Managing conflicts and tensions at the Remuneration Committee

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The objective of the Forum is to serve as a platform for dissemination of guidance to remuneration committee members. Such guidance will typically cover the following:

► Matters that relate to the function, duties and composition of remuneration committees;

► Matters concerning remuneration committees in the public domain; and

► The dissemination of such guidance will typically take the form of position papers and roundtable discussions.

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Introduction

The remuneration committee plays an essential role in ensuring high quality remuneration decisions of a company and in building public trust around the implementation of those decisions.

Effective remuneration committees must be prepared to manage conflicts of interest and the inevitable tensions between the expectations of executives, the company and its stakeholders.

Purpose of this paper

This paper has been developed to provide practical guidance to remuneration committee members on managing specific conflicts of interest and tensions that arise at the remuneration committee. It should be read together with the King III Code and Report on Corporate Governance (King III) and its related Practice Notes.

This paper identifies four typical scenarios of conflicts of interest and tension that can arise at the remuneration committee, and provides practical guidance on how to safeguard against such conflicts and ways to deal with them.

What are conflicts of interest?

Conflicts of interest are discussed in detail in Paper 5 of the IoDSA Corporate Governance Network, entitled “Conflict of Interest: Directors and Prescribed Officers”.

Specifically, it states that: “The basic element of any definition of conflict of interest is the tension between multiple competing interests. This often manifests in the entanglement of the private and professional interests of an individual.”

The Companies Act, 2008, section 75 prohibits directors from voting on matters at board meetings in which they have a direct material personal financial interest. Section 76 states that a director has a duty to act in good faith, for a proper purpose in the best interest of the company. The director also has a responsibility not to use the position as director to gain advantage for him or herself or for another person other than the company.
Four scenarios

1. **Determining Non-Executive Director (NED) Fees**

**Understanding the conflict**

In terms of the Companies Act, 2008 directors’ fees for services rendered as a director, executive or non-executive, are subject to prior approval by the shareholders within the preceding two years, by special resolution. Therefore, before any payment of such director fees can be made, shareholder approval is required.

Even though this shareholder approval requirement acts as a safeguard, there is still the risk of an actual or perceived conflict of interest where members of the remuneration committee make a proposal to the board which in turn tables a recommendation to the shareholders on the fees and fee structures for their services as directors.

The issue is who should determine the fees in a way that the remuneration committee members maintain their objectivity and independence?

**Recommendations**

The King III Remuneration Practice note states that, “To avoid a conflict of interest in determining their own fees and fee structure, the Remuneration Committee should request executive management (through independent advice if required) to recommend a fee structure.”

The following steps are suggested in determining the non-executive director fees:

- The CEO together with executive committee members, as a collective disinterested party, should take responsibility for formulating and proposing the NED fee quantum and the fee structure to the remuneration committee to consider.
- The remuneration committee should ensure adequate independence of the remuneration consultants, ensuring their solutions are tailored to the organisation.
- The remuneration committee members discharge their fiduciary duty by applying their minds to management’s recommendation, specifically as to whether due process has been followed through proper benchmarking and data analysis, considering any external advice (and the source thereof), and then makes a recommendation to the board. The remuneration committee would not however make any approval decision regarding the fees or the fee structure.
- When the NED fees or performance of any remuneration committee members are discussed, they must recuse themselves from the meeting. Where this affects the chair, the lead independent director would temporarily assume the role of the chair.
- A submission on the proposed fees and fee structure is then tabled at the board to make a recommendation to the shareholders, with the affected directors abstaining from the vote.
- Finally, the special resolution is tabled at the annual general meeting or any other general meeting for shareholder approval.

The roles and responsibilities concerning the setting of non-executive director fees are summarised below:

<table>
<thead>
<tr>
<th>Senior management</th>
<th>Remuneration Committee</th>
<th>Board of Directors</th>
<th>Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-executive director fees</td>
<td>Formulate and recommend</td>
<td>Review the proposal and recommend to the Board</td>
<td>Confirm the proposal and recommend to the shareholders</td>
</tr>
</tbody>
</table>

It is further recommended that a policy on the non-executive director fees should be included in the company’s remuneration policy that is tabled for the non-binding shareholder vote at the annual general meeting or any other general meeting. This policy would document the company’s approach to setting fees, including the structure (e.g. meeting attendance fees, retainer fees, hourly rates, and reimbursement of expenses), the targeted peer group (for benchmarking purposes and targeted position against the peer group [e.g. 50th percentile]).

For further guidance please refer to the King III Remuneration Practice Note on non-executive fee structures, noting also the guidance on differentiating fees for international directors.
2. Directors voting as shareholders on their own fees

Understanding the potential for conflict

A situation can arise where a shareholder who is also a director votes on a resolution to approve his own NED fees in their capacity as a shareholder. In this case the director has a personal financial interest in the resolution. The question is whether this is a conflict of interest.

Section 75 of the Companies Act prohibits directors from voting on matters at the board in which they have a material personal financial interest. This section does not apply to shareholders acting in their capacity as a shareholder.

Therefore, as a shareholder, the director is free to exercise his voting rights, in his capacity as a shareholder, as such rights are attached to the shares he owns and as such would not amount to a conflict of interest.

Recommendations

The setting of NED fees should follow the approach suggested earlier under the section "Determining non-executive director (NED) fees".
3. Representative Directors

Understanding the conflict

A major shareholder\(^8\) will often appoint one of its own directors/employees to the board, and the remuneration committee, of the investee company. Such a director is sometimes referred to as a ‘representative director’.\(^9\)

A director who is a representative of a shareholder who has the ability to control or significantly influence management or the board in the investee company would not be considered to be independent of the investee company. Such an appointment will therefore affect the independence of the remuneration committee of the investee company.

The conflict arises where the director’s actions at the remuneration committee are not in the best interests of the investee company. Specifically, the following risks arise:

► The interests of the company may be compromised in seeking ‘blind’ alignment with the major shareholder’s remuneration strategy. Whilst alignment with the legitimate interests of shareholders is encouraged, such alignment should always be in the best interests of the investee company.

► The interests of minority shareholders may be compromised where the majority of the NEDs on the investee company’s remuneration committee are representative directors.

► The representative director may be requested or feel compelled to share the investee company’s proprietary information with a major shareholder.

Recommendations

The following recommendations are suggested:

► In the first instance, the rationale for a major shareholder appointing a director to the board should be that they have appointed a competent representative who will take the appropriate action and ethical decisions when conflicting circumstances arise with due care, skill and diligence and in the best interests of the investee company. The objective should not be to appoint a director who will champion the cause of action beneficial to the major shareholder.\(^10\)

► The design of the fee arrangements should be shaped by the investee company’s unique business and strategy. In this way, the best interests of the investee company should be catered for. Any adoption of a holding company’s remuneration policy must be a matter for the board of the subsidiary/investee company to consider, amend, reject or approve as it sees fit.

► The shareholders need to vote on the remuneration policy at the annual general meeting. As part of broader stakeholder engagement, the remuneration committee is therefore encouraged to seek input from shareholders on its remuneration policy before putting the policy to vote at the AGM. In this case, the representative director would act as a conduit for relaying the views of the majority shareholder or the shareholder that it represents. However, the remuneration committee members would still need to act in the best interests of the investee company, by considering the views of the broader stakeholder group and ensuring that the policy supports the specific business strategy and business environment of the investee company.

► The remuneration committee of the holding company is encouraged to review the terms of reference and the activities of the subsidiary/investee company’s remuneration committee to assess the degree to which the holding company committee can rely on its work. Similarly, therefore the representative director would act as the conduit.

► Before divulging any information to the holding company, the representative director should exercise caution and consider whether this results in the divulging of confidential or price sensitive information which may result in the representative director breaching his or her fiduciary duties towards the investee company or result in a contravention of law.

► The majority of members on the subsidiary/investee remuneration committee should be independent non-executive directors.

The above recommendations would still apply where the subsidiary company is wholly-owned.

For further guidance in this regard please refer to chapter 2, paragraphs 140 – 146 of King III re a governance framework between the group and subsidiary companies (principle 2.24 of the King III code).

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8 A major shareholder includes a holding company (JSE listed or otherwise), a major institutional shareholder, or a shareholder with a significant stake in the company (listed or otherwise).

9 This term is not defined in the Companies Act, but is commonly used to refer to directors who are appointed to a board as a representative of a related party.

4. Setting targets based on internal measures of company performance

Understanding the tension

This example is not a conflict of interest for the remuneration committee member per se. It is however an example of a common tension that arises between the remuneration committee (which approves the incentive targets) and management (which recommends the targets).

Most goal-based bonuses and incentive payments are generally payable for performance above a minimum expectation. In these cases, a performance range is typically approved each year by the remuneration committee which includes threshold and stretch performance levels.

The potential for conflict arises where the threshold is an internal measure of performance, typically profitability measures, which are based on management’s predictions and recommendations for the forthcoming financial year. The members of the remuneration committee will not necessarily have the same depth of understanding of the business or the same amount of information as management in terms of the potential performance levels in the following year (or few years in the case of long term incentive plans) and the external and internal factors influencing such performance. With this in mind, management may have an interest to set an artificially low target whilst the remuneration committee would want to see sufficient stretch in the targets. Without sufficient or robust challenge or business understanding from the remuneration committee, inappropriate thresholds and targets may be set, which will not be in the longer term interests of the company. The following outcomes can arise:

- Targets being set too high, with a low probability of achievement, resulting in low motivation and mediocre performance;
- Targets being set too low, resulting in overpaying bonuses, wasteful expenditure and ultimately mediocre performance;
- An imbalance between short and long term targets negatively impacting the short term retention of staff or the long term sustainable performance of the company.
## Recommendations

Ways to deal with this tension are suggested below:

### Roles and responsibilities:
There should be a clear allocation of roles and responsibilities for the setting of targets for variable pay, as set out below.

<table>
<thead>
<tr>
<th>Human Resources</th>
<th>Finance</th>
<th>Senior management</th>
<th>Remuneration Committee</th>
<th>Board of Directors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provide guidance</td>
<td>Consult</td>
<td>Recommend</td>
<td>Approval</td>
<td>Final approval</td>
</tr>
</tbody>
</table>

- Recommend variable remuneration performance conditions to align with company strategy and support business objectives and plans.
- Undertake analysis and modelling to test implications.
- Provide actual performance information for the performance period.
- Approve performance measures.
- Set performance targets.
- Approve extent to which targets have been achieved.
- Review performance information for the performance period and final incentive awards for management.
- Acts as a safeguard against unintended consequences and windfall gains.
- Implements clawback policies where appropriate.
- Final approval of all incentive awards for Executive Directors and Prescribed Officers.

### Skills:
Setting performance targets and ranges requires skill and experience. Members of the remuneration committee should possess such skills or seek the views of independent advisors. There should, for instance, be minimum requirements for the on-boarding of new remuneration committee members and regular training and updates on remuneration trends.

### Information:
The remuneration committee should use its right to request and interrogate all necessary information, particularly the company’s performance related information. At the same time management should be transparent in providing such information, which should include benchmarks for the industry.

### Variable pay plan design principles:
- The performance range should be within the line of sight of management, especially executive management, encouraging them to take a long term view that creates sustainable performance. It should be balanced against the business prospects and risks of the company.
- The choice of metrics, the thresholds and targets should result in a win-win for shareholders and employees, and aligned to the company’s strategic objectives.
- Include multiple performance measures to avoid placing too much weight on a single metric. For example, measures of performance based on accounting, shareholder, absolute and relative aspects of performance should be considered together to provide a holistic view of business performance. The targets should include financial and non-financial, company and individual targets. Also consider including external market-based metrics in the mix of performance targets to increase the objectivity, such as sovereign ratings or customer satisfaction survey ratings.
- Personal or non-financial performance measures may determine a portion of the incentive, independently of the organisation’s annual financial performance.

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11 Extracted from Appendix C of the First Position Paper of the Remuneration Committee Forum and adapted.
Conclusion

The most effective way to reduce and manage conflicts of interest and tensions is that the remuneration committee must operate independently from management. Such a committee would be composed of at least three non-executive directors, a majority of whom should be independent non-executive directors.

In assessing director independence, the general comments in paragraph 66 of King III should be considered: “An independent director should be independent in character and judgement and there should be no relationships or circumstances which are likely to affect, or could appear to affect this independence. Independence is the absence of undue influence and bias which can be affected by the intensity of the relationship between the director and the company rather than any particular fact such as length of service or age.” The Companies Act, as well as the JSE Listings Requirements should also be referred to for the specific requirements for independence.

Finally, as a steward of the company, a member of the remuneration committee should discharge the following moral duties:

- **Conscience:**
  A director should act with the intellectual honesty and independence of mind in the best interest of the company and all its stakeholders in accordance with the inclusive stakeholder approach to corporate governance. Conflicts of interest should be avoided.

- **Inclusivity:**
  Inclusivity of stakeholders is essential to achieving sustainability and the legitimate interests and expectations of stakeholders must be taken into account in decision-making and strategy.

- **Competence:**
  A director should have the knowledge and skills required for governing remuneration within a company effectively and competently.

- **Commitment:**
  A director should be diligent in performing his duties and devote sufficient time to company affairs.

- **Courage:**
  A director should have the courage to take the risks associated with directing and controlling a successful, sustainable enterprise, and also the courage to act with integrity in all board decisions and activities.\(^{12}\)

\(^{12}\) Extracted from King Report on Governance for South Africa 2009, Chapter 1, paragraph 15
Notes: