

Board Governance Series

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A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



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Trends in Director Compensation

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards, Sibson Consulting, discusses changes in the structure and levels of board compensation, as well as trends in committee pay.



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In the wake of corporate scandals, increased regulation, and heightened institutional investor interest in board activity, we have seen a commensurate change in both pay levels and pay structure. This change reflects the greater time and effort required of board members, as well as the greater risk these individuals face. Board compensation generally has three components: retainer, meeting fees, and, typically, equity pay. We are seeing the greatest changes in the two cash components—retainer and meeting fees—both of which have increased.

A prospective Sibson study shows that board retainers appear to be rising by about 15% at the median. The study also found an increase in meeting fees. This trend is interesting because many companies previously had been moving toward eliminating meeting fees and using a larger retainer to cover all board requirements with the aim of reducing the complexity of their board compensation programs. But given the new environment, different boards will have different time requirements at different points and meeting fees—while not perfect—are one way to recognize the various levels of time activity that boards demand.

We haven't seen as much of an increase on the equity side of the equation, but we have seen more attention paid to the design of equity compensation and the features wrapped around it. Traditionally, companies have used stock options as the primary equity vehicle for boards, but now many companies are considering restricted stock as well. This trend is similar to what is happening in the executive pay arena where we see companies reexamining their use of options. The reexamination stems from both the public's distaste for options and the concern that options may influence

boards to make short-term decisions that are not in the long-term best interests of shareholders. From an internal standpoint, companies must also consider that board members have to come up with cash to exercise their options. To counter these factors, some companies have turned to restricted stock as a better vehicle. Since restricted stock doesn't have to be exercised, it can, in some ways, provide a more stable type of equity feature for a board. In addition, restricted stock avoids any unintended signals that might be sent by stock option exercise transactions related to stock options. That said, there are a number of boards that don't want to receive any compensation from their equity component unless the company's stock price increases. At the end of the day, which long-term vehicle is most appropriate represents a key philosophical decision.

A number of companies have introduced stock ownership guidelines for their board members similar to what we might see in the executive ranks. Typically, the guidelines are expressed as a multiple of the retainer similar to what a CEO would have—if a CEO has to hold five times his salary as an ownership guideline, then board members would need to hold five times his or her retainers. Another guideline is to require directors to hold shares until they retire from the board. Companies choose that option for different reasons, but the primary message they are trying to send is that they want board members to be committed to the company and ride with shareholders for the long term. So again, overall pay is increasing primarily in the cash component, but the structure is changing through more meeting fees, different forms of equity, and the introduction of stock ownership requirements.

Just as there have been changes in the structure and levels of board compensation, we've also seen trends emerging in committee compensation. Like board compensation, committee compensation has different components.

Some committees have retainers, which are flat yearly fees paid for committee service; some committees have meeting fees, and some committees have both components. One trend is that the prevalence of committee retainers is increasing, particularly for committee chairmen. The retainer is intended to recognize increased time commitment. The audit committee has most frequently offered a retainer to the chairman, because the audit committee has, at this point in time, received the most attention and has required the greatest additional time. The retainer is intended to recognize that increased time commitment. Now that a year or two of heightened governance attention has passed, we are starting to see retainers appear for the chairmen of the compensation committee, the finance committee, and the governance committee as well. Companies are realizing that any of these committees could have more or less work over time, and, regardless, the chairman has to do more prep work for their committee meetings.

That said, there is a recognition that the audit committee carries the heaviest burden right now, so the audit committee chair is often getting 50% more to double what other committee chairs receive. For instance, if an audit committee chairman receives \$15,000 as his or her committee chair retainer, then the other committee chairs will receive somewhere between \$7,500 and \$10,000 for their retainers. Committee member retainers are less prevalent for committees other than audit, but of the

others, the compensation committee has received the most attention.

Another trend is the increase in committee meeting fees. Whereas meeting fees might have been \$1,000 or \$1,500 in the past, we now see those fees increase to \$2,000, \$2,500, even \$3,000 per meeting. This increase recognizes that not only do directors have multiple meetings to attend, requiring significant time, but a lot of prep work required outside of the meetings.

As companies consider the mix of retainers and meeting fees for committee works, and also for their board in general, they need to examine how they are asking board members to spend their time. Retainers are a good reflection of the basic requirements of the board and committees. Meeting fees allow companies to add a flexible component to recognize different time requirements and appropriately compensate a director for the number and level of meetings the board, or a given committee, may demand over time.

We encourage companies to take an inside-out look as they think about how to structure board compensation going forward. First, consider what the company is trying to accomplish and the role that director compensation should play. Then, determine whether there is guidance from the external marketplace, perhaps in the form of a company that is in a similar situation or a broad group of peers that could be used to help gauge director compensation levels. Boards should also use guiding principles for director compensation similar to those they've developed to guide executive compensation, as a reference to examine the role of pay in attracting and retaining directors and influencing their decision making.

It is important to note that pay is not the only reason that directors join a board. Directors join boards for the development opportunity, to network, and for the chance to make a difference. They are going to join boards that have good reputations and sound governance. Pay is only one element in the attraction equation. So the question is: What role does pay need to play in that equation? At some level, pay is not going to be the reason people join a board. But if a director candidate is deciding between two boards with different compensation packages, a variance in pay could put one company at a competitive disadvantage with regard to recruitment. Or, if you have standing board members who sit on several boards and they see their compensation changing elsewhere, pay could become a point of discontent.

PRINCIPLES FOR STRUCTURING BOARD COMPENSATION

- What is the company trying to accomplish with board compensation?
- Do you want a unique plan or one that follows a peer group?
- Where do you position pay levels relative to the market?
- What mix of cash versus equity is best?
- What are the expectations regarding director stock ownership over time?

So balancing the role pay plays in attracting and retaining board compensation is the first principle.

The second principle a board should consider is how much it wants to follow the market. Does the board want a director compensation package that is specifically responsive to its needs, or does it want to emulate what a broad group of peers is doing? For instance, if a board is in a post-scandal situation such as those involving Enron, MCI, or Tyco, its circumstances may require it to structure its compensation differently. A board in that position might pay

decide if they want to structure their cash and equity mix differently. There are a variety of elements that go into that decision. For example, a board may wish to parallel its executive compensation policy, or it may structure the cash/equity mix to send a specific message to the marketplace.

The final principle relates to a board's expectations regarding director stock ownership. Does the board want its directors to hold shares over a period of time, and, if so, what is the expectation relative to that?

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higher retainers to reflect the tremendous time requirement of its board members, or the board might want to structure its equity differently because of certain sensitivities.

The third principle for a board to consider is where to position pay versus the market. Should pay be at the median of the market, or higher or lower? That decision depends on how prominent the board wants pay to be in the overall equation. For example, a board that lacks a great reputation and has a hard time recruiting directors may need to offer higher pay than a board with a great reputation.

Next, boards need to consider the mix of cash and equity. The median practice in the marketplace is about 50/50 cash and equity, but boards must

These principles help put stakes in the ground as boards start to design their director compensation programs. In turn, these decisions also send an explicit message out to the marketplace about what a company is trying to accomplish with its director pay.

Boards must also decide how frequently they want to update director compensation. At a minimum, companies generally evaluate executive compensation every two to three years. In the current environment, compensation programs have been changing more frequently than in years past. Companies should set a principle to specify the timeframe for examining director compensation, as well as to define when and under what circumstances they would change the program.

Clearly director pay is changing in the marketplace. As companies look at their internal situation, it is important that they determine how board pay fits into their director values proposition and then design their director compensation program based on what best serves the directors, the company, and its shareholders.