New scrutiny on director compensation

Director pay levels are rising, and shareholders and proxy advisers are taking note. But along with a few modest changes in oversight, basic good governance should be enough to keep excesses in check

By Ken Hugessen with Michelle Tan and Camille Jovanovic

Until recently, director pay attracted little attention from the shareholder community. More recently, however, a few cases in the U.S. of much higher pay have drawn some criticism from shareholders (including several class action lawsuits). In response to these concerns, ISS has developed new policies on director pay for both Canada and the U.S. market.

For the 2017 proxy season, ISS Canada adopted a new policy specific to "problematic director compensation practices." Under this policy, ISS will issue a "withhold" recommendation on any director elections where they identify *"...director compensation practices which pose a risk of compromising a non-employee director's independence or which otherwise appear problematic from the perspective of shareholders."* The problematic practices specifically called out include excessive inducement grants for new directors and performance-based equity grants to non-executive directors, which could pose a risk of aligning directors' interests away from those of shareholders.

For 2018, ISS adopted a policy for the U.S. market which also contemplates issuing "withhold" recommendations for those directors responsible for approving director compensation when *"there is a pattern...of excessive director pay magnitude without a compelling rationale or other mitigating factors."*

While these policies sound far-reaching, ISS explicitly states that they are only intended for "extreme director pay outliers," and they expect minimal impact for most boards. Our conversations with North American institutional shareholders, coupled with their recent track record of strong voting support on director elections and pay, affirm this. Rather than being overly concerned with director compensation levels, shareholders—in line with the new ISS policies—are simply looking to formalize and communicate their willingness to take action if or when significant concerns do arise.

One reason for director compensation's relatively low profile is that modern governance practices already address most institutional shareholders' potential concerns, as these examples illustrate:

- **Boards set their own pay levels.** While there is an inherent conflict for directors setting their own pay, transparent disclosure and shareholders' ability to hold directors accountable through elections provides reasonable checks and balances. Leading practice is to have an independent board committee responsible for reviewing and setting pay.
- **Performance-based pay may limit objective views and candid conversations in the boardroom.** Director compensation programs are predominantly delivered through a mix of cash and deferred share units (DSUs). DSUs vest immediately, and directors are required hold them for the duration of their tenure. Where equity awards are still used, grants are fixed in terms of size and timing to avoid any optics of "self-dealing."
- **Perks and pensions are inappropriate for elected representatives.** Once common, director perks and pensions have all but disappeared.

Beyond these solutions, boards that have not already done so may consider other governance practices, including:

- **Imposing aggregate limits on the dollar value of compensation paid to non-employee directors.** An aggregate dollar-value limit is a practice that was initiated in the U.S. to reduce risk of legal action by shareholders. In Canada, the *Bank Act* requires that these aggregate limits be subject to shareholder approval.
- **Adopting a fixed retainer compensation structure.** A fixed retainer structure (vs. annual retainers plus meeting fees) can make it easier to understand the level of compensation for the directors' workloads while preserving mechanisms to account for increased workloads for committee and board chairs.

While there is no reason to expect director pay to attract the same scrutiny as executive compensation, it is nonetheless receiving more attention than in the past. Boards that are aware of this trend will be in a better position to judge their compensation programs accordingly.

> While its new policies on director pay sound far-reaching, ISS says they are intended for "extreme outliers." Most shareholders are simply looking to show their willingness to take action if or when significant concerns arise.

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