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# KING IV INDEPENDENT DIRECTORS

# INTRODUCTION

The King Committee published the Draft King IV Report on Corporate Governance for South Africa 2016 (King IV) on 15 March 2016. Comments are due by 15 May 2016. While we acknowledge that most organisations suffer from regulation fatigue, we welcome this new version of the King Code as it not only provides a more practical, principle-based approach to good corporate governance, but also incorporates both global public sentiment and international regulatory change since King III was issued in 2009.

In our view, King IV is bolder than ever before. Firstly, the Code is principle-based and follows an outcome-based rather than rule-based approach. This is in line with current international sentiment which promotes greater accountability and transparency. It speaks to the expressed view that the application of the Code should contribute to the performance and health (sustainability) of the company. In this regard it is clear that King IV aims to establish a balance between conformance and performance. The Code is further bold in its relentless effort to reinforce corporate governance as a holistic set of arrangements that concerns itself with ethical leadership, attitude, mind-set and behaviour. This echoes global developments in the conduct risk arena and also seeks to address and prevent recent examples of corporate failure.

Lastly, the boldness of the Code is evident in the clear focus on transparency and targeted disclosures in all areas, specifically in the introduction of far more extensive executive remuneration disclosure than ever seen before. While we believe that this matter still warrants debate in the South African context, we acknowledge that the suggestions are in line with global developments and perhaps more relevant in a country where the income differential remains higher than desired.

In this document we specifically discuss the need for and value of independent directors, as well as the King IV approach to the assessment of the independence of directors. It should be noted upfront that all directors, regardless of the classification as an executive, non-executive or independent non-executive director, require the application of an independent state of mind and objective judgement. In essence, ALL directors are required to always act in the best interests of the company, and this can only be achieved if directors set aside their personal interests.

"A person is independent who, in reality and appearance, has no interests or position in, or association or relationship with, the company which in the opinion of a reasonable and informed third party would affect that person's objectivity and impartiality".

*– King IV*

# THE VALUE OF INDEPENDENT DIRECTORS

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 wields 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; and*
- *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 yields 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.

# PRACTICAL IMPLICATIONS OF ASSESSING INDEPENDENCE

The concept of independence has evolved from the position in King III. 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), whereas 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 judgement and 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. It is up 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 would 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 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 an informed outsider. The key question to be answered here is whether or not, in the perception of an informed outsider, a director has an interest, relationship, association or position which may lead to biased decision-making.

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 shareholder, or an officer or employee of a shareholder, who has the ability to control or significantly influence management or the Board*
- *is a shareholder where the holding is material to the personal wealth of the member of the Board*
- *had been in the employ of the company or the group in any executive capacity during the preceding three financial years*
- *is a member of the immediate family of an individual who is, or has been during the preceding three financial years, employed by the company or the group in an executive capacity*
- *had been the auditor responsible for performing the statutory audit for the company, or a key member of the audit team of the external audit firm, during the preceding three financial years*
- *had been an external legal adviser for an extended period during the preceding three financial years*
- *is a significant professional adviser to the company or the group, other than as a member of the Board*
- *is a member of the Board or an executive of a material customer of, or supplier to, the company; or*
- *is entitled to remuneration contingent on the performance of the company.*

Interestingly, 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 disqualification for audit committee membership in terms of the Companies Act).

With respect to 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, 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 publicly accessible media and communication platform regarding the composition of the Board and the classification of each director as independent or not. In each instance where one or more of the criteria which may indicate a lack of independence applies to a particular director, and the Board nevertheless decides to classify such director as independent, the Board is required to justify the decision and provide clear reasons for such classification. 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 an 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.*

## King III - Independent if:

- *The director is not a representative of a shareholder who has the ability to control or significantly influence management or the Board.*
- *The director does not have a direct or indirect interest in the company (including any parent or subsidiary in a consolidated group with the company) which exceeds 5% of the group's total number of shares in issue.*
- *The director does not have a direct or indirect interest in the company which is less than 5% of the group's total number of shares in issue, but is material to his personal wealth.*
- *The director is not a professional adviser to the company or the group, other than as a director.*
- *The director has not been employed by the company or the group of which it currently forms part in any executive capacity, or appointed as the designated auditor or partner in the group's external audit firm, or senior legal adviser for the preceding three financial years.*
- *The director is not a member of the immediate family of an individual who is, or has during the preceding three financial years, been employed by the company or the group in an executive capacity.*
- *The director is free from any business or other relationship (contractual or statutory), which could be seen by an objective outsider to interfere materially with the individual's capacity to act in an independent manner, such as being a director of a material customer of or supplier to the company.*
- *The director does not receive remuneration contingent upon the performance of the company.*

## King IV - Independent if an informed third party perceives the director as independent:

**Indicators of lack of perceptual independence:**

- *being a representative of a shareholder who has the ability to control or significantly influence management or the Board*
- *having been in the employ of the company or the group in any executive capacity, or appointed as the designated auditor or partner in the audit team of the group's external audit firm or external legal adviser during the preceding three financial years*
- *being a member of the immediate family of an individual who is, or has during the preceding three financial years, been employed by the company or the group in an executive capacity*
- *being a significant professional adviser to the company or the group, other than as a member of the Board*
- *any business or other relationship (contractual or statutory) which could be regarded by an objective outsider to interfere materially with the individual's capacity to act in an objective manner, such as being a member of the Board of a material customer of or supplier to the company, or*
- *receiving remuneration contingent upon the performance of the company.*

This is not an exhaustive list, nor does it detract from the obligation of the Board and director to apply these criteria judiciously when making an assessment of independence.

# 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 its 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 regarding independence.

# QUESTIONS FOR DIRECTORS TO ASK

- *What is the ratio between independent and non-independent directors on the Board?*
- *Is the Board able to explain and justify its decision for classifying a particular director as independent?*
- *Can the Board provide clear reasons for its decision to classify a director as independent where one or more of the criteria which may indicate a lack of independence applies to this director?*
- *Are there independent directors who have served on the Board for more than nine years? If so, did the Board assess the continued independence of these directors and disclose the details of the assessment and findings in this regard?*

# CONCLUSION

The value of appointing independent directors to the Board should not be underestimated. These directors have a crucial role to not only act as sounding boards 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).

The onus of classifying directors as independent rests with the Board. The adoption of the approach to apply conceptual, 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.

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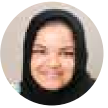

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