Director compensation with shares and the independence of the board

22E00500 Corporate Governance
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Introduction

What does the independence mean in the context of companies?

- Definition
- Regional variations
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How are the directors on the board compensated?

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- Regional variations

How is it connected to corporate governance literature?

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- Part of a corporate governance bundle

When is the independence compromised?

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What does the independence mean in the context of companies?

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Definition

- Finnish perspective
- Recommendation in the Finnish CG Code
- Independence vis-a-vis the company vs. the (significant) shareholders
- International perspective
    - The United States
    - Germany
- Rationale behind the independence (supervision & control)

RECOMMENDATION 10 – Independence of Directors

The board of directors shall evaluate the independence of the directors and report which directors are independent of the company and which are independent of the significant shareholders. The reasoning for determining that a board member is not independent must also be reported.

The majority of the directors shall be independent of the company. At least two directors who are independent of the company shall also be independent of the significant shareholders of the company.

Sources: Finnish Corporate Governance Code; Dalton et al., (1998); Mähönen & Villa, (2020); Upadhyay & Öztekin, (2021); Crespí-Cladera & Pascual-Fuster, (2014); Elisa AR2021

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Requirements in practice

- Board itself evaluates its independence
  - Need for external review?
- Concept of "*Independence of mind*"
  - Emphasizes supervisory and control duties
  - Practical point of view: director's capability and behaviour
- Determination to act in the interests of the company and its shareholders

Sources: IOSCO, (2007); Crespí-Cladera & Pascual-Fuster (2014); Aguilera & Cuervo-Cazurra (2009); SEC; NYSE; Sarbanes-Oxley Act of 2002; Gordon, (2006); Capital Requirements Directive (2013/36/EU); ESMA – EBA (2017); Ikäheimo et al., (2019)

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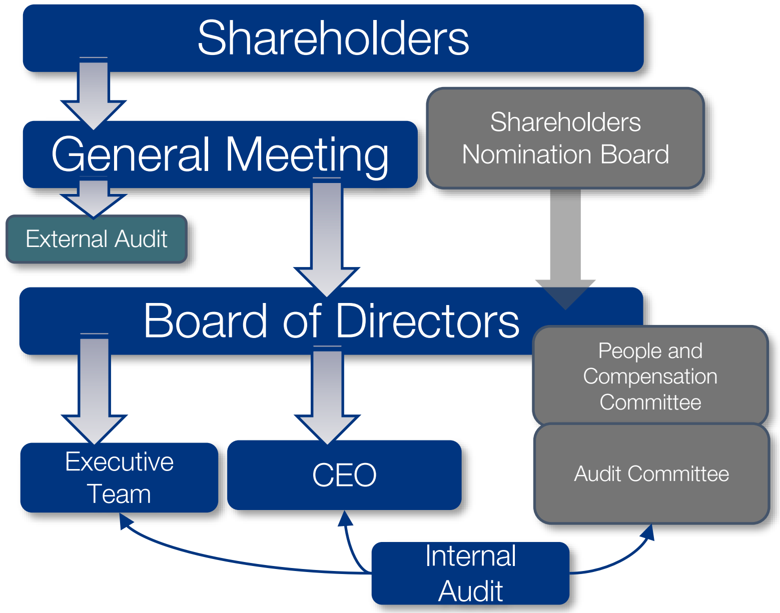
The example of the board at Elisa Plc

- Independent board members appointed by the AGM
- Members of the Nomination Board appointed by the most significant shareholders + Chair of the Board



Sources: Elisa IR webpages

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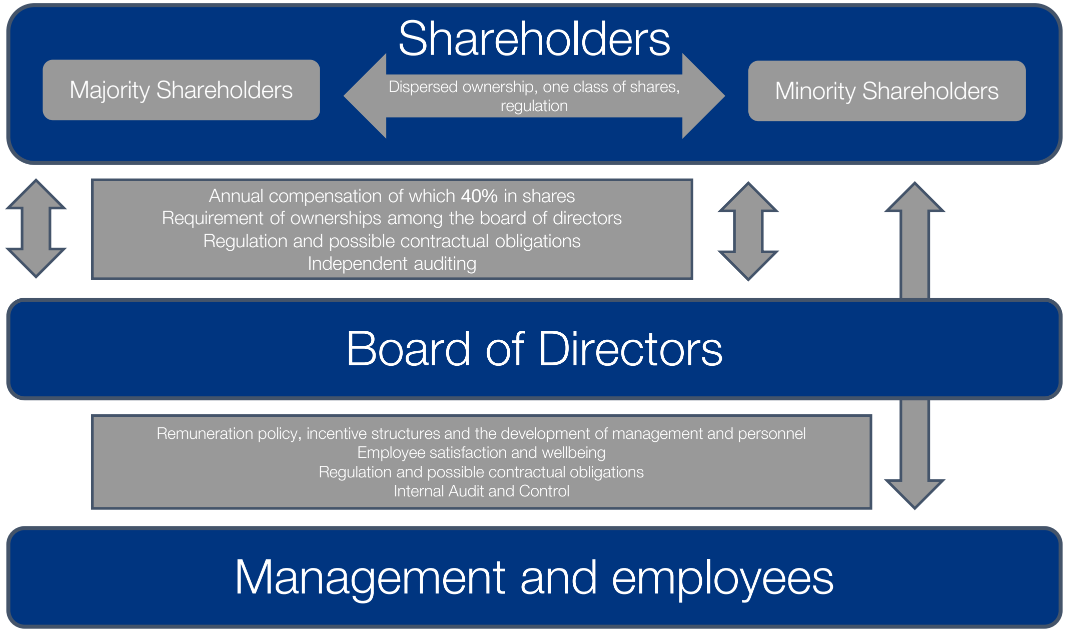
The example of the board at Elisa Plc

- Principal-agent problem in practice to set the scene for the analysis of compensation practices
- Principal-principal perspective



Sources: Elisa IR webpages

How are the directors on the board compensated?

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Alignment and methods of compensating

- Shareholder value thinking requires alignment of director remuneration and the value of the company (share price)

- Different ways of compensating:

  Fixed fee

  Fees per meetings (+ fees for committee members)

  Stock-based compensation

How are the directors on the board compensated?

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Director compensation in Finnish Plcs

- Legislation
  - *"In a listed company, the decision on the remuneration of the Members of the Board of Directors **shall be based on the remuneration policy presented to the General Meeting.**"*

- Corporate Governance Code
  - Remuneration may be paid in shares, promotes good corporate governance
  - Share-based systems should be separate for directors and management/other personnel

    Why? To avoid having the directors' and managers' interests too aligned, as directors should be monitoring the management

RECOMMENDATION 23 – Remuneration and Shareholdings of the Board of Directors

Remuneration for board and committee work may be paid, either fully or in part, in the form of company shares.

Remuneration of a non-executive director shall be arranged separately from the share-based remuneration scheme applicable to the company's managing director, management team, or personnel.

Sources: Limited Liability Companies Act; Finnish Corporate Governance Code

How are the directors on the board compensated?

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Director compensation in Finnish Plcs in practice

- Gummerus (2021)
  - Remuneration was mostly based on fixed fees
  - More than half of the listed companies paid additional meeting fees and they usually accounted for 10-30% of total remuneration
  - Many firms had additional compensation for board members who are members of committees
- Elisa Plc
  - Fixed annual fees
    - Chair 126k€
    - Vice chair and committee chairs 84k€
    - Members 69k€
  - Meeting fees
    - 800€ for board and committee meetings
    - 1600€ if permanent residence abroad but physically present in the meeting
  - 40% of remuneration paid in shares, rest in cash to pay the taxes on shares

Sources: Gummerus (2021); Elisa remuneration report

How are the directors on the board compensated?

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When is the independence compromised?

Regional variations

- US
  - Company's director compensation program must be publicly disclosed
  - No Corporate Governance Code
  - The most common pay elements at S&P 500 companies (2016):
    - Cash retainers
    - Annual equity grants
    - Committee chair retainers
  - Change in the last 20 years: instead of paying directors like executives they are now paid more like outside experts for their time and contribution
    - Taking away director pensions and benefits, less stock options, less meeting fees
- Germany
  - Legislation: *"...the remuneration is to be appropriate in relation to the tasks of the members of the supervisory board and to the company's economic situation..."*
  - Corporate Governance Code: *"Supervisory Board remuneration **should be fixed remuneration**. If members of the Supervisory Board are granted performance-related remuneration, it shall be geared to the long-term development of the company."*
  - In 2011 41% of listed companies paid only fixed fees and 46% paid fixed fees + short-run performance-based compensation

Sources: ICLG.com; Harvard Law School Forum on Corporate Governance; German Stock Corporation Act; Deutscher Corporate Governance Kodex; Lazar et al., (2014)

How is it connected to corporate governance literature?

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Incentives by (equity-based) compensation

- Equity-based compensation linked to positive performance and reduction of CEO power
- Problem of a “entrenched” CEO with a tenure that is overwhelmingly longer than current directors
- The total compensation should be high enough to attract talent, but not too high to potentially impact the board members' objectivity, independence, and judgment

Sources: Gummerus (2021); Magnan et al., (2010)

How is it connected to corporate governance literature?

When is the independence compromised?

Dynamics of Shareholders – Directors – Management

- “Grey directors” can act in a supportive-consultative role
  - Non-executive directors (NEDs) with ties to the company
  - Bankers, lawyers, etc.
- Fully independent boards can become passive
  - In studies linked to poor firm performance
- Even +20% ownership in pressure-resistant institutions has positive impact on preventing firm failure
- Principal-principal problem arises from due to ownership concentration, board structure, large director ownership, and direct link between the director and significant shareholder

Sources: Hsu & Wu, (2014); Adams et al., (2008); Faleye, (2014); Manzaneque et al., (2016)

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Part of a corporate governance bundle

- Aguilera et al., (2008)
  - **Costs** - High level of measuring and reporting has its costs, but provides brand value and trust
  - **Contingencies** - Core business lowers risks and enable risk taking on new ventures
  - **Complementarities** - Executive performance pay + independent board open reporting standards + high level control/audit
- Garcia-Castro et al., (2013)
  - Closest variables linked to our topic are board independence and remuneration disclosure
  - Performance-related compensations does not include directors
  - Overall, Elisa Plc can be seen as a company within “insider -classified country” but has adopted “outsider -classified” corporate governance bundle

Sources: Aguilera et al., (2008); Garcia-Castro et al. (2013)

When is the independence compromised?

Regulation perspective

- Finland
  - Directors should not be in the same remuneration scheme with the management
  - Majority of the board should be independent
  - At least two directors independent from major shareholders
- Germany
  - Employee representatives, shareholder representatives similar to Finland
- US
  - SEC: always independent if ownership under 10 %
  - Nasdaq and NYSE: no amount of stock itself compromises independence
  - No material relationship, capable of making decisions with the best of the corporation in mind

Sources: Finnish Corporate Governance Code; SEC; NYSE; Farano (2008)

When is the independence compromised?

Public perspective

- Major shareholders can have influence on board composition with nomination committees
  - Possible conflicts between major and minor shareholders
- Board evaluates their own independence
  - Conflict of interest?
- Independence always contextual
  - If necessary, court decides whether independence is compromised

Sources: Claessens et al. (2002); Zhao & Brehm, (2011)

When is the independence compromised?

Real-life border-line cases

fortum

- Finnish State as a majority shareholder (~51%)
- Strategy missteps followed by expensive loan arrangement from the Finnish State
- Loan arrangement terms requires free-or-charge special issue of shares to Finnish State

TALENOM
yrittämisen iloa

- Chairman of the board and his brother as a majority shareholder (~28%)
- Current strategy states +30% annual revenue growth and rising dividend

Sources: Fortum IR webpages; Talenom IR webpages; Talenom Q3 Press Conference

Key learnings

- In practice, besides the formal requirements laid down in soft law instruments, director's *independence of mind* is at the heart of the independence assessment
- Overall effects of equity-based compensation for directors seem to be positive and is more recommended than a breach of independence and trust.

Positives

- Tackles the principal-agent problem
- Enhances the motivation to monitor and actively participate in decision making
- Totally independent boards may end up being in passive supervisory role which increases the power of CEO

Negatives

- Big blockholders may lead to principal-principal problems
- Problems when the compensation or the ownership is too big part of the directors' overall wealth