Institute for governance
of private and public organizations

Directors' Compensation and Governance:

Issues and Challenges

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Institute for governance
of private and public organizations

1000 De La Gauchetière St. West, Suite 1410, Montréal (Québec) H3B 4W5

Telephone 514.439.9301 | **Fax** 514.439.9305 | **E-mail** info@igopp.org | **www.igopp.org**

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Text drafted by

Michel Magnan, PhD, FCPA, FCA, ASC, C.Dir

Professor and Stephen A. Jarislowsky Chair in Corporate Governance
John Molson School of Business, Concordia University

Contents

Summary

The expectations placed on directors in terms of their skills, availability and legitimacy have increased substantially since the beginning of the 2000s. This context raises the issue of directors' compensation and, in particular, its impact on their conduct and decisions. Indeed, directors have an obvious interest in the determination of their compensation, which can taint their decision in this respect. This report contains three complementary parts. Firstly, we provide an overview of the situation and reach a certain number of findings. Secondly, we discuss the role and responsibilities of directors and how their compensation correlates with these parameters. Lastly, we make recommendations for the management of directors' compensation.

FINDINGS

While it is true that directors' compensation has increased significantly over the past 10 years, the increase has been particularly apparent in large corporations, mainly in the resource and financial sectors. In fact, in contrast to the situation pertaining to CEO compensation, the compensation of Canadian corporate directors remains significantly below that paid by comparable American corporations. Therefore, one cannot speak of a crisis situation in directors' compensation. However, a debate has been sparked on this issue, which has been fuelled by certain corporate practices that have been criticized by large institutional investors. Although the debate relates, among other things, to the impact of directors' compensation on their independence, **the legitimacy and credibility of directors are, in our view, the more fundamental issues**.

DIRECTORS' ROLE AND RESPONSIBILITIES AND ALIGNMENT WITH THEIR COMPENSATION

In our view, directors' compensation is conditional on the legislative and regulatory context currently applying to boards of directors, which is oriented mainly toward fiduciary governance. This mode of governance by the board of directors is focused on the oversight of management, compliance and monitoring of controls, and the provision of advice. In this context, the scope and form of director's compensation adds nothing to the effectiveness of the corporation's governance, if the board is already composed of credible and legitimate directors. In fact, establishing a connection between the board of directors, including its work, decisions, and possibly compensation, and the corporation's financial performance remains a perilous and very rough exercise.

RECOMMENDATIONS

On the basis of these findings, we will make recommendations for the determination of directors' compensation whose purpose is primarily to maintain their legitimacy and credibility. The essential point to make note of is that directors' compensation is only one facet of the board's governance and adds little to the processes for the appointment and assessment of directors, which are already rigorous. In addition, in the Canadian context, **directors' compensation should reflect the fact that their responsibility is joint, continuous and focused on the long-term oversight of the corporation's interests as a whole, and not just the short-term interests of the shareholders**.

This research document makes the following recommendations:

1. The board's priority in governance matters is to maintain and increase its legitimacy and credibility through rigorous practices and processes (a process for the appointment of independent directors and linked to a skills matrix; periodic and rigorous evaluation of the directors' contribution by the chair of the board, their peers, etc.).
2. Directors' compensation should not be based on the achievement of short-term objectives or goals. This excludes the use of options and the annual granting of blocks of performance units, deferred share units, restricted shares or shares that can be acquired based on the achievement of medium-term (3 -year) or long-term (5 -year) objectives.
3. Directors' compensation must be sufficiently high to attract credible candidates that have integrity and specific skills corresponding to the corporation's objectives. However, the level and form of the compensation are not, and should not be, the decisive factors in the decision whether or not to join a board.
4. Directors' compensation policy should be developed and applied transparently and be based on objective criteria.
5. The directors should hold a significant long-term investment in the corporation's shares.
6. As for the quantum of the compensation to be offered, a starting point would be to assess the necessary commitment of the director as well as the expertise required to be able to perform his or her duties, taking into account the complexity of the corporation.
7. Since the board's responsibility is collective and should be assumed on a continuous basis, the directors' compensation should be uniform across individuals, the exception being compensation paid for specific tasks taken on by individual directors (committee chair, committee membership).
8. The process for determining directors' compensation should be rooted in the vision and organizational strategy and consistent with the governance philosophy emanating from the board.
9. The process for determining directors' compensation must be distinguished from the process generally used to determine executives' compensation, since their roles, responsibilities and institutional imperatives are different.
10. Directors' compensation must rationally reflect the specific risks they face.

Introduction

Given the increasing interest in the responsibilities, skills and decisions of the members of the boards of directors, one would expect their compensation to emerge as a governance issue. However, while the compensation of executives has been the subject of numerous comments, studies and recommendations, directors' compensation remains a relatively neglected subject despite its potential importance. Accordingly, the purpose of this report is to provide a general survey of the issue.

Firstly, we will conduct an overview of the amounts at stake and the trends in directors' compensation in Canada and the United States. This will enable us to make a certain number of findings and also raise issues concerning the determining factors underlying these trends and their impact on directors' decisions.

However, to understand the situation relating to directors' compensation and formulate appropriate recommendations, it appears essential to discuss the role and responsibilities of corporate directors in the Canadian context. Indeed, compensation is first and foremost a control lever whose purpose is to support the implementation of an organizational strategy. In other words, the compensation policy and practices are appropriate and will send a strong message provided they are consistent with the organization's vision and strategic direction[1]. Based on this analysis, we conclude that the governance context in which the boards of directors of Canadian corporations operate is primarily a fiduciary one. This has significant consequences for the form and level of compensation which should be provided to directors.

We conclude by making recommendations that should serve as a guide in setting directors' compensation in the context of fiduciary governance.

1 There is abundant literature on the issue. A key reference text is R. Simons. 2000. Performance Measurement and Control Systems for Implementing Strategy. Prentice-Hall: New York.

Directors' compensation: amounts and trends

There is absolutely no doubt that there has been a significant rise in directors' compensation over the past 10 years. Internationally, certain cases in which the compensation was considered excessive also made the headlines: for example, the compensation of the board members of Lehman Brothers was among the highest in North America. In Canada, the average directors' compensation has easily more than doubled since the early 2000s (Spencer Stuart, 2012; Korn Ferry, 2011). However, the most substantial increases have occurred in the large financial institutions and in corporations in the oil and mining industries, which are sectors whose performance has significantly exceeded the Canadian standard in the past decade. Except for these sectors, the trend in directors' compensation calls for a more nuanced interpretation. However, the evolution of directors' compensation has been accompanied by a significant change in board composition, with the appointment of so-called "professional" independent directors, i.e., with no other full-time occupation than as a director. On the other hand, directors who are not considered to be independent (e.g. executives other than the CEO), as well as directors who are CEOs of other organizations, are becoming less numerous (Spencer Stuart, 2012; Korn Ferry, 2011). The compensation received by this new class of professional directors can make up a significant percentage of their income, which can suggest the existence of a relationship of economic dependency that could undermine their independence.

The most substantial increases have occurred in the large financial institutions and in corporations in the oil and mining industries, which are sectors whose performance has significantly exceeded the Canadian standard in the past decade.

Over the 10-year period from 2001 to 2010, the average annual fees received by directors of Canadian public corporations have effectively increased substantially from \$17,044 to \$79,000, or an increase of 465%.

However, has the compensation of Canadian corporate directors achieved such heights that it warrants concern? The numbers compiled by two consulting firms (Spencer Stuart; Korn Ferry – O'Callaghan) lead to a certain number of findings in this regard. Over the 10-year period from 2001 to 2010, the average annual fees received by directors of Canadian public corporations have effectively increased substantially from \$17,044 to \$79,000, or an increase of 465% (Korn Ferry International – Patrick O'Gallaghan & Associates, 2011, p. 54). However, it should be noted that 60% of corporations pay fees of less than \$75,000 per annum, and that the average annual fees paid by corporations with assets of fewer than one billion are below \$50,000. Therefore, it seems that in most of the firms surveyed, directors' compensation has not attained levels that can be considered excessive after taking into account the growth in institutional and regulatory requirements during the same period. In addition, although the comparison is subject to caution, the surveys by Korn Ferry and Spencer Stuart also show that the level of compensation paid to directors of Canadian corporations remains below that of comparable corporations in the United States: Spencer Stuart (2012) estimates this gap at 40%. This contrasts with the situation pertaining to CEO compensation: a recent IGOPP policy paper written by Dr. Yvan Allaire (2012) clearly shows that, since 2000, CEOs of major Canadian corporations have essentially closed the gap in total compensation which previously separated them from the CEOs of American corporations.

However, in larger firms active in the resources sector (oil, gas, oil and gas pipelines, mines), there has in actual fact been a spectacular gain in directors' compensation. Indeed, of the 10 corporations paying the highest fees to their directors in 2010, seven were from the natural resources sector (energy and mines). In addition, according to the survey of the 100 largest Canadian corporations conducted by Spencer Stuart (2012), resource sector corporations posted the highest average compensation in 2011: \$190,000 (oil and gas) and \$180,000 (mines) versus \$130,000 for the entire sample (including these two sectors). Therefore, it seems that the directors in these sectors have benefited greatly from the favourable economic context characterized by increases in the prices of raw materials, a factor over which they have no control. Similarly, many junior natural resource corporations offer stock options to their directors, thus enabling them to receive substantial amounts upon a takeover. However, this choice is paradoxical

The level of compensation paid to directors of Canadian corporations remains below that of comparable corporations in the United States.

because, while cash shortages may constitute a handicap for these corporations, share grants would be just as appropriate, in addition to being transparent and more clearly defined in their scope as compared with options. On the other hand, the practice of granting of options to directors has practically disappeared among major Canadian corporations, in contrast to the United States where the practice is widespread but in decline. Conversely, the practice of paying attendance fees to directors is disappearing in the United States, but is still used by a large number of Canadian corporations, although it has been in decline for several years. Lastly, according to the available comparisons, the levels of compensation paid by major Canadian and American corporations seem to be among the highest in the world . For example, the compensation paid to the directors of the French company Total, a giant in the global oil industry, is within the range of 60,000 to 163,000 euros, with the median being about 70,000 euros (about $98,000). These amounts are considerably less than those paid by the companies in the Canadian energy sector, which are much smaller than Total.

On the whole, directors' compensation has in fact increased substantially over the last decade. Although the reference point is relatively low, what are the factors underlying this increase? In addition, the scope of the amounts granted to corporate directors operating in certain sectors raises questions both about the manner in which they have managed the conflicts of interest inherent in setting their compensation and their willingness and ability to distance themselves from positions that entail such potential for enrichment. Do the compensation levels in these sectors and in certain corporations compromise the directors' independence from management? Lastly, more generally speaking, what principles should guide the practice surrounding directors' compensation? To answer these questions, we must first correctly identify what the role and responsibilities of directors are.

Debate over directors' compensation and independence

The expectations placed on directors of Canadian corporations have considerably increased since the publication of the Dey Report in 1994 (*Where Were the Directors?*), which came a few years after the publication of the Cadbury Report in Great Britain (1992) , and the Treadway Commission Report in the United States (1987)[2]. Those reports instituted major changes in the functioning and *modus operandi* of corporate boards in the Anglo-Saxon world, which accelerated in the wake of subsequent studies (e.g., the Saucier Report in 2001), financial scandals (Enron, WorldCom) and the implementation of the Sarbanes-Oxley Act (2002). In Canada, this evolution was accompanied by the expressed intention of the large institutional investors to apply pressure on corporations that were regarded as poor performers or badly managed (e.g., creation of the Canadian Coalition for Good Governance) , as well as by the tightening of regulatory requirements. As a result, directors' obligations and responsibilities grew, particularly due to the increasing transparency imposed on public corporations.

In parallel with these changes in the economic, professional and institutional context surrounding directors' work, the foregoing analysis shows that there has been a significant increase in directors' compensation levels. Although this change can be explained by the growth in the requirements imposed on directors, it still raises the issue of the level and form of compensation that directors should receive. Indeed, some investors and observers suggest that the amounts received by directors may affect their independence from corporate management and, ultimately, their ability to exercise judgment objectively and consistently with the corporation's long-term interests.

Thus, already in 2004, in the context of its series of "20 questions that the directors should ask…", the Canadian Institute of Chartered Accountants published a text on directors' compensation setting out the principles and objectives that one should aim for (see Appendix I). More recently, in February 2011, the Canadian Coalition for Good Governance published a policy on the principles of directors' compensation (see Appendix II). Similarly, one of the largest institutional investors in Canada, the Ontario Teachers Pension Plan (OTPP) stated "…*we believe there is a point at which the amount of compensation may negatively impact a director's ability to act independently. In determining this "'tipping point', we may consider a peer comparison and/or our assessment of decisions taken by the board and/or directors.*" (OTPP, 2013, p. 37).

2 There are several definitions of governance. The IGOPP, through its chair of the board Dr. Yvan Allaire, offers the following vision: "How a small group of persons (working part -time) can succeed in supervising, controlling and directing the executives of an organization to make strategic decisions and protect and promote the interests of its principals."

These concerns have also become apparent within the community of directors. At the end of 2012, the newsletter of the Institute of Corporate Directors published two comments on this issue (November 2012). Firstly, Robert Astley (chairman of the board of the Canada Pension Plan Investment Board) expressed the view that directors' compensation must be reasonable and reflect the time spent on their duties, at a rate that is comparable to those of high level consultants and which compensates them for the risks they face. Secondly, John Eby, chair of the governance committees of Inmet Mining, Wajax Corporation and Crombie REIT, opined that attention should be focused on the process surrounding the development of the policy for determining directors' compensation.

The viewpoints and worries expressed by these various stakeholders have recently come to the fore. Thus, shareholder opposition to the compensation granted to the new co-chair of the board of Barrick Gold,[3] as well as the debate surrounding the compensation of the directors of Agrium[4] chosen by the Jana hedge fund, illustrate clearly that directors' compensation is now in the sights of many institutional investors and has become a good governance issue.

However, are these concerns over directors' compensation and their independence warranted? More generally, what is the appropriate method of compensating directors? In our view, to answer these questions, one must first properly define the problem. In other words, is there an independence problem? If so, what are the consequences thereof? If not, what is the problem and what are the possible solutions?

3 McFarland, J. 2013. Shareholders blast Barrick over bonus. The Globe and Mail – Report on Business. April 25.

4 McFarland, J. 2013. Jana's Agrium pay scheme draws fire. The Globe and Mail – Report on Business. May 4.

Directors' compensation: an issue beyond their independence

The very concept of independence is difficult to identify and define. The market regulatory authorities reduce the notion of independence to the criterion of not being related to the corporation's management or its controlling shareholder, which is undoubtedly a very operational definition, but also reductive in nature (see, in particular, Regulation 52-110 of the Autorité des marchés financiers). The IGOPP, under the aegis of its Executive Chair Yvan Allaire, published a policy paper on the issue (IGOPP 2008) in which it recommended that the debate on directors' independence should be refocused on legitimacy and credibility[5]. According to this policy paper, directors' independence as advanced by the regulatory authorities and pressure groups is only one facet of legitimacy, and *"While it is legitimacy that gives a board the authority to impose its will on management, it is credibility that makes a board effective and value-creating"* (Allaire, 2008, p. 15).

According to this policy paper, directors' independence as advanced by the regulatory authorities and pressure groups is only one facet of legitimacy, and *"While it is legitimacy that gives a board the authority to impose its will on management, it is credibility that makes a board effective and value-creating"* ALLAIRE, 2008

5 Allaire, Y. 2008. The Independence of Board Members: A Quest for Legitimacy. Institute for Governance of Private and Public Organizations. Policy Paper No. 3. In this policy paper, legitimacy is defined as follows: *"Legitimacy (is) based on independence from management as well as on a nomination and election process that ensures adequate representation for the organization's stakeholders, and in the case of exchange-listed companies, for its shareholders…. Legitimacy (is also) based on important, committed shareholding."* On the other hand, *"The credibility of a board hinges on its collective experience and expertise relevant to the specific issues and challenges of the organization. A director's individual credibility results from his or her specific expertise and experience, grounded in independent thinking."*

With respect to the relationship between directors' compensation and their independence, a causal connection is made between compensation that is regarded as excessive, financial independence and independence of mind. However, on the one hand, unless there is a direct intrusion in the personal affairs of the directors, it is almost impossible to establish their true level of financial independence, which will depend on their other sources of income and the scope of their assets. In addition, financial independence does not guarantee good judgment, expertise and a critical mind and, conversely, the lack of financial independence does not necessarily undermine these qualities. On the other hand, beyond financial independence, the independence that really counts, namely, independence of mind linked to strength of character, is not observable or measurable and may be conditioned by a set of factors that are both financial and non-financial. For example, the independent mindset of a director who is regarded as "independent" within the regulatory meaning of the term and who is also independently wealthy could nevertheless be compromised by his desire to continue being part of a network, having access to important contacts, participating in certain activities organized by the corporation, enjoying the prestige associated with his directorship, etc. (Chidambaran, Kedia and Prabhala, 2012). In addition, a director's personality will also affect his attitude toward independence during board discussions (see, in particular, Leblanc and Gillies, 2005). Therefore, every board must manage a complex of tensions, apparent or real conflicts of interest, and all kinds of non-arm's length relationships with varying degrees of closeness, with compensation being only one factor among others. Therefore, it is our opinion that the issue of directors' independence should instead be viewed in terms of legitimacy and credibility. From this perspective, board members must ensure on a continuous basis that they maintain both their individual and collective legitimacy and credibility. However, this goal will only be achieved through appropriate and effective internal governance processes. Therefore, in our opinion, the debate over directors' compensation and independence should instead be seen as an issue of board composition and functioning. Where cases arise in which directors' compensation is considered excessive, this only reflects more serious underlying governance problems that undermine the legitimacy, and possibly the credibility, of the board. In this context, any analysis and intervention should be based on a reference framework, i.e., the role and responsibilities of Canadian corporate directors.

The debate over directors' compensation and independence should instead be seen as an issue of board composition and functioning.

The context of fiduciary governance

The consensus reflected in most visions and definitions of governance is that, in fulfilling its duties, the board of directors must reconcile two separate roles which are integral to the directors' legal responsibility to make decisions in the best interests of the corporation and in keeping with its fiduciary role[6]. In other words, these are two sides of the same coin! Firstly, the directors seek to reduce the agency costs attributable to the fact that the interests of the corporate executives are not necessarily compatible with the interests of the shareholders and other stakeholders. In this context, the directors' role is to oversee the actions and decisions of the executives. Therefore, the directors will concern themselves with legislative and regulatory compliance and with the implementation and monitoring of the mechanisms and systems governing the controls, incentives and accountability. Secondly, particularly by giving the corporation and its executives access to resources (for example, networks of contacts), providing advice to management on strategy, and sharing their expertise, the directors contribute resources to management[7].

The predominant trend for nearly 20 years now has therefore been to give precedence to fiduciary governance[8]. This trend has been fuelled, in particular, by the passage of laws and regulations that either enhance directors' responsibilities relating to compliance or require the implementation of controls by organizations, which require monitoring. The Sarbanes-Oxley Act in the United States is one example. The Canadian securities authorities have also contributed to orienting corporate boards toward greater fiduciary governance by issuing regulations such as 52-108 (auditor oversight), 52-109 (certification of disclosure in issuers' annual and interim filings), 52-110 (audit committees), 52-111 (reporting on internal control over financial reporting) and 58-101 (disclosure of corporate governance practices). And, insofar as directorship is a part-time position, it is highly likely that these laws and regulations have increased the relative scope of the board's oversight and control functions (fiduciary governance).

6 See, among others, Adams, Hermalin and Weisbach (2010), Armstrong, Guay and Weber (2010), Brickley and Zimmerman (2010).

7 This fiduciary perspective, present as much in Canada as in the United States, is also reflected in the professional and academic literature concerning governance. For example, in their work *Corporate Governance*, Monks and Minow define the role of directors with the word "monitoring" (R.A.G. Monks and N. Minow. Corporate Governance. 4th edition. Blackwell Publishing: Malden, Massachusetts. 2010).

8 Other perspectives are also possible, in particular that of value-creating governance. According to that perspective, directors become actors in their own right in making strategic decisions and play a proactive rather than reactive role (Allaire and Firsirotu, 2003).

The regulatory requirements governing the number of "independent" directors, the financial expertise of directors and the mandatory existence of an audit committee of the board are also factors that have driven corporate boards toward greater fiduciary governance. The fact that the chair of the audit committee, after the chair of the board, is typically the best paid director is a concrete indicator of this same trend.

> The Court stated that, in contrast to the situation in the United States, in Canada there is no principle which provides that the interests of one or the other of the parties, for example the shareholders, should take priority over those of the other parties

By assigning responsibility to the directors for the protection of the corporation's interests, the Canadian legal context also gives a fiduciary orientation to corporate governance. In fact, in the BCE judgment, the Supreme Court of Canada noted that the directors, in fulfilling their obligations to the corporation in the context of its continued existence, should take an interest in the corporation's long-term interests, and that these obligations vary depending on the circumstances. Accordingly, the directors may take into account the interests of shareholders, employees, creditors, consumers, governments and the environment, among others, in support of their decisions. Notably, the Court stated that, in contrast to the situation in the United States, in Canada there is no principle which provides that the interests of one or the other of the parties, for example the shareholders, should take priority over those of the other parties[9]. Thus, the Canadian legal framework imposes a certain restraint on directors before they align themselves exclusively with the creation of value, which in practice often boils down to the maximization of stock market value because it is the only easily measurable value. By framing the role and duties of directors, this orientation toward fiduciary governance has consequences that affect the form and level of compensation that directors should receive. We will return to this issue in our findings and recommendations. A change in the governance model toward value creation would possibly entail an entirely different role for compensation. In this regard, the governance of companies held by private equity investors is an example of an alternative model that is difficult to transpose to listed corporations in the current legal and regulatory environment. Due to their different governance model, such companies have considerably different director compensation practices than those of listed corporations. However, changing the directors' compensation of listed corporations without changing the fundamental elements of governance would undermine internal consistency, because governance in corporations controlled by private equity investors entails other distinct features and a relationship between the board and management that is completely different from that of listed corporations.

9 Galway, J; M. Gans. 2008. The Supreme Court of Canada publishes the reasons for its decision in BCE. Blakes http://www.blakesfiles.com/Bulletins/Litigation_Dec_2008_BCE_Reasons.pdf

Effective directors' compensation in a fiduciary context

This section contains recommendations that can be used as a guide by corporate boards when establishing their compensation. The recommendations are subject to two prerequisites.

Prerequisites

The first prerequisite is that the governance model within which the issue of directors' compensation arises is fiduciary governance. The second prerequisite is that the fundamental issue underlying governance is the legitimacy and credibility of the directors.

Principles and recommendations

1. **The board's priority in governance matters is to maintain and increase its legitimacy and credibility through rigorous practices and processes (a process for the appointment of independent directors and linked to a skills matrix; periodic and rigorous evaluation of the directors' contribution by the chair of the board, their peers, etc.).**

Directors' compensation is only one facet of the board of directors' governance and is not necessarily the most strategic.

Directors' compensation is only one facet of the board of directors' governance and is not necessarily the most strategic. In fact, directors' compensation is a governance mechanism that can be described as a substitute in the sense that its impact will be marginal if the other governance mechanisms available to the board are sound and effective. For example, the implementation of a deferred share unit plan (DSU) will possibly have no beneficial impact (in strengthening governance) if it is added to a governance structure that is already strong, and a board comprised of directors who are already experts in the business of the corporation (and therefore credible), independent (legitimate) and/or significant shareholders[10]. In such a case, the tensions, inconsistencies or legitimacy problems that can arise with respect to certain individuals because of compensation must and can then be swiftly managed.

2. **Directors' compensation should not be based on the achievement of short-term objectives or goals. This excludes the use of options and the annual granting of blocks of performance units, deferred share units, restricted shares or shares that can be acquired based on the achievement of medium-term (3 -year) or long-term (5 -year) objectives.**

Indeed, such a formula encourages speculative behaviour and leads to the confusion of roles because it constitutes an encouragement of the directors to cross the boundary between governance and management. In addition, the directors should be concerned with preserving the long-term interests of the corporation, and not only the short-term interests of the shareholders or of certain shareholders[11,12]. Three arguments underlie this principle. Firstly, it is unlikely that directors' compensation can influence organizational performance (Allaire, 2008). Secondly, it is far from clear, even with respect to the compensation of the executives, although they are at the heart of the organization's management, that the method of compensation, and especially the so-called performance-based method, necessarily leads to better performance (e.g., Allaire, 2011; St-Onge and Magnan, 2008). Lastly, in regard to options, there is almost no evidence that granting them leads to better organizational performance: in fact, often the detrimental effects of granting overly generous options

Directors' compensation should not be based on the achievement of short-term objectives or goals.

10 See, among others, Gélinas, Magnan and St-Onge (2009) who survey the academic and professional research with a view to identifying effective director compensation models. At the end of their analysis, they make recommendations, some of which are repeated or adopted in the present text.

11 In this regard, the case of Jana-Agrium is instructive. Jana, an American hedge fund that had accumulated a substantial investment in Agrium, wished to appoint four directors to Agrium's board. In addition to their normal compensation, these directors were to be granted a bonus based on the gains achieved by the fund during the three- year period following September 27, 2012. In addition to introducing a differentiation between directors with respect to their compensation, such a bonus raises issues regarding the collective accountability of the directors as well as their responsibility toward all of the shareholders and other stakeholders, and not only Jana.

12 One current of thought advocates intensifying the link between directors' compensation and organizational performance, more specifically by granting options, a common practice in the United States. It is assumed that these grants encourage directors to be more involved in the corporation's business and to be accountable for it. By holding options, they are impacted economically by the good or bad performance of the corporation (Scott, 2012).

It is far from clear, even with respect to the compensation of the executives, although they are at the heart of the organization's management, that the method of compensation, and especially the so-called performance-based method, necessarily leads to better performance... In regard to options, there is almost no evidence that granting them leads to better organizational performance: in fact, often the detrimental effects of granting overly generous options seem to outweigh their benefits

seem to outweigh their benefits[13]. The research clearly shows that conflicts can arise[14]. In fact, the directors' fiduciary role even implies that some distance should be maintained between their compensation and the organizational results[15]. However, the conversion into shares or units of a part or all of the normal compensation received by a director is appropriate in order to achieve a specified level of share ownership.

13 See Allaire (2012), Allaire and Firsirotu (2009), Fogarty, Magnan, Markarian and Bohdjalian (2009), Magnan (2006) and St-Onge and Magnan (2008). For example, it has been shown that granting options can lead to excessive risk taking by executives, which can be detrimental to the permanence of the corporation and undermine the interests of the other stakeholders.

14 There is abundant literature on the issue of conflicts between shareholders and other stakeholders of the corporation in terms of the creation of value and the recovery of gains in value. The stakeholders theory takes this situation into account and proposes an alternative to the governance model centred on the shareholders, which is derived from the agency theory (see, for example, Freeman, Wicks and Parmar, 2004).

15 A recent counter-example is that of Barrick Gold, which recently revealed that it paid a $11.9 million special signing bonus to its new co-chair of the board who immediately invested the proceeds of this bonus (net of income taxes) in 177,500 common shares of Barrick. The Caisse de dépôt et placement du Québec as well as other institutional shareholders voted against Barrick's compensation policy at the last shareholders' meeting, in particular because of this special bonus, which they viewed as unjustified. Considering that the amount of this kind of payment is necessarily arbitrary and that it does not relate to work done, in our view, such a practice is inappropriate. In addition, it even undermines the spirit of shareholding clauses, which is to ensure that the directors face a personal issue when they make decisions because they have invested their own funds ("skin in the game"): however, here the opposite is true, since the director has invested nothing and merely joined the board. In other words, the capital at risk is provided to him by the corporation itself, which strongly resembles the modus operandi of "trading rooms".

3. **Directors' compensation must be sufficiently high to attract credible candidates that have integrity and specific skills corresponding to the corporation's objectives. However, the level and form of the compensation are not, and should not be, the decisive factors in the decision whether or not to join a board.**

Any debate about directors' compensation and their independence should go beyond the extrinsic (i.e. financial) motivation and should also include intrinsic considerations that may lead a person to join the board of a public corporation. Such an invitation, and its acceptance, undoubtedly enhance a director's reputation and increase the value of his human capital within the business community[16]. A recent survey by Spencer Stuart identifies a certain number of important parameters underlying the decision to join a board (Boren, Dawkins, Johnston and Richard, 2010):

Any debate about directors' compensation and their independence should go beyond the extrinsic (i.e. financial) motivation and should also include intrinsic considerations that may lead a person to join the board of a public corporation.

- Tackle interesting challenges, contribute to a success or business recovery;
- Learn or be exposed to new ways of doing things, practices or ideas, which can be useful in other contexts or enhance personal skills (in governance or management);
- Join a respected or prestigious organization as well as the associated network of directors;
- Remain relevant and active upon retirement from other duties…

In fact, it seems that a director's interest in holding an office in a given corporation may largely exceed financial considerations. However, if the corporation that the director joins is successful, he will benefit directly (e.g., through his ownership of shares) and also indirectly, through the positive impact on his reputation and the additional opportunities he will then be offered to join other, possibly more interesting, boards (Yermack, 2004).

16 The compensation is not the decisive factor in a decision to join a board, according to Brown (2007).

4. **Directors' compensation policy should be developed and applied transparently and be based on objective criteria.** In this regard, simplicity is an advantage because it makes the compensation easy to explain and justify. In fact, the board should be aware that, with its directors' compensation policy, it sets the tone for the governance, but also for the management of compensation, of the whole organization. Therefore, the level and composition of the directors' compensation should be consistent with the other aspects of organizational governance (role and importance of committees, involvement of controlling shareholders, intensity of regulatory monitoring, etc.).

5. **The directors should hold a significant long-term investment in the corporation's shares.** Ideally, this investment ensures that the directors will adopt a long-term perspective in their decision making and that they will remain vigilant in monitoring the management's actions and decisions, without however compromising their willingness to take some degree of risk. In this regard, the current trend is to base share ownership standards on a multiple of the fees collected by the directors because such standards are simple and easy to manage[17,18]. Granting a substantial part of the compensation in the form of shares or equivalent units is recommended in order to achieve these targets.

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The directors should hold a significant long-term investment in the corporation's shares.

17 However, the effectiveness of these requirements seems problematic. Indeed, in the case of wealthy directors, these requirements may not have any incentive effect and may be ineffectual. Conversely, such shareholding requirements may seriously compromise the judgment of less wealthy directors and, in fact, potentially exclude them from the recruiting pool. Perhaps individualized shareholder requirements that are customized on the basis of the directors' profiles and administered by the board's governance committee should be considered.

18 A complementary approach to consider would be to pay part of the compensation in the form of subordinated debt, which would broaden the directors' perspective beyond the shareholders toward the other stakeholders. The Swiss bank, UBS, has adopted such a practice for some of its executives and professionals and the practice could be extended to other categories of managers. In the case of UBS, the subordinated date is conditional on maintaining an adequate regulatory capital ratio.

6. **As for the quantum of the compensation to be offered, a starting point would be to assess the necessary commitment of the director as well as the expertise required to be able to perform his or her duties, taking into account the complexity of the corporation.** This workload and expertise could then be compared to the compensation actually offered in order to obtain an approximate hourly rate that falls within a reasonable range as compared with what an advisor or "coach" could obtain whose expertise is required (in an individual capacity or through a corporation)[19]. This first estimate, essentially reflecting the directors' fiduciary responsibility, should then be adjusted to take into account the particular context of the corporation, and the fact that the directors' compensation may have symbolic value (e.g., degree of expertise required). In consideration for this estimate, formal expectations should be drawn up for the director (e.g., availability)[20].

7. **Since the board's responsibility is collective and should be assumed on a continuous basis, the directors' compensation should be uniform across individuals, the exception being compensation paid for specific tasks taken on by individual directors (committee chair, committee membership).** In such cases, the additional compensation should be appropriate but should not create too many differences between individuals.
Therefore, it would be appropriate to discontinue attendance fees and to set directors' compensation at a flat rate and on an overall basis.

The additional compensation should be appropriate but should not create too many differences between individuals.

19 For example, if one considers that conscientiously performing a director's duties within a given corporation requires 150 hours per annum (time spent in meetings, preparing for meetings, and in informal discussions) and the compensation actually received is $200,000, the reasonableness of the estimated hourly rate of $1,333 could then be judged in light of what other professional experts could obtain. However, it should be remembered that, contrary to expert advisors who must "deliver" a report, recommendations or findings, in general, directors react to proposals by management to the best of their knowledge (the "business judgment rule").

20 For example, expansion of a corporation's geographical sphere of activity may lead it to solicit directors from different regions or countries, involving significant travel time for these individuals. Additional lump -sum compensation for these directors can be considered in order to take into account the extra time they must spend to perform their duties.

8. **The process for determining directors' compensation should be rooted in the vision and organizational strategy and consistent with the governance philosophy emanating from the board.**

To avoid unwarranted inflation of compensation, boards should not fall into the trap of benchmarking through control groups. More and more studies indicate that the institutionalization of the compensation of CEOs and other executives by means of comparison groups feeds continuous inflationary pressure. Moreover, Allaire (2012) believes that the use of groups of peer corporations as a benchmark for the market constitutes a weak link in the management of executives' compensation as currently practised: "…*by a savvy selection of these companies (including American companies to set the compensation of Canadian CEOs), it is possible to arrive at a median compensation that will please the executives of the target firm; then, the dynamics of this process will be such that target compensation will keep increasing*…" (Allaire, 2012, p. 42). Furthermore, analyzing the situation in an American context, Elson and Ferrere (2013, p. 35) reach similar conclusions and believe that the process of determining executive compensation has gradually become an institution which is based on control groups or comparison groups. This leads to a structural bias favouring systematic increases in compensation which perpetuate themselves over time, with the focus on the median from the preceding period, or higher, preventing any reduction in compensation.

To avoid unwarranted inflation of compensation, boards should not fall into the trap of benchmarking through control groups.

9. **The process for determining directors' compensation must be distinguished from the process generally used to determine executives' compensation, since their roles, responsibilities and institutional imperatives are different.**

Allaire (2012) points to several weaknesses in the process for determining executives' compensation. Therefore, unless the situation changes, it would be hazardous for boards to apply practices used for executives to themselves. In this regard, after completing an exhaustive analysis of the situation in the United States, Brick, Palmon and Wald (2006) observe that there is a positive relationship between the compensation of executives and directors. In addition, they note that when this compensation is excessive, it is often associated with weak performance of the organization. Moreover, they conclude "…*that the evidence is consistent with excessive compensation due to mutual back scratching or cronyism.*" (abstract).

10. **Directors' compensation must rationally reflect the specific risks they face.**

In performing their duties, directors face risks to their reputation (loss of opportunities if the corporation goes bankrupt) and legal risks (e.g., lawsuits from contested decisions). Therefore, it is appropriate, in determining their compensation, to consider the corporation's risk profile, particularly the volatility in the performance of the sector, the multiplicity of stakeholders, etc. However, it seems that the level of reputational risk is lower than the estimates circulated by many (Davidoff, 2011)[21].

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21 Boards of directors are members of relatively tight networks, even in the United (Hermalin and Weisbach, 2003; Slaughter and Rhoades, 2004). Therefore, the determination of the value of their services and reputations is essentially contextual and relatively insensitive to external shocks. In addition, an analysis concerning the effect of directors' networks concluded that there is an effect whereby executives' compensation packages increase beyond the usual economic determining factors, and one can infer that this finding also extends to directors' compensation (Larcker, Richardson, Seary and Tuna, 2005). Empirical analyses conducted in the United States tend to show that there is a link, albeit tenuous, between poor organizational performance and the reduction of opportunities offered to the organization's directors (see, among others, Schloetze, 2010). However, this link seems to prevail only in extreme cases (e.g. fraudulent bankruptcy) (Yermack, 2004).

The tightening of legal and regulatory requirements may also justify an increase in directors' compensation levels (Scott, 2012). Following exhaustive analyses of the American market, Black, Cheffins and Klausner (2004) and Davidoff (2011) concluded that unrelated directors who failed in the performance of their duties under corporate, securities, bankruptcy, environmental or other legislation only faced personal liability relating to such failures in very rare cases. With respect to the recent financial crisis, no unrelated director has yet been convicted or even formally charged. The report of the examiner appointed in the Lehman Brothers bankruptcy clearly illustrates the difficulty of holding the directors liable in a context in which they acted in accordance with the very broad parameters of the "business judgment rule"[22,23]. The situation is comparable in most of the developed Anglo-Saxon, Japanese and European financial markets (Black, Cheffins and Klausner, 2005). Fairfax (2005) comments on this situation as follows:"*When it comes to corporate directors, it appears that our society has tacitly agreed to spare them any significant liability for failing to perform their duties as board members*" (Fairfax, 2005, p. 394). Therefore, one can reasonably conclude that the compensation of directors, based on an economic analysis, for the risk of liability they face for damages or legal costs cannot represent a significant amount because such liability is unlikely. However, it should be kept in mind that, beyond the costs incurred, the time and stress involved in participating in legal proceedings as a witness or accused can be substantial. Conversely, if the obligations imposed on directors become too onerous or extensive, it is to be expected that very few people will wish to join a board.

22 See the analysis by Allaire and Firsirotu (2013).

23 Obviously, the institutional and legal context evolves recurrently. Thus, in an analysis of the implications of Quebec's Environment Quality Act (Bill 89), Messrs. Allaire and Laurin are of the view that several aspects of it involve "boundless" risk for directors. According to the wording of the Act, it is presumed that the directors "took all necessary precautions" a most vague expression, fraught with risk, which could discourage skilled candidates from joining boards of directors, particularly those of corporations in the natural resources sectors. Indeed, section 115.40 of the Act provides that a director is "presumed to have committed" the offence "unless it is established that the director…exercised due diligence and exercised all necessary precautions to prevent the offence". The director exposes himself to fines of up to $1 million and three years in prison or, to say the least, damage to his reputation. However, insurers do not cover penal misconduct and are reticent to insure environmental risks. Even if these aspects of the Act are ultimately found to be invalid by the courts, the psychological costs borne by the directors in the context of unfounded legal proceedings should not be ignored.

Conclusion

On the whole, our analysis leads us to conclude that there does not seem to be any “crisis” relating to directors’ compensation. However, directors’ compensation has indeed increased substantially in recent years. In addition, investors are not hesitating to challenge the skills and decisions of directors – that is, their credibility and legitimacy. In this context, there is a risk that their compensation will become a major governance issue. Therefore, we believe it is appropriate to frame the debate with an analysis of the potential determining factors of directors’ compensation and to suggest principles that can serve as guides for the boards’ work on this issue.

Our recommendations are consistent with the legislative and regulatory environment which listed corporations and their boards must contend with. The concerns of fiduciary governance mean that the role (and time) of directors is strongly focused on compliance and controls. Other governance models exist and involve different compensation policies for corporate directors. For example, the role of the boards of directors of closely held corporations owned by investment funds (“private equity”) is much more oriented toward the development, implementation and control of organizational strategy. This different role entails a different compensation policy, among other things. However, the transposition of this governance model to listed corporations necessitates a debate and analysis that goes well beyond the sole issue of directors’ compensation.

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Appendix I: Best Practices: Director Pay Principles and Goals[24]

- 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.

24 E. Greville; D. Crawford. 2004. 20 Questions Directors Should Ask about Director Compensation. Canadian Institute of Chartered Accountants, Toronto

Appendix II: Policy of the Canadian Coalition for Good Governance

The Canadian Coalition for Good Governance (CCGG) recently published a policy on directors' compensation. The CCGG's view is that directors are essentially fiduciaries and, therefore, that they are in a conflict of interest in establishing their own compensation. The CCGG suggests that directors' compensation should:

1. Promote independent thinking by the directors while aligning their interests with those of the shareholders;
2. Reflect their expertise and time commitment to their duties;
3. Vary according to the scope of the duties assumed by the board;
4. Promote shareholding by directors;
5. Be the least complex possible and transparent;
6. Possibly be subject to shareholder approval.

The CCGG considers that directors should have a duty to be objective and independently minded. Appropriate compensation should encourage these qualities. However, the CCGG feels that excessive compensation could compromise their independence, their ability to take a controversial stand on an important issue, or their preparedness to resign on a matter of principle.

The CCGG also considers that, except for the possibility of granting a part of their compensation in the form of shares, directors' compensation should not be aligned with the achievement of organizational performance objectives. This could compromise the directors' objectivity and undermine their credibility as stewards of the shareholders' interests.

In principle, each director should receive identical compensation except, obviously, if specific additional responsibilities are assumed (e.g., being a member of a committee, chairing a committee, chairing the board). The scope of the tasks performed by a committee should also affect the level of compensation.

There should be a minimum shareholding requirement for directors, probably based on a multiple of their compensation. The granting of compensation in the form of shares or units should not be subject to performance conditions or vesting periods, and directors should be required to hold their shares until their retirement. Stock options are not generally appropriate for directors of public corporations.

The process and rules for determining directors' compensation should be simple and transparent. In accordance with this principle, it might be appropriate to consider the periodic approval by the shareholders of the directors' compensation package.

(CCGG Policy - Director Compensation, February 2011)

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