the Corporate Governance advisor

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DIRECTOR COMPENSATION

# Director Pay: Taking the Lead

*by Edward C. Archer*

Service as a director continues to evolve in an increasingly challenging environment characterized by heightened public scrutiny and increased regulation. Board practices and policies are now subject to complex new rules and regulations that are intended to strengthen corporate governance. At the same time, directors must deal with increasingly influential outside forces, including major investors, voting advisory services, analysts, the courts, and the media.

These changes have spelled an end to the common paradigm under which directors relied on management to take the lead in providing them with information and advice. While boards continue to work closely with senior executives, directors have taken steps to be more active and independent overseers of shareholders' interests. They are working longer hours, asking more questions, and supplementing the guidance from internal staff with data and recommendations from outside consultants to gain the kind of independent perspective now expected. Not surprisingly, the increased time commitments and pressure of board service, combined with new requirements for independence and expertise by candidates and a shrinking pool of director candidates willing to serve on multiple boards, are presenting companies with new recruiting challenges.

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## Figure 1

**Average Total Remuneration and Year-to-Year Change**

| | Smaller 2004 | % Increase over 2003 | Small 2004 | % Increase over 2003 | Medium 2004 | % Increase over 2003 | Large 2004 | % Increase over 2003 | Top 200 2004 | % Increase over 2003 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Cash** Compensation | | | | | | | | | | |
| Cash Retainer | $14,005 | 24 | $20,282 | 24 | $26,316 | 13 | $33,155 | 18 | $45,276 | 18 |
| Board Fees | 7,500 | 20 | 7,244 | 5 | 8,913 | 5 | 9,815 | 5 | 8,053 | 12 |
| Total Comm. Fees | 8,434 | 42 | 12,433 | 38 | 17,078 | 37 | 20,050 | 31 | 23,163 | 36 |
| ***Total Cash*** | ***$29,938*** | **27** | ***$39,959*** | **24** | ***$52,306*** | **18** | ***$63,020*** | **19** | ***$76,492*** | **22** |
| **Stock** Compensation | | | | | | | | | | |
| Stock Options | $24,267 | 43 | $38,430 | 11 | $46,996 | 11 | $45,592 | 14 | $49,656 | (4) |
| Full-Value Share | 4,060 | 74 | $6,973 | 72 | $18,612 | 93 | $28,579 | 42 | 50,525 | 23 |
| ***Total Stock Award*** | ***$28,327*** | 46 | ***$45,403*** | 17 | ***$65,608*** | 26 | ***$74,171*** | 23 | ***$100,181*** | 8 |
| **Total Compensation** | **$58,265** | **36** | **$85,362** | **20** | **$117,914** | **23** | **$137,191** | **22** | **$176,673** | **14** |

Our sixth annual survey of non-employee director compensation reveals a broad-based effort by companies to recalibrate and restructure board compensation programs in response to these changes. Among the major changes noted in pay levels and practices:

- Double-digit growth in board total remuneration across all revenue groups;
- Reduced stock option use in favor of more full value share grants;
- Increased compensation for members of audit and compensation committees; and
- Additional compensation of committee chairs.

Our annual report on director pay, conducted in collaboration with the National Association of Corporate Directors (NACD) and The Center for Board Leadership, examines a broad range of revenue groups and industries. Using proxies filed between September 1, 2003, and August 31, 2004, we randomly selected 1,393 companies representing 26 industries with revenues ranging from $50 million to $9 billion. The report also incorporates select data from Pearl Meyer & Partners' 2004 Director Compensation Study, which is focused on the very largest US industrial and service corporations.

The analysis includes specific pay for each committee based on the actual number of meetings each com-

### About the 2005 Director Compensation Survey

The survey group is comprised of the Top 200 U.S. companies, along with 1,393 randomly selected companies representing 26 industry sectors and four revenue tiers:

Survey Companies

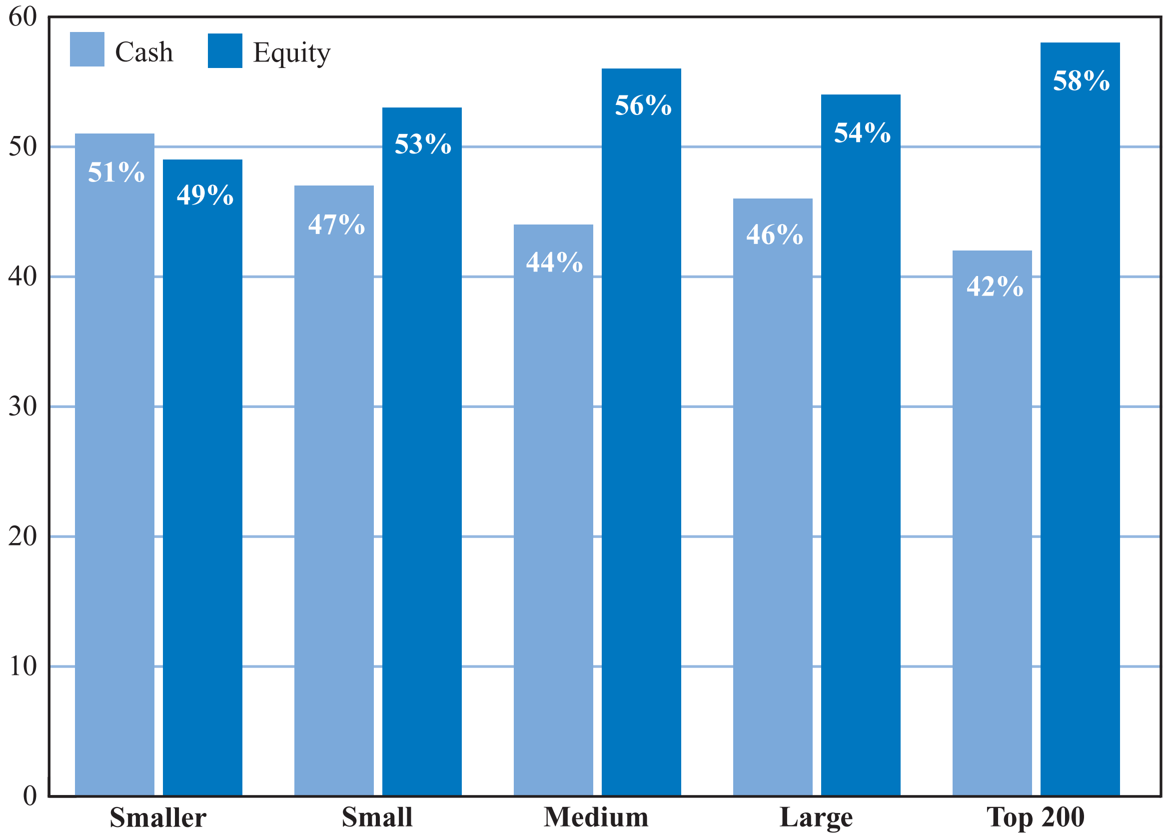
| | Number | Revenues |
|---|---|---|
| Smaller companies | 235 | $50 million < $200 million |
| Small companies | 339 | $200 million < $600 million |
| Medium companies | 396 | $600 million < $1.7 billion |
| Large companies | 423 | $1.7 billion < $9.0 billion |
| Top 200 | 200 | $9.0 billion and above |
| | 1,593 | |

Director remuneration information was collected from 2004 proxy statements and analyzed with respect to four pay elements:

1. Board cash retainer and meeting fees
2. Committee meeting fees/retainers
3. Committee chair fees/retainers
4. Stock-based compensation

Figure 2

**Cash vs. Equity as a Percent of Total Remuneration by Company Size**




mittee held during 2003. While some comparisons are made with the results of the 2004 NACD survey, there are some differences in the specific companies studied.

## Board Pay Growth Focused on Equity and Committee Service

The nature of board service has been transformed in recent years as a result of a series of major regulatory reforms. Until recently, however, most companies had held off making major changes to their board pay programs until the full impact of these new accounting and governance-related initiatives was better known. With the regulatory environment now more settled, we are seeing the start of a broad effort by companies of all sizes to adapt their director pay programs to the new environment.

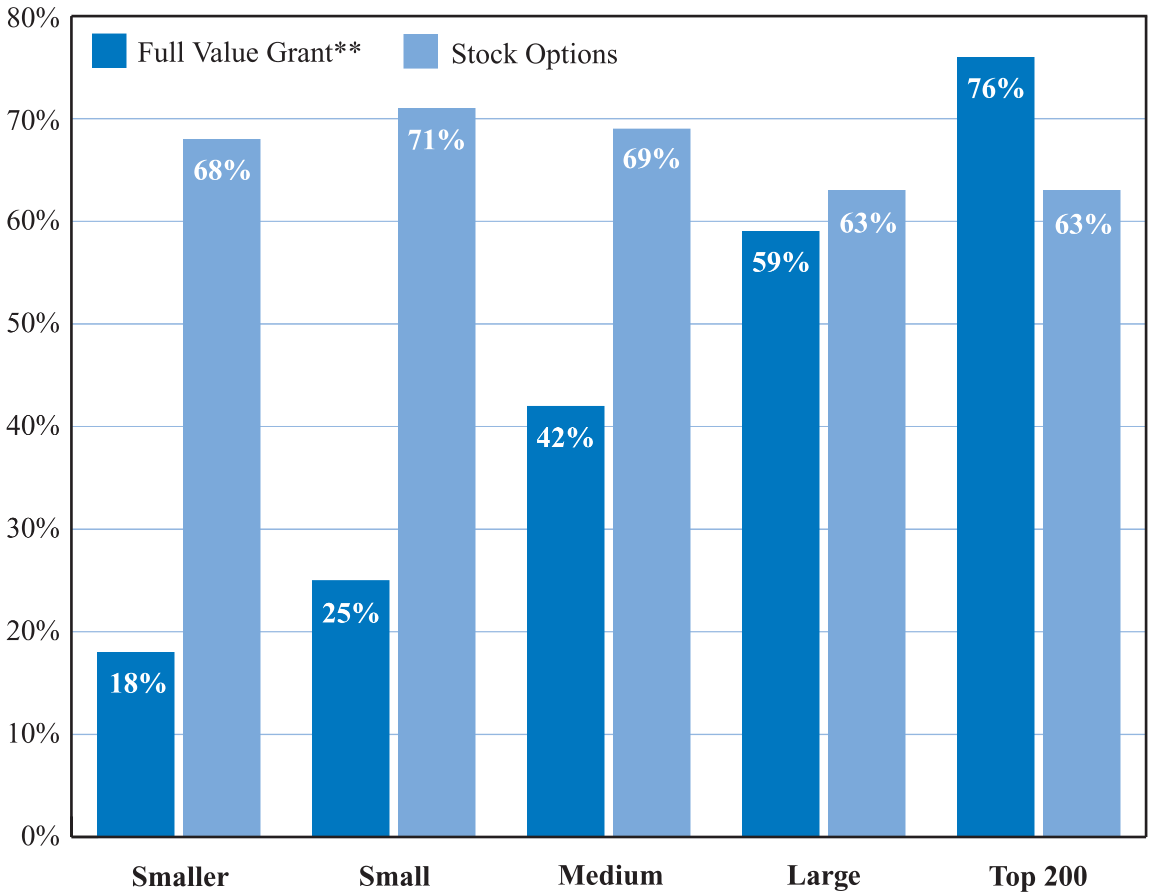
Most notably, companies of every size reported double digit growth in average board total remuneration, ranging from a 36 percent hike among the **Smaller** companies to a 14 percent increase among the **Top 200**. (Figure 1) In contrast, one year earlier, pay for directors at the **Smaller** companies declined 10 percent and was flat among the **Top 200**.

An early analysis of 2005 proxies filed by the **Top 200** companies indicates continued growth in director pay levels. In their most recent proxies, the nation's very largest companies reported an approximately 9 percent average increase in total board remuneration, a trend that can be expected to cascade down to other revenue groups.

For 2004, increases in overall board total remuneration were driven by steep growth in equity values. Rising share prices in 2003, following the earlier market slump, helped buoy the total value of stock-based board compensation across all revenue groups. Most dramatically, the average total value of board equity among the **Smaller** companies rose

**Figure 3**

**Prevalence of Full Value Grants and Stock Options by Company Size***




* Non-additive.
** Includes unrestricted, restricted and deferred stock.

46 percent, compared with a 27 percent decline in value a year earlier. Double-digit increases in grant value were also reported by the **Small**, **Medium**, and **Large** companies, with the **Top 200** showing an 8 percent increase.

Consequently, equity rose or stabilized as a portion of board total remuneration among all revenue groups, except the **Top 200**, where stock declined slightly as a percentage of pay from 60 percent to 58 percent (Figure 2). Overall, every revenue group met, or in the case of the **Smaller** companies, came very close to, the recommendation of the National Association of Corporate Directors' Blue Ribbon Commission Report on Board Compensation that at least half of director pay be delivered in stock.

A second significant source of compensation growth was committee pay, which grew by one-third or more in every revenue group, led by a 42 percent rise among the **Smaller** companies. Increases were focused on service on three key standing committees: audit, compensation, and governance/nominating committees. The critical role played by the three committees in compliance and governance has required longer and more frequent meetings in addition to more preparation time. For example, audit committees at the **Small**, **Medium**, and **Large** revenue groups report that

**Figure 4**

**2004 Prevalence of Full-Value Equity Vehicles***

| | Smaller | Small | Medium | Large | Top 200 |
|---|---|---|---|---|---|
| Unrestricted Stock | 9% | 12% | 16% | 22% | 23% |
| Restricted Stock | 8% | 13% | 22% | 28% | 32% |
| Deferred to Retire | 1% | 2% | 6% | 16% | 33% |
| ***Total*** | **18%** | **25%** | **42%** | **59%** | **76%** |

* Non-additive.

they are holding about twice as many meetings as four years earlier.

## Changes in Equity Delivery

Among the most striking changes in director pay programs is a shift from stock options toward more use of full-value equity grants. During the market boom, stock options accounted for an increasing proportion of both executive and board compensation, despite criticism that they promoted a relatively short-term performance perspective that was particularly inappropriate for directors. The subsequent downturn abruptly plunged many option holdings underwater, highlighting their inherent risk. These factors, combined with the long-awaited implementation of mandated option expensing that has started to take place, have accelerated a general rethinking of overall option use, although director grants generally account for only a small portion of companies' overall option use.

As a consequence, we see full-value use growing at many companies as they take steps to reduce or eliminate option grants to directors. Option use declined among all revenue groups with the exception of **Smaller** companies, where use was unchanged. Use of full-value grants, including unrestricted stock, restricted stock, and deferred shares, rose in every size group except the **Top 200**, where it was unchanged.

Option use differed relatively little by company size, with prevalence ranging narrowly from 63 percent of the **Top 200** to 68 percent of the **Smaller** companies (Figure 3). In contrast, the prevalence of full-value grants correlated closely with company size from just 18 percent of the **Smaller** group to 76 percent of the very biggest companies studied. Among the five revenue groups, the **Large** firms were notable for using options and full-value shares about equally.

Preferences in the type of full-value vehicles also are changing, most notably with a significant rise in restricted stock grants. In a reversal of past practice, restricted share grants surpassed the use of unrestricted awards across all revenue groups, except the **Smaller** companies, where prevalence was about equal. Deferred stock was the least-used full-value vehicle, except among the **Top 200**, where prevalence was about equal to that of restricted stock.

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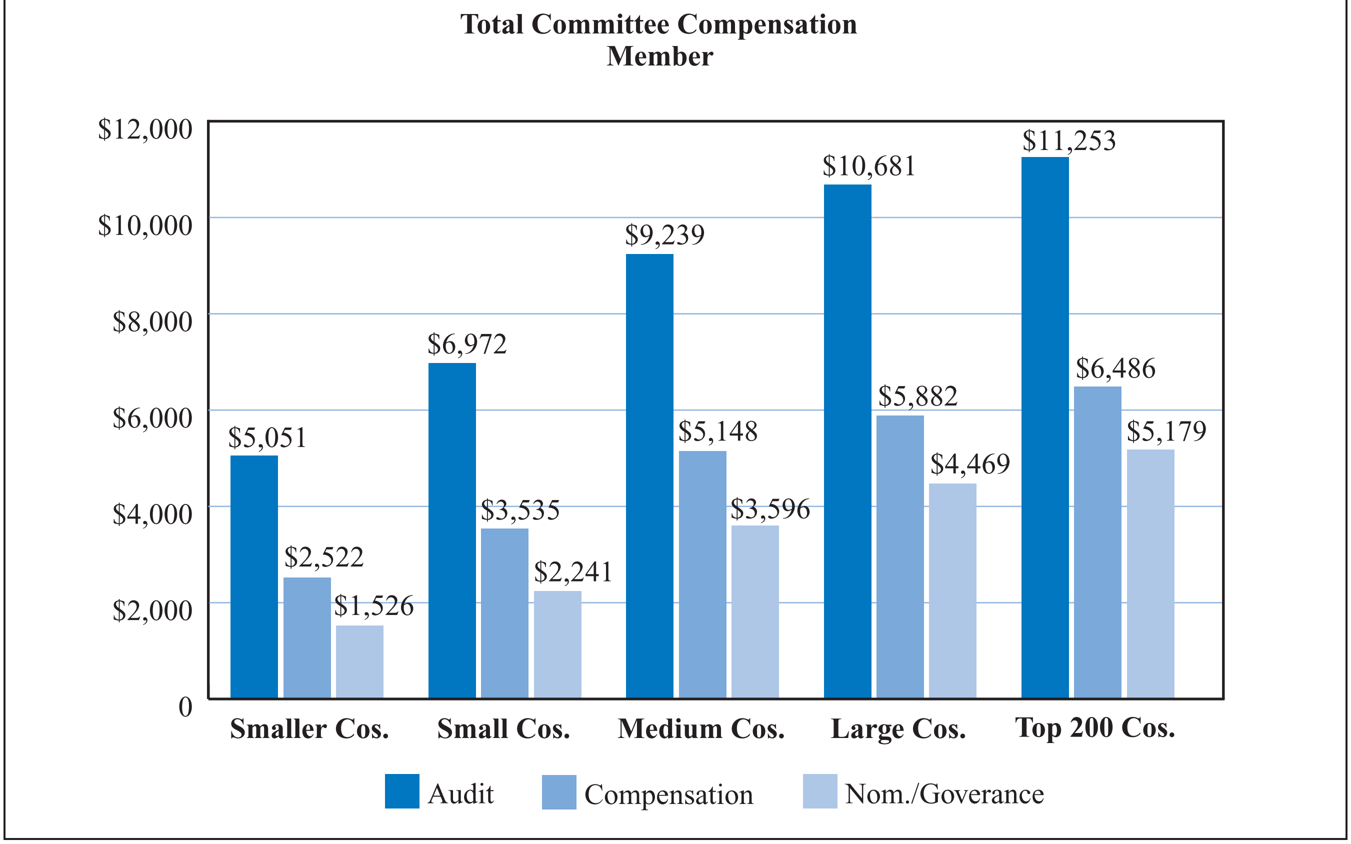
## Figure 5




## Growing Focus on Committee Service

Along with a resurgence in equity value, growth in director pay levels is being driven by increased pay for service on those key board committees that are most responsible for ensuring compliance with regulatory requirements and expected governance practices. As seen in Figure 5, companies of all sizes paid the highest remuneration for service on the audit committee, followed by the compensation and nominating/governance committees.

Some of those differences may abate over the next few years, given the narrowing differences between the oversight of the company's audit function compared to the growing perceived importance of compensation practices. Audit committee service has long been viewed as the toughest board assignment due to its highly technical nature, and recent reforms would appear to have made the job even tougher. However, there are also advantages to serving on the audit committee, as those directors have the benefit of a relatively clear and objective rubric of established requirements and protocols, as well as the support of a dedicated interior audit function at many companies.

In contrast, executive compensation programs are subject to few legal standards or regulations, and these programs can be highly complex and frequently controversial. That means that compensation committee members often render relatively subjective judgments that are more vulnerable to criticism from shareholders and the media and attack from the plaintiffs' bar. In matters of compensation, moreover, the compensation committee often is in the difficult position of having to balance the CEO's highly personal interests with the need to act independently of management, a scenario that increasingly is causing compensation committees to retain outside counsel to provide an additional source of data and recommendations.

Another growing practice is for companies to pay additional compensation to chairs of the audit, compensation, and nominating/governance committees. Figure 6 illustrates the difference between pay for members of those committees as compared to their chairs. Overall, the **Top 200** provided the biggest premium for the three committee chairs, the **Small** companies provided the second greatest premium, and the **Smaller** group paid the smallest proportion of extra pay.

**Figure 6**

**Premium Paid for Service as a Committee Chair**

| | Audit Chair vs. Member | Comp. Chair vs. Member | Nom/Gov Chair vs. Member |
|---|---|---|---|
| Smaller Cos. | 63% | 68% | 75% |
| Small Cos. | 78% | 90% | 106% |
| Medium Cos. | 71% | 77% | 98% |
| Large Cos. | 71% | 87% | 103% |
| Top 200 Cos. | 86% | 114% | 125% |
| *Average Premium for Committee Chairs* | *74%* | *87%* | *101%* |

## Major Companies Biggest Users of Ownership Guidelines

The NACD and other governance proponents have long advocated the adoption of stock ownership guidelines for directors and executives as a way to better align their interests with shareholders' interests. While support for this concept continues to grow for executives, ownership requirements for directors tend to be implemented only at the nation's largest companies (Figure 7). Just over half of the **Top 200** mandate a minimum level of equity holdings by their directors, while use of such guidelines for directors is limited to 14 percent of companies in the **Smaller**, **Small**, **Medium**, and **Large** groups.

### Computer and Pharmaceutical/ Medical Companies Lead in Pay

In a change from recent trends, companies in the Computer Products and Pharmaceutical & Medical Products sectors ranked first or second in director pay levels among four of the five revenue groups: the **Smaller**, **Small**, **Medium**, and **Large** revenue groups. Historically, industry pay rankings among companies of different sizes tended to vary significantly. As with numerous other aspects of board compensation programs, the **Top 200** group maintains distinct practices, providing the highest pay to directors serving in the Healthcare and Diversified Financial & Brokerage.

Paralleling a pattern in executive pay programs, director pay generally correlated with the level of equity use. Directors in the highest-paid Computer Products and Pharmaceutical & Medical Products sectors received more than 60 percent of their compensation on average in stock. On a proportional basis, the biggest users of stock among all five revenue groups were Pharmaceutical & Medical Products companies in the **Small** sector, at 86 percent of total compensation. Among companies of all sizes, the Utility & Energy industry had one of the lowest levels of board total remuneration and was also the only sector that fell well short of providing half of board pay in stock.

However, heavy equity use did not invariably translate to higher compensation. The Food, Beverages & Tobacco sector in the **Small** company revenue group ranked second in stock use at 83 percent of total remuneration, but its average level of pay exceeded that of the entire **Small** companies sector by just 13 percent.

## Looking Forward

Director compensation programs will remain in transition as the governance and legal climate regarding director service continues to develop. We anticipate further growth in overall pay levels, as well as continued adjustments to the structure of board pay programs to reflect the disproportionate workload of key board committees. Ownership requirements can

**Figure 7**

**Prevalence of Stock Ownership Guidelines**

| | % of | |
|---|---|---|
| | 1,393 Cos. | Top 200 |
| Guidelines only | 8% | 19% |
| Shares to retire only | 4% | 24% |
| Both | 2% | 8% |
| Total | 14% | 51% |

be expected to grow, given a continued push for direct links between pay and growth in shareholder value, most likely through a combination of equity-based awards, ownership guidelines, and retention requirements. Ultimately, we believe these changes will promote more rigorous and independent oversight of corporate affairs by those who serve as the shareholders' elected representatives.