CONSULTANT'S CORNER

The Evolution of Director Compensation

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Director pay continues to evolve in concert with evolving regulatory requirements, increased shareholder focus, and the growing influence of proxy advisory firms.

For the first time, our firm has conducted a review of director pay levels and program design among Russell 3000 companies ("Russell 3000 Study"), which we believe is a more robust review compared to surveys that rely on more limited datasets. Focusing on key elements of director compensation, this research delivers a comparative view of programs among companies of various size categories and industry sectors. This review provides an excellent vantage point to discuss the state and evolution of director compensation.

Much has happened to change the nature of corporate board service over the last 20 years. New federal and state legislations, new Securities and Exchange Commission (SEC) regulations, new stock exchange listing rules, a new sense of public outrage toward perceived corporate excess, and a new fear of shareholder litigation have caused directors to work harder, longer and more carefully than ever before. It would not be unusual for some directors at public companies to now devote about 250 hours per year to serve on a single board.

In addition, directors have become limited in the number of boards on which they may serve. Membership on too many boards, or sometimes referred to as "over-boarding", is negatively perceived by the public and the investment community. Shareholders want to make sure that qualified corporate directors devote sufficient time and attention to the oversight of their investment, and are not stretched too thin for effective performance. The push to spread out board service has reduced the economies of scale of the professional director class and has helped increase director compensation levels.

The combination of the re-

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duction in the number of boards on which a director can serve, the increase in hours devoted to board service, the new emphasis on training and expertise, and the pressure of increased accountability has accelerated changes, including a significant growth in director pay levels in the early 2000s.

In 2017, increases in director pay levels have stabilized. Heightened scrutiny from shareholders and a series of high-profile lawsuits in recent years has resulted in a standardization of pay levels between companies of similar size and industry. Companies are reviewing their plans more frequently than ever before and, subsequently, are making smaller changes.

In order to mitigate the risk of litigation, companies are (a) adopting annual-share- or annual-value-based-grant limits for director equity awards and (b) seeking shareholder approval of that limit. This trend has resulted in the splitting of director and executive compensation equity plans, which were combined in the late 1990s. A number of companies are even imposing annual limits on *total* director pay levels (including both cash and equity), similar to limitations on executive pay.

Generally, most directors receive a combination of cash-based and equity-based compensation. While the specific elements of director compensation are neither uniform nor consistent from industry to industry or from company to company, it is important for companies to be aware of both industry-specific and general market trends as they review their own programs.

A typical director compensation program review includes an analysis of the following:

- Board member retainer/meeting fees;
- Committee member retainer/meeting fees;
- Leadership premium: committee chair, lead director and non-executive chair premiums;
- Equity awards; and,
- Cash vs. equity mix.

While comparison to a specific peer group has long been considered a best practice for evaluating current director pay programs, it is also important to understand new trends and emerging best practices amongst a larger universe of companies, particularly within a company's size or industry scope. There are many published survey sources available, though most are limited to relatively small samples of larger companies such as the S&P 500 or the Top 200 companies.

The Russell 3000 Study is based on a sample of 1,813 U.S. public companies in the Russell 3000 divided among revenue (non-financial companies) or assets (financial companies), and also classified into ten industry sectors based on Standard & Poor's Global Industry Classification Standard (GICS) codes. Director compensation program details were sourced primarily from companies' proxy statements filed with the SEC in the one-year period ending May 31, 2016. The size and industry classifications as well as number of companies in each grouping are shown in Figure 1.

Figure 1. Size and Industry Breakdown of Companies Studied

Size Categories	
Revenue (Non-Financial)	***Assets (Financial)***
< $500 Million (398)	< $2.5 Billion (115)
$500–999 Million (219)	$2.5–9.9 Billion (143)

Size Categories	
Revenue (Non-Financial)	***Assets (Financial)***
$1–2.9 Billion (333)	$10–99.9 Billion (86)
$3–9.9 Billion (273)	> $100 Billion (34)
> $10 Billion (212)	

Industry Sectors
Consumer Discretionary (277)
Consumer Staples (81)
Energy (128)
Financials (378)
Health Care (218)
Industrials (251)
Information Technology (323)
Materials (84)
Telecommunication Services (16)
Utilities (57)

OVERVIEW OF TRENDS IN DIRECTOR COMPENSATION PROGRAMS

The independent director role is critical to the present and future success of the company. Director compensation as a core principal of good governance should be fair and reasonable. Director pay programs should be able to attract high-quality candidates, but not in such forms or amounts as to cause any speculation regarding independence.

An effective director pay program should achieve the following:

- Attract and retain high-performing/diverse director talent;
- Align the interests of board members, executives, and stakeholders;
- Be straightforward, understandable, and easy to explain to all stakeholders;
- Provide equity focus with a design that mitigates equity transactions that could be construed as "timing the market";
- Meet the needs of a diverse group of directors; and
- In setting compensation levels, ensure competitiveness with the market and alignment with the time commitment and responsibilities for various roles on the board.

Director pay is continuing to be simplified as companies eliminate board and committee meeting fees, and make up for this with a corresponding increase in board and/or committee member retainers. In the 2000s, it was most common for directors to be paid for attendance at each board meeting as well as for each committee meeting, in addition to receipt of a relatively low annual board retainer.

Essentially, each director had to earn his or her fees through meeting participation. Over time, this model of pay has been replaced as boards continue to move away from meeting fees in favor of increased cash and equity retainers. This communicates to shareholders that meeting attendance is mandatory, and the workload is spread more evenly across all directors.

Additional compensation is almost always paid for serving as a committee chair, lead director, or non-executive chair ("Leadership Premium"). More and more, these Leadership Premiums are the only additional amounts beyond the cash retainers and equity awards paid in these more streamlined director pay programs. As changes in the regulatory and corporate governance environment over the past several years have placed increasing time demands on committee chairs and lead directors who do far more than attend meetings, enhanced or incremental compensation for these roles has become very common.

For annual equity awards, the market trend over the last decade has been away from stock options and toward full value shares (restricted stock, deferred stock or outright stock). The prevalence of stock options continues to decline, and when companies do grant options, they often grant options along with full-value shares. An additional award upon initial election to the board continues to decrease in prevalence as well.

Other key findings based on our research are as follows.

Total Director Compensation

Total Compensation Values

Among all companies studied, median 2015 total director compensation was $191,043.[1] As might be expected, total compensation paid to directors increases with company size. For non-financial companies, median total compensation levels ranged from $147,750 (revenues < $500M) to $263,667 (revenues > $10B). For financial companies, total compensation levels ranged from $113,333 (assets < $2.5B) to $254,167 (assets > $100B).

Telecommunications Services is highest-paying of the sectors we studied, with median total compensation of $245,752. Financial sector companies have the lowest total compensation, with a median of just $148,865.

Figures 2 and 3 illustrate total director compensation values by company size and industry sector. These graphs also show the percentage of total compensation that is paid in cash versus the percentage paid in equity, which is discussed in further detail in the next section of this article.

Figure 2. Total Director Compensation by Company Size

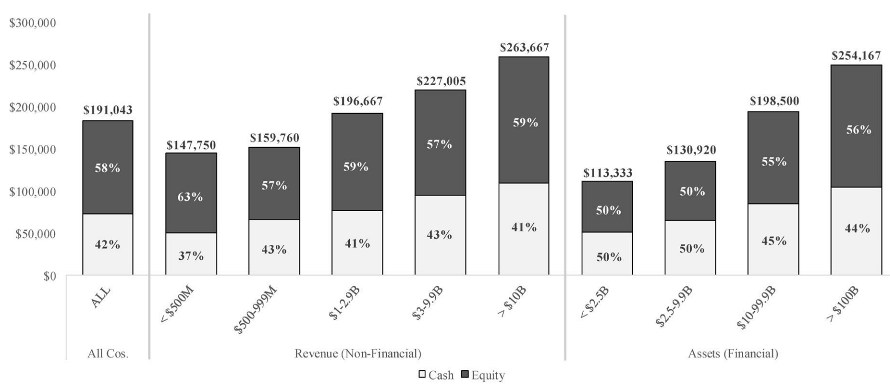
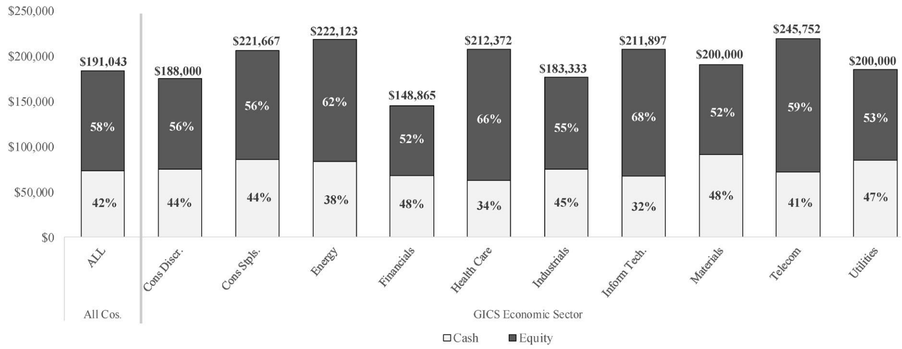


Figure 3. Total Director Compensation by Industry



Total Compensation Mix — Cash vs. Equity

Compensation for board service is typically composed of cash and equity, as shown in Figures 2 and 3. Of all companies studied, the median pay mix was 58 percent equity and 42 percent cash. For companies providing each director with the option of selecting payment in the form of cash and/or equity, we included the value based on the most prevalent election made during the latest fiscal year studied.

At median, non-financial companies in all revenue categories provided at least 57 percent of total director compensation in the form of equity. The smallest revenue category (< $500M) paid the greatest percentage of equity (63 percent).

Financial companies in all asset categories provided at least 50 percent of compensation in the form of equity, with the percentage of equity increasing with asset size from 50 percent for companies with assets < $2.5B to 56 percent for companies with assets > $100B.

In line with expectations, equity made up the highest portion of total compensation at Information Technology companies (68 percent). Surprisingly, the lowest portion of equity was at both Financial and Materials companies (52 percent for each industry).

Total Cash Compensation

Total Cash Compensation Values

Cash compensation for board service is typically provided through some combination of annual board retainer, board meeting fees, committee member retainer, and committee member meeting fees.

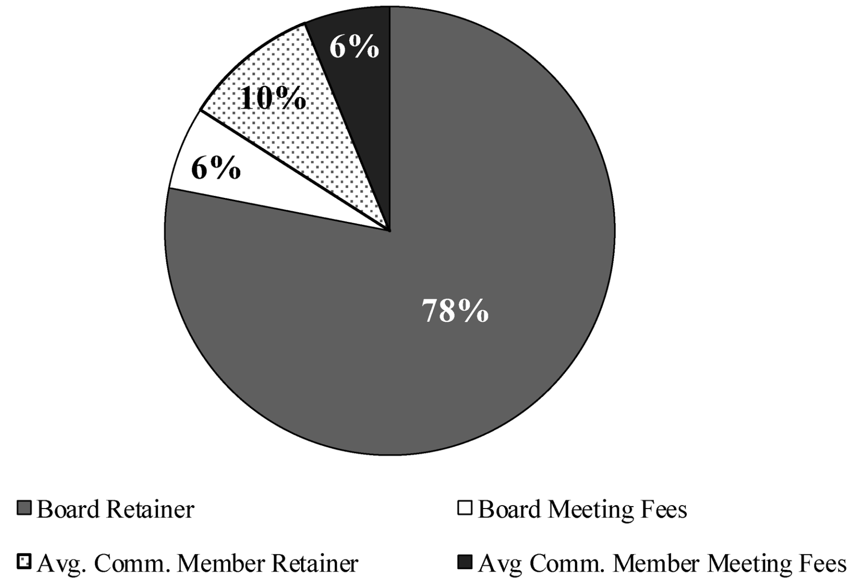
Among all companies studied, median total director cash compensation was $75,000.[2] As with total compensation levels, cash compensation paid to directors increased with company size. For non-financial companies, median total cash compensation levels ranged from $51,000 (revenues < $500M) to $110,000 (revenues > $10B). For financial companies, total cash compensation levels ranged from $52,400 (assets < $2.5B) to $105,250 (assets > $100B).

Of the industries studied, median total cash compensation ranged from $63,667 (Health Care) to $91,667 (Materials).

Total Cash Compensation Mix

Of all companies in our study, the average cash compensation program was comprised mostly of board retainer (78 percent), with small percentages allocated towards board meeting fees (6 percent), committee member retainers (10 percent), and committee member meeting fees (6 percent). See Figure 4.

Figure 4. Total Cash Compensation Mix — All Companies
(Median Total Cash Compensation: $75,000)



For non-financial companies, board retainers as a percentage of total cash compensation increased with company size, from an average of 73 percent among the smallest revenue category to 87 percent for the largest. This relationship was not mirrored among financial companies, as the smallest asset category had the second-highest percentage of board retainer pay. Of the industry sectors reviewed, Telecommunications Services and Information Technology had the lowest board retainer percentages (71 percent and 73 percent, respectively), and Industrials, Materials and Utilities had the highest (all at 83 percent).

Trend towards Full Bundling of Cash Compensation

A trend towards full bundling of cash fees that began in the early 2000s has migrated from large companies (> $10B in revenue) to smaller companies, as shown in Figure 5:

Figure 5. Evolution of Bundled Cash Fees

	Unbundled (1990s and earlier)	Partial Bundling of Fees (early 2000s)	Full Bundling of Fees (present day)
Board Retainer	Small	Larger (to reflect bundling of board meeting fees)	Even Larger (to reflect bundling of board meeting fees AND committee meeting fees)
Board Meeting Fees	Separate	Bundled (included in Board Retainer)	Bundled (included in Board Retainer)
Committee Meeting Fees	Separate	Separate	Bundled (included in Board Retainer)

Equity award size: *has increased with bundling of cash*

Company size: *This trend started with larger companies and has migrated to smaller companies*

Companies across all sizes and sectors continue to remove board meeting fees as part of the overall cash program. Board meeting fees make up the smallest percentage of total cash among the largest companies. Among the largest revenue category, board meeting fees made up just 2.9 percent of total cash compensation. Among the largest asset category, board meeting fees made up 4.7 percent. In general, board meeting fees made up a small percentage of total cash among all industry sectors, ranging from 5 percent (Information Technology) to 8.5 percent (Financials) for nine of the 10 industries studied. The tenth industry—Telecommunication Services—was somewhat of an outlier, with board meeting fees accounting for 14 percent of total cash compensation.

As board meeting fees have decreased in prevalence, so have committee member meeting fees. Similar to board meeting fees, committee member meeting fees made up the lowest percentage of total cash compensation among the largest non-financial companies, accounting for just 4.7 percent of total cash at companies with revenues > $10B. Interestingly, the opposite was seen among financial companies, with the smallest asset category of < $2.5B having the lowest percentage of committee member meeting fees (7.6 percent). Information Technology companies had the lowest percentage of committee member meeting fees (4.1 percent). Financial and Telecommunication Services companies had the highest percentage (9.0 percent and 8.4 percent, respectively).

Over the years, committee member meeting fees have been replaced with committee member retainers. Committee member retainers made up the highest percentage of total cash compensation among small, non-financial companies, making up 15.5 percent of total cash for the < $500M revenue category. This percentage decreased as revenue increased, with committee member retainers making up just 5.4 percent of total cash compensation at the largest companies with revenues > $10B.

Among financial industry companies, committee member retainers made up approximately 6.0 percent to 8.0 percent of total cash among all asset categories except the largest scope. These large companies (assets > $100B) had committee member retainers totaling just 4.8 percent of the average cash mix. While committee member retainers made up around 5.0 percent to 7.0 percent of total cash compensation among most industry sectors, the percentage nearly tripled for companies in the Information Technology Industry, where the average cash mix consisted of 18.0 percent committee member retainers.

Board Retainer (Cash)

Among all companies studied, the median annual board cash retainer was $55,000. Annual board cash retainers are correlated with company size, increasing from a median of $40,000 to $100,000 by ascending revenue size and, $40,000 to $88,000 by ascending assets.

Board cash retainers are highest among the Materials and Utilities sectors (both had a median retainer of $75,000). Retainers are lowest among sectors that place the greatest emphasis on equity compensation such as Health Care and Information Technology.

Figure 6. Cash Retainer Value by Company Size & Industry

By Revenue	
Category	*Retainer*
< $500M	$40,000
$500–999M	$50,000
$1–2.9B	$60,000

By Revenue	
Category	*Retainer*
$3–9.9B	$75,000
> $10B	$100,000

By Assets	
Category	*Retainer*
< $2.5B	$40,000
$2.5–9.9B	$50,000
$10–99.9B	$60,000
> $100B	$88,000

By Industry	
Category	*Retainer*
Health Care	$45,000
Financials	$50,000
Information Technology	
Telecommunication	$57,500
Services	
Consumer	$60,000
Discretionary	
Energy	
Industrials	
Consumer Staples	$65,000
Materials	$75,000
Utilities	

Meeting Fees

The trend away from meeting fees is evident in our sample. Among all companies studied, only 28 percent still provide board meeting fees, and 29 percent provide committee meeting fees. In general, smaller companies are more likely to pay meeting fees than larger companies.

Among all companies studied that did include meeting fees as part of their overall program, the median board meeting fee was $1,500. For all three main committees (audit, compensation and nominating & governance), the median committee meeting fee was also $1,500.

The board meeting fee remained relatively flat among the four financial services asset categories (with only the smallest asset group having a meeting fee under $1,500), and ranged from $1,500 to $2,000 among the non-financial revenue categories. When reviewed by industry, six of 10 provide a $2,000 board meeting fee, and the lowest median meeting fee of $1,500 was reported by Energy and Financial companies.

Figure 7. Board Meeting Fees by Company Size & Industry

By Revenue	
	Meeting
Category	*Fee*
< $999M	$1,500
> $1B	$2,000

By Assets	
	Meeting
Category	*Fee*
< $2.5B	$1,150
> $2.5B	$1,500

By Industry	
	Meeting
Category	*Fee*
Energy	$1,500
Financials	
Consumer Staples	$1,550
Utilities	$1,875
Consumer Discretionary	$2,000
Health Care	
Industrials	
Information Technology	
Materials	
Telecommunication	
Services	

Committee meeting fees are typically the same for all three standard board committees (audit, compensation and nominating & governance), and are also usually the same for the committee chair as well as the members. Committee meeting fees ranged from a median of $1,000 for the smallest revenue and asset groupings to $1,500 at the largest companies. All industry classifications pay a median committee meeting fee of $1,500 except for financial companies with a median of $1,000.

Committee Chair and Member Retainers

Almost all companies (94 percent)[3] provided committee chair retainers, consistent with the general industry market practice of providing premium pay to the directors with the most responsibility. Just under half of all companies (47 percent)[4] provided committee member retainers.

Of all companies that provided chair and member retainers, the median values were as follows (with prevalence in parentheses):

Figure 8. Median Chair and Member Retainers by Committee

Committee	Chair Retainer*	Member Retainer
Audit	$20,000	$10,000

Committee	Chair Retainer*	Member Retainer
	(94%)	(47%)
Compensation	$15,000 (89%)	$7,500 (40%)
Nominating & Governance	$10,000 (84%)	$5,000 (37%)

* Values are inclusive of the committee member retainer, if one is provided.

In general, compensation for committee service increased with company size. For both non-financial and financial companies, the median audit committee chair retainer increased from approximately $15,000 to $25,000 from the smallest to largest size categories.

Committee member retainers were more consistent among the various revenue and asset scopes, though in general did increase slightly with company size. There was little difference in retainers for committee service (both chairs and members) among the 10 industry sectors studied.

Among all revenue and asset categories, as well as all industry categories, the values of committee retainers for both chairs and members were highest for the audit committee, followed by the compensation committee and then the nominating & governance committee. While the audit committee has typically been tasked with the greatest workload and risk, heightened regulatory and shareholder scrutiny over executive compensation in recent years has increased the responsibility assumed by compensation committee members. As such, we continue to see retainers paid to this committee increasing and sometimes matching the audit committee.

Non-Executive Chair and Lead Director Incremental Fees

Of all companies in our study, 41 percent had a non-executive chair ("NEC"). Most of the companies with a non-executive chair (91 percent) provided additional compensation, with the median incremental fee for this leadership position being $65,000.

The value of this incremental NEC fee increased significantly with company size. For non-financial companies, the smallest companies had a median incremental fee of $19,000. The NEC fee increased to a median of $200,000 for companies with revenues > $10B.

For financial industry companies, the median incremental NEC fee ranged from $30,000 for companies with assets < $2.5B to $260,000 for companies with assets > $100B. By industry, the incremental fees for this role ranged from $45,000 (Telecommunication Services) to $117,500 (Utilities).

Fifty-three (53) percent of companies reported a lead director. Of these companies, 79 percent provided additional compensation, with a median incremental fee of $25,000. Unlike the NEC role, the difference in incremental compensation for this role did not vary significantly by company size or industry. All size and industry categories had a median incremental lead director fee ranging from $19,000 to $30,000, with most around $25,000.

For both leadership positions, more companies paid the incremental fee in the form of cash rather than equity.

Equity Awards

Equity Award Prevalence

As discussed above, equity compensation typically makes up at least half of director pay. Nearly all companies in our study provided equity awards to directors (1,755 of 1,813, or 97 percent). Equity awards to directors are paid in the form of stock options or stock awards (i.e., restricted stock/units, deferred stock/units, or outright stock grants).

Stock awards are much more prevalent than stock options in director compensation programs across all company size categories and industry sectors. Of all companies studied, 77 percent granted stock awards only, compared to just 8 percent granting stock options only. Twelve (12) percent of companies granted a mix of stock awards and stock options, and the remaining 3 percent of companies granted no equity awards at all.

Non-financial companies with revenues < $500M still rely on stock options only more than any other company size category. While not as prevalent as stock awards (used by 57 percent of these companies), a relatively high percentage (22 percent) granted stock options only. In general, stock option use declined as company size increased. Of the largest non-financial companies (revenues > $10B), only 1 percent granted stock options, and none of the largest financial companies (assets > $100B) granted stock options.

Stock award only usage remained high among all industry sectors, ranging in prevalence from 50 percent (Health Care) to 95 percent (Utilities). The decline of stock options is evident among almost all industries, with usage ranging from just 1 percent to 9 percent in all sectors except for Health Care, where stock option prevalence totaled 26 percent. In the Health Care sector, stock options are still an important component of a competitive director pay program, particularly among high-growth pharmaceutical and biotechnology companies. The smallest stock option prevalence was seen in the Materials industry (1 percent), followed closely by the Utilities and Energy industries (both at 2 percent).

See Figures 9 and 10 for further details.

Figure 9. Equity Award Prevalence by Company Size

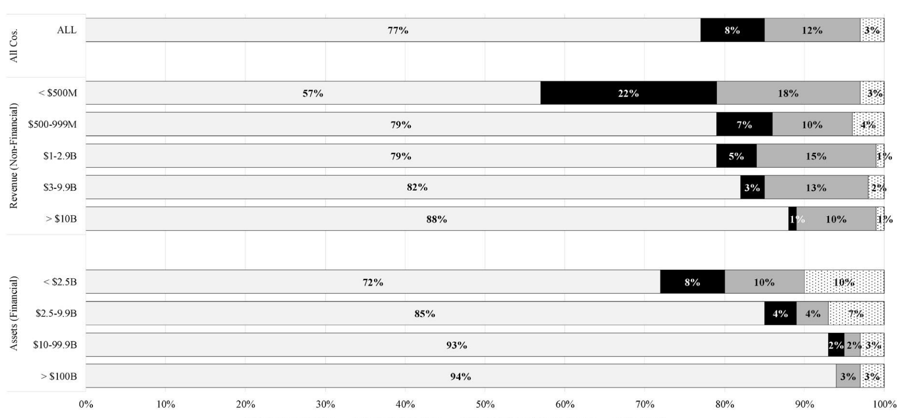
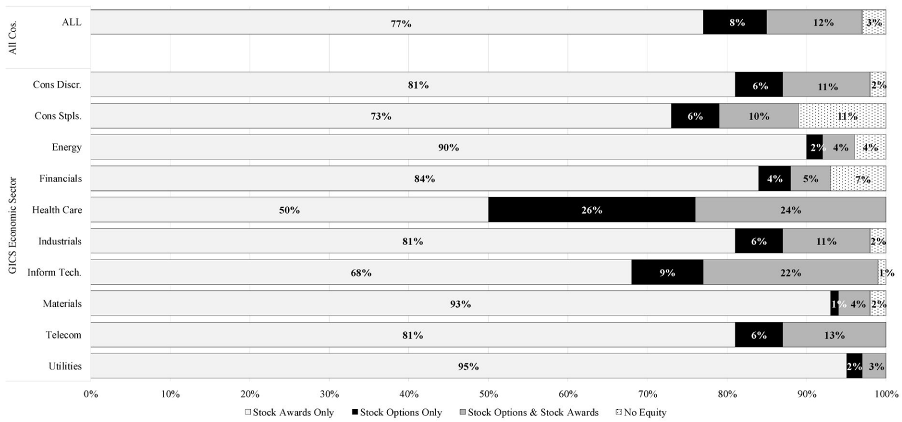


Figure 10. Equity Award Prevalence by Industry



Equity Award Values

Of all companies studied, the median total equity award value was $112,000. In general, total award values increased with company size, though non-financial companies in the second smallest revenue category ($550-$999M) had a slightly smaller median equity award than the smallest revenue category (< $500M). For non-financial companies, median total equity awards ranged from $90,000 ($550-$999M) to $150,091 (> $10B). For the four financial company categories, awards increased with asset size, ranging from $64,992 to $150,000.

When looking at industry sectors, Financial companies had the smallest total median equity award ($80,700) and Consumer Discretionary companies had the largest ($188,000).

See Figures 11 and 12.

Figure 11. Equity Award Value by Company Size

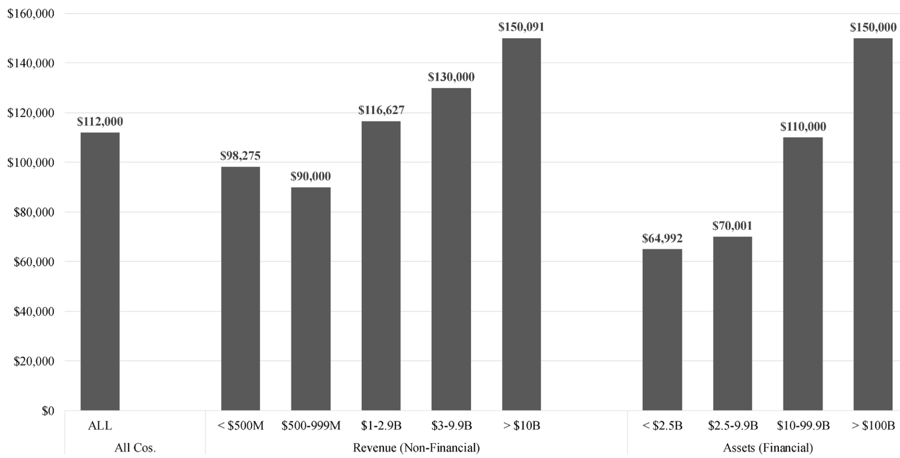
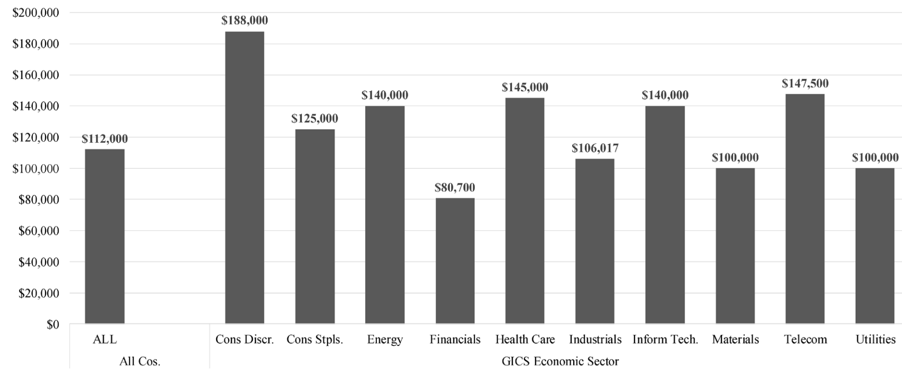


Figure 12. Equity Award Value by Industry



Equity Award Frequency

Of the companies that provided equity awards to directors (97 percent of all companies studied), 98 percent provided annual grants of equity. Only 1.5 percent made equity awards on a periodic basis (typically every three years which usually aligns with director voting frequency).

Twenty-three (23) percent provided an initial, "one-time" grant of equity upon election to the board for the first time (usually in addition to the annual grant). In general, smaller companies tend to provide these initial awards more often than larger companies, and non-financial companies are more likely to provide initial awards than financial companies. When companies make an initial award, most of the time the equity vehicle (stock options or stock awards) is the same as the annual award.

Equity Award Denomination — Shares vs. Value

Companies denominate equity awards based on either 1) a fixed dollar value or 2) a fixed number of shares. Companies of all sizes and across all industries have trended away from granting awards based on a fixed number of shares in an effort to control director pay levels by limiting volatility due to stock price fluctuations.

Of all companies studied, 79 percent denominated the annual equity award in terms of a fixed dollar value and 21 percent denominated the award in terms of a fixed number of shares. It was more common to use the value approach when granting annual stock awards versus annual stock options (85 percent of annual stock awards were granted based on value versus 62 percent of stock options).

Companies that made initial awards were also more likely to grant them based on fixed dollar value (68 percent). Like annual awards, it was more common to use the value approach when granting initial stock awards versus initial stock options (77 percent of initial stock awards were granted based on value versus 56 percent of stock options).

Looking Forward

Similar to executive pay, director pay continues to evolve. We expect to see further simplification of director pay programs and more recognition for leadership roles in the future. Increases in director pay levels will continue to level off, as more companies impose caps on director equity awards and total pay levels and the role of the independent director has stabilized.

Our consulting team plans to review director compensation plans among Russell 3000 companies on an annual basis. We expect that our next study will include an overview of how plan structure and value changed from 2015 to 2016. Look for our next article on this subject in early 2018.

Authors' Note: Molly Kyle (Manager, Marketing and Business Development) edited this article, and Egan Picken (Research Analyst) provided research assistance.

NOTES:

[1]In this study, total director compensation excludes leadership premiums (committee chair retainers as well as lead director and/or non-executive chair incremental retainers) and represents the average paid for committee member service assuming membership on two of three main committees (audit, compensation, and nominating & governance).

[2]In this study, total director cash compensation represents the average paid for committee member service assuming membership on two of three main committees (audit, compensation, and nominating & governance).

[3]94 percent of all companies studied provided a committee chair retainer to *at least one* committee chair.

[4]47 percent of all companies studied provided a committee member retainer to members of *at least one* committee.