



DRAFT KING III REPORT PUBLISHED FOR COMMENTS

Introduction

The third Report on Governance in South Africa (King III) was published in February this year by the Institute of Directors (IoD) in draft format for written comments.

The report is the culmination of the recent corporate law reform process in South Africa, following the Companies Act No 71 of 2008 (the new Companies Act), which is expected to become operative on 1 July 2010. The King III report will become effective on 1 March 2010 and until then, the current King II report will still apply.

The aim of this article is merely to highlight some of the more important issues and aspects contained in the new report and not to list and discuss all principles thereof in detail.

King III and the corporate law reform process

It is important to note that King III should be considered in its correct context, namely a code which will be based on the new Companies Act, when it is enacted. Even though King III follows the previous King II report, it is not really helpful to merely compare its contents with the previous report, which was published in March 2002.

Several of the recommendations made in King II have been introduced in the current Companies Act, and those recommendations are updated in the new report. An example is the introduction of audit committees in the current Companies Act during 2006 and

the evolving concept of an 'independent director' in King II, the current Companies Act and the new Companies Act.

A proper understanding of the corporate law reform process over the last seven years is therefore essential to fully understand and apply the provisions of the new report.

Commendable aspects of King III

The following aspects of King III can be seen as positive steps, which should all be welcomed:

- The new report consists of only 135 pages, compared to the 285 pages of King II. In addition, the new report is structured in a more logical way, which makes it a lot more user friendly and easier to find relevant provisions than in its predecessor.
- King III is divided into nine chapters in which each of the principles to be contained in the code are listed as headings and discussed in paragraphs underneath those headings. This makes it a lot easier to find any relevant discussions or further provisions on a specific principle.
- The report confirms the nature of corporate governance in South Africa as being a code of principles and practices and describes it as flexible and 'a recommendation for a course of conduct'. This approach to corporate governance differs materially from the United States of America, with specific legal sanctions for non-compliance (as found in the Sarbanes-Oxley Act (SOX)). It is interesting to note the contention on page 9 of the new report that SOX has not assisted the prevention of the collapse of many US companies in the current financial crisis.

- There is, however, an important departure from the previous requirement that companies have to ‘comply and explain’ with regard to the code. The requirement is now that companies have to ‘apply and explain’ the code. This is arguably more onerous - it could be seen as a move away from the so-called ‘tick box compliance’ approach to an approach which requires more consideration of what is actually done to implement the code.
- A helpful remark is made in the preface to the report about the use of instructive language in the report: the word ‘must’ indicates a legal requirement (for example that a public company is obliged to have an audit committee in terms of the Companies Act), ‘should’ indicates those instances where the authors of the code believe that the application of the code will result in good governance and the word ‘may’ indicates the areas where certain practices are proposed for consideration.

Application of King III

In contrast to King I and King II, the new report applies to all entities *"regardless of the manner and form of incorporation or establishment"*. It is stated in the preface that the principles have been drafted on the basis that, if they are adhered to, *"any entity would have practised good governance"*.

The report continues: *"For that reason, we have not focused on or discussed the implementation of the code and each entity should consider the approach that best suits its size and complexity"*.

The following statement is relevant in understanding the implementation of the report and code: *"It is recommended that all entities disclose which principles and/or practices they have decided not to apply and explain why. This level of disclosure will allow stakeholders to comment on and challenge the board to improve the level of governance."*

Emerging governance trends

The preface to the report, lists the following corporate governance trends which have been incorporated:

- **Alternative Dispute Resolution (ADR).** The report advocates administered mediation and if it fails, expedited arbitration. An enforceable ADR clause for inclusion in agreements has been developed for this purpose.
- **Risk-based internal audit.** The report states that internal audit should be risk-based and internal auditors should furnish an annual assessment to the audit committee on the adequacy of internal controls. In order to give substance to the endorsement by directors of the internal controls in a company, the audit committee needs to report fully to the board.
- **IT governance.** As part of exercising their duty of care, directors should ensure that prudent and reasonable steps have been taken in regard to IT governance.
- **Shareholders and remuneration.** Principle 1.27 of the code proposes that the remuneration policy of a company should be approved by shareholders in general meeting. It states, however, that the board is responsible for the remuneration of executive directors and that these decisions need not be approved by shareholders.
- **Evaluation.** The report contains proposals for performance assessment and evaluation of boards and individual directors, which it states in the preface as being entrenched internationally.

New issues in the report

The preface lists the following new issues which are contained in the report:

- **Business rescue.** These recommendations are made in line with the business rescue provisions to be contained in the new Companies Act.

- Fundamental and affected transactions. The report includes a section on fundamental and affected transactions as contemplated in the new Companies Act. The preface states that this was done "... to ensure that directors are aware of their responsibilities and duties in regard to mergers, acquisitions and amalgamations".

Some possible controversial recommendations

There are some recommendations in the report which may be controversial. The following are examples:

- Principle 1.17 states that the board should be comprised of a balance of executive and non-executive directors, with a majority of non-executive directors. This is a shift from King II, which used the qualification that the majority should 'preferably' consist of a majority of non-executive directors. It continues (in paragraph 67 of the new report) that the majority of non-executive directors should preferably consist of independent directors.
- The same shift can be seen in Principle 1.18, namely that the board should be led by an independent non-executive chairman in King II the word 'preferably' was used. If a board appoints a chairman who is not an independent non-executive director, this should be disclosed in the integrated report together with the reasons and justifications for it.
- In instances where there are sound reasons for appointing a chairman who does not meet all the criteria for independence or being non-executive, a lead independent non-executive director (LID) should be appointed. The role of the LID will be to provide leadership to the board where the chairman has a conflict of interests (Annex 1.4 sets out the role of the LID).
- Paragraph 177, which recommends that non-executive directors should not receive share options. This is again a move from King II where the word "preferably" was used.

- It is interesting to note that on board committees, there are two aspects which may need further consideration:

- Section 72(4) of the new Companies Act makes reference to a social and ethics committee, which may be compulsory for companies as prescribed by regulation. King III does not deal with such committee and recommendations on the powers and functions of such committee may be helpful.
- Section 72(2)(a) of the new Companies Act states that a board committee may include non-directors. Section 76 continues by placing the same standards of conduct and liability on such persons. Paragraph 142 of the report merely states that board committees should only comprise of members of the board without motivation. The perceived conflict should perhaps be clarified.

These are only some examples of matters that could possibly be controversial. The main criticism against the new report revolves around the fact that the report is merely a set of principles and the application thereof could easily be circumvented. The counter-argument to this is that corporate governance should not be legislated and the market place should be left to enforce compliance (the approach taken by the new report). We will gladly assist anybody who requires clarification and assistance with the report in its current form.

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