INSTITUTE OF DIRECTORS
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Remuneration Committee Forum

Position Paper 2 – December 2013

The Remuneration Policy

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The Remuneration Committee Forum (the "Forum") is constituted as a forum of the Institute of Directors in Southern Africa ("IoDSA"), and is sponsored by EY. The activities of the Forum have specific focus on the governance and accountability role and duties of remuneration committee members.

Working groups of the Forum are convened with the purpose to develop thought leadership material. The working group meetings are chaired by the representative from the Sponsor. The current members of the working group are:

- Mr R Harraway — EY (Chairman)
- Mr C Blair — 21st Century
- Ms J Cuffley — Orient Capital
- Mr R Hogben — Independent
- Mr M Hopkins — PwC
- Mr R Moholane — Nedbank
- Dr R Nienaber — South African Reward Association
- Mr B Olivier — Vasdex
- Mr M Pannell — HayGroup
- Ms D Pillay — IoDSA
- Ms A Ramalho — IoDSA
- Ms S Tosh — Standard Bank
- Mr M Westcott — PE Corporate Services
- Mr T Wixley — Independent

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**
- **Thought leadership on the function, duties and composition of remuneration committees by discussing, researching, developing and disseminating position papers and good governance guidelines.**

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

This position paper is compiled from the discussions of the Forum working group comprising remuneration committee members and experienced remuneration advisors. The information contained in the position papers disseminated by the Forum is of a general nature and is not intended to address the circumstances of any particular individual or entity. The views and opinions of the Forum do not necessarily represent the views and opinions of the sponsor, EY, the Institute of Directors in Southern Africa and/or individual members. Although every endeavour is made to provide accurate and timely information, there can be no guarantee that such information is complete or accurate as of the date it is received or that it will continue to be accurate in the future. No reliance should be placed on these guidelines, nor should any action be taken without first obtaining appropriate professional advice. The Forum shall not be liable for any loss or damage, whether direct, indirect, consequential or otherwise which may be suffered, arising from any cause in connection with anything done or not done pursuant to the information presented herein.

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Introduction

The King III Report on Governance (King III) requires that every year, the remuneration policy should be tabled to shareholders for a non-binding advisory vote at the annual general meeting (AGM)[1]. This vote enables shareholders to express their views on the remuneration policies adopted and on their implementation[2].

Clearly, the preparation and composition of a remuneration policy, and what criteria would be applied to its evaluation, is increasingly important for boards and remuneration committees.

Purpose of this paper

This paper has been developed to provide high level guidance to members of South African remuneration committees, and those responsible for appointing them, on the requirements of effective remuneration policies.

This position paper follows the first position paper of the Remuneration Committee Forum that focused on the pre-requisites for an effective remuneration committee entitled: "A Framework for Remuneration Committees".

This paper should be read together with King III[3] and its related Remuneration Practice Notes, and relevant legislation, including, but not limited to, the Companies Act, 2008, the JSE Limited Listings Requirements, and International Financial Reporting Standards.

What is a remuneration policy?

A remuneration policy:

- provides guidelines for the implementation of the reward strategy and the design and management of reward processes[3];
- sets the guidelines for the 'how' and 'why' of pay as opposed to the 'how much' of pay. Care should be taken to ensure that the commercial rationale ('the why') for remuneration arrangements is explained;
- is an important component of the remuneration system as referred to in Position Paper 1, Appendix C;
- helps shareholders understand the framework used by the remuneration committee and board to align management and shareholder interests;
- guides and informs managers and employees;
- is a primary governance tool to ensure remuneration decisions fall within an approved framework.

Distinction between the remuneration report and remuneration policy

The *annual remuneration report* is disclosed in the annual integrated report. It provides a clear explanation of key remuneration decisions taken by the remuneration committee in the past year and how the remuneration policy has been implemented, including explanations of any deviations therefrom.

The *remuneration policy* is typically included as the first part of the remuneration report. The second part of the remuneration report contains the *remuneration outcomes* of the policy.

Whilst the remuneration policy is tabled with the shareholders for the advisory vote, the full remuneration report, which contains the remuneration policy, forms part of the annual integrated report.

1 Private companies are not required to hold AGMs in terms of the Companies Act, 2008. In this instance, the policy could still be circulated once a year to the shareholders for their vote
2 Principle 2.27 of King III: Shareholders should approve the company's remuneration policy
3 The King Code of Governance Principles and the King Report on Governance 2009

The requirement for a remuneration policy

There is no legal framework that dictates the content and minimum requirements of a remuneration policy. The KING III Practice Notes on Remuneration set out guidelines for a remuneration policy and a template for the remuneration report, both of which should be referred to.

All listed companies should take into account the principles of King III and adopt the "apply or explain" doctrine[4]. Although compliance with King III is not legally required for unlisted companies it is suggested that all companies consider the King III principles and apply them in a way that is best suited to their circumstances.

The context for the remuneration policy

It is the business strategy that should drive the remuneration strategy and policy. Because companies are not generic, responsible pay programmes require remuneration policies that are unique to the organisation, supported by commercial rationale and the long term interests of stakeholders.

By implication:

- remuneration practices that may be inappropriate for some companies may still be legitimate or even necessary for other organisations. Deviations from conventional wisdom are therefore possible and in some cases should even be encouraged;
- the remuneration committee should invest significant time and effort to establish a remuneration approach tailored to its industry and strategic goals. For example, the metrics in a performance bonus plan should be specific to its strategic business goals;
- the more specialised or different a remuneration approach is, the greater the effort required in making the strongest possible case for how the approach will support the business performance and the long term success of the organisation;
- remuneration policies will require regular review and amendment to support changing business strategies over time.

Similarly, stakeholders are also not a homogenous group. Shareholders, in particular, will have a role to play in formulating the policy, they will need to be engaged to understand their diverse views. See Appendix A in this regard for further guidance.

In short, the remuneration policy should be informed by the following:

- The business strategy, HR strategy and remuneration strategy;
- The stage in the organisation's business lifecycle;
- The organisation's risk appetite and risk framework;
- The industry;
- The organisation's values, and desired organisation culture and behaviours to be influenced through remuneration;
- Legislation and corporate governance requirements;
- Stakeholder dialogue; and
- Leading practice.

Composition of a remuneration policy

A remuneration policy will typically address the following elements:

- *Remuneration philosophy*: this is a set of beliefs that underpin the remuneration strategy and governs the remuneration policy;
- *Remuneration strategy and objectives* under-pinning the business strategy. The remuneration strategy is a declaration of intent that states what the organisation wants to achieve in the long term with its remuneration policies, practices and policies to achieve its business strategy and meet the needs of its stakeholders;
- *Remuneration principles* underpinning the remuneration policy. These principles define the remuneration approach and provide the guidance for rewarding staff;
- *The salient features*, e.g. the rationale, award criteria, eligibility levels, targets, performance conditions, vesting periods, and purpose of each component of remuneration, namely:
    - *fixed, or guaranteed remuneration*. This comprises the cost to the company of all fixed or guaranteed elements of remuneration, including base salary, all benefits, such as the employer's contribution to pension, risk, medical aid and health insurance plans, vehicle and other allowances, 13th cheque, but excluding short and long term incentives as well as ad hoc, non-standard allowances such as acting, standby and shift allowances and overtime. The criteria for increases in the fixed package or basic salary should be set out;
    - *cash incentive and bonus schemes, both long- and short-term*. As stated in King III, consideration should be given to disclosing the threshold, target and stretch performance levels that relate to the respective levels of organisational performance. The approach to bonus deferrals should also be explained where appropriate;

4 Note 157.1 of the King III Practice Notes on Remuneration

- *retention and share based schemes.* This includes an explanation of the structure and design of the schemes as well as the conditions relating to vesting (time and performance) and termination rules.

- *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 organisation.
- *The use of job evaluation methodologies:* a description of how the internal relativities of one job to another are determined;
- *The remuneration benchmarking approach*, including 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*, noting how the performance management system informs remuneration decisions;
- The policy for *executive employment contracts*, including the period of the contract and the period of notice of termination as well as any other key contractual rights to payments such as golden handshake or change in control payments;
- The motivation for any *policy changes* from the previous year;
- The approach used to identify *prescribed officers* as defined in the Companies Act; and
- The approach to setting *non-executive director fees*.

It may also be appropriate to comment on the approach to assessing and managing risk in the remuneration structures. This will include risk mitigation steps such as stress testing the remuneration design to understand the potential effects, and any unintended consequences, of volatility on award values and the regular validation of the policy's effectiveness.

The remuneration committee's actual *terms of reference* (ToR), or a reference to it on the organisation's website, should be included in the remuneration report.

Technical jargon and abbreviations should be avoided and where possible a glossary should be provided.

Who sets the remuneration policy?

The primary roles of the remuneration committee are to ensure that:

- The directors, executives and prescribed officers are remunerated fairly and responsibly with the long-term interests of the organisation in mind;
- The remuneration report and disclosure of director and other executive and prescribed officer remuneration is simple to read and understand, accurate and complete; and
- *An effective remuneration policy is in place, aligned with the company's strategy, and is applied consistently throughout the entity at all employee levels*[5].

The remuneration committee, operating with authority delegated to it by the board, is therefore responsible for overseeing the establishment and maintenance of a remuneration policy that will promote the achievement of the strategic objectives and organisational performance in line with the board's objectives[6].

The remuneration committee therefore proposes the remuneration policy for approval by the board and ultimately tables it for the non-binding shareholder vote at the AGM.

The allocation of roles and responsibilities concerning the remuneration policy is set out in Appendix C of the First Position Paper, and is included below for ease of reference:

Human Resources	Executive/ Senior management	Remuneration Committee	Board of Directors	Shareholders	Social & Ethics Committee	Risk Committee
Recommend	Recommend • Monitor effectiveness, administer and implement policy • Recommend improvements to enhance alignment with strategy	Approval • Oversee and review effectiveness of policy and strategy • Table at the Board for approval	Final approval	Non-binding vote [7]	**Consult**	**Consult**

5 Extracted from the First Position Paper, emphasis added
6 First Position Paper Appendix B: Specimen Remuneration Committee Terms of Reference
7 This "non-binding advisory" nature of the vote is for all policy related sections of the remuneration report

What employee levels should the policy address?

The committee considers and recommends remuneration policies for all levels in the organisation, but should be especially concerned with the remuneration of senior executives, including executive directors, and should also advise on the remuneration of non-executive directors[8]. By implication, it would be similarly concerned with the remuneration of prescribed officers and roles identified by other legislation or regulation such as the South African Reserve Bank regulations.

Employees are an important stakeholder and shareholders should be informed as to the basis of their economic sharing with the other stakeholders. Furthermore, executive pay decisions should not be made in isolation and the relationship between the levels of pay for executives and other employee groups should be monitored. A robust remuneration system ensures that there is a balance between internal equity and external competitiveness.

The remuneration approach is likely to differ for each employee group. Judgment should be exercised to determine how the employees should be grouped when providing this disclosure.

Depending on their size, complexity, and ownership structure, subsidiary companies should have their own tailored remuneration policy in line with their own remuneration strategy, and jurisdictional requirements where they are located outside South Africa. Depending on the local jurisdiction's regulations and the organisation's founding documents these policies would typically be approved by the remuneration committee of the subsidiary company. Condensed versions, including any material deviations from the group remuneration policy, should be made available to the remuneration committee of the holding company for final approval.

How should the remuneration policy be disclosed?

Website

A full version of the policy should be available on the company's website for inspection by the shareholders. A condensed version should accompany the notice of AGM to shareholders to focus the attention of the non-binding vote on the appropriate part of the remuneration report.

Annual integrated report

To achieve the stated objectives of integrated reporting the annual integrated report should include an overview of how the organisation remunerates employees and specifically its senior executives, including factors that could influence future remuneration[9].

Determining the content of a condensed remuneration policy for the annual integrated report requires a high degree of judgment, care and skill. Consider the following guidelines:

- Do not overly concentrate on form at the expense of substance;
- Take the legitimate interests and expectations of stakeholders into account;
- Present a balanced and reasonable picture of the remuneration approach adopted;
- Include only relevant and important information that could substantively influence the assessments and decisions of the organisation or its stakeholders;
- Include only information that assists stakeholders evaluate the organisation's performance and to make assessments about the ability of the organisation to create and sustain value over the short-, medium-, and long-term; and
- Present the information without bias in the selection, omission or presentation of information.

Increasingly, companies are disclosing a condensed remuneration policy as the first part of the remuneration report which is included in the annual integrated report. The second part of the remuneration report includes summary information on the remuneration outcomes for the directors, prescribed officers and other identified roles as required by regulation. This summary information will typically refer to the detailed information in the audited[10] annual financial statements (either from the directors' report or the notes to the financial statements). It is however, recommended that all information of a remuneration nature, both policy and outcomes, is kept together in one section, in the remuneration report.

It is not necessary or advisable to include the remuneration policy in the annual financial statements.

The attached Appendix B sets out a diagram illustrating the above.

8 Paragraph 150 King III
9 Page 7, Framework for Integrated Reporting and the integrated report, Discussion Paper 25 January 2011, www.sustainabilitysa.org
10 In cases where an audit is performed

Guidelines for evaluation of a remuneration policy

The non-binding advisory vote is aimed at providing an opportunity for shareholders to understand, and if necessary, influence the board's perspective on remuneration matters, specifically as it concerns the structure of remuneration in terms of policy and its implementation. The nature of the advisory vote is therefore to provide feedback on the remuneration policy and implementation thereof (forward looking) as opposed to a vote on the level of remuneration paid (i.e. backward looking), which is not currently required in South Africa.

King III, specifically, principles 2.25, 2.26 and 2.27, and the King III Practice Notes on Remuneration set out the principles for sound pay practices. These principles should form the basis for informing which way the vote goes.

Investors and proxy advisors will largely look to the remuneration of executives, in particular the variable pay arrangements, in conducting their evaluation. Typical questions that investors may ask include:

- how does reward align with business strategy and long term shareholder interests?;
- how do the remuneration outcomes align with long term organisational performance?;
- is there an appropriate mix of guaranteed vs variable remuneration components?
- have any deviations from the policy been adequately explained?
- has the basis for executive salary increases been set out and have abnormally large increases or any discretionary awards been explained?
- have ex gratia payments, share awards, or severance payments been made which are not linked to performance, and has the reason for this been provided?
- do executive directors and prescribed officers have service contracts with no notice periods or with notice periods that exceed one year? Or do they carry any other key contractual rights to payments such as golden handshake or change in control payments?
- has the organisation adopted a claw-back policy?
- long term and share based incentive schemes will typically be tested against the following criteria:
  - is there clear and discernable alignment between the incentive scheme design and the long-term interests of the shareholders?
  - are there performance conditions and are they sufficiently challenging? Do they align management interests with long term shareholder interests?
  - can the performance conditions be re-tested or overruled by the committee?
  - performance should be measured over a period of at least three years or longer.
  - the plan should not allow for re-pricing, for the issue of shares at a discount, or for backdating.
  - the ceiling for the number of shares that can be issued in total should not cause excessive dilution.

Reviewing the effectiveness of the policy

It is advisable to undertake annual audits of remuneration practices against the approved policy to provide the committee with the required level of oversight of how the policy has been implemented.

Effective remuneration policies are successful in attracting and retaining staff with packages that are designed within the scope and principles of the policy. Where it is necessary for management to continuously exercise discretion or to agree one-off deals to attract or retain executives, the policy may need to be reviewed.

Over time, reward management will change in line with the changes in the organisation structure, market pressures to attract and retain talent, strategic priorities, legislation, regulations and governance requirements and organisation values. In line with the specimen work plan of the remuneration committee set out in Appendix A of the First Position Paper, it is therefore recommended that the remuneration policy be reviewed annually.

Appendix A: Engaging with shareholders on the remuneration policy

Introduction

The stakeholder inclusive model, emphasised in the King III Report on Governance (King III), calls for companies to take into account the legitimate expectations of all its stakeholders.

This stakeholder model does not give the shareholder de facto precedence in the matter being engaged on. Too much shareholder involvement will hinder effective governance whilst too little shareholder involvement will increase the risk of misunderstanding and surprises.

The responsibility of the remuneration committee is to ensure an effective remuneration policy is in place as developed and proposed by management. By implication, the remuneration committee is also responsible for defending an effective remuneration policy. The responsibility of the shareholder is to act as a responsible investor and vote on the remuneration policy at the AGM.

The trade-offs between the various stakeholders should be made on a case by case basis, to serve the best interests of the company. Even when agreement cannot be reached, seriously considering an investor's view will help to gain support for its remuneration policy.

The need for engagement

Both globally and locally, remuneration is drawing more attention at AGMs than in the past. This is due to a combination of factors:

- Shareholders, often via asset managers, proxy or shareholder advisory firms or other intermediaries or agents, are expected to exercise their voice at the AGM with the introduction of the annual non-binding vote on the remuneration policy;
- The introduction of the Code for Responsible Investing by Institutional Shareholders (CRISA) in South Africa, effective from 1 February 2012. Institutional shareholders have some responsibility for ensuring that an effective remuneration governance framework exists in the companies they invest in. In this regard, proxy voting is an essential governance tool for investment professionals to act as good stewards of their clients' assets. In South Africa, proxy voting policies and guidelines are a new phenomenon, and efforts are being made to tailor them to guide the remuneration policy decisions of the investee company;
- Institutional investors are increasingly transparent on their voting decisions, and on the reasons behind them. One of the five CRISA principles requires institutional investors to be transparent about their investment and corporate governance policies;
- Increasingly, institutional investors will not hesitate to withdraw their support for the remuneration policy if they see a problem. It is therefore necessary to understand the rationale for their decisions. Asset managers inherently want to protect their clients' interests and the value of their investments and in this regard are becoming increasingly interested in the governance of remuneration – specifically as remuneration aligns to organisation performance. Asset managers want to understand the role of the board in overseeing management and they want to play a role in helping develop and implement the policies that do this;
- Any dissent at the AGM on pay practices and policies is aired in the media more than ever before. Misunderstandings on remuneration and damage to reputation can be avoided by proactive engagement before the AGM; and
- High-performing companies are more advanced in building strong relationships with their stakeholders. Building stakeholder confidence, in general, is a key driver of competitive success, and this is built through engagement.

If less than 50% of the votes are in favour of the resolution on the remuneration policy, the board is not compelled to change the remuneration strategy and policies, but is strongly advised to engage with shareholders and investors, to understand the reasons for their concerns expressed through the voting. A pro-active discussion around intended changes to the remuneration policy with investors is encouraged[11].

Planning for shareholder involvement

A remuneration report alone is not sufficient to effectively explain the remuneration policy and the effectiveness of its implementation to ensure shareholder support. Stakeholder relations should also not be confined to the AGM.

A strategy for engaging shareholders on the remuneration agenda throughout the year should be developed on the following guidelines:

11 PN 186.4 of the King III Practice Notes on Remuneration

WHEN
Aligned with the remuneration committee's work plan[12] an annual calendar should be developed outlining when and how many times to engage throughout the year with shareholders and, potentially, shareholder advisory bodies.

A high level of support on the remuneration policy in the previous year is no guarantee of receiving high support again in the current year. Proxy advisory firms change their voting policies, for example, on the methodology for determining peer groups. This creates uncertainty and therefore requires proactive ongoing management throughout the year.

The more changes being introduced to the remuneration policy the earlier the engagement should take place relative to the AGM and the release of the remuneration report.

WHO
Know your investors
Successful engagement is focused, but without being exclusive. The remuneration committee should identify and prioritise which shareholders and advisors will be contacted. Focus on the largest investors and also the most vocal shareholders on remuneration governance issues. At the same time, the remuneration committee should be open to engage with all shareholders. This will help to ensure that a full range of perspectives on the remuneration issues are considered.

Allocate responsibilities
Has the board identified directors who could speak with investors on remuneration matters?

While most investors are comfortable engaging with management, provided the message is conveyed to the board, involving board or committee members is often preferred, as management is inevitably conflicted. Involving committee members will also help build investor trust and confidence in the committee and board decisions.

HOW
Develop a process
Stakeholder dialogue should include a holistic approach where all matters on investor relations including organizational results, strategy, governance and remuneration could be included. Alternatively, particularly if remuneration policy changes are needed, separate engagements could be arranged on remuneration only. The process for engagement should include how feedback is given to shareholders post the engagement.

WHAT
Develop the messages and materials to tell the right story in the right way. Key messages should focus on:

- Business strategy and shareholder alignment;
- Links between remuneration outcomes, which will tend to focus more on variable pay, and medium to long term performance;
- Acknowledge any prior year issues and reasons why certain suggestions were not implemented; and
- The rationale for any policy changes in the current year and those proposed for the next year.

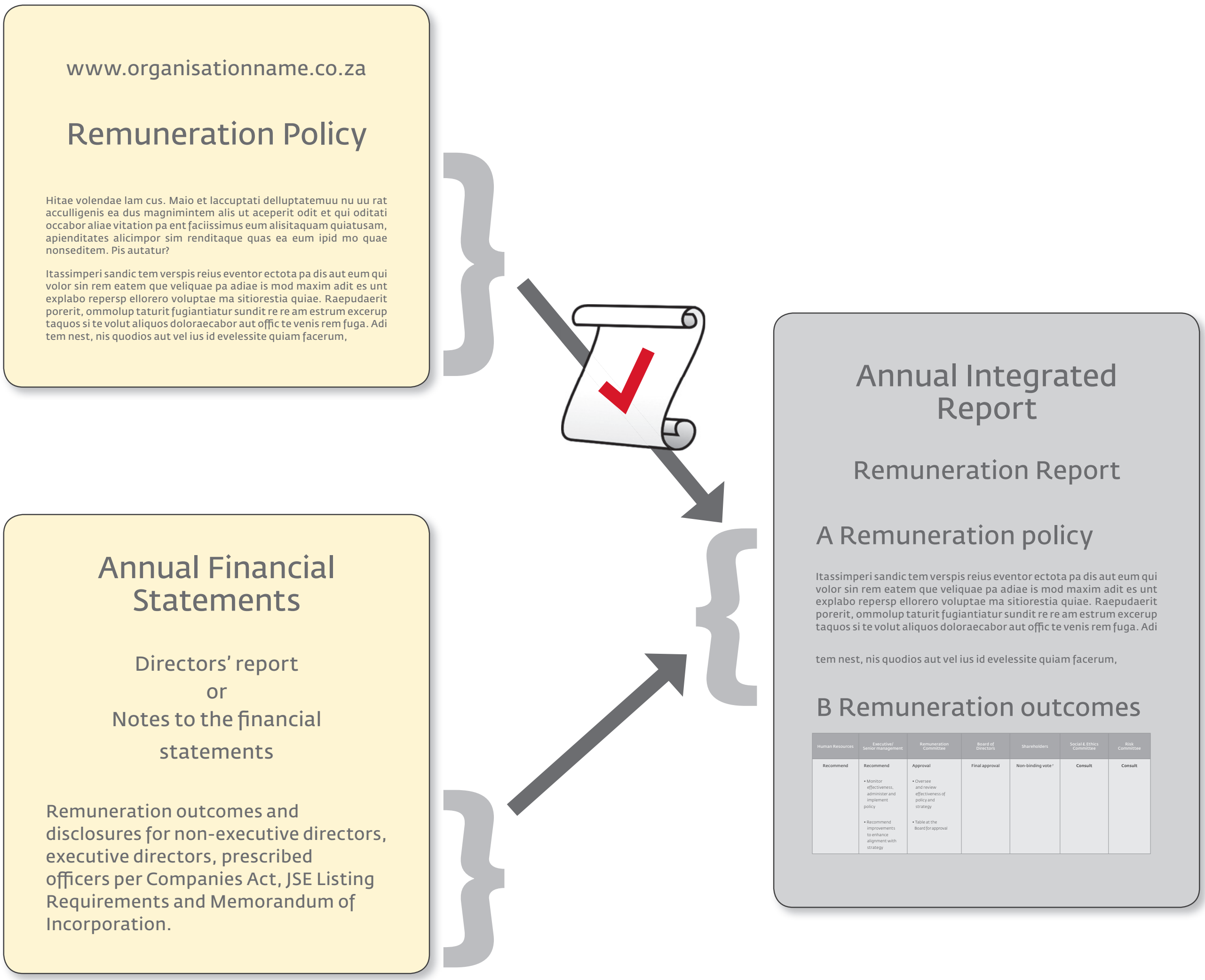
Practical considerations

Consider the following:

- Allow shareholders sufficient time to prepare, and if necessary, engage with the company before the AGM;
- Ensure that the remuneration committee's annual work plan and terms of reference are robust. The remuneration report should communicate how it followed the work plan and the terms of reference as this will make evident the nature and extent of the work done;
- Read the proxy voting guidelines of the asset managers and proxy advisors, which are now increasingly available on their websites;
- When dealing with asset managers, know that it is possible that one party deals with the proxy voting aspects and another with the engagement aspects. The party leading the engagement may not always be aware of how the votes are cast;
- Respond to shareholder correspondence in a timely manner;
- Sharing targets, forecasts and other market sensitive information likely to affect price will need to be managed with care and within the JSE Listings Requirements;
- Consider including in the annual remuneration report a summary of key concerns raised by shareholders in the past year and the remuneration committee's response to addressing them. This would include a response to a high prior year no-vote, setting out any changes made to the remuneration framework and the rationale for your decisions; and
- Just as significant effort is required to explain the rationale for the remuneration approach to shareholders, do not forgot to do the same for the other stakeholders, primarily the organisation's employees. The effectiveness of incentive plans and their internal credibility depends on participants' understanding, supporting and valuing the incentive schemes and knowing what level of performance is required of them.

12 See First Position Paper Appendix A: Specimen Remuneration Committee Annual Work Plan

Appendix B: Where should the remuneration details be disclosed?



Note that in terms of the Companies Act, 2008 directors' fees for services rendered as a director (executive or non-executive) are subject to approval by the shareholders within the last two years, by special resolution. Retroactive approval is not possible. Salaries and incentives paid to executive directors as an employee may require shareholder approval in terms of the company's Memorandum of Incorporation (MoI). This is because a standard clause contained in many companies' Articles of Association was: "the remuneration of the directors shall, from time to time, be determined in general meeting."