22E00500 Corporate Governance

Group Report

Director compensation with shares and the independence of the directors

Group 11
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4.12.2022

What does the independence of directors mean in the context of companies?

In this report, we will discuss the link between the independence of a company's directors and their share-based remuneration - or compensation as put in the United States. First, we will review the regulation laying down the requirements for a director's independence. Second, we will analyze how the directors are compensated. Third, we will reflect our practical findings to corporate governance research. Finally, we will assess whether the share-based compensation may comprise the director's independence and, thereafter, present our conclusions and key learnings.

How does the Finnish regulation determine the independence of directors?

In Finland, there is no legal requirement that directors should be independent. Therefore, no legal definition of independence exists. In the absence of a legal requirement laid down in the legislation, independence is self-regulated in soft law instruments such as the Finnish Corporate Governance Code. Regardless of its soft law nature, the listed companies carefully follow the Finnish Corporate Governance Code subject to the Nasdaq Helsinki's Stock Exchange Rules.

According to recommendation 10 of the Finnish Corporate Governance Code, the majority of the directors shall be independent of the company. Furthermore, at least two directors who are independent of the company shall also be independent of the company's significant shareholders, which are shareholders controlling at least ten percent of the company's shares or votes. In other words, independence shall be scrutinized first in relation to the company and second in relation to the significant shareholders.

In accordance with recommendation 10 of the Finnish Corporate Governance Code, a director is not independent of the company, i.a., if the director has or has had an employment relationship with the company in the last three years or has a significant business relationship with the company. In relation to the company's significant shareholders, the director is not independent if the director is a significant shareholder, a significant shareholder's director, or otherwise exercises direct or indirect control over a significant shareholder.

Bearing in mind the definition set out in the Finnish Corporate Governance Code, we will next move on to analyze the rationale behind the recommended independence of the directors. Research on corporate governance typically builds on the agency theory, which proposes that owners (principals) and managers (agents) of a company have different priorities. In other words, owners' and managers' interests are not aligned. As a main rule, it is suggested to reduce this agency loss by adopting supervisory and control mechanisms such as the board of directors. The rationale behind the concept of independent directors is that they provide benefits for the company as the independent directors are able to effectively fulfill their supervisory and control duties in the board of directors, resulting from their independence from the company (Dalton et al., 1998).

Basically, the board of directors has a fiduciary duty to promote the interests of the company. The interests of the company can be seen ultimately as the interests of all its shareholders. In other words, even though a particular shareholder or a shareholder group may have interests that differ from other shareholders, the board of directors shall act with due care for the common interests of the shareholders. This objective is supported by the independence of the directors (Finnish Corporate Governance Code; Mähönen & Villa, 2019). Consensus in the academic literature is that the independent board of directors results in more effective monitoring of the executive managers (Upadhyay & Öztekin, 2021) and in avoiding managerial misappropriation (Crespí-Cladera & Pascual-Fuster, 2014).

We will use Elisa Plc, a Finnish telecommunications company, throughout the report as our primary case example. Members of the board are appointed by Elisa Plc's annual general meeting. In line with the Finnish Corporate Governance Code, recommendation 7, the Shareholders' Nomination Committee prepares a proposal for the election of the members of the board of directors for the annual general meeting. Currently, Elisa Plc´s board of directors comprises nine members who are all independent of the company and Elisa Plc's significant shareholders.

However, it can be shortly noted that Elisa Plc's four most significant shareholders are represented in the Shareholder's Nomination Committee. This raises the question of whether the members of the board are genuinely independent of the significant shareholders. Even though the directors are formally elected by the annual general meeting, it would be extraordinary that the shareholders would not vote in favor of the Shareholders' Nomination Committee's proposal. We will later circle back to discuss the independence of directors in

practice and how the directors should act with the "*independence of mind*" regardless of who has appointed them and what connections they have.

How does this regulation differ between market areas?

The development of standards to determine the independence of directors is a global phenomenon. Usually, the standards build an additional layer on the mandatory company and securities laws (IOSCO 2007) which was also demonstrated by the Finnish regulatory solution discussed above. Currently, there is an increasing number of corporate governance codes that propose explicit recommendations regarding the structure of boards of directors and, more specifically, regarding the desirable proportion that independent directors should hold (Crespí-Cladera & Pascual-Fuster 2014). However, it can be noted that the definition of independence of directors may vary across countries and even firms (Aguilera & Cuervo-Cazurra 2009), and therefore, we will next review the regulations in the United States and Germany in order to shed light on differences and similarities of the regulations.

The United States

In contrast to Finland and Europe, there is no widely accepted Corporate Governance Code that would lay down the standard for the independence of directors in the United States. However, in principle, there has been an initiative to prepare a corporate governance code for listed companies also in the United States, which recommends an independent leadership structure of the board of directors (Corporate Governance Principles 2017). According to principle 4, the independence would be based on an independent chairperson of the board or a separate independent lead director of the board. In other words, the proposed code does not require a majority of independent directors on the board of directors.

Instead of a corporate governance code, the matter of independence is primarily addressed in stock exchange rules or, in a few cases, Securities and Exchange Commission's (SEC) regulations and in the legislation of the company's state of incorporation (IOSCO 2007). On a general level, stock exchange rules and SEC regulations concern the appointment of the directors, and state legislation comes into question if a director's independence is challenged during his term on the board of directors.

Both New York Stock Exchange (NYSE), Rule 803, and Nasdaq, Rule 5605, require that the majority of the directors are independent. Also, the requirement is notably stricter than in the Corporate Governance Principles. Even though the wording of the rules slightly differs from

each other, the link between the director and the company, as well as the director's financial reliance on the company, is emphasized in the criteria. Besides the stock exchange rules, the Sarbanes-Oxley Act of 2002, adopted following the corporate accounting scandals, sets out that each member of the listed company's audit committee shall be independent. SEC oversees that stock exchanges do not allow the listing of the company's securities if the company does not comply with the requirement. In comparison to the Finnish Corporate Governance Code, the imposed requirements are rather strict since the Finnish Code only recommends that the majority of the directors in the audit committee are independent.

There has been a strong increasing trend in the proportion of independent directors on the board of directors of large public companies from approximately 20% in 1950 to approximately 75% in 2005 in the United States (Gordon, 2006). Taking into account the soft law discussed above, it can be assumed that the proportion has not decreased in the 2000s. Traditionally, the chief executive officers have had a dual role, also acting as chairpersons of boards. Also, this practice has weakened in recent years, which has supported the independence of the board of directors.

Germany

Traditionally, in contrast to Finland and the United States, German stock corporations have a two-tiered board structure, which consists of a supervisory board and a management board. As a result of the two-tiered structure, the supervision and monitoring powers are separated from the executive powers. Therefore, the independence of the directors in the supervisory board is enhanced. Another specialty in the German system is that employees are represented in the supervisory board subject to national legislation. One-third of the supervisory board members shall be employees' representatives if the company has 500 to 2,000 employees and half of the board if the company has over 2,000 employees. Employees' representatives are naturally elected by the employees, whereas other members of the supervisory board are elected by the shareholders in the general meeting.

According to recommendation C.7 of the German Corporate Governance Code, more than half of the shareholders' representatives in the supervisory board shall be independent of the company and the management board. Interestingly, the recommendation does not necessarily lead to a majority of independent directors in the supervisory board taking into account the employees' representatives. For example, if there are 9 members in the supervisory board, three members shall be employees' representatives. This leaves the minimum number of

independent members to four which does not form a majority in the decision-making. In this sense, the German Corporate Governance Code can be seen as slightly looser than the Finnish Corporate Governance Code and the stock exchange rules in the United States.

In summary, the soft law instruments in Western countries impose similar requirements, although the actual source may differ. In practice, regardless of their formal position as soft law instruments, recommendations of corporate governance codes and stock exchange rules are actually very binding as they impose requirements, e.g., for the listing on a stock exchange. Also, the central concept behind the independence recommendations is to ensure that there is a sufficient number of independent directors supervising objectively the executive management and, consequently, to promote the interest of the company and all its shareholders.

What is required from the company's board of directors regarding their independence?

Usually, the board of directors shall evaluate their independence by themselves. Ultimately, it is the responsibility of each director to report the factors that should be taken into account in the evaluation. In the evaluation, all factors available shall be considered. This means that even if there is no absolute factor that itself would compromise the independence of a director, factors overall may give rise to doubts about whether the director is free from dependencies.

It can be seen as somewhat problematic that the determination of independence is based on self-assessment: a director shall evaluate which factors to take into account and disclose, and thereafter, the board shall collectively evaluate whether each director is independent. It could be well-reasoned to ask whether an external review would strengthen the evaluation of directors' independence. For example, the company's external auditor could give a statement on the board of directors' evaluation of its independence. Of course, this would increase the administrative burden of the companies, and the benefits are not easy to demonstrate.

Besides the formal independence of directors, a concept of "*independence of mind*" has been introduced to emphasize the supervisory and control duties of the directors in the EU's banking regulation, more specifically in the Capital Requirements Directive (2013/36/EU). Independence of mind relates to the director's behavior and capability to assess and challenge, if necessary, the decisions of executive managers. It is required that each director

acts with independence of mind regardless of whether the director is independent of the company or its significant shareholders (ESMA & EBA, 2017).

> *"No doubt, if it were even conceivable, board members should be assessed for their independence of mind and strength of character. It would also be useful to know about a director's social networks and friendships with members of management, the subtle ways a director's independence might be compromised or threatened.*"
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> (Institute for Governance of Private and Public Organizations, 2008)

The independence of mind is an expression of substance over form -thinking in the context of independence. Not only is it relevant that the majority of the directors are formally independent of the company, but also that the directors are determined to act independently and in the interest of the company and all its shareholders. In practice, the importance of independence of mind concerns especially remuneration as well as the appointment and dismissal of executives, strategy, and relationships with significant shareholders (Ikäheimo et al., 2019). At the end of the day, in particular, this determination of the director to carry out one's duties diligently is likely the factor that will promote the interests of the company.

How are directors compensated?

Compensation can be divided into two basic forms: compensation via cash and equity. Director remuneration with cash most often means fixed fees (e.g., annually) for board work or fees paid based on meetings attended. There can also be fees for being on different board committees and attending their meetings. The fees are not mutually exclusive and a company can pay several kinds of fees. Equity-based compensation uses the company's shares and can happen via stock grants and stock options, for example. Director compensation can combine both cash and equity-based methods.

The obvious difference between cash and equity-based director remuneration is that compensation with equity ties the directors' pay to the success of the company. They become part-owners of the company, and their financial interests are aligned with it. This connection between company value and director compensation supports shareholder value thinking and should be for the benefit of the owners of the company and good corporate governance. As

Gummerus discusses in her master's thesis (2021), director compensation and especially the link with shareholder value have received more attention in recent years.

Director compensation in Finnish Plcs

Finnish legislation does not dictate very closely how director compensation should be done in a publicly listed company. Apart from a few exceptions, the most important thing is that the remuneration policy has been presented to the general meeting. The Finnish Corporate Governance Code gives more specific instructions. According to recommendation 23, remuneration can be done fully or in part in the form of company shares. Director remuneration should be done separately from the share-based remuneration of the management or personnel of the company. In the Corporate Governance Code, director shareholding is seen as a positive thing promoting good governance, and paying them for board work in shares is seen as a good way to increase their shareholding. Separating the director compensation from the share-based compensation of management and personnel is needed to ensure that the shareholders' interests are looked after. If directors were in the same system, their interests would be more aligned with the management's, so they would have less incentive to monitor the management of the company.

According to Gummerus (2021), remuneration in Finnish Plcs is mostly based on fixed fees which are mostly paid annually. Less than half of the companies in her study used shares in remuneration. For those companies that used shares, usually, approximately 40-50% of the remuneration was paid with them, the rest with cash. Over half of the companies paid meeting fees for their directors, and they were usually approximately 10-30% of the total remuneration. Meeting fees were more common in larger companies. Over 80% of the companies in the study paid additional compensation for board members who were also members of committees. Stock option plans for directors were very rare.

As an example of director compensation in a Finnish publicly listed company, we can take a look at Elisa Plc. They pay fixed annual fees, which are different for the chair of the board (€126,000), vice chair and committee chairs (€84,000), and members of the board (€69,000). Meeting fees are €800 for board and committee meetings unless the director lives permanently outside of Finland, in which case meeting fees are €1,600 if the director is physically present in the meeting. Of the remuneration, 40% is paid in shares and the rest in cash for tax withholding purposes. Compared to the findings of Gummerus, director

compensation at Elisa is higher than the median of Finnish large companies for both board members (Gummerus: €57,619 in 2017) and the chair of the board (€106,900). On the other hand, it is noteworthy that the compensation from one board membership rarely amounts to a significant proportion of director's total annual income in either the case of Elisa or other Finnish companies. One can argue that the directors' independence is therefore not compromised.

Director compensation abroad

The United States

Much like Finnish legislation, the compensation of directors is not regulated very much in the United States. The compensation program must be publicly disclosed. For example, Delaware, where over half of the U.S. publicly traded companies are incorporated, leaves compensation mostly for the company to decide: "*Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors.*" This seems to create a considerable conflict of interest, as directors get to decide their own compensation without shareholder approval. There have been some legal cases where the fairness of director compensation has been questioned and the way it should be considered discussed (for example In re Investors Bancorp, Inc. Stockholder Litigation, C.A. No. 12327-VCS, and Stein v. Blankfein, C.A. No. 2017-0354-SG). However, there has not been a wider change in response to these, which can be seen as a sign of companies being confident that their director compensation methods are fair (Shearman & Sterling).

The 2017 Corporate Governance Principles For US Listed Companies by Investor Stewardship Group does not discuss director compensation. The 2016 Principles of Corporate Governance by Business Roundtable states that director compensation typically consists of both cash and equity. Equity compensation is seen as aligning the interests of directors and shareholders, and the schemes are instructed to be planned carefully to avoid focusing on short-term market value changes. Instead of meeting fees, the paper recommends that an annual retainer should be paid to emphasize that board work is ongoing and not periodical (Principles of Corporate Governance 2016).

In practice, there has been a shift to a greater focus on equity, and now it is common for the compensation to be 40-45% cash and 55-60% equity (NYSE CGG). While meeting fees are

less common, some companies still have them. This is more common in smaller and mid-size companies than in large ones. Directors in leadership positions such as board chair or committee chair get more compensation. While stock options used to make up most of the equity compensation in the early 2000s, this has now changed, and stock options are a clear minority. Earlier directors were also offered different benefits and pensions in many companies, but they are now rarer (Harvard Law School Forum on Corporate Governance). The compensation model for directors has diverged from that of management, and directors are nowadays paid more like outside experts for their time and contributions.

Germany

German legislation resembles those discussed above and states that the supervisory board's members' compensation may be specified in the by-laws or granted by the general meeting. Interestingly, there is one addition related to the amount of compensation not found in the other examples: "*As a rule, 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.*"

German Corporate Governance Code opens this up and recommends that compensation should consider the higher requirements of the chair and deputy chair of the supervisory board and the chair and members of committees. The company's economic situation is not addressed in the code. Since 2012 it has also been recommended that compensation for the supervisory board should be fixed. However, if performance-related compensation is used, it should emphasize the long-term development of the company.

Before the recommendation to only pay fixed compensation, the code recommended both fixed and performance-based compensation for the supervisory board. In 2011 41% of listed companies paid only fixed fees (Lazar et al., 2014). The combination of fixed fees and short-run performance-based compensation was the most common, and 46% of the companies used this model. The criteria for short-run performance-based compensation consisted mostly of dividend distribution and accounting-based figures such as net income and earnings per share. Only 12% used fixed compensation with either long-run or long-run and short-run performance-based components. The criteria for long-run performance-based compensation were accounting-based and share price-based. Performance-based compensation was more common in larger companies. Also, long-run incentives were more common in larger companies than in smaller companies.

After the change in 2012, the number of companies only paying fixed compensation to the supervisory board has increased: in a 68-firm study from 2020, 53 out of 68 companies, or 78%, only had fixed compensation (Spencer Stuart). This is up from the 2012 figure of 27% reported by the same source. In the 2020 study, long-term performance-based compensation was twice as common as short-term. Most companies paid meeting fees and committee fees.

Are director independence and compensation found to be linked together in corporate governance literature?

Reflections against various studies

Overall, in addition to regulatory reasons, equity-based compensation to directors has been linked positively to performance (Gummerus, 2021). Besides this, Gummerus (2021) found that equity-based compensation to the directors decreases the CEO's power over the board (this can be seen as increasing board independence), aligns the interests of the shareholder and the directors, and enhances the directors' motivation to monitor executives. In the case of Elisa Plc, the independence of the board could be negatively affected by the fact that the current CEO (Veli-Matti Mattila) could be seen as "entrenched" by his very long tenure since 2003. In her paper Gummerus (2021) states that board independence and CEO power are the most crucial factors affecting director compensation, and these independent directors tend to be given more equity-based compensation packages. The total compensation should be high enough to attract talent but not too high to potentially impact the board members' objectivity, independence, and judgment (Magnan et al., 2010). In their paper, Magnan et al. (2010) do not provide any hints about where this "too high" lies in, but they imply that it depends on how significant the total compensation is compared to the overall wealth of the director. To summarize, equity-based compensation has gained popularity and is seen as a positive, but possible negative aspects of this kind of compensation are much less studied.

In the literature, "grey directors" is a term that comes up quite often during research on this subject. For example, Hsu & Wu (2014) refer to these "grey (or affiliated) directors" as non-executive directors ("NED") with other personal or economic ties with the firm or management. Adams et al. (2008) give an example of these "grey directors" as lawyers or

bankers with personal business with the company or politically-connected directors. There is no mention of ownership of the company making directors “grey,” but this personal business connection to the company can be seen as making the directors “less independent.” In their study, Hsu & Wu (2014) found that boards with a more significant portion of “grey directors” (or non-independent NEDs) are less likely to fail. Their findings indicate that fully independent directors are more likely to act as supervisors when “grey directors” act more in a management-supporting advisory role. Faleye (2014) did a study on 2900 U.S. S&P 1500 firms between 1998-2011 and found that fully independent boards can be associated with poorer operating performance and firm value. To our overall subject in this paper, these findings could be interpreted as providing evidence promoting even significant ownership among the directors or including some “grey directors” on the board.

> *“... providing explicit incentives to directors leads them to be more vigilant (act more independently). Beyond incentive reasons, another potential explanation is the following: In firms that make use of incentive pay for directors, the directors have a professional rather than a personal relationship with the CEO and, thus, are relatively independent of him.”*
>
> (Adams et al. 2008)

In their study, Manzaneque et al. (2016) found that directors appointed by pressure-resistant institutions (like in the case of Elisa Plc) have a negative impact on the likelihood of business failure. Manzaneque et al. (2016) also looked into companies owned by the directors, and in their sample, non-distressed firms had higher ownership among directors overall (25.8% vs. 22.1%). Also, independent directors (10.5% vs. 6.2%) and pressure-resistant institutions (7.5% vs. 4.8%) had more extensive ownership. What makes their study especially interesting is their finding of the rising principal-principal problem, which apparently is a significant problem among Spanish companies (due to ownership concentration, board structure, large director ownership, and direct link between the director and significant shareholder). Manzaneque et al. (2016) recognize this as a problem in Japan and in continental Europe. In the study, it was proposed that the presence of institutional blockholders could work as a supervisor to prevent unfair wealth extraction from minor shareholders to benefit the major shareholders. In the case of Elisa Plc, this should not be a problem as ownership is extensively dispersed, and even though directors are proposed by institutional owners, the current directors seem to be independent of these institutions. Also to be noted, these findings

may not be widely applicable to other regions, as the sample of Manzaneque et al. (2016) consisted of 70 non-financial publicly listed Spanish firms in the period of 2007 to 2012.

It seems that tying directors to the company with partially equity-based or performance-based compensation has a positive impact on the board and company performance. Based on the literature, somewhat concentrated ownership, including directors appointed by pressure-resistant institution, have a positive impact. Overall, the optimal board structure and director ownership is a balancing act, as there is evidence for fully independent boards being too passive and only to monitor executives, but too concentrated ownership to the directors (or a director with direct affiliation to the owner) can create principal-principal problems. This problem can arise from the director (or the entity that appointed him/her and he/she has a direct relationship with) having a business connection to the company.

There is definitely a tipping point where director ownership becomes a problem, but this tipping point is relatively high, as Manzaneque et al. (2016) showed that even with over 20% ownership, there is still a positive impact in preventing firm failure. It needs to be taken into consideration that this is the case with pressure-resistant institutions, and individuals (or families) with this level of ownership in publicly listed companies might have "too much on the line" as the ownership represents the majority of their wealth.

Reflections against Aguilera et al. (2008)

Costs – Based on the pedantic approach of Elisa Plc in measuring and reporting, they pay a high price to ensure their corporate governance. This provides benefits, for example, excellent brand value and trust. Elisa has highly dispersed ownership, so agency costs trump the principal costs. On the other hand, we can assume the marginal utility of improving Elisa Plc's corporate governance further would be low (Garcia-Castro et al., 2013).

Contingencies – Elisa Plc has a very strong cash flow from the "basic" operations and does not need much external financing, even though they have the capacity to obtain it if necessary. Uncertainty about Elisa Plc's business is kind of a double-edged sword. Technologies constantly change and require investments. The change is usually relatively slow, but reacting to it is crucial. In Elisa Plc's core business of Telecommunications, it is hard to differentiate, but barriers for entry are high, and new competitors are unlikely.

Complementarities – In their text, Aguilera et al. (2008) mention an example of complementarities where executives have performance pay, and the board is highly independent. In Elisa Plc's case, both are implemented. Also, Elisa has open reporting standards complemented by meticulous internal control and audit functions.

Overall, Elisa Plc is a nationally significant company that carefully follows every law, rule, and guideline. Ownership is dispersed by ~27% to Finnish public entities, ~14% to international funds, ~6% to pension funds, and the rest to miscellaneous owners.

Reflections against Garcia-Castro et al. (2013)

In their study, Garcia-Castro et al. (2013) identified board independence as a variable for their "inside/outside"-classification of governance bundles. In the case of Elisa Plc, the chairman of the board, Anssi Vanjoki, can be seen as fully independent ("Chairman is non-executive and independent since several years"), which points Elisa Plc towards "inside"-classification. We must highlight the fact that in their explanation of board independence, Garcia-Castro et al. (2013) refer mainly to independence as non-executive roles, either currently or in recent years. They mention the director being an "outsider" but do not directly refer to share ownership. Based on the U.S. Securities and Exchange Commission (SEC) guidelines, a director with over 10% ownership can be seen as an "insider." Still, it is not clear whether Garcia-Castro et al. (2013) follow this guideline in their paper.

Garcia-Castro et al. (2013) did not identify share-based compensation of the board of directors as a variable. However, we took into account the most relevant information available for us, which was remuneration disclosure. On this variable, Elisa Plc sets in as "more in than out" as the compensation for individual board members and CEO is clearly communicated. This communication is available on their website as well as in annual remuneration reporting. Where Elisa Plc is lacking - in terms of "inside"-classification - is their reporting on the remuneration of top management other than the CEO.

As a side note, the compensation for the board of directors at Elisa Plc is fully fixed, and there is no performance-related compensation. For top management, there are separate short-term and long-term incentive plans, but directors are not included in these plans. For the years 2020 and 2021, the portion of performance-related compensation for the CEO has been around 23% and 27%. When we reflect these numbers to the variables in the paper of Garcia-Castro et al. (2013), Elisa Plc would be set in as "more in than out." When it is taken

into consideration that the directors are not included in the performance-related compensation systems, we would determine Elisa Plc more to the classification of “more out than in.”

Based on these findings, the corporate governance practices of Elisa Plc can be identified as “insider”-classification. This is consistent with the findings of Garcia-Castro et al. (2013), that firms in continental Europe end up quickly in this category. To be able to place Elisa Plc in the Garcia-Castro et al. (2013) “Nested Truth Table for Insider Firms” -diagram, we need to calculate the employee turnover rate and return on equity for Elisa Plc. We calculated the employee turnover rate based on the number in the Sustainability Report 2021 from Elisa Plc, and the average turnover rate for the years 2019-2021 was 21,8%, which points toward “outside”-classification. The ROE for Elisa Plc in these same years has been 27,8% on average (Elisa Plc AR2021), which points toward “inside”-classification. Entering all these variables into the diagram in the Garcia-Castro et al. (2013) study, the corporate governance in Elisa Plc can be categorized as “Insider - 2N”. This result is linked to a group of firms within “insider countries” (e.g., Scandinavian) classified by the legal tradition and financial market attributes, which have adopted outside corporate governance practice bundles (Garcia-Castro et al. 2013).

The corporate governance practices at Elisa Plc form a bundle where multiple complementary practices lead to high performance.

At which point can the independence of directors be seen as compromised by compensation?

As discussed earlier, the Finnish Corporate Governance Code recommends that the remuneration of board members is paid at least partially with the company shares. The reason for that is that it should promote good governance by aligning the interests of directors and shareholders. However, we should examine whether the directors' ownership can compromise their independence.

Regulation perspective

The Finnish Corporate Governance Code has some limitations to board remuneration and independence. The one most related to director compensation is that the directors should not be in the same stock remuneration scheme as the management. That could easily compromise their independence. If the remuneration of management and directors is linked, that could align their interests and reduce the monitoring of the management the board should do.

The Corporate Governance Code does not have any direct limitations or restrictions to how much the directors can own the company stock. We can also look at how this is regulated in other states. In the US, both major stock exchanges, Nasdaq and the New York Stock Exchange, have also stated that no amount of stock itself will compromise the independence of directors. This would suggest that stock ownership is also recommended and not a problem for independence. However, the wording of the rules leaves a chance that independence may be compromised if the ownership is combined with some other factors.

In the US, also the Securities and Exchange Commission has some regulations over board independence, mainly through the Sarbanes-Oxley Act. The act was introduced after accounting scandals in the early 2000s, so it focuses more on the accounting and audit perspective. In the board, it is thus related to the members who are on the audit committee and face extra regulation because of that. The act has introduced a safe haven of 10% when it comes to ownership. If the level of ownership is under that, directors' independence is not compromised even if they are on the audit committee. If it is over that, it doesn't mean that the independence is compromised, but it has to be reviewed on a case-by-case basis.

The New York Stock Exchange rules also state that there cannot be material relationships between the company and its directors, or they will not qualify as independent. The US court has defined independence as "for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind" (Parfi Holding AB v. Mirror Image Internet, 2001). That may be the most important thing when reviewing independence. A material relationship can originate in many ways, but just stock ownership shouldn't create that.

Farano (2008) has come to a conclusion in his study that the directors' stock ownership should not have an effect on independence. That is because it is seen as enhancing good governance. He also argues that regulation should take a stronger stance on stating this as the

current regulation does not have a firm stance on director stock ownership. This would have an effect on promoting governance.

The Corporate Governance Code also has some regulations about the composition of the board when it comes to independence. Over half of the directors should be independent of the company. Also, at least two of these independent directors should be independent of the major shareholders. A major shareholder has been defined as someone who has at least 10% of the company shares or the voting power of the company.

In Germany, the regulation is quite similar to Finland as there is also a Corporate Governance Code. The German Corporate Governance Code does not take as strong of an opinion on recommending the stock ownership of directors, but it also does not see it compromising the independence of directors. A German specialty is the employee representatives that affect the composition of the board, but as for the shareholder representatives, the requirements are quite similar to Finland. For example, a majority of the shareholder representatives should be independent.

There are, however, some small differences. If the board consists of less than six members, only one shareholder representative has to be independent of major shareholders instead of two. Also, in Germany, there are some roles that have to be independent, whereas in Finland, the requirement is usually that the majority has to be independent. These roles are the chair of the board, the chair of the audit committee, and the chair of the remuneration committee.

Public perspective

Even if there are no direct independence breaches, stock ownership can create differences between major and minor shareholders (principal-principal problem). That can be if the major shareholders get their representatives on the board, whereas the minor shareholders do not. One reason for this are the nomination committees. It is common that the biggest shareholders get their representatives in the nomination committee, and they get to decide the board members. If the directors are nominated by major shareholders, that does not mean that they are officially non-independent of them, but it could be questioned whether they would promote their interests.

Claessens et al. (2002) have found evidence that if large shareholders have more controlling rights than ownership, that has a negative effect on firm value. This is because with more

extensive control, the major shareholders can extract value from the company easier. These controlling rights can be achieved if the board is non-independent of the major shareholders. Zhao & Brehm (2011) have found in their research that, for example, the number of blockholders adds conflicts between the board and the minority shareholders. These are some reasons why it could be better if the major shareholders would not have too much power in the board.

Also noteworthy is that the board itself reviews whether the directors are independent or not. Also, the directors themselves are responsible for providing the board with all the necessary information to evaluate the independence. This can leave at least a possibility that the independence review is not always accurate. Someone could leave out important information, or when people are evaluating themselves, they may not always be totally objective. This could especially be the case when evaluating the overall picture of independence and not the absolute criteria. One reason for this is that the justification for independence doesn't have to be explained in any way. Instead, it only has to be disclosed when the directors are not independent and the reasons behind that. It could also be questioned whether the independence of the board should be reviewed externally.

Especially in the US, the board's independence sometimes requires external judgment. It has resulted in that sometimes it has to be decided in the court whether the independence has been compromised or not. The decisions are usually made in the Delaware Court, as most of the major US companies are based there. The decisions consider the overall picture very comprehensively in order to decide whether the directors are independent or not. In Finland, there are not that many court cases or preliminary rulings about the independence of directors.

Real-life examples of possible principle-principle problems

Currently, there are a couple of ongoing examples of possible principal-principal problems visible in Finnish-listed companies. The clearly more public one is the case of Fortum, where the Finnish state currently owns 50,76% through Solidium and can be seen steering the company in a way that may be harming the minority shareholders. After the failed acquisition and finally the divestment of Uniper, Fortum is clearly in distress. This has led to a point where Fortum has agreed to €2.35B bridge financing from the state (which is their majority shareholder via Solidium) with an effective annual interest rate of 14.2% (Fortum). This

arrangement included a condition that Solidium would also have a special issue of 9 million Fortum shares (worth almost €130m) free of charge, which means ~1% dilution to all shareholders. An extraordinary general meeting for this special issue was held on 23.11.2022. The vote required a supermajority of votes and the arrangement was accepted even though opposition to the decision was organized by Suomen Osakesäästäjät (registered association). It is plausible that Fortum has made significant losses due to Uniper and can not distribute dividends at least from the present year. It is speculated that the Finnish State tries to cover this lack of dividends (~€500m to the state from the year 2021) by extracting money from Fortum via this high-interest loan. There has been no transparency on whether or not Fortum tried to look for other sources for loans, perhaps with more beneficial terms for all the shareholders. It was stated by the chairman of the board of Fortum that there is no risk for the Finnish state to get their loan back, but the loan terms imply otherwise (Helsingin Sanomat). Note that Fortum states that its board is fully independent and is nominated by the shareholder nomination board, which consists mainly of a representation of three significant shareholders: Solidium, Ilmarinen, and Varma (Fortum).

The other example is Talenom Plc, which provides accounting services and develops accounting software. In Talenom Plc, the son of the original founder Harri Tahkola owns 17.7%, and his brother Markus Tahkola owns 10.7% of Talenom shares (Talenom). Harri Tahkola has been the CEO of Talenom in the past and has been on the board of directors since 1998. Currently, Harri Tahkola is serving as the chairman of the board. Talenom Plc has been growing by double digits for the past years and is currently trying to conquer new markets in Sweden and Spain. Ahead of their Q3/2022 report Talenom Plc released their updated medium-term targets, which stated that they are going for +30% annual revenue growth, +15% EBITDA growth, growing nominal EBIT, and growing dividend per share (Arvopaperi). This target with growing dividend per share (DPS) could be seen as a contradiction to revenue growth ambitions, and it was challenged on the same day in the Talenom Plc press conference for Q3 results (Inderes). In the Q&A section of the conference, the reason for this target decision was asked and CFO Antti Aho answered (at 35:47) that "We want to serve as many investors as possible. Some think that growth is really important, and some also want dividends. Especially the small investors like the dividend, so that's why we are also having that.". This explanation was not seen as sufficient, and among the minority shareholders, it was speculated that the Tahkola brothers wanted some cash flow from the company as it is expected to be a significant portion of their wealth. Some minority

shareholders saw that this decision to grow DPS would hamper the growth ambitions of Talenom Plc and favor the majority shareholder's will.

Conclusions and key learnings

As an addition to the above analysis, we can summarize that, besides the formal requirements laid down in soft law instruments, the directors' behavior and capability to assess and challenge the decisions of executive management are at the heart of the independence assessment. Equity-based compensation does not compromise the independence of directors if they act with the *independence of mind*. Director independence as a concept can be seen more fluid or as a spectrum than a binary question of independent or non-independent. In this paper, we have been focusing mainly on the directors' independence from the major shareholders. The major shareholder is repeatedly referred to as an entity owning +10% of the company. What is more ambiguous is that is the apparently independent director truly independent from the major shareholder if that shareholder has directly influenced the director's nomination. Even if the director does not have a direct link to the shareholder, he/she can at least be seen as being in debt for the shareholder of getting a possibly lucratively paying position as a director. This may be even more evident if the compensation for the directorship is significant compared to his/her overall income or wealth.

We can conclude that equity-based compensation is an essential part of the compensation scheme for directors. We have found the following positive aspects that can be derived from it:

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

With this said, we have still found possible dangers or conflicts that can follow equity-based compensation. These could be:

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

Our end-of-the-day assessment of equity-based compensation for directors is still positive. Linking shares to remuneration is more recommended than a breach of independence and trust. This is supported by the corporate governance “bundle theories” by Aguilera et al. (2008) and Garcia-Castro et al. (2013), as well as several studies (Gummerus, 2021; Magnan et al., 2010; Hsu & Wu, 2014; Faleye, 2014; Adams et al., 2008).

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