ENFORCEMENT OF CORPORATE GOVERNANCE REQUIREMENTS FOR LISTED COMPANIES IN KENYA: MANDATORY VERSUS VOLUNTARY REQUIREMENTS

A THESIS SUBMITTED TO THE SCHOOL OF LAW, UNIVERSITY OF NAIROBI,

IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF

THE DEGREE OF MASTER OF LAWS (LLM) OF THE UNIVERSITY OF NAIROBI

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DECLARATION

I, **CHERUIYOT HILLARY BIWOTT**, hereby declare that this Thesis is my original work which has been done in line with the requirements and regulations of the University of Nairobi for the degree of Master of Laws (LLM). This Thesis has not been submitted for a degree in any other university.

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This Thesis has been submitted for examination with my knowledge and approval as University Supervisor.

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ACKNOWLEDGEMENTS

I thank God for the opportunity and resources to pursue my dream. I appreciate the Capital Markets Authority for the scholarship to pursue this course.

I acknowledge and appreciate the support and guidance from my Supervisor, Mr. Richard Kariuki. Mr. Kariuki's prompt review and feedback enabled me to accomplish the research and drafting expeditiously.

I appreciate the review and supervision from my panel chaired by Ms. Laila Latif and my Reader Ms. Mary Ongore for their insightful comments.

I am grateful to Mr. Wanyonyi, my rider, who facilitated speedy delivery of my Supervisor's comments to my office.

Indeed, my family has been very supportive. Thank you my wife Carol and daughters Abby and Bella.

DEDICATION

I dedicate this work to the champions of corporate governance particularly in the capital markets sector for their commitment and leadership in the pursuit of good governance for the overall success and sustainability of companies and the prosperity of Kenya.

TABLE OF CONTENTS

ENFORCEMENT OF CORPORATE GOVERNANCE REQUIREMENTS FOR LISTED COMPANIES IN KENYA: MANDATORY VERSUS VOLUNTARY REQUIREMENTS .. i

DECLARATION ... ii

ACKNOWLEDGEMENTS ... iii

DEDICATION ... iv

ABBREVIATIONS ... 1

INTRODUCTION ... 2

1.0 Abstract ... 2

1.1 Background ... 2

1.2 Problem Statement ... 4

1.3 Significance of the research ... 5

1.4 Objectives of the research ... 5

1.5 Hypothesis ... 6

1.6 Literature Review ... 6

1.6.1 Enforcement of corporate governance Codes: Comparative study ... 6

1.6.2 Corporate governance developments in Kenya and the introduction of the Corporate Governance Code ... 10

1.7 Theoretical Framework ... 12

1.7.1 The agency theory ... 12

1.7.2 Stakeholder theory ... 13

1.7.3 Stewardship theory ... 13

1.8 Research Methodology ... 14

1.8.1 Research design ... 14

1.8.2 Research questions ... 15

1.8.3 Data collection procedures ... 16

1.8.4 Limitations and assumptions ... 16

1.9 Conclusion ... 16

MANDATORY VERSUS VOLUNTARY GOVERNANCE REQUIREMENTS ... 17

2.0 Introduction ... 17

2.1 Why the focus on corporate governance? ... 20

2.2 Distinction between mandatory and voluntary requirements ... 20

2.3 Any recommended enforcement framework? ... 26

2.4 Market forces as effective tools for enforcement ... 27

2.5 Linking Codes to mandatory disclosures ... 27

2.6 Challenges in complying with governance codes ... 29

2.7 Are shareholders the best advocates for enforcement voluntary codes? 29
MECHANISMS FOR MONITORING AND ENFORCEMENT OF CORPORATE GOVERNANCE 32
3.0 Introduction 32
3.1 Mechanisms for enhancing compliance and enforcement of corporate governance 33
3.1.0 Collaboration between securities regulators and the police for better surveillance and enforcement 33
3.1.1 Effective board 35
3.1.2 Shareholder and stakeholder engagement for better monitoring and enforcement 36
3.1.3 Corporate governance scorecards and indices 37
3.1.4 Corporate governance compliance audits 38
3.1.5 The role of the media 39
3.1.6 Integrated reporting 40
3.1.7 Focus on sustainability 41
3.1.8 Structure and systems to assess application and explanations 42
3.1.9 Value proposition and incentives for good corporate governance 43
3.2 Conclusion 43
COMPARATIVE STUDY ON ENFORCEMENT OF CORPORATE GOVERNANCE..... 45
4.0 South Africa 45
4.1 Malaysia 48
4.2 Japan 49
4.3 Brazil 51
4.4 United States of America 54
4.5 Conclusion from comparative study 55
CONCLUSION AND RECOMMENDATIONS 58
5.0 Introduction 58
5.1 Conclusion 58
5.2 Recommendations 64
REFERENCES 66

ABBREVIATIONS

CMA	Capital Markets Authority
CMFIU	Capital Markets Fraud Investigation Unit
CVM	Brazilian Securities and Exchange Commission
GEMS	Growth Enterprise Market Segment
ICGN	International Corporate Governance Network
IFC	International Finance Corporation
IOSCO	International Organization of Securities Commissions
KCB	Kenya Commercial Bank
NSE	Nairobi Securities Exchange
OECD	Organization for Economic Cooperation and Development
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America

CHAPTER ONE

INTRODUCTION

1.0 Abstract

The research seeks to investigate the enforcement standards on corporate governance for listed companies in Kenya. The key focus is on the interplay between mandatory and voluntary requirements on corporate governance. The research endeavours to interrogate whether mandatory, voluntary or a balance of the two is the best approach for Kenya's listed companies.

A detailed review of the emerging popularity of codes of corporate governance was also undertaken with emphasis on enforceability of its principles and recommendations.

1.1Background

The Capital Market Master Plan for Kenya[1] provides that a stable financial market is fundamentally reliant on sound corporate governance and transparent financial and non-financial reporting. The Master Plan further notes that weaknesses in governance or the publication of false financial reports can cause long-term damage to any capital market, which can be difficult to deal with. Good governance significantly leads to the sustainability and long-term success of companies.

The Code of Corporate Governance Practices for Issuers of Securities to the Public, 2015 defines corporate governance as the structure and process for directing and managing businesses towards building prosperity with the ultimate end of increasing shareholder value and stakeholder interests[2]. The Guidelines on Corporate Governance for Public Listed Companies in Kenya, 2002, were repealed by the Code of Corporate Governance for Issuers of

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[1] Capital Markets Master Plan 2014 – 2023 , p 75 available at *www.cma.or.ke/images/Capital_Market_Master_Plan.pdf accessed on 06/11/2015.*

[2]Code of Corporate Governance for Issuers of Securities to the Public, 2015, p. 2.

Securities to the Public, 2015 and the same definition was retained. The same definition has been adopted by the Corporate Governance Code for Issuers of Securities to the Public[3].

The Code takes the approach of 'Apply or Explain'.[4] This calls for listed companies to apply the provisions of the Code and explain any departure or non-adherence in the annual reports. In countries where codes have been issued, the response by public listed companies has been found to be positive and encouraging[5]. This is a departure from the Comply or Else approach (regulatory approach).

The Capital Markets Authority is required to work with other institutions including the securities exchange, registrar of companies and the courts to in ensuring that the Code is applied.[6]

Anand defines mandatory corporate governance requirements as those which are mandated by law, with sanctions applicable to those who do not to comply with the law.[7] Mandatory requirements are often found under the capital markets and companies' legislations and regulations[8]. The term 'voluntary' or 'enabling' refers to a company's choice to adopt governance requirements without a mandatory legal requirement to do so.

The mandatory requirements have no room for explanation for any non-adherence. The regulator, being the Capital Markets Authority, is empowered to take enforcement action for any violation of the governance requirements. Indeed the Capital Markets Authority has over the years taken enforcement action against non-compliance with governance requirements. The

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[3]Gazetted on 4th March 2016 through Gazette Notice No. 342 of 2016.

[4]Ibid.

[5] Holly J. Gregory et al, *Corporate Governance: What it is and Why it Matters*, 9th International Anti-Corruption Conference, October 1999, Durban, South Africa.

[6] Clause 1.1.3 of the Code.

[7] Anita Bindira Anand, *An Analysis of Enabling Vs. Mandatory Corporate Governance Structures Post-Sarbanes-Oxley*, Delaware Journal of Corporate Law, Vol. 31, 2006, p. 229.

[8]Found under the Companies Act, 2015, Capital Markets Act and the Capital Markets (Securities) (Public Offers, Listing and Disclosure) Regulations, 2002.

latest is when board members of Uchumi Supermarkets Limited, a listed company, were penalized for violating governance requirements.[9] The mandatory requirements are found under the following legal instruments-

(a) The Capital Markets Act;

(b) The Companies Act; and

(c) The Capital Markets (Securities) (Public Offers, Listing and Disclosure) Regulations, 2002; among others.

The mandatory requirements cover such areas as establishment of boards, audit committees, conflict of interest, reporting, disclosures, shareholder rights and listing requirements.

The research takes an in-depth interrogation of the mandatory and voluntary governance requirements and seeks to determine the appropriate framework for effective enforcement of corporate governance requirements.

1.2Problem Statement

The Capital Market Master Plan states that a code may not be adequate without structures for enhancing its adherence. It also states that the typical method is to require companies to conform to the code or explain instances where they have not applied.

The Master Plan notes that there is need for a review as to whether voluntary codes are sufficient to promote high ideals of governance. It is therefore necessary to establish an enforcement framework that will deliver a suitable and effective approach for the enforcement of corporate governance requirements and standards in Kenya. Research has shown that the

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[9] http://www.cma.or.ke/index.php?option=com_content&view=article&id=599:cma-takes-enforcement-action-against-former-uchumi-supermarkets-ltd-directors-and-connected-entities-for-regulatory-breaches&catid=80&Itemid=574 accessed on November 28, 2016. The enforcement actions taken against the CEO and directors of Uchumi include disqualification from holding office as director or key officer of a public listed company, complaint for institution of disciplinary proceedings by the Institute of Certified Public Accountants of Kenya, disgorgement of board allowances, among others.

implementation of the Guidelines on Corporate Governance for Listed Companies, 2002, has not been effective.[10]

Corporate governance regulations and codes may not be effective unless adequate enforcement mechanisms are incorporated. This research therefore sought to establish the appropriate and effective framework for the enforcement of governance for companies listed in Kenya.

The research also seeks to interrogate whether corporate governance codes are enforceable through sanctions imposed by the Capital Markets Authority.

1.3Significance of the research

The Master Plan recommends that there is need for a review on whether the development of corporate governance code is sufficient to facilitate enhanced standards of governance in Kenya. It further states that enforcement provisions need to be improved to deal with matters of failure to comply with the requirements. For any corporate governance framework to work, mechanisms for compliance and enforcement are inevitable. Effective corporate governance makes companies prosper[11].

This research therefore seeks to find out the appropriate compliance and enforcement approach for governance requirements for companies listed in Kenya.

1.4 Objectives of the research

The research seeks to find out the appropriate mechanism for the enforcement of governance requirements for listed companies. The research looks into the effectiveness and applicability

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[10] Gakeri Jacob, *Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities*, International Journal of Humanities and Social Science, Vol. 3 No. 6, Special Issue, March 2013, p. 101.

[11] Saidi Nasser, *Corporate Governance in MENA Countries, Improving Transparency and Disclosure*, The Second Middle East and North Africa Regional Corporate Governance Forum, Beirut, June 2004, available at http://www.oecd.org/investment/investmentfordevelopment/33944145.pdf.

of mandatory and voluntary corporate governance requirements. The research also establishes whether a balance between mandatory and voluntary requirements is appropriate.

1.5 Hypothesis

The research proceeds on the assumption that a balance between mandatory and voluntary requirements is necessary for effective enforcement of corporate governance requirements.

1.6 Literature Review

1.6.1 Enforcement of corporate governance Codes: Comparative study

Although extensive research on corporate governance has been done in Kenya, there is minimal research on the interplay between mandatory and voluntary requirements. There is little literature particularly on the appropriate and effective enforcement framework for Kenya's listed companies. A country's economy depends on the competitiveness and efficiency of its companies which is driven by the effectiveness of boards to discharge their responsibilities. The boards must be permitted to steer their companies to great heights, but use the freedom within a system of accountability.[12]

Corporate governance provides mechanisms upon which investors guarantee themselves of earning a profit on their investment[13]. Adrian Cadbury defined corporate governance as the system and processes by which companies are directed, led and controlled[14].

There has been an increasing attention to corporate governance of late. This has been occasioned by the increase of crisis over the past few decades which have adversely affected economic development. Weaknesses in corporate governance mechanisms within companies were mentioned as the reasons for increased risk-taking, haphazard compensation and focus on

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[12] *Report of the Committee on the Financial Aspects of Corporate Governance*, United Kingdom, 1992 (famously referred to as the Cadbury Report).

[13] Shleifer Andrei & Robert Vishny, *A Survey of Corporate Governance*, The Journal of Finance, Vol. LII No. 2, June 1997.

[14] Report of the Committee on the Financial Aspects of Corporate Governance, United Kingdom, December 1992.

immediate rather than long-term incentives.[15]Research has shown that corporate governance matters for growth and development through the following channels[16]-

i) increased access to outside capital by companies can lead to larger investment, better development and creation of employment;
ii) reduced cost of capital and increased company value results in more investments favourable to investors;
iii) better performance as a result of efficient allocation of capital and improved management leads to opportunities and wealth;
iv) good governance leads to reduced risk of financial crises; and
v) good governance leads to better interactions with stakeholders.

Between September 2015 and April 2016, three Kenyan banks have been placed under receivership by the Central Bank of Kenya. Major grounds for the collapses have been corporate governance lapses and the ineffective controls by boards and management. This shows that corporate governance is key in the success and sustainability of companies. In November 2016, the Capital Markets Authority took enforcement action against directors and senior managers of Uchumi Supermarkets Limited for violation of corporate governance requirements.[17]

Globalization and transformations in ownership structures of firms has led to increased need for mechanisms for monitoring and enforcing governance structures.[18] The introduction of

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[15]Stijn Claessens and Burcin Yurtoglu, *Corporate Governance and Development-An Update*, Global Corporate Governance Forum Publication, IFC (2012) p 15.
[16] Ibid, note 15, p. 16.
[17] https://www.standardmedia.co.ke/business/article/2000224531/double-trouble-for-shamed-former-uchumi-directors accessed on November 28, 2016. It is noteworthy that one of the sanctions issued against one of the directors was that he was required to attend corporate governance classes. This may have been occasioned by blatant oversights of fundamental corporate governance principles hence the need for a refresher course.
[18]Ruth V. Aguilera and Alvaro Cuervo-Cazurra, *Codes of Good Governance, What is the Trigger*? Organizational Studies, 25(3), 2004, p 418.

corporate governance codes helps complement the legal and regulatory structures and mitigate their inefficiencies.[19] The Cadbury Report and corporate governance code of the United Kingdom was as a result of low confidence and reduced reliability of the financial and audit reports.[20]

So, how are corporate governance codes different compared to hard law? Corporate governance codes are defined as recommendations on best practices regarding to the management and operations of a company.[21]

A study of some United States companies established that the more companies apply voluntary governance principles, the more their valuation and stability, and the lesser the cost of capital[22]. Studies have also shown that a less rigid approach to governance, with provision for company choice as opposed to a regulatory mechanism is necessary.[23]

After the corporate misfeasance in the USA between 1990 and 2000, Congress noted the importance of sound monitoring of corporate governance in the Sarbanes-Oxley Act of 2002. The Act enhanced the powers of the Securities Exchange Commission including civil penalties, disgorgement, equitable remedies and criminal sanctions.[24]

Despite the adoption of the corporate governance codes by many jurisdictions, which suggests the importance of these documents, minimal research has been done on the effectiveness of the codes. Many gaps remain on the "factors motivating their introduction, the effectiveness of their adoption, their bearing on the corporate governance of firms and securities markets, the

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[19]Ibid, p. 419.

[20]Ibid, p 420.

[21] Ruth Aquilera, et al, Taking Stock of Research on Codes of Good Governance, September 2008

[22] Extracted from Corporate Governance and Development-An update, published by Global Corporate Governance Forum, 2012) p. 33.

[23] Ibid, p 34.

[24]Ira M. Millstein, Shri G. N. Bajpai, et al, Enforcement of Corporate Governance: Three Views, Global Corporate Governance Forum Focus 3, IFC, 2003, p V.

status of the institutions issuing them and the strategies used in their implementation and enforcement".[25]

Annand has documented various researches done to establish the interplay between mandatory and voluntary corporate governance requirements.[26] The research has interrogated what works between mandatory and voluntary governance standards based on studies in a number of jurisdictions. Annand's studies have been resourceful in highlighting the fundamentals of an effective governance regime based on a country's level of development and culture.

It has been noted that although application of codes is voluntary, research in countries where codes have been introduced show that listed firms are responsive to code principles.[27]. Aguilera observes that this may be as a result of market determinants to comply with good governance practices in addition to the requirement for justification on non-compliance in annual reports[28].

A research by Cuervo-Cazurra and Aguilera analysed and compared corporate governance codes of fifteen common law countries and twenty codified law countries[29]. They found that the issuance of corporate governance codes was accelerated by exposure to foreign capital investment. They also noted that the introduction of corporate governance codes was not a guarantee in itself of its effectiveness.

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[25]Marcelle Colares Oliviera, *et al,Comparative Analysis of the Corporate Governance Codes of the Five BRICS Countries*, Contabilidade, Gestão e Governança – Brasília, 2014 · v. 17 · n. 3 · p. 49- 70.

[26] Anita Bindira Anand, *An Analysis of Enabling Vs. Mandatory Corporate Governance Structures Post-Sarbanes-Oxley,* Delaware Journal of Corporate Law, Vol. 31, 2006.

[27] Weil, Gotsall and Manges, Comparative Study of Corporate Governance Codes Relevant to the European Union and its Member States, January 2002.

[28] Ibid, note 27 p 42.

[29] Ruth V. Aquilera & Alvaro Cuervo-Cazurra, *Codes of Good Governance*, 2008, p. 69.

1.6.2 Corporate governance developments in Kenya and the introduction of the Corporate Governance Code

Dr Jacob Gakeri has noted that the principles and recommendations of governance for listed companies structured on 'comply or explain' have not been particularly effective[30]. He further states that the obligations of auditors, directors, shareholders and the ownership structure have not facilitated the foundation of effective values of good governance.

The Capital Markets Master Plan calls for mechanisms to promote corporate governance structures and align them with global practices. In order to enhance and monitor governance, the Capital Market Authority is required to create a uniform governance code for all listed companies and issuers. The Master Plan calls for the conversion of the governance guidelines for listed firms into a governance code.[31] This recommendation has been implemented through the enactment of the Code.

The Capital Markets Authority Strategic Plan (2013-2017) notes that though regulation is critical in achieving investor protection, the market participants and licensees prefer deregulation or light regulation.[32]This therefore calls for a necessary balance between regulation and enforcement by the Authority and self-regulation mechanisms.

The Authority's Corporate Governance Blueprint emphasizes that governance will remain to be fundamental in the development of capital markets as it reduces vulnerabilities, lowers transaction costs as well as the cost of capital.[33] In the 2015 CMA Annual Report, it was noted

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[30] Jacob K. Gakeri, *Enhancing Kenya's Securities Markets through Corporate Governance: Challenges and Opportunities*, International Journal of Humanities and Social Sciences, Vol. 3 No. 6, Special Issue, March 2013.
[31] Capital Markets Master Plan for Kenya, 2014-2013, p. 78.
[32] Ibid, note 31, p 13.
[33] A Corporate Governance Blueprint for Kenya, 2014 (Developed by the Capital Markets Steering Committee on Corporate Governance).

that the development of the Code was a key feature in the implementation of the Capital Markets Master Plan.[34]

The United Nations Conference on Trade and Development conducted a study on disclosures in Kenya in 2003.[35] The case study found that public governance had been largely weak. The case study urged the private sector to be competitive, well governed and efficient. It further called for legal, regulatory and policy reforms including the need for strengthening self-regulation. Self-regulation becomes effective through introduction of corporate governance codes as has been demonstrated by their introduction in other jurisdictions.

The Capital Markets Authority 2014 Annual Report highlights the enforcement actions taken by the Authority for the period 2013-2014[36]. The Authority undertook thirty enforcement actions against licensees and listed companies for varied breaches of the Capital Markets Act and regulations. Some of the breaches include late submission of shareholder returns and quarterly accounts, failure to execute client instructions, participation in fraudulent bond transactions, failure to constitute the board according to the law and liquid capital deficits.

In the case of *Capital Markets Authority v. Jeremiah Gitau Kiereini and Another*[37], the Court of Appeal held that CMA plays a vital role in enhancing, regulating and enabling the development of a fair, orderly and sustainable capital market. The Court found that effective corporate management and regulation fosters the interest of local and international investors.

The regulatory framework on corporate governance for companies listed in Kenya is both mandatory and voluntary. The Capital Markets Act and the Companies Act, 2015 set lout the mandatory governance structures. The Capital Markets (Securities) (Public Offers, Listing and

[34] CMA Annual Report, 2015, p. 19.
[35] United Nations Conference on Trade and Development, Case Study on Corporate Disclosures in Kenya, 2003
[36]http://www.cma.or.ke/index.php?option=com_docman&view=list&slug=annual-reports&Itemid=581 accessed on November 23, 2015.
[37] {2014} eKLR.

Disclosures) Regulations, 2002 provide the requirements for listing. The First Schedule of the Regulations provides the key corporate governance requirements for listing including board composition and share capital.[38]The Corporate Governance Code sets out mandatory and voluntary governance standards.

The new Companies Act, 2015 has codified common law principles including the role of directors to act within authority, enhance the long-term sustainability of the company, exercise independent judgment, act with reasonable care and skill and to avoid conflicting interests. The Act has reinforced the corporate governance framework for listed companies. It is important to see the results of the new Companies Act on the corporate governance environment particularly for listed companies.

1.7Theoretical Framework

1.7.1 The agency theory

The theory was postulated by Jensen and Meckling who considered corporate governance as the connection between the principals, such as shareholders and agents[39] In the theory, shareholders being the proprietors of the company recruit the agents to undertake the work. This creates an agency-principal relationship between the managers and the holders of shares. Jensen and Meckling argue that there exists agency costs arising out of the conflict either between managers and shareholders (referred to as agency costs of equity) or between shareholders and holders of debt (referred to as agency costs of debt).

The agency model states that the delineation of ownership and control leads to conflict of interest between the holders of shares and management. The theory therefore calls for the control of managers to avoid moral hazard and hidden costs.[40]. Eisenhardt has noted that

[38] The First Schedule provides for requirements for offering of shares and listing to the public.
[39] Michael Jensen & William Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, Journal of Financial Economics, October 1976, V. 3, No. 4, pp. 305-360.
[40]Arrow K.J. et al, *Barriers to Conflict Resolution*, New York, 1995.

agency theory resolves the conflict that occurs when the agenda of the principal and agent contradict or when it is difficult for the principal to confirm what the agent is doing[41]. Eisenhardt takes the notion that human beings are reasonable, self-motivating and driven by opportunities.

This theory forms the basis for the setting up of corporate governance standards and requirements that deal with the conflicts of interest. An interrogation of the interplay between this theory and the development of corporate governance codes has been undertaken.

1.7.2 Stakeholder theory

This theory states that corporations are instruments for stakeholders to maximize their investment returns[42]. The writings of Adam Smith also relate with stakeholder theory. Stakeholder theory argue that managers have a broad category of associations to serve including suppliers, employees and partners.[43] The stakeholder theory fosters the instrumentality of the interests of all stakeholders.

The Corporate Governance Code emphasizes the role of different stakeholders including regulatory bodies, self-regulatory organizations, investors, securities exchanges and the community in fostering good corporate governance practices. The Companies Act, 2015, also makes a case for the recognition and protection of the interests of all stakeholders.

1.7.3 Stewardship theory

Stewardship theory argues that the 'model man' is a good steward of company resources and acts in the best interests of the principals.[44]This theory postulates that governance structures of firms need to be strengthened so as to enhance the performance of the steward[45]Stewardship

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[41] Kathleen M. Eisenhardt, *Agency Theory: An Assessment and Review*, The Academy of Management Review, Vol. 14, No. 1, 1989, pp 57-74.
[42] Ibid, note 41.
[43] Adam Smith, *The Wealth of Nations*, 1776, Chapter 1, Part 3, Article 1.
[44] Lex Donaldson, & James H. Davis, *Stewardship Theory or Agency Theory, CEO Governance and Shareholder Returns*, Australian Journal of Management, 16, 1, June 1991.
[45] Ibid.

theorists lay emphasis on the need to empower and reinforce as compared to agency theory which focuses on control.[46] This theory takes the view that managers are interested in maximizing a firm's performance and shareholder value.

The stewardship theory guided the research while the agency and stakeholder theories provided the basis for comparison.

1.8Research Methodology

1.8.1 Research design

In order to carry out a thorough corporate governance analysis, it is important that the respondents who participate in the research play a critical role in the listed company or firm.[47] It is also important that interviews be conducted with those who are responsible for the fundamental corporate governance functions.[48] Questionnaires were submitted to select market participants and governance specialists. The sample was selected from staff within CMA working on governance, list of experts based on information from governance institutions and a sample of listed companies. The sample was drawn market segments of the Nairobi Securities Exchange.

In order to analyse the effectiveness of the Guidelines on Corporate Governance for Listed Companies, I reviewed the annual reports of the Capital Markets Authority from the year 2002.[49] I also analysed a sample of the annual reports of listed companies in order to find out their compliance standards.

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[46] Chor Tik, *Compliance and Impact of Corporate Governance Best Practice Code on the Financial Performance of New Zealand Listed Companies*, 2009, p. 22.
[47] Corporate Governance Instruction Sheet for Listed Companies, International Finance Corporation,
[48] Ibid. such persons include representatives of shareholders, chairpersons and members of the Board, chief executive officer, corporation secretary, among others.
[49] The Guidelines became effective in 2002. CMA annual reports have a section on the enforcement actions taken against issuers for failing to comply with corporate governance and other requirements.

The research analysed corporate governance frameworks for selected jurisdictions including South Africa, United Kingdom, Malaysia, Japan and Brazil. The sampled jurisdictions have had recent developments on corporate governance. Corporate governance principles and recommendations from the following international institutions have been leveraged on-

i) International Organization of Securities Commissions (IOSCO);
ii) Organization for Economic Cooperation and Development (OECD);
iii) International Corporate Governance Network (ICGN); and
iv) International Finance Corporation and the World Bank.

The international organizations prescribe the best practices and therefore it was be important to analyse international developments and trends on enforcement of corporate governance.

1.8.2 Research questions

The International Organization for Securities Commissions (IOSCO) Methodology for Assessing Implementation of the IOSCO Objectives and Principles for Securities Regulation[50]highlights the criteria for setting questions. Where questions require a "yes" or "no" answer, the answers need to be augmented by explanations. The research questions was tailored in a manner to ensure that adequate and comprehensive responses are received. The research sought to clarify on the following-

i) How effective is the enforcement of governance requirements for listed companies currently?
ii) Are mandatory requirements or voluntary requirements the appropriate corporate governance framework for listed companies?

[50]FR08/11, September, 2011.

iii) For voluntary requirements to work particularly where explanations are persistent, for how long can companies explain their non-application of corporate governance requirements?

iv) Is there a suitable balance between mandatory and voluntary approaches?

1.8.3 Data collection procedures

The research was undertaken through quantitative and qualitative methods including desk top, library, internet searches and the use of questionnaires. Data from primary and secondary sources was collected. Secondary sources will include annual reports from CMA and listed companies, publications, journal articles, books, court decisions and data from international bodies.

1.8.4 Limitations and assumptions

The research focused on enforcement of corporate governance from the year 2002 to 2016. The Guidelines on Corporate Governance for Public Listed Companies were issued in 2002. The research did not focus a lot on corporate governance prior to the issuance of the Guidelines.

1.9Conclusion

Corporate governance plays a key role in enhancing the sustainability of listed companies. It is important that an appropriate approach for ensuring compliance and enforcement of corporate governance requirements is established. This will ensure that Kenya's listed companies are attractive and competitive.

The research seeks to contribute in making Kenya the "heart of African capital markets" and the prime market for local, regional and global investors.[51]

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[51] Capital Markets Master Plan, p. 10.

CHAPTER TWO

MANDATORY VERSUS VOLUNTARY GOVERNANCE REQUIREMENTS

2.0 Introduction

Corporate governance is key in determining the growth and sustainability of companies particularly listed companies. Listing on a securities exchange may call for greater and more robust corporate governance requirements for a company. Some companies have found corporate governance as a disincentive for listing because of the monitoring and stringent requirements that come with it.

Where there are strict and costly corporate governance requirements, small and medium-sized companies may find listing unattractive as they consider the requirements bureaucratic and the environment overregulated.[52]

OECD has found that strict rules and regulations arguably have an unfavourable effect on the number of initial public offers and listed companies.[53] From the findings, it is necessary to establish the balance between strict corporate governance requirements and the need for flexibility for both small and big companies.

The Capital Markets Authority conducted a Regulatory Impact Assessment of its legal and regulatory framework between April and December 2014[54] whose findings informed regulatory interventions aimed at making Kenya's capital markets robust, competitive and facilitative. Some of the findings were-

(a) the requirements are too onerous for small firms;

(b) the cost of compliance is too high; and

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[52] OECD, *Corporate Governance, Value Creation and Growth- The Bridge between Finance and Enterprise,* 2012, p. 16.
[53] Ibid, p. 17.
[54] Capital Markets Authority, *Regulatory Impact Assessment of the Regulations on Market Development,* December 2014, p. 26-28.

(c) corporate governance requirements are prohibitive to small firms especially on board composition, board committees and reporting.

Mandatory corporate governance requirements may therefore inhibit the flexibility in application to different firm sizes, risks and needs of businesses. A facilitative governance environment together with obligatory disclosure of a company's governance may result in higher level of application at reduced direct expenses to the firm in comparison to a wholly mandatory environment.[55] Kenya's corporate governance framework for listed companies consists of mandatory and voluntary requirements. The mandatory requirements are provided for under the following instruments-

a) Companies Act, 2015;
b) Capital Markets Act; and the
c) Capital Markets (Public Offers, Listing and Disclosures) Regulations, 2002 as amended in 2016[56].

The voluntary requirements are provided for under the Code of Corporate Governance for Issuers of Securities to the Public, 2015. A code is defined as voluntary principles, standards or recommendations issued by a body dealing with the governance of organizations.[57] It is noteworthy that there have been advancements in the governance environment for listed companies in Kenya. Some companies have taken an active step of strengthening their governance and embracing global governance standards. This can be evidenced by the annual reports of companies like Kenya Commercial Bank (KCB) that have considered governance as

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[55] Anita Bindira Anand, *An Analysis of Enabling Vs. Mandatory Corporate Governance Structures Post-Sarbanes-Oxley,* Delaware Journal of Corporate Law, Vol. 31, 2006, p. 229.
[56] Capital Markets (Public Offers, Listing and Disclosure) (Amendment) Regulations, 2016 amended to incorporate mandatory corporate governance requirements under the Code of Corporate Governance for Issuers of Securities to the Public, 2015.
[57] Weil, Gotshal & Manges, LLP, *International Comparison of Selected Corporate Governance Guidelines and Codes of Best Practice,* New York, 2003.

central to the Group's approach to enhancement of shareholder value.[58] Other companies that have taken key steps to enhance governance include Safaricom, Sameer Africa, among others.

So, which regime offers the best framework for delivering effective and efficient corporate governance standards? Voluntary requirements have been recognized as providing a basis for companies to report and explain the status of compliance.[59]

On the other hand, investor advocates are of the view that a voluntary structure is inadequate since there are no guarantees that all companies will apply the voluntary provisions necessary to protect shareholders and check on the agency problems. The number of listed companies in Kenya over the years has been minimal. Could this be attributed to stringent or weak corporate governance and disclosure requirements?

Since 2013, there has been a steady increase of listings especially under the Growth Enterprises Market Segment (GEMS) set up in 2013. GEMS is structured in a flexible manner making it attractive to small and micro enterprises especially on the corporate governance requirements. Some of the flexible listing and disclosure rules for GEMS companies include-

a) being in operation for at least one year;
b) minimum authorized issued capital of at least Kshs 10 million;
c) at least 100,000 shares in issue;
d) appointment of a dedicated Nominated Advisor to assist the firm meet governance requirements; and
e) adequate working capital for at least twelve months after listing; among others

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[58] Kenya Commercial Bank Annual Report, 2015, p. 54.
[59] Ibid, note 57.

The introduction of GEMS provides a flexible environment for small and medium enterprises to list. The appointment of a Nominated Advisor helps the company meet the governance and financial requirements.[60]

2.1 Why the focus on corporate governance?

Corporate governance has been considered key for growth and development of firms. Some of the research findings[61] indicate that-

i) increased opportunities for outside investment by firms can lead to increased valuation, better growth and creation of employment;
ii) lowering of the cost of capital and increased firm value makes more investments viable to investment, leading to stability;
iii) performance through better distribution of resources creates wealth;
iv) governance is associated with a decrease in risk of financial calamities; and
v) good corporate governances leads to improved connections with all stakeholders, improving social and labour relationships, enhancing environmental protection and reducing poverty and inequality.

2.2 Distinction between mandatory and voluntary requirements

Kenya's corporate governance framework is a mix of both mandatory and voluntary governance requirements. The mandatory requirements require full compliance. Any non-compliance attracts from the regulator. Section 25A of the Capital Markets Act sets out the sanctions that can be imposed for breach of the Act, regulations and rules. Some of the sanctions include-

(a) a public reprimand;

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[60] http://www.africancapitalmarketsnews.com/1866/nairobi-securities-exchange-launches-growth-board-for-smes/ accessed on November 28, 2016

[61] Stijin Claessens and Burcin Yurtoglu, *Corporate Governance and Development-An Update*, International Finance Corporation, 2012, p. 17.

(b) suspension from trading;

(c) levying of financial penalties;

(d) disqualification from appointment to a listed company; and

(e) recovery of any benefit accruing to the person violating the law; among others.

The Code of Corporate Governance for Issuers of Securities to the Public is set out on a 'apply or explain' principle. The approach is principle-based and recognizes that a satisfactory explanation for any non-compliance may be acceptable in certain circumstances. For any non-compliance, the Code requires issuers to explain the reason for non-compliance and set out a firm commitment towards full compliance.[62]

The adoption of voluntary standards seeks to provide a high level of investor protection without encumbering the company with high costs of compliance. This means that firms will adopt the voluntary standards based on the incentives available. Voluntary governance regimes have been found to application compliance in the long run since more companies adopt the standards and as a result the standards become the norm among a big number of firms.

The table below provides a summary of a comparison of mandatory, voluntary and a combination of mandatory and voluntary corporate governance requirements[63].

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[62] Code of Corporate Governance for Issuers of Securities to the Public, 2015, p. 1

[63]A number of contents in the table are drawn from Anand's analysis of enabling compared to mandatory governance mechanisms referred to in note 55 and the questionnaire submitted to market participants.

Mandatory corporate governance requirements	Voluntary corporate governance requirements	Combination of mandatory and voluntary requirements
1. It leads to strong markets as it facilitates private contracting since compliance is high.	There is less assurance that firms will adopt the guidelines or codes.	Likely to result in a high level of application at reduced costs than a complete obligatory regime.
2. At a certain threshold, more investor protection instruments do not promote capital markets (diminishing returns argument).	Maintains a high level of protection of investors.	Investor protection enhanced through mandatory requirements and investor participation in providing oversight for voluntary requirements.
3. Minimum standards make compliance satisfactory	Compliance may be erratic as companies have the leeway to choose what to comply with.	Codes may not be a replacement for laws but they can limit the need for laws especially where the need is cultural and behavioural change over time[64].

[64]Comply or Explain, 20th Anniversary of the UK Corporate Governance Code, Financial Reporting Council, 212, p. 5.

4. Compliance may not be guaranteed as companies may not be inspired by sanctions for violations hence may disregard the law and absorb the costs of violations.	Firms may be unlikely to implement voluntary requirements if the costs of implementation are higher than the net benefits.	A balance between costs and benefits is created enabling a company to fit its corporate strategy in line with its business needs and peculiarities.
5. Unless the penalty is unbearable, including an order to stop trading, non-compliance may be an option for companies that are doing well.	Firms may promote voluntary corporate governance principles to avoid devaluation by investors.	Adoption of corporate governance standards not merely for compliance but also as part of the company's culture and ethics
6. May discourage potential issuers especially if the mandatory requirements increase a company's costs of doing business.	Voluntary disclosures may create weaknesses for the firm whereby firms may be disinterested in disclosing information that may be beneficial to their competition.	Mandatory requirements level the playing field while the voluntary aspects foster a need-based approach.
7. Mandatory requirements may be costly leading to decreased competition and market apathy.	Incentives for voluntary disclosures may be stronger if a company has good rather	Reduces the cost of compliance as a company has the flexibility.

	than undesirable news about its governance.	
8. Decreases information overlaps by giving investors minimum details on which to make their investment decisions[65]	May result in information asymmetries as companies may not have a uniform standard to apply	Sets out the minimum acceptable standards that apply to all and the voluntary standards that are good for the business
9. Provides some firmness to the reliability issues where managers may make only selfish voluntary disclosures[66].	Companies may only disclose what is of interest to shareholders and fail to identify areas that require action.	Disclosures on the status of application of the voluntary standards enable investors exert pressure on the company to apply certain provisions if the investors consider them to be good for the business
10. Ensures that investors do not make conclusions based on inferences about governance when firms choose to be silent.	Investors may lack all the information necessary to make an investment decision as disclosures may be arbitrary and haphazard.	Provides room for a balance between key disclosures which are mandatory and best practices.

[65]Ronald J. Gilson, et al, *The Mechanisms of Market Efficiency,* 70 VA. L. REV. 549, 638 (1984).
[66]Paul G. Mahoney, *Mandatory Disclosures as a Solution to Agency Problems,* 62 U. CHI. L. REV. 1047, 1051 (1995).

11. Facilitates transparency for investors especially on information they have about a company's governance practices	Transparency and accountability may be inhibited as investors may not get all the information they require in order to make an investment decision.	Gives companies the opportunity to assess governance requirements necessary for its business
12. Innovation may be stifled as companies are compelled to comply irrespective of the nature of their businesses	Enabling frameworks drive innovation because of the flexibility in application[67]	A balance between mandatory and voluntary enhances stability and fosters innovation
13. Adaptability may be stifled as laws will need to be amended to cater for changing societal perceptions and interests	Enabling frameworks allow for adaptability of corporate governance environment with societal values in a changing world.[68]	Allows adaptability as the voluntary requirements may be enhanced or lessened based on prevailing circumstances

The highlights in the table above illustrate that mandatory, voluntary and a mix of both present opportunities and challenges in enforcement. Whereas mandatory requirements are firm, constant and rigid, they at the same time are restrictive and stringent. The voluntary

[67]Comply or Explain, 20th Anniversary of the UK Corporate Governance Code, Financial Reporting Council, 212, p. 5

[68]Corporate Governance: Improving Competitiveness and Access to Capital in Global Markets, A Report to the OECD by the Business Sector Advisory Group on Corporate Governance, March 27, 1998, p. 13-15

requirements provide a flexible environment while at the same time create inconsistencies and confusion in application and enforcement.

A mix of both mandatory and voluntary requirements provides middle ground whilst creating confusion and inconsistencies in application. It may sometimes be difficult to determine what to make mandatory and those to be voluntary.

This therefore means that the choice of a governance framework depends on the level of economic growth and stability in a jurisdiction, the available enforcement mechanisms and the implementation strategies. There is no one-fits-all system. It should be noted that corporate governance is about building relationships and promoting ethical business practices. A framework that adequately fosters commitment to good governance and instils solid business relationships is worth embracing.

2.3Any recommended enforcement framework?

A one-size-fits-all governance standard may not be effective in enhancing corporate governance for listed companies.[69] Variances exist in complexities and peculiarities of governance needs of companies depending on structure, size, shareholding structure, risks and other factors that influence the governance requirements. Policy makers are therefore called upon to provide companies with a spread of flexibilities for setting relevant governance practice within a framework that sets out minimum requirements.[70]

The voluntary nature of governance codes does not mean that they lack enforceability and effectiveness. Kenya's Code of Corporate Governance for issuers of Securities to the Public, 2015 makes explicit requirements for companies to apply the provisions of the Code and explain any variances or non-application.

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[69]European Commission, Comparative Study of Corporate Governance Codes Relevant to the European Union Members and Its Member States, January 2002
[70]Ibid, note 71.

Under clause 1.1.3 of the Code, issuers are required to implement the Code and disclose to the Capital Markets Authority any non-application and the reasons thereof together with a timeframe and strategies to ensure full implementation of the Code. This requirement gives companies the flexibility necessary for determining the corporate governance standards relevant for their companies and the leeway to explain non-application of the Code.

2.4 Market forces as effective tools for enforcement

Codes place much reliance on markets as a key tool for promoting code application.[71] Kenya's Code requires institutional investors to have a significant role in guaranteeing that companies integrate the provisions of the Code into their governance framework.[72] Some of the responsibilities of institutional investors include-

(a) monitoring and evaluation governance of issuers of securities;

(b) developing guidelines to enhance their stewardship responsibilities;

(c) setting out voting policies; and

(d) periodic reporting to their clients.

The draft Stewardship Code for Institutional Investors seeks to provide guidelines on how institutional investors can ensure that listed companies apply the provisions of the Code in an effective and beneficial manner.

2.5 Linking Codes to mandatory disclosures

A number of codes rely on obligatory disclosure requirement where companies are mandated to disclose the status of compliance or application of the code. This makes it mandatory for companies to disclose in their annual reports the status of compliance with the code. Kenya's Code of Corporate Governance requires issuers of securities to the public, at the close of every

[71] Ibid, note 71.

[72] Clause 3.3.2 of the Code.

year, to disclose in their annual reports a statement on governance and the status of the implementation of the Code.

The European Corporate Governance Forum strongly advocates for enabling corporate governance requirements as they take into account the variety of situations of individual companies[73]. The Forum holds that for the approach to be useful there has to be-

a) a responsibility to comply (apply) or explain which may be found in corporate law, regulator or from listing standards;
b) high standard of accountability, with detailed disclosures; and
c) a system for shareholders to make boards responsible for their choices to comply (apply) or explain and the extent of their disclosures.

Kenya's Code takes a similar approach by calling for a more focused and dedicated stewardship and accountability by shareholders and in particular institutional investors. Corporate governance codes place a heavy reliance on the company and investors for its success. Seidl, Anderson and Roberts take the view that-

"The application of the 'comply –or-explain principle' thus depends on both the investor and the company acting with integrity, and, where necessary, entering into an dialogue to increase each side's understanding of the position of the other."[74]

It has been noted that shareholders sometimes do not have much interest in the corporate governance standards and policies. Much emphasis is placed on performance through the 'comply or perform' standard. This is where holders of shares are not concerned about how their companies are performing provided that they are paying dividends. In essence,

[73]Statement of the European Corporate Governance Forum on the comply-or-explain principle, February 22, 2006.
[74]Setting a Fox to Keep the Geese, *Does Company Explanation Work?* Journal of Corporate Finance*, (2008) 14,* 289.

shareholders may not monitor companies as required if they are performing well.[75] This model of monitoring may not deliver the best results as a company may have strategies for performing well in the short term and little consideration for its long term success and sustainability.

It has been found by the Financial Reporting Council (FRC) that discrete ownership may impede organization of shareholders in order to make directors responsible.[76] In a dispersed ownership structure, shareholders may not engage companies in a more robust and organized manner.

2.6 Challenges in complying with governance codes

Challenges have been witnessed in complying with codes especially on the explanation provided by companies for non-compliance. FRC has noted that there has been a lack of trust in terms of the explanations set out. Companies increasingly use boilerplate statements where open, non-specific statements that provide minimal details are used hence undermining the requirement for boards to be more accountable to shareholders.[77] In order to counter this weakness, the FRC proposed that an explanation must indicate the following[78]:

a) a context and historical background;

b) a well-thought-out reason for the decision; and

c) a background of vindicating position to address any other risk to enable compliance.

2.7 Are shareholders the best advocates for enforcement of voluntary codes?

As it has been noted through experiences in the UK and other jurisdictions, the oversight of comply or explain by shareholders has not been effective. Codes envisage that in situations

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[75]Andrew Keay, *Comply or Explain: In Need of Greater Regulatory Oversight?* Working Paper, September 2012, p. 8.

[76]FRC, *Response to the European Commission Green Paper on the EU Corporate Governance Framework,* 2011, p. 28.

[77]M. Moore, *Whispering Sweet Nothings, The Elusive Spirit of the Law Formalism and the Struggle for Legal Control,* Modern Law Review (1191) 54, p. 849.

[78]FRC, *What Constitutes an Explanation Under Comply or Explain?* February 2012, p. 6.

where companies are not applying the provisions of codes or providing inadequate or unjustified explanations, shareholders hold the companies accountable. Research indicates that investors do not sufficiently monitor and assess what companies report. Some reasons for investor apathy include the costs and complexities involved.[79]Arcot, *et al,* make a proposition that there is need for consideration whether the standard may be enhanced by the giving of monitoring obligations to a regulator.

For Kenya's Code, with the lessons from the UK and other jurisdictions, the Capital Markets Authority is charged with the responsibility of assessing the reports from listed companies especially the veracity of the explanations. Issuers are obligated to provide explanations to the satisfaction of the Capital Markets Authority. Where the explanations are not adequate or are incomplete, the Authority has the power to require better reporting and explanations.

With the involvement of the regulator in reporting compliance and setting out the explanations, arguments have been made on the need for sanctions to enforce compliance. It has been pointed out that the initiation of an enhanced oversight system may be useful where sanctions are tied to failure to comply or failure to adequately explain.[80]

The question then becomes, what kind of penalties should be applied? It has been proposed that it would be better to have 'softer' sanctions which are informal enforcement measures which seek to encourage boards to take the right track as opposed to forcing them to submit.[81] In order to facilitate better compliance and explanations, there may be need to develop

[79]S. Arcot, V. Bruno and A. Faure-Grimaud, *Corporate Governance in the UK, Is the Comply or Explain Approach Working?* International Review of Law and Economics, 2009, 193.
[80]Andrew Keay, *Comply or Explain: In Need of Greater Regulatory Oversight?,* Working Paper, September 2012, p. 29.
[81]J. Amour, *Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment, April 2008*

reporting templates to guide companies. The templates need to be drafted in a manner that it may not result in mere box-ticking that codes seek to dissuade.[82]

[82] Ibid, note 81, p. 32.

CHAPTER THREE

MECHANISMS FOR MONITORING AND ENFORCEMENT OF CORPORATE GOVERNANCE

3.0 Introduction

Monitoring of governance is pivotal for the stability and long-term success of any company. Enforcement in this context goes beyond its literal understanding that is focused on legal enforcement. The scope of enforcement here lies between public-private and formal-informal.[83] The shift from mandatory governance requirements to setting up of codes with the status of recommendations has intensified and evolved over time. At the onset of codes, they merely reflected recommendations developed by professional associations or academia without any contribution from regulators or public authorities.[84]

Codes later received official recognition from different entities including market participants of regulated markets including securities exchanges and securities regulators.[85] There is now an emerging trend where regulators require companies to disclose the status of compliance with codes in their annual reports. This is the case in Kenya, Netherlands, United Kingdom and other jurisdictions. In Kenya, the Capital Markets Authority requires issuers to show in their annual report a statement on governance and the position of their application and compliance with the Code.[86]

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[83]Informal public enforcement focuses on interventions by public bodies without involving judicial or quasi-judicial proceedings. This may result in informal sanctions including reputational sanctions by the regulator or by trading participants and investors. Informal private enforcement includes action taken by parties having a relationship with the company. Such parties may include suppliers, customers and creditors. The sanctions may include reducing the level of engagement with the company, divesting, reducing or denying credit facilities, among others. This taxonomy is drawn from the writings of John Armour, Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment, European Corporate Governance Institute, April 2008, p. 5.

[84] Alain Pietrancosta, *Enforcement of Corporate Governance Codes: A Legal Perspective*, University of Paris – Sorbonne Law School, 2011 p. 4.

[85] Ibid.

[86]Article 1.1.3 of the Code.

Codes contribute in enhancing innovation and creating an environment where companies can actively better their governance practices proactively.[87] Continuous engagement between the company and its investors increases trust and confidence in the company.

Key considerations for setting an effective corporate governance framework include a sound legal, regulatory and institutional framework reinforced by clear compliance and enforcement mechanisms.[88]The existence of an effective framework does not of itself deliver a functioning system. A functioning system requires an enforcement environment that is robust, consistent, reliable and competent. This means that the institutional arrangements for compliance and enforcement are fundamental.

It has been noted that enforcement alone is not adequate neither are regulations without supervision and enforcement.[89] For an effective framework, laws must be designed in a manner that promotes ease of supervision and enforcement.

3.1 Mechanisms for enhancing compliance and enforcement of corporate governance

3.1.0 Collaboration between securities regulators and the police for better surveillance and enforcement

It is necessary that dedicated departments within the police service or public prosecution collaborate to enhance surveillance, supervision and enforcement of securities law. In Kenya's Capital Markets Authority, the Capital Markets Fraud Investigation Unit (CMFIU) was formed in 2009 through collaboration between the Authority and the Kenya Police. The CMFIU

[87] Financial Reporting Council, Essays on Comply or Explain, 20th Anniversary of the UK Corporate Governance Code, p. 5.
[88]OECD, Policy Framework for Investment, User's Toolkit, 2011, p. 3.
[89]OECD, Public Enforcement Practices of Corporate Governance in Asia, Survey Results from 14 Jurisdictions, 2014, p. 3.

consolidates the investigations of fraud in the securities sector.[90]The CMFIU performs the following functions-

i) detection, prevention and apprehension of fraud offenders in the capital markets;

ii) collection, analysis and dissemination of relevant criminal intelligence;

iii) investigation and prosecution of cases in the securities market; and

iv) coordination of the Authority's investigation and enforcement department.

The International Organization for Securities Commissions Principles require that the regulator should have robust inspection, investigation, monitoring and surveillance instruments and systems.[91] The Principle also requires that the regulator should have comprehensive enforcement mechanisms. The regulatory system is also required to ensure efficient use of inspection, investigations, scrutiny and enforcement powers and use of an effective monitoring system.

It is noteworthy that IOSCO Principles recognize that enforcement of securities laws need not be given to a single regulator. The Principles recommend other models including shared responsibilities with other government agencies as well as involvement of the self-regulatory organizations.[92]

Monitoring and enforcement of corporate governance in Codes is buttressed by the involvement of a number of stakeholders keen on ensuring that the company applies necessary principles.

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[90]Capital Markets Fraud Investigation Unit Bulletin, available on www.cma.or.ke/index.php?view=download&alias=75. .. *Accessed on September 28, 2016*
[91]IOSCO Principle 8.
[92]IOSCO Principles, p.15.

3.1.1 Effective board

In order to enhance corporate governance, codes and regulatory requirements call for an effective board that is accountable and responsible for the sustainability of the company. In the UK Code, board effectiveness is achieved by focusing on the following-

i) board and its committees having an suitable balance of expertise, experience, independence and familiarity with the company;

ii) comprehensive, transparent method for the appointment of directors;

iii) formal annual evaluation of the board, its committees and individual directors;

iv) open mechanisms for considering how they should comply with reporting, manage risks and implement internal control principles; and

v) clear delineation between the roles of the board and those of managers.

Kenya's Code requires that the board be composed of members with relevant qualifications capable of exercising independent judgment, and with a focus on guiding strategy development.[93]

Some of the key requirements for enhancing the effectiveness and competence of boards include[94]-

i) open and well-laid systems and processes for appointment of boards;

ii) a balance between executive and non-executive directors;

iii) board be of adequate size to meet the business needs of the company;

iv) limit on multiple directorships to ensure effective participation;

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[93]Part II of the Code on board operation and control sets out fundamental prerequisites for an effective board including formal appointment process, establishment and role of nomination committee, balanced board with sufficient size, diversity in board composition, restriction on multiple directorships, succession planning, continuous board development and annual evaluation. These requirements call for an effective board whose composition, competence and contribution reinforces monitoring and enforcement of good corporate governance practices.

[94]These principles and recommendations are provided for in the Code.

v) succession planning for smooth transition;

vi) establishment of relevant committees including audit composed of competent members;

vii) separation of the roles of the board and management;

viii) mandate of CEO and chairperson of the board should not be exercised by the same person; and

ix) board policies on related party transactions, whistle-blowing, conflict of interest, corporate governance, competence up-skilling programmes for board members.

3.1.2 Shareholder and stakeholder engagement for better monitoring and enforcement

Shareholder engagement ensures that the company dialogues with its shareholders, updates them on company developments and incorporates shareholder feedback in company decision-making processes. Most codes call for a strong relationship between a firm and its investors. The institutional investors are required to actively engage the company and ensure that it aligns its operations within the set principles of corporate governance. South Africa's King III Code requires institutional investors to vote and engage with companies to ensure that governance best practices are consistently applied.[95]

Kenya's Code requires that the board shall promote and protect the rights of shareholders. More importantly, the institutional investors are required to have open and fair practices in their dealings with investee companies.[96] The institutional investors are required to be good stewards as the agents of their clients through[97]-

i) disclosure on their of their stewardship;

ii) monitoring and evaluation of their investments; and

[95] Institute of Directors, South Africa, King Code of Corporate Governance 2009, p. 9
[96]Article 3.3 of the Code.
[97]Article 3.1.1 of the Code.

iii) a policy on voting.

Stakeholder engagement has become a necessary principle for the enhancement of corporate governance, promotion of sustainability and inclusive participation of all. There has been a move from enlightened shareholder where interests and anticipations of stakeholders are considered as fundamental to a stakeholder-inclusive approach. This approach looks at the real interests and expectations of stakeholders as serving the values of the company and not merely for the shareholders only.[98] This shows that the interests of stakeholders are infused into the interests of the firm.

Under the Dutch Code, shareholders are required to carefully assess the reporting of companies and in particular the non-compliance elements and should dialogue to promote good governance practices.[99]

3.1.3 Corporate governance scorecards and indices

Corporate governance scorecards and indices provide a platform where companies can assess and make public their status of compliance or application of corporate governance requirements. In Malaysia, scores and rankings for companies have been established thereby enabling access to information to market participants and providing incentives for companies to comply with requirements or even go beyond the minimum requirements.[100]

Kenya's Corporate Governance Blueprint recognizes the place of scorecards and corporate governance indices and calls for the establishment of a governance index and scorecard by the Authority in collaboration with the Nairobi Securities Exchange.[101]

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[98] Institute of Directors, South Africa, King Code of Corporate Governance 2009, p. 12.

[99] Corporate Governance Code Committee, Dutch Corporate Governance Code, Principles of Good Corporate Governance and Best Practice Provisions, p. 11.

[100] Corporate Governance Country Assessment, Report on the Observation of Standards and Codes (ROSC), Malaysia, July 2012, p. 13.

[101] Capital Markets Steering Committee on Corporate Governance, A Corporate Governance Blueprint for Kenya, February 2014, p. 4.

3.1.4 Corporate governance compliance audits

Corporate governance is an essential component that determines the stability, profitability and sustainability of a company. A company may not always be competent to evaluate its governance mechanisms. This requires external parties to interrogate a company's governance framework and assess compliance with set standards and good practices. Kenya's Code requires the board to carry out governance audits at least annually to confirm that the company is operating on sound governance practices.[102]

The governance audits forestall any lapses and loopholes that may expose the company. The key areas for governance audits include-

i) leadership and management;

ii) openness and disclosure;

iii) compliance with laws, guidelines and regulations;

iv) dealings with stakeholders and other parties;

v) independence of the board and governance;

vi) systems and procedures of the board;

vii) value enhancement for stakeholders; and

viii) corporate responsibility.

These audits provide confidence and confirmation that the company is being run, managed and monitored in a sound and effective manner in line with legal and regulatory requirements. Where such audits are conducted in an independent and reliable manner, there is minimal likelihood that the company is operating in an illegal or unsound environment.

The Code also requires companies to ensure that they comply with the Constitution, relevant laws and legal instruments, national and international standards and its internal policies.[103]

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[102]Article 2.22 of the Code.
[103]Article 2.10 of the Code.

Further, the board is required to undertake comprehensive independent legal audit at least once every two years. These audits should be undertaken by a member of the Law Society of Kenya in good standing. Any recommendations arising out of the audits are required to be acted upon immediately. These legal audits provide comfort and reinforce the company's stability and confidence. The audits also ensure that non-compliance issues are dealt with upon identification without any regulatory or enforcement intervention.

The introduction of reporting of key audit matters under the International Standard on Accounting (ISA No. 701) strengthens reporting on governance and financial matters. The Capital Markets Authority in November 2016 announced the commencement of the standard and the need for disclosure of key audit matters for listed and unlisted entities.[104]

The audits provide a higher level of confidence for investors and regulators. However, there is need to ensure that the auditors involved in these audits are responsible for the recommendations they make. This will ensure that the auditors are held responsible for any misleading reports they make. It is also important that capacity-building and competence-enhancement of the auditors is undertaken especially by the Capital Markets Authority.

3.1.5 The role of the media

The media is a powerful for informing, educating, monitoring, whistle-blowing and dissemination of information. On corporate governance fronts, the media has been an effective tool for holding companies to account and ensuring that information disclosed is accurate, factual and material. The Capital Markets Corporate Governance Blueprint recognizes the key role of the media and calls for their capacity building and training.[105]

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[104] http://www.cma.or.ke/index.php?option=com_content&view=article&id=600:circular-no-11-12-of-2016-application-of-new-international-auditing-standard-no-701&catid=80:latest-newz&Itemid=574. Accessed on November 28, 2016.

[105] Capital Markets Authority, Corporate Governance Blueprint, 2014, p. 25.

3.1.6 Integrated reporting

As part of enhancing corporate governance, integrated reporting has now been introduced in most jurisdictions. The integrated reporting is defined as a process that-

i) brings together, the key details about a firm's focus, corporate governance, performance and forecasts in a manner that reflects its social, commercial and environmental context;

ii) sets out depiction of stewardship and how it provides value presently and in the long-term;

iii) sets out the key information reported in different reporting structures into a complete whole[106].

So, how does integrated reporting enhance monitoring and enforcement of corporate governance? Basically, an integrated report provides an overall picture about the company incorporating both financial and non-financial information. This means that holders of shares and the stakeholder community can make an informed judgment about the company based on the comprehensive information disclosed.

Integrated reporting has been hailed as a tool to enhance accountability, stewardship and trust particularly in building information flow and transparency.[107] The key focus of integrated reporting is conciseness, strategic relevance and future orientation in addition to the following key benefits[108]-

i) makes the reporting process more productive;

ii) brings out integrated thinking resulting in better understanding of factors that materially affect the company;

iii) leads to behavioural changes and improvement in performance

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[106]Article 1.1.2 of the Code, p. 3.

[107]http://integratedreporting.org/why-the-need-for-change/ accessed on October 19, 2016.

[108]http://integratedreporting.org/what-the-tool-for-better-reporting/ accessed on October 19, 2016.

iv) leads to value creation in the long and short term;

v) facilitates connectivity of information; and

vi) leads to better collaboration, more informed decision-making and positive impact on stakeholder relations.

3.1.7 Focus on sustainability

Sustainability considerations have become essential for the long-term success of companies. Sustainability is defined as conducting operations in a way that delivers current needs without jeopardizing future needs.[109] The board is required to ensure that the companies' strategies promote sustainability.[110]

Sustainability reporting have been considered fundamental for[111]-

i) meeting the changing information needs of investors;

ii) providing guidance to increasing disclosure requirements;

iii) managing sustainability performance; and

iv) dealing with social and environmental risks and opportunities.

The Sustainable Stock Exchanges Initiative launched by the United Nations in 2009 is key in ensuring enhanced disclosures through joint efforts with capital market regulators, stock exchanges and institutional investors.[112]

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[109]Article 1.1.2 of the Code.

[110]Article 2.3.7 of the Code provides that focus should be on social, governance and environmental social details of the company..

[111]UNCTAD, Best Practice Guidance for Policymakers and Stock Exchanges on Sustainability Reporting Initiatives, 2014, p. 1.

[112]UNCTAD, Best Practice Guidance for Policymakers and Stock Exchanges on Sustainability Reporting Initiatives, 2014, p.9.

3.1.8 Structure and systems to assess application and explanations

In Kenya's Apply or Explain approach, companies may apply the principle as is, explain its non-application or deviate from the set principles.[113] It is fundamentally important for a structure to assess company application and explanation of the principles of the Code. Without an assessment framework, companies may deviate from the principles and insist on providing explanations every year justifying the non-application of the principles.

It is important that the systems and processes to evaluate company applications and explanations are robust to ensure that the explanations and deviations are monitored and tracked over time. The Code requires that the Authority needs to be satisfied by the explanations given by companies. It is noteworthy that as the Authority is working on the necessary implementation frameworks, issuers are involved.

This will ensure that there is a distinct clarity between the regulator and the issuers on the issuer responsibilities and the expectations of the Authority. Guidance on the structure and content of reports by companies needs to be developed and agreed on in advance.

As indicated above, in an apply-or-explain system, the shareholder is also required to monitor application and engage companies to ensure proper governance practices are established. Both the majority and minority investors are required to take an active role in keeping companies in check. It is often the case that investors with a small proportion of the total shares of the firm rarely consider it necessary to engage and hold companies accountable.

[113]The Code recognizes that satisfaction details for any non-application may be accepted in some instances. It mandates boards to report any non-application to relevant stakeholders and the Authority with a commitment to full compliance. This requirement makes it necessary to at some point fully apply the principle as is. The principles are considered best practices hence the need for commitment for companies to move towards full application. It is noteworthy that some principles in the Code are considered fundamentally critical and they have been made mandatory through replication in the public offers regulations.

This occasions what has been called the 'problem of free riders' where the average investor seeks to benefit from the interventions of other investors.[114] One recommendation for dealing with the problem of free riding is the establishment of shareholder associations to provide an organized and structured way of engaging companies.

3.1.9 Value proposition and incentives for good corporate governance

Companies frown upon regulation and what they sometimes consider as burdensome requirements. They consider additional regulatory frameworks as imposing unnecessary burdens on the companies which sometimes causes the company to lose focus and concentrate on compliance functions. It is indeed noteworthy that a company exists to add value and make profits. A facilitative legal and regulatory framework then becomes fundamental. How can the regulatory environment be tailored to integrate with the companies' business operations?

The Corporate Governance Code recognizes that its principles and recommendations should be adopted so as to make good governance a key part of the companies' culture and business dealings. This requires a change of perception on regulations by companies. This perception can only change where the regulatory environment is facilitative, conducive and beneficial for companies to thrive. This requires close relationships between companies and the regulator and between companies and their shareholders. The regulatory environment must foster an environment built on openness, transparency and dialogue.

3.2 Conclusion

Enforcement of corporate governance requires a whole-rounded approach. It is important that regulators and issuers work together in ensuring that companies are well-managed and adhere

[114]Subrata Sarkar, *The Comply-or-Explain Approach for Enforcing Governance Norms*, Indira Gandhi Institute of Development Research, Mumbai, August 2015, p. 7.

to set legal and regulatory requirements. As detailed above, focus should be laid on detecting governance lapses and loopholes before they become catastrophic.

If all players in the governance environment play their role effectively and set up checks to promote monitoring and compliance, regulatory enforcement will be minimal.

CHAPTER FOUR

COMPARATIVE STUDY ON ENFORCEMENT OF CORPORATE GOVERNANCE

4.0 South Africa

The Institute of Directors has played a significant role in setting up and updating corporate governance for South African companies. The Institute established the committee on governance led by retired Judge M. E. King. With the dismantling of apartheid, the King Report I on Corporate Governance was issued in 1994 with an attached code based on stakeholder approach.[115] King I provided for recommended standards of conduct for boards of listed firms and called for the participation of all stakeholders.

The Report was updated in March 2002 when King II was introduced with more focus on the responsibilities of the board, management of risk, sustainability reporting and auditing. As a result of King II, the Johannesburg Stock Exchange resolved to make it compulsory for all listed companies to include a statement in their annual reports on how they had complied with the principles set out in the Code together with explanations for non-compliance.[116]

In March 2010 King III Report was published based on principle-based apply or explain approach (the earlier version was comply or explain).[117] King III Report is for to all organizations including private, public and non-governmental organizations. Some of the new elements introduced by King III include[118]-

i) integrated reports in place of annual reports;

ii) alternative dispute resolution;

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[115]Adeoye Amuda Afolabi, *Examining Corporate Governance Practices in Nigerian and South African Firms,* European Journal of Accounting Auditing and Finance Research, Vol. 3, No. 1, p. 12.
[116] King Code of Corporate Governance 2009, Institute of Directors, 2009, p. 5.
[117]Ibid.
[118]Ibid.

iii) risk-based internal audit;

iv) shareholders' approval of non-executive directors' remuneration;

v) evaluation of board and director performance; and

vi) information technology governance.

Institutional investors have an enhanced responsibility in enhancing governance in organizations especially given their substantial holdings in such companies. It has been noted that King III Report is sceptical on the responsibility of institutional investors due to the reasons of insider trading problems and the lack of cooperation by institutional investors.[119] One of the recommendations for bettering the Code is the need to particularly set out the roles of institutional investors in calling for companies to apply the principles and recommendations effectively.

Kenya's Code recognizes the role of investors in shaping governance standards for issuers of securities and therefore makes express provisions on how institutional investors can actively participate and engage with issuers of securities.

King III recognizes that the 'comply or else' standard is a one size fits all mechanism which may not be appropriate for all companies[120]. Some of the reasons set out include-

i) the business vary to a large degree;

ii) the cost of compliance is burdensome; and

iii) board and managers may become too focused on compliance at the expense of profits and business.

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[119]Ibid.

[120]Institute of Directors, Southern Africa, King Code of Governance Principles for South Africa 2009, p. 5.

In 2015, the Institute of Directors began the process of updating King III by introducing King IV. Some of the grounds for updating King III include[121]-

i) governance developments locally and globally;
ii) need to extend the scope of the Code to not-for-profit organizations, private organizations and the public sector;
iii) need to make the Code useable to all types of entities across all sectors.

Some of the changes introduced by King IV include-

i) simplified provisions enhancing ease of interpretation through differentiating principles from practice;
ii) ability for organizations to disclose their compliance with King IV online;
iii) new areas to be expanded include remuneration, integrated reporting and responsible investing;
iv) role of ethics committees;
v) obligatory rotation of audit firm;
vi) protection information and security; and
vii) risks.

King IV became effective in October 2016. The developments in South Africa show that corporate governance is not static. Its dynamic nature necessitates its structuring as a code rather than mandatory rules with sanctions for non-compliance. Codes set best practices where companies have the flexibility to apply the provisions as set, seek higher standards or explain their non-adherence.

[121]Institute of Directors, Southern Africa, King IV: Questions and Answers.

King III recognizes that South African companies are considered by global investors as being the best managed in the global growing economies.[122] In South Africa, the directors have a duty to act responsibly in the best interests of the company. In its application of the 'apply or explain' regime, the company determines whether to apply a recommendation would be in the interests of the company. The board may opt to apply the provision differently and still be able to achieve the desired objectives.[123]

4.1Malaysia

Malaysia's investor confidence was badly affected during the 1997/1998 Asian Financial predicament resulting many lessons especially on the need for greater focus on governance.[124]

The Malaysian Code of Corporate Governance was initially issued in March 2000. The issuance of the Code marked a significant milestone in governance reforms. Due to major developments, the Code was reviewed in 2007 in order to reinforce the responsibilities of the board, committees and audit functions.[125] Further revisions were made in 2012 after the development of the Corporate Governance Blueprint, 2011.

The Blueprint provides the necessary governance standards and seeks to achieve excellence through firming up own and market discipline, enhancing better compliance and a governance culture.[126] The key message under the Blueprint is that good business is not merely about achieving profitability but more importantly being ethical and sustainable.

Some of the key principles under the Code include-

i) clear responsibilities;

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[122]Ibid, note 117, p. 6.
[123]Ibid, note 117, p. 6.
[124] Securities Commission Malaysia, Malaysian Code of Corporate Governance, 2012, p. *vii.*
[125]Ibid, p. *v.*
[126]Ibid.

ii) improving board composition;

iii) enhancing independence;

iv) upholding commitment;

v) upholding integrity in financial reporting;

vi) suitable and quality disclosure; and

vii) promoting the relationship between company and shareholders.

4.2 Japan

Japan made key improvements in governance in 2014 and 2015 especially with the development of the Stewardship Code and the release of the final version of the Governance Code by the Financial Services Agency.[127] The reforms were driven to a large extent by need from the foreign business to deal with weak governance and a series of governance scandals.[128] Earlier reforms include the development of the Principles of Corporate Governance for Listed Companies in 2004 and later revision in 2009. Compliance with the Principles was weak since the Principles were not mandatory and companies needed to enhance their governance.[129]

The new Corporate Governance Code is a mandatory document on all listed companies while the Stewardship Code is on a voluntary basis. The Corporate Governance Code establishes principles for efficient governance in listed companies. The Code defines corporate governance as 'as a structure for open, accountable, fair, timely and firm decision-making by firms, with focus on the needs and perspectives of shareholders and clients, employees and stakeholders.' This is a broad definition that takes into consideration all the corporate governance actors and recognizes their role in enhancing governance.

[127] Freshfields Bruckhaus Deringer, May 2015, p. 1.
[128] Ibid.
[129] Ibid, p. 2.

The Stewardship Code on the other hand sets out principles necessary to facilitate the role of institutional investors in fulfilling their stewardship responsibilities. The Stewardship Code defines stewardship roles as the functions of institutional investors to promote return for their principals by enhancing investee companies' value and sustainable growth through focused engagement.[130]

This two-pronged approach is similar to Kenya's where the corporate governance code and the stewardship code work together to deliver a higher standard of corporate governance. The Corporate Governance Code sets out the required standards while the Stewardship Code establishes an oversight and enforcement framework. The two Codes are considered to be 'two wheels of a cart' with the critical emphasis of achieving better corporate governance in Japan.

Japan's Code applies to all companies listed in Japan excluding foreign companies. Some of the principles under the Corporate Governance Code include-

i) promoting the rights and treatment of shareholders;
ii) co-operation with stakeholders;
iii) information disclosure and accountability;
iv) roles of the board; and
v) communication with shareholders.

Some of the key principles of the Stewardship Code include-

i) development of a stewardship policy;
ii) management of conflicts of interest;
iii) monitoring of investee companies;
iv) engagement with investee companies;

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[130]Ibid.

v) voting;

vi) reporting; and

vii) knowledge, skills and resources.

Both Codes have adopted a principles-based approach where a company has the flexibility to implement the Codes with a focus on principles rather than the laws in a manner suitable for the particular situations of each company. Some of the considerations in the implementation of the Codes include the company size, nature of business, company organization and the surrounding environment.

An explanation given must be tacit and informed by the company's circumstances. The preface to the Code states that offering a cosmetic explanation using boilerplate details would be contrary to the principle of "comply or explain".

4.3 Brazil

Brazil's corporate governance framework is built upon a multi-stakeholder approach where the government and private sector play a significant role. The first Corporate Governance Code was issued in 1999 by the Brazilian Institute of Corporate Governance.[131] The Code sets out recommendations on the connection between controlling and marginal holders and standards for better-established board.

In Brazil, corporate governance practices and disclosures are drawn from public and private institutions.[132] The public bodies include legislative bodies, Securities and Exchange

[131]Alexandre Di Meceli de Silveira, *Corporate Governance in Brazil: Landmarks, Codes and Best Practices, and Main Challenges,* October 2008, available at www.ssrn.com.

[132] Marcelle Colares Oliveira, *2013 Review of the Implementation of Corporate Governance Disclosures: Brazil,* Paper presented to the United Nations Conference on Trade and Development Intergovernmental Working Groups of Experts on International Standards on Accounting and Reporting, 30th Session, 2013, p. 6.

Commission (CVM) and the Brazilian Central Bank. The private institutions include BM&FBovepa, corporate governance institutes, investors and company groups.

A review on corporate governance in Brazil by the Organization for Economic Cooperation and Development found that lack of independence and capital hamper the effectiveness of regulatory bodies to monitor and enforce corporate governance standards.[133] The review also found that corporate governance is not often a priority area for regulators. Supervision and enforcement of corporate governance may be through private or public means. Private supervision and enforcement mechanisms including lawsuits are necessary to complement the public mechanisms.[134]

The OECD Principles provide that the governance mechanisms should enhance open and fair businesses, and the balanced distribution of capital. It further states that the framework should be aligned with the law and facilitate effective monitoring and enforcement.[135] It is important to note that supervision and enforcement is efficient where there is a mix of both hard law and soft law.

OECD Principles also call for caution when preparing voluntary codes that have the force of law.[136] The Principles state that when voluntary codes and principles are issued either as a standard or as a counterpart to the existing legal framework, they must be clearly specified especially on matters of implementation, compliance and enforcement actions.

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[133] OECD, Supervision and Enforcement in Corporate Governance; OECD Publishing, 2013, p. 7. The document can be found at http://www.oecd-ilibrary.org/governance/supervision-and-enforcement-in-corporate-governance/brazil-the-corporate-governance-framework-and-practices-relating-to-supervision-and-enforcement_9789264203334-4-en accessed on July 13, 2016.

[134] Ibid, note 19 (OECD..), page 7.

[135] OECD (2015), G20/OECD Principles of Corporate Governance, OECD Publishing, Paris, p. 13. Principle 1 recognizes the need for a sound legal, regulatory and institutional framework. Self-regulatory arrangements, voluntary arrangements and efficient business practices are also considered important for effective corporate governance. This Principle calls for soft law elements founded on "comply or explain" established in corporate governance codes.

[136] Ibid.

The Brazilian Institute of Corporate Governance has developed and continually updated the Code of Best Practice for Corporate Governance since the 1990s.[137] The fundamental need for the Code is to suggest courses of action to all types of companies with a view to improving their performance and facilitating access to capital.[138] The Code is built upon the pillars of transparency, accountability, fairness and ethics.

Research has found that application and enforcement of corporate governance requirements in Brazil has been improving over the years.[139] This has been triggered by the pressure from external entities facilitating the culture of isomorphism. The improvement of governance in Brazil has also been fuelled by the introduction of the Brazil Corporate Governance Index.[140] The index measures six indices covering board composition, board systems, rights of shareholders and improved disclosures.

Enforcement of corporate governance by the Brazilian Securities and Exchange Commission is constrained by lack of direct accessibility to information protected by bank secrecy provisions granted through judicial orders.[141] Another factor is the limited human and financial resources to use its powers to effectively enforce actions.

The development of Novo Mercado, a self-regulatory mechanism issued by Brazilian Stock Exchange in 2000, fostered better governance practices.[142] Whereas Novo Mercado is a voluntary standard, its framework, established through the listing requirements, makes it binding and forceful. Some of the consequences for failing to meet the governance

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[137] Ibid, p. 45.

[138] Preamble to the Code.

[139] Marcelle Colares Oliveira, *2013 Review of the Implementation of Corporate Governance Disclosures: Brazil,* Paper presented to the United Nations Conference on Trade and Development Intergovernmental Working Groups of Experts on International Standards on Accounting and Reporting, 30th Session, 2013, p. 6

[140] Bernard S. Black, *The Evolution of Corporate Governance in Brazil,* Law and Economics Research Paper no. 12-22, found at http://ssrn.com/abstract=2181039.

[141] Alexandre Di Miceli da Silveira, *Corporate Governance in Brazil: Landmarks, Codes of Best Practices and Main Challenges,* School of Economics, Management and Accounting, University of Sao Paulo, 2008, p. 8.

[142] Ibid.

requirements include fines, suspension of shares from trading and cancellation of registration.[143] In addition, the Market Arbitration Panel seeks to ensure that investors have a more effective way of settling disputes and issues related to compliance with the listing requirements.[144] Novo Mercado allows shareholders to present any disagreements relating to the listing requirements to arbitration hence giving shareholders a forum entirely different from the Brazilian judicial mechanisms for resolution.[145]

Research has found that the voluntary adoption of corporate practices has increased divergence rather than convergence leading to greater corporate governance quality heterogeneity among firms.[146] Codes provide an effective model for understanding the importance of corporate governance hence reducing the box-checking mentality.

4.4 United States of America

The USA corporate governance framework for public listed companies is under the mandate of the Securities and Exchange Commission. The legislative instruments governing corporate governance include[147]-

(a) Securities and Exchange Act,

(b) Sarbanes-Oxley Act of 2002

(c) Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010;

(d) Rules of the US Securities and Exchange Commission;

(e) Corporate governance listing standards of the New York Stock Exchange and Nasdaq.

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[143] Ibid.
[144] Ibid.
[145] Ira M. Millstein, Shri G. N. Bajpai, et al, *Enforcement and Corporate Governance: Three Views*, Global Governance Forum, Focus 3, p. 11.
[146] Ibid note 27, p. 17, 18.
[147] http://www.iclg.co.uk/practice-areas/corporate-governance/corporate-governance-2016/usa accessed on November 28, 2016

The US framework is therefore governed by mandatory corporate governance requirements. Enforcement of corporate governance is USA is both private and public. Despite SEC's extensive enforcement powers, private enforcement structures are viewed as critical complement in having compliance with the laws.[148] Despite mandatory governance requirements, USA listed companies have continued to experience scandals and corporate misfeasance including-

(a) self-dealing by management;

(b) managing earnings;

(c) abuse of stock options;

(d) non-disclosures; and

(e) corruption, among others.

In the USA, corporate governance requirements are mandatory and strict. Corporate governance scandals have often resulted in the review and introduction new governance requirements. This shows that mandatory requirements often do not adapt to changing economic and societal dynamics.

4.5 Conclusion from comparative study

The comparative study has highlighted key mechanisms for enhancing compliance with governance requirements and the requisite enforcement tools. According to the Organization of Economic Cooperation and Development (OECD), effective governance requires a stable legal, regulatory and institutional support structure. The framework should comprise of laws, legislative instruments, self-regulatory bodies, voluntary principles and practices based on a country's situation, history and culture. [149]

[148] OECD, Supervision and Enforcement in Corporate Governance, 2013, p. 101

[149] G20/OECD Principles of Corporate Governance, OECD 2015, p. 14.

An enforcement mechanism should consist of a variety of overlapping structures from private to public. The effectiveness of private mechanisms depend on the effectiveness of public mechanisms.[150] Effective enforcement should not only address open breaches but also fill in uncertainties and gaps in the existing framework.[151]

The desirability and effectiveness of an enforcement framework is dependent on its costs and benefits.[152] Some of the mechanisms for enhancing the effectiveness of corporate governance include employee monitoring, media presence, arbitration, audits, competition, reputation and litigation.[153]

Some of the key recommendations drawn from the comparative study include-

(a) a mix of mandatory and voluntary requirements strengthens the corporate governance environment;

(b) stakeholders other than government (investors, communities and private organizations) have an important role in enhancing the adherence to corporate governance;

(c) alternative dispute resolution mechanisms necessary to reinforce disputes;

(d) corporate governance frameworks should clearly outline the implementation, compliance and enforcement mechanisms;

(e) public and private bodies should be incorporated into the corporate governance framework;

(f) corporate governance environment must strengthen the connection between the company and its members;

(g) resources necessary to enhance oversight and enforcement must be availed;

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[150] Ibid, p. 40.
[151] Ibid.
[152] Ibid, p.49.
[153] Ibid. p. 55.

(h) corporate governance requirements must be aligned to the law and linked to effective monitoring and enforcement;

(i) in order to avoid over-regulation, unenforceable laws and standards and onerous requirements, a balance of the costs and benefits of the regulations should be considered;

(j) listing rules should be aligned to corporate governance requirements;

(k) Novo Mercado in Brazil is a clear indication that securities exchanges can be useful avenues for enhancing corporate governance standards; and

(l) flexibility and dynamism should be entrenched into corporate governance frameworks.

CHAPTER V

CONCLUSION AND RECOMMENDATIONS

5.0 Introduction

It has been demonstrated that effective corporate governance cannot be solely mandated by law. Governance requires flexibility so as to fit into a company's business needs. Where governance is always mandated by law, it becomes a box-ticking exercise where companies just comply for purposes of avoiding enforcement actions and sanctions.

5.1 Conclusion

Kenya's capital markets governance framework is a blend of mandatory and voluntary governance standards. These legal and regulatory frameworks provide for the key governance requirements that companies must comply with at the time of being listed and continuously as a listed company. The voluntary requirements are found in the Code of Corporate Governance for Issuers of Securities to the Public, 2015.

The Code calls on companies to continuously improve their governance and report on the status of application of the Code. This is under a principle referred to as 'Apply or Explain'. This principle calls for issuers to apply the provisions of the Code and report any non-application to the Capital Markets Authority and relevant stakeholders. The reporting on non-application should be backed by a commitment by the company to full application of the Code within a set timeframe. This shift allows companies to continuously improve their governance and report to shareholders what is being done to meet the standards set in the Code.

Other actors are necessary to contribute in building and enhancing an effective governance ecosystem. Some of the key approaches for enhancing and strengthening corporate governance monitoring, supervision, compliance and enforcement include the following-

a) Private and public enforcement mechanisms

Private enforcement of governance often occurs through shareholder lawsuits and engagements while public enforcement involves securities regulators, stock exchanges and prosecutors. It has been established that private enforcement mechanisms can complement public supervision and enforcement.[154] This is because securities regulators normally lack the resources and capacity to prosecute and enforce all governance requirements.

It is also important that alternative dispute resolution mechanisms are utilized to ensure that any disputes are addressed in a timely, less costly and expedient manner. Such mechanisms include mediation, conciliation and arbitration.

b) Commitment to good governance

Corporate governance is beyond box-ticking and mere compliance checks. It requires a complete shift in mind-set and approach by corporates. Good governance should be integrated into business practices, procedures and corporate cultures. Without a rethink of the place and significance of good governance to a business or organization, regulatory frameworks may trigger minimal benefits.

It is therefore important that commitment to good governance begins from a personal level then permeates to the corporate environment. Where individual members of senior management and the board do not consider governance and ethics critical, laws and regulations will result in minimal progress.

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[154] Supervision and Enforcement in Corporate Governance, OECD, 2013, p. 7.

c) The role of stakeholders in enhancing good governance

Given that the benefits of good governance trickle down to all stakeholders; the economy, shareholders and governments, it is important that everybody commits to and ensures that good governance permeates to every sector of the economy. Good governance thrives in an environment that is committed to the following corporate governance principles-

i) responsibility;

ii) accountability;

iii) fairness; and

iv) transparency.

Building a culture of good governance requires concerted efforts of all stakeholders. The board and management of listed companies should embrace good governance and make commitments to their shareholders and stakeholders on their responsibilities.

The Code is cognizant of this and has specifically called on investors to be active in providing the oversight of investee companies. The Code requires institutional investors to take an active role in engaging companies they invest in for the purpose of monitoring and enforcing good governance practices.

Where investors actively engage and demand good governance from their investee companies, then regulators will have less enforcement actions to take. It is important that regulators provide established frameworks and facilitation for stakeholders to actively participate in the governance processes and monitoring activities. The draft Stewardship Code for Institutional Investors is calculated to provide better oversight.[155]

[155] The draft Code sets out the necessary framework and obligations for institutional investors for effective engagement with the companies they invest in. The draft is awaiting gazettment by the Cabinet Secretary, National Treasury.

The Companies Act, 2015, sets out a comprehensive framework to regulate registration, membership, management and oversight of companies, among others. The Act recognizes the role of stakeholders beyond the traditional shareholders. Section 143(1) of the Act provides that a director shall act in such a way as to promote the sustainability of the company in the interest of its members. The director is required to consider-

(i) the long term consequences of any decision;

(ii) the needs of employees of the company;

(iii)the need to promote the company's dealings with suppliers, clients, among others;

(iv)the effect of the operations of the business on the stakeholders and the environment;

(v) the need for the company to maintain a reputation for high principles of business; and

(vi)the need to be fair as between the directors and shareholders.

This shows that stakeholders including employees, suppliers, customers, community and the environment have a responsibility in ensuring that companies adhere to good governance practices and sustainability requirements. If companies disregard such stakeholders and the stakeholders do not demand adherence to good governance practices, the entire ecosystem may collapse. This therefore means that stakeholders should remain committed to and conscious of their role and eventual impact of governance to their existence and sustainability.

d) Governance and compliance audits

In order to get assurance of the status of a company's compliance with the law and governance requirements, audits and assessments become fundamental. The Corporate Governance Code calls for assurance of the status of a company's alignment with the law and governance requirements through internal as well as external audit. The audits provide a higher level of assurance of a company's compliance with the law and application of governance standards.

The Code now requires issuers of securities to the public to undertake annual governance audits and biannual compliance audits. The audits are geared towards enabling companies identify governance and compliance lapses and make necessary alignments towards full compliance.

The governance audits are structured on the foundation of 'apply or explain' principle of governance. This means that companies will apply the Code and identify any areas of non-application with clear strategies and commitments towards full application of the Code.

e) The role of the media

The Corporate Governance Blueprint as well as the Code recognize the fundamental role played by the media in monitoring, assessing and reporting governance. The media is an effective tool for analysing and investigating governance. Investors often rely on media reports to make investment decisions. It is therefore critical that the media is cognizant of its duties and is well capacitated to objectively and independently report.

It is therefore important that the media be strengthened and their capacity enhanced so as to provide incisive, comprehensive and factual reports about the status of governance in companies. The media should also be an effective watchdog through investigative reporting on governance and thorough analysis of findings.

f) Development of corporate governance reporting and assessment tools

Corporate governance is a journey, a step-by-step process that companies undergo with the aim of strengthening governance and narrowing any weaknesses. Being a journey, there is need for companies to consistently report and assess their performance over the years. This will require a reporting tool that allows companies to track its governance journey and commitments.

It is therefore noteworthy that the Capital Markets Authority is developing corporate governance reporting and assessment templates to be used by listed companies and the Authority respectively. These tools will be beneficial for companies to as they will enable them

to easily report on their performance and the Authority to assess the status of application of governance principles and recommendations.[156]

In conclusion, the monitoring and enforcement of corporate governance requirements under the mandatory and voluntary frameworks cannot be effective without concerted efforts between regulators, investors, securities exchanges, community, governments and other relevant stakeholders. In Kenya today, a lot of monitoring, supervision and enforcement burden is left to the Capital Markets Authority. This has not been successful.

It is important that the first line of monitoring and enforcement be that of shareholders and relevant stakeholders. The shareholders and stakeholders have a bigger stake in the company hence the need for them to exercise stewardship and responsibility.

Enforcement of corporate governance requires a whole-rounded approach. It is important that regulators and issuers work together in ensuring that companies are well-managed and adhere to set legal and regulatory requirements. As detailed above, focus should be laid on detecting governance lapses and loopholes before they become catastrophic.

[156] Code of Corporate Governance for Issuers of Securities to the Public, 2015, p. 2.

5.2 Recommendations

The key recommendations drawn from the research are that-

(a) a mix of mandatory and voluntary requirements strengthens the corporate governance environment;

(b) stakeholders other than government (investors, communities and private organizations) have an important role in enhancing the adherence to corporate governance;

(c) alternative dispute resolution mechanisms necessary to reinforce disputes;

(d) corporate governance frameworks should clearly outline the implementation, compliance and enforcement mechanisms;

(e) public and private bodies should be incorporated into the corporate governance framework;

(f) corporate governance environment must strengthen the connection between the company and its shareholders;

(g) resources necessary to enhance oversight and enforcement must be availed;

(h) corporate governance requirements must be consistent with law and support effective supervision and enforcement;

(i) in order to avoid to, much regulation, unenforceable laws and standards and onerous requirements, a balance of the costs and benefits of the regulations should be considered;

(j) listing rules should be aligned to corporate governance requirements;

(k) Novo Mercado in Brazil is a clear indication that securities exchanges can be important avenues for enhancing governance standards; and

(l) flexibility and dynamism should be entrenched into corporate governance frameworks.

If all players in the governance environment play their role effectively and set up checks to promote monitoring and compliance, regulatory enforcement will be minimal.

The Code of Corporate Governance calls for companies to make corporate governance a key part of their business dealings and corporate culture. For this to happen, companies should look at good corporate governance as a fundamental ingredient for their prosperity, long-term success and sustainability.

To reiterate the importance of corporate governance, the Chairman of the Authority's Board commended during the launch of the cooperation agreement between IFC and the Authority on November 2, 2016, that-

*"The ultimate success of the Authority and all other stakeholders will come when the whole corporate world accepts and embraces good governance not because regulators forced them to do so, not because it is 'global best practice', not for checking or ticking of boxes but because they recognize and accept that it is the **right** way to do business, it is **the** only way to do business."*[157]

[157] http://www.cma.or.ke/index.php?option=com_content&view=article&id=595:remarks-by-the-chairman-capital-markets-authority-board-during-the-launch-of-the-partnership-between-ifc-and-cma-on-the-implementation-of-the-corporate-governance-code-november-1-2016-at-sarova-stanley-hotel-nairobi&catid=80:latest-newz&Itemid=574 accessed on November 28, 2016

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