Fostering Diversity in Board Pay Practices, Part Two

In recent years, we have observed a remarkable level of homogenization of compensation practices for non-employee directors, even as what is expected from board members of public companies continues to evolve and—generally speaking—expand.

In our client work, we have also noted a great deal of diversity in the role that the board is expected to perform—both from company-to-company and, periodically, within the same company over time. Yet this diversity is rarely reflected in board compensation programs.

In this two-part series, we examine the current state of board compensation and whether it accommodates evolving governance practices. ***Part One*** summarized the typical 2019 board compensation pay model and various challenges to this model that are emerging. In ***Part Two*** we outline factors companies may wish to consider in their next review of board compensation, to ensure that program design and pay levels reflect what is unique about their own business model and governance structure.

Go beyond market prevalence studies

Board compensation market studies are powerful tools, especially when company-by-company level detail is provided in order to better understand the full array of pay practices. They are particularly useful when additional time is invested to understand whether and how a particular company's governance model and organizational needs do or do not diverge from typical practice. This step—the consideration of whether a given job's scope and complexity align with the chosen compensation benchmark—is fundamental to virtually all competitive pay reviews. But too often, board compensation is relatively static, and board roles are viewed as interchangeable from company-to-company.

Following are a number of topics that may be probed as part of your next board compensation review that may uncover deviations from market practice—and therefore suggest that changes in pay practice may be warranted.

Topic 1: Assessments of board activity and how it is shifting over time

Assessments—either via formal review or via regularly scheduled informal discussions—may address items including:

Performance: A wide variety of corporate governance ratings are published and marketed to institutional investors. Depending on the priorities of the ratings agency, these scorecards may yield conflicting results that cater to different stakeholders—but they are still worthwhile to review, in part to help the board more clearly articulate its own priorities and understand whether and how its own perception of performance and vulnerabilities do or do not align with market perceptions. How is the board (and where relevant, individual committees) faring relative to scorecards provided by various stakeholders, as well as its own internal scorecards? What is the multi-year trend? A positive trend—or clear indication that the board or a particular committee is viewed as exemplary—may call into question whether "just pay in the middle of the fairway" is appropriate.

Processes: Is the bulk of work conducted between meetings or during meetings? Is the role's primary role to review strategy as presented by management or partner with management in developing strategy? Has this dynamic evolved over time? If a board is being asked to perform a more active role over time, then the job has changed. Has the pay program?

Governance model vs. market norms: Does the company combine or split the CEO and Chairman of the Board roles? Is there a lead director, and what is the lead director's involvement in various committees? Does the company have active committees beyond the traditional "Big Three" of Audit, Compensation and Nominating/Corporate Governance? Divergence in governance model from typical market practice may support divergence in compensation from typical market practice.

Time investment: Has the level of investment stayed stable over time? Does it vary significantly depending on committee membership or chair assignments? Does it appear aligned with market studies? The answers may support greater variation in compensation by committee, or revisiting the appropriateness of meeting fees or other mechanisms to scale pay with level of activity.

Topic 2: Assessments of board capabilities

Regular assessments of board member backgrounds and fit with evolving organizational needs are good hygiene, and multiple vendors provide technology-enabled platforms to support these assessments. Companies may find that there are certain inflection points (e.g., following strategic merger, or pivot towards new markets or service offerings, or in response to a crisis) where board turnover is appropriate in order to bring on new directors better positioned to address new challenges. These pivot points are an excellent opportunity to revisit the board pay program and confirm it remains aligned with the company's governance model.

Capacity—that is, the actual number of directors on the board—is also worth review. If your board is comprised of 8 members while the more typical practice is 10 or 11, it does not seem unreasonable that your board members receive higher compensation on a per-member basis.

Topic 3: Role of equity

The dominant market practice is to denominate equity grants in the form of full value shares. This dynamic has arisen in part to avoid criticism relating to the timing of stock option exercises (both concerns relating to whether a director may time their exercise based on insider knowledge and concerns that the timing of exercise may be a "tell" to the market). An additional common criticism is that full value shares do a better job of promoting long-term ownership and shareholder value creation.

However, for many companies—especially in sectors such as pre-commercial biotech or high growth technology—regular awards of stock options do a fantastic job of promoting alignment between directors and an investor base that tends to be much less risk-averse than your average S&P 500 Index investor. These investors are laser focused on the "promote upside growth" aspect of board service.

A robust discussion relating to the current roster of investors and their investment priorities—and how it has evolved over time—may suggest there is still a place for stock options in the board pay program. If concerns remain relating to the optics of option exercises, keep in mind that many compensation-related risk reduction mechanisms such as robust stock ownership requirements, holding requirements, and 10b5-1 plans are available.

Conclusion

Board pay reviews should go beyond cursory market checks that aim to do nothing more than stay in the middle of the fairway.

While board compensation is increasingly scrutinized, data-driven decisions to diverge from typical practice are by no means impossible to justify. Crisp, transparent disclosure of pay decisions that demonstrate careful deliberations can mitigate the risks relating to being labeled an outlier.