

# Compensating Independent Non-Executive Directors

## Overview

With more frequent corporate scandals erupting and the on-set of the recent sub-prime crisis, questions such as “Where were the board of directors who were supposedly providing oversight to ensure such things don’t happen?” are often asked. While the answer to such a question is not a clear-cut one, there is no doubt that the demands and expectations on independent non-executive directors (INEDs) are increasing all the time. This begs the question of whether the INEDs should be compensated more. This article reviews the challenges involved in the compensation of INEDs.

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## The Increasing Role Of INEDs

INEDs are expected to shoulder a greater corporate stewardship role and provide active oversight with increasing responsibilities and time commitment. We are likely to see the continuing trends as follows:

- Each INED will sit on fewer boards.
- Each will bring his/her own expertise to round out what is needed on the board.
- Director compensation will rise in order to reflect the increased time and effort needed, as well as the supply/demand imbalance.

Σ Director compensation will have a more direct linkage to contribution.

### *Compensating The INEDs*

The Singapore Code of Corporate Governance, Guideline 8.2 reads, “The remuneration of non-executive directors should be appropriate to the level of contribution, taking into account factors such as effort and time spent, and responsibilities of the directors. Non-executive directors should not be over-compensated to the extent that their independence may be compromised.”

Implicit in the Guideline are also the principles that compensation should be attractive enough to attract quality candidates and that director compensation should be aligned with the long-term interests of the shareholders.

### *Challenges In Managing INEDs Compensation*

While recognizing that the director compensation level will rise as demand and complexity increase, we expect to see the following four challenges in the compensation management arena:

#### **1. Manage by the total as opposed to individual component**

As the compensation level rises and the variety of compensation arrangements increases, there is an increasing need to manage director compensation on an overall basis, rather than as an array of separate components. Boards should measure the total compensation value and ensure that it is commensurate with the directors’ responsibilities, contribution, risk or opportunity costs, and that it is within the range practiced by comparable companies. Once the total level is established, boards should then determine how best to deliver the total value via the appropriate components of fees and forms of equity compensation, each carrying a different message and reinforcing different types of

thinking and behaviors. Individually and collectively, the parts support the intent of aligning directors' interests with those of the shareholders.

## 2. Changing cash compensation components

While a meeting fee is still a common mode of director compensation, we expect to see a shift towards annual retainer fees. The obvious reason is the simplification of the fee structure. On the other hand, underlying the change is also the notion that it is not purely the time commitment that is being compensated, but the effort and value contributions of the director concerned.

Along the same lines, we are seeing an increasing use of role-based fees, i.e., chair fees, committee fees, lead director fees, etc., which reflect the differing demands in the form of differential fee payments.

## 3. Changing mix of cash vs. equity compensation

Equity compensation is a good way to align the directors' interests with the shareholders. The traditional mode of stock options as a form of director compensation has been criticized as encouraging a short-term focus and risky decisions while carrying little risk to the directors (as they can simply not exercise the options if the price goes under the water). Today, the more popular modes of restricted stock or performance shares, granted at fair market value, may take the edge off this criticism.

When the stock is granted as a part of the total compensation package to the directors and communicated as such, there is likely a perceived loss of compensation if the stock price declines significantly thereafter. Thus equity compensation is not necessarily "painless." Additionally, stock ownership and retention requirements, if put in place, can help to foster a long-term orientation and thinking.

Stock ownership requirements mandate that the directors attain a certain level of stockholding (typically 3-5 times of annual retainer fees) in typically 4-5 years.

Stock retention requirements mandate that directors hold a certain amount of stock for a specified time period, often going beyond retiring from the board. The rationale is that by doing so, the directors and the shareholders have the common interest in increasing total shareholder returns, and thus the decisions made during the directors' service term should be aligned with the interests of the shareholders as well.

In summary, equity compensation given as a part of a total compensation package, coupled with stock ownership and/or retention requirements help align interests. It is important to take note of the Code's cautioning against having excessive compensation that may compromise directors' independence. As long as equity compensation is reasonable and not excessive, the temptation to take undue risks would not be encouraged.

### 4. Managing an objective and transparent process with inherent conflict of interest

While executive compensation is reviewed by the Remuneration Committee (RC) that is made up of INEDs who are "disinterested" parties,

there is no such "disinterested" party in reviewing director compensation. In a sense, all directors are "interested" parties.

Managing the review and deliberation process is even more critical in this case. The RC should pay particular attention to the use of objective data and independent advice where needed; and to the creation of a rigorous deliberation process that sifts through the facts and establishes clear principles and rationales so as to reach the right conclusions and decisions relating to director compensation.

After the review by and recommendations of the RC, the full board deliberates on the recommendations and arrives at the final decision.

## Conclusion

The board, through the RC, should endeavor the following:

- Define a targeted total compensation value for each director, encompassing all forms of director compensation, based on sound principles, objectives and rationales.
- Streamline the fee components with clear objectives for each.
- Determine the desired mix between equity and fees.
- Consider the applicability of stock ownership and retention requirements and a time period during which this target is to be met and what the holding period should be.
- More importantly, maintain a process by which directors can determine the compensation program in a transparent and objective way.
- Disclose fully in the annual report the philosophy and process used in determining director compensation and the value of all compensation components.

