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Bolder than ever

Contents

The King Committee published the King IV Report on Corporate Governance for South Africa 2016 (King IV) on 1 November 2016. King IV is effective in respect of financial years commencing on or after 1 April 2017. *King IV replaces King III in its entirety.*

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Introduction

While we acknowledge that most organisations suffer from regulation fatigue, we welcome this new version of the King Code as it not only provides a more practical, principles-based approach to good corporate governance, but also incorporates both global public sentiment and international regulatory change since King III was issued in 2009.

In our view, King IV is bolder than ever before. Firstly, the Code is principles-based and follows an outcomes- rather than rules-based approach. This is in line with current international sentiment which promotes greater accountability and transparency and speaks to the expressed view that the application of the Code should contribute to the performance and health (sustainability) of the organisation. In this regard it is clear that King IV aims to establish a balance between conformance and performance. The Code is further bold in its relentless effort to reinforce corporate governance as a holistic set of arrangements that concerns itself with ethical leadership, attitude, mind-set and behaviour. This echoes global developments in the conduct risk arena and also seeks to address and prevent recent examples of corporate failure. Lastly, the boldness of the Code is evident in the clear focus on transparency and targeted disclosures in all areas, specifically in the introduction of far more extensive executive remuneration disclosure than ever seen before. We believe that the recommendations are in line with global developments and perhaps more relevant than ever before in a country where the income differential remains higher than desired.

In this document we take a closer look at recommendations for the remuneration policy, approval and disclosures in terms of King IV and practices from an international perspective. We also consider the prevalence of stakeholder activism in the context of the remuneration debate.

Remuneration of directors is one of the most debated topics in the corporate governance arena, due to the tension between stakeholders demanding to understand directors' remuneration levels and methods and the directors' desire for the privacy of their financial affairs. The tension is exacerbated by the high levels of inequality between employee and executive remuneration levels. In line with international developments, remuneration is receiving far greater prominence in King IV. The Code re-iterates the fundamental ethical leadership characteristics of accountability and transparency with renewed vigour by requiring a three part disclosure of remuneration:

- a background statement that provides the context for the remuneration policy and decisions
- an overview of the remuneration policy and
- the remuneration awarded, accrued and paid to each director and prescribed officer as a result of the implementation of the policy.

In addition to the above, the Code recommends that shareholders be provided with the opportunity to pass separate non-binding advisory votes on the policy and the implementation report. The remuneration policy should set out the measures that the Board commits to take in the event that either the remuneration policy or the implementation report, or both have been voted against by 25% or more of the voting rights exercised. Such measures should provide pro-active engagement with shareholders to address their concerns.

The Code opted for an advisory vote that is likely to be mandated by the Johannesburg Stock Exchange Listing rule. This is similar to the European Union proposals and current practice in the UK and Australia where either mandatory non-binding or binding votes are required on the remuneration report.

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REMUNERATION *Policy and* Structuring

Further to the shift in thinking from short-termism to long term sustainability based on ethical principles, King IV recommends that the Board should ensure that remuneration is used as a tool to ensure that the business creates value in a sustainable manner within the economic, social and environmental context in which the company operates. To this end, the Board should establish a remuneration committee, the role of which is to recommend to the Board a fair and responsible company-wide remuneration policy that promotes the creation of value in a sustainable manner. Pursuant to its outcomes-focused approach, King IV does not go into great detail on the recommended practices for the remuneration committee as was done in King III.

While King III required organisations to have an approved remuneration policy that is voted on by shareholders in the form of a non-binding advisory vote, King IV takes this further by stipulating the minimum requirements of the remuneration policy to be voted on. According to King IV, the remuneration policy should address all of the following:

- base salary, financial and non-financial benefits;
- variable remuneration, including short and long-term incentives and deferrals;
- payments on termination of employment or office;
- sign-on, retention and restraint payments;
- the provisions, if any, for pre-vesting forfeiture (malus) and post-vesting forfeiture (claw-back) of remuneration;
- any commissions and allowances; and
- the fees of non-executive members of the governing body.

Many of the above recommended components of the remuneration policy align with the directors' remuneration disclosure required in terms of the Companies Act.

"Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied."

The UK Corporate Governance Code, September 2014

Compensation Clawbacks

The SEC recently issued a proposed rule aimed at ensuring that executives do not receive "excess compensation" if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements.

Under the proposed rule, issuers would be required to adopt a written policy requiring them to recover "excess" incentive-based compensation awarded to any individuals (including former employees) that served as an executive officer during the three most recently completed fiscal years preceding the date on which it is determined that a qualifying financial restatement is required, provided that the executive officers were awarded more incentive-based compensation than they would have received if the financial statements had been prepared correctly. The ICGN Guidance on Executive Remuneration also recommends adopting a remuneration "claw back" policy.

In the true spirit of integrated thinking, King IV acknowledges that fair and responsible remuneration is a consideration of a company's corporate citizenship. In line with this integrated approach, King IV suggests that the Board ensures fair and responsible executive remuneration practices in the context of overall employee remuneration. This recommendation aligns with the principle of ethical leadership and is designed to ensure that executive remuneration is determined within the context of overall employee remuneration

King IV recommends that the Board oversees that the implementation of the remuneration policy results in all of the following:

- To attract, motivate, reward and retain human capital.
- To promote the achievement of strategic objectives within the organisation's risk appetite.
- To promote positive outcomes.
- To promote an ethical culture and responsible corporate citizenship.

These intended results are in accordance with recommendations of King III, however King IV now recommends detailed and specific disclosure on the policy and its implementation (discussed below). In light of the above, in order to properly draft the remuneration policy, the Board, in conjunction with the remuneration committee, will need to clearly articulate the link between strategy, sustainable value creation, performance and remuneration.

[1] For further information on the Companies Act requirements, refer to our **FAQ guide on the disclosure of directors' remuneration**

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Approval of REMUNERATION

A say on pay

In terms of the European Union Shareholder Rights Directive Proposal, shareholders are given the right to approve the remuneration policy and to vote on the remuneration report, which describes how the remuneration policy has been applied in the last year. All benefits of directors in whatever form will be included in the remuneration policy and report. Such report facilitates the exercise of shareholder rights and ensures accountability of directors.

King IV recommends that shareholder approval in respect of remuneration is sought as follows:

In the event that either the remuneration policy or the implementation report, or both were voted against by 25% or more of the voting rights exercised, King IV proposes that the following be disclosed in the background statement of the remuneration report succeeding the voting:

- with whom the company engaged, and the manner and form of engagement to ascertain the reasons for dissenting votes; and
- the nature of steps taken to address legitimate and reasonable objections and concerns.

The non-binding advisory shareholder vote appeared in King III as well, however, King III did not foresee any consequence where the shareholders do not support the policy. With respect to the content and approval process for the implementation report, the recommendations introduced by King IV seems to be more closely aligned to international trends where shareholders are increasingly having a "say on pay".

The fees of non-executive directors of companies must be submitted to a special resolution approved by shareholders within the previous two years. This recommendation is echoed in King III as well as the Companies Act. It should be noted that the special resolution amounts to a binding vote by shareholders, which is not required for the approval of the remuneration of executive directors.

In order to facilitate an effective approval process, King IV proposes that the remuneration policy should set out the specific measures that the Board commits to take in the event that either the remuneration policy or the implementation report, or both have been voted against by 25% or more of the voting rights exercised by shareholders at the AGM. It is recommended that such measures should provide for taking steps in good faith and with best reasonable effort towards the following at a minimum:

- An engagement process to ascertain the reasons for the dissenting votes.
- Addressing legitimate and reasonable objections and concerns raised, as is appropriate, and which may include amending the remuneration policy, or clarifying or adjusting remuneration governance or process.

It is interesting to note that King IV mentions shareholder engagement rather than stakeholder engagement – the reason is most probably that shareholders are responsible for the appointment of directors, and company resolutions are tabled at the annual general meeting of shareholders. It would be impracticle, if not impossible to require all stakeholders to express a view/vote on the remuneration policy and implementation report. It would however be advisable, in the spirit of the stakeholder inclusive model, for the Board and remuneration committee to assess whether it is necessary to engage with other key stakeholders in such a situation. It is foreseen that Board will need to play an important role in this regard. As required by King IV, Board must ensure fair and reasonable executive remuneration in view of overall employee remuneration, and as such the Board will have to work closely with the remuneration committee in its efforts to achieve these policy objectives.

Although not spelt out specifically, the message in King IV seems to be that, pursuant to the ethical leadership characteristics of accountability and responsibility, an advisory vote against the remuneration policy or implementation report be taken into account in the overall performance evaluation of the Board. It is clear that King IV pushes the debate on executive remuneration beyond the design of executive remuneration packages to include the justification of the link between remuneration, value creation and key performance indicators within the social, economic and environmental context.

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ACTIVE *stakeholders*

King IV is premised on the stakeholder inclusive model whereby directors should consider and balance the legitimate and reasonable needs, interests and expectations of all stakeholders in the best interest of the company.

It welcomes productive stakeholder engagement by encouraging stakeholders to engage with the companies that they have a stake in to promote the principles and outcomes contained in the Code. Stakeholders have an obligation to ensure that the company acts as a responsible corporate citizen and as such they should exercise their rights as well as their legitimate and reasonable needs, interests and expectations in a responsible manner towards the creation of value within the context that the company operates.

> "Investors have a distinct role in relation to executive remuneration. Investors have a fiduciary responsibility as well as a strong economic interest in remuneration. No aspect of corporate governance touches as many drivers in terms of performance, risk and incentive, or is ultimately more critical to long-term alignment of interests. However, investors are not, typically, insiders and in almost all cases are not in a position to dictate executive remuneration practices."
>
> **ICGN Guidance on Executive Remuneration, 2012**

Active stakeholders and/or stakeholder activism is an important consideration for the Board particularly in light of the often contentious remuneration discussion. In an effort to promote transparency, King IV recommends that the Board ensures and oversees regular dialogue with shareholders, to create and maintain a mutual understanding of what performance and value creation constitutes for the purpose of evaluating the remuneration policy. Again, it is advisable for Boards to consider extending this dialogue to other key stakeholders of the company. Furthermore, it is advisable for the remuneration committee to assist the Board with the dialogue with the shareholders to ensure that they are comfortable with the correlation between directors' performance, their individual and collective contribution to value creation and associated remuneration. This links to the King IV recommendation for shareholder engagement where there is a 25% or higher advisory vote against the adoption of either the remuneration policy or the implementation thereof, as described above.

The notion of constructive stakeholder engagement is echoed in King III and should be aimed at ultimately promoting enhanced levels of corporate governance in a company.

Perceptions and the pay gap

A recent study investigated the "executive pay gap" perception among people from different countries and backgrounds. The study explored how much people think CEOs should ideally be paid relative to unskilled workers in an organisation and what they estimated CEOs are actually taking home. In South Africa, the ideal ratio was approximately 9:1 (global ideal 4.6:1) which was lower than the South African estimate of nearly 17:1 (global estimate 10:1).

The actual CEO-unskilled worker ratios were only available for 16 countries in the study (which did not include South Africa). A consistent finding across all countries analysed was that the respondents' estimates were staggeringly lower than the actual amounts CEOs earned.

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Remuneration *disclosure*

One of the boldest changes in King IV is renewed focus on transparency and accountability regarding the disclosure of directors' and prescribed officers' remuneration.

King IV requires a three part disclosure relating to remuneration including the remuneration background statement, policy and implementation as follows:

- Remuneration background statement disclosure provides the context for remuneration considerations and decisions. Specific reference should be made to the following considerations:
  a. internal and external factors that influenced remuneration;
  b. the most recent results of voting on the remuneration policy and the implementation report and the measures taken in response thereto;
  c. key areas of focus and key decisions taken by the remuneration committee during the reporting period, including any substantial changes to the remuneration policy;
  d. whether remuneration consultants have been used, and whether the remuneration committee is satisfied that they were independent and objective;
  e. the view of the remuneration committee on whether the remuneration policy achieved its stated objectives; and
  f. future areas of focus of the Board/ remuneration committee.

> "Remuneration levels may take into account relevant benchmarks and market conditions but these criteria should not be used exclusively to justify levels of remuneration or plan design. Too much reliance on relative peer analysis leads to unjustified escalation in executive pay. Each plan should be tailored to the unique circumstances of the company as well as the responsibilities of the position(s) in question and the experience and expertise of the individual."
>
> **ICGN Guidance on Executive Remuneration, 2012**

- The brief overview of the remuneration policy should include:
  a. The remuneration elements and design principles informing the remuneration arrangements for executive management and, at a high level, for other employees.
  b. Details of any obligations in executive employment contracts which could give rise to payments on termination of employment or office.
  c. A description of the framework and performance measures used to assess the achievement of strategic objectives and positive outcomes, including the relative weighting of each performance measure and the period of time over which it is measured.
  d. An illustration of the potential consequences on the total remuneration for executive management, on a single, total figure basis, of applying the remuneration policy under minimum, on-target and maximum performance outcomes.
  e. An explanation of how the policy addresses fair and responsible remuneration for executive management, in the context of overall employee remuneration.
  f. The use and justification of remuneration benchmarks.
  g. The basis for the setting of fees for non-executive directors.
  h. A reference to an electronic link to the full remuneration policy for public access.
- Remuneration implementation disclosure must be aligned to the disclosure requirements set out in the Companies Act and should further include all of the following:
  a. The remuneration of each member of executive management, including providing in separate tables:
     i. a single, total figure of remuneration, received and receivable for the reporting period, and all the remuneration elements that the total comprises, each disclosed at fair value; and
     ii. details of all awards made under variable remuneration incentive schemes in the current and prior years that have not yet vested, including: the number of awards, the values at date of grant, their award, vesting and expiry dates (where applicable) and their fair value at the end of the reporting period; and
     iii. the cash value of all awards made under variable remuneration incentive schemes that were settled during the year.
  b. An account of the performance measures used and the relative weighting of each as a result of which awards under variable remuneration incentive schemes have been made, including: the targets set for the performance measures and the corresponding value of the award opportunity; and for each performance measure, how the organisation and executive managers, individually, performed against the set targets.
  c. Separate disclosure of, and reasons for, any payments made on termination of employment or office.
  d. A statement by the Board regarding compliance with, and any deviations from, the remuneration policy.

Employee – CEO Pay ratio

The Securities and Exchange Commission (SEC) in the USA recently issued a final rule on pay ratio disclosure*.

In terms of the rule the annual disclosure must include the ratio of:

- the median of the annual total compensation of all its employees (excluding the CEO) and
- the annual total compensation of its CEO

In order to meet the above disclosure requirements, it is crucial that the Board has an intimate understanding of how value creation, performance and reward are linked in the business. It is evident that whereas King III and the Companies Act ask the "what" in respect of remuneration disclosure, King IV goes beyond the numbers and also examines the "why" – in other words, the disclosure should not only include the numbers, but also a clear justification for the amounts awarded. This substantial enhancement in disclosure closely aligns to international trends where transparency is at the forefront of the governance agenda. Indeed, such disclosures strengthen the disclosure principle in King IV of enabling stakeholders to make an informed assessment of the performance of the company and its ability to create value in a sustainable manner. Furthermore, the remuneration disclosure requirements are intended to achieve a disclosure benchmark to facilitate the performance of a comparative analysis of remuneration by companies.

[3] For further information on the Companies Act requirements, refer to our FAQ guide on the disclosure of directors' remuneration

* Registrants must adopt the final rule for their first fiscal year beginning on or after January 1, 2017.

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QUESTIONS FOR *directors to ask*

- Does the strategy of the company identify the core purpose of the company and set its longer-term direction?
- Is the strategy expressed in terms of performance that creates value in a sustainable manner within the economic, social and environmental context in which the company operates?
- Do the key performance indicators against which the performance of directors and prescribed officers is measured take into account the contribution by the respective individual to value created across the economic, social and environmental context in which the company operates?
- Is the remuneration payable to directors and prescribed officers linked to the aforementioned key performance indicators, and can the Board illustrate and explain the link?
- Has the Board overseen that the social and ethics committee has considered the socially responsible component of the remuneration policy?
- Does the Board engage with shareholders regarding the remuneration policy and implementation prior to the non-binding advisory vote?

Good Governance in Action

"Remuneration levels may take into account relevant benchmarks and market conditions but these criteria should not be used exclusively to justify levels of remuneration or plan design. Too much reliance on relative peer analysis leads to unjustified escalation in executive pay. Each plan should be tailored to the unique circumstances of the company as well as the responsibilities of the position(s) in question and the experience and expertise of the individual."

Tidjane Thiam, CEO of Credit Suisse who asked the board of the Swiss bank to cut his pay after a year in which the bank posted its first loss since 2008.[4]

[4] The Guardian, Credit Suisse chief asks for 'significant reduction' to annual bonus, Jill Treanor, 8 February 2016 http://www.theguardian.com/business/2016/feb/08/credit-suisse-chief-asks-for-significant-reduction-to-annual-bonus

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Conclusion

King IV's bold move to go beyond the numbers and interrogate the underlying basis for remuneration aligns South Africa with international trends where accountability and transparency are at the forefront of the corporate governance agenda.

King IV successfully links the principles of responsible and ethical leadership with greater accountability and transparency with respect to executive remuneration. These recommendations builds on the disclosure requirements implemented through the Companies Act, but takes it a step further in that it proposes that Boards identify and illustrate a clear link between the performance of the company and each executive and the remuneration received by each director.

In light of the varying socio-economic landscape and high levels of income inequality in the country, executive remuneration remains under scrutiny. As such, Boards should strive for greater accountability and transparency in order to explain executive remuneration, not only in light of the performance of the company and its directors, but also in light of over-all employee remuneration. Stakeholder engagement in the corporate arena remains critical for the harmonious and productive functioning of business and society.

In order to create sustainable organisations and, in turn, sustainable opportunities for all, Boards should remunerate top talent in a manner that retain their interest in our country and our economy. The talent shortage in combination with the socio-economic landscape of South Africa should carefully be considered when fair executive remuneration is determined.

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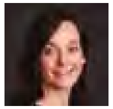

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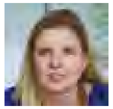

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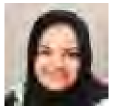

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