20 Questions

Directors Should Ask about Director Compensation

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The Canadian Institute of Chartered Accountants

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Preface

The Risk Management and Governance Board of the Canadian Institute of Chartered Accountants (CICA) has developed this briefing to help members of boards fulfill their responsibility for the oversight of compensation plans for non-executive (outside) directors of publicly-traded companies. It is intended primarily to help individual directors and those who support the board but boards may also wish to use it for orientation and discussion.

Compensation for stakeholder directors and directors of other types of organizations (e.g., crown corporations, unit trusts) is not specifically addressed in this publication. However, directors of these organizations may also find this to be a useful reference document.

The oversight role of a director includes asking tough questions to assure themselves that director compensation plans both enforce the important stewardship role of directors and fairly compensate them for their time and effort. This briefing provides suggested questions for boards to ask the CEO, senior management, professional advisors — and itself. For each question there is a brief explanatory background and some recommended practices. We hope that directors and CEOs will find it useful in assessing their present approach to the governance of director compensation and enhancing it where appropriate.

This publication is one of CICA's "20 Questions" series for directors. The text includes a list of the other titles.

The Board acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice, Elizabeth Greville and David Crawford the authors, and the CICA staff who provided support to the project.

Frank Barr, FCA
Chair, Risk Management and Governance Board

Director compensation is rapidly evolving in response to the corporate governance environment. In particular:

- Focus on Board independence is causing changes in governance structures (separation of roles of Board Chair/CEO, appointment of lead directors, committees comprised exclusively of independent directors, etc.), requiring traditional Board pay structures and levels to be revisited.
- Committee chair retainers, in particular for audit committees, have risen significantly, a trend that is expected to continue.
- Scrutiny and criticism of director stock options is leading Boards to substitute other forms of compensation and formalize share ownership requirements.
- Boards are being pressured to improve the extent and quality of disclosure of director compensation.

Consequently, directors face an ongoing challenge in setting pay that is commensurate with their skills and time commitment, aligned with the interests of shareholders, and reflective of their important stewardship role.

Background/Context

The Deteriorating Director Value Proposition

There are a range of benefits and costs associated with being a director of a Canadian public company. Table 1 provides a list of the traditional benefits and costs*. The table suggests that the value of some of the benefits have declined (↓). The focus is on the **change** in value/cost rather than the actual value/cost.

TABLE 1

Traditional Benefits	Value Shift Now versus Before	Costs	Cost Shift Now versus Before
Contacts (importance)	↓	Risks	
Business Development	↓	— Reputational	↑
Prestige/Affiliation	↓	— Legal	↑
Learning/Experience	= or ↓	Time and Effort	↑
Self-fulfillment	=	Expertise and Experience	=
Indirect Rewards (1)	?	— Additional Time/Effort	↑
Financial Rewards (2)	?	Required Investment (3)	↑

(1) Example: develop relationships for fundraising
(2) Cash, stock, options, perquisites, company discounts
(3) Requirement of board members to invest or allocate pay towards share ownership

The value of contacts and business development derived from Board membership has declined given the importance of independence (and need to avoid conflicts of interest). All directors have been somewhat tainted by the negative press relating to a number of corporate scandals — arguably negatively impacting the prestige associated with being a Director.

* A report entitled "Corporate Governance: A Human Capital Perspective", based on research by Sibson Consulting and cosponsored by Spencer Stuart, provides valuable insights in this area.

The time and effort required of board members is already increasing and will likely continue to accelerate. The risks (both legal and reputational) have surely increased at a time when D&O insurance is progressively harder to obtain. Finally, the pressure on directors to ensure that they have adequately invested in company shares has also intensified.

Yet, the non-financial benefits continue to decline. The end result is a deteriorating director value proposition. This puts upward pressure on director financial rewards at a time when compensation is being heavily scrutinized.

The Deteriorating Supply of Directors from Traditional Sources

It can also be argued that the ability to recruit directors from traditional sources such as current and retired CEOs will be reduced for perhaps all but the largest companies. This is due to the deteriorating value proposition, greater time commitment involved, general criticism of stakeholders and related response of company and board policies (limiting directorships of current CEOs and directors, and length of directors' tenure).

To fill the void, it is reasonable to expect that there will be increased representation of directors from non-traditional sources. The emergence of professional directors (individuals shifting from executive to professional director roles), executives from government or not-for-profit industries, and academics are examples of new sources of directors.

Generally speaking, the existing financial wealth of this new type of director is expected to be less than that of the more "traditional" director. This has significant implications for director pay and share ownership. For instance, a director with relatively modest economic means compared to a successful retired CEO:

- May have his or her annual income dramatically increased by serving on one or two boards (making the difference between a $50,000 and $100,000 total director pay package much more significant).
- Would likely prefer director pay in cash instead of shares.
- Would have a more difficult time making a substantial investment in company shares.
- Would have less economic diversification and, in turn, would have more to gain or lose with respect to a significant position in company shares or stock options.

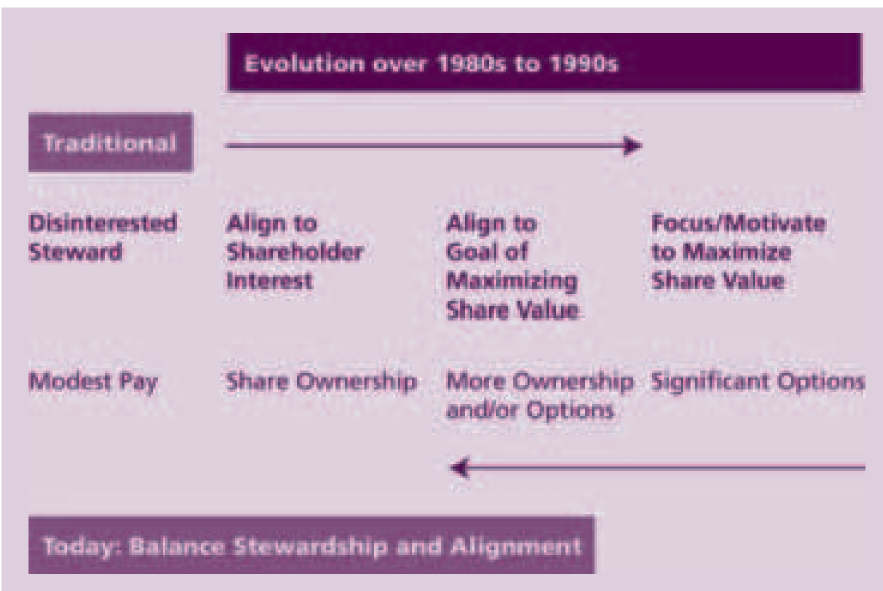
Another source of directors come from executives with functional leadership (e.g., EVP HR, Finance, and/or Public Affairs) in other companies. There are practical limits to the number of directorships these executives will be able to fill. Yet this source helps fill the void created by a reduction in active CEO directorships. Companies may be willing to allow functional executives to sit on another company board given the developmental benefits. The executive may have to remit cash compensation to his or her full-time employer. Guidelines may also be required to deal with share based compensation in these situations.

Evolution of Director Pay Goals

Historically, directors were intended to be "disinterested", that is, able to examine issues, provide advice, and report back to shareholders in a fair-minded or unprejudiced manner. In the extreme, this role would be akin to the company's external auditors. In this context, serving the interests of shareholders is not the same thing as being aligned to shareholder interest. For instance, the external auditor, who is serving the interests of shareholders, cannot own company shares.

During the 1980s and 1990s, the goals of director pay began to move away from the primary objective of reinforcing the stewardship role.

TABLE 2



Generally speaking, UK companies have been less likely to move much (if at all) beyond the "disinterested" approach. On the other hand, a number of US, and some Canadian companies have been more likely to shift their focus to the goal of maximizing shareholder value. At the extreme, there were examples of directors realizing more value from an option gain in their capacity as a director than in any year as a well paid full time executive.

In 1995 the NACD (National Association of Corporate Directors) Blue Ribbon Commission on Director Compensation (herein the "1995 NACD Report") stated as one of its principles that compensation should be used to motivate director behaviour. Moreover, they indicated that equity should represent a substantial portion of the total director pay up to 100 percent. It is important to note at that time some US boards were being criticized for having retirement programs and other less transparent benefits and perquisites.

More recently, many shareholder groups have expressed concern that the important stewardship role of directors has been lost due to the primary pursuit of maximizing shareholder value. Significant leveraged pay based on first increasing and then maintaining the share price is at odds with the directors' stewardship role (e.g., making sure shareholders know the bad news, not just the good news). Moreover, too much compensation, particularly leveraged (at risk) compensation, can put a director in situations where his or her independence could be challenged. "How much compensation can be paid before independence is jeopardized?" is a difficult question to answer. One reference point is to consider the time directors spend on Board related matters (preparation, travel, meeting time, etc.) and multiply this by an appropriate consulting rate (per hour fee).

A balance needs to be struck to ensure that pay is sufficient and aligned with shareholder interest, while not compromising the important stewardship role of directors.

Guidelines in Setting Board Pay

In contrast to executive pay, the concept of *pay for performance* is largely absent in developing defensible board pay. Pay for performance would suggest that:

- Better performing directors should earn more than other directors;
- Pay should vary with company performance (other than just share price performance).

However, directors are required to adjudicate performance and approve payments for executives under corporate incentive programs. If director pay varied according to individual performance and/or the financial success of the company, significant conflicts of interest could arise.

BEST PRACTICES: Director Pay Principles and Goals

- Directors should be adequately compensated for their time and effort.
- There should be no distinction in pay for board members performing similar roles (time and effort).
- Distinctions should be made for Board members with greater responsibilities (e.g., committee service, committee chair, board chair).
- Share ownership is a critical goal.
- The quantum of a mandatory Director share investment for a particular Board should be set at a level that recognizes the financial position of different board members (i.e., accommodate directors with lower economic means).
- Director tax efficiency should not be the main driver of director compensation design.
- Setting and disclosing director pay should be a deliberate and transparent process.

Large Established versus Small Companies

Canada has a disproportionate number of small listed companies. The value proposition of joining a small newer company versus a large mature company may be quite different. Often, new companies with limited resources rely on board members as a source of expertise — e.g., marketing, finance, strategy. Many of these companies do not have the brand name or prestige to help in attracting directors. At the same time, small companies may have limited cash resources to allocate to board pay. Accordingly, the composition of board compensation needs to be tailored to individual company circumstances. For example, for small companies, the compensation package may appropriately emphasize stock options over cash, but the reverse for large established companies.

Summary

The intent of the above section is to facilitate a sound understanding of the historical context, existing pressures and goals for director pay. The main themes can be summarized as follows:

- The value proposition of directorship has been deteriorating.
- There is a declining supply of directors from traditional sources.
- Director pay must be adequate and aligned with shareholder interests without compromising the important stewardship role of directors.
- Share ownership is an important goal, but should be structured in such a matter to accommodate reasonable financial constraints of directors on the particular board.
- Setting and disclosing director pay should be a formal and transparent process.
- Flexibility is required to accommodate the resource constraints and director supply issues faced by many small and/or less established companies.

The remainder of this document addresses the practical issues of structuring board pay, and the related governance processes and disclosure issues. Specific sections are devoted to the important subjects of stock options and share ownership.

Board Pay Structure

1. **What compensation elements are available and appropriate?**
2. **What are the relative merits of a bundled fixed fee approach versus a component-driven variable pay approach?**
3. **How should regular board pay be structured and valued?**
4. **How should committee pay be structured?**
5. **Should a board's US directors be paid more than its Canadian directors?**
6. **What guidelines and monitoring policies should be in place to monitor payments for expenses and indirect benefits?**

Pay for Regular Board Services

- *Annual Retainer.* Fixed annual compensation paid to outside directors for overall board service. This could be in the form of cash and/or shares (including phantom shares in the form of deferred share units). Further, it could include a distinct share component, an optional share component and/or a mandatory share component until ownership guidelines are met.
- *Stock Options.* If provided, options are normally granted annually. Note "stock option" section below.

- *Regular Board Meeting Fees.* Compensation earned for attendance at board meetings. Note: there may be a reduced fee for meetings attended by phone.
- *Other Benefits Provided to All Directors.* These are discussed in the Appendix.

Pay for Committee Services

- *Committee Retainer.* Fixed annual compensation in addition to regular Board retainer.
- *Committee Chair Retainer.* Supplemental annual compensation for the committee chair.
- *Committee Meeting Fees.* Compensation earned for attendance of committee meetings. Meeting fees may be reduced if held on the same day as another board related meeting and/or if attended by phone. Also, in some situations the committee chair retainer is greater than the regular committee member retainer.

The level and structure of Committee pay may vary from committee to committee. For example, in the current environment, the audit committee, and in particular the chair may receive higher pay than other committee chairs.

Travel Fees

Extra compensation paid (above expenses) to a director to compensate for his or her travel time. The travel fee might be equal to a regular board meeting fee.

At one time, travel fees were predominantly used by western Canadian companies. Now, the use has become more widespread in Canada.

TABLE 3

Approaches	Pay Elements	Rationale for Approach
A Fixed Common Fee for all Board Members	• Cash/Share Retainers • Stock options • Other benefits (Appendix A)	• Simplify pay structure • Increase transparency • Reinforce common effort and accountability
Fixed Fees but Differentiation for Committee Involvement	Same as above	• Recognizes different levels of committee participation by board members
Including Variable Fees (vary with number and nature of meetings)	• Per meeting fee • Adjustments to meeting fees — multiple meetings same day — telephone meetings • Travel fees	• Self adjusts to reflect shifting demands on the board from year to year • Reflects differing individual board member involvement

Generally speaking, the more modest the total director pay package, the stronger the argument that additional compensation should be received for travel time.

Bundled or All-in-one Fixed Fees

Bundled or all-in-one fixed fees are structured in various ways:

- One fee covers all board and committee service.
- One fee to cover all board and regular committee service, with supplemental fees for board and committee chairs (and lead directors).
- One fee to cover regular board service, with additional fees for committee service.

A number of US and a few Canadian companies have introduced various versions of bundled fees. It simplifies the fee structure, particularly as it relates to telephone meetings, multiple meetings on the same day and travel fees. It also reinforces a goal of common effort and accountability of all directors.

However, a fixed fee approach does not take into account potential variations in time commitments from one board member to another. Boards and/or board committees are required to work harder some years than others. Moreover, some committees, such as audit, typically have a higher workload and accountability that may warrant additional compensation. Finally, some boards allow different committee participation levels by members (e.g., one board member might sit on three committees, and another board member might sit on one committee).

All-in-one fixed fees tend to work best with boards where the number of directors is relatively low and the workload is fairly evenly distributed.

Both in assessing the competitive market and setting director pay, it is important to consider the total fees rather than individual elements. However, in developing appropriate and competitive pay levels, it is necessary to consider separately:

- Regular board and committee compensation; and
- Fixed fee versus variable (meeting fees).

Setting Regular Board Pay

The following table provides an illustrative approach for assessing regular annual board pay (excluding committees). It is important to focus on both total fixed pay and total regular Board pay (including meeting fees). To this end, stock options need to be valued and where awards are infrequent, stated on an annualized basis.

TABLE 4

		Regular Board Fixed Pay					
Company	Scope Data*	Cash Retainer	Share Retainer	Stock Options**	Total	Meeting Fees	Total Regular Board Pay (Assume 10 meetings)
A		$15,000	$15,000	NIL	$30,000	$750	$37,500
B		$20,000	NIL	$20,000	$40,000	$1,000	$50,000
C		$10,000	$15,000	NIL	$25,000	$1,000	$35,000
D		$30,000	$20,000	NIL	$50,000	NIL	$50,000
E		$20,000	$20,000	NIL	$40,000	$1,250	$52,500
F							
G							
H							
I							
J							
Median	→				$30,000***	1,000	40,000

* May include company revenue, market cap, profits.
** Annualized value of option grants using Black-Scholes or similar option valuation model.
*** Exclude companies with bundled fees (no meeting fees).

In assessing the appropriate pay level (positioning) of a particular board, it is also useful to consider:

- The pay of specific companies. Some companies may be more appropriate comparators than others
- The appropriate positioning versus the sample
- An assessment of relative responsibility and workload.

With this information, decisions can be made in terms of setting regular board pay levels and structure. In the end, this requires a judgement call of the directors themselves.

The table that follows is reflective of a number of pay studies using company samples with revenues around $1 Billion.

Regular Board Pay For Companies with Revenues of $1 Billion

TABLE 5

	1992	2002	2004 Est
Fixed Pay			
Median	$10,000 – $15,000	$20,000 – $25,000	$30,000 – $40,000
75th percentile*	$15,000	$50,000 – $60,000	$60,000 – $75,000
Option Usage	5 – 10%	30 – 40%	20%↓
Meeting Fee	$800	$1,250	$1,500

* Point at which 25% of observations lie above (75% below).

Note: Stock options largely drove the 75th percentile in 2002, enlarging the gap versus median.

Please refer to the sections that follow on stock options, share ownership and governance for further guidance, on setting regular board pay.

Committee Pay

In the current environment, there is a major shift in accountabilities and workload from the regular board to the committee level. This trend has and will put significant upward pressure on committee pay. In addition, certain committees (usually audit) stand out as having escalating workloads and in turn pay. For instance, it is no longer unusual to see the audit committee pay set at a level twice that of other committees.

Finally, for many companies, committee pay historically was comprised solely of meeting fees. Increasingly, annual committee retainers are being introduced.

US Director Pay Premium

Directors of US companies tend to be paid above their Canadian counterparts at similarly sized companies. To address this competitive deficiency, some Canadian companies provide higher compensation to their directors who are US residents by paying them the same nominal dollars in US currency.

CAUTION:

While there are competitive reasons for providing a differential, critics suggest that this creates two classes of directors. The Institute of Corporate Directors has strongly condemned the approach of paying US directors more than their Canadian counterparts.

Special Assignment Fees

These are fees paid to a director for services above and beyond regular service on the board and its standing committees, but permitted under the Board's mandate.

There may be times the Board desires and an individual director agrees to take on additional short-term duties as a board member.

BEST PRACTICES:

- Special assignments should be by exception and authorized only when it is not feasible or practical to use the regular board or a committee thereof.
- Delegated authorities should be as restrictive as reasonably possible.
- The results should be brought back to the Board.

Consulting and Other Services

There have been situations when compensation has been paid to a director for services provided as a consultant outside of the Board's traditional mandate. A number of stakeholder publications have argued against hiring board members or their firms as consultants.

CAUTION:

- Directors should not provide consulting and other services to the company.
- If the primary value of the individual in question is that of a consultant, (s)he should become the consultant and cease to be a director.

Establishing Guidelines and Monitoring Payments

Beyond regular compensation, it is important to establish guidelines for and monitor payments in areas such as:

- Travel expenses
- Director training
- Company product discounts
- Spousal expenses and/or benefits.

Director Stock Options

7. Are director stock options appropriate for a particular company?

8. If options are used, have they been structured in an appropriate manner?

9. What rules should be in place of governing the exercise of options and sale of option shares?

During the 1990s, director pay in the US changed significantly. Retirement arrangements were largely eliminated and pay was refocused on the goal of maximizing shareholder value. The *Blue Ribbon Commission of the US National Association of Corporate Directors* (1995) stated, as part of best practices, that compensation should be used to motivate director behaviour and paid largely in stock, implying a strong endorsement for stock options combined with stock ownership. Director stock options became a legitimate and common compensation tool.

In Canada, the Guidelines for Improved Corporate Governance (1994) (Dey Report) did *not oppose* stock options for board members provided that they were valued and considered as part of total compensation. In Canada, with the exception of a few industries (mining, oil & gas, technology, and small companies), it was not until the latter part of the 1990s that stock options became fairly prevalent. In the UK, stock options have generally been viewed as an inappropriate form of compensation for directors.

Today, a number of stakeholders and commissions have stated that directors (at least of large established companies) should not be granted stock options. (FN Canadian Coalition, Conference Board… on Trust, Breeden Report…). A number of Canadian companies have or are planning to discontinue stock options grants.

Pros of Director Options

- Directors who have a substantial level of stock options are more likely to take an active interest in the performance of the company, including tying CEO compensation closely to results.
- Directors who increase shareholder value should also benefit through the increased value of their own pay.
- Options can provide significant potential and competitive compensation, particularly for companies that are not in a strong financial position to otherwise attract directors.
- Options could be used to facilitate significant director share ownership.
- May be only form of compensation available for small companies or companies with liquidity issues.

Cons of Director Options

- Heavy reliance on stock options as an incentive can bias directors' independent judgement.
  - — As "guardians" of shareholder interests, directors need to ensure shareholders receive both good and bad news on a timely basis; and
  - — A director with significant *potential* wealth from options may be less willing to jeopardize his or her ongoing directorship on a point of principle.
- Stock options do not put directors in the same shoes as shareholders:
  - — Options do not have the same downside risk as ownership; and
  - — Options encourage growth decisions (e.g., reinvesting earnings) over return decisions (paying out earnings as dividends).

It is recognized that smaller, less established, companies may have limited financial resources which in turn increases the relative attractiveness of stock options.

> **CAUTION:**
>
> Boards considering stock options for directors should both carefully reflect on the criticisms of stock options and consider suitable alternatives. If it is determined that options are appropriate, care should be taken to ensure that best practices are followed with respect to the approval process, administration and overall governance of the director options.

Stock Option Design and Administration

Many of the governance issues in structuring director stock option programs relate to minimizing director discretion in terms of how the plan will be administered. This is done by a separate director option plan approved by shareholders that explicitly sets out the plan terms and operation.

There is generally little guidance on when and how directors should exercise stock options and/or sell shares. Most of the institutional investors' focus to date has been on ensuring that director option plans are set up appropriately.

In the US, most companies have shorter vesting periods for Board of Director options than for executives. In Canada about half have shorter vesting periods (others may simply adopt the executive plan features).

BEST PRACTICES: Where Director Stock Options Exist

- There should be a separate Director Option plan
  - Put forward to shareholders
  - Specific shares reserved
  - A pre-determined and approved granting formula.
- Options should not be conditional on director tenure (i.e., directors should be able to resign without forfeiting stock options).
- Options should not be exercised early in the term if the intent is to sell the underlying shares.
- An expectation should be set for directors to retain part of the option gain in shares.
- Companies should facilitate the retention of all or most shares by directors at option exercise
  - Easy administrative processes
  - Take advantage of $100,000 tax deferral.
- There should be full disclosure of transactions relating to stock options and shares.

Share Ownership

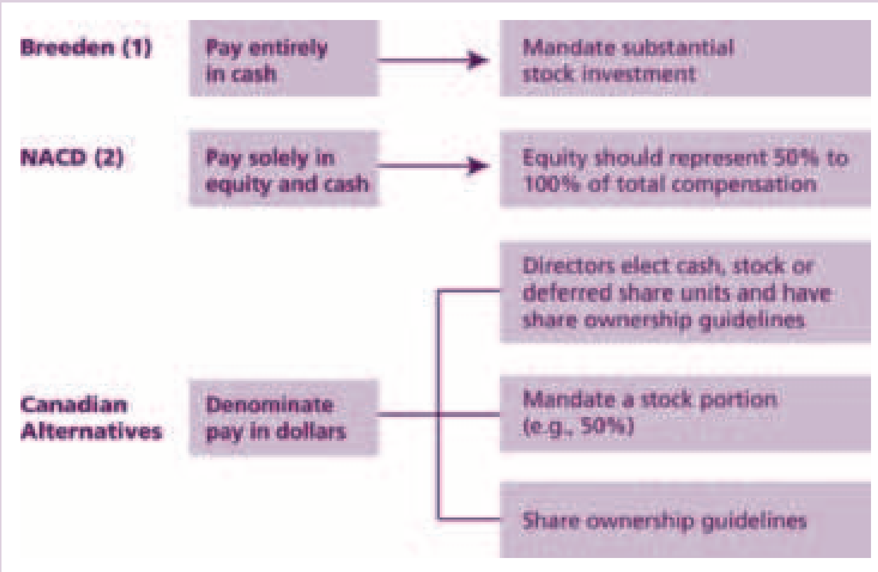
10. What is the appropriate level of share ownership for directors?

11. Are the appropriate mechanisms in place to encourage and/or facilitate share ownership?

12. What rules should govern directors' acquiring and selling shares, including shareholder disclosure?

Director share ownership is perhaps the best way for boards to demonstrate their alignment with shareholders.

TABLE 6



(1) "Restoring Trust" Report to United States District Court on Corporate Governance For the Future of MCI, Inc. Prepared by Richard C. Breeden, Corporate Monitor.
(2) Report on the NACD (National Association of Corporate Directors) on Director Compensation, Purpose, Principles, and Best Practices, 2001 Edition.

Share Ownership Guidelines

Most large Canadian companies have some form of share ownership guideline for directors. This can be expressed as a multiple of pay (e.g., 5 times the retainer), a fixed number of shares or a fixed dollar amount.

Often there is a prescribed amount of time (e.g., 5 years) within which the director is expected to achieve the guideline. Directors may be required to take all or a portion of their cash retainer in shares or in deferred share units ("DSUs"). DSUs are full value phantom shares, and are considered shares by institutional investors for purposes of meeting ownership guidelines. DSUs offer the advantage of tax deferral, since their value is taxed at settlement rather than at grant.

Paying Directors with Shares

Some companies provide part of the board retainer in shares. This has the advantage of ensuring that share ownership automatically increases.

However, it is important to consider whether "ever increasing" share ownership is always positive. There is a need to strike a balance between "acceptable" ownership levels and individual economic circumstances and risk tolerances.

Finally, it is important to consider if and when it is appropriate for directors to sell shares and any related disclosure processes. Please note section on Shareholder Approval and Disclosure below for further discussion.

Governance and Disclosure

13. Who should be involved in setting director pay?
14. Is there a director compensation philosophy and is it reasonable?
15. Does current proxy disclosure provide complete and accurate information?
16. What other disclosure processes (beyond proxy disclosure) should be in place?

Directors are in the awkward position of setting their own pay. Given this situation, many boards turn to the Governance Committee as the most logical group to examine and make recommendations with respect to director pay.

Governance

The 1995 NACD Report provides some interesting best practice insights:

- *Boards should establish a process by which directors can determine the compensation program in a deliberate and objective way.*
  - — Assign responsibility (e.g., governance committee)
  - — Define and understand the director's job. What does the director's job entail at the particular company
  - — Define the board's compensation philosophy.
- *Board pay should be disclosed completely to shareholders.* Currently pay disclosure requirements, in the view of many, are inadequate.
- *What are the overriding goals of the director pay program?*
  - — Provide competitive pay
  - — Balance director independence with director engagement
  - — Encourage reasonable share ownership
  - — Demand significant share ownership
  - — Have a strong pay-for-performance program by leveraging significant pay to the value of the company (e.g., stock options).
- *Who is the comparator group and what is the appropriate competitive positioning?*
  - — Companies with similar Board compositions
  - — Companies of similar size
  - — Companies in similar businesses
  - — Comparator companies used for setting executive pay.

Generally, for director pay, it is considered appropriate to use a broad sample of similarly sized/structured companies as the primary comparator group. In organizations where it is critical for directors to have strong industry knowledge, it is also important to review compensation paid to directors of companies in similar businesses.

In all cases, both the level and composition (e.g., cash versus stock) of competitive compensation should be reviewed.

> **CAUTION:**
>
> Care should be taken in referencing too small a comparator group or using too aggressive a positioning (e.g., top quartile of the market). As with executive pay, these practices may result in spiraling pay. At a minimum, the compensation of a small comparator group should be assessed relative to a larger sample.

Shareholder Approval and Disclosure

Currently, there are few items shareholders approve in relation to director pay. This, combined with the fact that directors set their own pay, means that complete and transparent disclosure is generally the only way in which shareholders can keep board pay in check.

The existing disclosure requirements for board pay in both Canada and the US are viewed by many stakeholders to be inadequate. The more progressive disclosure approaches provide complete pay component information, as well as individual board and committee attendance. Even in these instances, though, it can be difficult to determine the total quantum of annual director compensation.

The 1995 NACD Report called for complete individual disclosure of board pay and share-related transactions. The Canadian Coalition of Good Governance stated that boards should provide full disclosure of the actual compensation of each director, and of all sales of shares as a best practice.

The tables below provide examples of how individual director pay and share transactions could be disclosed.

TABLES 7 & 8

CASH, SHARES AND DEFERRED PAY

	Regular Board Fees		Committee Pay				
	Retainer	Meeting Fees	Member	Chair	Total	Cash Portion	Share* Portion
Director A							
Director B							
Director C							

* Real shares or deferred share units.

STOCK OPTIONS, SHARE OWNERSHIP AND SHARE TRANSACTIONS

	Stock Options			Share Ownership		
	Granted*	Total	In-the-money	Acquired	Sold	Owned
Director A						
Director B						
Director C						

* Detail of terms and conditions.

Share-related Transactions

In future, the disclosure of share transactions will be faster (within two days) and ideally more transparent. Some stakeholders are calling for advanced disclosure of any share-related transactions.

A good starting point is to have complete disclosure of all share-related transactions for all the board members. Beyond this, boards should consider other approaches (e.g., disclosure on company web site) and processes to ensure that share-related transactions are disclosed on a timely basis.

Non-executive Board Chair

17. How should the Board Chair pay be structured?

18. Is the total expected Board Chair compensation appropriate?

The responsibilities and roles of Board Chairs vary significantly. At one end of the spectrum, the Board Chair can be characterized as having a role of "first among equals" at the Board. His or her role is only slightly greater than that of other Board members and may be akin to that of a Committee Chair. At the other end of the spectrum, the Board Chair has a quasi-executive role, spending as much as 40% or 50% or more of his or her work week on company matters.

To make matters more complicated, the types of activities that the Chair is involved in can also vary. Some Chairs may carve out active roles in particular areas such as governance (and may chair the governance committee) or human resources, but otherwise function more as a regular board member (time commitment, scope of role, etc.). Other Chairs touch all aspects of director involvement and may be an ex-officio member of all board committees.

Accordingly, in determining appropriate compensation, it is important to consider:

- Nature and scope of role relative to other directors
- Quantum of regular board compensation
- Quantum of CEO's compensation
- Compensation paid to Chairs of equivalent organizations performing similar roles.

Lead Director

19. How should the Lead Director pay be structured?

20. Is the total expected Lead Director compensation appropriate?

The purpose and scope of the Lead Director's role also varies. Lead directors are outside directors who:

- Are normally appointed when the roles of Board Chair and CEO are combined.
- May be appointed when the Board Chair is not fully independent (e.g., represents major shareholder).
- May take on responsibility for activities such as Board meeting agendas, chairing meetings of outside directors and Board performance.

One of the difficulties in setting the compensation for Lead Directors is that their workload/role varies dramatically from Board to Board as well as with changing circumstances. The pay levels of committee chairs provide a useful low end reference point, while the pay levels of non-executive chairs provide a top end reference point.

Conclusion

Companies need to attract and retain directors who are competent and willing to spend considerable time and effort on meeting their responsibilities to shareholders and regulators. The increasing (and sometimes conflicting) demands of shareholders require boards to balance the important stewardship role of directors and shareholder expectations that the board will maximize share value. At the same time, shareholders are subjecting director compensation to greater scrutiny and are less tolerant of perceived excessive payments. To meet these expectations boards need to establish a formal and transparent director compensation process that:

- Aligns director compensation with the shareholder without compromising director independence.
- Treats all directors fairly by recognizing their responsibilities as board members and their specific individual contributions as chairs, committee members and participants in special assignments.
- Includes share ownership requirements that recognize the reasonable financial constraints of directors.
- Is competitive with that offered by comparable companies.
- Accommodates the resource constraints and director supply issues faced by many small and/or less established companies.
- Provides full and complete disclosure of director contributions and compensation.

Our comments are primarily relevant to publicly traded companies. However, while good governance practices may take different forms in other organizations, the underlying principles and values are equally important to the success of all enterprises.

Appendix: Board Compensation Elements

There are a range of compensation elements, including:

Traditional Compensation Elements for Directors

- *Cash*
- *Phantom Shares.* These are notional shares each having a value equal to the related real common shares. There are two basic structures (note: the names given to these structures vary):
  - — *Retirement Phantom Shares or DSUs* ("deferred share units"). These phantom shares cannot be settled until the director leaves the board. This structure takes advantage of specific provisions of the Income Tax Act (Canada) that permit cash compensation to be deferred in phantom shares provided:
    - – Settlement does not occur prior to employment (or director) termination, and
    - – Phantom shares are cashed out no later than the end of the year after employment termination.

    Most shareholders view this design as equivalent to real share ownership for the purpose of determining the directors' ownership positions. DSUs offer the advantages of directing pre-tax income to share ownership, and avoiding problems associated with directors buying and selling shares. The main shortcoming at this time is that the directors must cash them out when they leave the board and pay tax on the value at full marginal rates.
  - — *Three-year Deferred Phantom Shares* (often called RSUs or Restricted Stock Units). These are phantom shares that facilitate tax deferral for three years. They are generally structured to pay out in cash (although could settle in real shares) at the end of the three year-period. Unlike DSUs, RSUs are generally not viewed as equivalent to real share ownership. They are more commonly used in executive pay programs.
- *Real Shares.* Actual common shares either purchased in the open market or issued from treasury. An alternative approach is to pay cash to directors to be used to purchase common shares. In most situations, the value of real shares is an immediate taxable benefit.
- *Stock Options.* Financial instrument that gives holders the right (but not the obligation) to purchase shares at a fixed price (usually the market price at the date of grant) for a specified period of time.
- *Product Service Discounts.* Ability to receive company products or services at favourable rates. Normally at terms consistent with that offered to company management.

Less Traditional Director Compensation Elements

The following benefits are not commonly used in Canada.

- *Retirement Benefits.* Benefits conferred under a formal program that provides a post-board service payment schedule based upon length of board service and level of compensation — typically in relation to the annual retainer.

  These benefits are rarely used in Canada and have been criticized by shareholders as inappropriate for directors.

- *Perquisites.* Automobile, chauffeur and/or club memberships.
- *Director Legacy Donation to Charitable Institution.* A promise by the company to make a donation to a specific charity, on the director's behalf, usually upon his or her death.
- *Insurance.* Company provided insurance (life, dental, etc.).
- *Company share investment program.* Often set up as a company matching program.

Arguments against the above benefits include:

- Directors should not be paid as if they were employees.
- Rewarding directors for tenure can run counter to ensuring their independence.
- Such programs make it harder to compare the total director compensation value across companies and generally make pay less transparent.

Other Elements/Benefits

- *Administrative Support Services.* Office facilities and assistance provided by the company. Rarely used except, on occasion for non-executive board chairs.
- *Spouse's Travel Expenses.* Reimbursement of spouse's expenses incurred while accompanying the director to a board or company related function.

Where to find more information

Canadian Institute of Chartered Accountants Publications

The 20 Questions Series

20 Questions Directors Should Ask about Director Compensation
20 Questions Directors Should Ask about Executive Compensation
20 Questions Directors Should Ask about Internal Audit
20 Questions Directors Should Ask about IT
20 Questions Directors Should Ask about Management's Discussion and Analysis
20 Questions Directors Should Ask about Privacy
20 Questions Directors Should Ask about Risk
20 Questions Directors Should Ask about Strategy

Other CICA Publications on Governance, Strategy and Risk

Guidance for Directors: Governance Processes for Control, 1995
Guidance for Directors: Dealing with Risk in the Boardroom, April 2000
Managing Risk in the New Economy, 2000
Crisis Management for Directors, 2001
Strategic Planning: What Boards Should Expect from CFOs, 2003
Understanding the Financial Aspects of Governance: What Boards Should Expect from CFOs, 2004

Additional References

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20 Questions

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