

Human Resource Services



# Non-Executive Directors

Best Practices and Fees Report – South Africa

Spring 2008 Edition

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# From the Editor

In our last publication we highlighted the fact that many companies were looking – or should have been looking – far more closely at their executive compensation models, and in particular at their short and long-term incentive plans. Some hard questions were being asked. Have some of the executives been paid too much? Has anything gone wrong with our reward practices?

We emphasised that shareholders were increasingly adding their voice to the calls for reform and no doubt major changes in this area were imminent. This was particularly true in the financial services industry, where incentives were often above the median of the market.

Since then we have seen the financial services industry descend into turmoil and the resultant negative impact on global markets.

In the wake of the credit crisis, searching questions are once again being asked about whether compensation systems played a part in creating or fuelling the current situation.

The politicians are interested: Prime Minister Gordon Brown is quoted as saying: *“I think there’s an element of the bonus system that is unacceptable. When you get bonuses and salaries based on short-term deals that bears no relationship to long-term performance then you have to look again at what the system is doing”*; John McCain, Republican presidential candidate, is quoted as saying: *“The senior leaders of any firm that is bailed out should not be making more than the highest paid government official”*; Democratic

presidential candidate, Barack Obama, is quoted as saying: *“I tried to introduce legislation more than a year ago to give shareholders an advisory vote on determining the pay for corporate CEOs”*.

The world is becoming increasingly angry. However, whilst we believe reward was not the cause of the credit crunch, it did add fuel to the fire. Consequently, change is now inevitable. Understandably, most companies would not want change forced on to them through regulation. The regulators will take a stance on this issue, so companies will need to be ready. In order to achieve this change and have a system that works, it is imperative that a collaborative approach between regulators and industry should be adopted.

Economies are truly in meltdown.



**Gerald Seegers**  
**Director**  
**Human Resource Services**

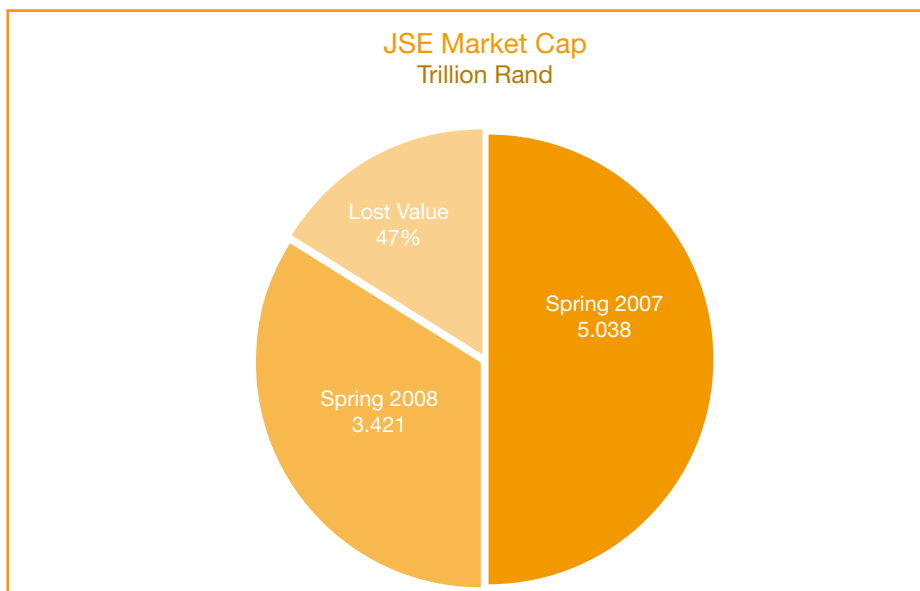
The President of the United States earns \$400,000 a year.



# Preamble

The downturn will touch every corner of the globe to a greater or lesser extent, and South Africa is no exception. As markets tumble and the value of companies (as perceived by stakeholders) heads south and eventually settles between where the slide started and where it steadies itself – with huge interventions by governments – anticipation holds the door ajar as the world trades stocks, bonds and other derivatives in a twenty-four hour trading frenzy. Each new day holds unpleasant surprises as the malignancy grows.

Everything is based on confidence levels badly wounded by the US housing crisis, which is at the root of this mess; destroying the widely-held perception that banks and insurance companies are in good shape. Now the king is in the altogether admitting that he has too much debt. They are right, yet if they all try to do the right thing and fix the problem by deleveraging, the crisis is simply worsened, since they are all trying to sell financial assets where the market glut is driving the values down. At the end of the day, their financial ratios are no better, and by selling more assets the vicious cycle repeats itself.



The US Congress recently passed massive bailout legislation allowing the Treasury to spend \$700 billion buying bad assets from struggling financial institutions. The US as a debtor nation owes the rest of the world, on balance, \$8 trillion dollars.

Things haven't changed much since Ronald Reagan addressed the US National Association of Realtors on March 28, 1982, saying: "...we don't have a trillion-dollar debt because we haven't taxed enough; we have a trillion-dollar debt because we spend too much..."

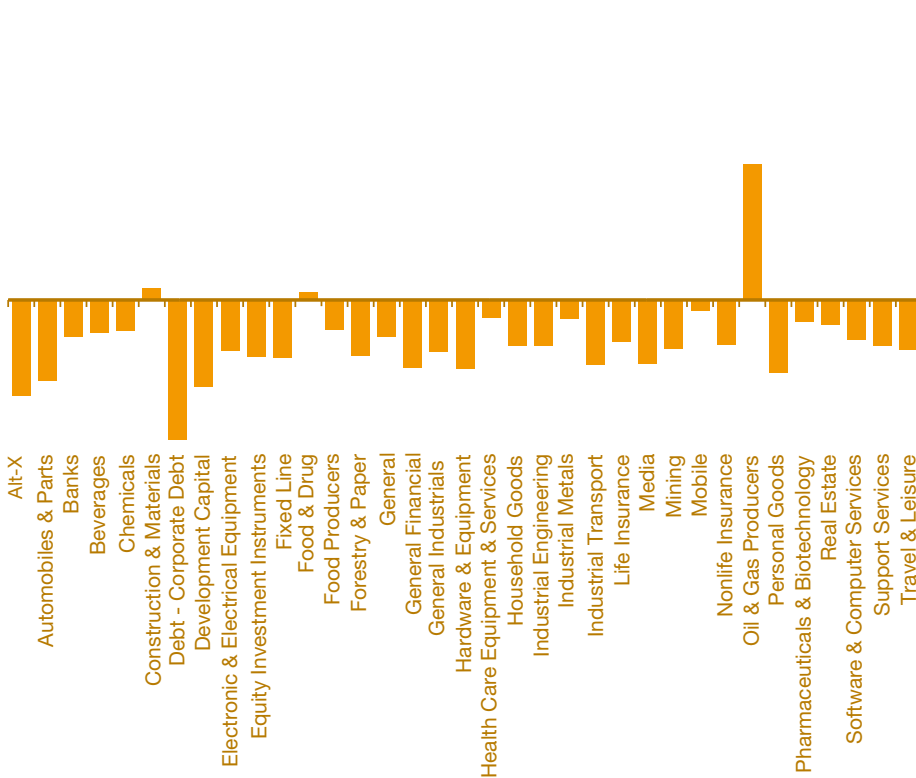
Today, the only difference is the number.

The widespread panic due to loss of confidence is based on real dollars this time around, not psychology. The psychological potion was the perceived injection of \$700 billion to save a multi-trillion dollar problem – probably the most expensive psychotherapy fee ever paid. The end is not in sight; there are many skeletons in the cupboard – such as Credit Default Swaps (US\$55 trillion), CDOs<sup>1</sup>, MBSs<sup>2</sup> and other exotic securities – which have not surfaced and nobody actually knows how these complex historical “hide your risk” scenarios will play out.

In our own backyard, the pain on the Johannesburg Securities Exchange was intense and the JSE total market capitalisation fell like a rock, and kept bouncing on the bottom like a drowning man gasping for air. We all know the picture graphically illustrated alongside, which views the absolute percentage movement in the market capitalisation between spring of 2007 and now:

As Napoleon Bonaparte<sup>3</sup> once said: “there are only two levers to set a man in motion, fear and self interest.” We trust that both these levers will be activated at the same time to save the market. Only time will be our teacher.

Market Cap Movement Spring 2007 – 2008



<sup>1</sup> Collateralised debt obligations offer exposure to esoteric asset classes such as high yield corporate and leveraged loans.  
<sup>2</sup> Mortgage-Backed Security - security backed by a pool of mortgages, such as those issued by Ginnie Mae, Fanny Mae and Freddie Mac, also called mortgage-backed certificates.  
<sup>3</sup> French General and Emperor; 1769 -1821.



# Corporate governance and regulatory environment

South African business is poised for a round of new regulatory requirements in disparate areas, and this section will deal with effective changes made and comments on changes in line of sight before the next publication.

## New JSE listing requirements

The JSE has published new listing requirements, and these are briefly dealt with here, and also at the end of this report under Audit Committees.

## Amendment to Schedule 14 JSE listing requirements

New updated JSE listing requirements were adopted effective 15 October 2008. Schedule 14 dealing with the requirements for share incentive schemes has been amended in its entirety, and the main changes include the following:

- Clause 14.1 – The adoption of, and any amendments to, share schemes must be approved by a 75% majority as opposed to the current 50% (will remain as an ordinary resolution). Furthermore, any shares held by existing participants may not participate in the vote should any changes be made to an existing scheme.

- Clause 14.1(b) – The limit imposed by the JSE on the number of shares that may be issued through a share scheme is removed but a scheme will still be required to fix the number of shares that it utilises. This number may be increased with shareholder approval.
- Clause 14.1(f) – All schemes must show the basis upon which awards are made and any changes to the basis require shareholder approval.
- Clauses 14.12 and 14.13 – Rolling over (recycling) and back-dating of options are prohibited.

## New JSE requirements for listed companies operating share incentive plans

The recent changes to Schedule 14 of the JSE Listing Requirements, governing the operation of share incentive plans, make it clear that the interests of shareholders of listed companies are taken to heart. Although executive remuneration is under the spotlight in South Africa, our counterparts in the UK remain subject to a greater degree of scrutiny when implementing new share plans.

... Changes to Schedule 14 of the JSE Listing Requirements – effective 15 October, 2008 ...

These changes are effective for all listed companies that implement new share incentive plans after 15 October 2008. Companies that have plans adopted before this date will have until 1 January 2011 to amend their plans in accordance with the new provisions. Grants that have already been made under existing plans adopted before 15 October 2008 will remain unaffected by the changes. The new provisions are, however, silent on the transitional requirements in those cases where a company with an existing plan uses that plan to make new grants after the effective date. One would expect such new grants to be subject to the new provisions. PwC has approached the JSE to provide further guidance in this regard.

The provisions are not applicable to phantom plans and it therefore seems that companies that operate these can still implement plans that are not subject to shareholder approval and the subsequent greater public scrutiny. Although phantom plans do not have a dilutive impact on shareholders, there is still a major cash impact as well as an impact on earnings as a result of the greater accounting charge. Although a number of JSE-listed companies that implement phantom plans voluntarily comply with the JSE listing requirements, one would have expected that the JSE would have viewed phantom plans in a similar light as equity-settled share plans.

A summary of the major changes follows.

Any new share incentive plan must be approved by 75% of the shareholders by way of an ordinary resolution, while the pre-October 2008 requirements only called for a 50% vote in favour of the plan. However, if the major or controlling shareholders are also participants under the plan, their votes are excluded and 75% of the remaining shareholders must vote in favour of the plan.

A major change revolves around the dilutive impact of share plans. The new requirements provide that shareholders must approve a fixed number of shares that can be utilised for the purpose of the plan. A fixed percentage over a period of time (e.g. 10% over a ten-year period) is no longer allowed. The 20% dilution limit referred to in the previous provisions has also been scrapped. This implies that as long as a company has permission from its shareholders to grant a certain number of shares, there is no limit on the number of shares that can be utilised. New shareholder approval must be sought as soon as this limit has been reached.

The dilution limit approved can, however, be adjusted where shares originally allocated to participants do not vest as a result of forfeiture, for instance. Shares that are delivered can, however, not be excluded from the limit. It seems as if shares purchased in the market will, as in the past, not count towards the dilution limit.

## ... Remuneration Committees – greater responsibility ...

In the event of a sub-division or consolidation of shares or the adjustment of the number of shares and the subsequent adjustment to the number of awards under the plan, such adjustment must give the participant the same rights as he previously had. Remuneration Committees should also use best endeavours to provide meaningful disclosure that quantifies the aggregate payments arising on a change of control. This requirement implies that shareholders expect that the underlying financial performance of a company that is subject to a change of control should be a key determinant of what share-based awards, if any, should vest for participants.

Companies should therefore satisfy themselves that the performance criterion genuinely reflects a robust measure of underlying financial achievement over any shorter time period. This furthermore implies that where share incentive awards vest early as a consequence of a change of control, awards should vest on a time pro-rata basis i.e. taking into account the vesting period that has elapsed at the time of change of control. This requirement is in line with standards in the UK for example.

Unless the plan explicitly provides for the purchase of shares in the market, no such purchases will be permitted. A number of companies have adopted this settlement method as an alternative to ensure that the cash cost is carried by the relevant operating entity in the group. It would therefore be important to ensure that approval from shareholders is specifically sought where shares will be purchased

in the market to settle benefits under the scheme. In the UK, the Association of British Assurers (ABI) acts as the watchdog of executive remuneration and the ABI Guidelines go even further to provide that there should be prudent and appropriate arrangements governing acquisition of shares, and financing thereof, to meet contingent obligations under share-based incentive plans.

The requirement of disclosure of share-based payments in a company's annual financial statement remains unchanged. However, the disclosure by South African companies is still a far cry from global standards and what shareholders would expect to be informed about. For example, in the UK the ABI expects companies to use a comprehensive approach to the valuation and reporting of the valuation of share-based payments. The following information should be disclosed in order that shareholders can make a judgment about total cost:

- The potential value of awards due to individual participants on full vesting. This should be expressed by reference to the face value of shares or shares under option at point of grant, and expressed as a multiple of base salary.
- The expected value of the award at the outset, bearing in mind the probability of achieving the stipulated performance criteria.
- The maximum dilution that could arise through the issue of shares to satisfy entitlements.

## Line of sight – King III update

In 1994, a Committee headed by Judge M. King issued what became known as the King Report (King I) on Corporate Governance. The aim of this report was to bring together, into one document, a code of corporate practice and conduct encompassing peripheral impact beyond financial matters and reaching out to the broader community. Building on this foundation, in 2002 the King Committee, now firmly entrenched in influence extended its reach and published King II. Although not

written into law, this became the roadmap for corporate governance, giving unambiguous direction as to how directors should run their business enshrined the main principles in King II, covering discipline, independence, accountability, transparency and, last but not least, social responsibility.

So today we await with keen anticipation for the expected release of King III in January 2009.



# Tax update

... The taxpayer:  
That's someone  
who works for the  
federal government,  
but doesn't have to  
take a civil service  
examination.

*Ronald Reagan*

Some interesting information has been received from our global offices regarding trends concerning taxation.

## Hong Kong – sign-on bonus

In a recent Board of Review case, it had to rule on whether employment income paid to an employee with a minimum service period and that had been assessed to tax in the year of receipt, should be excluded from taxable income. In this case, the excludable portion under review was the amount the employee had subsequently repaid the employer because of resignation during the minimum service period.

The background facts were briefly that the employee had been paid a sign-on-bonus and a settling-in allowance in February 2005, the first month of his employment on the terms that if he resigned within twelve months from the commencement of his employment, he would be required to repay the employer a pro-rata portion of both the bonus and the allowance.

The employee subsequently resigned in June 2005 and terminated his employment in September 2005.

The employer reported the full bonus and allowance on the 2004/05 Employer's Return, which

was submitted to the Hong Kong Inland Revenue in May 2005. In December 2005, the employer filed a revised Employer's Return reflecting the revised bonus and allowance after the employee's repayment. The Inland Revenue accepted the revised return.

The employee reported the full amount of his bonus and allowance in his 2004/05 Individual Tax Return. After receiving the revised Employer's Return he requested the Inland Revenue to revise his 2004/05 assessment, which they rejected.

The issue is whether the whole amount of the sign-on bonus and settling-in allowance should be treated as employee's income for the year of assessment 2004/05 (1 April 2004 to 31 March 2005) having considered the partial repayment made by the employee.

Generally speaking, in Hong Kong an individual will be taxable on income arising in or derived from any office or employment. With regard to timing of the taxation, it is provided that the assessable income of any person shall be the aggregate amount of income accruing to him from all sources in that year of assessment and that income accrues to a person when he becomes entitled to claim payment thereof.

All outgoings and expenses (other than expenses of a domestic or private nature and capital expenditure), which are wholly, exclusively or necessarily incurred in the production of assessable income are deductible from such assessable income.

The Inland Revenue's argument focused on whether the amount repaid by the employee was a deductible expense under their tax law. They argued that the amount repaid by the employee represented the price which he had to pay for not having fulfilled his obligation to serve twelve months and was not deductible for tax purposes.

While the Board disagreed with the Inland Revenue's argument, it had found that the refund made by the employee is not deductible, as it

was not incurred wholly, exclusively and necessarily in the production of assessable income and was of a capital rather than recurrent nature. The Board went further to review whether the employee had received, in reality, the full amount or only the pro-rated portion of the bonus and allowance.

The Board concluded that the employment contract should be construed to read that the employee was only entitled to receive the full amount of the sign-on bonus and settling-in allowance contingent on having served the full twelve months of service. As such, the employee was not entitled to the full amount of the bonus and the allowance, but was only entitled to the prorated portion and should be assessed on that prorated portion accordingly.



# Equity compensation – international tax update

## Denmark<sup>4</sup>

Danish tax practice has, until recently, taken the position that with regard to Restricted Shares and Restricted Stock Units, the taxation thereof occurred at the date of grant if the only vesting condition for release of the units was continued employment.

This arose from the fact that under Danish employment law, granted Restricted Stock Units cannot be taken away from a participant if he/she is dismissed by the employer, regardless of the vesting conditions of the plan. Only if the participant terminates employment himself/herself, could non-vested units be forfeited. For this reason, the tax authorities argued that the participant had gained a final right to the units at grant date and should accordingly be taxable at that point in time.

The Danish Tax Assessment Board has recently changed this position by stating that the taxable event of Restricted Stock Units is at the time when they vest, even though the only vesting condition was that the participant had to be employed at the point in time of vesting.

As the taxation of Restricted Stock Units is not regulated by special legislation but instead by the issue of rulings, the new rulings stipulate that taxation is

deferred until vesting. In these specific rulings, the vesting period was more than three years. If the vesting period is shorter than three years, it is possible that the Tax Assessment Board could reach another conclusion. It is our view that the vesting should not make any difference in this respect, but Danish clients with plans with shorter vesting periods are advised to obtain rulings in this regard.

## Italy

On 20 June 2008, the Italian tax press published a draft of the Law Decree, which if approved, will mean that the current tax favourable treatment for stock options will be abolished.

Under the current rules, the “spread” (the difference between the ‘normal value’<sup>5</sup> and the purchase price paid by the employee) realised upon exercise of stock option meeting certain requirements may be exempt from ordinary income if certain conditions are met. These conditions are as follows:

- The exercise price must be equal to or higher than the ‘normal value’ of shares at the date of grant;

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<sup>5</sup> ‘Normal value’ is defined as the average closing price of the shares during the one month leading up to and including the relevant date (e.g. date the stock option is exercised).

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<sup>4</sup> PwC circular issued to its clients on 8 September 2008

- The number of shares assigned to each employee must not exceed 10% of the voting rights in the ordinary shareholders' meeting or 10% of the capital or equity of the offering company;
- The options are not tradable;
- The shares must be issued by the employer or by an employer-related company;
- The options must not be exercised for three years from the grant date;
- Share underlying options shall be of a listed company, at exercise date;
- The employee must hold, for at least five years from the stock option exercise date, an investment in the shares acquired through the option exercise having a value not lower than the difference between the value of the shares at the time of exercise and the amount paid by the employee (holding period); and
- During the five-year holding period, the shares cannot be sold, pledged or otherwise used as a guarantee.

If all the above conditions are met, taxation is deferred until sale and the income is taxed at a flat rate.

The draft Law Decree provides that, upon exercise, the spread will be treated as ordinary income, regardless of whether the aforementioned conditions are satisfied. The income will be taxed to income tax, at the employee's marginal rate and social taxes.

Options granted before 5 July 2006, which currently qualify for special treatment, will be fully taxable at exercise<sup>6</sup>.

### South Africa

For broad-based employee share plans, the threshold participation is reduced to 80% of total employees (down from 90%), the maximum share allocation increased to R50,000 over five years (up from R9,000 over three years) and the maximum employer deduction increased to R10,000 per annum (up from R3,000).

For other employee share schemes, so-called 'phantom' schemes are brought into the section 8C rules since the definition of 'equity instruments' is extended to include contractual arrangements linked to equity. Furthermore, the threat of potential financial penalties could also rank as a restriction i.e. may prevent vesting.

The difference between death and taxes is death doesn't get worse every time Congress meets.

*Will Rogers*

<sup>6</sup> Options granted between 1 January 1998 and 15 January 2000, remain exempt from taxation upon exercise if newly issued shares were used.



# Financial and non-financial measures in incentive plans<sup>7</sup>

## Non-financial measures

There is little doubt that incorporating non-financial measures into bonus plans can deliver benefits, including:

- improved understanding of the business strategy and the organisation's areas of focus;
- increased relevance of bonus measures to individual's actions, enhancing motivation;
- greater focus on the longer-term strategic building blocks of success and reduced obsession with current-year budgets; and
- a change in culture and renewed understanding of what is important to the company.

However, as always with reward, it can seem easier to get it wrong than right and the use of non-financial measures is no exception. Risks to be managed include:

- a loss of clarity and focus in objective-setting through the use of too many targets;
- budget discussions and gaming can simply be multiplied across the non-financial as well as financial measures;

- a lack of historic patterns of performance on some of these newer measures can make forecasting and target-setting difficult;
- the effects of uncontrollable factors on performance are tough to predict; and
- the law of unintended consequences can mean that non-financial targets are somehow met, but through dysfunctional and unanticipated routes.

Based on our experience, the following steps can help to maximise the benefits and minimise the risks of changing the annual bonus plan:

- Don't just rely on the bonus plan: a considerable body of research shows that the effectiveness of incentive plans is highly dependent on related areas such as the quality of performance management, reporting and communications.
- Only use measures where you have a reliable track record: when introducing totally new measures, use them for performance reporting and management purposes until they are reliable and understood and only then link bonus payments to them.

<sup>7</sup> Extracted from PwC's third edition of "Executive Compensation", FTSE 100, Review of the year 2007.

- Retain some discretion to provide protection against the law of unintended consequences.
- Invest in training and communications about the new incentive approach on an on-going basis with regular reporting and discussion regarding non-financial measures, what affects them and how they can be improved.
- Start simply: begin by using the most obvious and reliable measures, for example customer satisfaction and use them with a low weighting, initially alongside traditional financial measures, increasing the weighting over time as confidence in the measures builds.

It is now widely accepted that ignoring non-financial measures in business is like driving looking backwards. A consensus seems to be emerging that such measures should also be used in bonus plans.

It is an old truism in management that what gets measured gets done, and in our experience, what gets rewarded gets done even more quickly. With the shift to reflect a broader stakeholder and corporate social responsibility agenda in corporate boardrooms, it is to be expected that bonus plans are reflecting performance goals and achievements in these non-financial domains. But is it desirable?

The answer is yes, but with qualifications. A bonus plan by itself will never achieve the desired result. But, if aligned with other initiatives in reporting, communication and performance management, it can be a powerful agent for change.

Two hundred years ago, Scottish mill owner Robert Owen proclaimed that ‘philanthropy goes hand in hand with economic advantage’. Today, even more than in Robert Owen’s time, it seems good companies really are just that: good to their shareholders, customers, employees and community. Whether this is real philanthropy or simply enlightened self-interest is of academic interest – we need more good companies, and good companies need good bonus plans.

### Financial measures

One of the easiest ways of kicking off the conversation at a dinner for executive or non-executive directors is to ask what they think about TSR as a performance measure. This issue seems to create a lot of heat. The major consultancies have picked up on this. Several have published studies over the last year or so identifying a particular flaw in this particular measurement approach.

Our own research last year showed that relative TSR (at least as commonly used in the UK) is surprisingly bad at aligning reward with performance over long periods, as it rewards volatility rather than sustained, above-average performance.

The other weaknesses of TSR are well known, including:

- difficulties with selecting an appropriate peer group;
- the influence that apparently random events such as takeovers have on vesting; and
- sensitivity to precise grant date and average period.

These issues all add up, in executive's minds, to a measure whose outcomes have very little connection to their performance, leading to frustration and demotivation.

The result has been a significant move away from relative TSR as the sole measure on long-term incentive plans.

Although TSR remains the single most common measure on performance share plans, it is now most commonly used in conjunction with another measure, such as earnings per share. It is felt that this improves the balance in long-term incentive plans by providing a portion of the award based on measures that are within management's control. Some companies have gone further, moving away from TSR altogether in their long-term incentive plans.

As with the overflow of any once-proud institution there comes a point where the glee of revolution gives way to sympathy and even regret. We find ourselves approaching that point – is relative TSR really so bad?

After all, at some point, over long enough periods, all debates about what constitutes value must fall away: surely TSR is ultimately what it is all about. You will not find many private equity investors being delighted at great earnings performance if they cannot exit their investment at a significant return to the purchase price. In our view, the problems with TSR have arisen from two sources:

- Too much has been expected of it; and
- It has been generally poorly implemented as a measure.

To illustrate this point, we analysed the performance of the FTSE 100 over the last ten years, segmenting the companies into four quartiles of performance over the entire ten-year period.

Having done this, we have then tracked where the companies spent their time over intervening rolling three-year periods (the typical performance period over a long-term incentive plan).

A number of features come out of the analysis:

- Companies that are upper quartile over ten years were rarely below median (fewer than one period in five) over intervening three-year periods.
- Companies that are upper quartile over ten years spent the majority of intervening three-year periods also in the upper quartile.
- Companies ending up below median were very rarely in the upper quartile.

So far so good. But the issue arises when we look at companies ending up between median and upper quartile over ten years. This is strong performance, but such companies spent nearly half (43%) of the intervening three-year periods below median. This would have resulted in zero pay-out, even though performance over longer periods was strong. This is at the root of the demotivating impact of TSR measures.

Of course, companies that end up above median spend significantly more time in the upper quartile than their lower performing counterparts. But one of the major drivers of the perceived relevance and motivational impact of a plan is how often at least something is delivered. With these statistics, it is not surprising that relative TSR plans are viewed as demotivating in many companies.

This analysis supports our conclusions from last year. TSR plans with a requirement for at least median performance before vesting occurs will never successfully differentiate companies that are between the second and third quartiles of performance over long periods.

As highlighted last year, one approach would be to allow vesting down to a lower quartile. Extending the range of differentiation would take much of the emotional heat out of the debate and would actually improve the alignment between reward and performance. There are international precedents: vesting below median is not uncommon in plans in the Netherlands, Germany, South Africa and the US.

So does this mean that we should ditch TSR altogether? Not necessarily. Instead, we should recognise that if median performance is imposed as a minimum requirement, then TSR no longer works as a good differentiator of performance across the entire performance range.

However, relative TSR remains excellent at picking out the truly outstanding performers. Relative TSR plans should be focused as 'top-slice' plans, designed to reward upper quartile and upper decile performance with truly outstanding payments. This may mean stretching the vesting scale up beyond the upper quartile (with correspondingly higher maximum rewards) and avoiding large cliffs in payment at median performance. As a result TSR will have a lower expected value, providing just the upside in the package.

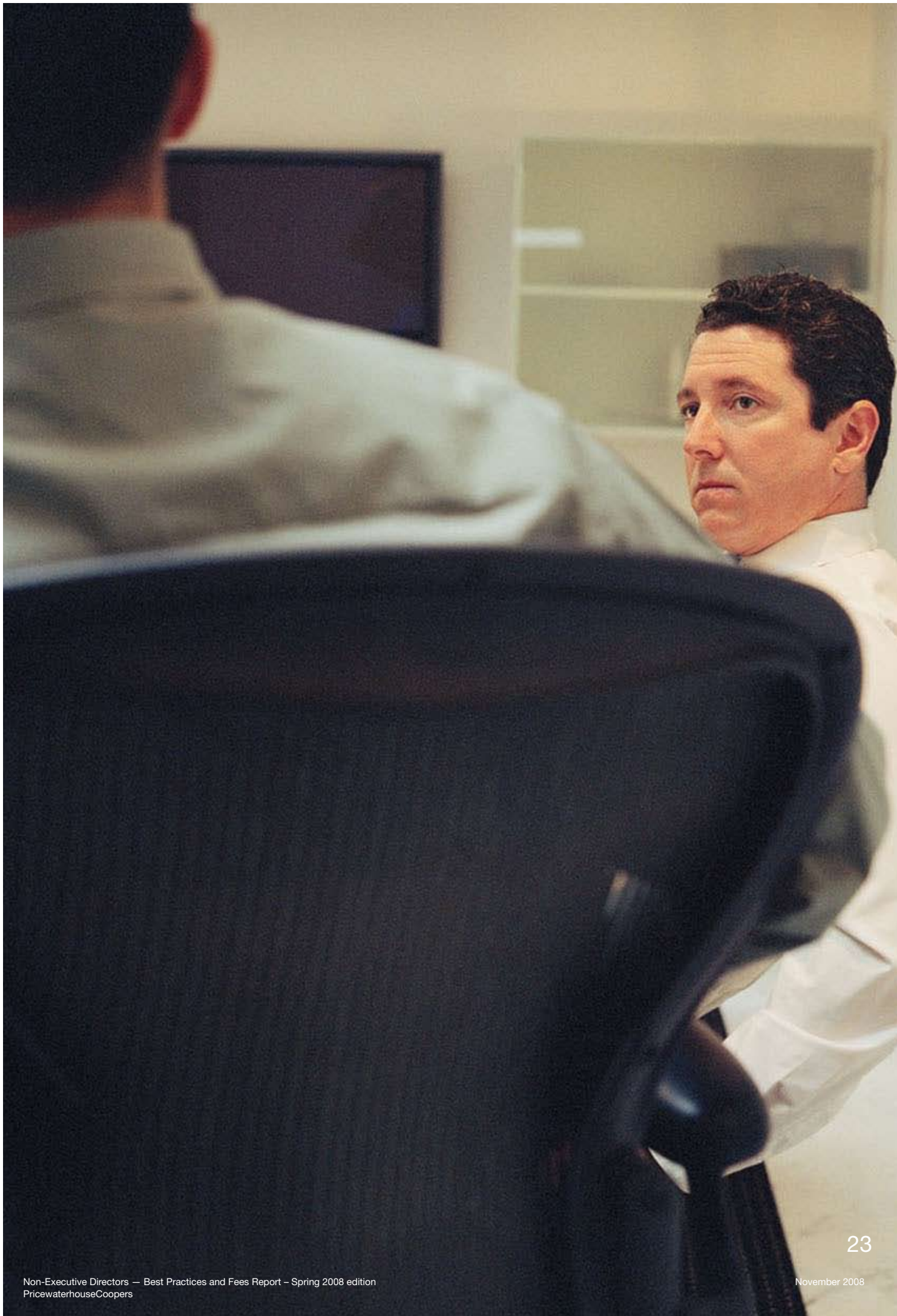
The rest of the package must adjust in response. With no vesting below median, relative TSR is not the way to provide graduated rewards for average to good performance – this must be the role of internal financial measures such as earnings per share, return on capital or cash flow. The trend towards TSR being used in conjunction with another measure is a therefore a good one.



# Non-executive director trends

The primary goal of the Board of Directors is to maximise shareholder value over the long-term. This should be achieved by creating superior value for the corporation's customers, employees, investors, suppliers, and the communities in which the corporation operates, by focusing on the task of perpetuating a successful business environment and by optimising financial returns. The Board is responsible for ensuring that management's processes, policies and decisions further this goal. The Board of Directors speaks for the corporation.

Following the corporate scandals in the early part of this decade, there were calls to fundamentally change the way in which Boards are structured – with some arguing that, drawing from the European model, Boards should be led by an independent Chairperson, instead of a combined Chairperson/CEO. Rather than implement this profound change, stock exchanges adopted a compromise requirement, namely that listed corporations must have a Presiding Director. The separation of the Chief Executive Officer and Chairman of the Board does not necessarily mean that true independent oversight will be improved.



# The Lead Director

The largest corporation in 1994 was the first to adopt the position of an independent Lead Director.

General Motors Corp. instituted the role of Lead Director by proxy in 1994, and is believed to be the first corporation to mandate the practice, which slowly gained adherents. It was generally adopted in 2002 when the New York Stock Exchange required the independent directors of listed companies to meet at least once yearly without management. The practice received an additional boost in 2004 when a commission of the National Association of Corporate Directors recommended that “where the chair and CEO roles are not separated ... there should be a designated leadership role for an independent director to serve as a focal point for the work of all the independent directors, with clarity of role and continuity of who performs that role.”

Numerous external factors led to the establishment of a Lead Director position, which include stock exchange listing requirements and pressure from various stakeholders for clearly mandated separation of the two offices - that of the Chairperson and the CEO. More importantly internal pressures have contributed to the evolution of the position. For example, in the event of a change of control transaction, continuity and smooth functioning of the Board by default dictate that the helm of the company is in good hands, with the ability to steer the

Board until succession is in place. This position will create a backstop for the Chairperson, or any other change or major functional challenge affecting the Board.

The different meanings that lie behind the titles — “Lead Director”, “Presiding Director”, “Non-executive Chairperson” or “Independent Non-executive Chairperson” — and how these titles relate to the responsibilities of the role are merely semantics, but the intention is clear. An independent gatekeeper.

Six years after the creation of the position, the most important contributions of Lead Directors have come not from the duties mandated by stock exchange requirements, but from the responsibilities that Lead Directors in fact have undertaken for their corporations. As some activist shareholders renew their call for the “European model” of Board leadership, it will be interesting to see whether the Lead Director position will continue to evolve as a viable and preferred alternative for corporations and their stakeholders.

Compared to the power wielded by Board Chairpersons, the official tasks assigned to this new position were limited, focused on routine tasks such as convening independent directors for executive

sessions and receiving shareholder communications. Corporations established this position with little fanfare, with most appointing a presiding or Lead Director, and a small number taking the step of appointing a Non-executive Chairperson.

Despite its humble beginnings, the Lead Director role has become increasingly important. Lead Directors are contributing to improved corporate performance in at least four key areas:

- Enhancing the responsibility for improving Board performance;
- Building bridges toward a productive relationship between Non-executive Directors and the Chief Executive Officer (CEO);
- Support effective communications with shareholders in a regulated manner; and
- Bolstering leadership in crisis situations.

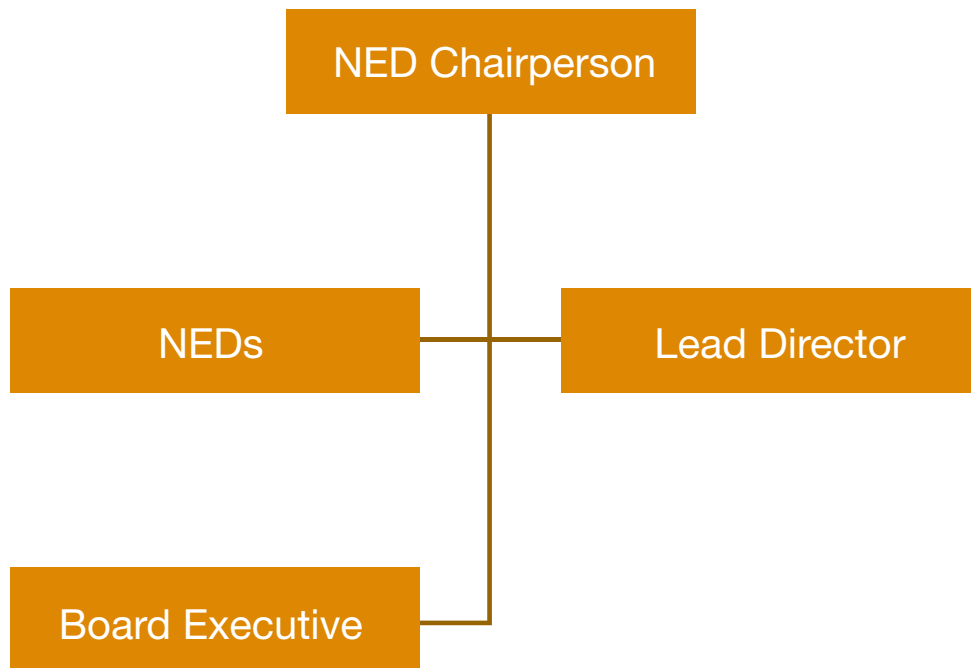
Internationally there is concern that these areas where Lead Directors are making the most valuable contributions are not among those officially mandated for the role.

While Boards must have an independent nominating and corporate governance committee accountable for certain aspects of Board and committee operations, increasingly Lead Directors are taking responsibility for monitoring and improving Board performance. For example, Lead Directors are increasingly active in facilitating Board discussions, helping directors reach consensus, and formulating “next steps” to be

taken on important matters. Lead Directors often keep the Board’s discussion at the right altitude and attitude – ensuring effective engagement on corporate issues, without meddling in management’s day-to-day decision-making. This engagement is particularly valuable in shaping the corporation’s strategy.

Many Lead Directors are now also handling a task that has always been difficult for the Chairperson-CEO: dealing with difficult or underperforming directors. Rather than letting these situations fester until annual Board self-evaluations or nominations, Lead Directors can proactively and politically address these situations.

The main criterion is independence.



It is interesting to note that very few South African quoted corporations still have the Chairperson/CEO position combined, in that these roles have been separated. This is in no small measure due to King II and the correct influence of the Johannesburg Securities Exchange.

To summarise global best practice, the following points are pertinent in setting corporate policy for Lead Directors:

- The Lead Director shall be an independent director.
- He/She will ensure that the Board of Directors discharges its responsibilities, evaluates the performance of management objectively, and understands the boundaries between the responsibilities of the Board of Directors and those of management.
- The Lead Director will chair periodic meetings of the independent directors and assume other responsibilities that the independent directors as a whole might designate from time to time.
- The Lead Director should be able to stand sufficiently back from the day-to-day running of the business to ensure that the Board of Directors is in full control of the corporation's affairs and alert to its obligations to the shareholders.
- The Lead Director shall provide input to the Executive Chairperson of the Board on preparation of agendas for Board and committee meetings.
- The Lead Director shall chair the Corporate Governance Committee and shall chair Board meetings when the Chairperson of the Board is not in attendance, subject to the provisions of the by-laws of the corporation.
- The Lead Director shall provide leadership for the independent directors and ensure that the effectiveness of the Board is assessed on a regular basis.
- The Lead Director shall set the agenda for the meetings of the independent directors. The Lead Director shall report to the Board concerning the deliberations of the independent directors as required.
- The Lead Director shall, in conjunction with the Chairperson of the Board, facilitate the effective and transparent interaction of Board members and management;
- The Lead Director shall provide feedback to the Chairperson of the Board and act as a sounding board with respect to strategies, accountability, relationships and other issues.



# Increased Audit Committee responsibilities

From directors and executives to stakeholders and consumers, what happens in the boardroom touches virtually everyone. These are momentous times, and grave responsibilities rest on the shoulders of the gatekeepers at the helm of the diverse organisations listed on the pivot point – The Johannesburg Securities Exchange (JSE).

Since the last publication, the JSE has issued new listing requirements concerning financial directors and auditors of listed entities.

These changes have important implications for many listed entities and their auditors, and NEDs need to keep abreast of developments to ensure that their companies are positioned correctly, since the penalties for non-compliance are onerous.

The JSE has introduced a Register of Auditors, and their advisers. The changes are contained mainly in new paragraphs 3.75(c), and 3.86 to 3.89; new Section 22 and the accompanying Schedule 15. Certain paragraphs and definitions in Sections 1, 4 and 8 have also been amended to accommodate these changes. In addition, every JSE-listed company is required to have a Financial Director.

Most importantly, the competence of the incumbent rests with the Audit Committee. These are major changes, and additional responsibility rests with NEDs to ensure that the directors and their committees are abreast of the requirements that are beyond this brief reminder and cover in detail the aspect of IFRS reporting and the competence rules required.



# Fees

The full survey of NED fees for all sectors on the JSE will be reviewed in the next edition, which marks the second year of the Non-Executive Directors Best Practices and Fees Report. Much additional research is being undertaken with the aim being that the first edition in 2009 will fire the interest of our many readers. We sincerely hope it does.

Suffice to say, the international perspective will figure more boldly so that the flavour of best practice becomes the benchmark, especially now that the global spotlight is beaming strongly on compensation plans and emerging trends.

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