Competitive Market for Outside Directors Is Driving Emerging Director Pay Trends

Since the crash of 2008, Boards of Directors have been devoting more and more time to board service. There are many reasons for this—navigating new Dodd-Frank requirements, ensuring compliance with new ESG and other disclosure requirements, and managing pandemic impacts, to name a few. In 2008-2009, directors served an average of 210 hours per year per board (2015-2016 Public Governance Survey, National Association of Corporate Directors). In 2015-2016, that number increased to 248.2 hours.

The board's role is to provide oversight and manage risk. Compensation for directors differs from executive compensation in that pay is not performance-based or tied to financial metrics. For example, because the role is focused on risk oversight, stock options are usually not included in equity awards. Stock options are highly performance-based and could drive the wrong behaviors from a risk management perspective. Rather, equity awards are usually denominated in full value awards with time-based vesting criteria.

Structuring Director Pay Programs

Over the last decade, director compensation programs have been streamlined and somewhat generic. There are three main components:

- Cash retainers paid for board service
- Equity grants paid for board service

- Additional compensation for additional responsibilities, such as chairing or membership in specific committees

With the continued trend towards declassified boards with annual director elections, vesting periods for director equity awards have moved towards one-year or immediate vesting. This approach aligns the vesting requirement with the annual service period of elected directors.

At large and mid-sized companies, the trend for director compensation programs has shifted away from per-meeting fees toward a retainer-based model. These organizations have more established expectations about what board service will entail, the general cadence of meetings over the year, and the time commitments necessary to get the work done. The initial months and years of growth are marked by uncertainty—there could be three board meetings a year, or there could be fifteen. In these scenarios, a per-meeting fee is ideal for keeping compensation equitable and fair.

Special Committee Compensation

Boards form temporary special committees for certain purposes, such as conducting a CEO search or navigating mergers and acquisitions. These roles are compensated in a few different ways, depending on the circumstances. Sometimes the level of effort required is unknown at the beginning of the project. Projects could wrap after a month or two, while others could last the full year.

In situations where the expectations are fairly clear, compensation should be aligned with that of committees with similar time commitments and responsibilities. In other cases, companies might use a per-meeting fee approach to compensate for a project of undetermined length. One-time stipends paid retroactively at the conclusion of a project are also common when the level of effort is not known upfront. The actual approach should align with each company's situation and what is appropriate for the circumstances.

Pandemic Impacts on Director Compensation

Typically, executives receive equity awards in Q1. Directors would then receive their equity awards at the annual meeting upon their reelection to the board, mid-year. The onset of the pandemic in mid-March meant dramatic changes in companies' financial positions. Many executives already received grants calculated from pre-pandemic performance measures. By the time directors were receiving equity, share prices could have fluctuated dramatically. This unique set of circumstances raised important questions—what do you do if there is a misalignment between the equity awards being granted to directors and executives?

There were conversations around whether director equity awards should be based on pre-pandemic share prices. Others wondered if executives and directors should be paid at the same time. Historically, the most common practice has been to let these situations play out. Economic swings happen, so there will always be years when pay is not ideally aligned. It is generally accepted that things even out over time. The magnitude of the pandemic, however, sparked discussions about what issues misalignment might cause in the near term and the future.

A typical board makes changes to director pay programs every two to three years. That means approximately 30-40% of companies are making changes to their director pay program any given year. In 2020, director pay increases were very limited. Many companies deferred the annual review of director pay to 2022; those that did conduct reviews in 2020 or 2021 held pay levels steady. In some cases, director pay increases that were approved prior to the pandemic were rolled back as companies continued to navigate uncertain circumstances.

Because so few companies made changes during the pandemic years, as many as 60-70% of companies could make changes to their programs this year. On an individual level, a company's programs may not look much different from what they would have been under more stable economic circumstances. In the past, director pay moves 2-4% a year. The programs that change this year are highly likely to move by a greater percentage—as high as 6%. The overall market is likely to move because a greater percentage of companies are making more impactful changes to their director programs. This is a wait-and-see scenario.

Trends in Director Pay for 2022

Committee Responsibility

As committee responsibilities expand, so too should compensation premiums for committee service. Most boards take a three-tiered approach to committee membership and committee chair premiums. The audit committee is usually paid highest, reflecting their responsibilities of risk management, Sarbanes-Oxley compliance, and more. The compensation committee is typically second-tier, though it has steadily taken on more responsibilities since Dodd-Frank. Tier 3 includes most other committees—governance, nominating, and technology are just a few.

Boards of directors will reevaluate roles and responsibilities as scopes of work increase. Over the next couple of years, the way premiums are structured will likely change. In keeping with the trend of doing away with meeting fees, some boards are exploring pay structures with an annual retainer plus additional compensation at greater levels of time commitment. The retainer compensates directors for service on one committee, but increasing levels of service through multiple committees and more frequent meetings would increase compensation at predetermined thresholds.

Competitive Recruitment

As with any career, compensation plays a critical role in the decision-making process. Talent is in high demand at the board level, and boards need to offer competitive compensation to attract the right candidates. As board responsibilities grow, so too do the required skill sets to do the work. Stakeholders and shareholders also expect to see more diverse boards that better reflect populations served. As with CEOs, the talent pool for qualified directors is limited and they are being recruited by peer companies. Appropriate compensation can be a key driver in getting the best talent in the door.

Mandatory Retirement Ages

About half of companies have a mandatory retirement policy for directors between ages 72 and 75, though it is sometimes waived for directors who continue to add significant value to the board. There are several reasons boards implement mandatory retirement ages. If nothing else, it provides an opportunity to open the conversation about whether it is time for a director to roll off the board. It is also important to ensure that the board routinely recruits new talent to maintain diversity of thought. While it is not yet a significant concern, waiving the mandatory retirement age frequently will open a company up to questions from proxy advisors and shareholders over whether the board composition is a true representation of the company's best interests.

Conclusion

The value of director pay is relatively small compared to executive compensation. It is not generally a topic that draws scrutiny from proxy advisors or shareholders unless a company pushes the boundaries. Director compensation programs require finding the right balance because directors are charged with setting their own pay. They must essentially compensate themselves fairly without incentivizing decisions or behaviors that could invite legal or other issues. The coming months will continue to show us the long-ranging impacts of the pandemic and provide more clarity on how pay program structures and trends may evolve.