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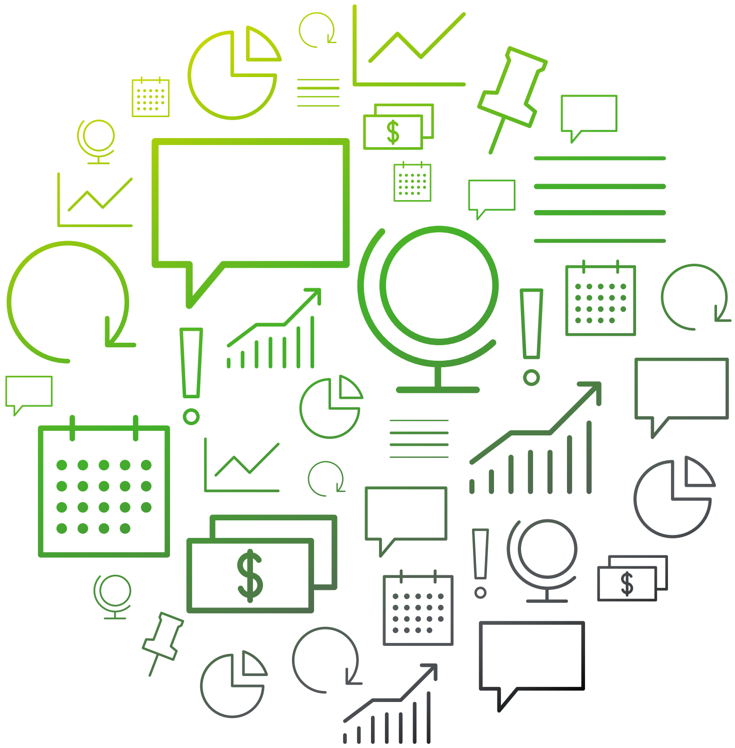

On the board's agenda | US

Is it time to review your board of director compensation program?

Board compensation is on investors' radar

Unlike compensation for executives, non-employee director compensation is not subject to independent review. While shareholders must approve equity plans in which non-employee directors may participate, and while those plans frequently include limitations on individual equity grants or aggregate pay levels, shareholders are not required to approve the director compensation program as a whole. As a result, non-employee director compensation programs that result in high levels of pay can be a lightning rod for proxy advisory firm criticism, shareholder litigation, negative media attention, and more.

Over the past several years, shareholder concerns over excessive non-employee director compensation have resulted in an uptick in shareholder litigation. These lawsuits[1] have been triggered by plaintiffs' beliefs that director compensation programs, generally equity plans approved by shareholders, permitted boards to set their own pay, which posed a real or perceived conflict of interest. Additionally, plaintiffs have asserted that the exercise of this discretion has resulted in excessive director pay levels when compared to peer companies, causing a waste of corporate assets. In a number of these cases, the Delaware courts have decided that shareholder approval of an equity compensation plan does not constitute ratification of director compensation when a plan lacks specific and meaningful limits on the amount of compensation that can be awarded to directors.

As a result, some companies are now including limits on non-employee directors' equity awards and, in some cases, total compensation in their shareholder-approved equity plans in order to establish reasonable boundaries on the board's discretion to set its own pay. Based on the *2017 Domestic Stock Plan Administration Survey*, 33% of respondents have limited the number of shares that can be granted to individual directors over a specified period.[2] Given the current litigious environment, the percentage of companies that have implemented pay limits may increase.

1. For example see the Delaware Chancery Court Opinions in: Seinfeld v. Slager; Calma v. Templeton; and In Re Investors Bancorp Litigation.
2. 2017 *Domestic Stock Plan Administration Survey*, co-sponsored by Deloitte Consulting LLP and the National Association of Stock Plan Professionals (NASPP).

Center *for* Board Effectiveness

While shareholder-approved limits may reduce exposure to non-employee director compensation litigation, they may inadvertently reduce a board's flexibility to change the non-employee director compensation program based on evolving needs or changes in the business. For example, if the company decides to separate the CEO and Chairman of the Board roles, the company may need to pay the Chairman significantly more than the other directors. Similarly, a major acquisition could exponentially increase the size and complexity of the company, in which case the current limits on non-employee director pay may need to be changed to attract and retain non-employee directors. Thus, limitations on non-employee director pay should be carefully considered.

Questions board members should consider asking themselves concerning non-employee director pay:

1. When was the last time we reviewed our director pay program?
2. How often do we review our director pay program?
3. Have we compared our director pay program to those of other companies? How does our pay program compare?
4. What peer companies were used for the review? How do they compare to us in size, business operations, and other factors?
5. Should we compare our director compensation program to a broader set of peer companies?
6. What is the rationale for the mix of cash and equity paid to our directors?
7. Is the type of equity we grant to non-employee directors appropriate for our company?
8. Is our vesting aligned with the non-employee directors' elected service?
9. Should we consider adopting equity ownership guidelines?
10. Are there any benefits or perquisites in our program that we should reconsider?
11. Should we engage an outside advisor to help us review our director pay program?
12. Should we provide shareholders with an opportunity to approve the board compensation program on a non-binding basis?

Institutional investors' concern with non-employee director pay has led proxy advisory firms to focus on the topic. Institutional Shareholder Services (ISS) has announced that it will review non-employee director pay and vote against members of the Compensation/Human Resources Committee or Nominating & Governance Committee (whichever committee sets director pay) if board compensation is deemed excessive in two or more consecutive years. ISS has specifically noted that it "will compare individual non-employee director pay totals to the median of all non-employee directors at companies in the same index and industry" in order to identify companies that provide excessive pay.[3]

Given the rise in non-employee director compensation litigation and shareholder concerns over board pay levels and practices, companies should consider reviewing the market competitiveness of their director compensation levels and structure at least biennially and revisiting the proxy disclosure of director pay to provide additional context and highlight the leading practices that have been adopted to demonstrate that compensation is reasonable and appropriate (see discussion below).

Setting and reviewing non-employee director pay

Boards of directors determine which committee is responsible for reviewing and setting non-employee director pay. The *2016 Board Practices Report*, a survey conducted by Deloitte's Center for Board Effectiveness and the Society for Corporate Governance, revealed that non-employee director compensation is typically overseen by the Compensation/Human Resources Committee, as indicated by 57% of survey respondents, followed by the Nominating & Governance Committee, reported by 37% of the respondents.[4] Regardless of which committee oversees non-employee director pay, it is a good governance practice to require full Board approval of non-employee director compensation.

Non-employee director compensation reviews can help companies maintain competitive compensation levels and practices in comparison to their peers. Most boards review their pay programs every one to three years, as identified in the *Board Practices Report*—78% of survey respondents reported conducting annual reviews of their board pay programs, while 18% of survey respondents review board pay once every two or three years.[5]

3. Institutional Shareholder Services' (ISS) *U.S. Compensation Policies Frequently Asked Questions* released on December 14, 2017.
4. Source: *2016 Board Practices Report*, tenth edition, co-sponsored by Deloitte LLP and the Society for Corporate Governance.
5. Ibid.

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Forgoing regularly competitive reviews can lead to pay levels that are out of sync with the market or an inappropriate pay mix (e.g., the mix between cash compensation and equity compensation or the types of equity awards provided to non-employee directors).

Leading practices for reviewing non-employee director pay

When reviewing the compensation program for non-employee directors, it is important to use a consistent methodology and document the observations and findings in a written report. An important first step in the process is to select an appropriate peer group. In many cases, the peer group can be the same as or very similar to the peer group used to assess and determine market pay levels for the company's senior executives. The peer group should reflect similarly-situated companies based on industry and company size. Supplementing the peer group data with general industry information reported in published surveys may also provide valuable insights, as the market for board talent often extends beyond a company's industry.

Once the market for board talent is identified, a board's review of its non-employee director compensation program might include a market comparison of the following components:

- the amount of pay;
- the components of pay—i.e., annual retainers (cash and/or equity), board and committee meeting fees, and committee retainers (including chair retainers);
- the mix between cash and equity compensation;
- the equity award design—i.e., the type of equity award, vesting period, and whether to base the equity award on the number of shares or a dollar value;
- the ability to defer compensation; and
- stock ownership and/or retention guidelines.

A board's review may also take into account the frequency of board and committee meetings in relation to the level of compensation provided. This can help determine whether more compensation is required due to board member activity and whether additional pay should be provided for directors who take on committee chair, board chair, or lead director roles. This can be especially important, as many companies have eliminated meeting fees, and boards or committees with significantly higher workloads may not be properly compensated for their time and expertise.

Selecting the form of non-employee director pay

Across publicly-traded and privately-held companies, the most common type of compensation provided to non-employee directors is an annual cash retainer. In publicly-traded companies, most non-employee directors receive an annual equity award in addition to an annual cash retainer.[6] A smaller number of companies pay individual board and committee meeting fees, which may include fees for participating in telephonic or videoconference meetings. Committee chair retainers are also a common compensation component, recognizing the significant time and effort expended by committee chairs to prepare for committee meetings and engage in other activities. In many companies, board leadership pay (i.e., compensation for service as a non-executive chairman or a lead independent director) often consists of an additional or enhanced cash or equity retainer.

In some cases, boards also provide committee member retainers in lieu of committee meeting fees. The additional retainers can compensate committee members for the extra time and effort required to prepare for and participate in committee meetings, for work done in between meetings, and to secure the level of experience that is needed for certain committees (e.g., financial literacy for audit committee members). These committee retainers can also allow the company to differentiate compensation based on the non-employee director's level of committee involvement.

The use of board and committee meeting fees continues to decline as meeting attendance is considered a basic duty of board membership that does not merit "extra" compensation. Eliminating meeting fees can also simplify the administration of the director compensation program. However, some companies pay individual meeting fees if the total annual number of meetings exceeds an annual threshold (e.g., individual meeting fees are paid if the total number of board meetings exceeds seven per year). Otherwise, the annual cash retainer and equity retainer serve

6. 2017 *Domestic Stock Plan Administration Survey*, co-sponsored by Deloitte Consulting LLP and the NASPP.

to compensate board members for their attendance at and participation in board and committee meetings and work that directors do outside of and in between meetings.

The structure and design of non-employee director compensation should reinforce the fiduciary role of the directors, which is why it is highly unusual for non-employee directors to participate in highly leveraged pay-for-performance programs that are the driving force behind most executive pay programs.

Granting equity to non-employee directors

Typically, board members receive annual grants of full-value equity awards, such as restricted stock, restricted stock units, or deferred stock.[7] There has been a continued decline in granting stock options to board members, in part because the volatility in value associated with stock options is inconsistent with the non-employee directors' fiduciary role (as opposed to an operator/manager of the business). Concerns have also been raised that if the board is paid based on performance metrics similar to those used for senior executives, it might impair their independence, which is also why full-value equity awards generally do not have performance-based vesting criteria. Instead, full value equity awards may vest based on the elected term of the directors, which for most boards is annual. In other situations, full value equity awards are paid in arrears (i.e., after service has been provided) and may be fully vested at grant.

For companies that grant equity awards to non-employee directors, providing an award that accounts for at least one-half of the value of total compensation for board members may help align the long-term interests of non-employee directors with those of shareholders.

According to the *2017 Domestic Stock Plan Administration Survey*, a majority of companies favors granting equity awards based on a target dollar value rather than a specified number of shares/units. This can help to eliminate year-to-year fluctuations in the value of the awards granted and provides the company with the ability to provide a targeted pay level that is consistent with market rates of pay. Some of the non-employee director compensation programs that have given rise to investor concerns and the litigation referred to earlier in this article were based on the granting of equity awards using a fixed number of shares being awarded each year. Over time, some of these companies and their stock price have performed extremely well, driving equity compensation to $500,000–$750,000 per year and total compensation close to $1 million per year, which investors and potential plaintiffs may regard as excessive.

Other board program practices

A number of companies allow non-employee directors to defer the receipt of cash and/or equity awards to a later date. Deferred compensation programs allow directors to determine the timing and taxation of earned compensation, which allows for tax-deferred compounding of returns on such funds. Deferral periods usually extend to the non-employee director's end of board service, with a number of companies allowing directors to withdraw their deferrals as a lump sum or in installments over 5, 10, or even 15 years. Some companies require mandatory deferrals on equity awards until a director retires from the board, which helps align the non-employee director's compensation with stock returns during their entire tenure on the board and alleviate any potential shareholder concerns with directors receiving equity grants.

Finally, stock ownership or stock retention policies serve as good governance practices. Stock ownership policies are by far more commonly adopted than stock retention policies. Stock ownership guidelines are typically based on a multiple of the annual cash retainer, with five times the annual cash retainer being the most common multiple. Few companies have adopted equity retention polices that require board members to hold all or a portion of their equity until their board service concludes, although many non-employee directors voluntarily retain shares or defer them until retirement.[8]

7. Source: 2017 *Domestic Stock Plan Administration Survey*, co-sponsored by Deloitte Consulting LLP and the NASPP.

8. Ibid.

Practices to consider avoiding when establishing non-employee director pay programs

With the recent increased scrutiny of non-employee director compensation programs, leading practices suggest that the following should be avoided:

- Excessive pay levels set based on an inappropriate peer group
- Performance-based pay
- Significant use of stock options instead of full value share awards (e.g., restricted stock or restricted stock units)
- Perquisites (with the possible exception of matching contributions to charitable organizations)
- Payment of compensation despite lack of meeting attendance
- Retirement benefits, such as pensions and retiree medical

Shareholder advisory firms and institutional investors generally advocate against using the above forms of compensation and benefits for non-employee directors.

Reviewing the proxy disclosure of non-employee director pay

The SEC rules do not require the same level of detailed disclosure for non-employee director compensation that is required to describe the compensation of the company's named executive officers. A number of companies currently describe the board committee responsible for recommending pay to the full board for approval, the peer group used to establish director pay, the various elements of compensation and the corresponding amounts of each element of compensation, and certain policies (for example, the stock ownership guidelines). However, these disclosures generally do not provide much context for how pay levels were determined or why the compensation program is designed a certain way.

Given the additional scrutiny of director compensation by the proxy advisory firms, shareholders and the courts, companies should consider providing sufficient details about the program to give shareholders and other interested parties confidence in the process used to determine pay levels and the elements of compensation. For example, companies might disclose how non-employee director pay is determined, the compensation philosophy on which it is based, and how it compares to director pay at peer companies. The committee overseeing director pay may also consider retaining an independent adviser and identifying leading practices adopted by the company and poor director pay practices not used by the company.

In summary

Boards of directors have a fiduciary responsibility to establish appropriate levels of non-employee director pay. To fulfill this responsibility, board members should consider conducting periodic reviews of competitive practices when establishing or updating their non-employee director compensation program. In addition to developing a board pay review methodology, companies should consider evaluating each component of pay along with total pay levels. Additional consideration should be given to implementing shareholder-approved limits on non-employee director pay, after giving careful consideration to the need for flexibility to adapt to a changing environment. Reviewing the structure, design, and level of director pay may enable companies to provide board compensation that attracts and retains high quality board talent and addresses shareholder concerns, institutional investor guidelines, and potential legal challenges.

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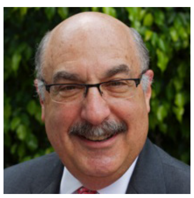

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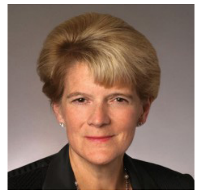

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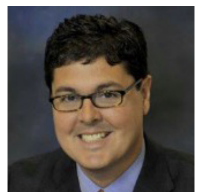

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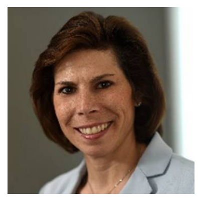

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About the Center for Board Effectiveness
The Center for Board Effectiveness helps directors deliver value to the organizations they serve through a portfolio of high quality, innovative experiences throughout their tenure as board members. Whether an individual is aspiring to board participation or a veteran of many board experiences, the Center's programs enable them to contribute effectively and provide focus in the areas of governance and audit, strategy, risk, innovation, compensation and succession.