Title: Corporate governance codes: Defining the role of the board through policy and practice

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Keywords: corporate governance, regulation, boards of directors, norms and soft law

Introduction

The focus of this paper is the increasing use of codes of corporate governance as an element of the regulation of corporations. A code of corporate governance can be defined as ‘a non-binding set of principles, standards or best practices, issued by a collective body and relating to the internal governance of corporations’.\(^1\) Codes comprise a relatively new form of soft regulation added to the control of corporate conduct in the last two decades.\(^2\) Indeed, the publication of the United Kingdom’s first code in 1992 marked the start of a remarkably fast proliferation of codes worldwide. Aguillera and Cuervo-Cazzurra noted that there were 24 countries with codes in 1999 and Lopez-Iturriaga reported 63 countries with codes in 2008.\(^3\) The trend has continued with 94 countries providing their codes to the European Corporate Governance Institute in 2015.

This paper charts the development of codes of corporate governance over the last 25 years and explores both the policy behind them and the practical challenges they are designed to resolve. Their flexible, non-legal nature permits regular review and amendment and enables them to tackle some of the more complex dilemmas faced by large organisations including: optimal board composition; risk management; stakeholder engagement; executive remuneration; and, most recently, gender diversity. Little discussed is the fact that code effectiveness depends both on the

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regulatory mechanism used as well as the content and substance of code provisions. The first part of the paper introduces these ideas, explaining the regulatory theory behind the commonly used ‘comply or explain’ mechanism as well as some of the theories behind common code recommendations, particularly those relating to the role of the board of directors in corporate governance. In this way the paper takes a novel interdisciplinary approach drawing on both the legal and regulatory literature as well as management theories.

The second part of the paper describes and analyses the development of corporate governance regulation in Australia against this theoretical background. While focusing on the Australian code of corporate governance, the paper draws on parallel developments internationally to compare and contrast the different approaches applied to common problems. Its analysis of the evolution of corporate governance codes over time provides insights into the changing role of the board of directors. On the basis that code reforms both reflect and encourage the institutionalisation of norms of practice, the paper finds that the board’s role has moved from a focus on monitoring towards stronger involvement in mediating and strategising. Research on corporate governance codes is still in its early stages and yet has great potential to further our understanding of the role of the board in corporate governance and the interplay between policy and practice.

Existing research on the topic of corporate governance codes is scarce and somewhat scattered. Several researchers have called for more studies into how corporate governance codes work in practice, particularly since the global financial crisis highlighted the fact that code compliance did not correlate with actual board effectiveness. Aguilera and Cuervo-Cazurra comment that there has been ‘little systematic analysis of how codes of good governance have affected how corporations are structured, or how managers behave across different corporate governance systems’. Aguilera et al.’s 2009 review of the literature on codes of corporate governance divides research into three categories: (1) cross-country comparative work; (2) within-country reviews of compliance; (3) studies of the link between corporate governance and firm performance. There is a notable lack of theory development regarding code effectiveness both in terms of regulatory mechanisms and code content.

Corporate governance and regulatory policy


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at its simplest as ‘the system by which companies are directed and controlled’. Since then, there have been many attempts to elucidate the concept in more detail. The OECD definition is often cited as an authoritative, internationally agreed definition. It states:

Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

Corporate governance is a broad topic – it covers the structures and processes that define and guide the roles and relationships of the key players in a corporation – shareholders, directors, managers and wider stakeholders such as employees and creditors. One of Australia’s most respected judges explains that ‘the expression ‘corporate governance’ embraces not only the models or systems themselves but also the practices by which that exercise and control of authority is in fact effected’.

This means that corporate governance regulation, at its broadest, encompasses any law, rule, standard or recommendation that is directed at influencing the way companies are controlled and held to account. This includes most corporate legislation but also the codes and standards set by stock exchanges, prudential regulators and accounting bodies which may be mandatory or voluntary. Corporate governance regulation spans jurisdictional boundaries and includes a burgeoning body of international initiatives – principles, frameworks and standards, most of which would be classified as soft law. Corporate governance regulation is an area where the regulatory ‘rules versus principles’ debate is often aired. Some countries, notably the United States, take a more prescriptive, rules based approach and others rely primarily on voluntary or semi-voluntary principles. Corbett and Bottomley claim that it is useful to think of corporate governance regulation as a body or category of law as well as a body of governance practices, processes and structures.

The focus of this paper is the use of codes of corporate governance as an element of regulatory policy. Perhaps connected to the globalisation of financial markets, since the 1990s there has been a fast spread of codes of corporate governance across the globe. Not only have they spread but they have become very influential: Branson comments that ‘at the level of large publicly held and multinational corporations, a principal determinant of corporate behaviour has become ‘soft law’ rather than law itself.

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9 Soft law tends to refer to quasi-legal instruments which do not have any legally binding force.
Comply or explain

The legal status of corporate governance codes varies from country to country but in most cases they do not prescribe behaviour but make suggestions, uptake of which is strongly encouraged but voluntary. They deal with the practical aspects of corporate governance such as the composition of the board of directors; its role and responsibilities; and communications with shareholders and other stakeholders. The voluntary approach to corporate governance is justified on the basis that every company has different needs which change over time making a ‘one size fits all’ approach inappropriate. The optimal structures and processes for any particular company will depend on contingencies such as size, ownership structure, industry and maturity. As a consequence, regulation is designed to give a high level of discretion to companies tempered by reporting requirements. Most codes of corporate governance operate on the basis of requiring information disclosure rather than mandating specific practices. Companies must explain if they do not adopt a particular practice but are permitted to choose, a mechanism known as ‘comply or explain’ or ‘if not why not’.

The theory behind comply or explain corporate governance codes is that they will be enforced by the investment market. The assumption is that there is a market for good governance – investors will value it and good governance will be recognised in demand for the company’s shares. Only a handful of studies have attempted to empirically test this theory and the results have been inconclusive. Keay concluded that codes are not effective because investors, even the large institutional investors, do not assess and engage with companies over their corporate governance practices and ultimately do not base investment decisions on them:

the idea behind the adoption of comply or explain is that the shareholders and the markets will assess what the company has done and judge it accordingly… The problem is that the research suggests that investors do not monitor sufficiently and do not generally bother to engage in any assessment of what companies have done or not done.

MacNeil and Li studied what they termed ‘serial non-compliers’ in the UK and found that investors would tolerate non-compliance with the corporate governance code as long as a company was still performing well financially. They also concluded that the benefits of flexibility associated with the Code were overstated. Hooghiemstra and van Ees also doubted the effectiveness of code flexibility because they found a strong uniformity in corporate responses that went against the logic of the code. However, Seidl et al, in their recent research based on the UK and German codes, found that ‘the sheer number of deviations recorded would seem to suggest that concerns about companies being driven towards full compliance are largely

unfounded’. Overall, despite the popularity of comply or explain codes, our understanding of how they function is still rather limited.

The role of the board of directors

Of course it is the board of directors that embodies the practical side of corporate governance and is the target of a large proportion of corporate governance regulation. This group of individuals is formally elected by the shareholders to act as the mind of the corporation and direct and supervise the managers of the company. In Australia, section 198A(1) of the Corporations Act 2001 provides that, ‘The business of a company is to be managed by or under the direction of the directors’, reflecting the fact that the historic role of the board was to manage. Boards of smaller, private companies may still be made up of executive managers but in large public companies the modern norm is for a separation between board and management, with boards comprised of a majority of independent, non-executive members who supervise, monitor and guide the executive management team.

This governance structure is based on agency theory, probably the most dominant theory influencing corporate governance policy, which emphasises a monitoring or control role for the board of directors.

Control/ monitoring role

It was Berle and Means’ seminal work in 1932 that described the fact that ownership and control in large Anglo-American companies becomes separated as companies grow and utilise public equity investment. The shareholders, owners of the equity of the company, can comprise a huge number of widely dispersed individuals with little power or knowledge over how the company is being run by its executive team of managers. This distance between the principals/owners of the company (shareholders) and their agents employed on the ground (executive managers) has been seen as a problem for the effective governance of companies for several reasons. Firstly, self-interested managers may not always act in the best interests of the shareholders. Managers, if not carefully controlled, may become tempted to

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18 Seidl, above n 6.
19 This is a replaceable rule. J Farrar, Corporate Governance: Theories, Principles and Practice (Oxford University Press, 3rd ed, 2008) 89.
act in their own best interests, for example, by awarding themselves large bonuses and/or taking unnecessary or fraudulent risks with corporate assets. They are able to do this because of the second agency problem - asymmetry of information – managers have more information and hence more power than most shareholders.

It is this principal-agent problem between shareholders and managers that much of corporate governance regulation is designed to mitigate. This means corporate governance regulation is aimed at improving shareholders' control of executive management, both directly through voting powers and indirectly through the board of directors. As listed companies will have a huge number of diverse shareholders unable to monitor management directly, responsibility is placed in the hands of a board of directors elected by the shareholders. In other words, agency theory predicts that the most important role of the board is to monitor management to ensure that they act in shareholders’ interests. Corporate governance codes aim to achieve this through recommending a majority of independent directors on the board and on the audit and remuneration committees.

Lazonick and O’Sullivan explain that one of the consequences of agency theory has been a focus on shareholder value as the measure of managerial performance. The agency theory approach to the role of the board tends to meld with economic theories that claim the purpose of the corporation as a whole is to maximise shareholder wealth. Reflecting an economic view of corporate governance, some theorists, particularly in the US, define corporate governance as the mechanisms by which suppliers of corporate finance assure themselves of a return on their investment. The shareholder primacy model of corporate purpose is attractive because of its simplicity and has been incredibly influential, particularly in the 1980s and 90s.

**Service/performance role**

Despite the predominance of agency theory, in practice directors perform many other roles: they lead and represent the company and ensure that it is accountable to both its shareholders and other relevant stakeholders. As well as monitoring the executive team, the board’s responsibilities include approving executive appointments and remuneration; setting strategy and risk appetite; and providing advice and resources such as industry knowledge or access to networks. Hilmer and Tricker describe the role of the board as balancing conformance (monitoring and

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26 Lazonick and O’Sullivan, above n 24.
accountability) with performance (strategy and policy). Huse labels these two board roles as control and service: firstly controlling and monitoring to provide external accountability; secondly, advising, leading and providing services to improve internal performance. Thus although the board’s monitoring role is important it should not be the sole focus of corporate governance regulation. Other theories explaining the board’s performance role are well known but are not so strongly reflected in corporate governance regulation. They include stakeholder theory, stewardship theory, resource-dependency theory and institutional theory.

Stakeholder theory is probably the strongest contender to agency theory and shareholder primacy. Although it is first and foremost a theory about corporate purpose, it has implications for board roles and responsibilities. Stakeholder theory suggests that the corporation should be viewed, not through the narrow lens of private ownership of shares but as a network involving multiple stakeholders including employees, customers, suppliers and creditors. The purpose of the corporation is to maximise total wealth creation in the long term rather than just shareholder returns. Stakeholder theory therefore posits a board role of coordination and co-operation whereby the board acts as a mediating body to balance the interests of coalitions of stakeholders. Hung states that ‘a stakeholder approach to the role of the governing board expects the board to negotiate and compromise with stakeholders in the interests of the corporation’. Stakeholder theory helps to explain the concepts of corporate responsibility and corporate sustainability.

Stewardship theory rejects the ‘homo-economicus’ of agency theory and incorporates a wider range of human characteristics enabling a more complex, but perhaps more accurate, explanation of managerial behaviour. Thankfully, evidence from the disciplines of psychology and sociology suggests that we are not all opportunistic individuals motivated only by personal wealth maximisation. We want to ‘do the right thing’ and be respected by our peers. Stewardship theory demonstrates that there are many situations where working towards collective interests will also further personal needs. As Muth and Donaldson have commented ‘[s]tewardship predictions regarding board independence are directly

opposed to those of agency theory’. Its consequences for the role of the board are that it does not predict a need for the board to monitor. Stewardship theorists focus on corporate governance structures that ‘facilitate and empower rather than those that monitor and control’. Stewardship theory would suggest that board structures that facilitate board input into strategic decision-making would be most valuable for improving board performance.

Resource dependency theory focuses on the role of the board as a link to external resources essential to corporate success. These may include access to capital, sources of information or links to key suppliers or customers. Resource-dependency theory addresses board members’ contributions as ‘boundary spanners of the organization and its environment’. Non-executive directors in particular provide skills, experience and information that can expand and improve board decision-making. As such, this theory falls into the performance side of board function rather than its monitoring role. Management scholars have explored this role of the board including its input into the strategic direction of the corporation. Kiel and Nicholson refer to intellectual capital theory whereby it is the skills mix on a board that is a major determinant of the value-adding that the board brings to the firm.

Rather than labelling directors as executive or non-executive, independent or non-independent and building board composition around these categories, resource dependence theory suggests that director categories based on experience, skills and networks will be more important to board composition. Hillman et al put forward four categories based on common resource needs: insiders (executives with in-depth firm knowledge); business experts (with experience running other large companies); support specialists (lawyers and accountants with specialist skills) and community influencers (with experience in politics, regulation or leadership of community groups).

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38 Hung, above n 33, 106.
44 Hillman et al, above n 39, 240.
them their personal reputation and credibility, qualities that add value to the firm in the same way as other resources or skills.\footnote{D C Langevoort, ‘The Human Nature of Corporate Boards: Law, Norms and the Unintended Consequences of Independence and Accountability’ (2001) 89(4) Georgetown Law Journal 797-832., 802; N Subramaniam, L McManus, J Zhang, ‘Corporate governance, firm characteristics and risk management committee formation in Australian companies’ (2009) 24(4) Managerial Auditing Journal 316 – 339, 321.}

Institutional theory explains organisational behaviour as a response to the internal and external environment. It would explain a company’s corporate governance structure as emerging from patterns of organisational interaction and adaptation.\footnote{P Selznick, ‘Institutionalism “Old” and “New”’ (1996) 41(2) Administrative Science Quarterly 270-277.}


It is evidenced by the fact that firms in similar situations tend to act in the same way – they adopt similar practices and portray themselves in a socially acceptable manner. Thus institutional theory can explain the spread of ‘best practices’ for corporate governance and the adoption of voluntary corporate responsibility reporting.\footnote{J L Campbell, ‘Why would corporations behave in socially responsible ways? An institutional theory of corporate social responsibility’ (2007) 32(3) Academy of Management Review 946-967.}

In terms of the role of the board, institutional theory conceptualises board structures and functions as responses to external pressures including regulation, environmental norms and firm history.\footnote{T Clarke, ‘Introduction’ in T Clarke (ed), Theories of Corporate Governance (Routledge, 2004) 10.}

Hung explains that institutional theory posits a role for the board in legitimising the corporation which usually involves conforming to social rules and conventions, otherwise known as norms.

**Development and reform of corporate governance regulation**

Henry Bosch, who produced one of the first reports on corporate governance in Australia, refers to the fact that corporate governance is a modern term, nearing 30 years old: ‘Before the crash of 1987 the term corporate governance was rarely used in Australia and few people gave much thought to the concepts now covered by it’.\footnote{H Bosch, ‘The changing face of corporate governance’ (2002) 25(2) University of New South Wales Law Journal 270–293, 273.}

This is a similar story worldwide: the development of corporate governance regulation is a relatively recent phenomenon and has tended to be a reactive process responding to bouts of corporate scandals and fear of economic downturn. It has involved both a strengthening of legislated hard law but also development of rules, standards and recommendations by many different organisations at national and international levels.

In most countries, corporate governance reform tends to be cyclical, following the boom and bust of the business cycle.\footnote{T Clarke, ‘Cycles of Crisis and Regulation: the enduring agency and stewardship problems of corporate governance’ (2004) 12(2) Corporate Governance: An International Review 153-161.} When the economy is good, corporate regulation will be left alone but when the economy falters, governments are placed under pressure to strengthen regulation in order to reduce the risk of similar
problems in future. There have been three notable economic downturns relevant to the development of corporate governance regulation. Each economic crisis has involved significant corporate collapses and then a wave of investigations followed by regulatory reform.

This second half of the paper takes a chronological journey through corporate governance reform splitting it into three phases. Starting with the emergence of the term corporate governance in the 1980s it charts Australia’s course of regulatory developments, drawing on relevant international developments along the way. As Australian law grew from a mix of English and American influences it is not surprising that corporate governance reforms in both the United Kingdom and United States have been highly influential. The work of international bodies such as the OECD, G-20 and European Union has also been taken into account in Australian regulatory reform. At times Australia has been at the forefront of corporate governance innovation and at other times Australian institutions have been slower to react, benefiting from the lessons learnt elsewhere.

The purpose of this story is to demonstrate the aims and objectives of corporate governance regulation, particularly codes of corporate governance. In a regulatory sense codes are a rather unique policy choice and, despite their popularity, the way in which they function is poorly understood. Their content has been regularly revised but in a slightly haphazard way based on politics and past problems rather than evidence of effectiveness.  

**Phase 1: Early development 1990s**

Although there had been use of the term corporate governance in America and the United Kingdom during the 1980s it was the 1990s that marked the birth of the code of corporate governance as it is known today. The main effect of the corporate collapses of the 1980s was that it became difficult for companies to raise capital. The law reform process was painfully slow so, while the legislators drafted and debated, the corporate community decided to take action to improve their own prospects through a form of self-regulation. The first set of Australian corporate governance standards was developed by a working group made up of leading business organisations (the Business Council of Australia, the Australian Institute of Company Directors, the Australian Securities Exchange and professional accounting bodies) who collaborated to publish the document, *Corporate Practices and Conduct* in 1991. Commonly known as the Bosch Report (after the group’s chairman, Henry Bosch) this document was revised and updated in 1993 following publication of the UK’s *Cadbury Report on the Financial Aspects of Corporate Governance* in 1992 (Cadbury Report) and revised further in 1995. The Bosch Report was not published as a code but marked the beginning of ‘soft law’ regulation of corporate governance which continues in Australia today.

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52 Romano, above n 6.
53 Mees, above n 11.
54 Bosch, above n 50, 274.
Market driven, flexible regulation

The way in which codes of corporate governance came into existence, immediately highlights some of the reasons why they have become a popular policy choice. Firstly good corporate governance is valuable to both companies and markets. This win-win nature makes it a topic suitable for soft regulation because there are internal incentives to make changes as well as external. Secondly the advantage of codes over law is their ability to be drafted and revised relatively quickly so that they can remain up-to-date and relevant to current practice. The ‘comply or explain’ mechanism has been seen to reflect a cost-effective balance between rules and principles, encouraging change through information disclosure whilst permitting flexibility.

This regulatory mechanism was first introduced in the United Kingdom in 1992 and has since become a very common basis for corporate governance codes worldwide. It was developed by the United Kingdom’s Cadbury Committee set up in 1991. This committee was asked to advise initially on the financial aspects of UK corporate governance following the collapse of companies such as Polly Peck and BCCI due to fraud. It resulted in the 1992 Code of Best Practice which provided boards with a checklist to enable them to assess where they stood against best practice. As with the Australian system, the Code was backed by the London Stock Exchange rules with compliance to be encouraged through market forces. Since then, the UK Corporate Governance Code has been regularly reviewed, refined and developed.

Another influential report produced by a working group chaired by Fredrick Hilmer was triggered by a court case (AWA Ltd v Daniels appealed as Daniels v Anderson) which caused considerable concern amongst Australian directors when it investigated the nature of directors’ duties and, on appeal, set a high duty of care. The Hilmer Report published in 1993 investigated the contemporary role of the board, determining that it was to ensure that management were striving for above-average corporate performance. The five key roles of the board were described as: appointing the CEO and other staff; strategy and policy; budgeting and planning; reporting to shareholders and regulatory compliance; and ensuring their own effectiveness. Thus Australia has never placed a strict monitoring role upon the board, emphasising the board’s value-adding and forward-looking functions such as strategy and planning.

Also in 1999, the first international standard for corporate governance was published. The OECD Principles of Corporate Governance (revised in 2004 and again in 2015) have become an important benchmark for corporate governance, forming the basis

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55 Aguilera and Cuervo-Cazurra, above n 5; D Seidl and P Sanderson, ‘Comply or Explain: The Flexibility of Corporate Governance Codes in Theory and in Practice’ (Paper presented at the 2nd Annual Cambridge Conference on Regulation, Inspection and Improvement, Cambridge University, 12 September 2007).
56 It was named ‘The Committee on the Financial Aspects of Corporate Governance’.
for regulatory initiatives in many countries worldwide.\textsuperscript{59} Indeed, they have been said to reflect a global consensus regarding the critical importance of good corporate governance in contributing to the economic vitality and stability of our economies.\textsuperscript{60} They have certainly helped to institutionalise corporate governance codes as an element of regulatory policy.

**Phase 2: Post Enron reforms 2001-2007**

The next major economic crisis in 2001 was caused by the collapse of large companies HIH Insurance and OneTel in Australia as well as US companies Enron and Worldcom. These corporate collapses were blamed primarily on misleading and unethical accounting practices. In Australia, a Royal Commission headed by Justice Owen was established to investigate the collapse of the HIH Insurance Group. The Commission found that there was a lack of independent board oversight and no testing of the practical effectiveness of the company’s governance model.\textsuperscript{61}

Corporate governance reforms in both Australia and the US focused on the audit process and better monitoring of corporate managers. In the US this was done through the Sarbanes Oxley Act of 2002 (SOX) and in Australia, through amendments to the Corporations Act 2001 that came into force in 2004 as well as publication by the Australian Securities Exchange (ASX) of the ‘Principles of Good Corporate Governance and Best Practice Recommendations’ in March 2003. Now revised and updated this ‘comply or explain’ code remains Australia’s primary corporate governance standard and has been highly influential in developing corporate practice. It comprises eight broad principles and a series of recommendations for putting them into practice. Disclosure against the code is a condition of listing on the exchange and failure to do so can result in delisting. The principles deal with separation of board and management, independence of directors, board performance evaluation, ethical decision-making and disclosure, gender diversity, board sub-committees (audit, nomination, remuneration and more recently risk), shareholder communications, risk management and executive remuneration.\textsuperscript{62}

**Transparency and independence**

The 2004 amendments to the Australian Corporations Act (CLERP 9) focused on four areas: executive remuneration, financial reporting, continuous disclosure and shareholder participation.\textsuperscript{63} The amendments regarding remuneration required companies to include within their annual directors’ report a remuneration report setting out details of senior executive and director remuneration. This caused quite a stir as it required previously confidential information to be publicly disclosed. There was debate over whether it would act as a restraint on excessive remuneration or

\textsuperscript{59} Available at \texttt{www.oecd.org/corporate/oecdprinciplesofcorporategovernance.htm}.


\textsuperscript{61} Owen, above n 8.

\textsuperscript{62} See ASX Corporate Governance Council, Corporate Governance Principles and Recommendations (ASX, 3\textsuperscript{rd} ed, March 2014).

\textsuperscript{63} These amendments were known as CLERP 9 because they were detailed in the ninth policy paper in the corporate legal reform program.
place pressure on companies to meet higher competitor salaries. When the
amendments were introduced, the Regulatory Impact Statement explained that the
legislation ‘does not seek to intervene in the market by placing limits on the quantum
of director or executive remuneration’. Instead the amendments were aimed at
ensuring transparency to enable shareholders to make informed decisions about the
remuneration policies of companies. Shareholder activism in Australia had not been
strong and so various provisions aimed at encouraging, or at least enabling,
shareholder participation in corporate governance were also introduced.

Despite their status as ‘hard law’ many of the amendments were based on a similar
principle to the ASX code – requiring disclosure of practices rather than prescribing
those practices. The Act does not permit explanations for non-disclosure like the
ASX code but generally does not prescribe in detail how companies must arrange
their internal affairs. The Australian approach overall is one of flexible regulation
tempered by information disclosure, designed to leave much of the enforcement to
the market.

The alternative regulatory approach of using black-letter, prescriptive law was
adopted by the United States. SOX prescribed governance practices enforced by
way of penalties for non-compliance. As a Federal Act, it marked a significant
change in United States corporate regulation as it removed much of the ‘contractual
choice’ that existed previously whereby firms could decide whether to be subject to a
body of rules through their choice of which state to incorporate in and which
exchange to list their company on. SOX involved some delegation to the
Securities and Exchange Commission (SEC) which had to set large numbers of rules
to implement the Act.

SOX was highly criticised as a knee-jerk reaction to Enron and Worldcom imposing
unreasonable costs on business. In particular, section 404 of SOX, requiring
companies to implement internal control systems, was said to be unduly onerous
and costly, particularly for smaller companies. Although much of the legislation
dealt with the independence of company audits, it also dealt with the role of the
board in ensuring accurate financial reporting. It required all companies to have
audit committees, made them responsible for hiring the auditor and required
disclosure of whether there was at least one ‘financial expert’ on the audit
committee.

In doing so SOX made some significant assumptions about the role of the board in
corporate governance placing strong focus on the ability of directors to monitor
management and exercise independence. In Australia the CLERP 9 Explanatory
Memorandum expressly confirmed the agency theory underpinnings of Australian
corporate governance regulation:

64 For a view of the impact of the Sarbanes-Oxley Act on boards, see B McDonnell, ‘Sarbanes-Oxley,
Fiduciary Duties and the Conduct of Officers and Directors’ (Research Paper No.04-13, University of
65 L E Ribstein, ‘Market vs Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley
66 Ibid, 19.
67 See speech by Securities and Exchange Commissioner C Glassman, ‘Internal Controls over Financial
Reporting – Putting Sarbanes Oxley Section 404 in Perspective’ (Speech delivered at the Twelfth
Annual CFO Summit, Tampa, Florida 8 May 2006).
Under Australia’s corporate regulatory framework, directors and senior company employees exercise control over company resources on behalf of shareholders, who have no direct operational control over the company. While this relationship is the most efficient approach to operating a company that is owned by hundreds or thousands of different parties, a recognised limitation is that it can give rise to a principal-agent problem.\(^{68}\)

**Phase 3: Post-Global Financial Crisis 2008-2015**

The GFC was a crisis of such magnitude that corporate governance was not the first priority of most governments. The immediate response in most countries was to take emergency measures to rescue vital institutions and stimulate economic recovery. Only after these initial measures had been put in place was attention diverted to regulatory and financial market reform including issues of corporate governance.\(^{69}\) Indeed, poor corporate governance was identified, in combination with weak supervisory authorities and excessive risk taking, as one of the causes of the crisis.\(^{70}\) A good deal of blame was placed on boards of directors for failing to properly supervise risk management and incentive systems. Kirkpatrick, in his report for the OECD, identified credit rating agencies, disclosure regimes and accounting standards as contributing to the problem but considered that a good board ought to have been able to overcome these weaknesses:

> [There were] significant failures of risk management systems in some major financial institutions made worse by incentive systems that encouraged and rewarded high levels of risk-taking. Since reviewing and guiding risk policy is a key function of the board, these deficiencies point to ineffective board oversight.\(^{71}\)

As appropriate for a global crisis, the reform agenda was led by international institutions including the Group of Twenty (G20) and the Organisation for Economic Co-operation and Development (OECD). The main corporate governance aspect of the G20 action plan was a focus on remuneration policy which had a strong influence on activity at the national level, particularly in the US where there had been reluctance to regulate in this area. The Financial Stability Forum (FSF) Principles on Pay and Compensation, published in April 2009, which all G20 countries agreed to implement, were intended to be applied to significant financial institutions. They required boards of directors to play an active role in the design, operation and evaluation of compensation schemes; they required compensation arrangements (including bonuses) to properly reflect risk; and firms to publicly disclose clear, comprehensive and timely information about compensation.

**Responsibility, risk and diversity**

In the UK there were efforts to make disclosure more meaningful: the Financial Reporting Council described its 2010 changes to the Corporate Governance Code

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\(^{68}\) Paragraph 4.347 Explanatory Memorandum.


\(^{70}\) G Kirkpatrick, ‘Corporate Governance Lessons from the Financial Crisis’ (OECD, 2009).

\(^{71}\) Ibid.
as fighting the ‘fungus of boilerplate’.\textsuperscript{72} The Code now asks Chairmen to include a personal discussion of risk management procedures in annual reports rather than resorting to standard statements. Spira and Page point out that:

While the use of ‘boilerplate’ has generally been deplored, there has been little analysis of why it occurs and whether it is an inevitable result of the ‘disclosure as regulation’ process.\textsuperscript{73}

It is perhaps time to question the purpose of corporate information disclosure. In theory, shareholders and potential shareholders need to have a certain amount of information in order to assess companies but if the information becomes minimal and standardised it quickly loses its value and purpose. It is the unique information that is valuable, that gives an impression of a company’s approach to certain issues or the way in which risks are mitigated. But this information is more subjective and harder to categorise and quantify, plus there are suggestions that investors do not actually read it. Indeed, understanding the nature of the audience for corporate disclosure is an area worthy of further research.

As stated above, a ‘comply or explain’ system relies on there being market demand for good corporate governance, monitored by the active engagement of investors. An interesting development stemming from the UK Walker Review in 2009 was the introduction of a UK Stewardship Code for investors which aims to enhance the quality of engagement between companies and institutional investors. The Code comprises seven key principles encouraging investors to monitor their investee companies and disclose their policy on discharging their stewardship responsibilities. The reasoning behind the Code was a belief that institutional shareholders may have contributed to the global financial crisis by being too short-term in their investment policies and failing to monitor their investments actively enough.\textsuperscript{74}

In Australia novel proposals were put forward to give bite to the non-binding shareholder vote on the remuneration report. Australia had introduced a ‘say on pay’ vote for shareholders in 2004-05 broadly following UK arrangements introduced in 2002. Although non-binding, the vote enables shareholders to signal their support or disapproval of the remuneration policy of a company. The reasoning is that, although companies are not legally required to respond to a substantial vote against their remuneration policy, most organisations will be sensitive to shareholder opinion and will make changes. Nevertheless, there were some examples of companies receiving consecutive ‘no’ votes at their AGMs and appearing to be resistant to change. The question of whether to make the shareholder vote binding on companies was considered at length by the Productivity Commission. The Commission’s answer was a proposal for a ‘two strike’ mechanism whereby two consecutive ‘no’ votes (each above 25\%) would trigger a resolution putting the entire board of directors up for re-election. The Government supported this proposal and legislation was passed which took effect from 1 July 2011.\textsuperscript{75} This is a wonderful

\textsuperscript{72} FRC, UK Corporate Governance Code (2010).
\textsuperscript{73} L F Spira and M Page, ‘Regulation by disclosure: the case of internal control’ (2010) 14 Journal of Management and Governance 409-433,
\textsuperscript{75} Corporations Amendment (Improving Accountability on Director and Executive Remuneration) Act 2011 (Cth).
example of Braithwaite’s concept of responsive regulation where a hierarchy of increasingly stringent sanctions can be used to influence behaviour based on the response of the target.\(^ {76} \)

Also at this time, the issue of women in leadership was topical worldwide with pressure mounting for governments to improve gender ratios through regulation. The answer in many nations, including the UK and Australia was to include recommendations on gender diversity into the corporate governance code. The 2010 recommendations on gender diversity provide an interesting example of soft law in action: they not only suggest that companies draft a diversity policy and disclose gender statistics but ask companies to set their own targets and report annually on progress towards those targets. They demonstrate how well designed ‘comply or explain’ regulation can do more than simply suggest one-off adoption of specific governance structures and procedures. These recommendations set up a cycle of self-measurement, self-set policy and self-monitoring, made public through disclosure. The need for women on boards can perhaps be best explained by resource dependency theory as it is thought that group decision-making is improved by including a more diverse range of views.\(^ {77} \) It seems resource dependency theory is also reflected in recent amendments to the Australian code that recommend use of a skills matrix in determining overall board composition.\(^ {78} \)

Lastly, the third edition of the ASX Principles recommends that boards ought to have a risk committee made up of a majority of independent directors. This recommendation is explained to have arisen directly from investigations into the causes of the financial crisis.\(^ {79} \) It seems that the third phase of corporate governance reform is still clinging to the concept of independence whilst at the same time there are subtle signs that regulators are recognising the importance of softer factors such as diversity, culture, ethics and corporate responsibility. We see a subtle reorientation of the board’s role from pure monitoring towards a more strategic role. Instead of simply checking that a risk system is in place the board is being asked to set risk appetite and risk-mitigation strategies going forward. The board is being encouraged to take a role in corporate responsibility both in terms of assessing risks (environmental and social) and looking for strategic opportunities. In 2014 the Australian code made a small concession to the CSR movement by recommending disclosure of material CSR risks. Other nations, for example South Africa and Japan have included CSR in their corporate governance codes more directly. The drive for companies to focus on long-term sustainability and provide integrated reporting relevant to wider stakeholders must carry with it a heightened role for the board.

78 ASX above n 62, 19.
79 ASX Corporate Governance Council, Review of the Corporate Governance Principles and Recommendations, (Public Consultation, 16 August 2013) 18.
Conclusions

This paper has reviewed the practical reform of corporate governance regulation over the last 25 years against some of the theories predicting likely effectiveness. It seems there is still doubt over the functional effectiveness of the ‘comply or explain’ mechanism despite its widespread popularity. Although shareholder enforcement is not as strong as expected it may be that that this does not matter - codes of corporate governance may incentivise behavioural change through other mechanisms such as norm development. It seems that codes may be becoming more sophisticated in terms of their understanding of the role of the board, taking into account more complex behavioural and cultural issues rather than relying on economic models. As code content expands and improves there may be internal value in adopting code recommendations, irrelevant of any external influence.

With regard to the ‘comply or explain’ mechanism there is a pressing need for more research on how codes change corporate behaviour and the conditions within which their effectiveness is limited or improved. Soft law appears to be most effective when it works in parallel with emerging norms of behaviour, helping to entrench them into practice through a process of codification and institutionalisation. The legal literature on norms and social expectations together with management scholars’ use of institutional theory can help to explain how legal and social institutions work together to influence firm behaviour. Norms and other institutional forces can either support regulatory objectives or work against them. Thus the effectiveness of a code of corporate governance will depend on its fit with local cultural practices and supervisory style.

In the case of the collapse of Enron, the purpose of corporate governance disclosure was defeated by internal cultural norms that supported highly risky trading, dubious accounting and personal financial gain. The importance of workplace culture on the effectiveness of soft regulation was also revealed by Gunningham and Sinclair in their research on mining companies. They found that soft regulation in the area of occupational health and safety was only effective where there was already a culture of trust and commitment in place. Corporate changes instigated in response to the Australian corporate governance provisions on gender diversity have undoubtedly been encouraged by the global trend for regulatory action and non-legal initiatives such as the 30% club.

With regard to the role of the board of directors in corporate governance, regulatory reform reflects a shift from a focus on monitoring towards stronger involvement in mediating and strategising. The use of pure agency theory to explain and predict corporate governance behaviour has been increasingly criticised. Critics argue that the concept of shareholders owning a corporation, based on the law of private property, has become distant from reality and hard to justify. When the legal concept

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82 N Gunningham and D Sinclair, Organizational Trust and the Limits of Management-Based Regulation (2009) 43(4) Law & Society Review 865
83 See http://30percentclub.org/
of the corporation was devised in the nineteenth century, corporations were relatively small and closely held with shareholders involved as managers. Today's listed companies are very different - the ownership of a share equates to a bundle of legal and contractual rights little different in practice to the rights of employees or creditors. Scholars are increasingly pointing out that empirical evidence also questions the validity of agency theory: Roberta Romano concluded that her ‘review of the empirical literature suggests that a case does not exist for the principal corporate governance mandates in SOX', which were all based on agency theory.84

Also, because many corporations have become global entities, some more powerful than small nation states, the question has arisen of whether, with such power and influence ought to come responsibilities of a more public nature – to the environment and communities within which they operate. Proponents of corporate responsibility argue that the legitimate concerns of a corporation and its board should include objectives such as sustainable growth, equitable employment practices, and long-term social and environmental well-being.85 Stakeholder theory is said to have more empirical backing than other theories both in terms of how corporate officers act in practice and how the law has developed in many countries.86 Stakeholder theory does not remove the need for the board to monitor management but changes the constituents on whose behalf the board must act. In a corporate governance sense it predicts a need for stakeholder engagement processes and explains the massive rise in corporate responsibility reporting.

This review of the development of corporate governance regulation over the last 25 years provides insights into the changing role of the board of the directors in corporate governance and the ability of codes, as a regulatory mechanism, to guide and support this role. This is an area fertile for future research with important implications for regulatory policy and corporate success.

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84 Romano, above n 6, 1543.