PRACTICE NOTES

Retirement by rotation of executive directors

October 2013

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INTRODUCTION

The purpose of this Practice Note is to provide guidance on the requirement for directors to retire by rotation and to explain why, for rotation purposes, a differentiation is made by the King Committee between executive and non-executive directors.

This Practice Note follows the following format:

- Relevant background information, including:
  - The Companies Act, 2008, The King Report and Code on Governance 2009 (King III) and the JSE Listings requirements on election of directors and rotation
  - Categories of directors and their respective governance function
  - Role of the board vis-a-vis the role of shareholders
- The possible/potential unintended consequences of executive retirement by rotation taking into account the background information
- Conclusion and recommendations

RELEVANT BACKGROUND INFORMATION

The Companies Act, 2008

The Companies Act, 2008 (the Act) allows for *"the direct appointment and removal of one or more directors by any person named in or determined in terms of the Memorandum or Incorporation"* (the MoI) subject thereto that in the case of a profit company, other than a state-owned company, the MoI *"must provide for the election by shareholders of at least 50% of the directors".* (Refer to section 66(4)(a)(i) and (b)). It further allows that the MoI may provide for *"a person to be an ex officio director of the company as a consequence of that person holding some other office, title, designation or similar status..."* (Refer to section 66(4)(a)(ii)).

Therefore, in terms of the Act:

- directors may be elected and removed by shareholders,
- directors may be elected and removed by persons other than shareholders as provided for in the MoI, or
- a person may become a director by virtue of holding a specific position in relation to the company.

The Act does not provide for, nor require, retirement of directors by rotation. Staggered rotation of directors is recommended as a well-established good governance practice.

King III

The relevant paragraphs from Chapter 2 of King III read as follows:

"73. As a minimum, two executive directors should be appointed to the board, being the chief executive officer (CEO) and the director responsible for the finance function. This will ensure that there is more than one point of contact between the board and the management. From June 2009, listed companies must appoint a financial director to the board.

74. A programme ensuring a staggered rotation of ***non-executive directors*** *should be put in place by the board to the extent that it is not already regulated by the company's memorandum of incorporation or relevant regulation. Rotation of board members should be structured so as to retain valuable skills, maintain continuity of knowledge and experience and introduce people with new ideas and expertise.*

75. At least one-third of ***non-executive directors*** *should retire by rotation yearly, usually at the company's AGM or other general meetings, unless otherwise prescribed through any applicable legislation. These retiring board members may be re-elected, provided they are eligible. The board, through the nomination committee, should recommend eligibility, considering past performance, contribution and the objectivity of business judgement calls."*

The JSE Listings requirements

Schedule 10.16(b) of the JSE Listings Requirements (the Requirements) provides that all directors' appointments (both executive and non-executive) are subject to shareholders' approval. However, schedule 10.16(g) of the Requirements supports King III in that it requires only non-executive directors to rotate. This is obviously only a minimum standard, but was introduced as such by the JSE as the potential unintended consequences associated with retirement of executive directors by rotation were recognised. Similar provisions were also in the previous version of the Requirements that dealt with the Articles of Association.

It also needs to be noted that for listed companies the Requirements do not allow the appointment of directors other than by shareholders.

Categories of directors

In law, there is no distinction between executive, non-executive and independent non-executive directors in terms of directors' duties and liability for breaching those duties. However, there are differences in the respective roles from a governance perspective. The governance terminology "executive director", "non-executive director" and "independent non-executive director" are purposely distinct in order to practically differentiate between these various governance roles.

The executive director participates in the board-room wearing two hats. On the one hand executives are full time salaried employees of the company and as such they will have a written contract of employment with the company. On the other hand, executive directors are also office bearers of the company who need to act and bear responsibility within the scope of statutory and common law duties and liabilities as well as relevant governance guidelines for directors. A major part of executive directors' participation in board meetings involves reporting to the non-executive directors on behalf of the management of the company.

Non-executive directors bring to bear a broader perspective, with a wider background and range of skills. Their role is to balance the power of the executive and to serve as a counterfoil to management’s potential self-serving interest. The enhanced objectivity of independent non-executive directors further strengthens this function and hence the shift in corporate governance in recent time towards greater independence on boards.

The power within the board should be carefully balanced and much of the board's effectiveness as a governance structure hinges on the dynamics of the relationship between executive and non-executive directors.

Role of the shareholders vis-a-vis the role of board

Shareholders are effectively the owners of a company, who invest their money to provide capital to the company. Shareholders' rights are enshrined in law and the incorporation documents of the company. These rights include setting the objectives of the company in the MoI and appointing the directors. Shareholders do not have the right to be involved in the day-to-day business operations of the company.

The board's role includes directing and controlling the company and appointing, overseeing and removing management.

Section 7(i) of the Act states as one of its purposes the balancing of the rights and obligations of shareholders and directors within companies. Various legal mechanisms have been created in the Act for this purpose. For instance, the board must call a shareholder meeting in the event that a written demand compliant with section 61(3) is received. Section 65(3) furthermore provides that any two shareholders of a company may propose a resolution concerning any matter in respect of which they are each entitled to exercise voting rights. In terms of section 71, shareholders are also entitled to remove a director by means of an ordinary resolution, subject to certain conditions.

UNINTENDED CONSEQUENCES OF EXECUTIVE RETIREMENT BY ROTATION

Staggered rotation of non-executive directors is a necessary and beneficial corporate governance practice. It balances retention of experience and knowledge about the company's operations and business affairs with bringing new thinking and fresh perspectives to board decision-making. Aside from this, the overarching benefit of non-executive rotation is to maintain independence on the board.

In order to reap these benefits, retirement by rotation normally happens at intervals of 3 years in respect of each non-executive director. It is, however, not intended to address matters of non-performance which require immediate intervention.

In this context retirement by rotation refers to the change of directors regardless of their performance. Should performance be an issue, the shareholders may indeed act before the expiry of any director’s term of office. In particular, when dealing with poor performance of executive directors, there is no question that they should be capable of being removed.

Possible reasons why shareholders may not re-elect an executive employee as a director include:

- dissatisfaction with the employment contract;
- the executive exerting too much power on the board;
- a lack of skills as an executive employee; or
- a lack of performance on the part of the executive.

There is the risk that all of these concerns could be based on perceptions, as shareholders seldom have regular direct interaction with executives. Therefore, we believe that in these instances, the board is much better placed to make an informed decision.

These possible shareholder concerns all link to the relationship between the board and management and shareholder involvement therein may impinge on the board's governance role overseeing management. From a governance perspective allowing the shareholders to intervene through the mechanism of retirement by rotation may disturb the balance of power between shareholders and the board vis-a-vis the company.

The following unintended adverse consequences may follow from subjecting executive directors to retirement by rotation:

- This could erode the relationship between management and the board, inadvertently leading to a situation where the executive, in his capacity as executive rather than director, is perceived to be primarily accountable to the shareholders.
- Should the executive not be re-elected by the shareholders as a director, neither the board nor that executive can ignore the consequence even if the employment contract remains unaffected. For example, this may expose the company to the consequences of losing a key employee at short notice as the executive director could resign as an employee if not re-elected as a director, because of a perceived loss of status and an explicit loss of confidence. Alternatively, the board may in any event want to relieve him/her of his/her duties as an employee, which may be contrary to the terms of the employment contract (although this can clearly be catered for by proper drafting of the employment contract).
- Further, it may be extremely difficult to attract a high calibre Chief Executive or Financial Director by making such appointment subject to retirement by rotation on an regular basis. The failure to take into account the term of the employment contract when the rotation of executive directors by shareholders takes place, would result in employment prospects being uncertain and this in turn would impact

unfavourably on the ability of the company to attract competent executive directors, or otherwise only at significantly higher rates of remuneration.

- Companies may attempt to avoid the adverse consequences of executive directors not being re-elected on rotation by not having any member of management serving as a director. This is contrary to the King III recommendation of a balance of executive and non-executive directors, with the CEO and director responsible for finance as a minimum being appointed as executive directors.

CONCLUSIONS AND RECOMMENDATIONS

The insistence by some shareholders that the MoI's being tabled for adoption include the requirement for executive directors to be subjected to retirement by rotation is not a requirement of South African legal or regulatory requirements, nor a recommendation of King III.

The Act affords shareholders the right to call for meetings, to table resolutions to be considered at those meetings and to remove directors. The shareholders' unfettered right (subject to following the appropriate process) to remove any director are unaffected by whether executive directors are rotated or not. In addition, shareholders of listed companies have the unequivocal right to not confirm the appointment of an executive director by the board, should the shareholders believe that the appointment is not appropriate or not acceptable.

The existence of legitimate shareholder concerns regarding executive performance and succession of senior executives is acknowledged. However, as a matter of sound governance, the board is responsible for and hence in the best position to judge the performance of executive directors, both as members of management and in how they fulfil the role as directors.

Considering the concerns raised above regarding the retirement by rotation of executive directors, the King Committee is of the view that its recommendation in King III for the retirement by rotation of non-executive directors should not be extended to include executive directors.

As with all King III recommendations, the boards of all companies should apply their minds to the application of the King III recommendations and could thus decide that it would be appropriate for the company to include executive directors in the rotation process. However, should rotation of executive directors be adopted, the King Committee's preference would be a longer rotation period for executives than is applied to non-executive directors. Another alternative is that when the executive's employment contract is due to expire, shareholders would then be afforded the opportunity to vote on whether the executive is to be re-elected to the board. This would however require careful attention to be paid to the terms of the employment contract, and could imply that executive contracts cannot be concluded for extended periods of time.

By choosing retirement by rotation, shareholders may be opting for a blunt instrument whereas there are more appropriate alternatives available in the interest of all concerned.