

AICD POLICY & ADVOCACY

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## Remuneration of Non-Executive Directors

*This position paper represents an amalgamation of comments previously made by the Australian Institute of Company Directors (AICD) on Non-Executive Director Remuneration. The paper has been prepared with a view to presenting AICD's policy positions in a readily accessible form.*

### Introduction

Boards of Directors fulfill an important role in the companies they serve. Good remuneration practices attract, retain and motivate directors of a high calibre, and thereby contribute to greater corporate effectiveness.

### Good practice in setting director remuneration

AICD believes it is good practice when structuring non-executive director remuneration to adhere to the following general guidelines:

- boards should have in place formal and transparent processes for determining remuneration
- remuneration should reflect the duties, responsibilities and risks of the role in a reasonable manner
- no director should be involved in deciding his or her own remuneration; rather professional advice should be sought in determining director remuneration levels and structure
- remuneration should be predominantly in the form of fixed fees
- options should not be granted to non-executive directors, unless there are special circumstances (see below)
- non-executives directors should not participate in bonus schemes designed for executives
- there should be no retirement benefits other than superannuation, however a severance payment in certain situations is considered appropriate (see below)
- boards should ensure their remuneration caps are regularly reviewed and are sufficient for the reasonably foreseeable future
- where substantial extra time and effort is required of directors in response to particular corporate situations or events, and this commitment is reasonably considered to be extraordinary, it is appropriate that such directors be entitled to additional remuneration (see below)
- corporate constitutions should be clear on directors' fees and exertion allowances.

## Level of remuneration

The level of remuneration for non-executive directors often varies between companies. It should take into account a number of elements, including:

- the company's existing remuneration policies
- the time needed for the task
- the risks inherent in the directorship
- qualifications and experience of the individual concerned
- industry comparisons
- the size and complexity of the company's operations, for example, the nature and variety of its businesses, geographic locations, national and international diversity, technology used
- the number and extent of board and related sub-committee meetings.

Non-executive directors should be remunerated according to the specific activities they undertake for individual companies. For example, the chairman should be remunerated at a level that is a multiple of other directors' remuneration, to acknowledge the additional workload. It may also be appropriate for committee chairmen or members to be remunerated for their contributions in those roles.

Irrespective of what their constitution says, listed companies cannot pay fees beyond those approved by shareholders. To do so would breach the Australian Securities Exchange's (ASX's) listing rules.<sup>1</sup>

Companies should ensure letters of appointment for board members are clear as to the expected time commitment and what will happen in cases where extraordinary additional exertions are required (see below).

## Structure of remuneration

AICD recommends the board determines the individual level and appropriate components of remuneration for each director. When deciding the appropriate level of remuneration the board needs to consider the capacity and workload of each non-executive director.

AICD does not endorse any particular remuneration structure, but strongly recommends that boards seek professional advice in this context. Whatever structure the board decides to adopt, it should be transparent and straightforward. Without endorsing any specific approach, AICD considers a combination of fees, shares and superannuation contributions is appropriate in most situations, and that the board (or if so delegated, the

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<sup>1</sup> ASX listed companies set an upper limit, or cap, on what can be paid to directors by way of fees (this does not include salaries paid to executive directors). ASX listing rule 10.17 states a company must not increase this cap without the prior approval of shareholders.

Remuneration Committee) should determine its attitude toward the components of overall remuneration and policies related to the level of remuneration for each individual director. Further, AICD supports the view that individual directors should have the freedom to determine the proportion of their total remuneration that falls into each category and this decision should relate to a director's specific personal circumstances.

AICD believes the board should make the final decision about the remuneration of each director, within a fee cap approved by the shareholders.

## **Equity Grants to Non-Executives**

Acknowledging that ownership of a company's shares by its directors aids in alignment with shareholder interests, AICD encourages the purchase of shares at market price by directors through the sacrifice of a portion of their fees under a company scheme.<sup>2</sup> AICD also encourages schemes that ensure directors hold these shares so long as they are serving on the board.

Except as discussed below, AICD does not support the granting of options or partly paid shares to non-executive directors. In this regard, any arrangement that negatively impacts on the independence or the perception of independence of non-executive directors should be discouraged. However, there are some relatively rare circumstances where the use of options may be acceptable. For example, a start up company uses options as a means of non-executive director remuneration where the company is unable to make cash payments. In these circumstances the allocation of options should be structured so that directors' and shareholders' interests are aligned. In particular the possibility of immediate windfall gains through market price movements unconnected to the board's and management's efforts should be minimised through the use of appropriate hurdles in both absolute and relative terms. Options allocated in this manner must be fully disclosed.

## **Exertion Allowances**

Boards set annual fees within the shareholder approved cap on the basis it is business as usual, however it is recognised there may from time to time be considerable additional demands on directors. AICD believes that where substantial extra time and effort is required of directors in response to particular corporate situations or events, and this commitment is reasonably considered to be extraordinary, it is appropriate that such directors be entitled to additional remuneration. Where the board approves such additional remuneration or exertion allowance, it should take into account both the time commitment and the level of complexity and responsibility, considered within the context of the standard fee level.

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<sup>2</sup> Directors should be mindful of their obligations to report such share transactions in accordance with the section 205G of the Corporations Act, as well as insider trading laws.

Examples of additional responsibilities include:

- involvement in ad hoc due diligence procedures, such as sitting on a specially convened due diligence committee
- work on merger and acquisition related activities where the proper discharge of directors' duties may require substantial involvement outside ordinary board and committee meetings.

Exertion allowances are separate from any independent consulting or advisory services that a director may provide to a company with which he or she is associated and for which fees should be agreed on an 'arms length' basis.

Where the exertion allowances, together with the standard annual fees, fall within the amount approved by the shareholders as the maximum amount that may be paid to the directors as a whole, shareholder approval is usually not necessary if the additional remuneration is reasonable<sup>3</sup>. Depending on the quantum of the proposed additional remuneration, Boards may consider that the advice of an external independent remuneration specialist should be obtained in advance of any payments to ensure it can be demonstrated that the amounts concerned are reasonable in the specific circumstances as they relate to the company. Whether or not shareholder approval is obtained, the additional remuneration should be fully disclosed in the company's annual remuneration report.

## Retirement Allowances

It was not uncommon in the early 1990s for Australian companies to provide non-executive directors with a promised end-benefit retirement allowance. Since that time the incidence of such allowances has declined considerably. This reflects growing sentiment that such arrangements do no represent good corporate governance practice.<sup>4</sup>

AICD believes directors' remuneration should reflect contribution to a board rather than longevity of service, and supports the abolition of retirement allowances that are additional to Superannuation Guarantee Contribution (SGC). Where such additional allowances do exist, they should be fully disclosed in a company's annual remuneration report, and included in the calculation of director fees paid for the purposes of determining whether aggregate payments fall under the directors' fee cap.

<sup>3</sup> Refer to sections 208 and 210 of the Corporations Act.

<sup>4</sup> For example, when the ASX Corporate Governance Council first released its Principles of Good Corporate Governance, in March 2003, the Council stated by way of guidance that "Non-executive directors should not be provided with retirement benefits other than statutory superannuation" (Commentary and guidance under Recommendation 9.3).

## Severance Payments

Directors are typically appointed for a three year term and their ability to accept alternative appointments is lessened during that time. In light of this, AICD believes a severance payment is appropriate where a company is taken over and the director loses his or her seat on the board. In some cases the level of the severance payment will be set out in a director's service agreement.<sup>5</sup> In any event, the amount of the severance payment should not exceed the unexpired portion of the three year term.

## Remuneration Committee

The board may find it beneficial to establish a Remuneration Committee to review, evaluate and make recommendations to the board in relation to non-executive director remuneration. In making these recommendations, the Remuneration Committee should source advice from external advisors in relation to market trends for non-executive director remuneration.

*For further guidelines on good corporate governance relating to remuneration matters refer to:*

AICD, Remuneration Committees: Good Practice Guide, 2004

AICD Position Paper No. 10, "Director Share Trading", June 2008.

ASX Corporate Governance Council, Corporate Governance Principles and Recommendations, 2<sup>nd</sup> edition, 2007

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<sup>5</sup> The ASX listing rules are also relevant in this context. ASX listing rule 10.18 states that no officer of a company should be entitled to termination benefits by reason of a change in shareholding or control of the company (ie unless at a later stage a director loses his or her seat). ASX listing rule 10.19 that a company must ensure, in the absence of shareholder approval, that no officer is entitled to termination benefits if the value of those benefits and the termination benefits that are or may become payable to all officers together exceed 5% of the company's equity interests as set out in the latest accounts given to ASX under the listing rules.

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