CONVERGENCE OF TRADITIONAL CORPORATE GOVERNANCE AND MODERN CORPORATE GOVERNANCE REFORMS: IS KING II déja vu FOR BOARDS OF DIRECTORS OR IS IT A SET OF NEW PRINCIPLES?

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SUMMARY

Contrary to popular belief, corporate governance is not a new subject. In fact, corporate governance has been practised for as long as there have been corporate entities. Corporate governance has always been reflected in legislation such as the Companies Act, Insolvency Act, Insider Trading Act and similar legislation. However, some of the recent recommendations resulting from reforms in this area reflect the improvement of corporate governance standards. This article is an attempt to point out similarities and divergences between traditional corporate governance and modern corporate governance as suggested by the latest reforms, particularly in the King Report on corporate governance (2002).

1 INTRODUCTION

According to Tricker, “corporate governance has been practised for as long as there have been corporate entities”.¹ This is correct and sums up the approach taken by this article. This means that in view of the fact that it has always been necessary to direct companies subject to certain controls,

corporate governance is not a modern concept. What is new, it is submitted, are some of the recent corporate governance principles established as a result of reforms in this area.\(^2\) It is indeed acknowledged that corporate governance reforms have contributed tremendously to the way in which corporate governance is undertaken today. As observed by one expert on corporate governance,

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\text{"[c]odes of corporate governance in the current form that we know them today have not existed for more than a decade. This does not mean that the issues that are dealt with in codes of corporate governance have not been considered or documented before. Indeed, since the creation of the joint-stock companies and the onset of the concept of appointing directors as trustees, agents or representatives of shareholders, the relationships that subsist between shareholders, directors and other parties who deal in the company have been topical matters for over a century".}\]

This makes it clear that company legislation (such as the Companies Act 1924 and 1973), articles of association and the common law have always regulated principles of corporate governance. Therefore, it is clear that corporate governance aspects such as fiduciary duties of directors, requirements for special resolutions, the role of shareholders and company meetings have always been provided for in terms of both common law and companies legislation. Corporate governance, as provided for in terms of common law, companies legislation and the articles, is referred to as traditional or conventional corporate governance. The principles of corporate governance under this regime are backed up by legal enforcement, either in terms of common law or pursuant to statutory provisions. For example, a breach of fiduciary duties enables shareholders or the company to sue the wrongdoers in terms of common law derivative action or in terms of statutory derivative action provided for by section 266 of the Companies Act 61 of 1973 ("the Companies Act"). Furthermore, shareholders have always been able to use common law personal action and section 252 of the Companies Act to enforce their personal rights affected as a result of breach of some corporate constitutional provision or as a result of a breach of common law or a statutory provision protecting rights of shareholders in their capacities as members. Such breach would obviously be a contravention of corporate governance principles.

On the other hand, there is a new regime of corporate governance which is concerned with the enhancement or fortification of the rules and principles of company direction (found at common law and in company legislation) for the purpose of accommodating the modern environment within which companies operate and the imposition of stricter checks and balances to curb or alleviate malpractices or wrongdoings by those engaged in corporate

\(^2\) Like the new reporting obligations in relation to social and environmental issues.

\(^3\) See Kihumba “Setting Governance Policies: Codes or Regulation?” Global Corporate Governance Trust Conference, Connecticut, 10 July 2000. This paper is available at http://www.gcgf.org/library/speeches/Kihumba.doc.
decision-making. This regime is embodied in codes of good practice and was established as a result of reviews undertaken by panels established by the private sector (or the corporate world). In the case of South Africa such a review was undertaken by the King Committee on Corporate Governance in South Africa and it published its recommendations in the Code of Corporate Practices and Conduct (“the Code”). This regime is referred to as the self-regulatory regime of corporate governance (or the “Code system” of corporate governance) in the sense that it has no legal basis for enforcement. The regime is underpinned by the philosophy of “comply or explain”. This article considers whether the Code constitutes a repetition of corporate governance principles as found at common law and in companies legislation, or whether there is something new to be learned from the regime.

It is worth mentioning that the importance of good corporate governance dawned after the weaknesses of conventional corporate governance were exposed, leading to the collapse of many companies all over the world. As a result of these collapses, the value of good corporate governance became apparent to all stakeholders within the corporate sector. King II accepts the findings of the McKinsey survey published in June 2001 that shareholders are willing to pay a premium for the shares of a well-governed company over one considered poorly governed but with a comparable financial record. Consequently, by simply developing good governance practices, directors can potentially attract a number of long-term investors. This, according to the Report, shows that the implications of good corporate governance for companies are profound. Arthur Levitt, former Chairman of the Securities Exchange Commission in the US once said: “If a country does not have a reputation for strong corporate governance practices, capital will flow elsewhere.” James Wolfensohn, President of the World Bank, is associated with the statement that: “The proper governance of companies will become as crucial to the world economy as the proper governing of countries.”

Affected companies are required to comply with the Code of Corporate Practices and Conduct as contained in the King Report. However, if

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4 See Mongalo 185.
5 The Report of the King Committee is referred to as King II.
6 Obviously, not all the collapses of companies during the 80s and 90s were due to poor corporate governance. There are plenty of reasons for businesses failing that have nothing to do with poor corporate governance. But most of the classic collapses were as a result of failure of traditional corporate governance principles.
8 See King II 10 par 16.
9 King II 8 par 7.2.
10 These include listed companies, banks, financial and insurance entities, and public sector enterprises that fall under the Public Finance Management Act. See par 1.1 of the Code.
companies fail to comply with any provision in the Code, this must be disclosed in the annual report and the reasons for non-compliance must be stated. This is the “comply or explain” philosophy. While it is the Code with which companies need to comply, the Report (King II) helps one in understanding the provisions of the Code. This article looks at the provisions of the Code, but will draw attention to the recommendations in the Report itself where necessary.

As already stated, it is important to realise that some of the recent corporate governance principles (as found in the Code) merely restate, perhaps in an enhanced manner, principles found in our traditional corporate governance. As a result, there are many corporate governance principles (recent or traditional) which may be legally enforced in our courts of law as shown above.

2 THE CODE ON DIRECTORS AND BOARDS OF DIRECTORS

This section considers corporate governance principles regulating directors and boards of directors and discusses whether such principles are new or whether they constitute principles that have always existed in the realm of conventional corporate governance. Boards of directors are dealt with in paragraph 2 of the Code of Corporate Practices and Conduct. It is common cause that the importance of the board has always been recognised by traditional corporate governance principles from as far back as the 19th century. It is noteworthy that the necessity of board meetings, requiring directors to act in concert, was recognised in the conventional regime by, among others, the case of *Re Haycraft Gold Reduction Co.* The Code, to a large extent, reinforces the well-known governance principles in this regard. For example, it advocates a unitary board structure which, it maintains, remains appropriate for South African companies.

The Code also emphasises the importance of having an effective board which will lead and control the company and monitor management in implementing board plans and strategies. Perhaps one of the most important developments concerning the board of directors is the emphasis in the Code that its function is to monitor

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11 [1900] 2 Ch 230 235.
12 Par 2.1.2. The unitary structure was, of course, inherited from the British system from which our principles of corporate governance emanate. Even though the Companies Act 1973 does not recognise the difference between executive and non-executive directors, in practice such a distinction has always existed even though it did not mean that the board was two-tiered.
13 See par 2.1.3 and 2.1.4. See also Cadbury Report par 4.1; Hampel Report par 2.3; and UK FSB Listing Rules (2000) Principle A1 (Combined Code).
management. The Code provides that the board should define levels of materiality, reserving specific power to itself and delegating other matters with the necessary written authority to management. These delegated matters should be monitored and evaluated on a regular basis. In addition to this, the board should ensure that the company complies with all relevant laws, regulations and codes of business practice and communicates with its shareholders and relevant stakeholders openly and promptly, with substance prevailing over form. In terms of the traditional regime, of course, non-executive directors were not obliged to give continuous attention to the affairs of the company, so it is unlikely that they could have ensured that the company complied with all relevant laws and regulations. Moreover, traditional corporate governance does not oblige directors to communicate with any other stakeholders except the shareholders, with whom the directors communicate in accordance with legislative provisions. Modern corporate governance reforms requiring boards to communicate frequently with stakeholders signify a departure from the traditional governance regime. King II details stakeholder communication matters in section 4 of the Report, entitled “Integrated Sustainability Reporting”. Stakeholder communication matters are also laid out in paragraph 5 of the Code.

Under the conventional regime of corporate governance, the laxness of the law with respect to non-executive directors and the latter’s part-time status within the company restricted their access to the company’s relevant resources. With the introduction of corporate governance reforms, however, the whole board is entitled to have unrestricted access to all company information, records, documents and property. Furthermore, the information needs of the board should be well defined and regularly monitored. In order to make the above recommendation effective, the Code provides that the board should have an agreed procedure whereby directors

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14 Under the traditional corporate governance regime this was not always strictly followed. This is illustrated by, among other things, the cases of *Re City Equitable Fire Insurance Company* [1925] 1 Ch 407; *Re: Brazilian Rubber Plantations and Estates Ltd* [1911] 1 Ch 425; and *Fisheries Development Corp v Jorgensen* 1980 4 SA 156 (W), where courts emphasised that non-executive directors were not obliged to give continuous attention to the affairs of the company.
15 Par 2.1.6.
16 See also Cadbury Report par 4.5; and Hampel Report par 3.8.
17 Par 2.1.5 of the Code.
18 See, eg, the cases of *Re City Equitable Fire Insurance Company* [1925] 1 Ch 407 and *Fisheries Development Corp v Jorgensen* supra.
19 Eg, at AGMs and other meetings. With the introduction of corporate governance reforms, however, boards are encouraged to ensure that there is effective communication between the company and its internal and external stakeholders.
20 Par 2.1.7 of the Code. On the issue of resources to be made available to non-executive directors see also the Cadbury Report par 4.8, 4.14, 4.18, 4.25-4.27; Hampel Report par 2.6, 3.4; and Combined Code Principle A4 Code A.1.3, A.1.4, A.4.1.
21 Par 2.1.7 of the Code.
22 Par 2.1.9.
may, if necessary, take independent professional advice at the company’s expense. Indeed, it would be absurd if directors were expected to play a monitoring role without being well-informed.\(^{23}\)

It is important to note that with all these recommendations comes the temptation on the part of the directors merely to comply with the letter rather than the spirit of the Code.\(^{24}\) In other words, the feeling among the directors may be that so long as they have complied with the relevant provision of the Code that would be enough for good corporate governance. The Code, however, makes it clear\(^{25}\) that the board must find the correct balance for its business between conforming with governance constraints and performing in an entrepreneurial way. In other words, the board should ensure a balance between “performance” and “conformance”. This requires the board to ensure that not only is it concerned about whether the company complies with corporate governance principles, but also with ensuring greater performance of the company. Merely concentrating on conformance will result in box-ticking and as a result, the value of corporate governance reforms will be drastically reduced. Furthermore, a “conformance supremacy” approach may lead to lack of innovation and nimbleness on the part of boards. Obviously, boards that emphasise performance over conformance are likely to yield favourable shareholder return for their shareholders, but this may ultimately be fatal to companies since, as they are not operating in a vacuum, ignoring other interests may have suicidal consequences.\(^{26}\)

In the traditional corporate governance regime, the balance between executive and non-executive directors within the board is not the issue. Even though, clearly, boards with more executives than non-executives have a tendency to flout good corporate governance principles, the traditional regime refused to budge.\(^{27}\) In terms of the Code, however, the board should comprise a balance of executive and non-executive directors, preferably comprising a majority of non-executive directors of whom sufficient should be independent of management so that shareholder interests (including minority interests) can be protected.\(^{28}\) Such balance may also be important in another respect. For non-executive directors to be seen as effective in

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\(^{23}\) See also Cadbury Report par 4.8, 4.14, 4.18 and 4.25-4.27; Hampel Report par 2.6 and 3.4; and Combined Code Principle A4 Code A.1.3, A.1.4 and A.4.1.

\(^{24}\) “Box ticking” approach.

\(^{25}\) Par 2.1.18.


\(^{27}\) The importance of maintaining the balance was first emphasised in the Cadbury Report par 4.10-4.12; Hampel Report par 2.5, 3.9 and 3.14; Combined Code Principle A3 Code A.3.1 and A.3.2.

\(^{28}\) Par 2.2.1.
curbing executive excesses such as unjustified executive pay, they should at least be equal or greater in number than the number of the executives.

Another issue of importance highlighted by the Code concerns the appointment of directors. By and large, the process of appointment under the traditional regime was not monitored; neither was it transparent. In practice, under the traditional regime, the chairman of the board, who was almost always also the CEO, would often have a decisive say as to the composition of the board. The shareholders’ vote was therefore merely a rubber stamp to the chairman’s (chairman-cum-CEO’s) choice. That is why in terms of the new regime the Code requires procedures for appointments to the board to be formal and transparent, and to be a matter for the board as a whole. In addition, the Code recommends that this process should, where appropriate, be assisted by or involve a nomination committee. More importantly, the nomination committee should constitute only non-executive directors of whom the majority should be independent, and be chaired by the board chairperson, who should preferably not be the CEO of the company.

On a related point, the new regime also recognises something sinister about the roles of a chairperson and a CEO being undertaken by one person within the company. This is not an issue under traditional corporate governance. The Code acknowledges that the roles should be separated or should be performed by separate persons. However, the Code goes on to say that where the roles of the chairperson and chief executive officer are combined, there should be either an independent non-executive director serving as deputy chairperson or a strong independent non-executive director element on the board.

To emphasise that it is good corporate governance practice not to combine the roles of chairman and CEO, the Code provides that any decision to combine roles should be justified each year in the company’s annual report.

The effectiveness of the role of non-executive directors has always been open to question under the traditional governance regime. Even under the new regime, the role of non-executive directors as vigilant monitors of management is still questionable. That is the reason why in terms of the

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29 Par 2.2.2.
30 In this way, it is thought that the previous influential role of the chairman cum CEO would be drastically diminished. See also Cadbury Report, par 4.30; Hampel Report, par 2.7, 3.19; Combined Code, Principle A5, Code A.5.1 on the role of the nomination committee.
31 See par 2.3.1, 2.3.2 and 2.3.3.
32 Consider a similar recommendation in Cadbury Report, par 4.7-4.9; Hampel Report par 2.4, 3.16-3.18; Combined Code, Principle A2, Code A.2.1. See also par 2.3.4 and 2.3.5 of the Code.
33 Par 2.3.4.
34 This has been made more so because of, among other things, the recent collapse of Enron, a multinational energy company. On the evolution of the role of non-executive directors, see Parkinson “Evolution and Policy in Company Law: The Non-Executive Director”
Code regime, the board should ensure that there is an appropriate balance of power and authority on the board, so that no one individual or block of individuals can dominate the board’s decision taking.\textsuperscript{35} For non-executive directors to be effective, the Code recommends that they should be individuals of calibre and credibility and must have the necessary skill and experience to bring judgment to bear, independent of management, on issues of strategy, performance, resources, transformation, diversity and employment equity, standards of conduct and evaluation of performance.\textsuperscript{36} To enable non-executive directors to be fully informed about the processes and thereby make informed contributions, the Code recommends, among others, that the company secretary\textsuperscript{37} has a pivotal role to play in this regard. The chairperson\textsuperscript{38} is entitled to the strong and positive support of the company secretary in ensuring the effective functioning of the board. Furthermore, the board as a whole and directors individually must have access to the detailed guidance of the company secretary as to how their responsibilities should be properly discharged in the best interests of the company.\textsuperscript{39} Generally, in order to strengthen the independence of directors, the company secretary should provide a central source of guidance and advice to the board, and within the company, on matters of ethics and good governance.\textsuperscript{40}

This change in the role of directors, especially non-executive directors, clearly highlights or exposes the shortfalls of traditional practice. Under the conventional governance regime, the practice was to appoint a well-known figure as a non-executive director. It did not matter whether or not such a person knew anything about the company. In addition, such non-executives were, in effect, merely ceremonial figures and did not perform any tasks on behalf of the company.\textsuperscript{41} The Code system attempts to do away with such a

\textsuperscript{35} Par 2.4.1.
\textsuperscript{36} Par 2.4.2. In accordance with the traditional corporate governance regime, as reflected in \textit{Fisheries Development Corporations \textit{v} Jorgensen supra} and other cases, a director is not required to have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company.
\textsuperscript{37} A company secretary is a senior administrative officer of a company. In terms of section 268A of the Companies Act, the directors of a public company with a share capital are obliged to appoint a secretary permanently residing in South Africa. A secretary’s duties are stated in section 268G and include “guiding directors as to their duties”.
\textsuperscript{38} See generally, par 2.10.
\textsuperscript{39} Who should preferably be a non-executive director.
\textsuperscript{40} Par 2.10.3.
\textsuperscript{41} Par 2.10.5.
\textsuperscript{42} See, \textit{eg}, Havenga; \textit{“Business Judgment Rule – Should We Follow the Australian Example?”} 2000 12 \textit{SA Merc LJ} 26-27, who supports the statement that in the past non-executive directors were regarded as figureheads and were often appointed because of their titles or reputations rather than their business skills. Consider also the statement by
self-defeatist practice. The Code goes even further by providing clear definitions of non-executive, executive and independent directors.43

A further point to be made is that in accordance with the pre-Code regime, executive directors could hold as many non-executive positions as they wished, so long as their contracts did not prevent them from doing so.44 This principle is endorsed in the new regime subject to the proviso that the non-executive directorships should not interfere with the director’s immediate management responsibilities.45 The Code adds, however, that non-executive directors should carefully consider the number of appointments they take in that capacity so as to ensure that the companies on which they serve enjoy the full benefit of their expertise, experience and knowledge.46

In the case of Fisheries Development Corp v Jorgensen,47 the court emphasised that

“a non-executive director is not obliged to give continuous attention to the affairs of his or her company. His or her duties are of intermittent nature to be performed at periodical meetings, and at any other meetings which may require his or her attention. However, such director is not bound to attend all such meetings, though he or she ought to whenever he or she is reasonably able to do so”.

This attitude led, in many cases, to company failures and massive collapses in the late 1980s since non-executives could not act as vigilant monitors of management.48 Unsurprisingly, the position has been changed by the present regime and the Code provides that the board should meet regularly, at least once a quarter if not more frequently as circumstances require, and should disclose in the annual report the number of meetings each year and the details of attendance of each director at such meetings.49 Furthermore, efficient and timely methods should be determined for informing and

Philip Armstrong, the chief convener of the King Committee, who was quoted as saying: “Non-executive directors in South Africa still tend to see appointments as honorific rather than contributory.” See Sunday Times of 2002-07-22 http://www.suntimes.co.za/2001/07/22/business/columns/columns4.htm.

43 See 2.4.3.
44 In the case of Bell v Lever Bros Ltd [1932] AC 161 195 Lord Blanesburgh ruled as follows about this governance principle: “The principle will be found in the case … of London and Mashonaland Exploration Co v New Mashonaland Exploration Co [1891] W. N. 165, where it was held that, it not appearing from the regulations of the company that a director’s services must be rendered to that company and to no other company, he was at liberty to become a director even of a rival company, and it not being established that he was making to the second company any disclosure of information obtained confidentially by him as a director of the first company he could not at the instance of that company be restrained in his rival directorate. What he could do for a rival company, he could, of course, do for himself.”

45 Par 2.4.5.
46 Ibid.
47 Supra 165.
48 See Mongalo fn 1 ch 7. See also Smerdon A Practical Guide to Corporate Governance (1998) 1-3.
49 Par 2.6.1.
briefing board members prior to meetings, while each board member has a responsibility to be satisfied that, objectively, they have been furnished with all the relevant information and facts before making a decision.\footnote{50}

On the functioning of the board, the Code makes it abundantly clear that there should be a formal procedure for certain functions of the board to be delegated, describing the extent of such delegation, to enable the board to properly discharge its duties and responsibilities and to effectively fulfil its decision taking process.\footnote{51} In the past, cases such as that of Guinness plc v Saunders\footnote{52} in the UK revealed that the process of delegation of duties by the board was usually haphazard. The Code system clearly tries to remedy the situation and provides that board committees with formally determined terms of reference, life span, role and function constitute an important element of this process and should be established with clearly agreed upon reporting procedures and written scope of authority.\footnote{53} In addition, there should, as a general principle, be transparency and full disclosure from the board committee to the board except where the committee has been mandated otherwise by the board.\footnote{54} Given the importance of the committees,\footnote{55} the Code recommends that at a minimum, each board should have audit and remuneration committees.\footnote{56} Since board committees are important in ensuring that independent judgment is attained in corporate decision-making, non-executive directors will, almost invariably, play an important role in these committees.\footnote{57} The importance of the role of non-executive directors in board committees is emphasised by the fact that all recommended committees should preferably be chaired by an independent non-executive director, whether this is the board chairperson or some other appropriate individual.\footnote{58} Moreover, board committees should, in terms of the Code, be free to take independent outside professional advice as and when necessary and should not be the alter ego of the management component of the board.\footnote{59} To ensure that board committees are not merely a conformance structure, they should be subject to regular evaluation as to their performance and effectiveness.\footnote{60}

\footnote{50}{Par 2.6.2.}
\footnote{51}{Par 2.7.2.}
\footnote{52}{[1990] 2 AC 663.}
\footnote{53}{Par 2.7.3.}
\footnote{54}{Par 2.7.4.}
\footnote{55}{Indeed, the board of directors cannot be expected to meet every time a decision has to be made, irrespective of how minor or important that decision is.}
\footnote{56}{Par 2.7.5.}
\footnote{57}{Par 2.7.6 of the Code. This is epitomised by the fact that in all the three committees mentioned in the Code (audit, remuneration and nomination committees), the majority of the members should be non-executive directors.}
\footnote{58}{Par 2.7.7. A board committee fulfilling an operational function should not be headed by the chairperson of the board, according to the Code.}
\footnote{59}{Par 2.7.8.}
\footnote{60}{Par 2.7.10.}
In terms of traditional corporate governance, boards of directors are not obliged to have committees. In other words, there is no minimum number of committees the board should have.  

There are further duties and responsibilities of boards of directors which either supplement traditional corporate governance or coin new corporate governance principles. These are reflected in the entire Code and in the Report itself. For example, in terms of the Code, the board should minute the facts and assumptions used in the assessment of the going-concern status of the company at the year end. Further, directors should make every effort to ensure that information is distributed via a broad range of communication channels. Other responsibilities of the board, which reflect the era of good corporate governance, include the following:

(a) The board is responsible for the total process of risk management, as well as forming its own opinion on the effectiveness of the process. Management is accountable to the board for designing, implementing and monitoring the process of risk management and integrating it into the day-to-day activities of the company.

(b) The board should set the risk strategy policies in liaison with the executive directors and senior management. These policies should be clearly communicated to all employees to ensure that the risk strategy is incorporated into the language and culture of the company.

(c) The board is responsible for ensuring the company has implemented an effective ongoing process to identify risk, to measure its potential impact against a broad set of assumptions, and then to activate what is necessary to proactively manage these risks.

(d) The board is responsible for ensuring that a systematic, documented assessment of the processes and outcomes surrounding key risks is undertaken, at least annually, for the purpose of making its public statement on risk management.

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61 A 80 of Table A merely states that “the directors may delegate any of their powers to committees consisting of such member or members of their body as they think fit. Any committee so formed shall, in the exercise of the powers so delegated, conform to the rules that may be imposed on it by the directors”.

62 Par 6.2.3.

63 Par 6.2.6.

64 Par 3.1.1.

65 Par 3.1.2

66 Par 3.1.3.

67 Par 3.1.5.
The board is responsible for disclosures in relation to risk management in the annual report and it must, at a minimum, disclose, among other things:\textsuperscript{68}

(i) that it is accountable for the process of risk management and the system of internal control, which is regularly reviewed for effectiveness and for establishing appropriate risk and control policies, and communicating these throughout the company, and

(ii) that there is an adequate system of internal control in place to mitigate the significant risks faced by the company to an acceptable level. Such a system is designed to manage, rather than eliminate, the risk of failure or maximise opportunities to achieve business objectives.

3 \hspace{1cm} \textbf{CONCLUSION}

It has been made clear that although corporate governance is not a new concept, there are principles which attempt to fortify or strengthen the existing regime. Indeed, boards need to be more vigilant in monitoring management than was the case a decade ago. The system may still be the same in private companies and closely held corporations, but for large listed companies the new regime of corporate governance is a must. For listed companies, the value of corporate governance (in terms of the new regime) is signified by the importance attached thereto by investors in making investment decisions. Since foreign direct investment is instrumental to the country’s economic growth, a good system of corporate governance must be in place. In conclusion, boards must be cautioned that corporate governance is not merely an amplified Companies Act.

\textsuperscript{68} Par 3.2.6.