The South African Institute
of International Affairs

Global Best Practice

Corporate Governance
South Africa, a pioneer in Africa

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Editor's Note

Africa is a continent which continues to suffer from high poverty rates and disease. While 30 years ago the average income in sub-Saharan Africa was twice that of both South and East Asia, Africa's is now well below half that of East Asia. It also lags far behind the mean in South Asia, Latin America and the Middle East.[1]

Based on such statistics, Africa seems like the college drop-out. Yet the last decade has been a significant one for many African states. Dictators are less in vogue today than they were 15 years ago; many economies are growing strongly, albeit from a very small base; institutions are being reformed; and there has been a very frank appraisal by Africans of the weaknesses and shortcomings of African states and of leaders themselves. Africa's reassessment of itself has been matched by greater engagement from the North on these issues in a more urgent and immediate manner than previously. Examples are the discussions on Africa at the various G-8 meetings since 2001 and, more recently (in March 2005), the publication of the report of the Commission for Africa, which was initiated by the British prime minister, Tony Blair. These represent serious efforts to arrive at solutions based on the premise of partnerships between the North and the South.

The adoption by African states of the New Partnership for Africa's Development (Nepad) in October 2001, and the introduction of the African Peer Review Mechanism (APRM) were significant steps in the continent's decision to take control of its future. Nepad recognises the important role that the North can and should play in helping Africa to overcome poverty and low economic growth. However, reforming African leaders have also acknowledged that more aid or trade barrier reductions from the North will not be sufficient to pull the continent's poor (estimated at more than 46%) out of poverty. A complementary

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1 Commission for Africa, *Our Common Interest*, report of the Commission for Africa, March 2005, p. 21.

commitment by African governments to improve the quality of governance is also required.

There are many lessons that countries can draw from the successes (and failures) of governance in others. With this in mind, in 2003 the South African Institute of International Affairs commenced a project entitled 'Global Best Practice', with the generous support of the Konrad Adenauer Foundation. The objective of the project was to assemble global success stories, and to assess their applicability in the context of problems faced by African countries. Such research is crucial for Africa if the Nepad initiative is to be successful.

A number of case studies were commissioned in various sectors, and in both developing and developed countries. Additional studies were also undertaken on four cross-cutting environmental factors that determine success. These were:

- the impact and role of the external environment;
- the role of leadership and expertise;
- the role of political and social infrastructure; and
- the role of the macro-economic and financial environment.

The first report in the series focuses on the development of a code of corporate governance in South Africa. The corporate governance theme is very significant within the context of peer review and is one of the four areas which will be scrutinised during the conduct of APRM in the acceding states—24 thus far. The other three areas are Democracy and Political Governance; Economic Governance and Management; and Socio-economic Development.

The corporate governance issues covered by the APRM can be grouped under five main objectives:

- promoting an enabling environment and an effective regulatory framework for economic activities;
- ensuring that corporations act as good corporate citizens with regard to human rights, social responsibility and environmental sustainability;

- promoting the adoption of codes of good business ethics in achieving the objectives of the corporation;
- ensuring that corporations treat all their stakeholders (shareholders, employees, communities, suppliers and customers) in a fair and just manner; and
- providing for the accountability of corporations, directors and officers.

One may argue that it is premature to talk about corporate governance regulations in much of Africa, where the private sector is very small and capital markets are poorly developed. The point could also be made that too much regulation too early in the private sector's development may stifle initiative and entrepreneurship. But any society requires a set of minimum conditions (especially in countries with weak regulatory and judicial frameworks) which will attract not only foreign direct investment but also encourage the domestic entrepreneur to invest in his/her country in a productive and sustainable manner. African states have much to learn in this regard.

In 2004 and 2005 the South African Institute of International Affairs conducted research on peer review in Malawi and Ghana. Both countries have acceded to the APRM. The findings were illuminating. Malawi is relatively underdeveloped. Poverty is widespread and the private sector is very small. For example, its stock exchange, inaugurated in 1995, has only nine listed companies. Ghana ranks as one of the more solid economies in Africa, although it too faces various socio-economic difficulties. In both cases the gap between theory/legislative frameworks and actual application was found to be quite substantial. In Malawi, for example, enforcing a commercial contract may be simple in theory but not in practice, because the courts lack capacity to process cases. Legislation exists for procurement procedures, yet regulation is subject to executive intervention. The Companies Act is outdated, and makes scant reference to corporate governance codes. Ghana's private sector is more well-developed, and has a very comprehensive code for companies. However, it too has had little 'enforcement muscle', owing to severe capacity constraints and low morale in the Registrar-General's department. Also, most companies, even multinationals such as Shell and TotalfinaElf, operate as private (unlisted) firms in Ghana.

There is also a case to be made for the existence of codes of conduct relating to the interaction between governments and multinational corporations (MNCs) operating in countries where both transparency and regulation are lax. A number of initiatives have been launched in the North to require greater openness concerning the way in which MNCs conduct their business. For example, 'Publish What You Pay', a non-governmental initiative with significant backing from the British and Canadian governments, seeks to secure disclosure of the details of unrecorded payments made to the governments of developing countries by international oil, gas and mining companies for oil and other concessions there. The reason is that much of this unacknowledged income fuels government corruption and mismanagement. The initiative, whose supporters comprise more than 80 NGOs (including the Open Society Institute, Global Witness and Partnership Africa-Canada) places the onus on the governments of developed countries 'to require trans-national extraction companies to publish net taxes, fees, royalties and other payments made' to recipient governments.[2] This would enable the citizens and civil society in the developing countries concerned to determine the amount of money misappropriated, and in this way act as a deterrent both for the companies and governments involved.[3]

In September 2002, Tony Blair announced the Extractive Industries Transparency Initiative. This too called for greater openness from companies (on their payments to governments and government-linked entities), and from host country governments (over revenues obtained

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2 Smillie I, *Motherhood, Apple Pie and False Teeth: Corporate Social Responsibility in the Diamond Industry*, The Diamonds and Human Security Project, Occasional Paper no. 10, 5 June 2003, p. 12; and also www.publishwhatyoupay.org.

3 Sidiropoulos E, 'Southern Africa's Sanctions Experience: Bringing About Change?', in Mills G and E Sidiropoulos (eds), *New Tools for Reform and Stability: Sanctions, Conditionalities and Conflict Resolution*. Johannesburg: South African Institute of International Affairs, 2004, p. 107.

from companies). However, the voluntary nature of both these initiatives makes compliance and enforcement very difficult.[4]

It is sometimes the case that foreign companies operating in Africa reckon they can follow a set of rules different from those they apply in their countries of origin, partly because of the operational difficulties they encounter. Indeed, some MNCs based in member countries of the Organisation for Economic Cooperation and Development (OECD) operating in states that are not OECD members do no better on the corporate ethics front than local businesses in the host country,[5] even though the former have committed themselves to complying with legislation banning bribery. Although corruption may emanate from State House or other government levels in the developing countries, the willingness of some foreign companies to engage in bribery fosters a climate of payment for favours. The culture of impunity for officials when it comes to taking bribes from corporations has exacerbated the problem. More specifically, few African governments have disclosure policies to identify conflicting interests, in the dealings of politicians and senior government officials.

However, there have also been a number of cases in Africa, most notably the Lesotho Highlands Water Project (LHWP), where MNCs who were the beneficiaries of contracts funded by the World Bank and engaged in bribery had investigations into their conduct re-opened only after Lesotho decided to take action. Of course, it was not only the MNCs who fell under the spotlight: questions were also raised about the corporate governance codes of the Lesotho Development Authority.

One area in which there is an opportunity to act fairly swiftly is that of state-owned enterprises (SOEs), of which Africa has many. *The Power of Governance*, written by the chairman of Eskom, Reuel Khoza,

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4 See Smillie, *op. cit.*, for a very good discussion of among others the efforts by the Organisation for Economic Cooperation and Development to refine its guidelines for multinational enterprises. These guidelines encourage high standards and best practices in corporate behaviour.

5 D Kaufmann, 'Corruption, Governance and Security: Challenges for the Richer Countries in the World', pp. 83-84. See www.worldbank.org/wbi/governance.

and Mohamed Adam, focuses on state-owned enterprises. Drawing on Eskom's experience, they identify ten hallmarks of improved corporate governance for SOEs. These include:[6]

- effective leadership by the board in a manner that is sustainable and inclusive;
- clear definition of the roles of parliament, the responsible minister, other government departments and the board;
- an appropriate legislative and policy framework for good governance and accountability, which should include mechanisms for regular reporting to the shareholder on performance;
- the appointment of an effective board through transparent processes that ensure, among others, independence and a diversity of skills and experience in its members; and
- effective disclosure to stakeholders; and
- procurement policies and practices that are efficient, effective and fair to minimise opportunities for corruption.

Khoza and Adam make the point that the role SOEs can play in economic development and creating a sustainable business environment is seldom harnessed effectively. This is the case despite the fact that through their control of key sectors of the economy, such as energy, telecommunications and transport, they are instrumental in creating an environment in which business can flourish.[7]

However, there are positive developments under way to ensure that SOEs meet these challenges. The OECD Working Group on Privatisation and Corporate Governance of State-Owned Enterprises is developing a set of guidelines that should be completed in 2005. In March 2005, the OECD and Nepad announced that they were working together to investigate new ways in which MNCs and governments could promote ethical business practices. This substantially bolstered

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6 Khoza R J and M Adam, *The Power of Governance: Enhancing the Performance of State-Owned Enterprises*. Johannesburg: Pan MacMillan and Business in Africa, 2005, pp. 281-284.

7 *Ibid.*, pp. 5-16.

the process to develop a framework that will require good behaviour on the part of MNCs in Africa. The OECD guidelines for Multinational Enterprises are now already widely regarded as the landmark instrument for promoting corporate responsibility.

In South Africa, the King reports provide guidelines for both private companies and SOEs. These self-regulatory initiatives have placed South Africa among those in the top rank of emerging market economies that follow corporate governance codes. Yet, even in South Africa, as the authors of this report tell us, questions can be raised as to whether there is sufficient institutional capacity to implement the codes.

The objective of Nepad is to foster higher rates of economic development. This will be brought about both through effective and relevant policy formulation and through the implementation of these policies by states. It is therefore important to ensure that corporate governance codes are applied in each country in accordance with its level of market sophistication.

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Elizabeth Sidiropoulos
Series editor

Corporate Governance: South Africa, a pioneer in Africa

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I am an African. I owe my being to the hills and the valleys, the mountains and the glades, the rivers, the deserts, the trees, the flowers, the seas and the ever-changing seasons that define the face of our native land.

Thabo Mvuyelwa Mbeki
President of the Republic of South Africa

Corporate governance has been a reasonably well-developed concept in South Africa since the establishment of the King Committee on Corporate Governance in 1992, at the instigation of the Institute of Directors of Southern Africa (IoD) and the release of the first King Report in November 1994. It was not stimulated by any significant crisis in the corporate sector at that time; rather it concerned the competitiveness of the South African private sector following the re-admission of the country to the global economy following its transition to a fully-fledged democracy after the collapse of apartheid.

The first King Report drew attention to the importance of a properly-functioning board of directors as a key ingredient of good corporate governance. It advanced many of the standards and principles advocated in the plethora of national codes that were adopted, particularly in the Commonwealth countries, following the release of the Cadbury Report in the United Kingdom in 1992. The King Report was distinguished by its integrated approach to good governance with regard to financial, social, ethical and environmental practice, to serve the interests of a wide range of stakeholders. This probably reflected the considerable role that business has played in South Africa in both social and economic issues, especially during the period leading up to the political transition from a white minority-dominated system to a democratically-elected black majority government.

South Africa's economy before 1994

Since the discovery of precious mineral deposits in the late nineteenth century, the private sector has been central to the country's economic performance. Even today, over three-quarters of South Africa's productive capacity rests in the hands of private business. However, the public sector is also a significant factor in the South African economy. State-owned enterprises account for about a quarter of the country's capital stock, and generate approximately a third of all savings in the country (on a gross basis). This means that the public sector plays a critical role in the allocation of capital in the South African economy, which has considerable implications for corporate governance standards in the country.

Until the early 1990s, the South African economy was dominated by a small number of mining finance houses that controlled diverse activities and investments. They operated primarily in South Africa (on account of the stringent exchange control regulations and the political isolation of the economy) although some international trade was carried out *sub rosa*. In consequence, the proper functioning of market mechanisms and the cultivation of a sound corporate culture of transparency and disclosure were largely stifled. These shortfalls were accompanied by excessive rent-seeking both by government and private sector management, often at the expense of employees and shareholders generally. This state of affairs was secured through preferential ownership arrangements, such as pyramids or low/non-voting shares, and was usually characterised by control blocs, intra-group transactions and other similar mechanisms that gave rise to a range of conflicting interests. At the same time, the capital and money markets, though mature and well developed by emerging market standards, were dominated by a small number of large insurance and pension funds. These had mutual ownership structures in which the same private sector institutions were central. Again, utilities, infrastructure industries and strategic sectors of the economy fell under the control of state-owned enterprises, where the rationale for government involvement was overtly political. In none of these was serious thought given to issues of governance.

Overall, economic enterprise — whether in the private or public sectors — featured a lack of accountability for performance. It was also severely constrained by inadequate governance structures which hindered the proper functioning of market mechanisms.

Political and economic transformation

The dismantling of the racially-based political system brought about a profound change in the socio-economic fabric of South Africa. By 1994, South Africa's economy was in an advanced state of decline owing to political isolation, inward-looking economic policies and the legacy of racial exclusion. The weak state of the economy was manifested by stagnant gross domestic product (GDP) growth, declining savings and investment rates, falling formal sector employment and a resultant drop in per capita GDP. The economy was also vulnerable to external forces because of insufficient net inflows, in turn a result of the unattractive investment climate.

In contrast, the new government has adopted a policy of economic liberalisation, with special emphasis on capital market development and corporate renewal. Macro-economic reforms have resulted in the stabilisation of major aggregates such as a reduced budget deficit as a percentage of GDP, a decline in inflation and real interest rates, improved transparency in, and predictability of, monetary and fiscal policies, and the successful reintegration of South Africa into the global economy. The creation of sound macro-economic fundamentals has made more targeted micro-economic reforms possible, to generate sufficient economic growth to address South Africa's policy goals. Corporate governance has very much been a feature of this process.

While South Africa's GDP is by far the largest on the African continent at \$160 billion, this is a fraction of the global GDP of approximately \$36,000 billion, making South Africa the 29th largest economy in the world in GDP terms. In respect of sub-Saharan Africa, South Africa makes up a significant part of the total GDP of $417 billion.[1] This presents both challenges and obligations to South Africa in relation to the rest of the continent. Examples of South Africa's efforts to meet these are its prominent role in the New Partnership for Africa's Development (Nepad), and the conduct of South African business interests that are operating in other countries on the continent.

Notwithstanding South Africa's prominence and the acknowledgement of its relatively advanced economic system in the context of emerging markets, it has not been a significant recipient of foreign direct investment (FDI), which remains a cause for concern for the government and the business sector. In 2001, South Africa received approximately $6.5 billion in FDI on account of an unbundling of cross-shareholdings by the London-listed company Anglo American and its subsidiary, De Beers, but this was an exception: the figure has remained at around $1 billion or less annually, a fraction of the total global FDI flows of $735 billion reported in 2002.[2]

South Africa's economy is inextricably linked to that of the Southern African region, and to Africa as a whole, and it is an important focus point in this country's global economic strategy. Hence the economic recovery of the African continent through the Nepad initiative is crucial to South Africa's long-term planning. However, Western Europe remains the largest source of inward investment for South Africa, and accounts for almost half of the country's total foreign trade. Seven of South Africa's top 10 trade partners are located in Western Europe, led by the UK, given the historical and political links between that country and its former colony, and is closely followed by Germany. Other partners outside Western Europe are the US, another major source of trade, mainly in unprocessed and semi-beneficiated material; and Japan in the Far East.

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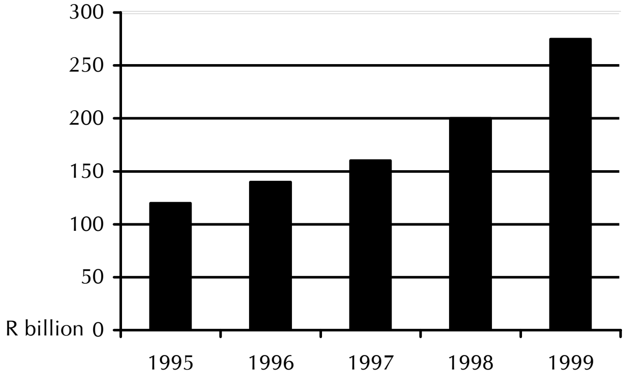
1 World Development Indicators, 2003, *http://www.worldbank.org/data/databytopic/GDP.pdf.*

2 United Nations Conference on Trade and Development, *World Investment Report 2002.*

Real level of portfolio investment in South Africa since 1994 (in constant 2000 prices)



Source: *South African Reserve Bank & Statistics South Africa, 2004*

While historically the bedrock of the South African economy has been the export of commodities derived from the mining and agricultural sectors, the manufacturing sector has become increasingly significant as a result of active official policy interventions. The secondary sector, buoyed by the strong growth in construction spending, has also become a factor in the country's economy. The development of the financial services sector has been particularly pronounced; it is now the largest contributor to GDP (18.8% in 2003), having eclipsed the manufacturing sector in 1998 (17.2% in 2003). This growth was achieved despite the currency crises in 1998 and 2002, and the economic uncertainty resulting from the political and social changes that occurred throughout the 1990s.

South Africa's financial system has emerged as a sophisticated and well-developed sector of the economy, comparable with those of the major financial centres of the developed world. In terms of size relative to GDP, private sector lending and the equity market rank among the deepest in the world. The increasing importance of financial services to the economy, and the role these play in the asset allocation process, have made increased investor activity on the local stock market, both by local and international investors, together with market reforms necessary to improve transparency and efficiency. Foreign investors in particular have played a catalytic role by applying pressure for market reform, and for higher corporate governance standards. Adding further emphasis to the need for higher standards has been South Africa's admission to the World Trade Organisation (WTO) and its participation in a number of other important multilateral arrangements and accords. These have given further impetus to a series of domestic regulatory initiatives directed towards fostering a market-orientated corporate culture.

Corporate governance reform

The first King Report was instrumental in raising awareness of what constitutes good governance, both in the private and public sectors. It offered to companies, and state-owned enterprises, for the first time, a coherent and disciplined governance framework that was relevant to local circumstances and offered practical guidance. The King Committee has no official mandate (unlike nearly all the other similar initiatives in other countries), and thus its recommendations are self-regulatory. However, it has made an important contribution to the significant progress South Africa has made towards corporate governance reform since the political transition in the mid-1990s. The breadth and sophistication of these reform measures must place South Africa in the top rank of emerging market economies, and in some cases even on a par with some of the more developed markets.

Some of the more significant measures that reinforced the corporate responsibility issues highlighted in the first King Report included the Labour Relations Act (1995), the Basic Conditions of Employment Act (1997), the Employment Equity Act and the National Environmental Management Act (1998). In the listings requirements of the former

Johannesburg Stock Exchange (JSE), now known as JSE Securities Exchange South Africa, were comprehensively revised, first in 1995 and again in 2000, to incorporate the King Report to ensure that these rules remained in line with international best practice. A number of amendments to the South African Companies Act recommended in the first King Report have also been promulgated, *inter alia*, compelling disclosure of the identity of beneficial owners of shares held by nominees. The Insider Trading Act, introduced in 1998, provides for rigorous supervision and monitoring of insider trading. For the first time in South African legislation the Act extended beyond criminal sanction to embrace civil remedies.

Running parallel with these developments was the introduction of the Public Finance Management Act (PFMA) in 1999, which introduced much more rigorous standards for reporting and accountability by adopting an approach to financial management in public sector institutions that focuses on performance in service delivery, and economic and efficient deployment of state assets and resources. It was also followed by a government policy protocol that laid down comprehensive guidelines for good corporate governance in public sector institutions. This emphasised the government's own requirements for high standards of accountability and good governance in public institutions falling under its direct control and supervision.

The second King Report followed a review of the developments that had taken place in the South African economy and in the global markets since 1994. Again, it was not driven by any major crisis in the corporate sector. However, as it happened, coincident with this assessment a number of crises in both private and public sector companies came to light, which provided additional reasons for the review.

Four primary guiding principles were established for the Committee's assessment process. The first was to review the first King Report and evaluate its currency in terms of developments, both local and international, since 1994. The second was to extend the integrated approach to embrace the interests of a wider range of stakeholders, without subverting the primary interests of shareholders as enshrined in South African corporate law. Another was to consider matters of risk and internal controls assurance; and the fourth was to recommend provisions for effective enforcement of good corporate governance standards and of the existing rules and regulations. The review was conducted by five task teams that covered the areas of boards and directors; accounting and auditing; internal audit, control and risk management; integrated sustainability reporting; and compliance and enforcement. The task teams were deliberately structured to include a wide range of interests. Their members were recruited from the private and public sectors and represented institutional and investor interests, civil society, government and regulators. This was to ensure a wide reference framework for the investigation and consideration of the recommendations arising out of the review. The King Committee itself is composed of leading proponents of corporate governance and representatives of significant professional, private and public sector institutions. The IoD plays an important facilitative role, and provides secretariat support.

Extensive consultation took place locally and internationally, from the inception of the review in August 2000 until the final release of the second King Report in March 2002. Members of the task teams were required to seek endorsement of the King recommendations in their respective constituencies, and contact was made with various experts and institutions at international level to discuss key aspects of corporate governance. The review procedure was led by a principal convenor, selected from among the King Committee members, who was responsible for the co-ordination of the process and much of the structure and content of the final document.

The second King Report was designed to elaborate on the practices of good governance as defined in law. It was not intended to offer a substitute for, or in any way make good the legal deficiencies in the current regime governing corporations in South Africa. To the extent that legal deficiencies were identified, recommendations were made for consideration by the relevant authorities. Little progress in addressing these shortcomings has been made thus far at the legislative level, pending the introduction of the government's corporate law reform programme. However, urgent consideration has been given to strong provisions to detect and sanction director delinquency and to introduce legal requirements for accounting standards likely to be promulgated in 2005. That the King Committee relied on the public relevance of its recommendations and on those directly involved in the review process to raise the issues with the regulators is probably a shortcoming.

A particular emphasis in the second King Report was on the qualitative aspects of good corporate governance. In other words, it was not designed as a regulatory instrument, but as a tool to identify core areas of good practice for boards, directors and companies, which extended beyond the existing legal and policy framework to embrace a number of aspirational principles. The review was noteworthy for bringing into this framework the societal obligations of companies, in this way indirectly reinforcing the expectations of government and the wider community that the corporate sector will contribute to the country's transition and development. Given the difficulties of applying the guidelines across the entire South African economy, the recommendations of the second King Report focus primarily on companies quoted on the JSE, banks and financial institutions, and public sector enterprises and agencies at both national and provincial levels. These fall within a structured and more readily regulated environment in which the standards of corporate governance can be more easily identified and measured. Public interest issues and investor rights and interests are also more likely to be affected by the behaviour of these particular categories of organisations.

There are a multitude of unquoted private companies, close corporations and other forms of corporate entities that fall outside the structures above. They do not fit easily into a framework that allows for supervision of their corporate governance practices. There is no easy way to include them, given the limited capacity for enforcement that South African currently possesses, although it is desirable that they should fall within the ambit of good business practice.

The King Code

The Code of Corporate Practices and Conduct, which enshrines the core principles in the second King Report, deals with the following key components of corporate governance.

Board structure

The board is identified as the focal point of the corporate governance system because it is ultimately accountable for the performance and affairs of the company. This calls for a unitary board structure (common to countries falling, broadly speaking, under the Commonwealth system of law) that requires a balance between executive and non-executive directors. A majority of the non-executive directors should be independent of management.

The need for a proportion of independent board members as a counter-balance was largely derived from the more rigorous requirements of international investors. It was directed at the tight-knit nature of the South African business community, and at the importance of opening up boards to consider a wider pool of candidates for directorships. It has allowed particular emphasis to be paid to issues of diversity, both in terms of gender and race (which have been highlighted as a strategic imperative for companies wishing to remain relevant in the South African business environment).

The appointment of independent directors has given rise to the need for a more effective induction process for directors, and strategies to enable them to develop further, to ensure that companies in both the private and public sectors remain competitive, with all directors well versed in their duties and obligations. The IoD has been particularly prominent in instituting training programmes for directors, whether inexperienced or experienced. Some 5,000 individuals have passed through the IoD's programmes over the past four years, following the interest stimulated by the second King review.

The requirement that directors and boards undergo regular evaluation, preferably from an independent facilitator, to ensure the effectiveness of the board and the continuing suitability of individual directors standing for re-election, has allowed the more sophisticated aspects of board governance to come into play. Given the shortage of skills in South Africa, it was not considered appropriate to prescribe age limits or constraints on the length of service of board members. Both are problems that are difficult to address among the many other demands on boards in South Africa at present.

While no recommendations as to the size of boards were made in the King Code, institutional investors and regulators have raised the issue. As a result a number of boards have seen fit to reduce their size, to conform with corporate governance norms.

The Code requires that the roles of chairman and chief executive officer are separate, a ruling which has since been reinforced by the JSE, banking and financial markets regulators, and the regulations governing public sector companies. Furthermore, the position of chairman should be held by an independent non-executive director. Companies across a wide spectrum have taken steps to address this requirement.

The length of executive director service contracts is restricted to a maximum term of three years. Any extension should be subject to shareholder confirmation. Extensive disclosure of individual director (executive and non-executive) remuneration and benefits is now enforced by all of the regulators mentioned above.

Detailed guidelines are provided in relation to the requirements for audit, remuneration and nomination committees. The Code places a strong emphasis on the role of independent non-executive directors in this process. Board committees, too, are required to undergo regular independent evaluation.

The second King Report calls for extensive disclosure. As a result, directors have become much more concerned about their ability to fulfil their obligations. They are also more aware of the implications of accepting invitations to serve on a company board.

Risk management and internal control assurances

Effective risk management and internal control systems are essential in a successful corporate governance system. The King Code provides clear-cut guidelines which emphasise the board's responsibility for the total process of risk in the business.

The guidelines also charge the board with developing risk strategy policies, setting the company's risk tolerance level, and assessing its risk profile on the basis of various categories including credit, market, operational, human resources, regulatory and legal risks. Boards are also required to introduce an appropriate whistle-blowing process in the company. This supplements recent legislation on the same subject.

Companies quoted on the JSE are required to provide a comprehensive annual statement on risk and internal control. Although this has been a feature of the banking and financial sectors for some time, the Code has made these requirements more stringent. Rigorous provisions are now also in force in the public sector.

The Code emphasises the importance of organisational integrity. Each company is expected to demonstrate its commitment to probity by drawing up an ethical code or statement of business principles, the implementation of which should be monitored by the board and management.

Accounting and reporting

The second King Report makes a number of recommendations with regard to accounting and auditing issues, paying particular attention to the role of the audit committee. This calls for companies to disclose any consulting services rendered by the same audit firm, so that it can be examined for any potential conflict of interest. It also calls for efficient audit processes using a combination of the external audit with an effective internal audit function and further requires that the audit committee should be chaired by an independent non-executive director, not the board chairman, and that its members should have experience in financial matters.

The need for an effective internal audit function is emphasised, and the efficacy and relative independence of the audit team assigned to the external audit should be checked on a regular basis.

A particularly important provision is that boards should examine regularly the basis for considering the company a 'going concern' for the year ahead. This generates serious deliberation in board meetings, bearing in mind the liabilities that inappropriate assessment or misreporting of the company's financial position could incur.

The guidelines provided in the second King Report reflected the broad compatibility between the Generally Accepted Accounting Practices (GAAP) and those of the International Accounting Standards (now known as International Financial Reporting Standards — IFRS). It is useful to note that steps have been taken by the accounting regulators in South Africa to ensure that local standards are compatible with international reporting standards, and that they will be in full alignment with the updated IFRS by 2005.

Integrated sustainability reports

Stakeholder rights, as previously observed, are addressed through specific laws providing for affirmative action and addressing historical racial imbalances in the workplace, employee skills development, labour and employee rights, the prevention of discrimination and harassment across a broad spectrum of issues and circumstances, and so on. The second King Report goes further in requiring that every company should report at least once annually on the nature and extent of its social, transformational, ethical, safety, health and environmental management policies and practices. This extended brief envisages companies going beyond the legal requirements and treating these aspects of their activities as strategic issues.

The more inclusive policy requirements are probably what most distinguish the South African guidelines from similar codes world-wide. These requirements should take the form of an integrated approach to the overall business strategy of companies, and should be designed as part of its economic profile. They should also be recognised as another dimension of risk, as previously noted.

Relations with shareholders

The second King Report did not deal with relations between the board and its shareholders extensively, given the rights conferred on the latter in the South African Companies Act. However, it recognised that this remains a serious area of concern that requires review because of the high cost and impractical nature of the remedies available to minority shareholders in the current South African system.

Companies are encouraged to enter into a dialogue, based on constructive engagement and the mutual understanding of objectives, with institutional investors. Clearly, this debate should also comply with regulatory and other directives governing the dissemination of information by companies and their directors and officers.

Proxy voting without significant restrictions or constraints is permitted, although the inefficiency of the system gives rise to concern (as it does in most systems world-wide). While the second King Report makes no explicit reference to the issue of one share, one vote, this is largely assumed under the terms of the Companies Act. Disproportionate voting rights (which were common at one time in South Africa) are now prohibited for companies quoted on the JSE.

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It would be unrealistic to anticipate that the second King Report on its own, given the voluntary nature of compliance with its recommendations, would of itself generate a significant transformation in corporate governance standards and practices in South Africa. It is acknowledged that other interventions will be necessary to create the climate necessary to ensure adherence to these guidelines. Therefore, the King Committee came to the conclusion that insofar as principles of corporate governance co-exist with established legal principles, no new sanctions or remedies were necessary. However, the second King Report recorded its particular concern over the current lack of enforcement of existing rules and regulations.

Recent reform measures and developments

The development of corporate governance in South Africa has manifested itself in a number of interesting ways.

Foremost among these has been the relocation of the primary listings of some of South Africa's major companies to international financial centres such as London and New York.[3] This has not been so much a reflection of any dissatisfaction at prevailing governance structures in South Africa, but rather has had more to do with issues of international expansion and the need to access capital in an arguably, more stable currency environment. A major effect, however, has been a growing appreciation in these companies of the high standards of governance required to operate with credibility in international markets, and the consequent importation of those standards into their operations in South Africa. A clear illustration is provided by the withdrawal by Telkom of its majority-owned mobile telephone operator, Vodacom, from the Nigerian market because of doubts relating to the integrity of certain local business dealings. (Telkom is a former parastatal — with government retaining a substantial interest — which was floated on the New York Stock Exchange in 2003, and thus subject to the US Securities and Exchange Commission (SEC) rules).

The JSE has undertaken yet another comprehensive revision of its listing rules, which makes a number of the recommendations under the second King Report mandatory and applies the 'comply or explain' principle with respect to conformity with the remaining guidelines. An interesting feature of the JSE is that its market capitalisation stands at approximately 1.65 times GDP (excluding cross-holdings). This is higher than that of many developed countries such as the UK, France, Germany and even the US. While there has been a marked shrinkage

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[3] Anglo American, BHP Billiton, Telkom, Old Mutual, SABMiller, Sasol.

of listings on the JSE, falling from 668 companies in 1998 to 426 in January 2004 (sometimes attributed to its more onerous listings requirements and the accompanying corporate governance rules), the reason is probably corporate consolidation and the declining demand for new equity issues in the domestic market.

Various elements of the recommendations in the second King Report have been incorporated into legislation and regulations relating to financial markets on the grounds that these support prudential conduct. Other reasons were probably the credibility and relevance of the King guidelines, and the cumulative effect of the wide participation of different interest groups, including representatives of the regulatory and supervisory agencies in both the private and public sectors, in the process.

The banking regulator went even further, in calling for an enquiry into the corporate governance of South Africa's major banks, more to validate their governance systems and processes than to suggest any impropriety.[4] This investigation resulted in a number of recommendations, which have given rise to significant amendments to the Banks Act. These introduced a number of mandatory provisions of a governance nature, and codified the duty of care expected of a bank director and certain categories of executive (including those associated with the bank's holding company) in relation to shareholders and depositors.

At pretty much the same time, the regulations accompanying the Public Finance Management Act (PFMA) were comprehensively altered to conform with a number of recommendations contained in the second King Report. This was followed by a completely revised Protocol on Corporate Governance for State-owned Enterprises, which replaced the earlier policy protocol. The new protocol incorporated more comprehensive and rigorous guidelines for public sector institutions. More recently, government has introduced the Municipal Finance Management Act, which imposes extensive governance

4 The enquiry was conducted under the leadership of Advocate JF Myburgh SC, a former high court judge.

obligations on officials and executives associated with municipal financial administration. This is a clear signal from policy-makers that corporate governance has been identified as a matter of national significance.

Within the policy environment, new and more rigorous legislation continues to be promulgated. A series of statutory interventions and regulations have been introduced to combat money laundering and support stricter anti-corruption measures. These are not only in line with the priority accorded to good governance, but advertise South Africa's intention to observe international conventions and standards so as to add credibility to the country's international standing. A cause for concern, however, is South Africa's low ranking in the global corruption perception index. (This may have been caused in part by the arms scandal.)[5]

With the advent of a truly democratic dispensation, South Africa has been able to boast an active and free media. Corporate governance has been closely monitored by the press, which has given considerable attention to the conduct of directors, boards and companies, and has made little distinction between malfeasance in the private and public sectors. This may have helped to stimulate a level of shareholder activism not previously observed in the South African market. Nonetheless, despite some well-publicised examples of poor governance, the general public profile of institutional investors and fund managers has remained low.

[5] The South African government has committed to a multimillion dollar refurbishment of its defence force equipment, based on a series of counter trade arrangements that would facilitate investment in the industrial sector of the South African economy. Allegations have subsequently arisen relating to facilitation payments, bribery and corruption and other similar activities that are in the process of investigation and prosecution.

Issues of enforcement and prosecution

South Africa has had its fair share of Enrons and Worldcoms. While these have reached nowhere near the magnitude of some of the spectacular corporate collapses in the US and Europe, they have had devastating effects on many minority shareholders and creditors. Examples of corporate failures include Macmed, a healthcare company which collapsed in 1999, losing some R986 million ($158 million).[6] Furthermore, it has come to light that the company secretary of Macmed was an unrehabilitated insolvent. Leisurenet, a lifestyle and health fitness company, had a board comprising some of South Africa's most respectable non-executive directors. The company collapsed in 2000, allegedly because of fraud committed by the two key executives and part-owners, losing some R1.2 billion ($173 million).[7] Disturbingly, a number of corporate governance debacles have also occurred in the financial sector, resulting in the collapse or absorption of a number of second-tier banks.

The main source of concern, at least from an international investor's perspective, has been the length of time that it has taken to investigate and prosecute such cases of corporate malfeasance. This has not been caused by unwillingness on the part of the authorities, but by the sheer capacity constraints facing an economy that is in transition and at the same time is attempting to meet all its international obligations and establish itself as a market of integrity.

Until 1994, the judiciary and the prosecution machinery were largely weighted by political considerations. With the transition to a proper political democracy, the focus has now shifted to the high levels of serious crime in the country, which includes economic offences. Given that South Africa's corporate laws were constructed some 40 years ago, many of their provisions are either outdated or out of kilter with the current capacity for practical enforcement.

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6 Currency converted at average rate for 1999 of R6.11 to the dollar. *Sunday Times*, *http://www.suntimes.co.za/2004/02/15/business/companies/comp06/asp*.

7 Currency converted at average rate for 2000 of R6.11 to the dollar. *Business Report*, *http://www.busrep.co.za*.

After a series of delays, largely caused by other policy priorities, the government has finally announced that South Africa is to embark on a major overhaul of its corporate law regime, starting with a review. This is likely to be guided by a number of developments internationally, most notably in the UK. From the initial announcements, it appears that the new legislation will focus on a series of corporate law reforms that offer a wider range of mechanisms for enforcement and redress, and possibly give greater emphasis to civil remedies as opposed to the prosecution of criminal offences (which predominates in the existing Companies Act).

The review aims to address institutional requirements to ensure simplicity, effective and consistent enforcement, and the clarification of roles and responsibilities in relation to agencies for, and measures of enforcement. It will identify the fundamental rules governing the procedures for company formation, corporate finance law, corporate governance, mergers and acquisitions, the closing down of a company and the administration and enforcement of the law. It will also consider the relationship between company law and other rules and measures for the protection of the interests not only of shareholders, creditors and employees, but the state, the environment, consumers and black economic empowerment. Some of the observations contained in this paper are similar to those made in the government policy statement announcing the review, in particular that company law should promote the competitiveness and development of the South African economy by:

- encouraging entrepreneurship and diversity of enterprise by simplifying the formation of companies and reducing the costs associated with the formalities of forming a company and maintaining its existence, thereby contributing to the creation of employment opportunities;
- promoting innovation and investment in South African markets and companies by providing a predictable and effective regulatory environment that allows for flexibility in the formation and management of companies;

- promoting the efficiency of companies and their management;
- encouraging transparency and high standards of corporate governance and recognising the broader social role of enterprises in South Africa; and
- ensuring compatibility and harmonisation with best practice internationally.[8]

Weak enforcement of rules and regulations has been a perennial concern for investors in emerging markets. It is often cited as a major problem in discussions concerning South Africa. Clearly from what has been stated above, this is recognised by the South African authorities. Probably the main reason for the negative perception is not so much a general lack of enforcement, as might be the case in other emerging markets, but erratic enforcement. In some areas it is of a high standard, but in others it is almost absent. This inconsistency might be exacerbated by the fragmented nature of South Africa's regulatory system, and the propensity for regulatory arbitrage that has resulted. The high costs that effective regulation would entail places an immense burden on South Africa's democratic government, especially in the light of equally significant financial priorities in the areas of housing, health, social welfare and education, among others.

That the government has achieved so much in the short space of 10 years is as much a miracle as was the peaceful transition to political democracy that took place in 1994. South Africa today is naked to the world in terms of what it does and how it does it. Its performance is increasingly measured against global standards, and the country's policy-makers are no doubt aware of it. Globalisation is a fact of life, and to engender foreign direct investment South Africa needs to demonstrate that it is a secure haven for overseas investors. Therefore the measures taken to improve corporate governance need to be embraced, rather than challenged and hindered by claims that they represent over-regulation.

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8 *South African Company Law for the 21st Century,* Guidelines for Corporate Law Reform announced by the Minister of Trade and Industry, May 2004.

Steps to consider and developments in the regulatory system

There is a need to look at more effective means of regulation that stimulate the market to respond to such interventions. This in turn might encourage a measure of peer oversight and sanctioning of non-compliance. For South Africa, that means considering some of the following ways in which corporate governance measures could be reinforced.

- A more synchronised system or structure of regulation could bring about an increased level of co-ordination in mandatory measures and enforcement. There has already been some debate over the desirability of a single regulatory oversight authority (which, if it were ever to be adopted, might lead to a rationalisation of regulatory agencies, and so address the current fragmentation of regulation).
- Another step might be to look at the role of pension fund trustees in South Africa, and to examine their obligations in relation to the funds placed in their care. South Africa has a large private retirement fund sector and a long-term insurance industry. There is also a significant quantum of retirement funds that lie in the public sector. Domestic institutional investors dominate the JSE, and account for around 40% of the total market capitalisation. Since exchange control restrictions regulate the investment of domestic funds to a large extent, issuers quoted on the JSE essentially operate in a captive domestic market.

  While it is an issue complicated by many factors such as the training of the employee and union nominees that must comprise 50% of pension fund trustee boards, a greater sense of awareness and accountability needs to be developed among pension fund trustees. This might stimulate a more rigorous process for selecting institutional fund managers. It might require some level of regulatory intervention (along the lines proposed in the UK currently and already practised in the US and Australia). South Africa's pension funds legislation is under review, and corporate governance issues have been accorded a high emphasis. This could, in turn, place pressure on institutional fund managers in South Africa to pay more attention to the votes of beneficiaries in respect of the investment of pension fund money placed under their control. If properly constructed, regulatory intervention would also draw attention to some of the conflicts among institutional investors that occur in this market. These are often closely aligned with the banking system and thus present additional structural and behavioural impediments to any activism on the part of shareholders in that a number of the more prominent institutional investors are closely linked or owned by some of the major commercial banks. Also, institutional investors rely considerably on transactions with private sector companies. This makes it difficult for fund managers to retain these funds on the one hand, if on the other their analysts are aggressively challenging management. This in turn therefore leads to a level of mutual cohabitation for reasons of convenience.

These institutions could also be required not only to publicly disclose their voting policies, but also what their voting decisions on material issues have been.

- The role of analysts in the corporate governance process requires more clarity and, perhaps, a level of market regulation. This is not an issue unique to South Africa. What requires investigation is the level of pressure applied to boards and executives to meet targets set by investment analysts, who themselves are often acting out of self-interest. This is a particularly tricky area of corporate governance. No doubt international developments will eventually inform South Africa's own response to this issue.
- The accounting profession in South Africa currently operates under a self-regulatory structure which, like those of other major international markets, is under review and is to be significantly restructured under proposed Accounting Professions Bill.[9]

All incorporated bodies in South Africa, both foreign and domestic, are required to register with the Companies Office responsible for the administration of the Companies Act. This institution falls under the

[9] This follows the findings of an enquiry commissioned by the minister of finance, under the leadership of Dr D (Len) Konar, an expert in accounting and corporate governance and a prominent board adviser and board member.

Minister of Trade and Industry. The banking sector is regulated by the Registrar of Banks, who is located in the South African Reserve Bank, while the financial markets sector, covering long- and short-term insurance, collective investment schemes, pension and retirement funds, and so on, is supervised by a self-financed independent statutory body, the Financial Services Board (FSB). The FSB, in turn, is accountable to the Minister of Finance. The institutions falling into the banking and financial markets sectors are also governed by international conventions and accords to which South Africa has subscribed.

As previously indicated, South Africa is committed to the implementation of the Basel II accord and International Financial Reporting Standards (IFRS). This puts it well ahead of many markets in the developed world. At the same time, perhaps in response to some of the observations above, the FSB has consolidated a number of securities-related legislative instruments into the new Securities Services Act, which includes even more exacting insider trading restrictions. One visible area of success within the South African enforcement regime has been the prosecution of insider dealings. Since the promulgation of this legislation in 1999, 164 cases have been registered for investigation. Legal action so far has been sought in 21 cases, and in 19 instances, the targeted individuals settled the matter out of court (or a total in the region of R47 million — $7 million).[10] No criminal prosecutions have yet taken place, although a landmark case is ready for submission to the courts.

Another significant regulatory instrument, the Securities Regulation Code (based on the takeover code in London), which was introduced in 1990, has played an important role in the South African market. By emerging market standards its application has been relatively successful. Again, like the insider trading directorate, it is a self-funded body. Budgetary constraints therefore impose certain limitations.

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[10] A presentation given to the press by the Financial Services Board, 4 August 2004. Currency converted at average rate for the first six months of 2004 of R6.74 to the dollar.

However, the South African takeover code is also under review, with the aim of introducing more effective and stringent measures, particularly where the existing concessionary measures are considered too permissive for prevailing requirements. Lessons learnt from the hostile Goldfields/Harmony transaction will likely inform some of the revisions.

Black economic empowerment

No discussion of corporate governance in South Africa would be complete without considering the issue of black empowerment. While ownership by black business and individuals of shares on the JSE has been nominal as a factor of market capitalisation, it is an area that has gained greater traction recently. A number of very significant transactions have been concluded in the banking and financial services sector in particular. Empowerment has been assisted by statutory intervention in the form of the Broad-based Black Economic Empowerment Act (2003), and various self-regulatory sectoral accords, such as those reached in the mining and finance sectors. A number of others have been agreed more recently. Although these measures are designed to address historical socio-economic imbalances, this reasoning and its political and economic significance in the South African business landscape is not sufficiently well understood in the international markets.

In pure governance terms, though, some of the steps taken to bring about black economic empowerment might even be seen to be regressive in their construction. However, the understandable commitment of government to accelerate the pace of black economic advancement, more specifically to generate a greater level of ownership of businesses by black people, has introduced new pressures that are potentially problematic for corporate governance. This is because the process of building a capitalist class on the basis of artificial financing structures can, all too readily, lead to business ventures with shareholding structures that transgress the principles of good governance. Such enterprises have taken root in South Africa since its transition to a political democracy. Balancing best business practice and this type of affirmative action is a delicate task that requires careful juggling of priorities, but has many strategic merits.

The commendable progress achieved by policy-makers since 1994 will have to be sustained by a certain level of vigilance on their part, to ensure that important developments towards the development of a black business class do not circumscribe the drive for good corporate governance. Perhaps symptomatic of this need for caution are the substantial donations made by companies in the private sector to political parties, and the lack of any regulations on this issue, although these exist in countries like the UK by virtue of institutional investor concerns.

Quo Vadis corporate governance in South Africa?

At the heart of many of these issues lies the question of ethics in the business and commercial environment (as is very much the case in any other market). Corporate governance is essentially concerned with common sense, ethics, business integrity and reputation.

Therefore, while the policy-makers and regulators can take the formal requirements of corporate governance to a certain point, it still devolves on the boards of South African companies in the private and public sectors to ensure that corporate governance as a guide to actual practice remains a priority issue. This is an economic imperative, given the global competition for international capital which is unrelenting in demanding sound corporate governance standards and the highest levels of accountability and probity.

South Africa's democratic dispensation is now well established, following three successful national elections. The authorities remain under pressure to improve the standard of living of the general population rapidly, through higher employment and expanded social services. In order to achieve higher economic growth, South Africa will need to increase both domestic and foreign capital, and use it more efficiently.

Notwithstanding the ambitious goals set by the policy-makers to ensure good corporate governance, a perverse consequence (which is typical of most emerging markets) has been to raise doubt as to the institutional capacity of South Africa to implement the high standards desired. By and large neither the structures nor the financial resources to carry out this mandate have been forthcoming. Consequently, the admirable objectives set by the authorities are sometimes undermined by the lack of capacity for full and proper enforcement of the regulations.

Connected to this, but even more important, is to ask whether the country can afford high governance standards in practical terms. Nowhere is this more apparent than in the small business sector, where the country's performance internationally is very weak. At the same time this is a key area for ensuring that the South African economy has a prosperous future. There is also a concern that the country's First World approach to corporate governance, regulation of the business sector and economic policy generally has imposed costs on the economy that may have held back the rate of economic growth. However, it is not necessarily the content of these measures that is in question, but rather the basis on which they can more effectively be implemented. Sober consideration of the economic benefits that ought to be derived from such measures is required. Possibly alternatives should be investigated: perhaps there is a 'smarter' way of achieving the same ends. It is a difficult dilemma that is not unique to South Africa, but perhaps it illustrates the perverse consequences of adopting high-level global standards that do not always accommodate the difficulties facing emerging markets like South Africa's.

All the same, the policy-makers are likely to continue their commendable promotion of measures designed to ensure sound corporate governance, in both the private and public sectors. South Africa is therefore likely to continue to pursue sophisticated measures to ensure that it holds its place as a prominent and desirable emerging market destination for investors.

Lessons for Africa

Notwithstanding the merits of advocating high global standards of corporate governance and regulation, these should be carefully measured against the capacity of countries to absorb such requirements, bearing in mind their other policy priorities, which are often of a social nature. This dilemma is particularly acute in Africa.

Also, many issues in corporate governance assume the existence of a well-developed capital market, which is not the case in many parts of Africa. Therefore other measures should be sought to foster appropriate levels of good corporate governance. An obvious example would be the continuing influence of state-controlled activities in the commercial sector, notwithstanding the widespread privatisation that followed the implementation of structural economic adjustment programmes during the 1990s. Well-functioning state-owned enterprises, following internationally accepted standards of good corporate governance that are appropriately designed for their particular structure of state ownership and control, would provide an immense boost to national standards. However, this implies a measure of political will that is often absent in governments. It also assumes that a country has appropriate institutions for credible director training and development, and readily available accounting and auditing skills.

Again, ensuring that regulations are enforced and that the country can provide a framework for prosecution of economic offences that is independent of political interests is extremely difficult in developing states.

However, none of these obstacles is insurmountable. What countries need to identify, perhaps with the objective assistance of initiatives such as Nepad, is where improved corporate governance would contribute to greater economic effectiveness. Then, taking other policy priorities into account, they could make well-considered advances in critical areas. The idea would be to introduce regulatory and other incentives that would encourage companies to adopt good governance standards and practices, but would be partly self-regulatory in nature.

Self-regulation is, of itself, a subject for extensive discussion. Instead of adopting complex securities laws and systems that are not essentially representative of the economic structure, it might be better, instead, to promote corporate governance practices that are more appropriate to the level of development of the economic system and which can often provide remedies of a more basic nature that are more easily capable of implementation and monitoring given limited resources or capacity. Introducing proper measures of public accountability and proper director selection and training for state-controlled commercial operations would also be likely to create a series of positive responses across the economy. These would improve the quality of service and commercial efficiency, and have a positive influence on the conduct of customers and suppliers.

As these small advances gather momentum, other, more sophisticated, measures could be considered. The timing should depend always on the capacity of the economy to absorb such measures and the costs of adopting and implementing them. The overall aim should always be to avoid compromising the country's financial and economic stability within the demanding requirements of the wider implications of the global economy.

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