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The selection, nomination and voting for non-executive directors**Introduction**

Principle 2.19- Directors should be appointed through a formal process

Shareholders are ultimately responsible for the composition of the board, and it is in their interest to ensure that the board is properly constituted from the viewpoint of skills and representivity. Procedures for the appointments to the board should be formal and transparent and should be a matter for the board as a whole, assisted by the nominations committee, subject to shareholder approval.

Target audience

This practice note provides guidance to the shareholders, board, nominations committee and company secretary on the best practice guidelines for the selection of, nomination of and voting for non-executive directors to serve on boards.

Board appointments

Section 68(1) of the Companies Act, 2008 (the Act) requires all directors (including any alternate directors) to be elected by the shareholders of profit companies, or members of non-profit companies that are entitled to exercise voting rights in that election. The only exception is directors appointed by persons named in the Memorandum of Incorporation (MOI), ex-officio directors, and where the board fills temporary vacancies.

The Act requires private companies or personal liability companies to have at least one director. Public companies are required to have at least three directors. This is in addition to the minimum number of directors that the company must have to satisfy any requirement to appoint an audit committee, or a social and ethics committee, in terms of the Act or its MOI.

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

In terms of the Act, the term of service of the elected directors (including any alternate directors) will be indefinite, or as set out in the MOI. However, from a sound governance point of view and regardless of whether the Act allows it, it is not advisable for companies, other than owner-managed companies, to elect a director or alternate director to serve for an indefinite term. Shareholders should have the opportunity to continually elect new directors and/or replace any existing directors. King III recommends that at least one third of non-executive directors should retire by rotation yearly, usually at the AGM or other general meetings, unless otherwise prescribed though any applicable legislation.

It also recommends that any term beyond nine years for an independent non-executive director should be subject to a particularly rigorous review by the board.

The rights of shareholders in the election of directors and alternate directors are important as these are part of the checks and balances built into the company structure. In recognition of this principle, the Act requires the MOI of all profit companies, other than state-owned companies, to require shareholders to elect at least 50% of all directors and 50% of any alternate directors.

A person becomes entitled to serve as a director of a company when that person has been appointed or elected in accordance with the Act and has delivered to the company a written consent to serve as its director.

In the interest of holding directors accountable, and to achieve board composition that reflects effective shareholder and material stakeholder participation, implementing the following practice is recommended.

1. Performing a needs assessment

As a first step, the board should conduct a 'needs assessment' to determine the skills and experience required to fill vacancies on the board. Where board vacancies arise, the nomination committee (and if no nomination committee, the board) should evaluate the range of skills, experience and expertise of the existing board, focusing particularly on the skills that would best increase the board's effectiveness. Previous evaluations of the board and individual directors will provide valuable information to assist in this needs assessment.

As it is critical for a board to have directors who possess a broad mix of skills and experience, any potential candidates' particular skills and expertise should be considered in relation to the other board members. In addition to their skills and experience, personal style and diversity aspects should be considered (i.e. gender and cultural differences bring different dynamics to discussions).

The key goal in selecting directors is to build a mix of skills and experience that achieves a well-rounded team in fulfilling the board's duties and responsibilities. King III states in principle 2.18, paragraph 71 that *every board should consider whether its size, diversity and demographics make it effective. Diversity applies to academic qualifications, technical expertise, relevant industry knowledge, experience, nationality, age, race and gender.*

Particularly in South Africa, the need for diversity (particularly diversity of race, age and gender), should be considered, bearing in mind the current board's demographic composition and the company's transformation targets.

Stakeholder representation on the board, which is required in some regulated industries (quite common in the public sector) also needs to be

taken into account. This includes board representation of empowerment partners as well as shareholder representation, where the company has a controlling shareholder. As the representative is appointed by a third party, there needs to be communication with this party to ensure that the board's skills and experience requirements are taken into account when the appointment is made.

Consideration should be given to the balance of independent directors on the board (King III requires that the majority of the non-executive directors should be independent); as well as the membership needs of the various board committees. For example, at least three independent non-executive directors will be needed on the board if the company is required to have an audit committee.

The needs of the various board committees also need to be taken into account with regard to required skills. For example, audit committee members need a collective understanding of the specific requirements of governance guidelines and particularly the Companies Act, 2008 - shareholders need to specifically appoint the audit committee members for the ensuing year. There may well also be other specialised committee skills requirements that need to be taken into account in determining the skills needed on the board.

A remuneration range for new directors could also be set at this "needs assessment" phase.

In light of this "needs assessment" the board/nomination committee should prepare a description of the board's requirements and communicate this to the shareholders to make them aware of the skills and experience needed on the board. In conveying these requirements, the board should guard against being so restrictive as to unduly limit shareholders' options.

2. Obtaining proposals

2.1. Call for proposals from shareholders

The second step in the process of locating and considering suitable nomination candidates is for the board to seek proposals for directors from the shareholders. The description of the board's requirements should accompany the call for nominations that is sent out to the shareholders.

In the interest of an effective nomination process, sufficient time should be allowed for meaningful input by shareholders. It is therefore crucial that adequate notice of the nomination process, and the role of the shareholders in this process, is given to shareholders. The notice given to shareholders of the process should provide sufficient information on the manner, time and place for shareholder submissions as well as how the board intends dealing with the proposals.

It is recommended that each proposal of a candidate by a shareholder to the board is accompanied by the candidate's consent to act and a detailed CV

outlining the candidate's relevant expertise, experience and qualifications.

Throughout the course of the proposal process the board could advise shareholders of the names of those candidates already proposed by shareholders, whether assessed by the board or not. Alternatively the board could choose to advise only the short-listed candidates to the shareholders after the nominations process has been completed.

The creation of a shareholders' liaison forum on the company's website could be useful to facilitate shareholders' involvement in the proposal process. The forum could publicise notice of the proposed process to be followed and the shareholders' role, as referred to above. It could also communicate with shareholders throughout the process. Should a company not be able to set up a shareholder liaison forum on its website or if it is not deemed appropriate to do so, alternative means of communicating with shareholders should be identified by the board.

2.2. Other sources of potential candidates

The board could consider other sources for finding potential candidates. These could be internal sources (for example nominations from board members themselves) or external sources (for example empowerment partners or other material stakeholders; using an executive search firm or media advertisements; or using business networks to reach potential candidates).

3. Individual attributes to consider

Once the proposals are obtained, each potential candidate should be assessed in relation to certain individual attributes. The board/nomination committee will need to make this assessment based on candidate CV's, background checks and candidate interviews.

In addition to contributing to the overall balance, needs and composition of the board, the following candidate factors need to be considered:

- Extent of experience as director
- Competencies and qualifications, including strategic, financial, risk, legal and industry knowledge (in particular, potential directors need to demonstrate a broad-based knowledge and understanding of the Companies Act 2008 and King III)
- Independence (perceived and actual)
- The number and nature of other directorships held
- Other commitments and time availability
- Reference and background checks (particularly on the ineligibility and disqualification factors listed below)
- Consent to act (where a potential candidate is nominated, the nomination committee needs to ensure that the candidate is willing to be considered for appointment)

Personal attributes to consider include:

- Integrity - acting honestly and in the best interests of the company
- Curiosity and courage - ability to ask tough questions
- Interpersonal skills and ability to work in a collegial team
- Genuine interest in the organisation and its business
- Instinct - good business instincts and acumen, ability to get to the crux of an issue
- An active contributor - attends meetings and participates actively
- Competence and commitment to serve as a director

In the case of retiring directors making themselves available for re-election, the nomination committee would need to consider the above attributes, as well as the particular director's past performance before recommending the director to shareholders for re-election. Past performance should be formally assessed through, for example, peer assessments.

Ineligibility and disqualification are also key factors for the nomination committee to consider. A person who is ineligible or disqualified must not be appointed or elected as a director of a company, or consent to being appointed or elected as a director, or to act as a director of a company. This forms part of the background checks mentioned above. The board/nomination committee needs to be satisfied that any potential candidate is eligible and is not disqualified in terms of the Act i.e.:

- Is not a juristic person;
- Is not an unemancipated minor, or under similar legal disability;
- Is not disqualified in terms of the MOI to act as a director;
- Is not prohibited by the court from being a director or been declared delinquent;
- Is not an unrehabilitated insolvent;
- Has not been removed from office of trust on account of misconduct involving dishonesty;
- Has not been convicted, in the Republic or elsewhere, and imprisoned without the option of a fine, or fined more than the prescribed amount, for theft, fraud, forgery, perjury or an offence involving fraud, misrepresentation or dishonesty;
- Has not been prohibited in terms of any public regulation from being a director of the company.

In addition to the provisions of the Act, a company's MOI may impose additional grounds of ineligibility or disqualification of directors; or minimum qualifications to be met by directors of that company. In certain regulated industries, additional restrictions may be in place in terms of other relevant legislative requirements.

In terms of the Act, the election or appointment of a person as a director is a nullity if, at the time of the election or appointment, that person is ineligible or disqualified.

4. Nominations

Based on the assessments of the proposed candidates (CV's, background checks and interviews) as well as the needs of the board, the board should determine the nominees who will be put forward for election by the persons (shareholders of profit companies and members of non-profit companies) who are entitled to exercise voting rights in that election.

The board's role in the nomination process gives it an opportunity not only to entrench itself in office (by only nominating current directors for shareholder consideration) but also to only nominate those who fit in with the current mould of thinking. Boards should guard against this whilst being mindful of its duty to act in the best interest of the company. Therefore, the board should strive to be as transparent as possible concerning the reasons for its decisions.

However, the board should also consider whether or not it is in the best interests of the company to disclose its deliberations. Disclosure may adversely affect the relationship of the board or the company with those not nominated; or it may give competitors insight into the company's shortcomings or key focus areas etc.

5. Voting

5.1. Series of votes

In terms of the Act, unless a profit company's MOI provides otherwise, in any director election, the election is to be conducted as a series of votes, each of which is on the candidacy of a single individual to fill a single vacancy. The series of votes continues until all vacancies on the board at that time have been filled. Each voting right entitled to be exercised may be exercised once; and the vacancy is filled only if a majority of the voting rights exercised support the candidate.

5.2. En bloc voting

En bloc voting is the election of two or more candidates as directors conducted by way of one single resolution. The Act permits this only in instances where the MOI allows it. En bloc voting deprives shareholders of the opportunity to consider the merits and suitability of individual candidates and thereby dilutes accountability. The board should ensure that shareholders understand the implication of including an en bloc voting provision in the MOI.

Should shareholders decide to include an en bloc voting clause in the MOI, the clause should set out the following procedure:

- A separate resolution, requiring all shareholders to agree to the use of the en bloc voting method; and
- The moving of the resolution electing two or more directors or alternate directors. In terms of the clause, the use of and reasons for the en bloc voting method should be proposed as a separate resolution.

We recommend that en bloc voting should only be used in closely held private companies or in a wholly-owned group situation, where a subsidiary has a single shareholder.

5.3. Election by others

The principle that the shareholder(s) with more than 50% of the voting rights determines the composition of the entire board is well-established.

In future, this may no longer be the case. Section 66(4) (b) of the Act allows for parties other than shareholders to elect directors subject to its requirements. The MOI of profit companies, other than a state-owned company, must require shareholders to elect at least 50% of all directors and 50% of any alternate directors. For instance, a creditor may demand the right to appoint up to 50% of the directors to mitigate the risk that it undertakes by extending finance to the company.

The appointment of directors by parties other than shareholders is a matter that must be provided for by the company's MOI as adopted by its shareholders.

A further issue to be considered is whether minority shareholders should be given rights to appoint directors. Clearly it would be impossible to permit every shareholder to appoint a director to the board in proportion to the shareholder's shareholding in relation to the entire issued capital. A listed company with hundreds of shareholders is a case in point.

The board may consider encouraging the controlling shareholder(s) to permit minority shareholders collectively to appoint a director/s. The director(s) "representing" the minority shareholders collectively are not permitted to take instructions from those shareholders or to represent solely their sectoral interests as doing so would be in breach of their fiduciary duties to act in the best interest of the company. If this caveat is adhered to, allowing the minority shareholders to appoint one or more directors would contribute to the balance of power on the board.

Directors appointed by the minority shareholders have the same rights, duties and liabilities as any other director, and should be treated as equals.

Conclusion

It is recommended that boards reconsider their election of directors' processes, and compile/update their policy dealing with procedures for appointments to the board of directors. Challenging allowances made by statute and increasing accountability driven by ethical shareholder engagement, may lead to more effective board composition.

It is also recommended that shareholders, boards and nomination committee members consider and improve on the composition of their boards, taking into account the needs of the company in terms of size and complexity,

relevant statutory requirements as well as the effective functioning of the board and its respective committees.

Resources :

- This practice note was compiled with the input of Chartered Secretaries Southern Africa.

