Dear Mr Sid

Re: Paying Good Money for Good Governance

In our meritocratic society, we expect rewards to be proportionate to efforts and achievements. But this is not always the case.

Since joining the board of a publicly listed company five months ago, I have witnessed firsthand the stark discrepancy between the humongous compensation bestowed upon top executives and the pint-sized pay doled out to non-executive directors (NEDs).

To be sure, our profits and share price have reached record levels. To reflect this, the remuneration committee (RC) recently recommended awarding the chairman cum CEO a total of $5 million in cash and stocks, up from $3 million last year. Other C-suites were also handsomely rewarded, with the CFO almost doubling her pay to $2 million.

However, we poor NEDs were left to contend with an average paltry stipend of $85,000. Of course, our role is part-time, but the company's success is due in no small measure to the board's leadership too.

Clearly, the director pay is not commensurate with the level of responsibilities and risks we take. I, therefore, proposed we first double the NED base pay, and implement a performance-based bonus system of 50 to 100 per cent, similar to management's. I said half of our pay could be in stock options. On the high side, the potential amount paid to the whole board of six directors (five NEDs actually) would still be less than half of what we just gave the CEO.

To my surprise, my colleagues on the board demurred. The RC chair cited concerns about public perception and the potential backlash on social media. However, I staunchly believe that our decisions should not be swayed by external media, but instead, reflect our internal values and recognise our responsibilities.

While the matter is currently under deliberation by the RC, I have been invited to attend their next meeting. I am reaching out to you, Mr Sid, for practical advice on navigating this situation.

SID says it champions governance for good. Good governance must, after all, go hand-in-hand with good rewards. I eagerly await your suggestions.

Yours sincerely,

Champion-of-Rewarding-Good-Governance

Dear Champion-of-Rewarding-Good-Governance

Your letter raises intriguing philosophical questions about the kind of society we are living in.

Let me first address your point that our system is a meritocratic one, and then offer you a different perspective on director and management remuneration.

Meritocracy

When there is pay disparity, it is not, as you suggest, that meritocracy is not functioning. It is the opposite. In a purely meritocratic system, individuals are rewarded based on their, well, merits, and, as a result, there would be a disparity in rewards (pay in this case) because of variations in "merits" of the job types and individual performances.

The question that arises is: what truly defines "merit"? In your case, your (biased) view is that the merits of directorship are not "fairly" recognised compared to the merits attributed to management's job. While the reasons for this discrepancy may vary, it is the exercise of meritocracy, rather than its failure, that causes the disparity in compensation.

However, it is crucial to recognise that our society is not solely driven by meritocracy. It needs to be balanced and aligned with social equity and justice. Social justice entails providing equal rights, opportunities and access to resources for all members of society. Occasionally, pay disparities resulting from the strict application of meritocratic principles in a free market may conflict with these principles.

Basis of remuneration

Before your discussion with the RC, it is essential to understand the distinction between the roles and remuneration basis of the board and management.

Directors are responsible for governance oversight, while management handles day-to-day operations. Consequently, their remuneration should be, and is, based on different criteria.

Executive compensation primarily aims to incentivise management's behaviour to create value and retain talent. Over time, compensation tools for management have evolved to include a combination of base compensation, short-term incentives (STIs), long-term incentives (LTIs), and employee benefits. STIs and LTIs are typically tied to tenure and performance, encompassing both corporate and individual achievements. Furthermore, a mix of cash and stocks is often utilised, with stocks being seen as a means to align the interests of the holder with that of the company.

On the other hand, director remuneration (specifically referring here to NEDs, as executive directors are part of management) is intended to compensate for the time and effort required for their roles and responsibilities. Directors, much like doctors, lawyers and accountants, are professionals who receive fees based on their expertise, diligence and time dedicated, rather than the specific outcome of their work. Therefore, it is worth noting that the industry commonly refers to it as "director fees" to differentiate it from "executive pay" (I noticed that you use the term "director pay").

It is important to recognise that performance-based measures (such as share options or performance shares, or even cash-based bonuses) are not in line with the remuneration philosophy of directors as professionals. However, a small proportion of stock-based remuneration may be considered appropriate to align directors' interests with the company's, provided it does not compromise the independence and objectivity of independent directors.

Quantum of director fee

You obviously feel that the current quantum of director fees is unfairly low.

To address this, you can present a case to the RC and the board, advocating for a fair amount based on the time and expertise required, as well as the responsibilities and liabilities associated with directorship. It is important to note that the calibration of director fees is likely to be subjective and viewed as such.

One significant challenge in this regard is that the board itself recommends what is fair to pay themselves, which can potentially raise concerns of self-dealing, although ultimately, director fees have to be approved by the shareholders. Consequently, most boards set their fees by benchmarking them to those of similar boards, rather than benchmarking against the company's management. It is also common practice to engage a third-party human resource consultant to conduct the exercise or at least to provide comparative data in such cases.

Quantum of CEO pay

If you disagree with the significant disparity in director's and CEO's compensation, it raises the question of whether it is the CEO's pay which is excessively high.

While average director fees tend to fluctuate within a narrow range across companies, CEO compensation exhibits significant variations across the industry.

In your case, $3 million to $5 million is a substantial sum by most company standards, especially when you are not a large company (since you only need six directors). Considering that the next highest-paid executive (presumably the CFO) earns less than half the CEO's pay, the disparity increases significantly as it goes down the staff levels.

Numerous studies and articles have highlighted the issue of excessively high CEO compensation, particularly in comparison to the wages of the average worker. For instance, according to the Economic Policy Institute, the CEO-to-worker pay ratio in the US reached as high as 399 times more in 2021. Such vast discrepancies have fuelled concerns and discussions about social equity, income inequality, the nature of capitalism and corporate governance.

Many reasons have been given for how this situation of excessive CEO compensation came about: talent scarcity, peer benchmarking, performance-based systems with outsized incentives and poor corporate governance.

You and your board should be careful, especially regarding the last point. Some boards are overly biased in decisions favouring the CEO because of personal and business relationships. It is especially difficult to be independent when the CEO is also a substantial shareholder and/or chairman (which is your case).

Facing the RC

Here are a few suggestions to guide your discussions with the RC:

- Acknowledge that director remuneration is primarily based on fees for time, expertise and diligence as professionals.
- Propose that the RC properly benchmark director fees against other boards, taking into account factors unique to your company.
- Advocate for a review of executive compensation, specifically focusing on the CEO's pay, considering both the internal inequities within the company and industry benchmarks.
- Advise your fellow directors to exercise caution regarding potential biases that may influence decisions in favour of the CEO, especially when personal and business relationships are involved. Objectivity and independence are vital, even when the CEO holds a substantial shareholding.

I wish you the best of luck in your efforts to champion fair remuneration for both directors and management.

Yours sincerely

Sid

Mr Sid

Who is Mr Sid?

Mr Sid is a meek, mild-mannered geek who resides in the deep recesses of the reference archives of the Singapore Institute of Directors.

Burrowed among his favourite *Corporate Governance Guides for Boards in Singapore*, he relishes answering members' questions on corporate governance and directorship matters. But when the questions are too difficult, he transforms into Super SID, and flies out to his super network of boardroom *kakis* to find the answers.

Mr Sid's References (for this question)

Remuneration Committee Guide
Section 3.2: NED Fee Philosophy
Section 3.4: Use of Equity
Section 3.5: Determining Non-Executive Directors Fees
Section 4.2: Executive Remuneration Philosophy
Section 4.3: Executive Remuneration Components
Section 4.4: Executive Remuneration Levels

SID Statement of Good Practice
SGP 10/2013 Fees Payable to Non-Executive Directors

Practice Guidance
PG 7: Level and Mix of Remuneration

Boardroom Matters
Vol 1, Chapter 40: "A Question of Pay" by Adrian Chan
Vol 1, Chapter 41: "Should Non-Executive Directors Own Shares" by Annabelle Yip
Vol 2, Chapter 40: "An Inconvenient Question: How Much is a Director Paid?" by Wong Su-Yen
Vol 2, Chapter 41: "Improving Remuneration Governance" by Jon Robinson
2021 November 8: "The Case for Proper Remuneration Governance" by Jon Robinson

SID Directors Bulletin
2016 Q1: "Scrutinising Singapore's Top Executives Pay" by Kevin Goh
2016 Q1: "NED Fees Face Upward Pressure" by Jon Robinson
2016 Q1: "Is 'Say on Pay' the Only Way" by Shai Ganu
2023 Q3: "Board Compensation Trends and Challenges" by Na Boon Chong, Jacob Tan and Abirami Devi