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The Duties of Directors

A Boardroom Brief series book

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The question of corporate governance as it pertains to directors is a very wide-ranging topic. This booklet is intended to provide general guidance in this regard only, and does not purport to cover all possible issues relating to the topic. For specific guidance, we suggest you contact Deloitte & Touche at one of the contact numbers listed on page 44.

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1. What is a Director?

“At common law, once a person accepts appointment as a director, he becomes a fiduciary in relation to the company and is obliged to display the utmost good faith towards the company and in his dealings on its behalf ”.

- Howard v Herrigel 1991 2 SA 660 (A) 678

The term “director” has not been defined in law. Generally however, the directors of a company are those individuals empowered by the Articles of Association of that company to determine its strategic direction. As a consequence of the nature of a company, being a lifeless corporate entity, human intervention is required to direct its actions and therefore determine its identity.

The directors are entrusted by the shareholders of the company with the ultimate responsibility for the functioning of the company. While some of the day-to-day running of the company is generally delegated to some level of management, the responsibility for the acts committed in the name of the company rests with the directors.

The legal status of a director

Where no express contract has been entered into between the company and its directors, the provisions contained in the company’s Memorandum and Articles of Association are generally viewed as guiding the terms of the relationship that the director has with the company.

Directors have been alternately viewed as trustees, agents, managers and caretakers of the companies they serve.

Whatever the view taken, a director occupies a position of trust within the company.

The implicit duties of the Board

The Code of Corporate Practices and Conduct contained in the King Report on Corporate Governance for South Africa 2002 (the King II Report) advocates that the Board has a number of duties, with the following being the most fundamental:

The Board should determine the company’s purpose and values.

The directors are therefore the individuals entrusted with the strategic decisions on the goals and objectives that the company should pursue, within the framework provided by the company’s Memorandum.

The Board should determine the strategy to achieve its purpose (that is, its strategic intent and objectives as a business enterprise) and to implement its values (that is, its organisational behaviour and norms to achieve its purpose) in order to ensure that it survives and thrives.

In many instances the implementation of the company’s objectives, once determined by the directors, is delegated to the management of the company. This delegation, however, does not relieve the directors of their obligation to ensure that the appropriate objectives are being implemented in the appropriate fashion.

What Company Directors Need to Know About the Companies Act Amendments

The balance between ensuring that the company “survives and thrives” can be a fine one. The Board has to determine the appropriate level of risk that it is comfortable taking on in order to generate a sufficient minimum level of return.

The Board should exercise leadership, enterprise, integrity and judgement in directing the company so as to achieve continuing prosperity for the company.

Directors should have a long-term outlook. Their duty is to ensure that the company not only performs adequately in the short-term but that the methods used to generate immediate returns do not jeopardise the continuing existence of the company.

The Board should ensure that the procedures and practices are in place that protect the company’s assets and reputation.

In practice, the responsibility for the on-going design and evaluation of the company’s internal procedures is often delegated to the audit committee. This committee in turn will, as a matter of practicality, need to rely on functions such as the risk management department and internal and external audit for information on the state of the company’s internal procedures and controls.

This delegation of responsibility however does not relieve the audit committee, and ultimately the full Board from their responsibilities to ensure that the assets and reputation of the company are safeguarded.

The Board should monitor and evaluate the implementation of strategies, policies, management performance criteria and business plans.

In addition to plotting the original course of the company, the directors are charged with continually evaluating whether the strategies and policies that they determined are being adhered to.

In this regard, the directors are generally reliant on management providing them with sufficient, appropriate information for them to make an informed decision on whether the company is currently achieving its objectives.

The Board should ensure that the company complies with all relevant laws, regulations and codes of best business practice.

In many cases, directors approve a code of ethics and acceptable business practice that is disseminated throughout the organisation. In addition to formulating a code, however, the directors are still required to obtain a level of assurance that a culture of ethical behaviour has been instilled into the management and staff of the company.

It is the responsibility of senior management to report to the Board any serious contraventions of laws or regulations or instances of unethical behaviour that has come to its attention.

The Board should ensure that the technology and systems used in the company are adequate to

run the business properly and for it to compete through the efficient use of its assets, processes and human resources.

The directors have an obligation to assure themselves that the technologies and processes currently employed are not outdated, are not exposing the company to the risks of obsolescence and not being competitive, and that the systems are able to provide management, and ultimately the directors with the necessary information to make appropriate, well informed economic decisions.

It is imperative that the directors continually weigh the costs of investing in new technology with the rewards associated with functioning closer to the leading-edge in the industry.

The Board should identify the key risk areas and key performance indicators of the business enterprise in order for the company to generate economic profit, so as to enhance shareholder value in the long term (and the wider interests of society should at the same time be recognised).

The directors’ primary focus is on generating long-term economic wealth for their shareholders. In order to achieve this objective, the directors require an understanding of key risk /return relationships in the company’s specific environment, and the primary indicators that the company’s strategies are being achieved.

In addition to the pure profit objective, directors should acknowledge that the company does not operate in a vacuum and that there are larger societal issues that impact on the company. The company also impacts to a large extent on the community that sustains it.

The ideal strategy, and one that directors often struggle to come to terms with in their particular environment, is one that focuses on achieving long-term value for the shareholders while contributing to the sustainable development of the surrounding community.

A director is “bound to take such precautions and show such diligence in their office as a prudent man of business would exercise in the management of his own affairs”.

- Trustees of the Orange River Land & Asbestos Company v King (1892) 6 HCG 260 285

The Board should regularly assess its performance and effectiveness as a whole, and that of individual directors, including the chief executive officer.

In most instances, the effectiveness of the Board will be reflected by the company’s operating results. The directors should therefore set performance benchmarks against which the results of the company should be evaluated. The

achievement or otherwise of these financial goals should be further analysed into the relevant controllable and non controllable factors influencing the results.

The Board should be seen as being effective where they achieve their pre-determined financial goals on an on-going basis, and the factors involved in achieving these were largely within the Board's control. By the same token, the Board should not conclude that it has been effective where it has reached its objectives largely as a result of factors that were outside of its sphere of influence.

No individual director should be immune from scrutiny in terms of their contribution to the achievements of the company. There may always be room for improvement on even the most effective of Boards.

The Board should ensure that the company has developed a succession plan for its executive directors and senior management.

Companies rely to a great (and sometimes inordinate) extent on the knowledge and expertise of their senior leaders. The value of the human capital lost when a senior executive or manager leaves the company can often be a devastating blow to a company. This is true no matter what the field of expertise of that individual, be it financial, marketing or operational.

The Board therefore has a responsibility to ensure that the company is not overly dependent on any one individual.

The directors therefore need to identify who the key individuals are throughout the organisation and determine whether there is a "Plan B" should that person leave the company.

The duty of care and skill

By accepting their appointment to the position, a director implies that he or she will perform their duties with a level of care and skill that one would expect from such an individual, taking into account the amount of knowledge and experience that that person brings to the company.

It is difficult to determine exactly to what extent a director is accountable to the shareholders. Where decisions are made in good faith, the courts have generally held that the shareholders can have no recourse against the directors for bad decisions. This principle is known as the "business judgment rule". The King II Report suggests that the application of the rule should be further investigated in South Africa.

On appointment as a director, it is a reasonable assumption of the shareholders that that director will apply his or her particular skills, experience and intelligence to the advantage of the company.

The King II Code recommends that the Board should: "ensure that the company complies with all relevant laws, regulations and codes of business practice, and that it communicates with its shareowners and relevant stakeholders (internal and external) openly and promptly and with substance prevailing over form."

Non-executive directors "should be judicious in the number of directorships they accept, in order to ensure that they do full justice to their onerous and demanding responsibilities".

- The King II Report, Section 1 Chapter 4

Good governance principles governing directors

In addition to the broad principle above, the King II Report suggests a number of principles that should be used to guide directors' actions. These guidelines are discussed below.

Directors must ensure that they have the time to devote to properly carry out their responsibilities and duties to the company.

It has become fashionable for directors to accept non-executive seats on a number of Boards. This often occurs when, for example, a director is appointed onto all of the various Boards within a large group of companies. In other instances an individual provides the company with a perceived advantage through the business contacts that they bring with them, or the fact that they are a high-profile individual.

However, the fact that such a director has committed their time and effort to a number of diverse companies does not in any way imply that their responsibilities and duties towards each individual company are in any way diminished.

"Whether the inquiry be one in relation to negligence, reckless conduct or fraud, the legal rules are the same for all directors"

- Howard v Herrigel 1991 2 SA 660 (A) 678

In such a circumstance, a director that does not adequately acquaint him or herself with the particular issues and needs at each of the companies that he or she serves, bears a large personal risk of loss, as he or she typically would have less of an understanding of the company than a director that has more time to devote to the post.

Locally, it has been established that directors need anywhere between eight and 26 days depending on the size and complexity of the company to do full justice to their post. This takes into account the time required to prepare adequately for meetings, communication with other directors and management and the days actually spent in directorship and other meetings.

Directors should exercise both the care and skill any reasonable persons would be expected to show in looking after their own affairs as well as having regard to their actual knowledge and experience.

What Company Directors Need to Know About the Companies Act Amendments

While all directors bring different skills and levels of experience to the company, it is expected that each director apply his or her particular areas of expertise in deliberating on the company's affairs. In addition, directors should treat the interests of the company very much as they would their own, and not be more or less prudent or aggressive in managing the company's affairs as they would their private investments.

Directors must exercise the utmost good faith, honesty and integrity in all their dealings with or on behalf of the company and must act independently of any outside fetter or instruction.

Directors must always act in the best interests of the company and never for any sectoral interest.

In many instances, a director represents an outside party, such as a major shareholder. This does not relieve the individual director of applying his or her mind to each and every issue that comes before the Board and making a decision based on the company's long-term interests.

It is not acceptable for a director to be overly influenced by the party he or she represents. Where such party instructs the director to act in a fashion that is contrary to the way the individual director would have acted, taking into account the best interests of the company, he or she is in breach of their fiduciary duty if they act on the instructions.

Directors must never permit a conflict of duties and interest and must disclose potential conflicts of interest at the earliest possible opportunity.

Each director has been entrusted with a personal responsibility to maintain the highest standard of ethical behaviour in his or her dealings with the company. Conflicts of interest represent a serious threat to the director's actual and perceived ability to exercise independent judgement, not just with respect to the issue causing the conflict, but in all dealings as a director.

"A director should avoid conflicts of interest, even where these could be perceived to be as such".

- King II Report Section 1 Chapter 1

Directors must qualify themselves on a continuous basis with a sufficient understanding of the company's business and the effect of the economy so as to discharge their duties properly, including where necessary, relying on expert advice.

Directors must be informed about the financial, industrial and social milieu in which the company operates.

Decisions at any company cannot be taken in a vacuum.

Without a thorough understanding of the environment in which the company operates, a director cannot fully appreciate

the impact of the company's actions. Not all directors are expected to be an expert in all fields in which the company operates. The director is, however, expected to take all such advice as may be necessary to make informed decisions.

Directors must be satisfied that they are in a position to take informed decisions.

In addition to the above knowledge, directors need to be aware of all other relevant factors that could impact the company, and consequently the decisions the directors make.

It is in the company's interests that the directors have access to all information necessary to assist in making informed decisions.

Directors must treat any matters relating to the company, learned in their capacity as a director, as strictly confidential and not divulge them to anyone without the authority of the company.

By the nature of their appointment, directors necessarily become privy to a wide spectrum of confidential information about the company's affairs. Apart from the legal provisions dealing with insider trading, the director is expected to keep all such information in his or her confidence and to share the information only with those that have a right to an understanding of the intimate details of the company.

In some circumstances, it may be difficult to determine what information should be kept confidential. In these instances, it is usually best to err on the side of conservatism.

Directors must insist that board papers and other important information regarding the company are provided to them in time for them to make informed decisions.

"The Board should have an agreed procedure whereby directors may, if necessary, take professional advice at the company's expense".

- King II Report Section 1 Chapter 1

The information contained within board papers distributed to directors is crucial in assisting directors to make good decisions in the interests of the company. It is therefore

important for the directors to have sufficient time to digest the information being presented to them prior to the meetings at which the decisions need to be made.

Directors must ensure that procedures and systems are in place to act as checks and balances on the information being received by the board and ensure that the company prepares annual budgets and regularly updated forecasts against which the company's performance can be monitored.

Directors require timely information in order to assess the impacts of their decisions. It is therefore important for management to regularly present the directors with updates as to the results of the company in relation to original estimates, together with the reasons for any variance.

Where the directors do not receive audited information, it is vital that the information they do receive can be relied upon to fairly present the financial and operational status of the business. This may be achieved by ensuring that the information is reviewed by a senior official of the company prior to distribution. In this regard, it is advisable for directors to monitor and enquire after any anomalous trends in the information being presented.

Directors must be diligent in discharging their duties to the company, regularly attend all meetings and must acquire a broad knowledge of the business of the company so that they can meaningfully contribute to its direction.

An understanding of the pertinent issues at a company can only be gained over time. It is therefore difficult to obtain such an understanding where the director does not regularly attend meetings as well as keep in constant communication with other directors and the management of the company.

Directors must be prepared and able, where necessary, to express disagreement with colleagues on the board including the chairperson and the chief executive officer.

One of the most important qualities required of a director is an objective point of view. If it was the intention of the shareholders of the company that it be run by one or two key individuals, they would not have gone to the effort and expense of appointing a full Board.

It is the individual director's duty to represent what he or she believes to be the true long-term best interests of the company. Where those interests are not being considered by his or her fellow directors, it is up to the individual to challenge such a decision.

Conflicts of interest

One of the fundamental duties of a director is to avoid any possible conflict of interests with the company. It is an accepted principle in South African law that, as a result of the trust placed in the director, he or she is bound to put the interests of the company before their own personal interests.

There are a number of components to this duty, which are discussed below.

The duty to disclose interests in a contract with the company

Section 234 of the Companies Act regulates the situation where a director has a personal interest in a contract or proposed contract with the company.

The section requires that a director provide full details of his or her interest in a contract that is both significant to

the company and which is authorised by the Board, or an individual director designated to enter into the contract. The interest may be either direct or indirect (via a close family member or through a company or trust that the director is associated with) for the purposes of this section.

Section 235 of the Act instructs the director to make the declaration at or before the first directors' meeting at which the proposed contract is discussed. Where it is not possible to make the declaration at that time, it should be made at the next directors' meeting, together with the reason for the late declaration.

Section 234 uses the term "materially" in relation to the interest of the director, however, it would be in the interests of good corporate governance and transparency for the director to disclose all interests in any contracts as a contract that may be immaterial to the director could be viewed as material by an outside party.

Where a director has been authorised by the Board to enter into a contract on behalf of the company and they have an interest in this proposed contract, they are regulated by section 237 of the Act. In this case, the director is prohibited from concluding the contract without providing full details of his or her interest in the contract to the Board and without the directors having passed a resolution approving thereof.

Where the director becomes interested in a contract after it is entered into by the company, he or she must provide written notice of this to the Board immediately. The Act requires that this declaration be delivered to the company secretary who should in turn pass it on to the Board.

"It is an elementary principle of company law, that (apart from explicit power in the articles of association) a director cannot vote for the adoption of a contract or on a matter in which he is an interested party".

- *Gundelfinger v African Textile Manufacturers Ltd* 1939 AD 314

The Articles may provide that any contract in which a director has an interest must be approved by the shareholders, or they may state that the approval of the directors may suffice. In addition, when the directors are voting on a contract, generally the Articles preclude any director with an interest in the contract under discussion from participating in the vote.

Section 238 of the Act requires that where a contract is to be decided on by the shareholders, the notice of the general meeting at which the proposed contract will be discussed must include the fact that one of the directors has an interest in the contract.

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Additionally, the Act in section 239 requires that any declaration of interest be written in the minutes of the directors' meeting at which the declaration was made. Also, section 240 requires that a register of directors' interests in contracts be maintained. Where a director does not declare his or her interest in a contract, the Articles of a company will generally require that the director be removed from office. In addition, the company may be able to void the contract and claim back any profits made by the director from that contract.

The duty to account for secret profits

A director is bound to declare to the company any profit that he or she makes from the office of director, in addition to any profits (such as directors fees) paid by the company itself. It is irrelevant in this instance whether the profits were earned as a result of a conflict of interest with the company.

Such profits may arise in a variety of situations, such as where the director is able to enter into a transaction purely because of the office they hold. The profit may or may not be at the expense of the company, but the principle of disclosure enables the company to decide whether the profit was made fairly, and did not deprive the company itself of any opportunity.

There is even a school of thought, first discussed in an English case (*Regal (Hastings) Ltd v Gulliver* 1967 2 AC 134n 150) that in the situation where a director invests in his or her private capacity in an investment previously declined by the directors on behalf of the company, any profits made in that investment must not only be disclosed, but are repayable to the company.

Competing with the company

Where a director somehow acts in competition with the company, a fundamental conflict of interest is inevitable. There are a number of ways in which such a situation could occur. One is where a director takes an opportunity that could have been taken by the company, in his or her personal capacity. Another is where the director holds directorships on rival companies.

Where an opportunity arises that could have been acted upon by the company, the director is precluded from acting upon it in his or her individual capacity. The director has a fiduciary duty to pass this opportunity on to the company. The courts have held that even where the company did not have the resources to pursue the opportunity, the director who came across it was not at liberty to pursue it personally.

It is debatable whether the holding of directorships on the Boards of rival companies in itself constitutes a breach of the director's fiduciary duties. However, it would be almost impossible for the director not to prejudice one of the two or more companies that he or she serves, and it is therefore not recommended to serve more than one company within the same industry.

"It would be a most unusual situation which allowed directors... of one company to act in the same or similar capacity for a rival without actual or potential conflict situations arising with frequent regularity".

- *Sibex Construction (SA) (Pty) Ltd v Injectaseal CC* 1988 2 SA 54 (T)

The different types of director

In law there is no real distinction between the different categories of directors. It is an established practice, however, to classify directors according to their different roles on the Board. The King II Code has provided definitions for each type of director.

It may be "unhelpful and even misleading to classify company directors as 'executive' and 'non-executive' for purposes of ascertaining their duties to the company or when any specific or affirmative action is required of them".

- *Re Elgindata Ltd* 1991 BCLC 959 985

The classification of directors becomes particularly important when determining the appropriate membership of specialist sub-committees, and when making disclosures of the directors' remuneration in the company's annual report.

An executive director is defined as:

"An individual involved in the day-to-day management and/or in the full-time salaried employment of the company and/or any of its subsidiaries."

An executive director, through his or her privileged position, has an intimate knowledge of the workings of the company. There can, therefore, exist an imbalance in the amount and quality of information regarding the company's affairs possessed by executive and non-executive directors.

Executive directors carry an added responsibility. They are entrusted with ensuring that the information laid before the Board by management is an accurate reflection of their understanding of the affairs of the company.

The King II Report highlights the fact that executive directors need to strike a balance between their management of the company, and the independent state of mind required when serving on the Board. The executive director needs to ask himself "Is this right for the company?", and not "Is this right for the management of the company?"

A non-executive director is defined as:

"An individual not involved in the day to day management

and not a full-time salaried employee of the company or of its subsidiaries.

An individual in the full-time employment of the holding company or of its subsidiaries, other than the company concerned, would also be considered to be a non-executive director unless such individual by his/her conduct or executive authority could be construed to be directing the day-to-day management of the company and its subsidiaries.”

An independent director is defined in detail by the Code. In essence, an independent director is a non-executive director who:

- * Is not allied to any major shareholders.
- * Has not been a high-level employee of the company for the past three years (and no close family members have been high-level employees for that period).
- * Does not provide professional advice to the company or the group.
- * Has no significant business or contractual ties to the company or group.

The need for this third category of director is especially apparent in the South African environment. In the past, extremely complex and diversified group structures have evolved. It has therefore become common to share the same directors on all the various Boards throughout the group.

“Non-executive directors bring an external judgement on issues of strategy, performance, resources and standards of conduct and evaluation of performance to the board”.

- King II Report, Section 1 Chapter 4

It consequently became obvious that, although a director may have been non-executive on a certain company's Board, he or she still had strong ties to the group as a whole and did not necessarily bring an independent state of mind and the fresh approach and thinking that one may expect from a true “non-executive” director.

The King II Report suggests that it may be useful to appoint an independent director who, as a result of his or her senior status, has the authority to facilitate any issues that may arise between executive and non-executive directors of the Board.

Such a function is noted as being especially relevant where the roles of chairperson and chief executive officer are combined and also where both the CEO and chairperson are executive directors.

Other instances where the role of a lead independent director may be needed are in the case of a fundamental disagreement between the auditors and management that cannot be resolved by the audit committee, and when the performance of the chairperson is being evaluated. Such an individual is noted as being an effective resource for the chairperson when in need of support in dealing with other members of the Board.

Personal characteristics of an effective director

The role of a director, whether executive or non-executive, is a particularly challenging one. While all appointments have their own unique demands, there are a number of characteristics that can contribute to the effectiveness of a director.

Some such characteristics may include:

- Strong interpersonal and communications skills
Increasingly, directors are being expected to represent the company at shareholders' meetings and in discussions with third parties such as analysts and the media. An obvious advantage is therefore the ability to clearly and definitively present the company's position.
- Energy
Directors typically have a number of competing commitments and priorities. Where critical decisions are being made on a daily basis, directors are constantly challenged to maintain their energy levels and enthusiasm.
- Of independent mind
A director is expected to apply his or her independent judgment to all issues presented to the Board. Directors are increasingly required to take a stand when, in his or her mind, the company's long term future is not being prioritised, no matter what the consequences.
- A strategic thinker
The primary duty of the director is to guide the company to long-term prosperity. This often requires the individual to be able to assess the long-term consequences of decisions taken.
- Analytical
Directors are often presented with problems that have a number of potential solutions, and the ability to sift through data to find an answer is a valuable personality trait.

In addition to personal characteristics, a number of experiential factors may contribute to the effectiveness of a director. Such factors are not mandatory for all directors, but can often be persuasive in evaluating an individual for appointment.

- International exposure
South African firms are increasingly competing on the world stage. This competition brings with it a number of unique challenges. A director that brings to the Board an international focus and an exposure to global benchmarks and processes is becoming more and more valuable.
- Industry expertise
The Board is enriched by any individual that can contribute knowledge of the particular industry when evaluating issues and decisions made at the company.
- Financial knowledge
All businesses are becoming increasingly driven by financial and accounting considerations. Having the ability to evaluate the financial implications of an action or decision is definitely an advantage as a director.

2. How a director is appointed

The directors “should disclose in the annual report the number of board and committee meetings held in the year and the details of attendance of each director (as applicable)”.

- King II Report Section 1 Chapter 1

The appointment of a director is one of the most important decisions that is put before the shareholders of a company. While the legislation has defined who may be appointed to the post of director, it is vitally important that the existing directors assess the qualitative characteristics necessary in an individual to effectively integrate with the culture and style of the organisation.

From a legal perspective, it is important to ensure that the required procedures of the appointment are carried out correctly, to avoid any unwanted ramifications in the future.

In practice, companies may encounter difficulties in identifying suitable individuals to approach as potential directors. The directors of small companies are often hampered by the fact that they do not possess the extensive network of contacts that the directors of larger companies have.

In such instances it is often best to enquire of the company's auditors or other professional advisors, or to contact a professional organisation such as the Institute of Directors to identify suitable individuals. Further, companies could make use of executive search agencies to identify suitable individuals for consideration.

Who qualifies as a director?

With a few specific exceptions, anyone can be appointed as a director of a company.

Legal qualities required to be a director

The Companies Act is the primary determinant of who may or may not be appointed to be a director. Section 218 of the Act in essence provides that any person may be appointed as a director, provided that he or she is:

- an individual (and not a juristic person)
- over the age of 21 (or where the Court has declared that they are no longer a minor)
- not under legal disability (where the Court has declared that the individual cannot manage their own affairs).

The Court is required to specifically approve the appointment of any of the following as directors:

- an unrehabilitated insolvent person
- any person who previously held a position of trust, but was removed as a result of misconduct
- anyone who has ever been convicted of:
 - fraud
 - theft
 - forgery
 - perjury
 - corruption
 - dishonesty
 - any offence related to the setting-up or running of any company.

Power of the Court to disqualify individuals

The Court has the power to approve an individual for appointment as a director generally to any company or specifically to one or more companies.

The intention of such a provision is to ensure that once a person has been found to be untrustworthy and not fit to hold a position as a director, such an individual should find it difficult to attain a position of trust again.

The Act provides the company with the discretion, through its Articles, to disqualify any person from appointment as a director of the company. Where the Articles seeks to disqualify a group of persons based on a certain characteristic, such a provision would probably be open to challenge in terms of the South African Constitution.

In addition to the above disqualifications, Section 219 of the Act provides the Court with the power to disqualify any person from acting as a director or serving in the management of a company where:

- He or she has been convicted of an offence in promoting, forming or managing a company.
- The Master of the Court has reported a suspected offence committed by that director or officer discovered in the winding-up of a company (this includes so-called shadow directors). Shadow directors are defined in the King II Report as being those individuals in accordance with whose directions or instructions the directors of the company are accustomed to act.
- It is reported in the winding-up or through the judicial management of the company that such person is suspected of committing an act related to reckless trading as contained in section 424 of the Act, or other fraud.

In terms of the above section, when applying to the Court to obtain the order against the director, 10 days' notice prior to the application must be given to the director. The director in turn has 10 days to appeal the decision once the order is granted.

The South African Act in this regard is quite narrow. In the United Kingdom, for instance, the Court has the power to disqualify any person that it deems "unfit" to hold the position of director of a company.

Register of Directors

It was the intention of the Companies Act to alert the public to directors that have a history of failed companies. Section 421 of the Act requires the Registrar of Companies to maintain a register of directors of dissolved companies (including all those directors who held the position up to two years prior to the company being dissolved), with the particulars of their directorship.

The onus is on the liquidator of a company to provide the Registrar with such details. The director has one month, from the time the details are supplied by the liquidator to the Registrar to appeal against his or her name being placed on the register. Once their name has been placed on the list, the director has a further month to appeal to the Court against this.

In spite of the fact that the Act provides that any liquidator who does not fulfil their duty in terms of the above section is guilty of an offence, the register does not appear to be an effective tool in identifying and blacklisting "rogue" directors.

What a new director should be told

The King II Report suggests that when a new director is appointed to the Board, he or she should receive the necessary induction to familiarise themselves with the duties and responsibilities of a director generally (where the individual has not performed the role previously), and with the issues specific to the company.

The Report recommends that such an orientation process be a formal programme designed to increase the awareness and effectiveness of each director appointed. While the Report states that the responsibility for this induction process lies with the chairperson, it suggests that the company secretary is the best person to actually perform the induction.

Orientation of inexperienced directors

The functions and responsibilities of a director are unlike any other management position. Therefore, even when an individual has served for a considerable period of time as a member of senior management, the responsibilities assumed on the appointment as a director are unique to that position.

There are certain critical issues that should be communicated to a new, inexperienced director:

- The time horizon of any decisions made
Most individuals, certainly when acting in a managerial capacity, become accustomed to dealing with a short time horizon. This arises due to the numerous deadlines imposed, and the importance ascribed to accounting results.
The director's role is not to maximise short-term returns, but should rather attempt to safeguard the sustainable development of the company in the long-run. Decisions should therefore be taken that are in the long-term interests of the company, and not to boost the next earnings statement.
- The independent frame of mind required
Managers in the business world are often accused of not being "team-players" when they criticise a decision made by their peers or superiors.

It should be stressed that the director's role is to take a step back and critically assess the motivation and consequences of a decision, and where necessary, to put forward a reasoned view.

- Personal liability of directors
Directors are often shocked by the high level of personal risk that they bear through their position.
The legal framework in South Africa (which extends far beyond the Companies Act) is increasingly looking to make directors liable in their personal capacity for actions of the company.

It is therefore only fair that an individual be given the opportunity to weigh up any risks against the rewards from serving as a director.

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The orientation of experienced directors

Each company and industry has its own unique issues. It is therefore vital for all directors to understand what these issues are and what their impact on the company is.

It is therefore beneficial for an experienced member of the Board to introduce the new director to these issues, which may include:

- Specific risks and the management thereof
The pertinent risks present in the industry, and those specific to the company, as well as the ways in which the Board manages these risks.
- Key members of senior management
New directors should be introduced to the various members of management on whom the directors depend for information.
- Pertinent accounting issues
With accounting decisions driving a company's share price to a greater extent than ever before, it is important that all directors are aware of the material choices that have been made, and the extent to which these choices influence the company's results.
- Quality of information and internal controls
Directors should satisfy themselves of the veracity of the information received from management, and the state of the internal control environment at the company.
- The Board's relationship with internal and external audit
The directors make certain assertions in the annual report, including:
 - the accounting results are free from misstatement, and that the internal controls at the company are operating effectively;
 - the company will be a going concern in the foreseeable future; and
 - the risk management framework and processes within the company are adequate to manage the risks inherent in the business.

In order to make such statements, the directors rely to an extent on assurances provided to them by the internal and external audit functions. It is therefore important for a director to understand the sources and reliability of this assurance.

The legal mechanics of appointment

The first directors of the company

The first directors are determined, in terms of section 209 of the Companies Act, in writing by a majority of the subscribers of the memorandum of the company. Until directors are officially appointed, every subscriber to the memorandum is deemed to be a director of the company.

When the subscribers act as the directors, prior to the appointment of directors as provided in the memorandum, their resolutions will only be effective if they act in terms of the articles that relate to the resolutions of directors.

By appointing the first directors of the company, however, they act not as directors but as the subscribers.

The sole subscriber to the memorandum of a private company with a single member is deemed to be its director, and consequently there is no need for an appointment to be made in writing.

A director of a company who is appointed before its certificate to commence business has been issued, is required by section 211 of the Companies Act to sign the prescribed form, thereby providing the Registrar with his or her written consent to act as director of the company.

A director who fails to comply with any of these provisions commits an offence, but his or her appointment and any of his or her acts are still valid.

Appointment by the shareholders

While it is usually the directors themselves who identify and nominate a new director to be elected to their number, it is the responsibility of the shareholders to evaluate and legally appoint each new director.

Each director must be voted on by a separate resolution at a general meeting of the company, unless the company first resolves, without a dissenting vote, to appoint all the directors by a single resolution.

In order for the shareholders to make an informed and objective decision regarding the appropriateness of a director up for appointment, the King II Report suggests that a brief CV of all directors up for election should be sent to shareholders with the announcement of the annual general meeting.

Once appointed, the director has 28 days to supply his or her written consent, using the appropriate form, to the company, in terms of section 211 of the Companies Act. This consent is then forwarded by the company to the Registrar of Companies.

In addition, where the company is listed, the JSE Securities Exchange listings requirements require that the company inform the JSE of any new appointments of directors (including the change of important function on the Board, or change of executive responsibilities of a director) by the end of the business day following the decision, or receipt of notice of the change. This information must also be disclosed on the JSE's news service SENS.

Where a director retires by rotation and is re-appointed, no notice needs to be given to the JSE.

The minimum number of directors

A public company is required by section 208 of the Companies Act to have at least two directors. A private company may have only one director.

Where the company is listed, Schedule 10 to the JSE Securities Exchange Listings Requirements states that the company should have at least four directors.

Qualification shares required

Directors may be required, in terms of the Articles of the company, to hold a certain number of shares in the company in order to qualify for appointment. Section 213 of the

Companies Act gives the director two months to acquire these shares, otherwise he or she must vacate their office or they are guilty of an offence.

It was decided in the case of Carbonic Gas Co.Ltd v Ziman (1938 TPD 102), that prior to the acquisition of the shares, any act committed by the director in his capacity as such is not valid.

The Register of Directors

The company is required by section 215 of the Companies Act to keep a register of directors. Whenever a new appointment is made to the Board, this change should be noted in the Register.

One of the details required by the Act to be entered is that of the other companies for which the individual also serves as a director. In practice, these details are often insufficient as the company secretary may struggle to obtain the information from the director, and to keep it current. The information does, however, serve as an important record in distinguishing between independent and non-executive directors.

3. The workings of the board of directors

“The Board should be composed of individuals of integrity, who can bring a blend of knowledge, skills, objectivity, experience and commitment to the Board”.

- King II Report Section 1 Chapter 1

Composition of the full board

The three different types of directors each bring a different area of focus to the Board of Directors. Executive directors have an intimate knowledge of the workings of the company. Non-executive directors may have a better understanding of the issues facing the group as a whole. Independent directors bring a totally unclouded viewpoint to the Board, as well as experience gained at other enterprises.

The challenge lies in getting the appropriate balance right. Each company faces different issues, and will require a unique combination of skills to meet those challenges. The King II Report suggests that the majority of directors be non-executive.

Factors that influence the composition of a company's Board would include:

- The need for independent scrutiny of the company's affairs.
- The requirement that the directors be well acquainted with the issues and problems faced by management.
- The need to keep up to date with trends in the industry, with competitors and with international practice.

The King II Report has re-affirmed the view that the South African business environment lends itself to having a single (unitary) board of directors that takes ultimate responsibility for the direction of the company. Having a single Board makes it essential to achieve the correct balance of power between the different categories of directors. In South Africa, best practice dictates that the majority of directors should be non-executive, and, preferably, independent.

Important roles of the board

The Board comprises a number of important individuals, each with a different role to play. The functions of these significant individuals are discussed below.

The Chairperson

The Articles of a company generally allow for the directors to elect a Chairperson to chair the meetings of the Board. Unless specified in the Articles, the Chairperson remains in that position for as long as he or she is a director, or until the Board elects otherwise.

The Chairperson of the Board is the individual charged with providing the Board with leadership, and to harness the talents and energy contributed by each of the individual directors.

The most obvious role played by the Chairperson is to govern the workings of the Board, including directing the meetings of the Board and acting as a conciliatory element when elements of the Board differ.

The Chairman of the Board in turn also usually functions as the Chairperson at general meetings of shareholders. The Chairperson has the power under section 192 of the Companies Act to adjourn any meeting of the shareholders, where the meeting has become disorderly, or where he or she validly believed that a resolution should not be passed as the appropriate decision makers are not present.

The Chairperson is obliged to use this power appropriately and not to influence the outcome of the meetings towards a specific agenda.

The Chairperson of a general meeting is empowered “to preserve order, and to take care that the proceedings are conducted in a proper manner, and that the sense of the meeting is properly ascertained with regard to any question which is properly before the meeting”.

- National Dwellings Society v Sykes [1894] 3

In addition to these duties, the King II Report recommends that the Chairperson also be involved in:

- The appointment of new directors
- Induction of these new directors
- The creation of a strategy for the Board
- Providing a link between management, represented by the CEO, and the Board
- Maintaining the quality of the information provided to the Board.

Further responsibilities of the Chairperson would be to ensure that the appropriate committees are established and are operating effectively, and to enter into official communications with stakeholders.

In terms of the Articles of the company, and as allowed under section 195 of the Companies Act, the Chairperson may have the responsibility to cast the deciding vote in a general meeting of shareholders, where the members' vote is undecided.

In addition, section 198 of the Companies Act requires that where the Chairperson is asked to conduct a poll of the members on a certain issue, he or she is obliged to conduct the poll providing the members requesting the poll exceed five in number or represent more than 10% of the total voting rights of all members having the right to vote at the meeting.

The Chief Executive Officer

The chief executive officer (sometimes referred to as the managing director) has the responsibility for determining and maintaining the strategic direction of the company. The CEO is usually seen as the figurehead for the company in the public eye, and as such should be an individual with the ability to present a positive image of the company.

Generally, the Articles of the company provide that the directors may appoint one or more CEOs. The Articles

usually allow the director involved to vote on his or her own appointment to the post of CEO if no additional remuneration is involved.

This appointment of the CEO usually continues until he or she ceases to be a director, and the CEO is not usually subject to retirement by rotation. The CEO does not necessarily have to be an employee of the company in addition to holding a post as director. Where the CEO is an employee of the company, however, best practice internationally and in South Africa is that he or she should enter into at most a three year employment contract with the company.

Where the Articles so provide, the directors may delegate all of their powers to this one individual, thus conferring onto him or her an enormous amount of responsibility.

“The chief executive officer should... maintain a positive and ethical work climate that is conducive to attracting, retaining and motivating a diverse group of top-quality employees at all levels of the company”.

- King II Report Section 1 Chapter 3

The King II Report recommends that roles of the CEO and the Chairperson should be separated due to the different focuses that the roles demand. While the Chairperson is required to retain an objective viewpoint of the affairs of the company, the CEO is often required to become intimately involved in developing and executing management plans for the company.

Where the roles of the CEO and Chairperson are combined, the Report suggests that the reasons for this should be explained in the annual report, together with the controls that mitigate any governance problems within the Board structure (including for instance an independent deputy Chairperson or a strong independent non-executive element on the Board).

Some of the more important functions that the King II Report suggests that the CEO perform include:

- Presenting the Board with a long-term strategy for the company, including achievable business plans and the budgets that support the strategy.
- Ensuring that the company's day-to-day affairs are appropriately supervised and controlled.
- Co-ordinating the formation of a management team that can effectively implement the company's long term strategy.
- Presenting the company to the media and its shareholders.

Sub-committees

The directors are generally empowered by the Articles to form sub-committees and delegate certain of their powers to these committees. The directors may even delegate certain powers to a committee of one (which is effectively what

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happens when the CEO is appointed). The members of each committee are usually able to elect one of the members as the Chairperson of the committee.

“Board committees are an aid to assist the Board and its directors in discharging their duties and responsibilities, and boards cannot shield behind these committees”

- King II Code Section 2

The King II Code recommends that the delegation of powers to a sub-committee be made official, in order for the members to have formal terms of reference to determine the scope of their powers, and the responsibilities they bear. In addition, the Report provides model terms of reference for a sub-committee. These terms of reference would generally encompass the following:

- The composition of the committee
- The objectives, purpose and activities
- The powers that have been delegated
- Any mandate to make recommendations to the Board
- The lifespan of the committee
- How the committee reports to the Board

The most common sub-committees encountered are the following:

- Nomination
- Remuneration
- Risk Management
- Audit
- Executive

The King II Code recommends that at a minimum, an audit and a remuneration committee should be created. In addition, it is suggested that in only rare circumstances, should a member of a committee not be a director on the Board.

Where all the members of a committee are not directors, the committee ceases to be a Board sub-committee as the members lack accountability to the Board and ultimately to the shareholders.

Board committees should, however, not be discouraged from seeking the advice of experts.

The composition and functions of each of these sub-committees are discussed below.

The Nomination Committee

The role of the nomination committee is to review, on a regular basis, the composition of the full Board, and where it appears that the Board is lacking in skills or experience in a certain area, to identify how best to rectify the situation. This may involve identifying skills that are required, and those individuals best suited to bring these to the Board.

The King II Report suggests that the committee should comprise at least three non-executive (and preferably

independent) directors. It would not usually be appropriate for any executive directors to sit on the committee.

The ideal situation is for the Chairperson of the Board to also chair the Nomination Committee, failing which an independent non-executive director should act as the Chairperson.

The committee is empowered to consider the size and balance of the full Board, and to make recommendations where, in the opinion of its members, improvements could be made. It remains the responsibility of the full Board of Directors to consider the recommendations made and to vote on any nominated appointments or, as the case may be, suggested removals.

One of the important considerations for the committee is whether there are adequate succession plans in place to mitigate the effects of losing key members of the Board, specifically non-executives as these individuals may be more difficult to replace than executive directors who have followed a defined career path through the management of the company.

The Remuneration Committee

The remuneration of a company's directors is one of the most sensitive and topical issues facing the Board of Directors today. It is therefore considered a crucial element of good corporate governance to establish a committee whose sole focus it is to consider and recommend the level and form of the directors' remuneration.

The King II Report recommends that the committee should comprise at least three non-executive directors. Again it is preferable for the directors to be mainly independent. The nature of the committee would make it entirely inappropriate for any executives to sit on the committee.

The chairman of the committee should be an independent, non-executive director.

One of the most important responsibilities of the members of the committee is to remain up to date on appropriate levels, structuring methods and types of remuneration in the environment in which the company operates.

The members of the committee are required to maintain a fine balance between recommending over-generous remuneration which is not in the interests of the shareholders, and a level of remuneration which fails to attract the desired quality of individual to the Board.

While it is usually within the committee's mandate to deliberate on the remuneration of the non-executive directors, it is up to the shareholders to make the final decision on the appropriate level.

The Risk Management Committee

Risk management is an often misunderstood discipline within a company. Too often the responsibility for ensuring that the significant risks are adequately managed is not acknowledged, or is inappropriately delegated to the audit committee.

There are two reasons that the risk management function should not report to the audit committee, but should be monitored by a separate Risk Management Committee.

The first is that, as a consequence of the composition of the committee, the function will often have financial focus when risk management should correctly extend far beyond the finances of a company.

Secondly, the audit committee should act as an independent oversight body.

Having to directly oversee the risk management function would generally involve a large amount of detailed review of the processes and workings of the company.

This would necessarily have a detrimental effect on the objectivity of the Audit Committee's members when considering reports of the Risk Management Committee. The formation of a separate committee recognises the fact that the identification and management of risks impacting the business, and the disclosure of this to the shareholders is vital to good governance.

The King II Report recommends that the committee should comprise an equal amount of executive and non-executive directors. It is further suggested that there should be a link to the audit committee by including on the risk management committee a non-executive member of the audit committee.

The Chairperson of the committee should be a non-executive director. The King II Report does not believe that the Chairperson of the Board should chair this committee.

The role of the committee is to perform an oversight function. This is achieved by monitoring the appropriateness of the policies and methods used by the executive directors and management to monitor and respond to the risks affecting the company.

The King II Report suggests that the main categories of risk present in most businesses are market, credit, liquidity, operational and commercial risk.

In addition to those recommended by the Report, both business and strategic risks would be relevant to most organisations.

Obviously in some companies some risks may be more significant than others, however it is important to consider all potential risk areas impacting the company.

It is of vital importance that members have experience within the industry in order that they identify areas of risk and are aware of the appropriate methods of managing the company's exposure via internal (the control environment) or external (such as thorough insurance cover) means.

To operate effectively, it is recommended that the committee produce reports that are reviewed and signed by the full Board as acknowledgment that their responsibilities in this regard have been adequately discharged.

The Audit Committee

The co-ordination of internal and external audit activities is increasingly becoming a vital component of the Board's responsibilities. It has been a trend in South Africa, however, for an increasing number of duties to be delegated to this committee to the point where many audit committees are overloaded with matters that other committees, or the full Board, should be considering.

The King II Report recommends that the committee should comprise at least three directors, with the majority being non-executive. It is also recommended that the Chairperson of the committee be non-executive and should not be the Chairperson of the Board. A reason for this is that the Chairperson of the Board plays an important role in evaluating the performance of the Audit Committee.

It may be within the committee's scope to recommend the appointment of the external auditors. In this case the committee should consider the appointment from a number of potential candidates.

Maintaining both the actual and perceived independence of the external auditors is vital to maintain confidence in the results posted by the company. It is therefore crucial for the audit committee to consider any threats to this independence and to respond appropriately.

One such threat is the other services that the external audit firm provides. In many jurisdictions throughout the world it is becoming common for the audit committee to pre-authorise any non-audit services. While such an approach may or may not be appropriate, the committee should determine whether it views any such services as being incompatible with the maintenance of auditor independence.

In addition to the above, the audit committee is required to consider the following with regard to the external auditors:

- The scope of the external audit engagement
- The timing of the engagements
- The remuneration of the external auditors
- The effectiveness of the audit

It is vital that a number of the members of the audit committee have a good understanding of accounting principles in order to make informed decisions regarding whether accounting choices made by management in consultation with the auditors are appropriate. In addition, where the auditors and management disagree, it is the responsibility of the committee to attempt to resolve the impasse.

An important responsibility of the committee is to consider any financial announcement to be made by the company. It is not, however, appropriate for the Board to delegate its responsibility for the approval of the company's results to the audit committee. The full Board should have the opportunity to conclude on this information prior to publication.

In particular, when reviewing the company's financial statements, the committee should review the contents of any audit report, and enquire of the external auditors whether

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there were any significant disagreements, uncertainties or decisions.

The internal audit function falls under the supervision of the audit committee. In this regard, the committee's responsibilities are to:

- Review the performance of internal audit
- Determine the internal audit function's mandate
- Appoint or remove the head of internal audit
- Follow up on significant internal audit findings
- Monitor the co-ordination of activities between internal and external audit
- Satisfy itself that there are adequate controls in place to mitigate the risk of fraud and error.

As suggested by the King II Report, the custodianship of the code of ethics often rests with the audit committee. This responsibility generally entails following up any ethical or legal issues within the company.

It is further suggested that the committee should meet at least four times a year, and that the head of internal audit and the audit partner as well as the finance director should attend the meetings.

It is very important that the Board should not focus only on meeting its calendar commitments, but should also be able to react to any significant unforeseen events that occur during the year.

The Executive Committee

The objective of creating an executive committee is that the directors with management responsibility need a forum at which the direction of the company is determined. The committee is generally chaired by the CEO, and the King II Report (in the model committee mandate) suggests at least five executive directors should sit on the committee (although this number should be appropriate in relation to the size of the company and the full Board). There is no need for nonexecutives to form part of this committee.

The committee has the responsibility for ensuring that the strategy determined for the company is appropriate, and to oversee the day-to-day implementation issues. The committee is also responsible for recommending senior management appointments or removals, and for the evaluation of those senior managers that are not directors.

In practice, in a group or large company, further sub committees are usually formed to take responsibility for the various divisions and subsidiaries with different business focuses, risks and issues.

The Executive Committee is charged with making recommendations to the Board on, amongst other matters, the following:

- Significant financial issues such as accounting choices, the approval of the annual financial statements and the consideration of any matters of opinion contained in these financial statements.
- Where additional capital is to be raised either through a fresh issue of shares or through large additional borrowings.

- Overseeing changes to the company's memorandum and articles.
- The appointment of the company secretary of the company.
- The development of a strategy for communication with the shareholders.
- The consideration of the recommendations made by the Nomination and Remuneration Committees.

Other Sub-Committees

The King II Report suggests that additional committees may be appropriate, depending on the circumstances of the company.

One such committee is the Employment Equity and Skills Retention Committee. The objective of this committee is to determine a comprehensive human resources strategy to ensure that the company attracts and retains the appropriate blend of skills.

Another suggested committee is the Environmental, Health and Safety Committee. The role of such a committee would be to identify and respond to any significant environmental, health or safety risks impacting the business.

Relationships within the company

The Board's relationship with the shareholders

The Board of Directors is ultimately accountable to the owners of the company. The shareholders therefore need to evaluate the performance of the Board to the extent that they are able to. By exercising their rights to appoint and remove the directors of the company, the shareholders effectively control the Board.

In most instances, however, the shareholders would not have access to the detailed decisions taken by the Board, and consequently are not in a position to evaluate the success or failure of each decision made by the directors.

“The directors should encourage shareholders to attend annual general meetings, at which the directors should be present, and more particularly the Chairpersons of each of the board's committees especially the audit and remuneration committees”.

- King II Report Section 1 Chapter 1

Directors are not required by law to attend general meetings of the shareholders. It is, however, general practice for the directors to attend the meetings to maintain a channel of communication between the shareholders and the Board.

Usually the Chairperson of the Board also acts as the Chairperson at a general meeting. However, depending on the company's Articles, the members may be able to appoint their own Chairperson.

The Board's relationship with the company secretary

“The Chairperson and the board will look to the company secretary for guidance on their responsibilities and duties to which they are subject, and how such responsibilities and duties should be promptly discharged in the interests of the company”.

- King II Report Section 1 Chapter 10

The Companies Act in section 268A requires that the directors of every public company having a share capital should appoint a company secretary. This individual is required in terms of the Act to have (in the opinion of the directors) sufficient relevant experience and knowledge to perform this function adequately. In addition, the secretary should be permanently resident in South Africa.

“The company secretary must guide the board, collectively, and each director, individually, as to their duties and responsibilities and make them aware of all legislation and regulations relevant to the company”.

- King II Report Section 1 Chapter 10

The Act in section 268D allows that the role of the company secretary be performed by a body corporate or partnership, provided that at least one of the members or partners possesses the required knowledge, and is resident in South Africa.

The directors have the power to remove the company secretary. The removed individual has the right under section 268I of the Act to place a statement setting out his or her objections to the removal in the annual financial statements of the company.

Where there is a casual vacancy of the company secretarial position, the directors have 90 days to find a replacement. The same restrictions on persons being appointed as directors apply to the appointment of the company secretary, apart from the fact that the company secretary does not have to be a natural person.

“The company secretary should be subjected to a fit and proper test in the same manner as is recommended for new director appointments”.

- King II Report Section 1 Chapter 10

The Act, in section 268G, sets out the duties of the company secretary as follows:

- providing the directors of the company collectively and individually with guidance as to their duties, responsibilities and powers.
- making the directors aware of all laws and legislation relevant to or affecting the company and reporting at any meetings of the shareholders of the company or of the company's directors, any failure to comply with such law or legislation.
- ensuring that minutes of all shareholders' meetings, directors' meetings and the meetings of any committees of the directors are properly recorded in accordance with section 242.
- certifying in the annual financial statements of the company that the company has lodged with the Registrar all such returns as are required of a public company in terms of this Act and that all such returns are true, correct and up to date.
- ensuring that a copy of the company's annual financial statements is sent, in accordance with section 302, to every person who is entitled thereto in terms of this Act.

As can be seen from the above duties, the company secretary plays a pivotal role in assisting and supporting the directors of the company.

“The company secretary should also help to carry out corporate strategies by ensuring that the board's decisions and instructions are clearly communicated to the relevant persons”.

- King II Report Section 1 Chapter 10

In the past, the role of company secretary was often delegated to individuals who were meticulous in record keeping, but not much more was usually required from the individual.

The secretary, however, plays an important part in educating and inducting new directors to the Board. This role is enforced by the King II Report. In the United Kingdom for instance, the company secretary is an important and powerful individual in the company.

The King II Report suggests that a further important function of the secretary is to ensure that the directors receive all relevant information in their board papers. Such information should be complete to allow for an informed decision to be made; concise to ensure that the directors do not suffer from information overload and timely to be of any use to the directors.

The secretary often acts as a vital link between management and the directors, where there are not sufficient executive directors on the Board to effectively communicate any decisions to those who need to implement them.

In addition, the King II Report suggests that the company secretary should act as the first port of call for questions raised by the company's shareholders. He or she should ensure that all shareholders are treated fairly and equally.

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“The company secretary needs also to be available to provide comprehensive practical support and guidance to directors, with particular emphasis on supporting the non -executive directors and chairman”.

- King II Report Section 1 Chapter 10

The Board’s relationship with management

The directors have the power to appoint and remove the management of the company, unless the manager is also a director of the company, in which case the shareholders are responsible for his or her appointment or removal.

In practice however, it is often the Board that takes decisions on executive director appointments, with shareholder approval being a “rubber-stamping” exercise.

It is management’s responsibility to provide the directors with all relevant information that they require to make an informed decision as to the financial and operational affairs of the company.

In exceptional circumstances, managers who are not directors may attend directors’ meetings. This may be the case where, for some reason, the directors require that a key member of management is required to explain or clarify an issue for the benefit of the Board.

Where executive directors play a dual role, the individual should ensure that he or she is able to detach him or herself from their role as a manager of the company when representing the interests of the shareholders on the Board of Directors.

The Board’s relationship with the external auditors

The Board is not in a position to appoint or remove the external auditors without authority from the shareholders. From a practical point of view, the audit committee generally makes recommendations regarding the appointment, removal and remuneration of the external auditors to the full Board.

The shareholders often delegate the responsibility for such issues to the Board.

“The audit committee and the external auditors should develop a strong and candid relationship. Lines of communication and reporting should facilitate independence from management and encourage the external auditors to speak freely, regularly and confidentially with the audit committee “.

- King II Report Section 5 Chapter 1

In turn, the Board often delegates the interaction with the external auditors to the audit committee. Significant audit and accounting issues are, however, the responsibility of the full Board.

It is the function of the audit committee to address any unresolved differences of opinion that the external auditors have with management. The King II Report recommends that the committee enquire of the auditor and management as to whether the management have engaged in any “opinion shopping” (where management engage an auditor who will provide an opinion on an issue that suits their purposes). Opinion shopping is viewed in a serious light.

The Board’s relationship with internal audit

The internal audit function offers the Board an objective review of the internal control systems within the company. The King II Report suggests that the function should be staffed with appropriate individuals who are well respected within the organisation.

“Internal audit is responsible to both the Board and executive management, providing them with reasonable assurance regarding the effectiveness of the company’s corporate governance, risk management and system of internal control.”

- King II Report Section 3 Chapter 1

Generally the internal audit function falls under the administrative control of the CEO of the company. In terms of reporting, however, the head of internal audit should have regular access to the audit committee, and the Chairperson of that committee in particular.

It is recommended that the charter of the internal audit function should comply with the guidance published by the Institute of Internal Auditors. In particular, the King II Report suggests that the role of internal audit be to:

- Provide assurance that management is in a position to effectively identify and respond to significant risks impacting the company.
- Ensure that the internal controls of the company are operating efficiently and effectively.
- Review and report on the risk management processes in place at the company.
- Provide a reasonable level of assurance on the information being provided to the Board by management.

The directors are required to take responsibility for the state of the internal controls at the company. In order to discharge this responsibility, the directors have to take a certain amount of reliance from the work performed by the internal audit department.

It is vital that each member of the Board understands the significant risks impacting the company, and is therefore able to make an informed decision on the appropriateness of the focus of the internal audit function, as well as the work

performed to draw an opinion on the functioning of the controls in place to mitigate the business, operational and financial risks.

Where the directors feel that there are significant risks that are not being sufficiently managed, they should be able to look to the internal audit function to work with management in creating and maintaining a comprehensive risk management plan to manage these risks.

The King II Report also recommends that the internal audit function play a role in identifying and evaluating the process by which the goals and values of the company are established, communicated and measured. This process is vital to ensure that management is accountable for achieving the strategies of the company that are decided on by the directors.

Communication with stakeholders The Directors' Report

“Companies should make every effort to ensure that information is distributed via a broad range of communication channels, including the Internet; having regard for its security and integrity while bearing in mind the need that critical financial information reaches all shareowners simultaneously”.

- King II Report Section 5 Chapter 5

The Companies Act requires in section 299 that every company is required to present a directors' report (unless the company is a wholly-owned subsidiary of another company registered in South Africa). As this report is considered part of the financial statements of the company, it is subject to review by the auditor.

The Act requires the directors to discuss in the Directors' Report any matter which will aid in the user's understanding of the company's affairs, and the financial statements in particular.

Schedule Four of the Act requires that certain additional, specific disclosures be shown. These disclosures should be in narrative form under the appropriate headings, with the exception of statistics or amounts which may be presented in tabular form. Where amounts are disclosed, the comparative amounts for the preceding period must also be shown.

The following information is required by Schedule Four:

- “the nature of the business of the company and of its subsidiaries, if any, and any major change therein during the accounting period;
- in aggregate figures the amounts and particulars of any shares, convertible instruments and debentures issued during the accounting period and the purposes for and circumstances in which such shares, convertible instruments and debentures have been issued;
- any major change in the nature of the fixed assets of the company and of its subsidiaries, if any, during the

accounting period or any change in policy relating to the use of fixed assets;

- the amount, if any, already paid or declared or proposed to be paid by way of dividends in respect of each class of shares;
- the fact that the business of the company or any part thereof or of a subsidiary has been managed by a third person or a company in which a director has an interest, under any agreement during the accounting period (if it has been so managed) and the names of such third person or company and the director's interest in such company, if material;
- the names of the directors and the secretary, the secretary's business and postal address, and any changes during the accounting period; and
- the name of the company's holding company and its ultimate holding company, if any, and if any such holding company has been incorporated in a foreign country, the name of that country.”

It is not necessary for the above information to appear in the directors' report itself but, if the information is not contained somewhere else in the annual report, it must be disclosed in the directors' report.

Where the company is a holding company (in other words the company has an interest in one or more subsidiaries), Schedule Four requires the following information regarding each “principal” subsidiary to be disclosed in the directors' report:

- “the name and, if incorporated in a foreign country, the name of that country;
- if any of the businesses, or part thereof, of any subsidiary controlled by the holding company, have been managed during the accounting period by any third person under an agreement, that fact and the name of such third person; and
- if the financial year of any subsidiary did not end with that of the company
 - (i) the reasons for that fact; and
 - (ii) the accounting period of such subsidiary in respect of which the information has been included in the annual financial statements of the holding company.”

The above information is often shown within an annexure to the financial statements, especially when there are a number of subsidiaries within the group. The directors would usually not refer to those subsidiaries that are essentially “shell” companies, with no assets, liabilities or trading activity.

In addition, the following information regarding each material subsidiary is to be shown (including where the company held an interest in a subsidiary in the prior year but not at the end of the current year):

- “the amount of its issued capital of any class, the percentage thereof held by the holding company, either in its own name or through a nominee or a subsidiary, and any changes in such holdings during the accounting period; and
- the amount of the interest of the holding company consisting of shares in the subsidiary or amounts owing to the holding company (whether on account of loan or otherwise) distinguishing shares from indebtedness and any change in such interest during the accounting period.”

What Company Directors Need to Know About the Companies Act Amendments

This information is again usually shown in the same annexure as that referred to above. The Schedule also requires that the aggregate income after tax and the aggregate amount of losses after tax of the subsidiaries be shown.

Additionally, the directors are required to discuss any material event, fact or circumstance that occurred within the company or its subsidiaries or affiliates between the end of the accounting period and the date of the directors' report.

The directors "should disclose in the annual report the number of board and committee meetings held in the year and the details of attendance of each director (as applicable)". - King II Report Section 1 Chapter 1

The Chairperson's Report

It has become common for annual reports to include a report by the Chairperson of the Board dealing with the general affairs of the group, in addition to the directors' report. This report does not form part of the financial statements, and is not required by the Companies Act, but the report often provides a useful overview of the operations and prospects of the company's operations for the year.

Meetings of directors

The directors may, subject to the company's Articles of Association, meet as often as required. The Articles usually allow any director to convene a meeting.

The King II Report suggests that the directors meet at least once per quarter and more regularly depending on the circumstances of the company throughout the year.

Decisions taken at the meetings are generally on a majority vote. Where the number of votes are equal, the Articles may allow the Chairperson to have the deciding vote. The information relating to the business to be conducted at the meeting is generally distributed ahead of time within a Board "pack" to enable each director to digest the information prior to the meeting.

The quorum necessary at such meetings is usually set out in the Articles.

Section 242 of the Companies Act requires that the minutes of the directors' meetings be kept in an appropriate minute book in one of the official languages of South Africa. Regulation 29 of Appendix II of the Companies Act provides administrative guidance in the maintenance of a minute book.

"Efficient and timely methods should be determined for informing and briefing board members prior to meetings while each board member is responsible for being satisfied that, objectively, they have been furnished with all the relevant information and facts before making a decision".

- King II Report Section 1 Chapter 1

The Chairperson of the meeting (usually also the Chairperson of the Board) should sign the minutes as evidence that they are correct. If the Chairperson of the meeting does not sign the minutes, the Chairperson of the following meeting should sign them.

A unanimous written resolution of the directors is valid, again subject to the company's Articles, provided the resolution is ratified at a subsequent Board meeting.

Section 245 of the Companies Act requires that an attendance register for each meeting of the directors be kept. This register is open to inspection by members of the company (while the minutes of the meetings generally are not publicly available at the discretion of the directors to preserve the confidentiality of the matters discussed).

The Articles of the company usually provide that where a director is absent without leave from the meetings for longer than six months, he or she automatically vacates the position.

4. The powers of the board of directors

The Board often reserves certain powers for itself, either because they are strategically important, or in monetary terms they are significant. This concept is discussed below.

How can a director bind the company?

In terms of section 33 of the Companies Act, the Memorandum of Association of a company sets out the capacity of the company through the use of main and ancillary objects. Section 34 of the Act provides that the company has all such powers (subject to exclusion by the memorandum) to achieve these objects.

It is therefore the directors' duty to use these powers to determine and implement the long term strategy of the company. Where the directors act outside of these powers (ultra vires), section 36 of the Act provides that the act does not become void purely as a result of the fact that it was ultra vires.

Section 214 of the Act provides that where there is some defect in the director's appointment, he or she may still legally act as a director if it was only discovered afterwards that there was something wrong with the appointment. Such a defect would have to be rectified once it was discovered.

It is the Board of Directors generally that has the power to contract on behalf of the company. Individual directors or members of management do not have such authority, unless the authority is expressly delegated on them by the Board. Often such delegation occurs through the terms of reference of a position within the company, for example the position of managing director.

The Board often reserves certain powers for itself, either because they are strategically important, or in monetary terms they are significant. This concept is discussed below.

Reservation of powers

As the Board of Directors bears the ultimate responsibility for the actions and performance of the company, it is usually considered appropriate that certain decisions may only be taken by the Board itself.

In many instances, monetary limits are set for each level of responsibility within the company. For example, when authorising capital expenditure, limits for authorisation may be set for the divisional manager, the group financial director and the managing director. Any projects exceeding the managing director's limit would then need to be authorised by the Board itself.

Further examples of when different levels of responsibility may be designated for the various tiers of management (or may be reserved only for the Board to decide upon, depending on the materiality or strategic nature of the decision) are:

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- Mergers, acquisitions and disposals of parts of the business
- Decisions regarding the use of auditors, consultants and other outside agencies
- Strategic marketing decisions affecting the company's brands and stakeholder communications
- Major tenders to be awarded
- Employee benefits awarded to senior and middle management
- Significant litigation issues

It is therefore appropriate for the Board to prescribe the types of decisions that may be delegated, and those that need to be brought before the Board. In some cases, it is appropriate for the Board to require that certain decisions should be "preapproved" or alternatively subsequently ratified.

The Board should set some level of quantitative materiality for itself to ensure that issues discussed are significant in terms of the company as a whole. These limits may be more complex than a single threshold, and may take into account additional factors such as whether the decision is for an unbudgeted expense.

Which powers are restricted?

The Companies Act reserves certain decisions for the shareholders and consequently the directors require the approval of the shareholders prior to any such decisions being finalised. In some instances the shareholders provide the directors with a general approval for such decisions, which is usually valid until the next AGM, but some decisions need to be voted on individually.

The significant powers reserved for the shareholders are discussed below.

Issue of shares in the company

Section 221 of the Companies Act requires the directors to seek prior approval of the shareholders when issuing shares (unless the memorandum or articles provide otherwise). This approval may be either general or specific. A general authority is valid until the next annual general meeting unless it is revoked by the shareholders prior to this.

Directors who issue shares in contravention of section 221 are liable to compensate the company for any loss suffered by the company, providing any action is brought against them within two years of the issue. However the Court has the power to validate any irregular issue of shares as stated in section 97 of the Act.

Disposal of the business of the company or the greater part of its assets

Section 228 of the Companies Act places a restriction on the authority of the directors when disposing of the "whole or substantially the whole" of the undertaking (business) of the company, or the majority of its assets.

In this situation, the directors would require the shareholders to approve by ordinary resolution such a decision. In addition, depending on the Articles and Memorandum of the company, such a disposal may be ultra vires the powers of the company and may therefore not be permitted.

The Courts have found (in *Novick v Comair Holdings Ltd 1979 (2) SA 116 (W)*) that the test for deciding whether the assets disposed of comprise the greater part of the company's assets is to use the market values at that date. In the same case it was found that the shareholders' approval is not required for a series of transactions which have the effect of disposing of the majority of the company's assets.

Shareholder compacts

In addition to the above restrictions, the shareholders of a company may feel that it is appropriate to enter into a "compact" or agreement with the directors further restricting their powers. This agreement would be legally enforceable until rescinded by the shareholders. When formulating and concluding shareholder agreements, the majority shareholder should be careful not to prejudice the rights of the minority shareholders.

5. Remunerating directors

Remuneration of directors is one of the most hotly debated topics in the corporate governance arena, due mainly to the tension between shareholders demanding to understand their directors' remuneration levels and methods and the directors' desire for the privacy of their financial affairs.

The director's right to remuneration

Both executive and non-executive directors provide services to the company for which they deserve to be remunerated. Executive directors generally enter into an employment contract in which their remuneration (which may take a variety of forms as discussed below) is agreed upon. In many cases, non-executive directors have no formal contract with the company but are paid a standard level of fees for attending Board and sub-committee meetings.

“The shareholders at a meeting duly convened for the purpose, can, if they think proper, remunerate directors for their trouble or make presents to them for the services out of assets properly divisible amongst the shareholders themselves.”

- Re *George Newman & Co* 1895 1 Ch 674 (CA) 686

The Articles of a company generally provide for the remuneration of the directors, both for the services they provide and any expenses that they incur on behalf of the company. Where the Articles do not provide for this remuneration, the directors are not entitled to any payments unless authorised by the shareholders, other than in respect of service as an employee.

In most instances the shareholders are able to determine the remuneration on an individual basis, depending on the perceived value added to the company by the director.

It is recommended that the remuneration committee set well defined criteria against which individual directors should be assessed. Directors often have a number of directorships within the same group, some executive and some non executive. It is therefore not unusual for an individual to receive emoluments in various forms and from various sources.

“No company shall pay to any of its directors (whether in his capacity as a director or otherwise) any remuneration free of any taxation in respect of his income, or otherwise calculated by reference to or varying with the amount of such taxation, or with the rate of taxation on incomes.”

- *Companies Act Section 225 (1)*

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What type of remuneration is appropriate?

Remunerating directors can take a number of forms, and there is ongoing debate as to the most appropriate way of both compensating the director for his or her time, and aligning their interests with the long term interests of the company they serve.

The various types of remuneration are discussed below. It is unusual for a remuneration policy to employ only one type and often a variety of different remuneration methods are negotiated.

“Levels of remuneration should be sufficient to attract, retain and motivate executives of the quality required by the Board.”

- King II Report Section 1 Chapter 4

Cash

While being the most traditional and easy-to-measure form of remuneration, cash can sometimes be the most controversial. When remunerating a director with cash, therefore, the only corporate governance issue is generally the size of the cash payment to the director.

The King II Report recognises the fact that the quantum of a director’s remuneration package should be appropriate in terms of the value that the director adds to the company, bearing in mind the levels of remuneration that the market pays individuals of similar calibre in similar industries.

The company’s own equities

Where a company is listed, and its shares are easily tradable, it is often appropriate to remunerate the directors by issuing them with the company’s shares. The purpose of issuing a director with the company’s own shares is that the shareholders’ and directors’ interests become more closely aligned.

Often a “share incentive trust” or other such vehicle is used to house the shares to be issued to directors and employees. The purpose of such a scheme is to hold these shares in trust on behalf of the beneficiary and is not a trading entity.

One of the problems with this remuneration strategy is that the directors become overly interested in maintaining the short-term share price, sometimes at the expense of the long-term interests of the company itself.

A possible solution to this issue is to lock the directors into holding the shares for a reasonable period of time before they can dispose of them. This does, however, prejudice the individual director from a cash flow perspective, and therefore it is usually preferable to employ a composite remuneration policy.

“Performance -related elements of remuneration should constitute a substantial portion of the total remuneration package of executives in order to align their interests with the shareowners”.

- King II Report Section 1 Chapter 4

In terms of the legalities of issuing shares to directors, section 222 of the Companies Act imposes restrictions on such issues. In terms of this section, shares may be issued to directors only in one of the following circumstances:

- The shareholders have approved the specific issue in terms of an ordinary resolution
- The shares are issued in terms of an underwriting contract over the shares
- The issue is in terms of each shareholders’ existing shareholding
- The issue is on the same terms as offered to the public.

As discussed in the section dealing with insider trading, it is becoming more difficult and onerous for directors to deal in the company’s shares. This may have the result that shares and options in the company’s own equity becomes a less popular choice of remuneration.

Options over the company’s equity

A popular remuneration strategy for both the management and the directors of a company is to issue options on the company’s own shares. The options are usually issued at an exercise (“strike”) price substantially below the ruling share price.

The King II Report recommends that where options are to be issued at a discount, the shareholders should approve this separately.

“A vesting period in relation to the allocation of share options to non-executive directors should be applied to dissuade short-term decision taking, but should also have regard to the possibility or consequences of the removal or resignation of such directors prior to the vesting period maturing and any perceived impact on their independence.”

King II Report Section 1 Chapter 4

In many cases the options issued have relatively short terms to their maturity dates, thereby exacerbating the directors’ incentive to look for short term gains at the expense of the long-term financial health of the company. It is therefore in the interests of the shareholders to ensure that the options have appropriate vesting periods.

A perceived benefit of issuing both equities and options is that the shares issued are seen as “free” to the company, with no

impact on the earnings of the company. Such a perception, however, is not entirely accurate as any shares issued at less than market value dilute the existing shareholders' interests in the assets and earnings of the company.

In addition, accounting standards require companies to reflect share-based compensation as an expense in the income statement.

The issue of options to directors is regulated by section 223 of the Companies Act. The Act requires that the issue of the options be authorised by a special resolution of the company. Where the option is genuinely issued to an executive director

in his or her capacity as an employee of the company, no authorisation is required.

A topic that has become increasingly controversial is when the strike prices on options issued to directors and employees are re-priced downwards. The argument normally mooted for such an action is that the current share price has been beset by conditions outside of the control of those running the company.

While this may well be true, it unfortunately highlights another of the shortfalls of remunerating in this fashion which is that generally the beneficiaries of the options are not being directly compensated for their decisions.

It is common that the Articles of a company require that when such a re-pricing occurs, the shareholders' approval should be sought. This concept is endorsed by the King II Report, which in addition recommends that all relevant information should be provided to the shareholders prior to them voting on the proposals individually.

Loans to directors

Section 226 of the Companies Act restricts the instances in which a loan may be advanced to a director. In particular, the Act states that a loan may not be made to a director of the company itself, the company's holding company or the director of a fellow subsidiary.

This restriction includes making a loan to an entity controlled by the director, or providing security on behalf of such a director. Exceptions to the restrictions include the following instances:

- Where the shareholders provide their prior, specific approval through a special resolution. This only applies to loans to, or security provided to a director (or entity controlled by the director) of the company itself.
- The loan is genuinely to allow the director to incur expenses on behalf of the company (either with the prior approval of the shareholders or with the condition that the loan will be repaid within six months of the next AGM).
- Where the loan is in the ordinary course of business of a company which regularly makes such loans.
- The loan is for the provision of housing, and the shareholders have approved via an ordinary resolution.
- Where the loan is to enable the executive directors to purchase shares in the company with respect to an employee share scheme.

- The loan is to a director of a subsidiary company and the director is not also a director of the company itself.

Compensation for Loss of Office

The Companies Act in section 227 requires that where payments are made related to the loss of office of a director (including payments on the retirement of a director and payments pursuant to a takeover of the company), such payments may only be made where the payment has been approved by special resolution by the shareholders.

The section does not apply to genuine payments for breach of contract, or pension payouts.

Disclosure of directors' emoluments

Section 297 of the Companies Act regulates the disclosure in the company's annual financial statements of the directors' emoluments.

“Companies should provide full disclosure of director remuneration on an individual basis, giving details of earnings, share options, restraint payments and all other benefits.”

- King II Report Section 1 Chapter 4

The information is required by the Act in aggregate but split between executive and non-executive directors. The JSE Listings Requirements, however, require that the information be reflected by individual director.

It is encouraging that more and more listed companies are compiling comprehensive remuneration reports which go far beyond the legislative and regulatory disclosure requirements.

These reports are increasingly reflecting not only the actual remuneration, but the justification for the levels of remuneration for each individual director in relation to the performance of the company for the period.

Where consolidated financial statements are provided, the information disclosed in terms of the Act relates only to the holding company's directors.

In terms of best practice however, it would be recommended that the company should also reflect the remuneration of directors of subsidiary companies. This would remove any instances where directors structure their employment contracts through subsidiaries to avoid making public disclosure of their remuneration.

The amounts are to include all payments made by the company, its subsidiaries and any other party. The Act gives the auditor of the company the power to call for all relevant information from the individual directors. Where the information is not furnished, the director is guilty of an offence.

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This disclosure is to be provided in the following broad categories:

Emoluments

The Companies Act defines emoluments as being directors' fees, basic salary, bonuses or other performance related awards, expense allowances, non-cash receipts, gains made on the exercise of share options (market price of the shares less any amounts paid by the director) as well as any contributions to pension schemes not reflected in the next category.

The JSE Listings Requirements require that the details of share options be disclosed, including the strike price and period, and the price at which the option was exercised.

Pensions

The information required by the Act relates to any payment made by the company (or another party) to a pension scheme on behalf of the director, or any pension paid directly by the company (or another party) to the director.

“It is not considered appropriate that an executive director's fixed- term service contract, if any, should exceed three years. If so, full disclosure of this fact with reasons should be given, and the consent of shareowners should be sought.”

- King II Report Section 1 Chapter 4

Where a director receives a pension from a pension scheme, this does not form part of the information to be disclosed.

The information is to be split between pensions in respect of services as a director of the company or its subsidiaries and other services.

Compensation for Loss of Office

The Act requires that this information be split between compensation for loss of office of director, and other offices lost, and also between the source of the payment being the company itself, its subsidiaries and any other party.

Details of service contracts

The Act requires that details and reasons therefor of a director's service contract with the company must be disclosed where that contract has a notice period in excess of one year and the contract includes provision for payment of compensation on termination.

Also, where a director is up for election or re-election at the AGM, the unexpired term of any service contract with the company must be shown. Where there is no service contract, this fact must be stated.

Shares

The JSE Listings Requirements require that the directors' interests in the share capital of the company be shown, in both a beneficial and non beneficial capacity. This

information is to be shown both in aggregate and by individual director.

Loans to directors

Section 295 of the Companies Act requires that information relating to loans provided to directors be disclosed. This includes disclosure of the details of all loans made to and security provided on behalf of directors during the year (including loans that have been repaid and security that has been cancelled).

Section 296 of the Act requires disclosure of the details of loans made to or security provided on behalf of directors prior to them becoming directors where the loan was still in existence at the date of appointment as a director.

“The overriding principle of full disclosure by directors, on an individual basis, should apply to all share schemes and any other incentive schemes proposed by management.”

- King II Report Section 1 Chapter 4

6. Assessment, removal and resignation

“The Board, through the nomination committee or similar Board committee, should regularly review its required mix of skills and experience and other qualities such as its demographics and diversity in order to assess the effectiveness of the Board as a whole.”

- King II Report Section 1 Chapter 6

Assessment of performance

The assessment of the Board of Directors (collectively and individually) is becoming a critical success factor in any effective system of corporate governance. In capital markets such as the United States, where the level of shareholder activism is far greater than in South Africa, it has become common practice for directors, and in particular the CEO to be evaluated against the company's results. Where the results have not been consistent with the shareholders' expectations, it is almost inevitable that the individuals concerned are removed from his or her post.

The King II Report recommends that formal evaluations on all the directors be performed by the chairperson. These evaluations should be reviewed by the nomination committee to be used in assessing whether the Board requires additional skills, or that certain members of the Board are not performing according to expectations. Due to the costs of initiating a new director, where possible it would be preferable for the existing directors to acquire any skills that the Board lacks, rather than to have to seek to expand the Board.

The review should be “by means of a self-evaluation of the Board as a whole, its committees and the contribution of each individual director. The evaluations should be conducted at least annually”

- King II Report Section 1 Chapter 6

Where the evaluations reveal a lack of performance by an individual, the King II Report suggests that this information be communicated to the remuneration committee, and that that committee take the appropriate action in relation to the director's compensation.

Why a director may be removed

Directors may be removed for a number of reasons. In some cases, the results of the evaluations discussed above may reveal the fact that an individual does not have the appropriate personality traits or other skills to continue to serve the Board.

In other cases the director becomes legally disqualified from his or her post as director, in terms of the Companies Act or other legislation. In some cases a director is removed not due to his or her performance (or lack

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thereof). When the nomination committee assesses the skills and balance of the Board, the conclusion may be that the Board is overloaded with certain skill sets, and unfortunately individual directors with redundant skills or experience may have to make way for others who possess the attributes that the Board requires.

The Articles of a company often provide that where a director becomes interested in a contract with the company, and he or she fails to declare that interest to the Board, that the director's office must be vacated.

Rotation of directors

The Articles of a company generally provide that a certain number or percentage of directors resign every year and offer themselves for re-appointment. The intention of such a provision is so that the shareholders will actively consider whether the director is performing according to their expectations, and where he or she is not performing, they will not be re-appointed.

Generally, the Articles will require that all directors retire at the first Annual General Meeting ("AGM") of the company, and that one third of the directors retire annually thereafter. It is usually the directors that have served the longest that are to retire, but where the directors have served an equal period of time, their retirement is to be selected by lot. Schedule 10 of the JSE Securities Exchange Listings

Requirements ("the JSE Listings Requirements") requires such provisions to appear in the Articles. The Schedule does however provide for the exception where a managing director or other executive director has a contract with the company, he or she does not have to retire so long as they are employed by the company. They would not be taken into account when determining the number of directors that need to retire annually.

"A brief CV of each director standing for election or reelection at the Annual General Meeting should accompany the notice contained in the annual report."

- King II Report Section 1 Chapter 1

Where a director is re-appointed, the director does not need to provide his or her consent to the appointment again.

In addition, the directors may have the power to appoint a director to the Board, provided that such an appointment is ratified by the shareholders at the following annual general meeting. Schedule 10 of the JSE Listings Requirements requires that any appointment of a director needs to be confirmed at the next AGM of the company. In general, the shareholders are not under any obligation to fill the vacancy left by a retiring director, unless the number of directors has fallen below the minimum required by the Companies Act, the Articles or the JSE Listings Requirements where the company is listed.

Where the minimum number of directors in terms of the Articles has been reached, a retiring director may be deemed to have been re-appointed where the shareholders do not fill the vacancy at the meeting even if they decided not to reappoint that particular director.

Where the number of directors falls below the number required in the Articles, Schedule 10 of the JSE Listings Requirements states that the Articles should contain a provision limiting the powers of the directors to filling the vacancy or to call a general meeting. In addition, the Articles may require that an individual may not be appointed as a director unless his or her name had been included in the notice of the meeting as a potential appointment.

The legal mechanics of removal

Section 220 of the Companies Act provides for the removal of a director prior to the end of his or her term of office.

Any such removal is, however, subject to the Articles of the company and any contract that the director has entered into with the company.

Any removal has to be sanctioned by the shareholders of the company. An ordinary resolution is generally sufficient for this purpose. However special notice (at least 28 clear days) needs to be given to those attending the meeting.

The Act provides the director concerned with the facility to air his or her grievances regarding the impending removal. The director is allowed the opportunity to make written representations to those attending the meeting. These representations are attached to the notice of the meeting, or if received too late for inclusion with the notice, may be read out at the meeting. Any person who feels that the representations may prejudice them, or that the opportunity is being used for needless publicity, may apply to the Court to stop the representations being communicated to the members.

"(A) director, once having given in the proper quarter notice of his resignation of his office, is not entitled to withdraw that notice, but, if it is withdrawn, it must be by the consent of the company properly exercised by their managers, who are the directors of the company. But, of course, that is always dependent upon any contract between the parties, and that has to be ascertained from the articles of association."

- Glossop v Glossop 1907 2 Ch 374 & 375

Where the director does have a valid contract with the company, compensation may have to be paid to the director, as removal would in most instances constitute a breach of the contract (unless of course the removal is due to the fact that the director breached the contract in the first place).

Any such payments should be reflected in the schedule of directors' remuneration in the annual financial statements of the company.

Formalities when a director resigns

A director generally resigns his or her office by providing the company with a notice of this intention (usually in writing in terms of the Articles of the company). From a practical point of view it would be preferable to have written record of the resignation.

In addition, the relevant form needs to be sent to the Registrar. In terms of the JSE Securities Exchange South Africa Listings Requirements, listed companies must report to the JSE when a director resigns or is removed from the Board.

The ease with which the director is able to resign will be a function of the existence of any contract between the director and the company, and whether in addition the director acts as an employee of the company.

7. Personal liabilities of directors

Serving as a director of a company (both public and private) is becoming a more and more hazardous occupation. Shareholders, legislators and other interested parties are increasingly looking to hold individuals responsible for company failures. Even when companies do not fail, shareholders are looking to recoup losses due to perceived bad decision making.

The Companies Act, as well as numerous other pieces of legislation, provide for criminal or civil prosecution against directors. It would be impossible to mention all such sections here. However some of the more common or important issues in this regard have been highlighted below.

Directors' legal position in terms of the Companies Act

The primary piece of legislation dealing with the situation when directors are being sued in their official capacity is the Companies Act.

Section 247 of the Act prevents the company from indemnifying its directors from liability under the common law. The Act does, however, provide that a company may indemnify the director against a loss suffered in an action where he or she is sued, but is acquitted (for example the legal fees incurred in defending the action).

In addition, the company is able to take out insurance on behalf of the director for such instances (professional indemnity insurance).

When being sued in connection with a breach of duty or trust or negligence, a director may apply to the Court for relief in terms of section 248 of the Act. This section provides the Court with the power to dismiss any action against a director in this instance where, in the opinion of the Court, the director acted "honestly and reasonably."

It may be difficult to convince a Court, on the balance of probabilities, that the director acted honestly and reasonably when being sued for negligence or a breach of trust. In many cases, the decision may hinge on the implied skill and experience of the individual as perceived by the Court.

Directors' liability for the debts of the company

The Companies Act itself provides for a number of instances where directors become liable for the debts of the company. These cases are listed below.

Where provided by the Memorandum

Section 53 of the Act allows for the inclusion in the Memorandum of a private company the provision that all directors (both present and past) are jointly and severally liable for the debts of the company that were incurred during their term of office.

While all private companies are able to include such a provision, it is usually those within certain professions such as companies of attorneys or auditors where personal liability is a necessity in terms of their professional

standards. The advantage of such a corporate structure over a partnership would be perpetual succession of the legal entity.

Where such a provision were to be included in the Memorandum subsequent to incorporation of the company it would require both a special resolution and written consent of the existing directors in terms of section 56(2) of the Act (as the directors are directly affected by the change).

In terms of Section 49 of the Act, such a company has to be referred to as "Incorporated" instead of a "(Proprietary) Limited" company.

Use of the Company's Name

Section 50(3) of the Act imposes stringent duties on the directors in terms of the use of the company's name when signing cheques or other means of payment.

The Act provides that a director becomes liable for the specific debt of the company if he or she:

- "(a) uses or authorizes the use of any seal purporting to be a seal of the company whereon its name is not so engraved as aforesaid; or
- (b) issues or authorizes the issue of any notice or other official publication of the company, or signs or authorizes to be signed on behalf of the company any bill of exchange, promissory note, endorsement, cheque or order for money or goods, wherein its name is not mentioned in manner aforesaid; or
- (c) issues or authorizes the issue of any letter, delivery note, invoice, receipt or letter of credit of the company wherein its name is not mentioned in manner aforesaid."

In addition, the director is guilty of an offence in such a situation.

Failure to fill a casual vacancy for the company's auditor

Section 280 of the Act allows the directors three months to fill a casual vacancy caused by the resignation of the auditor of the company. The three months commences from the time the written notice from the auditor is received by the Registrar.

Where the vacancy has not been filled within three months, any director holding office between the time that the three month period expires and the position is filled is jointly and severally liable for the debts of the company incurred during that period.

Reckless trading

The Act in section 424 sets out the instances where directors or other parties become personally liable for the company's debts in terms of what is termed "reckless trading".

"the mere carrying on of business by directors does not constitute an implied representation to those with whom they do business that the assets of their company exceed its liabilities. The implied representation is no more than that the company will be able to pay its debts when they fall due."

- In re Carbon Developments (Pty) Ltd 1993 (1) SA 493 (AD)

Reckless trading is defined as the situation where "any business of the company was or is being carried on recklessly or with intent to defraud creditors of the company or creditors of any other person or for any fraudulent purpose."

Generally reckless trading is understood to mean that the company is unable to pay the party with whom it is transacting in the ordinary course of business.

Where the Court decides that the company (even if it is in the process of being wound-up or is in judicial management) was trading recklessly, any person that knowingly contributed to such trading may be held personally liable for any or all of the debts of the company.

"If a transaction is part of the business of the company and it is executed recklessly or with intent to defraud creditors of the company or for any fraudulent purpose, it matters not... that it is done once or as part of a series of acts. In either case the guilty person may be visited with personal responsibility in terms of the section."

- Gordon and Rennie NNO v Standard Merchant Bank Ltd 1984 (2) SA 519 (C)

The creditors do not need to establish the link between the action of the accused parties and the debts that they are owed. This section therefore works in addition to the common law, as it helps those who are aggrieved to claim damages when it may be difficult to prove the link between the actions and the losses incurred.

Share buy-backs

Section 85 of the Act was brought into being in 1999 and for the first time allows a company to repurchase its own shares. One of the requirements for such a transaction is that, after the repurchase, the company must be able to pay its debts in the ordinary course of business and the consolidated assets of the company must exceed the consolidated liabilities.

Where the above section is contravened, section 86 of the Act requires that the directors pay to the company the amounts distributed in terms of the repurchase. It is therefore in the directors' interests to try to force the shareholders to repay the amounts.

Issue of a prospectus

The issue of a prospectus for the subscription or sale of shares in a company is considered essential to the workings of efficient capital markets. The legislature has therefore taken a tough stance on false or misleading statements made by directors in prospectuses.

In terms of section 160 of the Companies Act, where any untrue statements are made in a prospectus, the directors

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become liable to any person who, as a consequence of relying on the statements within the prospectus, suffered a loss.

The definition of a director in this section is very wide, and includes the current directors and any person who becomes a director between the issue of the prospectus and the first general meeting where directors are appointed. In addition, the promoters of the company and any individual who authorised the prospectus for issue may bear liability for the statements contained therein.

The section contains a number of defences for directors where they genuinely believed the statements to be true, or where they had withdrawn their consent to be named in the prospectus as a director. In addition, section 162(3) of the Act provides additional defences for directors in this regard, including where a statement is deemed immaterial.

Apportionment of damages

The release of the Apportionment of Damages Act makes it easier for plaintiffs to sue more than one party at a time. In the case of company failures, it has become common practice for the aggrieved creditors and shareholders to sue those parties with the “deepest pockets” namely the auditors, and occasionally the directors (although most directors of failed companies manage to alienate their assets prior to being sued).

In such instances, it will become more likely that the directors, together with any other relevant party, will be sued jointly under this Act.

Insider trading

The promulgation of the Insider Trading Act in 1998, which effectively replaced the insider trading provisions of the Companies Act, was a move towards a more regulated environment in terms of trading in securities. The Insider Trading Act was repealed by the Securities Services Act 36 of 2004, which aims to enhance confidence in the South African financial markets by requiring that securities services be provided in a fair, efficient and transparent manner. The Act provides for various mechanisms including prohibition of insider trading which are aimed at promoting the protection of regulated persons and clients; reduce systemic risk; and promote the international competitiveness of securities services in the Republic.

The Securities Services Act provides for both criminal and civil prosecution of any individual found guilty of insider trading and gives greater powers to the Financial Services Board to regulate any wrongdoing with regards to the dealing in securities.

As such, the Act is a very relevant piece of legislation for directors who receive and trade in their company's securities.

Inside information

The Act defines inside information as being: “specific or precise information which has not been made public and which:

- a) is obtained as an insider; and
- b) if it were made public would be likely to have a material effect on the price or value of any security listed on a regulated market.”

An insider

An insider is defined by the Act as an individual who “has inside information:

- a) through
 - (i) being a director, employee or shareholder of an issuer of securities listed on a regulated market to which the inside information relates; or
 - (ii) having access to such information by virtue of employment, office or possession; or her employment, office or possession; or
- b) where such person knows that the direct or indirect source of the information was a person contemplated in paragraph (a)

The definition of an insider is therefore far-reaching. It is probable that a director, as a result of his or her privileged position within the company, has access to a constant stream of unpublished price-sensitive information, and consequently needs to exercise extreme caution in his or her dealings in the company's securities.

Closed periods

A practice that has become more common in South Africa is for companies to establish “closed periods” during which the directors and management may not trade in the company's shares.

This practice was endorsed by the King II Report which recommended that the company's Board should establish a formal policy for dealing in the company's shares during times where the company has price-sensitive information.

The Report further recommends that this policy be implemented by the company secretary.

The JSE Listing Requirements prohibit company directors and the company secretary from dealing in securities of the company during a closed period, as defined:

- From the date of the close of the financial period (quarter, half-year or financial year) to the date of publication of the company's results for that period.
- While the company is trading under a cautionary announcement.
- Whenever the director has unpublished price-sensitive information.

In virtually all instances, it would also be necessary to increase the closed period to a defined length of time prior to the end of the financial period as a large amount of price sensitive information is usually available during this time.

In addition, all trades by directors be authorised in writing by the Chairperson of the Board, or another director designated for that purpose.

Currently, the JSE requires disclosure of trading in the company's shares by directors on SENS, as well as disclosing full particulars of all transactions (including off market transactions) in securities of the company entered into by or on behalf of:

- a) director or company secretary of the company
- b) director or company secretary of a major subsidiary of the company

- c) any associate of the company or a major subsidiary of the company
- d) any independent entity, in terms of which the company, major subsidiary or associate of the company may derive beneficial or non-beneficial interest now or in the future.

Directors are also expected to inform their family and other associates, as well as their investment manager, of the periods during which they are not allowed to trade in the company's shares.

It is therefore becoming increasingly difficult firstly for directors to find a period during which it is safe to trade their shares, and secondly to effect the trade itself.

Disclosure

The Act requires that unpublished price-sensitive information be made public to minimise the opportunities of such information being leaked out into the market. Where the information relates to a proposed transaction, the JSE requires that the directors publish a cautionary announcement on SENS, giving the basic details of the transaction under negotiation.

8. Financial institutions

Financial institutions are often viewed as companies with a higher public profile than their counterparts in other industries. These companies therefore often find themselves the focus of more regulation than companies operating in other sectors.

This fact results in the directors of these financial institutions being entrusted with added disclosure and performance responsibilities.

All financial institutions that are companies are regulated by the Companies Act and the case law that interprets it.

Consequently the discussions elsewhere in this guide are equally of application to directors of these institutions. Most financial industries, however, have specific legislation that increases the regulatory environment in that sector. The impact of this legislation on certain financial sectors is discussed in this chapter.

Directors of banks

Directors applying for registration of a bank

The Registrar of Banks is not obliged to approve the registration of a new bank unless certain criteria are met. Section 13 (2) (h) of the Banks Act require that the Registrar must be satisfied that the proposed composition of the Board of Directors is “appropriate having regard to the nature and scale of the business it is intended to conduct.”

In addition, in terms of section 25 (4) of the Banks Act, the Registrar has the power to apply to the Court to cancel or suspend the registration of a bank where the directors or executive officers have committed any offence in terms of the Act.

Fiduciary duties of a bank's directors

While in the case of other companies, the concept of a director's fiduciary duties to the company is a matter of case law, the Banks Act has codified these responsibilities in section 60. This section states that “ each director, chief executive officer and executive officer of a bank owes a duty towards the bank to:

- (a) act bona fide for the benefit of the bank;
- (b) avoid any conflict between the bank's interests and the interests of such a director, chief executive officer or executive officer, as the case may be;
- (c) possess and maintain the knowledge and skill that may reasonably be expected of a person holding a similar appointment and carrying out similar functions as are carried out by the director, chief executive officer or executive officer of that bank; and
- (d) exercise such care in the carrying out of his or her functions in relation to that bank as may reasonably be expected of a diligent person who holds the same appointment under similar circumstances, and who possesses both the knowledge and skill mentioned in paragraph (c) and any such additional knowledge and skill as the director, chief executive officer or executive officer in question may have.

“Each director, chief executive officer and executive officer of a bank owes a fiduciary duty and a duty of care and skill to the bank of which such a person is a director, chief executive officer or executive officer.”

- Banks Act 94 of 1990 Section 60 (1)

The Regulations to the Banks Act further expand on the responsibilities of the directors of a bank.

Regulation 39 requires that each director of a bank acquire at least a basic knowledge of the bank's business, and those laws and regulations that govern it. The Regulation further states that while not every director on a bank's Board necessarily has to have an intimate knowledge of the workings of a bank, each director's knowledge thereof must be evaluated, based on the size and complexity of the bank.

In the case of a director of a controlling company of a bank, his or her required level of knowledge becomes a function of the diverse nature of the banks controlled by that company.

Appointment of directors

When appointing any new director, the Banks Act requires that the particulars of the potential new director be forwarded to the Registrar of Banks at least 30 days before the appointment is made.

The Banks Act in section 60 (3) mandates the appointment of non-executive directors by requiring that at most 49% (rounded down to the next lowest whole number) of the directors of the bank may be employees of the bank or its subsidiaries. Where the bank is controlled by a controlling company, only 49% of that company's directors can be employees of that company or the bank.

In addition, at each directors' meeting, the votes of the executive directors may only count at most 49% of the total votes on each resolution voted on by the Board.

Audit Committee

The Banks Act in section 64 requires that the Board of Directors establish an Audit Committee. Regulation 64 to the Banks Act further requires that at least three directors be appointed to the committee. The majority of directors appointed to the committee must, in terms of section 64 (3) be independent non-executive directors.

The Chairperson of the Board may not serve on the Audit Committee. Also, the Chairperson of the committee may not be an executive director.

The Banks Act in section 64 (4) allows an exemption from creating an audit committee in the circumstances where the bank is part of a group of companies and the holding

company has appointed an audit committee that has assumed responsibility for all the banks within the group.

Section 64 (2) of the Act provides guidance for the functioning of the committee. The section states that the primary responsibilities assumed by the members of the committee are to:

“assist the board of directors in its evaluation of the adequacy and efficiency of the internal control systems, accounting practices, information systems and auditing processes applied within that bank in the day-to-day management of its business.”

The members of the committee are therefore required to have a reasonably detailed understanding of the workings of the bank, including the design and operation of the internal controls, the pertinent accounting issues, the information technology applied and the scope and function of the internal audit department.

“facilitate and promote communication, regarding the matters referred to in paragraph (a) or any other related matter, between the board of directors and the executive officers of, the auditor appointed under section 61 or 62 for, and the employee charged with the internal auditing of the transactions of, the bank.”

As in other companies, the audit committee is intended to bridge the gaps between management and the external and internal audit functions at the bank. Any unresolved differences that occur within the three parties must be brought before the committee for resolution.

“introduce such measures as in the committee's opinion may serve to enhance the credibility and objectivity of financial statements and reports prepared with reference to the affairs of the bank.”

It is clear that the audit committee is entrusted with the responsibility for optimising the disclosures made by the bank, whether in the annual report or in the statutory returns made to the Registrar of Banks.

Responsibilities of a director

The Regulations to the Banks Act provide guidance for directors in carrying out their responsibilities.

Regulation 38 states that the Board of Directors is responsible for establishing an effective corporate governance process within the bank. The scope of this process is intended to be consistent with the risks, complexity and nature of the bank's operations. Sub-committees may be established to assist the Board in carrying out these corporate governance processes.

The regulation stresses that a bank's business revolves around the effective management of the different risks impacting the bank. These risks are listed in the regulations as:

- Solvency
- Liquidity
- Credit

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- Currency
- Market or position risk
- Interest-rate
- Counterparty
- Technology
- Operational
- Compliance

“In view of the fact that the primary source of funds administered and utilised by a bank in the conduct of its business is deposits loaned to it by the general public, it shall be the duty of every director and executive officer of a bank to ensure that risks that are of necessity taken by such a bank in the conduct of its business are managed in a prudent manner.”

- Regulation 39 (3) to the Banks Act 94 of 1990

The Board has the responsibility for evaluating the effectiveness of the corporate governance processes at the bank (or controlling company) on an ongoing basis. While this task may be operationally delegated to a sub-committee of the Board, the responsibility for corporate governance at the bank remains with the Board.

At least once a year the corporate governance assessment is required to be formally documented.

Directors' duty to establish a compliance function

As a result of the numerous pieces of legislation impacting a bank, there is a considerable risk that the bank does not comply with all laws and regulations impacting it. In order to manage this risk, regulation 47 to the Banks Act requires that the directors establish an internal compliance function.

The function should be headed by a compliance officer who has the necessary senior status within the organisation to effectively address the bank's regulatory risk.

To be effective, the Regulation suggests that the compliance function should:

- be independent of internal audit;
- have direct access to, and be supported by the CEO of the bank;
- report to the Board and the Audit Committee on compliance with laws and regulations and submit a copy of this to the Registrar; and
- avoid any conflict of interest with other internal functions.

The compliance function performs an important monitoring role within the bank. The Regulation reinforces this by requiring the following activities to be performed:

- A culture of risk management and compliance should be established.
- Create a channel of communication to line management to monitor compliance with laws and regulations.

- Instil a compliance focus into line management.
- Incorporate regulatory requirements into operational manuals.
- Recommend improvements to ensure greater compliance with laws and regulations.

In terms of reporting, recommendations and findings reported by the compliance officer should be documented together with the action plan for rectifying problems. In order that issues are resolved promptly, the channel for the compliance officer to report problems should always be available and open.

The compliance function should be staffed by capable people that receive regular training to enable them to remain up to date technically with regulatory issues at the bank. A comprehensive compliance manual should be developed and kept up to date.

Reporting by directors

The Board of Directors of a bank is required by Regulation 39 (4) to the Banks Act to report to the Registrar of Banks on certain matters within 120 days of the end of the financial year of the bank, including whether:

- the bank's internal controls provide reasonable assurance as to the integrity and reliability of the financial statements and safeguard, verify and maintain accountability of the bank's assets;
- the internal controls are based on established policies and procedures and are implemented by trained, skilled personnel, whose duties have been segregated appropriately;
- adherence to the implemented internal controls is continuously monitored by the bank;
- all bank employees are required to maintain high ethical standards, thereby ensuring that the [bank's] business practices are conducted in a manner that is above reproach; and
- anything has come to the directors' attention to indicate that any material malfunction, as defined and documented by the board of directors, which definition has to be submitted to the Registrar of Banks, in the functioning of the aforementioned controls, procedures and systems has occurred during the period under review.

In addition, the directors are required annually to report to the Registrar of Banks on the going concern assumption at the bank. Where there is a potential going concern problem, the details thereof should be disclosed.

When making supervisory returns to the Registrar of Banks, both the CEO and Chief Accounting Officer are required to certify that the returns are correct.

Directors of insurance companies Audit Committee

Both the Long Term Insurance Act (in section 23) and the Short-Term Insurance Act (in section 22) require that the Board of Directors establish an Audit Committee unless exempted by the relevant Registrar on the grounds of impracticality or inappropriateness.

The committee must have at least three members, and at least two of those must be directors of that insurance company.

The Chairperson, as well as the majority of the members must be non-executive. The Acts state that the objectives of the committee are to:

- assist the board of directors in its evaluation of the adequacy and efficiency of the internal control systems, accounting practices, information systems and auditing and actuarial valuation processes applied by the insurer in the day-to-day management of its business;
- facilitate and promote communication and liaison concerning the matters referred to in paragraph (a) or a related matter, between the board of directors and the managing executive, auditor, statutory actuary and internal audit staff of the insurer;
- recommend the introduction of measures which the committee believes may enhance the credibility and objectivity of financial statements and reports concerning the business of the insurer, and;
- advise on a matter referred to the committee by the board of directors. The audit committee of an insurance company therefore has a similar brief to that of a financial institution.

9. Corporate Law Reform Programme

The Department of Trade and Industry in South Africa (the DTI) is currently engaged in a comprehensive review of corporate laws in the country. The Corporate Law Reform project seeks to establish a comprehensive legislation and regulatory framework, for the purposes of regulating companies in South Africa as well as addressing the future role of the director.

Background

Post 1994, South Africa has seen fundamental changes in its constitutional framework and political, social and economic environment. However, the extant framework for company law is based on the general principles of English law. The last extensive reform of company law occurred in South Africa in 1973 and hence there was a need to review this law in conformity with a changing economic and global environment in which South Africa companies operate.

The recent string of international corporate failures in the last 5 years has exacerbated need for corporate law reform in the major economies around the world in an effort to restore severely eroded investor confidence. The USA responded quickly with the introduction of the Sarbanes-Oxley Act, while South Africa, the United Kingdom and Australia responded with a corporate law review. Current company law in South Africa does not contain clear rules regarding corporate governance and the duties and liabilities of directors. These matters have been largely left to common law and Codes of Corporate Practices, such as King II Report on Corporate Governance. The aspects of South Africa's corporate reform project that relate to the future role of the director are in line with the reform projects of the United States of America (USA), Canada, the United Kingdom (UK) and Australia.

The DTI policy document on corporate laws, which forms the basis for discussion, was published for public comment on the 24th of June 2004. This review is the first in 30 years and heralds some major changes to the environment in which companies operate. The DTI policy document forms the foundation for the drafting of a new Companies Act which will be released in 2006 when the Companies Act Amendment Bill is enacted.

Objectives of new company law

The DTI believes that Company law should promote the competitiveness and development of the South African economy by:

1. Encouraging entrepreneurship and enterprise diversity by simplifying the formation of companies and reducing costs associated with the formalities of forming a company and maintaining its existence, thereby contributing to the creation of employment opportunities;
2. Promoting innovation and investment in South African markets and companies by providing a predictable and effective regulatory environment and flexibility in the formation and the management of companies;
3. Promoting the efficiency of companies and their management;

4. Encouraging transparency and high standards of corporate governance, recognising the broader social role of enterprises;
5. Ensuring compatibility and harmonisation with best practice jurisdictions internationally.

Scope of the review

The corporate law review includes an overall review of company law (viz, the Companies Act, 1973, the Close Corporations Act, 1984, and common law relating to these corporate entities) but excludes partnership law.

Summary of guidelines for new company law

The policy makes it clear that the overriding principles of corporate law reform should be simplicity of formation and flexibility for businesses. The policy document also contains the following:

- Suggestions to end the distinction between close corporations, private and public companies;
- A possible statutory code of conduct for directors;
- More reporting requirements for companies including remuneration, black economic empowerment, environmental and labour issues;
- The creation of a Companies Commission, with the Companies Tribunal to adjudicate legal matters on the proposed Companies Act. The policy document also proposes greater encouragement to directors, particularly of large companies, to consider stakeholders and their interests in the running of companies. The Review aims to bring the company legislation in line with the Constitution and international developments, enhance corporate governance and improve enforcement of legal standards.

The policy document outlines in broad terms each area of company law that will form part of the focus of the review and indicates broadly the approach to be taken. These broad core areas are:

1. Company formation

The policy suggests that only one formal business vehicle should be recognised and companies should be distinguished on the basis of size of turnover, which will in turn determine their reporting requirement. The policy document asserts that the current distinction between close corporations, private companies and public companies, which is based on shareholding, is artificial and does not allow easy transition from one type of company form to another.

The policy document envisages one model with a series of thresholds: the smaller you are the less the mandatory requirements. The idea is that there will be a lot of flexibility for growth without changing the form of your business,

2. Corporate finance

This includes rules around the issuing of shares and the maintenance of capital. The emphasis here is on the facilitation of capital formation. The policy document emphasizes that maintaining economically unnecessary limitations on equity investment, such as par values and legal capital, in South African companies will put these companies at a competitive disadvantage with companies formed under

the laws of jurisdictions with more modern and permissive statutes. Therefore, as pointed out in the policy document, one of the key aims of new legislation should be to facilitate the raising of capital.

3. Corporate governance

The major focus here is on international best practice, where the tendency has been to adopt additional reporting requirements. A fundamental goal of company law must be the protection of shareholders whose “inalienable rights” must include the right to information, to vote, to call a meeting and to elect directors, through methods including proxy and electronic voting. Crucial to enhanced shareholder activism and protection will be effective remedies. Consideration should be given to a dispute resolution mechanism than can provide recourse to aggrieved shareholders.

One of the most important challenges of the new law will be to clarify the rules governing the conduct of directors and enforcement of the rules. Rights and duties of directors have traditionally existed at common law. As a result there is little consensus on the precise content of fiduciary duties of directors. One option would be to codify these in law through a statutory standard for conduct, which could include outlining “the fiduciary duties, a duty of fair dealing and care and a duty to act in the overriding interests of the company”. This would oblige directors of a company, for instance, to disclose to the board any business opportunity that he or she might reasonably assume the company would be interested in.

Furthermore, disclosure and accurate reporting will be considered “paramount” in the new law. This will include not just financial information but also statements on non-financial information, including Black Economic Empowerment, and compliance with environmental and other imperatives. Annual statements may have to include remuneration and bonuses of all directors and senior managers.

4. Mergers and takeovers

It is suggested that the form of the current Takeover regulation (the Takeover Code) is to remain the responsibility of the Securities Regulatory Panel as it has been largely aligned with international practices. However it will be necessary to review enforcement mechanism and ensure harmonisation and policy consistency of competition law and company law to reduce the compliance burdens on companies.

5. Insolvency and corporate rescues

The emphasis is that there must be a shift, in law and practice, from liquidation of businesses to effective rescue mechanisms.

6. Non-profit corporate entities

This deals with section 21 companies and the emphasis is on the creation of an appropriate regime for the non-profit legal entities to flourish, without the need to treat them as commercial entities as it is the case under the Companies Act, 1973.

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The Changing Role of the Director

Corporate governance review will form the core of the South African corporate law review as has been with many of the international corporate law reform processes. The revisions regarding the role of directors are primarily aimed at improving director accountability, communication between directors and shareholders, and also to enable directors to conduct their duties more effectively. The emphasis of the reform on corporate governance in the South African context consists of 3 components:

Shareholder and investor protection

The director, as agent, trustee and custodian of a shareholders' investment, has the main objective to ensure the investment is protected, allowed to grow and provide a reasonable return to the investor. However, with the advent of multi-national corporations, the distance between shareholders and the board of directors grows, which ultimately affects the perceived influence shareholders have over their investments.

The current role of the director is to protect the interests of the company ahead of all other interests. An expansion of this duty, making directors responsible for the promotion of the company that is in the best interests of the shareholders, and ensuring that shareholders are sufficiently involved, is proposed. This will be promoted by ensuring that company law promotes the 4 basic rights of shareholders: (1) the right to capital, (2) the right to income, (3) the right to vote, and (4) the right to information.

Responsibilities of the board of directors

The current interpretation of the duties of directors evolved from Common Law. However, this is likely to be replaced by a statutory standard/statement of directors' duties in the Companies Act, which will clarify the expected duties of a director, in the setting out of a series of duties that deal with fiduciary duties, the duty of care and skill, the duty to act in the best interests of the company and the duty to identify any business opportunity that comes to the attention of a director. The challenge will, however to remain mindful of common law developments from the courts.

Disclosure and reporting

In terms of South African Company Law, the annual financial statements are required to include a directors' report. This is currently a very restricted report and the policy identifies potential for the inclusion of an operating and financial report which will compel directors to explain the performance of the company under their control and provide shareholders and other interested parties with information that more comprehensively explains the performance of the company. Disclosure is envisaged to cover other non-financial statements of compliance with public interest legislation, including Black Economic Empowerment Act, environmental regulation and labour regulation.

Conclusion

There is no doubt that the proposed changes will have a fundamental impact on the future roles and duties of directors. The key is to be prepared for these changes and to respond to them in a way that will improve the potential

future success of the company in which shareholders have invested their money. More importantly directors should realise that along with the increased professionalism required of them, they will have to undergo a significant amount of training and development. The current Boards need to establish supportive structures for new members by establishing and setting the trend of orientation and continuous learning and development for them to effectively execute their duties, and to ensure their impact on board performance is immediate and in compliance with the requirements of corporate law.

The revised corporate legislation will create a greater need to understand the mix of abilities, skills and competencies required by a board, over and above their combined technical skills. A significant amount of effort will need to be applied to identify the relevant skills and competence levels required by a board of directors of a company, since it is unlikely that the appropriate and diverse abilities will be found in any one individual. If a company has the right combination of skills available, it will stand a better position to protect its business and, ultimately, its shareholders.

10. Companies Act Amendment

The Companies Act Amendment Bill of (Bill) has been initiated through the Department of Trade and Industry Corporate Law Reform Project which is aimed primarily at evaluating the appropriateness of company law to corporations operating in the twenty-first century and addressing the future role of the director under company law. The amendment Bill was approved by Parliament in June 2006, and is expected to be enacted in early 2007.

Introduction

The Companies Act Amendment Bill introduces a number of important and overdue improvements to the Companies Act prior to the anticipated completion of the corporate law reform process which is currently underway. These amendments introduced fall into 6 categories:

- a) amendments required to give legal backing to accounting standards
- b) amendments required to promote and maintain auditor independence;
- c) amendments required to update the requirements for the registration of a prospectus;
- d) amendments required to further the objectives and expedite the procedures of the Securities Regulation Panel;
- e) amendments required to indemnify and impose a duty of confidentiality on inspectors; and
- f) an amendment required to effect a uniform standard of liability on officers performing duties under the Act.

The Bill defines companies as either in the Public Interest or Limited Interest.

A Public Interest company is any company which:

- allows for the unrestricted transfer of its shares in its articles;
- is permitted by its articles to offer shares to the public; or
- decides by special resolution to be a public interest company.

A subsidiary of a Public Interest company is also defined as being a Public Interest company in its own right.

A transfer of shares is unrestricted if it is not subject to an effective right of pre-emption, which is a right of pre-emption which operates in favour of all shareholders of the company and upon every proposed sale of shares to a person who is not a shareholder of the company.

A summary of the significant provisions introduced by the Bill is presented below:

1. Legal backing for accounting standards

The Bill seeks to align South African reporting with International Financial Reporting Standards which is envisaged to be of utmost importance in enhancing foreign investments and maintaining credibility of South African financial markets. In the past decades investors have lost considerable amounts of money due to dubious accounting and a rank overstatement of profitability.

Standard to be imposed

The amendments to Chapter XI of the Act will impose a uniform accounting standard to ensure that any financial information published by a company is calculated in

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accordance with generally accepted accounting practice ("GAAP"). This standard will be developed and maintained by a Financial Reporting Standards Council ("the Council"), to be established under the new Chapter XVB. The standard will need to be comparable with the international standards adopted from time to time by the International Accounting Standards Board. This will ensure a tight correlation between the accounting practices of South Africa and the international investment community, making our capital markets more accessible to foreign investment.

Compliance and sanction

An officer within the Department of Trade and Industry will become responsible for monitoring compliance with prescribed accounting standards. Together with other regulators such as the Financial Services Board and investors, the Department may refer any apparent non-compliance with standards for investigation by a team of experts, to be drawn from a newly established Financial Reporting Investigations Panel.

If an investigation finds evidence of non-compliance, the Registrar may require the company to republish the information, take other remedial action or pay a penalty. If the company fails to co-operate, the matter may be handed over for prosecution in terms of a new offence created under the proposed section 440FF.

More lenient standard for limited purpose companies

Since the standard to be imposed is primarily for the benefit of investors, and is onerous, provision has been made for closely held companies that do not offer their shares to the public. The amendments therefore proposes a category of company referred to as "limited purpose companies" - which will be allowed to deviate from the financial reporting standards imposed on other companies (termed "public interest companies"), provided that all shareholders consent, and provided also that the deviation is noted and reasons given.

As a further concession, certain other options will be retained for limited purpose companies, while being repealed for public interest companies. For example, the choice whether or not to consolidate group financial statements (dealt with under sections 289 - 291 of the Act).

Revision of the 4th Schedule

Schedule 4 of the Act has historically served as a detailed specification for disclosure in financial statements. A careful review of this schedule has identified those areas that are dealt with in current statements of GAAP and those provisions that are supplementary to GAAP. The supplementary provisions have been retained for all companies, whereas the other requirements have been retained for limited purpose companies only, which effectively result in maintaining a secondary, less onerous financial reporting standard for limited purpose companies.

2. Amendments to promote and maintain auditor independence

The amendments to the Companies Act respond in part to the provisions of the Auditing Profession Act, No. 26 of 2005 (the APA), which aims to address recent audit failures.

The APA came into effect on 1 April 2006 and brought about a more stringent regulation of the auditing profession and made provision for an Independent Regulatory Board for Auditors and for a Standard-Setting Board for Auditor Ethics and Auditing.

By virtue of the new section 268J to the Companies Act, 1973, only auditors registered under the APA may in future be appointed as auditors of companies. This means that all audits of company accounts will from be subject to the controls and safeguards of the APA.

In addition, several measures are introduced by the Act to ensure that auditors will remain independent and not prone to "capture" by a company's Board of Directors. The new section 269A of the Companies Act, 1973, requires that auditors be nominated by an audit committee, who will also be responsible for setting the auditor's remuneration. In terms of the new section 274A, a rotation of auditors will be required.

An individual auditor (the signing audit partner) may not be appointed to a company for more than five consecutive years. However, no rotation of the audit firm is required by the Act.

Section 271 of the Companies Act, 1973, has also been amended to require that; in the case of a public interest company with an audit committee, an appointment by the directors of an auditor shall only be valid if the audit committee is satisfied that the auditor is independent of the company.

The new section 275A will preclude an auditor from performing services for the company as defined by the Independent Regulatory Board for Auditors.

The distinction created between "public interest companies" and "limited interest companies", for purposes of compliance with accounting standards, will also apply in relation to audit committees and the rotation of auditors. The amended Act will not permit the same individual to serve as the auditor or designated auditor of a public interest company for more than five consecutive financial years. These requirements will apply only to public interest companies, with the current less onerous standard prevailing for limited interest companies.

The services that the auditor of a company is prohibited to performed are those that are covered by the code of professional conduct developed in terms section 21(2) (a) of the Auditing Profession Act, 2005 (Act No. 26 of 2005). The Independent Regulatory Board for Auditors shall, by use of the code of professional conduct define and prohibit the provision by an auditor of certain non-audit services in circumstances in which these will be subject to the auditor's own auditing. This does not affect the power of an audit committee to further limit the services which an auditor of that company may render.

A company's opportunity to remove an auditor, or for an auditor to simply resign and walk away when an irregularity has been detected, is curtailed by the amendments to sections 277, 278 and 280. The new section 287A also makes it an offence for any auditor or other person to be party to false or misleading information in the financial statements of a company.

In order to enable this, requirements on the audit committee of a Public Interest Company are set out in the Act and include audit committees:

- being required for Public Interest Companies;
- comprising on independent non-executive directors;
- being appointed by the board of directors in respect of a financial year
- being required to take responsibility for:
- Nominating and agreeing to the appointment of an auditor with the shareholders
- Determining the auditors:
- Fees for the audit and terms of engagement
- Appointment is in compliance with the Act and any other legislation
- Pre-approve any appointment for non-audit services the company may wish to obtain from the auditors
- Insert in the financial statements a report:
- Describing how the audit committee carried out its functions
- Stating whether or not the audit committee is satisfied that the auditor is independent of the company
- Receive and deal appropriately with any complaints relating to:
 - Accounting practices
 - Internal audit
 - The content or auditing of the financial statements
 - or any related matter

Audit Committees are required to comprise only of non-executive directors who act independently.

A director is non-executive if the director:

- (i) is not involved in the day to day management of the business and has not in the past three financial years been a full-time salaried employee of the company or its group;
- (ii) is not a member of the immediate family of an individual mentioned in subparagraph (i);

For a non-executive director to act independently the director:

- (i) expresses opinions, exercises judgment and makes decisions impartially;
- (ii) is not related to the company or to any shareholder, supplier, customer or other director of the company in a way that would lead a reasonable and informed third party to conclude that the integrity, impartiality or objectivity of that director is compromised by that relationship.

As a consequence Boards and Audit Committee members will need to:

- Review the composition of the audit committee (are all members independently minded non-executives?)
- Review the scope of the audit committee (what in addition to the statutory role does the Board wish the Audit Committee to attend to?)
- Build awareness of new role forming a planned and systematic response leading up to implementation of the Act within the Audit Committee and the Board.
- Address the audit committee's role in:
 - (i) Determining the audit fee appropriate to achieve the audit objective

- (ii) assessing the independence and compliance of the auditors with the appointment requirements
 - (iii) considering and pre-approving non-audit services, including best practice and methods of achieving this requirement
 - (iv) reporting on audit committee activities in the annual report
 - (v) identifying and dealing appropriately with complaints related to accounting practices, the financial statements, internal audit, external audit or related matters
- Where the Public Interest Company has subsidiaries, determine for which subsidiaries separate Audit Committees will be appointed. For those subsidiaries which are to be dealt with by the parent's own Audit Committee define a process for executing this responsibility.
 - Consider the resources allocated to supporting the Audit Committee, including the role of internal structures, external advisors and the level of remuneration set of Audit Committee members.

Offence to be party to false or misleading information

The new section 287A makes it an offence for any auditor or other person to be party to false or misleading information in the financial statements of a company.

3. Amendments to require additional information for a prospectus

The revised 3rd Schedule specifies more fully the form and content of the prospectus. Both the scope and detail of information required for a prospectus have been extended. This will close the current gap between the JSE listing requirements and the information to be provided in a prospectus. Because the ambit of information required in terms of the JSE listing requirements is so extensive, they make provision for an exemption from certain of the requirements, such as where publication of specific information may cause undue prejudice to the issuer. In view of the more onerous prospectus requirements introduced under the revised 3rd Schedule, it is considered necessary for the Act to provide the Registrar with a similar discretion.

The amended Schedule 3 requires disclosure in the prospectus of any dispensations obtained under section 148A.

4. Amendments to further the objectives and expedite the procedures of the Securities Regulation Panel ("SRP")

The Companies Act contains a number of provisions designed to protect minority shareholders of a company in the event of a takeover bid. Foremost amongst these are section 440K which requires the compulsory acquisition of the shareholding of minorities in affected transactions, and the other provisions of Chapter XVA which establishes the Securities Regulation Panel ("the SRP") to regulate affected transactions.

Amendment of Section 228

Section 228 currently allows directors to dispose of the assets or greater part of the business of a company by an ordinary resolution of the shareholders. (A change of name, by contrast, would require a special resolution.) Section 228

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is being used more and more often for purposes of effecting a takeover as an alternative to section 440K which has more stringent requirements. For the year ended February 2003, the SRP authorized 27 transactions in terms of section 228 and 33 transactions in terms of section 440K. For the year ended February 2004, 17 transactions were authorized in terms of section 228 and 16 in terms of section 440K.

The amendments to section 228(1) will require that the disposal of the greater part of assets of the business of a company should henceforth require a special resolution. In addition, there have been certain liberal interpretations of the term "substantially the whole" in relation to the disposal of a business undertaking in order to avoid the application of section 228(1). The amendment applies the more objective test already used in respect of assets, namely "the greater part", also to the disposal of a business undertaking.

Insertion of a new subsection (5) to section 228

Certain legal opinions hold that a disposal by a wholly owned subsidiary does not fall within the jurisdiction of the SRP - no matter how material it is in relation to the consolidated balance sheet of the holding company. This is because the Securities Regulation Code applies only to public companies and private companies of which shareholder capital exceeds R 5 million and which have more than ten beneficial shareholders. (A wholly owned subsidiary only has one beneficial shareholder.) The objective to protect minority shareholders in the holding company is thus defeated in such circumstances. Subsection 5 is inserted to remedy the current anomaly.

Amendment of sections 440B, C and D

The transactions referred to the SRP need to be attended to speedily. Long delays may have a negative impact on the prospects of the companies involved. These sections provide for the establishment of an executive committee of the SRP to hear appeals against the decisions of the Executive Director before the appeal is heard by the full Panel. This delays the bringing of appeals to finality and increases the costs for all parties. (One such hearing was only finalized after a year, and the SRP alone incurred legal costs of approximately R 1million.) The amendments will dispense with intermediate appeal to the executive committee in order to shorten the appeal process and reduce costs to all parties.

Conclusion

The Bill once enacted will result in significant improvements to the Companies Act, which is critical to strengthen financial reporting and enhance credibility of South African reporting entities in the global market. A revision of the South African Companies Act will certainly see the future role of the director becoming more clarified by statute primarily with the objective of improving director accountability, communication with shareholders, and also to enable directors to conduct their duties more effectively. However, the challenge will be for the director to remain abreast of these changing roles and responsibilities so as to remain competitive and effective in the 21st century corporate world.

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Special note

On 29 August 2006, the Portfolio Committee on Economic Affairs has asked for the term Public Interest Company to be changed to Widely Held Company. This change requires acceptance by the Portfolio Committee on Trade and Industry to be affected. If accepted the conditions described relating to Public Interest Companies in this chapter dealing with the Companies Act Amendment in 2006 will remain but the description of such companies will change to that of a Widely Held Company. 4 September 2006

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