# BOARD GOVERNANCE SERIES

## 'VESTING DOESN'T MAKE SENSE'

*Thoughts on director comp in 2018...*

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**It usually perks up the ears of most corporate directors when you say "board compensation." What's happened recently in this area, particularly with equity grants?**

If you take a step back, outside director compensation has generally been in a pretty narrow range, value-wise. Looking back over the past five to seven years, it's averaged about a 5 percent increase per year. In 2016, it was a little less than that. In 2018, I think we're going to again see a jump of about 5 percent. Nothing very exciting, with across-the-board increases, and no material pay delivery design changes, except for meeting fees. As we all know, those have decreased.

When you look at very large companies, [say the] S&P 100, a small number, maybe 10 percent, still provide board meeting fees. The smaller a company gets in revenue, the more likely it will still have meeting fees. But at this point, there's no governance issue with having meeting fees. It's really mostly an administrative and fairness issue. So, if you know you're in a situation where a lot of activity is going to happen, requiring many meetings, the greater the chance that maintaining meeting fees makes sense.

Moving beyond cash compensation to equity grants, that's really the game for outside directors now. There has been a change in course here with vehicle choice. About 20 percent of industries still use stock options, for example, pharmaceuticals. High tech might be in that same range. But, generally speaking, companies are fading to the norm of exclusively using full-value share grants, which ensures that your outside directors have shareholder perspective. Of course, with full-share grants, they become immediate shareholders.

So, the long-term incentive or equity retainer component has become almost

entirely full-value shares. These full-value stock grants can come in three forms: restricted stock or a restricted unit with a vesting schedule; equity units on a deferred basis; or simply an outright immediately vested stock grant. The strong majority practice is either a restricted stock grant with one-year vesting or deferred stock units. There are now about 10 to 15 percent of companies that provide outright stock grants with no vesting whatsoever. I think that's an increasing trend.

The whole concept of vesting—it really doesn't make sense for outside directors. They are elected; they're not employees. Also the vesting term has changed. About five years ago, the majority practice was three-year vesting. When we had classified boards with staggered three-year terms, three-year vesting made sense. Now, over the last couple of years, the practice has changed very quickly. The majority of board directors are elected every year, and the equity vesting schedule now matches that.

So about 70 percent of companies have moved to one-year vesting. Though as I mentioned earlier, the small but emerging trend is to have no vesting whatsoever, giving shares outright with holding requirements. But if there is vesting, it is going to be for one year or less.

**If you look back years ago, the audit committee was highly valued and the other committees trailed. Then came the comp committee. Lately, we've seen nom/gov take a jump. But the one that has always lagged behind is the lead director.**

Right now, 70 percent of organizations have lead directors, and the range of compensation is significant. There are still about 15 percent where [lead directors] get no extra retainer. Their job is simply to run the executive session. That's probably not worth an additional paycheck. However, many large organizations have interchanged the lead director duties with those of an independent outside director. It's a matter of degree with duties and responsibilities and, therefore, with pay.

So, the typical lead director is getting an extra retainer that's comparable to the audit chair retainer, even though

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[his or her] actual duties may suggest a higher pay level. For larger organizations, that's somewhere between $20,000 and $25,000. That's on top of the regular outside director compensation package. However, if that lead director really has more duties and responsibilities, his or her compensation should be going up. For example, he or she may now be attending every committee meeting and interacting with management. For a truly independent chairman role, that compensation could easily be over $100,000. It could be approaching $200,000, in addition to the regular board package.

**One thing we hadn't seen until last year—and this ended up being much more defining than any of us really expected—was the [Investors Bancorp] board compensation case that hit the Delaware courts. That was sort of the first shot across the bow that people were really looking hard at compensation.**

Outside director compensation has been a very quiet area. The proxy advisory firms have not gone after it. In the court system, we've had a string of cases for excessive pay over the last couple of years. So, what's the rule there, the learning outcome? Outside directors, they're self-interested. They're determining their own compensation. So there is a higher duty.

In the past, per the "business judgment rule," if [a director] makes an informed decision that's not self-serving, he or she is provided some legal protection. Well, with outside director pay, it is self-serving. So [a director] doesn't necessarily have the protection of the business judgment rule, instead you must consider an "entire fairness" standard. What the courts have said here is, if you put a shareholder-ratified, meaningful limit on outside director pay, and then allow the directors to determine their compensation within that meaningful [range], you could go back to business judgment rule protection, and that's the key to the recent court case.

In that case, although shareholder ratified, the limit was not meaningful, and [directors] were not allowed to hide behind business judgment because of that. The equity grant limit was 30 percent of the total pool, and that's not meaningful. What I've seen lately is organizations implementing limits of two or three times the equity retainer, or an overall pay limit of $1 million for larger organizations, something that is maybe three times the total regular compensation package. You'll have years where the lead director might make more if you've got a lot of meetings with meeting fees or new directors are coming on to the board for the first time and the company has a policy of making a startup equity grant upfront.

So it appears that adding a shareholder-ratified overall annual pay limit for outside directors will become standard practice very soon.

**So even with those things you mentioned, we heard some noise [on compensation] from the proxy advisory firms this year. ISS, for example, gave some wide guidance. Can you give us a quick update?**

Basically, it's a soft policy, but I think it's an opening salvo into this whole area that says, "If you consistently have excess compensation for your outside directors, ISS will vote 'no' for those directors responsible for setting compensation." They don't really define "excess" specifically, however, if you're in the top 5 percent of annual pay of your industry group, that probably puts you in a position to be looked at. And it's got to be consistently [higher] for two or more years. So if you have a one-time outlier grant, you might be OK.

But if you are consistently providing excessive outside director pay, it appears that they're not only going to vote "no," this may well unknowingly trigger a holistic review of your executive pay practices. In future years, I suspect ISS might tighten and better define this pay policy a bit more. CBM