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Duties of Directors

## Duties of Directors //

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## Preface //

#### A key feature of the Companies Act, 2008 (the Act) is that it clearly emphasises the responsibility and accountability of directors.

Recent international and local jurisprudence underline the demanding standard of conduct that is expected of company directors, all of which South African company directors would do well to take notice of.

The Companies Act clearly distinguishes the respective roles of the shareholders (as owners) of the company, and the board of directors (responsible for the management) of the company. Directors and prescribed officers act on behalf of the company, and as such their decisions and actions directly and indirectly affect not only the shareholders, but also all other stakeholders of the company, including employees, creditors, the community functioning around the company, regulators, suppliers and customers. In order for this construct to yield the best possible result for all parties involved in and affected by the company, it is paramount that the directors and other officers are accountable to stakeholders for all their actions. As such, a key feature of our corporate law is the responsibility, accountability and where appropriate the liability of directors and prescribed officers. The construction is that by accepting their appointment to the position, directors tacitly indicate that they will perform their duties to a certain standard, and it is a reasonable assumption of the shareholders that every individual director will apply his or her particular skills, experience and intelligence appropriately and to the best advantage of the company. In this regard, the Act subscribes to the "enlightened shareholder value approach" - which requires that directors are obliged to promote the success of the company in the collective best interest of shareholders. This includes, as appropriate, the company's need to take account of the legitimate interests of stakeholders including among others, the community, employees, customers and suppliers. The social responsibility of the company (and the directors) was noted in Minister of Water Affairs and Forestry v Stilfontein Gold Mining Company Limited and others 2006

(5) SA 333 (W), emphasising the broader responsibility of the directors and the company. In this case the court made direct reference to the King Code, which is interpreted by some as evidence that the King Code has *de facto* become part of the duties of directors.

The Act codifies the standard of directors' conduct in section 76. The standard sets the bar very high for directors, with personal liability where the company suffers loss or damage as a result of the director's conduct not meeting the prescribed standard. The intention of the legislature seems to be to confirm the common law duties and to encourage directors to act honestly and to bear responsibility for their actions - directors should be accountable to shareholders and other stakeholders for their decisions and their actions on behalf of the company. With the standard set so high, the unintended consequence may be that directors would not be prepared to take difficult decisions or expose the company to risk. Since calculated risk taking and risk exposure form an integral part of any business, the Act includes a number of provisions to ensure that directors are allowed to act reasonably without constant fear of personal exposure to liability claims. In this regard, the Act has codified the business judgement rule, and provides for the indemnification of directors under certain circumstances, as well as the possibility to insure the company and its directors against liability claims in certain circumstances.

The Act defines a director as "a member of the board of a company, as contemplated in section 66, or an alternate director of a company and includes any person occupying the position of a director or alternate director, by whatever name designated". The Act makes no specific distinction between the responsibilities of executive, non-executive or independent non-executive directors (in order to understand the distinction between different types of directors we turn to the governance codes, including King Report). The codified standard applies to all directors. In *CyberScene Ltd and others v iKiosk Internet and Information (Pty) Ltd* 2000 (3) SA 806 (C) the court confirmed that a director, even if he or she is a non-executive director.

In terms of this standard a director (or other person to whom section 76 applies), must exercise his or her powers and perform his or her functions:

- in good faith and for a proper purpose
- in the best interest of the company
- with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions and having the general knowledge, skill and experience of that particular director.

In essence, the Act combines the common law fiduciary duty and the duty of care and skill. This codified standard applies in addition to, and not in substitution of the common law duties of a director. In fact, the body of case law dealing with the director's fiduciary duty and the duty of care and skill remains applicable.

All directors are bound by their fiduciary duty and the duty of care and skill. The codified standard of conduct applies equally to all the directors of the company. Of course, it is trite that not all directors have the same skill and experience, and not all directors have a similar understanding of the functioning of the company. This raises the question as to what is expected of different types of directors when it comes to their duties. In this regard, the court, in *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty) Ltd* 1980 (4) SA 156 (W) made it clear that the test is applied differently to different types of directors. The court concluded that the extent of a director's duty of care and skill depends on the nature of the company's business, that our law does not require a director to have special business acumen, and that directors may assume that officials will perform their duties honestly.

The test for the duty of care and skill as contained in the Act provides for a customised application of the test with respect to each individual director – in each instance both the objective part of the test (measured against a person carrying out the same functions as that director), as well as the subjective element of the test (measured against a person having the same knowledge, skill and experience as that director) will be applied. Thus, even though all directors have the same duties, the application of the test will consider the specific skill and experience of the director, as well as the role of the director on the board (i.e. executive, non-executive or independent non-executive).

 ... a director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise." As stated above, the Act also codifies the business judgment rule. In terms of this rule a director will not be held liable if he or she took reasonable diligent steps to become informed about the subject matter, did not have a personal financial interest (or declared such a conflicting interest) and the director had a rational basis to believe that the decision was in the best interest of the company at the time.

In discharging any board or board committee duty, a director is entitled to rely on one or more employees of the company, legal counsel, accountants or

other professional persons, or a committee of the board of which the director is not a member. The director, however, does not transfer the liability of the director imposed by this Act onto such employee, nor can a director blindly rely on the advice of employees or advisors.

In a recent Australian judgment, *Australian Securities and Investments Commission v Healey* [2011] FCA 717, commonly referred to as the Centro case, the court re-emphasised the responsibility of every director (including non-executive directors) to pay appropriate attention to the business of the company, and to give any advice due consideration and exercise his or her own judgment in the light thereof. This case is relevant to directors of South African companies, because the Act indicates that a court, when interpreting or applying the provisions of the Act, may consider foreign company law.

In this case the non-executive Chairman, six other non-executive directors and the Chief Financial Officer of the Centro Property Group (Centro) faced allegations by the Australian Securities and Investments Commission that they had contravened sections of the Corporations Act 2001 arising from their approval of the consolidated financial statements of Centro, which incorrectly reflected substantial short-term borrowings as "non-current liabilities". Similar to our Companies Act, the Australian Corporations Act also requires the board to approve the financial statements.

The relevant detail facts are that the 2007 financial statements of Centro Properties Group failed to disclose, or properly disclose, significant matters. The statements failed to disclose some AUS\$1.5 billion of short-term liabilities by classifying them as non-current liabilities, and failed to disclose guarantees of short-term liabilities of an associated company of about US\$1.75 billion that had been given after the balance sheet date, but before approval of the statements.

The central question in those proceedings was whether directors of substantial publicly listed entities are required to apply their own minds to, and carry out a careful review of, the proposed financial statements and the proposed directors' report,

**G**...Whether, for instance, a director went through the financial statements 'line by line', he is not thereby taking all reasonable steps, if the director in doing so is not focused for himself upon the task and considering for himself the statutory requirements and applying the knowledge he has of the affairs of the company".

to determine that the information they contain is consistent with the director's knowledge of the company's affairs, and that they do not omit material matters known to them or material matters that should be known to them. In short, the question was to what extent non-executive directors may place reliance on the audit committee and the finance team.

In analysing the director's duty of care and skill, the court commented that:

"all directors must carefully read and understand financial statements before they form the opinions which are to be expressed ... Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company's financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director. These include the following:

- a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged
- a director should keep informed about the activities of the corporation
- while not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies
- a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements
- a director, while not an auditor, should still have a questioning mind."

Several statements were made in which it became apparent that every director is expected to apply his or her own mind to the issues at hand. Even though directors may rely on the guidance and advice of other board committees, employees and advisors, they nevertheless need to pay attention and apply an enquiring mind to the responsibilities placed upon him or her.

A key statement made by the judge is as follows:

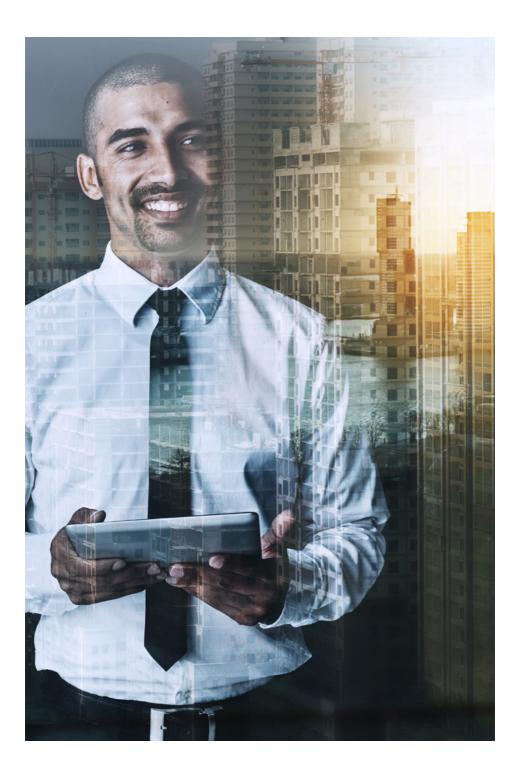
Nothing I decide in this case should indicate that directors are required to have infinite knowledge or ability. Directors are entitled to delegate to others the preparation of books and accounts and the carrying on of the day-to-day affairs of the company. What each director is expected to do is to take a diligent and intelligent interest in the information available to him or her, to understand that information, and apply an enquiring mind to the responsibilities placed upon him or her." The court concluded that in the Centro case each director failed to exercise the degree of care and diligence required by law in the course of their review of the financial statements, and as such can be held liable for the losses suffered by that company as a result of their failure to comply with their duties.

South African case law echoes the findings of the Centro judgment. In *Fisheries Development Corporation of SA Ltd v AWJ Investments* (Pty) Ltd 1980 (4) SA 156 (W) the court stated that:

Wowhere are [the director's] duties and qualifications listed as being equal to those of an auditor or accountant. Nor is he required to have special business acumen or expertise, or singular ability or intelligence, or even experience in the business of the company ... He is nevertheless expected to exercise the care which can reasonably be expected of a person with his knowledge and experience ... a director is not liable for mere errors of judgment. In respect of all duties that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgment, information and advice of the management, unless there are proper reasons for querying such. Similarly, he is not expected to examine entries in the company's books ... Obviously, a director exercising reasonable care would not accept information and advice blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his own judgment in the light thereof."

How do these judgments affect the position of directors (especially non-executive directors) where the audit committee considered complex financial reports? Are non-executive directors nevertheless expected to review such reports and vote on applicable resolutions? The answer seems to be 'yes'. The obligation to approve the financial statements of the company rests equally on each director. As such, every director has to study the relevant reports, and ensure for himself/ herself that the content of the report confirms and coincides with his/her view of the business. No director is entitled to blindly rely on the conclusions of the audit committee, the finance team or other experts.

These judgements emphasise the fact that the decision to accept appointment to the board of a company should not be taken lightly. A director cannot uncritically rely on the officials of the company, or on the other members of the board for the decisions of the company, but needs to be confident that he or she is able to pay adequate personal attention to the business of the company. Even though directors are entitled to rely on the guidance and advice from employees, advisors and other board committees, each director is obliged to apply their own mind (i.e. bring their own skill and experience to bear) to the facts at hand. They are not entitled to blindly rely on advice. What each director is expected to do is to ensure that they make a concerted effort to understand the business of the company and the information placed in front of them, and to apply an enquiring mind to such information.



## 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) 67

# What is a Director? //

The term "director" has been defined in law. The Companies Act, 2008 (the Act) defines a director as: "A member of the board of a company ..., or an alternate director of a company and includes any person occupying the position of director or alternate director, by whatever name designated".

The Act provides the board with all the authority it requires to manage and guide the business of the company. It is interesting that even though the Act makes no distinction between executive and non-executive directors, it nevertheless caters for this distinction in section 66 of the Act. In terms of this section the business and affairs of a company must be managed by (referring to the role of executive directors) or under the direction of (referring to the oversight role of non-executive directors) its board, which has the authority to exercise all of the powers and perform any of the functions of the Act or by the company's Memorandum of Incorporation. As such, in instances where shareholders identify the need to curtail the powers of the board, they need to ensure that such limitation is included in the Memorandum of Incorporation.

The definition of a director includes not only those individuals that are appointed to the board of the company (as well as alternate directors), but also "any person occupying the position of director or alternate director, by whatever name designated". The effect of this wide definition is that the provisions will apply not only to members of the board, but also to "de facto" directors.

The Act requires private companies and personal liability companies to appoint at least one director, whereas public companies, state owned companies and non-profit companies are required to appoint at least three directors. This number would be in addition to the number of directors required where an audit committee and/or social and ethics committee is required. It should be noted that this is the minimum requirement. Given the complexities of running a corporate, it may be necessary to appoint more directors. Furthermore, where companies apply the governance principles set out in the King Report on Corporate Governance for South Africa (King IV), it may be necessary to have more than the minimum number of directors. As such, the Memorandum of Incorporation may stipulate a higher number of required directors. Even though the Act prescribes a minimum requirement, it provides for instances where the number of directors fall below the prescribed minimum. The Act states that any failure by a company at any time to have the minimum number of directors required by this Act or the company's Memorandum of Incorporation, does not limit or negate the authority of the board, or invalidate anything done by the board or the company.

In general terms, the directors of a company are those individuals empowered by the Memorandum of Incorporation 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.

**"**A de facto director is a person who assumes to act as a director. He is held out as a director by the company, and claims and purports to be a director, although never actually or validly appointed as such. To establish that a person is a de facto director of a company, it is necessary to plead and prove that he undertook the functions in relation to the company which could properly be discharged only by a director"

*Re Hydrodam (Corby) Ltd* [1994] 2 BCLC (Ch); [1994] BCC 161 at 183 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.

#### **Prescribed officers**

The Act provides for the identification of prescribed officers. In essence, prescribed officers will be those individuals that are not directors, but that have authority similar to that exercised by directors. Prescribed officers include every person, by whatever title the office is designated, that:

- exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company
- regularly participates to a material degree in the exercise of general executive control over and management of the whole, or a significant portion, of the business and activities of the company.

Most of the provisions in the Act pertaining to directors apply equally to prescribed officers. The Act determines that prescribed officers are required to perform their functions and exercise their duties to the standard of conduct as it applies to directors. Prescribed officers will be subject to the same liability provisions as it applies to directors. As is the case with directors, the remuneration paid to prescribed officers must be disclosed in the annual financial statements. The following provisions, *inter alia* applicable to directors, will also apply to prescribed officers:

- Section 69 Ineligibility and disqualification of persons to be directors or prescribed officers
- · Section 75 Directors' personal financial interest
- Section 76 Standards of directors' conduct
- · Section 77 Liability of directors and prescribed officers
- Section 78 Indemnification and directors' insurance
- Section 30(4) and 30(5) Disclosure of remuneration.

A person will be a prescribed officer regardless of any title or office they are designated.

Although it is not a legislative requirement, it is recommended that the board records the names of all those individuals which are regarded as prescribed officers. The list of names will be necessary, among other requirements, when the company has to disclose the remuneration paid to or receivable by its prescribed officers in the annual financial statements.

Note that regardless of whether a company has officially identified a particular individual as a prescribed officer or not, that person may nevertheless be classified as a prescribed officer to the extent that the person's role in the company meets the definition.

In order to determine who the prescribed officers of the company are, one will have to apply a certain degree of judgment. The board will have to consider all the relevant provisions of the definition, such as "general executive management" and "control" and "significant portion of the business and activities" in the context of their specific company in order to identify the prescribed officers of the company.

The meaning of *general executive control and management* needs to be determined in view of the organisational and governance structure of the company. *Executive control and management* should be distinguished from *ordinary* control and management carried out in the day to day functioning of the company. Where a person is responsible for implementing specific decisions of the board, he or she will in all likelihood not be regarded as a prescribed officer, as the exercise of those functions will not be equated with *executive* management or control. Further, the company will have to determine, in its particular circumstances and in view of the company's structure, which parts of the company, if any, are regarded as *significant* portions of the company.

Not every division or business unit will necessarily be regarded as a *significant* portion of the business, and only persons that exercise general executive control over or management of a significant portion of the company are regarded as prescribed officers.

A person does not have to be employed by a particular company to be classified as a prescribed officer of that company.

The intention of the legislature seems to be to classify as prescribed officers those

individuals that are not appointed to the board of the company (thus, they are not directors) but nevertheless act with the same authority as that of a director (executive management and control). In an earlier draft of the Regulations, a prescribed officer was defined as anyone that has a significant impact on the management and administration of the company. This definition was much wider and included most of the (senior) management of a company. However, the definition in the final Regulations limits the scope to only those individuals that exercise "executive" management and control – this would limit the prescribed officers to only those individuals that have executive authority in the company, and it would exclude ordinary managers, even senior managers (depending of course on the organisational and governance structure of the company). Persons may be classified as prescribed officers under the following circumstances:

- A member of a company's executive committee
- The senior financial manager in a company that does not have a financial director
- A chief executive officer
- Regional manager.

A company secretary that performs the role contemplated in King IV (i.e. advising the board but not taking decisions on behalf of the board) would generally not be classified as a prescribed officer. Also, persons that perform an important operational role, but not general executive management and control functions, would not be prescribed officers.

#### The legal status of a director

The Act assigns to directors the authority to perform all the functions and exercise all the powers of the company. It sets out the minimum standard of conduct, and provides for personal liability where a director does not perform to the said standard. The Act does not specifically comment on 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 Act and the company's Memorandum of Incorporation are generally viewed as guiding the terms of the relationship that the director has with the company.

Once a person accepts appointment as a director he becomes a fiduciary in relation to the company and is obliged to always act in good faith in the best interest of the company.

#### The different types of directors

In law there is no real distinction between the different categories of directors. Thus, for purposes of the Act, all directors are required to comply with the relevant provisions, and meet the required standard of conduct when performing their functions and duties.

It is an established practice, however, to classify directors according to their different roles on the board. The classification of directors becomes particularly important when determining the appropriate membership of specialist board committees, and when making disclosures of the directors' remuneration in the company's annual report. Interestingly, King IV does not provide definitions for executive, non-executive, or independent non-executive directors. In order to understand the difference between these types of directors, we turn to King III and the JSE listings requirements.

#### **Executive director**

Involvement in the day-to-day management of the company or being in the fulltime salaried employment of the company (or its subsidiary) or both, defines the director as executive.

An executive director, through his or her privileged position, has an intimate knowledge of the workings of the company. There can, therefore, be 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.

Executive directors need to strike a balance between their management of the company, and their fiduciary duties and concomitant independent state of mind required when serving on the board. The executive directors need to ask themselves "Is this right for the company?", and not "Is this right for the management of the company?"

#### Non-executive director

The non-executive director plays an important role in providing objective judgement independent of management on issues facing the company.

Not being involved in the management of the company defines the director as non-executive.

Non-executive directors are independent of management on all issues including strategy, performance, sustainability, resources, transformation, diversity, employment equity, standards of conduct and evaluation of performance.

The non-executive directors should meet from time to time without the executive directors to consider the performance and actions of executive management.

An individual in the full-time employment of the holding company is also considered a non-executive director of a subsidiary company unless the individual, by conduct or executive authority, is involved in the day-to-day management of the subsidiary.

King III Report Annex 2.3

The JSE Listing Requirements defines executive directors as directors that are involved in the day to day management of the company and/or in full-time employment of the company and/or any of its subsidiaries.

The JSE Listings Requirements defines non-executive directors as directors that are not involved in the day-to-day management of the company or not full-time salaried employees of the company and/or any of its subsidiaries.

It should be noted that all directors, regardless of the classification as an executive, non-executive or independent non-executive director, requires the application of an independent state of mind and objective judgment. In essence, ALL directors are required to always act in the best interest of the company, and this can only be achieved if directors set aside their personal interest.

#### **Independent director**

According to the JSE Listings Requirements, independence of directors should be determined holistically on a substance over form basis in accordance with the indicators provided in section 94(4) of the Companies Act and the King Code. In addition, it must be noted that any director that participates in a share incentive/ option scheme, will not be regarded as independent. (It should be noted that in terms of section 94(4) of the Companies Act, shareholding is not per se a disqualification when determining independence).

One of the key principles in King IV is the establishment of a unitary board which reflects a balance of power. In order to ensure that no one individual, or group of individuals yield unfettered power on the board, King IV proposes the appointment of independent non-executive directors. The value of the inclusion of independent directors on the board is widely recognised and practised, and can bring a range of benefits to board decision-making, including:

- adding new skills, knowledge and experience that may not otherwise be available on the board or within the company, with positive impact on strategy development and oversight
- bringing an independent and objective view distinct from that of shareholders and management
- acting as a balancing element in boardroom discussions between different shareholder representatives; managing conflicts of interest affecting board members
- safeguarding the interests of minority shareholders and other stakeholders who may not be represented on the board and who may be unable to speak with a strong voice at shareholder meetings
- · benefiting from their business connections and other contacts
- · undertaking the bulk of the work of board committees

 ultimately, providing reassurance to external shareholders, stakeholders and wider society that the company is being run in an effective manner and in pursuit of its overall mission.

Even though the benefit of the inclusion of independent directors is well recognised, there is a growing concern that the over-emphasis of independence may lead to the under-valuation of industry skill and experience, as some may regard these two concepts as mutually exclusive. However, the composition of boards is nuanced to ensure not only a balance of power, but also to ensure the inclusion of a diverse group of directors. As such, King IV points out that a balance can only be created if the composition of the board accounts for a balance of required skills, experience, diversity, independence and knowledge of the company and industry. All of these factors (including independence) collectively yield a balanced board. The overriding consideration remains whether the board is composed so that it is able to fully discharge its duties. All directors, including the independent directors should have a comprehensive understanding of the industry within and the business of the companies that they serve.

It should be noted that the appointment of independent directors in itself does not mean that major shareholders relinquish ultimate control of the board. A majority vote of shareholders can appoint or remove any director at any time. Major shareholders can ensure that they only approve the appointment of independent directors that share their vision for the company – the involvement of outstanding independent directors can then only enhance boardroom capabilities and the likely success of the enterprise.

The concept of independence has evolved from the position in King III. Whereas King III provided a list of disqualifications from independence (i.e. where any of the listed disqualifications applied, a director is regarded as non-independent), King IV takes a more practical approach and rather focuses on the perception of independence. As such, factual independence or a tick-box approach is replaced by a much more balanced assessment of independence which requires judgment and the consideration of substance over form. It is thus possible for someone that meets one of the (King III) disqualification criteria to nevertheless be regarded as independent under King IV. It is down to the board to determine if a director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's

judgement. The yardstick for purposes of this assessment will be the perception of an informed third party, i.e. whether or not an informed and reasonable outsider regards a director as independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement.

As pointed out above, King IV adopts a perceptual approach to independence, i.e. the level of independence of any particular director should be viewed and judged from the perspective of a reasonable and informed third party. The key question to be answered here is whether or not, a director has an interest, position, association or relationship which, when judged from the perspective of a reasonable and informed third party is likely to influence unduly or cause bias in decision-making in the best interest of the company.

Although King IV rejects a tick-box approach for the independence assessment, it does provide a list of factors/criteria which may be considered during the independence inquiry, including whether or not a particular director:

- is a significant provider of financial capital, or ongoing funding to the organisation; or is an officer, employee or a representative of such provider of financial capital or funding
- if the organisation is a company, participates in a share-based incentive scheme offered by the company
- if the organisation is a company, owns securities in the company the value of which is material to the personal wealth of the director
- has been in the employ of the organisation as an executive manager during the preceding three financial years, or is a related party to such executive manager
- has been the designated external auditor responsible for performing the statutory audit for the organisation, or a key member of the audit team of the external audit firm, during the preceding three financial years
- is a significant or ongoing professional adviser to the organisation, other than as a member of the governing body
- is a member of the governing body or the executive management of a significant customer of, or supplier to, the organisation
- is a member of the governing body or the executive management of another organisation which is a related party
- is entitled to remuneration contingent on the performance of the organisation.

"Independence generally means the exercise of objective, unfettered judgement. When used as the measure by which to judge the appearance of independence, or to categorise a non-executive member of the governing body or its committees as independent, it means the absence of an interest, position, association or relationship which, when judged from the perspective of a reasonable and informed third party, is likely to influence unduly or cause bias in decision-making."

The approach adopted in King IV seems to be in line with the approach adopted in section 94(4) (b) of the Companies Act where the "independence" requirements for membership of the audit committee are set out. In this section it is made clear that the view of an informed third party is decisive in application of the criteria (rather than a list of disqualifications. (It is interesting to note that shareholding per se, or representing of a shareholder is in itself not a disgualification for audit committee membership in terms of the Companies Act).

With respect the effect of long-term tenure on the independence of directors, King IV reflects the recommendation we had under King III in that independent directors may serve longer than nine years but only if,

#### King IV

after an independence assessment by the board, there are no relationships or circumstances likely to affect, or appearing to affect, the director's objectivity and judgement.

Boards are accountable to all stakeholders and as such they should be cognisant of the extended disclosure requirements under King IV. The board is required to provide adequate disclosure on a publically accessible media and communication platform regarding the composition of the board and the classification of each director as independent or not. Where there are questions around the independence of any particular director (e.g. they have served for longer than nine years as an independent director, or they fall into any one or more of the criteria listed above), it is our contention that a mere statement to the effect that the board regards the director to be independent in thought and deed will not suffice. Rather, the board will need to provide well considered reasons as to why it believes a reasonable and informed third party will perceive the said director as independent, despite the presence of one or more of the aforementioned criteria.

#### Comparing independence requirements: The Companies Act, King III and King IV

#### **Companies Act**

Independent if:

• The director was not involved in the day-to-day management of the business for the previous financial year

- The director was not a full-time employee or prescribed officer of the company or a related company during the previous three financial years
- The director is not a material supplier or customer of the company such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship
- The director is not related to anybody who falls within the above criteria.

#### **JSE Listings Requirements**

Independence of directors should be determined holistically on a substance over form basis in accordance with the indicators provided in section 94(4) of the Companies Act and the King Code. In addition, it must be noted that any director that participates in a share incentive/option scheme, will not be regarded as independent.

#### /////// King IV

The board should consider the following and other indicators holistically, and on a substance-over-form basis, when assessing the independence of a member of the governing body for purposes of categorisation: The director:

- is a significant provider of financial capital, or ongoing funding to the organisation; or is an officer, employee or a representative of such provider of financial capital or funding
- if the organisation is a company, participates in a share-based incentive scheme offered by the company
- if the organisation is a company, owns securities in the company the value of which is material to the personal wealth of the director
- has been in the employ of the organisation as an executive manager during the preceding three financial years, or is a related party to such executive manager
- has been the designated external auditor responsible for performing the statutory audit for the organisation, or a key member of the audit team of the external audit firm, during the preceding three financial years
- is a significant or ongoing professional adviser to the organisation, other than as a member of the governing body
- is a member of the governing body or the executive management of a significant customer of, or supplier to, the organisation
- is a member of the governing body or the executive management of another organisation which is a related party
- is entitled to remuneration contingent on the performance of the organisation.

The board should always consider the independence of a director from the perspective of a reasonable and informed third party.

In addition to the different types of directors included in the composition of the board, King IV suggests that the board appoints an independent non-executive member as the lead independent to fulfil the following functions:

- to lead in the absence of the chair
- to serve as a sounding board for the chair
- to act as an intermediary between the chair and other members of the governing body when necessary
- to deal with shareholders' concerns where contact through the normal channels has failed to resolve concerns, or where such contact is inappropriate
- to strengthen independence on the governing body if the chair is not an independent non-executive member of the governing body
- to chair discussions and decision-making by the governing body on matters where the chair has a conflict of interest
- to lead the performance appraisal of the chair.

#### **International trends**

With respect to both the emphasis of the importance of including independent directors on the board as well as the approach to classifying a director as independent, King IV seems to be in line with international best practice.

When comparing King IV to some of the most influential international corporate governance codes (such as the International Corporate Governance Network's *Global Governance Principles*, the New York Stock Exchange's *Listed Company Manual*, the *Australian Corporate Governance Principles and Recommendations*, the *UK Corporate Governance Code*, the OECD Principles of Corporate Governance, and the Canadian *Corporate Governance Guidelines*) we see that King IV reflects international trends. All of these international codes propose that the majority of the members of the board should be independent. As is the case in King IV, most of the international codes require the board to determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. Another common feature in the aforementioned international codes is the emphasis on transparency – the board is required to disclose their reasons for classifying a director as independent.

More often than not the codes make it clear that independence is a matter of perception, and not a matter of fact, and proceed to provide a list of criteria which the board should consider when considering independence.

The value of appointing independent directors to the board should not be underestimated. These directors have a crucial role to not only act as a sounding board to the executive and to elevate the level and quality of board discussions by adding additional, independent perspectives, but they also act as custodians of the rights of shareholders (including minority shareholders) and stakeholders.

The onus of classifying directors as independent rests with the board. The adoption of the approach to apply perceptual, rather than factual, independence is welcomed. We support the move away from a tick-box approach to a more practical approach. However, this new approach places a heavy burden on boards in that they need to ensure they are able to explain and justify their decisions to classify directors as independent.

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.

#### Personal characteristics of an effective 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.

# Appointment of a director //

Get The processes for nomination, election and ultimately, the appointment of members to the governing body should be formal and transparent."

King IV Principle 7 par 15

## <sup>∞</sup> Appointment of a director //

### Certainly one of the most important responsibilities of shareholders is the appointment of directors.

While the Act and the company's Memorandum of Incorporation may prescribe the required qualifications and disqualifications for appointment as a director, it is vitally important that the existing directors assess the qualitative characteristics necessary in an individual to effectively perform their functions and 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 as set out in the Act and the company's Memorandum of Incorporation are carried out correctly. This may 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 Act is the primary determinant of who may or may not be appointed to be a director. A company's Memorandum of Incorporation may provide additional grounds for ineligibility or disqualification, or minimum qualifications to be met by directors.

Section 69 of the Act in essence provides that any person is ineligible for appointment as director, if that person is a juristic person, an unemancipated minor (or is under a similar legal disability), or does not satisfy the qualifications as per the company's Memorandum of Incorporation. Also, a person is disqualified from being a director, if the person:

- has been prohibited to be a director by the court
- has been declared by the court to be delinquent in terms of this Act or the Close Corporations Act
- is an unrehabilitated insolvent
- is prohibited in terms of any public regulation to be a director of the company
- has been removed from an office of trust, on the grounds of misconduct involving dishonesty, or
- has been convicted and imprisoned without the option of a fine, or fined more than the prescribed amount, for theft, fraud, forgery, perjury or an offence under the Companies Act, the Insolvency Act, the Close Corporations Act, the Competition Act, the Financial Intelligence Centre Act, the Securities Services Act, or the Prevention and Combating of Corruption Activities Act.

The Act provides the courts with wide discretion to either extend any disqualification for no longer than a period of five years at a time, or to exempt any person from the disqualifications as set out above.

The Act determines that the appointment of an ineligible or disqualified person as director is null and void.

#### The legal mechanics of appointment

Directors are either appointed or elected. The Act provides that the company's Memorandum of Incorporation may provide for:

- the direct appointment and removal of directors by any person who is named in, or determined in terms of, the Memorandum of Incorporation (e.g. shareholder representative)
- ex officio directors (e.g. the CEO)
- the appointment of alternate directors.

The Act makes it clear that, in the case of a profit company other than a state-owned company, the Memorandum of Incorporation must provide for the election by shareholders of at least 50% of the directors, and 50% of any alternate directors.

#### The first directors of the company

The Act determines that each incorporator of a company will also be a first director of that company. This directorship will be temporary and will continue until a sufficient number of directors have been first appointed or first elected in terms of the requirements of the Act.

The first appointment of directors should be done in terms of the provisions of the company's Memorandum of Incorporation (e.g. the Memorandum of Incorporation may permit the majority shareholder to appoint a certain number of directors). The first election of directors should be done in accordance with the provisions of section 68 (see below).

The required number of directors may be determined either in terms of the Act (private companies and personal liability companies to appoint at least one director, whereas public companies, state-owned companies and non-profit companies are required to appoint at least three directors) or the company's Memorandum of Incorporation. It should be noted that the number of directors as prescribed by the Act is in addition to the directors that must be appointed to serve on the audit committee or social and ethics committee.

If not enough directors are either first appointed or first elected to meet the required number of directors as required in terms of the Act or the company's

Memorandum of Incorporation, the board must call a shareholders' meeting within 40 days of incorporation to elect a sufficient number of directors.

#### Election of directors 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.

King IV indicates that before nominating a candidate for election, the board should consider the following:

- The collective knowledge, skills and experience required by the board
- The diversity of the board
- Whether the candidate meets the appropriate fit and proper criteria.

In terms of section 68 of the Act each director must be voted on separately at a general meeting of the company. Once elected, the person will become a director only once written consent to serve as a director was delivered to the company.

The company's Memorandum of Incorporation may prescribe a different process for the election of directors by the shareholders. However, it should be noted that this must still amount to an 'election'.

If a vacancy arises on the board, other than as a result of an *ex officio* director ceasing to hold that office, it must be filled:

- by a new appointment, if the director was appointed by a person identified in the Memorandum of Incorporation, or
- by a new election conducted at the next annual general meeting of the company (in the case of a public company and a state owned company), or
- in any other case, within six months after the vacancy arose at a shareholders' meeting called for the purpose of electing the director. In the latter instance, the election may be conducted by means of a written poll of the persons entitled to exercise voting rights in an election of the director.

King IV proposes that a formal and transparent board appointment process be implemented. The board, assisted by a nominations committee, should identify potential candidates and ensure that all such candidates will be in a position to contribute to the combined skill and experience of the board. When considering candidates, cognisance should be taken of the following:

- the knowledge and experience required to fill the gap on the board
- the apparent integrity of the individual
- the skills and capacity of the individual to discharge these duties to the board.

It is prosed in King IV that thorough background checks should be performed on each nominated candidate. In order to allow shareholders to make an informed decision, a brief professional profile of each candidate standing for election at the annual general meeting (AGM), including details of existing professional commitments, should accompany the notice of the AGM, together with a statement from the board confirming whether it supports the candidate's election or re-election.

Notwithstanding the consideration and evaluation of candidates, the onus is on the individual candidate to determine whether or not they have the time, skill, experience, and capacity to make a meaningful contribution to the company. They should consent to serve as a director only if they are of the opinion that they meet the requisite requirements and would be in a position to commit the time necessary to discharge their duties.

This is especially true for non-executive directors. Prior to accepting an appointment as director, they should consider the time and dedication required, and they should not accept an appointment if they would not be able to exercise the necessary care, skill and diligence. King IV suggests that a candidate for election as a non-executive member of the board should be requested to provide to the board with details of professional commitments and a statement that confirms that the candidate has sufficient time available to fulfil the responsibilities as member of the board.

The appointment of a non-executive director should be formalised in an agreement between the director and the company.

Even though executive directors may accept non-executive directorships, they should consider their responsibilities and only accept such appointment in consultation with the CEO and chairman.

It is important when identifying new directors to consider the balance of power and authority at board of directors' level, to ensure that no one director has unfettered powers of decision-making.

The JSE Listings Requirements require that the company inform the JSE of any new appointments of directors (including the change of important functions 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

The Act requires private companies and personal liability companies to appoint at least one director, whereas public companies, state-owned companies and non-profit companies are required to appoint at least three directors. This prescribed number of directors is in addition to the number of directors appointed to the audit committee and/or the social and ethics committee.

All public companies and state-owned companies need to appoint an audit committee comprising at least three directors that meet the prescribed criteria. All listed public companies and state-owned companies (as well as those other companies that would have scored at least 500 public interest points in any two of the last five financial years) must appoint a social and ethics committee comprising at least three directors or prescribed officers, of which one director must be an independent non-executive director. It is, however, permitted for committee members to serve on more than one committee. Thus, the members of the audit committee may also serve on the social and ethics committee. As such, the minimum prescribed number of directors for a public company is six (i.e. three directors as required by the Act, plus three committee members). Note: the obligation to appoint an audit committee and/ or a social and ethics committee does not apply where the company in question uses the said committee of its holding company. In such an instance, the minimum number will be one director for private companies and personal liability companies, whereas public companies, state-owned companies and non-profit companies are required to have at least three directors.

Any failure by a company at any time to have the minimum number of directors required by the Act or the company's Memorandum of Incorporation, does not limit or negate the authority of the board, or invalidate anything done by the board or the company.

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

#### **Effectiveness of appointment**

A director becomes eligible to serve as a director once appointed/elected, and when he or she has consented in writing to serve as a director. This process is not subject to the approval of the Commission, even though the company has to inform the Commission of the appointment of new directors.

#### **The Register of Directors**

The Act requires every company to keep a record of its directors. This record should be in written form, or other form as long as the information can be converted into written form within a reasonable time. The register of directors of a company must be open to inspection by any person who holds a beneficial interest in any securities issued by a profit company, or who is a member of a non-profit company, as well as any member of the public.

A record of its directors should comprise details of any person who has served as a director of the company, and include:

- full name
- identity number or date of birth
- nationality and passport number
- occupation
- · date of their most recent election or appointment as director of the company
- name and registration number of every other company or foreign company of which the person is a director, and in the case of a foreign company, the nationality of that company
- any other information as required by Regulations.

These records should be kept for a period of seven years after the person ceases to serve as a director.

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.

#### What a new director should be told

King IV recommends that when new directors are appointed to the board, they 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 such as operations, business environment and general sustainability matters.

A formal programme should be designed to increase the awareness and effectiveness of each director appointed (both new and existing director). While the responsibility for this process lies with the chairperson, it is suggested that the company secretary is the best person to actually perform the induction and development programme.

#### **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 surprised 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.

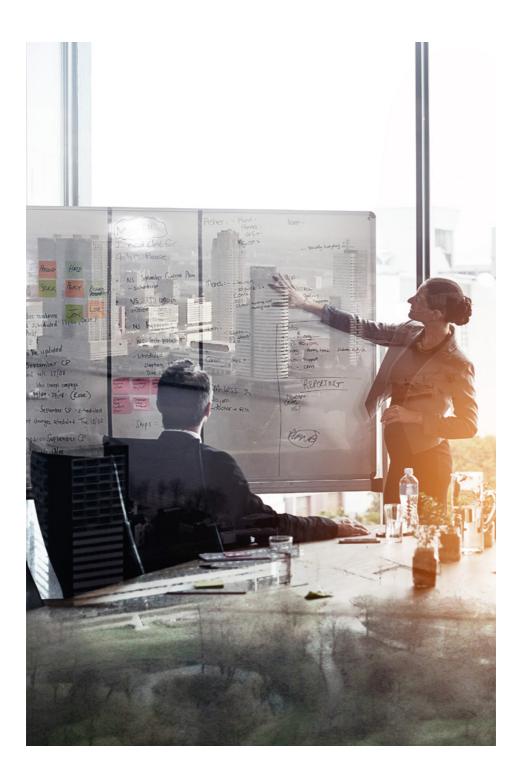
It is only fair that an individual be given the opportunity to weigh up any risks against the rewards from serving as a director.

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 may be 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
  - 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 or any other assurance provider. It is therefore important for a director to understand the sources and reliability of this assurance.



# Composition of the board of directors //

<sup>(1)</sup> The governing body should comprise the appropriate balance of knowledge, skills, experience, diversity and independence for it to discharge its governance role and responsibilities objectively and effectively."

King IV – Principle 7

## <sup>o3</sup> Composition of the board of directors //

#### **Composition of the board**

King IV has reaffirmed 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 appropriate balance of power between the different categories of directors.

In South Africa, best practice dictates that the majority of directors should be non-executive, of which the majority should be independent. At least two executive directors (the CEO and the director responsible for the finance function) should be appointed to the board. The JSE Listings Requirements stresses the fact that each company must have a policy evidencing a clear balance of power and authority at board level, to ensure that no director has unfettered power of decision-making.

King IV proposes staggered rotation for non-executive directors, while ensuring continuity of skills and experience. Rotation also allows for the introduction of new directors with different skills and experience from which the board may derive benefit. It is proposed that at least one third of non-executive directors be rotated every year. Rotating directors may be reappointed, if eligible.

The chairman and the board should reassess the independence of independent directors on an annual basis. King IV suggests that the reappointment of an independent director after a term of nine years should be seriously considered. It is suggested that the director's independence may be impaired after nine years. In this regard, the concept of perceptual independence, as set out in King IV, should be considered. The challenge in composing a well-functioning, effective board lies in establishing the appropriate balance. Each company faces different issues, and will require a unique combination of skills to meet those challenges. Every board should consider whether its size, diversity and demographics make it effective. In this regard, a number of factors may be taken into account, including academic qualifications, technical expertise, relevant industry knowledge, experience, nationality, age, race and gender. When determining the number of directors to serve on the board, the collective knowledge, skills, experience and resources required for conducting the business of the board should be considered.

The traditional boardroom of a fairly homogenous group of individuals is no longer appropriate and does not produce the most effective decisions and strategy for a company. It is critical that the board has exposure to a wide range of perspectives to facilitate robust discussions of issues.

#### What is board diversity?

Diversity takes various forms in a boardroom and can be broadly categorised into the following elements:

#### Skills, expertise and experience

Having the optimal mix of skills, expertise and experience is paramount to ensure that the board as a collective is equipped to guide the business and strategy of the company. Traditionally, boards recruit from C-suite executives. According to the Deloitte US 2014 Board Practices Report<sup>1</sup>, C-suite experience was found to be one of the top three desired board skills and experience in US public companies. While the experience from C-suite individuals is invaluable, it may be beneficial for boards to broaden their definition of "board-ready talent". Business unit heads, regional leaders, academics, entrepreneurs, government leaders, and other non–C-suite executives can create a wider, more diverse pool with some very talented individuals that could bring interesting and insightful perspectives into the boardroom.<sup>2</sup>

<sup>&</sup>lt;sup>1</sup> Deloitte LLP Center for Corporate Governance, 2014 Board Practices Report, Published by the Society of Corporate Secretaries and Governance Professionals in collaboration with Deloitte LLP's Center for Corporate Governance, 2014 http://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-2014-board-practices-report-final-9274051-12122014.pdf

<sup>&</sup>lt;sup>2</sup> NACD Directorship, Changing Course on Boardroom Composition, Deborah De Haas and Byron Spruell, March/April 2015 edition

http://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-aers-changingcourseboardroom-482015.pdf

Directors are usually selected for their leadership qualities - they often have experience with generalised management or leadership experience rather than narrow expertise or technical acumen.<sup>3</sup> However, a move towards having niched technical experience in the boardroom does not appear to be implausible. Currently in South Africa, directors of listed companies who serve on audit committees are expected to have keen financial expertise with an understanding of financial and sustainability reporting standards. Furthermore, given the increasingly digital environment that businesses operate in, having a technology expert sitting in the boardroom could prove to be a strategically advantageous decision for a company. The importance of the board's involvement in technology is reiterated by the King Report on Corporate Governance for South Africa 2016 (King IV) which recommends that the board should be responsible for information technology (IT) governance.

In order to appropriately discharge this responsibility, the board would need to have a keen insight into the IT environment of the company, further emphasising the need for specialised skills on the board in this regard. Another example of niched board skills would be human capital management. Most organisations argue that their workforce is their most valuable asset, yet very few boards have an individual with expertise in this area. According to a US survey<sup>4</sup>, only about one board in five had a member with expertise in human capital management. This is even more concerning in light of the fact that when the surveyed board members were asked who they rely on for expert knowledge pertaining to human capital management, the most common response was "other board members".

#### Gender

This element is one of the more emphasised forms of diversity in the boardroom. Historically, corporate boardrooms have largely been a male consortium. In recent years, this practice has been challenged as many companies, boards and shareholders have recognised the benefits of having a gender-balanced boardroom. According to a recent Deloitte global survey<sup>5</sup>, South Africa ranks fourth globally for the percentage of board chairs that are women at 7.8%,

<sup>&</sup>lt;sup>3</sup> Harvard Business Review, *All Boards Need a Technology Expert*, Jean-Louis Bravard, 23 September 2015 https://hbr.org/2015/09/all-boards-need-a-technology-expert

<sup>&</sup>lt;sup>4</sup> Boards & Directors, 33(3), 56-59, *Boards as Overseers of Human Capital*, Edward E. Lawler III, 2009 http://www.viennaindex.com/wp-content/uploads/2013/07/DBarticlespring20091.pdf

<sup>&</sup>lt;sup>5</sup> Harvard Business Review, *All Boards Need a Technology Expert*, Jean-Louis Bravard, 23 September 2015 https://hbr.org/2015/09/all-boards-need-a-technology-expert

against a global average of 4%. The 2014 Board Practices Report1 found that, on average, 18% of the 250 US public companies surveyed had increased the number of women on their boards in the last year. Females are increasingly sitting shoulder to shoulder with their male counterparts in the boardroom, bringing with them a unique style of management and perspective.

#### Ethnicity

Ethnic diversity pertains to having a mix of individuals from various racial, cultural and religious backgrounds. The ethnic mix of a board should ideally represent the area in which the company operates. In South Africa, legislation such as the Broad-based Black Economic Empowerment Act promotes ethnic diversity in the workplace.

#### Age

Age diversity is an often overlooked element in the boardroom. Board members tend to be older, as many boards equate age with experience. The 2014 Board Practices Report1 found marginal evidence of generational diversity in boardrooms, with so-called "younger" directors being in their fifties. While older directors do provide a wealth of knowledge, having younger directors introduces a fresh perspective into the boardroom which should not be underestimated.

#### Geography

Geographic diversity refers to having a mix of individuals from various geographic locations on the board. Ideally, the geographic mix should align to the areas that the company operates in. In an increasingly global workplace, neglecting this element of diversity would be particularly imprudent for a multi-national company as it may result in boardroom perspectives lacking a robust understanding of the company's operating environment. According to a recent study, nearly 90% of European boards include at least one director from a country other than where the company is headquartered. In 2014, roughly a third of all directors serving on major European boards were non-nationals.<sup>6</sup>

<sup>6</sup> Boards & Directors, 33(3), 56-59, *Boards as Overseers of Human Capital*, Edward E. Lawler III, 2009 http://www.viennaindex.com/wp-content/uploads/2013/07/DBarticlespring20091.pdf

#### Independence

Many argue that achieving the right balance of independent directors is crucial to a well-functioning board. The European Confederation of Directors' Associations (ecoDa) Principles view the involvement of independent non-executive directors on the board as a key step in the governance evolution of a company. Independent directors bring a balanced perspective to the boardroom as they assess matters in a more objective fashion. The ecoDa Principles also indicate that the board should determine if a director is independent in character and judgement after considering all relevant factors. These factors may include having regard to the relationship of the individual or his/her close family ties with the company, board and shareholders. In South Africa, approximately 60% of nonexecutive directors of listed companies are independent. This is largely due to the regulatory requirements in terms of the Companies Act, King IV and the JSE Listing Requirements to have such individuals on the board. When considering independence of directors, the company should be cognisant of the concept of perceptual independence, as described in King IV. Accordingly, when considering the independence of any particular director, the board should ask whether or not an informed and reasonable outsider will regard that director as independent.

#### Are there external pressures driving diversity into the boardroom?

In recent years, there has been an influx of regulatory reforms globally encouraging diversity in the boardroom – specifically, gender diversity. King IV proposes that each company should set and publish race and gender targets for board membership. In addition the JSE Listing Requirements now make it mandatory for each listed company to have a policy on the promotion of gender and race diversity at board level, and to regularly report to shareholders on progress in this regard.

The European Commission (EC) has introduced a Directive on improving the balance of males and females among non-executive directors of companies listed on stock exchanges. The EC Directive's purpose is to significantly increase the presence of women on corporate boards throughout the European Union by setting a binding minimum target of 40% females among non-executive directors of companies, with a focus on public limited companies.<sup>7</sup> These measures aim to promote gender equality in economic decision-making, and to take full advantage of the talent pool of candidates for a more equal gender representation on

<sup>&</sup>lt;sup>7</sup> International Corporate Governance Network, ICGN Statement and Guidance on Gender Diversity on Boards, 2013

company boards. Gender quotas have also been promoted via legislation in many European countries. In 2005, Norway became the first country to introduce board gender quotas when the Norwegian Public Limited Liability Companies Act was amended to require 40% representation of both genders on boards. Similar law reforms have also been adopted in Spain, France and Italy.

Although gender diversity on boards has increased in South Africa over the past 10 years, the change is happening very slowly. Currently, it is estimated that women occupy approximately 20% of directorships on boards in South Africa.<sup>5</sup> Furthermore, although there are a number of initiatives to improve the gender representation in the corporate sector, the government's proposal<sup>8</sup> to institute a 50% quota for women on boards lapsed in parliament. There are, however, other programmes in place to encourage the appointment of more women to boards, and which has contributed to a steady increase in the numbers.

One of the largest influencers of diversity in South Africa has been the Broadbased Black Economic Empowerment Act. The Act embodies government's efforts to situate black economic empowerment within the context of a broader national empowerment strategy focused on historically disadvantaged people, and particularly black people, women, youth, disabled, and rural communities. One of the Act's many objectives, specifically focused on women, is to increase the extent to which black women own and manage new enterprises and facilitate their access to economic activities, infrastructure, and skills training.<sup>9</sup>

With regard to independence, mechanisms such as the Companies Act, King VI and the JSE Listing Requirements include requirements to bring the objective view into South African boardrooms. For example, King IV recommends that the board should comprise a balance of power, with a majority of non-executive directors, that majority of whom should be independent. Having a majority of independent directors on the board is a notion echoed by various internationally recognised governance codes including those in the US, Canadian, Australian and UK as well as the Organisation for Economic Co-operation and Development (OECD) Principles of Corporate Governance. King VI also recommends that the chairperson of the board is an independent non-executive director. King IV further recommends that a lead independent director should be appointed to

<sup>8</sup>Women Empowerment and Gender Equity Bill, B 50B—2013 http://www.gov.za/sites/www.gov.za/files/Bill50B\_2013\_\_0.pdf

<sup>9</sup> Black Economic Empowerment www.southafrica.info be a sounding board for the chairperson and provide an unbiased point of view. The aforementioned internationally recognised governance codes include similar principles to promote objective decision-making in the boardroom.

Furthermore, in South Africa, to allow for the proper functioning of the audit committee, both the Companies Act and the JSE Listing Requirements have strict eligibility criteria for members of the committee to ensure that these directors are independent of the company.

The International Corporate Governance Network (ICGN) encourages the adoption of a policy on diversity which should include measurable targets for achieving appropriate diversity within a company's senior management and board (both executive and non-executive) and report on progress made in achieving such targets.<sup>7</sup> Countries like Australia have encouraged disclosure of diversity policies and objectives by adopting an "apply or explain" approach. Australian listed companies are required to benchmark their corporate governance practices against the recommendations developed by the Australian Corporate Governance Council, including the Diversity Recommendations which became effective in 2011.

Shareholder activism has increased significantly in recent years, with shareholders being more vocal about the changes they would like to see in a company's board composition. In light of the many benefits of having a diverse board, an opportunity arises for activists to put pressure on a company to achieve a more balanced and diverse board composition. According to Stephen Murray, the president and CEO of CCMP Capital, a major private equity firm: "The whole activist industry exists because public boards are often seen as inadequately equipped to meet shareholder interests."<sup>10</sup>

#### Why would a company consider board diversity?

The principal argument in favour of a diverse board is the wide range of perspectives that each individual would bring to the boardroom table. Principle 3.1 of the ICGN Global Governance Principles supports this view and states that the composition of the board should reflect a sufficient mix of individuals with relevant knowledge, independence, competence, industry experience and diversity of perspectives to generate effective challenge, discussion and objective decision-making.

<sup>&</sup>lt;sup>10</sup> Harvard Business Review, Where Boards Fall Short, Dominic Barton and Mark Wiseman, February 2015 https://hbr.org/2015/01/where-boards-fall-short

A diverse board better understands its customer base and the environment that the business operates in. As a result of this enhanced understanding, the board is better placed to find and seize opportunities for innovation, which ultimately creates value for the business. For example, in 2014 Walmart appointed 30-year-old Kevin Systrom, former CEO and co-founder of Instagram, to its board of directors. The company considered Kevin's technical and digital expertise to be invaluable as they planned to further connect with customers and deploy new capabilities through e-commerce and mobile channels.<sup>11</sup> The enhanced understanding also means that the board is able to react faster to changes in the environment. Where directors don't properly understand the market and applicable business environment, it can take a long time before the board is convinced and comfortable enough to make important decisions. This delayed reaction time to market changes can be paralysing in highly competitive markets where a company's longevity depends on its ability to respond and adapt quickly.

Having a wide range of perspectives in the room also means that the status quo is constantly challenged and critically reassessed, which guards against the notorious "group think". And although this may initially lead to "storming" around the boardroom table, it is likely to yield a more favourable result for the company ultimately. Interestingly enough, experts believe that due to group bias, "homogeneous groups don't come to better solutions - they're simply convinced that they did. Heterogeneous groups, on the other hand, come to better solutions - they just don't think that's the case."<sup>16</sup> Research by Columbia University's Katherine W Phillips and others revealed that diverse groups outperformed more homogeneous groups not because of a flurry of new ideas, but rather that the heterogeneity prompted a more careful evaluation of the information at hand, which was absent in homogeneous groups.<sup>12</sup> For example, research by Professor Aaron Dhir of York University into the experiences of a group of Norwegian corporate directors post the introduction of the 40% gender quota revealed that

<sup>12</sup> Kellogg Insight, Better Decisions Through Diversity, Based on the research of Katherine W. Phillips, Katie A. Liljenquist and Margaret A. Neale, 1 October 2010

 $http://insight.kellogg.northwestern.edu/article/better_decisions\_through\_diversity$ 

<sup>16</sup> Harvard Business Review, Women Directors Change How Boards Work, Laura Liswood, 17 February 2015 https://hbr.org/2015/02/women-directors-change-how-boards-work

<sup>&</sup>lt;sup>11</sup> Walmart, Instagram CEO and Co-Founder Kevin Systrom Joins Walmart's Board of Directors, 29 September 2014 http://news.walmart.com/news-archive/2014/09/29/instagram-ceo-and-co-founderkevin-systrom-joins-walmarts-board-of-directors

female directors are "more likely than their male counterparts to probe deeply into the issues at hand" by asking more questions, leading to more robust intraboard deliberations.<sup>16</sup> Another insightful finding from Professor Dhir's study was that the gender quota eroded at cliques being formed amongst the directors and forced people to tap outside of their own networks. Consequently, the more diverse a board becomes, the wider the networks and business connections that such a board has access to.

A spectrum of diverse perspectives in the boardroom, specifically with regard to skills and expertise, also aids in counteracting "silo thinking" when the board is faced with a challenge. A board that is equipped to consider an issue from many angles (e.g. financial, economic, legal, generational, geographic, etc.) is far more effective at assessing the risk of such an issue than one that adopts a onedimensional approach.

Incorporating independence into the boardroom also has its own specific advantages. Independent directors bring an unbiased view distinct from that of shareholders and management which provides reassurance to external parties that the company is being run in an effective manner. Due to their perceived distance from the company, they act as a balancing element in boardroom discussions between different shareholder representatives and managing conflicts of interest affecting board members. Their objectivity also allows them to safeguard the interests of minority shareholders and other stakeholders who may not be represented on the board and who may be unable to speak with a strong voice at shareholder meetings. Having considered the above, the question is whether there is evidence of enhanced company performance as a result of incorporating diversity into the boardroom. Currently, studies of this nature are largely focused on the benefit of gender diversity in the boardroom, but the same arguments may equally apply to all forms of diversity. According to the World Economic Forum<sup>13</sup>, compelling findings regarding the benefits of gender equality are emerging from companies. It says companies that include more women at the top levels of leadership tend to outperform those that don't. Findings from studies performed by Catalyst<sup>14</sup> showed that companies with a higher representation of women in top management, outperformed their counterparts with respect to Return on Equity and Total Return to Shareholders. More recent studies<sup>15</sup> have supported this, not only when looking at women in the boardroom, but also women executives and senior management.

A further benefit of having a diverse board is the external perception that may be created. A company that embraces diversity in the upper echelons of the organisation may be perceived by outsiders to adopt a top-down approach to being a good corporate citizen. Such a view may inspire investor confidence in the organisation which ultimately creates value for the company.

Lastly, seeing the positive impact of having a diverse board as mentioned above, in itself creates an incentive for companies to continue incorporating diversity in the boardroom. Boards that strive for effectiveness and embrace diversity as a mechanism to deliver that effectiveness are likely to perform better than boards who incorporate diversity with compliance in mind ("tick-boxing"). It remains important for boards to strive to create a balance between conformance and performance. While it remains necessary to ensure compliance and adherence to various statutory prescripts (which may differ from jurisdiction to jurisdiction) and applicable governance codes, the focus should always be on the performance of the business. A tick-box approach to compliance or conformance will not necessarily yield positive results. Rather, companies should

<sup>&</sup>lt;sup>13</sup> World Economic Forum, Global Gender Gap Report, 2014 http://reports.weforum.org/global-gender-gap-report-2014/preface/

<sup>&</sup>lt;sup>14</sup> Catalyst, The Bottom Line: Connecting Corporate Performance and Gender Diversity, 15 January 2004 http://www.catalyst.org/knowledge/bottom-line-connecting-corporate-performance-and-gender-diversity

<sup>&</sup>lt;sup>15</sup> Washington Post, More women at the top, higher returns, Jena McGregor, 24 September 2014 http://www.washingtonpost.com/news/on-leadership/wp/2014/09/24/more-women-at-the-top-higher-returns/

strive for a balance and determine how conformance can be viewed in a positive light to enhance the performance of the business. For example, consider a company that appoints a single director who possesses various elements of diversity to a fairly homogenous board - purely as a conformance exercise so the board can "tick a few diversity boxes". Such a director may be outvoted by the other board members, thus diminishing the performance benefit of having the diverse member on the board. In the above situation, the company should carefully consider how best to incorporate diversity in the boardroom in a way that will effectively improve the performance of the business. This might involve including other members on the board with elements of diversity (bearing in mind the necessary skill, experience and expertise requirement) to result in a more balanced board which makes effective decisions for the company.

#### Why might a company not adopt diversity in the boardroom?

The benefits of a having a diverse board must be weighed up against the costs of doing so. Finding the appropriately skilled individuals who also match other desired elements of diversity can be a difficult, time consuming and expensive task. This is especially true for boards operating in niche industries where highly specialised skills are required, causing the pool of potential board candidates to be reduced. Where a company places a greater emphasis on other aspects of diversity rather than the skills and expertise of an individual, it could run the risk of fronting or making such individuals feel disenfranchised from the greater board.

Where a company does manage to find appropriately skilled individuals to constitute a diverse board, it may initially find that board members need to earn each other's trust in decision-making as each person comes with a unique approach and perspective. This may result (at least initially) in more prolonged decision-making, reduced cohesion and additional conflicts initially and, if improperly managed, could lead to distrust and dissatisfaction in the boardroom.<sup>16</sup>

A further argument against heterogeneity is that it reduces over time as members become more familiar with each other. The more board members interact, the more similarly they think which takes one back to the initial problem of "group think". Given this phenomenon, regular board refreshment is of paramount importance. The board should be refreshed often enough to ensure that the appropriate level of debate and challenge is maintained in the boardroom, but not so often that it prevents synergies from being created between directors. In this regard, the King IV recommendation that at least one third of non-executive directors be rotated annually provides an ideal opportunity for the board to ensure regular refreshment.

Lastly, particularly in smaller family-owned companies, there may be a reluctance to introduce diversity into the boardroom as it may require the inclusion of "outsiders" into the company. For example, a company may be hesitant to introduce a larger proportion of independent directors to the board as major shareholders may feel that they are relinquishing ultimate control of the board. However, this may not be the case where the majority shareholder can influence the appointment or removal of directors. Major shareholders can ensure that they only approve the appointment of independent directors that share their vision for the company - the involvement of outstanding independent directors can then only enhance boardroom capabilities and the likely success of the enterprise. In such a scenario, one has to caution against the appointment of "puppet directors" as one should not ignore the obligation of each director to continuously comply with their fiduciary duty, i.e. to always act in the best interest of the company.

### How does a company create the optimally diverse board? *Creating the optimal framework*

An optimally diverse board is primarily built on the foundation of a skills-based framework, taking into account the appropriate skills, expertise and experience necessary for the proper functioning of the board. In other words, the first element of diversity explained above should be the single largest consideration for the optimal board.

Once the appropriate skills, expertise and experience have been identified, other elements of diversity should then be woven into the framework to allow for effective and robust decision-making and discussion in the boardroom.

We recommend that the optimal framework is formulated by the nomination committee and approved by the board. Shareholders can influence the framework through stakeholder engagement with the board. They can also express their preferences by including board composition requirements in the Memorandum of Incorporation or other founding documents of the company.

#### Maintaining the optimal framework

Once the board composition framework has been established, it should be periodically reviewed and refreshed as the company develops. The framework should always reflect a composition that will introduce the appropriate level of challenge and discussion in the boardroom to effectively cope with the company's ever-changing landscape. To this end, the framework should be seen as dynamic and tailored to the environment that the company operates in at a given point in time.

#### Assessment against the optimal framework

The current composition of the board should be regularly evaluated against the optimal framework. Ideally, this should be done on an annual basis however, in practice, it is likely to happen every 3 years to coincide with board refreshments.

The board should however consider the risk and opportunity cost of operating with a sub-optimal board for any given period, if the assessment is performed on a triennial basis. King IV supports regular board refreshments by recommending that at least one third of the non-executive directors on the board should rotate every year.

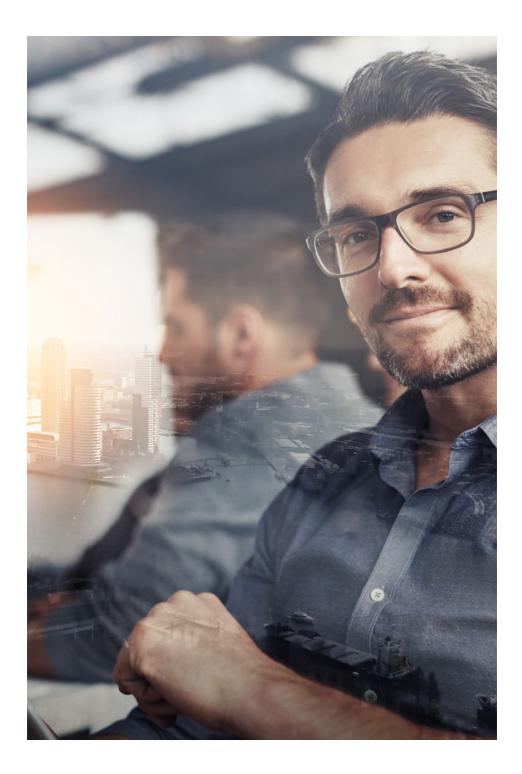
Assessing the board composition against the optimal framework should be inextricably linked to board refreshments, director tenure, succession planning and board recruitment initiatives. According to the 2014 Board Practices Report1, an overwhelming majority of companies turn to their own directors for board member recommendations when recruiting. Given the lack of heterogeneity in many boardrooms, this means that the network of individuals that are recommended to the board are fairly limited and homogenous, which further exacerbates the lack of diversity in the boardroom.

The ICGN7 provides guidance on practically incorporating gender diversity in the boardroom. This guidance has been adapted as below to reflect a wider diversity context:

- The nomination committee should conduct a structured evaluation of the board of directors on an annual basis to identify ways to strengthen the board's effectiveness, to assess the diversity in the boardroom, and to highlight gaps between the skills and background of existing directors and their optimal mix. This exercise will help inform the recruitment of new directors whose diversity of skills and experience should address any gaps
- The nomination committee should also develop a succession plan for the board, recognising that new director recruitment should be conducted strategically to help replace the skill sets of retiring directors
- The nomination committee should report to the full board on how it takes diversity into account when nominating candidates to the board
- The nomination committee should identify and recommend candidates for new board members and the committee should seek a candidate taking into account multiple elements of diversity. This will ensure that new directors are chosen from the widest possible group of qualified candidates
- The board should consider requiring the nomination committee to address diversity and talent management as an explicit element of its oversight work, and to report to shareholders specifically on this.

To remain relevant in an increasingly competitive world, directors cannot ignore the crucial role that diversity plays in governance, particularly in the boardroom. Companies that fail to dip into the ever-deepening talent pool of diverse, well-educated and ambitious individuals run the risk of limiting value creation, compromising sustainability and undermining their long-term competitiveness.

Although there are some challenges associated with having a diverse board, many of these may be viewed as temporary and will be far outweighed by the overall benefits of having a rich melting pot of diverse perspectives around the boardroom table.



# Director conduct //

It is 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 or specific or affirmative action is required of them. No such distinction is to be found in any statute. 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. That is the general rule and its application to any particular incumbent of the office of director must necessarily depend on the facts and circumstances if each."

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

# <sup>№</sup> Director conduct //

#### The standard of directors' conduct

By accepting their appointment to the position, directors imply that they will perform their duties to a certain standard, and it is a reasonable assumption of the shareholders that every individual director will apply his or her particular skills, experience and intelligence to the advantage of the company.

The Act codifies the standard of directors' conduct in section 76. The standard sets the bar very high for directors. The intention of the legislature seems to be to encourage directors to act honestly and to bear responsibility for their actions - directors should be accountable to shareholders and other stakeholders for their decisions and their actions. However, with the standard set so high, the unintended consequence may be that directors would not be prepared to take difficult decisions or expose the company to risk. Since calculated risk taking and risk exposure form an integral part of any business, the Act includes a number of provisions to ensure that directors are allowed to act without constant fear of personal exposure to liability claims. In this regard, the Act has codified the business judgement rule, and provides for the indemnification of directors under certain circumstances, as well as the possibility to insure the company and its directors against liability claims in certain circumstances.

It should be noted that the duties imposed under section 76 are in addition to, and not in substitution for, any duties of the director of company under the common law. This means that the courts may still have regard to the common law, and past case law when interpreting the provisions of the Act. The codified standard applies to all directors, prescribed officers or any other person who is a member of a board committee irrespective of whether or not the person is also a member of the company's board. Also, it should be noted that no distinction is made between executive, non-executive or independent non-executive directors. The standard, and consequent liability where the standard is not met, applies equally to all directors.

- In terms of this standard a director (or other person to whom section 76 applies), must exercise his or her powers and perform his or her functions:
  - in good faith and for a proper purpose in the best interest of the company
  - with the degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions and having the general knowledge, skill and experience of that director.

Directors have a fiduciary duty to act in the best interest of the company as a whole. A fiduciary duty can be described as the legal duty of a fiduciary to act in good faith in promoting and protecting the interests of a beneficiary and to avoid a conflict of interest between the fiduciary and the beneficiary. Directors owe this duty to the company as a legal entity, and not to any individual, or group of shareholders – not even if the majority shareholder appointed the director.<sup>1</sup> King IV subscribes to the stakeholder inclusive approach, and as such it takes the position that, "directors owe their duties to the company and the company alone as the company is a separate legal entity from the moment it is registered until it is deregistered ... The company is represented by several interests and these include the interests of shareholders, employees, consumers, the community and the environment. Thus requiring directors to act in good faith in the interest of 'the company' cannot nowadays mean anything other than a blend of all these interests, but first and foremost they must act in the best interest of the company as a separate legal entity ... An interest that may be primary at one particular point in time in the company's existence may well become secondary at a later stage."2

<sup>&</sup>lt;sup>1</sup>See Phillips v Fieldstone Africa (Pty) Ltd 2004(3); SA 465 (SCA) for a review of the law relating to the fiduciary duties of directors). See also section 76 of the Companies Act, 2008.

<sup>&</sup>lt;sup>2</sup> Esser I, Du Plessis JJ, "The Stakeholder Debate and Directors' Fiduciary Duties", SA Merc LJ 346-36, p360, 2007 (19).

Directors are obliged to act in good faith in the best interest of the company. They should act within the bounds of their powers, and always use these powers for the benefit of the company. Where a director transgresses his or her powers, the company might be bound by his or her action, although he or she can be held personally liable for any loss suffered as a result.

The Act prohibits a director from using the position of director, or any information obtained while acting in the capacity of a director to gain an advantage for himself or herself, or for any other person (other than the company or a wholly-owned subsidiary of the company), or to knowingly cause harm to the company or a subsidiary of the company.

The fiduciary duty of directors includes (but is not limited to):

... and the directors
 as occupying a fiduciary
 position towards the
 company must exercise
 those powers bona
 fide in the best interest
 of the company as a
 whole, and not for an
 ulterior motive ..."

#### *Treasure Trove Diamonds Ltd v Hyman* 1928 AD 464 at 479

- the duty to individually and collectively exercise their powers *bona fide* in the best interest of the company
- the duty not to exceed their powers
- the duty not to act illegally dishonestly, or *ultra vires*
- the duty to act with unfettered discretion
- the duty not to allow their personal interests to interfere with their duties
- a director is accountable to the company for secret profits made by virtue of the fiduciary position or from the appropriation of a corporate opportunity
- the duty not to compete with the company
- the duty not no misuse confidential information.

When determining whether a director complied with his or her fiduciary duty, the court may consider whether, in the circumstances, a reasonable person could have believed that the particular act was in the best interest of the company. This is typically known as an objective test.

The codified standard for director conduct combines "care, skill and diligence" in one single test. The test to measure a director's duty to exercise a degree of care, skill and diligence provides for an objective assessment to determine what a reasonable director would have done in the circumstances.

However, the objective assessment contains subjective elements in that it takes into consideration the, skill and experience of that particular director. In applying the test, a distinction is made between different types of directors.

the extent of a director's duty of care and skill depends to a considerable degree on the nature of the company's business and on any particular obligations assumed by him or assigned to him ... In that regard there is a difference between the so-called full-time or executive director, who participates in the day-to-day management of the company's affairs or a portion thereof, and the non-executive director who has not taken on any special obligation. The latter is not bound to give continuous attention to the affairs of the company. His duties are of an intermittent nature to be performed at periodical board meetings, and at any other meetings that may require his attention."

Fisheries Development Corporation of SA Ltd v AWJ Investment (Pty) Ltd 1980 (4) SA 156 (W)

In a recent Australian case (Centro case) the duty of care and skill was considered with respect to the duty of directors to approve the financial statements of the company. In this case that court found that all non-executive directors were in breach of their duty of care and skill. The failure to notice certain omissions may well be explicable – but here the directors clearly looked solely to management and external advisors. However, if they had acted as the final filter, taking care to read and understand the financial statements, the errors may have been discovered.

All directors must carefully read and understand financial statements before they form the opinions which are to be expressed ... Such a reading and understanding would require the director to consider whether the financial statements were consistent with his or her own knowledge of the company's financial position. This accumulated knowledge arises from a number of responsibilities a director has in carrying out the role and function of a director.

#### These include the following:

- a director should acquire at least a rudimentary understanding of the business of the corporation and become familiar with the fundamentals of the business in which the corporation is engaged
- a director should keep informed about the activities of the corporation
- while not required to have a detailed awareness of day-to-day activities, a director should monitor the corporate affairs and policies
- a director should maintain familiarity with the financial status of the corporation by a regular review and understanding of financial statements
- a director, while not an auditor, should still have a questioning mind."

... a director is not relieved of the duty to pay attention to the company's affairs which might reasonably be expected to attract inquiry, even outside the area of the director's expertise."

*Australian Securities and Investments Commission v Healey* [2011] FCA 717 at 17 and 18

As stated above, the Act also codifies the business judgment rule. In terms of this rule a director will not be held liable if he or she took reasonable diligent steps to become informed about the subject matter, does not have a personal financial interest (or declared such a conflicting interest) and the director had a rational basis to believe that the decision was in the best interest of the company.

<sup>(1)</sup> In respect of all duties that may properly be left to some other official, a director is, in the absence of grounds for suspicion, justified in trusting that official to perform such duties honestly. He is entitled to accept and rely on the judgment, information and advice of the management, unless there are proper reasons for querying such. Similarly, he is not expected to examine entries in the company's books ... Obviously, a director exercising reasonable care would not accept information and advice blindly. He would accept it, and he would be entitled to rely on it, but he would give it due consideration and exercise his own judgment in the light thereof".

### *Fisheries Development Corporation of SA Ltd v AWJ Investments (Pty)Ltd* 1980 (4) SA 156 (W)

In this regard, King IV stresses the importance of appropriate governance practices: "For directors of companies, adopting good corporate governance practice will be especially important if they were to rely on the protection afforded by the business judgement rule as provided for in the Companies Act in the course of litigation. In the absence of robust and sound governance structures and processes, it will be difficult, if not impossible, for a director to show that reasonably diligent steps have been taken to become informed; that material financial interests were absent or dealt with appropriately; and that there was a rational basis for believing – and that the director did believe – that a decision was in the best interests of the company".

In discharging any board or committee duty, a director is entitled to rely on one or more employees of the company, legal counsel, accountants or other professional persons, or a committee of the board of which the director is not a member. The director, however, does not transfer the liability of the director imposed by this act onto such employee/person.

Directors of a company may be held jointly and severally liable for any loss, damage or costs sustained by the company as a result of a breach of the director's fiduciary duty or the duty to act with care, skill and diligence. The Act sets out a range of actions for which directors may be held liable for any loss, damage or costs sustained by the company.

These actions include:

- acting in the name of the company without the necessary authority being part of an act or omission while knowing that the intention was to defraud shareholders, employees or creditors
- signing financial statements that were false or misleading in a material respect
- issuing a prospectus or circular that contained an untrue statement.

In certain instances companies are allowed to indemnify directors in respect of any liability, or companies may purchase insurance to protect a director against liability (but only for those instances for which the company may indemnify the director), or to protect the company against expenses or liability for which the company may indemnify a director. A company may indemnify a director in respect of any liability, except for:

- any liability arising from situations where the director:
  - acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that the director lacked the authority to do so
  - acquiesced in the carrying on of the company's business despite knowing that it was being conducted in a reckless manner
  - had been a party to an act or omission by the company despite knowing that the intention was calculated to defraud a creditor, employee or shareholder of the company, or had another fraudulent purpose

- any liability arising from wilful misconduct or wilful breach of trust
- incurred a fine as a result of a conviction on an offence in terms of national legislation.

Unless the company's Memorandum of Incorporation provides otherwise, a company may purchase insurance to protect a director against any liability or expense for which the company is permitted to indemnify a director or to protect the company against any expenses or liability for which the company is permitted to indemnify a director. The company may, however, not directly or indirectly pay a fine imposed on the director of the company or of a related company as a consequence of that director having been convicted of an offence unless the conviction was based on strict liability.

#### **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.

Section 75 of the Act makes clear provision for dealing with a director's use of company information and conflict of interest. Where a director has a conflicting personal financial interest (where his or her own interests are at odds with the interests of the company), he or she is prohibited from making, participating in the making, influencing, or attempting to influence any decision in relation to that particular matter. This provision seems to impose a strict duty on directors not to allow their personal financial interest to impact, in any way, on their dealings with the company. In addition, where a director has a conflicting personal interest in respect of a matter on the board agenda, he or she has to declare that personal interest and immediately leave the meeting. A director is also prohibited from any action that may influence or attempt to influence the discussion or vote by the board, and is prohibited from executing any document on behalf of the company in relation to the matter, unless specifically requested to do so by the board. It should be noted that section 75 of the Act extends the application of the conflict of interest provisions to prescribed officers and members of board committees (even if those persons are not directors).

The term "personal financial interest" is defined. It refers to any material interests of a person of a financial, monetary or economic nature, or to which a monetary value may be attributed. An interest is "material" if it is significant in the circumstances of a particular matter to a degree that is of consequence in determining the matter or if it might reasonably affect a person's judgement or decision-making in the matter.

The conflict of interest provisions apply equally to persons related to the director. Thus, where a director knows that a related person has a personal financial interest in a matter to be considered at a meeting of the board, or knows that a related person has acquired a personal financial interest in a matter, after the board has approved that agreement or matter, the director should disclose that fact to the board. In this regard, it should be noted that for purposes of section 75 the definition of a "related person", when used in reference to a director, not only has the ordinary meaning as set out in the Act, but also includes a second company of which the director or a related person is also a director, or a close corporation of which the director or a related person is a member. This extension of the meaning of the term "related" may cause difficulty in instances of crossdirectorships. Thus, where a person is a director of a subsidiary, and also serves as director of the holding company, the holding company is regarded as related to the director. This may require that the director recuses him/herself in instances whether there may be a conflict between the interests of the subsidiary and the holding company.

Where the board makes a decision where a director was conflicted, the Act makes it clear that such a decision is invalid. In order to fix this problem the company has two choices: the board can either re-take the decision, without the conflicted director; or the shareholders can ratify the board decision by ordinary shareholders resolution. In instances where one or more directors are conflicted due to the fact that they serve as directors for more than one company in the same group, it may be possible to request shareholders to ratify certain or all decisions of the board. It is important to emphasise that the shareholders' resolution must be made with the knowledge that the decision, agreement or transaction was approved by the board while a conflicted director was party to such a decision, agreement or transaction. Furthermore, the aforementioned subsequent shareholders' ratification does not absolve the directors from liability if they took the decision in contravention of their responsibilities in terms of S76 of

the Act. In a group situation where there are cross directorships and the directors do not recuse themselves, decisions taken at board meetings must be ratified by shareholder resolution in order to validate the board decision as it relates to the conflict of interest only. For example, a decision made at a board meeting where the directors are conflicted to make a distribution without complying with the solvency and liquidity provisions can only be ratified through a shareholders' meeting to the extent of the conflict of interest and not regarding the noncompliance with the solvency and liquidity test.

The conflict of interest provisions do not apply to a company or its director, if the company has only one director, and that director holds all the beneficial interest in all the issued securities of the company. However, where that one director does not hold all the beneficial interest in the issued securities, he or she may not approve or enter into an agreement, or determine any other matter, in terms of which a person related to him may have a personal financial interest. In these instances, the director has to obtain shareholder approval by ordinary resolution.

Directors are not required to disclose their personal financial interest if:

- the decision may generally affect all of the directors of the company in their capacity as directors
- the decision may generally affect a class of people, despite the fact that the director is one member of that class of persons, unless the only members of the class are the director or persons related or inter-related to the director
- the decision relates to a proposal to remove the relevant director, or
- the company has only one director that holds all of the beneficial interests in the securities of the company.

The provision makes it clear that conflict of interest is taken seriously by the legislature, and one may assume that the Commission and the Takeover Regulation Panel will enforce these provisions strictly.

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 provisions will potentially have an impact on the way in which members of boards are selected and appointed, as membership of a number of different boards might lead to possible conflicts, which in turn means that those directors will not be able to participate in or contribute to discussions and decisions related to such matters.

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.

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.

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

Of course, the provisions of the Act relating to conflicts of interest (as discussed above) will prevent a director from such a position.

#### **Liability of directors**

The Act makes it clear that a person is not, solely by reason of being an incorporator, shareholder or director of a company, liable for any liabilities or obligations of the company, unless where the Act or the company's Memorandum of Incorporation provides otherwise. The directors of a company may only incur liability in specific instances. In terms of the Act, a director of a company may be held liable for any loss, damages or costs sustained by the company as a consequence of any breach by the director of a duty contemplated in the standard of directors conduct, failure to disclose a personal financial interest in a particular matter, or any breach by the director of a provision of the Act or the company's Memorandum of Incorporation.

In addition, the Act determines that a director of a company is liable for any loss, damages or costs sustained by the company as a direct or indirect consequence of the director having:

- acted in the name of the company, signed anything on behalf of the company, or purported to bind the company or authorise the taking of any action by or on behalf of the company, despite knowing that he or she had no authority to do so
- persisted and went along with any action or decision despite knowing that it amounts to reckless trading
- been a party to any action or failure to act despite knowing that the act or omission was calculated to defraud a creditor, employee or shareholder of the company
- signed, consented to, or authorised the publication of any financial statements that were false or misleading, or a prospectus that contained false or misleading information

 been present at a meeting, or participated in the making of a decision, and failed to vote against a decision to issue any unauthorised shares or securities, to issue options for unauthorised shares or securities, to provide financial assistance to a director or any person without complying with the requirements of the Act and the Memorandum of Incorporation, to approve a distribution that was contrary to the requirements of the Act, or for the company to acquire any of its own shares, or the shares of its holding company, or make an allotment despite knowing that the acquisition or allotment was contrary to the requirements of the Act.

The Act makes it clear that a director is jointly and severally liable with any other person who is or may be held liable for the same act. Also, any claim for loss, damages or costs for which a person is or may be held liable in terms of the Act prescribes after three years after the act or omission that gave rise to that liability.

#### **Delinquency and probation of directors**

The Act determines that directors may be declared delinquent or placed on probation as a result of certain conduct. This can be achieved by an application to court by the company, a director, a shareholder, the company secretary, a registered trade union or representatives of employees of the company. The grounds for the application for delinquency and probation are set out in the Act, but in general terms, directors could be:

- declared delinquent if they grossly abused their position or if they caused intentional harm to the company, and
- placed on probation if they improperly supported a resolution in contravention of the solvency and liquidity test or otherwise acted in a manner which is inconsistent with the duties of directors.

Delinquency usually lasts for 7 years from date of the order or a longer period as determined by the court order. A person who has been declared delinquent may apply to court after 3 years, for suspension of the delinquency order and substitution thereof with a probation order. A probation order will lapse automatically after 5 years.

#### **Personal liability company**

The Act allows for the inclusion in the Memorandum of Incorporation of a private company the provision that all directors (both present and past) are jointly and severally liable, together with the company, for the past and present debts and liabilities of the company that were incurred during their term of office. Such a company is classified as a personal liability company, and the name of the company will end with the expression 'Incorporated' or the abbreviation 'Inc'.

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.

#### **Apportionment of damages**

The Apportionment of Damages Act makes it easier for an aggrieved party 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**

#### **Insider Trading and Closed Periods**

The Financial Markets Act 19 of 2012 replaced the Securities Services Act which governed the regulation of securities services in South Africa since 2005. With the purpose of maintaining the integrity of South African financial markets, aligning the regulatory framework with relevant local and international developments and standards and mitigating the potential impacts of any possible future financial crisis, the Financial Markets Act refines its predecessor's provisions regulating insider trading. The revisions further extend the liability of directors and their proxies, mainly through the amendment of allowable defences, in dealing with unpublished price-sensitive information within their companies.

Given the Financial Services Board and Legislature's continued focus on market abusive transactions as well as the criminal and civil sanctions envisaged by the Financial Markets Act, this piece of legislation is very relevant to directors who receive and trade in their company's securities.

#### Inside information

Inside information is defined by the Financial Markets Act as specific or precise information which has not been made public and which is obtained or learned as an insider and, 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.

#### Insider

An insider, as defined by the Financial Markets Act, is 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
- (b) where such person knows that the direct or indirect source of the information was a person contemplated in paragraph (a)"

The definition, borrowed from the Security Services Act (Act 36 of 2004), stretches a far-reaching net to include not only directors as insiders, but also those that have direct or indirect exposure to inside information.

#### The offences

Similar to its predecessor, the Financial Markets Act makes it an offence for an insider to deal directly, indirectly or through an agent for his or her own account or for any other person, in the securities listed on a regulated market to which the inside information relates or which are likely to be affected by it. The disclosure of inside information to another person, encouragement of another person in dealing in securities of the company or discouragement of another person from dealing in the securities of the company by an insider who knows that he or she has inside information, similarly remains an offence in terms of the Financial Markets Act.

The Financial Markets Act, however, for the first time extends liability to any person dealing for an insider who knew that such person is an insider. Insider's proxies are hereby included within the realm of liability and are treated as insiders themselves if acting for another insider of the company.

#### The defences

An insider, dealing for his or her own account, may no longer utilise the defence that insider trading was performed in pursuit of an affected transaction as defined in section 440A of the Companies Act 1973. The only defence available to such an insider is where he or she only became an insider after having given the instruction to deal to an authorised user (i.e. licensed security services provider) and the instruction was not changed in any manner after he or she became an insider. A similar defence is given to the authorised user acting on the insider's behalf.

Where an insider deals for another person's account, the Financial Markets Act has amended the defence available to the authorised user acting on the instruction of the insider and now places the onus on that authorised user to prove that he or she did not know the client was an insider at the time that the instruction was given. The defence previously available to public sector bodies in pursuit of monetary policy was completely removed in the Financial Markets Act. A new defence has been added, known as the "safe harbour defence", for *bona fide* commercial transactions among insiders that are not designed to benefit from the price sensitive information. This defence requires that all parties to the transaction have possession of the same inside information and that trading is limited to these parties. An authorised user acting on the instruction of the insider(s) may also utilise this defence.

Lastly, disclosure of insider information by an insider to another person is defensible where the insider can prove that such disclosure was made pursuant to the proper performance of his or her employment, office or profession in circumstances unrelated to dealing and that he or she at the same time disclosed that the information was inside information.

The table below summarises the available defences:

The Defence	Available to
I only became an insider after having given the instruction to deal to an authorised user (i.e. licensed security services provider) and the instruction was not changed in any manner after I became an insider.	<ul> <li>An insider dealing for own account</li> <li>The authorised user dealing on instruction of the insider</li> </ul>
I am an authorised user acting on the instruction of the insider. The onus is on me to prove that I did not know the client was an insider at the time that the instruction was given.	The authorised user dealing on instruction of the insider
I entered into a bona fide commercial transaction amongst fellow insiders. The transaction was not designed to benefit from the price sensitive information. All parties to the transaction had possession of the same inside information and the trading was limited to these parties.	<ul> <li>An insider dealing for another person's account</li> <li>An authorised user dealing on instruction of the insider</li> </ul>
I disclosed insider information to another person. I can prove that such disclosure was made pursuant to the proper performance of my employment, office or profession in circumstances unrelated to dealing and that I at the same time disclosed that the information was inside information.	<ul> <li>An insider dealing for own accoun</li> <li>An insider dealing for another person's account</li> <li>An authorised user dealing on instruction of the insider</li> </ul>

#### **The Penalty**

Any director responsible for contravening the Financial Markets Act's provisions regulating insider trading will be liable to pay an administrative sanction not exceeding the profit on insider trading or loss avoided as a result thereof, an amount of up to R1 million, interest on any amount payable as well as the costs of suit, including any investigation costs incurred by the Enforcement Committee. In addition, the Financial Services Board has wide-ranging powers to investigate allegations of insider trading, including the search of premises and examination of any documentation related to their investigation on authority of a warrant.

#### Publication

The insider trading provisions do not apply to public information. The Financial Markets Act has amended the definition of public information to ensure that such information be more widely available before insiders may deal. This was done by removing information obtained by persons exercising diligence or observation, information only communicated on the payment of a fee or information only published outside South Africa, from the definition of public information in the Financial Markets Act.

#### **Closed periods**

Regulators commonly utilise "closed period" provisions to curb insider trading practices of directors and management. The provisions prohibit trading in company securities by designated persons during closed periods which commonly coincide with periods during which the persons might be privy to price sensitive information.

The JSE Listing Requirements ("the JSE") defines a "closed period" as:

- (a) the date from the financial year end up to the date of earliest publication of the preliminary report, abridged report or provisional report
- (b) the date from the expiration of the first six month period of a financial year up to the date of publication of the interim results;
- (c) the date from the expiration of the second six month period of a financial year up to the date of publication of the second interim results, in cases where the financial period covers more than 12 months
- (d) in the case of reporting on a quarterly basis, the date from the end of the quarter up to the date of the publication of the quarterly results
- (e) any period when an issuer is trading under a cautionary announcement.

The director of a company and company secretary (of the issuer company or a major subsidiary of the issuer) as well as associates of the director, which include immediate family, are prohibited from trading in the securities of a listed company during a closed period or any period when there exists any matter which constitutes unpublished price sensitive information in relation to the issuer's securities (whether or not the party has knowledge of such matter).

As it is quite possible that unpublished price sensitive information might already exist prior to the end of a financial period, the closed period could, applying the definition above, result in extended periods during which no trading is allowed. Even during periods of allowed trading, the director or company secretary (excluding his or her associates) require written authorisation to trade in the securities from the issuing company's chairman or another director designated for the purpose.

A director is expected to notify his or her immediate family and other associates as well as his or her investment manager of periods during which no trading is allowed and such communication should include the names of the issuer(s) of which he or she is a director. The investment manager of a director should be instructed by the director that no trades should be entered into on his or her behalf without prior written consent.

Similarly, immediate family and associates of the director have to inform the director of their trading activities in the securities of the issuer to allow the director to comply with the disclosure requirements set by the JSE.

#### Disclosure

Trading in the securities of a listed company requires disclosure on Stock Exchange News Service (SENS) when trading is entered into by or on behalf of:

- (a) a director and company secretary (held beneficially, whether directly or indirectly) of the issuer
- (b) a director and company secretary (held beneficially whether directly or indirectly) of a major subsidiary company of the issuer
- (c) any associate of the company or a major subsidiary of the company.

The SENS disclosure shall include all details of the transaction, including offmarket transactions. In terms of the JSE Listing Requirements, a company must, without delay, unless the information is kept confidential for a limited period of time as allowed by the JSE, release an announcement providing details of any development(s) in such company's sphere of activity that is/are not public knowledge and which may, by virtue of its/their effect(s), lead to material movements of the reference price of such company's listed securities.

Immediately after a listed company acquires knowledge of any material price sensitive information and the necessary degree of confidentiality of such information cannot be maintained or if the company suspects that confidentiality has or may have been breached, the company must publish a cautionary announcement on SENS in terms of the JSE Listing Requirements.

The company is required to update the cautionary statement at least every 30 business days after issuing the initial cautionary statement.

# The powers of the board of directors //

## The powers of the board of directors //

#### How can a director bind the company?

A company is a juristic person, and unless the company's Memorandum of Incorporation provides otherwise it has all of the legal powers and capacity of an individual, except if a juristic person is incapable of exercising any such power, or having any such capacity.

A company may limit, restrict or qualify the purposes, powers or activities of that company in its Memorandum of Incorporation. In addition, the Memorandum of Incorporation may limit the authority of the directors to perform an act on behalf of the company. It should be noted that the Act determines that where a company or its directors acts in contravention of such a limitation, qualification or restriction the action is not regarded as void for this reason only. Therefore, the Act provides that any person dealing with a company in good faith may presume that the company has complied with all of the formal and procedural requirements in terms of the Act, its Memorandum of Incorporation and any rules of the company, unless the person knew or reasonably ought to have known of any failure by the company to comply with such requirement.

Where an action by the company or the directors is inconsistent with any limit, restriction or qualification as set out in the company's Memorandum of Incorporation, the shareholders, by special resolution, may ratify such action.

The business and affairs of a company are managed by or under the direction of its board. The board of directors has the authority to exercise all of the powers and perform any of the functions of the company, except to the extent that the Act or the company's Memorandum of Incorporation provides otherwise. It is important for directors to ensure that they are familiar with the provisions of the Memorandum of Incorporation, especially those provisions that limit or restrict the authority of the board and the directors.

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 to 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:

- 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 "pre-approved" or alternatively subsequently ratified.

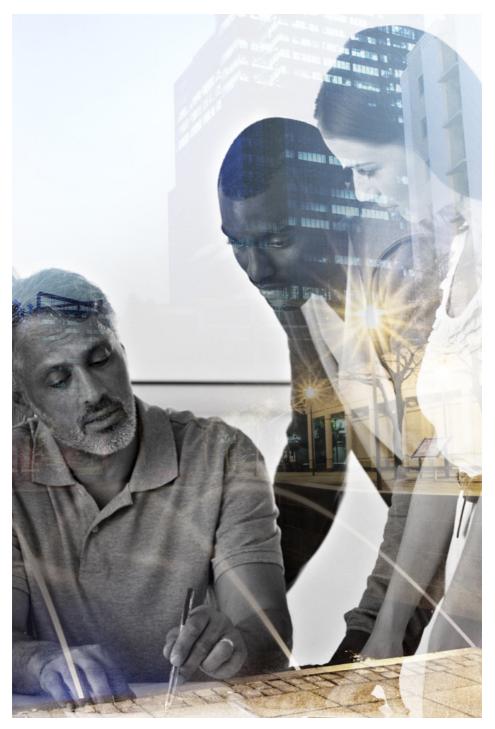
The board should set some level of quantitative materiality for itself to ensure that issues discussed are significant in terms of the company as a whole. These limits may be more complex than a single threshold, and may take into account additional factors such as whether the decision is for an unbudgeted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

#### Which powers are restricted?

The 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 Act requires approval of the shareholders by special resolution in the following instances:

- amendment of the company's Memorandum of Incorporation
- approval for the voluntary winding-up of the company
- approval of any proposed fundamental transaction (including the disposal of all or greater part of assets or undertaking, amalgamation, merger or scheme of arrangement)
- ratification of any action by the company or the directors that is inconsistent with a limit, restriction or qualification in the Memorandum of Incorporation
- approval of an issue of shares or securities to a director, future director, prescribed officer, or any person related or inter-related to the company, or to a director or prescribed officer of the company
- approval of financial assistance for subscription of securities (special resolution of the shareholders should be adopted within the preceding two years)
- approval of loans or other financial assistance to directors as well as related and inter-related companies (special resolution of the shareholders should be adopted within the preceding two years), and
- approval of the policy or parameters for director remuneration (special resolution of the shareholders should be adopted within the preceding two years).



## The workings of the board of directors //

King IV requires the board to lead ethically and effectively, and for directors to individually and collectively cultivate the following characteristics:

- Integrity
- Competence
- Responsibility
- Accountability
- Fairness
- Transparency"

King IV - Principle 1

## The workings of the board of directors //

#### The implicit duties of the board

When considering governance codes in key jurisdictions it becomes clear that the board has a number of core duties. These duties are reflected in King IV.

#### The board has to provide effective and ethical leadership

Effective leadership is built on four pillars, namely responsibility, accountability, fairness and transparency. This entails doing business ethically and sustainably by having regard for the company's economic, social and environmental impact on the community.

Good corporate governance is essentially about effective, ethical leadership. While leadership starts with each individual director, it finds its expression through the board as a collective, setting the appropriate example and tone which is referred to as ethical governance. King IV explains the governance of ethics as the role of the governing body in ensuring that the ethical culture within the company is aligned to the tone set by the governing body through the implementation of appropriate policies and practices.

The notion of governance of ethics is not new and was covered in King III which stated that ethics is the foundation of, and reason for, corporate governance. King III further included principles around providing ethical leadership and overseeing that the company's ethics are managed effectively.

While the requirement in King IV of the board to set the tone of leading by example by being ethical and effective, and to ensure that the company's ethics is managed effectively, is broadly similar to King III, King IV specifically introduces the need for the board to oversee that ethics is monitored and assessed for whether it is successful in establishing ethical norms, and to make the required public disclosures in this regard. It also asks of the board to oversee that there is consequence management for adherence to or contraventions of ethics standards and proposes disclosure of effective ethics management and the outcomes thereof.

While the letter of the word in terms of requirement differs only slightly between King III and IV, the notion of the outcomes-versus-rules-based application of the Code should greatly improve the impact of the increased focus on an ethical culture. Regulators around the world are carefully considering the limited effectiveness of rules and regulations to address cultural matters. We therefore welcome the emphasis on an ethical culture as well as the outcomes-based lens used to assess its effectiveness.

While typically corporate culture is described as a "soft" matter, it is most often the hardest to implement due to the fact that there is no box to tick to conclude that an end goal has been reached. The "what" and the "how" begins in the boardroom. Substantive engagement and oversight is required as a mere process focus will not be good enough. King IV is clear in its expectation that the board cannot simply set the standard, but must also monitor progress. A major sustained improvement in culture can be achieved by focusing on values and conduct that are the building blocks of culture. Focusing on values and conduct is a more practical approach, since these are observable and measurable, can be specified in policies and linked to incentive structures. When an ethical culture is properly understood and well embedded, desired corporate values and conduct should be reflected in the daily habits and practices of employees - how they work, how they are evaluated, who is hired, promoted and rewarded; and how employees act when managers are not present and when matters of personal judgement arise. When broken down to this level, monitoring becomes easier. The Social and Ethics Committee will in all likelihood be tasked to monitor ethics management and the extent to which the executive (individually and collectively) complies with the ethics KPIs. Since King IV now proposes that companies establish a clear link between performance and remuneration, it will

be necessary for the Remuneration Committee to consult with the Social and Ethics Committee when a determination is made on executive remuneration.

King IV specifically requires boards to disclose the effectiveness of ethics management and the outcomes thereof. In order to apply with this recommendation, boards will have to set clear, measurable objectives and monitor the successful (or not) implementation thereof. It goes without saying that this is not easily achievable, and boards will have to carefully apply their minds to creating clear objectives, establish a common understanding of these objectives throughout the business and establish clear KPIs for management to ensure effective implementation. To some extent, each company will have to create its own 'ethics language' to ensure that the values and culture of the business is appreciated and understood at all levels. The disclosure requirements proposed in King IV may seem light at first glance, but on closer inspection it is clear that proper, effective disclosure will require extensive effort – much effort is required to embed the ethics, value and culture throughout the business, monitor success and disclose the results to stakeholders.

Of course, the King IV disclosure requirement also means that the board remains accountable to stakeholders, and this level of transparency will enable stakeholders to hold the board to account also with respect to the company's performance on embedding values, ethics and culture.

Internationally the move to transparent ethical leadership is well supported. In particular the financial services industry is publically committing to making improvements in culture as it goes hand in hand with restoring public trust. Yet, at a pan-European level, there is a general lack of ethical language in corporate governance provisions, with Belgium and the United Kingdom being the exception having limited requirements.

A recent publication "Banking Conduct and Culture – A call for sustained and Comprehensive Reform" published by the Group of Thirty provides actionable advice to boards that we believe is applicable across industry, cultural and geographical boundaries.

Despite the lack of a formal requirement, there is global acceptance that an undue short-term focus does not only impair capital allocation for the longer

term, but impacts the focus on embedding a sustainable culture. This leads to bad behaviour, wilful blindness, tolerance of lapses that should be dealt with more harshly. It also covers up rather than deals with matters that impair the accepted values of the company. It is widely accepted that business is much more vulnerable to reputational damage than ever before – digitisation is positive in getting boardrooms to focus on this vulnerability.

All business operates with an implicit social licence to do so, and the speed of and access to information as well as the legislated level of corporate transparency makes it hard to maintain that social licence. It is fair to say that many leaders are already engaged in the important endeavour to embed an ethical culture which is commendable as it is a prerequisite for sustainable economic returns, and – in the medium term – a source of competitive advantage.

#### The board must ensure that the company is a responsible corporate citizen

Responsible corporate citizenship is closely related to ethical leadership. As a responsible corporate, the board has to ensure that the company should have regard to not only the financial aspects of the business of the company but also the impact that business operations have on the environment and the society within which it operates.

#### The board should ensure that the company's ethics is managed effectively

The board should set the tone for ethical behaviour within a company, and is responsible for creating and sustaining an ethical corporate culture, both formal and informal. The ethical culture should be reflected in the company's vision, mission, strategies, operations, decisions, conduct and its stakeholder relationships. Ethical risks and opportunities should be identified and managed. It is advisable to articulate ethical standards in a code of conduct, which provides guidance and rules to avoid unethical behaviour. The board should further ensure that ethics are integrated into all the company's strategies and policies, and that its ethics performance is assessed, monitored, reported and disclosed. As such, the principles and values underlying the company's code of conduct should be incorporated into all agreements entered into by the company, including employee and supplier contracts.

King IV emphasises the importance of managing the ethics performance of the business, and proposes that this function be delegated to the social and ethics committee.

The board has to act as the focal point for, and custodian of, corporate governance and as such the board should manage its relationship with management, the shareholders and other stakeholders of the company along sound corporate governance principles.

As the focal point for, and custodian of, corporate governance the board should exercise leadership, integrity, enterprise and judgment when it directs, governs and controls the company. The most important function of the board is to ensure value creation, and in doing so, it should account for the interest of all stakeholders. It is important no note here that we have moved away from a shareholder-centric approach to a stakeholder inclusive approach. In terms of this approach, the interest of all key stakeholders should be considered when the board considers the 'best interest of the company'.

The board should appreciate that the company's core purpose, its risks and opportunities, strategy, business model, performance and sustainable development are all inseparable elements of the value creation process.

In order to give effect to this principle, the board should consider the company's purpose, risks and opportunities, business model, performance and sustainability when considering and approving the company's strategy. The board, through the risk committee should satisfy itself that the strategy and business plans are not encumbered by risks that have not been thoroughly assessed by management. Furthermore, the board should identify key performance and risk areas, ensure that the strategy will result in sustainable outcomes.

## The board must ensure that the company has an effective and independent audit committee

Although the Act prescribes the composition and functions of the audit committee for state owned and public companies, King VI proposes that all companies should appoint an audit committee. The audit committee should comprise at least three members and all members should be independent non-executive directors. The committee as a whole should have sufficient qualifications and experience to fulfil its duties, and should be permitted to consult with specialists or consultants after following an agreed process. The terms of reference of the audit committee should be approved by the board.

## The board is responsible for risk governance

Aligned with the King III Code, risk management, opportunity recognition and enablement remain a key focus within the King IV Code. Through the assessment of risk, key opportunities should be considered by companies and their governance oversight structures. Similar to the King III Code, internal audit should 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

audit and express an opinion over the risk and opportunity management function and process. King IV emphasises the importance of risk management to assist the company in considering the interdependences of risk. The board should consider what constitutes excessive risk taking and set the level of risk appetite and tolerance. The board and associated committee/s should have the appropriate level of oversight and approval. King IV recommends that there should be overlap in membership between the audit and risk committee and that the risk committee should constitute at least three directors the majority being non-executives.

While opportunity and risk management is regarded as the responsibility of the risk committee, King IV recognises that opportunities do not always originate from current risks. This is particularly true for strategic opportunities which is typically considered when setting the organisational strategy at board level. Ultimate risk and opportunity management rests with the board the company and the implementation of the policy is delegated to management. The board should oversee the adequacy and effectiveness of risk and opportunity management and this should focus on the company's resilience to withstand vulnerabilities including recovery plans. The board should receive combined assurance

regarding the effectiveness of the risk management process. The board may assign its responsibility for risk management to the risk committee. Membership of this committee should include executive and non-executive directors. Where the company decides to assign this function to the audit committee, careful consideration should be given to the resources available to the audit committee to adequately deal with governance of risk in addition to its audit responsibilities.

The level of disclosure regarding the effectiveness of the risk and opportunity management process has increased. King IV is calling for companies to disclose the processes for managing risk and opportunity, key focus areas, mechanisms for monitoring the effectiveness of risk and opportunity management and how uncertainties affect performance and future strategies.

## The board is responsible for the governance of information and technology

King III for the first time officially introduced IT Governance in South Africa and demanded a greater level of IT risk awareness at director level. It recommended that in exercising their duty of care, directors should ensure that prudent and reasonable steps have been taken with regard to IT governance.

In light of the prevalence of the Fourth Industrial Revolution, King IV takes this theme further and recognises information separate from technology as a corporate asset that is part of the company's stock of intellectual capital and confirms the need for governance structures to protect and enhance this asset.

Technology is described in the Code as a way in which to access, protect and manage information, but it is also much more than an information management system. The Code also focuses on the disruptive nature of technology on long-term business models and highlights the significant risk this poses to companies.

The Code recommends that the board governs both technology and information so that these support the company in achieving its purpose and strategic objectives. The board is specifically tasked with approving and overseeing the technology and information policy of the company. The overseeing of these policies should be in relation to:

- integration of people, technologies, information and processes across the company
- integration of technology and information risks into company-wide risk management
- · arrangements to provide for business resilience
- proactive monitoring of intelligence to identify and respond to incidents, including cyber-attacks and adverse social media events
- management of the performance of, and the risks pertaining to, third-party and outsourced service providers
- the assessment of value delivered to the company through significant investments in technology and information, including the evaluation of projects throughout their life cycles and of significant operational expenditure
- the responsible disposal of obsolete technology and information in a way that has regard to environmental impact and information security
- ethical and responsible use of technology and information
- compliance with relevant laws.

Interestingly, the board is required under King IV to periodically carry out a formal review of the adequacy and effectiveness of the company's technology and information function. Although the assessment of the technology function is reasonably common practice, the formal assessment of the information function is still less common. It is critical that this process is carefully considered and that the nature of this assessment is properly planned. It is our view that the assessment should extend beyond and assessment of the control environment and include a view on the effectiveness of the information strategy of the company.

Lastly, the Code requires disclosure on the structures and processes for information and technology, the key focus areas, the mechanisms for monitoring technology and information management, and also gives an indication of how the company's current and future objectives are affected by digital development.

## The board should ensure that the company complies with applicable laws and consider adherence to non-binding rules and standards

The board is responsible for overseeing the management of the company's compliance risk. The board should ensure awareness of and compliance with laws, rules, codes and standards throughout the business. In turn, management is responsible for the implementation of an effective compliance framework and processes, and for the effective management of the company's compliance risk. The board may mandate management to establish a compliance function to implement measures and procedures to ensure that the board's policy on compliance is implemented.

### The board has to ensure that there is an effective risk-based internal audit function

In order for internal audit to contribute to the attainment of strategic goals, the internal audit function should be positioned at a level within the company to understand the strategic direction and goals of the company. It should develop a programme to test the internal controls vis-a-vis specific risks. The internal audit function should provide assurance with reference to the adequacy of controls to identify risks that may impair the realisation of specific goals as well as opportunities that will promote the achievement of the company's strategic goals.

As an internal assurance provider internal audit should form an integral part of the combined assurance model. It should provide a written assessment of internal controls and risk management to the board, and specifically on internal financial controls to the audit committee.

### The board should appreciate that stakeholder's perceptions affect the company's reputation

King IV emphasises the critical role of stakeholders in the governance process. Not only must the board consider the legitimate and reasonable needs, interests and expectations of stakeholders as a matter that enjoys intrinsic value, but active stakeholders are required to hold the board and the company accountable for their actions and disclosures. King IV points out that it adopts the stakeholder inclusive model (as was the case in King III). In terms of this model the needs, expectations and interests of stakeholders are not subject to or dependent on shareholder interests. The board should ensure that it provides strategic direction and the necessary policy to enable proper management of the stakeholder relationships. The board should oversee the effective management of stakeholder relationships that affect value creation and the achievement of the company's strategic objectives. The board should exercise ongoing oversight of the management of stakeholder relationships, in particular, that it results in methodologies for identifying individual stakeholders and stakeholder groupings, determination of material stakeholders, management of stakeholder risk as an integral part of company-wide risk management, formal mechanisms for engagement and communication with stakeholders, including the use of dispute resolution mechanisms and associated processes, and measurement of the quality of material stakeholder relationships, and appropriately responding to the outcomes.

With respect to companies specifically, King IV proposes a number of specific measures to ensure effective engagement with shareholders, including steps to ensure that the company encourages shareholders to attend general meetings, attendance of these meetings by the chair of the board and the chairs of respective board committees as well as their active participation in meetings. King IV further proposes that the designated partner of the external audit firm should also attend the general meeting.

## The board should apply integrated thinking and ensure the integrity of the company's integrated report

The concepts and principles introduced by the Integrated Reporting Framework by the IIRC (International Integrated Reporting Council) in 2013 have been reaffirmed in the King IV Code. King IV has incorporated the philosophy of integrated thinking into the Code while reaffirming the governance oversight and involvement required. King IV recognises the need for company's oversight bodies to consider their value creation and preservation story within the context of the 6 capitals (as introduced in the Framework). The Code has reaffirmed the importance of the ability to manage and monitor performance, risk and opportunities across the 6 capitals through the company's business model while taking key stakeholder consideration into account.

King IV confirms the importance of the combined assurance model in achieving credibility over the Integrated Reporting process and outcome. The assurance over external reporting has been highlighted within King IV and the responsibility

of the board/audit committee to provide the necessary oversight over this process. King IV specifically addresses assurance over reporting that is not regulated for example Integrated Reporting assurance. Considering the risk within unregulated reporting the board/audit committee should consider whether the processes or data will be assured, determine the boundary of such assurance, the level of assurance, and the criteria against which the assurance will be evaluated. The board/audit committee will need to consider the assurance requirement over future-orientated information.

King IV requires companies to disclose the description and nature of the assurance work performed over the published reports, other than financial statements, as well as the assurance conclusion.

While King IV has underpinned the concepts of Integrated Reporting and thinking, the Code does not seem to guide companies in the Integrated Reporting disclosure requirements. The Code's introductory sections makes reference to the IIRC Integrated Reporting Framework and the need for companies to embrace the principles and disclosure elements of the framework. The individual outcome disclosure requirements however do not make a direct link to the disclosure in the Integrated Report. Often reference is made to the company's report and external reporting. It appears that the objective of making the Code applicable to different types of companies, private and public, large and small, for profit and NGOs, has impacted on the ability to make direct reference to the companies' report as the primary means of disclosure.

## The board must commence business rescue proceedings as soon as the company is financially distressed

The Act sets out the processes and procedures to be followed when a company is financially distressed. The board has the responsibility to ensure that all stakeholders are consulted in the preparation of the business rescue plan.

## The board must elect a chairman of the board that is an independent non-executive director

King VI confirms the principle that the chairman should be independent and free of conflicts. The chair has to set the ethical tone for the board and the company, provide leadership to the board and the company, and act as a link between the board and company.

## The board must appoint and evaluate the performance of the chief executive officer

Arguably the most important function of the board is to identify and appoint a suitable chief executive officer. The collective responsibility of management vests in the chief executive officer, and as such the chief executive officer bears ultimate responsibility for the decisions and actions of management.

#### **Meetings of directors**

The directors may meet as often as required. Generally, boards meet quarterly, but more meetings may be scheduled, depending on circumstances.

A director authorised to call a board meeting is obliged to do so if 2 or more directors (or 25% of directors where the board comprises more than 12 members) ask him or her to call a meeting.

In terms of the Act, board meetings may be conducted by electronic communication as long as the electronic communication facility employed ordinarily enables all persons participating in that meeting to communicate concurrently with each other without an intermediary, and to participate effectively in the meeting. Directors that participate in the meeting via electronic communication are regarded as being present at the meeting – both for quorum and voting purposes.

The majority of directors must be present at a board meeting before a vote may be called, in other words, the quorum for the meeting to commence is 50% plus one.

Decisions taken at the meetings are generally on a majority vote. In this regard, it should be kept in mind that a resolution will be passed by a majority of the directors that participate in the meeting. Where there is a tie, the Act allows the chairperson to have the deciding vote (but only if the chair did not participate in the initial vote). The Act allows a decision that could be voted on at a meeting of the board to be adopted by written consent of a majority of the directors, given in person, or by electronic communication, provided that each director has received notice of the matter to be decided (round-robin). This allows for a handy alternative to a physical meeting.

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. This is usually the responsibility of the company secretary. Given the strict standard of director conduct, and the requirement for directors to take reasonably diligent steps to become informed on any matter on the agenda, it is important that the company secretary ensures that directors are provided with relevant and accurate information.

Section 73 of the Act requires that the minutes of the directors' meetings be kept, including any declaration of a conflict of personal financial interest, as well as every board resolution adopted by the board. Again, given the strict standard of director conduct, it is important for all directors to carefully read the minutes, and ensure that it provides a clear reflection of the proceedings and decisions taken at that particular meeting. Directors may have to rely on the minutes, should their decisions or actions ever be challenged.

The chairperson of the meeting (usually also the chairperson of the board) should sign the minutes as evidence that they are correct. Any minutes of a meeting, or a resolution, signed by the chair of the meeting, or by the chair of the next meeting of the board, is evidence of the proceedings of that meeting, or adoption of that resolution, as the case may be. If the chairperson of the meeting does not sign the minutes, the chairperson of the following meeting should sign them.

#### 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 Memorandum of Incorporation of a company generally allows for the directors to elect a chairperson to chair the meetings of the board. Unless specified in the Memorandum of Incorporation, 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.

King IV recommends that the chairperson should be an independent nonexecutive director. The chairperson should not also be the CEO. 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.

King IV recommends that a lead independent director (LID) should be appointed. Functions allocated to this role includes leading in the absence of the chairman, serve as a sounding board to the chairman, strengthen independence of the governing body if the chairman is not independent and lead the performance appraisal of the chairman. In essence, the role of the LID would be to act as the 'independent conscience' of the board, i.e. to ensure that all decisions of the board are justifiable from an independent point of view.

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. In case of a tied vote, the chairperson may cast the deciding vote (but only if he did not cast a vote in the initial round of voting).

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

<sup>(1)</sup> 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

King III contained a useful list of the core functions of the chairperson (this list is not included in King IV, but remains relevant and useful):

- setting the ethical tone for the board and the company providing overall leadership to the board
- formulating (with the CEO and company secretary) the yearly work plan for the board against agreed objectives, and playing an active part in setting the agenda for board meetings
- presiding over board meetings and ensuring that time in meetings is used productively
- managing conflicts of interest
- acting as the link between the board and management and particularly between the board and the CEO
- ensuring that complete, timely, relevant, accurate, honest and accessible information is placed before the board to enable directors to reach an informed decision
- monitoring how the board works together and how individual directors perform and interact at meetings
- ensuring that good relations are maintained with the company's major shareholders and its strategic stakeholders, and presiding over shareholders' meetings
- upholding rigorous standards of preparation for meetings, and
- ensuring that decisions by the board are executed.

Further responsibilities of the chairperson would be to identify and participate in selecting board members (via a nomination committee), and overseeing a formal succession plan for the board, CEO and certain senior management appointments such as the chief financial officer (CFO).

The chairperson should ensure that all directors are appropriately made aware of their responsibilities through a tailored induction programme, and ensuring that a formal programme of continuing professional education is adopted at board level. Also, he or she should ensure that directors play a full and constructive role in the affairs of the company and taking a lead role in the process for removing non-performing or unsuitable directors from the board.

#### **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 collective responsibility of management rests with the CEO, and as such the CEO bears responsibility for all management functions and decisions. 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.

Certainly one of the most important functions of the board is to appoint a CEO. The CEO does not necessarily The governing body should set the direction and parameters for the powers which are to be reserved for itself, and those that are to be delegated to management via the CEO."

#### King VI principle 10 par 84

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

However, it should be made clear that the board remains accountable to shareholders and stakeholders. The board should have regard to the directors' fiduciary and statutory responsibilities when delegating authority to management. Also, the board should have clear performance indicators to hold management accountable. King IV is not specific on the duties of the CEO, but King III provided a useful list. Some of the more important functions that King III suggests that the CEO perform includes:

- recommending or appointing the executive team and ensuring proper succession planning and performance appraisals
- developing the company's strategy for consideration and approval by the board
- developing and recommending to the board annual business plans and budgets that support the company's long-term strategy
- monitoring and reporting to the board the performance of the company and its conformance with compliance imperatives
- establishing an organisational structure for the company which is necessary to enable execution of its strategic planning
- setting the tone in providing ethical leadership and creating an ethical environment
- ensuring that the company complies with all relevant laws and corporate governance principles, and
- ensuring that the company applies all recommended best practices and, if not, that the failure to do so is justifiably explained.

**11** The governing body should determine if and when to delegate particular roles and responsibilities to an individual member or members of the governing body, or to standing or ad hoc committees. The exercise of judgement by the governing body in this regard, is subject to legal requirements and should be guided by what is appropriate for the organisation and achieving the objectives of the delegation."

King VI principle 8 par 39

King IV suggests that the following be disclosed in relation to the CEO:

- the notice period stipulated in the CEO's employment contract
- other professional commitments of the CEO
- whether succession planning is in place for the CEO position.

#### **Board committees**

The Act provides the board with the power to appoint board committees, and to delegate to such committees any of the authority of the board. The authority of the board to appoint board committees is subject to the company's Memorandum of Incorporation.

If the company's Memorandum of Incorporation, or a board resolution establishing a committee, does not provide otherwise, the committee may include persons who are not directors of the company. However, it should be noted that where non-directors are appointed to a board committee, such persons are not allowed to vote on a matter to be decided by the committee.

It is good practice for the delegation of powers to a committee to 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.

King IV proposes that the terms of reference (committee charter) should include detail pertaining to:

- the composition of the committee and, if applicable, the process and criteria for the appointment of any committee members who are not members of the governing body
- the committee's overall role and associated responsibilities and functions
- · delegated authority with respect to decision-making
- the tenure of the committee
- · when and how the committee should report to the governing body and others
- · the committee's access to resources and information
- the meeting procedures to be followed
- the arrangements for evaluating the committee's performance.

The Act requires public companies and state owned companies to appoint an audit committee comprising three independent non-executive directors. King IV proposes that all other companies also provide for the appointment of an audit committee (the composition, purpose and duties to be set out in the company's Memorandum of Incorporation).

The Act requires listed public companies and state owned companies, as well as any other company that scored more than 500 Public Interest Score points in any two of the last five years, to establish a social and ethics committee. This committee should comprise at least three members. The members may be directors or prescribed officers, but at least one must be a director that is not involved in the day-to-day management of the company, i.e. a non-executive director.

King IV proposes that the board should appoint the audit, risk, remuneration, nomination and social & ethics committees as standing committees. The board may also consider establishing any other committee, e.g. governance, IT steering and sustainability committees.

Smaller companies need not establish formal committees to perform these functions, but should ensure that these functions are appropriately addressed by the board itself or by another committee. We often find that companies combine certain of the committees, most notably the audit and risk committees.

Board committees are allowed to consult with or receive advice from any person, including employees, advisors, or other board committees.

King IV suggests that all board committees should only comprise non-executive directors only. The majority of the non-executive directors serving on these committees should be independent. Committees should be chaired by independent non-executive directors, other than the executive committee which is ordinarily chaired by the CEO. The one exception will be the risk committee, which should comprise executive and non-executive directors.

Advisors, experts and other external parties may attend committee meetings by invitation.

Non-directors serving as members on committees of the board are not entitled to vote, and will be subject to the same standards of conduct and liability as if they were directors. Executive directors and senior management may be invited to attend committee meetings if the chair of the committee considers their input and contribution to be of value to the decision-making process.

King IV proposes that the following should be disclosed in relation to each committee of the board:

- · its overall role and associated responsibilities and functions
- its composition, including each member's qualifications and experience
- · any external advisers or invitees who regularly attend committee meetings
- key areas of focus during the reporting period
- the number of meetings held during the reporting period and attendance at those meetings
- whether the committee is satisfied that it has fulfilled its responsibilities in accordance with its terms of reference.

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.

King IV suggests that all the members of the nominations committee should be non-executive, of which the majority should be independent. The ideal situation is for the chairperson of the board to also chair the nomination committee, failing which an independent non-executive director should be 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 role of the nominations committee may be extended to also consider the skill, experience and succession planning with respect to the executive management team.

#### **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' (and senior management's) remuneration.

King IV suggests that all the members of the remuneration committee should be non-executive, of which the majority should be independent.

The chairman of the committee should be an independent, non-executive director. The chair of the board should not chair the remuneration committee, but may be a member.

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.

In line with international developments, remuneration is receiving far greater prominence in King IV. As such, King IV is clear that the responsibility for fair and equitable remuneration rests with the board. The remuneration committee will fulfil this function on behalf of the board.

King IV makes it clear that the remuneration committee (on behalf of the board) needs to ensure that the company adopts a fair and responsible remuneration policy, that the policy be approved by shareholders (with a non-binding vote), and that proper disclosure is made – not only in terms of the Act, but that, in addition to the amounts disclosed, an implementation report be published in which the

amounts are contextualised, explained and justified.

King IV stipulates the minimum requirements of the remuneration policy. The Code now requires the board to oversee the implementation of a policy to:

- to attract, motivate, reward and retain human capital
- promote the achievement of strategic objectives within the organisation's risk appetite
- promote positive outcomes
- promote an ethical culture and responsible corporate citizenship.

A key function of the board and the remuneration committee is to ensure that the remuneration policy results in fair and responsible executive remuneration practices in the context of overall employee remuneration.

King IV recommends that the committee oversees ongoing dialogue with the shareholder based on the mutual understanding of what performance and value creation constitutes for the purpose of evaluating the remuneration policy. In order to properly draft the policy, the committee will be required to properly articulate the link between strategy, sustainable value creation, performance and remuneration.

The policy and the implementation report will have to be approved by nonbinding advisory vote by shareholders on an annual basis. Should there be a 25% or higher advisory vote against the adoption of the policy or implementation plan, the remuneration policy should set out the specific measures that the committee commits to take to pro-actively attend to the underlying reasons for the vote. Such measures should include an engagement process to ascertain the reasons for the dissenting votes, as well as measures to address the legitimate and reasonable objections and concerns raised by shareholders. These steps may result in amendments to the remuneration policy, or clarifying or adjusting remuneration governance or processes.

In addition and in accordance with the Act, the fees of the non-executive director must be approved by special resolution by the shareholders within the previous two years.

King IV requires a three-part disclosure relating to remuneration including the remuneration background statement, policy and implementation.

- the background statement disclosure includes the context considerations and decisions as well as the opinion of the remuneration committee on whether the implementation of the policy achieved its stated objectives
- the overview of the remuneration policy should include the elements and design of the remuneration system, the achievement of fairness and responsibility in the context of overall employee remuneration and the justification of benchmarks. Specific disclosures are required for executive directors to illustrate the application of the remuneration policy under different performance scenarios – these may include a description of the framework and performance measures used to assess the achievement of strategic objectives and positive outcomes, including the relative weighting of each performance measure and the period of time over which it is measured. King IV recommends the use of performance measures that support positive outcomes across the triple context (financial, environmental, social) in which the organisation operates, and/or all the capitals that the organisation uses or affects. This is a departure from linking remuneration to financial performance only, and requires an account of the performance measures and targets used as a result of which awards of variable remuneration have been made
- remuneration implementation disclosure includes the remuneration paid to or accrued to executive directors and prescribed officers as well as to illustrate the link between remuneration and the contribution by directors and prescribed offers to the value created across the whole of the economic, social and environmental context within which the company operates.

The remuneration committee will have to take cognisance of the above as this will inform the effectiveness of the committee as a whole and will be considered in the performance assessment of the individual committee members. The mandate of the committee has moved beyond the design of executive remuneration packages and now includes the justification of the link between remuneration, value creation and performance within the social, economic and environmental context. The remuneration committee will have to assist the board with the dialogue with the shareholders to ensure they are comfortable with the correlation between directors' performance, their individual and collective contribution to value creation and associated remuneration.

#### **The Risk 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 why the risk management function should not report to the audit committee, but should be monitored by a separate risk 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 function. The formation of a separate committee recognises the fact that the identification and management of risks impacting the business, and the disclosure of these to the shareholders is vital to good governance.

King IV recommends that the committee should comprise executive and nonexecutive directors, with a majority of non-executive directors.

The chairperson of the committee should be a non-executive director. The chairperson of the board may chair this committee.

The role of the committee is to perform an oversight function. In doing so, it should consider the risk policy and plan, determine the company's risk appetite and risk tolerance, ensure that risk assessments are performed regularly, monitor the whole risk management process, and receive assurance from internal and external assurance providers regarding the effectiveness of the risk management process. In turn, management is responsible for the design, implementation and effectiveness of risk management, as well as continual risk monitoring.

It is of vital importance that members of the risk committee have experience within the industry. This would allow them to identify areas of risk and be 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 produces reports that are reviewed and signed by the full board as acknowledgment that their responsibilities in this regard have been adequately discharged.

For more information on the Risk Committee visit the Centre of Corporate Governance at www.corpgov.deloitte.co.za

#### **The Audit Committee**

The audit committee plays a vital role in ensuring the integrity of financial controls and integrated reporting (both financial and sustainability reporting), and identifying and managing financial risk. The appointment of an audit committee is regulated as part of the enhanced accountability and transparency requirements set out in Chapter 3 of the Act. The Act requires all public companies and all state owned companies to appoint an audit committee. Any other type of company may elect to appoint an audit committee (although the provisions of the Act pertaining to the audit committee will only apply to these companies to the extent provided for in their respective Memorandums of Incorporation.

Notwithstanding the requirements of the Act, King IV proposes that all companies should have an audit committee.

The Act determines that where the appointment of an audit committee is required, the audit committee must be appointed by the shareholders at every annual general meeting.

This requirement highlights the importance of the board's nomination committee. As all audit committee members must be directors (members of the board), it is important that the nominations committee identifies suitably skilled and qualified individuals to nominate for appointment to the audit committee. The shareholders may appoint anyone they deem fit and proper. Section 94 of the Act determines that the audit committee must consist of at least three members. Each member of the committee must be a director of the company and not:

- be involved in the day-to-day management of the company for the past financial year
- be a prescribed officer or full-time employee of the company for the past 3 financial years
- be a material supplier or customer of the company such that a reasonable and informed third party would conclude in the circumstances that the integrity, impartiality or objectivity of that director is compromised by that relationship
- be related to anybody who falls within the above criteria.

The requirements of section 94 are prescriptive. It appears that if the company appoints an audit committee with persons other than those prescribed, it would not be an audit committee as required by the Act. As a result, any functions undertaken by a non-compliant (that is an "incorrectly constituted") audit committee will not have been performed by the audit committee as required by the Act.

The audit committee can consist of as many members as the company wishes to appoint, but each of them must meet the criteria and each of them must be a director of the company. The audit committee would, of course, be entitled to utilise advisors and obtain assistance from other persons inside and outside of the company. The audit committee may also invite knowledgeable persons to attend its meetings. However, the formally appointed members of the audit committee entitled to vote and fulfil the functions of the audit committee will have to meet the criteria (non-executive independent directors) in accordance with the prescribed requirements.

In this regard, cognisance should be taken of the position of shareholders as potential members of the audit committee. The Act makes no reference to shareholders, and the value judgement pertaining to independence relates only to suppliers and customers. The mere fact that a person holds shares in the company (or meets any of the other factual tests such as being related to a supplier) would not, on its own, preclude such a person from serving on the audit committee. It is proposed that, in line with the best practice principles set out in King IV, the appointment of shareholders to the audit committee be carefully considered. A judgment on the effect of the shareholding or other relationship is required in order to establish the likely factual impact on the independence of a particular person. The question to be considered should be 'would an informed and reasonable third party regard the director as independent?'.

The statutory duties of the audit committee include:

- making submissions to the board regarding the company's accounting policies, financial controls, records and reporting
- · nominating an auditor that the audit committee regards as independent
- determining the audit fee
- ensuring that the appointment of the auditor complies with the Companies Act and other relevant legislation
- · determining the nature and extent of non-audit services
- pre-approving any proposed agreement with the auditor for the provision of non-audit services
- preparing a report to be included in the annual financial statements describing how the committee carried out its functions, stating whether the auditor was independent, and commenting on the financial statements, accounting practices and internal financial control measures of the company
- receiving and dealing with relevant complaints, and
- any other function designated by the board.

Since the Act prescribes the appointment process, composition and functions of the audit committee, it can now be described as a statutory committee. The audit committee will bear sole responsibility for its decisions pertaining to the appointment, fees and terms of engagement of the auditor. On all other matters it remains accountable to the board and, as such, it will function as a board committee.

It is important to note that the audit committee is obliged to also report to shareholders. The audit committee will report to shareholders by including in the annual financial statements the audit committee's report describing how the committee carried out its functions, stating whether the auditor was independent, and commenting on the financial statements, accounting practices and internal financial control measures of the company.

In addition to the legislative duties set out in the Act, it is common practice for the audit committee to perform a number of additional functions, including:

- overseeing financial risks and reporting, internal financial controls and fraud and IT risks as they relate to financial reporting
- ensuring that a combined assurance model is applied to provide a coordinated approach to all assurance activities
- overseeing integrated reporting (both financial and sustainability reporting)
- satisfying itself with regard to the expertise, resources and experience of the finance function
- overseeing the internal audit function
- · playing a key role in the risk management process, and
- overseeing the external audit process.

A key function of the audit committee is to recommend the appointment of the external auditor to shareholders and to oversee the external audit process. Globally there have been developments regarding the assessment of the auditor's independence as well as the implementation of audit firm rotation in certain jurisdictions. King IV has acknowledged the need to assess and confirm the external auditor's independence, but does not specifically address audit firm rotation.

The King IV Code suggests that the audit committee oversees auditor independence. This aligns with the publication of the rule by the Independent Regulatory Board for Auditors that the number of years for which the audit firm has been the auditor of the company be disclosed in the auditor's report.

In addition, the audit committee will need to disclose any significant audit matters considered and how the committee has addressed the matters. In terms of the auditing standards, the auditor is required to address all key audit matters, among other issues, in order to provide the user of the annual financial statements with some context when they assess said statements. The additional disclosure should be considered for inclusion in the audit committee report and will need to include:

- a statement as to whether the audit committee is satisfied that the external auditor is independent. The statement should specifically address:
  - the policy and controls that address the provision of non-audit services by the external auditor, and the nature and extent of such services rendered during the financial year

- the tenure of the external audit firm and, in the event of the firm having been involved in a merger or acquisition, including the tenure of the predecessor firm
- the rotation of the designated external audit partner; and
- significant changes in the management of the company during the external audit firm's tenure which may mitigate the attendant risk of familiarity between the external auditor and management.
- significant matters that the audit committee has considered in relation to the annual financial statements, and how these were addressed by the committee
- the audit committee's views on the quality of the external audit, with reference to audit quality indicators such as those that may be included in inspection reports issued by external audit regulators
- the audit committee's views on the effectiveness of the chief audit executive and the arrangements for internal audit
- the audit committee's views on the effectiveness of the design and implementation of internal financial controls, and on the nature and extent of any significant weaknesses in the design, implementation or execution of internal financial controls that resulted in material financial loss, fraud, corruption or error
- the audit committee's views on the effectiveness of the CFO and the finance function.

King IV has refined the concept and requirements of combined assurance by no longer prescribing the three lines of defense model. Instead it requires that the board ensures that a combined assurance model is designed and implemented to cover adequately the company's significant risks and material matters through a combination of a number of assurance services and functions, including the company's line functions that own and manage risks, the company's specialist functions that facilitate and oversee risk management and compliance, internal auditors, internal forensic fraud examiners and auditors, safety and process assessors and statutory actuaries, independent external assurance service providers such as external auditors, other external assurance providers such as sustainability and environmental auditors or external actuaries, and external forensic fraud examiners and lastly regulatory inspectors.

## For more information on the Audit Committee visit the Deloitte Centre for Corporate Governance website at www.corpgov.deloitte.co.za

#### **Social and Ethics Committee**

During the public hearings on the Companies Bill conducted by the Portfolio Committee on Trade and Industry in 2007, a proposal was made to include a requirement in the new Act to oblige certain companies to appoint a member of a trade union as a board member (director). The Portfolio Committee rejected this proposal, but presented a compromise. It was argued that there is a definite need in the South African context to encourage large companies (especially those companies that have a significant impact on the public interest) to not only act responsibly, but also to be seen doing so and to account from the public interest perspective for their decision-making processes and the results thereof.

In essence, it was argued that these companies should be obliged to develop a social conscience, and behave like responsible corporate citizens. As such, the Companies Act now provides the Minister of Trade and Industry with the authority to require certain companies to have a social and ethics committee, having regard to the impact such companies have on the public interest. However, regardless of the requirement to appoint a social and ethics committee, the directors and prescribed officers of all companies are bound to act in accordance with an acceptable standard of conduct.

In terms of section 72 of the Act (read with Companies Regulation 43), the following companies should have appointed a social and ethics committee within one year after the Act became effective (i.e. by 30 April 2012):

- every state owned company
- every listed public company
- any other company that has, in any two of the previous five years, had a public interest score of at least 500 points.

As mentioned above, King IV recommends that every company appoints a social and ethics committee.

The social and ethics committee must comprise not less than three members. These members may be directors or prescribed officers of the company, however, at least one must be a director who is not involved in the day-to-day management of the company's business, i.e. a non-executive director, and must not have been so involved during the previous three financial years.

In terms of Companies Regulation 43 a social and ethics committee has to monitor the company's activities with regard to matters relating to social and economic development, including the company's standing in terms of the goals and purposes of:

- the 10 principles set out in the United Nations Global Company Principles
- the Organisation for Economic Co-operation and Development (OECD) recommendations regarding corruption (refer to the OECD website for further details (www.oecd.org))
- the Employment Equity Act, No 55 of 1998
- the Broad-based Black Economic Empowerment Act, No 53 of 2003
- good corporate citizenship, including the company's:
  - promotion of equality, prevention of unfair discrimination, and measures to address corruption
  - contribution to development of the communities in which its activities are predominantly conducted or within which its products or services are predominantly marketed
  - record of sponsorship, donations and charitable giving
- the environment, health and public safety, including the impact of the company's activities and of its products or services
- consumer relationships, including the company's policies and record relating to advertising
- · public relations and compliance with consumer protection laws
- · labour and employment matters.

If one considers the requirements of King IV with respect to ethical leadership and ethical behaviour, it appears advisable to assign to the social and ethics committee some of the responsibilities in this regard. The additional functions may include:

- reviewing the adequacy and effectiveness of the company's engagement and interaction with its stakeholders
- considering substantive national and international regulatory developments, overseeing their operationalisation as well as practice in the fields of social and ethics management
- reviewing and approving the policy and strategy pertaining to the company's programme of corporate social investment
- determining clearly articulated ethical standards (code of ethics), and ensuring that the company takes measures to achieve adherence to these in all aspects of the business, thus facilitating a sustainable ethical corporate culture within the company
- monitoring that management develop and implement programmes, guidelines and practices congruent with the company's social and ethics policies
- reviewing the material risks and liabilities relating to the provisions of the code of ethics, and ensuring that such risks are managed as part of the company's risk management programme
- reviewing the company's performance in implementing the provisions of the code of ethics and the assertions made in this regard
- obtaining independent external assurance of the company's ethics performance on an annual basis, and include in the Integrated Report an assurance statement related to the ethics performance of the company
- ensuring that management has allocated adequate resources to comply with social and ethics policies, codes of best practice and regulatory requirements.

The social and ethics committee must report to shareholders at the Annual General Meeting. At least one member of the committee must attend the Annual General Meeting of the company to report back to shareholders on the activities of the company. Although there is no legislative requirement for the committee to issue a written report, it is recommended that a written report be included in the company's Integrated Report, Director's Report or its Governance report, whichever is the most appropriate in the circumstances.

#### 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 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.

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

The board should oversee that the company encourages proactive engagement with shareholders, including engagement at the AGM of the company. All directors should be available at the AGM to respond to shareholders' queries on how the board executed its governance duties."

#### King VI Report principle 16 par 5 and 6

a channel of communication between the shareholders and the board. Where a company is required to have a social and ethics committee, one member must attend the AGM to report to shareholders on the activities of the committee. Usually the chairperson of the board also acts as the chairperson at a general meeting. However, depending on the company's Memorandum of Incorporation, the members may be able to appoint their own chairperson.

### The board's relationship with the company secretary

The Act requires every public company and state owned company to appoint a company secretary. The company secretary may be appointed either by the board or by an ordinary resolution of the holders of the company's securities. This individual is required to have (in the opinion of the directors) sufficient relevant experience and knowledge to perform this function adequately.

The company secretary is accountable to the board.

The Act allows that the role of the company secretary be performed by a juristic person or partnership.

The directors have the power to remove the company secretary. The removed individual has the right 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 60 business days to find a replacement. The same restrictions on persons being appointed as directors apply to the The governing body should ensure that it has access to professional and independent guidance on corporate governance and its legal duties, and also that it has support to coordinate the functioning of the governing body and its committees."

#### King VI Report principle 10 par 90

appointment of the company secretary, apart from the fact that the company secretary does not have to be a natural person.

The Act, in section 88 sets out the duties of the company secretary. The company secretary is responsible for:

- providing the directors of the company collectively and individually with guidance as to their duties, responsibilities and powers
- making the directors aware of any law relevant to or affecting the company
- reporting to the company's board any failure on the part of the company or a director to comply with the Memorandum of Incorporation or rules of the company or the provisions of the Act
- ensuring that minutes of all shareholders meetings, board meetings and the meetings of any committees of the directors, or of the company's audit

committee, are properly recorded

- certifying in the company's annual financial statements whether the company has filed required returns and notices in terms of the Act, and whether all such returns and notices appear to be true, correct and up to date
- ensuring that a copy of the company's annual financial statements is sent to every person who is entitled to it
- ensuring that the company's annual return is filed in terms of section 33 of the 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. 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. In recent years the company secretary has become an important and powerful individual within the company. This role is enforced by the Act and King IV.

The secretary must 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 company secretary or other professional providing corporate governance services should report to the governing body via the chair on all statutory duties and functions performed in connection with the governing body. Regarding other duties and administrative matters, the company secretary or other professional providing corporate governance services should report to the member of executive management designated for this purpose as is appropriate for the organisation."

King VI Report principle 10 par 97

#### 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.

It should be noted that the Act determines that prescribed officers are required to perform their functions and exercise their duties The governing body should ensure that internal audit provides an overall statement annually as to the effectiveness of the organisation's governance, risk management and control processes."

#### King VI Report principle 15 par 58

to the standard of conduct as it applies to directors. Prescribed officers will be subject to the same liability provisions as it applies to directors.

Prescribed officers include every person, by whatever title the office is designated, that:

- exercises general executive control over and management of the whole, or a significant portion, of the business and activities of the company
- regularly participates to a material degree in the exercise of general executive

control over and management of the whole, or a significant portion, of the business and activities of the company.

A person will be a prescribed officer regardless of any title or office they are designated.

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 shareholders are responsible for the appointment of the auditor at the annual general meeting. The audit committee has to nominate an independent auditor for appointment. However, nothing precludes the appointment by the company at its annual general meeting of an auditor other than one nominated by the audit committee.

However, if such an auditor is appointed, the appointment is valid only if the audit committee is satisfied that the proposed auditor is independent of the company.

The board may remove the auditor. A vacancy created in the appointment of the auditor, either through the removal of the auditor by the board or by the resignation of the auditor, must be filled by the board within 40 business days. In such an instance, the company's audit committee must be satisfied that the auditor is independent of the company.

The audit committee is responsible, to the exclusion of the rest of the board, for the terms of engagement, the fees and the appointment of the external auditor.

#### 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 function should be staffed with appropriate individuals who are well respected within the company.

The internal audit function is accountable to the board, and operates under the direct oversight of the audit committee.

The charter of the internal audit function should comply with the guidance published by the Institute of Internal Auditors. The key responsibility of internal audit is to the board, its committees, or both, in discharging its governance responsibilities.

Internal audit should pursue a risk-based approach to planning as opposed to a compliance approach that is limited to evaluation of adherence to procedures. A risk-based internal audit approach has the benefit of assessing whether the process intended to serve as a control is an appropriate risk measure. An internal audit function should be independent from management who instituted the controls and should be an objective provider of assurance with respect to the risks that may threaten the achievement of the company's strategic goals, as well as the opportunities that may contribute to the achievement of such goals.

The Chief Audit Executive should have a standing invitation to attend as an invitee any of the executive committee or other committee meetings. The Chief Audit Executive should be apprised formally of the company's strategy and performance through meetings with the chairman, the CEO, or both.

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.

#### Communication with stakeholders The Directors' Report

The Act requires that the annual financial statements of a company must include a directors' report. The Act requires the directors to discuss in the directors' report any matter with respect to the state of affairs, the business and profit or loss of the company, or of the group of companies, if the company is part of a group, including any matter material for the shareholders to appreciate the company's state of affairs.

<sup>CC</sup>All communication to stakeholders should use clear and simple language and should set out all relevant facts, both positive and negative. It should be structured to enable its target market to understand the implications of the communication. Companies should use communication channels that are accessible to its stakeholder"

#### The Integrated Report

The actual effective ownership by the board of the Integrated Reporting process, and the Integrated Report itself, is of significant practical importance as it is one of the key determinants for a good Integrated Report.

There is indeed an important difference between the board actually setting and owning the agenda in this regard, or effectively acquiescing to an agenda actually set, and populated by, executive management or those that report to them and which is submitted to the board for approval, very often at a late stage of the process.

King III Report principle 8.5 par 33

King IV recommends that the board should oversee that the organisation issues an integrated report at least annually, which is either:

- a standalone report which connects the more detailed information in other reports and addresses, at a high level and in a complete, concise way, the matters that could significantly affect the organisation's ability to create value
- a distinguishable, prominent and accessible part of another report which also includes the financial statements and other reports issued in compliance with legal requirements.

To properly discharge these responsibilities, as well as those set out in the Companies Act and contained in Company Law, the board should pro-actively set and own the Integrated Reporting agenda. In this regard, the view from executive management is obviously important to take into account in setting the agenda and framework, but once these are finalised by the board, the primary role of executive management and those that report to them is to operationalise and report back to the board within the framework thus established. If, as is generally accepted, the Integrated Report indeed reflects the collective mind of the board and the integrated thinking that is essential for business in the modern world, a more reactive approach by the board would not effectively enable capturing the essential qualities and pre-requisites for Integrated Reports.

The purpose of an Integrated Report is telling the unique story of the company and the manner in which it sustains and adds value in the short, medium and long term. The board is clearly intended to be ultimately overall accountable for the company and its journey, and has been placed in a unique position to practically discharge this responsibility by a variety of formal and informal arrangements. In order to effectively discharge this accountability responsibility, the board should therefore also embrace the proactive and effective ownership of the Integrated Reporting process and the Integrated Report.

#### **General disclosure**

King IV suggests that the board should oversee that the following information is published on the organisation's website or on other platforms or through other media as is appropriate for access by stakeholders:

- a. Corporate governance disclosures required in terms of the King Code
- b. Integrated reports
- c. Financial statements and other external reports.

# Remunerating directors //

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Remuneration of directors is one of the most debated topics in the corporate governance arena, due 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.

#### Introduction

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, nonexecutive directors have no formal contract with the company but are paid a standard level of fees for attending board and committee meetings.

Remuneration of directors is one of the most debated topics in the corporate governance arena, due to the tension between stakeholders demanding to understand directors' remuneration levels and methods and the directors' desire for the privacy of their financial affairs. The tension is exacerbated by the high levels of inequality between employee and executive remuneration levels. In line with international developments, King IV re-iterates the fundamental ethical leadership characteristics of accountability and transparency with renewed vigour by requiring detailed disclosure of remuneration and a justification or contextualisation on said remuneration.

The Memorandum of Incorporation of a company generally provides 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 Memorandum of Incorporation do not provide for this remuneration, the Act determines that the directors are entitled to payments only if such remuneration is authorised by a special resolution approved by the shareholders within the preceding two years.

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.

#### **Remuneration Policy & Structuring**

Further to the shift in thinking from short-termism to long-term sustainability based on ethical principles, King IV recommends that the board should ensure that remuneration is used as a tool to ensure that the business creates value in a sustainable manner within the economic, social and environmental context in which the company operates. To this end, the board should establish a remuneration committee, the role of which is to recommend to the board a fair and responsible company-wide remuneration policy that promotes the creation of value in a sustainable manner. Pursuant to its outcomes-focused approach, King IV does not go into great detail on the recommended practices for the remuneration committee as was done in King III.

Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied."

#### The UK Corporate Governance Code, September 2014

While King III required organisations to have an approved remuneration policy that is voted on by shareholders in the form of a non-binding advisory vote, King IV takes this further by stipulating the minimum requirements of the remuneration policy to be voted on. According to King IV, the remuneration policy should address all of the following:

- a. base salary, financial and non-financial benefits
- b. variable remuneration, including short and long-term incentives and deferrals
- c. payments on termination of employment or office
- d. sign-on, retention and restraint payments

- e. the provisions, if any, for pre-vesting forfeiture (malus) and post-vesting forfeiture (claw-back) of remuneration
- f. any commissions and allowances
- g. the fees of non-executive members of the governing body.

Many of the above recommended components of the remuneration policy align with the directors' remuneration disclosure required in terms of the Companies Act.

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#### **Compensation Clawbacks**

The SEC recently issued a proposed rule aimed at ensuring that executives do not receive "excess compensation" if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements.

Under the proposed rule, issuers would be required to adopt a written policy requiring them to recover "excess" incentive-based compensation awarded to any individuals (including former employees) that served as an executive officer during the three most recently completed fiscal years preceding the date on which it is determined that a qualifying financial restatement is required, provided that the executive officers were awarded more incentive-based compensation than they would have received if the financial statements had been prepared correctly. The ICGN Guidance on Executive Remuneration also recommends adopting a remuneration "claw back" policy.

In the true spirit of integrated thinking, King IV acknowledges that fair and responsible remuneration is a consideration of a company's corporate citizenship. In line with this integrated approach, King IV suggests that the board ensures fair and responsible executive remuneration practices in the context of overall employee remuneration. This recommendation aligns with the principle of ethical leadership and is designed to ensure that executive remuneration.

King IV recommends that the board oversees that the implementation of the remuneration policy results in all of the following:

- to attract, motivate, reward and retain human capital
- to promote the achievement of strategic objectives within the organisation's risk appetite
- to promote positive outcomes
- to promote an ethical culture and responsible corporate citizenship.

In light of the above, in order to properly draft the remuneration policy, the board, in conjunction with the remuneration committee, will need to clearly articulate the link between strategy, sustainable value creation, performance and remuneration.

#### 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.

#### 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 the only corporate governance issue is generally the size of the cash payment to the director.

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.

Where the company employs bonuses as part of the remuneration package, the bonuses should be related to specific performance indicators. Such performance indicators should be consistent with the long-term objectives of the company and

long-term value for shareholders. Although long- and short-term goals may be utilised in this regard, the company should guard against manipulation of results.

#### 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.

It is generally accepted that the participation in share incentive schemes should be restricted to employees and executive directors. Such schemes should have appropriate limits for individual participation, and such limits should be disclosed. The chairperson and other non-executive directors should not receive share options or other incentives aligned to the share price or the company's performance, as this may impair their objectivity and align their interest too closely with those of the executive directors.

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. The share incentive trust 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.

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 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. It is advisable that options or other conditional share awards should be granted for the year in question and in expectation of service over a performance measurement period of not less than three years. This means that vesting of rights should be dependent on performance. Accordingly, shares and options should not vest or be exercisable within three years from the date of grant. In addition, options should not be exercisable more than 10 years from the date of grant. For new schemes it is best practice to restrict the exercise period to less than seven years. This may, however, prejudice the individual director from a cash flow perspective, and therefore it is usually preferable to employ a composite remuneration policy in which performance-related elements of remuneration constitute a substantial portion of the total remuneration package of executives. Such an approach will ensure the alignment of the directors' interests with those of the shareholders.

The price at which shares are issued under a scheme should not be less than the mid-market price or volume-weighted average price (or similar formula) immediately preceding the grant of the shares under the scheme.

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 shares or securities convertible into shares, or a grant of options for the subscription of securities, or a grant of any other rights exercisable for securities is regulated by section 41 of the Companies Act. In these instances, the Act requires authorisation by a special resolution of the company. However, no shareholder approval is required if the issue of shares, securities or rights is:

- under an agreement underwriting the shares, securities or rights in the exercise of a pre-emptive right to be offered and to subscribe shares
- in proportion to existing holdings, and on the same terms and conditions as have been offered to all the shareholders of the company or to all the shareholders of the class or classes of shares being issued
- pursuant to an employee share scheme
- pursuant to an offer to the public.

#### Loans to directors

The Act regulates financial assistance to directors (and others) in terms of section 45. In terms of this section, unless the company's Memorandum of Incorporation

provides otherwise, the board may authorise direct or indirect financial assistance to the following parties:

A director or prescribed officer of:

- the company
- a related or inter-related company, or
- a related or inter-related company or corporation
- a member of a related or inter-related company or corporation, or
- a person related to any of the above parties.

The requirements for the provision of financial assistance in terms of this section are:

- the provision of financial assistance must be pursuant to an employee share scheme, or
- the shareholders must have approved such financial assistance by special resolution (within the past 2 years), and
- the company's board of directors must be satisfied that after the transaction, the company will remain solvent and liquid, and the terms of the agreement are fair and reasonable to the company.

An important development is that fact that the Act requires the board to inform all shareholders and trade unions representing employees whenever it decides to provide financial assistance in terms of this section.

#### **Employment contracts, severance and retirement benefits**

Employment contracts (also for executive directors) should not commit companies to pay on termination arising from the executive's failure. Also, with respect to bonuses, there should be no automatic entitlement to bonuses or share-based payments in the event of early termination. Companies should not provide for balloon payments on termination.

Contracts should not compensate executives for severance because of change of control.

Where a company pays compensation to a director for loss of office, the Act requires the particulars of such compensation to be disclosed in the annual financial statements.

It should be noted that for purposes of the Income Tax Act, the SARS ruled that in determining whether a non-executive director receives "remuneration", it is accepted that such non-executive director is not a common law employee. SARS further accepts that no control or supervision is exercised over the manner in which such non-executive director performs his or her duties, or the nonexecutive director's hours of work. The director's fees received by a non-executive director for services rendered as a non-executive director on a company's board, are thus not "remuneration", and are not subject to the deduction of employees' tax. As such, SARS considers non-executive directors to be carrying on an "enterprise" for VAT purposes in respect of the non-executive director services rendered to the company, and are required to register and charge VAT in respect of those services (if the value of such fees exceed the compulsory VAT registration threshold of R1 million in any consecutive 12-month period).

#### **Approval of remuneration**

The fees of non-executive directors of companies must be submitted to a special resolution approved by shareholders within the previous two years. It should be noted that the special resolution amounts to a binding vote by shareholders, which is not required for the approval of the remuneration of executive directors.

King IV recommends that shareholder approval in respect of remuneration is sought as follows:

In the event that either the remuneration policy or the implementation report, or both were voted against by 25% or more of the voting rights exercised, King IV proposes that the following be disclosed in the background statement of the remuneration report succeeding the voting:

- with whom the company engaged, and the manner and form of engagement to ascertain the reasons for dissenting votes
- the nature of steps taken to address legitimate and reasonable objections and concerns.

The non-binding advisory shareholder vote appeared in King III as well, however, King III did not foresee any consequence where the shareholders do not support the policy. With respect to the content and approval process for the implementation report, the recommendations introduced by King IV seems to be more closely aligned to international trends where shareholders are increasingly having a "say on pay". In order to facilitate an effective approval process, King IV proposes that the remuneration policy should set out the specific measures that the board commits to take in the event that either the remuneration policy or the implementation report, or both have been voted against by 25% or more of the voting rights exercised by shareholders at the AGM. It is recommended that such measures should provide for taking steps in good faith and with best reasonable effort towards the following at a minimum:

- a. an engagement process to ascertain the reasons for the dissenting votes
- addressing legitimate and reasonable objections and concerns raised, as is appropriate, and which may include amending the remuneration policy, or clarifying or adjusting remuneration governance or process.

It is interesting to note that King IV mentions shareholder engagement rather than stakeholder engagement – the reason is most probably that shareholders are responsible for the appointment of directors, and company resolutions are tabled at the annual general meeting of shareholders. It would be impractical, if not impossible to require all stakeholders to express a view/vote on the remuneration policy and implementation report. It would however be advisable, in the spirit of the stakeholder inclusive model, for the board and remuneration committee to assess whether it is necessary to engage with other key stakeholders in such a situation. It is foreseen that the board will need to play an important role in this regard. As required by King IV, the board must ensure fair and reasonable executive remuneration in view of overall employee remuneration, and as such the board will have to work closely with the remuneration committee in its efforts to achieve these policy objectives.

Although not spelled out specifically, the message in King IV seems to be that, pursuant to the ethical leadership characteristics of accountability and responsibility, an advisory vote against the remuneration policy or implementation report be taken into account in the overall performance evaluation of the board. It is clear that King IV pushes the debate on executive remuneration beyond the design of executive remuneration packages to include the justification of the link between remuneration, value creation and key performance indicators within the social, economic and environmental context.

#### A say on pay

In terms of the European Union Shareholder Rights Directive Proposal, shareholders are given the right to approve the remuneration policy and to vote on the remuneration report, which describes how the remuneration policy has been applied in the last year. All benefits of directors in whatever form will be included in the remuneration policy and report. Such report facilitates the exercise of shareholder rights and ensures accountability of directors.

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#### **Remuneration disclosure**

Active stakeholders and/or stakeholder activism is an important consideration for the board particularly in light of the often contentious remuneration discussion. In an effort to promote transparency, King IV recommends that the board ensures and oversees regular dialogue with shareholders, to create and maintain a mutual understanding of what performance and value creation constitutes for the purpose of evaluating the remuneration policy. Again, it is advisable for boards to consider extending this dialogue to other key stakeholders of the company. Furthermore, it is advisable for the remuneration committee to assist the board with the dialogue with the shareholders to ensure that they are comfortable with the correlation between directors' performance, their individual and collective contribution to value creation and associated remuneration. This links to the King IV recommendation for shareholder engagement where there is a 25% or higher advisory vote against the adoption of either the remuneration policy or the implementation thereof, as described above.

The notion of constructive stakeholder engagement is echoed in King III and should be aimed at ultimately promoting enhanced levels of corporate governance in a company.

The Act provides clear requirements pertaining to the disclosure of director and prescribed officer remuneration. These disclosures, made in the company's annual financial statements, provide the final figures (actual amounts). King IV proposes additional disclosures aimed at a renewed focus on transparency and accountability regarding the disclosure of directors' and prescribed officers' remuneration by contextualising and justifying the actual remuneration received by directors.

Section 30 of the Act regulates the disclosure in the company's annual financial statements of the directors' emoluments.

The Act requires the annual financial statements of a company to include particulars of the remuneration and benefits received by each director.

This should include:

- the amount of any pensions paid by the company to directors
- any amount paid by the company to a pension scheme
- the amount of any compensation paid in respect of loss of office
- the number and class of any securities issued to a director and the consideration received by the company for those securities, and
- details of service contracts of current directors.

<sup>11</sup> Investors have a distinct role in relation to executive remuneration. Investors have a fiduciary responsibility as well as a strong economic interest in remuneration No aspect of corporate governance touches as many drivers in terms of performance, risk and incentive, or is ultimately more critical to long-term alignment of interests. However, investors are not, typically, insiders and in almost all cases. are not in a position to dictate executive remuneration practices."

ICGN Guidance on Executive Remuneration, 2012 For the purpose of disclosure, the Act defines remuneration so as to include:

- fees paid to directors for services rendered by them to or on behalf of the company
- salary, bonuses and performance-related payments
- expense allowances
- contributions paid under any pension scheme
- the value of any option or right given directly or indirectly to a director
- financial assistance to a director for the subscription of shares, and
- with respect to any loan or other financial assistance by the company to a director, or any loan made by a third party to a director (if the company is a guarantor of that loan), the value of any interest deferred, waived or forgiven.

Section 30(5) of the Act requires that the disclosure must show the amount of any remuneration or benefits paid to or receivable by persons in respect of:

- (a) services rendered as directors or prescribed officers of the company, or
- (b) services rendered while being directors or prescribed officers of the company
  - (i) as directors or prescribed officers of any other company within the same group of companies, or
  - (ii) otherwise in connection with the carrying on of the affairs of the company or any other company within the same group of companies.

It is important to note that the requirements do not relate to remuneration paid to the director by the company, but rather to all remuneration and benefits paid to or receivable by the director. Thus, 'who pays' is irrelevant – the disclosure pertains to any remuneration or benefits received from any source 'for services as a director'.

The effect of these requirements is that all remuneration paid to or receivable by a director or prescribed officer must be disclosed - thus, not only the remuneration paid to or received by the director or prescribed officer for services to the company, but also all other remuneration received by the director or prescribed officer to any other company with the group. One person's remuneration may have to be disclosed by more than one company in the same group of companies.

Disclosure is required of all remuneration paid to or receivable by the directors and prescribed officers of the company for services as a director or prescribed officer of any other company within the same group of companies. In this regard the definition of a group should be considered. This means disclosure will have to account for all other companies in the group, and not only the subsidiaries of the company in question, therefore the company will have to take into account all companies in the group – thus upward, downward and sideways. It should be noted that the requirement applies only with respect to all "companies" within the group. In terms of the Companies Act a "company" is a juristic person incorporated in terms of the previous or current Companies Act, i.e. only South African companies.

Therefore, any amounts paid to directors and prescribed officers for services rendered to a trust or a foreign subsidiary within the group would not be included in the disclosure, since a trust or a foreign subsidiary (company) is not a "company" for purposes of the Companies Act. The Act requires all remuneration paid to or receivable by directors and prescribed officers to be disclosed – it does not only account for remuneration paid by the company, or another company in the group. Rather, it focuses on the amounts a director or prescribed officer earns for services as a director or prescribed officer (to the company or any other company within the group), or for carrying on the affairs of the company (or any other company within the group).

In addition to the disclosure in the company's annual financial statements, King IV proposes that the company (through its remuneration committee) contextualise the amounts by means of a three part disclosure relating to remuneration including the remuneration background statement, policy and implementation as follows:

The **background statement** provides the context for remuneration considerations and decisions. King IV proposes that the background statement should make specific reference to the six areas detailed below:

- (a) internal and external factors that influenced remuneration
- (b) the most recent results of voting on the remuneration policy and the implementation report and the measures taken in response thereto
- (c) key areas of focus and key decisions taken by the remuneration committee during the reporting period, including any substantial changes to the remuneration policy

- (d) whether remuneration consultants have been used, and whether the remuneration committee is satisfied that they were independent and objective
- (e) the view of the remuneration committee on whether the remuneration policy achieved its stated objectives
- (f) future areas of focus of the board/remuneration committee.

The disclosure should further include a brief overview of the remuneration **policy**, and should include, among others the remuneration elements and design principles informing the remuneration arrangements for executive management and, at a high level, for other employees; a description of the framework and performance measures used to assess the achievement of strategic objectives and positive outcomes, including the relative weighting of each performance measure and the period of time over which it is measured; and an explanation of how the policy addresses fair and responsible remuneration for executive management, in the context of overall employee remuneration.

Remuneration **implementation** disclosure must be aligned to the disclosure requirements set out in the Companies Act. It should include remuneration for each member of executive management, including separate tables for total remuneration received for the reporting period, as well as all the elements that make up this total, declared at fair value.

Variable remuneration requires specific disclosure and explanation in the implementation report. Details of all awards made under variable remuneration incentive schemes in the current and prior years which have not yet vested, including the number of awards, the values at the date of granting, their award, vesting and expiry dates, and their fair value at the end of the reporting period should be included. The cash value of all awards made under such a scheme settled during the year should be disclosed. Performance measures and their relative weighting for remuneration calculations should be explained, including targets set and the corresponding value, and how the organisation and individual executives performed against each target.

If payments were made on termination of employment or office, these should be separately disclosed and reasons given.

The board should include a statement regarding the extent of compliance with, and any deviations from, the remuneration policy. Importantly, the board should explain how the remuneration policy results in executive remuneration that is fair and responsible in light of overall employee remuneration. The latter statement is clearly aimed at addressing the pay gap.

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#### **Employee – CEO Pay ratio**

The Securities and Exchange Commission (SEC) in the USA recently issued a final rule on pay ratio disclosure\*.

In terms of the rule the annual disclosure must include the ratio of:

- the median of the annual total compensation of all its employees (excluding the CEO) and
- the annual total compensation of its CEO

\*Registrants must adopt the final rule for their first fiscal year beginning on or after January 1, 2017.

In order to meet the above disclosure requirements, it is crucial that the board has an intimate understanding of how value creation, performance and reward are linked in the business.

While King III and the Companies Act ask the "what" in respect of remuneration disclosure, King IV goes beyond the numbers and also examines the "why". In other words, disclosure should not only include the numbers, but also a clear justification for the amounts awarded. This closely aligns to international trends where transparency is at the forefront of the governance agenda and strengthens the disclosure principle enabling stakeholders to make an informed assessment of company performance and its ability to create sustainable value.

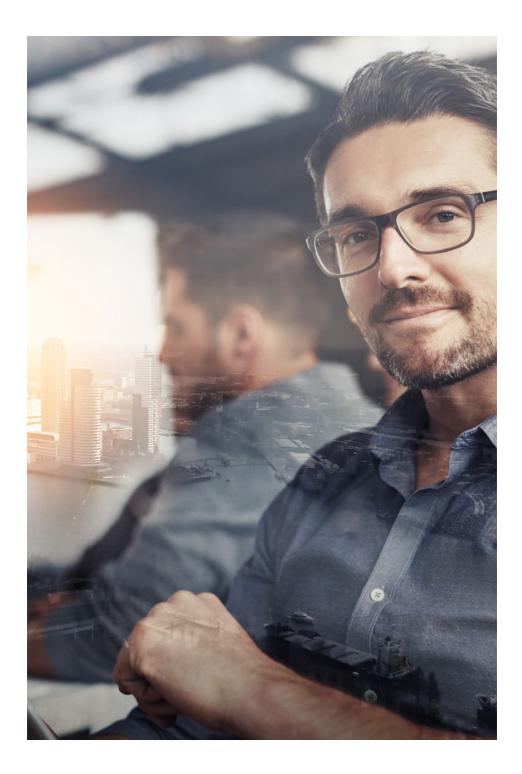
In order to meet the above disclosure requirements, it is crucial that the board has an intimate understanding of how value creation, performance and reward are linked in the business. It is evident that whereas King III and the Companies Act ask the "what" in respect of remuneration disclosure, King IV goes beyond the numbers and also examines the "why" - in other words, the disclosure should not only include the numbers, but also a clear justification for the amounts awarded. This substantial enhancement in disclosure closely aligns to international trends where transparency is at the forefront of the governance agenda. Indeed, such disclosures strengthen the disclosure principle in King IV of enabling stakeholders to make an informed assessment of the performance of the company and its ability to create value in a sustainable manner. Furthermore, the remuneration disclosure requirements are intended to achieve a disclosure benchmark to facilitate the performance of a comparative analysis of remuneration by companies.

King IV's bold move to go beyond the numbers and interrogate the underlying basis for remuneration aligns South Africa with international trends where accountability and transparency are at the forefront of the corporate governance agenda. King IV successfully links the principles of responsible and ethical leadership with greater accountability and transparency with respect to executive remuneration. These recommendations build on the disclosure requirements <sup>10</sup> Investors have a distinct role in relation to executive remuneration Investors have a fiduciary responsibility as well as a strong economic interest in remuneration No aspect of corporate governance touches as many drivers in terms of performance, risk and incentive, or is ultimately more critical to long-term alignment of interests. However, investors are not, typically, insiders and in almost all cases are not in a position to dictate executive remuneration practices."

ICGN Guidance on Executive Remuneration, 2012 implemented through the Companies Act, but takes it a step further in that it proposes that boards identify and illustrate a clear link between the performance of the company and each executive and the remuneration received by each director.

In light of the varying socio-economic landscape and high levels of income inequality in the country, executive remuneration remains under scrutiny. As such, boards should strive for greater accountability and transparency in order to explain executive remuneration, not only in light of the performance of the company and its directors, but also in light of over-all employee remuneration. Stakeholder engagement in the corporate arena remains critical for the harmonious and productive functioning of business and society.

In order to create sustainable organisations and, in turn, sustainable opportunities for all, boards should remunerate top talent in a manner that retains their interest in our country and our economy. The talent shortage in combination with the socio-economic landscape of South Africa should carefully be considered when fair executive remuneration is determined.



## Assessment, removal and resignation //

<sup>(1)</sup> Principle 9: The governing body should ensure that the evaluation of its own performance and that of its committees, its chair and its individual members, support continued improvement in its performance and effectiveness."

**King IV Principle 9** 

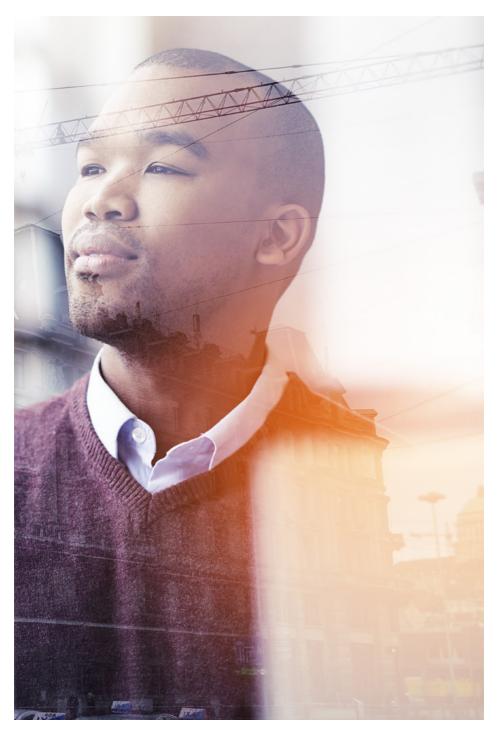
# Assessment, removal and resignation //

#### 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. King IV recommends that the company carefully considers whether performance appraisals should be done in-house or by an independent service provider. Although an in-house process may yield proper results, an independent process may provide a more honest assessment.

The assessment is usually led by the chairperson (through the nominations committee) with the assistance of the company secretary, or by an independent service provider. King IV proposes that a formal assessment of the board, the various board committees, and each individual director be done every alternate year, and that enough time is set aside for the board to carefully consider its performance. In line with the underlying theme in King IV that performance (whether of the company or individual directors) should be evaluated in terms of the triple context (i.e. financial, social and environmental performance), it is recommended that these factors be built into any board performance assessment. Further, it is advisable that the board as well as the skill, experience and contribution of each individual director, but also the extent to which the board is successful in governing the business to achieve its strategic objectives.



An effective assessment process will assist the nominations committee to evaluate the levels of skill and experience on the board and committees with a view to identify training and skills development needs, as well as to evaluate the composition of the board and the respective committees. 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 and time 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 outcome of the evaluation should be used as the basis for an action plan to ensure that the board as a whole has the required skill and experience, how to refine the governance framework and practices, and that the board agenda aligns with the strategic objectives of the business. The annual evaluation of director performance should be used to determine whether or not a particular director should be nominated for re-appointment. Re-appointment should not be an automatic process, but rather be based on the director's contribution to the board and relevant committees.

The chairperson should ensure that all directors are aware of the annual evaluation, and that they understand the criteria used for evaluation. A director's role and contribution should be measured against his or her specific duties, considering the company's financial, social and environmental performance.

The chairperson should also be evaluated, and he or she should not be present when his or her performance is discussed by the board. Where an independent service provider is not used, the Lead Independent Director should lead the evaluation of the chairperson.

#### 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 may become 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 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 Memorandum of Incorporation of a company may 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 Memorandum of Incorporation of a company generally provides 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 Memorandum of Incorporation will require that all directors retire at the first annual general meeting of the company, and that one third of the directors retire annually thereafter. It is usually the directors that have served the longest that retire, but where the directors have served an equal period of time, their retirement is selected by lot. The JSE Listings Requirements requires such provisions to appear in the Memorandum of Incorporation.

King IV proposes staggered rotation for non-executive directors.

The Listings Requirements 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.

Any appointment (even re-appointment) is only valid once the director has provided written consent to serve as a director.

#### Vacancies on the board

In terms of the Act, a person ceases to be a director, and a vacancy arises on the board of a company when the person's term of office as director expires (in

the case of a company whose Memorandum of Incorporation provides for fixed terms). A vacancy may also arise where a director:

- resigns or dies
- in the case of an ex officio director, ceases to hold the office, title, designation or similar status that entitled the person to be an ex officio director
- becomes incapacitated to the extent that the person is unable to perform the functions of a director
- is declared delinquent by a court, or placed on probation
- becomes ineligible or disqualified in terms of the provisions of the Act, or
- is removed by resolution of the shareholders or the board, or by an order of court.

In the case of a vacancy, the directors may have the power to appoint a director to the board. Such appointment will be temporary, until the director is elected and appointed by the shareholders in terms of the provisions of the Act. 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 company's Memorandum of Incorporation or the JSE Listings Requirements where the company is listed.

The Listings Requirements require that the company's Memorandum of Incorporation provide for, where the minimum number of directors in terms of the Memorandum of Incorporation has been reached, a retiring director to be deemed to have been re-appointed where the shareholders do not fill the vacancy at the meeting even if they decided not to re-appoint that particular director.

#### The legal mechanics of removal

Section 71 of the Act determines that a director may be removed by an ordinary resolution adopted at a shareholders meeting. In any such case, the director should be given a reasonable opportunity to state his or her case. Also, where a company has a board comprising two or more directors, the board may remove a director where it is resolved that he or she:

- has become ineligible or disqualified in terms of the Act
- has become incapacitated to the extent that the director is unable to perform the functions of a director, or

• has neglected, or been derelict in the performance of his or her functions.

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 representations to those attending the meeting. Any person who feels that the representations may prejudice them may apply to the Court to stop the representations being communicated to the members.

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 Memorandum of Incorporation of the company). From a practical point of view it would be preferable to have a written record of the resignation. The company will then remove the director's name from the Register of Directors.

(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

In addition, the relevant form needs to be sent to the CIPC. In terms of the JSE 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.

## Contacts



#### Johan Erasmus

Director Direct: +27 (0)11 806 6292 Mobile: +27 (0)82 573 2536 Email: jerasmus@deloitte.co.za



Nina le Riche Director Direct: +27 (0)21 427 5669 Mobile: +27 (0)82 331 4840 Email: nleriche@deloitte.co.za



Claire Hoy Director Direct: +27 (0)21 427 5664 Mobile: +27 (0)83 410 2139 Email: choy@deloitte.co.za



Mark Victor Director Direct: +27 (0)11 8065594 Mobile: +27 (0)82 772 3003 Email: mvictor@deloitte.co.za



Nabilah Soobedaar Senior Manager – Corporate Governance Direct: +27 (0)11 209 8543 Email: nsoobedaar@deloitte.co.za

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