reasons, and that the rewards are linked to performance.<sup>42</sup>

## 2.2. Corporate governance framework in South Africa

To assess whether South Africa has the enforcement framework that assures public investors that their assets will be protected, the discussion will now primarily focus on the developments of the four main elements upon which the foundation of good corporate governance rests, namely:

- the Companies Act No 71 of 2008 (the new Companies Act);
- common Law;
- King III; and
- other statutes.

This discussion departs with the findings of empirical work undertaken by Deutsche Bank Securities Inc. in which they sought to evaluate corporate governance in South Africa and the comments and recommendations made in King II. This valuation by Deutsche Bank Securities Inc. was conducted in August 2002. At that time already they held, with the support of empirical

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<sup>40</sup> Holly J. Gregory and Marsha E. Simms *Corporate Governance: What it is and Why it matters* (1999) at 5.

<sup>41</sup> Mervyn King *The Corporate Citizen* (2006) at 126.

<sup>42</sup> Holly J. Gregory and Marsha E. Simms *Corporate Governance: What it is and Why it matters* (1999) at 7.

evidence that South Africa was a leader, amongst emerging markets, in the implementation and enforcement of corporate governance standards.<sup>43</sup> They also noted that the challenges facing the corporate governance framework at the time included: enforcement, lack of awareness by directors of their responsibilities and rising levels of corruption.<sup>44</sup> In respect of enforcement, they note that the existing legislation at the time was strong, even comparable to developed countries. However, South Africa suffers from weak enforcement partly due to a lack of financial resources attached to the task. Furthermore, they indicated that the judicial system is loaded with unresolved cases that impact on its ability to resolve cases speedily.<sup>45</sup>

King II also addressed factors contributing to the inefficiencies in enforcing conventional corporate governance principles. They identified a lack of resources and challenges associated with the criminal justice system as influencing the effectiveness of conventional corporate governance principles. King II explained that the criminal justice system is under-resourced and in instances where resources were available, it was not effectively used. King II also identified the poor resources available at the South African Police Services (SAPS) as contributing to weak enforceability. It was explained that the SAPS did not have the necessary expertise to investigate commercial cases nor were prosecutors adequately trained to prosecute commercial cases. This view also ties in with the sentiment to de-criminalise company law.<sup>46</sup>

To improve enforceability, King II<sup>47</sup> made the following recommendations:

- The office of the Registrar of Companies needs to be adequately resourced to regulate compliance with the Companies Act;
- Enforcing and improving civil remedies; and
- Introduction of class actions, contingency fees and register of delinquent directors.<sup>48</sup>

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<sup>43</sup> Deutsche Bank Inc *Global Corporate Governance: Valuing Corporate Governance in South Africa* (2003) at 40.

<sup>44</sup> Supra at 41.

<sup>45</sup> Supra at 39-42.

<sup>46</sup> Department of Trade and Industry *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform* (2004).

<sup>47</sup> Report on Corporate Governance (King II) 2002.

<sup>48</sup> This has subsequently been codified; see section 162 of the Companies Act No 71 of 2008.

### 2.2.1 The Companies Act

This discussion will focus on the developments in respect of South Africa's regulatory framework with the view of highlighting its improvements.

The Companies Act No 61 of 1973 is still in operation and is to be replaced by the new Companies Act in its entirety. As mentioned earlier, the new Companies Act was promulgated in April 2009 and is not yet in operation. At the time of writing this research paper, there was no certainty as to when the Act would commence.<sup>49</sup>

The promulgation of the new Act was preceded by a reform process that involved a complete overhaul of South African Company Law. Despite the comprehensive corporate law reform process, it does not infer a complete abolishment of company law jurisprudence. As part of the reform process it was decided to retain many provisions of the current law which were found to be 'appropriate for the legal, economic and social context of South Africa as a constitutional democracy and open economy'.<sup>50</sup>

Important features of the new Act include:

- modernises company law and aligns it with international best practice, especially in relation to corporate governance, communications and public companies;
- simplifies company law by -
  - introducing simpler administrative and other procedures;
  - reducing the number of provisions from 450 to 225;
  - using simple language; and
  - introducing simpler administrative and other procedures;

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<sup>49</sup> Also worth noting is that draft regulations in respect of the Act was published. However, there was much uproar about its completeness and applicability. This could further delay the commencement date of the Act.

<sup>50</sup> The Department of Trade and Industry *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform* (2004) at chapter 1.

- promotes transparency, high standards of corporate governance and accountability, particularly by directors and other officers, including minimum standards for annual reports;
- gives greater protection to minority shareholders;
- codifies the fiduciary duties of directors and liabilities of directors;
- includes a complete overhaul of provisions relating to Takeovers; and
- introduces a new business rescue regime which replaces the judicial management system.<sup>51</sup>

For the purpose of this research paper, focus will primarily be placed on the provisions ensuring enforcement. This discussion in itself will be divided into general provisions and provisions that establish regulatory agencies.

#### (a) General provisions

In this regard, the discussion will focus on chapters 2 and 7 of the new Companies Act. Chapter 2 deals with 'Formation, Administration and Dissolution of Companies' and includes governance of companies whilst chapter 7 deals with remedies and enforcement.

Chapter 2 retains most of the provisions found in the old Companies Act relating to corporate governance; however the following changes were incorporated:

- quorum of 25% is required at a general meeting (s 73);
- shareholders are entitled to participate in meetings by electronic communication (s 74);
- the duties of directors were codified (s 75-78); and
- the provisions relating to conflict of interest, directors' liability, indemnities and insurance were supplemented (s 77-78).

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<sup>51</sup> Update on Companies Act by Bowman and Gilfillan (2009).

Of particular importance is the codification of directors' duties.<sup>52</sup> In order to ensure that directors know what their duties are and what is expected of them, the new Companies Act attempts to create certainty by partially codifying the duties of directors. Whether this is the best means available to increase awareness around directors' duties continues to be a subject of an ongoing debate. This debate, however, is not related to the objective of this research paper. It is safe to say that the 'codification does not entail a rigid fixation of law, but a proposed code with provisions that if used correctly by courts, can ultimately lead to the development of the law, based on existing principles of South African common law.'<sup>53</sup> To supplement this view, a distinction can be drawn between complete codification and partial codification. Complete codification cannot accommodate an environment that is subject to change as opposed to partial codification that allows for some room for development of common law since it is based on general principles of law. The option chosen by the new Companies Act therefore allows for some room for development of the common law.<sup>54</sup>

Chapter 7 makes provision for remedies and enforcement. Like its predecessor, the chapter also provides that the High Court remains the main medium for remedies. It also retains the existing remedies whilst introducing additional remedies, which includes:

- right to seek a declaratory order as to a shareholder's rights (s 161);
- right to submit an application to have a director declared delinquent or under probation (s 162);
- appraisal rights for dissenting shareholders to certain actions (s 164);
- Derivative action; which gives a person other than a company the right to bring legal action in the name of the company – (s 165 - statutory derivative action)<sup>55</sup>; and
- improves the regime to protect 'whistle-blowers' and establishes a stronger right for an aggrieved person to address the court on a matter before it – (s 159).

It is worth highlighting the inclusion of a derivative action in the new Company Law Act since this action authorises a minority shareholder to commence legal action in the name of the

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<sup>52</sup> Sections 75-78 of the Companies Act 71 of 2009.

<sup>53</sup> Walter Geach *Statutory, Common Law and Other Duties of Directors* (2009) at 8.

<sup>54</sup> *Supra* at 9.

<sup>55</sup> This provision abolished the common law derivative action.

company. This action is pursued to redress the wrongs done to the company.<sup>56</sup> In contrast to the normal rules of corporate action – the decision to commence legal action in the name of the company – a derivative action does not require approval by the board of directors or by the company’s general meeting. This action bypasses these formal procedures and allows a minority shareholder to bring an action on behalf of the company. A derivative action therefore amounts to an exception to the ordinary principle of corporation, since it does not subscribe to the majority rule principle. On this basis, this should be regarded as a powerful deterrent.<sup>57</sup>

It is important to note that there is a distinct difference between the derivative actions as contained in the new Act compared to the derivative action of the previous Act. As indicated above, s 165 of the new Companies Act regulates derivative actions. Section 165(1) abolishes the common law derivative action whilst s 165(2)-(6) provides for the new statutory derivative action. Unlike s 266 of the previous Act, s 165 is much broader in its application and spells out a different procedure to be followed. Also s 165 widens the net of parties that can initiate a derivative action. Under s 266 of the previous Act, the initiation of derivative actions was limited to shareholders only whereas s 165(2) allows the following persons to initiate proceedings –

- a shareholder or a potential shareholder of the company or of a related company - s 165(2) (a);
- a director or prescriber officer of the company or of a related company - s 165(2) (b);
- a registered trade union or another representative of the company’s employees - s 165(2) (c); or
- person who has been granted permission to protect the ‘legal rights of that other person’ - s 165(2) (d).

It is also worth noting that both the remedies provided by s 161 and s 162 are new to the company law set-up; as they were not found in the previous legislation.<sup>58</sup>

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<sup>56</sup> S 165 of the Companies Act No 71 of 2008.

<sup>57</sup> John Armour *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US* (2009) at 19-21.

<sup>58</sup> Sections refer to the Companies Act No 71 of 2008.

## (b) Regulatory agencies

This discussion focuses on the main functions of the regulatory agencies identified in Chapter 8 of the new Companies Act and also highlights the remedies and enforcement procedures which these entities will make available to any person entitled to apply for relief. This chapter establishes one new institution, namely the Companies Tribunal and transforms the three existing entities, namely the Companies and Intellectual Property Registration Office (CIPRO), the Securities Regulation Panel (“SRP”), and the Financial Reporting Standards Council (“FRSC”), into new bodies.<sup>59</sup>

### (i) The Companies and Intellectual Property Commission

Section 185 of the new Companies Act establishes the Companies and Intellectual Property Commission (the Commission) as a juristic person. This agency has evolved from CIPRO. The main difference between the Commission and CIPRO is that the Commission’s functions and powers have significantly been expanded.

The Commission will be tasked with –

- enforcing the Companies Act. The enforcement excludes matters that fall in the exclusive jurisdiction of the Takeover Regulation Panel. In so doing, the Commission can promote voluntary resolution of disputes between a company and shareholder or director; and monitor compliance with the new Companies Act. It is also important to note the enforcement of the new Companies Act entails receiving or initiating complaints concerning alleged contravention of the new Companies Act, evaluating complaints and initiating investigations into complaints – s 187 (2).
- promoting the reliability of financial statements by monitoring patterns of compliance with, and contraventions of, financial reporting standards – s 187 (3).
- the registration and deregistration of companies, external companies and intellectual rights. This function includes establishing and maintaining information concerning

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<sup>59</sup> Meiring, Ina *Regulatory Agencies in terms of the Companies Act 71 of 2008* (2009) at 1-2.

companies and making the information available to the public and to other organs of state. This information should be kept in relevant registers in the prescribed form and manner – s 187(4); and

- accrediting a juristic person or an association of persons, with or without conditions, that functions mainly to provide conciliation, mediation or arbitration services – s 166(4) (a). The Commission must also monitor the effectiveness of any accredited person or an association relative to the purpose and policies of the Companies Act – s 166(4)(b).

Furthermore, the Minister may issue policy directives to the Commission regarding the application, administration and enforcement of the new Companies Act. The Commission may also receive directions from the Minister regarding investigations to be conducted into alleged contraventions of the Companies Act.<sup>60</sup>

The order issued by the Commission could have the status of a High Court order provided that certain procedural requirements are met.<sup>61</sup>

#### (ii) The Companies Tribunal

Section 193 of the New Companies Act establishes the Companies Tribunal (the Tribunal) as a juristic person with jurisdiction throughout South Africa.

The functions of the Companies Tribunal include:

- Adjudicating in relation to any application that may be made to it, and make and order as provided for in the Companies Act in respect of such an application; and
- Assisting in the resolution of disputes.<sup>62</sup>

Importantly, s 195 (7) provides that a ‘decision by the Companies Tribunal on a decision, notice or order by the Commission is binding on the Commission, subject to any review by the court’. It

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<sup>60</sup> Section 190 of the Companies Act No 71 of 2008.

<sup>61</sup> Ibid.

<sup>62</sup> Section 195 of the Companies Act No 71 of 2008.

is important to note that an order of the Companies Tribunal may be filed in the High Court as an order of the court – s 195(8).

### (iii) The Takeover Regulation Panel

Section 196 of the new Companies Act also establishes a Takeover Regulation Panel ('the Panel') as a juristic person with powers similar to the existing Securities Regulation Panel.

The Panel is responsible to –

- regulate any affected transaction and offers;
- investigate complaints regarding affected transactions and offers; and
- apply for a court order to wind up a company.<sup>63</sup>

Moreover, the Minister, in consultation with the Panel, is responsible for prescribing the Takeover regulations which will provide, amongst others, for the compliance with and enforcement of the administration, operation and procedures of the Panel, prescribed fees and levies imposed on certain companies, and any other matter relating to the powers and functions of the Panel.<sup>64</sup>

The Panel also has the power insofar as to ensure compliance with, amongst others the Takeover Regulations, to issue a compliance order that prohibit or require any action by a person, or order a person to divest of an acquired asset, or account for profits – s 119(5). Furthermore, s 119(6) provides that the Panel may exempt an offeror to an affected transaction or an offer from the application of any provision if -

- there is no reasonable potential of the affected transaction prejudicing the interests of any existing holder of a regulated company's securities,
- the cost of compliance is disproportionate relative to the value of the affected transaction, or
- doing so is otherwise 'reasonable and justifiable in the circumstances'.

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<sup>63</sup> Section 201 of the Companies Act No 71 of 2008.

<sup>64</sup> Section 201(d) of the Companies Act No 71 of 2008.

This exemption may be ‘wholly or partially’, and or subject to conditions.

(iv) The Financial Reporting Standards Council

Section 203 of the new Companies Act establishes the Financial Reporting Standards Council (the Council). The functions of the Council include –

- receiving and considering any relevant information relating to the reliability of, and compliance with, financial reporting standards. This function include adapting international reporting standards for local circumstances and considering recommendations from the Commission for amendments to financial reporting standards – s 204 (a),
- advising the Minister on matters relating to financial reporting standards – s 204(b); and
- consulting with the Minister on the regulations which establishes financial reporting standards s 204 (c).

From the above it is clear that the new Companies Act provides for various alternative procedures to address complaints; regulate disputes, address contraventions of the Companies Act and enforce provisions of a company’s Memorandum of Incorporation and rules, other than seeking relief via the High Court. Examples of alternative procedures for addressing complaints or securing rights include the following:

- the Companies Tribunal or an accredited entity can resolve disputes through an alternative dispute resolution;
- an application can be made to the Companies Tribunal to adjudicate a matter which falls within its jurisdiction as determined by the Companies Act; and
- the Commission and the Panel are also empowered to receive and investigate complaints and to issue compliance notices.<sup>65</sup>

It is anticipated that the new Companies Act will –

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<sup>65</sup> Meiring, Ina *Regulatory Agencies in terms of the Companies Act 71 of 2008* (2009) at 1-2.

- improve regulatory oversight, enforcement and redress for shareholders especially minorities;
- improve transparency and accountability of public interest firms;
- reduce regulatory burden for small and medium sized firms; and
- reduce cost of registration and maintenance of companies.<sup>66</sup>

### 2.2.2 Common law

Common law refers to law which is not contained in the statute books of a country but which nevertheless over time and through wide acceptance has gained the force of law. The common law which pertains to companies arose primarily as a result of judicial interpretation of the Act and the general body of company law. This body of law draws extensively on English legal precedent.<sup>67</sup>

In addition to the statutory duties prescribed by the Act, there are certain common law duties, also known as fiduciary duties, incumbent on the directors and officers of a company. A fiduciary duty simply means that a director of a company must exercise the powers and perform the functions of director in good faith and in the best interests of the company. Also the directors owe the duty to the company itself and not to the shareholders or stakeholders.<sup>68</sup>

In the event that a director breaches his fiduciary duty, a company has three primary remedies, namely:

- a right to claim any profit or business opportunity that was obtained or kept;
- a right, in certain circumstance to set aside transactions entered into; and
- a right to claim monetary compensation for any loss or damage.<sup>69</sup>

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<sup>66</sup> Department of Trade and Industry *South African Company Law for the 21<sup>st</sup> Century: Guidelines for Corporate Law Reform* (2004).

<sup>67</sup> Walter Geach *Statutory, Common Law and Other Duties of Directors* (2009) at 9.

<sup>68</sup> *Ibid.*

<sup>69</sup> Michael Judin *Director's legal responsibilities override corporate governance diktats* (2008)24-25.

### 2.2.3 The King Report on Corporate Governance (King III)

King III was published in February 2009 and stakeholders were invited to comment on the draft. This report was given effect to as a result of the recent corporate law reform process in South Africa which included the promulgation of the new Companies Act and the developments in international corporate governance.<sup>70</sup>

As was the case with King I and King II, the Committee aimed to be at the forefront of corporate governance. This objective has arguably been realised by its proposal to report annually on how a company has affected the economic life of the community in which it operates.<sup>71</sup> In addition, King III also recommends that a company's reporting should be extended to include a reference on its efforts to improve the positive aspects and eradicate any possible negative aspects that impacts on the economic life of the community in which it operates.<sup>72</sup>

Another distinguishing feature of King III is that it broadens the scope of corporate governance in South Africa by emphasizing leadership, sustainability and being a good corporate citizen<sup>73</sup>. Moreover, King III places emphasis on the following emerging governance trends; namely: Alternative Dispute Resolution (ADR), Risk based internal audit, IT governance, Shareholders and remuneration, and Evaluation of the board of directors and the board committees. In respect of ADR, the report supports controlled mediation to resolve disputes. In the event that the ADR is unsuccessful, the report recommends expedient arbitration. It is also worth noting that an enforceable alternative dispute resolution clause has been developed for inclusion in agreements.<sup>74</sup>

King III states that the Code applies to all companies 'regardless of the manner or form of incorporation or establishment', and has opted for an 'apply or explain' governance framework.<sup>75</sup> This means that a company is not compelled to follow King III strictly, the

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<sup>70</sup> Andries Brink *Corporate governance and the Companies Act* (2009) at 6.

<sup>71</sup> DLA *Update: Company Law* (2009) at 1.

<sup>72</sup> Andries Brink *Corporate governance and the Companies Act* (2009) at 7.

<sup>73</sup> Andries Brink *Corporate governance and the Companies Act* (2009) at 7 and Chapter 2 of the King Report III.

<sup>74</sup> Andries Brink *Corporate governance and the Companies Act* (2009) at 7.

<sup>75</sup> *Ibid.*

company can deviate from the principles contained in King where the company believes it is in the best interest of the company but it must explain. Hence, even if a company fails to mechanically implement the principles in King III, by explaining the basis for its decision will still render it consistent with the spirit of King III. This arrangement empowers stakeholders to be in a position to challenge the board on the level of governance in an organisation. There is a view which holds that this approach is more burdensome. It is explained that this approach goes beyond the 'tick box compliance' approach to an approach that involves more consideration of what is actually done to implement the code.<sup>76</sup> Another view sees this approach as deliberately equating the principles and recommendations to that of law.<sup>77</sup>

The corporate governance framework recommended by King III is principles-based. As such there is no one size fits all approach and even though entities are strongly encouraged to adopt the principles contained in King III as far as practically possible. This principles-based approach takes into consideration the different size, nature and complexity of various organisations. It has been argued that this approach avoids some of the shortcomings evident in the United States where a 'one size fits all approach' was initially adopted.<sup>78</sup>

The main criticism levelled against this Report is based on the fact that the report is simply a set of principles as opposed to laws and therefore could easily be circumvented. In response to this view, it has been argued that the market place should be the primary compliance enforcer and therefore there is no need to give these principles legislative backing. The latter view encapsulates the approach taken by King III. These sentiments capture an on ongoing debate which centres on the enforceability of the Code.<sup>79</sup>

The Codes of good corporate principles, in particular King II, have indicated that new principles of good corporate governance do not require further legislation. The reasoning behind this preference is based on the idea that the Code should be self-regulatory for principles that do not enjoy legal remedies. The main reason afforded for making the Code non-prescriptive is that

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<sup>76</sup> Johan Coetzee *Update on Company Law* (2009) at 1-3.

<sup>77</sup> Walter Geach *Statutory, Common Law and Other Duties of Directors* (2009) at 6.

<sup>78</sup> Andries Brink *Corporate governance and the Companies Act* (2009) at 7.

<sup>79</sup> DLA *Update: Company Law* (2009) at 2-3.

significant differences exist between companies. In other words, the Codes recognise that some companies are better positioned to implement the recommendations contained in the Code whilst other companies are not capable of implementing them. The system of self regulation is thus favoured for its flexibility.<sup>80</sup>

For purposes of completeness it will be useful to highlight the advantages and disadvantages for adopting a self regulatory system. In a paper entitled 'Standards of Self-Regulation of the Securities Markets' the International Capital Markets Group identifies a number of advantages of self regulation.<sup>81</sup> These include:

- Unlike the statutory system, self-regulation allows for the imposition of ethical standards;
- A self-regulatory system has built in checks and balances which facilitates oversight;
- A self-regulatory system is a more complete system as opposed to the statutory approach. It is also more cost effective to operate and implement; and
- Such a system is also based on a willingness to be regulated.<sup>82</sup>

In addition, it is recognised that such a system is more flexible than a system with legal backing. In other words, a self regulatory system is amenable to change and can therefore keep abreast with changes in the corporate world. This characteristic is not true for a system that enjoys legal backing. The disadvantage of the statutory approach is that it is based on the notion that 'one size fits all' approach. As has been highlighted before, this is not the case in the corporate world.<sup>83</sup>

In contrast, this self-regulatory system is susceptible to non-compliance since it is not associated with serious sanctions. This shortcoming is exacerbated in instances where compliance is of an urgent nature. Black Economic Empowerment (BEE) and affirmative actions have been identified as initiatives that required urgent attention. In respect of both these initiatives the corporate world was slow to respond and calls to legislate on these issues were intensified to cure the lack of compliance.<sup>84</sup>

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<sup>80</sup> Tshepo Mongalo *Self Regulation versus Statutory codification: Should the new regime of corporate governance be accorded statutory backing?* (2004) at 270.

<sup>81</sup> *Supra* at 275.

<sup>82</sup> *Supra* at 275-276.

<sup>83</sup> *Supra* at 274-276.

<sup>84</sup> *Supra* at 277-279.

It is also worth noting that companies listed on the Johannesburg Stock Exchange (JSE) are required to divulge their extent to which they are complying with King II and where companies deviate from the Code, they are required to explain their deviance. Also the JSE has revised its listing requirements in 2000 to improve corporate governance. The new listing requirements include:

- directors of companies are required to complete a “fit and proper” declaration prior to the listing of the company;
- directors are required to disclose their dealings in shares of the company;
- pyramid companies or companies with low-voting shares will no longer be accommodated on the JSE; and
- the results of South African Companies must be reported in compliance with the South African generally accepted accounting practices (GAAP) whilst the results of non South African companies must be reported in compliance with the relevant international accounting standards.<sup>85</sup>

#### 2.4.4 Other key legislation

In addition, to the provisions of the Companies Act, common law and King III there are several pieces of legislation that have been enacted, which impacts on corporate governance in South Africa. In a survey conducted by KPMG in 2004 entitled ‘Survey of Integrated Sustainability Reporting in South Africa’ it was noted that from 1994 to 2004 approximately 60 Acts were passed or substantially revised that had a direct impact on corporate governance.<sup>86</sup>

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<sup>85</sup> JSE *Listing Requirements – Service Issue 2* (2009).

<sup>86</sup> These include:

- Closed Corporations Act No 69 of 1984
- Competition Act No 89 of 1998,
- Copyright Act No 98 of 1978
- Trade Marks Act No 194 of 1993
- Patents Act No 57 of 1978
- Banks Act No 94 of 1990
- Securities Services Act No 36 of 2004
- Financial Advisory and Intermediary Services Act No 37 of 2002
- Collective Investment Schemes Control Act No 45 of 2002
- Financial Intelligence Centre Act No 38 of 2001
- Financial Institutions (Protection of Funds) Act No 28 of 2001
- Income Tax Act No 58 of 1962
- Value-added Tax Act No 89 of 1991
- Insider Trading Act No of 1998
- Financial Intelligence Centre Act No 38 of 2001, which complies with international standards for the prevention of money laundering

In light of the developments that have taken place in the Corporate Law arena and the corporate governance that has been identified by both King II and the Deutsche Bank Securities Inc., the researcher argues that many of the concerns around the enforcement framework in respect of corporate governance were addressed. For instance, the challenge relating to the judicial system struggling with backlogs seems to be addressed by the new Companies Act, which provides for a number of alternative dispute mechanisms.

Furthermore, the previous evaluation of corporate governance in South Africa, which saw it as a ‘reasonably good legal and institutional infrastructure for corporate governance’, and the modernised and simplified regulatory framework, leads one to conclude that South Africa has the corporate governance enforcement framework that assures public investors that their assets will be protected.<sup>87</sup>

#### 2.4.5 Comparison between South Africa and United Kingdom – enforcement tools

This part of the discussion compares the enforcement tools available in the UK with the tools available in South Africa (SA). This comparison will involve listing the predominant tools in the UK and SA. The table below depicts the enforcement mechanisms available in the UK and SA in respect of regulatory agencies, shareholder actions to enforce breaches of directors’ fiduciary duties:

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<sup>87</sup> Deutsche Bank Inc *Global Corporate Governance: Valuing Corporate Governance in South Africa* (2003) at 41

Figure I:

	<b>United Kingdom</b>	<b>South Africa</b>
<b>Regulatory agencies</b>	The Financial Services Authority	The Companies and Intellectual Property Commission
	The Financial Reporting Review	The Financial Reporting Standards Council
	The Takeover Panel	The Takeover Regulation Panel
	The Department of Business Enterprise and Regulatory Reform	The Companies Tribunal
<b>Shareholder actions to enforce breaches of directors' fiduciary duties</b>	Derivative action – s 265	Derivative action– s 165
	Unfair prejudice – s 994	Relief from oppressive or prejudicial conduct – s 163
		Application to declare a director delinquent or under probation – s 162
<b>Code on Corporate Governance</b>	Combined Code on Corporate Governance	King Codes (King I, King II, King III)

\*These sections refer to the Company Acts of the selected countries.

From the figure above, one can make the following deductions –

- SA and UK have similar mechanisms available in their corporate governance framework; and
- SA and UK enjoy a good blend of enforcement mechanisms. Importantly, the functions attributed to the regulatory agencies vary in scope.

## 2.5 Relationship between corporate governance and enforcement

There is a correlation between good corporate governance and enforcement to the extent that enforcement influences the overall effectiveness of the corporate governance system.<sup>88</sup> As indicated earlier, corporate governance is in essence about mitigating the commitment problem and balancing the rights and interests of multiple stakeholders. It is enforcement that ensures that corporate governance operates effectively. In other words, the benefits of corporate governance are enhanced through enforcement. Various studies have been conducted in this regard confirming a positive relationship between corporate governance and enforcement. Berglöf and Claessens (2003) submit that corporate governance and enforcement mechanisms are ‘intimately linked’. They explain that corporate governance and enforcement mechanisms play a pivotal role in enhancing a firm’s commitment to their stakeholders and helps with balancing of interests and rights of multiple stakeholders. It is observed that a mix of ‘poor enforcement of property rights and weak resolution mechanisms give rise to corporate governance problems’.<sup>89</sup>

To further highlight the relationship between corporate governance and enforcement, practical examples of how enforcement mechanisms have been used to improve corporate governance will be discussed. The following mechanisms will be focused on –

- Private Ordering;
- Enforcement by contract;
- Mechanisms to get to court;
- Non-Profit Organisations;
- Dispute resolution forums;
- Role of stock exchanges;
- Lending Institutions; and
- Other ‘softer’ enforcement mechanism, which include: rating agencies and the media.

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<sup>88</sup> Erik Berglöf and Stijn Claessens *Corporate Governance and Enforcement* (2003) at 31.

<sup>89</sup> *Supra* at 8.

Private Ordering: This category can be further divided into three forms of enforcement mechanisms, namely: unilateral enforcement arrangements, bilateral enforcement arrangements and multilateral enforcement arrangements.<sup>90</sup> For the purpose of the research paper, the discussions of these informal private enforcement mechanisms will be restricted to the extent that they relate to corporate governance.

Unilateral private informal enforcement arrangements generally refer to initiatives by firms to enhance their commitment power. In other words, they use expensive advertising to build their reputation and to ultimately mitigate commitment issues. This form of enforcement becomes critical in the absence of a well-functioning general enforcement environment. Also, this form of enforcement is subject to future interactions, which in itself can pose serious limitations on its importance.<sup>91</sup>

Bilateral private informal enforcement arrangements occur when two firms strengthen their commitment power through interactions with each other. This can happen through partnerships between two firms, where the reputation of the one firm can play a critical role in mitigating the commitment problem. Other examples of this form of enforcement include: ‘control oriented investment’<sup>92</sup> or ‘exchange hostages’.<sup>93</sup> These examples generally require some duration and reputation.<sup>94</sup>

Multilateral private informal enforcement arrangements are by far the most important form of enforcement for corporate governance. This refers to arrangements where private parties opted to establish institutions for ‘collecting and conveying information about the adherence to these customs and erect credible punishments for deviations.’<sup>95</sup> Examples include: trade associations, self-regulatory organisations and stock exchanges.

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<sup>90</sup> Supra at 21.

<sup>91</sup> Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 18.

<sup>92</sup> Refers to one shareholder taking a large stake in a firm.

<sup>93</sup> Refers to the interaction between two companies where one company leaves with the assets belonging to the other. These assets are valuable to the provider but not to the party holding the asset.

<sup>94</sup> Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 17-18.

<sup>95</sup> Supra at 19.

The efficiency of these private enforcement mechanisms in the area of corporate governance is dependant on the general institutional environment. For example, private arbitration is more likely to work when courts and enforcing agencies work well. It is submitted that the spread of firms across boundaries adhering to higher corporate governance standards can facilitate the improvement of corporate governance. Also cross-border mergers and acquisitions between firms of different standards of corporate governance generally improve the overall standard of corporate governance. Notwithstanding, the advantages as listed above, it should be borne in mind that the reverse is also possible. In other words, foreign investors could also have an adverse impact on corporate governance as was evidenced by some of the corporate governance scandals where foreign investors from developed countries took over firms in developing and transition countries.<sup>96</sup>

Enforcement by contract: Investors can insist that their relationships with companies are regulated by contracts, which include provisions pertaining to corporate governance. These agreements could be drafted with the objective of improving corporate governance and in turn ensuring that rights of investors are protected. For example, investors can request that the contract include the following corporate governance provisions: anti-dilution provisions, board representation; board committee requirements (composition and duties); access to information; disclosure requirements, change of control rights; and procedures for approving related party transactions.<sup>97</sup> Concluding a contract of this nature will allow the investors to rely on the court to enforce their contractual rights. Examples of such contracts include: credit agreements, securities purchase agreements, shareholder agreements, indentures and other loan agreements between investors and companies.<sup>98</sup>

Enforcement of this mechanism can be both costly and time consuming. In countries where the judiciary poses a serious part of the enforcement challenge, this enforcement mechanism does not provide investors with adequate protection. It is also noted that even in countries where the enforcement of the contract is effective; it generally favours those with considerable economic

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<sup>96</sup> Ibid.

<sup>97</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* (2003) at 8.

<sup>98</sup> Ibid.

power. Moreover, this mechanism is usually only available to those investors with the power to extract important rights from the companies in which they invest.<sup>99</sup>

Mechanisms to get to Court: A number of procedural devices can be developed to enable investors to commence legal action in respect of breaches of their rights as investors. These procedural devices include: derivative suits;<sup>100</sup> and class action suits<sup>101</sup> which facilitate access to courts and lower the burdens on individual plaintiffs. In the United States these mechanisms have been further enhanced by attorneys who are willing to accept contingency fees (part of the award is used to remunerate the attorney) as opposed to charging an hourly rate.<sup>102</sup>

In many parts of the world there is a reluctance to introduce the concept of contingency fees into the legal fraternity. This reluctance is fuelled by the argument that it will promote unwarranted and frivolous suits. Despite the scepticism, it must be borne in mind that devices like contingency fees deter wrong behaviour from directors or managers.<sup>103</sup>

Non-Profit Organisations (NPOs): The use of non-profit organisations for collective action has been identified as alternates to ‘class action contingency litigation’ by individual shareholders. In this sense, NPOs provide a group of shareholders with a means of accessing the courts and enforcing shareholder rights. This type of organisation has been developed in Taiwan and Korea with remarkable success.<sup>104</sup>

NPOs have also engaged in informal enforcement by threatening to use legal action to ensure that companies agree to adopt a range of investor protections. In these instances settlements are not restricted to cash rewards but also extend to commitments from the defendant company to design improved corporate governance structures.<sup>105</sup>

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<sup>99</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* at 8.

<sup>100</sup> This action allows a shareholder to sue on behalf of the company.

<sup>101</sup> This action improves accessibility to courts and lowers the burdens on individual plaintiffs.

<sup>102</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* at 8-9.

<sup>103</sup> *Supra* at 9.

<sup>104</sup> *Ibid.*

<sup>105</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* (2003) at 9.

This mechanism of enforcement is valuable where the level of private enforcement is inadequate and government is not susceptible to the idea of improved protection for investors.<sup>106</sup> It is not currently possible to evaluate the role of NPOs in South Africa due to the fact that it has not been discussed in any academic literature.

### Dispute Resolution Forums

The challenges facing developing countries often include ineffective and corrupt courts with judges that are inexperienced to deal with investor protection issues. As such, an obvious lacuna exists in their enforcement system. To remedy this state of affairs, investors can consider negotiating the inclusion of an alternative dispute resolution forum. This will ultimately ensure that investors have access to a forum that they can trust.<sup>107</sup>

This apparent solution to ineffective and corrupt courts is not without its own shortcomings. Including a clause that pre-determines the venue for arbitration could in most instances be costly and therefore not viable for small or start-up companies. Also developing countries are generally faced with a lack of arbitrators with specialised experience and knowledge in investor rights issues.<sup>108</sup>

It is also worth noting that arbitration efforts are being extended beyond bilateral agreements, which involves the investor and the company. In Brazil, for example, the Novo Mercado (a separate segment of the Bovespa Stock Exchange in Brazil) has included arbitration provisions into its listing agreements, which provides shareholders of listed companies with enforcement rights.<sup>109</sup> To give effect to this arrangement, the Novo Mercado rules make provision for shareholders to refer any disputes relating to listing rules to binding arbitration. As a consequence of the nature of the listing rules, which address matters usually the subject of

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<sup>106</sup> Ibid.

<sup>107</sup> Supra at 10-11.

<sup>108</sup> Ibid.

<sup>109</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* at (2003) 10-11.

company law, this arbitration provision gives shareholders a forum to seek redress for violations of their rights of shareholders in a forum completely separate from the judicial system.<sup>110</sup>

### Role of Stock Exchanges

A stock market can be an effective means to enforce corporate governance standards by providing a 'right of action to aggrieved shareholders outside the traditional judiciary', particularly where legal and judicial institutions are inefficient.<sup>111</sup>

### Lending Institutions

Like stock exchanges, banks too have self-enforcement capabilities and are therefore also positioned to play a critical role in enforcing corporate governance standards in the developing world.<sup>112</sup>

Millstein (2003) suggests that banks could enhance their lending criteria by offering better interest rates for 'well governed' companies. In other words, where companies are exercising good corporate governance practices, banks could extend additional credit at lower interest rates. Similarly, where companies have weak corporate governance practices, banks can refuse to extend credit until they reform their governance practices. Millstein explains that such an arrangement give banks the 'ability to compel compliance with governance standards.'<sup>113</sup>

### Other 'softer' enforcement mechanisms: Rating agencies, institutional investors and the media

Rating agencies, institutional investors and the media can also play an important role in enforcement, despite it not having the formalities associated with courts, arbitration panels, stock exchanges and lending institutions and so forth.<sup>114</sup>

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<sup>110</sup> Supra at 11.

<sup>111</sup> Supra at 12-13.

<sup>112</sup> Supra at 13.

<sup>113</sup> Ibid 13.

<sup>114</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* (2003) at 14 and Shri G. N. Bajpai *India at the Cutting Edge of Corporate Governance* (2003) at 22.

Rating agencies can assume the role of an unambiguous yardstick by measuring and monitoring progress in respect of corporate governance. By publishing these ratings, rating agencies provide clear incentives to promote good governance practices as poor ratings will not attract investment. An example of an agency that has developed into an unambiguous yardstick is the Governance and Value Creation (GVC) in India. This agency differs in many respects from the Traditional Corporate Governance Rating (TCG), which is available in several regulatory jurisdictions. Firstly, unlike the TCG rating that focuses on internal processes, the GVC aims to ‘balance process assessment with an assessment of good governance’.<sup>115</sup> Also TCG rating focuses on the treatment of shareholders whilst GVC focuses on the treatment of all stakeholders. Furthermore, the TCG rating is either qualitative or historical whilst the GVC focuses on sustainable practices.<sup>116</sup>

The GVC has a detailed assessment process, which is made up of assessments of governance processes, wealth creation, wealth management and wealth sharing. This agency has been recognised as a unique initiative and has been gaining good reviews as a result of its forward looking measurement of governance and its development of a ‘common language’ for understanding corporate processes and their effectiveness.<sup>117</sup>

Investor activism has also emerged as a role player in ensuring enforcement with good corporate governance standards. The Pensions and Investment Research Consultants Ltd (PIRC) is an example of an organisation that provides guidance and gives voice to shareholders’ concerns. The PIRC achieved this by developing its own governance principles and then monitoring companies’ compliance with these principles. Where companies fail to comply, the PIRC invites the management of the company to discuss the matter. This is followed by a recommendation to the shareholders in respect of the viability to invest in the company. This process adopted by PIRC has been relatively successful judging from the companies that opt to comply with the governance principles of the PIRC, instead of receiving a negative recommendation.<sup>118</sup>

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<sup>115</sup> Shri G. N. Bajpai *India at the Cutting Edge of Corporate Governance* (2003) at 23.

<sup>116</sup> *Ibid.*

<sup>117</sup> *Supra* at 25.

<sup>118</sup> Ira M Millstein *Non-Traditional Modes of Enforcement* (2003) at 14-15.

Furthermore, the media provides an important oversight for the public. Publishing stories of companies exercising weak governance practices naturally deters investment. As a consequence, the media can play a role in facilitating enforcement and recognition of investor rights.<sup>119</sup>

## 2.6 Summary of part B

Corporate governance has economic value and should not be perceived as an empty gesture to shareholders. It should be borne in mind that investors will reward companies that strive to exercise good corporate governance. This inevitably facilitates the acquisition of capital. It has been established that South Africa has the enforcement framework to assure public investors that their assets will be protected. Various enforcement mechanisms were discussed to highlight their role in improving the enforcement of good corporate governance. This inevitably leads to a consideration of effective ways to enforce shareholder rights within this enforcement framework. In other words, does South Africa utilise the correct enforcement strategies to drive good corporate governance and derive all the benefits associated with good corporate governance? One aspect of such a debate is whether South Africa should favour private enforcement over public enforcement.

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<sup>119</sup> Supra at 15.

## PART C

### ENFORCEMENT

'In the simplest possible characterisation the written laws has no independent function, the only thing that matters is what part of laws and regulations are actually enforced.'<sup>120</sup> Erik Berglöf and Stijn Claessens

In part B it was established that good corporate governance protects investors and that the protection is bolstered by effective enforcement. In this chapter, the researcher critically considers a specific enforcement strategy, namely: whether private enforcement should be favoured over public enforcement to protect investors and ultimately strengthen financial markets and propel economic growth. To execute such an investigation, the research paper will primarily rely on empirical research conducted in the area of securities law.<sup>121</sup>

#### 3.1. Overview of enforcement

In the area of corporate governance, enforcement is the primary difference between developed and developing countries. In many developing countries 'laws on books' have undergone some form of reform process but often the enforcement of these laws have not been effective.<sup>122</sup>

Companies are repeatedly ignoring written rules relating to corporate governance and declarations made by companies to comply are not followed up by actions. This is primarily due to a lack of enforcement of relevant rules and regulations. Hence the effectiveness of corporate governance rules remains a concern. Policymakers have come to realise that 'enforcement more than regulations and laws-on-books' is the key challenge facing transition and developing countries.<sup>123</sup>

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<sup>120</sup> Erik Berglöf and Stijn Claessens *Corporate Governance and Enforcement* (2003) at 24.

<sup>121</sup> This branch of law deals with shares of stock, bonds and debentures issued by corporations and governments to evidence ownership in terms of payment of dividends or final pay-off.

[http://www.statelawyers.com/Practice/Practice\\_Detail.cfm/PracticeTypeID:85](http://www.statelawyers.com/Practice/Practice_Detail.cfm/PracticeTypeID:85).

<sup>122</sup> Erik Berglöf *A Note on Corporate Governance and Development* (2006) at 6.

<sup>123</sup> Erik Berglöf and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 3.

Academics, including Berglöf (2003), note that reforming enforcement is an extremely complicated exercise but vitally important for development. This challenge is aggravated by the lack of research in the enforcement area, particularly in relation to the interaction between laws-on-books and enforcement.<sup>124</sup>

### 3.1.1. Why enforcement?

The effective enforcement of corporate governance has a critically important role in improving markets, which in turn attract and protect investments. This view is reiterated by empirical evidence on insider trading, which indicates that ‘it is not the presence of laws but rather actions taken against insider trading that help to explain the development of securities markets’.<sup>125</sup> Another study undertaken by Defond and Hung (2003) found that the ‘level of enforcement is much more important than quality of laws-on-the-books explaining turnover of chief executive officers.’<sup>126</sup> This finding does not mean laws are unimportant but that they alone do not suffice.<sup>127</sup>

It is generally accepted that countries that has better enforcement have stronger financial markets regardless of their laws.<sup>128</sup>

### 3.1.2. What is enforcement?

According to Ira M. Millstein (2003), the renowned corporate governance expert, enforcement can be defined as ‘the basis for determining whether a violation of investor rights has occurred or might occur (whether expressly or explicitly covered by law or regulation), and an apparatus to translate these violations into regulatory sanctions or recovery for those harmed.’<sup>129</sup>

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<sup>124</sup> Erik Berglöf *A Note on Corporate Governance and Development* (2006) at 6.

<sup>125</sup> Bhattacharya and Durnev (2001) in Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 4.

<sup>126</sup> Defond and Hung in Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 4.

<sup>127</sup> Ibid.

<sup>128</sup> Ira M. Millstein *Non-Traditional Modes of Enforcement* (2003) at 3.

<sup>129</sup> Ibid.

Pursuant to this definition, effective enforcement is required to address both clear cut violations of law and the ambiguities and gaps that the law leaves open. This function of enforcement is extended to both developed and developing countries, as well as civil law jurisdictions and common law jurisdictions.<sup>130</sup>

Fiduciary duties together with enforcement mechanisms form the basis of an effective enforcement system. In this context, fiduciary duties spell out the manner in which directors and managers are supposed to act. It also sets the standard by which the actions of these parties are judged, thus creating a foundation for the enforcement of investor rights. Fiduciary duties essentially refer to four fundamental duties, which include: the duty of good faith, care, skill and diligence.<sup>131</sup> In common law countries, like South Africa, the boundaries of these fiduciary duties are interpreted and refined by judges on a case-by-case basis. As such, these duties continually evolve alleviating the gaps that exist in law. As for enforcement mechanisms, it refers to mechanisms which exist to ensure compliance with the spirit of the law.<sup>132</sup>

Since law and regulation are not able to anticipate all future contingencies, it is by its very nature incomplete. As a consequence, law and regulation are unable to cater for all potential harmful actions. A need therefore exists for tools/mechanisms to ensure that the spirit of the law is complied with. It is in this context that both enforcement mechanisms and fiduciary duties play a pivotal role because they fill the inevitable gaps and ambiguities created within the law.<sup>133</sup>

### 3.1.3. Enforcement mechanisms

#### (a) Classification of enforcement mechanisms

There is no uniform classification of enforcement mechanisms. A number of proposals exist in this regard. For purposes of this research, the ‘popular method’ will be adopted, distinguishing

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<sup>130</sup> Ibid.

<sup>131</sup> Mervyn King *The Corporate Citizen* (2006) at 127.

<sup>132</sup> Millstein I *Non Traditional Modes of Enforcement* (2003) at 4-5.

<sup>133</sup> Katherina Pistor and Chenggang Xu (Incomplete Law) in Millstein I *Non Traditional Modes of Enforcement* (2003) at 2.

between private and public enforcement.<sup>134</sup> This distinction is essentially based on the character of the party initiating the action. Hence, if a private party initiates the action then it is considered private enforcement. Similarly, if a public party initiates the action then it is considered public enforcement.<sup>135</sup>

Differentiating between private enforcement and public enforcement is important. It highlights the different incentives that exist between the parties initiating the action. For instance, a public enforcer is generally entitled to a fixed salary regardless of the outcome of the enforcement action whereas a private enforcer is reliant on the success of the litigation for payment. As a consequence, it can be expected that private enforcement will prevail where the cost to litigate is relatively low. Similarly, private enforcement will fail where litigation costs are exorbitant. Secondly, public agencies are normally centralised and under political control. This is not true for private enforcement. John Armour submits that these characteristics provide that public enforcement is easier to coordinate. Others argue that the influence of political control makes public enforcement susceptible to bribery.<sup>136</sup>

This classification of enforcement mechanisms into private enforcement and public enforcement can be further subdivided into –

- (a) private enforcement comprising formal and informal private enforcement; and
- (b) public enforcement comprising formal and informal public enforcement.<sup>137</sup>

In this context, formal enforcement refers to a reliance on legal proceedings to ensure compliance whereas informal enforcement refers to securing compliance without recourse to legal proceedings. Extending the classification of enforcement mechanisms to include formal and informal mechanisms is essential as it makes provision for the enforcement role played by the institutional investors. In this regard, Armour (2008) showed via an empirical assessment that

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<sup>134</sup> The method generally used to classify enforcement mechanisms.

<sup>135</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 3.

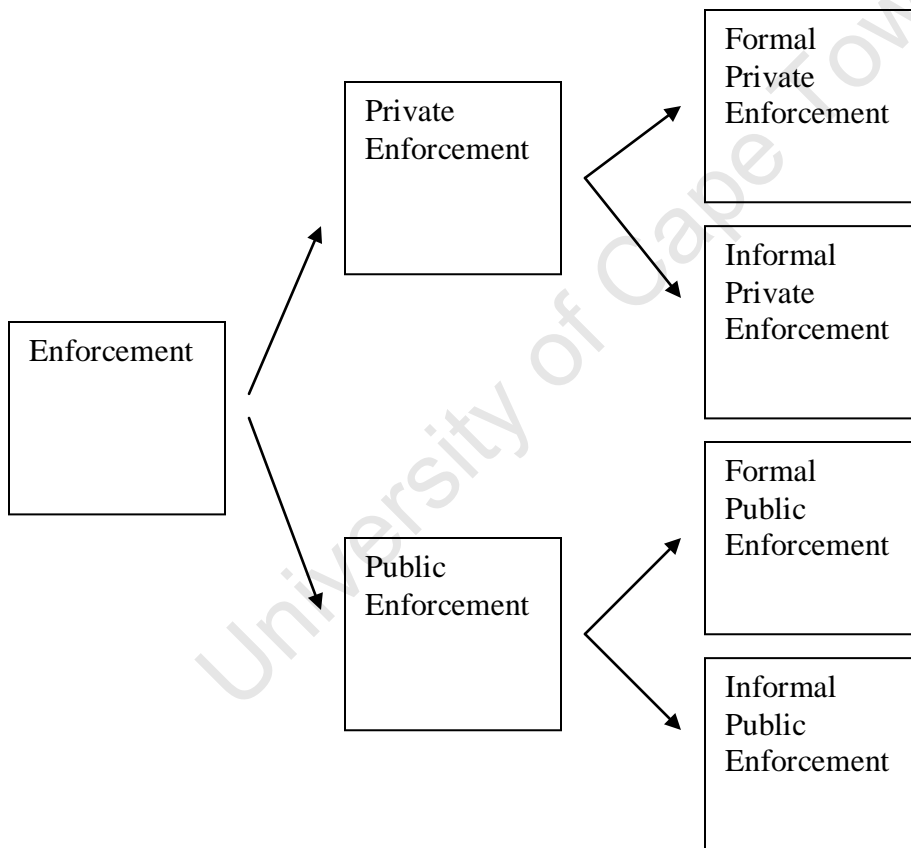
<sup>136</sup> *Ibid.*

<sup>137</sup> *Supra* at 4.

institutional investors with the majority of the shares in UK listed companies have used rules and norms to ensure low-cost informal interventions to combat corporate governance challenges.<sup>138</sup>

It is also important to note that for ‘private enforcers’ the option between formal and informal mechanisms is dependant on the relative expertise of courts versus investors and other institutional features of the two mechanisms. It is explained that the rules of civil procedure have a direct bearing on the success of formal private enforcement, whereas informal private enforcement is reliant on the success of the reputation/identity of major investors.<sup>139</sup>

In essence, the paper uses a two-by-two classification of enforcement mechanisms which can be depicted as follows<sup>140</sup>: Figure II



<sup>138</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 4.

<sup>139</sup> Ibid.

<sup>140</sup> As pointed out earlier there are a number of ways to classify enforcement mechanisms, this two-by-two classification has been adopted mainly to serve a framework for organising the paper and ensuring that a common understanding is developed.

### (i) Private enforcement

As indicated earlier, private enforcement refers to actions initiated by private agents, which can either secure compliance with or without recourse to legal proceedings. As such, private enforcement can further be divided into formal private enforcement and informal private enforcement.<sup>141</sup>

Importantly, this category of enforcement depends mainly on the imposition of penalties *ex post*<sup>142</sup> upon the detection of the misconduct. There are exceptions, for example, the ‘scheme of arrangement’ procedure which is provided by s 114 of the new Companies Act. In this regard, there are certain instances when the company is required to apply to court for approval of the restructuring transaction. If the court is satisfied with the procedural steps taken and subsequently sanctions the scheme, it cannot be challenged *ex post*. Moreover, this category of enforcement is primarily aimed at enforcing contracts and hence is critical to the functioning of the economy.<sup>143</sup>

Formal private enforcement: Under formal private enforcement, private agents utilise interventions as defined by law or regulation to secure compliance with contracts. This type of enforcement therefore involves government creating rules that regulate private conduct but relies on private agents to enforce the law. In this context, courts are used to adjudicate disputes and the state is relied upon to enforce the final judgment.<sup>144</sup> In other words, if a private agent feels that his or her rights have been violated, the agent can initiate a private suit and take the wrongdoer to court or alternatively refer the matter to an appropriate public agency. Berglöf and Claessens (2003) submit that most societies are dependant on this category of enforcement to enforce laws and regulation.<sup>145</sup>

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<sup>141</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 3.

<sup>142</sup> After the fact.

<sup>143</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 4.

<sup>144</sup> Erik Berglöf and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 22 and John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* at 6.

<sup>145</sup> *Supra* at 22.

The efficiency of formal private enforcement depends on a number of factors. Firstly, for this category of enforcement to flourish the law must mandate a certain standard. In countries where laws and regulations are drafted broadly, without stipulating a certain standard, private formal enforcement will fail.<sup>146</sup> Secondly, the cost to pursue legal action should not be exorbitant. Also for formal private enforcement to be effective, agents need to be incentivised to initiate action. This category of enforcement also needs institutions that can impose sanctions. For example: a court and a judge; institutions like self-regulatory agencies or authorities.<sup>147</sup> Moreover, research work found that formal private enforcement mechanisms need the support of government interventions and cannot operate optimally on its own.<sup>148</sup>

Examples of formal private enforcement include: securities litigation to enforce breaches of disclosure laws; shareholder actions to enforce breaches of directors' fiduciary duties; and insolvency litigation relating to breaches of directors' duties.<sup>149</sup>

Informal private enforcement: In contrast, informal private enforcement can be defined as private initiatives that 'secure compliance without recourse to legal proceedings'.<sup>150</sup> This primarily refers to action taken by stakeholders who contract with companies. These stakeholders include investors, customers, employees and suppliers. These parties can penalise a company by being reluctant to enter into agreements with the company. For example, an employee that is unwilling to enter into an employment relationship with the company. Similarly, an investor can refuse to buy shares or can choose to sell existing shares. This will undoubtedly have a negative impact on the company's share price. Alternatively, stakeholders of a company may be entitled to exercise their contractual entitlements that have the effect of penalising individuals liable of wrongdoing. An example of such an entitlement is the removal of managers from office following a shareholder vote.<sup>151</sup> This form of informal private enforcement can also place a company at risk of a hostile takeover – when investors sell large number of shares as a consequence of their

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<sup>146</sup> Supra at 22.

<sup>147</sup> Supra at 23.

<sup>148</sup> Supra at 19.

<sup>149</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 7.

<sup>150</sup> Supra at 3.

<sup>151</sup> Supra at 5.

dissatisfaction with managers' performance, they automatically depress the share price and render managers vulnerable to displacement by takeover.<sup>152</sup>

## (ii) Public Enforcement

As indicated above, public enforcement refers to initiatives that are undertaken by public agencies or bodies. Hence, it specifically refers to all legal and regulatory actions brought by organs of state. This category of enforcement includes criminal and civil suits brought by public officials and public agencies, and various *ex ante*<sup>153</sup> rights of approval. The latter include securities offering statements exercised by either public officials or agencies.<sup>154</sup>

Public enforcement can be instigated by a wide variety of public actors which can include local prosecutors, The Takeover Panel, The Companies Tribunal, The Companies and Intellectual Property Commission. This category, like private enforcement can either secure compliance with or without recourse to legal proceedings and can therefore be further subdivided into –

- Formal public enforcement; and
- Informal public enforcement.

### Formal public enforcement

Formal public enforcement refers to an intervention by a public body or public actor that involves 'judicial or quasi judicial proceedings'.<sup>155</sup>

In measuring the importance of these mechanisms Berglöf and Claessens (2003) recognised that the efficiency and effectiveness of enforcing institutions such as courts, stock exchanges, self-regulatory agencies, are challenging to study empirically. It is submitted that efficiency generally

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<sup>152</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 3-8.

<sup>153</sup> beforehand

<sup>154</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 3-8.

<sup>155</sup> Supra at 4.

refers to ‘outputs relative to inputs’<sup>156</sup>. An evaluation of the efficiency of courts should include a consideration of timelines to conclude a case, accessibility to court, fairness and predictability.<sup>157</sup>

### Informal public enforcement

On the other hand, informal public enforcement ‘consists of interventions by public bodies that do not involve judicial or quasi-judicial proceedings’.<sup>158</sup>

A public agency that favours informal public enforcement has the potential to save large sums of money that would otherwise have been spent on legal proceedings. Arguably this type of enforcement, could allow a public agency to focus its attention on detecting improper conduct as opposed to prosecuting those that had already been detected. In the case where informal sanctions are effective, informal public enforcement is better positioned to secure compliance as opposed to reliance on formal sanctions.<sup>159</sup>

Informal public enforcement is commonly executed via the imposition of ‘reputational sanctions’.<sup>160</sup> These reputational sanctions can take place by publishing a public statement highlighting that a firm has failed to comply with a required standard or alerting other firms to avoid doing business with the company liable of wrongdoing. These sanctions are more effective if carried out by an objective and expert agency, which investigates and publicises the results as opposed to a disgruntled stakeholder. Alternatively, the public agency could engage in informal talks with the wrongdoer encouraging them to remedy the wrongdoing. In these kinds of instances, sanctions are merely mooted and not immediately imposed.<sup>161</sup>

It is worth noting that both private enforcement and public enforcement systems have strong advantages and serious shortcomings. In respect of private enforcement, its efficiency is negatively impacted by being dependant on ‘collective action and free-rider effects among

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<sup>156</sup> Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 18-20.

<sup>157</sup> *Ibid.*

<sup>158</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 4.

<sup>159</sup> *Ibid.*

<sup>160</sup> *Ibid.*

<sup>161</sup> *Ibid.*

dispersed investors, slow and inaccurate judiciaries, to lawyers' rent-seeking, and to the potential inability of private enforcement' to secure suitable financial sanctions for wrongdoers. On the positive side, private enforcement could be brought by 'well-informed actors with well-aligned incentives'.<sup>162</sup>

In contrast, the significance of public enforcement is elevated by its ability to secure financial, criminal and reputational sanctions that can deter firms from wrongdoing. As with private enforcement, public enforcement also has its shortcomings. A public enforcement system is negatively impacted by public officials that are poorly compensated to effectively execute their duties. Consequently, this leads to the public agency being susceptible to corruption and also not being in a position to secure effective information relating to both general market and specific firm conditions. In light of the above, the researcher submits that there is no obvious a 'p priori winner' in this debate.<sup>163</sup> This leads us to consider whether private enforcement should be favoured to protect investors and ultimately corporate governance.

The effectiveness of many enforcement mechanisms is directly linked to the degree of importance it has been allocated by the political fraternity. Given this simple fix, many countries are still grappling to improve the effectiveness of their enforcement of corporate governance. See item 3.1.6 which discusses enforcement and the political economy.

#### 3.1.4 Relationship between enforcement mechanisms

Private and public enforcement mechanisms complement each other and should not be perceived as substitutes for one another. Experts in the area, including Berglöf and Claessens (2003), submit that the 'effectiveness of private enforcement mechanisms depends on the effectiveness

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<sup>162</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) at 1.

<sup>163</sup> *Ibid.*

of the public enforcement mechanisms'.<sup>164</sup> It is further submitted that public enforcement brings down the costs of private enforcement.<sup>165</sup>

### 3.1.5 Choice of enforcement mechanisms

The optimal blend of enforcement mechanisms is dependant on the country's characteristics and will vary by type of activities. The optimal blend of mechanisms will therefore be subject to the institutional development of the country, especially its contracting environment.<sup>166</sup>

In some country's social norms will be the first point of call whilst other formal enforcement mechanisms will follow suit. It has been submitted that social pressures are probably the most important corporate governance mechanism. Moreover, the media can fulfil a critically important role to enforce corporate governance despite its not utilising any legal tools.<sup>167</sup>

The following factors have an influence on the choice of the enforcement mechanism used:

- The overall environment that prevails in a country. In the instance where the institutional environment is weak public enforcement plays a limited role. Similarly, where courts are weak and ineffective other enforcement mechanisms are usually favoured<sup>168</sup>;
- The costs and benefits of the enforcement mechanism. In countries where litigation cost are exorbitant, private enforcement will struggle<sup>169</sup>;
- 'Path dependence' – This means that an enforcement mechanism may be introduced and then remain in use for a considerable time, despite more efficient mechanisms having been developed<sup>170</sup>;

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<sup>164</sup> In an examination of the history of private and public enforcement, John Armour discovered that 'significant public enforcement agencies in the UK owe their origins to private informal enforcement.' See *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 2-3.

<sup>165</sup> Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 15.

<sup>166</sup> Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 25.

<sup>167</sup> *Supra* at 25.

<sup>168</sup> *Supra* at 31.

<sup>169</sup> *Ibid.*

<sup>170</sup> *Ibid.*

- The corporate governance problem(s) evident in a particular country. In the UK and the US, the main corporate governance challenge relates to holding managers accountable to shareholders, whilst emerging markets grapple with ‘balancing incentives for controlling shareholders and protecting minority rights against actions by inside shareholders’<sup>171</sup>

The usage of an enforcement mechanism will also depend on the interaction between other enforcement mechanisms to ensure that a decision is reached. For example, legal backing is required for shareholder lobbying groups.<sup>172</sup>

### 3.1.6 Balanced enforcement

As indicated above, jurisdictions that better enforce legal rights in respect of protection of shareholders tend to have more developed financial markets regardless of the laws-on-the-books.<sup>173</sup>

Even though this theory is plausible, it seems to be weighted on the side of investor protection at the expense of providing managers with sufficient incentives and discretion to ensure the success of the company. This theory also limits the role of institutional and large shareholders in closely held companies, particularly in respect of monitoring management.<sup>174</sup>

For the purpose of this research paper it is important to emphasise that enforcement strategies should be cognisant of the balance needed in corporate governance.

### 3.1.7 Enforcement and Legitimacy

The essence of enforcement lies in its legitimacy. It is explained that legal rules and codes of good corporate governance that lack legitimacy are not likely to be effectively enforced.<sup>175</sup>

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<sup>171</sup> Ibid.

<sup>172</sup> Supra at 25.

<sup>173</sup> Ira M. Millstein *Non-Traditional Modes of Enforcement* (2003) at 3.

<sup>174</sup> Erik Berglöf *A Note on Corporate Governance and Development* (2006) at 4.

<sup>175</sup> Supra at 7.

To ensure legitimacy there is a general caution against transplanting enforcement mechanisms from one country to another without proper consultation. As a result, enforcement from the top-down is strongly discouraged.<sup>176</sup>

### 3.1.8 Enforcement and Politics

The effectiveness of many enforcement mechanisms is directly linked to the degree of importance it has been allocated by the political fraternity. Therefore, in instances where the political will is strong in respect of enforcing existing laws and regulation, enforcement in general will enjoy resounding efficacy. The experience of Poland, for example, is evidence that a strong political will is critical. Despite having a strong regulatory framework and sufficient competence in the Securities and Exchange Commission and the Warsaw Stock Exchange, Poland has weak regulatory bodies due to poor political will. As a result these bodies are unable to focus on corporate governance or its enforcement.<sup>177</sup>

Despite this easy solution to what appears to be a complex challenge for developing nations, this political will seems insignificant and in some instances absent. Many reasons can be attributed to the lack of political will. Firstly, investment in enforcement of corporate governance needs to compete with the other uses of government funds, which at times are more pressing than improved levels of enforcement. Also investing in public enforcement mechanisms often requires capacity-building which is a long term effort with minimal political reward. As such, securing sufficient funding for these types of initiatives proves challenging. Thirdly, improving public enforcement involves changes to a number of bodies that generally operates in sequence or alternatively in a hierarchy. For example, action is initiated by the police then referred to courts, and then back to the police. Revamping these bodies could be both a costly and complex matter. Fourthly, the gains achieved via the improvement of these bodies are not distributed evenly among citizens and hence not seen as a priority. Moreover, when government is closely linked to business, they would generally not be susceptible to corporate reform.<sup>178</sup>

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<sup>176</sup> Ibid.

<sup>177</sup> Erik Berglof and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 26-27.

<sup>178</sup> Ibid.

### 3.1.9 Enforcement and Corruption

Corruption is one of the major challenges facing the effectiveness of the enforcement system. This particularly affects the state of affairs in developing countries. It has been noted that regulators in developing countries often use their political power to extract bribes from stakeholders. Furthermore, there is also evidence that governments in the developing world also use regulation to punish their political opponents. It goes without saying that this has an adverse impact on enforcement, and in particular public enforcement mechanisms. These occurrences are not conducive to building strong financial markets. Similarly, private enforcement does not escape the impact of corruption. Often private litigation via the judiciary also bears the brunt of corruption.<sup>179</sup>

To combat such corrupt governments, Jackson and Roe (2008) suggest that nations should focus on improving their public administration. They explain that improving public administration involves either improving regulatory bodies in respect of public enforcement or the courts in respect of private enforcement. They further suggest that efforts of improvement should initially be focused on regulators. It is reasoned that the specialised assistance through regulators will be easier to transform than broad based assistance programs offered by the judiciary.<sup>180</sup>

### 3.2. Private enforcement versus public enforcement

Private enforcement versus public enforcement is emerging as an important concern in an ongoing debate about the extent to which law explains differences in financial markets around the world.<sup>181</sup> There are some commentators, of whom Rafael La Porta is noteworthy, that favour private enforcement over public enforcement whilst others support a 'blend' of enforcement mechanisms comprising both private enforcement and public enforcement as a means to strengthen financial markets and propel economic growth.<sup>182</sup>

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<sup>179</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) at 11-12.

<sup>180</sup> *Supra* at 12.

<sup>181</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) and La Porta, Lopez-de Silanes and Shleifer *What works in securities laws?* (2003).

<sup>182</sup> *Ibid.*

This debate has spilled over onto the agenda's of development agencies. To this end, the World Bank has proclaimed that private enforcement should be favoured as opposed to public enforcement. Accordingly, the World Bank has encouraged countries to think about ways to enhance their private enforcement mechanisms.<sup>183</sup> Similar views are also held by researchers currently in the employ of the International Monetary Fund (IMF) and the European Central Bank. Also many European countries supported the view that stronger private enforcement was needed to expand domestic capital markets and improve corporate governance. To give effect to this view they proceeded to change procedural rules that inhibited private suits.<sup>184</sup>

Despite this proclamation by the World Bank and others, assessing the relative importance of private enforcement over public enforcement is still immensely important. Such a study has major implications both for the academic understanding of what strengthens corporate governance and for the content of current development programmes.<sup>185</sup>

To ascertain whether private enforcement should be favoured over public enforcement, the research paper will rely on empirical work undertaken in the area of securities regulation. This methodology is possible since many elements of securities regulation involve issues related to corporate governance, which in turn applies to the enforcement of corporate governance more generally.<sup>186</sup>

Why consider enforcement strategies? To highlight the need for enforcement strategies two hypotheses can be advanced.

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<sup>183</sup> World Bank, Financial Sector Operations and Policy Note: 5.

<sup>184</sup> Howell Jackson and Mark Roe *Public and Private Enforcement of Securities Laws: Resource-Based Evidence* (2009) at 1-2.

<sup>185</sup> *Ibid.*

<sup>186</sup> Erik Berglöf and Stijn Claessens *Enforcement and Corporate Governance* (2003) at 22.

The first hypothesis – the null hypothesis – advocates that law does not matter. It is premised on the view that sufficient market and legal mechanisms - found in contract and delict law - exist for the securities markets to prosper.<sup>187</sup>

The second hypothesis – the enforcement hypothesis – is premised on the view that reputations, contract and delict law are inadequate to ensure that managers do not cheat investors. It is submitted that the benefits of cheating are significantly attractive whilst litigation is too costly and unpredictable to serve as an effective deterrent. On this basis, it is argued that there is a need for effective enforcement strategies.<sup>188</sup>

Importantly, these two hypotheses differ primarily in their scope of the enforcement framework. It goes without saying that there is need for enforcement in general and enforcement strategies specifically. In a study conducted by La Porta et al (2003) it was found that there is a correlation between investor protection matters and securities market confirming the importance of enforcement.<sup>189</sup>

In respect of the debate on whether to favour private enforcement over public enforcement to strengthen financial markets and propel economic growth, two theories have to date been developed; namely:

- Private enforcement primacy ; and
- Multi-enforcement primacy.<sup>190</sup>

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<sup>187</sup> This hypothesis points out that securities transactions take place between “sophisticated” issuers and investors. Issuers, on the one hand, have reputational and legal reasons not to mislead the investors. Investors, on the other hand, have an active interest to become informed and to purchase securities underwritten by reputable firms to ensure that they are not be cheated. La Porta, Lopez-de Silanes and Shleifer *What works in securities laws?* (2003) at 3-4.

<sup>188</sup> La Porta, Lopez-de Silanes and Shleifer *What works in securities laws?* (2003) at 4.

<sup>189</sup> *Supra* at 4-5.

<sup>190</sup> John Armour *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US* at 5.

### 3.2.1. 'Private enforcement Primacy'

'Public enforcement appears to play a small role in the development of stock markets. Private enforcement systems foster greater investor confidence and ultimately more robust securities markets.'<sup>191</sup>

As can be deduced from the quotation above, proponents of the private enforcement primacy view advocates that private parties have better incentives to bring appropriate actions as opposed to public actors and are thus better enforcers. They further submit that there is an insignificant relationship between public enforcement and financial development and hence public enforcement is unlikely to facilitate financial market development.<sup>192</sup>

### 3.2.2 'Multiple mechanisms'

This theory considers private enforcement as one of the categories required to create an effective enforcement system that can deter manager misconduct and provide the foundation for strong securities markets. In this regard, private enforcement is potentially useful but not critical.<sup>193</sup>

## 3.3 Review of relevant literature

### 3.3.1 Overview of relevant literature

In various articles, La Porta et al show that there is a link between the protection of shareholders and the development of financial markets. They submit that countries with stronger shareholder protection will generally have stronger financial markets.<sup>194</sup> For the purpose of this research paper, I agree with this theory and use it as a point of departure for examining whether private enforcement should be favoured as opposed to public enforcement.

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<sup>191</sup> La Porta, Lopez-de Silanes and Shleifer *What works in securities laws?* (2003) at 4.

<sup>192</sup> La Porta, Lopez-de Silanes and Shleifer *What works in securities laws?* (2003) at 4.

<sup>193</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) and John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008).

<sup>194</sup> La Porta, Lopez-de Silanes and Shleifer *Corporate Ownership Around the World* (1999) at 471-517, La Porta, Lopez-de Silanes and Shleifer *Agency Problems and Dividend Policies Around the World* (1999), and La Porta, Lopez-de Silanes, Shleifer and Vishny *Law and Finance* (1998) at 1113-1155.

In a later article by La Porta et al (2003) they further developed the theory by proclaiming that private enforcement mechanisms promotes greater investor confidence and stronger financial markets. This proclamation was based on the premise that financial development is encouraged by introducing extensive disclosure requirements and facilitating recovery of investor losses.<sup>195</sup>

Pursuant to this proclamation there has been many countries including development agencies that have given effect to this finding. As mentioned earlier, the World Bank encouraged countries to favour private enforcement over public enforcement.<sup>196</sup>

This theory is however not without criticisms. Firstly, the measurement of public enforcement adopted by La Porta et al is problematic. Jackson and Roe (2008) submit that indexing the regulators' formal qualities falls short of 'reliably indicating public enforcement's bottom-line efficacy'.<sup>197</sup> They further submit that the measurement relies too heavily on the regulators formal legal powers to investigate and sanction. In this regard, it is noted that many regulatory agencies fail to use these powers despite being entitled to do so. The research undertaken by Bhattacharya and Daouk into the efficacy of insider trading regulations is used in support of this criticism, since they showed that the key issue is not whether the agency had the powers but whether the agency actually utilised the powers.<sup>198</sup>

Following this study, Armour (2008) undertook an empirical assessment of the enforcement strategies used in the UK in an attempt to determine the significance of both private enforcement and public enforcement. In assessing the importance of these two categories of enforcement, he revealed that the public enforcement dominates the enforcement strategies in the UK. He further found that formal private enforcement, particularly shareholder litigation was insignificant in the realm of enforcement whilst informal private enforcement through the exercise of shareholder governance entitlements play a pivotal role in developing the financial market. This assessment

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<sup>195</sup> La Porta, Lopez-de-Silanes and Shleifer *What works in securities laws?* (2003) at 22-23.

<sup>196</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) at 1.

<sup>197</sup> *Supra* at 7.

<sup>198</sup> *Supra* at 7- 8.

primarily addresses the central problem of corporate governance for UK listed firms, namely: rendering managers accountable to shareholders.<sup>199</sup>

Even though the assessment is addressing a particular corporate governance problem, it is significant in that it highlights that the UK, a country with a well developed financial market, is dominated by public enforcement strategies. Another important element of this study is that it reflects the importance of private enforcement albeit informal private enforcement.

In March 2009, Jackson and Roe undertook to evaluate the value of public enforcement of securities law for the development of stock markets. In so doing, they developed a new set of 'resources devoted to securities market oversight around the world'.<sup>200</sup> This measurement involved measuring the resources of the staffing levels of securities regulators and their budgets. The use of such a measurement differentiates it from previous studies which focused on the formal powers of regulatory officials to measure the strength of public enforcement.<sup>201</sup>

Jackson and Roe (2008) submits a number of reasons for preferring these resource-based measurements. Firstly, securities regulators with higher budgets facilitate the conducting of market surveillance by public authorities. This is achieved by identifying infringements and determining the need for rules to remedy the infringement. Similarly higher budgets also encourages the perception that the public authority is more likely to detect and subsequently punish infringements. Secondly, public authorities that are well resourced are better positioned to conduct effective investigations to secure the success of the enforcement action. Thirdly, a sufficiently resourced public authority is in a position to draft, amend and better enforce regulatory rules. Lastly, there is evidence that public enforcement is also executed informally. It is submitted that these resource-based measurements of public enforcement are more strongly associated with robust financial markets. In other words, it is assumed that allocating more resources to public enforcement is strongly associated with robust capital markets. It is worth mentioning that these measurements are not without its caveats. It is recognised that that they are

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<sup>199</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 21-22.

<sup>200</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) at 1.

<sup>201</sup> *Ibid.*

limited in both concept and construction. For example, the allocation of adequate resources does not necessary infer that these resources will be used effectively.<sup>202</sup>

This study revealed that private enforcement is not prevalent over public enforcement. It does, however, demonstrate that public enforcement plays a role in market development. Furthermore, a direct comparison between private enforcement and public enforcement highlighted that public enforcement is generally on par with disclosure-based private enforcement in explaining financial outcomes around the world.<sup>203</sup>

In light of these findings, the paper questions the wisdom behind the proclamation of the World Bank, which favours private enforcement over public enforcement.<sup>204</sup>

According to Armour (2008) the findings of this study infer that enforcement by securities regulators can serve as a replacement where lawsuits are uncommon in the UK.<sup>205</sup> He further argues that if this is assertion is accepted, and then it should follow that an investigation into the measures of regulatory output (the number of enforcement actions brought and the size of the penalties imposed relative to market size) should be significant. Armour notes further that this is not the case. To this end, he submits that 'enforcement by securities regulators is thus an unlikely substitute for private enforcement in the UK corporate or securities law'.<sup>206</sup>

Notwithstanding the criticism highlighted above, this study has illustrated and argued that there is a role for both private enforcement and public enforcement.<sup>207</sup>

In a response to the ongoing debate about whether private enforcement should be favoured over public enforcement, Armour (2009) undertook a further study which involved a comparative

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<sup>202</sup> Supra at 9.

<sup>203</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008) at 41-43.

<sup>204</sup> Ibid.

<sup>205</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* (2008) at 21.

<sup>206</sup> Ibid.

<sup>207</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* (2008).

quantitative analysis of corporate law in the USA and the UK. This analysis was prompted by the view that stronger private enforcement was needed to expand domestic capital markets and improve corporate governance. In many instances, this view encouraged countries to entrench private enforcement by changing the procedural rules that inhibit private suits. The author found that private enforcement of corporate law through lawsuits against directors of publicly traded companies is more common in the USA than in the UK. This occurrence was primarily due to differences in civil procedure and substantive law. The comparative quantitative analysis also indicated that there was no support for the hypothesis that private enforcement of corporate law is central to strong markets and dispersed share ownership. The research also revealed that private enforcement of securities and insolvency law do not fill the gaps left by corporate law since proceedings are hardly ever brought against directors of UK companies. To remedy this situation the paper promotes the following substitutes:

- Private enforcement of related areas of law (securities and bankruptcy law). This substitute can also constrain a director's actions and could therefore possibly address managerial agency costs;
- Public enforcement. In the UK context, the Takeover Panel may offer partial substitute for private enforcement; and
- Shareholder governance rights – This concept refers to powers enjoyed by shareholders over key decisions in a company. It is recognised that governance rights has the potential to reduce managerial agency costs by giving shareholders the power to remove directors who fail to act in their best interest. Shareholder governance rights also gives shareholders *ex ante* decision rights for transactions that could harm shareholders' interest.<sup>208</sup>

Armour also makes the point that the lack of formal private enforcement highlights the importance of procedural rules, particularly general rules not limited to corporate cases. These procedural rules play a pivotal role in the practical operation of substantive rules. It is further noted that the differences that exist in 'general rules governing class actions, contingency fees, and who pays the winner's legal expenses, in tandem with rules specific to corporate law that

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<sup>208</sup> John Armour *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US* at 19-21.

govern the availability of derivative actions and direct claims by shareholders', could probably explain the large differences in levels of private enforcement.<sup>209</sup>

### 3.3.2 Comparative analysis of relevant literature (see Table 1)

In view of the comparative analysis (as captured in Table I), the following deductions can be drawn:

- The debate around whether to favour private enforcement as opposed to public enforcement stems from the notion that investor protection is related to strong financial markets, which is capable of propelling economic growth.
- There is no unequivocal winner between private enforcement and public enforcement. More recent literature seems to prefer a 'multiple mechanisms' approach, which advocates that private enforcement is useful but not critical. This view is supported by resource based evidence focussing on the measurement of staffing levels of regulators and their budgets; empirical assessment of enforcement strategies in the UK and an empirical assessment comparison of the UK and the USA. In contrast, dated literature explicitly supports private enforcement as the main enforcement system to foster greater investor confidence and better developed stock markets. Proponents of this view support the 'private enforcement primacy' view. They base their argument on the view that private parties have better incentives to bring appropriate actions as opposed to public actors. On this basis private actors are better enforcers.
- Both private enforcement and public enforcement has a role to play in protecting shareholders and thus in developing strong financial markets.
- This leads us to the next obvious conclusion; there is no uniform measure of the effectiveness of the two different systems of enforcement. It is worth noting that the

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<sup>209</sup> Supra at 26.

articles by La Porta et al and, Jackson and Roe are very similar but differ in their measurements.

- Furthermore, it is evident that most of the proposed measurements have their own set of shortcomings.
- The debate is ongoing and seems to have picked up momentum in recent times.

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Table I: Comparative analysis of the relevant empirical research

	<b>What works in Securities Laws?</b>	<b>Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment</b>	<b>Public and Private Enforcement of Securities Laws: Resource Based Evidence</b>	<b>Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US</b>
<b>Theory categorisation</b>	Private enforcement primacy	Multiple mechanisms	Multiple mechanisms	Multiple mechanisms
<b>Objective</b>	To evaluate the impact of securities laws on the development of stock markets.	To provide an overview of the ‘empirical incidence’ of both private and public enforcement mechanisms to determine their importance. <sup>210</sup>	To evaluate the importance of public enforcement of securities law for the development of global stock markets. <sup>211</sup>	To study private enforcement of corporate law in the UK and the US with the objective of ascertaining whether to favour the private enforcement primacy view or multiple mechanisms view.
<b>Scope</b>	A comparison of securities laws in 49 countries, including South Africa. The selection of countries extends to both common and civil law countries.	The study was confined to the United Kingdom (UK).	55 countries, including South Africa.	This study was confined to UK and US. <sup>212</sup>
<b>Methodology</b>	A comparative evaluation which included an – - analysis of the relevant provisions in securities law governing initial public offerings; - examination of the relationship between these provisions and the various measures of stock market development; and - interpretation of these correlations using available theories in securities law.	An empirical assessment of the number of enforcement interventions used in relation to the range of enforcement mechanisms available in the UK.  In limited instances, the data is supplemented with data on the size or quantum of typical enforcement actions. <sup>213</sup>	A comparative evaluation was used in this study. It involved collecting resource-based evidence in respect of public enforcement.	A comparative quantitative analysis to test the hypothesis about (i) the role and (ii) rate of private enforcement of corporate law in the US and UK. <sup>214</sup>
<b>Time</b>	July 2003	April 2008	March 2009	July 2009

<sup>210</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* at 8-30.

<sup>211</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* at 1.

<sup>212</sup> These countries were selected since both the UK and US are common law countries with strong judiciaries, minimal government corruption and highly developed stock markets. Also in both countries the majority of large business enterprises are publicly traded and many lack a ‘block holder’ large enough to exercise regular oversight over management.

<sup>213</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* at 8-30.

<sup>214</sup> John Armour *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US* at 5.

Measurements				
<b>Private Enforcement</b>	Disclosure requirements and liability rules.	Three different actions that minority shareholders can bring against directors.		
<b>Public Enforcement</b>	Attributes of public agency.	Activities of the public agencies were considered.	Resources of staffing levels of securities regulators and their budgets.	
<b>Findings</b>	<ul style="list-style-type: none"> <li>▪ Public enforcement plays a modest role in the development of stock markets. It is explained that a supervisor's investigative powers and the strength of both criminal and non-criminal sanctions only applied in limited instances.</li> <li>▪ Stock market development is strongly associated with private enforcement via extensive disclosure requirements and a relatively low burden of proof on investors seeking to recover damages. This led the authors to conclude that a private enforcement system promotes greater investor confidence and more robust securities markets.<sup>215</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Shareholder litigation, which can be categorised under formal private enforcement, is insignificant in the realm of enforcement.</li> <li>▪ Enforcement efforts are dominated by public enforcement agencies.</li> <li>▪ Informal private enforcement through the exercise of shareholders governance entitlements plays a pivotal role in developing the securities market. These mechanisms are generally used to remove managers who have underperformed, induce high compliance rates with non-prescriptive codes of good corporate governance.<sup>216</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Public enforcement enjoys a direct relationship with financial outcomes, which include: stock market capitalisation, trading volumes and the number of domestic firms.</li> <li>▪ A direct comparison between private enforcement and public enforcement highlighted that public enforcement is generally on par with disclosure-based private enforcement in explaining the financial outcomes around the world.</li> <li>▪ The data does not indicate that private enforcement is prevalent over public enforcement – it does however indicate that public enforcement also has a critical role to play in financial market development.<sup>217</sup></li> </ul>	<ul style="list-style-type: none"> <li>▪ Private enforcement of corporate law through lawsuits against directors of publicly traded companies is more common in the US than in the UK. This was primarily due to differences in civil procedure and substantive law.</li> <li>▪ There was no support for the hypothesis that private enforcement of corporate law is central to strong markets and dispersed share ownership.</li> <li>▪ Private enforcement of securities and insolvency law do not fill the gaps left by corporate law.<sup>218</sup></li> </ul>

<sup>215</sup> La Porto et al *what works in Securities Laws?* (2006) at 22-23.

<sup>216</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* at 21-22.

<sup>217</sup> Howell E. Jackson and Mark J. Roe *Public and Private Enforcement of Securities Laws: Resources Based Evidence* at 41- 43.

<sup>218</sup> John Armour *Private Enforcement of Corporate Law: An Empirical Comparison of the UK and US* at 26-27.

### 3.4. Summary of part C

This section commenced with an overview of enforcement, indicating that enforcement is crucial for development, in particular for the creation of strong financial markets. It goes on to describe enforcement as relating to both rules and conduct. It is explained that restricting the concept to a 'rule-based account' automatically infers a contravention of a rule or code which forms the basis of the enforcement activity. This, however, fails to take into account the actions and inactions that attract an enforcement intervention.

Pursuant to this understanding of enforcement, a two-by-two classification of enforcement mechanism is used. This classification is a means to organise the debate that follows and capture the significance of the initiating parties. Importantly, the categorisation also highlights that both private and public enforcement have advantages and limitations. From this one can infer that the debate in respect of private enforcement versus public enforcement is a complex matter. The categorisation also highlights the mechanics of these various mechanisms, explaining factors that either promote or inhibit the usage of these mechanisms. It is worth emphasising that these categories of enforcement should not be seen as substitutes for each other but rather as complementing each other. More clarity is provided in item 3.1.5 in this regard, where specific factors are highlighted that influences the choice of enforcement mechanisms. This discussion reiterates the view that favouring one category of enforcement mechanism over another is a complex exercise that requires due consideration to the institutional structures of a country. One could probably argue that private enforcement mechanisms may be better suited to weak institutional environments since their reliance on these institutions is less intense than public enforcement. In my view, this argument is limited particularly in respect of establishing good corporate governance.

Furthermore, the paper also makes reference to certain elements that are crucial to the development of effective enforcement. These include: developing an enforcement system that creates a corporate governance equilibrium (ideal balance between shareholder protection and managerial discretion), ensuring the legitimacy of enforcement structures, and securing the buy-

in of the political fraternity. On the other side, corruption is identified as the main threat to the viability of the enforcement system.

Turning to the unfolding debate about whether private enforcement should be favoured over public enforcement to establish good corporate governance, the following conclusions can be drawn:

- Reforming enforcement is a complex process but crucial for development. For enforcement to be successful there needs to be a degree of legitimacy.
- There is no obvious winner between private enforcement and public enforcement.
- In declaring whether private enforcement should be favoured over public enforcement or vice versa there needs to be some sort of due consideration to the corporate governance challenges facing a particular country.<sup>219</sup>
- It is important to create a degree of balance – a corporate governance equilibrium – between ‘investor protection and the desire to provide managers and controlling owners with sufficient incentives and discretion.’<sup>220</sup>
- The debate has not spilled over into South Africa or even Africa. Empirical research on private and public enforcement seems to be lacking.

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<sup>219</sup> Erik Berglöf and Stijn Claessens *Enforcement and Corporate Governance* (2003).

<sup>220</sup> Erik Berglöf *A Note on Corporate Governance and Development* (2006) at 4.

## **PART D**

### **4. CONCLUSION**

The research paper recognises that good corporate governance, amongst others, can assure providers of corporate finance that their investments will be protected. In response to this recognition, the paper sets out to develop an understanding of good corporate governance in South Africa and to ascertain whether South Africa has the enforcement framework to assure providers of corporate finance that their investments will be protected. In so doing, it was established that good corporate governance varies from country to country. However, there are elements that can be regarded as common to establish good corporate governance. It was also noted that South Africa has recently undertaken a complete overhaul of its company law. The objective of this reform process was to modernise and align company law with international and legislative trends. As such the new company law set-up is both modern and comprehensive, particularly in respect of its enforcement framework. This was highlighted with a discussion on the developments of the enforcement framework relating to corporate governance and a comparison with the UK enforcement framework. This discussion led us to conclude that South Africa has the enforcement framework to assure providers of capital finance that their assets will be protected. This led into the next phase of the research paper, which submits that enforcement can guarantee good corporate governance.

In this section of the paper, it was established that enforcement has an impact on the overall effectiveness of the corporate governance system. In other words, it is enforcement that ensures that corporate governance operates effectively. It follows, that efforts should be concentrated on developing sound strategies of enforcement to guarantee good corporate governance.

In response to this, the paper established a common understanding of an effective enforcement system and then proceeded to critically evaluate whether private enforcement should be favoured over public enforcement in the South African context.

Having regard to relevant literature, it is evident that the debate has been subjected to limited empirical analysis. This analysis was mainly in the field of economics and finance, with law only recently joining the discussion. The debate is an ongoing one with important considerations relating to the development of strong markets capable to propel the economic growth of a country. It therefore goes without saying that the debate is both relevant and important in the South African context, more so after the recent global financial crises.

In evaluating the viability of an enforcement strategy in relation to corporate governance, the researcher submits that a three-pronged analysis should be adopted, which include the following stages:

- (i) The first stage involves an investigation into whether a country is capable of good corporate governance. Apart from the elements highlighted in part B of this research paper, such an investigation should also consider whether a country has good laws, principles and codes relating to corporate governance.
- (ii) The second stage involves an evaluation of the enforcement framework. As indicated in part C of this research paper, elements indicating efficiency includes: legitimacy, political support, institutional environment and corporate governance equilibrium.
- (iii) A correlation between the enforcement framework and the prevailing corporate governance problem(s). This includes, identifying the corporate governance problem(s).

If one applies this proposed analysis to the South African context, it can be inferred that South Africa meets the first two stages. South Africa has the necessary laws, rules and procedures capable of establishing good corporate governance.

Furthermore, the enforcement framework seems adequate and relatively satisfactory when compared to the UK, a developed nation with a strong financial market. In light of the recent corporate law reform, one could probably submit that South Africa has the political support

necessary to drive enforcement. As for legitimacy, there has been extensive consultation during the drafting of the new Companies Act and some of the new bodies were merely reformed to address challenges. The institutional context may be challenging to understand, particularly in the absence of relevant empirical research. South Africa has a fairly balanced institutional context, favouring both private and public enforcement. On this basis, it can be concluded that South Africa has an effective enforcement system.

The third stage involves determining whether the enforcement framework correlates with the corporate governance challenges. In the absence of empirical evidence in this regard, one can argue that South Africa faces many corporate governance problems, which varies from holding managers accountable to ‘balancing incentives for controlling shareholders and protecting minority rights against actions by insider shareholders’.<sup>221</sup> This view is based on the fact that South Africa is one of the leading developing countries in the world, continually developing its financial markets. As such, it is burdened with varied corporate governance problems, which includes the typical corporate governance challenges facing both developed and developing countries.

On this basis, the research paper would favour a multiple mechanisms approach to enforcement. An approach capable of addressing most corporate governance challenges.

Furthermore, it also makes intuitive sense for developing countries to strive to develop an enforcement system containing both private enforcement and public enforcement to entrench good corporate governance. Good corporate governance is too important to risk favouring one mechanism over another.

Notwithstanding this analysis, there is need in South Africa for empirical analysis on enforcement. It is important to keep in mind that this research paper restricted itself to enforcement of one aspect of corporate governance; namely: assuring providers of corporate finance that their investments will be protected. Going forward an investigation into other aspects of corporate governance would be useful.

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<sup>221</sup> John Armour *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment* at 1.

Hopefully, this research paper will serve as a basis to encourage similar studies in developing countries at large, but specifically in respect of South Africa. The reform process in South Africa has opened up new prospects and will give rise to new challenges for corporate governance. Academics, researchers and practitioners would do well to take heed of the discussions, findings and recommendations put forward in this paper.

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