BOARD GOVERNANCE SERIES

In this interview, Gerard Leider, partner, Meridian Compensation Partners, discusses current issues that are having an effect on director compensation policies and offers guidance for ensuring the board has a responsible process for setting director pay.

There are a lot of compensation topics that we cover throughout the year in our Board Governance Series webcasts, but we don't often home in on director pay, and that's pretty important to our audience. Gerard, what can you tell us about the landscape for director pay practices and trends in 2017?

Over the past couple of years, outside director compensation has changed modestly, and projections for 2017 are consistent with that trend. The first comment is regarding board leadership structure as it relates to the growing prevalence of the lead director role. This role is needed where the CEO is also the chairman. The lead director's primary role is to help run the executive sessions of the board. As reference, about 70% of large companies appoint a lead director.

In return for these services, a premium or incremental pay of $25,000 to $30,000 is typically paid to the lead director.

Second, when looking at year-over-year annual compensation increases in total pay opportunity, we are projecting increases to be in the range of 3% to 5%. This modest adjustment is in line with a general merit increase. Third, when looking at the components of pay and how compensation packages are being designed and delivered, the market continues to see movement away or a "shift" from meeting fees and a transition toward delivering pay in the form of retainer paid in cash and/or equity.

This is particularly true among the largest companies. Lastly, when looking at how equity is being delivered to outside directors, you do not find the use of performance plans, and continue to see a strong movement away from stock options. The primary market practice would be to deliver equity to outside directors in the form of full-value shares. When granting full-value shares, most organizations are awarding restricted stock units (RSUs), not restricted stock.

What about vesting schedules?

In today's market, we are finding the predominate practice to be a one-year cliff vesting on equity. However, we are seeing a significant movement in the market to award outright company shares, with no vesting requirements for directors.

Any changes in the area of perks and benefits?

There have been very few changes related to perks and benefits, since it is not an area of focus. Similar to executive plans, historical perquisites and benefits for outside directors are a component of pay that has significantly decreased in market practice and is almost nonexistent today. There is a small percentage of companies that provide directors access to company products or discounts to company products. Additionally, companies may provide matching charitable gift contributions. This benefit is provided when an outside director contributes to a nonprofit organization, and the company matches that gift up to a certain limit.

Let's turn to the process of setting and reviewing director pay. Obviously the board is responsible for approving the director pay plan, but who has the specific authority to make pay plan decisions and what sort of checks and balances are in place for proper oversight?

In terms of the day-to-day activity of trying to manage the compensation program, responsibilities are somewhat split between the compensation committee and the governance committee, with the board ultimately approving the pay levels for outside directors. Approximately 60% of the time, programs are managed by the compensation committee because these directors are familiar with the components of pay, the equity plans, and the relative comparisons the company has made for the executive team. The other 40% of the time, the governance committee sets and establishes outside director pay as a result of its involvement in the recruitment and nomination of board members. The important piece here, as you think about setting and establishing pay, is for a company to have an articulated written compensation philosophy. Establish that compensation philosophy upfront, then use that as the blueprint to determine how you are going to set outside director pay.

That leads to the next question I wanted to ask, which is about pay disclosure. Since the board has to clearly communicate how it sets its philosophy and rationale, what are some good practices to make sure that information is clearly communicated to shareholders?

From an SEC perspective, disclosure of outside director pay has not really changed in the past couple of cycles. What we have seen is the development of so-called best practices that are included in the proxy disclosure to provide more transparency around the establishment of the compensation philosophy and the peer group for reviewing outside director pay. Director pay should not be changing every year. Director pay should change every two to three years, as appropriate, relative to your stated competitive posture.

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In 2017 as it relates to outside director disclosure, we are going to see enhanced information around director qualifications in biographies provided in the proxy statement. Companies want to demonstrate that they have been thoughtful about who is on the board and what directors are contributing. Most directors are well qualified, but we are seeing a bit more pressure in the marketplace today to make sure companies have the right people sitting around the table and are articulating why they are there and what their qualifications are to be there. Therefore, as we look in the proxies this year, we are going to see more background information on qualifications and detailed biographies.

Right, and we've certainly seen shareholders holding boards' feet to the fire to make sure those needs and skill sets are understood and that they have the right people at the table. Before we wrap up, are there any other issues that are having an effect on director compensation planning that you'd like to share with us today?

One last item: This past winter, there was a derivative lawsuit in play that was specifically related to director pay. The question at hand focused on whether the directors were self-serving in setting and establishing their own pay. Again, these were only allegations, but what came out of it were some best practices to consider. First, have a specific plan and identify the frequency of when the company is going to review compensation and how it is going to set director pay. Second, we have seen a lot of organizations put in plan limits—specifically equity limits, in their omnibus plan or the long-term incentive plan—that articulate the maximum equity opportunity that can be provided to directors. When a company puts a limit in place, Meridian's recommendation would be to articulate a dollar value. It needs to be reasonable, not outlandish in nature. The third consideration involves charters. Whose responsibility is it to review and assess director pay? If it is the governance committee or the compensation committee, those responsibilities need to be included in the charter so it is front and center. When you do so, discuss how often the company is going to review the pay plan.

Reviewing director pay should not be done haphazardly; it should be part of the process, so prepare accordingly. The other advice is to find an independent resource to help the committee think through the process. That independence will provide guidance relative to what is happening in the market and how to structure the plan in an appropriate fashion going forward.

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