

GUIDANCE NOTE ON REMUNERATION PHILOSOPHIES AND POLICIES

Introduction

Recently, substantial focus has been placed on the issue of remuneration of executive and non-executive directors, with a particular focus on the remuneration of executive directors and executive management in general. Company shareholder engagement is said to be reshaping the governance landscape. Shareholders are providing more input into corporate governance decisions and gaining more access to management teams and directors. They are using this engagement and proxy disclosures to elevate the company's governance practices and effectiveness¹. One of the areas being impacted by this trend in particular is that of the remuneration practices of listed companies.

In terms of the King Report on Corporate Governance for South Africa, 2009 (King III), companies in South Africa (SA) should adopt remuneration policies aligned with the strategy of the company and linked to individual performance². This remuneration policy should then be presented to shareholders for purposes of obtaining a **non-binding advisory** vote at the company's annual general meeting (AGM)³. A non-binding advisory vote means that the vote by the shareholders will not be binding on the board but will give an indication as to whether shareholders are in support of the remuneration practices adopted by the company. But, as Matt Orsagh puts it in his article on the topic of how voting on executive pay is evolving globally: *"No one wants to receive a failed vote on pay. A negative say-on-pay vote has the potential to adversely brand a company and its board in the minds of investors and the public at large. Because a relatively small number of companies receive a failed pay vote in a given market each year, a negative vote on pay embarrasses a board and sends the message to the markets and society that the company just doesn't get it — or worse, just doesn't care that executive pay is perceived to be disconnected from performance."*

Statistics on voting patterns at the AGM are not that readily available in SA but this will probably change when the proposed changes to the JSE Listings Requirements are implemented, one of which will see listed companies having to disclose detail on the outcome of voting on all resolutions tabled at the AGM. Based on personal experience however, it is evident that a number of companies often have a significant, albeit not necessarily a majority, vote against the remuneration policy. The main purpose of this publication is thus to attempt to provide guidance to companies on what it is that shareholders wish to see in these policies that would persuade them to rather vote in favour of than against same at the AGM.

Global trends moving towards binding shareholder votes

In **South Africa**, as indicated above, the outcome of the non-binding advisory vote or "say on pay" as it is generally referred to, does not have any direct, mandatory impact, other than to provide a **signal to the board** that shareholders are not in favour of the manner in which the company remunerates its employees, and more specifically its executives.

In the **United Kingdom**, section 439 of the UK Companies Act stated that the "say-on-pay" by shareholders is not binding on the Board. The debate on whether the vote should perhaps become

¹ Ernst and Young, "Preparing for shareholder engagement", *Board Matters Quarterly*, April 2013

² King III Principle 2.25.1

³ King III Principle 2.27.1

binding has now resulted in changes being introduced. In terms of new UK legislation⁴, the overall policy of pay is now capable of being rejected by shareholders, but no specific right to determine the amount of pay has yet been introduced.

On 3 March 2014 a 69.7% vote was passed in **Switzerland** in approval of shareholders controlling questions of executive pay⁹.

The position in **Australia** is unique in that, if during two consecutive meetings, over 25% of shareholders vote against directors' remuneration package, all the directors have to stand for re-election again in 90 days⁵.

As part of the global trend, it is evident that shareholders are also becoming **more active and outspoken** on the topic of executive remuneration.

Nabors Industries shareholders voted against "say-on-pay" in both 2011 and 2012 (75% opposition in 2012) as a result of concerns over the high CEO pay and severance payments. Shareholders also voted against the company's new incentive bonus plan and long-term incentive plan in 2012⁹.

Hewlett Packard failed a "say on pay" vote in 2011 in light of new CEO Leo Apotheker's employment agreement and the company's stock performance⁶.

Citigroup failed "say on pay" with 55% opposition in 2012 after giving CEO Vikram Pandit three retention grants valued at \$27.9 million⁹.

The list goes on and on. Suffice it to say that if the global trend is anything to go by, listed companies in SA need to prepare themselves not only for more activism on the part of shareholders but potentially also a strengthening of shareholders' rights in this respect via amendments to relevant regulatory mechanisms.

The South African context and relevant considerations

A survey done by Ernst & Young in 2013 entitled, 'Remuneration Governance in South Africa' also confirms the phenomenon of shareholders in SA voting against the remuneration policies of listed companies, indicating a **definite dissatisfaction** with pay levels as well as a lack of disclosure of performance targets, according to the report. It is thus important for a board to not only apply its mind to the content of the remuneration policy as tabled at the AGM but to also have an **understanding of shareholder expectations** and views in this regard.

The Ernst & Young survey⁷ also questioned whether the non-binding vote by shareholders brings **changes to company remuneration policies**. This study involved feedback from 51 remuneration committees of JSE listed companies. Of the 51 companies, 20% stated that the vote prompted changes to their pay programmes. Of the 20%, 10% changed their pay programmes prior to the AGM and 10% made changes to their pay programmes after the AGM. In terms of a comparison done by the same study, a vast majority of the respondents (82%) felt that institutional shareholders specifically, have become more active in the remuneration affairs of the company.

Another interesting consideration was the level of votes against the remuneration policy which would be considered as a 'failed vote'? Information from the Ernst & Young study indicated that 33% of respondents were of the opinion that a **failed vote** is when more than 30% of the shareholders vote against the policy, whilst 29% believed that this cut-off point should be more than 50%. King III recommends a minimum of more than 50% of shareholders' vote in approval of the remuneration policy⁸. The question then posed is whether the company is prepared to face possible

⁴ Section 79 of the Enterprise and Regulatory Reform Act 2013

⁵ The Corporations Act 2001 new sections 250R(2) and 250U-V

⁶ http://em.wikipedia.org/wiki/Say_on_pay

⁷ Ernst & Young, "Remuneration Governance in South Africa", *2013 Survey Results 'Remuneration committees under pressure'* June 2013

⁸ Institute of Directors Practice notes, "A guide to the application of King III: Remuneration", *Practice note*

negative media or reputational damage in the event that a substantial minority (for example 30%) votes against the policy?

For the SA context, **King III** states several **principles and recommended practices** relating to the remuneration of directors and executives. These principles as well as their disclosure requirements are discussed in full detail in the King III Practice notes⁹.

The Companies Act in SA furthermore specifies certain **disclosure requirements** in respect of reporting on remuneration¹⁰. Inter alia, details of service contracts of current directors and individuals who hold any prescribed office in the company must be disclosed. For listed companies in SA, having to apply the principles of King III to the extent required by the JSE and the market, adequate disclosure of remuneration in the integrated report (as part of the AFS) to the extent prescribed by law is not only a given but also the inclusion of information concerning the remuneration philosophy and policy which will form the subject matter of the non-binding, advisory vote at the AGM.

When putting together a remuneration strategy, the company's **long term sustainability and financial well-being** should be a strong consideration. Primary considerations should also include **business values** as well as the company's **human resources strategy**. A **link** needs to be established between the remuneration policy, the company's overall strategy and its human resources philosophy/strategy.

Remuneration philosophies and policies are **living documents** and must regularly be reviewed in terms of the company's current economic performance and strategic objectives. An effective remuneration policy should **inspire employees** to show a culture of commitment to do one's best. Remuneration policies and philosophies should serve to **attract and retain talent** and should function as an **effective tool to motivate employees** of a company to perform well and to grow with the company.

Key performance indicators must be set for senior management and executive board members in order to drive the company's value creation in respect of identified material issues. An integrated approach should be followed when determining performance targets in that both **financial and non-financial targets** should be set. A strong focus should be placed on performance criteria in order to qualify for incentives. As part of the remuneration policy, detailed information on key performance indicators, how these are linked with the company's values and overall strategies and how these influence and impact on the level of potential remuneration to be earned by executives, are important aspects to be addressed in **sufficient detail** for shareholders to have comfort that targets are stretched and that mediocre performance will not be rewarded.

Companies should address the following questions when formulating their rewards **philosophies**¹¹:

1. Does the total rewards strategy translate across business units as well as boundaries?
2. How do employees regard the total rewards strategy?
3. How does the total rewards strategy apply to all employees while maintaining distinctiveness from other companies?
4. What is the meaning and value of total rewards?

Furthermore, a remuneration **policy** should typically address the following elements¹²:

- *Remuneration philosophy*: The set of beliefs that underpin the remuneration strategy and govern the remuneration policy

^{186.1} and www.iodsa.co.za - King III & CRISA – King III Practice Notes

⁹ Institute of Directors Practice notes, "A guide to the application of King III: Remuneration" and www.iodsa.co.za King III & CRISA – King III Practice Notes

¹⁰ Sections 30(4) – (6) of the Companies Act 71 of 2008

¹¹ Corporate Leadership Council, "Trends in Employee Value Propositions"

¹² Institute of Directors, "Remuneration Committee Forum", *Position Paper 2*, December 2013

- *Remuneration strategy and objectives underpinning the business strategy:* The remuneration strategy is a declaration of intent that states what the organisation wants to achieve in the long run with its remuneration policies and practices to achieve the business strategy and meet the needs of the stakeholders
- *Remuneration principles underpinning the remuneration policy:* The principles define the remuneration approach and provide guidance for rewarding staff
- *Salient features:* This refers to award criteria, eligibility levels, targets, performance conditions, vesting periods and the purpose of each component of remuneration. The detail of this section would comprise of the description of fixed or guaranteed remuneration, cash incentive and bonus schemes as well as retention and share based schemes
- *The remuneration mix:* The balance between fixed and variable remuneration (short term and long term incentives), by level of employee or other relevant category used by the company
- *The remuneration benchmarking approach:* This includes the methodology for determining peer groups and a statement on the desired levels of remuneration for employees against the market
- *The link to performance management:* Note how the performance management system informs remuneration decisions
- *Policy for executive employment contracts:* This includes the period of notice of termination as well as any other key contractual rights to payments
- *Motivation for any policy changes from the previous year*
- *The approach used to identify the prescribed officers as defined in the Companies Act¹³*
- *The approach to setting non-executive director fees*

Shareholder engagement

In terms of the shareholder engagement process, where does one then start to determine which shareholders may have voted against the policy and should be engaged in discussions? Institutional shareholders often have **proxy voting guidelines** posted on their websites which may serve as a guide on how some of the company's largest shareholders would have voted. In terms of the Code for Responsible Investing in South Africa ("CRISA"), institutional shareholders have some responsibility for ensuring that an efficient remuneration governance framework exists in the companies they invest in. Institutional investors are **increasingly transparent** on their voting decisions, and the reasons behind them. This is in all probability as a result of one of the 5 CRISA principles that requires institutional investors to be transparent about their investment and corporate governance principles¹⁴.

For companies receiving a substantial vote against the remuneration policy at the AGM, it is **important to engage** with relevant shareholders, to the extent possible, on their reasons for not supporting the remuneration policy. In the dematerialised environment, identifying the actual "voting party" and responsible individual can however prove to be a significant challenge. For this reason and in the interest of transparency, shareholders should not only exercise their rights of voting against a resolution tabled at the AGM but should also ensure that the board is made aware of their reasons for voting against the matter. Voting against is therefore **not only a right**, but is also accompanied by a **responsibility** of ensuring that the company is adequately informed in order to address shareholders' concerns and, hopefully, turn a possible negative into a positive.

Examples of award winning reports

The InterContinental Hotels Group were the winners of the PricewaterhouseCoopers "Building public trust award for 2013" in the category "Executive remuneration reporting in the FTSE100". In terms of this specific award category, the report (and hence the philosophy and policy) must provide

¹³ Section 66 of Act 71 of 2008

¹⁴ Institute of Directors, "Remuneration Committee Forum", *Position Paper 2*, December 2013

evidence of a manifest commitment to best practice and communicate how the company's approach to remuneration supports its business strategy and aligns the interests of its executives with those of its shareholders. An example of the InterContinental Hotels Group remuneration report can be viewed at <http://www.ihgplc.com>.

In South Africa, Altron¹⁵ was the winner of the 2013 CSSA/JSE best annual report award. A copy of the Altron remuneration report can be viewed at <http://www.altron.co.za/iar2014/gov/rem.asp>. A large amount of detail is publicised regarding the content as well as the implementation of the company's remuneration policy. A specific section relating to shareholder engagement also forms part of the integrated report.

In conclusion

The solution is not that simple, and the **consequences of non-approval** can be quite severe. Shareholders can fail to re-elect members of the board that form part of the company's remuneration committee in subsequent meetings. Should the company fail to adjust its policy, the company could also suffer reputational damage as it may be considered as a company that does not maintain healthy relationships with its shareholders. The possibility of more stringent regulations providing shareholders with a binding vote on executive remuneration is, considering the global trend, very real. Shareholder expectations and requirements therefore need to be taken seriously and considered in an attempt to address same in the longer-term interest of the company.

On the other hand, companies can **benefit** by building trust, establishing a mutual understanding and maintaining constructive relationships with their investors. Companies may be able to secure better support for proposals that are put to shareholder vote. Companies may also be able to identify earlier in any process involving investors, potential issues that require attention before putting a matter to shareholders for approval.¹⁶

The **key** to not only avoiding the negative consequences of non-approval but in fact turning this issue around to the benefit of the company and all its stakeholders lies in the **ability of the board** (with the assistance and input of the remuneration committee) to:

- seriously apply its mind to the content of the remuneration philosophy and policy to ensure that it adequately addresses the salient features highlighted above;
- benchmark and consider local and global trends in remuneration practices;
- engage with all relevant stakeholders including employees and shareholders;
- take cognisance of the input received from interested parties; and, above all
- act in a manner that will not only protect but also enhance the long-term survival and sustainability of the company.

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¹⁵ Allied Electronics Corporation Ltd – registration number 1947/024583/06

¹⁶ Ernst & Young, "Preparing for Shareholder engagement", *Board Matters Quarterly*, April 2013