CORPORATE GOVERNANCE –
A COMPARATIVE ANALYSIS OF THE APPROACH TO CORPORATE GOVERNANCE REGULATION AND ENFORCEMENT IN THE UK AND THE US

KINSHA RYANNA WORME

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ABBREVIATIONS

AAP	Audit and Assurance Policy
AGM	Annual General Meeting
AIM	Alternative Investment Market
ARGA	Audit, Reporting and Governance Authority
ASV	Alaskan Seismic Ventures
AudCom	Audit Committee
BCCI	Bank of Credit and Commercial International
BEIS	Department of Business Energy and Industrial Strategy
BHS	British Home Stores
BJR	Business Judgement rule
CA 2006	Companies Act 2006
CDDA 1986	Company Directors Disqualification Act 1986
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COGS	Cost of Goods Sold
COO	Chief Operating Officer
CPA	Certified Public Accountant
CPS	Crown Prosecution Service
D&O	Director and Officer
DGCL	Delaware General Corporation Law
Dodd-Frank	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
DO	Disqualification orders
DOJ	U.S. Department of Justice
DPA	Deferred Prosecution Agreement
EBITDA	Earnings before interest, tax, depreciation and amortisation
Exchange Act	Securities Exchange Act of 1934
FCA	Financial Conduct Authority

FCPA	Foreign Corrupt Practice Act of 1977
FINRA	Financial Industry Regulatory Authority
FRC	Financial Reporting Council
FRRP	Financial Reporting Review Panel
FSA	Financial Services Authority
FSMA	Financial Services Markets Act 2000
FTC	Federal Trade Commission
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GP	Gross Profit
HCF	Health Care Fraud Unit
HP	Hewlett-Packard
IA 1986	Insolvency Service 1986
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants for England and Wales
IDOL	Intelligent Data Operating Layer
IPO	Initial Public Offering
IS	The Insolvency Service
KHC	The Kraft Heinz Company
LID	Lead independent director
LSE	London Stock Exchange
M&A	Mergers and acquisitions
MIMF	Market Integrity and Major Frauds Unit
MoU	Memorandum of Understanding
MSA	Managed Shared Audit
NASD	National Association of Securities Dealer
NASDAQ	National Association of Securities Dealers Automated Quotations
NED	Non-executive director
NFP	Not-for-profit

NomCom	Nomination Committee
NPA	Non-prosecution Agreement
NYSE	New York Stock Exchange
OTC	Over the counter market
PCAOB	Public Company Accounting Oversight Board
PFI	Public-private partnership contracts
PIE	Public Interest Entity
PLC	Public limited company
PPP	Paycheck Protection Programme
PSLRA	Private Securities Litigation Reform Act of 1995
PwC	PricewaterhouseCoopers
QC	Queens Counsel
R&D	Research and Development
RSB	Recognised Supervisory Body
RemCom	Remuneration Committee
Remedies Act	Securities Enforcement Remedies and Penny Stock Reform Act 1990
Sarbanes-Oxley	Public Company Accounting Reform and Investor Protection Act of 2002
SEC	U.S. Securities and Exchange Commission
Securities Act	Securities Act of 1933
SFO	Serious Fraud Office
SID	Senior Independent Director
SPAC	Special purpose acquisition company
SRO	Self-regulatory organisation
U.S.	United States
UK	United Kingdom
UKCG	UK Corporate Governance Code
USAO	United States Attorney's Office

ABSTRACT

Corporations play a crucial role in the functioning of global economies. As a result, the importance of regulating corporate behaviour continues to be a topic of great debate. Despite the introduction of corporate governance regulations over two decades ago, instances of corporate misconduct continue to emerge, which calls into question the effectiveness of corporate governance regulations to prevent and detect corporate misconduct. It is well accepted that regulations alone cannot prevent misconduct. To be effective, regulations must be adequately enforced. The UK and U.S. have adopted two different approaches to regulating corporate behaviour. While the UK has adopted a voluntary comply-or-explain approach, the U.S. has adopted a rules-based approach with mandatory compliance and sanctions for non-compliance.

The main aim of this study is to investigate the differences in the approach to corporate governance regulation and enforcement in the UK and the United States. In so doing, the research ventures beyond the law in the books and considers how the law operates and how it is enforced. The study combines doctrinal, socio-legal and comparative law methodologies to achieve the research objectives and uses Becker’s theory on measuring enforcement to analyse the effectiveness of enforcement in the UK and the United States.

The study concludes that the approach to corporate governance (the rules-based or principles-based) does not materially impact corporate misconduct. Instead, the study contends that the effectiveness of the UK’s approach to corporate governance enforcement is hindered by a cluttered enforcement framework with multiple civil and criminal regulators. As a result of the centralised approach adopted in the U.S., this study finds that there is a higher likelihood that U.S. directors will face sanctions for corporate misconduct, when compared to their UK counterparts. Given that the effectiveness of regulations is measured in relation to its enforcement, the effectiveness of the UK system of corporate governance enforcement to deter corporate misconduct is questionable. Ultimately, there is little incentive for directors to engage effectively in preventing and detecting corporate misconduct.

DECLARATION

No portion of this work referred to in this thesis has been submitted in support of an application for another degree or qualification of this or any other university or institute of learning.

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Chapter 1
INTRODUCTION

Governance and leadership are the yin and the yang of successful organisations. If you have leadership without governance you risk tyranny, fraud and personal fiefdoms. If you have governance without leadership you risk atrophy, bureaucracy and indifference.'

\- Mark Goyder[1]

1.1 RESEARCH BACKGROUND

Corporations play a crucial role in economic growth and development. In fact, according to Anderson and Cavanagh 'of the 100 largest economies in the world, 51 are corporations; only 49 are countries.'[2] It is therefore imperative that corporations do not operate unchecked and corporate behaviour be regulated to protect not just shareholders, but other stakeholders and society at large. In the aftermath of a series of corporate scandals in the late 90s (such as Maxwell Group, BCCI and Polly Peck in the UK and Enron, WorldCom and Tyco in the U.S.), the UK and the U.S. introduced corporation governance regulations aimed at addressing corporate behaviour and deterring corporate misconduct. The UK adopted the Cadbury Code which operated on a comply-or-explain approach and was therefore voluntary and not legally binding. While the Code has been revised several times since its introduction, the comply or explain approach remains at the centre of UK corporate governance. The U.S. on the other hand opted for a rules-based approach and introduced the Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley).

Since the introduction of corporate governance regulations, a significant body of scholarship has developed which has focused on the substantive rules. However, focusing on the substantive aspects of corporate governance only takes into consideration the law on the books and does not take into account how the law

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[1] Mark Goyder, Director of Tomorrow's Company.

[2] Sarah Anderson and John Cavanagh, 'Top 200: The rise of corporate global power' Institute for Policy Studies (2000) <www.iatp.org/sites/default/files/Top_200_The_Rise_of_Corporate_Global_Power.pdf> accessed 19 August 2021.

operates in action. Therefore, in recent years academic scholarship has turned its attention to enforcement related mechanisms with a view to assessing the effectiveness of corporate governance regulations.[3] The importance of enforcement was noted by McDaniel, who argued that 'a right without a remedy is worthless.'[4] In discussing the importance of enforcement Armour posited that 'the deterrent effect of a legal rule is a function not only of the size of the potential penalty but of the probability of its enforcement.'[5] In other words, the deterrent effect of laws is dependent on the likelihood that it would be enforced. Despite the increasing focus on enforcement in corporate governance, no studies, as far as the author is aware, have undertaken a comparative analysis of public and private enforcement outcomes between the United States and the UK.

Unlike the Cadbury Code, in the UK, which relied on inclusion into the London Stock Exchange (LSE) listing rules to ensure compliance, Sarbanes-Oxley included mandatory requirements and sanctions for non-compliance. Non-compliance sanctions were included in Sarbanes-Oxley with the specific aim of deterring corporate misconduct. However, as discussed above to be an effective deterrent against corporate misconduct, laws and regulations must be effectively enforced. This was supported by Hail, Tahoun and Wang, who argued that regulations alone do not have an impact on the instances of corporate misconduct.[6] However, Hail,

[3] See Ira M Millstein and others, *Enforcement and Corporate Governance: Three Views* (Global Corporate Governance Forum Focus 3, 2005); Eddy Wymeersch, 'The Enforcement of Corporate Governance Codes' (2006) 6 J Corp L Stud 113; Erik Berglof and Stijn Claessens, 'Enforcement and Good Corporate Governance in Developing Countries and Transition Economies' (2006) 21 The World Bank Research Observer 123; J E Parkinson, 'The Enforcement of Directors' Duties', *Corporate Power and Responsibility Issues in the Theory of Company Law* (Corporate Power and Responsibility Issues in the Theory of Company Law, OUP 1995); John Armour, 'Enforcement Strategies in UK Corporate Governance: A Roadmap and Empirical Assessment' (2008) ECGI - Law Working Paper No 106/2008 <https://ssrn.com/abstract=1133542> accessed 25 July 2018; Renee M Jones and Michelle Welsh, 'Toward a Public Enforcement Model for Directors' Duty of Oversight' (2012) 45 Vand J Transnatl L 343; Andrew Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry' (2014) 43 Common Law World Review 89; John Armour and others, 'Private Enforcement of Corporate Law: An Empirical Comparison of the United Kingdom and the United States' (2009) 6 Journal of Empirical Legal Studies 687; Katarzyna Barbara Szczudlik, 'Enforcement of Corporate Governance Mechanisms in Transactional Economics' (Masters thesis, Tilburg University 2013)Linda Chatman Thomsen and Donna Norman, 'Sarbanes-Oxley Turns Six: An Enforcement Perspective' (2008) 3 J Bus & Tech L 393; Matthias Hoeltken and Germar Ebner, 'Enforcement of Financial Reporting: A Corporate Governance Perspective' (2015) SSRN <https://ssrn.com/abstract=2727656> accessed 8 June 2018; Marcus Witzky, 'Enforcement of Accounting Standards and Changes in Corporate Governance' (2015) SSRN <https://ssrn.com/abstract=2691109 > accessed 8 July 2018; A Mitchell Polinsky, 'Private versus public enforcement of fines' (1980) 9 The Journal of Legal Studies 105.

[4] Morey W McDaniel, 'Bondholders and stockholders' (1988) 13 The Journal of corporation law 205, 309.

[5] Armour (n 3) 8.

[6] Luzi Hail, Ahmed Tahoun and Clare Wang, 'Corporate Scandals and Regulation' (2018) 56 Journal of Accounting Research 617.

Tahoun and Wang's study did not consider the impact of enforcement in determining the effectiveness of regulations. Zubcic and Sims investigated the relationship between enforcement and compliance and found that enforcement reduces the instances of non-compliance and therefore has a deterrent effect.[7] This view was later supported by Berglof and Classens, who argued that enforcement was the key to effective corporate governance.[8] These studies add support to the view that corporate governance regulations will not be successful without effective enforcement.

As mentioned above, measuring the effectiveness of regulation to deter misconduct on the basis of compliance without also considering enforcement does not represent an adequate assessment of its' deterrence effect. Adopting Becker's theory on measuring enforcement, the effectiveness of corporate governance regulations to prevent and deter misconduct can be measured by (i) the probability that misconduct will be detected (ii) the probability that the wrong-doer will be convicted/punished, (iii) the size of the punishment and (iv) the form of punishment.[9]

However, Kwan and Lau note that there is a lack of research on the regulatory enforcement of corporate governance.[10] This study entails a comparative analysis of corporate governance regulation and enforcement in the UK and the United States. The study goes beyond the substantive requirements of the UK Corporate Governance Code and Sarbanes-Oxley and measures the effectiveness of corporate governance enforcement using Becker's theory on measuring enforcement. The UK and the U.S. were chosen for study as both counties operate shareholder focused corporate governance systems built on foundations of common law. These two countries also represent two different approaches of ultimately attaining the same goal; regulating corporate behaviour and protecting shareholders. Furthermore, share ownership in the UK and the U.S. have become increasingly diverse, widening the gap between ownership and control. This separation of ownership and control creates an agency relationship between the

[7] Joseph Zubcic and Robert Sims, 'Examining the link between enforcement activity and corporate compliance by Australian companies and the implications for regulators' (2011) 53 Int Jnl Law Management 299.

[8] Millstein and others (n 3).

[9] Gary S Becker, 'Crime and punishment: An Economic Approach' (1968) 76 The Journal of Political Economy 169.

[10] Jing-Hui Kwan and Wee-Yeap Lau, 'A review of regulatory enforcement, corporate governance and market reactions' (2011) 5 African Journal of Business Management 13510.

directors and shareholders who manage the company on behalf of the shareholders.

1.2 RESEARCH OBJECTIVES

Vinod and Hareendran describe research as ‘the systematic process of collecting and analysing information (data) in order to increase our understanding of the phenomenon about which we are concerned or interested.’[11] This study aspires to gain an understanding of the effectiveness of corporate governance regulation and enforcement in the UK and the United States. Despite the introduction of corporate governance regulations over 20 years, both the UK and the U.S. continue to experience instances of corporate failures. These continuing instances call into question the effectiveness of the approach to corporate governance regulation and enforcement. With a view to comparatively assess the approaches to corporate governance regulation and enforcement in the UK and the U.S., this study has the following four objectives:

1. To identify the key differences in the approach to corporate governance regulation and enforcement in the United Kingdom and the United States.
2. To critically evaluate the relationship between the approach to corporate governance and its impact on instances of corporate misconduct in the UK and the United States.
3. To critically evaluate the relationship between corporate governance enforcement and its impact on instances of corporate misconduct in the UK and the United States.
4. To analyse the effectiveness of corporate governance enforcement in the UK and the U.S. using Becker’s theory of optimal enforcement.

1.3 RESEARCH CONTRIBUTIONS

This thesis is original in three ways and makes a contribution to knowledge. Firstly, the thesis builds on Armour’s 2008 study on enforcement mechanisms in the UK.[12] However, there have been significant changes to the UK’s enforcement framework since Armour’s study. For instance, at the time of Armour’s study the Financial Conduct Authority (FCA) did not exist. Since Armour’s study, the Financial Reporting

[11] Vinod Chandra and Anand Hareendran, *Research methodology* (1st edition edn, Pearson India Education Services 2018).

[12] See Armour (n 3).

Review Panel (FRRP) has been consolidated as part of the Financial Reporting Council (FRC). Another important change in the UK landscape since Armour's study was the introduction of the Bribery Act in 2010 and the introduction of deferred prosecution agreements (DPAs). While Armour's study focused solely on enforcement strategies in the UK, this study compares enforcement mechanisms in the UK and the U.S. and provides detailed evidence on the levels of enforcement in the UK and the U.S. over several years. The study also differs from Armour's study as it entails an analysis of the effectiveness of enforcement using Becker's deterrence theory.[13] In so doing, the study provides a comprehensive summary of the levels of public and private enforcement in the UK and the U.S. over a six-year period, between 2015 and 2021.

Secondly, the thesis contends that the UK has the legislative framework to enforce corporate governance. This study argues neither in favour of nor against either a rules-based or principles-based approach to corporate governance regulation. Instead, the study argues that the effectiveness of corporate governance lies not with its rules-based or principles-based approach but with whether the legislative and enforcement framework exists to hold directors accountable for corporate misconduct. It argues that the muddled enforcement framework in the UK, with overlapping regulators, has hindered the UK's ability to effectively enforce and therefore deter corporate misconduct. For instance, under the UK's current enforcement framework, three regulators prosecute corporate misconduct. Thirdly, the thesis proposes that the UK should adopt a more centralised approach to corporate governance enforcement. Under the centralised approach there will be a single criminal regulator for prosecuting corporate misconduct.

1.4 RESEARCH METHODOLOGY

Leedy and Ormrod define research methodology as 'the general approach the researcher takes in carrying out the research project.'[14] In other words, the research methodology includes all aspects of the research, including the research design, research methods and methods of data analysis. According to Kothari when determining the research methodology, it is important to first consider the type of research being undertaken; applied, fundamental, quantitative, qualitative,

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[13] See Becker (n 9).

[14] Paul D Leedy, Jeanne Ellis Ormrod and Laura Ruth Johnson, *Practical research: Planning and design* (12th edition, Global edition. edn, Pearson 2021) 32.

conceptual, empirical, descriptive or analytical.[15] Applied research, also known as action research, aims to find solutions to everyday problems facing society. Fundamental research, on the other hand, is driven by 'curiosity or interest' and aims to expand knowledge on a topic. Quantitative research aims to investigate a phenomenon using statistical or mathematical techniques. Conversely, qualitative research aims at assessing a phenomenon that is difficult to quantify, such as behaviour, attitudes and opinions. Conceptual research uses already available information to develop theories and concepts. Unlike conceptual research, empirical research relies on evidence obtained from observations or experiences. As the name suggests, descriptive research is used to describe the current state of a phenomenon. On the other hand, analytical research involves critically analysing already available information to make an evaluation. Taking all the above into consideration, this research best fits under the umbrella of analytical research. The research uses already available information provided by regulatory bodies in the UK and the U.S. to critically evaluate the effectiveness of corporate governance regulation and enforcement in the UK and the United States.

1.4.1 Research philosophy

Guba and Lincoln explain that research philosophy is the 'basic belief system or worldview that guides the investigation.'[16] When considering research methodology, it is important to acknowledge that researcher philosophy can affect the outcome of the study, as it can play a role in the research design, choice of methodology and research methods.[17] An important aspect of research philosophy is epistemology. According to Michael, epistemology is 'a way of understanding or explaining how we know what we know.'[18] There are three different types of epistemological stances including; objectivism and constructivism. The objectivist view holds that 'things exist as meaningful entities independently of truth or consciousness.'[19] In other words, objectivists believe that there is a universal objective truth and that

[15] Catherine Kothari, *Research Methodology - Methods and Techniques* (New Age International Pvt Limted 2001) 3.

[16] Egon G Guba and Yvonna S Lincoln, 'Competing paradigms in qualitative research' in Norman K Denzin and Yvonna S Lincoln (eds), *Handbook of qualitative research* (Handbook of qualitative research, 2nd edn, SAGE 1994) 105.

[17] Crossan Frank, 'Research philosophy: Towards an understanding' (2003) 11 Nurse researcher 46, 47.

[18] Michael Crotty, *The foundations of social research: Meaning and perspective in the research process* (Sage Publications 1998) 3.

[19] ibid 5.

knowledge is 'obtained from direct experience or observation.'[20] Unlike the objectivist view, constructivists believe that knowledge is constructed from interactions with the world. This means that there will be 'multiple, contradictory, but equally valid accounts of the world,' as knowledge is continually built upon and constructed based on an individuals' apperceptions.[21] According to Crotty, constructionists investigate and will generally begin with 'a question that needs to be answered'.[22]

This study aims to investigate the relationship between the approach to corporate governance regulation and enforcement and corporate misconduct. It begins with the question of whether the rules-based or principles-based approach to corporate governance regulation and enforcement has an impact on corporate misconduct. The study also examines the effectiveness of the UK and U.S. approach to corporate governance enforcement and argues that enforcement in the UK is not effective in deterring corporate misconduct, compared to the United States. The UK approach to corporate governance would benefit from adopting a centralised approach to enforcement. Thus, this study adopts the constructivist epistemology.

1.4.2 Methodological approach

This research utilises a combination of doctrinal, socio-legal and comparative research methodologies to achieve the research objectives. The remainder of this section will address the different methodologies adopted and justify the rationale behind the methodological approach chosen for this research.

Doctrinal research

The term doctrine refers to 'a synthesis of various rules, principles, norms, interpretive guidelines and values.'[23] Doctrinal research, therefore, is an important process that can be used 'to identify, analyse and synthesise the content of the law.'[24] This involves a two-part process that begins with locating the sources of law

[20] Colin Robson, *Real world research: A resource for users of social research methods in applied settings* (3rd edn, Wiley-Blackwell 2011) 21.

[21] David E Gray, *Doing research in the real world* (3rd edn, Sage 2014) 20.

[22] Crotty (n 18) 13.

[23] Trischa Mann, *Australian law dictionary* (3rd edn, OUP 2017).

[24] Terry Hutchinson, 'Doctrinal research: researching the jury' in Dawn Watkins and Mandy Burton (eds), *Research methods in law* (Research methods in law, Routledge 2013) 9.

and is followed by an interpretation and analysis of the text.[25] Therefore, by its very nature, doctrinal research is limited to identifying the prescriptive content of the law. In other words, it focuses on the law in the books. The rules governing corporations have developed through case law and statute and is therefore compatible with the doctrinal approach. For the purposes of this study, the doctrinal methodology is used for researching what the law is in the UK and the U.S. through case law and legislation, including the Companies Act 2006 (CA 2006) and the Company Directors Disqualification Act 1986 (CDDA 1986) in the UK, and the Sarbanes-Oxley Act and Delaware General Corporation Law (DGCL) in the United States.

Doctrinal research has been criticised for being 'rigid, dogmatic, formalist and close-minded,' as it does not consider the external factors or the environment in which it operates.[26] However, corporations and the laws governing corporations do not operate in isolation, as corporate failures have wider social and economic implications. For this reason, the doctrinal methodology has been combined with socio-legal methodology.

Socio-legal research

While doctrinal research focuses on identifying and analysing the law in the books, socio-legal research considers the 'law in action.' This means socio-legal research goes beyond the content of the law and looks at how the law operates in practical terms. Although there is no universally accepted definition of socio-legal research, the term has been used to refer to an approach to the study of law and legal processes which…covers the theoretical and empirical analysis of law as a social phenomenon.'[27] However, as explained by Cownie and Bradney, not all socio-legal research is empirical.[28] Adopting a broader definition, Arthurs and Buntin, explain that socio-legal research 'investigates legal institutions, processes, cultures, texts, experiences, and outcomes from a variety of external perspectives.'[29] Socio-legal

[25] ibid 13.

[26] Douglas W Vick, 'Interdisciplinarity and the Discipline of Law' (2004) 31 Journal of law and society 163, 181.

[27] Fiona Cownie and Anthony Bradney, 'Socio-legal studies: A challenge to the doctrinal approach' in Dawn Watkins and Mandy Burton (eds), *Research Methods in Law* (Research Methods in Law, Routledge 2013) 35.

[28] ibid 45.

[29] Harry Arthurs and Annie Bunting, 'Socio-legal Scholarship in Canada: A Review of the Field' (2014) 41 Journal of law and society 487.

studies also tend to be interdisciplinary.[30] In addition to examining the corporate governance requirements in the UK and the U.S, this study also evaluates the effectiveness of enforcement in the UK and the U.S. using Becker's deterrence theory.[31] The deterrence theory is used within the field of criminology and economics and argues that criminal penalties deter corporate misconduct.

Cotterrell notes that law is required to address a social problem.[32] It is generally accepted that corporate governance regulations have been introduced to address the problem of corporate/director misconduct. Therefore, it is important to understand not just what the law is, but how the law operates, how it is enforced, the regulatory environment, enforcement outcomes and the effectiveness of enforcement. The socio-legal methodology, therefore, fills the gaps not addressed by a purely doctrinal approach.

Comparative law

This study also entails a cross-national comparative examination of the different legal rules and regulatory systems in the UK and the United States. For this reason, the thesis also adopts a comparative research methodology. Reitz explains that the comparative method entails an 'explicit comparison of aspects of two or more legal systems.'[33] The UK and U.S. were chosen for comparison as both countries have adopted different approaches to corporate governance, with the UK adopting a principles-based approach and the U.S. opting for a rules-based approach. Another important consideration in choosing the UK and U.S. was that the legal systems in both countries developed through common law roots and therefore have many similarities. Nevertheless, despite both approaches being shareholder-centric, there are key differences that arise. The comparative aspect of this research, therefore, begins with an examination of the corporate governance requirements in the UK and the U.S., with the aim of identifying the key differences between Sarbanes-Oxley and the UK Corporate Governance Code (UKCG) 2018.

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[30] Michael Salter and Julie Mason, *Writing law dissertations: An introduction and guide to the conduct of legal research* (Pearson Education 2007) 35.

[31] Becker (n 9).

[32] Roger Cotterrell, 'Theory and Values in Socio-legal Studies' (2017) 44 Journal of law and society S19, S22.

[33] J C Reitz, 'How to Do Comparative Law' (1998) 46 The American journal of comparative law 617, 618.

Comparative analysis is also useful for comparing the legal and enforcement framework in the UK and the United States. Importantly, the approach to corporate governance enforcement in both countries is also different. For instance, the U.S. has adopted a centralised approach with the U.S. Securities and Exchange Commission (SEC) acting as a single super civil regulator and the U.S. Department of Justice (DOJ) with exclusive dominion over criminal violations. On the other hand, the UK has multiple overlapping regulators. For example, in the UK the Serious Fraud Office (SFO) and the Financial Conduct Authority (FCA) prosecute cases of corporate misconduct.

The study also examines instances of corporate failure in the UK and the United States. In particular, the cases are examined to gain an understanding of the similarities and differences in the governance failures that contributed to the scandals and the enforcement outcomes in both jurisdictions. The cases that will be used for the UK aspects of this study are Autonomy, Tesco, Carillion, and Ted Baker. These companies were chosen due to the plethora of publicly available information that enabled a thorough and detailed analysis of the governance issues that contributed to the failure and the sanctions that followed in the aftermath. For the U.S. aspects of the study, the cases used are Hertz, Kraft-Heinz, SAExploration and Nikola Corporation. These companies were all registered in the state of Delaware and experienced a governance failure in which the financial implications were over $100 million. As a result of the size of these governance failures, a greater range of published materials was available. These cases were therefore selected on the basis that it would allow the researcher to draw well-grounded and comprehensive conclusions on enforcement in the United States.

Importantly, comparative law entails more than simply describing the similarities and differences that exist between the U.S. and the UK.[34] Instead, comparative research should also aim to make original policy recommendations.[35] By comparing corporate governance regulation and enforcement in the UK and the U.S., the study can add new knowledge to the debate and makes practical recommendations for improving corporate governance enforcement in the UK.

[34] Mathias M Siems, 'Legal Originality' (2008) 28 Oxford journal of legal studies 147, 151.

[35] ibid 151.

1.4.3 Data collection and analysis

The first step in the data collection process is to ensure that key terms are defined to ensure that the data collected is relevant to the research objectives. This research focuses on corporate governance regulation and enforcement and therefore the term corporate failure takes a central role. For the purposes of this study, a corporate governance failure is defined as any act by a company or director resulting in earnings restatement, fraud, fraudulent financial reporting or insolvency.

This thesis uses data from a variety of sources. To evaluate the effectiveness of public enforcement in the UK data was derived from the reports published by the Financial Conduct Authority and the Serious Fraud Office between 1 April 2010 and 31 December 2021. To evaluate the effectiveness of private enforcement in the UK, data was derived from the annual reports of the Financial Reporting Council (FRC) and the Insolvency Service (IS) for the same period. Data on derivative claims was also collected from the Westlaw UK database.

In evaluating the effectiveness of public enforcement in the U.S., data was derived from reports published by the SEC and the DOJ between 1 October 2015 to 30 September 2021. To evaluate the effectiveness of private enforcement data was derived from reports published by the Financial Industry Regulatory Authority (FINRA), the Public Company Accounting Oversight Board (PCAOB), Cornerstone Research and the Stanford Class Action database.

To ensure that the thesis is robust, data was derived from a range of primary and secondary sources. Primary data sources include case law, statutes and corporate governance codes. Secondary sources include published books, journal articles, parliamentary reports, annual financial statements, newspaper articles, company reports, various websites and online databases.

When collecting data for the purposes of this research, it is important to discuss the problems and limitations faced in the data collection process. Firstly, there was difficulty in obtaining derivative claims in the U.S., given the large size and federal structure of the United States. However, the Stanford Class Action Database has expressed a desire to create an entire U.S. database that will be useful for future studies on private enforcement in the United States. As a result, the data used in regard to derivative claims in the U.S. is limited to securities class actions that also includes a derivative claim. Another difficulty in obtaining information was due to the limited enforcement information published by the FRC. Although the FRC has been in existence for over 30 years, the regulator did not report on its enforcement actions until 2018/19. As a result, the analysis of FRC's enforcement outcomes is limited to 1 April 2017 to 31 March 2021.

As previously mentioned, this research combines doctrinal, socio-legal and comparative law methodologies to achieve the research objectives. As a result, this study uses inductive/deductive reasoning to draw conclusions. This is consistent with the constructivism model whereby learning occurs by interpretation.[36] The study also tabulates the annual enforcement outcomes of the FCA, SFO, FRC in the UK, and the SEC, DOJ, FINRA and PCAOB in the United States. The enforcement outcomes are tabulated with a view to determining average annual enforcement outcome and used as a key means in measuring levels of enforcement and therefore the effectiveness of enforcement.

1.5 THESIS OUTLINE & STRUCTURE

As illustrated in Figure 1, the thesis consists of 11 chapters.

Chapter 1 outlines the research questions and describes the research methodology.

Chapter 2 provides an overview of corporate governance. It considers the purpose and the main theories underpinning corporate governance. The chapter will discuss the key players in the corporate governance environment and their respective roles and responsibilities in regulating and enforcing corporate governance.

Chapter 3 focuses on corporate governance in the UK. It discusses the history and development of corporate governance and describes the UK's comply or explain approach to corporate governance. The chapter has six sections. The first section introduces the topic. The second section outlines the corporate governance framework in the UK. The third discusses the history and development of corporate governance in the UK. The fourth examines the principles of the UKCG 2018. The fifth section provides an overview of the UK's approach to corporate governance, which relies on voluntary compliance, disclosures and pressure from shareholders.

[36] William W Cobern, 'Constructivism' (1993) 4 Journal of Educational and Psychological Consultation 105, 110.

Chapter 4 examines instances of corporate governance failures in the UK at Autonomy, Tesco, Carillion and Ted Baker. It analyses the governance failures that contributed to the scandal and the regulatory response in the aftermath of the scandals.

Chapter 5 has five sections. The first section entails a brief introduction. The second provides a brief overview of the corporate landscape in the UK. The third examines the UK's legislative and enforcement framework and the primary agencies responsible for enforcing corporate misconduct. The fourth section analyses the public enforcement outcomes of the Financial Conduct Authority (FCA), the Serious Fraud Office (SFO) and the Insolvency Service (IS). The final section concludes.

Chapter 6 analyses private enforcement in the UK. The chapter evaluates private enforcement in the UK by analysing the enforcement outcomes of the Financial Reporting Council and shareholders. The chapter also summarises the public and private enforcement outcomes in the UK and evaluates the effectiveness of enforcement in the UK using Becker's theory of measuring enforcement.

Chapter 7 discusses the rules-based approach to corporate governance adopted in the United States. The chapter examines the requirements of Sarbanes-Oxley Act, including the sanctions for non-compliance.

Chapter 8 examines instances of governance failures at Hertz, SAExploration, the Kraft Heinz Company and Nikola Corporation. The chapter explores the background leading up to the scandal, the corporate governance failures that contributed to the scandals and the regulatory outcomes in the aftermath of the scandal.

Chapter 9 evaluates public enforcement in the United States. The chapter consists of five sections. The first section introduces the topic. The second section considers the corporate landscape in the United States. The third section examines the legislative and enforcement framework. The fourth section evaluates the public enforcement mechanisms by the U.S. Securities Exchange Commission (SEC) and the U.S. Department of Justice (DOJ). The final section concludes.

Chapter 10 analyses private enforcement mechanisms in the United States. The chapter analyses the enforcement outcomes by Financial Industry Regulatory Authority (FINRA), the Public Company Accounting Oversight Board (PCAOB) and shareholders. The chapter summarises the enforcement outcomes in the U.S. and analyses the effectiveness of enforcement using Becker's approach to measuring enforcement.

Chapter 11 summarises the main findings of this research. The chapter has six sections and includes recommendations and contributions.

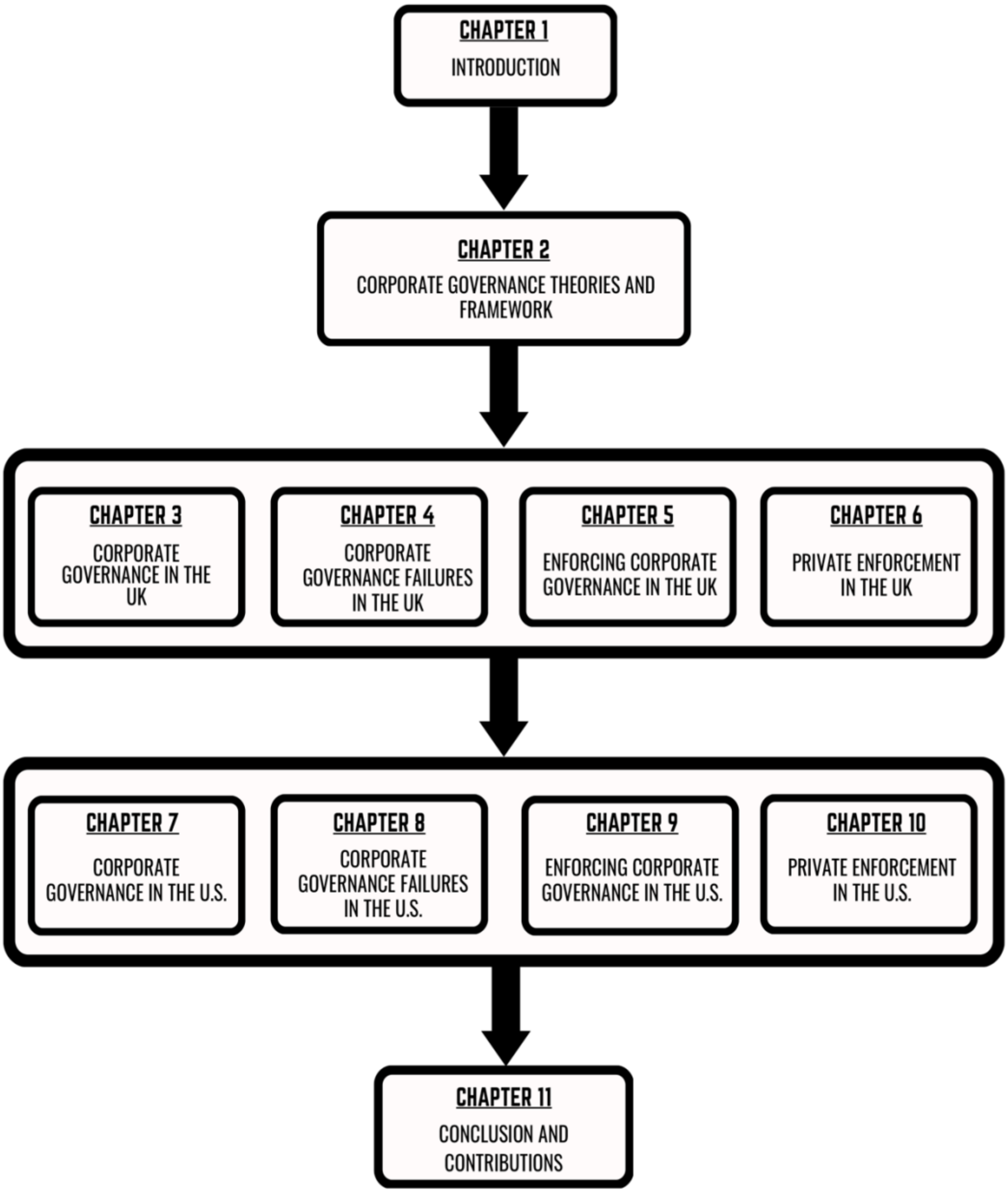

Figure 1: Thesis structure

Chapter 2
CORPORATE GOVERNANCE: THEORIES AND FRAMEWORK

'If the business community does not come together to define its social and environmental responsibility and then act on that definition, I fear we will not achieve a (that) better society.'

- Courtney Pratt[37]

2.1 INTRODUCTION

The previous chapter introduced the research and discussed the research background and objectives. The purpose of this chapter is to discuss the theories underpinning corporate governance and the role of shareholders, directors, auditors and regulators in corporate governance. The chapter proceeds as follows; Section 2.2 describes the principles of corporate governance and identifies the key players in regulating and enforcing corporate governance. The roles and responsibilities of shareholders directors, auditors and regulators in corporate governance are addressed in section 2.5. Section 2.6 concludes.

2.2 WHAT IS CORPORATE GOVERNANCE

The term 'corporate governance' first appeared in the U.S. Federal Register in the 1970s.[38] Following the rise of the corporate form in the aftermath of WW2, the need to govern the behaviour of large corporations in the U.S. was beginning to emerge as an area of serious concern.

Since then, several definitions of corporate governance have emerged. Nevertheless, despite the plethora of definitions that have emerged to define corporate governance, Cadbury's definition of corporate governance is among the best known and most often cited. According to Cadbury corporate governance is 'the system by which companies are directed and controlled.'[39] This study focuses on the key differences in the approaches to corporate governance regulation and

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[37] Courtney Pratt, Former President of Noranda Inc.

[38] Brian R. Cheffins, 'The Rise of Corporate Governance in the UK: When and Why' (2015) 68 Current Legal Problems 387.

[39] Cadbury Committee, *The Financial Aspects of Corporate Governance* (Gee and Co Ltd, 1992) para 2.5.

enforcement in the UK and the U.S. and therefore adapts Cadbury's definition for two reasons. Firstly, Cadbury's definition considers both the internal aspects, such as internal controls and board composition, as well as external aspects, such as stakeholders.[40] Secondly, Cadbury is often considered the father of corporate governance in the UK and is credited with pioneering the 'comply or explain' approach to corporate governance, which still applies in the UK today and has been adopted by several other countries including Germany and the Netherlands.

2.3 PURPOSE OF CORPORATE GOVERNANCE

Ultimately, corporate governance regulations are aimed at preventing and detecting corporate misconduct. The S&P 500, which is made up of the largest 500 publicly traded companies in the U.S., manages funds greater than the GDP of several countries. For instance, in 2017 Netflix's revenue exceeded the GDP of Malta.[41] Standing at over $2 trillion the market cap of Apple exceeds the GDP of several countries.[42] The collapse of this colossal giant could undoubtedly affect global economies. Given the grave consequences that can often times flow from a failure of effective corporate governance, it is imperative to regulate corporate behaviour to protect financial markets, shareholders and other stakeholders.

2.4 THEORIES OF CORPORATE GOVERNANCE

Long before the term corporate governance began to gain international attention, several academics observed that the relationship between shareholders and directors gave rise to a conflict of interest. With the rise of the corporate form, the separation between ownership and control effectively meant that shareholders did not have a role in the day-to-day operations of the company, thereby entrusting the running of the company to directors. This section describes the main theories of corporate governance that have emerged to explain this relationship, namely agency theory, stewardship theory and stakeholder theory.

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[40] Karel Lannoo, 'A European perspective on corporate governance' (1999) 37 Journal of Common Market Studies 269, 271Chris Mallin, Andy Mullineux and Clas Wihlborg, 'The financial sector and corporate governance: the UK case' (2005) 13 Corporate Governance: An International Review 532, 532.

[41] Fernando Belinchón and Qayyah Moynihan, '25 giant companies that are bigger than entire countries' (*Business Insider,* 25 July 2018) <www.businessinsider.com/25-giant-companies-that-earn-more-than-entire-countries-2018-7?r=US&IR=T> accessed 9 May 2019.

[42] Patrick McGee and Tim Bradshaw, 'Apple market value hits $2tn ' *Financial Times* (London 19 August 2020) <www.ft.com/content/ef09a97a-fcea-44d7-a5c0-5dc67becf286> accessed 18 September 2020.

2.4.1 Agency Theory

According to Jenson and Meckling, an agency relationship is created when an individual (the principal) delegates decision making authority to another (the agent).[43] This agency relationship extends far beyond shareholders and directors. For instance, the contractual arrangement between an employer and an employee also gives rise to an agency relationship. Applying the agency relationship in the context of a company, the owners (the principals) appoint directors (the agents) to run and manage the company on their behalf. The rise of the corporate form widened the gap between those who owned the companies and those who were responsible for decision making. Ultimately, this gap means that shareholders in publicly traded companies have virtually no role in the day-to-day operations of the company. According to Berle and Means, this separation of ownership and control gives rise to the agency problem.[44] This gap could be exploited by managers to seek their own interest. Corporate governance regulations, therefore, aim to address the issues from this gap that results from the separation of ownership and control and prevent abuse.

Given that corporate governance is grounded in agency theory and aims to address the agency problem by improving accountability and transparency, perhaps it is also no surprise that despite the introduction of corporate governance regulations, instances of corporate abuse continue to occur. This view was supported by Dalton and others, who argued that the very foundation upon which corporate governance has been built appears to be broken.[45] In other words, corporate governance regulations aim to address the agency problem arising from the separation of ownership and control, on the premise that aligning the interest of shareholders and directors would result in better performance. Moore and Rebérioux held a different view, arguing that instead of attempting to minimise the consequences of separation and control, corporate governance should aim to exploit the consequences of separation and control.[46] By using "incentives and disciplinary mechanisms" at a firm level, the consequences of separation and control are minimized and

[43] Michael C Jensen and William H Meckling, 'Theory of the firm: Managerial behavior, agency costs and ownership structure' (1976) 3 Journal of Financial Economics 305.

[44] Adolf Augustus Berle and Gardiner Coit Means, *The modern corporation and private property* (Transaction Publishers 1991).

[45] Dan R Dalton and others, 'The fundamental agency problem and its mitigation' (2007) 1 Academy of Management annals 1.

[46] Marc T Moore and Antoine Rebérioux, 'Revitalizing the institutional roots of Anglo-American corporate governance' (2011) 40 Economy and Society 84.

shareholders interest are aligned with directors interest.[47] For example, the granting of stock options to directors is used as an incentive to align the interest of shareholders and directors. However, stock ownership has also been shown to be open to abuse by directors for their own interest and can act as an incentive for directors to manipulate the company's share price.[48]

One of the limitations of agency theory is the supposition that companies have a singular purpose; to maximise shareholder value. Stout points out however that pursuing shareholder wealth is not a legal requirement, but merely a management choice.[49] Nevertheless, this supposition has been embraced and agency theory has been used as the foundation upon which corporate governance has been built. However, it can be argued that the pursuit of this singular objective, to maximise profit for shareholders, has led to a series of corporate abuses. The maximisation of shareholder value puts pressure on companies to report results in line with or exceeding market expectations. In 2018 Elon Musk tweeted about his desire to take electronic car company Tesla private.[50] In a memo to employees, Musk later explained that the pressure of fluctuating stock prices and short-term thinking were affecting the company's long-term success and performance.[51] Although agency mechanisms aim to address the problems of agency by incentivising directors to act in shareholders' interest. These incentives also act as pressure on managers to achieve wealth creation for shareholders.

2.4.2 Stewardship Theory

Unlike agency theory which assumes that an agents' behaviour is motivated by their own self-interests, stewardship theory holds that the interest of the managers (stewards) are aligned with the interest of the principals from the onset of the relationship. This suggests that this relationship is built on the assumption of mutual trust. However, unlike agency theory, stewardship theory focuses on the behaviour

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[47] ibid.

[48] David A Skeel, *Icarus in the Boardroom: The Fundamental Flaws in Corporate America and Where They Came From* (OUP 2005).

[49] Lynn A Stout, *The shareholder value myth how putting shareholders first harms investors, corporations, and the public* (1st ed. edn, Berrett-Koehler 2012) 11.

[50] Mike Colias and Miriam Gottfried, 'Elon Musk Tweets He Is Considering Taking Tesla Private' *The Wall Street Journal* (New York 8 August 2018) <www.wsj.com/articles/elon-musks-twitter-account-am-considering-taking-tesla-private-at-420-1533661152> accessed 9 May 2019.

[51] Tesla, 'Taking Tesla Private' (*Tesla,* 7 August 2018) <www.tesla.com/en_GB/blog/taking-tesla-private> accessed 9 May 2020.

of the 'man'. In differentiating between the two competing theories, Davis explains that while agency mechanisms seek to 'monitor and control', stewardship mechanisms aim to 'facilitate and empower'.[52] Several researchers have opined that stewardship theory is inferior to agency theory.[53] Under this theory, managers are motivated by intrinsic rewards, rather than extrinsic financial gains, such as career advancement and personal development. Arguably, the underlying supposition of stewardship theory that individuals are motivated by intrinsic needs is flawed. Suppose that an individual has chosen to remain in his position for professional career development. Although this is an intrinsic motivation, professional career development will ultimately lead to a higher salary. No matter how much we spin the cartwheel, the needle comes right back to financial gain as a primary motivator of human behaviour.

2.4.3 Stakeholder Theory

In the past few decades, stakeholder theory has emerged as an influential, but controversial proposition in an attempt to redefine the company's purpose. Where agency theory presumes the purpose of the company is wealth generation through profit maximisation or increases in market value, stakeholder theory puts forward that companies owe a duty of care to all stakeholders, including employees, suppliers and local communities. Although this theory has gained significant ground, it has also been described as 'deeply dangerous and wholly unjustified'.[54]

Where agency theory assumes a contract between the agent and the principal, stakeholder theory assumes that managers should balance the competing interest of all stakeholders, without prioritising the needs of any particular stakeholder. In support of a stakeholder approach to corporate governance, Alpaslan, Green and Mitroff argued that companies would be able to prevent or respond more effectively to crises by considering the impact of their decisions on a greater range of stakeholders.[55] Using the Exxon oil spill to illustrate the pitfalls of the shareholder value approach to corporate governance, Alpaslan, Green and Mitroff underscore

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[52] James H Davis, F David Schoorman and Lex Donaldson, 'Toward a stewardship theory of management' (1997) 22 Academy of Management Review 20, 26.

[53] ibid 21.

[54] Elaine Sternberg, 'The Defects of Stakeholder Theory' (1997) 5 Corporate Governance: An International Review 3, 8.

[55] Can M Alpaslan, Sandy E Green and Ian I Mitroff, 'Corporate Governance in the Context of Crises: Towards a Stakeholder Theory of Crisis Management' (2009) 17 Journal of Contingencies & Crisis Management 38.

that the company reduced safety and maintenance costs in the pursuit of shareholder value, following a sudden decrease in market value.[56] Similarly, in an attempt to reduce operating costs BP skimmed on safety procedures which results in the Deepwater Horizon and ultimately cost shareholders over $100 billion.[57] While this argument in favour of the stakeholder approach to corporate governance may hold some weight in the context of environmental disasters, the study did not take into consideration that no amount of stakeholder analysis or stakeholder engagement could have prevented the majority of corporate governance failures that have occurred in the past. In fact, the majority of corporate governance scandals that have come to light have been the result of internal control weaknesses, audit failure and corporate misconduct. The stakeholders in many instances were none the wiser prior to the emergence of these scandals. On this basis, it can be argued that adopting a stakeholder model to corporate governance is unlikely to prevent instances of corporate governance failures.

2.5 THE CORPORATE GOVERNANCE ENVIRONMENT

Although different approaches to corporate governance have been adopted by the UK and the U.S., similarities exist. For instance, corporate governance regulations in the UK and the U.S. both address board composition and CEO duality. Similarly, corporate governance in the UK and the U.S. address four key areas; board composition, audit, remuneration and internal controls. Thus, each of the players in Figure 2 has a role to play in corporate governance.

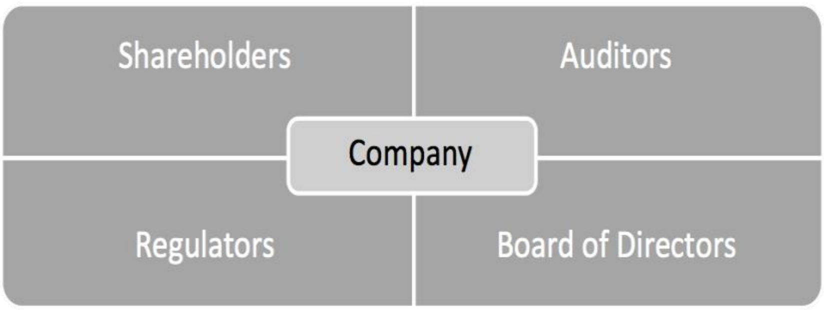

Figure 2: Diagram showing the key players in the corporate governance environment

Given that corporate governance regulations have been geared at addressing the problems that arise from the separation of ownership and control, a significant

[56] ibid 43.

[57] Stout (n 49) 10.

portion of the regulations have been geared toward directors. However, shareholders, auditors and regulators also have an important role to play in ensuring an effective system of corporate governance. As the gatekeepers of financial markets, auditors provide assurance to shareholders. The remainder of this section will discuss the role of shareholders, auditors, directors and regulators in corporate governance.

2.5.1 The Role of Directors

The board of directors play a fundamental role in preventing and detecting corporate misconduct. Corporate abuse by company directors was the catalyst that propelled corporate governance into the spotlight. The directors of Enron were complicit in the massive fraud that brought the energy giant to its feet. In collaboration with the company's auditors, Arthur Andersen, Enron's chief executive director and chief financial officer perpetrated serious accounting irregularities and engaged in a massive fraud.

Ultimately, directors are responsible for ensuring effective controls are in place to prevent and detect corporate misconduct. For this reason, a significant portion of corporate governance regulations have been aimed at regulating the behaviour of directors, including board structure, composition and remuneration. Bainbridge argues that boards as currently constituted are not fit for purpose and fail, and has called for outsourcing the function of the boards to provide director services.[58] This again does not take into consideration that there would still be a need to oversee the company hired to perform this function. Again, it raises the question of who would watch the watchdog? Simply introducing regulations to regulate directors' behaviour is not sufficient and has not been effective. Ultimately, corporate governance is not a stand-alone initiative geared only at directors. The success of corporate governance relies on the effectiveness of all key players working harmoniously.

2.5.2 The Role of Shareholders

Although shareholders are the ultimate owners in the majority of publicly listed companies, shareholders have little to no active involvement in the day-to-day operations of the company. Accordingly, directors are therefore accountable to the

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[58] Stephen M Bainbridge, 'Rethinking the Board of Directors: Getting Outside the Box' (2019) 74 Business Lawyer 285.

shareholders. In the UK, corporate governance was built on the premise that shareholders would be the ultimate enforcers of corporate governance and would express their will by voting.[59] However, in the past decade share ownership has grown increasingly diverse and the ability of shareholders to effect any meaningful change through voting has been diminished. Additionally, in the U.S. in particular companies utilise dual-class stock which effectively limits the power of other shareholders. For instance, Mark Zuckerberg has been able to remain in control at Facebook through Class B shares which give him 60% voting control.[60] Despite attempts to put controls on his power, shareholders have been unsuccessful.[61]

2.5.3 The Role of Auditors

The external auditor has long been recognised as key to effective corporate governance and restoring public trust. Instances of corporate governance failures continue to call into question the effectiveness of the external auditor as the watchdog of financial regulation. In an attempt to restore trust in the profession, there has been seen a significant increase in enforcement actions against auditors as serious audit failures are a significant impediment to the proper functioning of corporate governance. In the aftermath of every corporate governance scandal, there are renewed calls for audit reform. This was also the case over 20 years ago in the aftermath of Enron, yet we continue to experience instances of corporate governance failure that went undetected by the auditors. As a result of these continuing instances of auditor failure, the question remains 'who watches the watchdog.'[62]

2.5.4 The Role of Regulators

In recent years UK and U.S. regulators have faced heavy criticisms for oversight failures following a series of corporate governance scandals. Although research is limited on the enforcement of corporate governance in the UK and the U.S., one of

[59] Cadbury Committee (n 39).

[60] Julia Carrie Wong, 'Zuckerberg's control of Facebook is near absolute – who will hold him accountable?' *The Guardian* (London 21 November 2018) <www.theguardian.com/technology/2018/nov/21/zuckerbergs-control-of-facebook-is-near-absolute-who-will-hold-him-accountable> accessed 9 May 2019.

[61] Naomi Nix, 'Facebook Board Rejects Proposals to Curb Zuckerberg's Power' (*Bloomberg,* 26 May 2021) <www.bloomberg.com/news/articles/2021-05-26/facebook-board-rejects-proposals-to-reduce-zuckerberg-s-power> accessed 9 August 2021.

[62] Alison Herren Lee and Caroline A Crenshaw, 'Who Watches the Watchers? Joint Statement on Auditor Independence Amendments' (*SEC,* 16 October 2020) <www.sec.gov/news/public-statement/lee-crenshaw-who-watches-watchers> accessed 9 May 2021.

the issues facing corporate governance enforcement in the UK stems from a large number of regulators. According to Sikka there are roughly 41 regulators covering the financial sector in the UK.[63] In the UK, the Financial Reporting Council regulates and oversees corporate governance compliance and auditing standards. The Financial Conduct Authority oversees the securities market and the Serious Fraud Office investigates and prosecutes serious white-collar crime. It is also important to note here, that unlike the SEC, the FRC does not have prosecution powers. As a result, the UK regulatory landscape has been referred to as 'cumbersome and ineffective'.[64] This can be contrasted to the U.S. where the SEC is the sole federal securities regulator responsible for corporate governance compliance, white collar crime and other securities related fraud. Additionally, unlike its UK counterpart, the SEC prosecutes its own cases.

2.6 CONCLUSION

Corporate governance regulations are designed to prevent and detect instances of corporate misconduct and are grounded in agency theory. This means that corporate governance regulations seek to align the interest of shareholders with managers and improve accountability and transparency. While agency theory by no means perfectly characterises the relationship between a company and its owners, building corporate governance regulations on the premise of stewardship theory is not prudent and is unrealistic in today's economic climate. Ultimately, the effectiveness of any system of governance relies on proper enforcement as a means of deterring misconduct. At its core, corporate governance regulations address four main areas; board composition, internal controls, remuneration and enforcement. For instance, while the board of directors plays more of a monitoring role, in the end their duty is to ensure the actions of the managers are in the best interest of the shareholders. Unfortunately, despite repeated attempts to prevent instances of corporate misconduct and as much as we would like to think we have moved forward we have not addressed the fundamental underlying issues which give rise to corporate governance failures.

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[63] Prem Sikka, 'Labour will prevent more corporate scandals by making companies focus on the long-term' *Independent* (London 9 December 2019) <www.independent.co.uk/news/business/comment/labour-business-scandals-conservatives-general-election-gdp-a9239621.html> accessed 15 August 2021.

[64] ibid.

Chapter 3
CORPORATE GOVERNANCE IN THE UK

'The business of government is not the government of business.'
- Nigel Lawson[65]

3.1 INTRODUCTION

The previous chapter discussed the framework and theories underpinning corporate governance. This chapter entails an analysis of corporate governance in the UK. The Chapter proceeds as follows; Section 3.2 discusses the UK corporate governance framework. Section 3.3 explains the history and evolution of corporate governance in the UK. The principles of the 2018 UK corporate governance code (UKCG) are addressed in Section 3.4. Section 3.5 discusses the UK's comply or explain approach and Section 3.6 concludes.

3.2 CORPORATE GOVERNANCE FRAMEWORK IN THE UK

The corporate governance framework in the UK consists of a combination of codes, statutes, regulations and case law. As discussed in Chapter 2, agency theory is considered the foundation upon which corporate governance in the UK was built. The basic framework that governs this relationship is derived from the CA 2006, which also codified the following director's duties:[66]

S. 171 - Duty to act within powers
S. 172 - Duty to promote the success of the company
S. 173 - Duty to exercise independent judgement
S. 174 - Duty to avoid conflicts of interest
S. 175 - Duty to exercise reasonable care, skills and diligence
S. 176 - Duty not to accept benefits from third parties
S. 177 - Duty to declare interest in proposed transaction or arrangement

[65] Nigel Lawson, Former Chancellor of the Exchequer.

[66] Companies Act 2006, s171-177.

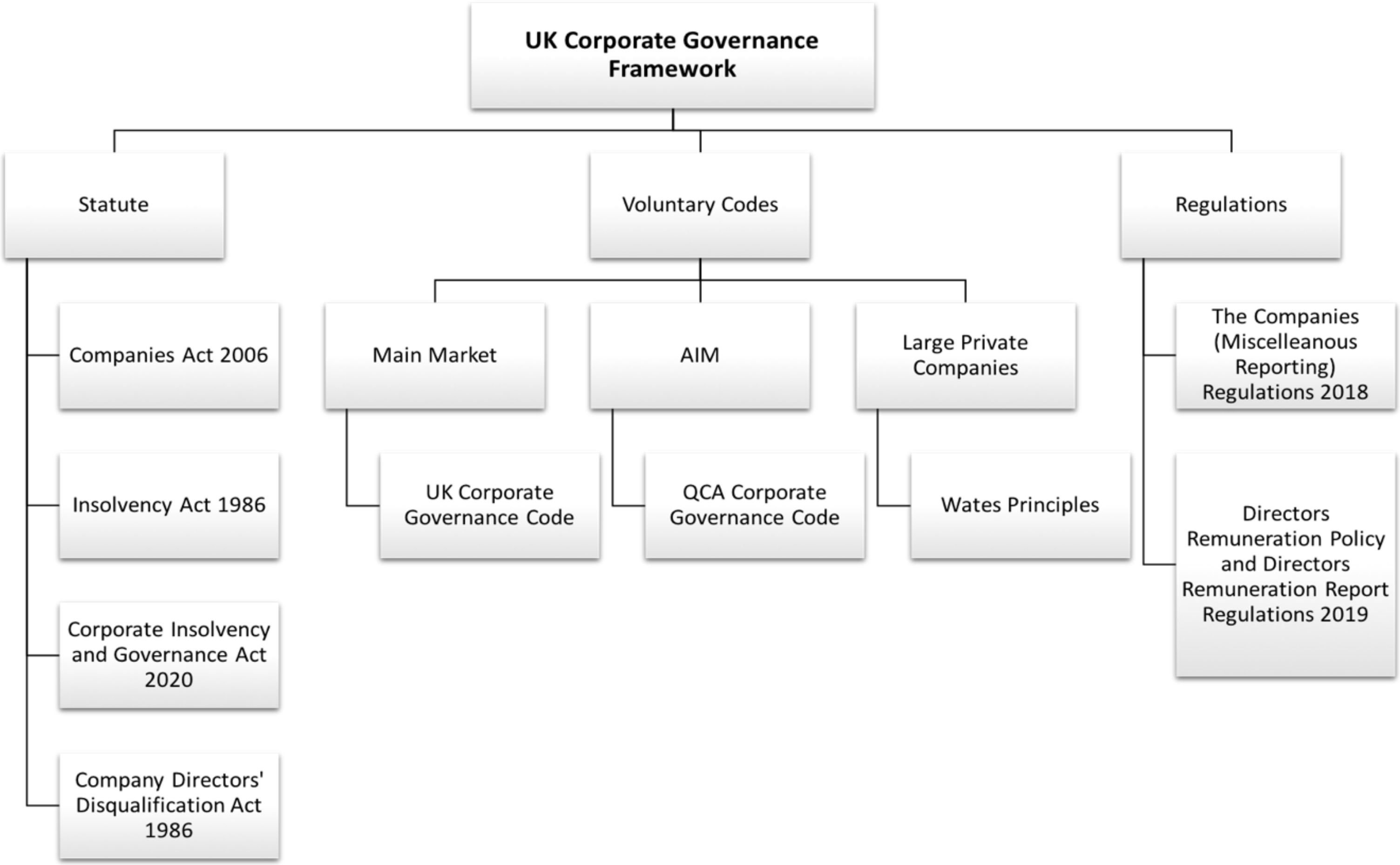

Figure 3: The UK Corporate Governance Framework

Section 172, the most controversial of these duties, introduced the enlightened shareholder value approach into UK corporate governance requiring directors to take into consideration the effect of the company's operations on other stakeholders, including employees and creditors.[67] In addition, the CA 2006 also set out the requirements of the annual accounts and reports,[68] the director's report,[69] and require directors to be satisfied that the accounts give a 'true and fair view' of the financial position of the company.[70] As shown in Figure 3 above, the corporate governance framework in the UK consists of several other statutes, such as the Insolvency Act 1986 (IA 1986), the Corporate Insolvency and Governance Act 2020, and the CDDA 1986.

3.3 HISTORY OF CORPORATE GOVERNANCE IN THE UK

Several high-profile scandals in the 90s including Maxwell Communications, Polly Peck and BCCI put the need for regulating corporate behaviour in the spotlight. In response to the loss of trust in financial markets and fear of government intervention, the London Stock Exchange, the Financial Reporting Council (FRC) and the accounting profession commissioned the UK's first ever review into corporate governance. The committee's seminal report (the Cadbury report), built on the principles of openness, integrity and accountability, would form the foundation of UK corporate governance for years to come and would lead to corporate governance reform worldwide.

By the time the Cadbury Committee was established in 1991, the UK economy had seen a shift towards a free enterprise economic model initiated under Thatcherite conservative policies of deregulation and privatisation. In line with this new free market approach, Cadbury argued that effective accountability should not constrain free enterprise, but should strike the right balance.[71] As a result, Cadbury proposed the comply or explain approach which required companies to comply with the code or give reasons for non-compliance.[72]

[67] ibid s172.

[68] ibid s471(2).

[69] ibid s415.

[70] ibid s393(1).

[71] Cadbury Committee (n 39).

[72] ibid para 3.7.

Although Cadbury's report did not revolutionise governance, for the first time the Cadbury Code established a clear corporate governance framework based on existing best practice at the time.[73] At the centre of many of the governance failures which led to the creation of the Cadbury Committee was the failure of financial reporting and auditing safeguards. Consequently, the Cadbury Committee was limited in its remit and focused on the financial aspects of corporate governance, such as the structure and composition of the board and the roles and responsibilities of auditors and shareholders. Cadbury reasoned that improving accountability and transparency in turn reduced the risk of fraud or company failure. With regards to enforcement, Cadbury maintained that shareholders would be the ultimate enforcers of the code, holding directors accountable by exercising their voting rights.

The Greenbury Committee was set up in 1995 in response to the 'fat cat' pay scandal. By the late 90s executive remuneration in the UK had skyrocketed to near the top of the international directors pay league.[74] The Greenbury Code addressed four key areas which supposedly contribute to good practice in determining executive remuneration: the composition of the remuneration committee, disclosures, remuneration policy and directors service contracts and compensation. While Greenbury endorsed much of Cadbury's recommendations, Greenbury's view differed on the composition of the remuneration committee.[75] Where Cadbury recommended the remuneration committee consists 'wholly or mainly' of non-executive directors.[76] This meant that an executive could potentially sit on the remuneration committee (so long as he was not involved in setting his own remuneration), Greenbury expressly ruled this out recommending the committee should comprise exclusively of NEDs.

Three years after Greenbury, the Hampel Committee was established in 1998 to review the implementation of the Cadbury and Greenbury principles as originally suggested by Cadbury.[77] Despite Cadbury's hope that companies would consider

[73] ibid para 1.7.

[74] Martin Conyon and Robert Singh, 'Taking care of business: the politics of executive pay in the United Kingdom' (1997) 11 Contemporary British History 1, 7.

[75] Greenbury Study Group, *Directors Remuneration* (Gee Publishing Ltd, 1995).

[76] Cadbury Committee (n 39) para 4.42.

[77] Hampel Committee on Corporate Governance, *Final Report* (Gee Publishing Ltd, 1998) 5.

the spirit of the principles, Hampel found that a tick-box approach was inadvertently being applied to the principles.[78] Like Cadbury and Greenbury before, Hampel did not seek to place controls on executive remuneration arguing that controls on remuneration were not possible in free market economies.[79] Hampel's final recommendations were consolidated with Greenbury and Cadbury resulting in the UK Combined Code 1998.

Although Cadbury acknowledged the role of internal controls in good governance, Cadbury's report did not specifically address the requirements of an effective internal control system. This was addressed in 1999 with the Turnbull Report, which provided guidance on internal controls, internal audit and risk management.[80] Turnbull purposely did not specify controls to be adopted but suggested that companies take a risk-based approach to identifying and implementing the system of internal controls based on their specific risks. This required the board of directors to identify the risks facing the company and express an opinion on the effectiveness of the company's system of internal controls to address these risks.

As a result of the collapse of Enron and the subsequent collapse of the company's auditors Arthur Andersen in 2001, questions emerged regarding the effectiveness of non-executive directors (NEDs). In response, the UK Government established the Higgs and Smith Committees in 2002. Higgs recommended that at least half the board should be made up of NEDs, thereby shifting the balance of power away from the executives.[81] The Smith Committee issued guidance clarifying and strengthening the audit committee requirements and recommended that at least one (1) member of the audit committee should have financial expertise. Following the Higgs and Smith Reviews, a revised Code was issued in 2003 emphasising the importance of NEDs and the independence of NEDs.

By 2010, 18 years after the introduction of Cadbury, the role of shareholders in enforcing corporate governance as envisioned by Cadbury did not materialise.

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[78] Ronald Hampel, 'Judgment should prevail over prescription' *Financial Times* (London 29 January 1998) 11.

[79] ibid.

[80] Turnbull Committee, *Internal Control Guidance for Directors on the Combined Code* (ICAEW 1999).

[81] Derek Higgs, *Review of the role and effectiveness of non-executive directors* (The Stationery Office, 2003).

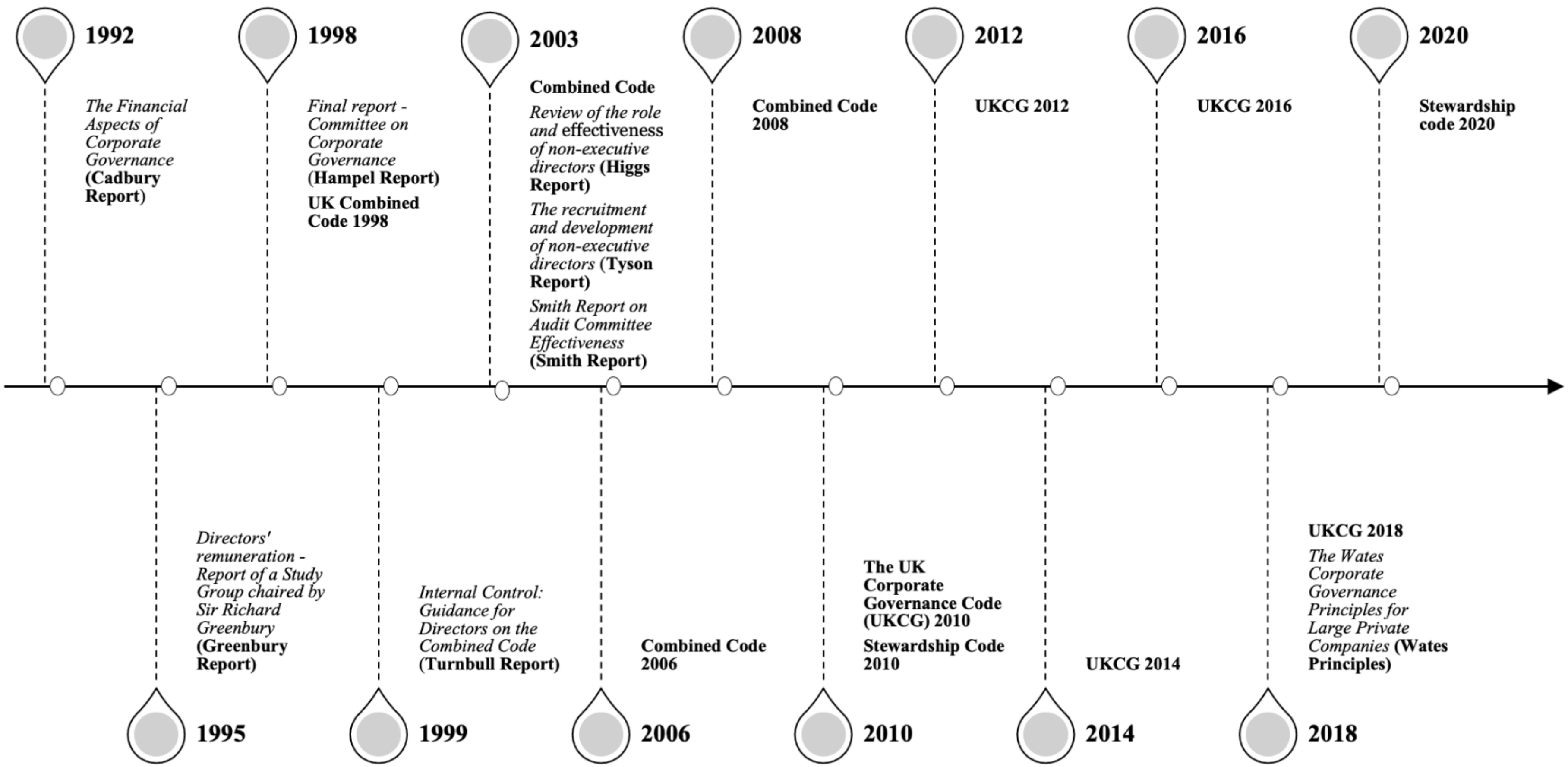

Figure 4: The Evolution of Corporate Governance in the UK

Following the UK banking crisis in 2008 institutional investors were accused of being 'asleep at the wheel'.[82] In response, the FRC published the Stewardship Code in 2010 to encourage institutional investors to monitor the companies they invested in. Intended as complimentary guidance to the Code, the Stewardship Code required companies to disclose their voting policy and voting activity. Like the Combined Code, the Stewardship Code also adopted the comply or explain approach.

Following the Walker Report on corporate governance in banks and financial institutions, in the aftermath of the UK banking crisis, the Combined Code was updated and rebranded as the UK Corporate Governance Code (UKCG) in 2010. The UKCG 2010 incorporated several recommendations from the Walker report and focused on improving risk management. The updated code also recommended that directors of FTSE 350 companies should be put up for re-election every year.

The UKCG 2012 improved audit committee reporting requirements and required boards to confirm the accounts present a fair and balanced assessment of the company's performance. The UKCG 2014 required remuneration policies to take into consideration the long-term success of the company and for the first time the UKCG 2014 included a recommendation for remuneration policies to include a clawback provision. The UKCG was updated again in 2016 to implement the EU Audit Regulation and Directive. The UKCG 2016 required the audit committee to report on how the effectiveness of the external auditor has been assessed and the framework in place to ensure the independence and objectivity of the auditor.[83]

The UKCG 2018 introduced a new principle geared toward recognising and improving the role of corporate culture in corporate governance and required directors to consider the interest of stakeholders in keeping with s 172 duty.[84] Ultimately, the UKCG 2018 is meant to represent a shift away from the tick-box approach, towards companies applying the spirit of the code as originally envisioned by Cadbury. However, over the past two decades the UK has continued to experience continuing instances of corporate governance failures which call into

[82] Julia Finch, 'Myners in veiled criticism of M&S over Rose's two roles' *The Guardian* (London 18 June 2010) <www.theguardian.com/business/2010/jun/18/myners-criticises-marks-and-spencer> accessed 20 September 2019.

[83] Financial Reporting Council, *The UK Corporate Governance Code 2016* (FRC, 2016).

[84] Financial Reporting Council, *The UK Corporate Governance Code 2018* (FRC, 2018) principle B.

question the effectiveness of the corporate governance code in preventing or detecting some of the UK's largest corporate governance scandals, such as Tesco and Carillion. Whether the UKCG 2018 will prove more effective seems unlikely. Similar to the scandals of the past, companies will continue to report compliance to UKCG 2018. While the UKCG has been updated with a view to preventing another Carillion, it is important to point out that the UK's very first corporate governance code, commissioned over 20 years ago, was done with a view to preventing corporate governance scandals, such as Carillion. In the end, the UKCG 2018 does not change the legal environment in which corporate governance operates where penalties for non-compliance and mechanisms for enforcement are virtually non-existent. Consequently, the effectiveness of the UKCG 2018 in preventing instances of corporate failure will continue to be a topic of great debate.

Following a series of consultations in the aftermath of scandals such as BHS and Carillion, the UK government published the response to the proposals to strengthen and improve transparency and accountability in corporate governance in May 2022.[85] The 197 page report sets out several proposed changes to the UK corporate governance environment, including the new enforcement powers of ARGA to hold directors of public interest entities (PIEs) accountable for breach of directors' duties and increased directors obligations for the prevention and detection of fraud.[86]

Despite Cadbury and the many revisions to the code since its introduction, corporate governance failures continue to emerge. Taking into consideration Armour's premise that the effectiveness of law and regulations to deter misconduct is dependent on the likelihood of enforcement, it is submitted that these proposed changes will do little to deter corporate misconduct.[87] Apart from the explicit enforcement powers set out for ARGA for breach of director's duties, the proposals do little to address or improve the UK's enforcement framework. The past failures to prevent or deter corporate misconduct arguably did not stem from a lack of enforcement powers, but due to regulatory failures exasperated by a muddled enforcement framework with overlapping regulators. In fact, the Government

[85] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (GOV.UK, 2022).

[86] ibid.

[87] Armour (n 3).

acknowledged the potential for overlap, with any areas of overlap addressed by a Memorandum of Understanding (MoU) between the FCA and the ARGA.[88] It is important to point out here that despite the existence of a MoU between the FCA and FRC, there was still confusion over which regulator was responsible for investigating Carillion.

3.4 PRINCIPLES OF THE UK CORPORATE GOVERNANCE CODE

While the new code does contain a few new principles, much of the spirit of the Code has remained unchanged. Noticeable among these changes however, is the removal of Section E which contain guidelines on the company's relations with shareholders. Given the pivotal role of shareholders in monitoring and enforcing compliance under UK corporate governance, Mujih questions whether this change represents a shift from shareholder primacy in the UK.[89] In contrast to Mujih, Reddy held the view that Section E resulted in vague statements on shareholder engagement and its removal from the corporate governance code as a separate section encourages companies to consider shareholders interest more extensively.[90] Interestingly, the debate on whether the UK model more closely aligns to the stakeholder-oriented or shareholder-oriented model has been ongoing for many years. Armour, Deakin and Konzelman, using the example of the sale of Rover by BMW, argue that the inclusion of employee voices in the transaction altered the balance in favour of stakeholder-oriented models.[91] Adopting this argument, the inclusion of the employee engagement provision in the code could therefore also be considered as another indication that the UKCG 2018 represents a shift in favour of stakeholder value. However, according to Keay, given that other stakeholders are unable to take any action against the directors for breach, the UK model remains shareholder-oriented at its core, even after the introduction of the s. 172 duty.[92] Therefore, it can be argued that the UKCG 2018, which operates on a comply or explain basis, does not actually represent a further shift away from

[88] Ernst & Young LLP, *Summary of the UK Government's response to the proposals on reforming audit and corporate governance* (EY, 2022) 4.

[89] Edwin Mujih, 'Do not simply tick the box: the effectiveness of the Corporate Governance Code 2018 in the absence of an implementation mechanism' (2021) 42 Company Lawyer 43.

[90] Bobby V Reddy, 'Thinking Outside the Box – Eliminating the Perniciousness of Box-Ticking in the New Corporate Governance Code' (2019) 82 The Modern Law Review 692.

[91] John Armour, Simon Deakin and Suzanne J Konzelmann, 'Shareholder primacy and the trajectory of UK corporate governance' (2003) 41 British Journal of Industrial Relations 531, 22.

[92] Andrew Keay, 'Moving towards stakeholderism-constituency statutes, enlightened shareholder value, and more: Much ado about little' (2011) 22 Eur Bus L Rev 1.

shareholder primacy. Instead, the UKCG 2018 more closely aligns the corporate governance code with s. 172.

The remainder of this section will discuss the main principles of the UKCG 2018: (i) board leadership, (ii) division of responsibilities, (iii) composition, (iv) succession and evaluation and (v) audit risk and internal control and remuneration.

3.4.1 Board Leadership

The importance of the board in effective corporate governance is well established.[93] In the aftermath of a corporate scandal, the board of directors is often first on the chopping block. For that reason, their role in effective corporate governance remains a subject of great debate. Consequently, a significant portion of the UKCG 2018 is geared toward improving the performance and effectiveness of the board.

The UKCG 2018 sets out five main principles to improve and strengthen leadership: (i) effective and entrepreneurial board (ii) purpose, integrity and culture, (iii) objectives and resources (iv) engagement with stakeholders and (v) workplace policies and practices. Each will now be addressed in turn.

Effective and Entrepreneurial Board

According to Cadbury, corporate governance and accountability should not place undue restraints on free enterprise.[94] Instead, good governance should find the right balance between accountability and the entrepreneurial role of directors in driving the company forward. In keeping with this, the UKCG 2018 recommends that companies be led by an 'effective and entrepreneurial board.'[95] However, unlike previous versions of the code which only referenced the board's responsibilities to the long term success of the company, the 2018 Code widens the scope of the boards responsibilities and requires directors to describe how they have identified and addressed risks to the long term success of the company.[96] This is more in line with the enhanced stakeholder value principle adopted by the CA 2006 and supports the new legislative requirement for companies to publish a section 172

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[93] Barry D Baysinger and Henry N Butler, 'Corporate Governance and the Board of Directors: Performance Effects of Changes in Board Composition' (1987) 1 Journal of Law, Economics and Organization 101.

[94] Cadbury Committee (n 39).

[95] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) principle A.

[96] ibid provision 1.

report on the impact of their operations on employees, suppliers, customers and other stakeholders.

Purpose, Integrity and Culture

In accordance with agency theory, the UKCG 2018 stipulates that the board is responsible for establishing the company's purpose and strategy in the best interest of the shareholders.[97] Although previous versions of the Code drew passing reference to the role of the company's culture in the preamble, culture was not previously included as a principle of good governance. According to a report produced by the Association of Certified Fraud Examiners, the tone at the top was a primary risk factor in 22% of all financial statement fraud.[98] The recognition of culture as a principle is perhaps one of the most significant changes to the UKCG 2018, which recommends that the company's values and strategy should be aligned with its corporate culture.[99] Its elevation to inclusion within a principle appears to show a recognition at last that corporate culture has played a role in the corporate failures of the past, such as Barings Bank and UBS.

Objectives & Resources

Principle C of the UKCG 2018 recommends that the board should ensure the efficient allocation of resources to meet the company's objectives and establish a framework of controls to assess and manage risk.[100]

Engagement with Stakeholders

If shareholders are meant to be the ultimate enforcers of good governance under the UK system of corporate governance, they must have access to timely and accurate information. Chariri describes financial statements as the main source of information by which shareholders monitor directors.[101] Nevertheless, the AGM, where the financial statements are presented to shareholders, has for some time

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[97] ibid principle B.

[98] Association of Certified Fraud Examiners, *Report to the Nations: 2020 Global study on occupational fraud and abuse* (ACFE, 2020) 26.

[99] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) principle B.

[100] ibid principle C.

[101] Quoted in Anis Chariri, 'Questioning the Popularity of Agency Theory in Accounting Research' (2008) 14 Journal of Economics and Busniess 1 (as cited in Ifedapo Francis Mname Awolowo and others, 'Accounting Scandals: Beyond Corporate Governance' (2018) 9th Conference on Financial Markets and Corporate Governance (FMCG) <https://ssrn.com/abstract=3101057> accessed 18 June 2020).

now been considered by directors and institutional shareholders as 'an expensive waste of time'.[102] In 2000 a study by Bird and others found that less than 1% of shareholders attend the AGM.[103] Although there have been increasing reports of companies facing shareholder rebellion in the local media recently, Lafarre argues that shareholder participation in the AGM remains low.[104] Furthermore, given the wide disbursement of UK company shares it is very unlikely that a single investor will hold sufficient shares to pass a resolution.[105] Perhaps this lack of attendance and participation can be explained by the increasing trend whereby institutional investors express their dissatisfaction by divesting. In the lead up to the Carillion collapse, when the company's debts began to grow out of control, investors began 'fleeing for the hills.'[106] The collapse of Carillion also Illustrates how difficult it can be for institutional investors to effect change. For instance, faced with the inaction of Carillion management to implement changes to its strategic direction Standard Life responded by divesting its shares in Carillion.[107]

Consequently, the role of the AGM as an effective means of holding directors to account is questionable. The UKCG 2018 appears to have taken this into consideration and recommends that the chairman seek 'regular engagement' with major shareholders in addition to the AGM.[108]

Workplace policies and practices

The sub-par workplace practices at Sports Direct once again brought UK corporate

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[102] Quoted in Mahmoud Ezzamel and Robert Watson, 'Executive Remuneration and Corporate Performance', *Corporate Governance: Responsibilities, Risks and Remuneration* (Corporate Governance: Responsibilities, Risks and Remuneration, John Wiley & Sons 1997) 67 (as cited in Alistair Howard, 'UK corporate governance: To what end a new regulatory state?' (2006) 29 West European Politics 410, 417).

[103] Quoted in John Bird and others, *Boyle Birds' Company Law* (4th edn, Jordan, 2000) 387 (as cited in Rebecca Strätling, 'General meetings: a dispensable tool for corporate governance of listed companies?' (2003) 11 Corporate Governance: An International Review 74, 75).

[104] Anne Lafarre, *The AGM in Europe: theory and practice of shareholder behaviour* (Emerald Group Publishing 2017) 8.

[105] Office for National Statistics, 'Ownership fo UK quoted shares: 2018' (*Office for National Statistics,* 14 January 2020) <www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/ownershipofukquotedshares/2018> accessed 9 May 2020.

[106] BBC, 'Carillion investors were 'fleeing for the hills'' (*BBC,* 19 February 2018) <www.bbc.co.uk/news/business-43107500> accessed 9 September 2019.

[107] Yoosof Farah, 'Standard Life Aberdeen: Carillion wouldn't listen to us' (*City Wire,* 19 February 2018) <https://citywire.co.uk/wealth-manager/news/standard-life-aberdeen-carillion-wouldnt-listen-to-us/a1093660> accessed 11 November 2020.

[108] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) provision 3.

governance regulation into the spotlight. In 2016 reports surfaced regarding the company's 'six strikes and you're out' policy, harsh wage deductions and the inhumane working standards at its' warehouse.[109] In response the UKCG introduced a new principle to improve engagement and encourage companies to take into consideration the impact of their operations on the workforce. Principle E of the UKCG 2018 places responsibility on the board to ensure workforce policies and practices are consistent with the long-term success of the company. The inclusion of this new principle is not entirely surprising given the UK's approach to corporate governance has generally been reactive.[110] After all, Cadbury was itself a reaction to the series of corporate scandals in the 90s, the Greenbury committee was a reaction to the excessive executive remuneration scandal and the Walker Review was in response to the UK banking crisis.

To aid the board in meeting their responsibilities the UKCG 2018 outlines three mechanisms for workforce engagement; (i) a director appointed from the workforce, (ii) a formal workforce advisory panel and (iii) a designated non-executive director.[111] However, true to the inherently flexible nature of the principles-based approach, the UKCG 2018 provides even greater flexibility to boards to determine the method by which they engage with employees as long as any alternative arrangement is disclosed and explained.

3.4.2 Division of Responsibilities

Given the unitary structure adopted in the UK, the composition of the board consists of both executive and non-executive directors, each with different and distinct roles and responsibilities but jointly responsible for effectively managing the company's operations.

The UKCG 2018 includes four principles aimed at ensuring a clear division of responsibility at the top so that no individual has unfettered control. The principles cover the responsibilities of the chairman, the composition of the board, time considerations for non-executive directors and the policies, time and resources for the efficient functioning of the board as a whole.

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[109] Business Innovation and Skills Committee, *Employment practices at Sports Direct* (HC 219).

[110] Howard (n 102).

[111] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) provision 5.

Chairman Responsibilities

According to Cadbury, CEO duality would result in a great 'concentration of power' at the top and recommended a separation of these roles.[112] While several studies have found no significant relation between CEO duality and firm performance, the majority of this research has been focused on the United States.[113] Dahya, Garcia and Van Bommel's study was among one of the first studies to examine this relationship among UK companies after the introduction of Cadbury and found no significant difference in performance between companies that split the role and companies that did not, consistent with the findings among U.S. companies.[114] Nevertheless, the UKCG 2018 continues to recommend that the position of chief executive and chairman be split on the basis that a concentration of power can lead to a lack of independence and objectivity and result in corporate abuse, consistent with the theory advanced by Fama and Jenson.[115]

The UKCG 2018 also stipulates that the chairman should be independent on appointment and outlines the responsibilities of the chairman in leading the board and facilitating constructive engagement among the board.[116] This includes ensuring all directors have access to timely and accurate information.[117] Additionally, to reduce the risk of familiarity and lack of objectivity, the UKCG 2018 recommends that the company's chief executive should not ordinarily become chairman.[118]

Combination of executive and non-executive directors

Cadbury recommended the board consist of at least three NEDs, two of which

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[112] Cadbury Committee (n 39) para 4.9.

[113] Sanford V Berg and Stanley K Smith, 'CEO and Board Chairman: A Quantitative Study of Dual Vs Unitary Board Leadership' (1978) 3 Directors & Boards 34; Brian K Boyd, 'CEO Duality and Firm Performance: A Contingency Model' (1995) 16 Strategic Management Journal 301; James A Brickley, Jeffrey L Coles and Gregg Jarrell, 'Leadership structure: Separating the CEO and Chairman of the Board' (1997) 3 Journal of Corporate Finance 189; Catherine M Daily, 'CEO and Board Chair Roles Held Jointly or Separately: Much Ado About Nothing?' (1997) 11 Academy of Management Executive 11; B Ram Baliga, R Charles Moyer and Ramesh S Rao, 'CEO Duality and Firm Performance: What's the Fuss?' (1996) 17 Strategic Management Journal 41.

[114] Jay Dahya, Laura Galguera Garcia and Jos Van Bommel, 'One man two hats: What's all the commotion!' (2009) 44 The Financial Review 179.

[115] Eugene F Fama and Michael C Jensen, 'Separation of Ownership and Control' (1983) 26 The Journal of Law & Economics 301.

[116] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) principle F.

[117] ibid principle F.

[118] ibid provision 9.

should be independent.[119] According to the UKCG 2018 at least half the board, excluding the chairman, should comprise independent non-executive directors.[120] Compared to Cadbury, later versions of the code saw a move away from setting a minimum number of NEDs toward setting a minimum fraction, offering companies greater flexibility and tipping the balance on the board towards NEDs.

Challenge, Guidance and Advice

Ever since Cadbury, the role of NEDs in corporate governance in the UK has been the subject of intense debate with mixed results on their effectiveness in preventing and deterring corporate misconduct. In recognition of their dual role in maintaining good governance, the UKCG 2018 emphasises the role of the NEDs as more than just monitors of executive behaviour. The Code suggests that non-executives should serve as an important sounding board and strategic resource in moving the company forward in addition to their role of holding the executive to account.[121]

Policies, Processes, Time and Information

To ensure non-executive directors are able to perform their duties effectively the UKCG 2018 highlights the importance of time considerations when appointing NEDs.[122] Additionally, the Code seeks to place limits on the number of external non-executive directorships to be held by full time executive directors, recommending no more than one external appointment.

3.4.3 Composition, Succession and Evaluation

In the UK there is no mandatory maximum number of directors that are required to sit on the board. However, publicly listed companies are required to have a minimum of three directors. The UKCG 2018 contains three principles aimed at ensuring the board is made up of directors with the capability to effectively and efficiently perform their duties: (i) appointment and succession, (ii) skills, experience and knowledge, and (iii) annual evaluation.

Policy for Appointment

In keeping with Cadbury's original recommendation, the UKCG 2018 stipulates that

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[119] Cadbury Committee (n 39) para 4.11.

[120] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) provision 11.

[121] ibid provision H.

[122] ibid principle H.

a nomination committee (NomCo), made up primarily of independent NEDs, should be established and should be responsible for the process of appointments to the board. As part of its responsibilities, it should ensure there is a 'formal, rigorous and transparent procedure' for appointments and ensure that all appointments are based on merit and without discrimination.[123]

Skills, Experience and Knowledge

The UKCG 2018 recommends that the board should consist of a combination of 'skills, experience and knowledge' to improve efficiency and effectiveness in the performance of their duties as a whole.[124] Unlike previous versions, the UKCG 2018 places a 9-year term limit on the chairman of the board from the date of first appointment. The addition of this requirement appears to take into consideration the impact that length of service can have on independence and objectivity.

Annual Evaluation

The requirement for directors to be subject to annual evaluation was first introduced in the 2003 Combined Code following the Higgs Review. Higgs found that over a third of boards did not conduct a performance evaluation and therefore did not have effective measures in place to deal with poor performance.[125]

The UKCG 2018 requires a 'formal and rigorous' evaluation of the board as a whole, including its committees, the chairman and the individual directors.[126] For FTSE 350 companies the Code goes even further suggesting that at least every three years, this evaluation should be conducted by an external evaluator.[127]

3.4.4 Audit, Risk and Internal Control

The UKCG 2018 includes three principles aimed at ensuring objectivity and effectiveness of the audit process; (i) independence and effectiveness of internal and external audit, (ii) assessment of company performance and (iii) risk management and internal controls.

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[123] ibid principle J.

[124] ibid principle J.

[125] Higgs (n 81) 49.

[126] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) provision 21.

[127] ibid provision 21.

Independence and Effectiveness of Internal and External Audit

To create a bridge between the executives and the external auditor, Cadbury recommended the board should establish an audit committee (AudCom). According to the UKCG 2018, the AudCom should be charged with establishing 'formal and transparent policies and procedures' aimed at ensuring independence and objectivity in the audit function.[128] In so doing, the UKCG 2018 requires the AudCom to explain how they have assessed the independence and effectiveness of the internal and audit function in the annual report.[129]

Consistent with Cadbury, the UKCG 2018 continues to endorse the three member minimum on the AudCom, with an exemption for small companies.[130] While Cadbury never explicitly addressed the need for the members of the AudCom to possess financial expertise, the UKCG 2018 stipulates that at least one member should have financial experience and outlines the roles and responsibilities of the AudCom.[131] Furthermore, the chairman of the board should not be a member of the AudCom.[132] However, unlike Cadbury, the UKCG 2018 recommends that the AudCom should comprise entirely of independent NEDs.[133]

Given the important role of the AudCom in corporate governance, the Government in its response paper has stated its intention to give ARGA the power to set minimum standards for AudComs.[134] Importantly, these minimum standards will only be applicable to FTSE 350 companies.[135]

With the aim of improving audit quality, the Government has proposed introducing managed shared audit (MSA). Under the proposal for MSAs, all UK incorporated FTSE 350 companies will be required to appoint a 'challenger firm', as the sole group auditor or which will be responsible for a proportion of the subsidiary audits.

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[128] ibid principle M.

[129] ibid provision 26.

[130] ibid provision 24.

[131] ibid.

[132] ibid provision 24.

[133] ibid provision 24.

[134] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85) para 7.1.10.

[135] ibid para 7.1.12.

According to ICAEW, shared audits are not a new or novel concept.[136] In fact, the move away from shared audits and toward single audit firms was in response to the scandals such as Parmalat.[137] While joint audit regimes operate in countries such as Belgium and France, Siddiqui found that joint audits have no material impact on audit quality.[138] It is also important to point out here that prior to its collapse Carillion employed two of the Big Four audit firms, Deloitte and KPMG as internal and external auditor respectively. Neither firm appears to have detected the manipulation of revenue and goodwill that contributed to the company's collapse. Ultimately, MSA will likely lead to increase costs of audit, increase the workload of the new regulator and are unlikely to materially impact audit quality.

Assessment of Company's Position

Ultimately, the board as a whole is responsible for ensuring the financial statements present a fair and balanced assessment of the company's performance.[139] The UKCG 2018 reinforces this and outlines the responsibilities of the AudCom, including monitoring, providing advice, reviewing the company's internal controls and managing the relationship with the external auditor.[140]

As part of the planned corporate governance reforms, the Government intends to require directors to prepare and publish a new Resilience Statement and a new Audit and Assurance Policy (AAP).[141] The new statutory Resilience Statement would 'incorporate and build on the existing going concern and viability statements.'[142] Interestingly, going concern and viability statements have been long established disclosures in annual reports. Despite this, instances of corporate failures continue to emerge, such as Carillion, BHS and Patisserie

[136] ICAEW, 'Shared and joint audits: are two auditors better than one?' (*ICAEW,* 2019) <www.icaew.com/-/media/corporate/files/technical/audit-and-assurance/the-future-of-audit/shared-and-joint-audits.ashx> accessed 10 February 2023.

[137] ibid.

[138] Javed Siddiqui, 'Are four eyes better than two? An examination of recent empirical evidence on the impact of joint audits' University of Manchester (2019) <https://assets.publishing.service.gov.uk/media/5c63fcd840f0b676d487d06b/dr_javed_siddiqui_response_to_update_paper.pdf> accessed 27 August 2022 .

[139] CA 2006, s393.

[140] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84) provision 25.

[141] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85) 10.

[142] ibid para 3.1.2.

Valerie. Introduced as part of the UKCG 2014, the Viability Statement has 'not been a success,' with companies resorting to boiler-plate disclosures that 'lacked specificity and sufficient detail.'[143] In light of this, it is difficult not to surmise that the new Resilience Statement will also result in boiler plate disclosures that result in nothing more than surface compliance.

Risk Management and Internal Control

Cadbury referred to internal control systems as 'an effective part of the efficient management of a company'.[144] Accordingly, the UKCG 2018 recommends that the board should establish policies to address risk and internal controls and ensure acceptable levels of risk. The ability of the board to identify the risks facing the company contributes to the design of an effective internal control system. Given the crucial role of internal controls in good governance, Cadbury concluded that directors should report on the effectiveness of the company's internal controls systems.[145] However, over the years this would eventually be watered down. To that end, the UKCG requires directors to confirm only that the internal control system had been reviewed.

Despite the role of internal controls failures in corporate scandals of the past, the Government has opted to strengthen internal controls reporting through the 'tried and tested' approach of updating the UKCG.[146] To this end, the Government intends to require companies to provide an explicit statement on the effectiveness of internal controls systems and the basis for that assessment. Most importantly however, auditors will not be required to attest to the veracity of this statement. In other words, companies will be free to deviate from the provision, so long as their non-compliance is explained. For all intents and purposes, Carillion was in compliance with the UKCG. Given the tick-box approach and the boiler plate disclosures that have become synonymous with corporate governance reporting it would not be entirely surprising if this new statement becomes nothing more than a boiler-plate

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[143] ICAEW Insights, 'The Resilience Statement – everything you need to know' (*ICAEW,* 27 July 2022) <www.icaew.com/insights/viewpoints-on-the-news/2022/jul-2022/the-resilience-statement-everything-you-need-to-know> accessed 28 February 2023 .

[144] Cadbury Committee (n 39) para 5.16.

[145] ibid para 5.16.

[146] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85) para 2.1.30.

disclosure, lacking clarity and having little if any material impact on corporate transparency and accountability.

3.4.5 Remuneration

Despite repeated attempts aimed at addressing directors' remuneration, excessive remuneration continues to be a topic of great debate in UK corporate governance with the executive remuneration reforms generally considered a failure.

The UKCG 2018 contains three principles aimed at addressing director's remuneration. These are (i) policies and practices, (ii) executive remuneration and (iii) judgement and discretion.

Policies and Practices

According to the UKCG 2018, the remuneration committee (RemCom) should consist of at least three independent NEDs and should be responsible for designing the company's remuneration policies and determining executive remuneration for the board and senior management.[147] To address the issues of short-termism in setting executive remuneration policies, the UKCG 2018 recommends that remuneration must take into consideration the long term success of the company.

Executive Remuneration Policy

Cadbury's recommendations were based on the principle of 'openness' and focused on increasing disclosure of director's remuneration.[148] In keeping with agency theory, remuneration is used to align shareholders' interest with directors' interest. In designing effective remuneration policies, the UKCG 2018 recommends that remuneration should take into consideration the time commitments of the directors and should be based on policy.[149] Furthermore, incentives should be aligned to rewards, however, remuneration for NEDs should not include share options or performance related elements.[150]

Judgement and Discretion

The UKCG 2018 requires the RemCo to exercise judgement and discretion in

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[147] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84).

[148] Cadbury Committee (n 39) para 4.40.

[149] Financial Reporting Council, *The UK Corporate Governance Code 2018* (n 84).

[150] ibid provision 34.

approving remuneration, including taking into consideration performance. However, this discretion allows the RemCo to override the wishes of the shareholders. For instance, in spite of falling profits and against shareholders' wishes the RemCo of Morrisions authorised pay and bonuses of £9 million for the chief executive, David Potts, and two senior managers.[151]

Despite the continuing instances of corporate governance in the UK, it was not until 2014 that the UKCG recommended that companies develop a clawback provision. A study by Dehaan, Hodge and Shevlin found that the quality of financial reporting increased when companies adopted clawback provisions.[152] Several studies later supported this view.[153]

Given that clawback provisions effectively aim to strip directors of financial gains arising from misconduct, it can be argued that clawback provisions act as a deterrent. However, one of the main weaknesses of the UKCG 2018 approach to clawbacks is that companies retain flexibility in determining the triggering events for clawback provisions. Although the UKCG 2018 continued to recommend that companies include clawback provisions, like its predecessor it does not stipulate what should be included in this policy. However, the case of Carillion illustrates the downside of this discretionary approach. Two years before the collapse in 2018, the directors of Carillion removed corporate failure as a clawback trigger event.[154]

Nevertheless, the Government has opted against mandating clawbacks. Instead, as part of the Government's proposed reforms, the FRC through the code would provide 'greater transparency' and 'encourage consideration and adoption of a

[151] Jasper Jolly, 'Morrisons shareholders reject executive bonuses amid falling profits' *The Guardian* (London 10 June 2021) <www.theguardian.com/business/2021/jun/10/morrisons-shareholders-reject-executive-bonuses-amid-falling-profits> accessed 9 August 2021.

[152] Ed Dehaan, Frank Hodge and Terry Shevlin, 'Does voluntary adoption of a clawback provision improve financial reporting quality?' (2013) 30 Contemporary Accounting Research 1027.

[153] See Michael H R Erkens, Ying Gan and B Burcin Yurtoglu, 'Not all clawbacks are the same: Consequences of strong versus weak clawback provisions' (2018) 66 Journal of Accounting and Economics 291; Yin Liu, Huiqi Gan and Khondkar Karim, 'Corporate risk-taking after adoption of compensation clawback provisions' (2020) 54 Review of Quantitative Finance and Accounting 617.

[154] Charlotte Fleck, 'The corporate governance lessons from Carillion's collapse' (*The Chartered Governance Institute UK & Ireland,* 6 March 2018) <www.cgi.org.uk/knowledge/governance-and-compliance/analysis/corporate-governance-carillion-collapse> accessed 9 May 2019.

broader range of conditions.'[155] In other words, clawback provisions will continue to operate on a comply or explain basis. Therefore, it can be argued that the proposed reforms to clawbacks will unlikely prevent directors from abusing the flexibility of the UK approach, as illustrated in the case of Carillion, given that companies will continue to be free to deviate from the provision.

3.5 UK APPROACH TO CORPORATE GOVERNANCE

Figure 5: The "comply or explain" approach

Cadbury proposed that a system built upon voluntary compliance, disclosure, shareholder pressure, underlined by the principles of 'openness, integrity and accountability' would result in good governance.[156] According to Mujih, Cadbury advocated a principles-based approach for fear that a statutory approach would be overly prescriptive and result in minimum standards and box ticking.[157] Focusing instead on principles would arguably result in better governance as companies were free to go beyond the letter of the Code and apply the principles in light of firm specific circumstances. Apparently, Cadbury's fears appear to be well founded as corporate governance in the UK has been almost three decades of box ticking in the UK.[158] Given that the system is not a rigid set of rules, it effectively operates through 'voluntary compliance and mandatory disclosure', and therefore relies heavily on the explanations for effective governance.[159] As shown in Figure 5 above, a key assumption of the 'comply or explain' approach is that increased disclosure and shareholder engagement will lead to effective governance. However, a number of researchers support the view that the quality of explanations is inadequate and

[155] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85) para 5.2.7.

[156] Cadbury Committee (n 39).

[157] Mujih (n 89) 9.

[158] ibid 10.

[159] Amama Shaukat and Grzegorz Trojanowski, 'Board governance and corporate performance' (2018) 45 Journal of Business Finance & Accounting 184, 185.

undermines the effectiveness of the system in achieving accountability and transparency.[160] To address these criticisms the concept of 'explain' has continuously evolved since Cadbury from simply identifying and giving reasons for non-compliance towards a more multifaceted description of what constitutes an explanation.

3.5.1 Voluntary Compliance

As a means of encouraging compliance, the LSE included compliance with the corporate governance code in the listing rules.[161] More importantly, Cadbury put forward that a lack of compliance would lead to legislation.[162] To that end, Cadbury reasoned that compliance could be achieved if auditors, directors, shareholders and regulators worked together.[163] As explained by MacNeil and Li the market would be responsible for monitoring compliance and will respond to disclosures by lowering the share price in response to deviations from the code or by accepting the reasons for non-compliance.[164]

3.5.2 Disclosures

Corporate governance in the UK effectively relies on disclosure as a regulatory tool. Each major review of UK corporate governance in the UK has in some way resulted in an increase in disclosure requirements. In other words, in the aftermath of a corporate governance failure, the general response has been an increase in disclosure requirements. This view was supported by Maclean who found that the continuous revisions to the code and the increase in disclosure requirements in response to scandals negatively affect shareholders and wider society.[165]

Not surprisingly, the Government's proposed reforms to corporate governance in the aftermath of Carillion will result in an increase in disclosures. In addition to the new Resilience Statement and the AAP, the Government also intends to require

[160] Iain MacNeil and Xiao Li, '"Comply or Explain": market discipline and non-compliance with the Combined Code' (2006) 14 Corporate Governance: An International Review 486.

[161] Ian P Dewing and Peter O Russell, 'Regulation of UK Corporate Governance: lessons from accounting, audit and financial services' (2004) 12 Corporate Governance 107, 110.

[162] Cadbury Committee (n 39) para 1.10.

[163] ibid.

[164] MacNeil and Li (n 160) 487.

[165] Mairi Maclean, 'Corporate Governance in France and the UK: Long Term Perspectives on Contemporary Institutional Arrangements' (1999) 41 Business History 88.

companies to disclose their distributable reserves and to include a statement on the steps taken to prevent and detect material fraud.[166] This potentially represents a significant increase in disclosures, with financial statements of FTSE 350 already running at over one hundred pages.

3.5.3 Shareholder Engagement

At the time of Cadbury's report, institutional investors owned the majority of UK listed shares.[167] Over the last two decades this has shifted significantly with institutional investors, such as investment trusts, insurance companies and other financial institutions accounting for approximately 13.5% of UK shares.[168] When compared to the 54.9% of UK shares held by international investors outside the UK this percentage appears rather insignificant.[169] However in the UK, this arguably puts institutional investors in a position to exert influence over directors' behaviour. Nevertheless, the role of institutional shareholders continues to be subject to intense scrutiny. Following the global financial crisis, investors faced intense criticism for their failure to hold company directors accountable. Lord Myners accused institutional investors of being 'absentee landlords.'[170] The same sentiment was later echoed by Hector Sants, the chief of the FSA, who criticised investors for being 'too reliant and unchallenging'.[171]

Nevertheless, pressure from shareholders is considered to be one of the key mechanisms to enforce good governance practices. Cadbury reasoned that increased disclosure would lead to increasing shareholder engagement, which would in turn contribute to good governance.[172] In practice, getting shareholders to engage proved difficult and shareholder engagement as an enforcement mechanism did not appear to have the intended effect. To that end, the FRC issued

[166] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85).

[167] Cadbury Committee (n 39) para 6.9.

[168] Office for National Statistics (n 105).

[169] ibid.

[170] Kate Burgess, 'Myners lashes out at landlord shareholders' *Financial Times* (London 21 April 2009) <www.ft.com/content/c0217c20-2eaf-11de-b7d3-00144feabdc0> accessed 19 September 2019.

[171] Jennifer Hughes, 'FSA chief lambasts uncritical investors' *Financial Times* (London 11 March 2019) <www.ft.com/content/9edc7548-0e8d-11de-b099-0000779fd2ac> accessed 9 May 2019.

[172] Cadbury Committee (n 39).

the UK Stewardship Code in 2010.[173] Similar to the UKCG, the Stewardship Code 2010 endorsed the "comply or explain" approach and requires companies to publish a statement on how the Stewardship Code was applied.[174]

3.6 CONCLUSION

Corporate governance in the UK is based on the underlying assumption that disclosures and shareholder engagement will result in effective governance. However, given the flexibility and voluntary nature of the UK corporate governance code, its effectiveness in preventing and detecting instances of corporate governance continues to be a topic of great debate. Although compliance with the UKCG has been incorporated into the FCA Listing Rules, companies can still opt to depart from the code. The reliance on the market to monitor compliance and punish non-compliance is not without its drawbacks, given that financial markets can also create pressure for directors to meet or beat market expectations.

Although Cadbury envisioned that the flexible nature of the Code would result in better governance as companies would be free to apply the principles in their firm specific circumstances, companies in the UK have adopted a box ticking approach. Whether the UKCG 2018 will have the intended effect of moving companies away from box ticking towards a principles-based approach where companies to the spirit of the code appear too soon to tell.

[173] Financial Reporting Council, 'History of the UK Stewardship Code' (*FRC,* 9 December 2020) <www.frc.org.uk/investors/uk-stewardship-code/origins-of-the-uk-stewardship-code> accessed 9 December 2020.

[174] Financial Reporting Council, *The UK Stewardship Code* (FRC 2010).

Chapter 4
CORPORATE GOVERNANCE FAILURES IN THE UK

"Capitalism without failure is like religion without sin. Bankruptcies and losses concentrate the mind on prudent behaviour."
- Allan H. Meltzer[175]

4.1 INTRODUCTION

The previous chapter discussed the history and development of corporate governance in the UK and the requirements of the UK corporate governance code. This chapter critically evaluates the corporate governance failures at Autonomy, Tesco, Carillion and Ted Baker. The Chapter proceeds as follows: Section 4.2 to 4.5 examines the following corporate governance failures over the past decade: Autonomy, Tesco, Carillion and Ted Baker respectively. Due to the scale of these failures, a plethora of information was publicly available to enable a thorough and worthwhile analysis of the weaknesses in the UK system of corporate governance.

4.2 THE AUTONOMY SCANDAL

The HP-Autonomy scandal was a spectacular failure of corporate governance on both sides of the Atlantic. The directors of Hewlett Packard (HP) in the U.S. and Autonomy Corporation in the UK faced severe criticism for failure to detect material misstatements in the accounts of Autonomy. The scandal, also considered one of the biggest accounting fraud scandals in the last decade, yet again placed the auditing profession firmly back into the spotlight for failing to detect yet another instance of serious accounting irregularities. Once again, investors lost confidence in auditors as the gatekeepers of financial regulations.

The HP-Autonomy saga has drawn several comparisons to the purchase of Time Warner by AOL over a decade ago.[176] At the time, the Time Warner deal was widely

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[175] Allan H Meltzer, American economist.

[176] Pamela R Hurley and Richard E Hurley, 'HP's Risk in the Acquisition of Autonomy a Cost of $11 Billion to a Write-Down of $8.8 Billion in 1 Year' (2013) 2 Academy of Business Journal 1; Dov Fischer, 'HP's Purchase of Autonomy: 'Hubris at the Top' and Failure of Internal Controls' (2013) SSRN <https://ssrn.com/abstract=2357327> accessed 9 September 2019; James B Stewart, 'From H.P., a Blunder That Seems to Beat All' *The New York Times* (New York 30 November 2012) <www.nytimes.com/2012/12/01/business/hps-autonomy-blunder-might-be-one-for-the-record-books.html> accessed 9 May 2020.

reported as the ‘worst corporate deal ever,’ that is until HP-Autonomy.[177] Although several analysts argued that the $11.1 billion purchase price of Autonomy was highly overvalued, HP advised its shareholders that the deal would represent a transition away from a low margin hardware producer towards a high-tech software company.[178] According to Hurley and Hurley, the purchase price of Autonomy represented a payback period of over 50 years.[179] How the directors of HP managed to justify or approve the purchase of Autonomy for eight times forward earnings remains a mystery.[180] It is worth pointing out here that the purchase of Autonomy was not the first disastrous deal by HP in its troubled history. In fact, HP had a history of overvalued acquisitions.[181]

4.2.1 Background

Autonomy Corporation Plc was a software development company founded in 1996 by British tech entrepreneur Mike Lynch.[182] Having previously sold his fingerprint and facial recognition technology to the police, Lynch was highly regarded in the UK tech industry and often referred to as the British Bill Gates.[183] Under Lynch’s leadership, Autonomy developed IDOL (Intelligent Data Operating Layer), its unique information processing software platform which extracted and processed information from a host of sources including email, webpages, blogs and audio files.[184] Within a year, Autonomy became the latest tech start-up to watch with over 100 corporate customers in Europe and North America.[185]

For HP, the acquisition of Autonomy represented a seminal change in strategic

[177] Stewart, 'From H.P., a Blunder That Seems to Beat All' (n 176).

[178] ibid.

[179] Hurley and Hurley (n 176) 176.

[180] Sarah Miloudi, 'HP paying too much for Autonomy, says top investor' (*Citywire,* 2011) <https://citywire.co.uk/funds-insider/news/hp-paying-too-much-for-autonomy-says-top-investor/a517618> accessed 10 May 2019.

[181] Robert Amrstrong and Stuart Kirk, 'HP and Autonomy: how to lose $8.8bn' *Financial Times* (London 8 May 2013) <www.ft.com/content/7a52adb4-b70d-11e2-a249-00144feabdc0> accessed 9 May 2019.

[182] Autonomy Corporation Plc, 'Annual Report and Accounts for the year ended 31 December 2010' Companies House <https://find-and-update.company-information.service.gov.uk/company/03175909> accessed 9 September 2019.

[183] Gavin Clarke, ''British Bill Gates' Lynch laments HP's Autonomy 'botch-up'' (*The Register,* 16 September 2013) <www.theregister.com/2013/09/16/lynch_autonomy_fumble/> accessed 9 May 2019.

[184] Autonomy Corporation Plc, 'Annual Report and Accounts for the year ended 31 December 2010' (n 182).

[185] Autonomy Corporation Plc, 'Report & Accounts 1998' Companies House <https://find-and-update.company-information.service.gov.uk/company/03175909/filing-history> accessed 9 September 2019.

direction away from a hardware producer to a software company. By the time HP expressed interest in acquiring Autonomy, the software company appeared to be enjoying record success with over 25,000 global customers, including the BBC, FedEx and the NYSE.[186] Despite warnings from analyst[187] that Autonomy was overvalued, HP purchased Autonomy in October 2011 for $25.50 per share in cash, a 64% premium.[188] Within 12 months of acquiring Autonomy in an £11.1 billion deal, HP announced a 80% write-down on the acquisition, alleging that £5 billion related to accounting irregularities and fraud.[189] In what could be considered one of the most egregious failures of corporate governance in the UK, the directors of Autonomy were accused of engaging in a 'wilful effort' to deceive shareholders.[190]

4.2.2 The governance failure

Although the scandal represented a failure of corporate governance for both HP and Autonomy, the remainder of this section will focus on the corporate governance structures in place at Autonomy. In analysing the events that led to the HP-Autonomy scandal several elements of Autonomy's corporate governance structure contributed to the scandal, including; (i) a lack of effective board oversight, (ii) creative accounting and failure of internal controls, and (iii) audit failure. Each will now be analysed in turn.

Lack of effective board oversight

On paper, Autonomy's board met all the requirements of the Combined Code 2008. The roles of chief executive and chairman were separate with clear, distinct roles and responsibilities. The board was composed of a mix of executives and NEDs with the balance of power supposedly in the favour of the NEDs. In fact, of the seven directors Mike Lynch, the chief executive and Sushovan Hussain, the chief

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[186] Business Wire, 'HP to Acquire Leading Enterprise Information Management Software Company Autonomy Corporation plc' (*Business Wire,* 18 August 2011) <www.businesswire.com/news/home/20110818006398/en/HP-to-Acquire-Leading-Enterprise-Information-Management-Software-Company-Autonomy-Corporation-plc> accessed 9 September 2019.

[187] Miloudi (n 180).

[188] Autonomy Corporation plc and Hewlett-Packard Company, 'Recommended Cash Offer By Hewlett-Packard Vision B.V. an indirect wholly-owned subsidiary of Hewlett-Packard Company for Autonomy Corporation PLC' (*SEC,* 18 August 2011) <www.sec.gov/Archives/edgar/data/47217/000110465911047805/a11-24706_1ex99d1.htm> accessed 9 September 2020.

[189] Murad Ahmed and Richard Waters, 'Hewlett-Packard v Autonomy: Bombshell that shocked corporate world' *Financial Times* (London 12 August 2014) <www.ft.com/content/c7c141ca-2172-11e4-a958-00144feabdc0> accessed 9 May 2019.

[190] ibid.

financial officer were the only executives.

Although Autonomy's board appeared to have an impressive array of distinguished professionals, on closer examination, the majority of the NEDs on Autonomy's board had little or no experience in the tech industry. For example, the chairman of the board, Robert Webb, a Queen's Counsel (QC) with an impressive legal career, and the former British Airways General Counsel, had had no experience in tech.[191] Even the chief financial officer came from a background in oil and gas exploration.[192] Apart from John McMonigall, a partner at a private equity firm who specialised in telecoms and software, Mike Lynch appeared to be the only other member of the board with significant tech expertise.[193] It is also interesting to note that the co-founder, Richard Gaunt, was appointed as a NED in 2006 after 10 years of serving on the board. This clearly calls into question his objectivity. Perhaps the composition and lack of tech experience on the board can be attributed to Lynch's stronghold on the board. According to reports, Mike Lynch, maintained a 'very unusual level of control for a FTSE 100 chief executive.'[194] When all these factors are taken together it can be argued that Autonomy's NEDs lacked the experience or expertise to effectively challenge and hold the executives to account. This highlights one of the problems with the inadvertent tick-box approach to corporate governance in the UK. To be effective, the board should include directors of significant and relevant experience in the field. While on its face Autonomy's board adhered to the letter of the code, the company does not appear to have adhered to the spirit of the code as originally envisioned by Cadbury.

Creative accounting and failure of internal controls

Similar to many of the UK corporate governance scandals examined in this chapter, the failures at Autonomy can be linked to serious deficiencies in internal controls and external audit failures. When news of the scandal broke, HP accused Lynch

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[191] Autonomy Corporation Plc, 'Annual Report and Accounts for the year ended 31 December 2010' (n 182).

[192] ibid.

[193] ibid.

[194] Jessica Clark, 'Autonomy founder Mike Lynch kicks off testimony in UK's biggest fraud trial' (*City A.M.,* 27 June 2019) <www.cityam.com/autonomy-founder-mike-lynch-kicks-off-testimony-in-uks-biggest-fraud-trial/> accessed 9 September 2020.

and Hussain of 'widespread and systematic false reporting'.[195] Time and time again, many instances of corporate governance failures have been linked to revenue manipulation, facilitated in part by the flexibility of accounting standards, and a lack of effective internal controls. Similar to many of the corporate governance scandals of the past, Autonomy appears to have taken advantage of the subjective nature of accounting standards and engaged in a concerted effort to inflate revenue and conceal losses. Before exploring the techniques used by Autonomy to manipulate its financial position, it is important to first understand Autonomy's business model.

Initially promoted as a "pure software" model, Autonomy's primary source of revenue was supposedly derived from the sale of software licences for the company's software platform IDOL.[196] This pure software model was a key selling point and central to HP's interest in Autonomy. Prior to the sale, Autonomy engaged in a series of questionable accounting transactions in an effort to boost its revenue and ultimately its resale value. Despite repeatedly promoting itself as a pure software model and unknown to investors Autonomy inflated its revenue with hardware sales. Instead of correctly classifying the revenue as hardware sales, revenue from pure hardware sales was included as "IDOL product revenue", however there was no indication in the annual report that this was derived from the sale of hardware, such as laptops and computer equipment.[197] One of the other techniques used by Autonomy was recording losses on hardware sales as marketing expenses. As an example, in 2009 Autonomy purchased hardware for $45.4 million and sold it at a loss of $8.8 million. Such a transaction would normally result in a decrease in Autonomy's gross profit (GP) margin.[198] However, Autonomy only allocated 37% of the cost of the hardware to cost of goods sold (COGS).[199] The other 62% of the cost was allocated to sales and marketing.[200] This had the effect of

[195] Georgina Prodhan and Paul Sandle, 'Autonomy founder Lynch was scapegoat for HP's incompetence, court told' (*Reuters,* 27 March 2019) <www.reuters.com/article/us-autonomy-hp-lynch-idUSKCN1R81HB> accessed 21 May 2020.

[196] Autonomy Corporation Plc, 'Annual Report and Accounts for the year ended 31 December 2010' (n 182).

[197] Financial Reporting Council, *Explanatory memorandum to the tribunal report: The Executive Counsel to the Financial Reporting Council and Deloitte LLP, Richard Knights, Nigel Mercer* (FRC, 2021).

[198] GP margin is a key metric and is the difference between revenue and cost of goods sold.

[199] Financial Reporting Council, *Explanatory memorandum to the tribunal report: The Executive Counsel to the Financial Reporting Council and Deloitte LLP, Richard Knights, Nigel Mercer* (n 197) para 49.

[200] ibid para 49.

artificially inflating Autonomy's GP margin by 15%.[201] Unlike Enron, which utilised off balance sheet entities to conceal losses, Autonomy attempted to conceal losses by capitalising it or including it as operating expenses. For instance, Autonomy allocated the $8.8 million loss on hardware sales to research and development (R&D).[202] Despite the increase in hardware sales, Autonomy's annual report provided no indication of Autonomy's strategic shift toward the sale of hardware but continued to promote the company as a pure software model.

When instances of misconduct such as this come to light, questions also arise about the role of internal controls. Generally, internal controls systems are aimed at preventing and detecting instances of corporate misconduct. This begs the question of whether the Autonomy scandal also represented a significant failure of internal controls. In the case of Autonomy, the chief executive officer and the financial director were both accused of being involved in the scheme to manipulate Autonomy's financial position Therefore, it can be argued that it would not have been reasonable to expect that any system of internal controls to be effective in preventing the Autonomy scandal. Ultimately, internal controls are not immune to management override. Equally important is the fact that Autonomy's directors would have played a role in developing and maintaining Autonomy's internal control. Internally, it is reasonable to assert that Hussain would likely have been involved in the decision to determine the final allocation of the hardware costs.

Audit failure

Autonomy's AudCom was made up of three independent NEDs in accordance with the Combined Code. Apart from Dr Frank Kelly, a Professor of Mathematics, the two other members of the AudCom had significant financial expertise. For instance, the chairman of the AudCom was a partner at an asset management firm. It is also important to point out here that Autonomy's AudCom underwent significant changes in the lead up to the sale to HP. Two of the three members who had served on the AudCom for 10 years resigned and was replaced in September 2010.[203] Therefore, the members of the AudCom in the immediate lead up to the sale were actually new

[201] ibid para 49.

[202] ibid para 52.

[203] Autonomy Corporation Plc, 'Annual Report and Accounts for the year ended 31 December 2010' (n 182).

to Autonomy and was not an experienced group of accountants.[204] Consequently, it would have been increasingly difficult for the AudCom to identify the misstatements.

Furthermore, the FRC found that the AudCom relied on the information provided to them from Deloitte, which coincidently was not sufficient for them to realise that something was amiss.[205] For instance, while Deloitte included reference to the cost allocation for the hardware sales transactions in their report to the AudCom, they did not explain their rationale for approving the allocations. To be effective in their role, it is imperative that the AudCom have access to adequate information and be informed of areas of concern, especially in cases where subjective judgement is required. This view was supported by DeZoort and others, who argued that it was unreasonable to expect the AudCom to detect instances of corporate misconduct given their limited meetings and limited knowledge of the company's operations.[206]

The Autonomy earnings management scandal also represented yet another epic failure of the company's external auditors. By the time of the HP-Autonomy deal, Deloitte was Autonomy's auditor for seven years, having been appointed in 2003. In understanding the auditor-client relationship between Autonomy and Deloitte it is important to re-iterate that Autonomy was the only FTSE 100 client in Deloitte's Cambridge office.[207] Undoubtedly Autonomy would have been crucial to the success of the office and created an incentive for the auditors to act in their own interest. This has been evidenced by emails among the Deloitte audit team where the auditors noted their intent of increasing revenue from Autonomy. In making assessments the auditor also seemed to prioritise the effects of market pressure and volatility on Autonomy's stock. Deloitte was keenly aware of the 20% drop in share price which resulted from a 3% decrease in Autonomy's 2010 revenue.[208] Given the potential impact of a 12% decrease in GP margin could have on Autonomy's share price the auditors did not exercise professional scepticism or

[204] Financial Reporting Council, *Explanatory memorandum to the tribunal report: The Executive Counsel to the Financial Reporting Council and Deloitte LLP, Richard Knights, Nigel Mercer* (n 197).

[205] ibid para 104.

[206] F Todd DeZoort and others, 'Audit committee effectiveness: A synthesis of the empirical audit committee literature' (2002) 21 Journal of accounting literature 38.

[207] Louisa Clarence-Smith, 'Deloitte 'gave in to pressure' by Autonomy' *The Times* (London 7 January 2021) <www.thetimes.co.uk/article/deloitte-gave-in-to-pressure-by-autonomy-lmxrl75xw> accessed 9 September 2021.

[208] Financial Reporting Council, *Explanatory memorandum to the tribunal report: The Executive Counsel to the Financial Reporting Council and Deloitte LLP, Richard Knights, Nigel Mercer* (n 197) para 40.

design the audit to obtain sufficient audit evidence that the financial statements represented a true and fair view of Autonomy's actual business.

Furthermore, given the allegations that the misconduct which led to the misstatement was being perpetrated at the management level, the auditors' failure to detect such material misstatements also calls into question their professional scepticism. This view was shared by Bazerman, Loewenstein and Moore, who argued that Deloitte's reliance on the Autonomy, as the only FTSE 100 company in its Cambridge office, contributed to the instances of earnings management.[209] Ultimately, corporate governance regulations cannot reasonably be expected to be effective if the watchdogs are incentivised to turn a blind eye for their own interest, or in cases where their interests are aligned with that of their client.[210] In other words, Deloitte's role as the watchdog of financial regulation was outweighed by its own self-interest.

4.2.3 Sanctions

Autonomy provides a unique opportunity to directly compare the sanctions faced by the directors and auditors in the UK and the U.S., and to explore whether sanctions can act as an effective deterrent. Although Autonomy delisted from the NASDAQ in 2007, the company maintained a head office and several offices in the U.S. with roughly 68% of its revenue originating from the U.S. and North America.[211]

As already established, corporate governance in the UK relies heavily on shareholders to hold directors accountable and therefore act as the primary enforcement mechanism of good governance. In the case of Autonomy however, there was no incentive for Autonomy shareholders to express dissatisfaction or concern as it was not in their financial interest to do so. Autonomy first listed on the LSE at 30p per share, by the time of the sale to HP the share price had increased to $15.50 per share. Nevertheless, Autonomy shareholders received $25.50 per share. Given that shareholders are primarily driven by financial incentives, they had no reason to question whether the annual report presented a true and fair view of the company's financial position. Ultimately their responsibility to hold directors

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[209] Max H Bazerman, George Loewenstein and Don A Moore, 'Why good accountants do bad audits' (2002) 80 Harvard Business Review 96.

[210] ibid.

[211] *United States v Hussain* Case No 16-cr-00462-CRB (ND Cal Jul 30 2018).

accountable was outweighed by their financial interests. This suggests that the underlying principle of corporate governance that relies on shareholders to enforce good governance is flawed.

Interestingly, the UK's SFO investigation found there was 'insufficient evidence for a realistic expectation of a conviction.'[212] This meant that as long as Lynch and Hussain remained in the UK, they would face no criminal sanctions for their role in the HP-Autonomy scandal. On the contrary, the DOJ brought criminal charges against both Hussain and Lynch. Hussain was convicted of 16 counts of wire fraud, securities fraud and conspiracy in the US and was sentenced to 5 years imprisonment and a $4 million fine.[213] Lynch, on the other hand, continues to fight his extradition from the UK. Hurley and Hurley question whether Autonomy's delisting from the U.S. stock exchange was motivated by escaping U.S. jurisdiction.[214] Indeed, it is easy for Lynch to maintain the case should remain in the UK, given that the UK authorities have already signalled their intention not to bring any charges.[215] Instead, Lynch continues to place the blame on HP for mismanagement after the sale.[216] When considering the fact that Lynch continues to fight against his extradition to the U.S., coupled with Hussain's continued attempts to appeal his conviction on jurisdictional grounds, it can be argued that Lynch and Hussain intended to rely on being outside the jurisdiction of the U.S. as a means of escaping punishment. Lynch also faced a $5 billion civil suit in the UK by HP.[217]

The failure of the SFO to prosecute Lynch and Hussain is not entirely surprising given the findings of the De Grazia report. One of the key findings from this report was the lack of skills in the SFO which resulted in "unfocused cases" because case

[212] Serious Fraud Office, 'HP Autonomy investigation' (*SFO,* 19 January 2015) <www.sfo.gov.uk/2015/01/19/hp-autonomy/> accessed 19 May 2019.

[213] Reuters, 'HP had 'buyer's remorse' over ill-fated Autonomy deal, court hears' (*Reuters,* 6 January 2020) <www.reuters.com/article/us-autonomy-hp-lynch/hp-had-buyers-remorse-over-ill-fated-autonomy-deal-court-hears-idUSKBN1Z51VC> accessed 9 May 2020.

[214] Hurley and Hurley (n 176).

[215] Rupert Neate, 'Autonomy co-founder's lawyers attack 'overweening' US extradition effort' *The Guardian* (London 9 February 2021) <www.theguardian.com/business/2021/feb/09/autonomy-co-founders-lawyers-attack-overweening-us-extradition-effort> accessed 9 September 2021.

[216] Clarke, ''British Bill Gates' Lynch laments HP's Autonomy 'botch-up'' (n 183).

[217] Jane Croft, 'Mike Lynch and Hewlett-Packard trade blows as $5bn trial nears end' *Financial Times* (London 12 December 2019) <www.ft.com/content/8078ea8c-1ce6-11ea-9186-7348c2f183af> accessed 9 March 2020.

controllers were not capable of seeing the investigation from cradle to grave.[218] Furthermore, the SFO's decision not to prosecute raises questions about whether the decision was motivated by the fact that Lynch was often lauded as a British tech genius and success story. This wasn't the first time UK authorities declined to take action in high profile cases. For example, despite his role in the collapse of British Homes Stores (BHS), Phillip Green escaped unscathed and even retained his title.

Although Autonomy's auditors did not face criminal sanctions, Deloitte was fined £15 million, plus costs, for serious failures in the 2009 and 2010 audits.[219] Former Audit partner Richard Knights was excluded from the Institute of Chartered Accountants for England and Wales (ICAEW) register for 5 years and fined £500,000. Nigel Mercer was fined £250,000 along with a severe reprimand but was allowed to continue practising.[220] While the fine received by Deloitte was the largest fine issued by the FRC at the time and appears significant, this represents less than 1% of Deloitte's revenue for 2010.[221] In another blow to Deloitte, the auditor settled a $45 million lawsuit brought by HP in 2016, the details of which are subject to a confidentiality agreement.[222]

4.3 THE TESCO ACCOUNTING SCANDAL

The profit overstatement scandal at Tesco PLC was the sixth largest corporate loss in UK history.[223] Despite Tesco's reported compliance with the UK's corporate governance regulations, the circumstances that led to the misstatement at the UK's largest grocery retailer highlighted serious deficiencies in Tesco's corporate governance structures. The scandal was considered yet another failure of the UK's voluntary compliance mandatory disclosure approach to corporate governance and

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[218] Jessica de Grazia, *Review of the Serious Fraud Office: Final Report* (Serious Fraud Office, 2008) para 47.

[219] Joanna Patridge, 'Deloitte fined record £15m for failings in Autonomy audits' *The Guardian* (London 17 September 2020) <www.theguardian.com/business/2020/sep/17/deloitte-fined-record-15m-for-failings-in-autonomy-audits> accessed 8 January 2020.

[220] Aoife Morgan, 'Autonomy auditors criticised in FRC investigation' (*AccountancyAge,* 19 January 2021) <www.accountancyage.com/2021/01/19/autonomy-auditors-criticised-in-frc-investigation/> accessed 9 September 2021.

[221] Deloitte, *Annual Report 2010* (Deloitte 2010) 3.

[222] Gareth Corfield, 'Deloitte settled HPE's Autonomy lawsuit for $45m back in 2016 and agreed to cooperate with US DoJ' (*The Register,* 29 March 2021) <www.theregister.com/2021/03/29/deloitte_settled_hpe_lynch_lawsuit_45m/> accessed 9 September 2021.

[223] Graham Ruddick, 'Tesco reveals biggest loss in UK retail history' *The Telegraph* (London 22 April 2015) <www.telegraph.co.uk/finance/newsbysector/retailandconsumer/11555979/Tesco-reveals-biggest-loss-in-UK-retail-history.html> accessed 8 September 2018.

highlighted serious gaps in the UK's regulatory enforcement framework.

4.3.1 Background

Formed in 1919 by Jack Cohen in the East End of London, Tesco would grow into the world's third largest retailer with over 7,000 stores and 420,000 employees in 11 countries.[224] A FTSE 100 company, Tesco PLC listed on the LSE in 1947. By the end of 2013 the company had a market capitalisation of $44 billion.[225] Hailed around the world as another British success story, Tesco's reputation took a serious hit when news of the massive accounting scandal emerged.

In August 2014 Tesco PLC issued its' six month trading update with an estimated profit of £1.1 billion up to 23 August 2014.[226] Less than a month later the retailer announced a £250 million profit overstatement and the suspension of four senior executives, including the head of its UK operations and the chief financial officer.[227] The bombshell announcement related to Tesco Stores Ltd, a wholly owned subsidiary of Tesco PLC which accounted for the majority of the company's revenue and wiped £2.1 billion from the company's value in an instant.[228] Tesco would later admit the overstatement was the result of 'accelerated recognition of commercial income and delayed accrual of costs'.[229] The retailer was under increasing pressure from competitors and blamed its fledging performance on an 'aggressive programme of discount coupons by its rivals'.[230] At the height of Tesco's success,

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[224] Statista, 'Tesco's number of stores worldwide from 2008 to 2020' (*Statista,* 27 November 2020) <www.statista.com/statistics/238667/tesco-plc-number-of-outlets-worldwide/> accessed 1 December 2020.

[225] CompaniesMarketCap, 'Market capitalization of Tesco (TSCDF)' (*CompaniesMarketCap,* <https://companiesmarketcap.com/tesco/marketcap/> accessed 9 September 2020.

[226] Sean Farrell, 'Tesco suspends senior staff and starts investigation into overstated profits' *The Guardian* (London 22 September 2014) <www.theguardian.com/business/2014/sep/22/tesco-investigators-overstating-profit-250m> accessed 18 September 2018.

[227] BBC, 'Tesco suspends execs as inquiry launched into profit overstatement' (*BBC,* 22 September 2014) <www.bbc.co.uk/news/business-29306444> accessed 8 September 2018.

[228] Zoe Wood and Sean Farrell, 'Tesco loses £2bn in value as investigation of profit overstatement begins' *The Guardian* (London 23 September 2014) <www.theguardian.com/business/2014/sep/22/tesco-loses-2bn-value-250m-profit-overstatement-investigation> accessed 8 September 2018.

[229] Tesco, 'Trading Update' (*Investigate.co.uk,* 22 September 2014) <www.investegate.co.uk/tesco-plc--tsco-/rns/trading-update/201409220700142186S/> accessed 8 September 2018.

[230] BBC, 'Tesco unveils profits rise and £1bn investment in UK' (*BBC,* 18 April 2012) <www.bbc.co.uk/news/business-17752194> accessed 9 September 2018.

the company's shares were valued at 487p.[231] After many years of dominating the UK grocery market, Tesco reported a 95% drop in profit for the year ended 2013, from over £2.8 billion to £120 million.[232] In an attempt to revamp its UK presence, Tesco announced a massive £1 billion investment. The low pricing model of German retailers Aldi and Lidl placed tremendous pressure on Tesco's pricing model and the company was no longer considered among the cheapest grocery retailers.[233] It was against this backdrop that Tesco's woes began. The final report from Deloitte would confirm an overstatement of £285 million split over several financial years. Following the scandal, several senior employees, later known as members of 'the Cheshunt Eight', resigned.[234]

4.3.2 The governance failures

Right up until the announcement, the corporate governance structures at Tesco appeared on the surface, to be an exemplary example of good corporate governance in the UK. Compared to companies like Polly Peck and the Maxwell Group, both of which displayed serious corporate governance concerns before their collapse, Tesco PLC was a symbol of the advantages of the flexible approach originally endorsed by Cadbury. Notwithstanding, within a matter of months, the majority of the board would be replaced and Tesco would be embroiled in the biggest corporate governance scandal in its history.

In many instances the corporate governance framework at Tesco went well beyond the requirements of the UKCG. For instance, only two of the ten members on the board of Tesco were executives. All four members of the AudCom had recent and relevant financial expertise. Nevertheless, the scandal at Tesco highlighted a major failure of oversight by the board. Tesco's declining financial position and its loss of market share in the preceding years due to increased competition posed significant risks to its operations. This intensified pressure on executives whose compensation

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[231] Shane Croucher, 'Tesco: Despite shares plunge and competition from Aldi, the supermarket is too big to fail' (*International Business Times,* 9 December 2014) <www.ibtimes.co.uk/tesco-despite-shares-plunge-competition-aldi-supermarket-too-big-fail-1478782> accessed 19 September 2015.

[232] Tesco, 'Annual Report and Financial Statements 2014' Companies House <https://find-and-update.company-information.service.gov.uk/company/00445790> accessed 18 July 2018.

[233] Zoe Wood, 'Tesco market share shrinks to lowest level in almost a decade' *The Guardian* (London 11 March 2014) <www.theguardian.com/business/2014/mar/11/tesco-market-share-shrinks-lowest-level-decade-aldi-supermarket> accessed 11 September 2018.

[234] Zoe Wood, 'Three of Tesco's 'Cheshunt Eight' have left following accounting scandal' *The Guardian* (London 27 November 2014) <www.theguardian.com/business/2014/nov/27/tesco-accounting-scandal-executives-left-company> accessed 9 September 2020.

was tied to the company's performance. As a result of these circumstances, there was an increased risk that the company's revenue recognition would be highly susceptible to abuse. This increased risk required the board of directors to modify its risk approach and increase vigilance and controls on revenue. Despite warnings from the group financial officer, Laurie McIlwee, the board apparently took no additional steps to ensure the accuracy of commercial revenue.[235] Evidently, very little regard was placed on these additional risks by the board, as the company remained without a Chief Financial Officer for 6 months until October 2014, despite the group's stated compliance with the succession planning requirements of corporate governance.

The remainder of this section analyses the scandal at Tesco and argues that four factors contributed to the corporate governance failures: (i) lack of effective board oversight, (ii) corporate culture, (iii) creative accounting and (iv) audit failure. Each will now be addressed in turn.

Lack of effective board oversight

The scandal at Tesco was the result of several years of poor management and poor decision making. At the top of Tesco's corporate governance framework was a board of directors responsible for strategic oversight and control, and an executive committee responsible for management and implementation. Three years before the scandal, Philip Clarke replaced the company's long serving chief executive Terry after 14 years at the helm. Clarke's leadership style alienated several executives and under his leadership, the board underwent significant changes. Within a year of his tenure, the majority of Tesco's board was replaced taking with them a combined 109 years of retail experience.[236]

In a sign of the board's failure to effectively manage Tesco's strategic direction, the company's misadventure into the U.S. market by its former chief executive, Terry Leahy, would cost the retailer around £1.7 billion.[237] At the time of the profit scandal in 2014 Tesco's chief executive, Philip Clarke, had been at the helm since 2011,

[235] *SFO v Tesco Stores Limited* (EWHC).

[236] James Davey, Neil Maidment and Kate Holton, 'Tesco's 250-million-pound black hole: Who was minding the shop?' (*Reuters,* 2 October 2014) <www.reuters.com/article/uk-tesco-accounts-probe-insight-idUKKCN0HR0BY20141002> accessed 9 January 2019.

[237] Julia Finch, 'Philip Clarke fiddled while Tesco burned' *The Guardin* (London 21 July 2014) <www.theguardian.com/business/blog/2014/jul/21/philip-clarke-tesco-fiddled-while-burned> accessed 19 September 2018.

having worked his way up from the shop floor. Clarke's premiership would be marred by a series of controversies, including the infamous horse meat scandal. During his three year tenure, the company failed to address the severe underfunding of its core UK business and was slow to respond to changes in the market with the retailer losing roughly '1 million customers a week.[238] Ultimately, the retailer struggled to find its place in the UK market between upscale retailers, such as Sainsbury's and Waitrose and low cost retailers which affected its bottom line. Given the increasing competition in the market, Tesco's board failed to identify and manage the risk facing the company, in particular the risk that revenue was subject to manipulation due to increasing market pressures.

Corporate culture

Long before the scandal at Tesco, corporate culture of greed and profit maximisation played a significant role in several corporate governance scandals of the past. For instance, in 2011 an employee of UBS made a series of unauthorised trades and would later be convicted for what was, at the time, 'the biggest fraud in British history'.[239] Nick Leeson, the infamous rogue trader at the centre of the 1995 collapse of Baring's Bank explained the pressure of the corporate culture that existed in the bank as being 'driven to make profits, profits, and more profits'.[240] This culture of profit maximisation was also echoed by the trader at the centre of the UBS failure.[241] The role of corporate culture that gave rise to the failures at UBS and Baring's Bank calls into question not only the company's internal control processes but the true extent of management's role in promoting the profit maximisation culture.

Similar to many of the scandals before it, the pressure to meet financial targets led to a toxic corporate environment at Tesco and contributed to the scandal. In order to

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[238] ibid.

[239] Sean Farrell, 'Rogue UBS trader Kweku Adoboli says banks still at risk of huge frauds' *The Guardian* (London 1 August 2016) <www.theguardian.com/business/2016/aug/01/banks-still-at-risk-of-huge-frauds-warns-rogue-ubs-trader-kweku-adoboli> accessed 9 July 2019.

[240] Jason Rodrigues, 'Barings collapse at 20: How rogue trader Nick Leeson broke the bank' *The Guardian* (London 24 February 2015) <www.theguardian.com/business/from-the-archive-blog/2015/feb/24/nick-leeson-barings-bank-1995-20-archive> accessed 8 January 2019.

[241] James B Stewart, 'At UBS, It's the Culture That's Rogue' *The New York Times* (New York 23 September 2011) <www.nytimes.com/2011/09/24/business/global/at-ubs-its-the-culture-thats-rogue.html> accessed 7 July 2020.

meet the impossible performance targets, senior managers falsified reports.[242] The repeated instances by which corporate culture has been a contributory factor in corporate governance scandals suggest that corporate governance regulations in the UK fail to effectively address the role of corporate culture in effective governance. Furthermore, as discussed in Chapter 3, corporate governance enforcement in the UK places significant reliance on shareholders to hold directors accountable. However, as illustrated in the case of Autonomy where the directors were accused of engaging in a series of fraudulent transactions with the intent of inflating the market value, shareholders have little incentive to question the company's corporate governance structure or culture as long as the company remains profitable and its value increased.

Creative accounting

The accounting issues at Tesco stem from a well-known and often criticised accounting concept; revenue recognition. Revenue recognition has long been identified as the area with the highest susceptibility to fraud and abuse. Although accounting for revenue under IAS 18 is subjective and requires a degree of judgement, Tesco's newly appointed CEO, Dave Lewis, explained that he had never witnessed the kind of revenue recognition practices being used during his 27 year career at Unilever.[243]

As the UK's largest supermarket chain, Tesco's purchasing power enabled the retailer to secure competitive commercial contracts with suppliers. However, determining when to account for the income from these commercial contracts as revenue in the financial year required 'an element of judgement.'[244] Before the massive accounting scandal in 2014, there were warnings regarding the increased risk of aggressive revenue recognition practices at Tesco which apparently went ignored. A report in 2012 regarding the company's Polish business found similar irregularities with accounting for commercial income. Former UK chief financial officer, Laurie McIlwee, then warned that profits should not be accounted for 'where

[242] Serious Fraud Office, 'Deferred Prosecution Agreement between the SFO and Tesco published' (*SFO,* 23 January 2019) <www.sfo.gov.uk/2019/01/23/deferred-prosecution-agreement-between-the-sfo-and-tesco-published/> accessed 9 May 2020.

[243] Farrell, 'Tesco suspends senior staff and starts investigation into overstated profits' (n 226).

[244] *SFO v Tesco* (n 235) [27].

they cannot be justified'.[245] With the declining share in the market and pressure to meet targets senior managers aggressively brought forward income for the UK food business. Generally, UK corporate governance relies on the market to enforce good governance. However, as seen in the case of Tesco, pressure from financial markets to meet targets can have the unintended consequence of encouraging misconduct or corporate abuse.

Audit failure

Before analysing the role of the group's external auditors in the corporate governance failure at Tesco, it is also important to first discuss the role of Tesco's internal audit function. While internal audit was responsible for oversight of all group entities, the 'independence' and effectiveness of the group's internal audit function is indeed questionable.[246] While it is widely expected that internal audit would have been best equipped and would have possessed the financial expertise to investigate accounting irregularities, the whistleblower's report was sent to the legal department. This suggests serious failings in the group's internal reporting mechanisms.

When compared to the one page auditor's report in Tesco's 2012 and 2013 financial statements, the 2014 auditor's report was three pages long and outlined areas of focus during the audit. Of particular interest among these was commercial income 'because of the judgement required in accounting for the commercial income deals and the risk of manipulation of these balances.'[247] After outlining the steps taken to address these concerns PwC issued an unqualified auditor's report in May 2014. Less than four months later, Tesco would be at the centre of a massive accounting scandal involving commercial income recognition practices. At the time of the scandal, PwC had been the group's external auditor for over 28 years. While not strictly prohibited under UK corporate governance, the scandal at Tesco highlighted the dangers of familiarity and lengthy auditor-client relationships regardless of the regular audit partner rotation.[248] This familiarity can often times lead to carelessness and inadvertent negligence. Two of the NEDs on Tesco's board were former PwC

[245] Kamal Ahmed, 'Tesco: Where it went wrong' (*BBC,* 19 January 2015) <www.bbc.co.uk/news/business-30886632> accessed 9 January 2019.

[246] Tesco, 'Annual Report and Financial Statements 2014' (n 232) 35.

[247] ibid 70.

[248] ibid 35.

employees, including Ken Hanna, the chairman of Tesco's AudCom.[249] Furthermore, in another indication that PwC's independence and objectivity was impaired, non-audit fees in 2014 made up 46% of their total fees.[250] The objectivity and independence of PwC was very much a cause for concern after 28 years as the auditor-client relationship became entangled.

Similar to revenue recognition practices, the concept of materiality has also been at the centre of controversy among the accounting profession. While there is no universally accepted definition of materiality, Messier, Martinov-Bennie and Aasmund explain that information is considered material to the financial statements if its omission could affect the users' judgement or decision-making.[251] Former SEC Chairman noted that many companies abused the concept of materiality to avoid disclosure requirements and meet targets.[252] According to Tesco's annual report, PwC's level of materiality during the audit was £150 million; 5% of pre-tax profits. This suggests that material misstatements under this amount were unlikely to be detected during the audit. PwC also agreed to report any misstatements over £7 million to the AudCom.[253]

Nevertheless, the findings from the investigation by Deloitte would later confirm that the financial statements for the year end 2013/14 were overstated by £55 million.[254] Given that Tesco's 2014 revenue in the year was £63.5 billion, this explains why the £55 million overstatement could have gone undetected during the audit as it was significantly below the auditor's level of materiality. Interestingly, each of the years which were overstated fell below the materiality threshold set by the company's auditor. It is for this reason that former SEC Chairman Arthur Levitt rejected quantitative measures of materiality.[255] However, this does not explain why the

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[249] Aditya Chakrabortty, 'Awkward questions for Tesco should be answered by its accountants too' *The Guardian* (London 29 September 2014) <www.theguardian.com/commentisfree/2014/sep/29/tesco-accountants-auditors> accessed 20 September 2018.

[250] Tesco, 'Annual Report and Financial Statements 2014' (n 232) 36.

[251] William F Messier Jr, Nonna Martinov-Bennie and Aasmund Eilifsen, 'A review and integration of empirical research on materiality: Two decades later' (2005) 24 Auditing: A Journal of Practice & Theory 153, 155.

[252] Arthur Levitt, 'The "numbers game"' (Speech at NYU Center for Law and Business, New York, 29 September 1998) <www.sec.gov/news/speech/speecharchive/1998/spch220.txt> accessed 9 September 2019.

[253] Tesco, 'Annual Report and Financial Statements 2014' (n 232) 65.

[254] *SFO v Tesco* (n 235) [3].

[255] Levitt (n 252).

material misstatement, well over the £7 million threshold that was required to be brought to the attention of the AudCom, appears instead not to have been addressed by the AudCom. Perhaps this explains the subsequent resignation of all four members of the AudCom following the scandal.

4.3.3 Sanctions

Despite Tesco's announcement and the company's willingness to cooperate, it took UK regulators over 3 years before the company would face regulatory sanctions. In April 2017, three years after the events, Tesco Stores Ltd and the SFO entered into a deferred prosecution agreement (DPA), the SFOs fourth such agreement.[256] According to the terms Tesco agreed to a financial penalty of £129 million and costs.[257] Furthermore, the SFO required the company to commission a review and report on the company's Global Finance Transformation Programme and to improve its accounting controls system.

Although the FCA did not levy additional financial penalties against Tesco in March 2017, the FCA ordered Tesco PLC and Tesco Stores Ltd to establish an £85 million compensation scheme for investors who bought shares or bonds between 29 August 2014 and 19 September 2014.[258] This was the first time the regulator exercised its power under s 384 of FSMA. On the other side of the Atlantic, U.S. shareholders agreed to a $12 million settlement with Tesco for false and misleading statements.[259]

More than four years after the events, three of the company's former executives, Christopher Bush,[260] former UK Managing Director, Carl Rogberg,[261] former UK

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[256] Serious Fraud Office, 'Deferred Prosecution Agreement between the SFO and Tesco published' (n 242).

[257] ibid.

[258] Financial Conduct Authority, 'Tesco to pay redress for market abuse' (*FCA,* 28 March 2017) <www.fca.org.uk/news/press-releases/tesco-pay-redress-market-abuse> accessed 9 May 2020.

[259] Jonathan Stempel, 'Tesco in $12 million U.S. settlement over accounting scandal' (*Reuters,* 25 November 2015) <www.reuters.com/article/uk-tesco-settlement/tesco-in-12-million-u-s-settlement-over-accounting-scandal-idUKKBN0TE2WM20151125> accessed 9 July 2019.

[260] Zoe Wood and Sarah Butler, 'Two Tesco directors cleared of fraud as judge labels case 'weak'' *The Guardian* (London 6 December 2018) <www.theguardian.com/business/2018/dec/06/two-tesco-directors-cleared-of-false-accounting> accessed 9 March 2020.

[261] Zoe Wood and Sarah Butler, 'Former Tesco executive Carl Rogberg cleared of fraud' *The Guardian* (London 23 January 2019) <www.theguardian.com/uk-news/2019/jan/23/former-tesco-executive-carl-rogberg-cleared-of-fraud> accessed 9 March 2020.

Finance Director and John Scouler,[262] former UK commercial director, were acquitted of fraud by abuse of position and false accounting. Despite the company's admitting the role of senior management in the statement of facts the SFO was unable to secure a conviction against the company's senior executives and was subject to intense scrutiny following the acquittal. According to Royce LJ, the SFO case was 'so weak that it should not be left for a jury's conviction'.[263] The SFO's failure to secure a conviction, even with the cooperation of the company suggests that serious operational failures continue to exist despite the recommendations of the de Grazia report.

As the UK's auditing regulator, the FRC announced an investigation into PwC's audit of Tesco for FY2012, FY2013 and FY 2014, including the results in the 26 weeks up to the profit announcement. However, following the DPA between Tesco and the SFO, the FRC closed its investigation into Tesco asserting that it was unlikely that the conduct of PwC would have risen to the level of negligence.[264] This is in keeping with Tesco's own admission in its 2015 Annual Report that the misstatement was not considered 'material' for accounting purposes.[265] Nevertheless, despite the magnitude of the losses suffered by shareholders Tesco's directors or auditors for all intents and purposes faced no punishment.

4.4 THE CARILLION COLLAPSE

The collapse of the UK's second largest construction company in 2018 put over 400,000 jobs at risk, with over 18,000 in the UK alone. The £2.6 billion pension deficit left UK regulators under a mountain of pressure to pick up the pieces of one of the largest corporate collapses in the UK. Carillion's collapse was many years in the making and by the time of the collapse the company had grown into a colossal corporate entity with 326 subsidiaries and 169 directors worldwide.[266] At the height of the Carillion's success, the company maintained 50,000 homes, 50 prisons and

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[262] ibid.

[263] ibid.

[264] Alia Shoaib, 'FRC closes investigation into PwC over Tesco accounts' (*AccountancyAge,* 6 June 2017) <www.accountancyage.com/2017/06/06/frc-closes-investigation-into-pwc-over-tesco-accounts/> accessed 9 September 2019.

[265] Tesco, 'Annual Report and Financial Statements 2015' Companies House <https://find-and-update.company-information.service.gov.uk/company/00445790> accessed 18 July 2018.

[266] Julia Kollewe, 'Calls for more scrutiny of top accounting firms after Carillion collapse' *The Guardian* (London 30 January 2018) <www.theguardian.com/business/2018/jan/30/carillion-collapse-prompts-fresh-scrutiny-of-uk-accounting-giants> accessed 8 February 2019.

roughly 900 schools in the UK.[267]

In a sign that the rosy picture did not represent the true position of the company, Carillion's shares were the most shorted stock on the LSE in the years leading up to the collapse.[268] It would soon become clear that the construction giant had become too big to manage and its subsequent collapse sent shockwaves through the UK. With hindsight, the market anticipation of volatile changes to the company's stock price should have been considered a red flag that behind the rosy picture painted in the financial statements the construction giant was not financially stable. Similarly, prior to the collapse of retail giant Debenhams, the company was among the most shorted stock on the LSE.[269] The fall of the construction giant would later be described as 'a story of recklessness, hubris and greed, its business model was a relentless dash for cash'.[270] By the time of the collapse, Carillion had lost 90% its market value.[271]

4.4.1 Background

In 1999 construction and aggregates group Tarmac spun off its construction arm into Carillion. Carillion's core business activities focused primarily on construction contracts, support services and public-private partnership contracts (PFI) with operations in the UK, Canada, the Middle East and North Africa. Although PFI carried considerably more risk in the construction industry, PFI contracts only accounted for roughly 6% of Carillion's revenue.[272] Despite this, PFI contracts would play a significant role in the collapse of the construction giant. In a further sign of Carillion's precarious business model, the company was overly reliant on UK

[267] Daniel Thomas, 'Where did it go wrong for Carillion?' (*BBC,* 15 January 2018) <www.bbc.co.uk/news/business-42666275> accessed 8 January 2019.

[268] Alex Ralph, 'Hedge funds made £200 million short-selling Carillion shares' *The Times* (London 15 January 2018) <www.thetimes.co.uk/article/hedge-funds-made-200-million-short-selling-carillion-shares-sh5cgblv7> accessed 9 December 2019.

[269] Kate Beioley, 'Debenhams and Metro Bank among most-shorted UK stocks' *Financial Times* (London 8 March 2019) <www.ft.com/content/407d4778-4025-11e9-b896-fe36ec32aece> accessed 9 September 2020.

[270] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (HC 768, 2018) 3.

[271] Reuters, 'Timeline - Carillion collapses under debt pile after profit warnings' (*Reuters,* 15 January 2018) <https://uk.reuters.com/article/uk-carillion-restructuring-dates-timelin/timeline-carillion-collapses-under-debt-pile-after-profit-warnings-idUKKBN1F40UQ> accessed 8 November 2018.

[272] Carillion, 'Annual Report and Accounts 2016' Companies House <https://find-and-update.company-information.service.gov.uk/company/03782379/filing-history> accessed 1 March 2017.

contracts, which accounted for 45% of the company's total revenue.[273]

Nevertheless, within 10 years, Carillion would become the second largest construction company in the UK after a series of aggressive acquisitions. Despite the company's aggressive expansion into international markets, over 70% of Carillion's revenue was derived from domestic contracts.[274] This aggressive growth strategy was the beginning of the end for the construction giant. Within the space of three years Carillion acquired Planned Maintenance[275] for £40 million, Mowlem[276] for £291 million and Alfred McAlpine[277] for £572 million. Carillion's growth strategy appeared to be based on the premise that large scale acquisitions would allow the company to dominate the market and save on costs through economies of scale.[278] Under the guise of increasing its market share and realising further economies of scale Carillion made three failed attempts to merge with its main rival, Balfour Beatty, on the basis that once combined, they would generate £175 million in cost savings.[279]

4.4.2 The governance failure

Less than six months after issuing its 2016 annual report, Carillion issued a profit warning disclosing a £865 million write-down on three PFI contracts; £375 million related to its UK operations and £470 million related to exiting the Middle East and Canada.[280] The governance failures that led to Carillion's collapse was yet another instance of history repeating itself. This view was shared by the chair of the Works

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[273] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Oral evidence: Carillion* (HC 769, 2017) Q411.

[274] Carillion, 'Annual Report and Accounts 2016' (n 272) 4.

[275] Carillion, 'Carillion acquires Planned Maintenance Group' (*Investegate,* 9 March 2005) <www.investegate.co.uk/articlePrint.aspx?id=200503090700315042J> accessed 9 December 2018.

[276] Sophie Kernon, 'Carillion agrees £291m swoop for Mowlem' (*Construction News,* 7 December 2005) <www.constructionnews.co.uk/archive/carillion-agrees-291m-swoop-for-mowlem-07-12-2005/> accessed 9 November 2018.

[277] Dan Milmo, 'Alfred McAlpine agrees reduced takeover offer' *The Guardian* (London 10 December 2007) <www.theguardian.com/business/2007/dec/10/carillionbusiness.alfredmcalpine> accessed 10 November 2018.

[278] For more on economies of scale see Jeffrey H Dyer, Prashant Kale and Harbir Singh, 'When to ally and when to acquire' (2004) 82 Harvard business review 108.

[279] Work and Pensions Committee, 'Carillion plc' (*Parliament UK,* 16 May 2018) <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/76905.htm> accessed 9 December 2019.

[280] Simon Goodley, 'Carillion has 'no future without rights issue of at least £500m'' *The Guardian* (London 13 July 2017) <https://www.theguardian.com/business/2017/jul/13/carillion-has-no-future-without-rights-issue-of-at-least-500m> accessed 9 August 2018.

and Pension Committee, Frank Fields, who referred to the collapse of Carillon as the '…same old story. Same old greed. A board of directors too busy stuffing their mouths with gold to show any concern for the welfare of their workforce or their pensioners.'[281] Similar to many of the corporate governance scandals before it, Carillion's collapse was the culmination of a lack of effective management oversight and an aggressive accounting strategy which ultimately led to an abuse of accounting principles on revenue recognition and goodwill accounting.

Despite the appearance of compliance to the UKCG, yet another company collapsed as a result of poor governance. Unsurprisingly and similar to scandals of the past, Carillion's auditors issued a clean bill of health in the months leading up to the collapse. A look behind Carillion's veil of compliance would reveal systematic payments of illegal dividends and excessive performance related remuneration based on inflated profits, all stemming from a lack of effective management oversight and a failure of effective audit.

Lack of effective board oversight

For all intents and purposes, on the surface at least, Carillion's governance structure appeared to illustrate first class corporate governance. The roles of chairman and chief executive were distinct and separate. Five of the seven directors on the board were independent NEDs, two of which had financial experience, and each of the board's subcommittees was chaired by an independent NED. Nevertheless, under the facade of good governance, the directors of Carillion would oversee the collapse of the UK's second largest construction company. By the time Carillion issued its first profit warning in July 2017 the longest serving member on the company's board was CEO Richard Howson.[282] After three years as an executive director for Carillion's UK Building, Private Finance, Middle East and North Africa business, Howson was appointed CEO at the end of 2011.[283] Until his resignation in 2017, following the shocking profit warning, Howson would oversee a series of egregious corporate governance failures that ultimately led to the

[281] Andrew MacAskill, 'Carillion bosses' personal greed and recklessness led to downfall: MPs' (*Reuters,* 16 May 2018) <www.reuters.com/article/us-carillion-collapse-idUKKCN1IG3GC> accessed 9 March 2019.

[282] Carillion, 'Annual Report and Accounts 2016' (n 272) 50.

[283] Carillion, 'Annual Report and Accounts 2009' Companies House <https://find-and-update.company-information.service.gov.uk/company/03782379/filing-history> accessed 1 March 2017.

company's downfall.[284]

Appointed to the board in 2007 as Group Finance Director, Richard Adam would oversee Carillion's aggressive acquisition strategy. Under Adam, Carillon's pension deficit increased 347% and its liabilities increased 185%.[285] Former chief executive Howson would later admit that 65% of Carillion's £1 billion pension deficit was the result of the acquisitions of Mowlem and McAlphine.[286] Interestingly, less than two years before Carillion collapsed Adam resigned after nine years of overseeing the most aggressive period of acquisitions at Carillion. Carillion's aggressive growth strategy calls into question not only the supervisory role of the board but also their role in setting and overseeing the strategic direction of the construction giant. Within a year of his resignation, Adam divested his entire shareholding in Carillion for £876,000.[287] Like rats fleeing a sinking ship, the timing of Adam's resignation and the subsequent sale of his shares in Carillion suggest a lack of confidence in Carillion's future performance. In keeping with agency theory, Carillion's remuneration policy sought to align the interest of shareholders and directors. However, on the other hand, the case of Carillion also illustrates the pitfalls that can arise from performance related remuneration policies, which are subject to abuse and manipulation.

In 2014, after three years as senior NED, Phillip Green was appointed as Carillion's chairman. Given the length of his tenure, Green should undoubtedly have had first-hand knowledge of Carillion's rising debts and its precarious financial position. Instead, Green would oversee a series of board failures that would contribute directly to the collapse of Carillion. During his tenure as chairman, Carillion's liabilities doubled to £1.3 billion. It is worth pointing out here that Green's corporate history is not without controversy. In the 1990s, Green was chief executive of the home furnishing group Colorall before the company collapsed in 1990 under a

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[284] Simon Goodley, 'Carillion's 'highly inappropriate' pay packets criticised' *The Guardian* (London 15 January 2018) <www.theguardian.com/business/2018/jan/15/carillion-highly-inappropriate-pay-packets-criticised> accessed 31 July 2018.

[285] UK Parliament, 'Carillion collapse: what went wrong?' (*UK Parliament,* 19 January 2018) <https://commonslibrary.parliament.uk/carillion-collapse-what-went-wrong/> accessed 9 September 2020.

[286] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Oral evidence: Carillion* (n 273) Q496.

[287] Rob Davies, 'Ex-Carillion CFO sold £800,000 in shares after retirement' *The Guardian* (London 26 February 2018) <www.theguardian.com/business/2018/feb/26/ex-carillion-cfo-sold-800000-in-shares-after-retirement> accessed 19 June 2019.

mountain of debt. Green was subsequently found guilty of breach of trust and maladministration by the Pensions Ombudsman, after allowing the Colorall's pension to be used for the purchase of a luxury flat at an inflated price from a close colleague.[288] Despite this, Green continued to receive several high profile appointments in the years following the collapse of Collorol, including his appointment as a government advisor on corporate governance under former Prime Minister David Cameron.[289] Although it can be argued that this was over 25 years ago and before corporate governance regulations were introduced and therefore should not be used as an indication of his future actions or his general approach, corporate governance failures have generally been examples of history repeating itself.

Although the UKCG 2018 does not explicitly prohibit NEDs from owning shares, being a shareholder while also being a NED can result in a conflict of interest. Interestingly, in the case of Carillion the majority of directors owned shares, including three of the five NEDs.[290] In light of this, it is difficult not to surmise that this played a role in the dividend policy. Most notable among the directors with shares in Carillion was the chairman of Carillion's AudCom Andrew Dougal, although his shareholding represented less than 1% of the shares held by the executives. It is also important to point out here that even when faced with Carillion's cash flow issues, Green and Cochrane continued to oppose withholding dividends to preserve cash.[291] Instead, the board agreed to the payment of £55 million in dividends one month before Carillion issued its first profit warning.[292] Furthermore, despite having the 15th largest pension deficit among FTSE 350 companies, Carillion also continued to pay dividends.[293] In other words, Carillion was barely managing to meet its debt obligations and working capital requirements but continued to take money out of the company by way of dividends. This business

[288] Patrick Hosking, 'Carillion chairman Philip Green was censured by pensions tsar' *The Times* (London 15 January 2018) <www.thetimes.co.uk/article/chairman-was-censured-by-pensions-tsar-wjjvzk7xw> accessed 9 June 2018.

[289] Catherine Neilan, 'Carillion boss Philip Green has previously been found guilty of a breach of trust over pensions' (*City A.M.,* 16 January 2018) <www.cityam.com/carillion-boss-philip-green-has-previously-been-found/> accessed 23 July 2021.

[290] Carillion, 'Annual Report and Accounts 2016' (n 272) 71.

[291] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (n 270) para 17.

[292] ibid para 17.

[293] Federico Mor and others, *The collapse of Carillion* (House of Commons Briefing Paper, 2018) 22.

model would later be criticised as nothing more than a 'relentless dash for cash'.[294]

Carillion's remuneration policy also exposed serious loopholes in the UK's corporate governance system regarding clawback provisions. It has been observed that clawback provisions tend to improve the quality of financial reporting and reduce instances of accounting restatements.[295] Despite the changes to Carillion's clawback provisions, it is worth pointing out that corporate failure was conspicuously absent from the events which would trigger a clawback. This view was also shared by the Institute of Directors who criticised the amendment of Carillion's clawback provisions to remove corporate failure as a trigger, as a sign that 'effective governance was lacking.'[296] It would later come to light that Carillion changed the clawback provisions on the heels of concerns expressed by Standard Life Bank over Carillion's financial management, strategy and corporate governance, before divesting its 5% shareholding.[297] Ultimately, the change to Carillion's clawback provisions removed considerable downside for the directors. If we consider the clawback provisions as a safety net against directors' abuse, then when a house of cards is approaching collapse and there are no drawbacks, there is no incentive for the dealer to prevent the house of cards from falling. Instead, the impending collapse motivates the dealer to take away all they can before the house of cards collapses on itself.

It was clear that years before the collapse that Carillion's directors were out of touch with the reality of the situation facing Carillion by their failure to take the necessary steps to address the growing debt obligations. This view was also expressed by one of Carillion's shareholders, who opined that the directors 'showed no inclination to drive the management to change'.[298] Generally, Carillion's directors showed a

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[294] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (n 270) 3.

[295] Lilian H Chan and others, 'The effects of firm-initiated clawback provisions on earnings quality and auditor behavior' (2012) 54 Journal of Accounting and Economics 180; Dehaan, Hodge and Shevlin, 'Does voluntary adoption of a clawback provision improve financial reporting quality?'.

[296] Institute of Directors, 'Carillion bonus rule change sign of 'ineffective governance'' (*IoD,* 15 January 2018) <www.iod.com/news-campaigns/news/articles/Carillion-bonus-rule-change-sign-of-ineffective-governance> accessed 9 May 2019.

[297] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Oral evidence: Carillion* (n 273) Q405.

[298] Rob Davies, 'Carillion shareholders considered suing after profit warning' *The Guardian* (London 19 February 2018) <www.theguardian.com/business/2018/feb/19/carillion-shareholders-considered-suing-after-profit-warning> accessed 9 March 2019.

serious lack of awareness. In other words, the events that led to Carillion's collapse stemmed from a series of bad decisions of Carillion's board and raises important questions on directors' culpability in the UK.

Aggressive accounting

To boost its financial position, Carillion engaged in a series of aggressive accounting practices by abusing existing accounting standards. IAS 11 (Construction contracts) and IFRS 3 (Business Combination) require a degree of subjective judgement in recognising income on construction contracts and accounting for goodwill.[299] As previously mentioned, to boost its balance sheet and financial position Carillion's goodwill carrying value was overstated and accounted for 84% of Carillion's balance sheet.[300] With little evidence to support the perceived benefits of the aggressive acquisition strategy, Carillion underbid on several construction contracts on the basis of economies of scale that never materialised. Consequently, the resulting goodwill from these acquisitions was overstated and failed to take into consideration any impairment.

As part of the company's flawed business model Carillion underbid on several contracts. Therefore, in order to boost its income Carillion engaged in a concerted effort to inflate the income from its construction contracts. According to former CEO Emma Mercer, the company had begun to engage in a 'slightly more aggressive approach to recognising contracts.'[301] Mercer went on to explain that the number of contracts and the size of the judgements had increased.[302] Furthermore, in what can only be described as an attempt to conceal the extent of its losses flowing from its misadventure into the Middle East, the company failed to account for losses on the Qatar contracts. In another attempt to conceal the extent of its liabilities, Carillion also misclassified £498 million.[303] Instead, Carillion's financial statements provided

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[299] Alia Shoaib, 'Carillion inquiry: missed red flags, aggressive accounting and the pension deficit' (*AccountancyAge,* 26 February 2018) <www.accountancyage.com/2018/02/26/carillion-inquiry-missed-red-lights-aggressive-accounting-pension-deficit/> accessed 19 August 2020.

[300] ibid.

[301] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (n 270).

[302] ibid.

[303] UK Parliament, 'Carillion used its suppliers to "prop up failing business model"' (*UK Parliament,* 14 May 2018) <https://committees.parliament.uk/committee/164/work-and-pensions-committee/news/97957/carillion-used-its-suppliers-to-prop-up-failing-business-model/> accessed 9 March 2019.

the basis for excessive abuse of dividend payments and performance related payment scheme. According to former finance director, Khan, the board increased dividend payments over the 16 years since the formation of the company in 1999.[304] By 2016 Carillion had paid over £600 million in cash dividends.[305] With little regard to the growing debt obligations and the huge pension deficit, Carillion continued year on year to honour its dividend policy. It can be argued that many of these dividends were likely illegally paid from capital contrary to the requirements of the CA 2006, which requires dividends to be paid out of accumulated or realised profits.[306]

Audit failure

Historically, studies suggest that the Big Four are more successful at curbing earnings management.[307] Therefore, in what many would have thought to be a sign of top-notch accounting oversight, Carillion's internal and external functions were provided by members of the Big Four; Deloitte and KPMG. Nevertheless, a strategy of aggressive accounting for revenue and improper accounting for goodwill conducted under the nose of two of London's largest accounting firms would thrust the role of auditors as the corporate watchdog into the spotlight once again.

By the time Carillion collapsed KPMG had been the external auditor for 19 years, since the company's formation in 1999 and was paid over £29 million in audit fees.[308] An analysis of the role of Carillion's auditors in the years leading up to the collapse paints a picture of auditor ineptitude further comprised by a long-standing relationship that led to an apparent lack of auditor independence. In another illustration of the cosy auditor-client relationship between Carillion and KPMG two of Carillion's three former finance directors were former employees of KPMG.[309] Chair

[304] Miles Johnson, 'Carillion collapse offers warning to dividend fetishists' *Financial Times* (London 19 January 2018) <www.ft.com/content/89576266-fd15-11e7-a492-2c9be7f3120a> accessed 9 September 2020.

[305] Chris Higson, 'Two lessons from the failure of Carillion' (*London Business School,* 2018) <www.london.edu/think/two-lessons-from-the-failure-of-carillion> accessed 9 September 2020.

[306] CA 2006, s803.

[307] Ann L Watkins, William Hillison and Susan E Morecroft, 'Audit quality: A synthesis of theory and empirical evidence' (2004) 23 Journal of accounting literature 153.

[308] Lea Robert, 'Carillion wasted £40m on useless audits, say MPs' *The Sunday Times* (London 23 February 2018) <www.thetimes.co.uk/article/carillion-wasted-40m-on-useless-audits-say-mps-0t702slmp> accessed 19 March 2019.

[309] Rob Davies, 'Carillion: accountants accused of 'feasting' on company' *The Guardian* (London 12 February 2018) <www.theguardian.com/business/2018/feb/13/carillion-accountants-accused-of-feasting-on-company> accessed 9 March 2019.

of the Work and Pensions Committee, Frank Field, referred to KPMG as Carillion's 'pet rubber-stampers.'[310]

In order to analyse the failure of KPMG as gatekeepers, it is important to consider two crucial areas; revenue and goodwill. Interestingly, goodwill was the largest asset on Carillion's balance sheet; £1.5 billion on its 2016 balance sheet.[311] When Carillion acquired Mowlem and Alfred McAlphine for £863 million, the company added goodwill of £1.4 billion to its balance sheet. Even a cursory view of Carillion's 2016 annual report would reveal that goodwill, a non-tangible asset that represents the difference between the purchase price and the fair value of the assets, was the most substantial asset on Carillion's balance sheet. It is very striking to note that a subjective asset with no physical value accounted for 35% of Carillion's assets, given that any impairment would have a material effect on the company's financial position. Most notable however, is the acquisition of Eaga, which was an illustration of the questionable goodwill accounting practices in play at Carillion. When Carillion purchased Eaga for £260 million Carillion recognised an additional £329 million of goodwill. Despite five years of continuous losses at Eaga, the value of goodwill recognised on Carillion's balance sheet remained unchanged.

As a result, the auditor's assessment of goodwill was a key area in an effective audit. However, according to the FRC, KPMG failed to challenge management assumptions for testing impairments for goodwill.[312] In addition to the high levels of goodwill and despite the increasing and unsustainable levels of debt KPMG issued unqualified audit reports in the years preceding the collapse. The audited financial reports would later be referred to as 'a worthless as a guide to the true financial health of the company.[313] Interestingly, the audit partner in charge of the Carillion audit was also revealed to be the lead auditor of Halfords audit, following a £12

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[310] UK Parliament, 'Carillion board minutes reveal last CFO blew whistle on accounting irregularities' (*UK Parliament,* 27 February 2018) <https://committees.parliament.uk/committee/164/work-and-pensions-committee/news/97763/carillion-board-minutes-reveal-last-cfo-blew-whistle-on-accounting-irregularities/> accessed 19 March 2019.

[311] Carillion, 'Annual Report and Accounts 2016 (n 272).

[312] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (n 270) 53.

[313] UK Parliament, 'Major shareholders views on Carillion collapse published' (*UK Parliament,* 19 February 2018) <https://committees.parliament.uk/committee/164/work-and-pensions-committee/news/97846/major-shareholders-views-on-carillion-collapse-published/> accessed 19 March 2019.

million inventory write off.[314]

Carillion's internal auditor, Deloitte, a constituent of the Big Four was paid over £700,000 per year for providing Carillion's internal audit service.[315] Generally, internal auditors are considered to have a greater understanding of a company's operations and principal risks. Furthermore, Deloitte provided several other services to Carillion, including due diligence, and collected over £52 million in fees from Carillion.[316] Nevertheless, Deloitte appears to have failed to identify several key deficiencies in Carillion's operations and its internal control environment. For instance, despite Deloitte's role in the acquisition of Eaga, Deloitte, nor KPMG, recommended a goodwill impairment following years of losses.

4.4.3 Sanctions

The collapse of Carillion represented a complete failure of UK corporate governance. In the lead up to the collapse, there were warning signs that the company was heading for trouble, and its subsequent collapse casts serious doubts about the effectiveness of UK corporate governance regulations to prevent corporate failures, such as Carillion.[317] When considering that corporate governance in the UK has been built upon three pillars; (i) effective oversight by the regulators, (ii) oversight and controls on directors and (iii) enforcement by shareholders, the collapse of Carillion represented a failure of each pillar. In the aftermath of the scandal, it would come to light that the FRC was monitoring Carillion in the two years leading up to the collapse but did not intervene, arguing that it did not have the power to do. The collapse of Carillion also illustrates that reliance on shareholders to enforce corporate governance is based on a flawed premise as shareholders are more likely to divest, as was the case with two of Carillion's majority shareholders.[318] In another example, as far back as 2015, Standard Life

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[314] Tabby Kinder, 'KPMG investigates Carillion auditor over other outsourcer' *Financial Times* (London 25 February 2020) <www.ft.com/content/b4926ec6-5335-11ea-8841-482eed0038b1> accessed 19 April 2020.

[315] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (n 270).

[316] ibid.

[317] Sophie Brookes, 'Would the new corporate governance code have saved Carillion?' (*Gately,* 24 January 2018) <https://gateleyplc.com/insight/quick-reads/would-the-new-corporate-governance-code-have-saved-carillion/> accessed 19 March 2019.

[318] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Oral evidence: Carillion* (n 273).

expressed concerns over 'financial management, strategy and corporate governance' at Carillion and divested its shareholding in the company shortly thereafter.[319] This supports the view that reliance on shareholder enforcement to deter misconduct is indeed misguided. Therefore, it can be argued that a system which places reliance on shareholders to enforce good governance practices (internal enforcement), should be supported by strong and robust external statutory enforcement mechanisms.

Following the collapse, a joint Commons inquiry by the Business, Energy and Industrial Strategy and the Work and Pension Committee laid the majority of the blame for the collapse at the feet of Carillion's chairman Philip Green, chief executive Richard Howson, and former finance director Richard Adam.[320] The final report was a sharp rebuke of the UK's corporate governance system. Nevertheless, given the committee's limited enforcement powers, the report served primarily as a consolidation of the facts and events that led to Carillion's collapse. Ultimately the purpose of the joint enquiry appears to be an exercise in corporate accountability, the cornerstone of effective corporate governance. Inherent to corporate accountability however is effective enforcement. In other words, corporate accountability should entail more than an acceptance of responsibility, corporate accountability should entail effective enforcement to deter corporate misconduct.

Despite blistering criticisms for their failures in the years since the collapse, none of Carillion's directors have faced any criminal or civil sanctions for their role in the collapse to date. It can be argued that the reason for this lack of enforcement action stems not from the lack of available sanctions, but is rooted in the general snail like approach to enforcement in the UK. For instance, following the collapse of British retailer BHS in 2016, it would take a further three years before former director Dominic Chappell was disqualified.[321] It is interesting to note here that unlike the case of Carillion where the Business Secretary requested that the scope of the investigation into Carillion's directors be broadened to include former directors, the

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[319] ibid Q405.

[320] Business Energy and Industrial Strategy Committee and Work and Pensions Committee, *Carillion - Second Joint report from the Business, Energy and Industrial Strategy and Work and Pensions Committees of Session 2017–19* (n 270).

[321] Jasper Jolly, 'Former BHS owner Dominic Chappell banned as director' *The Guardian* (London 5 November 2019) <www.theguardian.com/business/2019/nov/05/former-bhs-owner-dominic-chappell-banned-from-becoming-company-director> accessed 9 March 2020.

long-time former director of BHS Sir Philip Green escaped disqualification for his role in the years leading up the collapse of the retail giant.[322] This appears to support the view that there is indeed a selective approach to enforcement where certain individuals are also considered too big to fall. This assertion was also supported by MP Frank Fields, who expressed the view that the disqualification of Chappell was an illustration of a 'monkey being shot while the organ grinder goes free'.[323]

While the outcome of Carillion's directors' disqualification proceedings remains ongoing, the directors have not faced any other criminal or civil sanctions to date. Unlike the directors, the company's auditors have been subject to sanctions and are facing a £250 million negligence claim from the Official Receiver.[324] KPMG is also facing a £1 billion claim and is locked in a bitter battle with the FRC over claims it misled the regulator and falsified documents.[325] In the aftermath of the scandal, the sanctions appear to be geared heavily toward punishing the auditors, and less so against the directors who should also be held directly responsible. Interestingly, but not surprisingly, the collapse of Carillion has prompted changes to the UK corporate governance landscape with recommendations to create a new statutory body in the UK, the Audit, Reporting and Governance Authority (ARGA).[326] Arguably, this is unlikely to address the issues that lie at the heart of UK corporate governance enforcement. The creation of this new department appears to be in line with the UK's history of successive UK government's renaming and reshuffling departments with little evidence this improves functionality or effectiveness. For instance, the current UK Visas and Immigration department has been reshuffled and replaced several times over the years, however the inherent problems remain. When compared to the U.S., the SEC and the PCAOB have been operating for over 87

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[322] Department for Business Energy & Industrial Strategy and Greg Clark, 'Business Secretary outlines departmental action following Carillion liquidation' (*GOV.UK,* 2018) <www.gov.uk/government/news/business-secretary-outlines-departmental-action-following-carillion-liquidation> accessed 19 September 2019.

[323] Jolly, 'Former BHS owner Dominic Chappell banned as director' (n 323).

[324] Sabah Meddings and Jill Treanor, 'Carillion liquidators hit KPMG with £250m claim' *The Times* (London 21 November 2021) <www.thetimes.co.uk/article/carillion-liquidators-hit-kpmg-with-250m-claim-jsnvr377f> accessed 9 December 2021.

[325] Michael O'Dwyer, 'KPMG admits 'misconduct' as regulator alleges forgery by Carillion auditors' *Financial Times* (London 10 January 2022) <www.ft.com/content/fb22432a-ebd1-45ea-8966-0bac7953efd3> accessed 11 January 2022.

[326] ICAEW Insights, 'Do the BEIS plans for ARGA give us the regulator we need?' (*ICAEW,* 6 July 2021) <www.icaew.com/insights/viewpoints-on-the-news/2021/jul-2021/do-the-beis-plans-for-arga-give-us-the-regulator-we-need> accessed 9 September 2021.

years and 19 years respectively. Perhaps this explains why the U.S. appears to be much more effective in enforcement, by focusing on improving its operations and addressing weaknesses in the system instead of starting anew.

4.5 THE TED BAKER OVERSTATEMENT

After a series of profit warnings and the announcement of a £58 million inventory overstatement at luxury fashion retailer group Ted Baker lost 90% of its value within 12 months.[327] When considered in the context of the greatest corporate governance failures in the UK, the Ted Baker restatement can by no means be considered an extreme instance of governance failure. However, when taking into consideration the company's post tax profit for 2019 was £41 million, the £58 million inventory write off can be considered highly material and therefore represented yet another failure of corporate governance in the UK.[328]

4.5.1 Background

Founded in 1988, the British apparel maker Ted Baker has become synonymous with British fashion. In 1997 the group listed on the London Stock Exchange and began its international expansion with over 200 concession stores worldwide, including Asia, North America, the Middle East and Australia. In the last decade, Ted Baker has suffered a string of setbacks. The 2019 inventory overstatement was not the first time serious deficiencies in Ted Baker's inventory controls had come to light. Between 2000 and 2008 an employee stole roughly £1 million worth of inventory from its London warehouse.[329] When taken together the events regarding Ted Baker's inventory suggests that the group's inventory controls were not strengthened following the theft. More recently, Ted Baker's founder and chief executive, Ray Kelvin, resigned following reports of inappropriate behaviour toward staff.[330]

Amid tough market conditions and declining sales and profits, Ted Baker's share

[327] Myles McCormick, 'Ted Baker warns of £58m writedown on inventory error' *Financial Times* (London 22 January 2020) <www.ft.com/content/f06051e0-3ce5-11ea-a01a-bae547046735> accessed 9 March 2020.

[328] Prem Sikka, 'Why didn't auditors spot Ted Baker's overstated inventory?' (*Left Foot Forward,* 23 January 2020) <https://leftfootforward.org/2020/01/why-didnt-auditors-spot-ted-bakers-overstated-inventory/> accessed 9 January 2021.

[329] *Ted Baker plc v AXA Insurance UK plc [2017] EWCA Civ 4097*.

[330] Julia Kollewe, 'Ted Baker boss Ray Kelvin quits after 'forced hugging' claims' *The Guardian* (London 4 March 2019) <www.theguardian.com/business/2019/mar/04/ted-baker-boss-ray-kelvin-quits> accessed 9 September 2019.

price had been on the decline for the past couple of years.[331] By the time of the announcement in December 2019, Ted Baker's shares had lost almost 90% of their value following a series of profit warnings.[332] The latest inventory mishap at Ted Baker came to light after a preliminary assessment estimated a £20-£25 million hole in the company's accounts.[333] Less than a month later, the true extent of Ted Baker's overstatement was revealed to be more than £58 million, more than double the initial estimate and resulted in a £20.2 million inventory overstatement for the year ended January 2019.[334]

4.5.2 The governance failure

To understand what contributed to the governance failure at Ted Baker, the first aspect to be analysed is the company's corporate governance structure. Unlike the majority of FTSE 350 companies, Ted Baker's corporate governance structure differed in one significant aspect: the majority shareholder, Ray Kelvin, was also the founder and the chief executive since 1988. His resignation in March 2019 marked the end of 31 years at the helm, though he maintained his majority shareholding. Ray Kelvin's long tenure as chief executive and majority shareholder would have undoubtedly played a role in shaping Ted Baker's governance structure. Although his shareholding was reduced to 35% by 2019.[335] Even then the size of his shareholding would have made it unlikely that shareholder resolutions could have passed without his approval.[336] More recently, Kelvin's shareholding was reduced to 15.8%. As a result, he is no longer the majority shareholder for the first time in the company's history.

It is important to point out that for all intents and purposes, Ted Baker's corporate

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[331] Ted Baker, 'Share Price Data Chart' (*Ted Baker PLC,* <http://www.tedbakerplc.com/investor-relations/share-price-data-charting/share-price-data-chart> accessed 9 December 2020.

[332] McCormick (n 327).

[333] Investegate, 'Ted Baker PLC Update on Independent Review of Inventory' (*Investegate,* 22 January 2020) <www.investegate.co.uk/ted-baker-plc--ted-/rns/update-on-independent-review-of-inventory/202001220700065583A/> accessed 9 March 2020.

[334] Investegate, 'Ted Baker PLC Final Results' (*Investegate,* 1 June 2020) <www.investegate.co.uk/ted-baker-plc--ted-/rns/final-results/202006010700085005O/> accessed 9 September 2020.

[335] Sean Farrell, 'Ted Baker's former boss Ray Kelvin said to be considering buyout' *The Guardian* (London 22 July 2019) <www.theguardian.com/business/2019/jul/22/ted-baker-former-boss-ray-kelvin-considering-buyout> accessed 9 September 2020.

[336] Ted Baker, 'Annual Report and Financial Statements for the 52 weeks ended 25 January 2020' Companies House <https://find-and-update.company-information.service.gov.uk/company/03393836/> accessed 26 June 2021.

governance structure appeared compliant with the requirements of the UKCG. The board was made up of six directors, four of which were described as NEDs. The roles of chairman and chief executive were separate, distinct and clearly defined. However, a more detailed review of the tenure of Ted Baker's directors reveals potential threats to their objectivity and effectiveness. For instance, at the time of the failure, Ron Steward was the chair of Ted Baker's AudCom for 11 years and was also the senior independent director (SID). Former chief executive Lindsay Page was finance director for 22 years before his appointment to chief executive in 2019. David Bernstein, the former executive chairman was a NED for over 15 years before being appointed as executive chairman in 2019. Despite their rather long tenure on the board, they were still listed as independent NEDs with no explanation as to how their continued independence has been maintained. It has already been observed that the length of directorships can negatively impact director effectiveness.[337] Unlike other companies that tend to include boiler-plate explanations for the rigorous process used to assess directors' independence in the circumstances, Ted Baker's annual report did not provide an explanation or justification. Arguably, this could be considered a technical breach of the code by failing to disclose how the company assessed the independence of the aforementioned directors in the circumstances. However, under UK corporate governance the adequacy of disclosures is ultimately assessed by the market.[338]

Notwithstanding the above, in analysing the corporate governance failure at Ted Baker two aspects can be identified as key contributing factors: (i) failure of internal controls and (ii) audit failure. Each will now be addressed in turn.

Failure of internal controls

As discussed in Chapter 3, Cadbury acknowledged the important role of internal controls in effective corporate governance. Nevertheless, despite years of internal control guidelines by the accounting profession, yet again another corporate governance scandal had been linked to another failure of internal controls. Under UK corporate governance, ultimately, the board of directors at Ted Baker was responsible for the design and implementation of effective internal controls. To

[337] Noel O'Sullivan and Pauline Wong, 'Board composition, ownership structure and hostile takeovers: Some UK evidence' (1999) 29 Accounting and Business Research 139.

[338] MacNeil and Li (n 160); Laura F Spira and Michael Page, 'Regulation by disclosure: the case of internal control' (2010) 14 Journal of Management & Governance 409.

avoid a one size fits all approach, corporate governance regulations allow companies the flexibility to design internal control systems based on their circumstances.

It is very interesting to note that this was not the first time Ted Baker experienced an internal control failure over inventory. A former Ted Baker employee was found guilty and sentenced to three years for stealing over £2 million worth of inventory from a distribution centre between 2003 and 2008. The theft together with legal fees would cost the company over £5 million.[339] Interestingly, the theft went on for 5 years before it was discovered and in each of those years, the directors reported in the company's annual report that the internal controls systems were reviewed and were effective. The reality was clearly different. Again, this is yet another example of the annual report failing to indicate serious governance deficiencies, which later come to light.

Nevertheless, the company's internal controls over inventory would again be in the spotlight years later. According to the 2020 annual report, the inventory overstatement was due 'to inappropriate cost values being attributed to inventory, inventory reflected on the balance sheet which did not physically exist and intercompany profit in stock that was not adjusted for in previous calculations.'[340] Arguably effective safeguards over the company's inventory should have uncovered this material misstatement beforehand. Most notable in the company's explanation is the reference to inventory that did not exist. The inclusion of inventory that does not physically exists on the company inventory ledger is serious cause for concern and suggests misconduct within the company. Furthermore, given the company's history with deficiencies in its internal controls for inventory, the recent misstatement suggests that the board failed to adequately address and improve inventory controls and reporting.

Audit failure

Like many of the scandals before it, the overstatement of inventory at Ted Baker represented yet another failure of the auditors to detect material irregularities. At the time of the announcement, KPMG had acted as Ted Baker's auditor for over 19

[339] *Ted Baker v AXA Insurance* (n 329).

[340] Ted Baker, 'Annual Report and Financial Statements for the 52 weeks ended 25 January 2020' (n 336) 4.

years, since 2000.[341] However, the auditor-client relationship between KPMG and Ted Baker was subject to controversy before. In 2018 KPMG was fined £2 million by the FRC for a breach of ethics in relation to the provision of non-audit services for being an expert witness during an insurance dispute with AXA following the theft of inventory by one of its employees.[342] Months before Ted Baker announced the material irregularities regarding the 2019 inventory value KPMG's audit report showed no indication of trouble. Given KPMG's materiality level of £2.5 million, the £58 million restatement of inventory which followed suggests serious failures with KPMG's audit planning and procedures and role in assessing the effectiveness of internal controls.

Auditors have long argued that they are not responsible for detecting material misstatements and financial statement fraud. The auditors are required to understand the internal control system relevant to financial reporting, assess the risk and design the audit tests to reach an opinion that the system is effective.[343] Nevertheless, the issue of internal controls in corporate governance and audit in the UK has been an ongoing issue dating back to Cadbury. According to the Independent Forum of Independent Audit Regulators (IFIAR), internal controls account for 24% of audit deficiencies.[344] In an attempt to explain this, the ICAEW attributes the internal control deficiencies to a lack of IT specialists among auditors.[345] This is especially true for large multinational corporations such as Ted Baker which would undoubtedly have a complex IT system for inventory controls. The complexity of Ted Baker's inventory accounting system was highlighted following the theft of inventory by employees. After conducting an internal investigation, the company still could not account for the discrepancies in inventory. Interestingly, the company's system of internal controls appears to have failed to detect the inventory discrepancies. Were it not for the tip-off from another Ted Baker employee, the inventory fraud may have continued to go undetected.

Given that inventory accounts for 45% of Ted Baker's total assets, the accuracy of

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[341] Katie Martin and Oliver Ralph, 'KPMG fined £2m for misconduct related to work for Ted Baker' *Financial Times* (London 20 August 2018) <www.ft.com/content/2ea1be48-a440-11e8-926a-7342fe5e173f> accessed 19 March 2019.

[342] ibid.

[343] ICAEW, *Risk assessment and internal controls: continuing challenges for auditors* (ICAEW 2015).

[344] ibid 9.

[345] ibid.

inventory is undoubtedly material to the financial statements. While attributing incorrect cost values to stock can be chalked up to human error, the inclusion of inventory that did not actually exist calls into question the effectiveness of Ted Baker's internal controls. Furthermore, given that millions worth of inventory was non-existent yet remained undetected in previous stock counts raises serious questions regarding the effectiveness of the company's internal audit function.

In line with UK corporate governance, the responsibility for monitoring the effectiveness of internal controls and the internal audit function at Ted Baker was delegated to the AudCom, chaired by long-time director Ron Steward. Again, while technically compliant with the AudCom composition requirements, Ron Steward's finance experience was predominantly in corporate banking at the Royal Bank of Scotland. His 39 years of banking experience coupled with his long tenure on the board does call into question his effectiveness as head of the AudCom. This raises important questions regarding whether his experience in corporate banking was relevant to the role and responsibilities of the AudCom chair and whether this experience adequately prepared him to challenge inventory accounting. Furthermore, Steward was the only member on Ted Baker's AudCom with finance experience. IAS 2 inventory accounting, unlikely a career in corporate banking would have IAS 2, the accounting standard for valuing inventory in the financial statements, which requires inventory to be valued as the lower of cost or net realisable value.

4.5.3 Sanctions

To date, there has been no formal investigation by UK regulators into Ted Baker's £58 million inventory restatement. However, the directors have acknowledged the possibility of civil or criminal sanction following the 2019 restatement.[346] In the aftermath of the failure, there were a series of board changes and an internal review of misconduct which has yet to be concluded. Former chief executive and finance director at the time of the inventory misstatement, Lindsay Page resigned in the aftermath of the scandal. As the financial director Page would have had direct oversight responsibility for the effective implementation of the company's system of internal controls.

[346] Ted Baker, 'Annual Report and Financial Statements for the 52 weeks ended 25 January 2020' (n 336) 4.

Unlike Tesco which was fined for market abuse by the FCA in the aftermath of the £245 million profit restatement, Ted Baker faced no such charges. Although both companies announced a restatement, the enforcement approach appears to have differed. When considered in conjunction with Tesco's accounting restatement, the FCA's lack of enforcement brings into question whether this represents another case of selective enforcement. Perhaps this can be explained by the type of overstatement.

Unlike the overstatement at Ted Baker which affected the balance sheet, the Tesco fiasco was the result of a profit overstatement. Nevertheless, both instances would have affected the share price and valuation of the company. Perhaps the key difference lies in the fact that Tesco issued a profit estimation in the months leading up to the overstatement, unlike Ted Baker which issued a series of profit warnings in the lead up to the overstatement. As a result of Tesco's positive profit estimation, several investors purchased shares which were overvalued. On the other hand, Ted Baker's profit warnings were already an indication of trouble to investors. Given the FCA's risk-based approach to enforcement based on the seriousness of the harm caused, it can be argued that Ted Baker's misstatement does warrant its intervention and is not in the public interest.[347] Instead, the failure of internal controls is a matter between the company and its shareholders. Ultimately, corporate governance regulations in the UK aim not to overreach in the relationship between the company and its shareholders, on the basis that it is up to the shareholders to force changes to the management of the company.

Since the scandal, calls for the UK's audit watchdog, the FRC, to investigate KPMG's role in the overstatement have gone unanswered. The Big Four auditing firm also found itself in the spotlight of the overstatement of several other UK companies including Halfords[348] and M&C Saatchi.[349] To date, it appears that KPMG has escaped liability for its role in the corporate governance failures at Ted Baker. Given that the company's internal misconduct investigation remains ongoing,

[347] Financial Conduct Authority, *FCA Mission: Approach to Enforcement* (FCA, 2019).

[348] Tabby Kinder and Jonathan Eley, 'Halfords accounts change puts KPMG in spotlight' *Financial Times* (London 12 November 2019) <www.ft.com/content/64808924-04a5-11ea-a984-fbbacad9e7dd> accessed 9 September 2021.

[349] Michael O'Dwyer and Alex Barker, 'Senior KPMG executive faces scrutiny over M&C Saatchi audits' *Financial Times* (London 12 April 2021) <www.ft.com/content/931792fc-cb7f-4b00-af93-dad1811c6ce1> accessed 9 September 2021.

it is not prudent to completely rule out the possibility of an investigation into the Ted Baker overstatement by UK authorities in the future.

4.6 CONCLUSION

While the UK's comply or explain approach is not considered a rigid framework and has been imitated by many other countries, the current corporate governance regulations do not appear to go far enough to prevent and deter corporate misconduct. Instead, the voluntary compliance mandatory disclosure regime has been applied as a tick-box approach and has resulted in a significant number of disclosures. As seen in many instances of corporate failures that have occurred and as illustrated by the companies examined in this chapter, all reported compliance with the UK corporate governance regulations. History has shown that reliance on published financial reports is not necessarily reliable or reflective of the true circumstances. Therefore, measuring the effectiveness of corporate governance in the UK by compliance does not truly reflect the effectiveness of regulations in preventing and deterring corporate misconduct.

Ultimately, corporate governance systems continue to fail at the hurdle of internal controls and audit failure. A system built on enforcement by shareholders places significant reliance on the effectiveness of the external auditor. Time and time again auditors have failed and continue to fail as the watchdogs of financial regulation. Therefore, a system built on this is effectively built on a flawed foundation at best. Furthermore, corporate governance regulations and reforms in the UK have failed to tackle the accounting weaknesses that led to corporate scandals of the past remain, namely the subjective nature of accounting standards, in particular revenue recognition.

Chapter 5
ENFORCING CORPORATE GOVERNANCE IN THE UK

'If people are good only because they fear punishment, and hope for reward, then we are a sorry lot indeed.'
– Albert Einstein[350]

5.1 INTRODUCTION

The previous chapter evaluated corporate governance failures in the UK. This chapter evaluates corporate governance enforcement in the UK. The chapter proceeds as follows: Section 5.2 provides an overview of the landscape of companies registered in the UK. Section 5.3 examines the legislative and enforcement framework for corporate governance in the UK. Section 5.4 evaluates the public enforcement mechanisms in the UK. Section 5.5 concludes.

5.2 CORPORATE LANDSCAPE

Before analysing the effectiveness of the UK's approach to enforcing corporate governance failures, it is important to first understand the make-up of companies incorporated in the UK. As previously mentioned, the UK corporate governance code is only applicable to companies listed on the Main Market of the LSE. As shown in Table 1, the number of public companies in the UK has seen a general decline over the past decade decreasing by 15% between 2015 and 2021. Conversely, the number of private companies in the UK has been on the rise; increasing by 28% over the same period.

Although there are over four million companies registered in the UK, roughly 96.4% of companies registered in the UK automatically fall outside the scope of the UKCG and therefore are not subject to the provisions. Furthermore, roughly 0.15% of all companies registered in the UK are public companies. However, it is important to note that not all public companies are listed on the LSE.

[350] Albert Einstein, Winner of the 1921 Nobel Prize for Physics.

Table 1: Companies registered in the UK, 2015-2021 (thousands)

Year	Type of Company		
	Private	Public	Other corporate body
2015-16	3671.7	7.14	124.9
2016-17	3889.8	6.94	131.6
2017-18	4026.6	6.76	146.5
2018-19	4191.2	6.53	155.9
2019-20	4340.3	6.20	161.4
2020-21	4705.6	6.10	169.4
Mean	4137.5	6.6	148.3

Source: Companies House, *Activities Register* 2015-2021. "Other corporate body" shows Limited Liability Partnerships, Charitable Incorporated Organisations, Limited Partnerships, Overseas Companies, Registered Societies and Scottish Charitable Incorporated Organisations.

As shown in Table 1, there are over six thousand public companies registered in the UK. However, less than 1% of these are listed on the Main Market of the LSE, and therefore subject to the provisions of the UKCG. In other words, the UKCG is only applicable to 0.027% of companies registered in the UK.

Table 2: Companies listed on the London Stock Exchange

Year	Main Market	AIM	Total
2015	1257	1044	2301
2016	1256	982	2238
2017	1162	958	2120
2018	1166	921	2087
2019	1143	862	2005
2020	1125	818	1943
2021	1127	850	1977
Mean	1177	919	2096

Source: London Stock Exchange, Issuer List 2015-2021.

It is important however, to point out that the UKCG does not include sanctions for non-compliance. This means that the UK relies on supplementary legislation, such as the Fraud Act 2006 and Theft Act 1968 to enforce corporate misconduct. Taking into consideration the relatively small number of publicly listed companies in the UK that are subject to the provisions of the UKCG, it begs the question of whether it is necessary for the UKCG to include direct sanctions for non-compliance.

Furthermore, over 98% of companies registered in the UK are privately owned and are subject to the same indirect sanctions for corporate misconduct. This suggests that the weaknesses of the UK system of corporate governance lies not with its comply or explain approach. Instead, it can be argued that the weaknesses are rooted in how the system enforces serious instances of corporate misconduct. The following section will explore the UK regulatory enforcement framework.

5.3 ENFORCEMENT FRAMEWORK

An effective system of governance should be comprised not only of laws and regulations but should also include adequate enforcement mechanisms. While Chapter 3 discussed the regulatory corporate governance framework in the UK, this section focuses on the UK corporate governance enforcement framework. The effectiveness of laws and regulations to deter corporate misconduct has been the subject of debate for many years.[351] Although the UK does not have direct sanctions for breaches of the UKCG given the comply or explain approach, the UK statute book does include indirect sanctions to hold directors accountable, in the aftermath of corporate governance failures.

5.3.1 Legislative framework

Inherent to the UK approach to corporate governance is the comply or explain approach, which relies on voluntary compliance to a code of best practice with no legal backing and is therefore non-binding. However, despite UK companies reporting compliance with the code, instances of corporate misconduct continue to emerge and the UK has been criticised for failing to effectively enforce corporate governance.

As illustrated in Chapter 4, which examined instances of corporate governance failures in the UK in the past decade, the majority of directors in the UK have faced little or no sanctions in the aftermath of some of the biggest corporate governance scandals. Given that the UKCG has no legal backing, corporate governance enforcement in the UK therefore relies on supplementary legislation.

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[351] See Gary S Becker and George J Stigler, 'Law Enforcement, Malfeasance, and Compensation of Enforcers' (1974) 3 The Journal of Legal Studies 1; Andrew Keay, 'Company directors behaving poorly: disciplinary options for shareholders' (2007) Journal of Business Law 656; Keay, 'The Public Enforcement of Directors' Duties: A Normative Inquiry (n 3)'; Andrew Keay, 'An Assessment of Private Enforcement Actions for Directors’ Breaches of Duty' (2014) 33 Civil Justice Quarterly 76; William M Landes and Richard A Posner, 'The private enforcement of law' (1975) 4 The Journal of Legal Studies 1; Millstein and others (n 3).

Table 3: Overview of sanctions available for corporate wrong-doing in the UK

Statute	Section	Offence
Theft Act 1968	17	False accounting
	19	False statements by company directors
Criminal Justice Act 1993	52	Insider dealing
Bribery Act 2010	2	Bribing another person
	3	Being bribed
	7	Failure of commercial organisation to prevent bribery
Modern Slavery Act 2015	54	Modern slavery statement
Proceeds of Crime Act 2002	327	Concealing criminal property
Companies Act 2006	387	Duty to keep accounting records
	501	Misleading, false or deceptive statements to an auditor
	993	Fraudulent trading
Fraud Act 2006	2	Fraud by false representation
	3	Fraud by failing to disclose
	4	Fraud by abuse of position
	6	Possession of articles for use in fraud
Insolvency Act 1986	89	False declarations of solvency
	206	Fraud in anticipation of winding up
	208	Misconduct in the course of winding up
	211	False representation to creditors
	213	Fraudulent trading
	214	Wrongful trading
Company Director Disqualification Act 1986	2	Disqualification on conviction of an indictable offence
	3	Disqualification for persistent breaches of companies legislation
	4	Disqualification for fraud in winding-up
	5	Disqualification on summary conviction
	6	Duty of court to disqualify unfit directors of insolvent companies
	14	Acting in contravention of a disqualification order
Financial Services Market Act 2000	346	Provision of false or misleading information to auditors
	397	Misleading statements
Financial Services Act 2012	89	Misleading statements
	90	Misleading impression

Although not an exhaustive list, Table 3 shows some of the sanctions on the UK statute book for corporate misconduct. Most importantly however, Table 3 illustrates that the UK does indeed appear to have the legislative framework to enforce corporate misconduct that stems from governance failures. In other words, it can be argued that the continued instances of corporate failures by which directors tend to escape almost unscathed in the UK, stem instead from a lack of effective enforcement. In fact, the UK Corruption Watchdog, Transparency International, has repeatedly criticised the UK for failure to effectively combat economic crime, with £100 billion of dirty money passing through the UK system every year.[352] This view was also expressed by Dame Margaret Hodge, the former chair of the Public Accounts Committee who criticised the 'weak and toothless enforcement agencies' in the UK.[353] However, as evidenced by Table 3, UK regulators have long had remedies available to enforce corporate misconduct irrespective of whether the company is subject to the provisions of the UKCG.

As mentioned in the previous chapter, the case of Autonomy provided an ideal opportunity to compare the enforcement framework in the UK and the United States. While the U.S. authorities have successfully prosecuted Hussain, the former chief financial officer, the UK authorities were unable to do so. While the Autonomy scandal was the result of a series of governance failures, it is interesting to point out here that Hussain was not prosecuted under Sarbanes Oxley, instead he was indicted for wire fraud offences in violation of Title 18 of United States Code (U.S.C).[354] The inability of SFO to prosecute Hussain or Lynch lies not with a lack of available statutes but stems from a lack of skills and experience as originally identified in the de Grazia report.[355] The case of Autonomy also supports the view that it is not necessary for the UKCG to include sanctions if supplementary legislation is available to address serious instances of corporate misconduct.

Furthermore, the case of Autonomy was not the first time the U.S. prosecutors were successful while their UK counterparts were not. For instance, in the case of Unaoil, the DOJ was able to secure guilty pleas from company executives for offences against the Foreign Corrupt Practices Act 1977 (FCPA 1977).[356] On the other hand,

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[352] Transparency International UK, 'Overview: Corruption Statistics' (*Transparency International UK,* <www.transparency.org.uk/corruption-statistics> accessed 9 December 2021.

[353] Rowena Mason, 'MP warns of financial corruption in UK escaping 'toothless' enforcers' *The Guardian* (London 2 December 2021) <www.theguardian.com/politics/2021/dec/01/mp-warns-of-financial-corruption-in-uk-escaping-toothless-enforcers> accessed 19 December 2021.

[354] US Department of Justice, 'Former Autonomy CFO Sentenced To 60 Months In Prison' (*DOJ,* 13 May 2019) <www.justice.gov/usao-ndca/pr/former-autonomy-cfo-sentenced-60-months-prison> accessed 9 December 2019.

[355] de Grazia (n 218).

[356] US Department of Justice, 'Oil Executives Plead Guilty for Roles in Bribery Scheme Involving Foreign Officials' (*DOJ,* 30 October 2019) <www.justice.gov/opa/pr/oil-executives-plead-guilty-roles-bribery-scheme-involving-foreign-officials> accessed 19 March 2020.

the convictions by UK authorities in the Unaoil case have been overturned.[357] These instances support the view that U.S. authorities are more successful in prosecuting instances of corporate misconduct. Interestingly, yet again the Unaoil executives were not charged under Sarbanes-Oxley. Consequently, the lack of sanctions in the UKCG should not be considered the primary impediment to UK enforcement, as U.S. counterparts were able to secure convictions in instances of corporate misconduct without reliance on the sanctions in Sarbanes-Oxley. Furthermore, even in the case of Enron which led to the passage of Sarbanes-Oxley, U.S. authorities used existing legislation to hold Enron executives to account, for what was at the time the largest corporate governance failure in U.S. history.

The arguments presented in this section suggest that the UK does have the legislative framework to combat corporate misconduct, and by extension serious instances of corporate governance failures. However, it is important to point out here that since the UK voted to leave the EU, the UK government has repeatedly stated its intention to relax regulations to increase competitiveness and attract businesses to the UK.[358] This drive towards deregulation with the aim of achieving the new UK vision of 'Singapore on the Thames' is unlikely to lead to a strengthening of the UK's current enforcement framework.[359]

5.3.2 Enforcement Framework

The previous section discussed the legislative framework for enforcing instances of corporate misconduct. This section will examine the framework for how instances of corporate misconduct in the UK can be enforced and the mechanisms available to hold directors accountable. As shown in Figure 6, the UK system includes both public and private enforcement mechanisms for corporate misconduct. Nevertheless, the UK's regulatory enforcement system has been criticised for being cumbersome and ineffective' with over 700 'overlapping and uncoordinated

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[357] Ellen Milligan, 'A Botched Bribery Case Prompts Calls for SFO Reform' (*Bloomberg,* 30 December 2021) <www.bloomberg.com/news/articles/2021-12-30/a-botched-bribery-case-prompts-calls-for-sfo-reform> accessed 9 January 2021.

[358] Daniel Thomas, Philip Strafford and George Parker, 'Ministers plan overhaul of capital market rules to boost City' *Financial Times* (London 11 March 2021) <www.ft.com/content/38708475-a61f-4795-9622-247a67822738> accessed 9 December 2021.

[359] Howard Davies, 'Will the UK really turn into 'Singapore-on-Thames' after Brexit?' *The Guardian* (London 17 December 2019) <www.theguardian.com/business/2019/dec/17/uk-singapore-on-thames-brexit-france> accessed 9 March 2020.

regulators.'[360] According to Sikka, 41 regulators deal with the financial sector, 25 regulators with money laundering and five regulators with auditing and accounting.[361] Perhaps then it is not surprising that the UK has continued to suffer from a lack of co-ordination and co-operation between regulators, which has undoubtedly contributed to the failure to effectively enforce laws and regulations.

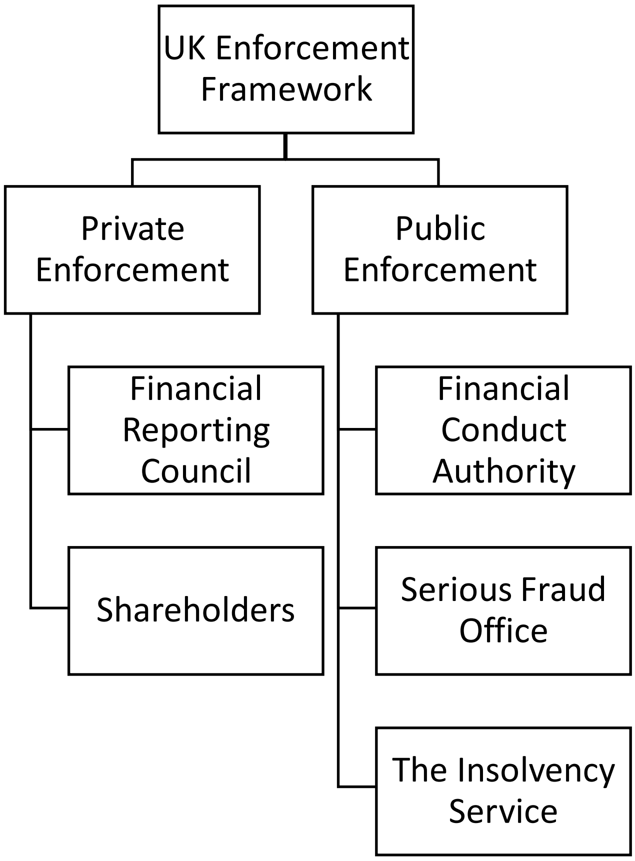

Figure 6: UK corporate governance enforcement framework

As illustrated in Figure 6, there are three primary public agencies responsible for enforcing corporate misconduct; the Financial Conduct Authority (FCA), the Serious Fraud Office (SFO) and the Insolvency Service (IS). It is important to point out here, that instances of corporate misconduct are also investigated by the local police and prosecuted by the Crown Prosecution Service (CPS). For instance, CPS prosecuted

[360] Prem Sikka, 'The UK's regulatory maze benefits the powerful. It's time for an overhaul' (*Left Foot Forward,* 22 November 2019) <https://leftfootforward.org/2019/11/cut-a-swathe-to-clean-up-the-uk-regulatory-maze-around-finance/> accessed 9 May 2020.

[361] ibid.

10,000 economic crime cases during 2020/21.[362] In addition to the public enforcement regulators, the UK system includes private enforcement mechanisms which enable shareholders to hold directors accountable. This also includes the FRC, which is a private body independent of the government, charged with the oversight of the auditing profession.

5.4 PUBLIC ENFORCEMENT

Public enforcement as a means of deterring corporate misconduct continues to be a subject of debate. While the UK does not have direct sanctions for non-compliance to the UKCG, there are several public enforcement bodies empowered to impose sanctions in cases of corporate misconduct. Nevertheless, the UK continues to experience instances of corporate misconduct which continue to call into question the effectiveness of the UK's regulatory bodies in enforcing and deterring corporate misconduct.

This section will consider the effectiveness of the FCA, the SFO and the IS. Each will now be addressed in turn.

5.4.1 Financial Conduct Authority

Before the FCA was established in 2013, the Financial Services Authority (FSA) was the UK's sole financial regulator. This singular regulatory approach to the financial sector was criticised following a series of banking failings, such as HBOS and RBS. Consequently, the FSA was subsequently replaced by the FCA and the Prudential Regulatory Authority (PRA). Under the new system, the PRA would regulate banks, building societies, credit unions, insurers and large investment firms and be overseen by the Bank of England. The FCA would function as the UK's listing authority and securities regulator with a single strategic objective; ensuring financial markets function well.[363] As the regulator of the UK's primary market, the FCA oversees the LSE, including publishing, maintaining and enforcing the Listing Rules.

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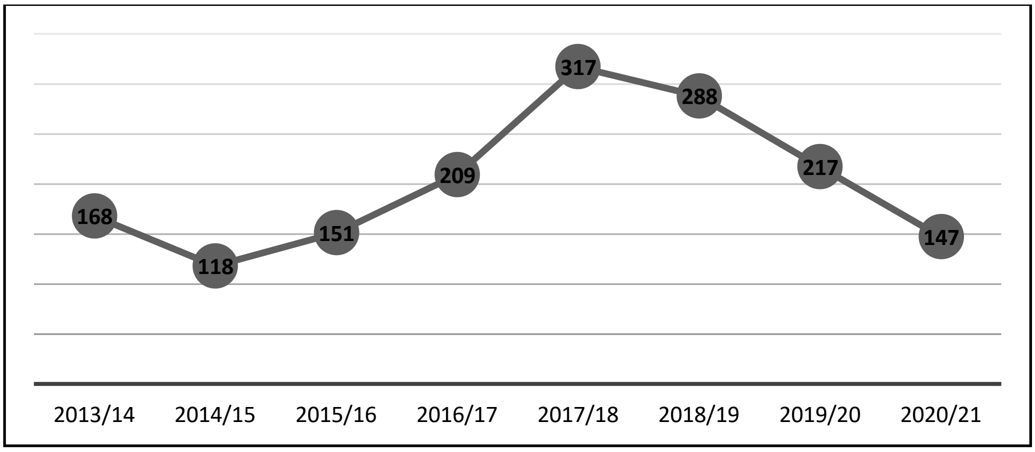
[362] Crown Prosecution Service, 'CPS launches ambitious plan to combat economic crime' (*CPS,* 30 March 2021) <www.cps.gov.uk/cps/news/cps-launches-ambitious-plan-combat-economic-crime> accessed 15 August 2021.

[363] Financial Conduct Authority, *FCA Mission: Approach to Enforcement* (n 347) 5.

With regard to its enforcement powers, the FCA does not consider enforcement as the only regulatory tool available in instances of misconduct.[364] According to the FCA, penalties are based on the principles of disgorgement, discipline and deterrence.[365] However, the FCA has adopted a risk-based approach to enforcement. This risk-based approach focuses on breaches that amount to serious misconduct and result in serious harm. Nevertheless, the FCA has a wide range of criminal and civil enforcement powers including withdrawing or suspending a listing, censuring, imposing financial penalties, seeking restitution and prosecution.[366]

Figure 7: FCA enforcement outcomes, 2013-2021



Source: FCA, *Annual Report Enforcement data*, 2013-2021

Despite being the UK's regulator for over 51,000 businesses, the total number of enforcement outcomes by the FCA appears significantly low, as shown in Figure 7.[367] From 01 April 2013 to 31 March 2021 there was a total of 1615 enforcement outcomes imposed by the FCA. This represents an average of 202 enforcement outcomes per annum. Most noticeable however from Figure 7, is the significant decrease in the total number of enforcement outcomes in the last four years, from a high of 317 enforcement outcomes in 2017/18. This signifies a 53.6% decrease in the total number of enforcement outcomes between 1 April 2017 and 31 March

[364] Financial Conduct Authority, 'FCA Handbook' (*FCA,* 7 November 2020) <www.handbook.fca.org.uk> accessed 7 November 2020.

[365] ibid para 6.5.

[366] Financial Conduct Authority, 'Enforcement' (*FCA,* 22 April 2016) <www.fca.org.uk/about/enforcement> accessed 9 December 2019.

[367] Financial Conduct Authority, 'About the FCA' (*FCA,* 20 April 2016) <www.fca.org.uk/about/the-fca> accessed 9 May 2019.

2021. Although the number of listed companies has decreased in the same period, it can be argued that the decline in the number of enforcement outcomes by the FCA cannot be wholly attributed to the decrease in the number of listed companies, as shown in Table 1.

Given the total number of businesses regulated by the FCA and the annual average number of enforcement outcomes, the FCA has an average enforcement rate of 0.4%. In other words, less than 1% of companies regulated by the FCA have faced sanctions for misconduct. At first glance, this low level of enforcement could be indicative of low levels of misconduct. However, it is important to point out that many of the largest Ponzi schemes and corporate scandals were not discovered until after the house of cards had already collapsed or was on the verge of collapse. This includes cases such as Enron in the U.S., Carillion in the UK and Wirecard in Germany. In each of those scandals, misconduct went undetected by regulators until it was too late. Therefore, it can be argued that low levels of enforcement cannot be used to measure the impact of enforcement on underlying misconduct.

Criminal sanctions

As a regulatory body, the FCA can prosecute any offence that is consistent with meeting its' statutory objectives and is not limited to the offences contained in the FSMA 2000.[368] Although breaching the listing rules is not a criminal offence, individuals or companies can be subject to disciplinary sanctions. Nevertheless, as evidenced by Table 4, the FCA has shown a general reluctance to use its criminal enforcement powers. In the eight-year period from 1 April 2013 to 31 March 2021 there were 72 criminal enforcement outcomes. That is an average of nine criminal outcomes per year. While there has been a slight uptick in the number of criminal enforcement outcomes between 2015 and 2019, only approximately 4.4% of the FCA's total number of enforcement outcomes from 1 April 2013 to 31 March 2021 resulted in criminal sanctions.

According to Clark, the average sentence for fraud offences in the UK is 23.5 months.[369] Perhaps the lenient sentences handed down by UK courts for white-

[368] Financial Conduct Authority, 'FCA Handbook' (n 364) EG 12.1.1.

[369] D Clark, 'Average custodial sentence length (ACSL) at all courts to immediate custody in England and Wales in 2021, by offence group' (*Statista,* 14 December 2021) <www.statista.com/statistics/1100192/prison-sentence-length-in-england-and-wales-by-offence/> accessed 9 January 2022.

collar offences also contribute to the FCA's general reluctance to use criminal enforcement. Although the FCA's total enforcement outcomes are generally low, it can be argued that even in the cases where the regulator takes action, the punishment handed down by UK courts is also not sufficient to act as a deterrent. It has also been argued that the UK's approach to determining corporate criminal liability creates high hurdles for prosecutors.[370] For instance, unlike bribery, which is a strict liability offence, fraud includes a mental element and requires prosecutors to prove the defendant acted dishonestly.[371]

Table 4: Criminal enforcement outcomes, 2013-2021

Year	Criminal outcomes
2013/14	4
2014/15	6
2015/16	13
2016/17	11
2017/18	14
2018/19	12
2019/20	9
2020/21	3
Total	72
Mean	9

Source: FCA, *Enforcement data Annual Performance Report* 2013-2021

Civil sanctions

In addition to its criminal prosecution powers, the FCA can also initiate civil proceedings against businesses and individuals. From 1 April 2013 to 31 March 2021 the FCA had 49 civil enforcement outcomes. This represents an average of six civil enforcement outcomes per year, as shown in Table 5.

[370] Jonathan Grimes, Rebecca Niblock and Lorna Madden, 'Corporate criminal liability in the UK: the introduction of deferred prosecution agreements, proposals for further change, and the consequences for officers and senior managers' (2013) Practical Law 1.

[371] Crown Prosecution Service, 'The Fraud Act 2006 - Legal Guidance, Fraud and economic crime' (*CPS,* 16 July 2020) <www.cps.gov.uk/legal-guidance/fraud-act-2006> accessed 19 June 2021.

Table 5: Civil enforcement outcomes, 2013-2021

Year	Civil outcome
2013/14	7
2014/15	4
2015/16	10
2016/17	4
2017/18	14
2018/19	0
2019/20	4
2020/21	6
Total	49
Mean	6

Source: FCA, *Annual Report Enforcement data* 2013-2021

Similar to its criminal enforcement powers, the FCA also appears reluctant to initiate civil proceedings. Compared to the criminal enforcement outcomes as shown in Table 4, the number of civil enforcement incomes are lower than the number of criminal enforcement outcomes. Although the penalties for criminal offences are considered stiffer and by extension more effective than civil sanctions as a deterrent, arguments in favour of civil enforcement include lower costs and a lower burden of proof. Unlike criminal enforcement where the standard of proof is beyond a reasonable doubt, the standard of proof in civil cases is the balance of probabilities. Given that the total number of enforcement actions for the period 1 April 2013 to 31 March 2019 was 1615, this means that there were 1543 civil and regulatory outcomes. In other words, over 95% of the FCA's enforcement outcomes were civil/regulatory in nature.

Regulatory sanctions

In addition to criminal and civil enforcement mechanisms, the FCA has several other disciplinary and regulatory tools available to deter corporate misconduct and maintain trust in financial markets. Regulatory sanctions include restrictions, conditions, limitations, financial penalties, public censure, prohibition, suspension and redress. However, the FCA maintains that formal sanctions are only imposed when the FCA considers it appropriate to do so.[372] This means that many instances

[372] Financial Conduct Authority, 'FCA Handbook' (n 364) EG 7.1.1.

of non-compliance or misconduct are addressed without using formal sanctions.

Table 6: Regulatory outcomes, 2013-2021

Year	Regulatory outcomes
2013/14	157
2014/15	108
2015/16	128
2016/17	194
2017/18	289
2018/19	276
2019/20	204
2020/21	138
Total	1494
Mean	187

Source: FCA, *Annual Report Enforcement data* 2013-2021

During the period 1 April 2013 to 31 March 2021, the FCA issued 1494 regulatory sanctions, which is an average of 187 regulatory outcomes per annum. As illustrated by Table 6, regulatory sanctions appear to be the FCA's preferred mechanism, accounting for over 92% of all FCA enforcement outcomes between 1 April 2013 and 31 March 2021. Nevertheless, it is important to consider this in the wider context given that the FCA regulates the conduct of around 51,000 businesses. This means that during the period 1 April 2013 and 31 March 2021, only 2.9% of businesses regulated by the FCA have faced regulatory sanctions. On this basis, it can be argued that the likelihood of a regulatory sanction is much greater than criminal or civil enforcement.

As shown in Table 7, the FCA's main regulatory sanction appears to be placing limitations and conditions on the company's ability to trade. From 1 April 2013 to 31 March 2021, the FCA reported 1093 variations, cancellations and/or refusals of authorisations to trade. That's an average of 137 outcomes per year and accounts for approximately 73% of total regulatory outcomes during the eight year period. Not surprisingly, the number of variations and limitations for the eight year period to 31 March 2021 exceeds the combined number of criminal and civil enforcement outcomes over the same period, as shown in Table 4 and Table 5 respectively.

As part of the FCA's enforcement powers, the FCA can suspend a company from trading for misconduct or non-compliance, including failure to meet the continuing obligations of listing. Importantly, the corporate governance rules, which are contained in the Disclosure and Transparency Rules (DTR) 7, are part of the continuing obligations. As shown in Table 7, the FCA issued nine suspensions during the period 1 April 2013 to 31 March 2021. This represents an average of one suspension per annum. However, there have been no suspensions in the last two years. Given the relatively low incidence of use, perhaps this is considered the FCA's nuclear option and is therefore only used in the most serious and grave instances of corporate misconduct.

Under the FSMA 2000, the FCA also has the power to issue a public statement/ censure.[373] Importantly, this includes failure to comply with the Listing Rules, Prospectus Regulation Rules, Transparency Rules and corporate governance rules (collectively known as the Part 6 rules). During the period 1 April 2013 to 31 March 2021, the FCA issued 27 public censures. This represents an average of three public censures per annum and 1.8% of all regulatory sanctions over the eight-year period. To put this in a larger context, this means that roughly 0.05% of businesses regulated by the FCA have been publicly censured in the last eight years.

However, it is interesting to note that the FCA issued five public censures in the year ended 31 March 2021. Although still not very substantial given the number of companies the FCA regulates, this represents a 400% increase compared to the year before. Perhaps this illustrates the FCA's acknowledgment that reputational damage can be a powerful motivator to effect change, especially in the age of social media. Public censure can be an important enforcement tool as it uses reputational damage as a means of deterring corporate misconduct. Consequently, this could have a significant impact on the company's market value and can prompt shareholders to take action. On the other hand, given the wide disbursement of shares, it is unlikely that any single shareholder will have the votes to effect change.

[373] See Financial Services and Markets Act 2000, s66, 87M, 88A, 123, 249.

Table 7: Analysis of regulatory outcomes, 2013-2021

Year	Variation/cancellation/refusal of authorisation/approval/permissions	Financial penalty	Public censure	Prohibition	Suspension/ Restriction	Redress/ Restitution	Total
2013/14	80	46	5	26	0	0	157
2014/15	29	43	7	26	3	0	108
2015/16	65	34	4	24	1	0	128
2016/17	149	15	4	23	1	2	194
2017/18	249	16	1	19	2	2	289
2018/19	238	16	0	20	2	0	276
2019/20	176	15	1	12	0	0	204
2020/21	107	10	5	15	0	1	138
Total	1093	195	27	165	9	5	1494
Mean	137	24	3	21	1	1	187

Source: FCA, *Annual Report Enforcement data* 2013-2021

The FCA also has the power to prohibit individuals from engaging in regulated activities. Although an important regulatory tool, this will only be applicable to directors/managers and approved persons of listed companies that are engaged in regulated activities and bound by the individual conduct rules to act with integrity, due skill, care and diligence.[374] From 1 April 2013 to 31 March 2021 the FCA issued 165 prohibitions. This represents 21 prohibitions per annum and 11% of total regulatory outcomes for the eight-year period.

More importantly however, the FCA can also order redress/restitution where a business has breached its duty of care. According to the FCA Handbook, the basic purpose of redress is to put the complainant, so far as is possible, in the position he would have been in if the breach had not occurred.[375] As illustrated by Table 7, the use of redress/restitution appears to be a seldom used power. For the period 1 April 2013 to 31 March 2021, the FCA reported only five redress/restitution outcomes. That's less than one case per year. Perhaps this is not surprising given that the FCA didn't exercise its power to require restitution under section 384 of the FSMA 2000 for over 20 years.

Table 8: Financial penalties, 2013 to 2021

Year	Total Fines		Individual		Firms	
	No. of fines	£m	No. of fines	£m	No. of fines	£m
2013/14	46	£425.0	28	£3.6	18	£421.4
2014/15	43	£1,409.8	20	£6.7	23	£1,403.1
2015/16	34	£884.6	17	£4.2	17	£880.4
2016/17	15	£181.0	9	£0.9	6	£180.1
2017/18	16	£69.9	10	£0.9	6	£69.0
2018/19	16	£227.3	8	£80.2	8	£147.1
2019/20	15	£224.4	3	£0.3	12	£224.1
2020/21	10	£189.8	2	£0.2	8	£189.6
Total	195	£3,611.8	97	£97.0	98	£3,514.8
Mean	24.4	£451.5	12.1	£12.1	12.3	£439.4

Source: FCA, *Enforcement data Annual Performance Report*, 2013-2021

During the period 1 April 2013 to 31 March 2021, the FCA imposed 195 financial penalties, as shown in Table 8. This represents an average of 24 financial penalties

[374] Financial Conduct Authority, 'FCA Handbook' (n 364) COCON 2.1.

[375] ibid DISP App 1.2.1.

per year. While this is more than double the number of criminal enforcement outcomes, the number of financial penalties appears modest given the number of businesses regulated by the FCA. Most noticeable from Table 8 is the almost even split between individuals and firms, with 97 financial penalties imposed against individuals and 98 imposed against firms.

As shown in Table 8, the FCA issued £3.6 billion in financial penalties for the eight-year period between 1 April 2013 to 31 March 2021. That's an average of £451.5 million per annum. However, it is important to point out here that £1.1 billion of the total fines imposed over the eight-year period was imposed against five banks for failings in their foreign exchange (FX) trading operations.[376] At the time it was the FCA's largest financial penalty.[377] Based on Table 8 it appears that remains the case. Interestingly, but perhaps not surprisingly, 97% of the total sum of fines for the eight-year period was imposed against firms, while only 3% was imposed against individuals.

Although it is well established that a company is a separate legal person, it does not have a mind of its own.[378] Therefore, in the case of a publicly listed company, when breaches or misconduct occur arguably it is the board of directors that should be held accountable. However, the concept of collective board responsibility makes it near impossible to determine and assign liability to the board. Consequently, when a fine is issued against the company, arguably it is really the shareholders who are being punished although they do not have any day-to-day involvement in the business. Perhaps the financial penalty against the company is meant to act as a motivator for shareholders to act and effect change. However, as previously mentioned, it is remarkably difficult for shareholders to effect meaningful change.

Another noticeable observation from Table 8, is the 62% decrease in financial penalties in the year 2017/18. This significant decline raises questions on whether the severity of the fines in the preceding years had any impact on the underlying misconduct and therefore acted as a deterrent. However, given the total financial

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[376] Financial Conduct Authority, 'FCA fines five banks £1.1 billion for FX failings and announces industry-wide remediation programme' (*FCA,* 12 November 2014) <www.fca.org.uk/news/press-releases/fca-fines-five-banks-£11-billion-fx-failings-and-announces-industry-wide-remediation-programme> accessed 10 September 2019.

[377] ibid.

[378] *Salomon v Salomon & Co Ltd* [1896] UKHL 1.

penalties increased by 228.9% the following year, that appears to be an unlikely explanation for the comparatively low level of financial penalties in 2017/18. Interestingly, more than 70% of the total fines in 2016/17 were levied against Deutsche Bank for failure to maintain adequate anti-money laundering controls.[379]

Given that corporate governance in the UK places heavy reliance on disclosures, it can be argued that many breaches of corporate governance could also be a breach of the Disclosure and Transparency Rules (DTR). However, the FCA recognises that some disclosures will have a greater impact on the company and the market. In those instances, failure to disclose will be considered serious enough to warrant financial penalties.

Table 9: Cases for breach of the listing rules, 2016-2021

Year	Open as at 1 April	Opened during the year	Closed during the year	Open as at 31 March
2016/17	3	13	2	14
2017/18	14	12	9	17
2018/19	17	3	8	12
2019/20	7	3	3	7
2020/21	7	0	3	4
Total	48	31	25	54
Mean	10	6	5	11

Source: FCA, *Enforcement data Annual Performance Report* 2016-2021. For the year 2018/19, the number of cases open as at 31 March 2019 was originally reported as 12 cases, however the opening cases as at 1 April 2019 was restated to seven cases. The figures for cases opened during the year and closed during the year for 2018/19 were therefore estimated.

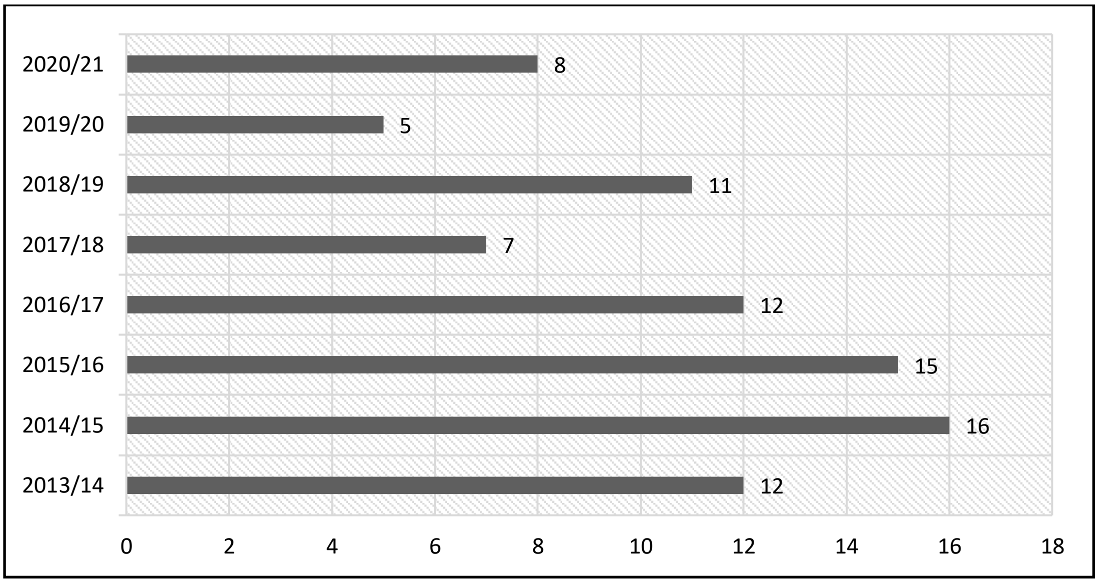
As shown in Table 9, from 1 April 2016 to 31 March 2021 the FCA closed 25 cases for breach of the listing rules, prospectus rules or disclosure rules. This represents an average of five cases per annum. When taking into consideration the average number of companies listed on the LSE (Table 2), the FRC investigated 0.2% of listed companies for breaches of the listing rules. This suggests that the likelihood of detection appears low.

[379] Financial Conduct Authority, 'FCA fines Deutsche Bank £163 million for serious anti-money laundering controls failings' (*FCA,* 31 January 2017) <www.fca.org.uk/news/press-releases/fca-fines-deutsche-bank-163-million-anti-money-laundering-controls-failure> accessed 8 July 2019.

5.4.2 Serious Fraud Office

Although no system of corporate governance can prevent all instances of corporate misconduct, egregious instances of misconduct continue to call into question the effectiveness of the UK's system of corporate governance. At the forefront of the UK's public enforcement framework for corporate misconduct lies the SFO, which deals exclusively with complex fraud, bribery and corruption. Although the UK does not have direct offences for breaches of the UKCG, many instances of corporate failures have often times been the result of complex fraud and misconduct, which can be prosecuted under several criminal law provisions (see Table 3). While the SFO has been instrumental in prosecuting individuals involved in several high profile scandals, including "the Guinness Four", there have been and continue to be questions regarding the effectiveness of the SFO in deterring corporate misconduct.[380] The purpose of this section is to evaluate the effectiveness of the SFO's enforcement mechanisms as a deterrent to corporate misconduct.

Figure 8: Investigations opened by the SFO, 2013-2021



Source: SFO, Annual Report and Accounts 2010-2021

The scandals that led to the creation of the Cadbury Committee was not the first time trust in the UK's legal and regulatory system was put under the spotlight. The

380 Philip Smith, 'Guinness Four appeal fails' (*AccountancyAge,* 21 December 2001) <www.accountancyage.com/2001/12/21/guinness-four-appeal-fails/> accessed 8 September 2019.

SFO was also the result of a series of corporate scandals in 1970s and 1980s which lead to the creation of the Fraud Trails Committee. The committee concluded that the UK's legal system was 'archaic, cumbersome and unreliable' and included 112 recommendations geared primarily at improving systematic and procedural deficiencies in the UK's fraud prosecution framework.[381] To give effect to the recommendations the UK enacted the Criminal Justice Act 1987 (CJA 1987) which established the SFO and outlined its powers and responsibilities in the fight against fraud.

The SFO's structure and approach is quite unique compared to the CPS, which makes decisions on whether to prosecute following a police investigation. Unlike the CPS, the SFO investigates and prosecutes its own cases. Given the complex nature of corporate failures, there is a distinct advantage in seeing cases through from cradle to grave. Nevertheless, the SFO continues to be the subject of much criticism as an effective enforcement organisation. According to the SFO, its role is 'to investigate and, where appropriate, prosecute cases of serious or complex fraud, bribery and corruption'.[382] However, there is very little guidance on what is considered serious or complex and therefore falls within the SFO's remit. Furthermore, the SFO has complete autonomy over which cases it accepts and its acceptance criteria can at best be considered subjective. This approach has undoubtedly led to a confused agency. This was supported by the HM Crown Prosecution Service Inspectorate report which suggested that the SFO suffered from a possible lack of clarity in its corporate objective.[383]

As illustrated in Figure 8, the SFO opens a relatively small number of investigations per year. From 1 April 2013 to 31 March 2021, the SFO opened 86 investigations. That represents an average of 10 investigations per year. As a law enforcement agency, the SFO has several criminal and civil enforcement powers including civil recovery orders, confiscation orders, compensation orders, unexplained wealth orders and prosecution. The SFO's powers were expanded in 2014 to include DPAs. While civil recovery and confiscation orders are crucial enforcement mechanisms, they are unlikely to act as a deterrent to corporate misconduct as they

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[381] Fraud Trials Committee, *Fraud Trials Committee Report* (HM Stationery Office 1986).

[382] Serious Fraud Office, *Annual Report and Accounts 2019-2020* (SFO 2020) 11.

[383] HM Crown Prosecution Service Inspectorate, *Report of the Attonery General on the inspection of the Serious Fraud Office* (HMCPSI, 2012) 9.

seek not to punish but to deprive wrong-doers of any ill-gotten gains or benefits.

Prosecutions

As previously discussed, the main purpose of enforcement is to deter corporate misconduct. Therefore, it can be argued that the increased likelihood of punishment is a powerful incentive to encourage responsible corporate behaviour. However, the relatively modest number of prosecutions by the SFO combined with its average conviction rate of 68%, as shown in Table 10, continues to call into question its effectiveness to deter corporate misconduct. Despite having been in existence for roughly 20 years at the time of the global financial crisis, it would take another 12 years before any of the executives were prosecuted by the SFO.[384] Given the length of time between the alleged misconduct and the prosecution, perhaps it is not surprising that the executives were acquitted. Consequently, the SFO has been and continues to be subject to intense criticism for its failure to secure convictions.

Table 10: Prosecutions and convictions from 2010-2021

Year	Prosecutions	Convictions	Conviction Rate
2010/11	31	26	84%
2011/12	52	38	73%
2012/13	20	14	70%
2013/14	13	11	85%
2014/15	23	18	78%
2015/16	19	6	32%
2016/17	15	13	87%
2017/18	13	10	77%
2018/19	32	17	53%
2019/20	13	4	31%
2020/21	5	4	80%
Total	236	161	68%
Mean	21	15	

Source: SFO, *Annual Report and Accounts* 2010-2021. Prosecutions show the number of defendants tried. Convictions show the number of defendants convicted.

As seen in Table 10, for the period 1 April 2010 to 31 March 2021, the SFO brought 236 defendants to trial. That represents an average of 21 defendants per year. For

[384] Serious Fraud Office, 'Barclays PLC and Qatar Holding LLC' (*SFO,* 28 February 2020) <www.sfo.gov.uk/cases/barclays-qatar-holding/> accessed 9 September 2020.

an agency that is meant to specialise in complex financial crime, that appears to be a very modest number of prosecutions. However, even more concerning is that roughly 68% of those prosecutions have resulted in convictions. This is an average of 15 defendants convicted per annum. It could be argued that the relatively low level of prosecutions could suggest that underlying corporate misconduct in the UK is minimal. However, using history as a reliable indicator, serious instances of misconduct tend to remain hidden until it's too late. Instead, the modest levels of prosecutions support the view that the SFO is not an effective regulator. For instance, following the Autonomy-HP scandal, the SFO concluded there was 'insufficient evidence' to secure a conviction'.[385] Conversely, the DOJ would later convict the company's chief financial officer for wire fraud relating to the scandal.[386] This latest example continues to demonstrate serious deficiencies in the SFO's enforcement mechanisms and questions, yet again, the effectiveness of the law enforcement agency.

Critics of corporate prosecution often argue that the threat of going out of business is arguably the most powerful incentive and as such financial penalties alone are insufficient to deter corporate misconduct.[387] On the other hand, supporters of corporate prosecution posit that the threat of conviction and its effect on the ability of companies to tender and generate revenue provides the greatest incentive to encourage responsible corporate behaviour.[388] The collapse of accounting firm Arthur Andersen in the U.S. and the loss of 28,000 jobs following its conviction for destruction of documents is often considered one of the most drastic outcomes. Although there is little evidence to support the 'Andersen effect', the UK's approach to corporate prosecution is met with its own hurdles.[389] In defence of the SFO's low corporate conviction rates, legal practitioners argue that corporate criminal liability in the UK 'is stacked against the prosecutor'.[390] This view was supported by the current director of the SFO, Lisa Osofky, who argued that the SFO was 'hamstrung'

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[385] Serious Fraud Office, 'HP Autonomy investigation' (n 212).

[386] US Department of Justice, 'Former Autonomy CFO Sentenced To 60 Months In Prison' (n 354).

[387] Assaf Hamdani and Alon Klement, 'Corporate crime and deterrence' (2008) 61 Stan L Rev 271.

[388] Rick Claypool, *Soft on Corporate Crime: DOJ Refuses to Prosecute Corporate Lawbreakers, Fails to Deter Repeat Offenders* (Public Citizen, 2019).

[389] See Gabriel Markoff, 'Arthur Andersen and the myth of the corporate death penalty: Corporate criminal convictions in the twenty-first century' (2012) 15 U Pa J Bus L 797.

[390] Grimes, Niblock and Madden (n 370).

by the identification principle.[391] Apart from bribery, which is a strict liability offence, most corporate misconduct offences including fraud and false accounting require intent or negligence. However, under the identification principle a company can only be held liable where the misconduct can be attributed to the 'directing will and mind'.[392]

Deferred Prosecution Agreements

Ulhmann argues that prosecution remains the most effective way of combatting corporate crime.[393] However, prosecuting corporate entities is considered to be fraught with difficulty and expense.[394] To address the hurdles faced by prosecutors, UK authorities introduced DPAs with the aim of addressing the problems faced in securing corporate convictions. Although initially reluctant, the SFO later advocated for the use of DPAs as a means of quickly resolving cases of corporate criminal wrongdoing.[395] Shortly after the introduction of DPAs, Ben Morgan, the joint head of Bribery and Corruption at the SFO put forward that DPAs must include an element of punishment and deterrence to be effective.[396] Ultimately, DPAs aim to strike a balance between ensuring adequate use of prosecutors' resources and ensuring corporations are held accountable, by eliminating the lengthy and expensive trial and going straight to the financial penalty.

Nevertheless, the use of DPAs continue to be the subject of much controversy, with several academics arguing that DPAs undermine corporate liability and fail to provide adequate incentives to deter corporate misconduct.[397] However, given that DPAs are limited to companies, it can be argued that it is less likely to undermine

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[391] Bribery Act 2010 Committee, 'Corrected oral evidence: Bribery Act 2010' (*UK Parliament,* 13 November 2018) <http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/bribery-act-2010-committee/bribery-act-2010/oral/92752.html> accessed 8 December 2019.

[392] *Tesco Supermarkets Ltd v Nattrass* [1971] UKHL 1.

[393] David M Uhlmann, 'Deferred Prosecution and Non-Prosecution Agreements and the Erosion of Corporate Criminal Liability' (2013) 72 University of Michigan Law School 1295, 1299.

[394] See Markoff (n 389).

[395] Quoted in Serious Fraud Office, *Serious Fraud Office, deferred prosecution agreements code of practice: Crime and Courts Act 2013* (SFO, 2013) 3 (as cited in Mike Koehler, 'Measuring the Impact of Non-Prosecution and Deferred Prosecution Agreements on Foreign Corrupt Practices Act Enforcement' (2015) 49 UCDL Rev 497, 561).

[396] Ben Morgan, 'The future of Deferred Prosecution Agreements after Rolls-Royce' (*SFO,* 8 March 2017) <www.sfo.gov.uk/2017/03/08/the-future-of-deferred-prosecution-agreements-after-rolls-royce/> accessed 24 June 2020.

[397] Uhlmann (n 393).

issues with assigning liability given that corporate prosecutions often end with the imposition of a financial penalty. Therefore, the effectiveness of DPAs to deter corporate misconduct in these circumstances will therefore be dependent on the severity of the financial penalties. According to the Criminal Justice Act 2003 (CJA 2003) the fine must be 'broadly comparable to the fine a court would have imposed' following a guilty verdict.[398] This ensures there is no unfair advantage to the company by entering into a DPA and companies are therefore subject to the same level of fine, irrespective of the method used to conclude the case.

Table 11: Deferred Prosecution Agreements, 2015 to 2021

Year	No. of DPAs	Financial penalties £000
2015	1	£16.8
2016	1	£0.4
2017	2	£369.7
2018	0	£0.0
2019	2	£19.2
2020	3	£399.8
2021	3	£99.9
Total	12	£905.7
Mean	2	£129.4

Sources: SFO, *Final Notices* 2015-2021; SFO, *Deferred Prosecution Agreements* available at www.sfo.gov.uk/publications/guidance-policy-and-protocols/guidance-for-corporates/deferred-prosecution-agreements. The financial penalty for 2021 excludes penalties for two companies relating to bribery offences which have not been reported due to reporting restrictions.

Since the introduction of DPAs seven years ago, the SFO has entered into 12 such agreements. That represents an average of two DPAs per year. The paltry number of DPAs to date could likely be the result of a steep learning curve by the SFO. In fact, the moderate number of DPAs in the early years of its introduction is quite similar to the trend by the DOJ when the use of DPAs and non-prosecution agreements were first recorded. Between 1992 and 2000, the DOJ entered into 13 DPAs and non-prosecution agreements (NPAs).[399] If trends remain similar, there could be an increase in the use of DPAs in the UK as the SFO becomes familiar and experienced in the process.

[398] Criminal Justice Act 2003, Schedule 17(5)(4).

[399] Uhlmann (n 393) 1316.

As shown in Table 11, between 2015 and 2021, the SFO imposed £905.7 million in financial penalties. That's an average of £129.4 million per year in financial penalties from the use of DPAs. It is also important to note here that nine of the 12 DPAs relate to offences against section 7 of the Bribery Act. In other words, 75% of DPAs relate to a strict liability offence which does not require a mental element. The meagre number of DPAs that relate to corporate wrongdoing, other than bribery, suggests that DPAs have done little to address the problems associated with corporate criminal liability and the identification principle. Instead, DPAs are being used primarily to address strict liability offences which defeat the purpose. For instance, despite entering into a DPA with Tesco, the SFO was unable to secure convictions against the directors. As part of Tesco's DPA, the company did not dispute that three directors were involved in falsifying records.[400] Nevertheless, following a lengthy and expensive trial the directors were acquitted and the effectiveness of the SFO as a prosecutor was again under scrutiny.[401]

The SFO has wide discretion to determine the level of financial penalties to impose. This was illustrated in the case of Guralp Systems Ltd (GSL), where the SFO opted against imposing a financial penalty on the basis of the company's cash flow.[402] In approving the DPA, the court agreed that it was 'fair, reasonable, and proportionate' not to impose a financial penalty because doing so would have put the company out of business.[403] Nevertheless, the company did not escape completely unscathed. Under the terms of the DPA, GSL was required to pay disgorgement of profits of £2.1 million. Interestingly, when compared to their U.S. counterparts, UK courts play a much greater role in approving DPAs. The effective 'rubber-stamping' role of U.S. courts in DPAs was confirmed in *United States v Fokker Services*, where the court noted that the DOJ was the ultimate arbitrator of DPAs.[404] Conversely, UK courts will only approve a DPA if it is found to be in the interest of justice, fair, reasonable and proportionate.[405] Responding directly to critics of DPAs as having an unfair advantage for companies, Davis LJ reiterated the court's role stating that DPAs will

[400] *SFO v Tesco* (n 235).

[401] James Davey, 'Third former Tesco director cleared of fraud over 2014 scandal' (*Reuters,* 23 January 2019) <www.reuters.com/article/us-britain-tesco-fraud-idUSKCN1PH105> accessed 15 Septemebr 2020.

[402] *SFO v Guralp Systems Limited* (Royal Courts of Justice) [42].

[403] ibid [52].

[404] *United States v Fokker Servs BV* 422 US App DC 65, 818 F3d 733 (2016).

[405] *SFO v Serco Geografix Limited* (Royal Courts of Justice) [9].

only be approved where there was 'the clearest possible demonstration of integrity'.[406]

In keeping with the general deterrence effect of statutory punishment, the guidelines for determining financial penalties for corporate wrong-doers are aimed at punishing and deterring misconduct, as well as ensuring any gain is removed.[407] According to the corporate offenders sentencing guidelines 'the fine must be substantial enough to have real economic impact which will bring home to both management and shareholders the need to operate within the law.'[408] In *R v Thames Water Utilities Ltd*, the court refrained from imposing limits on financial penalties. Instead, the court reasoned that financial penalties could be as high as 100% of pre-tax profits based on the severity of the harm and the level of culpability.[409] In *R v Sellafield Limited,* the court concluded that a fine of 2% of weekly profit was sufficient to meet the statutory objectives of a fine in the circumstances.[410] While *Thames Water* and *Sellafield* dealt with penalties for environmental and health and safety misconduct respectively, UK courts have generally applied the same principles in approving DPAs by the SFO.

Several studies have measured the effectiveness of DPAs as a deterrent based on the number of DPAs. While DPAs have resulted in an increase in the quantity of enforcement actions, its effect on the quality of enforcement remains questionable. Koehler posits that measuring the effectiveness of DPAs using the number of DPAs, does not represent the true impact of DPAs as a deterrent.[411] According to Koehler, DPAs merely give the illusion of enforcement as companies enter into DPAs for a variety of reasons, including fear of conviction and the 'Andersen effect'.[412] Instead, the impact of DPAs as a deterrent should be measured by the number of enforcement actions against the directors/managers of the company that have entered into the DPA on the basis that companies do not have a mind of their

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[406] ibid [47].

[407] Sentencing Council, 'Corporate offenders: fraud, bribery and money laundering' (*Sentencing Council,* 2014) <www.sentencingcouncil.org.uk/offences/magistrates-court/item/corporate-offenders-fraud-bribery-and-money-laundering/> accessed 9 October 2020.

[408] ibid.

[409] *R v Thames Water Utilities Ltd* [2015] EWCA Crim 960 [40].

[410] *R v Sellafield Limited* [2014] EWCA Crim 49 [65].

[411] Koehler (n 395) 528.

[412] ibid 528.

own.[413] Applying Koehler's approach to measuring the effectiveness of the SFO's use of DPAs, it would appear that DPAs are not effective as a deterrent on the basis that the SFO has been unable to secure a conviction against any of the individuals involved in the DPA related offences. The cases of Tesco and GSL illustrate this point. Despite entering into DPAs with both Tesco and GSL, the SFO was unable to secure convictions against any of the directors/managers involved.[414] The fact that none of these directors thus far has been successfully prosecuted stemming from DPAs suggests the likelihood of individual liability remains low. Therefore, it can be argued that DPAs do not provide an adequate incentive for deterring corporate misconduct. Given that only two of the twelve DPAs were against listed companies, it can be concluded that the likelihood that a listed company will be subject to a DPA is relatively low. Furthermore, when taking into consideration the average number of companies listed on the Main Market (Table 2), only 0.2% of listed companies have entered into a DPA with the SFO.

5.4.3 The Insolvency Service

As an executive agency of the Department of Business Energy and Industrial Strategy (BEIS), the Insolvency Service (IS) exercises the powers contained in the Companies Act 1985, the CA 2006, the Insolvency Act 1986 (IA 1986) and the CDDA 1986 to hold directors accountable for insolvency related fraud and corporate misconduct. Before 2017, the IS was limited to investigating breaches of company law and insolvency law and criminal prosecutions were referred to the Criminal Enforcement Team of BEIS.

The IS receives its funding primarily from three sources; the BEIS, income from HMRC and fees for insolvency administration.[415] However, as a government regulator, the IS enforcement and investigation activities are funded by the BEIS.[416] This funding arrangement has previously been criticised as "not fit for purpose".[417] For instance, in 2016/17 the IS employed 1394 staff members with total income

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[413] ibid 528.

[414] Davey (n 401); Serious Fraud Office, 'Three individuals acquitted as SFO confirms DPA with Güralp Systems Ltd' (*SFO,* 20 December 2019) <www.sfo.gov.uk/2019/12/20/three-individuals-acquitted-as-sfo-confirms-dpa-with-guralp-systems-ltd/> accessed 9 October 2020.

[415] The Insolvency Service, *Annual Report and Accounts 2020-21* (HM Stationery Office) 38.

[416] ibid 99.

[417] Jane Wild, 'Budget cuts hamper Insolvency Service' *Financial Times* (London 6 February 2013) <www.ft.com/content/e308f96e-6fad-11e2-8785-00144feab49a> accessed 3 October 2018.

from fees of £87 million and brought 97 criminal prosecutions, yet at the end of the financial period, the department barely managed to break even.[418] This supports the view that the IS does not have the financial resources to effectively enforce misconduct over four million companies.

Disqualification of directors

Under the CDDA 1986, the IS can apply to the courts to have an individual banned/disqualified from acting as a company director for a period of two up to 15 years.[419] This was amended by the Insolvency Act 2006 (IA 2006), which allowed the IS to enter into undertakings. Under this new procedure, directors voluntarily disqualify themselves and avoid the need to apply through the courts. Another advantage of directors voluntarily entering into undertakings is the costs associated with court proceedings. The CDDA 1986 includes several grounds for disqualification, including conviction of certain offences, persistent breach of the companies legislation, fraudulent trading, and being an unfit director of an insolvent company.[420]

According to Mavrikakis and others, the majority of disqualification orders (DOs) are issued against unfit directors of an insolvent company.[421] In the absence of imprisonment, DOs are arguably the most direct form of punishment for company directors, as it can have a significant impact on their means of generating income. For instance, directors who have been disqualified under the CDDA 1986 are not permitted to act as lawyers or accountants.[422] Directors that are subject to a DO are also banned from being 'concerned in the management' of a company.[423] This means that the ban extends to acting as a shadow director or to any activity which can be considered as being engaged in the running of a company.

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[418] The Insolvency Service, *Annual Report and Accounts 2016-17* (HM Stationery Office).

[419] Company Director Disqualification Act 2006.

[420] ibid

[421] Alexis Mavrikakis and others, *Business Law and Practice* (College of Law Publishing 2016) 132.

[422] GOV.UK, 'Company director disqualification' (*GOV.UK,* <www.gov.uk/company-director-disqualification> accessed 9 May 2021.

[423] The Insolvency Service, 'Effect of a disqualification' (*GOV.UK,* 21 June 2022) <www.gov.uk/government/publications/corporate-insolvency-effect-of-a-disqualification-order/effect-of-a-disqualification> accessed 9 August 2022.

Table 12: Directors' disqualifications, 2010-2021

Year	Directors disqualified
2010/11	1437
2011/12	1151
2012/13	1031
2013/14	1273
2014/15	1209
2015/16	1208
2016/17	1214
2017/18	1231
2018/19	1242
2019/20	1280
2020/21	981
Total	13,257
Mean	1205

Source: IS, *Annual Report and Accounts* 2010-2021

As shown in Table 12, from 1 April 2010 to 31 March 2021, 13,257 directors were disqualified by the IS. That represents an average of 1205 DOs per year. When compared to Armour's 2008 study on the use of DOs from 1996 to 2006, the average number of disqualifications has reduced by 21.8%, from an average of 1542 DOs per annum.[424] Perhaps this can be explained by the significant decrease in the IS workforce. As at 31 March 2011 the IS employed over 2600 members of staff. By 31 March 2021, the IS workforce was reduced by 32.5% to just over 1800 employees. This is directly in contrast to the number of companies registered in the UK, which has continued to increase over the same period.

Another noticeable observation from Table 12 is the 23.3% decrease in the number of DOs from 2019/20 to 2020/21. When compared to the preceding years, this significant decrease in the number of DOs raises questions about the efficiency of the IS. Although the number of DOs has decreased, it can be argued that this does not signify that DOs have had any impact on underlying corporate misconduct. Instead, the drop in DOs could be explained by changes in how the IS operated during the COVID-19 pandemic when the UK entered into numerous lockdowns between 1 April 2020 and 31 March 2021.

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[424] Armour (n 3) 33.

Although the CDDA 1986 places a 15-year limit on the length of DOs, the courts have wide discretion in determining the length of the DO in each individual case. In *Re Sevenaoaks Stationers Ltd* the courts set out guidelines for deciding the length of the DO.[425] In so doing, the court divided the disqualification periods into three categories; over 10 years, six to ten years and two to five years. Accordingly, periods over 10 years would only be imposed for the most serious offences.

While DOs are used primarily against directors of private companies, the court can also disqualify directors of listed companies. For instance, Tim Coleman, the chief financial officer of Redcentric Plc, was disqualified for 10 years for publishing misleading statements and false accounting.[426] Coleman was also sentenced to five and a half years imprisonment.[427] Coleman engaged in a series of transactions that materially inflated the company's financial position by over £12 million.[428] It is worthwhile pointing out here that Redcentric is an AIM listed company and was therefore not subject to the provisions of the UKCG. Nevertheless, the FCA was able to rely on the Theft Act 1968, the Financial Services Act 2012 and the CA 2006, to hold Coleman accountable.[429] Following Coleman's sentence, the FCA hailed the severity of Coleman's punishment as a message to others and a deterrent to corporate misconduct.[430]

Although the number of DOs seems modest when taking into consideration the number of companies registered in the UK, as shown in Table 1, DOs are further evidence that the UKCG does not need to include direct sanctions for non-compliance in order for misconduct to be addressed. In other words, the failures of corporate governance in the UK cannot be attributed entirely to the UK's comply or explain approach. DOs are yet another illustration that the enforcement mechanisms exist in the UK.

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[425] *Re Sevenoaks Stationers (Retail) Ltd* [1991] Ch 164.

[426] Financial Conduct Authority, 'Former Redcentric CFO sentenced to five and a half years imprisonment' (*FCA,* 3 March 2022) <www.fca.org.uk/news/press-releases/former-redcentric-cfo-sentenced-five-and-half-years-imprisonment> accessed 7 March 2022.

[427] ibid.

[428] Louisa Clarence-Smith, 'Redcentric finance chief misled market' *The Times* (London 12 February 2022) <www.thetimes.co.uk/article/redcentric-finance-chief-misled-market-3nkbcj80f> accessed 9 March 2022.

[429] Financial Conduct Authority, 'Former Redcentric CFO sentenced to five and a half years imprisonment' (n 426).

[430] ibid.

Nevertheless, it is very rare for disqualification proceedings to be issued against directors of companies listed on the London Stock Exchange.[431] Most recently, and arguably in response to public pressure, Kwasi Kwarteng, the Business Secretary initiated disqualification proceedings against eight former directors of Carillion 'in the public interest'.[432] Ultimately, the evidence suggests that although the IS can pursue DOs against directors of listed companies, it is not a key enforcer for listed companies. It can be argued that this is not due to a lack of availability of proper enforcement mechanisms, but due simply to the decision by the regulatory authority.

5.5 CONCLUSION

The UK has generally adopted a risk-based approach to enforcing corporate misconduct which is focused not on the breach itself but on the effect or harm caused by the breach. While the UK does not have direct sanctions for breaches of the UKCG, the legislative and enforcement framework exists to hold directors accountable and encourage responsible corporate behaviour. The most egregious breaches of corporate governance tend to result in substantial financial losses and have wider reaching effects that can be addressed under the existing legislative framework.

However, one of the weaknesses of the UK's approach to enforcing corporate governance lies in its somewhat complex regulatory enforcement structure. For instance, both the FCA and the SFO can investigate and prosecute instances of corporate misconduct. However, the FCA is also responsible for regulating 51,000 firms. Perhaps a single regulator with responsibility for enforcing instances of corporate misconduct against listed companies will deliver better results. Given that both the FCA and the SFO can investigate instances of corporate misconduct, there will be some confusion in the initial stages regarding which regulator will be responsible for conducting the investigation. Perhaps this also contributes to why investigations tend to move slowly in the UK. Arguably, in the time it takes the FCA and SFO to determine which investigation falls under their remit, instances of misconduct can fall through the cracks.

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[431] Roland Gribben, 'Director disqualification orders on the rise' *The Telegraph* (London 15 August 2018) <www.telegraph.co.uk/finance/businessclub/8703066/Director-disqualification-orders-on-the-rise.html> accessed 18 September 2018Dominic O'Connell, ''Unusual' course of action' (*BBC,* 14 January 2021) <www.bbc.co.uk/news/business-55659196> accessed 9 July 2021.

[432] BBC, 'Carillion: Legal bid launched to ban former directors' (*BBC,* 14 January 2021) <www.bbc.co.uk/news/business-55659196> accessed 9 May 2021.

CHAPTER 6
PRIVATE ENFORCEMENT IN THE UK

"Good governance never depends upon laws, but upon the personal qualities of those who govern"
- Frank Herbert[433]

6.1 INTRODUCTION

The previous chapter discussed public enforcement of corporate governance in the UK. This chapter evaluates private enforcement of corporate governance in the UK The chapter proceeds as follows. Section 6.2 examines the private enforcement mechanisms in the UK. Section 6.3 summarises and analyses the effectiveness of the UK approach to corporate governance enforcement using Becker's theory on measuring enforcement. Section 6.4 concludes.

6.2 PRIVATE ENFORCEMENT

Unlike public enforcement which relies on government agencies to enforce instances of corporate misconduct, private enforcement relies on privately funded agencies and shareholders to enforce good governance. In the UK, this includes shareholders and the FRC. Although the FRC is a private body, it does have a degree of government backing.[434] As the recognised regulator of the accounting profession, the FRC is empowered under the CA 2006 to review the reports and accounts of public and large private companies to ensure they comply with reporting requirements.

Several academics propose that the enforcement of corporate governance should be left entirely to private enforcement.[435] However, Musikali questions whether private law and non-law mechanisms are effective in protecting shareholders.[436]

[433] Frank Herbert, American author.

[434] Geoffrey Whittington, 'Corporate governance and the regulation of financial reporting' (1993) 23 Accounting and Business Research 311.

[435] Becker and Stigler (n 351).

[436] Lois M Musikali, 'Why criminal sanctions still matter in corporate governance' (2009) 20 International company and commercial law review 133.

Armour and others have criticised reliance on private enforcement, arguing that directors rarely make any personal payments arising from breach of their duties.[437] In his study, Armour concluded that there was only a 0.017% chance of a public company director being sued in the UK.[438] Therefore, it can be argued that the absence of any real consequence is unlikely to deter corporate misconduct. The remainder of this section will consider the private enforcement mechanisms in the UK.

6.2.1 Financial Reporting Council

The FRC was established in 1990, as an oversight body for seven operating bodies.[439] Not surprisingly, this complex structure resulted in overlap and miscommunication.[440] In 2012, following consultation with the government, the FRC structure was updated by consolidating the Accounting Standards Board (ASB), the Auditing Practices Board, the Board for Actuarial Standards, the FRRP, the Professional Oversight Board, the Audit Inspection Board and the Accountancy and Actuarial Discipline Board into a single regulator.[441] Under this new structure the FRC would have three primary objectives; (i) setting accounting and auditing standards, (ii) enforcing accounting and auditing standards, and (iii) oversight of the accounting bodies.[442]

The FRC is also responsible for preparing and maintaining the UKCG. However, as previously explained, enforcement of the UKCG in the UK is generally left to the market and shareholders. Nevertheless, as the regulator for the auditing profession, the FCA is empowered to hold accountants, auditors, accountancy firms and actuaries to account for serious instances of misconduct.[443] It is important to point out here that unlike the SFO and the FCA who can pursue directors and companies, the FRC enforcement powers are limited to CFOs and CEOs who are also accountants or auditors.

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[437] Armour and others (n 3).

[438] ibid 699.

[439] Financial Reporting Council, *Annual Report 2011/12* (FRC, 2012) 5.

[440] ibid 5.

[441] ibid 4.

[442] Department of Trade and Industry, *Review of Accountancy Regulation: Legislative Proposals Consultation Document* (DTI, 2003) 3.

[443] Financial Reporting Council, 'Enforcement Division' (*FRC,* 9 September 2021) <www.frc.org.uk/auditors/enforcement-division> accessed 9 September 2021.

Although each professional accountancy body maintains its own rules of conduct, the FRC has overall oversight responsibility for over 300,000 accountants and auditors.[444] Given that each professional accountancy body also maintains procedures for disciplinary action against members, the FRC has outlined a two-part criteria for when it will investigate; (i) when it is in the public interest and (ii) if there are 'reasonable grounds to suspect misconduct.[445] Perhaps the public interest criteria explains why the majority of FRC investigations tend to be related to misconduct of the Big Four, given that 100% of FTSE 100 companies are audited by the Big Four.[446]

Given that the FRC does not receive funding from the government, it is difficult to argue that the FRC is not constrained by its financial resources. In light of this, it can be surmised that the FRC starts off the race at the back, already hamstrung by its limited resources. This view was shared by the chief executive of the FRC, Sir Jon Thompson, who acknowledged that the FRC was not 'big enough' to effectively regulate the accounting and auditing profession.[447] Unlike the SEC which also can take enforcement action against auditors, accountants and directors and is funded by Congress, the FRC is funded primarily by the same accounting profession that it regulates. For instance, for the year ended 31 March 2021, 48% of the FRC's total income was derived from accountancy bodies.[448]

In addition to its limited resources, the high hurdles faced by the FRC to prove misconduct was often considered one of the key impediments to the FRC's success as an enforcer. Before the FRC can actually impose sanctions against auditors, accountants or accounting firms it must first prove that the circumstances/behaviour in question rose to the level of misconduct. The FRC defines misconduct as:

> an act or omission or series of acts or omissions, by a member … in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls

[444] Financial Reporting Council, *Key Facts and Trends in the Accountancy Profession* (FRC, 2021) 4.

[445] Financial Reporting Council, *Accountancy Scheme - Effective 1 January 2021* (FRC, 2021).

[446] Financial Reporting Council, *Key Facts and Trends in the Accountancy Profession* (n 444) 48.

[447] Daniel Thomas and Michael O'Dwyer, 'Head of UK's financial regulator says it was not up to the job' *Financial Times* (London 27 May 2021) <www.ft.com/content/79eb7217-5ea6-4662-818d-375a74a0519a> accessed 8 September 2021

[448] Financial Reporting Council, *Annual Report and Financial Statements for the Year Ended 31 March 2021* (HM Stationery Office 2021) 42.

> significantly short of the standards reasonably to be expected of a member… or has brought, or is likely to bring, discredit to the member … or to the accountancy profession.[449]

The difficulties faced by the FRC in meeting this high evidentiary test was illustrated in the aftermath of the HBOS collapse. Seven months before the bank collapsed KPMG issued an unqualified audit report. Although the FRC found that KPMG's work 'raised questions about the nature and extent of some of the audit procedures', the evidence did not rise to the level of misconduct.[450] To address the difficulties faced by the FRC, the Audit Enforcement Procedures (AEP) was introduced which lowered the standards required for auditors from misconduct to 'breach of a relevant requirement.'[451] Another difficulty faced by the FRC was the difficulty in obtaining information from auditors, audit firms and public interest audited entities. This was finally amended with the introduction of the Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR). Under the SATCAR, the failure to provide information was a criminal offence and the FRC could apply to the High Court to ensure information is provided if a company failed to comply.[452] The exercise of this power was demonstrated in the case of Sports Direct. Although Sports Direct was not the focus of the FRC investigation, the regulator requested information from the company when investigating Grant Thornton's 2016 audit of Sports Direct.[453]

Although the SATCAR 2016 represented an important development in the FRC's role and powers, the new evidentiary standard only applies to FRC investigations under the AEP. Under the AEP, the FRC can investigate the audits of public interest entities, including listed companies and AIM listed companies with a turnover of over €200 million.[454] In other words, the AEP applies to statutory audits and therefore misconduct remains the evidentiary test for members of professional

[449] Financial Reporting Council, *Accountancy Scheme - Effective 1 January 2021* (n 445) 5.

[450] Madison Marriage and Kate Martin, 'Watchdog admits it was slow to investigate HBOS audit' *Financial Times* (London 30 November 2017) <www.ft.com/content/484265bc-d5cb-11e7-8c9a-d9c0a5c8d5c9> accessed 9 August 2020; Huw Jones, 'UK watchdog says was too slow to probe HBOS audit' (*Reuters,* 30 November 2017) <www.reuters.com/article/us-lloyds-accounts-hbos-idINKBN1DU10Z> accessed 7 June 2020.

[451] Financial Reporting Council, 'Audit Enforcement Procedure' (*FRC,* 9 July 2020) <www.frc.org.uk/auditors/enforcement-division/audit-enforcement-procedure> accessed 9 July 2020.

[452] Financial Reporting Council, *The Audit Enforcement Procedure* (FRC, 2022).

[453] Financial Reporting Council, 'The Financial Reporting Council v Sports Direct International plc' (*FRC,* 18 February 2020) <www.frc.org.uk/news/february-2020-(1)/the-financial-reporting-council-v-sports-direct-in> accessed 4 May 2021.

[454] Financial Reporting Council, 'Audit Enforcement Procedure' (n 451).

accountancy bodies.[455] The effect is that there are different standards of proof and therefore it can be argued that there isn't a level playing field in the profession. This view was shared by Kingman in his review of the FRC.[456] The case of Carillion can be used to illustrate the potential inequity that can result from the different evidentiary tests. While the behaviour of Carillion's audit partner and audit firm will be investigated under the AEP, the conduct of Carillion's directors, who are members of a professional accountancy body, will be investigated under a different scheme. Consequently, the FRC will face the higher evidentiary hurdle of misconduct. This also means that the FRC would not be able to compel information, as this power is only available for investigations under the AEP disciplinary scheme. The provision of requested information under an alternative disciplinary scheme is currently voluntary.[457] Unfortunately, this disparity is likely to remain the case, unless legislation is introduced or until there is an agreement between the FRC and the accounting profession.

As part of the proposed reforms, the UK government has stated its intention to expand the definition of PIEs. Under the new proposals, ARGA will have the power to investigate the audits of private companies and AIM listed companies with a turnover of $750 million turnover or 750 employees.[458] According to EY, this will bring roughly 600 additional companies under the remit of the new regulator.[459] It is important to note here that this will result in a significant increase in the regulator's responsibilities, especially when taken together with its intended enforcement obligations for breach of directors duties.

Another noteworthy proposal for reform would see PIE auditor registration undertaken by the FRC. Consequently, all audit firms that audit PIEs would be required to be registered with the FRC.[460] This will be 'separate from, and additional

[455] Financial Reporting Council, *Annual Enforcement Review 2019* (FRC, 2019) 8.

[456] John Kingman, *Independent Review of the Financial Reporting Council* (HM Stationery Office, 2018) 41.

[457] ibid 43.

[458] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85) 9.

[459] Ernst & Young LLP, *Point of view - The UK Government's response to strengthen audit, corporate reporting and corporate governance* (EY, 2022) 4.

[460] Financial Reporting Council, 'FRC publishes regulations for PIE Auditor Register' (*FRC,* 18 August 2022) <www.frc.org.uk/news/august-2022/frc-publishes-regulations-for-pie-auditor-register> accessed 11 September 2022.

to' the existing requirement for statutory auditors to be registered with their Recognised Supervisory Body (RSB), such as ICAEW.[461] Importantly this was only delegated to RSBs in 2016.[462] However, not surprisingly, instead of strengthening and improving any weaknesses, the proposed reforms pass the buck back to the FRC, which further increases the workload of the regulator. As an alternative, the FRC could have been given additional powers to impose sanctions without the additional burden of maintaining a separate register.

Table 13: FRC source of enquiries, 2017-2021

Year	Horizon scanning	FRC teams	Complaints	Whistle-blowing	External Referrals	Total
2017/18	-	-	-	-	-	52
2018/19	25	9	8	1	3	46
2019/20	45	22	15	2	4	88
2020/21	52	29	6	1	7	95
Total	122	60	29	4	14	229
Mean	41	20	10	1	5	70

Source: FRC, *Annual Enforcement Review*, 2019-2021. Breakdown for 2017/18 not reported.

As the primary regulator for the accounting profession in the UK, the FRC operates three disciplinary schemes; the AEP, the Accountancy Scheme and the Actuarial Scheme. As mentioned above, the AEP represented a significant overhaul of audit enforcement. Introduced in 2016, the AEP also introduced the process of constructive engagement as an alternative to referring cases for a full investigation. According to the FRC Guidance, constructive engagement can be used in cases where the impropriety was not substantially material to the financial statements, and unlikely to affect the decisions of the users of the financial statements.[463] Since its introduction over five years ago, the FRC has resolved a significant number of its

[461] Financial Reporting Council, 'Public Interest Entity (PIE) Auditor Registration' (*FRC,* 2023) <www.frc.org.uk/auditors/audit-firm-supervision/public-interest-entity-auditor-registration> accessed 8 March 2023.

[462] Department for Business Energy & Industrial Strategy, *Restoring trust in audit and corporate governance - Government response to the consultation on strengthening the UK's audit, corporate reporting and corporate governance systems* (n 85) 123.

[463] Financial Reporting Council, 'Audit Enforcement Procedure - Guidance for the Case Examiner' FRC (2021) <www.frc.org.uk/getattachment/c53e4493-3349-4891-8d89-5921d2a9cf8e/Guidance-for-Case-Examiner-(January-2021).pdf> accessed 1 January 2022.

cases using constructive engagement.[464] During the period 1 April 2020 to 31 March 2021, the FRC closed 46.6% of its cases through constructive engagement. Not surprisingly, 34 of the 48 cases resolved using constructive engagement involved the Big Four.[465] This is yet further evidence that the audit quality at the Big Four is not up to the mark. Nevertheless, the Big Four continue to dominate the profession.

As shown in Table 13, the FRC receives enquiries from several sources, including complaints from the public, horizon scanning and other enforcement agencies, such as the FCA. For the period 1 April 2017 to 31 March 2021, the FRC received 229 enquiries. That's an average of 70 enquiries per annum. Most notable from Table 13, but perhaps not surprisingly, is that the majority of the FRC's enquiries are derived from horizon scanning, which uses data from RSS feeds and press reports. From 1 April 2017 to 31 March 2021, 122 enquiries were derived from horizon scanning. That represents over 53.2% of all cases opened during the period.

Table 14: FRC case outcomes, 2018-2021

Year	Constructive Engagement	Referred for Investigation	No further action	Referrals
2018/19	19	15	15	4
2019/20	33	18	32	0
2020/21	48	14	41	0
Total	100	47	88	4
Mean	33.3	15.7	29.3	1.3

Source: FRC, *Annual Enforcement Review*, 2019-2021.

Similar to the FCA, it appears the FRC also takes a risk-based approach to enforcement focusing on instances of misconduct which results in serious harm to the public interest. This also aligns with the FRC's stated position that punishment is not the primary purpose of sanctions. Instead, sanctions are aimed at protecting the public.[466] The FRC's increased use of constructive engagement could also indicate

[464] Financial Reporting Council, 'FRC resolves record number of cases through constructive engagement' (*FRC,* 31 July 2020) <www.frc.org.uk/news/july-2020/frc-resolves-record-number-of-cases-through-constr> accessed 5 July 2020.

[465] Financial Reporting Council, *Annual Enforcement Review 2021* (FRC, 2021) 16.

[466] Financial Reporting Council, 'Sanctions Policy (AEP)' FRC (2022) <www.frc.org.uk/getattachment/80f12020-a499-4b0d-9310-1a5199a4272e/Sanctions-Policy-(AEP)_January-2022.pdf> accessed 25 January 2022.

that the levels of misconduct uncovered are not serious enough to warrant full enforcement. However, it is important to note that the use of constructive engagement is entirely at the discretion of the FRC, and doesn't necessarily suggest that levels or instances of misconduct have been impacted. It is submitted that similar to accounting standards, such as IAS 18, that leave room for subjective judgement, so too can the subjective nature of constructive engagement be exploited.

Another problem affecting the FRC's effectiveness is the number of complaints received that are outside the remit of the FRC. For the year ended 31 March 2020, 264 of the 356 complaints received were outside the remit of the FRC.[467] That represents 74% of complaints received for the year. This was also the case for the year ended 31 March 2021, where 84% of the 609 complaints received were outside the regulator's remit.[468] These figures highlight one of the downsides of having multiple regulators, which consequently leads to uncertainty over where instances of misconduct should be reported. Perhaps this is not surprising given that FRC was itself confused about its role in the lead up to the HBOS scandal. Despite receiving reports from a whistle-blower that HBOS financial statements did not accurately reflect the company's true position, the FRC failed to act.[469] In an unprecedented move and in response to parliamentary pressure, the FRC published a 65-page report explaining its failures in the HBOS scandal.[470] The FRC acknowledged the confusion of its role, explaining that its failure to be more 'pro-active' was due to the fact that it considered the FSA to be the lead regulator.[471]

Another important point to note is that, unlike the FCA, the FRC cannot prosecute its own cases. This is yet another significant impediment to the FRC's enforcement powers. Instead, the FRC must refer cases to other regulators for prosecution. Finally, although the FRC's replacement, is meant to represent a significant

[467] Financial Reporting Council, *Report and Financial Statements for the year ended 31 March 2020* (HM Stationery Office 2020) 26.

[468] Financial Reporting Council, *Annual Report and Financial Statements for the Year Ended 31 March 2021* (n 448) 35.

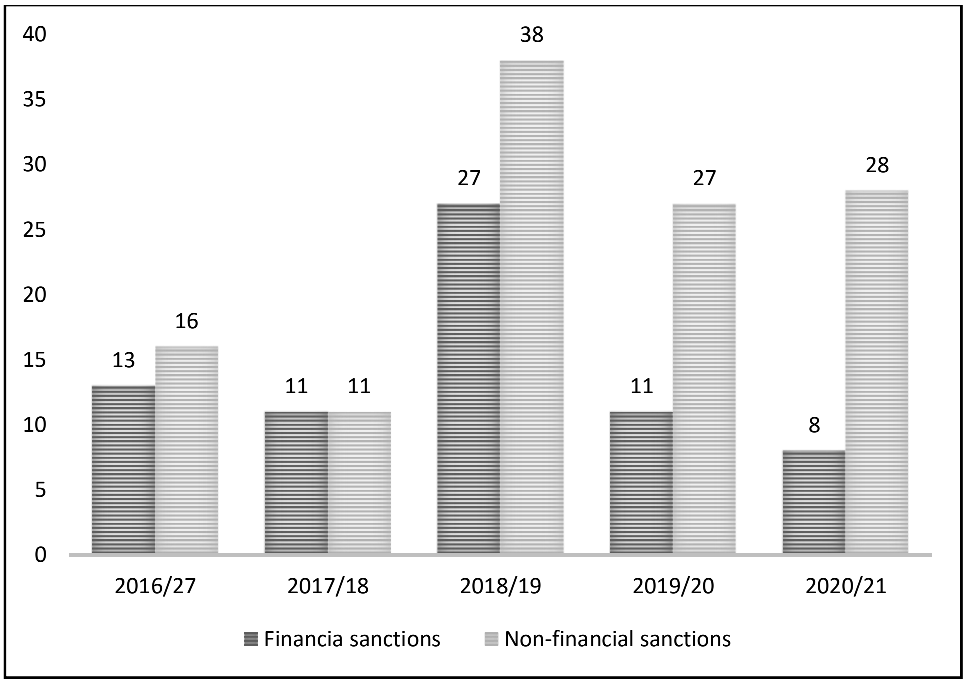
[469] Louis Ashworth, 'Audit watchdog 'whitewashed' my HBOS evidence, says whistleblower' (*City A.M.,* 6 February 2019) <www.cityam.com/audit-watchdog-whitewashed-my-hbos-evidence-says/> accessed 7 September 2020.

[470] Marriage and Martin (n 450).

[471] Financial Reporting Council, *The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS* (FRC, 2017) 4.

improvement in the regulator's enforcement powers, it must be noted that instilling ARGA with the power to hold directors accountable (including directors not belonging to a professional accountancy body) can also contribute to further confusion. If so, ARGA will join three other regulators (the SFO, the FCA and the IS) that can enforce instances of misconduct against directors. This approach can certainly lead to confusion among the regulators themselves.

Figure 9: Number of sanctions imposed by the FRC, 2017-2021



Source: FRC, *Annual Enforcement Review*, 2019-2021

Despite being in existence for over 20 years, the FRC published its first enforcement review in July 2019. During the period 1 April 2016 to 31 March 2021, the FRC issued 190 financial and non-financial penalties (Figure 9). That represents an average of 40 penalties per year. When taking into consideration the size of the accountancy profession regulated by the FRC, the number of penalties imposed appears rather meagre. The remainder of this section will examine in greater detail the use of financial and non-penalties by the FRC.

Financial sanctions

As shown in Table 15, from 1 April 2016 to 31 March 2021 the FRC imposed 70 financial sanctions. That's an average of 14 financial sanctions per annum, totalling £103.6 million in financial penalties. During 2018/19 the FRC issued a significantly higher number of financial sanctions. Interestingly, £40.6 million of these sanctions were issued against nine audit firms. Six of which relate to the Big Four. Not surprisingly, the Big Four also account for the majority of the £40.6 million imposed against audit firms. For instance, the largest individual fine of £10 million was imposed against PwC for misconduct during the audit of Taveta.[472] In another example, KPMG was fined a total of £18.5 million relating to four separate cases of misconduct in relation to the audits of Quindell Plc, Ted Baker Plc, Co-op Bank and Equity Syndicate Management Ltd.[473]

Table 15: Financial sanctions, 2016-2021

Year	No. of financial sanctions	Financial penalty
2016/17	13	£12.0
2017/18	11	£15.5
2018/19	27	£42.9
2019/20	11	£16.5
2020/21	8	£16.7
Total	70	£103.6
Mean	14	£20.7

Source: FRC, *Annual Enforcement Review*, 2019-2021. "Financial penalty" shows financial sanctions imposed, pre-discount.

As shown in Table 16, the FRC imposed 26 financial sanctions against firms and 32 financial sanctions against audit partners between 1 April 2016 and 31 March 2021. When compared to the total number of financial sanctions for the same period (Table 15), 82% of the total financial sanctions imposed by the FRC were imposed against audit firms and audit partners. Not surprisingly, although audit partners received a greater number of financial sanctions during the period, the total sum of financial sanctions imposed against audit firms was far greater. For instance, £15.8 million of the £16.7 million imposed for financial sanctions in 2020/21 was against four audit firms.[474]

[472] Financial Reporting Council, *Annual Enforcement Review 2019* (n 455) 26.

[473] ibid.

[474] Financial Reporting Council, *Annual Report and Financial Statements for the Year Ended 31 March 2021* (n 448).

Most noticeable among the fines for 2020/21 was the £15 million fine imposed against Deloitte for its role in the Autonomy scandal.[475] If financial penalties are meant to act as a deterrent against corporate misconduct, they must also be sufficient to have a real impact on the firm. Consequently, the deterrent effect of a £15 million financial sanction against an audit firm with reported revenue of $50 billion is debatable.[476]

Table 16: Financial sanctions against audit firms and audit partners, 2016-2021

Year	Audit Firm		Audit Partner	
	No. of financial sanctions	Financial penalty	No. of financial sanctions	Financial penalty
2016/17	4	£11.1	6	£0.5
2017/18	4	£14.8	4	£0.5
2018/19	9	£40.6	13	£1.6
2019/20	5	£15.9	6	£0.7
2020/21	4	£15.8	3	£0.8
Total	26	£98.2	32	£4.1
Mean	5.2	£19.6	6.4	£0.8

Source: FRC, *Annual Enforcement Review*, 2019-2021. The number of financial sanctions for audit partners in 2016/17 was not reported. The figure used in the Table represents an average.

Furthermore, when compared to the level of financial sanctions imposed by the FCA, the FRC sanctions appear diminutive. Perhaps this shift away from financial sanctions can be explained by the recommendations of the Clarke Review. The Clarke Review recommended that FRC penalties should focus on non-financial sanctions.[477] While non-financial sanctions can be useful tools in protecting the integrity of financial markets, financial sanctions seek to punish bad behaviour and

[475] Financial Reporting Council, 'Sanctions against Deloitte and two audit partners in relation to Autonomy Corporation Plc' (*FRC,* 2020) <www.frc.org.uk/news/september-2020-(1)/sanctions-against-deloitte-and-two-audit-partners> accessed 8 January 2022.

[476] Deloitte, 'Deloitte reports FY2021 revenue' (*Deloitte,* 8 September 2020) <www2.deloitte.com/global/en/pages/about-deloitte/articles/global-revenue-announcement.html> accessed 9 May 2021.

[477] Review Panel, *Independent review of the Financial Reporting Council's Enforcement Procedures Sanctions* (FRC, 2017).

therefore are likely to have a greater impact on the instances of misconduct. Nevertheless, the number of financial sanctions issued by the FRC is unlikely to deter corporate misconduct, particularly among the Big Four whose combined revenue was reported to exceed $167 billion.[478]

Non-financial sanctions

As an alternative to imposing financial penalties, the FRC can also impose several non-financial sanctions including reprimands, exclusions from the profession and remedial action. Similar to the FCA, it appears that the FRC also favours non-financial sanctions. While the FRC issued 70 financial sanctions between 1 April 2016 to 31 March 2021 (Table 15), the FRC imposed 120 non-financial sanctions for the same period, as shown in Table 17. That represents an average of 24 non-financial penalties per year and is almost double the average number of financial sanctions, as shown in Table 15.

Table 17: Non-financial sanctions, 2016-2021

Sanction	Year					Total	Mean
	2016/17	2017/18	2018/19	2019/20	2020/21		
Severe reprimands	5	5	13	8	7	38	7.6
Reprimands	4	4	8	4	4	24	4.8
Exclusions	7	2	6	0	1	16	3.2
Requirements	0	0	7	10	0	17	3.4
Remedial actions	0	0	0	0	12	12	2.4
Undertakings	0	0	2	0	-	2	0.5
Declarations	0	0	2	5	4	11	2.2
Total	16	11	38	27	28	120	24.1

Source: FRC, *Annual Enforcement Review*, 2019-2021

A notable observation from Table 17 is the number of reprimands. Although very modest, reprimands account for the majority of non-financial sanctions imposed by the FRC. For the period 1 April 2016 to 31 March 2021, the FRC imposed 24 reprimands and 38 severe reprimands. This is an average of 12 total reprimands

[478] Michael O'Dwyer, 'Big Four post strongest performance since Enron as advisory business booms' *Financial Times* (London 9 December 2021) <www.ft.com/content/95a0c80b-1262-42c3-ac5b-bb693e06d3c4> accessed 9 January 2022.

per annum. Although reprimands have no impact on the right to continue practicing, reprimands show on the member or firm's disciplinary record.[479] In light of this, the deterrent effect of reprimands is questionable.

Another noteworthy observation from Table 17 is the number of exclusions. For the period 1 April 2017 to 31 March 2021, the FRC imposed 16 exclusions from the profession. That represents an average of three exclusions per year. From the Table above it can be argued that exclusions are indeed reserved for the most extreme cases where 'misconduct is fundamentally incompatible with continued membership'.[480] Unlike reprimands, exclusions are a direct means of punishment as it affects the members' earnings potential, and therefore can act as a powerful deterrent.

6.2.2 Shareholders

As part of the UK's market-led approach to corporate governance enforcement, the system places great reliance on shareholders and financial markers to enforce good governance and hold directors accountable. However, first and foremost shareholders should have access to accurate and timely information. This reinforces the importance of the role of auditors in assuring the accuracy of the information provided by the directors. In any instance, a system that places reliance on shareholders to enforce good governance should include effective mechanisms which enable shareholders to hold directors accountable. In the UK, the mechanisms available to shareholders are included in the CA 2006 and include; the power to remove a director, unfair prejudice petitions and derivative claims.

Unlike unfair prejudice petitions and derivative claims, which are adjudicated by the UK courts, the removal of a director is an internal company process and therefore increasingly difficult to collate. According to the CA 2006, a director can be removed at any time by passing an ordinary resolution.[481] However, it is important to note that over 54% of shares are held outside the UK, with pension funds and institutional investors holding less than 30%.[482] Given the wide disbursement of UK shares, coupled with the fact that an ordinary resolution requires a simple majority, it can be

[479] Financial Reporting Council, *Accountancy Scheme - Effective 1 January 2021* (n 445).

[480] Financial Reporting Council, *Accountancy Scheme Sanctions Guidance* (FRC, 2018) 14.

[481] CA 2006, s168(1).

[482] Office for National Statistics (n 105).

increasingly difficult for shareholders to remove a director.

Although unfair prejudice petitions and derivative claims are more common, section 33 of the CA 2006 also established a contractual right for shareholders, derived from the company constitution that binds the company to each of its members.[483] However, section 33 relates to disputes involving shareholders' rights, such as the right to vote in meetings and the right to dividends once declared.

The remainder of this section will analyse the use of unfair prejudice petitions and derivative claims to determine their effectiveness as a means of deterring corporate misconduct and whether the mechanisms available in the UK to support shareholder engagement are effective.

Unfair prejudice petitions

When a shareholder believes that the affairs of the company 'are being or have been conducted in a manner that is unfairly prejudicial', the shareholder can seek an unfair prejudice remedy from the courts.[484] Introduced in the CA 2006, the bar for unfair prejudice petitions is relatively high. For an unfair prejudice petition to be approved the conduct must be unfair **and** prejudicial.[485] In *Rock Nominees v RCO Holding*, the directors were accused of transferring shares at an undervalue.[486] Although the court found that the directors had breached their duties, the minority shareholders were not prejudiced. Conversely, in *Re Woven Rugs Ltd* the court held that refinancing the company with the intent of making payments to a personal company constituted a breach of fiduciary duty and was unfairly prejudicial.[487]

Between 1 January 2012 and 31 December 2021, there were 138 cases involving unfair prejudice. This is an average of 12.6 cases per year. However, more importantly, only one of these cases relates to a publicly listed company; ASA Resources Global. Although, it is important to note here that ASA Resource was listed on the AIM and therefore not subject to the provisions of the UKCG. The case of ASA Resources goes to support the view that UKCG does not need to include

[483] CA 2006, s33.

[484] ibid s994(1)(a).

[485] Mavrikakis and others (n 421) 103.

[486] *Rock Nominees v RCO Holding* [2004] 1 BCLC 434 CA.

[487] *Re Woven Rugs Ltd* [2010] EWHC 230 (Ch).

direct sanctions for instances of misconduct to be addressed.

When compared to companies listed on the LSE, it is considerably more difficult to sell shares in a private limited company. This is further compounded by the difficulty faced to determine the fair value of shares in a private company. Perhaps this explains why unfair prejudice petitions are initiated primarily by private companies. Another significant consideration to bringing an unfair prejudice petition is the costs involved. Unlike derivative claims, there is no allowance for shareholders to be indemnified by the company.[488]

Table 18: Decisions on unfair prejudice, 2012-2021

Year	Unfair prejudice	Listed Companies
2012	8	0
2013	9	0
2014	9	0
2015	11	0
2016	8	0
2017	12	0
2018	14	1
2019	19	0
2020	28	0
2021	20	0
Total	138	1
Mean	12.6	0.1

Source: Compiled from case transcripts available on Westlaw UK. “Listed company” shows the number of unfair prejudice decisions against companies listed on the Main Market of the LSE.

Although section 992 includes a non-exhaustive list of remedies available to the court, CA 2006 gives the court wide powers to ‘order as it thinks fit for giving relief’.[489] However, the most common remedy is for the company to purchase the shares of the petitioner at fair value.[490] A notable example of this was the case of *VB Football Assets v Blackpool FC and Others*.[491] In *VB Football Assets*, the court ordered the majority shareholders of Blackpool to pay £31.3 million to the minority

[488] Armour (n 3).

[489] CA 2006, s996(1).

[490] Mavrikakis and others (n 421) 104.

[491] *VB Football Assets v Blackpool FC and Others* [2017] EWHC 2767 (Ch).

shareholder.[492] While unfair prejudice petitions may prove a useful tool in resolving disputes in privately owned companies, it is submitted that the likelihood of a shareholder of a listed company initiating an unfair prejudice petition remains extremely low. This suggests that placing the responsibility on shareholders to enforce corporate governance appears faulty. Furthermore, as mentioned above, given the costs associated with litigation shareholders in listed companies are likely to find it more cost effective to divest rather than pursue timely and expensive litigation. Therefore, the use of unfair prejudice claims as a means of deterring misconduct and enforcing directors' duties in listed companies is weak at best. There is no incentive for shareholders to hold directors accountable. Given that successful petitions will most likely result in the applicants' shares being purchased by the company, there is no actual benefit to the shareholders pursuing a claim when they can opt to sell their shares on their own accord.

In attempting to find the right balance between limiting meritless petitions and holding directors accountable, unfair prejudice petitions do not appear to be an effective means of deterring director misconduct, as there appears to be little financial incentive to encourage shareholders to initiate petitions. Ultimately, although there has been an increase in the number of unfair prejudice petitions, it remains a mechanism used primarily by private companies in the UK.

Derivative claims

Derivative claims are another option available to shareholders, and was introduced in the CA 2006. Before the CA 2006, it was difficult for shareholders to initiate proceedings against directors due to the proper plaintiff rule established in *Foss v Harbottle*.[493] Under the proper plaintiff rule, only the company could bring an action for any wrong done against the company. Section 260 of the CA 2006 created an exemption to this rule, which permitted shareholders to initiate proceedings against directors and to seek relief for wrong done against the company, on the company's behalf.[494] This means that, unlike unfair prejudice petitions, derivative claims are brought in the name of the company and any relief granted will be for the benefit of

[492] Adam Fisher and Ben Hess, 'Unfair Prejudice leads to own goal in High Court' (*Eversheds Sutherland,* 2017) <www.eversheds-sutherland.com/global/en/what/articles/index.page?ArticleID=en/Sport/unfair-prejudice-leads-own-goal-high-court> accessed 9 September 2020.

[493] *Foss v Harbottle* (1843) 67 ER 189.

[494] CA 2006, s260(3).

the company as a whole.

According to section 260(3) a derivative claim:

> may be brought only in respect of a cause of action arising from an actual or proposed act or omission involving negligence, default, breach of duty, or breach of trust by a director of the company.[495]

This means that shareholders can initiate derivative claims against directors for breach of duties contained in sections 170-177 of the CA 2006. However, unlike unfair prejudice petitions shareholders are required to obtain permission from the courts before a derivative claim can proceed. Therefore, despite the exception created by section 260, the process of bringing a derivative claim is still fraught with some difficulty. For instance, before the courts will grant permission for a derivative claim to proceed the applicant must also pass the good faith test. This requires the applicant to show that the claim was not brought in bad faith. For instance, in the case of *Barrett v Duckett*, the court refused to grant permission due to the applicants' personal grievances against the directors.[496] The courts must also determine that the claim is in the best interest of the company. In *Phillips v Fryer*, the directors withdrew over £400,000 of company funds without proper authorisation. The court granted permission on the basis that the directors failed to provide sufficient evidence to refute the accusation.[497] In *Zavahir v Shankelman and others*, although there was a prima facie case, the court denied permission on the basis that the cost of proceeding was disproportionate.[498]

Generally, when compared to unfair prejudice petitions, there have been significantly fewer derivative claims before the courts.[499] This is evidenced by Table 19. From 1 January 2010 to 31 December 2021, there were 55 derivative claims. That represents an average of 5 claims per annum. Perhaps this is explained by the difficulty in obtaining permission from the courts. Lee argued that the system was effectively biased in favour of directors.[500] While the approach by the courts has

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[495] ibid s260(3).

[496] Julia Tang, 'Shareholder Remedies: Demise of the Derivative Claim?' (2012) 1 UCL Journal of Law and Jurisprudence 178.

[497] *Phillips v Fryer* [2013] BCC 176.

[498] *Zavahir v Shankelman* [2016] EWHC 2772.

[499] Keay, 'An Assessment of Private Enforcement Actions for Directors' Breach of Duty' (n 351).

[500] John Lee, 'Is corporate governance overrated?' *Financial Times* (London 24 August 2014) <www.ft.com/content/966a24b2-26bc-11e4-bc19-00144feabdc0> accessed 7 July 2018.

limited the number of frivolous claims, it also acts as a deterrent for shareholders and potentially affords directors far too many protections.

Table 19: Derivative claims, 2010-2021

Year	Derivative claims	Listed companies
2010	4	0
2011	4	0
2012	6	0
2013	3	0
2014	5	0
2015	7	0
2016	5	0
2017	1	0
2018	4	0
2019	5	0
2020	5	0
2021	6	0
Total	55	0
Mean	4.6	0.0

Source: Compiled from case transcripts available on Westlaw UK. "Derivative claims" shows the number of derivative claim decisions. "Listed company" shows the number of derivative claims against companies listed on the Main Market of the LSE.

Another significant barrier to derivative claims is the cost associated with the court proceedings.[501] Although the courts can order that the shareholder be indemnified by the company for the costs associated with the derivative claim, if the claim is unsuccessful the shareholder will be required to pay the costs. Furthermore, even if the claim is successful any financial benefit received shall belong to the company as a whole. On that basis, it can be argued that derivative claims have no direct benefit to the shareholder. It is widely accepted that the majority of shareholders are motivated by financial means. Derivative claims therefore provide little to no financial incentive for shareholders. For shareholders of listed companies in particular, derivative claims can be somewhat of a double-edged sword. For instance, even where the claim is successful news of pending litigation is also likely to affect the share price and therefore shareholder wealth. According to a study by Liesera and Kolarica, initial revelations of misconduct and pending litigation can

[501] Armour (n 3).

negatively impact shareholder wealth by 20%.[502]

Given the limited number of derivative claims that have been brought before the courts since its introduction, it can be argued that derivative claims do not provide an effective means of deterring misconduct. There is no incentive for shareholders to act, instead they are faced with high costs and a reluctant judiciary fearful of upsetting the balance of power in the UK.

Collective securities actions

According to Getz and Barnett, collective securities action claims are most likely to be brought under sections 90 and 90A of FSMA.[503] Although introduced in 2006, there have been very few s90 or s90A cases in the UK. Following the 2014 overstatement, Tesco settled a s90 collective action with two claimant groups.[504] It is important to point out here that not all s90 and s90A claims are collective actions, as illustrated in *ACL Netherlands BV & Ors v Lynch & Anor*, the first s90A claim to reach judgment.[505]

A distinguishing feature of UK collective securities actions, when compared to U.S. class actions, is the requirement for shareholders to opt-in by filing a claim form.[506] This differs from U.S. class actions where individual shareholders have to opt out from being included in the class. This means that collective action settlements in the UK are distributable only to the shareholders that have registered or opted in. Although collective actions allow shareholders to consolidate cases that 'give rise to common or related issues of fact or law,'[507] the process is still time consuming and

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[502] Patrick Liesera and Sascha Kolarica, 'Securities class action litigation, defendant stock price revaluation, and industry spillover effects' (European Financial Management Association Conference 2016).

[503] Matt Getz and Peter Barnett, 'Collective action and securities law in the UK: recent and anticipated developments and international trends' (2017) Butterworths Journal of International Banking and Financial Law, 299.

[504] Graham Ludlam, Francesca Muscutt and William Naylor, 'Tesco Shareholder Litigation settles: a sign of the complexities of bringing securities class actions under s90A FSMA?' (*DAC Beachcroft,* 13 October 2020) <www.dacbeachcroft.com/en/gb/articles/2020/october/tesco-shareholder-litigation-settles-a-sign-of-the-complexities-of-bringing-securities-class-actions-under-s90a-fsma/> accessed 8 February 2023.

[505] *ACL Netherlands BV & Ors v Lynch & Anor* [2022] EWHC 1178 (Ch).

[506] Getz and Barnett (n 503) 300.

[507] Civil Procedure Rules, 19.10.

costly with each party responsible for paying their proportion of the costs.[508] In light of this, the wide disbursement of shareholders and the rise of retail investors, through platforms such as Freetrade and Trading 212, there remains little financial incentive for shareholders in the UK.

6.3 ENFORCEMENT SUMMARY

According to Becker, the effectiveness of enforcement can be measured by (i) the probability that misconduct will be detected, (ii) the probability that the wrong-doers will be convicted/punished (iii) the form of punishment and (iv) the size of the punishment.[509] This section provides a summary of the UK's enforcement framework and analyses the effectiveness of the UK's public and private enforcement mechanisms using Becker's approach to measuring enforcement.

(i) The probability that misconduct will be detected

When considering the effectiveness of enforcement, it is important to first consider the likelihood that misconduct will be detected. Many instances of corporate governance failures that have emerged were not detected by regulators beforehand. For the purposes of this study, the likelihood that misconduct will be detected by a public enforcement agency is measured using the average number of cases opened per year. As the primary regulator for listed companies, the FCA opens an average of six cases per year for breach of the listing rules. The UK's other primary enforcement agency, the SFO, opens an average of 10 cases per year. Therefore, it can be argued that the likelihood of a listed company being subject to an SFO investigation also remains low. Although the IS plays a minor role as an enforcer, its role is even more limited in listed companies.

[508] Pinsent Masons, 'Class actions in England and Wales' (*Pinsent Masons,* 7 January 2022) <www.pinsentmasons.com/out-law/guides/class-actions-in-england-and-wales> accessed 9 February 2023.

[509] Becker (n 9).

Table 20: Enforcement Summary, 2015-2021

Year	Listed Companies	Public Enforcement				Private Enforcement					
		FCA		SFO		FRC		Unfair prejudice		Derivative claims	
		No. of Enforcement actions	Rate	No. of Enforcement actions	Rate	No. of enforcement actions	Rate	No. of enforcement actions	Rate	No. of enforcement actions	Rate
2015/16	2238	151	6.7%	7	0.3%		0.0%	0	0.0%	0	0.0%
2016/17	2120	209	9.9%	14	0.7%	29	1.4%	0	0.0%	0	0.0%
2017/18	2087	317	15.2%	12	0.6%	22	1.1%	1	0.0%	0	0.0%
2018/19	2005	288	14.4%	17	0.8%	65	3.2%	0	0.0%	0	0.0%
2019/20	1943	217	11.2%	6	0.3%	38	2.0%	0	0.0%	0	0.0%
2020/21	1977	147	7.4%	7	0.4%	36	1.8%	0	0.0%	0	0.0%
Mean	2061.7	221.5	10.8%	11	0.5%	38.0	1.6%	0.2	0.0%	0.0	0.0%

Notes: "Listed companies" shows the number of companies listed on the London Stock Exchange (Table 2). The number of enforcement actions by the FRC for 2015/16 was not reported.

Furthermore, it can be argued that a significant number of cases opened by the SFO, FCA and FRC originate from press reports and RSS feeds. For instance, Tesco announced the £245 million write-down that led to its subsequent DPA with the SFO and the FRC investigation into the company's auditors. Again, in the case of Autonomy, it was HP that announced the accounting fraud that led to investigations by the SEC, the FRC and the SFO. Yet again, even in the recent case of Redcentric Plc, where several directors were convicted, it was an announcement from the company that lead to the FCA investigation. The evidence suggests that the likelihood that misconduct will be detected, in the absence of self-reporting, appears relatively low.

ii) The probability that the wrong-doers will be convicted/punished

As shown in Table 20, the number of enforcement outcomes compared to the number of listed companies suggests that the likelihood of punishment/sanctions is relatively low. Given that the FCA is the primary regulator of the UK's financial market perhaps this explains why its average enforcement rate is significantly higher, albeit not overly impressive, than that of the SFO.

Unfair prejudice petitions and derivative claims against listed companies are very rare and therefore play little to no role in holding directors accountable. The FRC on the other hand, oversees the conduct of accountants and auditors and is limited by both its funding and workforce. Ultimately, it is submitted that there is a low probability that wrong-doers will be punished. As previously mentioned, the FRC has re-shifted its focus away from punishment, which has been evidenced by the increasing use of constructive engagement.

(iii) The form of punishment

The form of punishment depends on whether the misconduct is addressed under private or public enforcement mechanisms. As discussed previously, the SFO and the FCA are the primary criminal prosecutors for corporate misconduct. However as discussed in Chapter 5, the FCA relies more heavily on civil and regulatory sanctions.

While the SFO prosecution rate looks impressive at first glance, the SFO prosecutes a handful of cases. Furthermore, the SFO has been unable to secure convictions of directors even after the companies involved entered into DPAs. This does not inspire much confidence in the effectiveness of the SFO as a prosecutor.

Unlike public enforcement mechanisms which include the power to prosecute, private enforcement mechanisms are primarily financial or regulatory in nature. While there have been several debates on the use of financial sanctions as a deterrent, the effectiveness of non-financial sanctions as a means of deterring corporate misconduct is questionable. Although DOs can be another important mechanism to deter corporate misconduct, its use against directors of listed companies is sparse.

While criminal prosecutions, fines and even non-financial sanctions can be used as a means of punishment and deferring misconduct, unfair prejudice petitions are aimed at seeking remedies or compensation and not necessarily aimed at punishment. Ultimately, the evidence suggests that the likelihood of a director facing criminal prosecution is relatively low. Instead, the evidence suggests that there is a much higher likelihood that even when misconduct is detected, punishment is likely to take the form of a financial or regulatory/non-financial sanction.

(iv) The size of the punishment

When measuring the size of the punishment, Becker put forward that fines can be measured in monetary terms while imprisonment can be measured in units of time.[510] In the UK the FCA, the SFO and the FRC can impose unlimited fines. However, the majority of these financial penalties are issued against companies as opposed to individuals. It is important to point out here that while these sanctions may appear significant in isolation, when compared to the revenue of the company involved, the fine does not make a dent. For instance, Rolls Royce was fined £671 million for bribery related offences.[511] As one of the world’s largest defence contractors, the revenue of Rolls Royce is in the excess of $11 billion per year. The FCA and the SFO have issued significant financial penalties over the last decade. Nevertheless, instances of corporate misconduct continue to come to light. Perhaps this can also be explained by the fact that directors rarely pay out of their own pockets and therefore are not incentivised.

Compared to the SFO and the FCA, the size of FRC fines is substantially smaller. However, the majority of these fines are imposed against audit firms, with only a

[510] ibid.

[511] Rob Evans, David Pegg and Holly Watt, 'Rolls Royce to pay £671m over bribery claims' *The Guardian* (London 16 January 2017) <www.theguardian.com/business/2017/jan/16/rolls-royce-to-pay-671m-over-bribery-claims> accessed 6 October 2017.

small percentage imposed against audit partners. Furthermore, as previously mentioned, when taking into consideration the revenue of the Big Four, the financial sanctions imposed by the FRC are unlikely to act as a deterrent. Even in the cases where audit partners have been fined for misconduct, the deterrent effect of a financial sanction against an audit partner of a Big Four firm is again questionable. The profit split for a PwC audit partner was recently reported as £868,000.[512]

As previously discussed, the likelihood of criminal conviction is relatively low. However, it is still important to consider the potential length of imprisonment. For instance, offences prosecuted under the Theft Act 1968 carry a maximum sentence of seven years, while offences under the Fraud Act 2006 carry a maximum term of 10 years. Given the already low likelihood of detection coupled with an average custodial sentence of less than two years, it can be argued that the benefits of corporate misconduct outweigh the potential pitfalls.[513]

Apart from financial penalties, exclusions are by far the most severe sanction that can be imposed against an audit partner. However, as seen in Table 17, exclusions account for a small percentage of the FRC's sanction. Given that the Big Four alone have over 3,000 audit partners collectively, the likelihood of exclusion is very low.[514]

6.4 CONCLUSION

Private enforcement in the UK is almost non-existent. The powers of shareholders do not provide any incentives for shareholders to engage. Yet this is the premise on which the UK corporate governance system has been built. Furthermore, even in cases where shareholders take action, the outcome is not an incentive. Therefore, shareholders are likely to continue voicing their dissatisfaction by divesting their shares.

Ultimately, the relatively low levels of enforcement in the UK are unlikely to act as a deterrent. The failures of the UK system of corporate governance stem from three decades of a light touch approach to enforcing instances of corporate misconduct,

[512] Michael O'Dwyer, 'PwC's UK partners take home record pay as deals surge boosts profits' *Financial Times* (London 11 August 2021) <www.ft.com/content/5731763b-effe-490d-a328-948a04389131> accessed 9 September 2021.

[513] Clark, 'Average custodial sentence length (ACSL) at all courts to immediate custody in England and Wales in 2021, by offence group' (n 369).

[514] Accountancy Age, 'Big 4 Accounting Firms' (*AccountancyAge,* <www.accountancyage.com/rankings/top-5050-top-15-audit-firms/> accessed 9 May 2020.

further complicated by a complex regulatory enforcement structure. Perhaps the UK system might benefit from a single regulator, similar to the SEC, that is empowered to hold directors, companies and auditors to account. This will be addressed in greater detail in Chapter 9.

Chapter 7
CORPORATE GOVERNANCE IN THE U.S.

There is no evidence that more regulation makes things better. The most highly regulated industry in American is commercial banking, and that didn't save those institutions from making terrible decisions.
- Wilbur Ross[515]

7.1 INTRODUCTION

The previous chapter evaluated private enforcement mechanisms in the UK. This chapter discusses corporate governance in the United States. The chapter proceeds as follows: Section 7.2 examines the corporate governance framework in the U.S. The history and evolution of corporate governance in the U.S. is addressed in Section 7.3. Section 7.4 examines the key corporate governance requirements of Sarbanes-Oxley. Section 7.5 discusses the U.S. approach to corporate governance and section 7.6 concludes.

7.2 CORPORATE GOVERNANCE FRAMEWORK IN THE U.S.

The corporate governance framework in the U.S. consists of a combination of statutes, case law and listing rules. Unlike the UK, which operates as a unitary system of government, the U.S. operates as a federal system of government. This means that power is shared between the state and the federal government. Therefore, in the U.S. corporate law covering the formation and dissolution of companies operates at the state level. Given that the majority of U.S. publicly listed companies are based in Delaware, the state has developed an expansive and well-developed body of corporate law.[516] Therefore, for the purpose of this study Delaware is used as a point of reference for state law purposes.

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[515] Wilbur Ross, 39th United States Secretary of Commerce.

[516] Holly J Gregory, Rebecca Grapsas and Claire H Holland, 'Corporate Governance and Directors' Duties in the United States: Overview' (*Practical Law,* 1 September 2021) <https://uk.practicallaw.thomsonreuters.com/w-011-8693> accessed 9 December 2021.

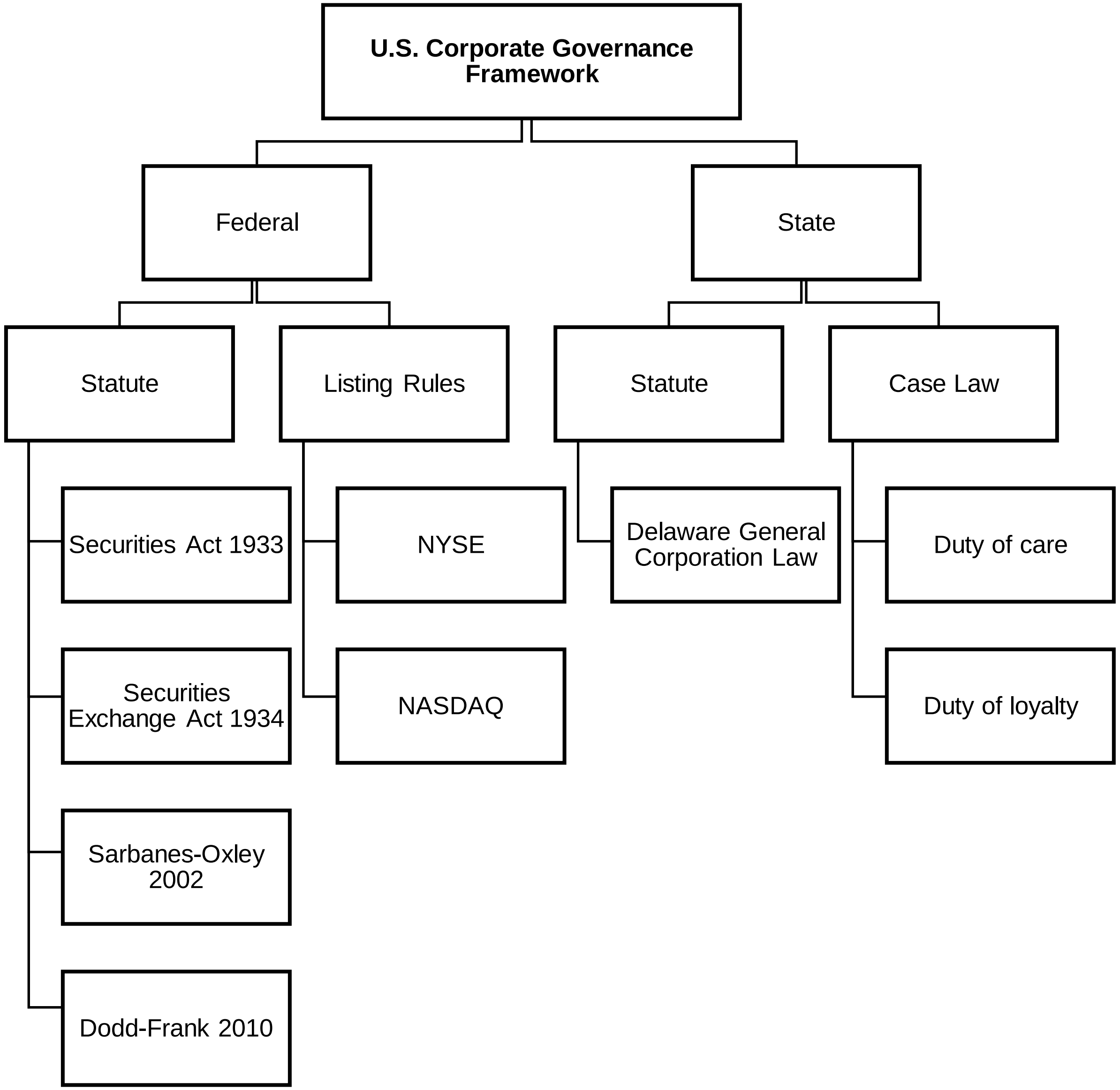

Figure 10: The U.S. corporate governance framework

Consistent with agency theory, Delaware case law has established that directors are fiduciaries and therefore owe a duty of care and a duty of loyalty.[517] Unlike the UK where directors' duties are codified in the CA 2006, directors' duties in Delaware are still scattered amongst an extensive body of case law.

The duty of care requires directors to exercise reasonable skill and knowledge. Often considered the most controversial, the duty of care has been the subject of intense debate and criticism. According to Einsberg, the general duty of care gave rise to four specific duties, (i) duty to monitor, (ii) duty of inquiry, (iii) duty to make reasonable decisions and (iv) duty to employ a reasonable decision-making process. An important case in the development of directors' duties of care is *Smith v. Van Gorkom*. In *Van Gorkom*, the director failed to disclose material information and the board failed in its duty to review material information.[518] Consequently, the directors were found to be grossly negligent and jointly and severally liable for over $23 million.[519] In *Guth v Loft, Inc,* the court opined that 'corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests".[520] The duty of loyalty, therefore, requires directors to act in good faith and in the best interest of the company.

7.3 DEVELOPMENT OF CORPORATE GOVERNANCE IN THE U.S.

The debate to regulate corporate behaviour was ongoing in the U.S. long before the term corporate governance began to gain dominance in the UK in the 1990s.[521] Following World War II, the U.S. experienced a rapid rise in the corporate form.[522] As a result, several academics expressed concerns that this rise in corporate form and the move towards a capitalist economy could be subject to abuse and corporate

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[517] Delaware.gov, 'The Delaware Way: Deference to the Business Judgment of Directors Who Act Loyally and Carefully' (*Delaware.gov,* <https://corplaw.delaware.gov/delaware-way-business-judgment/> accessed 9 September 2021.

[518] *Smith v Van Gorkom* 488 A2d 858 (Del 1985).

[519] Randy J Holland, 'Delaware Directors' Fiduciary Duties: The Focus on Loyalty' (2010) 11:3 U of Pennsylvania Journal of Business Law 675; Craig W Palm and Mark A Kearney, 'A Primer on the Basics of Directors' Duties in Delaware: The Rules of the Games (Part II)' (1997) 42 Vill L Rev 1044.

[520] *Guth v Loft Inc* 5 A2d 503, 23 Del Ch 255 (Del 1939).

[521] Brian R Cheffins, 'The History of Corporate Governance' (2011) Oxford Handbook of Corporate Governance, Mike Wright, Donald Siegel, Kevin Keasey and Igor Filatotchev, eds, Oxford University Press, 2013, University of Cambridge Faculty of Law Research Paper No 54/2011, ECGI - Law Working Paper No 184/2012 <https://ssrn.com/abstract=1975404> accessed 19 March 2019.

[522] ibid 2.

greed.[523] Despite these concerns, regulators appeared generally reluctant to introduce major corporate governance reforms due to concerns of 'pervasive government supervision.'[524] Consequently, the internal struggle within the U.S. to regulate company behaviour including shareholders voting rights, remuneration packages and placing controls on company directors continued to rage on for several decades.

In 2001 the U.S. experienced a string of corporate scandals, such as Enron, Tyco and WorldCom, which precipitated the now famous Sarbanes-Oxley Act. It is important to point out here that common among the companies embroiled in these corporate scandals, is the use of earning management strategies such as inflating revenues, understating costs, or, in the case of Enron hiding losses off the balance sheet. Signed into law on July 30, 2002, Sarbanes-Oxley was publicised as the widest overhaul of corporate law in 70 years.[525] Although Sarbanes-Oxley has often been criticised for its one-size fits all approach, Wiesen held the view that Sarbanes-Oxley filled a void left by the Securities Exchange Act of 1934 (Exchange Act) by addressing 'what people do' and therefore added flesh to the bones of a framework for the regulation of companies that first began to take shape over 70 years ago with the passage of the Exchange Act.[526]

An important achievement of Sarbanes-Oxley is the creation of the Public Company Accounting Oversight Board (PCAOB). According to Coates IV, Sarbanes-Oxley represented a recognition that auditing was functioning poorly and explains that is why so many of the requirements are geared toward the auditing profession.[527] This sentiment was shared by Coffee and Coffee Jr, who explained that the true purpose of Sarbanes-Oxley was to improve audit quality and therefore reduce instances of fraud.[528] Despite being regarded as the watchdogs of financial regulations, the

[523] Brian R Cheffins, 'Corporate Governance since the Managerial Capitalism Era' (2015) 89 Business History Review 717; Ronald J Gilson and Jeffrey N Gordon, 'The Rise of Agency Capitalism and the Role of Shareholder Activists in Making It Work' (2019) 31 Journal of Applied Corporate Finance 8.

[524] Cheffins, 'The History of Corporate Governance' (n 521) 3.

[525] Thomsen and Norman (n 3).

[526] Jeremy Wiesen, 'Congress enacts Sarbanes-Oxley Act of 2002: A two-ton gorilla awakes and speaks' (2003) 18 Journal of Accounting, Auditing & Finance 429.

[527] John C Coates IV, 'The goals and promise of the Sarbanes-Oxley Act' (2007) 21 Journal of Economic Perspectives 91.

[528] John C Coffee and John C Coffee Jr, *Gatekeepers: The professions and corporate governance* (OUP 2006).

auditors had failed spectacularly to identify serious and material accounting irregularities, which lead to a series of financial scandals that lead to the passage of Sarbanes-Oxley. However, since its introduction Sarbanes-Oxley has been the subject of intense debate. Perino criticised the haste at which Sarbanes-Oxley was passed, arguing that Congress failed to take into consideration much of the academic research on corporate governance and many of the provisions merely delegates power to the U.S. Securities and Exchange Commission (SEC) to adopt rules.[529] This view was shared by several other academics.[530] In a scathing attack on Sarbanes-Oxley, Professor Romano referred to Sarbanes-Oxley as ‘quack corporate governance’.[531] Of Romano’s many criticisms, she also focused on the process of how Sarbanes-Oxley was passed through Congress, with little debate and in response to public pressure.

On the contrary, Coates IV held a different view arguing that the US has a long history of corporate governance debate and auditing oversight which dated back to 1978 with the first Public Accounting Oversight body.[532] Furthermore, because much of the provisions of Sarbanes-Oxley delegate rules making power to the PCAOB, it is able to respond quicker than Congress.[533] In defending Sarbanes-Oxley, Prentice and Spence did not dispute the haste at which Congress acted, however they argued that like most legislative reform Sarbanes-Oxley was the result of public and political pressure.[534] This was also the case with the Securities Act of 1933 (Securities Act) and the Exchange Act, both of which were in response to public pressure amid the stock market crash of 1929.[535]

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[529] Michael A Perino, 'Enron's legislative aftermath: Some reflections on the deterrence aspects of the Sarbanes-Oxley Act of 2002' (2002) 76 St John's L Rev 671, 673.

[530] See Stephen M Bainbridge, 'Sarbanes-Oxley: legislating in haste, repenting in leisure' (2006) 2 The corporate governance law review 69; Larry E Ribstein, 'Sarbox: The Road to Nirvana' (2004) 2004 Mich St L Rev 279; Roberta Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (2005) 114 Yale Law Journal 1521; Luigi Zingales, 'The costs and benefits of financial market regulation' (2004) ECGI - Law Working Paper No 21/2004 <https://ssrn.com/abstract=536682> accessed 9 August 2019.

[531] Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (n 530).

[532] Coates IV (n 527).

[533] ibid.

[534] Robert A Prentice and David B Spence, 'Sarbanes-Oxley as quack corporate governance: how wise is the received wisdom' (2006) 95 Geo LJ 1843.

[535] ibid 1849.

Nevertheless, Sarbanes-Oxley introduced several mandatory requirements, including director certification of financial statements and placed restrictions on the type of non-audit work that external auditors can undertake. Unlike the UK corporate governance code which operates on a voluntary compliance mandatory disclosure basis, compliance to the requirements of Sarbanes-Oxley is mandatory. For instance, Sarbanes-Oxley specifically prohibits non-audit work with penalties for breach. The UKCG 2018 on the other hand gives discretion to the AudCom to determine the scope of non-audit work that can be provided by the external auditor.

In 2003, following the passage of Sarbanes-Oxley, the NYSE and the NASDAQ both updated their listing requirements for publicly traded companies. According to Karmel, the listing rules were generally considered to be a 'substitute for government regulation'.[536] However, in the aftermath of the scandals and following the passage of Sarbanes-Oxley, Craig noted that the updated listing requirements actually go beyond the requirements of Sarbanes-Oxley.[537] For example, the NYSE listing rules require all the members of the audit, compensation and nominating committees to be independent directors. Given that listing rules of the NASDAQ and NYSE, the two largest stock exchanges in the U.S., go beyond the requirements of Sarbanes-Oxley begs the question of whether the rules-based approach adopted with the passage of Sarbanes-Oxley was necessary.

7.4 THE SARBANES-OXLEY ACT OF 2002

Before the passage of Sarbanes-Oxley, federal corporate governance in the U.S. consisted primarily of disclosure requirements.[538] At the time of its passage, then President of the U.S. George W. Bush hailed Sarbanes-Oxley as the 'most far-reaching form of American business practices since the time of Franklin Delano Roosevelt.'[539] With over 1100 sections spread over 11 Titles, Sarbanes-Oxley is a convoluted and lengthy piece of legislation. Despite its extensive effects, the key corporate governance provisions that relate to auditor independence, corporate

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536 Roberta S Karmel, 'The future of corporate governance listing requirements' (2001) 54 SMUL Rev 325, 327.

537 Valentine V Craig, 'The changing corporate governance environment: Implications for the banking industry' (2004) 16 FDIC Banking Rev 121, 126.

538 Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (n 530) 1523.

539 Elisabeth Bumiller, 'Bush Signs Bill Aimed at Fraud in Corporations' *The New York Times* (New York July 31, 2002) <www.nytimes.com/2002/07/31/business/corporate-conduct-the-president-bush-signs-bill-aimed-at-fraud-in-corporations.html> accessed 17 July 2020.

accountability, AudCom effectiveness and internal controls are contained in Titles II, III and IV.

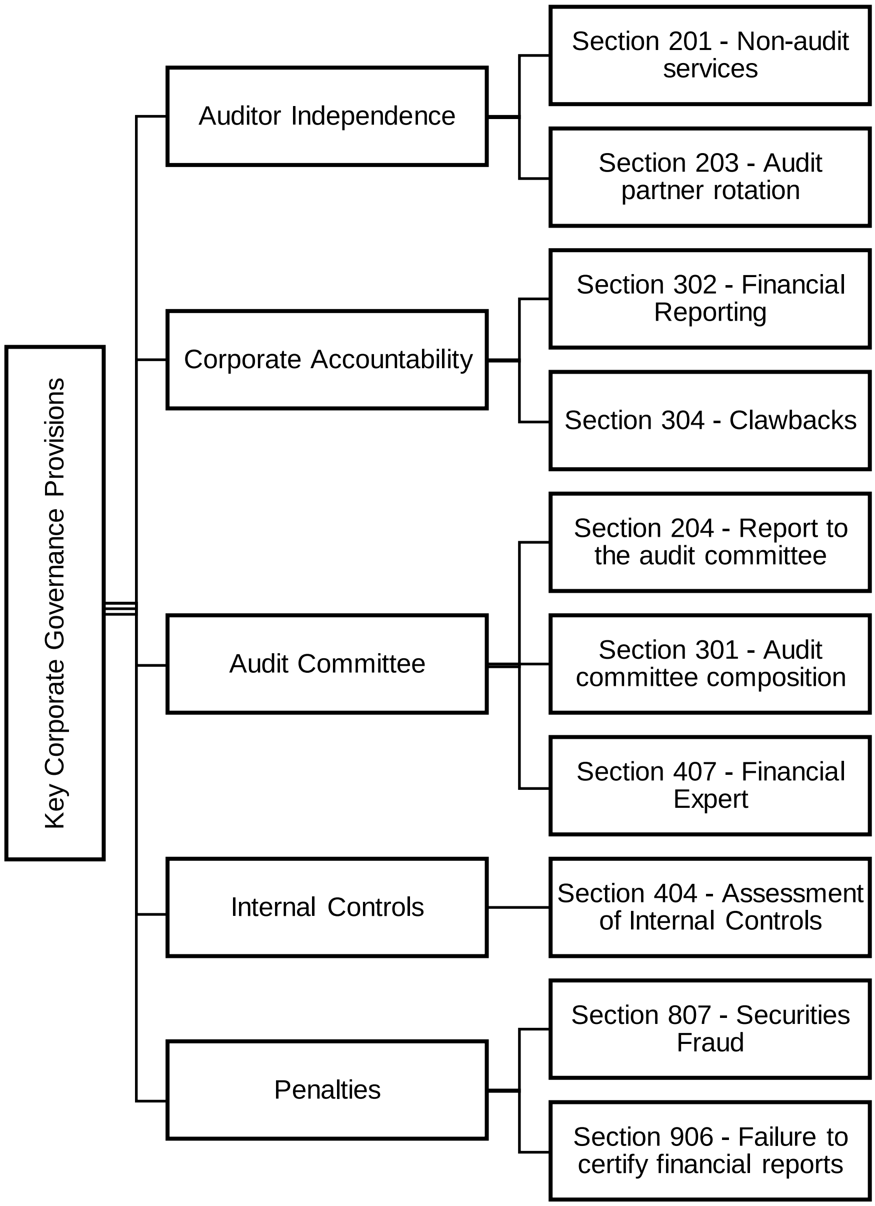

Figure 11: The key corporate governance provisions of Sarbanes-Oxley

Title II (Auditor independence), as surmised from its title, is aimed at ensuring and improving the independence of the external auditor. The provisions that relate to corporate governance include sections 201, 203 and 204. Section 201 addresses the provision of services outside the scope of the audit. Section 203 regulates the tenure of the audit partner and section 204 requires the auditor to provide timely reports to the AudCom.

While Title II regulates the external auditor relationship, Title III (Corporate Responsibility) is aimed at corporate officers. Under Title III, sections 301 and 302 relate to corporate governance. Section 301 sets out the composition requirements and responsibilities of the AudCom. Section 302 requires corporate officers to certify the accuracy of the annual or quarterly reports and section 304 addresses clawback provisions.

Title IV (Enhanced Financial Disclosure) addresses internal controls and disclosures. The main corporate governance sections in Title IV are 404 and 407. Section 404 addresses the internal control environment and section 407 requires companies to disclose whether at least one member of the AudCom is a financial expert.

7.4.1 Auditor Independence

Long before Sarbanes-Oxley was introduced, the then chair of the Securities and Exchange Commission (SEC), Philip Loomis Jr, referred to auditor independence as a ‘fundamental concept’.[540] As a result of the failure of Arthur Andersen following the Enron scandal, ensuring the independence of the auditor was considered key to restoring trust in financial markets. As demonstrated by the collapse of Arthur Andersen, it is inherently difficult for an auditor to objectively and impartially assess the true financial position of a client when the auditors’ interest is also tied to the success of the client. As a result, Sarbanes-Oxley introduced several provisions aimed at regulating and improving the auditor-client relationship. This section focuses on the requirements of sections 201 and 203. Each will now be addressed in turn.

Section 201 - Non-audit services

Following the collapse of Enron, questions quickly emerged whether the provision of non-audit services adversely affected Arthur Andersen’s independence and objectivity. In addition to the $25 million audit fee, Arthur Andersen received $27 million in consulting fees from Enron.[541] Sarbanes-Oxley expressly prohibits external auditors from engaging in the following non-audit services:

> *(1) bookkeeping or other services related to the accounting records or*

[540] Philip A Loomis, 'Audit Committees - The American Experience' SEC (1978) <www.sec.gov/news/speech/1978/110378loomis.pdf> accessed 12 August 2020.

[541] James Tackett, Fran Wolf and Gregory Claypool, 'Sarbanes-Oxley and audit failure' (2004) 19 Managerial Auditing Journal 340.

> *financial statements of the audit client;*
> *(2) financial information systems design and implementation;*
> *(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;*
> *(4) actuarial services;*
> *(5) internal audit outsourcing services;*
> *(6) management functions or human resources;*
> *(7) broker or dealer, investment adviser, or investment banking services;*
> *(8) legal services and expert services unrelated to the audit; and*
> *(9) any other service that the Board determines, by regulation, is impermissible.*

As expected, the auditing profession fiercely fought against section 201 arguing that the provision of non-audit services allowed the auditor to develop a greater understanding of the client, which in turn would improve the quality of the audit and create economies of scale.[542] This 'knowledge spillover' from the provision of audit and non-audit service by the same auditor has been examined in several studies.[543]

Nevertheless, in his seminal study Simunic acknowledged that even though efficiencies are gained, there is the potential for the auditor's independence to be impaired.[544] Since then, several studies have examined the relationship between auditor independence and non-audit services with mixed results. A well-known study by Frankel, Johnson and Nelson found that the provision of non-audit services adversely affected auditor independence and in turn audit quality.[545] A later study by Ashbaugh, La Fond and Mayhew later disputed the findings of Frankel, Johnson and Nelson, arguing that there was no association between auditor independence and non-audit fees. This view was later supported in another study by Huang, Mishra and Raghunadan conducted after the introduction of Sarbanes-Oxley.[546] The mixed results on non-audit service and auditor independence lend support to Romano's argument that many of Sarbanes-Oxley provisions were enacted without

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[542] W Robert Knechel and Divesh S Sharma, 'Auditor-provided nonaudit services and audit effectiveness and efficiency: Evidence from pre-and post-SOX audit report lags' (2012) 31 Auditing: A Journal of Practice & Theory 85.

[543] Dan A Simunic, 'Auditing, consulting, and auditor independence' (1984) 22 Journal of Accounting Research 679; Zoe-Vonna Palmrose, 'Audit fees and auditor size: Further evidence' (1986) 24 Journal of Accounting Research 97; A Rashad Abdel-Khalik, 'The jointness of audit fees and demand for MAS: A self-selection analysis' (1990) 6 Contemporary Accounting Research 295.

[544] Simunic (n 543).

[545] Richard M Frankel, Marilyn F Johnson and Karen K Nelson, 'The relation between auditors' fees for nonaudit services and earnings management' (2002) 77 The Accounting Review 71.

[546] Hua-Wei Huang, Suchismita Mishra and Kanan Raghunandan, 'Types of nonaudit fees and financial reporting quality' (2007) 26 Auditing: A Journal of Practice & Theory 133.

thought and consideration to academic research.[547] This begs the question of whether in trying to prevent another Enron, Congress went too far by punishing all companies for one bad apple and whether section 201 puts an undue burden on companies.

Section 203 - Audit partner rotation

Section 302 requires the mandatory rotation of the lead audit partner every five years.[548] This appears to be based on the premise that an auditors' independence and objectivity can become impaired as a result of over-familiarity. Several studies have examined the auditor-client relationship and its impact on the independence and objectivity of the auditor.[549] However, Sarbanes-Oxley stops short of mandating rotation of the audit firm and only requires mandatory rotation of the audit partner. Supporters of audit partner rotation argue that the change in auditor can bring a fresh perspective and therefore improve audit quality.[550]

7.4.2 Corporate Accountability

On the basis that personal responsibility would encourage executives to take a more active role, Sarbanes-Oxley introduced several provisions aimed at improving corporate accountability. Key among these provisions were sections 302 and 304. In what was then described as an 'unprecedented step,' section 302 requires corporate executives to personally attest to the company's financial report.[551] To motivate executives to take their corporate responsibilities seriously and to ensure that executives did not profit from misconduct, section 304 introduced clawback provisions. Clawback provisions allow incentive-based compensation and bonuses

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547 Romano, 'The Sarbanes-Oxley Act and the Making of Quack Corporate Governance' (n 530).

548 Public Company Accounting Reform and Investor Protection Act 2002, s203(j).

549 James N Myers, Linda A Myers and Thomas C Omer, 'Exploring the term of the auditor-client relationship and the quality of earnings: A case for mandatory auditor rotation?' (2003) 78 The accounting review 779; R K Mautz and H A Sharaf, *The philosophy of auditing* (American Accounting Association 1961); Donald R Deis Jr and Gary A Giroux, 'Determinants of audit quality in the public sector' (1992) 67 Accounting review 462.

550 Clive S Lennox, Xi Wu and Tianyu Zhang, 'Does mandatory rotation of audit partners improve audit quality?' (2014) 89 The accounting review 1775; Peter Carey and Roger Simnett, 'Audit partner tenure and audit quality' (2006) 81 The accounting review 653; Henry Laurion, Alastair Lawrence and James P Ryans, 'US audit partner rotations' (2017) 92 The Accounting Review 209.

551 US Securities and Exchange Commission, 'SEC Publishes List of Companies Whose Officers Are Ordered To Certify Accuracy and Completeness of Recent Annual Reports' (SEC, 28 June 2002) <www.sec.gov/news/press/2002-96.htm> accessed 19 June 2021.

to be recouped from executives in the event of material restatements or misconduct. The requirements of sections 302 and 304 will now be addressed in turn.

Section 302 - Financial Reporting

Misleading financial reporting has been at the centre of many of the biggest corporate governance scandals of the past. In an attempt to improve the overall quality of financial reporting and ensure that management was aware of their responsibilities, section 302 of Sarbanes-Oxley codified the responsibilities of corporate executives in corporate reporting.

Section 302 requires the chief executive and the chief financial officer to certify that the annual and quarterly reports 'fairly present in all material respects the financial condition and results' and 'does not contain any untrue statement of a material fact or omit to state a material fact.'[552] At its core, it can be argued that section 302 aims to ensure that all material information is disclosed. However, it is important to point out here that materiality by its very nature is subjective and has been subject to abuse in the past.[553] As explained in Chapter 4, information is material if its omission could influence the decisions of users. Nevertheless, the subjective nature of materiality continues to lead to confusion over what information should be disclosed and has resulted in financial reports being increasingly cluttered and unreliable. For instance, the annual report of Valeant Pharmaceuticals was over 120 pages. Interestingly, the company was recently fined $45 million by the SEC for 'improper revenue recognition and misleading disclosures.'[554]

Most importantly, section 302 places personal responsibility directly on the CEO and CFO (or equivalent officers) for ensuring that the company's quarterly and annual reports are free from material error. Although section 302 does not include criminal sanctions, the filing of a false 302 declaration can amount to securities fraud.[555] However, Fairfax questions the effectiveness of section 302 certifications as a

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[552] Sarbanes-Oxley, s302.

[553] Levitt (n 252).

[554] US Securities and Exchange Commission, 'Pharmaceutical Company and Former Executives Charged With Misleading Financial Disclosures' (*SEC,* 31 July 2020) <www.sec.gov/news/press-release/2020-169> accessed 9 September 2021.

[555] Joseph McLaughlin and Yafit Cohn, *SOX Certification Requirement and Clawback Provision* (Simpson Thacher & Bartlett LLP, 2016); Alexander F Cohen and D Jamal Qaimmaqami, 'The U.S. Sarbanes-Oxley Act of 2002: 2004 Update for Non-U.S. Issuers' (2004) Latham & Watkins <www.lw.com/upload/pubcontent/_pdf/pub1059_1.pdf> accessed 26 August 2020.

deterrent. Fairfax contends that while section 302 certification changed the scope of personal liability, it did little to change the standard of liability for directors under section 10 (b) of the Exchange Act.[556]

Section 304 – Forfeiture of bonuses and profits

Section 304 empowers the SEC to order the reimbursement of bonuses and incentive-based compensation from the chief executive and chief financial officer. Unlike section 807 of Sarbanes Oxley, which can be enforced by shareholders, section 304 does not create a private right of action.[557] In other words, it is only the SEC that can pursue reimbursement under section 304. However, historically the SEC has shown a general reluctance to use section 304. In the five years following its introduction, the SEC only brought five actions under section 304.[558] This represents an average of one action per year. According to Friedman and others, section 304 continues to be a rarely used power.[559]

Interestingly, despite the SEC's limited use of section 304, the number of financial restatements has decreased by 80% since 2006.[560] Perhaps this can be explained by the fact that companies have voluntarily adopted clawback provisions. A study by Babenko and others reported that 80% of S&P 500 companies had voluntarily adopted clawback provisions by 2017.[561] More recently a study of 200 S&P 500 companies found that 98% had adopted clawback policies.[562] The increase in the number of companies reporting clawback policies combined with the decrease in the number of financial restatements suggests that clawback provisions can act as a

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[556] Lisa M Fairfax, 'Form over substance: officer certification and the promise of enhanced personal accountability under the Sarbanes-Oxley Act' (2002) 55 Rutgers L Rev 1US Securities and Exchange Commission, 'Proposed Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports' (*SEC,* 18 June 2002) <www.sec.gov/rules/proposed/34-46079.htm> accessed 15 July 2020.

[557] *Cohen v Viray* 622 F3d 188 (2d Cir 2010)*In re Digimarc Corp Derivative Litigation* 549 F3d 1223, 1233 (9th Cir 2008).

[558] Allison List, 'The lax enforcement of Section 304 of Sarbanes-Oxley: why is the SEC ignoring its greatest asset in the fight against corporate misconduct?' (2009) 70 Ohio State law journal 195, 217.

[559] Alan R Friedman and others, 'SEC Settlement Invokes Rarely Used Sarbanes-Oxley Act Provision Requiring Reimbursement of Incentive Compensation' (*Kramer Levin,* 22 February 2021) <www.kramerlevin.com/en/perspectives-search/sec-settlement-invokes-rarely-used-sarbanes-oxley-act-provision-requiring-reimbursement-of-incentive-compensation.html> accessed 8 December 2021.

[560] Audit Analytics, *2020 Financial Restatements: A twenty-year review* (Audit Analytics, 2021) 4.

[561] Ilona Babenko and others, 'Clawback Provisions and Firm Risk' (2019) Fisher College of Business Working Paper No 2019-03-013, Charles A Dice Center Working Paper No 2019-13 <https://ssrn.com/abstract=3382498> accessed 18 July 2021.

[562] Meridian Compensation Partners, *2021 Corporate Governance and Incentive Design Survey* (Meridian Compensation Partners, LLC, 2021) 31.

powerful means of motivating directors to be more vigilant. As a result, it can be argued that clawback provisions can be an effective deterrent.

7.4.3 Audit Committee

Interestingly, the concept of AudComs has a long history in the U.S. dating back to the General Motor Corporation in 1939.[563] Although Enron is often credited for reforming the corporate governance landscape in the U.S., fraudulent financial reporting was not new. This view was later shared by Foster and Strauch, who contended that corporate fraud is 'nothing new under the sun.'[564]

Despite its collapse, for all intents and purposes, Enron appeared to have a 'well qualified' AudCom composed of six independent external directors.[565] Furthermore, four of the members of Enron's AudCom had expertise in Enron's industry and financial literacy.[566] Not surprisingly, Enron's AudCom was criticised for its failure to protect financial markets from corporate greed. To address the failures, Sarbanes-Oxley introduced a series of measures aimed at improving audit quality and strengthening the auditor relationship.

Section 204 - Report to the Audit Committee

According to DeZoort and others, to be effective the AudCom must have authority and influence.[567] Section 204 of Sarbanes-Oxley attempts to address this and empower the AudCom by creating a direct link between the AudCom and the external auditor. Section 204 requires the external auditor to report directly to the AudCom on 'all critical accounting policies and practices to be used.'[568] This includes 'material written communication' between the external auditor and management.[569]

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[563] Loomis (n 540).

[564] Sheila D Foster and Bruce A Strauch, 'Auditing cases that made a difference: McKesson & Robbins' (2009) 5 Journal of Business Case Studies (JBCS) 1, 1.

[565] Erica Beecher-Monas, 'Corporate governance in the wake of Enron: an examination of the audit committee solution to corporate fraud' (2003) 55 Admin L Rev 357.

[566] George J Benston and Al L Hartgraves, 'Enron: what happened and what we can learn from it' (2002) 21 Journal of accounting and public policy 105.

[567] DeZoort and others (n 206).

[568] Sarbanes-Oxley, s204(k)(1).

[569] ibid s204(k)(3).

As previously mentioned, many instances of corporate governance failures have been linked to the manipulation of accounting standards. Sarbanes-Oxley therefore mandates the type of information that should be reported to the AudCom, including information on how accounting standards have been applied. By prescribing the type of information and the responsibilities in federal law, the AudCom is legally empowered to hold directors accountable.[570] Nevertheless, instances of revenue manipulation and other accounting standards manipulation continue to emerge. For instance, The Hertz Corporation (Hertz) manipulated annual depreciation to reduce its expenses, by increasing the holding period of its rental car fleet.[571] The continuing instances of accounting standards manipulation continue to call into question the effectiveness of the AudCom in preventing and detecting corporate misconduct. It is also important to note here that although Sarbanes-Oxley empowers the AudCom, the Act does not include penalties for AudCom failures. Unlike the chief executive and chief financial officers, AudCom members are not required to certify the accuracy of the financial reports. Therefore, it can be argued that Sabarnes-Oxley does little to motivate the AudCom to be more vigilant.

Section 301- Audit committee composition

Although Sarbanes-Oxley is silent on the number of directors required on the AudCom, the NYSE and the NASDAQ require the AudCom of listed companies to consist of a minimum of three directors.[572] In fact, the NYSE and NASDAQ required listed companies to have an AudCom since 1999.[573] Most importantly section 301 requires all members of the AudCom to be independent.[574] To be considered independent members of the AudCom may not 'accept any consulting, advisory, or other compensatory fee' from the company.[575] Nevertheless, there remain concerns regarding the impact of independence on the probability of accounting fraud. According to a study by Beasley, AudComs have very little impact on corporate

[570] DeZoort and others (n 206).

[571] US Securities and Exchange Commission, 'In the Matter of Hertz Global Holdings, Inc and The Hertz Corporation,' (*SEC,* 31 December 2018) <www.sec.gov/litigation/admin/2018/33-10601.pdf> accessed 8 December 2021.

[572] Deloitte, *Audit committee requirements and governance topics* (Deloitte, 2018).

[573] Seil Kim and April Klein, 'Did the 1999 NYSE and NASDAQ listing standard changes on audit committee composition benefit investors?' (2017) 92 The Accounting Review 187.

[574] Sarbanes-Oxley, s301(a).

[575] ibid s301(b)(i).

fraud.[576] A study by Beasley and others suggests that the main weaknesses of AudComs can be attributed to the oversight process, which includes the selection process for AudCom members, the meeting schedule and over reliance on management assertions.[577] Nevertheless, Sarbanes-Oxley appears to have done little to address the oversight process and therefore call into question the effectiveness of AudComs. This view was shared by Beecher-Monas who argued that the AudCom proposals contained in Sarbanes-Oxley are not new and therefore unlikely to be effective.[578]

Section 407 - Financial Expert

Section 407 requires the SEC to issue rules on financial experts and outlines factors that should be taken into consideration when determining if an individual is a financial expert. To determine whether an individual can be considered a financial expert, section 407 requires consideration to be given to the 'education and expertise' of the individual.[579] Most importantly, section 407 explicitly prescribes that financial experts should have an understanding of Generally Accepted Accounting Principles (GAAP), experience with internal controls, and experience preparing or auditing financial statements.[580]

Although section 407 does not mandate that AudComs include a financial expert, it does mandate disclosure.[581] In other words, section 407 only requires companies to disclose whether the AudCom includes a financial expert or to disclose the reasons why a financial expert has not been appointed. According to the Centre for Audit Quality, all S&P 500 companies have a financial expert.[582] In fact, 51% of S&P 500 have reported having three or more financial experts on the AudCom.[583] Nevertheless, instances of corporate misconduct continue to come to light. Perhaps the focus on simply having accounting experience is not sufficient. Instead, financial

[576] Mark S Beasley, 'An Empirical Analysis of the Relation Between the Board of Director Composition and Financial Statement Fraud' (1996) 71 The Accounting Review 443.

[577] Mark S Beasley and others, 'The Audit Committee Oversight Process' (2009) 26 Contemporary Accounting Research 65.

[578] Beecher-Monas, 'Corporate governance in the wake of Enron: an examination of the audit committee solution to corporate fraud'565).

[579] Sarbanes-Oxley, s407(b).

[580] ibid s407(b)(2).

[581] ibid s407(a).

[582] Center for Audit Quality, 'CAQ Insights: Audit Committee Financial Expert' (*CAQ,* 6 June 2016) <www.thecaq.org/caq-insights-audit-committee-financial-expert/> accessed 15 April 2022.

[583] ibid.

experts should also have industry specific experience. Perhaps this may prove to be more effective in enabling AudComs to detect accounting manipulation and abuse. For instance, despite all three members of the Hertz AudCom being considered financial experts, the company engaged in a years' long scheme to manipulate its financial statements.[584]

7.4.4 Internal Controls

In the aftermath of the Enron collapse, the importance of effective internal controls, in preventing and detecting corporate misconduct and ensuring the adequacy of financial disclosures, was firmly in the spotlight. Due to material weaknesses in Enron's internal controls, the company's annual report did not accurately reflect the financial position of the company. Due in part to weak internal controls, the company's executives engaged in a series of complex transactions in an attempt to conceal the true position of the company. Section 404 introduced two key provisions aimed at improving internal controls. Section 404(a) addresses management's responsibilities, while section 404(b) addresses the auditors' responsibilities. Each will now be addressed in turn.

Section 404(a) - Management assessment of internal controls

Section 404 of Sarbanes-Oxley was specifically introduced with the aim of improving internal controls and preventing another Enron by requiring management to evaluate and report on the effectiveness of the company's internal controls. According to section 404, companies are required to prepare an annual internal control report. Ultimately section 404 makes it clear that the responsibility for designing and implementing effective internal controls rests with management.[585] Furthermore, to encourage directors to engage, section 404 also requires an assessment and report on the effectiveness of the system of internal controls.[586]

[584] US Securities and Exchange Commission, 'SEC Charges Hertz with Inaccurate Financial Reporting and Other Failures' (*SEC,* 1 February 2019) <www.sec.gov/enforce/33-10601-s> accessed 29 June 2021.

[585] Sarbanes-Oxley, s404(a)(1).

[586] ibid s404(a)(2).

Since its introduction section 404 has been the most contentious and hotly debated provision of Sarbanes-Oxley.[587] A significant portion of these debates has involved the expensive costs of implementing section 404. Notwithstanding its costs, by implementing section 404 Congress recognised the importance of internal controls in preventing and detecting corporate fraud and misconduct.

More importantly, Congress cemented management's direct responsibility to identify and address weaknesses in the company's system of internal controls. Nevertheless, despite the introduction of section 404, instances of internal controls failure continue to emerge. However, it is important to note here that no system of internal control is expected to detect all instances of fraud or misconduct. At its core Sarbanes-Oxley encourages disclosures, not an impenetrable system of internal controls. It requires deficiencies to be identified and material weaknesses disclosed.

Section 404(b) - Auditors' assessment of internal controls

Although the primary responsibility for the effectiveness of internal controls rests with management, Sarbanes-Oxley added another layer of protection by requiring auditors to 'attest to, and report on' management assessment of the company's internal controls.[588] Arguably section 404(b) recognises that relying solely on management assessment of internal controls was akin to relying on unaudited financial statements, which can be subject to abuse. However, it is important to point out that in the lead up to many of the corporate scandals of the past, the auditors' report proved to be worth nothing more than the paper it was printed on.

7.4.5 Penalties

To encourage compliance and deter corporate misconduct, Sarbanes-Oxley includes criminal sanctions for non-compliance. However, the effectiveness of Sarbanes-Oxley in deterring corporate misconduct continues to be an ongoing topic

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[587] See Parveen P Gupta, Heibatollah Sami and Haiyan Zhou, 'Do companies with effective internal controls over financial reporting benefit from Sarbanes–Oxley Sections 302 and 404?' (2018) 33 Journal of Accounting, Auditing & Finance 200; Huasheng Gao and Jin Zhang, 'SOX section 404 and corporate innovation' (2019) 54 Journal of Financial and Quantitative Analysis 759; Tim Leech and Lauren Leech, 'Preventing the next wave of unreliable financial reporting: Why US Congress should amend Section 404 of the Sarbanes–Oxley Act' (2011) 8 International Journal of Disclosure and Governance 295; Zvi Singer and Haifeng You, 'The effect of Section 404 of the Sarbanes-Oxley Act on earnings quality' (2011) 26 Journal of Accounting, Auditing & Finance 556; Tim J Leech, 'Sarbanes-Oxley Sections 302 & 404: A White Paper Proposing Practical, Cost Effective Compliance Strategies ' CARD decisions Inc (2003) <www.sec.gov/rules/proposed/s74002/card941503.pdf> accessed 9 May 2020.

[588] Sarbanes-Oxley, s404(b).

of debate. The remainder of this section will consider the sanctions included in sections 807 and 906.

Section 807 - Securities Fraud

Section 807, also known as the Securities Fraud Statute, creates a criminal offence for 'whoever knowingly executes, or attempts to execute, a scheme or artifice' either (1) 'to defraud any person in connection with any security' or (2) 'to obtain, by means of false or fraudulent pretenses, representations, or promises, any money or property in connection with the purchase or sale of any security'.[589] The offence carries a maximum penalty of 25 years, and/or a fine.[590]

Lambert argues that section 807 did nothing to change the securities fraud laws in place before the passage of Sarbanes-Oxley.[591] In fact, according to Lambert U.S. prosecutors have been able to enforce corporate misconduct and fraud since 1933.[592] At its core, section 807 aims to make it easier for federal prosecutors to hold wrong-doers accountable. However, given that federal prosecutors have long had criminal sanctions available to them, the effect of section 807 on corporate misconduct remains questionable.

Section 906 - Failure to certify financial reports

In addition to the section 302 certificate, section 906 requires the CEO and CFO (or equivalent officers) to certify that the financial statements 'fairly presents, in all material respects, the financial condition and results of operations' of the company.[593] However, unlike the section 302 certificate which is only required for quarterly and annual reports, the section 906 certificate is required for all reports 'containing financial statements.'[594] This means that all quarterly and annual reports must contain both a section 302 and a section 906 certificate.

Most importantly, section 906 amends the United States Code and creates criminal penalties for filing a false report, which can lead to imprisonment for up to 20 years

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[589] ibid s807.

[590] ibid s807(a)(2).

[591] Phillip Wesley Lambert, 'Worlds Are Colliding: A Critique of the Need for the Additional Criminal Securities Fraud Section in Sarbanes-Oxley' (2002) 53 Case W Res L Rev 839.

[592] ibid 842.

[593] Sarbanes-Oxley, s906(b).

[594] ibid s906(a).

or a fine of up to $5 million.[595] Although section 906 distinguishes the penalties based on wilful or knowing certification, Sarbanes-Oxley does not define what is considered wilful or knowing. In explaining Congress' intent, Biden Jr explained that knowing conduct simply requires corporate executives to possess 'knowledge of the facts'. On the other hand, wilful conduct requires officials to engage in activities 'with knowledge that the conduct is unlawful.'[596]

7.5 U.S. APPROACH TO CORPORATE GOVERNANCE

Figure 12: U.S. approach to corporate governance

Unlike the principles-based approach to corporate governance in the UK which relies on voluntary compliance to a code of principles, Sarbanes-Oxley codified the responsibilities of corporate executives, AudComs and external auditors. Most importantly however, Sarbanes-Oxley includes several penalties for non-compliance. Sama and Shaof reasoned that the rules-based approach to corporate governance in the U.S. is based on the premise that 'social control is not historically, or traditionally woven into the fabric of American life'.[597] In other words, relying on social norms to control corporate behaviour in the U.S. would unlikely have been effective in curbing corporate greed. However, according to May '… honesty and ethics cannot be compelled by legislative fiat and the unethical can always devise ways of circumventing even the most carefully drawn statute'.[598] May's words ring as true today as they did over 80 years ago, as corporate wrong-doers continue to find more innovative ways around legislation. While it is a commonly held view that

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[595] ibid s906(a).

[596] Joseph R Biden Jr, 'Certifying Statements under Section 906 of Sarbanes-Oxley Act: Holding Corporate Executives Accountable for the Accuracy of Corporate Financial Statements' (2002) 15 Fed Sent R 257, 259.

[597] Linda M Sama and Victoria Shoaf, 'Reconciling Rules and Principles: An Ethics-Based Approach to Corporate Governance' (2005) 58 J Bus Ethics 177, 181.

[598] A Wilfred May, 'Financial regulation abroad: The contrasts with American technique' (1939) 47 Journal of Political Economy 457, 460.

legislation alone cannot generally control behaviour, penalties that are effectively enforced can act as a strong deterrent.

Although Sarbanes-Oxley adopts a rules-based approach, its primary purpose was to improve the accuracy of financial reporting and reduce earnings management. To that end, several studies have examined the relationship between Sarbanes-Oxley and financial reporting.[599] Several studies have also examined the merits of the principles based and the rules-based approaches to regulation.[600] In the aftermath of the Enron scandal, the UK's principles-based approach to corporate governance was lauded as superior on the basis that it had successfully prevented an Enron-like scandal in the UK. In his study examining the validity of the 'UK principles superiority' Kershaw contends that whether the regulations were applied as a rule or as a principle, Enron would have been prevented if the regulations were applied correctly.[601] In other words, Enron was the result of a deliberate effort to abuse regulation and not based on the approach to regulation. Although Kershaw's study focused on comparative accounting regulations, corporate governance in the U.S. is also rules based.

The legitimacy of the principles superiority claim was blemished in the aftermath of the collapse of the UK's second largest construction company. Dubbed the 'British Enron', the collapse of Carillion 26 years after the introduction of Cadbury's comply-or-explain code suggests that the approach to corporate governance does not have a significant impact on instances of corporate misconduct.[602] Like Enron, Carillion's

[599] Daniel A Cohen, Aiyesha Dey and Thomas Z Lys, 'Real and accrual-based earnings management in the pre- and post-Sarbanes-Oxley periods' (2008) 83 The Accounting review 757; Gerald J Lobo and Jian Zhou, 'Did conservatism in financial reporting increase after the Sarbanes-Oxley Act? Initial evidence' (2006) 20 Accounting Horizons 57; Jian Zhou, 'Financial reporting after the Sarbanes-Oxley Act: Conservative or less earnings management?' (2008) 20 Research in Accounting Regulation 187.

[600] Sama and Shoaf (n 597); Surendra Arjoon, 'Striking a balance between rules and principles-based approaches to effective governance: A risks-based approach' (2006) 68 Journal of Business Ethics 53; Franklin Nakpodia and others, 'Neither Principles Nor Rules: Making Corporate Governance Work in Sub-Saharan Africa' (2018) 151 J Bus Ethics 391; Dain C Donelson, 'Rules-Based Accounting Standards and Litigation' (2012) 87 Accounting Review 1247; Christopher P Agoglia, Timothy S Doupnik and George T Tsakumis, 'Principles-Based versus Rules-Based Accounting Standards: The Influence of Standard Precision and Audit Committee Strength on Financial Reporting Decisions' (2011) 86 The Accounting Review 747; Mark W Nelson, 'Behavioral Evidence on the Effects of Principles- and Rules-Based Standards' (2003) 17 Accounting Horizons 91; David Alexander and Eva Jermakowicz, 'A true and fair view of the principles/rules debate' (2006) 42 Abacus 132.

[601] David Kershaw, 'Evading Enron: Taking principles too seriously in accounting regulation' (2005) 68 The Modern Law Review 594.

[602] Tara Patel and Robert Hutton, 'Carillion collapses after U.K. government refuses bailout' (*Bloomberg,* 15 January 2018) <www.bloomberg.com/news/articles/2018-01-15/carillion-files-for-liquidation-after-failing-to-get-bailout> accessed 18 August 2020.

directors attempted to conceal the true position of the company with an inflated balance sheet. It is submitted that whether the UKCG had been mandatory the outcome would have been the same. On that basis, it can be argued that neither a principles-based or rules-based approach to corporate governance would have prevented the collapse of Carillion.

7.5.1 Mandatory compliance

According to McBarnet and Whelan, rules by their very nature are susceptible to creative compliance.[603] Creative compliance utilises a narrow approach to interpreting the rules to achieve compliance to the letter of the law. Such a narrow approach impacts the effectiveness of the rules as companies focus on adhering to the letter of the law without considering the purpose and spirit of what the law intends to achieve. Perhaps this narrow interpretation of Sarbanes-Oxley also contributes to why instances of corporate misconduct continue to emerge in the U.S., as companies continue to apply a box-ticking approach to complying with Sarbanes-Oxley. However, considering the inadvertent box-ticking approach that has also come to represent corporate governance in the UK, it can be argued that creative compliance does not only apply to rules.

7.5.2 Disclosures

Although the U.S. has adopted a rules-based approach to corporate governance, at its core corporate governance in the U.S. is aimed at improving disclosures. This view was shared by Senator Biden Jr, who noted that the 'success of securities regulation in the United States is based on full disclosure of a company's financial state.'[604] Coates IV later posited that Sarbanes-Oxley did not actually prescribe many corporate governance changes other than 'greater disclosure'.[605] To assist companies in improving the adequacy of disclosures, the SEC recommends that public companies establish a disclosure committee to assess the reliability and materiality of the information presented in financial reporting.[606] Although not mandated, a 2020 survey of 175 public companies by Ernst & Young found that 94% had adopted disclosure committees.[607] This is consistent with prior surveys

[603] ibid.

[604] Biden Jr (n 596) 258.

[605] Coates IV (n 527).

[606] Ernst & Young LLP, Financial Education and Research Foundation and Society of Corporate Governance, *Disclosure committee report: Practices and trends* (Ernst & Young LLP, 2021).

conducted by CorporateCounsel which indicated that disclosure committees have been common since 2004.[608]

Similar to the UK, Sarbanes-Oxley has also resulted in an increase in the number of disclosures. This has led to concerns that disclosures have been 'counterproductive' as investors are bombarded with information under the new disclosure requirements.[609] Ultimately, access to accurate and timely information is vital to the effective functioning of capital markets. Therefore, it can be argued that the focus on disclosures was not necessarily about overhauling the ways by which companies operate but instead ensuring investors have access to accurate and meaningful information about how the company is operating. However, complex and overly prescriptive disclosures that are difficult to understand and scattered among hundreds of pages of text arguably defeat the entire purpose of disclosures.

7.5.3 Sanctions

Central to the effectiveness of the U.S. approach to corporate governance are the penalties for non-compliance contained in Sarbanes-Oxley. Although there are ongoing debates on whether financial or non-financial penalties are more effective as a deterrent, it is well accepted that punishment can be the best means for deterring misconduct. To that end, Sarbanes-Oxley introduced the Securities Fraud Statute. However, it is important to point out that while Sarbanes-Oxley significantly increased the jail sentences for mail fraud and wire fraud from five to twenty years, the mail fraud and wire fraud statutes existed long before Sarbanes-Oxley. Nevertheless, questions remain regarding whether the Securities Fraud Statute is any more effective in deterring corporate misconduct than the wire and mail fraud statutes that existed before. In fact, the top executives of WorldCom, Tyco and Enron were all charged with offences that existed before the passage of Sarbanes-Oxley.

An important distinction in the U.S. approach to corporate governance is the active role that shareholders can play in enforcing corporate governance through private

[607] ibid 5.

[608] Deloitte, 'Disclosure Committees—Frequently Asked Questions' (*The Wall Street Journal,* 12 December 2013) <https://deloitte.wsj.com/articles/disclosure-committees8212frequently-asked-questions-1386824537?tesla=y> accessed 19 August 2020.

[609] Troy A Paredes, 'Symposium Foreword-After the Sarbanes-Oxley Act: The future of the mandatory disclosure system' SSRN <https://ssrn.com/abstract=464381> accessed 8 August 2021.

litigation. Although Sarbanes-Oxley does not explicitly set out a role for shareholders in enforcing good corporate governance, U.S. common law has long recognised that shareholders have a private right of action under certain statutes. For example, shareholders in the U.S. can bring a private cause of action for violations of section 10(b) of the Exchange Act.[610] In other words, shareholders can also initiate proceedings against corporate executives for breach of federal securities law in the United States.

7.6 CONCLUSION

Although the U.S. has adopted a different approach to regulating corporate behaviour at its core Sarbanes-Oxley, like the UKCG, aims at improving disclosure and preventing corporate misconduct. In other words, the UK and the U.S. have adopted two different systems with the aim of achieving the same goals. Although Sarbanes-Oxley was hailed as a major reform of the securities market, penalties for securities fraud have existed in the U.S. for over 80 years but did not prevent the wave of corporate scandals such as Enron, WorldCom and Tyco.

Ultimately, Sarbanes-Oxley prescribes the minimum corporate governance standards for publicly listed companies in the United States. Furthermore, the NYSE and NYSE listing requirements have gone beyond the requirements of Sarbanes-Oxley. This calls into question the necessity of the rules-based approach adopted with the passage by Sarbanes-Oxley and its impact on the instances of corporate governance failures. Nevertheless, since the introduction of Sarbanes-Oxley, the U.S. has continued to experience continuing instances of corporate misconduct. Despite the increased penalties for non-compliance, the continuing instances of corporate misconduct that emerge call into question the deterrent effect of Sarbanes-Oxley and by extension the rules-based approach to regulating corporate behaviour.

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[610] American Bar Association, 'Section 10(b) Litigation: The Current Landscape' (*ABA,* 20 October 2014) <www.americanbar.org/groups/business_law/publications/blt/2014/10/03_kasner/> accessed 27 April 2021.

Chapter 8
CORPORATE GOVERNANCE FAILURES IN THE U.S.

'…greed, for lack of a better word, is good. Greed is right. Greed works. Greed clarifies, cuts through and captures the essence of the evolutionary spirit.'

- Gordon Gekko[611]

8.1 INTRODUCTION

The previous chapter discussed the history and development of corporate governance and the corporate governance requirements in the United States. This chapter critically analyses the corporate governance failures at Hertz, SAExploration, the Kraft-Heinz company and Nikola Corporation. The Chapter proceeds as follows; sections 8.2 to 8.4 examine the corporate governance failures at Hertz, SAExploration, the Kraft-Heinz Company and Nikola respectively. As previously explained in Chapter 7 corporate law in the U.S. operates at the state level, with the state of Delaware often considered to have the most extensive body of corporate law. Furthermore, given that over 66% of the Fortune 500 companies are registered in the state of Delaware, this Chapter focuses on companies incorporated in the state of Delaware. The companies chosen for examination in this chapter exhibit similarities which make them suitable for drawing reliable conclusions. In particular, the companies chosen are publicly listed corporations registered in Delaware and have experienced reporting and disclosure failures of over $100 million. Selecting similar cases allows the research to draw well-grounded conclusions on the enforcement of corporate governance failures in the United States.

8.2 THE HERTZ MISSTATEMENT

In 2014 the global car-rental company, Hertz, announced that the company's 2011 financial statements could not be relied upon and would be restated.[612] At the time

[611] Gordon Gekko, Fictional character in the 1987 movie Wall Street.

[612] Hertz Global Holdings, 'Form 8-K' (*EDGAR,* 6 June 2014) <www.sec.gov/Archives/edgar/data/0000047129/000110465914044345/a14-14905_18k.htm> accessed 9 March 2020.

the company asserted that the effect of the 2011 restatement would not be material to the 2012 and 2013 financial years. However, as it turned out, the 2014 announcement was merely the tip of the iceberg of the serious accounting irregularities at the company. It would later come to light that the company's net income was overstated by $235 million between 2011 and 2013, with several directors, including the chief executive officer, accused of being involved in a systematic effort to meet earnings targets.[613] The Hertz misstatement was yet another instance of corporate governance regulations failing to deter or detect corporate abuse at the top.

8.2.1 Background

The humble beginnings of what is now considered one of the largest rental companies in the world date back to 1918 when Walter L. Jacobs launched a rental car company with a fleet of 12 Model-T cars.[614] Within five years the company was sold to John D. Hertz, whose name remains with the well-known brand today. However, Jacobs would remain involved with the company in various roles until his retirement in 1960.[615] By the time the company listed on the NYSE for the second time in 2006 it had already changed hands several times.[616] Beginning with its first airport location in 1932, the company would expand its operations with roughly 11,400 locations around the world, including Europe, Latin America and the Caribbean. Operating four brands ranging from premium to value (Hertz, Dollar, Thrifty and Firefly), the company's main sources of revenue derived from car and equipment rentals and revenue from selling used cars.[617] However, in 2014 the company announced that it would spin off its equipment rental business into Hertz Equipment Rental Corporation.[618]

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613 Dave Michaels, 'Former Hertz CEO Agrees to Settle Claims Tied to Accounting Misconduct' *The Wall Street Journal* (New York 13 August 2020) <www.wsj.com/articles/former-hertz-ceo-agrees-to-settle-claims-tied-to-accounting-misconduct-11597367286> accessed 9 September 2021.

614 Hertz, 'Hertz Corporation Rental Car History' (*Hertz,* <www.hertz.ca/rentacar/abouthertz/index.jsp?targetPage=CorporateProfile.jsp&c=aboutHertzHistoryView> accessed 17 June 2021.

615 ibid.

616 Hertz Global Holdings, *Annual Report 2006* (Hertz, 2007).

617 Hertz Global Holdings, 'Form 10-K for the fiscal year ended December 31, 2021' (*EDGAR,* 2021) <www.sec.gov/ix?doc=/Archives/edgar/data/1657853/000165785322000012/htz-20211231.htm> accessed 1 March 2022.

618 Hertz Global Holdings, 'Hertz Board Approves Separation Of Equipment Rental Business' (*PR Newswire,* 18 March 2014) <www.prnewswire.com/news-releases/hertz-board-approves-separation-of-equipment-rental-business-250752011.html> accessed 5 June 2020.

In what can be argued as the beginning of the company's misfortune, Hertz appointed Mark Frissora as chief executive officer in 2006. A year later Frissora was also appointed chairman of the board and maintained both roles until his departure in 2014. Frissora's tenure would come to mark a tumultuous period for the company. Under his leadership, Hertz would commence a five-year battle to acquire the budget rental company Dollar Thrifty Automatic Group (Dollar Thrifty).[619] The acquisition of Dollar Thrifty in 2012 was not the company's first attempt to enter the low-cost segment of the car rental market. In 2009 Hertz purchased the assets of Advantage Rent a Car out of bankruptcy for $30 million.[620] However to protect the market, the Federal Trade Commission (FTC) required Hertz to divest Advantage Rent a Car as part of the agreement to acquire Dollar Thrifty.[621] Interestingly, within a year after the company was offloaded by Hertz, Advantage Rent a Car would file for bankruptcy a third time.[622] The collapse of the company on the heel of its sale suggests that the brand was not profitable under Hertz. Instead, it can be argued that Hertz was likely keeping the brand afloat at great costs. Perhaps this explains why Frissora continued to engage in the five-year battle to acquire Dollar Thrifty.

The acquisition of Dollar Thrifty and divestment of Advantage Rent a Car, all within the space of a year, would have undoubtedly added pressure on the company's internal systems. This was further compounded by the announcement that the company would move its corporate headquarters to Florida.[623] As a result of the relocation, over 50% of the company's staff left.[624] The acquisition, divestment and corporate relocation, all within such a short time frame, created the perfect storm for a governance failure.

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619 Rupert Neate, 'Hertz buys car rental rival Dollar Thrifty for $2.3bn' *The Guardian* (London 27 August 2019) <www.theguardian.com/business/2012/aug/27/hertz-buys-dollar-thrifty> accessed 15 July 2021.

620 Phil Wahba, 'UPDATE 1-Hertz wins Advantage auction with $30.3 mln bid' (*Reuters,* 1 April 2009) <www.reuters.com/article/advantage-hertz-idINN0115597220090401> accessed 6 June 2020.

621 Federal Trade Commission, 'In 2014 the company spun off its equipment rental business into another Hertz Equipment Rental Corporation (HERC). ' (*FTC,* 15 November 2012) <www.ftc.gov/news-events/news/press-releases/2012/11/ftc-requires-divestitures-hertzs-proposed-23-billion-acquisition-dollar-thrifty-preserve-competition> accessed 15 July 2021.

622 Rachel Premack, 'A car-rental company previously owned by Hertz just filed for bankruptcy for the third time since 2008' (*Business Insider,* 27 May 2020) <www.businessinsider.com/hertz-bankruptcy-advantage-rent-a-car-2020-5?r=US&IR=T> accessed 8 June 2021.

623 Hertz Global Holdings, 'Hertz Announces Corporate Headquarters Relocation' (*PR Newswire,* 7 May 2013) <www.prnewswire.com/news-releases/hertz-announces-corporate-headquarters-relocation-206396511.html> accessed 15 May 2020.

624 *The Hertz Corporation et al v Frissora et al* 2:2019cv08927-ES-CLW [17].

In the first sign of trouble at Hertz, the company announced in 2014 that the financial statements for 2011, 2012 and 2013 would be restated due to material errors and weaknesses in the company's internal controls.[625] As it turned out the company overstated its pre-tax income by $235 million.[626] In an attempt to increase its bottom line and meet earnings targets, the company manipulated its receivables and depreciation. Similar to revenue recognition, accounting for receivables and depreciation is also subject to a degree of judgement. To ensure that the company's financial position is adequately presented, ASC 450 (Contingencies) requires companies to make a provision for uncollectible receivables that are 'probable' and can be 'reasonably estimated.'[627] However, the company attempted to manipulate the way the receivables allowance was calculated by amending the methodology for identifying and recording unrecoverable receivables. The effect of this was that the company's balance sheet was inflated with income that was likely unrecoverable, while its expenses were understated. For example, in one instance the change in policy resulted in a seven million dollar understatement in the company's expenses.[628] In another attempt to meet targets, the company also extended the useful life of its rental car fleet without disclosing this material change in accounting policy.[629] By doing so Hertz was able to lower the annual depreciation expense by extending the number of months the cars would be held.

8.2.2 The governance failure

To understand what contributed to the failure at Hertz, it is important to first analyse the corporate governance structure of the company. For all intents and purposes, Hertz appeared to be compliant with the corporate governance requirements of Sarbanes-Oxley, on the surface at least. The board of Hertz Corporation was made up of 11 directors, all of whom were considered independent apart from Frissora, who was the chief executive and the chairman of the board. The board comprised of four committees; the AudCom, Compensation Committee, Nominating and Governance Committee and the Executive and Finance Committee, each with their own charter and responsibilities. More importantly, each member of the AudCom

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[625] US Securities and Exchange Commission, 'In the Matter of Hertz Global Holdings, Inc and The Hertz Corporation,' (n 571).

[626] ibid.

[627] ibid.

[628] ibid.

[629] ibid.

was considered to be 'financial experts' and 'financially literate.'[630] Although the majority of the members of the AudCom had tourism related experience, it is important to note that none of the members of the AudCom had direct experience in the car rental industry. For instance, the chair of the AudCom, Carl Berquist, was an executive at the international hotel chain Marriott International.[631]

Although Sarbanes-Oxley is silent on CEO duality, Frissora' s role as both chairman and chief executive created a greater concentration of power in one individual. This would eventually contribute to the circumstances that led to the governance failure at the global car rental company. Importantly, and as expected, the financial statements of Hertz for periods that were subsequently restated included sections 302 and 906 certifications. None of which indicated that the financial statements of Hertz did not adequately reflect the company's financial position.

The remainder of this section will argue that three factors directly contributed to the failure at Hertz; (i) lack of effective board oversight, (ii) failure of internal controls and (iii) a corporate culture of greed. Each will now be addressed in turn.

Lack of effective board oversight

Several studies argue that CEO duality creates a concentration of power and can affect the board's ability to effectively oversee management.[632] Although Sarbanes-Oxley does not require the roles of chief executive and chairman to be split, roughly 60% of S&P 500 have separated the roles.[633] As was the case with Hertz, when the roles of chief executive and chairman are combined, the lead independent director (LID) is generally responsible for holding the chairman to account. However, it is interesting to note that George Tamke, the LID at Hertz had no experience in the

[630] Hertz Global Holdings, '2014 Notice of Annual Meeting of Stockholders and Proxy Statement' (*SEC Edgar,* 14 May 2014) <www.sec.gov/Archives/edgar/data/1364479/000104746914003719/a2219488zdef14a.htm> accessed 12 June 2021.

[631] ibid 15.

[632] Hichem Khlif, Khaled Samaha and Ines Amara, 'Internal control quality and voluntary disclosure: does CEO duality matter?' (2021) 2 Journal of Applied Accounting Research 286; Khaled Samaha, Hichem Khlif and Khaled Hussainey, 'The impact of board and audit committee characteristics on voluntary disclosure: A meta-analysis' (2015) 24 Journal of International Accounting, Auditing and Taxation 13; Fabrizio Cerbioni and Antonio Parbonetti, 'Exploring the Effects of Corporate Governance on Intellectual Capital Disclosure: An Analysis of European Biotechnology Companies' (2007) 16 European Accounting Review 791.

[633] Mengqi Sun, 'Microsoft's Combination of CEO and Chairman Roles Goes Against Trend' *The Wall Street Journal* (New York 17 June 2021) <www.wsj.com/articles/microsofts-combination-of-ceo-and-chairman-roles-goes-against-trend-11623970653> accessed 17 November 2021.

car rental industry. Tamke was a partner at a private equity investment firm. Although it can be argued that direct industry experience is not necessary, it is submitted that without experience in the car rental industry Tamke would not have the requisite knowledge to challenge material policy changes. Consequently, it appears Frissora was able to operate unrestrained and without challenge at the board level. Frissora's near total control of the board was also cited in a lawsuit filed by Hertz against three former directors to recoup performance related compensation.[634] In the lawsuit, the company argues that Elyse Douglas, the CFO did not challenge Frissora on the changes in policy.[635] Instead, Douglas deferred to Frissora and contributed to the pressure to meet targets. However, it is important to point out that Douglas was appointed and promoted to the position of CFO by Frissora. Therefore, it is argued that it would not have been in her interest to challenge Frissora out of concern for her position. Ultimately Frissora maintained too much control over the company. Not surprisingly, since his departure the roles of chief executive and chairman at Hertz have since been held separately.

To address the conflicts of interest that arise from the agency relationship, performance related compensation and stock awards are used to align directors' interest with shareholders' interest. However, as illustrated by the case of Hertz, performance related compensation and stock awards can lead to short-termism at the expense of the long-term interest of the company and shareholders. According to the company's bonus plan, senior executives were entitled to annual cash bonuses and equity awards based on the company's earnings before interest, tax depreciation and amortisation (EBITDA). Under Frissora's leadership, Hertz revenue increased 34% and the share price increased 144% by 2013.[636] As it turns out Frissora's total compensation was based on figures that he was instrumental in inflating. For instance, over 50% of Frissora's $16.3 million compensation in 2013 was related to stock awards.[637] Given that over 50% of Frissora's total compensation was tied to the company's performance, perhaps this explains Frissora's drive to meet market expectations.

[634] *Hertz v Frissora et al* (n 624).

[635] ibid.

[636] Travis L Jones and Marcus T Allen, 'A look at corporate control: the case of Hertz Global Holdings' (2018) 44 Managerial Finance 1200.

[637] Hertz Global Holdings, '2014 Notice of Annual Meeting of Stockholders and Proxy Statement' (n 630).

According to McAnally, Srivastava and Waver, missing earnings targets tends to have a negative impact on the company's share price.[638] For instance, the share price of Amazon dropped 4% after the company missed market expectations.[639] More recently, Facebook lost over 26% of its value after reporting disappointing earnings.[640] Taking the above into consideration, the corporate governance failures at Hertz illustrate yet again that performance based compensation also creates an incentive for directors to engage in corporate misconduct for their own interest. It is submitted that given Frissora's position as both chief executive and chairman, combined with the fact that over 50% of his compensation was tied to the company's performance there was an increased risk of earnings management. Ultimately, the board failed to identify and effectively address these risks. Perhaps the board's failure to assess the risk and hold Frissora accountable can be explained by the fact that the independent directors also received stock awards. For instance, roughly 38% of Tamke's compensation in 2013 was related to stock awards.[641]

An analysis of the board's failure would be incomplete without also examining the role of the company's AudCom. The misstatement at Hertz was not the first time that an AudCom failed to identify earnings management or corporate misconduct, nor will it be the last. Although Sarbanes-Oxley outlines specific responsibilities of the AudCom, it is important to point out that the AudCom is often limited by the information received from the executives and the external auditor. On one hand, it can be argued that the material changes to the company's depreciation policy and method for calculating the loss provision should have been reviewed by the AudCom. On the other hand, given the concerted effort by the chief executive and the chief financial officer to artificially inflate the company's performance, it is unlikely that these policy changes would have been brought to the attention of the AudCom. The continued instances of AudCom's failure to prevent and detect

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[638] Mary Lea McAnally, Anup Srivastava and Connie D Weaver, 'Executive Stock Options, Missed Earnings Targets, and Earnings Management' (2008) 83 The Accounting Review 185, 212.

[639] RTTNews, 'Amazon Q3 Profit And Revenue Miss Street, Outlook Below View; Shares Slip Over 4%' (*Nasdaq,* 28 October 2021) <www.nasdaq.com/articles/amazon-q3-profit-and-revenue-miss-street-outlook-below-view-shares-slip-over-4-2021-10-28> accessed 14 December 2021.

[640] Deepa Seetharaman and Salvador Rodriguez, 'Facebook suffers $230bn wipeout in biggest one-day US stock plunge' *The Wall Street Journal* (New York 2 February 2022) <www.wsj.com/articles/meta-platforms-facebook-fb-q4-earnings-report-2021-11643762900> accessed 7 April 2022.

[641] Hertz Global Holdings, '2014 Notice of Annual Meeting of Stockholders and Proxy Statement' (n 637).

instances of corporate misconduct suggest that reliance on AudComs in corporate governance may be flawed.

Failure of internal controls

As previously mentioned, internal controls are the cornerstone of effective corporate reporting. In fact, since the introduction of section 404, testing over internal controls has been the costliest aspect of Sarbanes-Oxley compliance. Nevertheless, despite the requirement for directors and auditors to certify the effectiveness of the company's systems of internal controls, instances of corporate governance failures linked to failures of internal controls continue to emerge. In *The Hertz Corporation et al v. Frissora et al*, a subsequent lawsuit filed against several former directors, Hertz outlined several internal control weaknesses that contributed to the governance failure.[642] Most notable among the failures identified were the tone at the top, lack of skills and training among personnel, ineffective controls over accounting estimates and policies and ineffective internal audit.[643] Arguably, these represent some of the most egregious control weaknesses.

Similar to the UKCG, Sarbanes-Oxley does not prescribe what is considered an effective system of internal controls. In this regard, it can be argued that companies maintain a degree of flexibility in designing their systems of internal controls. However, it is also important to note that any system of internal control is subject to management override. The system of internal controls at Hertz was put under tremendous pressure in light of the acquisition, divestment and corporate relocation, all within a short period. As a result of the acquisition, the internal control systems of Hertz and Dollar Thrifty, two separate and distinct companies before the merger, would need to be merged and streamlined. This was further complicated when Hertz lost 'more than half' of its staff as a result of the relocation of its corporate office to Florida.[644]

Corporate culture

Under Frissora's leadership, the company pursued an aggressive cost cutting strategy. As a result, Frissora created an environment where employees felt pressured to meet targets. For instance, in order for the company to meet expected

[642] *Hertz v Frissora et al* (n 624).

[643] ibid [27].

[644] ibid [7].

targets, Frissora pressured the company's interim financial controller to 'find money' by 'finding methodology discrepancies.'[645] In other words, staff was pressured to manipulate the way certain allowances were identified and accounted for. For instance, the company's policy was to create an allowance for debts over 360 days. This would have increased expenses by seven million.[646] Instead, the company only recognised one million. By manipulating the allowance, the company's expenses were understated by six million.

Unlike the UKCG, Sarbanes-Oxley does not explicitly recognise the role of corporate culture in corporate governance. This is somewhat surprising given the role of corporate greed in American history. According to Rothberg, the history of corporate greed in American society dates back to the Great Recession.[647] Since then several instances of corporate abuses have continued to emerge, despite the great overhaul of federal corporate governance with the passage of Sarbanes-Oxley. Using the 2005 Krispy Kreme restatement when discussing the effectiveness of Sarbanes-Oxley, DeCelestino aptly asserted that fraud is a 'manifestation of the sins of a greedy corporate culture.'[648] An analysis of the Hertz restatement is yet another illustration that Sarbanes-Oxley has failed to address a corporate culture of greed that focuses on profit maximisation.

8.2.3 Sanctions

Following an investigation into the restatement the SEC fined Hertz Global and the Hertz Corporation $16 million for fraud and failure to disclose material financial information.[649] Interestingly, the SEC did not charge Hertz with breaches of Sarbanes-Oxley. Instead, the violations relate to offences against the Securities Act and the Exchange Act. This supports the view that the SEC does not have to rely on the penalties in Sarbanes-Oxley to enforce corporate misconduct.

One year later the SEC charged Frissora with aiding and abetting Hertz in failing to

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[645] US Securities and Exchange Commission, 'In the Matter of Hertz Global Holdings, Inc and The Hertz Corporation,' (n 571).

[646] ibid.

[647] Michael S Rothberg, *American Greed: A Personal and Professional Look at How Greed Caused the Great Recession of 2008* (AuthorHouse 2010).

[648] Christina Michelle DeCelestino, 'Krispy Kreme, Sarbanes-Oxley, and Corporate Greed' (2006) 15 U Miami Bus L Rev 225, 226.

[649] US Securities and Exchange Commission, 'SEC Charges Hertz with Inaccurate Financial Reporting and Other Failures' (n 584).

file reports on time, failing to keep books and records, failure to disclose material information, and violating section 304 of Sarbanes-Oxley.[650] Without admitting guilt, Frissora agreed to repay $1.98 million in bonuses and incentive based compensation and was fined $200,000.[651] Interestingly between 2011 and 2013, Frissora's total compensation, including stock awards was approximately $45 million.[652] Frissora's fine represents less than 1% of his total compensation for the period restated. This calls into question the deterrence effect of the fine. In addition to Frissora, the SEC also fined the company's Corporate Controller, Jatinda Kapur, $75,000.[653] Kapur, a Certified Public Accountant (CPA) was also barred from practising as an accountant for two years.[654] Interestingly, although Frissora also played a crucial role in the misstatement, he was not barred from being a director of a public company. In fact, Frissora has since moved on to another senior position as the President and Chief Executive of the Nasdaq listed hotel and entertainment company, Ceasars Entertainment Corporation.[655] Perhaps Kapur's bar can be explained by the fact that as a CPA, there is a much higher standard of accountability.

As a result of the misstatement, the company was subject to several class action lawsuits by shareholders.[656] Although the class actions were since dismissed, the company expended considerable resources on legal fees to defend the claims. In an unprecedented move, considered to be the first of its kind, Hertz sued Frissora and two former directors to recover over $70 million in incentive-based

[650] *US Securities and Exchange Commission v Mark P Frissora* 2:20-cv-10453

[651] US Securities and Exchange Commission, 'SEC Charges Hertz's Former CEO with Aiding and Abetting Company's Financial Reporting and Disclosure Violations' (*SEC,* 14 August 2020) <www.sec.gov/litigation/litreleases/2020/lr24869.htm> accessed 4 May 2021.

[652] Hertz Global Holdings, '2014 Notice of Annual Meeting of Stockholders and Proxy Statement' (n 637) 41.

[653] US Securities and Exchange Commission, *In the Matter of Jatindar Kapur, CPA* (SEC, 2019).

[654] ibid.

[655] Caesars Entertainment Corporation, 'Mark Frissora Becomes President and CEO of Caesars Entertainment Corporation' (*Caesars,* 1 July 2015) <https://investor.caesars.com/news-releases/news-release-details/mark-frissora-becomes-president-and-ceo-caesars-entertainment> accessed 5 July 2021.

[656] See *Borteanu v Nikola Corp* No CV-20-01797-PHX-SPL (D Ariz Apr 21, 2022); *Re Nikola Corporation Derivative Litigation* Lead Case No 20-cv-01277-CFC.

remuneration.[657] In the suit the company also sought damages of $200 million for the costs of the SEC investigation and the costs of defending class action lawsuits arising from the restatement.[658]

8.3 THE SAEXPLORATION ACCOUNTING FRAUD

The SAExploration accounting fraud was yet another instance of corporate governance laws and regulations failing to prevent another instance of corporate misconduct. In the aftermath of a series of corporate failures, such as Enron and WorldCom, Congress introduced sweeping reforms to federal securities law and increased sanctions for corporate misconduct. At its core Sarbanes-Oxley was aimed at encouraging responsible corporate behaviour and deterring corporate misconduct.

In the case of SAExploration four of the company's senior executives, including the chief executive and chief financial officer, were engaged in a $100 million accounting scheme to defraud investors and the company. As a result of the accounting irregularities, the company's financial statements for 2015 to 2018 were misleading and could not be relied upon.

8.3.1 Background

Operating as a seismic data acquisition company, the origins of SAExploration began in Puerto Rico in 2006 as Exploración Sudamericana.[659] Five years later the company registered in Delaware as SAExploration and continued to expand its operations.[660] By the time the company merged with Trio Merger Corp in 2013, the company's operations had expanded to several countries including Canada, Peru, Australia, and New Zealand.[661]

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[657] David Lopez, Arthur H Kohn and Margot G Mooney, 'Hertz Pursues Novel Theory to Hold Former Management Team Personally Liable for Restatement and Ensuing Legal Proceedings' (*Cleary Gottlieb,* 7 May 2019) <www.clearymawatch.com/2019/05/hertz-pursues-novel-theory-to-hold-former-management-team-personally-liable-for-restatement-and-ensuing-legal-proceedings/> accessed 21 May 2021.

[658] ibid.

[659] SAExploration, 'History' (*SAExploration,* <https://saexploration.com/history/> accessed 29 June 2021.

[660] ibid.

[661] SAExploration Holdings, 'Form 10-K - For the fiscal year ended December 31, 2013' EDGAR <www.sec.gov/Archives/edgar/data/0001514732/000114420414020584/v371060_10k.htm> accessed 5 May 2020.

Initially registered as a 'blank cheque company' in 2011, Trio Merger Group was actively seeking opportunities to merge with another business entity.[662] Koh and Leong explain that blank cheque companies, also known as special purpose acquisition companies (SPACs), are formed without a specific aim.[663] Although SPACs can be considered a type of shell company, SPACs raise capital through an initial public offering (IPO) and are therefore considered publicly listed.[664] Renamed SAExploration following the merger, key positions on the company's board and management were held by former executives of the acquired entity (Former SAE). Arguably the two most important positions were held by Former SAE executives; Jeff Hastings and Brian Beatty. Initially appointed as the company's executive chairman following the merger, Hastings would be appointed as chief executive three years later, thus combining the roles of chairman and chief executive. At the same time, Beatty was appointed chief operating officer, after serving as the company's chief executive since the merger.

As a seismic data company, SAExploration operated in a volatile industry and relied heavily on oil and gas customers to generate revenue. Consequently, the global downturn in oil prices in 2014 and 2015 put unprecedented pressure on the company's financial position. According to Stocker, Baffes and Vorisek, oil prices saw a 70% decline between mid-2014 and early 2016.[665] In what can arguably be considered the first sign that the company's financial position was already precarious, the company underwent a $30 million restructure in 2016 to improve its liquidity.[666] In hindsight, most notable from the restructuring agreement, was the company's stated intention of reliance on receiving tax credit receivables, which

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[662] Trio Merger Corp, 'Form 10-K - For the fiscal year ended December 31, 2011' EDGAR <www.sec.gov/Archives/edgar/data/0001514732/000114420412021309/v308948_10k.htm> accessed 17 May 2020.

[663] Jerry K C Koh and Victoria Leong, 'Spotlight on SPACs: Key Trends and Issues' (2021) 22 Business Law International 279, 279.

[664] Statista, 'Number of special purpose acquisition company (SPAC) IPOs in the United States from 2003 to February 2022' (*Statista,* 2 February 2021) <www.statista.com/statistics/1178249/spac-ipo-usa/> accessed 9 September 2021.

[665] Marc Stocker, John Baffes and Dana Vorisek, 'What triggered the oil price plunge of 2014-2016 and why it failed to deliver an economic impetus in eight charts' (*World Bank…Blogs,* 18 January 2018) <https://blogs.worldbank.org/developmenttalk/what-triggered-oil-price-plunge-2014-2016-and-why-it-failed-deliver-economic-impetus-eight-charts> accessed 7 June 2020.

[666] SAExploration Holdings, 'SAExploration Announces New Financing and Entry Into Comprehensive Restructuring Support Agreement' (*Globe Newswire,* 13 June 2016) <www.globenewswire.com/fr/news-release/2016/06/13/848208/0/en/SAExploration-Announces-New-Financing-and-Entry-Into-Comprehensive-Restructuring-Support-Agreement.html> accessed 6 May 2020.

would be used to offset against the cost of oil exploration in Alaska.[667] It was against this backdrop and the global downturn in oil prices that Hastings, Beatty and two other executives would engage in a concerted effort to misappropriate company's funds and inflate revenue. To maximise tax credits from the State of Alaska and inflate revenue, Hastings and Beatty created Alaskan Seismic Ventures (ASV). Without disclosing the true nature ASV and their ownership interest, Hastings and Beatty then created shell companies, owned and operated by themselves or their relatives, to engage in a series of round-tripping transactions.[668] In other words, the company moved money from SAExploration to ASV then back to SAExploration, which was then reported as income for SAExploration. To maintain the illusion that the shell companies were genuine vendors, the executives created fictitious lease agreements and invoices for rental equipment and the provision of other services to SAExploration.[669] As an example, the company paid roughly $4.1 million to RVI Consulting for legal and professional services from 2012 to 2019. Without disclosing his ownership, Brent Whitely, the chief financial officer and general counsel of SAExploration, used RVI Consulting as a vehicle to pilfer money from the company's coffers.

The announcement in August 2019 that the company was subject to an SEC investigation for accounting fraud was only the beginning of turbulence for the company. Following the announcement, the company lost 34% of its market value.[670] Ten months later, the company was delisted from the NASDAQ as its stockholders' equity value fell below the required $2.5 million.[671] By 2020 SAExploration filed for bankruptcy with $130 million in debt.[672] A year later, the company emerged from bankruptcy as a private company and therefore no longer

[667] ibid.

[668] *United States v Jeffrey Hastings* 20 MAG 9706.

[669] ibid.

[670] Bronstein Gewirtz and Grossman, 'Bronstein, Gewirtz & Grossman, LLC Announces Investigation of SAExploration Holdings, Inc. (SAEX)' (*Accesswire,* 19 August 2019) <www.accesswire.com/556611/Bronstein-Gewirtz-Grossman-LLC-Announces-Investigation-of-SAExploration-Holdings-Inc-SAEX> accessed 8 June 2020.

[671] Joshua Mann, 'Exchange suspends trade on Houston seismic data co.' (*Houston Business Journal,* 6 May 2020) <www.bizjournals.com/houston/news/2020/05/06/exchange-suspends-trade-on-houston-seismic-data-co.html> accessed 9 September 2021.

[672] US Securities and Exchange Commission, 'SEC Charges Seismic Data Company, Former Executives with $100 Million Accounting Fraud' (*SEC,* 9 October 2020) <www.sec.gov/litigation/litreleases/2020/lr24943.htm> accessed 8 June 2021.

subject to the provisions of Sarbanes-Oxley.[673] It is important to point out here that although the company has now gone private, this does not mean it is now outside the reach of the SEC. In one of the most notable instances of SEC enforcement against a privately held company, the SEC charged two executives of the now defunct health technology company Theranos with breaches of the Securities Act and the Exchange Act.[674]

8.3.2 The governance failure

As expected, and as is the case in many instances of corporate misconduct, the company reported compliance to the requirements of Sarbanes-Oxley. Most importantly, as required by Sarbanes-Oxley, the company's annual reports for the periods subsequently restated, included section 302 and 906 certifications signed by the chief executive and chief financial officer. Interestingly, despite a false section 906 certification carrying a maximum term of 25 years, the fear of imprisonment does not appear to have deterred Hastings and Beatty from filing false certifications.

In analysing the corporate governance failures at SAExploration, three factors can be identified as having contributed to the accounting fraud; (i) lack of effective board oversight, (ii) failure of internal controls and (ii) audit failure. Each will now be addressed in turn.

Lack of effective board oversight

Before examining the effectiveness of the company's board of directors, it is important to first consider its composition. As required, the company's board consisted of a majority of independent directors. In fact, apart from Hastings and Beatty, five of the company's seven directors were considered independent. However, as previously mentioned, Hastings was chairman of the board and chief executive. Although not a requirement of Sarbanes-Oxley, CEO duality has been

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[673] SAExploration Holdings, 'SAExploration Successfully Completes Financial Restructuring' (*Globe Newswire,* 21 December 2020) <www.globenewswire.com/news-release/2020/12/21/2148955/34359/en/SAExploration-Successfully-Completes-Financial-Restructuring.html> accessed 9 June 2021.

[674] US Securities and Exchange Commission, 'Theranos, CEO Holmes, and Former President Balwani Charged With Massive Fraud' (*SEC,* 14 March 2018) <www.sec.gov/news/press-release/2018-41> accessed 8 May 2020.

recognised as a conflict of interest that can lead to undue influence on the board.[675] In explaining the decision to combine the roles of chairman and chief executive, the board explained that Hastings 'extensive knowledge and full time focus' would make for 'a more effective Chairman than an independent director.'[676] While it is acknowledged that CEO duality can result in synergies, the board appears to have failed to address the conflicts of interest. As a result of holding both positions, Hastings was in a position where he could exercise unfettered control with little challenge to his authority. As chairman of the board, Hastings was responsible for setting the board agenda. As chief executive Hastings maintained control over what information was provided to the board.

When examining instances of corporate misconduct, Donald Cressey's fraud triangle can be a useful tool. According to Cressey for fraud to occur there must be three elements; pressure, opportunity and rationalisation.[677] Pressure considers the motivation or incentives for engaging in fraud. Opportunity normally stems from weak internal controls and rationalisation refers to the justification for the misconduct. Adopting Cressey's fraud triangle, the combined roles of chairman and chief executive provided the opportunity for Hastings to engage in the fraud. As a result of his position, Hastings was also well placed to conceal his collusion with Beatty, the company's chief financial officer, from the board.

For all intents and purposes, the AudCom at SAExploration appeared well qualified, with two of the three AudCom members having industry experience. L. Melvin Cooper, the AudCom financial expert, was a Certified Public Accountant (CPA) with experience in the energy services sector as chief financial officer of Forbes Energy Services. Michael Faust had extensive experience in the oil and gas industry, including stints at Exxon Exploration and Esso. Taking the makeup of the AudCom into consideration, the accounting fraud at SAExploration exposes a key weakness

[675] Joseph P O'Connor Jr and others, 'Do CEO stock options prevent or promote fraudulent financial reporting?' (2006) 49 Academy of Management Journal 483; Hermann Achidi Ndofor, Curtis Wesley and Richard L Priem, 'Providing CEOs with opportunities to cheat: The effects of complexity-based information asymmetries on financial reporting fraud' (2015) 41 Journal of Management 1774.

[676] SAExploration Holdings, 'Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934' EDGAR <www.sec.gov/Archives/edgar/data/0001514732/000144757218000003/a51348.htm> accessed 8 June 2020.

[677] Quoted in Donald R Cressey, 'A study in the social psychology of embezzlement: Other people's money' (1953) 20 Glencoe, IL, Free Press 79 (as cited in Dianne M Roden, Steven R Cox and Joung Yeon Kim, 'The fraud triangle as a predictor of corporate fraud' (2016) 20 Academy of Accounting and Financial Studies Journal 80).

of corporate governance. While the board of directors is generally responsible for oversight, the effectiveness of the board as a whole to detect corporate misconduct is hindered by their reliance on corporate executives to provide accurate information. For instance, the company's Audit Charter specifically states it is the responsibility of the AudCom to 'review and approve all related-party transactions.'[678] However, Hastings and Beatty deliberately concealed their ownership interest in several companies that they used to defraud the company.

Internal Controls

Another important function of SAExploration's board of directors, was the oversight of the design and implementation of risk policies and procedures.[679] Although Sarbanes-Oxley only requires the chief executive and chief financial officer to certify the effectiveness of the company's internal controls, the role of the board in assessing and addressing risk is crucial to the effective design and implementation of a system of internal controls. Although the company did not report any material weaknesses in its annual evaluation of internal controls, the accounting fraud was the culmination of several material weaknesses in the company's internal controls. After restating its financial statements, the company identified several material weaknesses in internal controls, including controls over revenue, complex accounting and management estimates, vendor set-up, related parties and segregation of duties.[680]

As a result of weaknesses of the controls over vendors, the company failed to identify several related party transactions. An effective system of internal controls over vendors should include a separation of duties between the individual who is involved in setting up vendors and the individual that makes the vendor payments. The events that led to the accounting fraud, suggest that SAExploration had very poor internal controls over vetting vendors. However, it is important to note here that both the chief executive and chief financial officer went to some length to conceal the true nature of these transactions and their relationship with the shell companies. As previously mentioned, no system of internal control will prevent all instances of

[678] SAExploration Holdings, 'Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934' (n 676) 8.

[679] ibid 8.

[680] SAExploration Holdings, 'Form 10–K/A - For the fiscal year ended December 31, 2018' EDGAR <www.sec.gov/Archives/edgar/data/0001514732/000156459020003869/saex-10ka_20181231.htm> accessed 19 June 2020.

corporate misconduct. However, controls are inherently subject to management override, as seen in the case of SAExploration. Furthermore, given the extent of management's involvement in the fraud, it is reasonable to expect that employees may have been hesitant to report any red flags for fear of losing their jobs and livelihood. After all, four of the company's six executive officers were involved. Ultimately, it is submitted that given Hastings role as chief executive and chairman, combined with the collusion of the chief financial officer and the chief operating officer in perpetrating the fraud, even the most well designed system of internal controls could do little to prevent a concerted effort by management at the very top.

Audit failure

Appointed in 2014, the company's auditor PKF issued clean or unqualified audit reports in each of the years that were subsequently restated. This is not surprising. Instances of auditors issuing clean audit reports in the years preceding a governance scandal are nothing new. When considering the role of PKF in the SAExploration accounting fraud, it is important to note that as a smaller reporting company, SAExploration was exempt from the section 404 auditor attestation requirement.[681] While this means that PKF was not required to attest to the effectiveness of the company's internal controls, SAExploration was still subject to an annual audit. Importantly, during the course of an independent annual audit, auditors are required to exercise due care and professional scepticism. This requires auditors to approach an audit with a questioning mind. In the context of Cressey's fraud triangle, auditors are aimed at reducing the opportunities for fraud to occur.[682] However, the accounting fraud at SAExploration calls into question PKF's audit planning and audit testing during the audit.

In gaining an understanding of the company's control environment, it can be argued that PKF should have been able to identify internal control weaknesses over revenue reporting. However, it is important to point out that senior executives made a concerted effort to conceal their involvement in the accounting fraud, including providing false management statements to the auditors.[683] Even so, it can be

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[681] ibid.

[682] Chris E Hogan and others, 'Financial statement fraud: Insights from the academic literature' (2008) 27 Auditing: A Journal of Practice & Theory 231, 236.

[683] *US Securities And Exchange Commission v SAExploration Holdings Inc, Jeffrey H Hastings, Brent N Whiteley, Brian A Beatty, And Michael J Scott, Thomas W O'neill And Lori E Hastings* 1:20-cv-08423.

argued that PKF appears to have also failed to exercise professional scepticism in assessing management's assertions.

Turning now to audit planning, revenue and related party transactions have been identified as high-risk audit areas and therefore should be subject to higher levels of scrutiny.[684] Furthermore, the global downturn in oil prices would have put significant pressure on the company's financial position. As a result, there was an increased risk that revenue could be subject to manipulation to meet performance expectations. To encourage directors to act in shareholders' best interest, performance related compensation aims to align shareholders interest and directors' interests. Nevertheless, the accounting fraud at SAExploration is yet another illustration of the weaknesses of performance related compensation, where directors are incentivised to prioritise their short-term interest over the long-term interest of the company as a whole. Taking the above into consideration, an effective audit plan should have identified the above risks and included sufficient audit testing over the accuracy of revenue.

8.3.3 Sanctions

As a civil regulator, the SEC is not empowered to initiate criminal proceedings. As a result, the SEC and DOJ undertook parallel investigations into the accounting fraud at SAExploration. In December 2020, the SEC and SAExploration reached a deal to settle charges for misleading investors.[685] Interestingly, but perhaps not surprisingly the SEC did not impose a financial penalty against SAExploration. The company was already in a precarious financial position, having declared bankruptcy a mere matter of months before.[686] Although the SEC did not explain its rationale, Caswell commented that collecting a financial penalty given the company's financial position would have been unlikely.[687] As part of the agreement, the company was barred

[684] Public Company Accounting Oversight Board, 'PCAOB Standing Advisory Group Meeting: Meeting Agenda' (*PCAOB,* 8-9 September 2004) <http://www.pcaobus.org/News_and_Events/Events/2004/09-08-09.aspx> accessed (as cited in Hogan and others, 'Financial statement fraud: Insights from the academic literature', 242).

[685] US Securities and Exchange Commission, 'SEC Obtains Final Judgment Against Seismic Data Company' (*SEC,* 17 December 2020) <www.sec.gov/litigation/litreleases/2020/lr24988.htm> accessed 9 May 2021.

[686] Becky Yerak, 'Seismic-Data Provider SAExploration Files for Bankruptcy' *The Wall Street Journal* (New York 28 August 2020) <www.wsj.com/articles/seismic-data-provider-saexploration-files-for-bankruptcy-11598641364> accessed 8 June 2021.

[687] Mike Caswell, 'Seismic data provider avoids fine for overstated sales' *Daily Stockwatch* (Vancouver 21 December 2020) <www.pressreader.com/canada/stockwatch-daily/20201221/281513638752653> accessed 18 June 2021.

from committing future violations of the Securities Act and the Exchange Act.[688]

While it can be argued the company escaped punishment, companies do not make decisions. Therefore, the SEC's decision to not impose a financial penalty against the company does not mean the directors escaped unscathed. The SEC permanently barred Hastings, Whiteley, Beatty and Scott from acting as officers or directors.[689] As part of the settlement, the SEC required the three directors to repay bonuses and performance related compensation.[690] The SEC also required Scott and Whiteley to pay monetary penalties to be determined by the court.[691]

A notable observation from the SEC's enforcement in the case of SAExploration is the inclusion of the spouses of Hastings and Whitely as relief defendants.[692] Although they have not been accused of being involved in the fraud, the SEC sought disgorgement from the spouses on the basis that they were 'unjustly enriched.'[693] According to the SEC, Hastings and Whiteley transferred funds into accounts jointly held with their spouses. This far-reaching power illustrates the extent of the SEC's power to protect financial markets extend far beyond directors.

Hastings, Whiteley and Scott were also charged with conspiracy to commit securities fraud and conspiracy to commit wire fraud. In an attempt to conceal their scheme, the directors met in a Toronto hotel room with the intention of creating a cover story.[694] Hastings, the company's former chief executive and chairman, was sentenced to three years imprisonment, two years supervised release and ordered to forfeit $590,807.[695] Hastings is also required to pay restitution.[696] The company's

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[688] US Securities and Exchange Commission, 'SEC Obtains Final Judgment Against Seismic Data Company' (n 685).

[689] *SEC v SAExploration Holdings Inc, Jeffrey H Hastings, Brent N Whiteley, Brian A Beatty, And Michael J Scott, Thomas W O'neill And Lori E Hastings* (n 683).

[690] ibid [195].

[691] Mike Caswell, 'Regulator permanently ousts seismic data schemers' *Daily Stockwatch* (Vancouver 29 June 2021) <www.pressreader.com/canada/stockwatch-daily/20210629/281522229064238> accessed 12 December 2021.

[692] *SEC v SAExploration Holdings Inc, Jeffrey H Hastings, Brent N Whiteley, Brian A Beatty, And Michael J Scott, Thomas W O'neill And Lori E Hastings* (n 683).

[693] ibid.

[694] ibid [29].

[695] US Department of Justice, 'Former CEO Of Publicly Traded Houston Company Sentenced To Three Years In Prison For Accounting Fraud And Misappropriation Schemes' (*DOJ,* 15 November 2021) <www.justice.gov/usao-sdny/pr/former-ceo-publicly-traded-houston-company-sentenced-three-years-prison-accounting> accessed 9 February 2022.

former General Counsel Whiteley and former chief operating officer Scott have also pled guilty and are awaiting sentencing.[697] As expected, given the litigious nature of the U.S., the company was subject to several class actions and paid $3.5 million to settle a class action lawsuit.[698]

8.4 THE KRAFT-HEINZ MISSTATEMENT

In February 2019, four months after receiving a subpoena from the SEC, one of the largest food and beverage companies in the world announced it was under investigation by the regulator.[699] Following news of the SEC investigation into the Kraft Heinz Company (KHC) accounting practices, the company's stock price fell 20%.[700] Although the company maintained that the investigation would not materially affect the company's bottom line, it would later be revealed that the company was engaged in a years' long scheme which resulted in a $208 million overstatement between 2015 and 2018.[701] Although the overstatement is not material when taking into consideration the company's average annual revenue of over $28 billion, the long term scheme which operated under the nose of senior management, highlights yet again the importance of internal controls in ensuring the adequacy of financial reporting.[702] Not surprisingly, at the centre of the SEC investigation was the company's 'accounting policies, procedures and internal controls' over its procurement process. After all, as previously discussed failure of internal controls has been identified as a primary contributor to misstatements and corporate misconduct. Nevertheless, despite Sarbanes-Oxley requiring the CEO and CFO to certify the accuracy of the company's financial statements and internal controls, the Kraft Heinz scandal illustrates that Sarbanes-Oxley has indeed

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[696] ibid.

[697] ibid.

[698] *Bodin v SAExploration Holdings Inc et al* 4:2019cv03089.

[699] Alistair Gray, 'SEC opens investigation into Kraft Heinz accounting' *Financial Times* (London 22 February 2019) <www.ft.com/content/bb32ac58-3628-11e9-bb0c-42459962a812> accessed 17 May 2020.

[700] Jackie Wattles, 'Kraft Heinz posts huge loss, slashes dividend and reveals SEC investigation' (*CNN,* 22 February 2019) <https://edition.cnn.com/2019/02/21/investing/kraft-heinz-sec-investigation/index.html> accessed 17 August 2020.

[701] US Securities and Exchange Commission, 'SEC Charges The Kraft Heinz Company and Two Former Executives for Engaging in Years-Long Accounting Scheme' (*SEC,* 3 September 2021) <www.sec.gov/news/press-release/2021-174> accessed 9 January 2022.

[702] The Kraft Heinz Company, 'H.J. Heinz Company and Kraft Foods Group Sign Definitive Merger Agreement to Form The Kraft Heinz Company' (*Kraft Heinz Company,* 25 March 2015) <https://ir.kraftheinzcompany.com/static-files/2303265e-a98f-4082-bfc1-fc90f462742f> accessed 12 September 2019.

become a box-ticking exercise, especially in companies as large as KHC.

8.4.1 Background

KHC was formed in 2015 following the merger of H.J. Heinz Co., and Kraft Foods Group Inc.[703] As a result of the merger, orchestrated by Berkshire Hathaway and 3G Capital Partners, KHC became the third largest food and beverage company in North America and the fifth largest food and beverage company in the world. With combined revenues of approximately $28 billion, the merger was sold as an opportunity for international synergies which would in turn result in cost savings for the company. However, since the merger the company has lost 60% of its value.[704] The shift toward healthier eating habits caused significant difficulties, which led to a $15.4 billion write down on several of its brands, such as Kraft and Oscar Meyers.[705] In addition to the changing consumer trends, KHC has also been the subject of accounting improprieties, after announcing the restatement of several years of financial reports arising from employee misconduct.

Following the merger, three of the 10 executive directors on the executive board of KHC were partners of 3G Capital, including Bernado Hees, the CFO and Paulo Basilio, the CEO.[706] Perhaps this change in strategy contributed to the environment where employees felt pressured to meet ambitious and unrealistic cost-savings targets. As a result of the misstatement, KHC restated its financial statements for the financial years ending 2016 and 2017. Interestingly, this was not the first time since the merger that the company's internal controls over financial reporting resulted in a restatement. In November 2017, the company restated its quarterly financial statements for the periods 1 April 2017 and 1 July 2017.[707] As a result of a 'material weakness' in the company's internal controls, cash receipts were incorrectly classified in the company's consolidated statements of cash flow.[708]

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[703] ibid.

[704] Richa Naidu, 'Kraft Heinz takes $666 million charge, misses sales expectations' (*Reuters,* 13 February 2020) <www.reuters.com/article/us-kraft-heinz-results-idUSKBN2071K7> accessed 14 July 2021.

[705] Uday Sampath Kumar and Nivedita Bhattacharjee, 'Kraft Heinz discloses SEC probe, $15 billion write-down; shares dive 20 percent' (*Reuters,* 21 February 2019) <www.reuters.com/article/us-kraft-heinz-results-idUSKCN1QA2W1> accessed 8 September 2019.

[706] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2016* (Kraft Heinz, 2017) 6-7.

[707] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2017* (Kraft Heinz, 2018) 16.

[708] ibid 16.

Although the quarterly restatements did not affect the company's income statement and therefore its bottom line, it can be argued that the restatement indicates a history of deficient internal controls.

8.4.2 The governance failure

Although, as previously mentioned the misstatement did not materially affect the company's bottom line, the fact that systematic levels of misconduct remained undetected for over three years calls into question the effectiveness of the board in their general oversight responsibilities. Furthermore, as a result of the misstatement key financial metrics relied on by shareholders and market analysts were overstated. For instance, reducing the company's COGS had the effect of inflating the company's EBITDA, which is a key performance metric used to value business entities.[709] The overstatement also raises serious questions about the company's system of internal controls. Despite previous internal control weaknesses, it appears that the board failed to effectively address the deficiencies over financial disclosures.

Although Sarbanes-Oxley requires the audit partner to be rotated every five years, PwC has been the company's external auditor since 1979.[710] That's over 43 years. Given the length of the auditor-client relationship in this case, it can be argued that despite rotating the audit partner, the auditors' objectivity could likely have been impaired out of fear of ruining a 43 year old relationship and reliance on an audit fee of over $12 million.[711] Nevertheless, the auditors' assessment of quantitative materiality during the audit of KHC, a company with revenue of over $25 billion, would have unlikely detected this misstatement in any instance. The misstatement represented less than 1% of the company's annual revenue.

The remainder of this section examines the Kraft Heinz misstatement and argues that two factors contributed to the corporate governance failure: (i) lack of effective board oversight and (ii) failure of internal controls. Each will now be addressed in turn.

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[709] Oded Rozenbaum, 'EBITDA and managers' investment and leverage choices' (2019) 36 Contemporary Accounting Research 513.

[710] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2021* (Kraft Heinz, 2022) 48.

[711] The Kraft Heinz Company, *2021 Proxy Statement and Notice of Annual Meeting of Stockholders* (Kraft Heinz, 2021) 67.

Lack of effective board oversight

As part of the Kraft-Heinz merger agreement, three of the company's directors were nominated by Berkshire Hathaway, three by 3G Capital and five by Kraft Foods.[712] Although Sarbanes-Oxley does not require the roles of chairman and chief executive to be separate, the roles of chairman and chief executive were separate and distinct. However, it is interesting to point out here that the three key board positions, that of chairman, chief executive and chief financial officer were held by partners of 3G Capital, the company's second largest shareholders. Bernado Hees, the chief executive officer had previous experience in the food and beverage industry with prior stints at Burger King.[713] Hees was a partner of 3G Capital for over eight years.[714] Paulo Basilio, the chief financial officer until 2017, was a partner of 3G Capital since 2012.[715] The chairman of the Board, Alexandre Behring, was a founding partner, and the managing partner of 3G Capital since 2004.[716] In light of this, it can be argued that 3G Capital exercised significant control over the company. As previously discussed, the board of directors has a crucial role in setting the strategic direction of the company. Perhaps then it is not surprising that following the merger, KHC began a drastic campaign to cut costs given that 3G Capital had already developed a reputation for cost cutting to increase production margins.[717] With, the CFO and CEO both from 3G Capital it is difficult not to surmise that the pressure to meet targets came from the top, which set the tone for the entire company. This was also argued by one of the company's shareholders in a securities lawsuit against KHC and 3G Capital. In Hedick v. The Kraft Heinz Company, the complainant put forward that cost cutting strategy adopted after the merger was detrimental to the company's best interest.[718] Furthermore, according to

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[712] The Kraft Heinz Company, *2016 Proxy Statement and Notice of Annual Meeting of Stockholders* (Kraft Heinz, 2016) 3.

[713] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2018* (Kraft Heinz, 2019) 10.

[714] ibid 10.

[715] ibid 11.

[716] ibid 218.

[717] Scheherazade Daneshkhu, Lindsay Whipp and James Fontanella-Khan, 'The lean and mean approach of 3G Capital' *Financial Times* (London 7 May 2017) <www.ft.com/content/268f73e6-31a3-11e7-9555-23ef563ecf9a> accessed 18 August 2020; Jonathan Stempel, 'Kraft Heinz must face shareholder lawsuit over merger, $15.4 bln writedown' (*Reuters,* 13 August 2021) <www.reuters.com/legal/litigation/kraft-heinz-must-face-shareholder-lawsuit-over-merger-154-bln-writedown-2021-08-13/> accessed 27 September 2020.

[718] *Hedick v Kraft Heinz Company et al* No 1:2019cv01339.

the SEC investigation the misconduct dates back to late 2015.[719] This suggests that the misconduct began after the merger. Therefore, it can be argued the misconduct is a direct result of the drastic strategy adopted by the board after the merger.

Following the merger and at all material times the board of KHC comprised 11 directors, nine of which were considered independent. The board comprised of four committees; AudCom, governance committee, compensation committee and an operations and strategy committee, each with their own charter outlining their respective roles and responsibilities. As required by Sarbanes-Oxley the AudCom comprised entirely of independent directors. As previously discussed, one of the primary duties of AudComs is the assessment of internal controls systems and the control environment. In fact, the AudCom at KHC went beyond the requirements of Sarbanes-Oxley and consisted of two financial experts; John Pope and Jeanne Jackson.[720] The other AudCom member, Feroz Dewan, had extensive experience in investments and private equity, but no experience in the food and beverage industry. While Pope had extensive experience in marketing, business communication, waste management and locomotives, it is important to point out that he too had no experience in the food and beverage industry. Although industry experience is not a requirement for membership of the AudCom, it is important for directors to understand the industry and the specific risks in order to effectively identify risks and ensure internal controls are designed to address the risks identified. Nevertheless, despite having two financial experts on the AudCom, the misconduct and consequential misstatement remained undetected. It is submitted that the Kraft-Heinz misstatement illustrates that the requirement to have a financial expert is no guarantee that the AudCom would be effective in its duties. Furthermore, it also suggests that industry specific experience can be more valuable than general accounting experience.

Another important consideration when examining the effectiveness of the company's board is the shareholders agreement between its two largest shareholders; Berkshire Hathaway, which held 27% and 3G Capital, which held

[719] US Securities and Exchange Commission, 'In the Matter of The Kraft Heinz Co, and Eduardo Pelleissone,' SEC (2021) <www.sec.gov/litigation/admin/2021/33-10977.pdf> accessed 9 January 2022.

[720] The Kraft Heinz Company, *2018 Proxy Statement and Notice of Annual Meeting of Stockholders* (Kraft Heinz, 2018) 15.

24% at the time.[721] Together, their combined shareholding represented 51% of the company shares. Unlike the majority of listed companies where shareholders are not actively involved in the day-to-day management, 3G Capital through its directors appointed on the KHC board played a significant role in the management of KHC. Furthermore, according to the shareholders' agreement Berkshire Hathaway agreed to vote in favour of 3G Capital directors and vice versa.[722] According to the company's by-laws, directors do not require a majority of the votes to be appointed to the board.[723] Instead, to be elected, directors only need more votes in favour of their appointment than against.[724] In other words, as long as Berkshire Hathaway and 3G Capital maintain a majority stake in the company and vote in unison, the company's other shareholders have no voice in the appointment or removal of directors from the KHC board. This agreement effectively acts as a safety net for the directors appointed by 3G Capital and Berkshire Hathaway as they can only be removed by consent.[725] At its core corporate governance regulations were introduced to address the agency problems that arose from the separation of ownership and control. On one hand, based on the above it can be argued that corporate governance regulations do little to protect shareholders when boards are dominated by directors appointed by corporate shareholders. On the other hand, it can be argued that since KHC's board included shareholders' representatives the needs of the shareholders and directors were aligned. However, as evidenced by the number of class action lawsuits that followed since the merger it can be argued that the majority shareholders, through their board representatives, pursued a strategy that was not in the best interest of the shareholders as a whole.

In examining the effectiveness of the board, it is also important to consider the role of the chairman in challenging the executives. However, in the case of KHC, the chairman and the chief executive had a pre-existing relationship and were both partners of 3G Capital. It can be argued therefore that their interest would likely have been aligned. Furthermore, as partners of one of the company's largest shareholders, it can also be argued that profit maximisation or increasing

[721] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2016* (n 706) 21.

[722] The Kraft Heinz Company, *2016 Proxy Statement and Notice of Annual Meeting of Stockholders* (n 712) 23.

[723] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2016* (n 706) 50.

[724] ibid 50.

[725] The Kraft Heinz Company, *2016 Proxy Statement and Notice of Annual Meeting of Stockholders* (n 712) 23.

shareholder wealth would have been their primary motivation. Such a scenario is unlikely to create an incentive or the environment for the chairman to remain objective and impartial. Technically, given that Behring was not previously employed by KHC he was considered to be independent by the Sarbanes-Oxley standard of independence. However, Behring's pre-existing relationship with the chief executive and the chief financial officer is likely to have affected his effectiveness. Arguably, in the same way familiarity can affect an auditors' objectivity and independence, so too it is submitted that the relationship between the Hees and Behring impaired Behring's ability to challenge and hold the Hees to account.

Failure of internal controls

The Kraft-Heinz misstatement was by no means the first time a company's annual report did not paint the full picture. Immediately following the merger, the directors of KHC acknowledged that one of the risks facing the company was merging the internal control systems of Kraft and Heinz to comply with section 404 of Sarbanes-Oxley.[726] Nevertheless, as expected, the chief executive and the chief financial officer duly signed and attested to the effectiveness of the company's internal controls as required by Sarbanes-Oxley. However, this was not the first time that the company's internal controls were found to be inadequate. In 2017 the company disclosed 'material weaknesses' in the company's internal control over the classification of cash. Perhaps not surprisingly, the financial reports of KHC between 2016 and 2018 provided no indication that the company's internal controls over procurement were inadequate or subject to abuse.

The Kraft Heinz misstatement is yet another illustration of weak internal controls and the importance of risk management in assessing the effectiveness of internal controls. As part of KHC's new strategy following the merger, the company initiated an ambitious cost savings target, this included laying off 2,500 employees.[727] At the time that was more than 5% of the staff. Undoubtedly, the fear of job loss would have also increased pressure on the procurement team to meet the ambitious targets. Furthermore, despite the increased cost of raw materials and changing consumer demands, internal targets remained unchanged. Therefore, it can be argued that the company's system of internal controls was not designed to meet the

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[726] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2016* (n 706).

[727] Paul Monica, 'Kraft Heinz cuts 2,500 jobs' (*CNN,* 12 August 2015) <https://money.cnn.com/2015/08/12/investing/kraft-heinz-job-cuts-layoffs/> accessed 16 August 2019.

increased risks arising from changing consumer demands and the company's cost cutting strategy. Adopting Deakin and Konzelmann's argument following the failure of Enron, the misstatement at KHC was linked to the boards' inability to understand the risks facing the company and design effective internal controls to address these risks.[728]

8.4.3 Sanctions

As part of the settlement agreement with the SEC, KHC agreed to pay a financial penalty of $62 million.[729] The SEC also reserved the right to reopen the investigation and increase the penalty if it later came to light that KHC provided false or misleading information. The threat of reopening the agreement and additional financial penalties can be a potential motivation for companies to cooperate during SEC investigations. Interestingly, although the misstatement was not quantitatively material, the SEC still issued a rather significant financial penalty on the basis that the information published was misleading. This appears different from the UK's risk-based approach which focuses enforcement efforts based on the level of harm.

In the aftermath of the scandal, the SEC also charged two former executives for the role in the years long scheme. Eduardo Pelleissone, the company's former Chief Operating Officer (COO) was also fined $300,000 and a disgorgement order of $12,500. The financial penalty represents less than 12% of Pelleissone's $2.5 million compensation for the year ended December 2016.[730] Interestingly, since his departure from KHC, Pelleissone has gone on to hold top level positions in freight and logistic companies, including Chief Transportation Officer at GXO Logistics and President of logistic operations for the Americas and Asia Pacific at XPO Logistics.[731] In light of this, it can be argued that the benefits far outweigh the downsides and calls into question the deterrent effect of this penalty. Klaus Hofmann, the company's former Chief Procurement Officer, was fined $100,000 and given a five year ban from being a director of a public company.[732]

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728 Simon Deakin and Suzanne J Konzelmann, 'Learning from Enron' (2004) 12 Corporate Governance: An International Review 134.

729 US Securities and Exchange Commission, 'SEC Charges The Kraft Heinz Company and Two Former Executives for Engaging in Years-Long Accounting Scheme' (n 701).

730 The Kraft Heinz Company, *2016 Proxy Statement and Notice of Annual Meeting of Stockholders*, (n 712) 41.

731 GXO Logistics, 'Eduardo Pelleissone' (*GXO,* 2022) <www.gxo.com/leadership-team/eduardo-pelleissone/> accessed 9 January 2022.

732 *US Securities and Exchange Commission v Klaus Hofmann* No 1:21-cv-07407.

Within three months of the announcement of the SEC investigation, shareholders filed four securities class action lawsuits[733] and five shareholder derivative claims.[734] Although two of the shareholder derivative claims have since been voluntarily dismissed, the other three have been combined into *In re Kraft Heinz Shareholder Derivative Litigation*. While the outcome of *In re Kraft Heinz* is still pending as the case makes its way through the judicial system, shareholders are seeking unspecified damages and costs for breach of duties and violations of the Securities Act by publishing 'materially false or misleading statements.'[735]

8.5 THE NIKOLA FRAUD

In September 2020, roughly six months after the Nikola Corporation went public, short-seller and research firm Hindenburg Research accused the company of being involved in 'an intricate fraud built on dozens of lies.'[736] Within days the company's stock price fell roughly 24%.[737] Although the company initially denied the claims, the Hidenburg allegations would later prove to be correct.[738] Within months the company's founder, Trevor Milton, was charged with securities and wire fraud.[739] Under Milton's direction, the company engaged in a deliberate attempt to inflate its market value. As a result of Milton's public statements, and press releases issued by the company under his direction, the company was valued at over $28 billion at its peak.[740] For a pre-revenue startup without a functioning product to bring to market, Nikola's valuation was based almost entirely on statements made by or on behalf of the company. Within a year of the fraud allegations, the company lost 85%

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[733] See Hedick v The Kraft Company; Iron Workers District Council (Philadelphia and Vicinity) Retirement and Pension Plan v The Kraft Heinz Company; Timber Hill LLC v The Kraft Heinz Company; Walling v Kraft Heinz Company.

[734] See DeFabiis v Hees; Vladimir Gusinsky Revocable Trust v Hees; Kailas v Hees,; Silverman v Behring; Green v Behring.

[735] The Kraft Heinz Company, *Annual Report For the fiscal year ended December 30, 2021* (n 710) 126.

[736] Hidenburg Research, 'Nikola: How to Parlay An Ocean of Lies Into a Partnership With the Largest Auto OEM in America' (*Hidenburg Research,* 10 September 2020) <https://hindenburgresearch.com/nikola/> accessed 2 February 2021.

[737] *Huhn v Milton et al* Case No 2:20-cv-02437-DWL [7].

[738] Nikola Corporation, 'Nikola Sets the Record Straight on False and Misleading Short Seller Report' (*Nikola,* 14 September 2020) <https://nikolamotor.com/press_releases/nikola-sets-the-record-straight-on-false-and-misleading-short-seller-report-96> accessed 19 July 2021.

[739] Matthew Goldstien, 'Nikola will pay $125 million to settle a securities fraud investigation' *The New York Times* (New York 21 December 2021) <www.nytimes.com/2021/12/21/business/nikola-sec-fraud-investigation.html> accessed 19 January 2022.

[740] Pippa Stevens, 'Meet Nikola, the speculative electric vehicle stock that traders believe is as valuable as Ford' (*CNBC,* 17 June 2020) <www.cnbc.com/2020/06/09/meet-nikola-the-speculative-electric-vehicle-stock-that-traders-believe-is-as-valuable-as-ford.html> accessed 9 May 2021.

of its value.[741]

8.5.1 Background

What would later become known as the Nikola Corporation began life as Bluegentech LLC, a private company founded by Trevor Milton in 2015.[742] Two years later the company was renamed Nikola Corporation, after the famous electrical inventor Nikola Tesla. Promoted as the next disruptive company in the electric vehicle market since electric car giant Tesla, Nikola proposed to design and produce hydrogen powered heavy duty trucks.[743] Since Tesla entered the automotive industry in 2010, big name car manufacturers, such as General Motors (GM) and Ford, have been under pressure to find alternative fuel solutions. In fact, Nikola's value even surpassed that of GM and Ford combined.[744] Nikola was therefore well placed to ride the wave in alternative fuel solutions with over 70 countries around the world announcing net zero strategies to cut emissions.[745]

Five years after the company's formation, Nikola went public through a merger with VectoIQ Acquisition Corp.[746] Established by former vice chairman of General Motors, Steve Girksy, VectoIQ was a blank cheque company focused on acquiring a company in the smart automotive industry.[747] As a result of the reverse merger with the SPAC, Nikola was able to take advantage of regulatory loopholes over disclosures. For instance, unlike an IPO which requires companies to disclose information about their finances and operations, the merger between VectoIQ and

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[741] Jonathan Stempel and Ben Klayman, 'U.S. charges Nikola founder Trevor Milton with lying to investors' (*Reuters,* 2021) <www.reuters.com/business/autos-transportation/us-charges-nikola-founder-trevor-milton-with-lying-investors-2021-07-29/> accessed 9 September 2021.

[742] US Securities and Exchange Commission, 'In the Mater of Nikola Corporation' SEC (2021) <www.sec.gov/litigation/admin/2021/33-11018.pdf> accessed 9 February 2022.

[743] Nikola Motor Company, 'Nikola Motor Company Formed to Transform U.S. Transportation Industry' PR Newswire <www.prnewswire.com/news-releases/nikola-motor-company-formed-to-transform-us-transportation-industry-300265791.html> accessed 19 June 2021.

[744] Matthew Fox, 'Tesla competitor Nikola Corp sees market value soar past car giants Ford, Fiat Chrysler' (*Markets Insider,* 10 June 2020) <https://markets.businessinsider.com/news/stocks/nikola-stock-market-value-soar-past-ford-fiat-chrysler-surpass-2020-6-1029298004> accessed 19 June 2021.

[745] United Nations, 'For a livable climate: Net-zero commitments must be backed by credible action' (*United Nations,* 2022) <www.un.org/en/climatechange/net-zero-coalition> accessed 9 March 2022.

[746] Nikola Corporation, 'Nikola and VectoIQ Acquisition Corp. Announce Closing of Business Combination' (*Nikola,* 3 June 2020) <https://nikolamotor.com/press_releases/nikola-and-vectoiq-acquisition-corp-announce-closing-of-business-combination-77> accessed 8 May 2021.

[747] VectoIQ Acquisition Corp, 'Proxy Statement, Prospectus and information statement dated May 8, 2020' (*EDGAR,* 2020) <www.sec.gov/Archives/edgar/data/1731289/000104746920002928/a2241585z424b3.htm#cc15> accessed 8 May 2021.

Nikola was treated as a business combination.[748] This means that Nikola was not subject to the stringent disclosures required during an IPO. Interestingly, there has been a significant increase in the number of companies that have gone public using SPACs. According to Wayland, five of seven electric vehicle companies that went public via SPACs over the span of two years have disclosed an SEC investigation.[749] This suggests that the SEC has recognised that the loopholes for SPACs can be prone to abuse and used to facilitate fraud.

Following the merger, Milton transitioned from chairman and chief executive of the private company to executive chairman of the publicly listed company. In his role as executive chairman, Milton engaged in a 'relentless public relations blitz' with the intention of keeping Nikola in the spotlight and thereby boosting the company's share price.[750] In explaining his transition to executive chairman, Milton referred to the role as a promotion that allowed him 'nearly unfettered control' of the company.[751] This element of control was seemingly very important to Milton who later stated that he should 'fully control the board at all times.'[752] It was this level of control that would contribute to the fraud at the electric vehicle start-up.

Central to the success of Nikola's business plan was the cost of hydrogen. According to an SEC filing, the company acknowledged that its profitability and survival depended on the cost of producing hydrogen.[753] Despite Milton claiming on several occasions that the company was producing hydrogen at below $4 per kilogram, Nikola did not have the facilities or permits required to produce hydrogen. Instead, the company was purchasing hydrogen at $16 per kilogram. Furthermore, the company also failed to disclose that it would require '5% of all electricity consumed in the United States' to produce sufficient hydrogen.[754] In another glaring red flag that there was more than meets the eye to Nikola's operations, Milton

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748 Clifford Chance, 'Putting SPACs on the spot - the case of Nikola Motor Company and its former CEO' (*Clifford Chance,* 9 August 2021) <www.cliffordchance.com/briefings/2021/08/putting-spacs-on-the-spot---the-case--of-nikola-motor-company-an.html> accessed 12 December 2021.

749 Michael Wayland, 'Investigations, scandals and executive upheaval drag down shares of SPAC-backed EV start-ups' (*CNBC,* 8 February 2022) <www.cnbc.com/2022/02/08/probes-executive-upheaval-continue-to-tank-spac-backed-ev-start-ups.html> accessed 19 March 2022.

750 US Securities and Exchange Commission, 'In the Mater of Nikola Corporation' (n 742).

751 *US Securities and Exchange Commission v Trevor Milton* 1:21-cv-06445 [26].

752 ibid [27].

753 US Securities and Exchange Commission, 'In the Mater of Nikola Corporation' (n 742).

754 ibid.

appointed his brother, Travis Milton, as Director of Hydrogen Production.[755] According to the Hidenburg report, Travis was experienced in pouring concrete.[756] Milton's scheme to mislead investors did not stop there. In another example of Milton's false and misleading narrative, he uploaded a video to Twitter that purported to show the company's first semi-truck prototype, the Nikola One, in motion using its own power. It would later come to light that the video was entirely misleading. Instead, Milton arranged to have the vehicle towed up a hill, where it was filmed rolling down the hill with the handbrake disengaged. According to the DOJ, the Nikola One was nowhere near complete at the time, the truck was still missing integral components, including gears and motors and had yet to be tested.[757]

8.5.2 The governance failure

As an emerging growth company with annual gross revenues of less than one billion, Nikola was exempt from certain reporting requirements. For instance, the company was not required to comply with the auditor attestation requirement of section 404 of Sarbanes-Oxley.[758] Accordingly, the company reported compliance to the applicable sections of Sarbanes-Oxley and the NASDAQ listing rules. The board consisted of an AudCom, a compensation committee and a nomination and governance committee. The majority of the company's directors were external independent directors. In fact, following the merger apart from Milton and Mark Russell, the President and chief executive, the other seven members of the company's board were external independent directors.

The remainder of this section argues that the corporate governance failure at Nikola can be attributed to a lack of effective board oversight and a failure of internal controls. Each will now be addressed in turn.

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755 Hidenburg Research (n 736).

756 David Welch and Ed Ludlow, 'Nikola founder Milton's fall reveals what his backers feared' (*BNN Bloomberg,* 20 September 2020) <www.bnnbloomberg.ca/nikola-founder-milton-s-fall-reveals-what-his-backers-feared-1.1500376> accessed 15 February 2021.

757 US Department of Justice, 'Former Nikola Corporation CEO Trevor Milton Charged In Securities Fraud Scheme' (*DOJ,* 29 July 2021) <www.justice.gov/usao-sdny/pr/former-nikola-corporation-ceo-trevor-milton-charged-securities-fraud-scheme> accessed 17 October 2021.

758 US Securities and Exchange Commission, 'Emerging Growth Companies' (*SEC,* 28 April 2022) <www.sec.gov/education/smallbusiness/goingpublic/EGC> accessed 2 May 2022.

Lack of effective board oversight

Although on the surface Nikola's board appeared to be compliant with the corporate governance requirements of Sarbanes-Oxley and the NASDAQ listing rules, this was not the first time a company reported compliance and was later embroiled in a governance scandal. The continued instances of corporate governance scandals that have been linked to the failure of an effective board suggest that the effectiveness of a company's board cannot be measured by its composition. To be effective the board is required to play an active role in the strategic direction and oversight of the company as a whole. Importantly, this requires the board to have the technical skill and expertise required to make valuable contributions to the success of the company. Given the subsequent governance scandal, it can be argued that the board of directors at Nikola failed in their oversight responsibilities, later admitting, that several statements made by Milton were 'inaccurate in whole or in part.'[759]

In analysing the failure of Nikola's board of directors, it can be argued that equity-based compensation played a significant role in the board's failure. It is well established that equity-based compensation is one of the mechanisms used to align the interest of shareholders with that of directors. However, on the other hand, equity-based compensation can also motivate directors to engage in corporate misconduct for their own short-term self-interest. Before examining the compensation of Nikola's board, it is also important to point out here that six of the company's directors came from the acquired company, including Russell, the chief executive. Arguably, given their history with Milton and Nikola, the directors should have been aware of the actual progress of Nikola's technology, including the status of the company's electric vehicles and components. The subsequent governance failure also calls into question the board's role in reviewing the company's progress and the information that was disseminated. For instance, the board appears to have been completely unaware at the time that contrary to Milton's claims Nikola was not producing hydrogen. This is rather surprising given that hydrogen was a component that was central to the company's success.

[759] Nikola Corporation, 'Form 10-K - For the fiscal year ended December 31, 2020' EDGAR <www.sec.gov/ix?doc=/Archives/edgar/data/0001731289/000173128921000006/nkla-20201231.htm> accessed 9 September 2021.

Immediately following the merger Milton sold $70 million worth of his shares.[760] Perhaps Milton's drive to inflate the company's share price can be explained by reference to his compensation package and his 35% stake in the company. Post-merger Nikola adopted a 'low-cash, high-stock' compensation policy.[761] As such, Milton's compensation was primarily in stock awards, apart from a $1.00 cash component. While this is becoming common among chief executives of tech start-ups, it can be argued that compensating all the independent directors of Nikola primarily in stock awards affected their effectiveness.[762] Furthermore, it can also be argued that compensation packages that are weighed heavily in favour of stock awards create an incentive for directors to inflate the stock price, as illustrated by the case of Nikola. Therefore, in the same way it can be argued that Milton was motivated by financial motives, so too can it be argued that Nikola's board was incentivised by financial motivations. While Milton controlled 35% of the company's stock, the other directors controlled 63% of the company.[763] This means that together Milton and the board exerted total control over the company. This also means that the other directors had an interest in maximising the stock price.

Given that over 98% of the directors' compensation was tied to Nikola's stock price, there was no real incentive or motivation for the board to reign in Milton or correct his misstatements. Any such announcement would have resulted in the stock price taking a nosedive, which was not in their financial interest. For instance, within a week of the announcement that Milton had voluntarily resigned as executive chairman, Nikola's share price dropped 43%, from $34.19 to $19.46.[764] In fact, the company's share price has continued to decline.[765] Given the directors were paid primarily in shares, it would not be in their interest to disclose information that had the potential of lowering the company's share price. In a notable example of the board's failure, the directors were presented with a report that the Badger

[760] Clifford Chance (n 748).

[761] Nikola Corporation, *2021 Proxy Statement* (Nikola, 2021) 37.

[762] Rachel Gillett and Marissa Perino, '13 top executives who earn a $1 salary or less' (*Insider,* 22 July 2019) <www.businessinsider.com/ceos-who-take-1-dollar-salary-or-less-2015-8> accessed 19 November 2020.

[763] VectoIQ Acquisition Corp, 'Form S-4 ' (*EDGAR* 13 March 2020) <www.sec.gov/Archives/edgar/data/0001731289/000104746920001479/a2240989zs-4.htm#bg12402a_main_toc> accessed 19 July 2021.

[764] *United States v Milton* 21 Cr 478 (ER) (SDNY Nov 15, 2021).

[765] Nasdaq, 'Nikola Corporation Common Stock' (*Nasdaq,* 1 March 2022) <www.nasdaq.com/market-activity/stocks/nkla> accessed 1 March 2022.

partnership with GM had the potential of generating losses of $3.1 billion over six years.[766] Despite the internal reports not supporting the claim, the company continued to claim potential cost savings of $4 billion over 10 years.[767] The board had an opportunity to correct Milton's misstatement but appears to have chosen not to do so.

Internal controls

Despite repeated attempts by regulators to encourage directors to engage in ensuring the proper design and implementation of internal controls, yet again the failure of internal controls has contributed to another corporate governance scandal. In the age of social media, where more and more companies are using social media platforms to communicate, internal controls over the dissemination of information have become particularly important.[768] This includes ensuring proper and effective internal controls to verify the accuracy of information. The company's failure to design and implement internal controls over social media played an integral part in Milton's scheme to inflate Nikola's share price. Milton recognised that using social media platforms, such as Twitter and Facebook, would enable him to reach a wide audience of retail investors. In an email to a member of the board in March 2020, Milton made his intention of focusing on retail investors clear. According to Milton, it was important that Nikola get 'retail investors on our side.'[769] Milton went as far as tracking the daily number of Robinhood investors who invested in Nikola.[770]

The case of Nikola is not the first time social media has been used to inflate a company's share price. In fact, social media has in the past been linked to pump and dump schemes, which involve inflating the share price by spreading false information with the aim of benefitting financially.[771] For Milton, Nikola was arguably a pump and dump scheme on a larger scale. The former executive chairman

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[766] *SEC v Milton* (n 751) [41].

[767] ibid [41].

[768] Santiago Chaher and James David Spellman, 'Corporate Governance and Social Media: A Brave New World for Board Directors' (*World Bank,* 2012) <https://openknowledge.worldbank.org/handle/10986/17092> accessed 19 June 2020.

[769] *US v Milton* (n 764) [24].

[770] *SEC v Milton* (n 751) [43].

[771] US Securities and Exchange Commission, 'Updated Investor Alert: Social Media and Investing -- Stock Rumors' (*SEC,* 5 November 2015) <www.sec.gov/oiea/investor-alerts-bulletins/ia_rumors.html> accessed 7 September 2020.

intended to offload shares as soon as the six month lock-up period expired.[772] Using Facebook, Twitter, podcasts and media platforms Milton continuously disseminated false and misleading information about the company's operations. In one instance, Milton tweeted that the company's truck, the Badger, was built 'from the ground up.'[773] This was nowhere near the truth. The fact of the matter was that Nikola had outsourced production and used parts from other vehicles, such as Ford pickup trucks.[774] In another example, the company disclosed that it had 14,000 reservations for the purchase of the Nikola One.[775] In reality 13,200 of those reservations were not binding and did not represent a firm commitment to purchase.[776] Even when confronted during a podcast interview with the notion that the reservations were nothing more than 'letters of intent,' Milton maintained that the reservations were 'billions and billions and billions and billions of dollars in order.'[777]

Taking the above into consideration, it is apparent that Milton engaged in a concerted effort to mislead investors. In what can be considered a glaring weakness of the company's internal controls, the board was not even aware of most of Milton's interviews or tweets until after the fact. Ultimately, the board failed to implement controls over the dissemination and accuracy of information. However, it is important to point out that internal control systems are only as good as the environment they operate in and the people who oversee and implement the controls. Milton's hold over the company was so complete that he maintained 'ultimate control and authority over the company's social media posts and press releases.'[778] While senior executives did make an effort to reign in Milton's tweets by suggesting the Chief Legal Officer review his tweets, all attempts seemed futile.[779] In the end, it appears that Milton's full control of the board would have been the biggest obstacle to the effective operation of any system of internal controls.

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[772] *US v Milton* (n 764) [20].

[773] ibid [59].

[774] ibid [47].

[775] Mark R Hale, 'Nikola Stock Is Likely Overvalued Right Now' (*Nasdaq,* 25 August 2020) <www.nasdaq.com/articles/nikola-stock-is-likely-overvalued-right-now-2020-08-25> accessed 9 October 2021.

[776] *US v Milton* (n 764) [77].

[777] ibid [78].

[778] *SEC v Milton* (n 751) [29].

[779] ibid [156]-[158].

8.5.3 Sanctions

Impressively, less than a year after the fraud allegations by Hidenburg Research, the DOJ charged Milton with securities fraud and wire fraud in relation to the Nikola fraud.[780] Around the same time, the SEC also charged Milton with breaching the Securities Act and the Exchange Act.[781] While the final outcome of the SEC enforcement action against Milton has yet to be finalised, the SEC is seeking disgorgement, civil penalties and to ban Milton from acting as a director or officer.[782]

In the aftermath of the scandal, the SEC fined Nikola $125 million for defrauding investors.[783] As a result of fraud Nikola faces several class action lawsuits and derivative claims from shareholders which are still ongoing.[784] Although the company could not yet estimate the outcome, it has acknowledged that outcome is likely to be material.[785]

As previously mentioned, this isn't the first time the SEC has initiated action against companies for failure to ensure effective internal controls over social media communications. In 2018, the regulator fined Tesla and its chief executive Elon Musk $20 million each for internal control failures over Musk's tweets.[786] The case of Nikola also illustrates that the SEC does not need to rely on Sarbanes-Oxley to pursue Nikola. Technically, on paper, Nikola was in compliance with the corporate governance requirements of Sarbanes-Oxley. Therefore, it can be argued that none of the provisions contained in Sarbanes-Oxley appears to have prevented the fraud.

8.6 CONCLUSION

Since the introduction of Sarbanes-Oxley, the U.S. has continued to experience instances of corporate governance failures. These continuing instances suggest that

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[780] US Department of Justice, 'Former Nikola Corporation CEO Trevor Milton Charged In Securities Fraud Scheme' (*DOJ,* 29 July 2021) <www.justice.gov/usao-sdny/pr/former-nikola-corporation-ceo-trevor-milton-charged-securities-fraud-scheme> accessed 17 October 2021757).

[781] US Securities and Exchange Commission, 'SEC Charges Founder of Nikola Corp. With Fraud' (*SEC,* 29 July 2021) <www.sec.gov/news/press-release/2021-141> accessed 9 November 2021.

[782] ibid.

[783] US Securities and Exchange Commission, 'Nikola Corporation to Pay $125 Million to Resolve Fraud Charges' (*SEC,* 21 December 2021) <www.sec.gov/news/press-release/2021-267> accessed 9 February 2022.

[784] See *Borteanu v Nikola CorpRe Nikola Corporation Derivative Litigation* (n 656).

[785] Nikola Corporation, *2021 Proxy Statement* (n 761).

[786] US Securities and Exchange Commission, 'Elon Musk Settles SEC Fraud Charges; Tesla Charged With and Resolves Securities Law Charge' (*SEC,* 29 September 2018) <www.sec.gov/news/press-release/2018-226> accessed 9 December 2020.

Sarbanes-Oxley has done little to address instances of corporate governance failures and call into question the rules-based approach adopted in the United States. As illustrated by the corporate governance failures examined in this chapter, the manipulation of accounting standards continues to feature predominantly in instances of corporate abuse. Therefore, it is submitted that as long as accounting standards continue to include an element of subjective judgment, these loopholes will continue to be exploited irrespective of the approach taken to regulating corporate governance.

Furthermore, as illustrated in this chapter, performance related compensation continues to be linked to instances of corporate abuse. Instead of promoting the long term interest of shareholders, performance related compensation appears to be more of an incentive for directors to prioritise short term goals to meet performance related targets. However, to the credit of the SEC, the regulator appears to be a rather active and adept public enforcer of corporate misconduct. The evidence suggests that there is a much higher likelihood of corporate executives in the U.S. facing sanctions in the aftermath of corporate failures when compared to their UK counterparts. Nevertheless, instances of corporate misconduct in the U.S. continue to emerge. This suggests that the rules-based approach to corporate governance does not have a material impact on the instances of corporate governance failures. Instead, it can be argued that whether rules-based or principles-based, corporate governance regulations have failed to address the root cause of corporate misconduct.

Chapter 9
ENFORCING CORPORATE GOVERNANCE IN THE U.S.

"You cannot legislate good behaviour."
– Mervyn King[787]

9.1 INTRODUCTION

The previous chapter analysed instances of corporate governance failures in the United States. This chapter evaluates public enforcement mechanisms in the United States. The chapter proceeds as follows: section 9.2 outlines the corporate landscape in the United States. Section 9.3 considers the legislative and enforcement framework for corporate governance. Section 9.4 examines public enforcement mechanisms and section 9.5 concludes.

9.2 CORPORATE LANDSCAPE

With a market capitalisation of $27 trillion, the New York Stock Exchange (NYSE) is the largest stock exchange in the world.[788] As such, many of the world's largest companies are traded on the U.S. securities market. Therefore, in order to gain a better understanding of corporate governance in the U.S., it is important to first understand the corporate landscape. According to the latest census data, there are over 32 million businesses registered in the United States.[789] While this appears considerable, it is important to point out here that roughly 23 million of these are sole proprietors, 7.4 million are partnership and S-corporations (S-Corps) and 1.7 million are C-corporations (C-Corp).[790] Although both S-Corps and C-corps are considered separate legal persons, S-corps are restricted to 100 shareholders and

[787] Mervyn King, Chairman of the King Report.

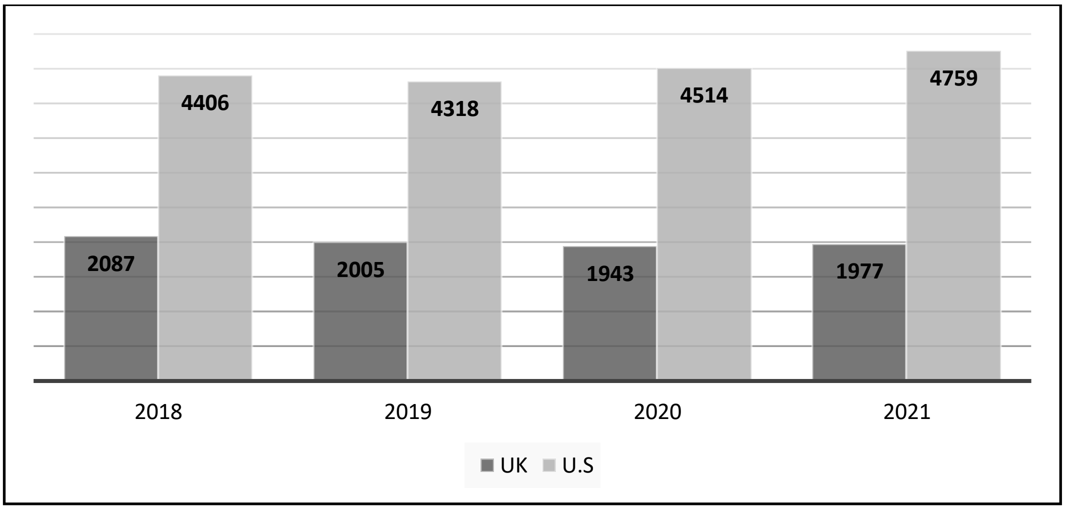
[788] Statista, 'Largest stock exchange operators worldwide as of March 2022, by market capitalization of listed companies' (*Statista,* 5 May 2022) <www.statista.com/statistics/270126/largest-stock-exchange-operators-by-market-capitalization-of-listed-comp> accessed 12 May 2022.

[789] Todd Kehoe, 'What counts as a 'business'? It might not be what you think it is' (*Albany Business Review,* 11 April 2019) <www.bizjournals.com/albany/news/2019/04/11/number-of-businesses-in-the-united-states.html> accessed 29 September 2021.

[790] Scott A Hodge, 'The U.S. Has More Individually Owned Businesses than Corporations' (*Tax Foundation,* 13 January 2014) <https://taxfoundation.org/us-has-more-individually-owned-businesses-corporations/> accessed 17 June 2020.

can only issue one class of shares.[791] As a result of these limitations, S-corps cannot be used to raise funds through IPOs.[792] This means that 95% of businesses in the U.S. automatically fall outside the scope of Sarbanes-Oxley. This also means that only 5% of businesses registered in the U.S. are C-corps. However, it is important to point out here that not all C-corps are publicly listed.

Figure 13: Companies listed in the U.S and UK, 2018-2021



Source: Cornerstone Research, *Securities Class Action Filings 2021 Year in Review*; London Stock Exchange, *Issuer List* 2018-2021

As illustrated in Figure 13, there are over four thousand companies listed in the United States. In other words, Sarbanes-Oxley is only applicable to roughly 0.26% of C-corps registered in the United States. Although this percentage appears insignificant, the NASDAQ and NYSE have a combined market capitalisation of $49.6 trillion.[793] This is more than the GDP of several countries around the world. For instance, the market capitalisation of Apple alone is more than the GDP of 186 countries including, the UK, Italy, Brazil and Columbia.[794] For that reason, the regulation of the securities market in the U.S. is crucial to the functioning of global economies.

[791] Helen Huston, 'Compare S corporation vs C corporation' (*Wolters Kluwer,* 1 September 2020) <www.wolterskluwer.com/en/expert-insights/s-corp-vs-c-corp-differences-benefits> accessed 19 July 2021.

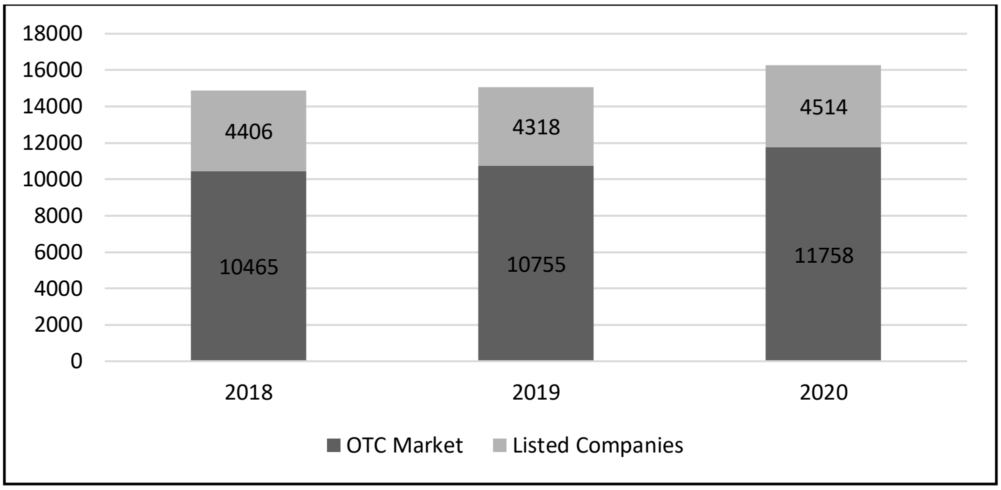
[792] ibid.

[793] Statista, 'Largest stock exchange operators worldwide as of March 2022, by market capitalization of listed companies' (n 788).

[794] Pawan Nahar, 'Apple's m-cap at $3 trillion less than just 4 nations' GDP' *The Economic Times* (Mumbai 4 January 2022) <https://economictimes.indiatimes.com/markets/stocks/news/apple-m-cap-at-3-trillion-only-four-nations-worth-more-than-the-iphone-maker/articleshow/88685135.cms> accessed 31 March 2022.

Given the size of the U.S. market, it is therefore not surprising that the number of listed companies registered in the U.S. far exceeds the number of listed companies registered in the UK (Figure 13). Interestingly in the four year period between 2018 and 2021, the number of corporations listed on the U.S. stock market increased 8%. Conversely, the number of companies listed on the LSE decreased 5% in the same period. This suggests that the U.S. rules-based approach to corporate governance has not deterred companies from listing.

Figure 14: Securities listed on the over-the-counter market, 2018-2021



Source: OTC Markets Group Inc., *Annual Report* 2017-2020; Cornerstone Research, *Securities Class Action Filings 2021 Year in Review*

A discussion of the corporate landscape in the U.S. will not be complete without also briefly addressing the over-the-counter market (OTC). Also known as the micro-cap market, the OTC is home to some of the largest foreign companies, such as the Korean multinational Samsung Electronics. As shown in Figure 14, the number of securities listed on the OTC is substantially more than the number of companies listed on the NYSE and NASDAQ combined. However, unlike companies listed on the NYSE and NASDAQ, companies listed on the OTC are not subject to the provisions of Sarbanes-Oxley and can therefore appear to be an attractive alternative. In 2013 the Japanese electronics conglomerate Panasonic, a large cap company with a market capitalisation of $26 million, voluntarily delisted from the

NYSE.[795] The company explained that it was not 'economically justifiable' to remain listed on the NYSE and instead listed on the OTC.[796]

Although the OTC is twice the size of the NYSE and the NASDAQ combined and not subject to the provisions of Sarbanes-Oxley, companies listed on the OTC market are not completely unregulated. In fact, the SEC has taken enforcement action against several micro-cap companies for securities fraud.[797] Ultimately, as discussed above, over 99% of companies registered in the U.S. fall outside the scope of Sarbanes-Oxley. This begs the question of whether the rules-based approach to corporate governance adopted by Sarbanes-Oxley was necessary given that it applies to less than 1% of companies registered in the United States.

9.3 ENFORCEMENT FRAMEWORK

To gain a thorough understanding of how corporate governance is enforced in the U.S., it is important to first examine the legislative framework. This will be followed by an overview of the enforcement framework. Importantly, although Sarbanes-Oxley has received considerable attention, it is not the only piece of legislation that includes penalties for corporate misconduct. As previously explained in Chapter 7, sanctions for corporate misconduct have existed in the U.S. long before Sarbanes-Oxley was introduced.

9.3.1 Legislative Framework

The 1929 stock market crash marked a pivotal moment in the history of American capitalism. Before the stock market crash of 1929, federal securities regulation in the U.S. was largely non-existent. Between 1911 and 1933, individual states enacted securities statutes, known as Blue Sky Laws.[798] Nevertheless, as evidenced by the 1929 stock market crash, these state laws did not prevent the collapse of the stock market in the United States. In the aftermath investors lost billions, which subsequently led to a series of bankruptcies and job losses and

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[795] Panasonic Corporation, 'Panasonic announces delisting from New York Stock Exchange became effective' Panasonic (2013) <https://news.panasonic.com/global/press/data/2013/04/en130423-2/en130423-2.pdf> accessed 6 June 2020.

[796] ibid.

[797] US Securities and Exchange Commission, 'SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters' (*SEC,* 2 March 2015) <www.sec.gov/news/pressrelease/2015-44.html> accessed 8 March 2020.

[798] Jonathan R Macey and Geoffrey P Miller, 'Origin of the blue sky laws' (1991) 70 Tex L Rev 347, 348.

sparked the beginning of the Great Depression. While the introduction of Sarbanes-Oxley changed the legislative framework, the securities market in the U.S. was not completely unregulated prior to the passage of Sarbanes-Oxley. Table 21 provides a brief overview of some of the offences available to regulators in the United States. Interestingly, many of these sanctions existed long before Sarbanes-Oxley. Consequently, the effectiveness of Sarbanes-Oxley continues to be subject to much debate.

When considering the legislative framework in the U.S., it is also important to point out that the Securities Act and the Exchange Act created private rights of action. This means that any shareholder who has suffered harm can initiate proceedings directly against the company's directors.[799] Perhaps this explains why the U.S. has developed a reputation for being a litigious society. In fact, according to Savitt and Yavitz, class-action lawsuits account for the majority of all private enforcement of securities law.[800]

Although private litigation against directors can lead to a litany of frivolous lawsuits, it can also be a powerful mechanism to hold directors accountable.[801] For example, in 2017, shareholders forced Mark Zuckerberg to abandon plans to issue a new class of shares. Under Zuckerberg's plan, the new class of shares would have no voting rights.[802] Although Zuckerberg controls 60% of the company's voting shares, shareholders were successful in forcing a U-turn after bringing a class-action lawsuit against the company's founder and chief executive.[803] Ultimately, Sarbanes-Oxley has strengthened the legislative framework by adding stiffer penalties for corporate abuse with the introduction of the Securities Fraud Statute. Based on the arguments

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[799] Harvard Law School Forum on Corporate Governance & Financial Regulation, 'The Interrelationship Between Public and Private Securities Enforcement' (*Harvard Law School Forum on Corporate Governance & Financial Regulation,* 11 December 2011) <https://corpgov.law.harvard.edu/2011/12/11/the-interrelationship-between-public-and-private-securities-enforcement/> accessed 9 August 2020.

[800] William Savitt and Noah B Yavitz, 'The Securities Litigation Review: USA' (*The Law Reviews,* 7 June 2021) <https://thelawreviews.co.uk/title/the-securities-litigation-review/usa> accessed 17 November 2021.

[801] Jeffrey T Cook, 'Recrafting the Jurisdictional Framework for Private Rights of Action Under the Federal Securities Laws' (2005) 55 American University Law Review 621.

[802] Tom Hals, 'Zuckerberg nixes new Facebook share class after shareholder lawsuit' (*Reuters,* 22 September 2017) <www.reuters.com/article/us-facebook-stock-trial-idUSKCN1BX2PA> accessed 19 July 2021.

[803] ibid.

above, the U.S. appears to have a strong legislative framework for enforcing corporate misconduct.

Table 21: Overview of sanctions available for corporate misconduct in the U.S.

Federal	State
• **Sarbanes Oxley Act of 2002** o § 807 – Securities fraud o § 902 – Attempt and conspiracy o § 906 – Failure of corporate officers to certify financial reports • **Title 18 U.S.C** o § 2 – Aiding & Abetting o §371 – Conspiracy to commit offense or defraud United States o § 1001 Statements or entries generally (False statements) o § 1341 – Fraud and swindles (mail fraud) o §1343 – Fraud by wire, radio or television o § 1346 – Honest services fraud o § 1348 – Securities Fraud o § 1349 – Attempt and conspiracy o § 1350 - Failure of corporate officers to certify financial reports • **Title 15 U.S.C.** o § 201 – Bribery of public official and witnesses o § 78 – Books and records o § 78dd-1(a) – Payments to foreign officials to obtain or retain business o § 78j – Manipulative and deceptive devices	• **Delaware Code** o 8 DE § 611 – Disqualification of officer, shareholder, agent or employee o 6 DE Code § 73-201 - Fraud o 6 DE Code § 73-604(a) – Fraud of $50,000 or more o 6 DE Code § 73-604(b) – Fraud of $10,000

9.3.2 Enforcement Framework

The effectiveness of regulations to prevent and deter corporate misconduct cannot be measured reliably solely by the mere existence of regulation. Laws and regulations are effectively meaningless unless they are effectively enforced. As such, this section will outline the system of enforcement in the United States.

As illustrated in Figure 15, there are two public federal regulators in the U.S.; the DOJ and the SEC. Although both regulators operate at the federal level, there is clear distinction between their roles and responsibilities. While the SEC is the civil securities regulator, the DOJ is a criminal regulator responsible for all criminal prosecutions of securities law. As such, there is no confusion over their jurisdiction and their responsibilities.

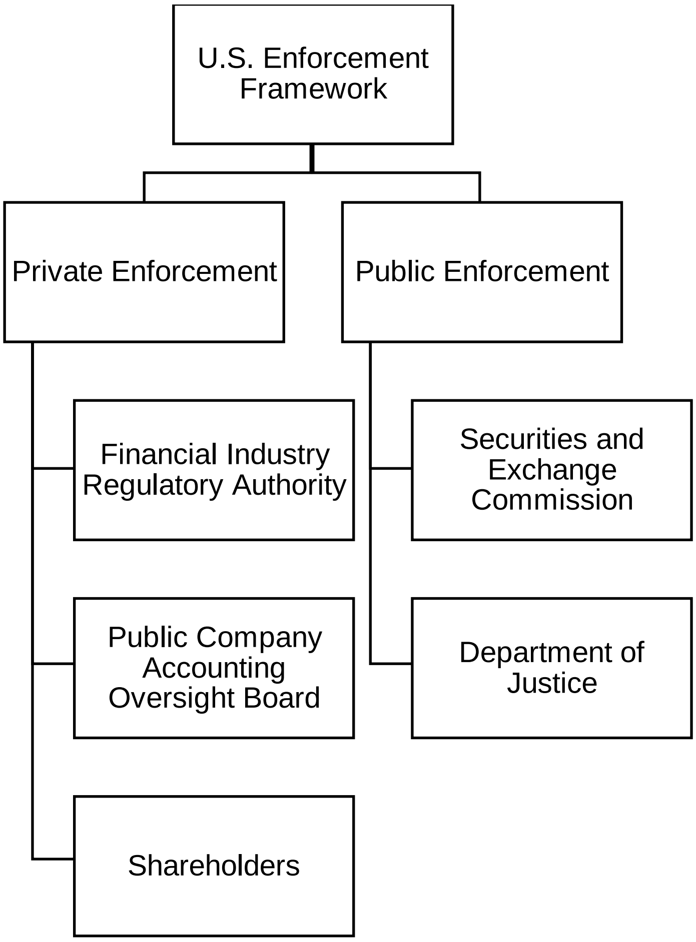

Figure 15: Corporate governance enforcement framework in the U.S.

In addition to public enforcement bodies, the U.S. also has private enforcement mechanisms; the PCAOB, the FINRA and shareholders. As previously explained the PCAOB was created by Sarbanes-Oxley to regulate the accounting profession. Although the PCAOB is a private regulator, it operates under the supervision of the SEC.[804] Similar to the PCAOB, FINRA is also overseen by the SEC. In light of this, it can be argued that the SEC appears to be a very powerful regulator with wide reaching power and jurisdiction over the securities market. In fact, given its oversight of the other regulators, it can be argued that the SEC is the primary civil regulator of securities regulation in the United States. Perhaps this singular

[804] Public Company Accounting Oversight Board, 'About ' (*PCAOB,* 31 December 2020) <https://pcaobus.org/about> accessed 8 June 2021.

regulatory approach to corporate misconduct explains why the U.S. appears to be more effective in enforcing corporate misconduct.

9.4 PUBLIC ENFORCEMENT

As previously explained, public enforcement refers to enforcement by public regulatory bodies. Unlike codes of practice which are non-binding and have no legal backing, Sarbanes-Oxley delegated powers to public bodies to enforce non-compliance. Despite this, instances of corporate misconduct continue to emerge which calls into question not only the effectiveness of Sarbanes-Oxley, but the effectiveness of U.S. regulators to deter corporate misconduct.

The remainder of this section will examine the effectiveness of the SEC and the DOJ. Each will now be addressed in turn.

9.4.1 The Securities and Exchange Commission

In an attempt to protect shareholders and regulate the securities market, the U.S. Congress enacted the Securities Exchange Act of 1934 (Exchange Act). One of the most important achievements of the Exchange Act was the creation of the SEC, a federal supervisory body responsible for oversight of the financial markets. As part of its responsibilities, the regulator monitors approximately 28,000 entities.[805] However, since its inception the SEC has been on the receiving end of severe criticism for its failure to detect instances of corporate misconduct.[806] One of the most notable examples of the SEC's failure to detect corporate misconduct was the notorious Bernie Madoff Ponzi scheme. Before the scheme famously collapsed in 2008, the SEC was warned several times since the 1990s that the scheme was a fraud.[807] In fact, over the course of 16 years Madoff was investigated by the SEC eight times.[808] Madoff himself would later express surprise that the regulator did not

[805] US Securities and Exchange Commission, 'What We Do' (*SEC,* 22 November 2021) <www.sec.gov/about/what-we-do> accessed 8 January 2022.

[806] Joel Seligman, 'Self-funding for the Securities and Exchange Commission' (2004) 28 Nova law review 233.

[807] History.com Editors, 'Billionaire conman Bernard Madoff arrested' (*History,* 20 July 2011) <www.history.com/this-day-in-history/billionaire-conman-bernard-madoff-arrested> accessed 18 May 2020.

[808] Reuters Staff, 'Regulators probed Madoff eight times over 16 years: report' (*Reuters,* 5 January 2009) <www.reuters.com/article/us-madoff-regulators-idUSTRE5040HP20090105> accessed 7 May 2020.

detect the fraud.[809] In the aftermath of the Madoff scandal, the SEC introduced a number of reforms aimed at strengthening its enforcement division.[810]

As a federal government agency, the SEC is funded through Congress and is led by five commissioners, appointed by the President with the approval of the Senate to serve a five-year term. As such, it can be argued that the SEC is subject to a level of political influence, with U.S. politics having become increasingly partisan in recent years.[811] However, it is important to note that no more than three commissioners can come from the same political party.[812] Nevertheless, it can be argued that the SEC's approach to enforcement is significantly influenced by these political appointments. For instance, under the Trump nominated chair, Jay Clayton, the SEC undertook a series of changes that many argued weakened investor safeguards and corporate disclosure rules.[813] Following the appointment of the Biden nominated chair, Gary Gensler, companies were warned to expect an 'aggressive shift' in enforcement.[814] In outlining his approach to enforcement Gensler emphasised the importance of investor protections and issued a stern warning to gatekeepers to focus on the 'spirit of law'.[815] In fact, according to Carney and others, since Gensler's appointment as SEC chair in 2021 there has been an uptick in enforcement.[816]

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[809] US Securities and Exchange Commission, 'Interview of Bernard L Madoff ' SEC (2009) <www.sec.gov/news/studies/2009/oig-509/exhibit-0104.pdf> accessed 8 February 2020.

[810] US Securities and Exchange Commission, 'The Securities and Exchange Commission Post-Madoff Reforms' (*SEC,* 15 July 2019) <www.sec.gov/spotlight/secpostmadoffreforms.htm> accessed 8 August 2020.

[811] Bob Abeshouse, 'The Disunited States: How partisan politics is polarising the US' (*Al Jazeera,* 2 August 2019) <www.aljazeera.com/features/2019/8/2/the-disunited-states-how-partisan-politics-is-polarising-the-us> accessed 14 July 2021.

[812] US Securities and Exchange Commission, 'Current SEC Commissioners' (*SEC,* 29 December 2020) <www.sec.gov/Article/about-commissioners.html> accessed 9 June 2021.

[813] Svea Herbst-Bayliss, Katanga Johnson and Jarrett Renshaw, 'Biden to name Gary Gensler as U.S. SEC chair, sources say' (*Reuters,* 12 January 2021) <www.reuters.com/article/us-usa-biden-sec-exclusive-idUSKBN29H2PQ> accessed 19 November 2021.

[814] Mark D Lytle and Robert J McManigal, 'The SEC plans more aggressive enforcement-securities-fraud strategy' (*Nixon Peabody,* 12 November 2021) <www.nixonpeabody.com/en/ideas/articles/2021/11/12/the-sec-plans-more-aggressive-enforcement-securities-fraud-strategy> accessed 8 January 2022.

[815] Michael J Blankenship, 'SEC Chair Warns of Increased Enforcement and Oversight of Crypto Assets' (*Winston & Strawn LLP,* 10 November 2021) <www.winston.com/en/capital-markets-and-securities-law-watch/sec-chair-warns-of-increased-enforcement-and-oversight-of-crypto-assets.html> accessed 9 January 2022.

[816] John J Carney and others, 'The future of SEC enforcement under the Biden administration' (2021) 22 J of Investment Compliance 334.

One of the primary criticisms faced by the SEC is that it has been continuously underfunded by Congress. As such, there have been calls for the SEC to be self-funded, on the basis that it would be a more effective regulator and free from the whims of politicians. In 1993 then chair of the SEC, Arthur Levitt, argued in favour of self-funding to 'ensure that the Commission has adequate resources.'[817] Levitt unsuccessfully sought additional funding from Congress to add an additional 200 examiners to the SEC inspection program. Levitt was not the first SEC chair to call for the regulator to be self-funded. In 2010, the then chair of the SEC, Mary Schapiro, and five former chairs also called for the regulator to be self-funded from the fees it collects.[818] In support of self-funding Schapiro argued that the agency tends to collect more in fees than its annual appropriation from Congress.[819] Therefore, moving to a self-funded model would allow the regulator to set its own goals and agenda and expand its operations as it sees fit, in line with growing financial markets.

As a result of its reliance on congressional appropriations, the regulator has been somewhat hamstrung. For instance, Geslar's plan to appoint 400 additional employees relies completely on receiving Congressional approval.[820] In support of his proposition for an increase in the SEC budget to $2.15 billion, Geslar argued that the regulator has not grown in correlation with the market, noting that the Division of Enforcement "shrank five percent" between 2016 and 2021.[821] While this represents a modest 6% increase in the regulator's budget, it is important to emphasise that the regulator oversees a stock market valued at $49.6 trillion.[822] Such a limited budget supports the view that the agency is in fact 'outgunned' by the

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[817] Seligman (n 806) 240.

[818] Ronald D Orol, 'Five SEC chairmen and Schumer push for self-funded SEC' (*MarketWatch,* 15 April 2010) <www.marketwatch.com/story/five-sec-chairs-and-schumer-want-self-funded-sec-2010-04-15> accessed 19 August 2020.

[819] Mary L Schapiro, 'Speech by SEC Chairman: Statement Concerning Agency Self-Funding' (*SEC,* 15 April 2010) <www.sec.gov/news/speech/2010/spch041510mls.htm> accessed 19 June 2020.

[820] Bill Flook, 'SEC Seeks Funding for 400 New Positions' (*Thomson Reuters,* 30 March 2022) <https://tax.thomsonreuters.com/news/sec-seeks-funding-for-400-new-positions/> accessed 9 May 2022.

[821] Gary Gensler, 'Testimony by Chair Gensler at Hearing before the Subcommittee on Financial Services and General Government, U.S. House Appropriations Committee' (*Harvard Law School Forum on Corporate Governance,* 18 May 2022) <https://corpgov.law.harvard.edu/2022/05/18/testimony-by-chair-gensler-at-hearing-before-the-subcommittee-on-financial-services-and-general-government-u-s-house-appropriations-committee/> accessed 20 May 2022.

[822] Statista, 'Largest stock exchange operators worldwide as of March 2022, by market capitalization of listed companies' (n 788).

companies it oversees.[823] Nevertheless, the regulator has successfully taken action against some of the largest companies for corporate misconduct, as illustrated in Chapter 8. This suggests that the agency has managed to effectively allocate its limited resources.

As shown in Table 22, the SEC imposed 5524 enforcement actions during the period 1 October 2015 to 30 September 2021. That represents an average of 789 enforcement actions per year. Given the number of entities regulated by the SEC and the average number of enforcement outcomes, the SEC has an enforcement rate of 2.8%. In other words, roughly 3% of entities regulated by the SEC have been subject to enforcement action.

Table 22: Enforcement actions, 2010-2020

Year	Enforcement Outcomes			
	Stand-Alone	Follow-on	Delinquent filings	Total # of enforcement actions
2015	508	167	132	807
2016	548	195	125	868
2017	446	196	112	754
2018	490	210	121	821
2019	526	210	126	862
2020	405	180	130	715
2021	434	143	120	697
Total	3357	1301	866	5524
Mean	480	186	124	789

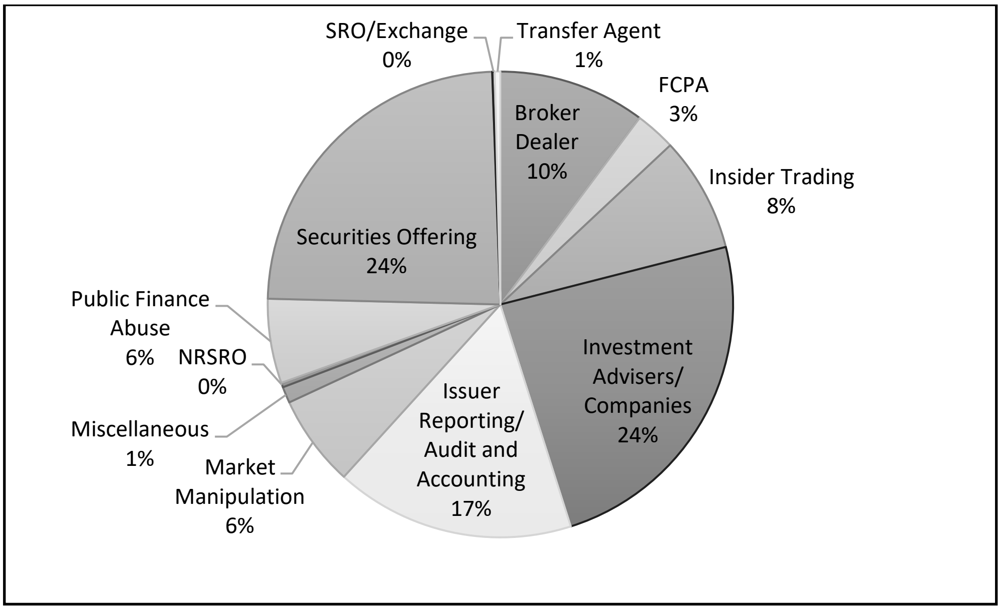
Sources: SEC, *Performance and Accountability Report* 2010-2011; SEC, *Agency Financial Report* 2012-2014 and 2017; SEC, *Summary of Performance and Financial Information* 2015-2016; SEC, *Division of Enforcement Annual Report* 2017-2020; SEC, Addendum to Division of Enforcement Press Release Fiscal Year 2020 available at www.sec.gov/files/2021-238-addendum.pdf.

Interestingly, the number of enforcement actions by the SEC has been on the decline since 2019. Perhaps this can be explained by the decrease in the number of enforcement staff. However, on closer inspection of the SEC's staffing for the years 2016 and 2019, the agency was able to attain a similar number of enforcement

823 Melanie Rodier, 'Outgunned: Why the SEC Can't Effectively Police Wall Street' (2012) Wall Street & Technology - Online

outcomes. For the year 2016, the division of enforcement had 1620 members of staff, compared to 2019 when the number of employees decreased 9% to 1472 employees. Nevertheless, despite this decrease in staff numbers the number of enforcement actions was substantially similar in 2016 and 2019, as shown in Table 22. This suggests that the continuing decrease in enforcement actions over the past four years cannot be attributed entirely to the decline in enforcement staff. Most notable from Table 22, was that the number of enforcement actions in 2020 represented a seven year low for the agency. However, this could be attributed to the challenges brought on by the Covid-19 pandemic. It is also important to note that as a result of the pandemic, the SEC shifted its focus to misleading disclosures related to Covid-19.[824] In its first Covid-19 enforcement action, the SEC fined the Cheesecake Factory $125,000 for misleading disclosures about the impact of Covid-19 on its operations.[825]

Figure 16: Diagrammatic representation of SEC enforcement from 2016 to 2021



Sources: SEC, *Division of Enforcement Annual Report* 2017-2020; SEC, *Addendum to Division of Enforcement Press Release Fiscal Year 2020* available at www.sec.gov/files/2021-238-addendum.pdf.

[824] J Gregory Deis and others, 'SEC Enforcement During Covid-19' Bloomberg Law (2021) <www.mayerbrown.com/-/media/files/perspectives-events/publications/2021/03/secenforcement.pdf> accessed 19 November 2021.

[825] US Securities and Exchange Commission, 'SEC Charges The Cheesecake Factory For Misleading COVID-19 Disclosures' (*SEC,* 4 December 2020) <www.sec.gov/news/press-release/2020-306> accessed 19 May 2021.

As shown in Figure 16, the majority of the SEC's enforcement actions related to investment advisers and securities offerings. As previously explained, corporate governance at its core is concerned with ensuring and improving disclosures. During the period 1 October 2016 to 30 September 2021, the SEC issued 474 enforcement actions relating to issuer reporting and auditing and accounting (Table 24). This is an average of 79 issuer reporting/audit and accounting enforcement actions per year. When considered in the context of the total number of enforcement outcomes, this represents an average rate of roughly 17% per year as illustrated in Figure 16. In other words, approximately 17% of the SEC enforcement outcomes relate to issuer reporting and audit and accounting.

Table 23: Enforcement action against individuals and entities, 2015-2019

Year	Individual	Entity
2015	326	182
2016	353	195
2017	363	83
2018	292	198
2019	304	222
Total	1637	881
Mean	327	176

Source: SEC, *Division of Enforcement Annual Report* 2017-2020. Figure for individual enforcement actions calculated by using the percentage of stand-alone actions against individuals stated in the Annual Enforcement Report.

However, when considered in the context of the number of publicly listed companies (Figure 13), this represents 1.3% of publicly listed companies. This means that less than 2% of companies listed on the stock exchange have been subject to enforcement action for issuer reporting and disclosures per year.

Table 24: Breakdown of enforcement actions, 2016-2021

Year	Broker Dealer	FCPA	Insider Trading	Investment Advisers/ Companies	Issuer Reporting/ Audit and Accounting	Market Manipulation	Miscella neous	NRSRO	Public Finance Abuse	Securities Offering	SRO/Exc-hange	Transfer Agent
2016	61	21	45	98	93	30	9	2	97	90	0	2
2017	53	13	41	82	95	41	7	0	17	94	0	3
2018	63	13	51	108	79	32	3	2	15	121	1	2
2019	38	18	30	191	92	30	1	0	14	108	3	1
2020	40	10	33	87	62	22	5	3	12	130	0	1
2021	36	5	28	120	53	26	7	2	12	142	1	2
Total	291	80	228	686	474	181	32	9	167	685	5	11
Mean	49	13	38	114	79	30	5	2	28	114	1	2

Sources: SEC, *Division of Enforcement Annual Report* 2017-2020; SEC, *Addendum to Division of Enforcement Press Release Fiscal Year 2020* available at www.sec.gov/files/2021-238-addendum.pdf.

When considering the SEC's approach to enforcement it is also important to consider the breakdown of enforcement action against companies and individuals. As illustrated in Table 23, the number of enforcement actions against individuals in any given year has always outnumbered the number of enforcement actions against entities. As shown in Table 23, the SEC brought 1637 enforcement actions against individuals and 881 enforcement actions against entities between 1 October 2015 and 30 September 2019. That's an average of 327 enforcement actions per year against individuals and is almost double the average annual number of enforcement actions against entities. This is in keeping with the SEC's view that holding individuals accountable is a more effective means of deterring corporate misconduct.[826] This is also a clear recognition by the agency that corporations do not have a mind of their own.

As a civil regulator, the SEC has several penalties available to enforce corporate misconduct, including injunctions, cease-and-desist orders, NPAs, DPAs, civil money penalties, bars and trading suspensions. The remainder of this section will examine the SEC's use of financial penalties, bars and suspensions. Each will now be addressed in turn.

Civil money penalties

The SEC has become well known for imposing substantial financial penalties for corporate misconduct. Interestingly, it was only in 1990, 56 years after its creation, that the SEC was given the power to impose civil money penalties with the passage of the Securities Enforcement Remedies and Penny Stock Reform Act 1990 (the Remedies Act). According to Atkins and Bondi, this period marked a shift in the SEC's enforcement from remedial to punitive.[827]

As shown in Table 25, the SEC imposed over $8.3 billion in civil money penalties between 1 October 2015 and 30 September 2021. That's an average of $1.2 billion per year. While the penalties appear significant, the SEC regulates a securities market valued at over $49 billion.[828] Therefore, when considered in the context of

[826] US Securities and Exchange Commission, *Division of Enforcement 2020 Annual Report* (SEC, 2020) 4.

[827] Paul S Atkins and Bradley J Bondi, 'Evaluating the mission: a critical review of the history and evolution of the SEC enforcement program' (2008) 13 Fordham journal of corporate & financial law 367.

[828] Statista, 'Largest stock exchange operators worldwide as of March 2022, by market capitalization of listed companies' (n 788).

the companies regulated by the SEC, the financial penalties appear less significant. However, it is important to point out here that the agency is constrained by penalty limits. This means that, unlike the FCA in the UK, the SEC is not empowered to impose unlimited civil money penalties.

Table 25: Civil money penalties and disgorgements, 2015-2020 (millions)

Year	Penalties	Disgorgements	Total
2015	$1,175	$3,019	$4,194
2016	$1,273	$2,809	$4,082
2017	$832	$2,957	$3,789
2018	$1,439	$2,506	$3,945
2019	$1,101	$3,248	$4,349
2020	$1,091	$3,589	$4,680
2021	$1,456	$2,396	$3,852
Total	$8,367	$20,524	$28,891
Mean	$1,199	$2,918	$4,116

Sources: SEC, *Division of Enforcement Annual Report* 2017-2020; SEC, *Year-by-Year Monetary Sanctions in SEC Enforcement Actions* available at www.sec.gov/news/newsroom/images/enfstats2.pdf.

According to the regulator's penalty framework, there are three tiers based on whether the violator is an individual or an entity. For violations of the Securities Act, civil money penalties for individuals range from $9,639 per violation for less serious violations to $192,768 per violation for violations involving fraud and deceit.[829] For entities, the penalties range from $96,384 for less serious violations to $963,837 per violation.[830]

Given that the penalties are applied per violation, the total penalty imposed can be quite considerable based on the number of violations. However, on the other hand the penalty limits can hinder the deterrent effect of the fines given the size of the companies the regulator oversees. For instance, the revenue of Apple for 2021 was $365.8 billion.[831] This is over 4000% more than the total penalties issued by the

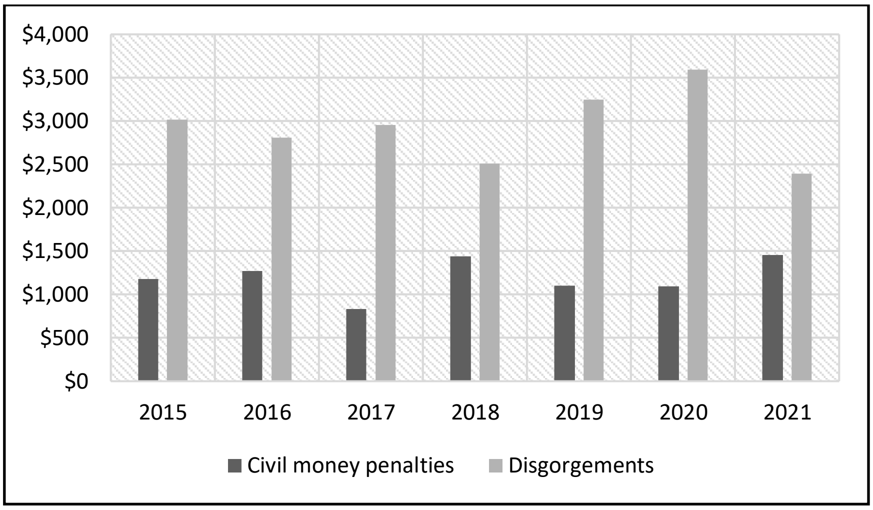
[829] Robert Cohen, Stefani Myrick and Benjamin Wasserman, '4 Ways To Prepare For SEC Or CFTC Penalty Negotiations' Davis Polk & Wardwell LLP <www.davispolk.com/sites/default/files/52739049_1.pdf> accessed 18 September 2021.

[830] ibid.

[831] Statista, 'Global revenue of Apple from 2004 to 2021' (*Statista,* 4 May 2022) <www.statista.com/statistics/265125/total-net-sales-of-apple-since-2004/> accessed 18 May 2022.

SEC for the seven year period between 2015 and 2021. Furthermore, Apple is not the only company with revenues that far exceed the aggregate penalties imposed by the SEC. Another illustration of the disparity between the penalty limits of the regulator and the market players it oversees is the $20 million fine against the chief executive of Tesla, Elon Musk. Although the penalty appears substantial, this represented little more than pocket change for Musk, who later commented that the fine was 'worth it.'[832] Although the SEC does appear to be an active regulator, instances of corporate misconduct continue to emerge. Therefore, it is submitted that if financial penalties are to be an effective deterrent, the SEC should be empowered to issue unlimited penalties given the size of the market it regulates.

Figure 17: Bar chart comparing civil money penalties and disgorgements, 2015-2021



Sources: SEC, *Division of Enforcement Annual Report* 2017-2020; SEC, *Year-by-Year Monetary Sanctions in SEC Enforcement Actions* available at www.sec.gov/news/newsroom/images/enfstats2.pdf.

The SEC has long emphasised its focus on protecting and recompensing harmed investors. This commitment is clearly illustrated in Figure 17. Between 1 October 2015 and 30 September 2021, the SEC ordered over $20.5 billion in disgorgement. This represents roughly $2.9 billion in disgorgements per annum. Interestingly, but not surprisingly, disgorgements are more than double the civil money penalties imposed by the SEC as illustrated in Table 25.

[832] Reuters Staff, 'Tesla's Elon Musk says tweet that led to $20 million fine 'Worth It'' (*Reuters,* 27 October 2018) <www.reuters.com/article/us-tesla-musk-tweet-idUSKCN1N10K2> accessed 18 June 2020.

Unlike civil money penalties which seek to punish, disgorgement aims to remove any financial benefit gained from the misconduct. Given that the majority of governance scandals can be linked to a financial motive, disgorgement can be an effective deterrent as it has the potential to render the misconduct fruitless. When combined with the penalties imposed for the same period, the SEC imposed over $28 billion in penalties and disgorgement for the seven year period between 2015 and 2021. When compared to the $13.5 billion in civil money penalties and disgorgements collected by the SEC between 2003 and 2007, this appears to suggest that the regulator has stepped up its enforcement actions.[833]

Bars and suspensions

Under the Remedies Act, the SEC was expressly empowered to seek federal court approval to bar or suspend any individual who violated securities law and was 'substantially unfit' to serve as an officer or director.[834] According to Berg, before the Remedies Act, the regulator faced great difficulty in obtaining court orders to permanently bar individuals. In fact, before 1989 the regulator never secured such a court order and instead had to rely on consent decrees.[835]

Table 26: Bars and suspensions, 2017-2021

Year	Bars and Suspensions
2017	625
2018	550
2019	595
2020	475
2021	*
Total	2245
Mean	561

Source: SEC, *Division of Enforcement Annual Report* 2017-2020. *Data for 2021 not yet reported.

[833] Atkins and Bondi (n 827).

[834] Philip F S Berg, 'Unfit to serve: Permanently barring people from serving as officers and directors of publicly traded companies after the Sarbanes-Oxley Act' (2003) 56 Vand L Rev 1871, 1879.

[835] ibid 1876.

The substantially unfit hurdle proved to be an increasingly high hurdle for the regulator to overcome. Consequently, in the aftermath of Enron, Congress lowered the standard from 'substantial unfitness' to 'unfitness' with the passage of Sarbanes-Oxley.[836] Importantly, Sarbanes-Oxley also removed the requirement for the SEC to seek court approval for bars and suspensions.[837]

As shown in Table 26, the SEC issued 2245 bars and suspensions between 1 October 2017 and 30 September 2020. That represents an average of 561 bars and suspensions per year. Bars and suspensions arguably represent the most direct penalty for individual accountability as it impacts the individual's livelihood. This can be an important deterrent when compared to civil money penalties on the basis that civil money penalties can be covered using D&O insurance. As a result, civil money penalties tend to have a less direct effect on the individual. Interestingly, the number of bars and suspensions have been decreasing during the period. This appears to suggest that the SEC only seeks bars and suspensions in the most serious cases.

Trading suspensions

As part of its broad regulatory powers, the SEC can 'suspend trading in any security… for a period not exceeding 10 business days'.[838] As shown in Table 27, the SEC suspended 1056 companies from trading between 1 October 2017 to 30 September 2020. That represents an average of 264 trading suspensions per year.

It is important to note that although the SEC can suspend trading for an exchange listed company, the majority of suspensions tend to relate to companies traded the OTC market. Between 2012 and 2015, in an operation know as Operation Shell Expel, the regulator suspended over 800 micro-cap companies.[839] At the time this represented roughly 8% of the OTC market.[840]

[838] Securities Exchange Act of 1934, s12(k)(1)(a).

[838] Securities Exchange Act of 1934, s12(k)(1)(a).

[838] Securities Exchange Act of 1934, s12(k)(1)(a).

[839] US Securities and Exchange Commission, 'SEC Suspends Trading in 128 Dormant Shell Companies to Put Them Out of Reach of Microcap Fraudsters' (n 797).

[840] ibid.

Table 27: Trading suspensions, 2017-2021

Year	No. of trading suspensions
2017	309
2018	280
2019	271
2020	196
2021	*
Total	1056
Mean	264

Source: SEC, *Division of Enforcement Annual Report* 2017-2020. *Data for 2021 not yet reported.

A notable observation from Table 27 is the steady decrease in the number of trading suspensions over the four year period. Given the continual decrease in the number of trading suspensions over the period, it raises the question of whether trading suspensions are proving successful as a deterrent. However, as noted by the current SEC chair, the securities market is growing at a faster rate than the SEC which is constrained by budgetary limits.[841] Therefore, it can be argued that the decline in trading suspensions is more representative of an agency that is over extended.

9.4.2 Department of Justice

Created in 1870, the DOJ is considered the 'largest law office in the world' with over 40 different components, including the Offices of the United States Attorneys, the Criminal Division and the Federal Bureau of Investigation. Operating under the supervision of the Attorney General of the U.S., the agency has a budget of over $29 billion, over 110,000 employees[842] and offices in all states across the U.S. and over 100 countries around the world.

As a federal department of the government, the agency is much more than a criminal prosecutor. For instance, the Civil Division of the DOJ represents the interest of the U.S., its departments and Members of Congress in civil and criminal

[841] Gensler (n 821).

[842] US Equal Employment Opportunity Commission, 'Department of Justice (DOJ)' (*EEOC,* 18 May 2021) <www.eeoc.gov/federal-sector/department-justice-doj-0> accessed 18 May 2021.

matters.[843] Considered the ‘primary litigators’, United States Attorneys (USAs) operate in each of the 94 federal districts in the United States. Using the case of Nikola as an illustration of the federal approach in the U.S., Trevor Milton, the former founder of Nikola, the Delaware registered corporation, was charged with fraud by the United States Attorneys Office for the Southern District of New York.[844]

Unlike the SEC which is a civil regulator, the Criminal Division of the DOJ enforces criminal violations of federal law, including securities law.[845] The Division consists of several offices including the Fraud Section.[846] The Fraud Section consists of three litigating units; the Market Integrity and Major Frauds Unit (MIMF), the Foreign Corrupt Practices Act Unit (FCPA Unit), and the Health Care Fraud Unit (HCF). As the name suggests the FCPA Unit prosecutes cases relating to violations of the FCPA, while the MIMF, previously known as the Securities and Financial Fraud Unit, prosecutes ‘complex and sophisticated securities, commodities, and other financial fraud cases.’[847] Although the DOJ has developed a reputation as an ‘aggressive’ prosecutor, the agency has faced its share of criticisms. In the aftermath of the Enron scandal, the DOJ was heavily criticised for its decision to pursue accounting firm Arthur Andersen for obstruction of justice.[848] The decision was described as nothing more than government overreach to calm investors following the scandal.[849]

Prosecutions

As previously explained, the Fraud section consists of three litigating units; the MIMF unit, the FCPA unit and the HCF unit. The HCF unit focuses on the prosecutions of illegal prescription and distribution of opioids and is therefore excluded. The MIMF unit which targets complex financial fraud, works with other

[843] US Department of Justice, 'About the Civil Division' (*DOJ,* 4 September 2020) <www.justice.gov/civil/about> accessed 16 May 2021.

[844] US Department of Justice, 'Former Nikola Corporation CEO Trevor Milton Charged In Securities Fraud Scheme' (n 757).

[845] US Department of Justice, 'About the Criminal Division' (*DOJ,* 18 January 2017) <www.justice.gov/criminal/about-criminal-division> accessed 16 June 2020.

[846] ibid.

[847] US Department of Justice, 'Market Integrity and Major Frauds Unit' (*DOJ,* 16 November 2021) <www.justice.gov/criminal-fraud/market-integrity-and-major-frauds-unit> accessed 30 December 2021.

[848] Carrie Johnson, 'U.S. Ends Prosecution Of Arthur Andersen' *The Washington Post* (Washington, D.C. 23 November 2005) <www.washingtonpost.com/archive/business/2005/11/23/us-ends-prosecution-of-arthur-andersen/755271de-5387-40fa-b8ce-611efc4ac1fe/> accessed 7 July 2020.

[849] Linda Greenhouse, 'Justices Unanimously Overturn Conviction of Arthur Andersen' *The New York Times* (New York 31 May 2005) <www.nytimes.com/2005/05/31/business/justices-unanimously-overturn-conviction-of-arthur-andersen.html> accessed 9 June 2018.

regulators, such as the SEC, and consists of roughly 42 prosecutors.[850] As shown in Table 28, the MIMF unit charged 509 individuals between 1 January 2016 and 31 December 2021. That's an average of 85 individuals charged per year. When considering the number of individuals convicted during the same period however, this represents an average conviction rate of 65% for the MIMF Unit. Quite impressive and most notable from Table 28, is the 100% conviction rate in 2021. This significant achievement represents a six year high and appears to suggest that the unit is becoming more adept at prosecuting corporate misconduct compared to previous years.

Although the number of individuals convicted in 2021 increased by 94.4%, it is important to note that over 50% of the charges relate to the Paycheck Protection Programme (PPP). Introduced as a federal initiative to help small businesses during the Covid-19 pandemic, 58 individuals were charged with PPP fraud in 2021.[851] Nevertheless, given that the PPP was only introduced in March 2020, the number of charges and convictions in 2021 highlights the quick response by the DOJ.

Table 28: Individuals charged and convicted by the FCPA and MIMF units, 2016-2021

Year	MIMF Unit			FCPA Unit		
	Charged	Convicted	Conviction rate	Charged	Convicted	Conviction rate
2016	52	34	65%	17	17	100%
2017	55	41	75%	24	21	88%
2018	66	44	67%	31	19	61%
2019	100	43	43%	34	30	88%
2020	131	54	41%	28	15	54%
2021	105	105	100%	26	19	73%
Total	509	321	65%	160	121	77%
Mean	85	54		27	20	

Source: DOJ, *Fraud Section Year In Review* 2016-2021.

[850] US Department of Justice, *Fraud Section - Year in Review 2020* (DOJ, 2021) 32.

[851] US Department of Justice, *Fraud Section - Year In Review 2021* (DOJ, 2022) 30.

As shown in Table 28, the FCPA unit charged 160 individuals between 1 January 2016 to 31 December 2021. This is an average of 27 individuals charged per year. The FCPA unit also works alongside the SEC for violations of the FCPA and consists of 39 prosecutors.[852] Interestingly, the FCPA unit appears to have a much higher conviction rate compared to the MIMF unit. However, in considering the conviction rate it is also important to note that the MIMF handles a much larger case load. For instance, between 1 January 2016 and 31 December 2021 the MIMF unit charged 509 individuals. In the same year the FCPA unit charged 160 individuals. Not surprisingly, this appears to suggest that FCPA offences are less rampant than market abuse cases. However, similar to market manipulation cases which remain hidden for some time, the low number of FCPA violations does not necessarily mean that underlying misconduct is at a minimum.

Although Sarbanes-Oxley introduced penalties for false certifications of financial statements, prosecutions for false certifications are rare.[853] Perhaps this can be explained by the fact that fraud prosecutions actually tend to include several other charges. For example, HealthSouth CEO Richard Scrushy, the first Sarbanes-Oxley prosecution, was indicted on eight counts including securities fraud, mail fraud and wire fraud.[854] Although Scruschy was later acquitted, the false certification charge was only one of eight charges.[855] Therefore it can be argued that the additional count of false certification is unlikely to materially impact the penal outcome. As illustrated in one of the most notable sentences imposed in 2021, Richard Ayvazyan was sentenced to 17 years for his role in a Covid relief fraud.[856] According to the DOJ indictment, Ayvazyan was charged with several offences, including wire fraud, money laundering and conspiracy to commit bank fraud.[857]

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[853] Reuters, 'Sarbanes-Oxley’s lost promise: Why CEOs haven’t been prosecuted' (*Reuters,* 2012) <www.reuters.com/article/idUK351297342520120727> accessed 16 April 2020.

[853] Reuters, 'Sarbanes-Oxley’s lost promise: Why CEOs haven’t been prosecuted' (*Reuters,* 2012) <www.reuters.com/article/idUK351297342520120727> accessed 16 April 2020.

[854] Carrie Johnson, 'HealthSouth Founder Is Charged With Fraud' *The Washington Post* (Washington D.C. 5 November 2003) <www.washingtonpost.com/archive/politics/2003/11/05/healthsouth-founder-is-charged-with-fraud/f6eb909f-9369-4436-acd5-67245ce900f4/> accessed 9 August 2020.

[855] Krysten Crawford, 'Ex-HealthSouth CEO Scrushy walks' (*CNN Money,* 28 June 2005) <money.cnn.com/2005/06/28/news/newsmakers/scrushy_outcome/index.htm> accessed 18 February 2020.

[856] US Department of Justice, 'San Fernando Valley Family Members Sentenced to Years in Prison for Fraudulently Obtaining Tens of Millions of Dollars in COVID Relief' (*DOJ,* 16 November 2021) <www.justice.gov/usao-cdca/pr/san-fernando-valley-family-members-sentenced-years-prison-fraudulently-obtaining-tens> accessed 8 March 2022.

[857] US Department of Justice, 'US v Richard Ayvazyan et al - First superseding indictment' (*DOJ,* Ocotber 2020) <www.justice.gov/opa/press-release/file/1375701/download> accessed 9 August 2021.

When considering the deterrent effect of imprisonment, it is important to consider the length of the prison sentence. Although there have been and continue to be significant prison sentences for high-value economic crimes, such as the Madoff Ponzi scheme, the average prison sentence for securities and investment crimes is 52 months.[858] Ultimately, the U.S. approach to sentencing appears to take into consideration the value of the fraud and has resulted in much harsher sentences when compared to the UK. Despite this, instances of market manipulation, fraud and corporate misconduct continue to emerge in the U.S., which suggests that the threat of imprisonment does not have a material impact on instances of corporate misconduct.

Corporate resolutions

Holding corporations criminally liable for the conduct of directors has long been a topic of great debate. Although considered a separate legal person, corporations cannot realistically be imprisoned. Under the *respondeat superior* doctrine, corporations can be held liable for the acts of their agents, including directors.[859] To be held liable, the agent's actions are required to be within the scope of his duties and intended to benefit the company. Criticised for being overly broad and unfair, the *respondeat superior* doctrine was aimed at motivating companies to prevent illegal acts.[860] Nevertheless, instances of corporate misconduct continue to emerge that call into question the effectiveness of holding corporations liable for the misconduct of directors. As such, corporate convictions are controversial.

As shown in Table 29, the MIMF and FCPA units imposed 70 corporate resolutions between 1 January 2016 and 31 December 2021. This represents an average of 12 corporate resolutions per year. Given the number of companies listed in the U.S., this is very modest. For the same period, the DOJ convicted 442 individuals. When considered in the context of the total number of enforcement outcomes, 86% were against individuals. This is consistent with the DOJ's view that focusing on individual

[858] Courtney Semisch, *What Does Federal Economic Crime Really Look Like?* (United States Sentencing Commission, 2019) 28.

[859] US Department of Justice, 'Principles of Federal Prosecution of Business Organisations' (*DOJ,* July 2020) <www.justice.gov/jm/jm-9-28000-principles-federal-prosecution-business-organizations> accessed 19 August 2021.

[860] John C Coffee, 'Crime and the Corporation: Making the Punishment Fit the Corporation' 2021 SSRN <https://ssrn.com/abstract=3914961> accessed 18 November 2021.

accountability is the 'strongest deterrent' against corporate misconduct.[861] This is also similar to the approach taken by the SEC.

Table 29: Corporate resolutions, 2016-2021

Year	SSF/MIMF	FCPA	Summary
2016	1	13	14
2017	3	7	10
2018	6	3	9
2019	8	7	15
2020	5	8	13
2021	6*	3*	9
Total	29	41	70
Mean	5	7	12

Source: DOJ, *Fraud Section Year In Review* 2016-2021. Monetary penalties show total global monetary awards payable to both US and foreign authorities. *Includes a joint investigation by the FCPA unit and the MIMF unit.

Another important consideration when examining the number of corporate resolutions is that not all have been against publicly listed companies. As illustrated in Figure 18, the number of corporate resolutions with publicly traded companies is not substantial. From 1 January 2019 to 31 December 2021, roughly 13 corporate resolutions involved public companies. That's an average of four corporate resolutions per year. This means that less than 1% of public corporations listed in the U.S. have been subject to DOJ enforcement.

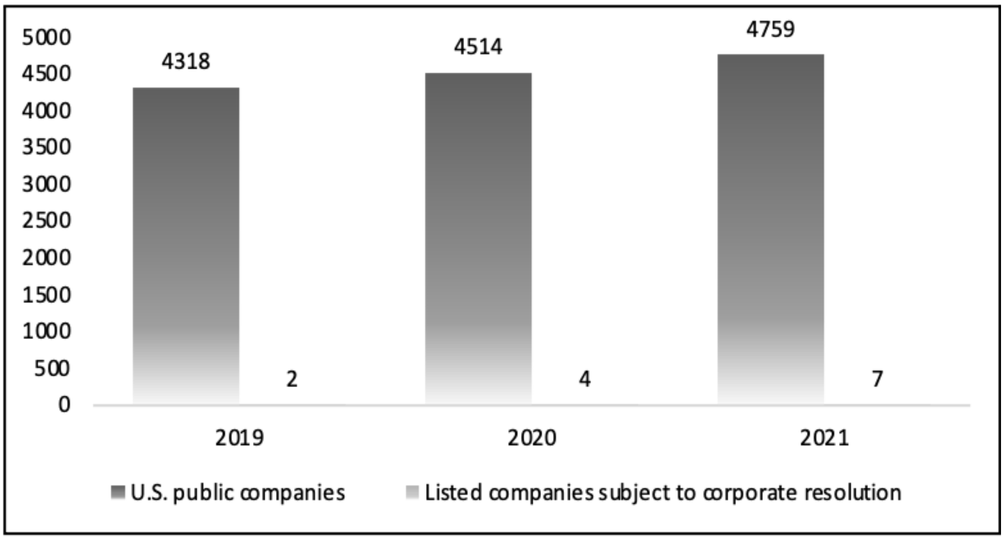
As mentioned above, corporations cannot be imprisoned. Therefore, corporate resolutions are generally resolved using DPAs, NPAs and plea agreements with the imposition of a financial penalty. The effectiveness of financial penalties as a deterrent continues to be a subject of debate. Although the DOJ has been noted to impose substantial financial penalties, instances of corporate misconduct continue to emerge.

As illustrated in Table 30, the MIMF and FCPA units imposed over $32 billion in financial penalties in the six year period between 1 January 2016 and 31 December 2021. This represents an average of $5.4 billion in financial penalties per year. Most

[861] US Department of Justice, 'Principles of Federal Prosecution of Business Organisations' (n 859).

notably, however, over 70% of the financial penalties were imposed by the FCPA unit. When compared to the financial penalties imposed by the FCPA unit, the fines imposed by the MIMF unit are relatively modest. To put this in the context of the securities market, the total financial penalties imposed by the FCPA Unit and the MIMF Unit for the six year period is roughly equivalent to the revenue of Amazon for 2021.[862] Given that S&P 500 companies have a combined market capitalisation of $38 trillion, it can be argued that the DOJ is outgunned.[863]

Figure 18: Corporate resolutions against publicly traded companies, 2019-2021



Source: DOJ, *Fraud Section Year In Review* 2016-2021.

The effectiveness of imposing financial penalties against corporations is questionable given that corporations do not make decisions. Furthermore, as illustrated by Arthur Andersen, financial penalties against corporations arguably do very little to deter individual misconduct. This view was shared by Claypool, who argued that companies that have entered into DPAs and NPAs tend to be repeat offenders.[864] By way of illustration, before Arthur Andersen became infamous for its

[862] Statista, 'Annual net income of Amazon.com from 2004 to 2021' (*Statista,* 16 February 2022) <www.statista.com/statistics/266288/annual-et-income-of-amazoncom/> accessed 18 April 2022.

[863] YCharts, 'S&P 500 Market Cap' (*YCharts,* March 2022) <https://ycharts.com/indicators/sp_500_market_cap> accessed 19 April 2022.

[864] Claypool (n 388).

role in the Enron debacle, the auditing firm entered into a DPA in 1996 with regards its audit of Colonial Realty.[865]

Table 30: Monetary penalties (millions), 2019-2021

Year	SSF/MIMF unit	FCPA unit	Summary
2016	$1.6	$7,300.0	$7,301.6
2017	$4,380.0	$2,500.0	$6,880.0
2018	$886.5	$1,860.0	$2,746.5
2019	$384.0	$2,800.0	$3,184.0
2020	$1,060.0	$7,840.0	$8,900.0
2021	$649.0	$2,820.0	$3,469.0
Total	$7,361.1	$25,120.0	$32,481.1
Mean	$1,226.9	$4,186.7	$5,413.5

Source: DOJ, *Fraud Section Year In Review* 2016-2021. Monetary penalties show total global monetary awards payable to both US and foreign authorities.

Ultimately, financial penalties against corporations for the misconduct of directors effectively punish shareholders and fail to hold those responsible accountable. This view was supported by Coffee Jr, who argued that corporate convictions in effect punish the shareholders, employees and other stakeholders for acts of directors.[866] Nevertheless, despite its limitations and budgetary constraints as a federal department of the government, the DOJ has attempted to find the right balance between punishing corporations and protecting shareholders, by focusing on individual accountability.

9.5 CONCLUSION

In the U.S. regulators have approached enforcement by focusing on individual accountability. This approach recognises that decisions are made not by corporations but by individuals. Although corporations can be and have been held liable, the U.S. approach acknowledges that for enforcement to be an effective deterrent individuals must be held accountable. Despite the focus on individual

[865] George Judson, 'Accountants to Pay $10 Million To Victims of Real Estate Fraud' *The New York Times* (New York 26 September 2020) <www.nytimes.com/1996/04/24/nyregion/accountants-to-pay-10-million-to-victims-of-real-estate-fraud.html> accessed 19 May 2021

[866] John C Coffee Jr, 'Rehabilitating Corporate Criminal Liability' (*Oxford Business Law Blog,* 5 November 2021) <www.law.ox.ac.uk/business-law-blog/blog/2021/11/rehabilitating-corporate-criminal-liability> accessed 9 February 2022.

accountability, instances of corporate misconduct continue to emerge. However, the effect of Sarbanes-Oxley on the legislative framework seems minimal at best as regulators continue to rely on sanctions that were available before Sarbanes-Oxley. This enforcement framework is further strengthened by the clear division of responsibilities between criminal and civil enforcement agencies. As the sole federal prosecutor for market abuse and fraud cases, the DOJ has exclusive criminal jurisdiction. As such, there are clear distinct roles and responsibilities between the agencies which contribute to increased efficiencies in enforcement.

Chapter 10
PRIVATE ENFORCEMENT IN THE U.S.

"The real mechanism for corporate governance is the active involvement of the owners."
- Louis Vincent Gerstner, Jr.[867]

10.1 INTRODUCTION

The previous chapter considered the corporate landscape in the U.S. and examined public enforcement in the United States. This chapter evaluates private enforcement mechanisms in the United States. The chapter proceeds as follows; section 10.2 examines the private enforcement mechanisms available in the United States. Section 10.3 analyses the effectiveness of enforcement in the U.S. using Becker's theory for measuring the effectiveness of enforcement and section 10.4 concludes.

10.2 PRIVATE ENFORCEMENT

Unlike public enforcement which relies on public agencies to enforce corporate misconduct, private enforcement relies on non-governmental bodies to enforce corporate governance. In the U.S., there are three primary private enforcement bodies; the PCAOB, FINRA and shareholders.

10.2.1 Financial Industry Regulatory Authority

FINRA was created in 2007 following the merger of the National Association of Securities Dealers (NASD) and the member's regulation section of the NYSE.[868] Before FINRA, the NASD and NYSE operated two separate rulebooks for regulating members. To address the 'duplicative regulation', FINRA was created to merge the rulebooks and streamline the regulation of public security firms.[869] Although FINRA plays an important role in regulating the securities market and protecting investors, Black points out that FINRA's role in protecting investors and financial markets is often overlooked and consequently its enforcement actions receive far less attention

[867] Louis Vincent Gerstner Jr, Former chairman and chief executive of IBM.

[868] Financial Industry Regulatory Authority, *2007 Year in Review and Annual Financial Report* (FINRA, 2007).

[869] ibid 2.

when compared to the SEC.[870]

Established as a not-for-profit (NFP) self-regulatory organisation (SRO), FINRA operates under the supervision of the SEC and is responsible for regulating firms and individuals that operate in the securities market, particularly broker-dealers, capital acquisition brokers and crowdfunding portals.[871] While corporate governance regulations are aimed at addressing the agency problem that arises from the separation of ownership and control, it is important to note that broker-dealers in the U.S. also represent some of the largest shareholders. For instance, BlackRock Inc., the Vanguard Group and State Street Capital, collectively known as the Big Three, own 22% of companies in the S&P 500.[872] Importantly, Sharfman points out that since the birth of index funds broker-dealers, like the Big Three, also manage securities on behalf of beneficial owners.[873] Therefore by its very nature, this relationship also gives rise to an agency relationship. This view was shared by Bebchuk, Cohen and Hirst, in their analysis of the agency problems of institutional investors.[874] Bebchuk, Cohen and Hirst, put forward that institutional investors have a tendency to be passive and defer to management in order to keep down stewardship costs.[875]

To gain a better understanding of FINRA's role in regulating the securities markets it is important to first consider FINRA's regulatory landscape. As illustrated in Figure 19, FINRA is responsible for regulating the conduct of over 3400 security firms and over 617,000 registered individuals. However, the number of members has been steadily decreasing since 2015. This appears to suggest that the securities industry in the U.S. is shrinking. On one hand, it can be argued that the shrinking number of

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[870] Barbara Black, 'Punishing bad brokers: Self-regulation and finra sanctions' (2013) 8 Brook J Corp Fin & Com L 23.

[871] Financial Industry Regulatory Authority, 'Firms We Regulate' (*FINRA,* <www.finra.org/about/firms-we-regulate> accessed 9 May 2020.

[872] Sam Potter, 'BlackRock-Led 'Big Three' May Forestall Chaos in Stock Markets' (*Bloomberg,* 20 July 2021) <www.bloomberg.com/news/articles/2021-07-20/blackrock-led-big-three-may-forestall-chaos-in-stock-markets> accessed 15 August 2021.

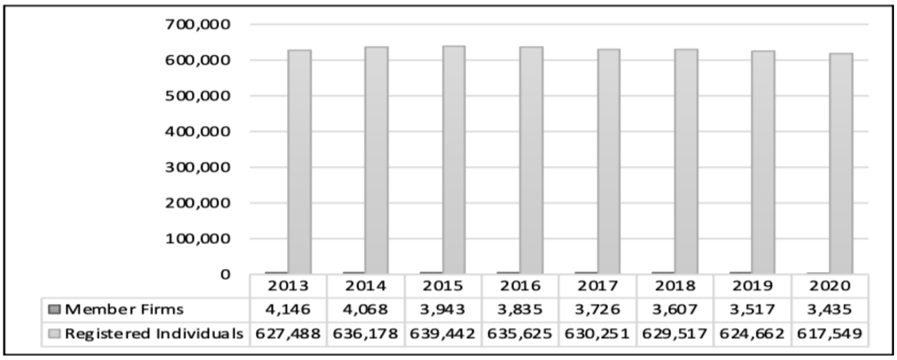
[873] Bernard S Sharfman, 'Looking at the 'Big Three' Investment Advisers Through the Lens of Agency' (*University of Oxford,* 18 February 2022) <www.law.ox.ac.uk/business-law-blog/blog/2022/02/looking-big-three-investment-advisers-through-lens-agency> accessed 8 March 2022; Bernard S Sharfman, 'Opportunism in the Shareholder Voting and Engagement of the 'Big Three' Investment Advisers to Index Funds' SSRN <https://ssrn.com/abstract=3995714 or http://dx.doi.org/10.2139/ssrn.3995714> accessed 8 March 2022.

[874] Lucian A Bebchuk, Alma Cohen and Scott Hirst, 'The agency problems of institutional investors' (2017) 31 Journal of Economic Perspectives 89.

[875] ibid 100.

brokers represents greater efficiency and the presence of less unscrupulous players and therefore suggests that FINRA has been effective in deterring misconduct. On the other hand, it seems more plausible that the decline in the securities industry can be attributed to the rise of Fin-Tech firms and low commission trading. This means that the landscape of the industry is shifting. This view was shared by Giannone, who reported that the number of investors migrating to online discount brokers has been increasing substantially.[876] Nevertheless, although technology has changed the way the securities market is accessed, it has not removed the need for regulation and oversight.

Figure 19: Member firms and regulated individuals, 2013-2021



	2013	2014	2015	2016	2017	2018	2019	2020
Member Firms	4,146	4,068	3,943	3,835	3,726	3,607	3,517	3,435
Registered Individuals	627,488	636,178	639,442	635,625	630,251	629,517	624,662	617,549

Source: FINRA, *Statistics* available at www.finra.org/media-center/statistics.

Essentially, FINRA acts as an important layer of protection for minority shareholders with the aim of reducing incentives for misconduct and fraud in the securities industry. As its primary objective FINRA aims to ensure the fair and honest operation of the securities market by publishing and maintaining the official rule book for all brokers that operate in the securities market. Similar to the SEC, FINRA has a wide range of sanctions including censures, fines, suspensions, expulsions and bars.[877]

As an SRO, FINRA derives its powers from being recognised by the SEC.[878] McLaughlin explains that the SEC has basically delegated all of its responsibilities

[876] Joseph A Giannone, 'Online brokers are gaining on big brokers: report' (*Reuters,* 1 December 2010) <www.reuters.com/article/us-onlinebrokers-idINTRE6B06H820101201> accessed 4 May 2020.

[877] Financial Industry Regulatory Authority, '8310. Sanctions for Violation of the Rules' (*FINRA,* 9 August 2021) <www.finra.org/rules-guidance/rulebooks/finra-rules/8310> accessed 9 August 2021.

[878] Joseph McLaughlin, 'Is FINRA Constitutional?' (2011) 12 Financial Services & E-Commerce 111.

for registering brokers to FINRA.[879] Consequently, in addition to its own rules FINRA also enforces securities law and SEC rules.[880] Perhaps more importantly, FINRA plays a central role in regulating the over-the-counter (OTC) markets.[881] As shown in Figure 14, the size of the OTC market far outnumbers the securities listed on the NASDAQ and the NYSE combined. In fact, the markets have been growing inversely. While the number of securities quoted on national exchanges continues to decline, the number of securities quoted on the OTC market has continued to increase over the same period. Perhaps this can be explained by the fact that securities quoted on the OTC market are exempt from the requirements of Sarbanes-Oxley. Nevertheless, FINRA's oversight of the OTC market also illustrates that regulators do not need to rely on the Sarbanes-Oxley, section 906 certifications or mandatory governance provisions to enforce corporate misconduct.

Table 31: Disciplinary actions, 2013-2020

Year	Disciplinary actions
2013	1535
2014	1397
2015	1512
2016	1434
2017	1369
2018	921
2019	854
2020	808
Total	9830
Mean	1229

Sources: FINRA, *Year in Review and Annual Financial Repor*t 2013; FINRA, *Statistics* available at www.finra.org/media-center/statistics.

As shown in Table 31, FINRA imposed 9830 disciplinary actions between 1 January 2013 and 31 December 2020. That represents an average of 1229 disciplinary actions per year. For the most part, it appears that FINRA is indeed a relatively active regulator, with significantly more enforcement actions when compared to the SEC. Perhaps this can be explained by the fact that FINRA also regulates the OTC

[879] ibid.

[880] ibid.

[881] US Securities and Exchange Commission, 'Over-the-Counter Market' (*SEC,* 9 May 2013) <www.sec.gov/divisions/marketreg/mrotc.shtml> accessed 7 January 2020.

market. Nevertheless, the number of disciplinary actions imposed by FINRA has been decreasing steadily. Most noticeable from Table 31 is the 32.7% decrease in disciplinary actions between 2017 and 2018. This calls into question whether the downward trend represents a shift in FINRA's enforcement approach.

Fines

As shown in Table 32, from 1 January 2013 to 31 December 2020 FINRA imposed fines of $682.6 million. That's an average of $85.3 million per year. Unlike the SEC and the PCAOB, FINRA is not constrained by penalty limits. In 2021, FINRA reported its largest financial penalty to date against Robinhood, the Fin-Tech company popular with retail investors.[882] In addition to the fine of $57 million, the company was ordered to pay $12.6 million in restitution to retail investors. In announcing the penalty against the investment platform, Jessica Hopper, the head of FINRA's enforcement department emphasised the importance of sending 'a clear message' that non-compliance with securities rules will not be tolerated.[883]

From 1 January 2013 to 31 December 2020, FINRA ordered $311.2 million in restitution (Table 32). This represents $38.9 million per annum in restitution. According to FINRA's Sanctions Guidelines, the amount of restitution ordered is based on the loss suffered and therefore can exceed the ill-gotten gains from engaging in the misconduct.[884] In other words, the restitution isn't limited to the financial benefits gained from the misconduct. This effectively means that the wrong-doer could be left worse off from engaging in the misconduct. On that basis, it can be argued that FINRA's use of restitutions can be a powerful deterrent. Although the total fines imposed by FINRA over the eight-year period exceeds the total sum of restitution, it is important to point out that there are several instances where the restitution ordered exceeds the financial penalty imposed. For instance, in 2015 the regulator ordered a broker-dealer to pay a financial of $500,000.[885] In

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[882] Financial Industry Regulatory Authority, 'FINRA Orders Record Financial Penalties Against Robinhood Financial LLC' (*FINRA,* 30 June 2021) <www.finra.org/media-center/newsreleases/2021/finra-orders-record-financial-penalties-against-robinhood-financial> accessed 19 November 2021.

[883] ibid.

[884] Financial Industry Regulatory Authority, 'FINRA Revises Sanction Guidelines' (*FINRA,* March 2011) <www.finra.org/rules-guidance/notices/11-13> accessed 19 May 2020.

[885] Financial Industry Regulatory Authority, 'Department of Enforcement v. Anthony Lodati and Brookville Capital Partners, LLC' FINRA <www.finra.org/sites/default/files/fda_documents/2012030968601_FDA_JMX2532%20%282019-1563104966463%29.pdf> accessed 26 June 2020.

the same case, FINRA ordered one million in restitution.[886] That's double the fine.

Table 32: Fines and restitution, 2013-2020 (millions)

Year	Fines	Restitution	Total
2013	$60.0	$9.0	$69.0
2014	$132.6	$32.3	$164.9
2015	$93.8	$96.6	$190.4
2016	$173.8	$27.9	$201.7
2017	$64.9	$66.8	$131.7
2018	$61.0	$25.5	$86.5
2019	$39.5	$27.9	$67.4
2020	$57.0	$25.2	$82.2
Total	$682.6	$311.2	$993.8
Mean	$85.3	$38.9	$124.2

Sources: FINRA, *Year in Review and Annual Financial Report* 2013; FINRA, *Statistics* available at www.finra.org/media-center/statistics. Restitution for 2013 is an average based on the annual report which states that FINRA ordered over $9 million in restitution.

Similar to the SEC, FINRA has recovered substantial sums for shareholders. In so doing, the regulator has attempted to take away the gain reducing the likelihood that individuals will want to engage in misconduct in the first place. While fines aim to punish misconduct, restitution takes away the ill-gotten gains and therefore takes away any benefit. However, as long as the benefits of misconduct continue to outweigh the costs, the effectiveness of financial penalties alone to deter corporate misconduct will remain contentious.

Suspensions

In addition to financial penalties, FINRA is also empowered to suspend firms and individuals. Suspensions can range from a number of days to two years. Although FINRA can impose suspensions for longer than two years, FINRA's Sanctions Guidelines suggest that any conduct that warrants a suspension over two years should instead be considered for expulsion or barred from the industry.[887]

[886] ibid.

[887] Financial Industry Regulatory Authority, *Sanction Guidelines - March 2019* (FINRA, 2019).

During 1 January 2013 and 31 December 2020, FINRA suspended 144 firms and 4834 individuals. That represents an average of 18 firms and 604 individuals suspended per annum. Interestingly, the average number of individuals suspended shows that FINRA suspends at least one individual every day. Therefore, it can be argued that FINRA prioritises enforcement against individuals. This is generally in keeping with the SEC's approach to enforcement on the basis of individual accountability as a means of deterring misconduct. Perhaps the significant difference between the number of suspensions against individuals compared to firms could also be a recognition that much like listed companies, broker-dealer firms do not have a mind of their own. Although the average annual number of individual suspensions appear substantial, when considered in the context of the number of individuals regulated by FINRA (Figure 19), this represents less than 1%. In other words, approximately 0.1% of individuals regulated by FINRA have been subject to suspension.

Table 33: Suspensions, 2013-2021

Year	Firms suspended	Individuals suspended
2013	38	670
2014	5	705
2015	0	737
2016	26	727
2017	29	733
2018	23	472
2019	21	415
2020	2	375
Total	144	4,834
Mean	18	604

Sources: FINRA, *Year in Review and Annual Financial Report* 2013; FINRA, *Statistics* available at www.finra.org/media-center/statistics.

When compared to individual suspensions, the number of firms suspended appears very modest. Most notable from Table 33 however is the 90% decrease in the number of firms suspended between 2019 and 2020. Going from roughly 20 firm suspensions per year in the four years preceding to two in 2020 is very striking. Although the number of registered firms has also been on the decline, such a significant decrease does not correlate with the decrease in registered firms.

Instead, the decline in suspensions could be explained by the change in working arrangements brought on by the Covid-19 pandemic and is unlikely to represent a permanent shift away from firm suspensions. Nevertheless, when considered in the context of the number of firms regulated by FINRA, only 3% of firms regulated by FINRA have been subject to suspension over the eight-year period.

Bars

Similar to suspensions, bars can have a direct effect on the individual's earning potential. Between 1 January 2013 and 31 December 2020, FINRA barred 3391 individuals from the industry. That's an average of 424 individuals barred a year. This also means that on average FINRA bars an individual a day. Similar to suspensions, bars are exercised more heavily against individuals. Again, this further supports FINRA's approach of focusing enforcement against individuals as an incentive to encourage good practices.

Table 34: Individuals barred, 2013-2021

Year	Individuals Barred
2013	429
2014	481
2015	492
2016	517
2017	492
2018	386
2019	348
2020	246
Total	3391
Mean	424

Sources: FINRA, *Year in Review and Annual Financial Report* 2013; FINRA, *Statistics* available at www.finra.org/media-center/statistics.

Macey and Novogrod question the deterrent effect of expulsion on the basis that bars and expulsions do not stop the individual from entering another profession that is also lucrative.[888] Most notable from Table 34 however, is the continuous decrease in the number of individuals barred since 2016. This is in keeping with the trend of

[888] Jonathan Macey and Caroline Novogrod, 'Enforcing self-regulatory organization's penalties and the nature of self-regulation' (2012) 40 Hofstra law review 963.

suspensions and expulsions which have also been continuously decreasing since 2016. Perhaps not surprisingly, in light of the pandemic, the number of individuals barred was at an all-time low over the entire eight-year period in 2020. However, it is important to point out that the number of individuals regulated has also been decreasing for the same period, as shown in Figure 19. Although the decrease in registered individuals could be an indicator that FINRA's enforcement has had an impact on underlying misconduct, perhaps the decline is more representative of a shift in the way the securities market operates with retail investors now having direct access.

Expulsions

Used only in the most egregious instances of corporate misconduct, FINRA expelled 110 firms from the industry between 1 January 2013 and 31 December 2020. That represents an average of 16 firms expelled per annum and appears very modest.

Table 35: Expulsions, 2013-2020

Year	Firms expelled
2013	24
2014	18
2015	*
2016	24
2017	20
2018	16
2019	6
2020	2
Total Mean	110
Mean	16

Sources: FINRA, *Year in Review and Annual Financial Report* 2013; FINRA, *Statistics* available at www.finra.org/media-center/statistics. *Data not available.

As an enforcement mechanism, expulsions have the most direct effect as it affects the firm's ability to generate revenue. Given the number of firms regulated by FINRA, less than 1% of firms have been expelled. This appears to suggest that similar to the SEC, FINRA also appears to be focused on individual accountability.

Referrals

Instances of misconduct outside the scope of FINRA's authority are referred to the

SEC and other federal regulatory bodies. As shown in Table 36, between 1 January 2013 and 31 December 2020 FINRA referred 6616 cases. That's an average of 827 cases per year.

Table 36: Case referrals and actions resulting from cases referred, 2013-2020

Year	Cases referrals	Actions resulting from cases referred
2013	660	*
2014	700	*
2015	900	52
2016	785	53
2017	855	70
2018	919	85
2019	827	37
2020	970	11
Total	6616	308
Mean	827	51

Sources: FINRA, *Year in Review and Annual Financial Report* 2013; FINRA, *Statistics* available at www.finra.org/media-center/statistics. *Data not available. "Case referrals" show the number of fraud and insider trading cases referred to the SEC and other federal and state regulators. Case referrals for 2015 reported as more than 900.

As previously mentioned, although not officially a government department FINRA operates under the supervision of the SEC and is therefore accountable to the SEC. As shown in Table 36, of the 6616 cases referred by FINRA between 2015 and 2020, roughly 308 cases resulted in enforcement action by another state or federal regulator. This represents less than 51 cases per annum. In other words, approximately 5% of cases referred by FINRA have resulted in enforcement action.

10.2.2 Public Company Accounting Oversight Board

Prior to Sarbanes-Oxley, the accounting profession in the U.S. was effectively self-regulated.[889] Created in the aftermath of a string of governance failures, the PCAOB is authorised by section 105 of Sarbanes-Oxley to investigate and discipline registered firms and associated persons.[890] Established by Congress as a private non-profit corporation, several academics contend that the regulator functions more

[889] Jerry Wegman, 'Government regulation of accountants: the PCAOB enforcement process' (2008) 11 Journal of legal, ethical and regulatory issues 75.

[890] Sarbanes-Oxley, s105.

like an agency of the federal government.[891] Similar to federal government bodies, the PCAOB is immune from prosecution and is authorised to subpoena documents.[892] Nevertheless, the PCAOB operates under the supervision of the SEC, which appoints the five members of the board and approves the budget. The SEC is also the final arbiter for any appeals against PCAOB decisions.[893]

Figure 20: PCAOB registered firms, 2010-2020

Source: Public Company Accounting Oversight Board, *Annual Report* 2010-2020

Unlike the SEC and DOJ which are funded by Congress, the PCAOB is funded from 'annual accounting support fees.'[894] Importantly, the regulator uses three primary mechanisms; investigations, inspections and disciplinary orders, and also has a range of sanctions available, including fines, censures, suspensions and revocation of registration. However, it is important to point out that PCAOB investigations are private.[895] This means that until a disciplinary case has been concluded and the sanction imposed has been approved, the public is not informed of the alleged misconduct. Former Director of Enforcement, Claudius Modesti, acknowledged the lack of transparency in PCAOB investigations and the potential impact on

[891] Wegman (n 889); D. M. Nagy, 'Playing PEEKABOO with constitutional law: The PCAOB and its public/private status' (2005) 80 The Notre Dame law review 975.

[892] Nagy (n 891).

[893] Claudius B Modesti, 'The Need for Transparency in PCAOB Disciplinary Proceedings' (*PCAOB,* 28 September 2010) <https://pcaobus.org/news-events/speeches/speech-detail/the-need-for-transparency-in-pcaob-disciplinary-proceedings_274> accessed 17 June 2020.

[894] Public Company Accounting Oversight Board, *2020 Annual Report* (PCAOB, 2020) 20.

[895] Modesti (n 893).

shareholders due to lack of information.[896] Given that corporate governance at its core is about improving disclosures and access to information for shareholders to make informed decisions, shareholders should also be entitled to information regarding the potential misconduct of audit firms. The private nature of PCAOB investigations causes serious cause for concern about the regulator's role in protecting the securities market and its effectiveness in deterring misconduct. Instead, it can be argued that this shield is just yet another way of protecting and preserving the integrity of the audit profession. The remainder of this section will examine the use of inspections and disciplinary orders as a means of deterring corporate misconduct.

Inspections

As previously discussed in Chapter 7, Sarbanes-Oxley requires auditors to 'attest to' management assertions of internal controls.[897] This requires auditors to design audit tests and procedures to evaluate the effectiveness of a company's internal controls and plays an important role in ensuring the accuracy of financial disclosures. Inspections therefore allow the PCAOB to assess compliance to rules and regulations and by extension audit quality. While audit firms that audit more than 100 public companies are inspected annually, audit firms that audit less than 100 public companies are inspected once every three years.[898] Given that 99% of S&P 500 companies are audited by the Big Four, it can be concluded that the Big Four are therefore subject to an annual PCAOB investigation.[899] Despite this, the Big Four continue to be criticised for audit failures. In 2019, Big Four auditor PwC was fined $7.9 million by the SEC for violating auditor independence rules and improper conduct.[900]

As shown in Table 37, the PCAOB conducted 1113 inspections between 1 October 2010 and 30 September 2020. That represents an average of 186 inspections per

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[896] ibid.

[897] Sarbanes-Oxley, s404(b).

[898] Public Company Accounting Oversight Board, 'PCAOB Inspection Procedures: What Does the PCAOB Inspect and How Are Inspections Conducted?' (*PCAOB,* <https://pcaobus.org/oversight/inspections/inspection-procedures> accessed 19 November 2021.

[899] John Pakaluk, 'Auditor Market Share of the S&P 500' (*Audit Analytics,* 27 February 2017) <https://blog.auditanalytics.com/auditor-market-share-of-the-sp-500/> accessed 19 August 2020.

[900] Katanga Johnson, 'PwC to pay $7.9 million to settle U.S. SEC charges over independence, conduct' (*Reuters,* 23 September 2019) <www.reuters.com/article/us-sec-pwc-idUSKBN1W81XB> accessed 19 August 2020.

annum. Given the number of firms under the supervision of the regulator, the average number of inspections is relatively modest representing roughly 9% of registered firms. However, the likelihood of being subject to an investigation could be a motivator for auditors to ensure compliance with applicable rules and standards. In other words, being subject to PCAOB investigations has the potential to improve the quality of audits. This view was shared by DeFond and Lennox, who found that auditors were more likely to issue adverse audit opinions after a PCAOB investigation.[901] DeFond and Lennox's study on PCAOB inspections and audit quality is complimented by Church and Shefiuck's study on PCAOB inspections which found that investigations improved audit quality.[902]

Table 37: Firms inspected, 2010-2021

Year	Inspections
2010	*
2011	*
2012	*
2013	*
2014	*
2015	220
2016	210
2017	195
2018	160
2019	175
2020	153
Total	1113
Mean	186

Source: PCAOB, *Staff Preview of Inspection Observations* 2018-2021; PCAOB, *Staff Inspection Brief* 2015-2017. * Data not available. Number of inspections for 2015-2017 shows the number of firms the PCAOB expected to inspect.

[901] Mark L Defond and Clive S Lennox, 'Do PCAOB Inspections Improve the Quality of Internal Control Audits?' (2017) 55 Journal of Accounting Research 591.

[902] Bryan K Church and Lori B Shefchik, 'PCAOB Inspections and Large Accounting Firms' (2012) 26 Accounting Horizons 43.

Disciplinary orders

As shown in Table 38, the PCAOB issued 294 disciplinary orders between 1 October 2013 to 30 September 2021. That represents an average of 33 disciplinary orders per year. When considered in the context of the average number of registered firms this represents an average of 2%. In other words, roughly 2% of PCAOB registered firms have been subject to disciplinary action. Given the role of auditors as gatekeepers of financial regulation this appears very modest and calls into question the effectiveness of the PCAOB. The number of disciplinary orders supports Wegman's view that the PCAOB has adopted a 'soft approach' to enforcement.[903]

Table 38: Disciplinary orders, 2013-2021

Year	Disciplinary orders
2013	17
2014	25
2015	46
2016	58
2017	55
2018	25
2019	30
2020	17
2021	21
Total	294
Mean	33

Source: PCAOB, *Annual Report* 2013-2021.

Although the number of disciplinary actions is not overly significant, a study by Lamoreaux, Mowchan and Zhang on the deterrent effect of PCAOB enforcement found that audit quality in non-sanctioned firms improves after the announcement of a disciplinary order.[904] In support of the deterrent effect of PCAOB disciplinary sanctions, Boone Khurana and Raman contended that audit firms suffer reputational

[903] Wegman (n 889) 83.

[904] Phillip T Lamoreaux, Michael Mowchan and Wei Zhang, 'Does PCAOB regulatory enforcement deter non-sanctioned auditors' (2017) Working Paper, Arizona State University <https://community.bus.emory.edu/FacultySeminars/Shared%20Documents/Lamoreaux,%20Phillip%20-%20workshop%20paper.pdf> accessed 18 May 2020.

loss when a disciplinary sanction is made public.[905] Boone, Khurana and Raman's study considered the effects of disciplinary action on Big Four auditor, Deloitte, over a three year period. Although Boone, Khurana and Raman argued that the PCAOB sanction imposed actual costs on Deloitte, it is submitted that these costs are short-term and have little long-term or material impact on the reputation of the Big Four, as evidenced by their continued dominance of the market, despite being repeat offenders.

10.2.3 Shareholders

As explained in Chapter 7 directors owe two primary duties in the U.S.; a duty of care and a duty of loyalty.[906] As a result, directors can be held personally liable for breach of these duties.[907] Similar to the UK, share ownership in the U.S. is also considered to be widely dispersed. This means that it is very rare for an individual shareholder to maintain voting control. However, the growing use of dual class structures has presented additional governance challenges in corporate control and accountability. According to Papadopoulos, seven of the ten largest companies that went public in 2019 included a dual class structure.[908] This dual class structure has also been adopted by some of the largest companies including, Facebook, Alphabet (Google) and Berkshire Hathaway.[909] In fact, Mark Zuckerberg's control over Facebook has been the subject of intense criticism with the company being described as a dictatorship.[910] Not surprisingly, Zuckerberg was not the only chief executive of an S&P 500 company to be criticised, Tesla founder and chief executive Elon Musk has also managed to maintain control over the company

[905] Jeff P Boone, Inder K Khurana and K K Raman, 'Did the 2007 PCAOB Disciplinary Order against Deloitte Impose Actual Costs on the Firm or Improve Its Audit Quality?' (2015) 90 The Accounting review 405.

[906] *Van Gorkom* (n 518).

[907] Roberta Romano, 'The Shareholder Suit: Litigation without Foundation' (1991) 7 JL Econ Org 55.

[908] Kosmas Papadopoulos, 'Dual-Class Shares: Governance Risks and Company Performance' (*Harvard Law School Forum on Corporate Governance,* 28 June 2019) <https://corpgov.law.harvard.edu/2019/06/28/dual-class-shares-governance-risks-and-company-performance> accessed 19 September 2020.

[909] Tom Lauricella and Leslie Norton, 'How Facebook Silences Its Investors' (*Morning Star,* 7 October 2021) <www.morningstar.com/articles/1061237/how-facebook-silences-its-investors> accessed 12 November 2021.

[910] John Naughton, 'Has Mark Zuckerberg's total control of Facebook turned into a liability?' *The Guardian* (London 25 September 2021) <www.theguardian.com/commentisfree/2021/sep/25/mark-zuckerberg-facebook-senate-hawley-thiel-cambridge-analytica> accessed 1 January 2022.

despite his 22% stake in the company.[911]

In addition to the growing trend of dual class structures, the growth of index funds in recent years has further changed the corporate ownership landscape in the United States. According to Goshen, over 70% of publicly traded equity is owned by institutional investors, with Black Rock, Vanguard and State Street (the Big Three) controlling over 90% of S&P 500 companies.[912] As a result, index fund managers vote using shares held on behalf of their clients.[913] Therefore, institutional investors tend to play a much bigger role in U.S. corporate governance and can wield significant power. As a result of the shifting landscape in the U.S., the mechanisms available to hold directors accountable can play a crucial role in effective corporate governance.

Shareholders in the U.S. have two primary enforcement mechanisms available to hold directors accountable including, (i) direct actions or class actions and (ii) derivative actions. Each will now be addressed in turn.

Securities class actions

Unlike shareholders of UK listed companies, shareholders of U.S. listed companies have the option of bringing a securities class action against directors. Securities class actions allow investors to initiate private proceedings for violations of securities law on behalf of a group of investors, known as a class.[914] In other words, class actions allow shareholders to join forces and initiate litigation for damages and compensation. Although class actions were originally unique to the U.S., by 2011 over 22 countries had adopted some form of class action, including Australia, Italy and Denmark.[915] Arguably class actions can be considered one of the most

[911] Scott A Barshay and Paul Weiss, 'Elon Musk and the Control of Tesla' (*Harvard Law School Forum on Corporate Governance,* 23 April 2018) <https://corpgov.law.harvard.edu/2018/04/23/elon-musk-and-the-control-of-tesla/> accessed 19 November 2020.

[912] Columbia Law School, 'Five Questions on Breaking Up BlackRock for Corporate Governance Expert Zohar Goshen' (*Columbia Law School,* 9 September 2021) <www.law.columbia.edu/news/archive/five-questions-breaking-blackrock-corporate-governance-expert-zohar-goshen> accessed 19 November 2021.

[913] Caleb N Griffin, 'Margins: Estimating the Influence of the Big Three on Shareholder Proposals' (2020) 73 SMU L Rev 409.

[914] Lucia dalla Pellegrina and Margherita Saraceno, 'Securities Class Action' in Alain Marciano and Giovanni Battista Ramello (eds), *Encyclopedia of Law and Economics* (Encyclopedia of Law and Economics, Springer New York 2020).

[915] Debra Lyn Bassett, 'The future of international class actions' (2011) 18 Southwestern journal of international law 21, 22.

important enforcement mechanisms available, as it enables shareholders to hold directors accountable directly for misconduct. In what was the largest class action settlement at the time, Enron shareholders were awarded $7.2 billion from financial institutions that were accused of being involved in the Enron fraud.[916] Nevertheless, the effectiveness of securities class actions as a deterrent remains the subject of much debate.

Table 39: Securities class-actions, 2010-2021

Year	No. of filings	No. of settlements	Settlement Amt. ($m)
2010	176	86	$3,118.5
2011	188	65	$1,362.0
2012	152	53	$2,901.5
2013	166	67	$4,773.9
2014	170	63	$1,068.0
2015	189	80	$3,072.8
2016	270	85	$5,990.0
2017	412	81	$1,511.1
2018	403	78	$5,064.3
2019	428	75	$2,227.5
2020	334	77	$4,395.2
2021	218	87	$1,787.7
Total	3106	897	$37,272.5
Mean	259	75	$3,106.0

Sources: Cornerstone Research, *Securities Class Action Filings Year in Review* 2010-2021; Cornerstone Research, *Securities Class Action Settlements Review and Analysis* 2010-2020.

Although the Securities Act did not explicitly create a private right of action, the U.S. Supreme Court in *J.I. Case v Borak* held that there was an implied private right of action for violations of section 14(a) of the Securities Act, which prohibits companies from issuing misleading proxy statements.[917] The court reasoned that the SEC could not be expected to police all proxy statements issued by companies and private

[916] Karina Frayter, 'Enron investors to split billions from lawsuit' (*CNN,* 9 September 2008) <https://edition.cnn.com/2008/US/09/09/enron.settlement/> accessed 17 June 2020.

[917] *J I Case Co v Borak* 377 US 426 (1964).

rights of actions would therefore supplement the agency's limited enforcement.[918] By implying this private right of action, the U.S. Supreme Court opened the door for shareholder litigation in securities fraud, which has now come to dominate the U.S. court system.

Although securities class actions can play an important role in enforcing corporate governance and deterring corporate misconduct, class actions have also been subject to abuse. For instance, some shareholders will be encouraged to file claims hoping to extract a quick settlement.[919] In an attempt to limit the number of frivolous lawsuits and balance the need for enforcement with preventing abuse, Congress enacted the Private Securities Litigation Reform Act of 1995 (PSLRA).[920] The PSLRA introduced more stringent requirements for filing securities class actions, included sanctions for frivolous litigation and placed limits on attorneys' fees.[921] Most importantly, under the PSLRA shareholders are required to specify each misleading statement and explain how the statement was misleading when filing a claim. In order to bring a securities class action shareholders are required to establish that there was; (i) a material misrepresentation or omission, (ii) an intent to deceive or defraud, (iii) a connection with the sale or purchase of securities, (iv) reliance on the misrepresentation or omission (v) an economic loss (vi) causal connection between the economic loss and the material misrepresentation or omission.[922]

As shown in Table 39, 3106 securities class actions were filed between 1 January 2010 and 31 December 2021. That represents an average of 259 class actions per year. An interesting observation from Table 39, is the 52.5% increase in the number of filings in 2017. According to Stempel, the sharp increase can be attributed to an increase in the number of filings relating to merger and acquisition (M&A)

[918] Jayne W Barnard, 'The Supreme Court and the shareholder litigant: Basic, Inc. v. Levinson in context' (1989) 16 Pepperdine law review 985.

[919] John C Coffee Jr, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation' (2006) 106 Columbia law review 1534.

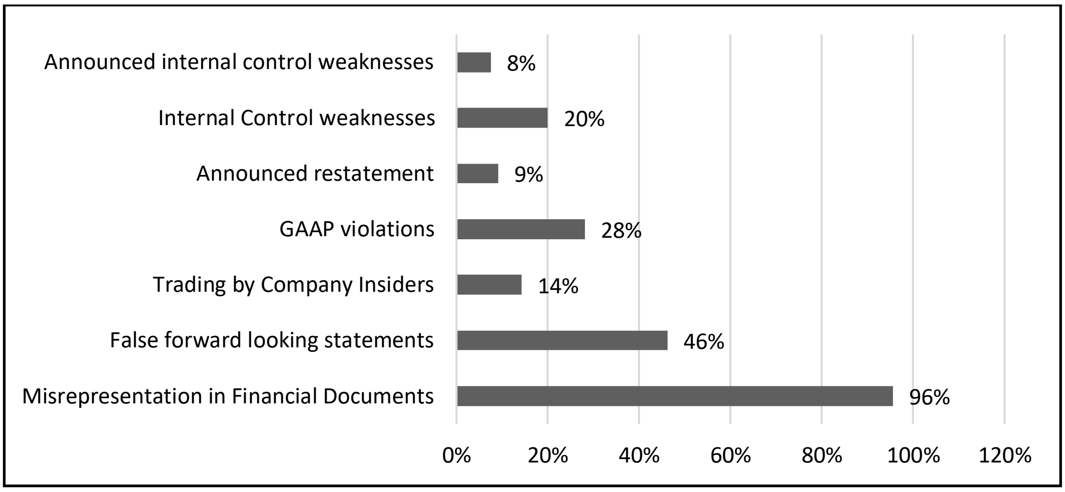
[920] Albert H Choi, Stephen J Choi and Adam C Pritchard, 'Just Say No? Shareholder Voting on Securities Class Actions' (2021) NYU Law and Economics Research Paper No 21-21, U of Michigan Law & Econ Research Paper No 22-009 <https://ssrn.com/abstract=3928021> accessed 9 February 2022.

[921] Practical Law, 'Private Securities Litigation Reform Act of 1995 (PSLRA)' (*Practical Law,* <https://uk.practicallaw.thomsonreuters.com/w-000-3647> accessed 3 March 2022.

[922] *Dura Pharmaceuticals Inc v Broudo* 544 US 336 (2005).

transactions.[923] Nevertheless, from a 12 year high of 428 securities filings in 2019, it is very notable that the number of securities class actions filed has been decreasing. While the decrease in filings in 2021 represents a return to the pre-2017 levels, it is important to acknowledge that the Covid-19 pandemic would have had an impact on the number of securities filings. The continuing decrease in filings post-2019 also raises questions on whether the increase in filings in the period 2017 to 2019 had a deterrent effect on underlying instances of corporate misconduct. Instead, perhaps the decrease in filings can be explained by the companies taking a more conservative approach to disclosures. This is consistent with Rogers and Buskirk's view that the information provided by companies decreases after litigation.[924] Although Billings, Cedergren and Dube's study provided support for the findings of Rogers and Buskirk, their study found that the frequency and timeliness of news that was not positive increased following litigation.[925]

Figure 21: Class action lawsuit allegations, 2010-2021



Source: Cornerstone Research, *Securities Class Action Filings Year in Review* 2014-2021. Percentages represent an average between 2010 and 2021.

Despite the significant number of securities class actions filed, only 897 class actions have been settled during the period from 1 January 2010 to 31 December

[923] Jonathan Stempel, 'A lawsuit a day: U.S. securities class actions soar' (*Reuters,* 29 January 2018) <www.reuters.com/article/us-stocks-classaction/a-lawsuit-a-day-u-s-securities-class-actions-soar-idUSKBN1FI2FM> accessed 20 May 2020.

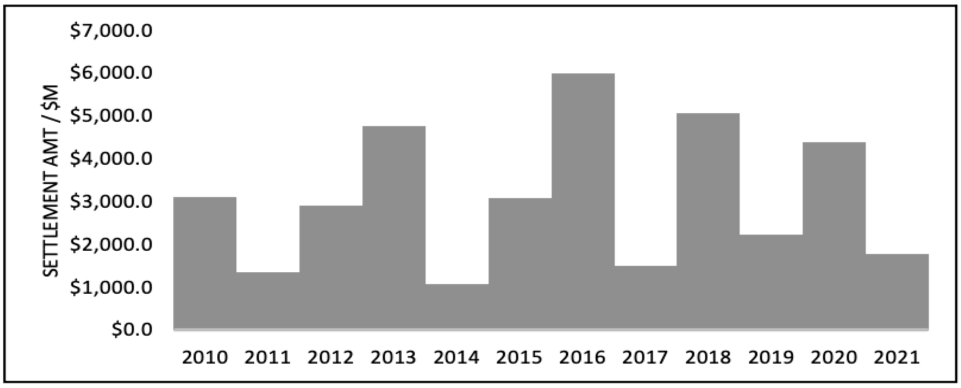
[924] Jonathan L Rogers and Andrew Van Buskirk, 'Shareholder litigation and changes in disclosure behavior' (2009) 47 Journal of accounting & economics 136.

[925] Mary Brooke Billings, Matthew C Cedergren and Svenja Dube, 'Does litigation change managers' beliefs about the value of voluntarily disclosing bad news?' (2021) 26 Review of accounting studies 1456.

2021. That represents an average of 75 class actions settled per year. However, it is important to take into consideration the fact that settling securities class actions can take several years. For instance, the Enron settlement of $7.2 billion was awarded in 2008, seven years after the company collapsed.[926] When considered in the context of the number of class actions filed for the same period roughly 29% of securities class actions have been settled. This suggests that the majority of class actions are frivolous and without merit. It also raises doubts whether the PSLRA has been effective in limiting frivolous class actions.

As illustrated in Figure 21, misrepresentation in financial documents account for the majority of the securities class actions filed between calendar years 2010 and 2020. This appears to suggest that Sarbanes-Oxley has not been successful in its goal of improving disclosures. Interestingly, but not surprisingly roughly 28% of securities class actions filed in the period allege GAAP violations. After all, abuse of accounting standards has been, and continues to be, at the centre of some of the largest corporate scandals, including Enron. Despite the significant number of allegations for misrepresentations in financial statements and GAAP violations, it is quite puzzling that auditors have not generally been listed as defendants. For instance, none of the securities class actions filed between 2017 and 2021 listed auditors as defendants.[927]

Figure 22: Securities class action settlements, 2010-2021



Source: Cornerstone Research, *Securities Class Action Settlements Review and Analysis* 2010-2020.

[926] Institutional Shareholder Services, '20 Years Later: Why the Enron Scandal Still Matters to Investors' (*ISS,* 20 October 2021) <https://insights.issgovernance.com/posts/20-years-later-why-the-enron-scandal-still-matters-to-investors/> accessed 19 November 2021.

[927] Cornerstone Research, *Securities Class Action Filings 2021 Year in Review* (Cornerstone Research, 2021) 13.

According to Coffee Jr, auditors have been 'well-insulated' from liability, therefore the few cases over the years that have included auditors as defendants have generally tended to be related to the insolvency of the company.[928] Given that auditors play a crucial role in protecting and promoting trust in financial markets, perhaps excluding auditors from liability for securities fraud continues to contribute to instances of corporate abuse right under the nose of the auditors. Although auditors do not escape completely unscathed and can be subject to sanctions by the SEC and the PCAOB, if auditors are truly expected to be effective the mechanisms to hold auditors accountable as the watchdogs of financial regulation must also be effective. This view was supported by several academics who argued that auditors were not incentivised to detect fraud. This was disputed by Park who argued that auditors have contributed to financial settlements in the most severe frauds.[929] However, Park's study considered securities class actions filed between 1996 to 2007. This was before the seminal ruling in *Janus Capital Group Inc v First Derivative Traders*, where the U.S. Supreme Court ruled that third parties could not be held liable for material misrepresentations.[930] Furthermore, in the same way the SEC is limited in resources to enforce all violations of securities fraud, so too is the regulator limited in its ability to enforce action against all auditor failings. Therefore, excluding the primary gatekeeper from securities fraud liability does not provide any real incentive for auditors to challenge directors' conduct.

As illustrated in Table 39, over $37.2 billion has been awarded in securities class actions between 1 January 2010 and 31 December 2021. That represents an average of $3.1 billion in securities class action settlements per annum. Interestingly, this exceeds the penalties imposed by the SEC (Table 25). Based solely on the size of the settlements, it can be argued that securities class actions can provide an effective deterrent for corporate misconduct. However, the effectiveness of class action settlements to deter corporate misconduct is not without concern. Firstly, given that the settlements tend to be borne by insurance companies and in some cases the company, directors rarely pay out of their own

[928] Coffee Jr, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation' (n 919).

[929] James J Park, 'Auditor settlements of securities class actions' (2017) 14 Journal of Empirical Legal Studies 169.

[930] *Janus Capital Group Inc v First Derivative Traders* 564 US 135.

pockets.[931] If the actual wrong-doers escape unscathed there is little motivation for a change in corporate behaviour. Secondly, Coffee Jr asserts that class action settlements represent nothing more than a transfer of wealth from one class of shareholders to another.[932] This is in effect holding companies liable for decisions made by directors. Instead of shareholders bearing the brunt of directors' corporate misconduct, to be effective as a deterrent securities class actions should exclude companies.[933]

Table 40: U.S. exchange listed companies subject to securities class action, 2010-2021

Year	Percentage of listed companies subject to class action
2010	3.0%
2011	3.6%
2012	2.9%
2013	3.4%
2014	3.5%
2015	4.4%
2016	5.9%
2017	8.4%
2018	8.8%
2019	8.4%
2020	6.3%
2021	4.2%
Mean	5%

Source: Cornerstone Research, *Securities Class Action Filings Year in Review* 2021.

Despite the relatively significant number of securities class actions filed during the period, it is important to point out that not all securities class actions relate to publicly listed companies. As illustrated in Table 40, roughly 5% of securities class actions filed between 1 January 2010 and 31 December 2021 were against publicly listed companies. Given the number of publicly listed companies operating on the

[931] Romano, 'The Shareholder Suit: Litigation without Foundation' (n 907).

[932] Coffee Jr, 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation' (n 919).

[933] ibid.

U.S. stock exchanges, this does not appear to be overly significant. For instance, considering securities class actions against publicly listed companies in the context of the number of class actions filed between 2010 and 2021, roughly 5% (154) were against publicly listed companies.

Derivative actions

Referred to as the 'chief regulator of corporate management,' derivative actions are also available to U.S. shareholders as a mechanism of holding directors accountable.[934] Unlike securities class actions that are brought directly against the company and/or directors on behalf of a class of shareholders, derivative actions are initiated on behalf of the company. This also means, that unlike class action settlements which are distributed to members of the class, settlements from derivative actions belong to the company.

Table 41: Class action settlements with derivative action

Year	No. of settlements
2010	35
2011	24
2012	29
2013	27
2014	28
2015	39
2016	35
2017	38
2018	43
2019	40
2020	41
2021	37
Total	416
Mean	35

Source: Cornerstone Research, *Securities Class Action Settlements Review and Analysis* 2010-2020

In light of the dual court structure in the U.S., federal and state courts have 'concurrent jurisdiction' over derivative claims.[935] There is however an exception for

[934] *Cohen v Beneficial Industrial Loan Corp* 337 US 541 (1949).

[935] *Cyan Inc v Beaver County Employees Retirement Fund* 583 US ___.

Exchange Act actions which must be filed in federal court.[936] This has led to plaintiffs and attorneys forum shopping for where they are likely to achieve a more favourable outcome. As a result, companies have started including exclusive forum provisions in their by-laws. However, according to Cornerstone Research, derivative suits are commonly filed in three states; New York, California and Delaware. Therefore, the state of Delaware will be used for the purpose of discussing the laws governing derivative actions.

Under Delaware state law, before a shareholder can initiate court proceedings on a company's behalf, the shareholder must show that 'the board was presented with a demand and refused it wrongfully or the board could not properly consider a demand thereby excusing the efforts to make demand as futile.'[937] Established in *Aronson v. Lewis*, the demand futility test requires the plaintiff shareholders to show that the directors are not independent, and the transaction was not the product of a valid business decision.[938] In one of the most notable derivative actions, *In Re Walt Disney Co. Derivative Lit*., shareholders brought a derivative action challenging the hiring and firing of Michael Ovitz, who walked away with $140 million after a year's work.[939] The court found that in the absence of a 'reckless indifference to or a deliberate disregard of the whole body of stockholders,' the decision to hire Ovitz was a valid business decision and therefore protected by the business judgement rule (BJR).[940] This BJR is one of the most significant hurdles for shareholders to overcome as courts have shown a general unwillingness to express an opinion on a business decision.

As shown in Table 41, 416 settlements between 1 January 2010 and 31 December 2021 included a derivative action. That's an average of 35 settlements per annum. However, importantly when considered in the context of the number of securities class-actions settled during the same period (Table 39), this represents roughly 46%. In other words, 46% of securities class action settlements include a derivative action. This suggests that, unlike the UK, derivative claims are also a favoured

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[936] Alison Frankel, 'The Gap nixes Exchange Act derivative claims via forum selection - 9th Circ.' (*Reuters,* 16 May 2022) <www.reuters.com/legal/transactional/gap-nixes-exchange-act-derivative-claims-via-forum-selection-9th-circ-2022-05-16/> accessed 21 May 2022.

[937] Delaware Court of Chancery Rules 23.1.

[938] *Aronson v Lewis* 473 A2d 805 (Del 1984).

[939] *In Re Walt Disney Co Derivative Lit* 731 A2d 342 (1998).

[940] ibid.

enforcement mechanism among U.S. shareholders. However, according to Keay, derivative claims have led to little direct financial benefit for shareholders in both the UK and the U.S., as claims are brought on the company's behalf, and as such any funds recovered belong to the company.[941]

10.3 ENFORCEMENT SUMMARY

Becker posits that the effectiveness of enforcement could be measured using (i) the probability that misconduct will be detected, (ii) the probability that the wrong-doers will be punished (iii) the form of punishment and (iv) the size of punishment.[942] The remainder of this section will analyse the effectiveness of the U.S. approach to enforcement using Becker's approach.

(i) The probability that misconduct will be detected

As the primary civil regulator for the securities market, the SEC's Analysis and Detection Centre uses analysis tools to detect suspicious trading activity. According to the SEC's Annual Enforcement Report, the agency receives over 15,000 tips, complaints and referrals each year.[943] More important, however is the SEC's whistle-blower program which has resulted in awards of over one billion to whistle-blowers.[944] Given that many instances of fraud tend to be well hidden, the U.S. approach recognises the importance of whistle-blowers in fighting fraud. Whistle-blower awards significantly increase the likelihood that misconduct will be detected and reported. The underlying principle of corporate misconduct is that individuals are motivated by financial incentives. Therefore, whistle-blower awards can provide a powerful incentive for individuals to report fraud. For instance, the SEC recently awarded $14 million to a whistle-blower.[945] Ultimately, there is a much higher likelihood that fraud will be detected and reported to U.S. regulators.

(ii) The probability that the wrong-doers will be convicted/punished

When measuring the effectiveness of enforcement as a deterrent, it is important to

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[941] Keay, 'An Assessment of Private Enforcement Actions for Directors' Breaches of Duty' (n 351).

[942] Becker (n 9).

[943] US Securities and Exchange Commission, *Division of Enforcement 2020 Annual Report* (n 826) 19.

[944] US Securities and Exchange Commission, 'SEC Surpasses $1 Billion in Awards to Whistleblowers with Two Awards Totaling $114 Million' (*SEC,* 15 September 2021) <www.sec.gov/news/press-release/2021-177> accessed 8 January 2022.

[945] US Securities and Exchange Commission, 'SEC Awards Approximately $14 Million to Whistleblower' (*SEC,* 11 March 2022) <www.sec.gov/news/press-release/2022-40> accessed 19 April 2022.

consider the likelihood that wrong-doers will be punished. As illustrated in Table 42, the SEC has an average enforcement rate of 10% when taking into consideration the number of publicly listed companies. Impressively, and perhaps surprisingly, FINRA has a significantly higher enforcement rate. However, it is important to reiterate here that FINRA operates under the supervision of the SEC. Although FINRA is a private regulator, it plays an important role alongside the SEC in enforcing securities laws. Therefore, when taken together, FINRA and the SEC have a combined enforcement rate of roughly 37%. This is rather impressive and suggests that there the likelihood that misconduct in the securities market will be sanctioned in the U.S. is much higher when compared to the UK.

As the watchdogs of financial regulation auditors play an important role in protecting financial markets. Therefore, it is important to consider the likelihood that auditors will face sanctions. Quite surprisingly, the PCAOB has the lowest enforcement rate as illustrated in Table 42. Despite acknowledging the importance of the role of auditors in the aftermath of Enron, the U.S. approach to enforcement seems to insulate auditors from liability. Arguably, without the threat of liability or sanctions, there is little motivation for auditors to challenge directors.

(iii) The form of punishment

As a civil regulator, the SEC is limited to civil remedies. Consequently, the SEC sanctions tend to involve the imposition of a financial penalty. The effectiveness of financial penalties to deter corporate misconduct remains a question of debate. However, although the SEC has been focused on individual accountability, directors tend to escape personal liability in any event as financial penalties tend to be covered by D&O insurance. However, as illustrated earlier in this chapter the SEC has imposed significant disgorgement orders. While not technically considered a punishment, disgorgement can be a powerful deterrent as it takes away the gain which in turn takes away the incentive.

Although shareholder litigation is prevalent in the U.S., it is important to note that like financial penalties, securities class actions and derivative claims do not actually impose direct liability on directors. Ultimately, securities class actions and derivative claims result in awards of financial compensation and damages which are ultimately paid for by the company.

Table 42: Enforcement Summary, 2016-2021

Year	Listed Companies	Public Enforcement				Private Enforcement							
		SEC		DOJ		FINRA		PCAOB		Securities class actions		Derivative claims	
		No. of Enforcement actions	Rate	No. of Enforcement actions	Rate	No. of enforcement actions	Rate	No. of enforcement actions	Rate	No. of enforcement actions	Rate	No. of enforcement actions	Rate
2016	4593	508	11.1%	65	1.4%	1512	32.9%	58	1.3%	85	1.9%	35	0.8%
2017	4411	548	12.4%	72	1.6%	1434	32.5%	55	1.2%	81	1.8%	38	0.9%
2018	4406	446	10.1%	72	1.6%	1369	31.1%	25	0.6%	78	1.8%	43	1.0%
2019	4318	490	11.3%	88	2.0%	921	21.3%	30	0.7%	75	1.7%	40	0.9%
2020	4514	526	11.7%	82	1.8%	854	18.9%	17	0.4%	77	1.7%	41	0.9%
2021	4759	405	8.5%	132	2.8%	808	17.0%	21	0.4%	87	1.8%	37	0.8%
Mean	4500	487.2	10.9%	85	1.9%	1149.7	25.6%	34.3	0.8%	80.5	1.8%	39.0	0.9%

Notes: “Listed companies shows the number of companies listed on the NYSE and the NASDAQ. “Number of enforcement actions” for PCAOB shows the number of disciplinary orders. “Number of enforcement actions” for DOJ shows the number of individuals convicted and the number of corporate resolutions.

The threat of imprisonment was meant to be the greatest weapon in the fight against corporate misconduct. However, as illustrated in Table 42, the likelihood of criminal enforcement appears low. Furthermore, although the DOJ has an impressive enforcement rate and is a well adept prosecutor, it is important to bear in mind that the regulator is constrained by its limited resources and the Fraud Department's budget is severely surpassed by the securities market that it oversees.

(iv) The size of the punishment

Adopting Becker's approach to measuring the size of the punishment, fines are measured in monetary terms while imprisonment is measured by time.[946] Apart from the DOJ, the other regulators are limited to civil remedies. This means that individuals only face prison sentences following a DOJ conviction. One of the key achievements of Sarbanes-Oxley was the Securities Fraud Statute, which introduced the offence of securities fraud and extended the prison sentence for mail and wire fraud from five years to twenty-five years. Furthermore, as mentioned previously the average prison sentence for fraud related offences is 52 months.[947] However, prison sentences in the U.S. appear to be based on the value and impact of the fraud. For instance, Bernie Madoff was sentenced to 150 years.[948] Such sentences are unheard of in the UK for fraud offences.

Although FINRA has a higher enforcement rate and is not constrained by penalty limits, when compared to the SEC, the financial penalties imposed by FINRA are considerably lower. Instead, FINRA appears to expend considerable resources on bans and expulsions. Nevertheless, despite the significant fines imposed by the SEC and the DOJ, instances of corporate misconduct continue to emerge. However, given the size of the U.S. securities market, this is not overly surprising as both the SEC and DOJ suffer from budgetary constraints. Furthermore, although the regulators have attempted to focus on individual accountability, the system is arguably tilted in favour of directors who rarely pay out of pocket. Therefore, financial penalties fail to act as a deterrent.

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[946] Becker (n 9).

[947] Semisch (n 858).

[948] David Teather, 'Bernard Madoff receives maximum 150 year sentence' *The Guardian* (London 30 June 2009) <www.theguardian.com/business/2009/jun/29/bernard-madoff-sentence> accessed 19 June 2020.

10.4 CONCLUSION

The structure of the U.S. enforcement framework presents several advantages which appear to contribute to more efficient enforcement in the U.S. when compared to the UK. For instance, although FINRA and PCAOB are SROs, they operate under the remit of the SEC. Therefore, as the primary civil regulator the SEC is a considerably powerful regulator in the securities market and continues to go from strength to strength. As such, the SEC has authority over all market players and related parties, irrespective of their role. In fact, the SEC's power is so broad that it is not limited to individuals directly connected to the company.

Unlike the UK, shareholders in the U.S. have much greater muscle. Nevertheless, the effectiveness of shareholder litigation as a means of deterring corporate misconduct has been hindered by frivolous lawsuits aimed at extracting quick settlements.

Chapter 11
CONCLUSION AND CONTRIBUTIONS

'Corporate conglomerates run without regulation do not work in the service if society, and run reckless and unchecked whenever possible.'
- Robert Greenwald[949]

11.1 INTRODUCTION

The previous chapter considered the private enforcement mechanisms in the United States. This chapter concludes and provides recommendations. The chapter proceeds as follows; section 11.2 outlines the research objectives and summarises the main findings of the study. Section 11.3 provides recommendations and section 11.4 discusses the contributions of the research. Section 11.5 considers the limitations of this research and section 11.6 recommends areas for future research.

11.2 SUMMARY OF MAIN FINDINGS

11.2.1 Key differences in approach to corporate governance

Put simply, the UK approach is characterised by voluntary compliance, disclosures and pressure from shareholders to achieve good governance. On the other hand, the U.S. approach is characterised by mandatory compliance, disclosures and penalties for non-compliance. Although the UK and the U.S. have adopted different approaches to regulating corporate governance, both approaches have the central aim of improving the accuracy of corporate disclosures. Both of which has resulted in a substantial increase in the number of corporate disclosures, with companies disclosing a plethora of information scattered among hundreds of pages.

Nevertheless, there are several key distinctions that can be drawn when comparing the UK and U.S. approaches to regulating corporate behaviour. Firstly, the UK has opted for a comply-or-explain approach characterised by voluntary compliance to a code of best practice. The U.S. on the other hand, has adopted a legislative approach with the passage of Sarbanes-Oxley. This means that unlike the UKCG which is non-binding and does not have the force of law, the requirements of

[949] Robert Greenwald, President of Brave New Films.

Sarbanes-Oxley are mandatory. In other words, there are no sanctions for failing to comply with the UKCG. This means that although many companies listed in the UK have complied with the UKCG, they can technically opt out of compliance at any time. Given the voluntary nature, it also means that compliance is technically not mandatory for listing on the LSE, so long as the reason for non-compliance has been explained. Conversely, companies listed in the U.S. are legally required to comply with the corporate governance requirements of Sarbanes-Oxley with sanctions for non-compliance. In fact, failure to comply can lead to an array of sanctions including delisting from the stock exchange. Secondly, unlike the UKCG, Sarbanes-Oxley requires the chief executive and the chief financial officer to personally attest to the accuracy of the financial statements. As a result of this declaration, the chief executive and the chief financial officer can be held personally liable for false declarations. Thirdly, unlike the UKCG, Sarbanes-Oxley requires management to assess and report on the effectiveness of internal controls and to disclose any material weaknesses identified. This means that unlike directors in the UK, who are only required to confirm that internal controls have been reviewed, directors in the U.S. can face sanctions for failing to identify and disclose material weaknesses in internal controls. Despite these differences in regulating corporate behaviour, instances of corporate governance failures continue to emerge in both the UK and the United States. These continuing instances suggest that the approach to corporate governance, whether rules-based or principles-based, does not have a material impact on instances of corporate misconduct.

11.2.2 Relationship between approach and corporate misconduct

Due to its voluntary nature, the UKCG is non-binding and does not have legal backing. Therefore, to encourage compliance the UKCG has been incorporated into the LSE listing rules as a requirement of listing. Conversely, Sarbanes-Oxley as an Act of Congress has the force of law and is mandatory for publicly listed companies. Importantly however, Sarbanes-Oxley sets minimum standards with the listing requirements of the NYSE and NASDAQ going beyond those of Sarbanes-Oxley. Nevertheless, although the UK and the U.S. have adopted two different approaches to regulating corporate governance, both systems have been applied as a tick-box exercise. This tick-box approach, adopted by the UK, defeats the inherent flexibility of the comply-or-explain approach. Under this flexible approach in the UK, companies are considered to be compliant as long as non-compliance has been explained, with the adequacy of the explanation left up to financial markets.

Due to the principles-based approach and voluntary nature of the UK approach to corporate governance, the UKCG does not include direct sanctions for non-compliance. Instead, the UK relies on indirect sanctions scattered amongst several pieces of legislation to enforce corporate misconduct. Sarbanes-Oxley on the other hand, includes direct sanctions and introduced several criminal offences, including securities fraud and falsely certifying a financial report. While Sarbanes-Oxley strengthened the legislative framework in the U.S., it did not represent a massive overhaul. Furthermore, all indications suggest that Sarbanes-Oxley prosecutions are rare. In fact, prior to Sarbanes-Oxley, U.S. regulators relied on several statutes including, mail fraud, wire fraud, and honest services fraud statutes to hold executives accountable following several corporate scandals, such as Enron, WorldCom and Tyco. Despite the introduction of Sarbanes-Oxley, these offences continue to be used.

In the UK, a majority of publicly listed companies have reported compliance to the UKCG. Nevertheless, and not surprisingly, instances of corporate governance failures continue to emerge. Similarly, the U.S. has also continued to experience corporate governance failures. These continuing instances suggest that making corporate governance requirements mandatory does not have a material impact on corporate misconduct. Since the introduction of corporate governance regulations in both the UK and the U.S., listed companies have reported compliance, on the surface at least, before news of a corporate governance scandal emerges.

11.2.3 Relationship between enforcement and corporate misconduct

The effectiveness of regulation to deter corporate misconduct cannot be reliably assessed without also considering enforcement. The legislative and enforcement framework in the UK and the U.S. was examined in Chapter 5 and Chapter 9 respectively. Interestingly, the UKCG applies to less than 1% of companies listed in the UK. Similarly, Sarbanes-Oxley applies to less than 1% of companies listed in the United States. Both the UK and the U.S. have several statutes available for corporate misconduct and several mechanisms available to hold directors accountable. Nevertheless, there are key distinctions that can be drawn from the UK and U.S. approaches to enforcement.

The UK has adopted a multiple regulator approach to corporate misconduct, with three primary public enforcement bodies; the FCA, the SFO and the IS, each operating independently. The FRC, the primary private regulator for auditors in the

UK, also operates independently. This multiple regulator approach has contributed to confused agencies and inefficiencies in holding corporate officers accountable, where the FCA, the SFO and CPS are all empowered to prosecute cases of corporate misconduct. This is directly contradictory to the U.S. approach where the DOJ is the single prosecutor for all securities fraud offences, whether committed by an individual, a private company or an exchange listed company. This regulatory approach to criminal enforcement consolidates resources, experience and expertise into a single super prosecutor that as a result is much more adept at enforcing corporate misconduct. As a result, the DOJ has a much more successful rate of holding individuals accountable.

Another key distinction between the UK and U.S. enforcement framework is the clear distinction between criminal and civil regulators. In the U.S., the SEC can be considered a super civil regulator. Despite being the primary public regulator for civil violations of securities law, the SEC also oversees the private SROs. The SEC is indeed a very powerful regulator with auditors, directors and basically anyone who has benefitted financially, whether directly connected or not, under its remit. So far-reaching are the regulators' powers that it is not limited to publicly listed companies and can take action against private companies and their directors. Compared to the UK, the FCA is limited to companies it regulates, including publicly listed companies, the IS primarily regulates private limited companies and the SFO has the autonomy to choose which cases it undertakes. Given the multiple regulators in the UK, enforcement is likely to move much slower compared to the U.S., as agencies quibble over which is best suited to handle the case.

As a result of the centralised approach to enforcement in the U.S., regulators have a much more successful rate of individual accountability. This means that directors in the U.S. face a much higher likelihood of facing sanctions for corporate misconduct, when compared to their UK counterparts. Individual accountability can be a much more effective deterrent than holding corporations accountable given that corporations don't make decisions. Furthermore, unlike the UK approach which responds to regulator failures by renaming and replacing enforcement bodies without addressing the underlying failures, the U.S. approach to enforcement is focused on improving regulator deficiencies and empowering regulators accordingly. The long history of the DOJ and the SEC has undoubtedly contributed to the success of the regulators. Ultimately, the effectiveness of the UK approach to deter corporate misconduct is hindered, not by the principles-based approach to corporate governance or the lack of a legislative framework, but by a muddled enforcement framework.

11.2.4 Effectiveness of enforcement

According to Becker, the effectiveness of enforcement can be measured using the following: (i) the probability that misconduct will be detected, (ii) the probability that wrong-doers will be punished, (iii) the form of punishment and (iv) the size of punishment.[950] Each will now be addressed in turn.

(i) The probability that misconduct will be detected

Given the average number of cases opened by UK regulators in the year, the likelihood of misconduct being detected is considerably lower when compared to U.S. regulators. The SEC receives over 15,000 tips, complaints and referrals each year.[951] Conversely, in the UK, detection levels by regulators appear relatively low in the absence of self-reporting. The U.S. system is further strengthened by its whistle-blower award program, which encourages and motivates individuals to report corporate misconduct.

When compared to UK shareholders, shareholders in the U.S. are encouraged and motivated to actively review corporate reports. Although the U.S. approach to shareholder litigation has led to a number of frivolous lawsuits, the vigilance of shareholders has also increased the likelihood that corporate misconduct will be detected in the United States. Although collective actions provide another remedy which allows shareholders to share costs, there remains little financial incentive for shareholders, given the costs and risks associated with litigation.

Historically shareholders in the UK have not played a significant role in enforcing corporate governance. While collective securities actions have begun to gain steam in the UK, the requirement for individual shareholders to opt-in can still present a cost hurdle for some shareholders. While securities class actions have been instrumental in effecting changes in some companies, shareholders continue to be motivated by financial incentives. Given the size of U.S. securities class action settlements, there is more incentive for shareholders to engage, when compared to their UK counterparts.

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[950] Becker (n 9).

[951] US Securities and Exchange Commission, *Division of Enforcement 2020 Annual Report* (n 826) 19.

(ii) The probability that wrong-doers will be convicted/punished

At the centre of the U.S. approach to enforcement is individual accountability. When considering the effectiveness of the DOJ in terms of the number of convictions, the evidence suggests that the likelihood of individuals being convicted by the DOJ is significantly higher. The DOJ obtained 442 convictions over a six-year period. Over the same six-year period the SFO obtained 54 convictions and the FCA obtained 62 criminal outcomes. That's a combined total of 116 convictions by the SFO and the FCA, which isn't very substantial compared to the United States. Overall, this suggests that the probability of an individual being convicted in the U.S. is significantly higher when compared to the UK.

The SEC has gone on to become a super regulator since its creation over 88 years ago. Although the regulator is constrained by its budget, it appears to be a very active and adept regulator. While the FCA imposed 1447 enforced actions in a seven year period, the SEC imposed 4717 enforcement actions in the same period. That represents an average of 207 and 674 enforcement actions per year by the FCA and SEC respectively. However, it is important to re-emphasise that for comparative purposes, a significant aspect of the FCA's responsibilities, (i.e.) the registration and oversight of financial services firms, has been delegated to FINRA in the United States.[952] By delegating this responsibility to an SRO, that is still overseen by the SEC, the agency can focus its resources on corporate misconduct.

(iii) The form of punishment

Although imprisonment can act as a powerful deterrent, there are several sanctions available in the UK and the U.S. to enforce corporate misconduct, including fines, suspensions and disbarments. In the UK the probability of directors facing imprisonment is not very likely. Even in cases where directors have been prosecuted in the UK, prosecutors have struggled to obtain convictions. Ultimately, there is a much higher likelihood of directors in the U.S. facing imprisonment when compared to their UK counterparts.

The imposition of financial sanctions appears to dominate the remedies imposed in instances of corporate misconduct. Nevertheless, questions remain regarding the effectiveness of financial sanctions to deter corporate misconduct given that

[952] Financial Industry Regulatory Authority, 'What We Do' (*FINRA,* <www.finra.org/about/what-we-do> accessed 19 May 2021.

directors in both the UK and the U.S. rarely pay sanctions out of their own pockets. Financial sanctions instead appear to be more of a punishment to shareholders as the company ultimately pays the sanctions through D&O insurance premiums. Arguably, disbarment could be considered the most direct from of punishment. In both the UK and the U.S. disbarment appears to be reserved for the most serious instances of corporate misconduct. However, the effectiveness of disbarment as a deterrent is also questionable as it does not prevent individuals from entering other lucrative fields. Furthermore, given the changing landscape of the securities market and advent of social media, the avenues for earning a very lucrative living have been expanding. Taken together, it is difficult to assert that disbarment is the punishment it was once considered to be.

(iv) The size of punishment

According to Becker, imprisonment can be measured using time, while financial sanctions can be measured in monetary terms.[953] While the average prison sentence in the UK is 23.5 months,[954] the average sentence in the U.S. is 52 months.[955] That's roughly double the average sentence when compared to the UK. Furthermore, whereas the UK courts are limited by a ten-year maximum sentence for fraud,[956] securities fraud offences in the U.S. can carry a maximum penalty of up to 25 years.[957] The threat of long prison sentences can be a powerful deterrent. In serious instances of corporate fraud, U.S. courts have imposed long sentences as a means of deterring corporate misconduct.

Since the introduction of corporate governance, regulators in the UK and U.S. have continued to impose financial sanctions. Over a seven-year period, the SEC imposed $8.3 billion in financial penalties, compared to the FCA which imposed $3.1 billion over the same seven-year period. However, this does not represent a fair comparison, given that $1.1 billion of the fines imposed relate to banking failures, which are outside the remit of the SEC. Nevertheless, instances of

[953] Becker (n 9).

[954] Clark, 'Average custodial sentence length (ACSL) at all courts to immediate custody in England and Wales in 2021, by offence group' (n 369)

[955] Semisch (n 858) 28.

[956] Fraud Act 2006.

[957] Sarbanes-Oxley s807.

corporate misconduct continue to emerge which supports the view that financial sanctions are not an effective deterrent.

11.3 RESEARCH RECOMMENDATIONS

With a view to improving corporate governance in the UK, the following recommendations are suggested:

1. The UK should adopt a centralised approach to regulating companies and enforcing corporate misconduct. Currently, there are too many independent overlapping regulators with similar powers, which leads to regulatory inefficiencies. The SFO, the CPS and the FCA are all empowered to prosecute cases of corporate misconduct. The expertise and resources of the SFO and the prosecution department of the FCA should be consolidated under the CPS. This means that there will be only one department in the UK for prosecuting all cases of corporate misconduct.

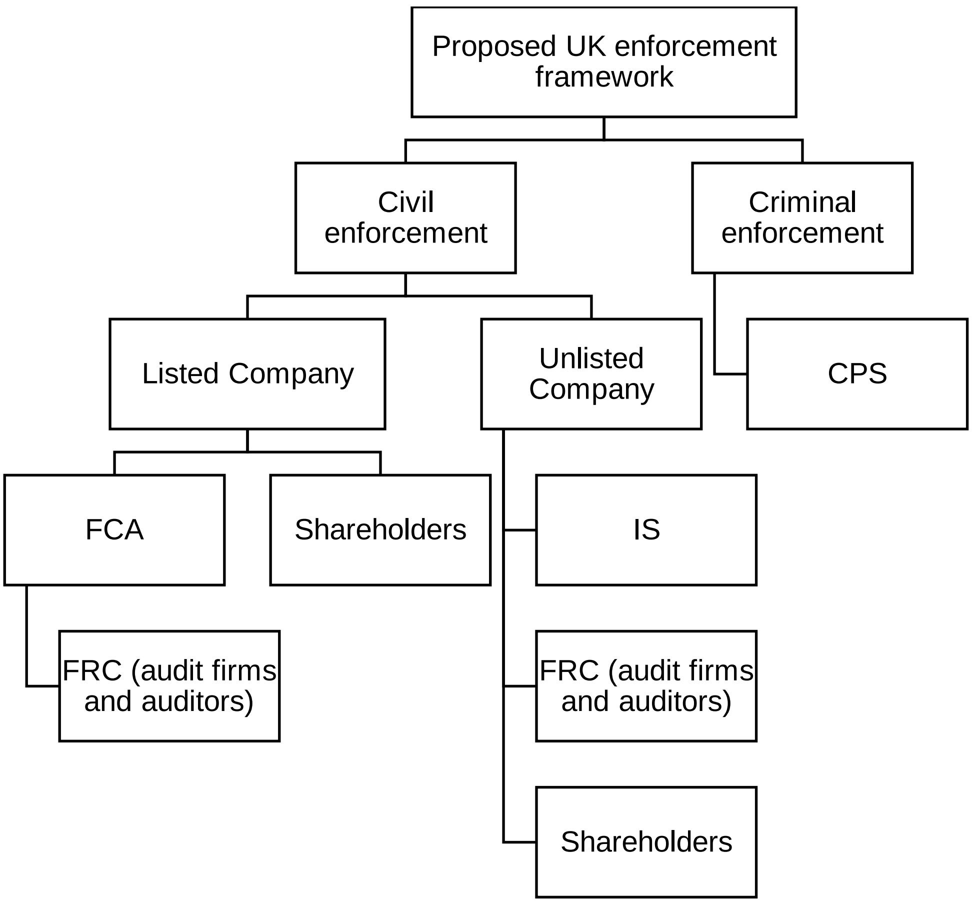

Figure 23: Proposed UK corporate governance enforcement framework

As the oldest prosecutor in the UK, the CPS should have primary responsibility for prosecuting corporate misconduct cases. This will undoubtedly lead to an increase in the CPS workload and will therefore require an increase in the CPS budget. However, like the CPS, the SFO is also funded by Parliament. Therefore, the current SFO funding can be redirected to the CPS for the increased workload. Combining corporate misconduct prosecutions under a single regulator will also require the FCA prosecutions to be absorbed into the CPS. Unlike the SFO, the FCA is funded through fees collected by the companies it regulates. However, the number of prosecutions by the FCA is not significant to cause an undue burden if the resources of the CPS and SFO are consolidated. Ultimately, the single prosecutor approach to corporate misconduct can lead to increased efficiencies, as staff resources and experience can be consolidated.

As illustrated in Figure 23, under the proposed enforcement framework, the regulator responsible for civil enforcement would be dependent on whether the company is publicly listed or unlisted, with the exception of the FRC. Under the proposed framework the FRC would have oversight for audit firms and accountants, irrespective of whether the company is a publicly listed or unlisted. Although the proposed reforms intend to expand the companies under the remit of the audit regulator, it also proposes to expand the regulator's remit to investigating breach of directors' duties. Instead, it is recommended that as the audit regulator, the FRC should be left solely to focus on audit firms and accountants.

Given the role of audit in corporate governance, the FRC would then be supervised by the FCA, in its role as the ultimate civil enforcer of the securities market. This would be similar to the PCAOB in the U.S., which operates under the supervision and oversight of the SEC.

The distinct line of separation will prevent a repeat of the FCA and FRC failure to determine which regulator was initially responsible for investigating Carillion. Using Carillion to illustrate how this would operate in practice, the FRC would be limited to investigating the conduct of the KPMG and Deloitte, while the FCA focused on the conduct of the company's directors and breaches of securities regulations. Although the FCA will be limited to civil/regulatory sanctions, the regulator would cooperate and investigate Carillion jointly with the CPS. This is also similar to how the SEC operates, whereby the regulator regularly undertakes joint investigations with the DOJ. This will ensure that there is no confusion or regulatory overlap between areas of responsibility for the FRC, the FCA and the CPS.

While the IS plays a very minor role in enforcing corporate misconduct for publicly listed companies, the proposed framework would see the IS restricted to investigating private and unlisted companies only. Again, using Carillion to illustrate, the FCA and the IS both investigated different aspects of the Carillion collapse. Under the proposed framework the FCA would have overall responsibility for civil enforcement, including any director disqualifications.

Consideration of an effective enforcement framework would be incomplete without also considering the powers of directors in the UK to enforce corporate governance and hold directors accountable. However, ultimately shareholders are motivated by financial incentives and unlike the U.S., punitive/exemplary damages in the UK are only available in limited circumstances. Furthermore, UK judges appear reluctant to order punitive damages against corporations.[958] When coupled with the changing landscape of share ownership due to technological advancements, it is very likely that shareholders in the UK will continue to choose to divest.

More importantly, such a significant shift in the UK landscape will require government intervention. However, with the desire to attract companies post-Brexit, the UK government will likely shift its focus to ways that are perceived to be more attractive to companies. Interestingly, despite the centralised enforcement framework and the rules-based approach to corporate governance, U.S. stock exchanges remain attractive, as evidenced by 8% growth of companies listed in the U.S. over the past four years. This suggests that deregulation of the securities market is unlikely to have a material impact on how attractive the UK market is viewed. This also

[958] James Goudkamp and Eleni Katsampouka, 'Punitive Damages in Action' (*Oxford Business Law Blog,* 6 July 2017) <https://blogs.law.ox.ac.uk/business-law-blog/blog/2017/07/punitive-damages-action> accessed 9 March 2023.

suggests that overhauling the enforcement framework will have little material effect on the attractiveness of the UK securities market. Nevertheless, given the current UK government's stated desire to deregulate post-Brexit, it is unlikely that the political will exists in the UK to overhaul key aspects of its corporate enforcement framework.[959]

2. D&O insurance policies paid for by the company should not cover director misconduct and regulatory sanctions imposed against directors. This will increase the effectiveness of financial penalties as a deterrent as directors will be faced with out of pocket payments. This means that any financial penalties levied against directors as a result of corporate misconduct will be paid directly by the directors. Alternatively, directors should fund their own liability insurance. However, when considering the practical application in the UK, it is important to take into consideration the fact there is much lower likelihood of directors in the UK facing sanctions, compared to their U.S. counterparts. The case of Carillion illustrates this point, more than three years later and the directors have not actually faced any financial sanctions despite their role in the company's collapse. It is therefore questionable whether this will have a material impact on corporate misconduct in the UK.

   However, before director out-of-pocket payments can be used as an effective means of deterring director misconduct, the UK must first address the enforcement framework which appears to hinder its ability to effectively enforce corporate governance against directors. In the immediate however, excluding directors who are registered auditors or accountants from D&O cover can be considered. In practice, this means that D&O policies will exclude liability for company directors that are also qualified as accountants and auditors, with very few exceptions. For instance, a D&O policy for a company director that is also a qualified accountant (accountant-director) could include a clause where the policy would only pay-out where it can be determined that there was a deliberate attempt to conceal a fraud/misrepresentation by the others directors, the accountant-director was not complicit and there was no reasonable expectation that the accountant-

[959] Peter Foster and George Parker, 'Benefits of Brexit' paper to set out plans for future deregulation' *Financial Times* (London 28 January 2022) <www.ft.com/content/c00ab524-4320-4036-b8f4-813cfd491bd5> accessed 19 February 2022.

director was aware of the fraud/misrepresentation. Any disagreements between the insurance company and the accountant-director would then be adjudicated as a breach of contract claim in the courts. As the watchdogs of financial regulation, it is only fitting that auditors and accountants be held to a higher standard. Personal out-of-pocket payments will encourage professional accountants and auditors to be more vigilant in the performance of their duties.

3. The FRC should not be replaced by ARGA. Although the UK accounting regulator has encountered several regulatory failures, replacing the FRC with ARGA will not address the issues that contributed to the regulators' failures. Many of the improvements suggested by the Kingman Review aimed at improving the effectiveness of the FRC does not require the regulator to be replaced with a statutory body.[960] The improvements to the FRC can be addressed without the need to constitute a statutory body. However, it appears that the re-name and replace approach to regulator failure is the UK's go-to response, even though it has done little to address the underlying issues or improve regulatory efficiency. Instead of replacing a regulator that has been in existence for over 32 years, the FRC should be given the additional powers needed and its limited resources should be utilised on improving and addressing its failures without the need for a complete re-organisation of the regulator.

   A statutory body accountable to Parliament could be subject to the whims of politicians. Instead, the FRC should be supervised by and accountable to the FCA, which already plays a significant role in regulating the UK securities market. This also means that appointments to the FRC board should be made by the FCA and not the Secretary of State for Business Energy and Industrial Strategy (BEIS).[961] As a result, current FRC appointments are arguably subject to the whims of politicians. Furthermore, it can be argued that the FRC's enforcement failures were due to internal inefficiencies and not entirely due to lack of appropriate enforcement powers. The SFO is a

[960] See Kingman (n 456).

[961] Financial Reporting Council and Department for Business Energy and Industrial Strategy, 'Framework Document between Department for Business, Energy and Industrial Strategy and The Financial Reporting Council' (*FRC,* 11 May 2022) <www.frc.org.uk/getattachment/c107a0f3-f164-4e88-9c09-664c4b476e60/FRC-BEIS-Framework-Document-(May-2022).pdf> accessed 20 June 2022.

government department and has continuously been criticised for being an ineffective regulator. Furthermore, replacing the FRC with ARGA does little to address the muddled enforcement framework where regulators continue to overlap. Replacing the FRC with ARGA is akin to knocking down a house every time there is a crack in the foundation. Knocking down and rebuilding the house on the same lot of land will not address the foundational issues. The FRC should instead focus on improving internal processes, improved staff training and clear and distinct lines of responsibility.

11.4 RESEARCH CONTRIBUTIONS

This section considers the study's contribution to knowledge and policy. The research set out to add to the debate on corporate governance, particularly in the area of corporate governance enforcement. This research is original as it is the first holistic comparative analysis of public and private enforcement in the UK and the U.S., to the best of the researchers' knowledge. It combines doctrinal, socio-legal and comparative research methodologies to achieve the research objectives. The study summarises and compares the enforcement outcomes of the SEC and DOJ in the U.S. with the enforcement outcomes of the FCA and SFO in the UK over a six-year period. It also compares the private enforcement mechanisms of SROs, namely the PCAOB and FINRA in the U.S., and the FRC in the UK over the same period.

The conclusions of this study contribute to knowledge in the field of corporate governance by arguing that the U.S. approach appears to be more effective in detecting and enforcing corporate misconduct when compared to the UK as a result of the centralised enforcement framework, with a single public civil regulator and a single public criminal regulator. The study further argues that the weakness of the UK approach cannot be attributed to the principles-based approach to corporate governance or the lack of a legislative framework. Instead, the UK approach is hindered by a muddled and confused enforcement framework. The study also provides further evidence that despite the level of financial sanctions imposed since the introduction of corporate governance regulations, financial sanctions do not appear to act as a deterrent given the continuing instances of corporate misconduct.

This study can also contribute towards UK corporate governance policy reform by suggesting a more centralised enforcement framework be adopted in the UK. This thesis should also prove useful for UK policy makers, as UK regulators appear to lag behind their U.S. counterparts in terms of corporate governance enforcement. This study concludes that although the UK has adopted a different approach to corporate governance, the legislative framework exists to enforce corporate misconduct. Instead, it finds that the corporate governance enforcement framework is a significant contributory factor hampering the UK's ability to effectively enforce and therefore deter corporate misconduct.

11.5 LIMITATIONS

There are several limitations to this study. Firstly, the research entailed the manual collection of data from websites such as the LSE, Stanford Class Action Database, PCAOB and annual reports from Cornerstone Research, the FCA, SFO, FRC, SEC, DOJ and FINRA and entering all the data into spreadsheets. The data collected for each regulator spanned a period of up to ten years, where available. As a lengthy process there were risks of errors being made when entering the data into spreadsheets. To reduce the risk of errors, the data entered was reviewed by an accountant, a former colleague of the researcher.

Secondly, the study focuses on corporate governance regulations applicable to publicly listed non-financial companies and therefore does not consider corporate governance in banks and financial institutions. The conclusions therefore cannot be generalised to companies in the banking and financial sector due in part to the differences in governance requirements for the financial industry.

Finally, due to the federal structure of the U.S., references to corporate law, which operates on a state-by-state basis, were limited to the state of Delaware. The cases of corporate governance failures in the U.S., that were examined in this study were therefore also limited to the state of Delaware. As a result, generalisations cannot be made about corporate governance in the U.S. as a whole.

11.6 RECOMMENDATIONS FOR FUTURE RESEARCH

This research has compared the approach to corporate governance regulation and enforcement in the UK and the United States. A comparative analysis of the corporate governance enforcement framework in the UK and Australia can be another significant area for future study. Similar to the UK, Australia has adopted a soft-law, principles-based approach to corporate governance regulations with companies required to comply with the ASX Principles.[962] Unlike the UK, but similar to the U.S., Australia has a centralised enforcement framework with the Australian Securities and Investment Commission (ASIC) as the primary public civil and criminal regulator for corporations.[963] Although this differs from the U.S. approach where there is a clear separation between the primary criminal and civil regulator, the Australian enforcement framework represents an alternative approach to a centralised enforcement framework and the effectiveness of such an approach is also worthy of consideration and comparison.

While this research suggests the UK adopt a more centralised approach to corporate governance enforcement, the costs of adopting such a model in the UK has not been considered in great depth. Therefore, a full cost-benefit analysis of adopting a centralised enforcement framework in the UK is also recommended as another important area for future research. Such an analysis will require a comprehensive in-depth comparative analysis of the funding for the SEC, DOJ in the U.S., and the FCA and FRC in the UK. Such a study could also include a cost-benefit analysis of the ASIC, as Australia's approach displays certain characteristics found in both the UK and U.S. approach to corporate governance regulation as discussed above.

[962] Maryam Safari, Soheila Mirshekary and Victoria Wise, 'Compliance with corporate governance principles: Australian evidence' (2015) 9 Australasian Accounting, Business and Finance Journal 3.

[963] Australian Securities & Investments Commission, 'ASIC's approach to enforcement' (*ASIC,* November 2021) <https://asic.gov.au/about-asic/asic-investigations-and-enforcement/asic-s-approach-to-enforcement/> accessed 19 June 2022.

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