The Role of Directors is Changing. Should Compensation?

A question for boards and their shareholders

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SHAREHOLDERS ARE TAKING a much more active role in overseeing their investments, scrutinizing board oversight more closely. In order to enhance governance, and to ensure independence and diversity of skills, shareholders are encouraging boards to evaluate their members, their composition and their renewal process. At the same time, as the expectations placed on directors grow, shareholders are discouraging directors from joining too many boards.

These recurring themes – the need for board rejuvenation, the need for more diversity among board members, and the growing expectations placed on directors – create new challenges and perhaps unintended consequences regarding director compensation. Going forward, boards will want to assess their needs and use their judgment to determine an appropriate approach to compensation, rather than simply adhering to traditional benchmarking studies. They will also need to communicate the rationale for their decisions effectively to shareholders.

Scrutiny of Board Composition and Renewal

Board composition and the rationale for each director's inclusion on the board are under greater scrutiny. Greater transparency in the board review process has attracted considerable attention, especially when it comes to director term and retirement policies and efforts to create diverse boards and effective board dynamics. As a result, boards increasingly strive for the "right" skills and optimal experience matrix, which typically includes industry knowledge and subject matter expertise to ensure fresh, diverse perspectives.

In order to meet such requirements, boards are being encouraged to draw from a more diverse set of backgrounds, beyond traditional sources of C-suite executives and senior lawyers, bankers and accountants. Recently, boards have been addressing the underrepresentation of women, which we expect will be an area of greater focus this proxy season, given the adoption of diversity and tenure disclosure requirements by the Canadian Securities Administrators.

Growing Demands Placed on Directors

At the same time as board member selection is under the microscope, directors of public companies are taking on an expanded role, including greater involvement in CEO succession; oversight of strategy development and implementation; assessment of management's performance and compensation, and disclosure and engagement with shareholders. The non-executive board chair and committee chair roles are most affected by these heightened expectations, which are substantially greater than those for a director-at-large.

Ultimately, the increase in the workload and expectations for directors has caused shareholders and their advisors to suggest limitations on the number of public company boards on which a director may serve at one time to avoid "overboarding." In fact, some directors themselves are choosing to limit the number of public company board roles they assume.

"Serving on four public company boards has become close to a full-time role," director Sarah Raiss recently noted.

Implications on Director Pay and Related Governance

In a new paradigm of a more diverse, harder working board with limitations on the number of directorships one can serve, there may well be a feeling that compensation should be increased. Boards dominated by financially successful businessmen often felt pay was relatively unimportant – these individuals joined boards to "stay in the game", remain part of the business community, as a means of "giving back" and for related social and prestige considerations.

So far, pay changes have been constrained by widespread concern. Some high-profile shareholders feel director pay should be modest and

any director worth their salt neither needs nor wants significant compensation. But there is a wide variety of perspectives on director pay. At the 2013 ICD National Conference, Mark Wiseman, president and CEO of the CPP Investment Board, told delegates: "You [directors] need to be paid more. If we expect directors to work more days and be more engaged with their companies, we need to increase compensation levels to reflect the increased workload."

Furthermore, certain parts of the director compensation system may be seen as burdensome, particularly for those directors without substantial income from other sources. For example, share ownership guidelines are easily attainable for the wealthy, but burdensome for those with more modest income and balance sheets. Similarly, the portion of total compensation paid to directors in the form of equity (the majority of which is in deferred share units), limits cash flow and may therefore prove onerous to some.

Advice for Directors

In light of all this, what are boards to do? We recommend that directors begin with an assessment of the board's role and of the demands being made of individual directors, both members-at-large and board and committee chairs. The entire board should be involved with this assessment. From there, we recommend:

- Deciding how important compensation is, or should be, to attract the diverse directors the board may need in the future. Director pay, for example, may be an important attraction tool for a small or troubled issuer, while large, well-recognized organizations routinely attract accomplished, high-profile directors for little to no pay at all.
- Review pay levels and practices beyond the company's executive pay peer group. The director screen will typically be much broader than the typical executive search screen.
- Anticipate that pay in stock and share ownership guidelines may be seen as an impediment to some high-potential directors with relatively modest incomes. It may be important to consider some flexibility in how these guidelines apply.During this process, boards should seek input from the shareholder community. In the new era of shareholder engagement, and given that the setting of director pay places board members in an unavoidable potential conflict, seeking input from the shareholders who ultimately foot the bill just makes sense. Most importantly, regardless of the decision made, it is important to "tell your story" clearly. This is particularly important where the board concludes that the role has expanded and directors should receive more pay. Increases in director compensation will be more easily accepted by shareholders if accompanied by: clear disclosure on how the roles have expanded, details of the director compensation review process, and a description of the board's process for managing "overboarding" and long tenures.

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