

Director Pay: A Work in Progress

By *Jannice L. Koors*

From Enron and Sarbanes-Oxley to the SEC's new rules that require more rigorous disclosure of executive compensation and the current controversy over option backdating, the focus of corporate governance reform has moved steadily into the boardroom. Regulators, investors, and the media want directors to actively demonstrate an in-depth understanding of the issues and programs on which they make decisions, particularly the details of often-controversial executive pay programs.

About the 2006 Director Compensation Survey

The survey group is comprised of the Top 200 US companies, along with 1,187 randomly selected companies representing 26 industry sectors and five revenue tiers:

	Survey Companies	
	Number	Revenues
Smaller companies	179	\$50 million < \$200 million
Small companies	256	\$200 million < \$600 million
Medium companies	349	\$600 million < \$1.7 billion
Large companies	403	\$1.7 billion to \$9.0 billion
Top 200	200	\$9.0 billion and above
	1,387	

Director remuneration information was collected from 2005 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

Directors also have a great deal more on their plates. Traditionally, boards served as somewhat removed overseers of the corporate ship, establishing general corporate strategy and providing broad oversight of the programs to implement those goals. Today, directors face the need to become far more directly involved in vetting the design and implementation of programs, bringing functions under their umbrella historically left entirely in the hands of management.

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Nowhere is this trend more pronounced than in the SEC's new disclosure rules, which clearly are aimed at ensuring a broader and deeper involvement by directors in the structure and administration of executive compensation programs.

Not surprisingly, these changes have had a profound impact on the role of directors. As members assume greater responsibilities, their board and committee meetings grow longer and more frequent.

There is more direct and frequent interaction with senior management, which is now expected to provide the board with far more detailed information. In another change, members face the potential of greater legal liability in the wake of new regulatory obligations and increased shareholder activism.

Looking ahead, directors face an environment in which they can no longer take their incumbency for granted. Pressure is growing for more widespread adoption of majority voting practices and increased ballot access, while shareholders increasingly are publicly criticizing, and even targeting, individual board members with whom they find fault. The future delivery of director pay will be additionally influenced by inauguration of new accounting and disclosure mandates.

Not surprisingly, our seventh annual survey of non-employee director compensation reveals these changes being paralleled by a steep and continuing rise in the level of members' pay, along with a gradual restructuring of how that pay is delivered. Companies are continuing a trend towards enhancing compensation for service on the most demanding board committees—Audit, Compensation and Governance/Nominating—as well as differentiating pay levels among the three committees to reflect their different workloads.

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. Among the major changes noted in pay levels and practices:

- a double-digit rise in the level of board total remuneration across all revenue groups for the second straight year,
- flat or declining use of stock option grants, alongside an increased utilization of full-value shares,
- a sharp rise in the number of companies providing additional fees or retainers for service as a committee chair,
- stabilization of the proportion of board compensation delivered in equity, following several years of decline,
- a significant increase in stock ownership and retention guidelines.

The report is based on a random selection of 1,187 proxies filed between September 1, 2004, and August 31, 2005, representing 26 industries with revenues ranging from \$50 million to \$9 billion. Additionally, select data is incorporated from Pearl Meyer & Partners' 2005 Director Compensation Study, which focuses on the very largest US industrial and service firms.

The analysis includes specific pay for each board committee based on the actual number of meetings each committee held. While some comparisons are made with the results of the 2005 NACD survey, there are some differences in the specific companies studied.

Steady Pay Growth Focuses on Rewards for Committee Service, Full-Value Share Grants

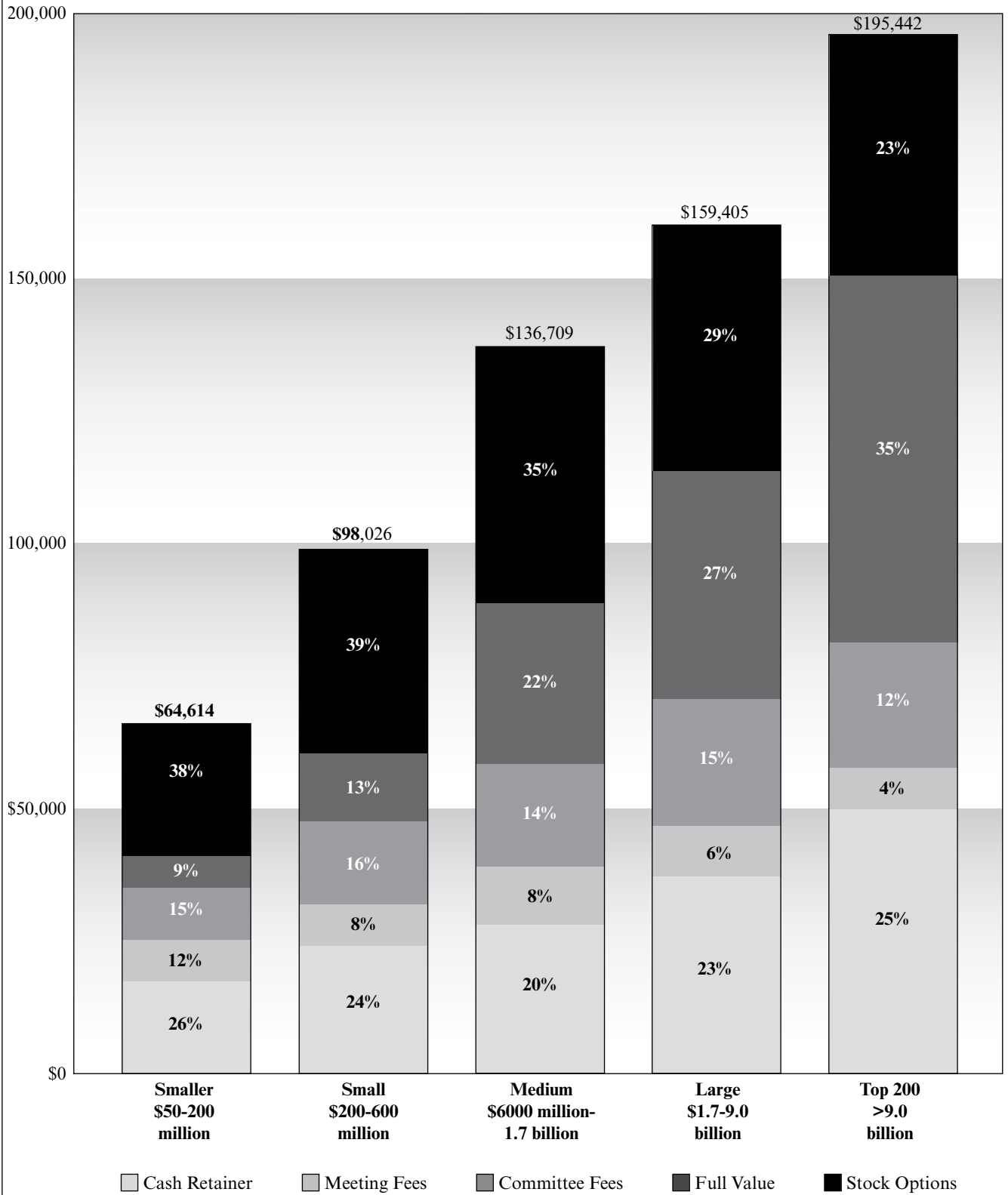
Board compensation was distinguished by a second year of double-digit growth across all revenue groups, albeit less dramatic than a year earlier. Growth ranged from an 11 percent increase among the **Smaller** and **Top 200** companies to 15 percent for the **Small** Companies and 16 percent for the **Medium** and **Large** companies. **Smaller** companies saw a relative slowdown in pay growth compared to a year earlier—an 11 percent rise, compared to a 36 percent increase reported last year.

Overall, the value of equity awards rose across all revenue groups, albeit more modestly than a year earlier. **Medium** and **Large** companies reported

Figure 1. 2005 Average Total Remuneration and Year-to-Year Comparison by Company Size

	Smaller		Small		Medium		Large		Top 200	
	2005	2005 vs. 2004	2005	2005 vs. 2004	2005	2005 vs. 2004	2005	2005 vs. 2004	2005	2005 vs. 2004
Cash Compensation										
Cash Retainer	\$16,945	21%	\$23,284	15%	\$29,371	12	\$37,778	14%	\$51,736	14%
Board Fees	8,063	8	8,299	15	10,712	20	9,610	(2)	8,327	3
Total Committee Fees	9,537	13	16,465	32	19,816	16	24,133	20	24,343	5
Total Cash	\$34,545	15%	\$48,048	20%	\$59,899	15%	\$71,521	14%	\$84,406	10%
Stock Compensation										
Stock Options	\$24,855	2%	\$37,926	(1)%	\$47,718	2%	\$45,862	1%	\$43,235	(13)%
Full-Value Share	5,214	28	12,052	73	29,092	56	42,023	47	67,801	34
Total Stock Award	\$30,070	6%	\$49,978	10%	\$76,810	17%	\$87,884	19%	\$111,036	11%
Total Compensation	\$64,614	11%	\$98,026	15%	\$136,709	16%	\$159,405	16%	\$195,442	11%

Figure 2. 2005 Average Total Remuneration by Company Size



the steepest rise at 17 percent and 18 percent, respectively. Cash growth was also more moderate, ranging from 10 percent among the **Top 200** to 20 percent at **Small** companies.

The proportion of pay delivered in cash versus equity was stable, with companies of all sizes continuing to deliver close to or more than half of total board pay in stock. (Figure 2) The National Association of Corporate Directors' Blue Ribbon Commission Report on Board Compensation strongly recommends that at least half of director pay be provided in the form of equity.

Companies also continued to focus on boosting pay for service on the three key standing committees. Over the past several years, the audit, compen-

sation and governance/nominating committees all have been meeting more frequently and at greater length in response to their expanded responsibilities. In the vast majority of revenue groups, these three key committees reported holding an average of one additional meeting each, compared to their schedules from a year earlier. Not surprisingly, the number of committee meetings generally correlates with company size.

Equity Use Focuses on Full-Value Shares

Paralleling a trend in executive pay, all size companies are choosing to deliver more of directors' stock-based compensation in the form of full-value shares and focusing less on grants of

Figure 3. 2005 Prevalence of Full Value Grants and Stock Options by Company Size*

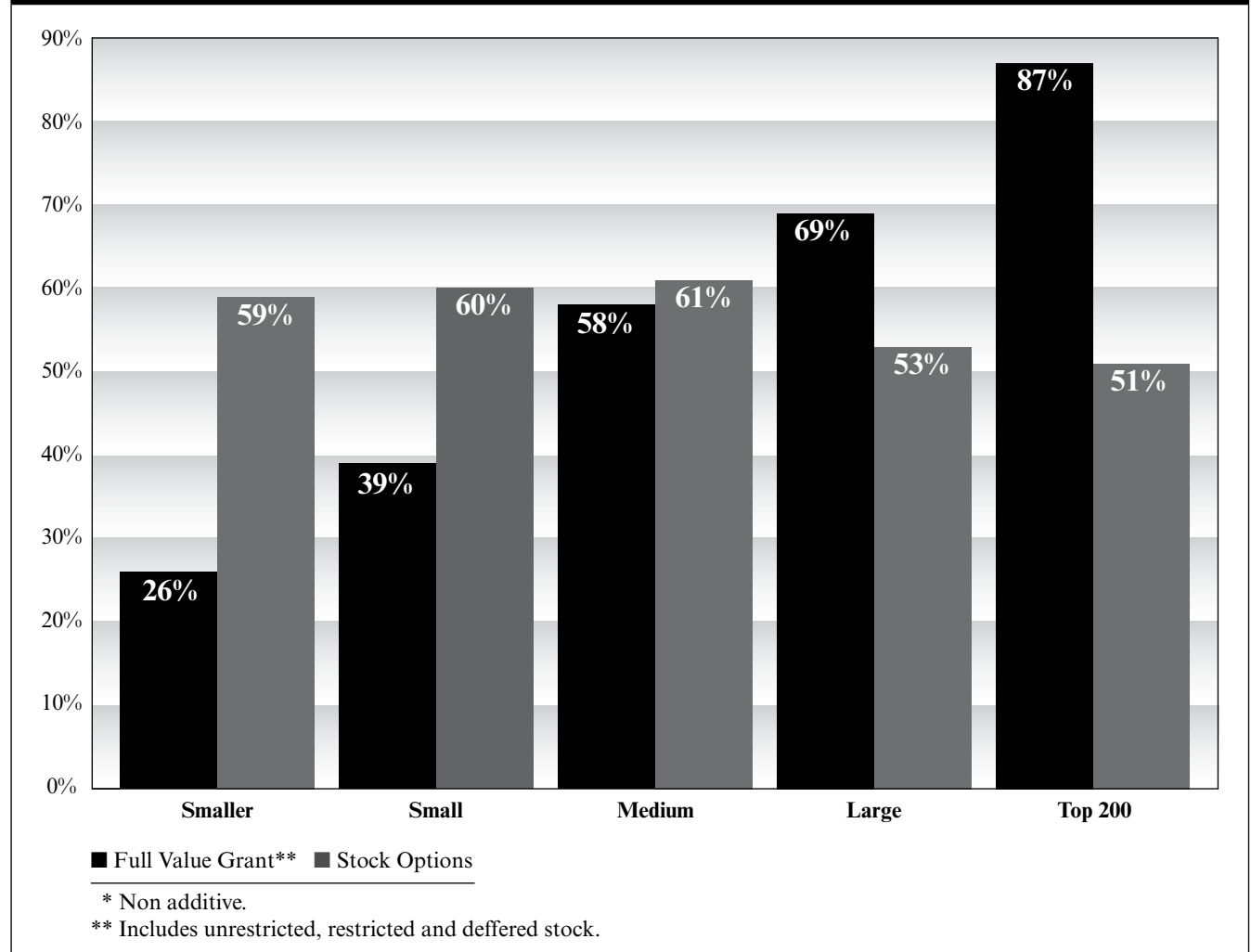


Figure 4. 2005 Prevalence of Pay Elements by Company Size

	Smaller	Small	Medium	Large	Top 200
Cash Compensation					
Annual Cash Retainer	87%	90%	93%	96%	99%
Board Meeting Fees	71%	70%	78%	70%	56%
Committee Fees/Retainers	63%	78%	89%	87%	76%
Chair Fees/Retainers	71%	81%	91%	90%	93%
<i>Differentiated Committee Pay</i>	53%	62%	65%	65%	64%
Equity Compensation					
Any Full-Value Shares	26%	39%	58%	69%	87%
<i>Unrestricted Stock</i>	11%	23%	24%	32%	44%
<i>Restricted Stock</i>	15%	18%	34%	35%	60%
<i>Deferred to Retire</i>	2%	5%	10%	22%	37%
Stock Options	59%	60%	61%	53%	51%
All Stock Awards	75%	86%	91%	95%	98%

stock options. The shift has been driven mainly by longtime governance concerns that stock option awards tend to promote a focus on short-term price growth. An added incentive is the inauguration of mandatory option expensing, which puts full-value grants and stock options on an equal financial footing.

Across all revenue groups, share grants to directors (including awards of unrestricted stock, restricted stock and deferred shares) saw double-digit growth, including increases of nearly 50 percent or more in the **Small**, **Medium** and **Large** size revenue groups. At the same time, the value of option grants was flat across all groups except the **Top 200**, where option values fell 13 percent.

Share grants account for a steadily larger piece of the equity pie as company size increases. Full-value shares swell from just one-sixth of total equity among the **Smaller** companies to more than 60 percent of equity value among the **Top 200** companies.

In terms of prevalence, full-value grants are now the dominant equity vehicle in two of the revenue groups studied. **Large** size companies joined the **Top 200** companies in preferring share grants to options, with 69 percent and 87 percent of companies, respectively, providing directors with grants of full-value stock. (Figure 3) Among other size

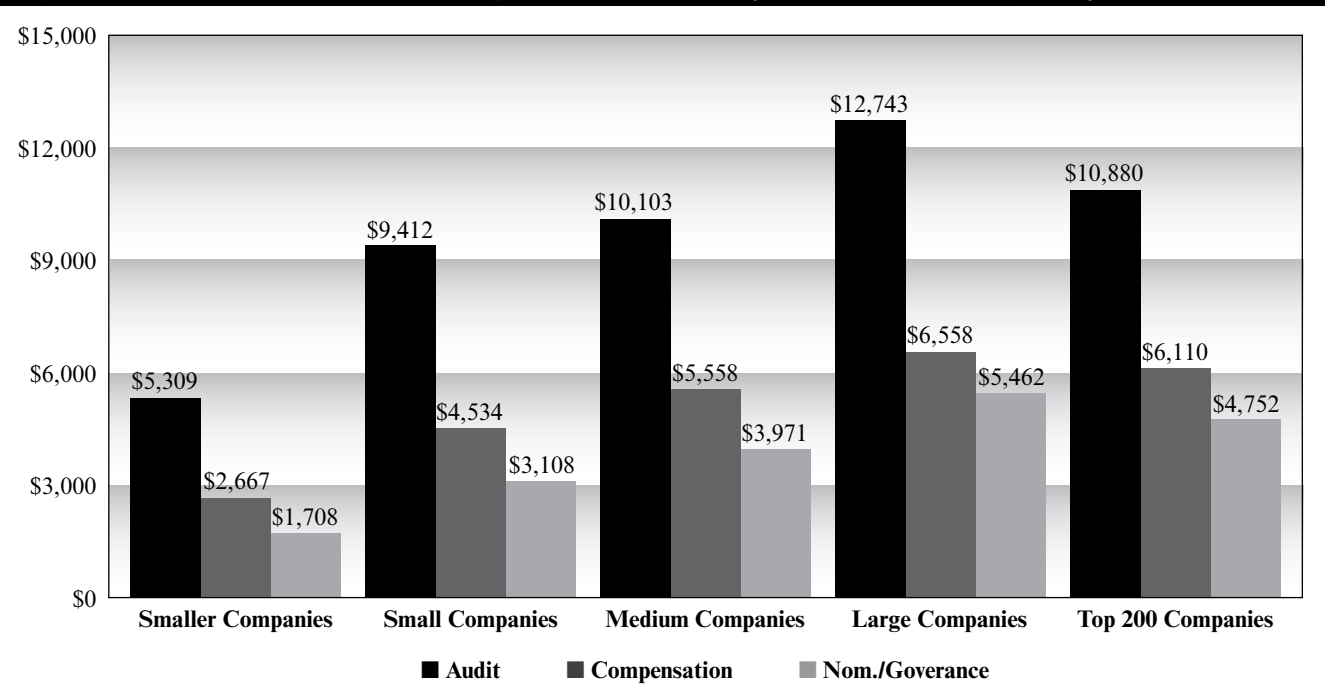
companies, differences in equity use narrowed significantly, with boards at **Medium** size companies providing the two forms of equity to about the same extent, following a sharp increase in full-value share use alongside a decline in option use compared to a year earlier. The overall level of option use did not differ significantly with company size, ranging somewhat narrowly from 51 percent of the **Top 200** to 61 percent of the **Medium** companies. In contrast, utilization of full-value share grants ranged widely, from a low of 26 percent of the **Smaller** companies and increasing directly with company size to 87 percent of the **Top 200**.

The choice of full-value vehicles is also changing. There was across-the-board growth in use of unrestricted and restricted stock, while the prevalence of deferred shares saw little or no growth. (Figure 4) Among the **Top 200** companies there was a notable rise in grants of unrestricted and restricted stock, both of which nearly doubled in prevalence.

Enhanced Compensation for Chairs of Major Committees

Companies of all sizes continue to move toward better aligning pay for members and chairs of the three key board committees—audit, compensation

Figure 5. 2005 Total Committee Compensation Member (Retainer & Meeting Fees)



and governance/nominating—with their relative workloads. Audit committee service has long been considered the most demanding—and has also been the most highly compensated. However, compensation committees face major new responsibilities and mandates under the new SEC disclosure rules slated to go into effect in 2007, which may prompt growth in pay levels over the next few years. Among the new requirements is inclusion in the proxy of a detailed explanation of the rationale behind executive compensation programs and how payouts fit into that structure. The SEC also now requires to have that disclosure treated as a filed document, which could subject the committee to more legal liability if its version of events is subsequently challenged.

Currently, lower revenue companies tend to have the most differentiated pay structure. The premium for audit committee chairs ranged from 56 percent (among **Top 200** companies) to more than double (at **Smaller** and **Small Companies**) over the pay for compensation committee chairs. The latter receive a premium of between 13 percent and 40 percent over the pay for governance/nominating committee chairs, with both premiums generally provided in the form of a higher retainer. Pay for members of the three committees is differentiated to a somewhat lesser extent, with the largest premium again provided for service on the audit committee and smaller premiums for members of the compensation and governance/nominating committees. (Figures 5 & 6)

Figure 6. 2005 Average Committee Retainer/Fees**

	Chair Retainer			Meeting Fees		
	Audit	Comp.	Nom./Gov.	Audit	Comp.	Nom./Gov.
Smaller Cos.	\$9,203	\$5,218	\$4,998	\$964	\$900	\$893
Small Cos.	11,025	6,732	6,226	1,302	1,183	1,171
Medium Cos.	11,975	7,762	7,272	1,287	1,227	1,227
Large Cos.	13,040	8,308	8,241	1,578	1,475	1,498
Top 200 Cos.	16,082	11,312	10,217	1,539	1,449	1,466

** Average of those companies using pay component.

**Figure 7. 2005 Reported
Stock Ownership Guidelines**

	% of	
	1,187 Companies	Top 200
Guidelines only	18%	38%
Shares to retire only	12%	12%
Both	4%	23%
Total	34%	73%

Use of Share Ownership Guidelines Up Sharply

Nearly three-quarters of the **Top 200** companies said they maintain share ownership guidelines for their boards, up sharply from just over half of companies reporting such standards a year earlier. Among all other size companies, use of ownership guidelines jumped from 14 percent to nearly one-third. The increase is likely partially due to more public disclosure of the existence of these guidelines, as some companies disclosed existing guidelines for the first time in response to strong support for such retention programs from the NACD and other governance proponents. (Figure 7)

Computer and Pharmaceutical/Medical Companies Remain Pay Leaders

For the second year, the **Computer Products & Services** and **Pharmaceutical & Medical Products** industries reported the highest level of board pay in nearly every revenue group. Directors in both sectors ranked among the four most highly paid in every revenue group except the **Large** and **Top 200** firms,

where the **Pharmaceutical/Medical** companies ranked sixth. As in past years, pay practices differed among the **Top 200** companies, where the highest board pay was reported by the **Healthcare** sector, followed by firms in the **Diversified Financial and Brokerage** and **Entertainment/Hotels/Restaurants** industries. Companies in the **Wholesalers/Distributors** sector spanned the pay spectrum, ranking relatively high among the **Small** and **Large** companies, but reporting the second-to-lowest pay levels in the other three revenue groups.

As has historically been the case, the level of equity use was generally a key factor in the level of board compensation. For example, nearly three quarters of members' compensation was in stock at the highly-paid **Diversified Financial and Brokerage** boards in the **Top 200** group. In the other revenue groups, however, those companies' use of stock ranged from just 29 percent to 50 percent and the sector did not rank as highly in total pay.

Looking Forward

A continued shift in director compensation practices can be expected in response to further changes in the regulatory and governance environment. In particular, the new SEC disclosure rules may trigger major growth in the workload of compensation committee members and an attendant increase in their pay. Other trends likely to continue include heightened interest in ownership guidelines for board members; the shift from stock options to more use of full-value equity awards; and a continued—although likely more moderate—growth in the total level of board pay. Overall, the result should be further development of board pay programs that are better aligned with the push for more rigorous board oversight of corporate affairs.