Compensation for outside directors takes a cautious path

Compensation packages are increasingly under scrutiny, not only for senior executives but also for outside directors. For external directors of large public companies, there is a trend to ensure that compensation packages do not stray too far from market norms, as the latest research from **Meridian Compensation Partners** shows.

The last two years have been challenging for businesses both large and small, and volatile economic circumstances have forced many to rethink their strategy, finding new ways to thrive – or merely to survive. Additionally, as companies have sought to add additional director talent to their boards, the market for qualified directors continues to tighten. Amid these economic challenges and tight talent market, companies have had to look closely at pay levels and programme designs not only for executives, but also for outside directors.

So how have large companies approached the structuring of compensation for outside directors during this challenging time? By analysing market data and leveraging expertise from the boardrooms of over 700 clients, Meridian Compensation Partners, an independent executive compensation consulting firm, seeks to answer that question.

Steady growth

Outside directors have an important fiduciary duty to the company and its shareholders. They oversee company strategy, implement strong corporate governance principles, engage with shareholders and establish executive pay, among many other things. Directors have the unique task of helping the company make informed business decisions to drive results, while also mitigating risk and complying with regulatory and governance standards.

Director pay must be structured in a way to support these objectives. Companies most often provide directors with a mix of a fixed cash retainer as well as an annual equity grant. Trends such as eliminating per meeting fees and avoiding stock options and performance-based equity have helped streamline director pay programmes over the past decade.

The latest report from Meridian studied the recent proxy filings on director compensation from publicly traded Fortune 100 companies. At the time of publication, 88 of those companies, with a median market value of $109bn, had filed information on their director compensation levels and design practices.

Those 2022 proxies suggest that total compensation increased modestly for Fortune 100 companies, and that in the two-year period from 2019 to 2021, annual cash retainer values increased by 2%, while equity values increased by 5%. Given that public company directors continue to face risking shareholder criticism on board pay, it is to be expected that compensation has grown modestly for outside directors.

Some proxy advisors, including Institutional Shareholder Services (ISS), have increased focus on director pay in the suite of assessments they examine. Furthermore, in the US, there seems to be a

2%

Annual cash retainer value increase for outside director compensation.

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> "Pay has grown but not significantly over the last five or six years."

heightened litigation risk around director pay, with some cases challenging director pay that would normally have been thrown out at an early stage going further than might be expected.

"Pay has grown but not significantly over the last five or six years," says Ryan Harvey, partner at Meridian. "Looking at the director market, I would have expected a bigger jump because companies have been actively hiring more directors with a focus on diversity at board level. We have seen a significant increase in women on corporate boards, but despite significant recruitment there has only been a modest uptick in pay."

"There are competing factors," explains Meridian's Mike Meyer. "Companies are recruiting a more diverse range of directors, but pay is being heavily scrutinised in the US now. Advisory firms are really honing in on levels of pay."

The data shows that the cash retainer for board members has risen modestly from 2015, when it was around $100,000, to 2021, when it reached $110,000. Over the same period, equity compensation has risen from $170,000 to $193,750. When factoring in fees for committee service, this has resulted in an increase in total compensation from $291,333 to $323,423.

Careful consideration

Two years of the pandemic, which brought disruption not only to the global economy, but to the everyday lives of citizens, has engendered a cautious approach to increases in outside director compensation. Meridian's data shows that, between 2015–2017, total compensation grew from $291,333 to $305,417. This is larger than the increase between 2019–2021, during which time total pay rose from $314,129 to $323,423.

"The additional recruitment we have seen was happening during Covid, and boards were reluctant to increase pay when there was so much uncertainty in the business environment," notes Harvey. "Generally, boards faced a challenging business environment and there was uncertainty about the ability to deliver strong performance for shareholders. That leads them to be more cautious about pay.

"For outside directors, compensation is relatively simple compared to executive pay, as they are governance officials not executives and therefore their pay is typically not linked to company performance metrics," he adds. "Their role is one of governance and oversight rather than management and therefore directors are paid using simple elements – a retainer, which is a fixed amount delivered every year as a single cash payment, and another fixed amount in stock."

There are other smaller components that must be factored into compensation packages, related to the role of outside directors on various subcommittees, which generate their own fees. The audit, compensation, and nominating and governance committees will pay a separate fee to the chair, and there may be additional fees for members. More rarely, there are fees paid per meeting.

"One trend in general for board members and their pay is that at least two committees – the nominating and governance committee and the compensation committee – have seen their roles expand," says Harvey. "This is due to the fact that they have expanding responsibilities, such as oversight of environmental, social and governance (ESG) issues.

"Ten years ago, pay for a role on the governance committee was half of the pay for the audit committee, but now they are converging," Harvey adds.

Playing with the pay mix

Although the components of compensation packages for outside directors are in essence simple, companies do have some flexibility in how they change each element. The pay mix – the relative weight of cash and equity as part of total compensation – can, in other words, be tweaked.

Meridian's research has found that equity incentives have consistently comprised well over half of total compensation at Fortune 100 companies. In 2022, the mix was 59% equity and 41% cash. Further, 97% of Fortune 100 companies grant equity as a portion of total annual compensation, and the most common annual equity vehicles granted are deferred stock (47%) and restricted stock (39%). Almost all companies (99%) target a specific grant value when granting annual equity awards. For annual restricted stock/RSU awards, one-year cliff vesting provisions are most prevalent, followed by immediate vesting.

In terms of board meeting fees, their prevalence has been consistently low. Only 6% of companies in the survey pay separate board fees for meeting attendance. When it comes to committee fees, additional chair retainers continue to be highly prevalent (over 90%) for the three most prominent committees – audit, compensation and nominating/governance. At the same time, committee meeting attendance fees have decreased in prevalence and, in many cases, have been replaced with higher board or member retainers Meridian determined that the audit committee chair retainer continues to be highest, with a median value of $30,000, followed by compensation ($23,000) and nominating/governance ($20,000). "Per meeting fees are declining," says Meyer. "The preferred structure is now a more simple cash and equity retainer plus committee chair and member fees."

Another point of interest is the preferred board leadership structure for Fortune 100 companies, and how this impacts various compensation measures associated with committee roles. The median number of outside directors is ten, with four members typically serving on each committee. The research shows that the majority (67%) of these companies appointed a lead director, compared to 33% with a non-executive chair. The median premium/incremental compensation paid to a lead director is $50,000, while median premium/incremental compensation paid to a non-executive chairman is $200,000. Executive chairs are typically paid substantially more, especially when transitioning from the CEO role.

"Often the chair is also the CEO, so there is a potential question of conflict of interest," says Harvey. "There is a question of whether the governing body overseeing the CEO should be chaired by the CEO, so sometimes those roles split. When the CEO is the chair, there is another lead non-executive director presiding over the board. The non-executive chair role and the lead director role both get additional pay."

A key finding in Meridian's analysis is that the prevalence of the lead director role continues to decrease, while the non-executive chair role is increasing in prevalence. Additionally, the median supplemental retainer has remained consistent from 2019 to 2021 for both of these roles.

Equity Ownership

The award of equity as part of the compensation package for outside directors comes with conditions, and Meridian's research examines the stock ownership guidelines that come with these awards. The majority of companies (89%) have established and disclosed stock ownership guidelines for outside directors, often as a multiple of retainer while the typical time allowed for achievement is five years. The median guideline values are currently $625,000, which represents an increase from $575,000 in 2019. For 41% of companies with stock ownership guidelines, directors are required to hold stock until board service ends.

The median guideline value grew 9% from 2017 and 2019. Meridian indicates these levels are now expected by investors and proxy advisors. "These guidelines reinforce the alignment of the interests of directors and the shareholders they represent," says Harvey. "A decade ago, ownership guidelines were pretty rare. Now proxy advisors have factored them into their governance assessment. Most directors hold stock anyway, and a guideline simply recognises that fact. They have become a nearly universal feature in any medium-sized or large company."

Holding course

So much of corporate strategy is about differentiation, outperforming competitors and building a unique market proposition. In executive compensation, offering a more attractive package can be a key tool in the drive to attract or retain key talent. When it comes to compensation for outside directors, however, a very different set of drivers come into play. "We've seen the range of director compensation levels compress fairly dramatically in the past decade," says Meyer. "Executive pay levels can vary drastically based on several factors related to the role or the individual, but with directors, there is a much narrower range of pay."

"Directors don't want to stand out...so they bunch around the median," adds Harvey. "No one wants to be a 90th percentile payer. Also, with executives there is a performance element and more ways to differentiate in terms of pay because a highly successful CEO can make a real difference to a company's performance. The directors' main role, however, is oversight."

While changes in outside directors' compensation may not be eye-watering, they do reflect an interesting trajectory given the changes that are happening to the composition of the boards of the largest US companies. "There is nothing too surprising in the report, but we aren't seeing a stronger increase in pay than I would have expected two years ago," says Harvey. "I would have expected increases of between 2–4% as boards are recruiting directors from a small pool of talent. But there are many pressures keeping pay down. However, we are seeing higher fees at the committee level where many are seeing their roles expanded."

Making sense of trends in compensation programmes, whether for executives or for directors, is essential for medium-sized and large businesses, which need to not only align with good governance practice, but also structure their packages in a way that can be compared to market norms. In its latest report, Meridian is helping companies to benchmark pay for outside directors with the leading companies in the US. "Whether it is for executives or directors, we help companies make informed business decisions," says Meyer. "While market data is certainly an important point of reference, you can't analyse any one component of pay in a vacuum – companies must analyse the programmes holistically to ensure all the pieces are working together to support company strategy and drive shareholder value."

"We act as external advisors to the board and committees on director compensation, just as we do on executive pay," adds Harvey. "We come to the table with hard data and clear analytics on what the market is doing. More and more on directors' pay we see that it is the softer side of things that counts: our experience of working with hundreds of public companies; our understanding of proxy advisor and shareholder concerns; and our ability to navigate difficult decisions with our clients."

In the case of outside directors' compensation, Meridian is able to use its custom market data and its vast experience with large public companies to help businesses achieve the right level of compensation. ●

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