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Surging pay for directors draws criticism

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Companies paying more to attract top talent, but scrutiny of compensation lacking

Board Games 2016: Additional tables on company and director diversity and a full report card are available for purchase[1].

There has never been a more lucrative time to be a corporate director in Canada.

Director compensation has soared over the past five years, outpacing the rate of chief executive officer pay growth. Yet unlike the intense focus on executive pay in recent years, director compensation has drawn almost no scrutiny during the same period.

Median pay for directors at 300 public companies in Canada climbed 30 per cent between 2010 and 2015, according to new data from Korn Ferry Canada and Patrick O'Callaghan and Associates. The rate of increase was highest at mid-sized and smaller companies, where median pay climbed by 98 per cent and 50 per cent, respectively, during the same period, while directors of large companies with over $10-billion in assets saw a 24-per-cent raise.

Board Games 2016

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Directors and board experts – even some major shareholders – say pay levels have risen to keep pace with growing workloads as directors face demands for tougher oversight in a growing array of areas.

But critics are starting to question whether the workload for the part-time jobs has grown enough over the five-year period to justify such large pay increases. Some worry board pay is being subjected to the same forces driving CEO compensation higher, including a desire to attract U.S. talent and a ratcheting up effect as companies compare pay with others and raise theirs to keep up.

"Part of the problem is companies are buying credibility through recruiting directors who have a certain pedigree," said Don Gray, chairman of the board of Peyto Exploration & Development Corp., who believes many large companies have raised pay levels too high.

"The problem is that pedigree typically means they are not big shareholders, and they are not terribly interested or capable in standing up to management."

More than 40 per cent of large Canadian companies have adopted a flat-fee pay model for director pay, most of them making the conversion over the past five years. In theory the model has the potential to limit payouts, but in practice many boards have seen pay rise under the system.

Under the flat-fee model, directors are paid a base retainer but are not given additional fees for each meeting they attend, which means pay is capped no matter how many meetings the board holds.

Canadian National Railway Co. introduced a new all-inclusive retainer in 2015, paying a base of $235,000 (U.S.) in cash and shares, plus additional fees for sitting on committees. The railway company raised its base board and committee retainers in 2015 "given that they now apply regardless of the number of meetings attended by the directors."

The result is that total pay per director – excluding the board chair – rose 22 per cent in the first year under the new system, to an average of $378,363 (Canadian) a director in 2015 from $311,303 in 2014. CN said much of the increase was due to the falling Canadian dollar because it pays its directors in U.S. dollars, but reports compensation in Canadian dollars. In constant U.S. dollar terms, the company said pay rose 6.5 per cent.

CN corporate secretary Sean Finn said the new retainer was designed by an independent consultant after comparing compensation trends across North America.

"That review took into account our U.S. presence, the need to attract directors with extensive U.S. business experience, and trends in director pay in the U.S. and Canada," he said.

Mr. Finn said the flat-fee model streamlines and improves predictability of compensation while increasing transparency for shareholders.

Royal Bank of Canada introduced a flat-fee model in 2010, initially paying directors base compensation of $185,000 (Canadian) in 2011, then raising it to $210,000 in 2014 and to $250,000 in 2016 for a 35-per-cent increase between 2011 and 2016.

RBC board chair Kathleen Taylor said more than ever, board members have to be fully engaged, and said the flat-fee model simplifies compensation. She said the model has worked well to reward the responsibilities of each director.

"Over the last decade, the workload, time commitment and expertise required of directors has definitely increased," Ms. Taylor said.

Canadian boards hold an average of nine meetings a year, according to Korn Ferry data, while directors on key audit and compensation committees meet an average of five times a year. Committee meetings are often held in advance of board meetings so directors do not need to travel twice.

A 2014 survey of 120 corporate directors in Canada found they estimated they work an average of 304 hours a year, with most of the work coming outside of the boardroom in meeting preparation or in attending other functions.

With large Canadian companies paying a median of $180,000 a director in 2016, the pay works out to just under $600 an hour, assuming 304 hours are worked.

The amount is in line with pay for top board advisers such as senior lawyers, argues independent board consultant Patrick O'Callaghan.

"Directors are spending more time for sure, and they are definitely getting paid more, and as far as I'm concerned that's absolutely fair," Mr. O'Callaghan said. "They're working much harder and I don't think it's out of whack at all."

Some major shareholders, including the Canada Pension Plan Investment Board, have pushed for higher pay levels for directors to professionalize the role.

Former CPPIB chief executive officer Mark Wiseman, who is now an executive at investment giant BlackRock Inc., has strongly advocated for current average pay levels to rise, saying shareholders should expect more from directors and should pay them more as a result.

"We keep saying people shouldn't be overboarded, that we should have people who are on fewer boards, not more boards," he recently told an audience of major investors at a Toronto event.

"Well guess what? We also have to pay them if we want high-quality directors and we want them to be aligned with our interests and we want them to make long-term decisions."

Other investors, however, are watching current trends with concern, warning that excessive pay can make directors fearful of rocking the boat and losing their coveted positions.

The Canadian Coalition for Good Governance, which represents most of Canada's largest institutional investors, has guidelines warning that director pay should not be so high "as to potentially compromise the independence of directors," said executive director Stephen Erlichman.

Mr. Erlichman said directors must be willing to resign on a matter of principle, and that freedom can be jeopardized when pay is too high or when pay programs contain retention provisions, such as share units that only vest if directors remain on the board for at least three years.

"What is reasonable depends on the circumstances," Mr. Erlichman said. "But it shouldn't be so high or structured in some way that it interferes with a director's ability to be independent and forthright and challenge management."

Pay levels have risen most rapidly at mid-sized and smaller firms over the past five years, and compensation consultant Ken Hugessen believes it is because they "are not so much on the radar screen," taking advantage of a lower profile to raise pay without garnering scrutiny from major activist investors.

Directors at "micro" companies (defined as having less than $1.5-billion in assets) earned median pay of $110,500 in 2015, while directors of mid-sized companies earned $140,000 and directors at large companies with more than $10-billion in assets earned $180,000, according to Korn Ferry data.

The pay differences are not large considering there is often a major gap in workload, Mr. Hugessen argues.

"Smaller companies can have as few as four or five meetings a year, and there's a lot less work," he said. "It's probably a better deal to be a director on a smaller company than a big one."

Michelle de Cordova, director of corporate engagement and public policy at ethical mutual fund firm NEI Investments, said her firm does not typically invest in or monitor smaller companies, so pay trends at that level can be hard to spot. She believes there should be more discussion about creating say-on-pay votes specifically for director pay, giving shareholders an ability to protest unpopular practices.

The only other option, she said, is for shareholders to vote against board members themselves to protest inappropriate director pay decisions, a move she calls "the nuclear option."

"The issue with director pay is that they're actually paying themselves," she said. "There isn't really anybody beyond the shareholders who have oversight of directors pay."

References

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