2011 CCBE Research Recommendations

By Chris MacDonald & Matt Fullbrook

Introduction

The report below summarizes our findings, based on an extensive review of the relevant professional and academic literatures, as well as interviews with dozens of Canadian directors and a survey of hundreds. We feel confident that what we present here provides a unique insight into the challenges those directors face, as well as providing a starting point for meeting those challenges.

The findings below fall under ten headings, each of which forms a point of intersection between categories of concerns we heard expressed by Canadian directors and opportunities we see for generating new and useful knowledge. Those categories are: Risk Management, Director Liability, Under-Performing Directors, Top Management Compensation, Say on Pay, the Proxy Voting System, Director Compensation, Director Diversity, Director Continuing Education and Regulatory Effects in the Boardroom. Under each of those headings, we have divided our analysis into three sections: What We Heard (from Canadian directors, through our interviews and survey); Gaps We Saw (including gaps in theoretical and practical knowledge as well as gaps in the availability of practical tools); and Research Opportunities.

The most significant part of this report, of course, lies in the ten topic-driven 'Research Opportunities' sections below. We are at pains to point out that the research opportunities we outline are not merely avenues for academic investigation, though in some cases that will be important. The task facing Canadian directors is a highly practical one. And while we have found directors to be a uniformly thoughtful, and eager to access knowledge of all kinds, they believe they would most benefit from practical tools aimed at helping them carry out their increasingly complex obligations. Thus what we were most concerned with, in making these recommendations, was to suggest areas in which opportunities exist to bridge the gap between theory and practice. We believe that the recommendations below, if implemented, can have practical impact in the short to medium term. In particular, we have pointed to a number of ways in which research could be directed not just at expanding our knowledge in the abstract sense, but also at translating *what we know* into the kinds of knowledge that implies *knowing how to do something*.

CCBE believes that it is often impossible to concretely prove any causal linkage between adoption of governance practices or behaviour and firm performance. This is as a result of three key challenges. Firstly, 'good' governance is highly individual from firm to firm: the set of governance structures, processes and values that a firm adopts ought to be tailored to its own goals, culture and people. As a result, an analysis of linkage between good governance and good performance must attempt to consider the nuances specific to each firm in the sample. Secondly, the effectiveness of the structures, processes and values that comprise the governance of a given firm is highly sensitive to the effectiveness of the people involved from the top of the firm to the bottom, a factor that is always changing. Finally, and perhaps most importantly, CCBE believes that the core benefit of good governance is not that it will, as a matter of course, result in *improved* corporate performance, although such might be the case over a very long time horizon. Rather, an effectively-governed firm will make value-added strategic decisions and provide ongoing analysis and management of risk. The desired outcome of these practices would be better described as an increase in the capacity to avoid bad decisions, and thus possibly poor performance, rather than a predictable increase in good performance.

A very large portion of extant scholarly research on corporate governance attempts to measure the effectiveness of different governance practices by searching for a link between those practices and corporate performance. Due to the challenges described above, we believe the results of such studies can be misleading, and that most causal relationships they identify are not sufficiently verifiable. We have attempted in this document to recommend research approaches that deviate from the goal of linking good governance to good performance, and instead examine the suggested topics with the goal of understanding the impact they will have on governance proper and the effectiveness of boards and directors.

The challenges facing directors at Canadian firms are enormous. What follows presents the beginnings of a roadmap to guide directors toward meeting those challenges.

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Risk Management

What We Heard

We focused on two key issues with regard to risk management: responsibility for risk management, and how effectively risk is managed. With regard to the former, directors in our survey indicated a wide range of practices. In a large majority of cases (77%), the board as a whole is involved in the oversight of risk. Nearly as many directors (73%) suggested that the Audit Committee also plays an important risk management role, and a significant minority (35%) indicated that senior management contributes to the process.

With regard to effectiveness of risk management, directors gave interestingly inconsistent responses to different questions. On one hand, a significant majority of directors (nearly 71%) expressed confidence that their boards provide effective oversight of material strategic risks. On the other hand, fewer than half (49.7%) of respondents felt that their boards have effective downside planning.

A third issue that arose had to do with the kinds of risks for which boards are responsible. Our interview data, in particular, suggested that directors feel very strongly that too many boards think of risk, and risk management, primarily in financial terms, and have a tendency to ignore other kinds of risks such as operational and strategic risks.

Gaps We Saw

Directors' responses regarding the effectiveness of risk oversight and ineffectiveness of downside planning present an interesting disconnect. Downside planning is of course a key component of risk management. It is highly unlikely that boards that are not engaged in effective downside planning are in fact engaged in effective risk management.

It is also worth pointing out that risk management is intimately connected with strategic planning. In fact, without fully effective strategic oversight, comprehensive risk management is impossible. A CCBE and PricewaterhouseCoopers survey in partnership with the ICD from 2009 showed that most boards feel they are not spending sufficient time on strategy (CCBE 2009) – a trend that has continued since at least 2004, as identified in a director survey by McKinsey & Company and the Canadian Coalition for Good Governance (not published). If that perception is correct, it suggests that – contrary to the views of 71% of our survey respondents – it is in fact unlikely that boards are providing effective risk oversight.

Together, these disconnects suggest that boards likely do not fully recognize the gaps in their risk oversight practices, nor in their knowledge-base with regard to risk management.

Our Literature Review also suggested an important practical gap: we were unable to locate resources or tools to assist boards in developing risk profiles for their own organizations.

Research Opportunities

Our research suggests a clear need for more and better materials to help boards to better understand and carry out their risk management role. A little more than half (59.6%) of respondents to our survey indicated that they think that Canadian boards have sufficient access to tools and information resources to help overcome risk management challenges.

The evidence here suggests an opportunity for three kinds of research. One useful field of research would involve studying evolving board practices with regard to risk oversight, and the effectiveness of those practices. Such research should consider board oversight of both financial and non-financial risk. One goal of such a study would be to understand which, if any, risk management processes are most successful and resilient to changes in the marketplace, strategic shifts and performance crises. Secondly, this research could focus on common points of failure in boards' oversight of risk.

A second fruitful area of research would involve developing practical tools to help boards integrate risk management into their discussions of non-financial topics. Among those directors we interviewed who expressed concern that risk continues to be considered primarily as a financial issue, there were two common explanations provided. Firstly, board agendas and processes are often influenced by long-standing routine, and proposed changes to agendas and decision-making process often face considerable inertia. Secondly, thorough consideration of strategic risks requires boards to provide sophisticated and comprehensive oversight of corporate strategy. CCBE research suggests that many boards continue to struggle to spend adequate time on strategic oversight (CCBE 2009). We suggest that the development of practical tools for board oversight of risk management focus specifically on these areas, thus assisting boards in providing comprehensive, value-added risk oversight.

A third research opportunity involves the development of practical tools to help boards understand the relationship between risk management and other key board functions. As boards continue to struggle to optimize their time allocation and to satisfy a perceived need to focus more on strategy, risk oversight may actually suffer. This suggests an opportunity to create tools to illustrate the important link between strategy and risk, as well as to guide boards through the process of 'stress testing' strategy for upside *and* downside risk.

In addition, based on a gap found via our search of the literature, there is an opportunity to devise practical tools aimed at helping boards write up robust risk profiles for their own organizations. Such a tool should illustrate for directors how to identify and manage the full range of risks, including financial, operational, and strategic risks, and link them to the unique business realities of their firms. This would be particularly valuable to many not-for-profit boards and other boards that lack financial resources to access independent advice.

Director Liability

What We Heard

A majority of directors who responded to our survey (61%) said that they are aware of the frequency of lawsuits involving directors. And most directors (76%) believe that they have sufficient resources to assist them in understanding director liability.

Gaps We Saw

Directors' confidence that they have a sense of the frequency of lawsuits involving directors is almost certainly misguided. Our Literature Review suggests that good resources are available to help directors understand their liability as directors and to understand the contexts in which they could, in principle, be found liable. However, we know of no reliable data regarding the *frequency* of lawsuits brought against Canadian directors. Yet only 22% of respondents acknowledged that they are actually unaware of the frequency of such lawsuits. Although successful litigation against directors is often reported in the media – perhaps giving some directors the feeling that they are aware of the risks – it is very difficult to know how frequently directors are sued *un*successfully. And clearly even an unsuccessful lawsuit can cost a great deal of time and reputation, as well as raising insurance premiums.

Research Opportunities

The most obvious area of investigation suggested by our findings with regard to director liability would involve an empirical study of the frequency of lawsuits involving Canadian directors over a sufficiently long timeframe. Most boards feel confident that their access to legal and technical data and advice provides them with a comprehensive understanding of their responsibilities, and conversely of the liability associated with a violation of those responsibilities. However, directors can be subject to litigation even in situations where there has been no breach of fiduciary or ethical duty, thus exposing them to potential loss of time and reputation. CCBE believes that a study focusing on the frequency of litigation involving Canadian directors would provide current and potential board members with information that would allow them to make fully-considered decisions regarding their board appointments (e.g. whether or not to join a new board), in addition to enhancing the quality of advice that boards are provided by their legal counsel.

Such a project might most usefully be undertaken in collaboration with one or more insurance companies, since such companies are likely the only source of relevant data. It would be useful to understand not just the frequency of litigation, but also the specific nature of such litigation.

Under-Performing Directors

What We Heard

Respondents to our survey suggested a range of factors impeding director effectiveness, ranging from lack of experience, to lack of formal director education, to lack of independence from management. The factor most commonly cited was that directors are often too busy with outside matters. In addition, our interviews with directors suggested that the rapid increase in the *complexity* of board responsibilities may leave many directors underequipped to perform their responsibilities optimally. Most importantly, perhaps, our survey results show that most directors are not confident that their boards will dismiss under-performing directors, regardless of the reason for lackluster performance. A little more than one third of directors (39%) expressed confidence that an under-performing director would be dismissed. In our interviews, some directors suggested that boards rely on term limits and retirement policies as devices for eliminating under-performing directors. These processes, however, result in the departure of highly effective directors as well.

In addition, CCBE's interviews with directors of Small- and Medium-Sized Enterprises (SMEs) from 2006-2009 indicated that boards often struggle as they progress through significant growth or contraction phases. As firms progress through their life-cycle, the expectations placed on boards and directors change dramatically, often leaving boards in need of new skills. As described above, however, many boards struggle to achieve the turnover they desire, even when in dire need of change.

Gaps We Saw

Boards clearly face challenges with regard to their ability to dismiss under-performing directors. Anecdotal evidence suggests that the key obstacles are cultural and 'political.'

It is important to note that dismissal of an under-performing director is in some cases effectively an admission that a board has failed to select and orient directors properly. In this regard, our Literature Review revealed a lack of materials aimed at helping boards to create effective orientation processes for new members. Likewise, we did not find any empirical research focused on the long-term effectiveness of different board renewal or director orientation processes.

In addition, we believe there is an important gap in the availability of governance-focused research regarding the impact of director interlocks. While interlocks were not cited as a concern by directors in any of the phases of this study, the worry that director effectiveness is impeded by outside distractions raises questions regarding the potential governance effects resulting from directors holding multiple board appointments.

There is a long history of research regarding the effects of director interlocks on firm performance and governance, some of which is covered in the accompanying document, *CFGR-CCBE Literature Review Report*. Much of this research has focused on negative impacts of interlocks such as collusion (Burt 1983), fraud (Kang 2008), and poor performance (Devos et al. 2009). Since 2004, CCBE has examined the effect of director interlocks on the adoption of governance best practices among firms listed on the S&P/TSX Composite Index. Our findings have shown that director interlocks are an effective conduit for the transmission and widespread adoption of best practices (Rowley & Fullbrook 2004). This has been further supported in academic research focusing on the same sample over a long time horizon and considering many interrelated variables (Shipilov et al. 2010). We believe there is an important gap in empirical research on director interlocks focusing on board effectiveness and decision-making rather than on financial performance and value. Although CCBE has begun investigation in this area, we are not aware of any qualitative studies involving corporate directors that validate or build on our findings. Nor are we aware of quantitative studies in other jurisdictions focusing on the effects of director interlocks on governance proper.

Research Opportunities

There is a clear opportunity here to investigate further just why it is that boards seem to find it so difficult to dismiss directors who are not performing their duties. Boards would also benefit from examples of processes that allow boards to dismiss bad directors without upsetting the cultural balance.

Another fruitful avenue of investigation would concern the interplay of the dismissal problem with other parts of the director-selection process. For example, just how often do boards rely on term limits and retirement policies in lieu of more direct action in response to underperformance? Would the implementation of more rigorous director assessment protocols and outcomes help boards optimize director effectiveness without creating political difficulties?

A related line of investigation would look at the relationship between board electoral systems and the handling of director performance. What effect do board election processes have on the willingness of boards to tolerate under-performing directors? In particular, are boards more proactive in terms of improving director performance or dismissing bad directors when investors have a material impact on elections via majority voting, for example? Both qualitative and quantitative research would be useful, here. From a qualitative point of view, it would be useful to investigate whether and how majority voting has affected how boards manage and oversee director performance on an ongoing basis. From a quantitative point of view, what impact, if any, has majority voting had on director turnover, director tenure, board size, director characteristics, and so on? If majority voting has had a measurable effect on board composition, there is an opportunity for qualitative and quantitative research regarding the long-term effect on board effectiveness and culture.

We noted that dismissal of a board member can often signal a prior problem with selection and orientation. Given the gap found through our Literature Review, this suggests an important opportunity to undertake empirical research regarding the effectiveness of various approaches to board renewal and director orientation. For example, by examining the linkage, or lack thereof, between the use of board skills matrices and board turnover rates, it may be possible to measure the positive effects of monitoring the balance of board skills on an ongoing basis.

Similarly, we believe there is an appetite among Canadian boards for highly-practical tools aimed at helping boards devise tailored director orientation processes and programs of continuing education.

We also believe that there is a need for additional research focus on the effect of director interlocks on board effectiveness. There is some recent evidence that interlocks provide boards with access to valuable information and encourage adoption of best practices. However, a majority of research on this topic focuses on the potential pitfalls of closely-tied director networks, rather than on the potential benefit of information transmission through interlocks. We believe that boards may benefit from new insights to help them take advantage of opportunities to learn from each other through shared directors, while effectively managing the inherent risks. This research may also help boards get greater value from their overworked members and learn from their experiences on other boards and committees. For example, supplementing findings by CCBE as well as by Shipilov, et al., we believe that qualitative research involving highly-interlocked boards or directors holding multiple board appointments would help to illuminate the board-level impact of the transmission of governance practices through interlocks.

Finally, as described by Olivier Roche (2009), we believe there is an opportunity for quantitative study on the effects of board composition on board effectiveness in times of great organizational change. Such a study could focus on how boards' needs change at different points in a firm's life cycle, and examine which factors help boards to remain resilient under those conditions.

Top Management Compensation

What We Heard

Our research looked at two sets of issues with regard to compensation of top managers. First, we asked about results. In particular, we asked directors about the extent to which they feel that their boards are in fact successful at devising compensation structures that effectively align pay with meaningful performance metrics. Our survey suggests that only 65% of directors feel that their boards have succeeded in effectively aligning pay with performance.

Secondly, we asked about process, and in particular about the use of compensation consultations. Responses to our survey suggest that only 59% of directors feel their boards have improved their decision-making regarding executive compensation through the engagement of outside consultants. This implies that fully 41% of respondents were either negative or neutral regarding their experience with compensation consultants. This result is supported anecdotally by our interviews with directors: many directors cited doubts about the value of compensation consultants as being a significant concern.

Gaps We Saw

The most obvious gap is by now an infamous one – namely, access to resources to help boards align top-management compensation with meaningful measures of long-term performance.

But given ongoing controversies over executive compensation (not just with regards to absolute numbers, but also with regard to justification) even the modest (65%) confidence of directors in this regard seems overly optimistic. That is, it seems unlikely that two thirds of Canadian companies are successfully doing what so many academics and other critical voices suggest is generally being done poorly. This suggests a gap between what directors think they know how to do, and what they actually know how to do.

Our Literature Review also suggests important gaps in the realm of top management compensation. While there is a substantial scholarly literature on executive compensation, most of it is highly theoretical. Many researchers are currently focusing on pay/performance alignment. Specific focal points include the psychological/behavioural effects of different forms of incentives (Laux 2010), the consideration of executives' personal wealth in pay and performance alignment (Core & Guay 2010), and long-term strategies for performance-based pay (Bebchuk & Fried 2010). The insights from this body of literature are compelling; however there is little opportunity to test the theories therein in 'real-world' scenarios on a large scale, leaving the question of whether or not boards *ought* to integrate these theories into their own decision-making.

Finally, we were unable to find tools aimed at helping boards work through the basic process of benchmarking and designing their own compensation schemes. We have also seen nothing that provides boards with concrete advice on how to select, evaluate, and incorporate advice from compensation consultants.

Research Opportunities

Opportunities for research in this area are legion, especially with regard to the development of practical tools to help boards. Basic research is needed to help translate what is known about methods for aligning pay and performance into concrete advice for boards. Since 2007, CCBE has undertaken a large-scale data collection and analysis initiative focusing on pay/performance alignment at large Canadian firms. Our findings suggest that most boards are struggling to achieve ongoing alignment even under modest performance fluctuations. There is an opportunity to build on the CCBE's foundation to identify which approaches to executive pay are the most successful at aligning pay and performance over longer time horizons.

Similarly, research is needed to assist boards in effectively and appropriately seeking and integrating outside advice. This could begin with a study of the long-term impact of compensation consultants on boards' decision-making.

We also see room for in-depth qualitative investigation into the actual behavioural effects of different forms and combinations of executive incentives, and into ways boards can design compensation systems that are robust in the face of unanticipated performance anomalies. In particular, it seems that many boards would find value in research that assessed the impact of various forms of at-risk equity-based pay (such as PSU, performance-based DSU grants, etc.). While there is a growing body of empirical and theoretical research in this area, it is unclear whether any findings have been tested in 'real world' situations, and further, we are unaware of any such studies with a particularly Canadian focus. We believe there is a great opportunity to identify and test trends in the effects of various executive compensation structures, strategies and philosophies on the behaviour of Canadian executives.

Most importantly, we see the need for concrete tools aimed at helping boards to design compensation schemes that align pay, performance, and strategy. Even where doubt remains (e.g., in the scholarly literature) about the optimal mechanisms for aligning those factors, it ought to be possible to provide boards with tools that provide them with more, rather than less, confidence about their decisions, and that at a minimum allow them to understand just what it is that they do, or do not, know about this topic. As the empirical knowledge base grows, such tools can be updated to integrate the most up-to-date research.

Say on Pay

What We Heard

Canadian directors are generally undecided with respect to the benefit of the adoption of 'say on pay' in Canada. Indeed, their ambivalence is striking: only 24% of directors in our survey were in favour of mandatory 'say on pay', and fully 41% of directors expressed a general 'neutral' stance with respect to 'say on pay' adoption whether voluntary or mandated by regulators. That ambivalence seems to extend to shareholder engagement more generally, at least as it applies to the question of executive compensation. According to our survey, only 24% of directors who sit on public boards believe that their boards have benefitted from shareholder engagement on executive compensation.

Gaps We Saw

Given recent controversy over executive compensation, and given the fact that 'say on pay' was implemented in the UK six years ago, it is somewhat surprising that Canadian directors, collectively, seem to have no strong opinion on the matter. This strongly suggests that, at least as far as Canadian directors are concerned, there is a lack of convincing data about the overall desirability of 'say on pay' requirements. We know of just one comprehensive study of the UK experience (Gilshan 2009), and that study suggests that there has been little measurable improvement in alignment between pay and performance over the six years since 'say on pay' became mandatory there.

Research Opportunities

Our findings suggest a clear need for more research on the pros and cons of 'say on pay,' from both the board and investor sides. For example, are investors able to acquire enough strategic knowledge about firms to provide informed guidance on pay, and do 'say on pay' resolutions provide investors with the kind of influence, or at least engagement, that they seek? Can say on pay be effective without ongoing direct discussion, between investors and boards, regarding compensation? What lessons can be gleaned from nearly a decade of experience with 'say on pay' in the UK? In particular, is 'say on pay' effective at achieving desirable executive compensation outcomes?

Given the adoption of 'say on pay' in both the UK and the US, the adoption of *some* form of 'say on pay' in Canada seems all but inevitable. But, as noted above, a significant minority of directors oppose 'say on pay,' and an even larger minority are neutral on the question. This raises questions at the level of implementation. If 'say on pay' is to achieve either of its plausible objectives – better alignment of pay with performance, and increasing democratization of corporate governance – it seems essential that the particular form that 'say on pay' takes be one that breaks through the combination of resistance and ambivalence manifested in our survey results. This suggests a fruitful avenue for research: if 'say on pay' were to be implemented in Canada, what particular form should it take? Should it follow the UK model or US model, or is there some uniquely Canadian version of 'say on pay' that would meet the objectives of advocates while satisfying the concerns of directors?

Proxy Voting System

What We Heard

Respondents to our survey echoed the sentiment that others have expressed regarding the need for a careful review of the proxy voting system. In a letter to the Ontario Securities Commission dated March 28, 2011, Stan Magidson, President and CEO of the Institute of Corporate Directors, wrote:

> "…if the continued evolution of corporate governance best practices is going to put greater emphasis on voting by shareholders, resulting in more potentially contentious business, then the integrity of the proxy voting system should be reviewed before additional pressure is placed on it."

Our survey data suggests that fewer than half of Canadian directors (42%) are confident that, in a close vote, the Canadian proxy voting system will produce results that fairly reflect the views of shareholders. Further, doubts were expressed regarding the ability of boards to manage that system. Fewer than half (49%) of survey respondents indicated that they feel that their boards fully understand the Canadian proxy voting system and its strengths and weaknesses, and just barely half (53%) felt that boards have sufficient access to tools and information resources to help ensure the accuracy of the proxy votes.

Gaps We Saw

Our data suggest two different, equally important, gaps. One has to do with confidence in the operation of the proxy voting system. The other has to do with confidence in boards' *understanding* of that system. It would not be surprising to find that the average citizen doesn't understand the niceties of a process in which few participate directly; it is positively alarming to think that a significant percentage of those working at the highest levels in corporate Canada admit to not understanding that system. Interestingly, when asked, respondents to our survey had very little to say in terms of specific resources that they thought could, if made available, help with this problem.

Research Opportunities

The two gaps cited above suggest two fruitful streams of research. One stream of research would tackle directly the question of how the proxy voting system works in practice, and how effective it is at achieving its democratic purposes. For example, it is understood that, given the complexities of modern stock trading, there is some significant danger of a miscount occurring during a vote, and this could in principle have a material impact when votes are close. How accurate is the system, in reality? One researchable indicator of this might be the frequency with which judicial review of the outcome of votes has been sought. More generally, how well does the outcome of a vote typically reflect the voting preferences of shareholders? What procedural changes could be contemplated that would render the process more accurate, and more transparent, in the eyes of both directors and shareholders?

The second stream of research would involve developing materials to assist boards (and perhaps shareholders) to understand and manage the proxy voting system itself. Such materials might usefully range from fairly basic materials suitable for orientation of new directors, through to more sophisticated materials aimed at senior directors and chairs faced with impending complex or contentious votes.

Director Compensation

What We Heard

In terms of director compensation, our survey asked Canadian directors about two different issues related to the adequacy of such compensation. First, we asked whether directors see current levels of compensation as fair. A large majority (70%) of respondents agreed that compensation is currently fair. Interestingly, however, a much smaller number (40%) agreed that current director compensation levels are sufficient to *attract* suitable candidates to their boards.

Gaps We Saw

Our survey findings suggest an interesting gap between the perceived fairness and perceived effectiveness of director compensation. That is, respondents to our survey feel that current levels of compensation are fair – presumably, this means such compensation is adequate to the nature and complexity of a director's responsibilities – but also feel that such compensation is none the less not adequate to incentivize potential recruits to join their boards. Our interview participants suggested that Canadian directors do not 'do it for the money,' perhaps at least partially explaining this discrepancy.

Research Opportunities

We feel that Canadian boards would benefit from a research project that reports Canadian trends in director compensation on all types of organizations. Such a study might usefully report compensation ranges and average compensation, as well as the compensation of director pay for different types of boards. Boards of small or newly-formed companies currently have little frame of reference for devising appropriate compensation schemes for directors. That is, the raw materials for suitable benchmarking simply are not readily available. Of course, there is some worry that, in the realm of *executive* compensation, benchmarking has led to a ratcheting effect, moving pay higher and higher without rational justification. However, for many boards, the alternative to benchmarking against a comprehensive study of director compensation is likely to be benchmarking rooted in a much smaller sample found anecdotally, which is likely to be even worse.

Additionally, there is a risk that director compensation may in the future be subject to the same level of scrutiny as executive compensation. Currently, the two most common complaints regarding executive pay are 1) the lack of ongoing alignment between pay and performance, and 2) the absolute dollar amounts paid to executives are egregiously high. It is unlikely that directors will be subject to the first complaint, as currently no Canadian boards offer performance-based incentives. While many directors are expected to hold stock, the value of which is dependent on firm performance, the *amount* of equity granted to directors is never linked to performance. In addition, directors are generally expected to retain ownership of equity grants for the duration of their tenure as directors, ensuring that they cannot take advantage of market upswings for personal gain. Linking director pay levels to operational performance would constitute a material conflict of interest as boards are expected to provide independent oversight without consideration of short-term personal gain. However, recent increases in disclosure of director compensation details among publicly traded boards open the door to criticism of director pay *levels*, thus increasing the likelihood of exposure to the second complaint. Additionally, even among firms listed on the S&P/TSX Composite Index, the variance between highest paid directors (directors of Consolidated Thompson Iron Mines Limited made $1,033,000 in 2009 including retainer and option grants) and lowest (directors of Bonavista Energy Trust, Cominar REIT and Ventana Gold were all paid nothing in 2009) is very large.

We believe there is an opportunity for valuable research that provides directors with broad comparative data that allows them to make informed decisions when setting director compensation structures and levels. In addition to benchmarking among boards as recommended above, this research could include comparisons to executives, middle managers, the lowest paid employees in the organization, as well as comparisons to boards in other sectors and jurisdictions. If boards are able to access and consider these factors when setting director compensation, they will be better able to justify their decisions if and when they are subject to greater scrutiny.

Director Diversity

What We Heard

In general, our research suggests that director diversity is not currently seen as a high priority by Canadian boards. Only 50% of directors indicated that their boards consider director diversity to be a high priority. 43% indicated that their boards are currently actively recruiting female directors, and just 21% indicated that their boards are actively recruiting ethnic minority directors. Further, 63% of respondents indicated that they feel comfortable that Canadian boards have access to the resources they need in order to optimize director diversity. In contrast, 74% of directors reported that "personality" of candidates is a major factor when considering new directors, and 72% said that their boards make use of a skills matrix in that process.

Gaps We Saw

Our data suggests a clear gap between the extent to which Canadian boards are concerned with diversity and the extent to which society as a whole is concerned with that issue. For no diversity-based question did more than half of respondents answer in a way that indicated concern.

It may not be coincidental that fewer than half – only 47% – of respondents indicated that their boards undertake an ongoing director succession process at all. Clearly, a board that does not plan for succession at all cannot plan to increase diversity through succession.

Further, although the body of research on the subject is globally quite small, there is an increasing amount of research that suggests that, over the short term, more women on boards leads to improved corporate performance (Carter & Wagner 2011). Complicating matters, a recent study suggests that attempts to balance gender representation on boards can lead to the appointment of under-qualified directors (Ahern & Dittmar 2010). We were unable, however, to identify any research that captures a long time horizon, or any studies with a particular focus on Canadian firms. Additionally, these studies often search for a direct causal link between board effectiveness and corporate performance, an approach that CCBE believes is usually flawed as described above on pages 1-2. As a result, we did not find any high-quality studies that focused on the impact of increased diversity on board effectiveness specifically. In fact, as expressed by Richard Leblanc (2011), the recent body of research on gender diversity in the boardroom presents, perhaps, more questions than it answers.

Research Opportunities

Given the way the issue of diversity tends to polarize opinion, there is a clear need for research into the impact of both gender diversity and ethnic diversity on the effectiveness of boards. Several respondents suggested that diversity of opinion is crucially important; it would be useful to determine the extent to which gender and ethnic diversity (i.e., kinds of diversity about which Canadian boards seem ambivalent at best) are correlated with diversity of opinion.

The lack of attention currently being paid by boards to issues of diversity may also indicate a need for new practical tools. While 63% of respondents indicated that they feel comfortable that Canadian boards have access to the resources they need in order to optimize director diversity, the apparent lack of attention to diversity suggests that this statistic may indicate more about board complacency than it does about the actual sufficiency and availability of relevant tools.

Anecdotally, we know that many Canadian boards have indicated that they would gladly recruit more women if in fact suitable female candidates were more readily available. The implication is that the *supply* of potential female directors must improve before demand for them will. Yet at least some countries (Norway is a key example) have instituted quotas for female directors on the boards of listed companies. This suggests obvious avenues for research. Have Norwegian boards, in complying with that quota, managed to recruit female directors with whom they are happy? What process(es) have Norwegian firms used to recruit women? Perhaps these processes are applicable to Canadian boards, and also to increasing diversity in other areas in addition to gender.

Finally, we believe that, while research attention has been paid to board diversity in recent years, much of this research makes unrealistic assumptions about the relationship between governance and corporate performance. As a result, there exists an important gap in both qualitative and quantitative research regarding the impact of director diversity on governance proper (i.e. decision-making enhancement, and strategic value-addition by the board).

Director Continuing Education

What We Heard

Directors, both in our interviews and in our survey, were enthusiastic supporters of the value of formal educational opportunities for directors. Fully 91% of survey respondents indicated that existing educational opportunities for directors provide knowledge and tools that are practical and applicable in the boardroom, and 82% believe that Canadian boards have sufficient access to continuing education resources to ensure director effectiveness on an ongoing basis. Just under half (48%) of respondents said that their boards have formal continuing education policies, and yet a majority (61%) indicated that their boards provide useful opportunities for continuing education. And 67% of respondents said that director education courses have made directors on their boards more effective. Interestingly, satisfaction with existing resources was very nearly uniform across large and small companies, as well as across the private and public sectors.

Gaps We Saw

Interestingly, despite their overwhelming agreement that existing educational opportunities for directors are valuable, just over half (56%) of respondents to our survey said that participation in formal director education courses is the *best* way to ensure ongoing director effectiveness, and just under half (49%) said that formal director education (of any kind) is the best way to ensure ongoing director effectiveness.

A number of survey respondents, particularly those serving on not-for-profit boards, commented that cost is a barrier to access to formal director education (even though most directors, even in the not-for-profit sector, agreed that educational resources available to directors are easily accessible to all directors.)

A number of the directors we spoke to mentioned a particular need for educational resources aimed specifically at board chairs. We are aware that the Rotman School of Management offers a course (the *Excellence in the Boardroom Program*) that includes a session on board chair effectiveness. However, this offering is primarily tailored to directors of large firms, and as such there remains an important gap in continuing education for Canadian board chairs.

Research Opportunities

Our research suggests enthusiasm, on the part of Canadian directors, for director education, and an appetite for more. Clearly this means an opportunity to develop new and even better educational resources aimed at directors, chairs, and entire boards. In relative terms, the need for resources aimed at helping chairs to understand and carry out their duties is particularly noteworthy.

In order better to serve Canadian directors, it would be useful to see research efforts devoted to determining the full range of educational resources of which directors and boards make use. Our data suggests that formal educational experiences are highly valued, and yet many directors declined to agree that such experiences are essential to director effectiveness. What resources do Canadian directors rely upon, in lieu of formal education?

Another useful avenue of research would involve the development of effective alternatives to formal, in-person director education. Given that several directors indicated that cost is a significant barrier, we see an opportunity to develop cost-effective alternatives, especially alternatives aimed at directors in the not-for-profit sector. Self-guided study (either individual or group) would be one likely alternative; distance education would be another.

Also of value would be a study of the longer-term impact of various formal educational experiences. While it is useful to know that Canadian directors express a general (and very substantial) appreciation for those experiences, a better understanding of the value of those experiences could be achieved through a more formal assessment of learning retention and of long-term impact on board behaviour and performance.

Regulation and Corporate Governance

What We Heard

This topic was not raised in our interviews, nor was it covered in our survey. However we have included this section because the ever-changing nature of regulation and legislation governing boards presents an ongoing challenge for directors as well as investors and managers.

Gaps We Saw

The financial crisis of 2007-2008 has prompted a flurry of research attention focusing on boards, particularly in the context of 'what went wrong?' and the effectiveness of the resulting regulatory changes, specifically the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank). It is now nearly nine years since the enactment of the *Sarbanes-Oxley Act* (S-OX), which, among other requirements, changed the nature of auditors' relationships with boards and increased the required expertise of audit committees. Some experts predicted similar fallout from the recent financial crisis, requiring boards to bolster their expertise in other key areas (Beatty 2008). The impact of Dodd-Frank on corporate governance turned out to be exactly that, specifically with respect to board oversight of executive compensation.

Researchers have begun to study the impact of increased regulation through S-OX on firms' performance during the financial crisis, mostly with pessimistic results. One study (Klein et al. 2010) suggests that firms who had adopted best governance practices following S-OX fared *worse* during the meltdown and concluded that increasing shareholder activism through regulation produces dire results. Another study (Beltratti 2009) suggests similarly that banks with pro-shareholder strategies prior to the crisis took unwise risks, and that adoption of best governance practices was insufficient to offset these effects. They also found that country-level securities regulation did in fact have a notable effect on bank resilience through the crisis, though not specifically with respect to governance. These and other studies propose theories about why these outcomes occurred, but all are based on empirical data, and none that we found sought feedback from boards or directors themselves.

Research Opportunities

It is clear that regulation does indeed impact boards directly, either by mandating new skill sets or increasing disclosure and 'shining a light', thus prompting adoption of new behaviour. It is not always the case, however, that boards benefit from the increased regulation. A study by Rookmin Maharaj (2009), found that nominating board members based on regulatory requirements often results in gaps in skills and experience needed for effective oversight. This, however, was the only study we found that focuses specifically on the impacts of regulatory shifts on the effectiveness of board processes. Because regulation has a direct impact on board decision-making, we believe there is an opportunity to explore this impact with the ultimate goal of optimizing the effectiveness of board integration of regulatory change. 2012 will be the 10th anniversary of the enactment of S-OX, providing a rich opportunity for examination of its effects in the boardroom.

APPENDIX I: Study Methodology

In early 2011, the Canadian Foundation for Governance Research (CFGR) commissioned the Clarkson Centre for Board Effectiveness (CCBE) to undertake a study of challenges currently facing Canadian corporate directors. The goal of this endeavour was to identify current governance issues that would most benefit from future study.

We began our process with one-on-one telephone Interviews between CCBE staff and Canadian directors from various sectors and regions, many of whom are current ICD members. Our goal was to identify which governance topics and concerns currently pose the highest-priority challenges to Canadian boards and directors. The interviews were largely unscripted in order to allow participants to direct the discussion toward governance topics of particular importance and relevance to their experience. Several key challenge areas were identified through the interview process and these formed the framework for an online survey which, in partnership with the ICD, was distributed to the ICD members to gather quantitative feedback on key governance topics. The purpose of the survey was threefold:

1. To identify quantitatively the most important challenges currently being faced by Canadian directors in the boardroom;
2. To determine if directors are aware of the tools and information resources available to them;
3. To assess whether or not directors feel that these tools and information resources are sufficient to help them overcome these difficult challenges.

CCBE based the content of this survey primarily on the preliminary interviews conducted with 44 Canadian directors who represented diverse industries and sectors. The feedback we received from these directors resulted in the identification of eight broad topics. For the purpose of our survey, we broke these down further into 13 areas of immediate concern to Canadian directors:

Director Recruitment

- Board composition
- Director diversity

Board Independence

- Board effectiveness and evaluations
- Boardroom decision-making
- Board-management relationships
- Director Compensation

Succession Planning

Executive Compensation

Director Education

Risk Management

- Board oversight of risk

- Board oversight of change of control

Director Liability

Shareholder Engagement

These formed the focal points of our director survey, which was completed by 304 Canadian directors in February and March, 2011. In addition, by comparing the results from this survey to the CCBE's governance database, we identified several areas where survey participants indicated high confidence while real-world behaviour indicates otherwise. A summary of our survey results is available in the accompanying document titled *CFGR-CCBE 2011 Director Survey Summary*.

Concurrently with the delivery of our survey, the CCBE, with support from the Business Information Center (BIC) at the Rotman School of Management, conducted a broad scan of existing literature, research and reports that focus on the topics identified through our director interviews. The goal of the literature scan was twofold:

1. To identify, where applicable, gaps in existing literature where new research would most benefit corporate directors;
2. To identify what topics, if any, directors are struggling with despite the existence of relevant and useful research and tools.

The accompanying document *CFGR-CCBE Literature Review Report* details the findings of the literature review process, and lists recommended resources to help directors overcome key challenges, as well as highlighting important gaps in existing governance research. We are reasonably confident that, while it is impossible to review the entire body of literature that exists on corporate governance, the insights we present in the literature review report have considered a highly relevant cross-section of extant literature and research.

Following the close of the online survey, we conducted 7 follow-up interviews focusing on three key areas where we felt we could benefit from further qualitative insight:

- Risk management and board time allocation;
- The importance of Chair effectiveness;
- Shareholder engagement on compensation compared to shareholder engagement on other topics.

Generally, these interviews provided validation for our findings from the survey. Additional insights from these conversations have been included in our report above.

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