COMPENSATION

THE DIRECTION OF DIRECTOR PAY

With ISS beginning to focus on board member compensation, it's a good time to re-examine pay practices.

ADOBE STOCK

DIRECTOR COMPENSATION has largely flown under the radar during the last decade, generally escaping the sort of scrutiny and criticism that seems to continually plague executive pay. That's partly because pay practices for board service tend to be relatively straightforward and stable. Director compensation rises steadily, but at a rate modest enough to be considered acceptable. Still, the topic of how much board members should be paid and in what form always bears discussion—and especially so now that Institutional Shareholder Services is ramping up its monitoring.

"To date, Say on Pay has caused the attention to be placed on executive compensation issues, but we may see that change in the years to come as ISS intensifies its focus on director pay and criticism of outlier director pay programs," says Todd Krauser, principal at FW Cook. "It opens the door for scrutiny down the road."

Continuous Evolution

To understand the future direction of director compensation, it's a good idea to look at the changes that have unfolded in the past and what drove them. Over the past decade, director compensation has seen continual evolution rather than dramatic shifts. Pay has risen annually between 3 percent and 5 percent, reflecting the increasing demands on directors as organizations and markets grow more complex and competition intensifies, explains Krauser.

"The median pay is now much greater than it was 10 years ago, which supports the fact that directors face increased workloads and have more significant reputational risk," he says. "We've seen increases in committee chair retainers, particularly for audit and compensation committees. For instance, all the pressures from activist shareholders and ISS, as well as regulatory developments, has intensified compensation chair workloads."

Meanwhile, companies have also been moving toward simplifying director pay programs and bringing them into market alignment. As a result, companies in the same size range now tend to have very similar board compensation programs. "We've undergone a standardization process over the last few years where most companies have adopted pay practices that look very similar, not only in structure but also in pay levels," says Steven Knotz, a principal at FW Cook. "The ranges have been compressing to the point where you see only small differences in compensation levels between the highest- and lowest-paying companies at a similar size. There's not as much variation as there used to be." Some variation still exists by industry, with technology and energy sector companies tending to pay more than financial services, he adds.

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Also disappearing are per-meeting fees and the practice of providing directors with additional perks, such as healthcare. "There's been a movement broadly to simplify the plans—it's easier for companies to provide an annual cash retainer versus paying activity-based fees and having to track and manage per-meeting payments," says Knotz. "Special benefits and perquisites have also been mostly eliminated, with the only exception being programs that allow directors to defer compensation for tax purposes or where companies match charitable gifts under the same terms as for company executives. Those are generally considered acceptable because they have minimal cost for the company and are attractive for directors."

Historically, equity and cash compensation have been relatively balanced, and that remains the case today, with equity comprising, on average, 58 percent of director pay. However, more companies have been transitioning away from director pay plans that confer stock options and toward equity compensation in time-based, restricted stock. "With the exception of the technology sector, we've reached a point where director equity pay is almost entirely restricted stock," says Knotz. "That reflects the view that the director's role is one of oversight, and performance-based compensation such as options might compromise that role and oversight capability."

Annual limits on director compensation have also become more common, driven primarily by shareholder strike lawsuits. However, the limits are set so high—150

percent or even 200 percent more than what most companies are paying their directors yearly—that they rarely, if ever, come into play. "It's very much a defense mechanism, motivated by some very highly publicized lawsuits," says Knotz.

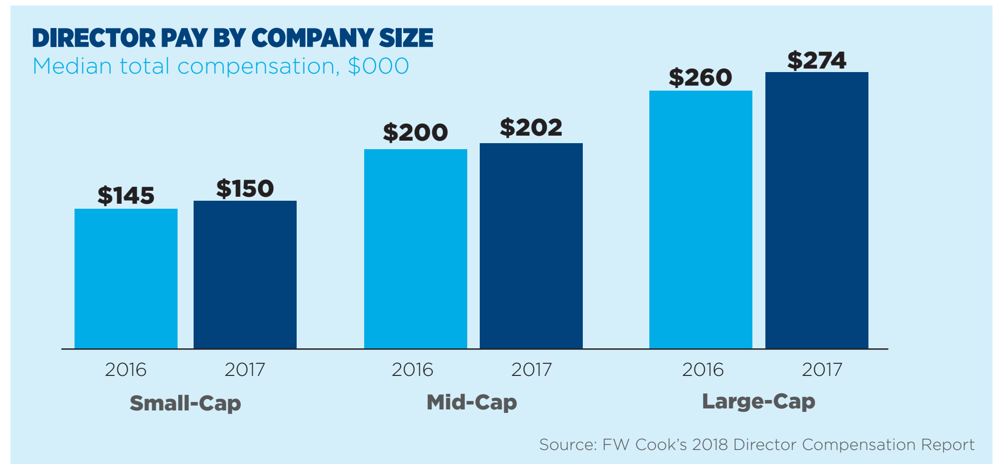
The Future Focus

All of the changes outlined above began playing out before ISS announced a new policy regarding "excessive" nonemployee director compensation in 2017. The proxy advisory firm had already been monitoring nonemployee executive director compensation for patterns of "excessive pay" or policy features that might hamper the independence of directors. However, it had no formal policy of issuing negative vote recommendations due to excessive nonexecutive director pay levels.

The new policy, however, calls for ISS to start recommending negative votes beginning in the 2019 proxy season after two or more years of excessive director pay, unless mitigating factors offer a rationale for the pay practice. While no negative vote recommendations were made in the 2018 proxy season, ISS did begin flagging individual directors with higher compensation levels, setting the stage for the possibility of negative votes next year.

However, pay practice experts anticipate adjustments to ISS's policy on director pay, including a more definitive explanation of both "excessive pay" and "mitigating factors." For example, while ISS supports separating the CEO and chairman roles, nonemployee chairs tend to be the most well compensated directors—and therefore the most likely to be flagged.

"All of the directors I've seen called out so far have been nonexecutive chairmen, whose individual compensation numbers are often much higher than those of the other board directors due to their additional responsibilities," explains Knotz, who sees the practice of flagging outlier director pay as at odds with ISS's support of breaking up the chairman and CEO roles. "If you have a nonexecutive chairman and you pay them the market rate, you're almost automatically at risk of being singled out right now—but I believe that will change because for years, ISS has stated that breaking up the chairman and CEO roles is good governance. I think ISS's director pay policies will continue to evolve over the next few years, or maybe they'll start looking at the compensation for typical directors and the nonexecutive chairs separately."



"It's still early," agrees Krauser. "ISS often goes through a process refining their policies. The way they screen CEO pay has been through several revisions now, and I think they'll continue to refine this policy as well. It will be interesting to see where that goes."

A Proactive Pay Plan

In the meantime, companies seeking to avoid being singled out by ISS for having outlier director pay can make the following moves:

Review and adjust director pay annually. Historically, director pay reviews take place every few years rather than annually, but that practice tends to result in larger jumps that may not align with company performance. "We're encouraging our clients to switch to evaluating director pay on an annual basis so that smaller pay adjustments can be made more frequently," says Krauser. "That helps ensure that you don't end up with a large increase during a year of poor performance for the company. Having smaller bites of the apple on a more frequent basis also minimizes the kind of large jump that can subject a company to external criticism."

Benchmarking pay. Since ISS and other pay critics primarily target "outlier" pay, deviations from the market as a whole or a company's peer group, companies should strive to blend in. "To make sure you don't fall into the crosshairs, you want to be right in the middle of the playing field," notes Krauser. "Now is the time to conduct studies and make changes to programs that are inconsistent with peer practices to avoid issues with ISS down the road."

Conduct a compensation review. If you haven't conducted a director pay policy review recently, now is the time to identify areas of compensation that are inconsistent with the market and make adjustments. For example, companies that still pay directors in a fixed number of equity shares rather than a dollar-denominated equity award should consider changing their equity pay practice. "There are very few companies that still use this approach, but for those that do, now is a good time to revisit that methodology and possibly adopt an approach that is more consistent with today's market practices," says Krauser.

In the immediate future, those steps should be sufficient to prepare for ISS's intensifying focus on director pay, he says. "At this point, it's about being mindful of that shift, staying aware of the potential changes and being sure that you're adopting a defensive mindset to avoid any unwanted attention down the road." **CBM**

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