

# Board Effectiveness Insights

Chapter 5 / Version 1.0

## FOCUS

BOARD EFFECTIVENESS PARTNERS (BEP) collaborates with directors and CEOs to objectively analyze and improve the effectiveness of their boards.

## INSIGHTS

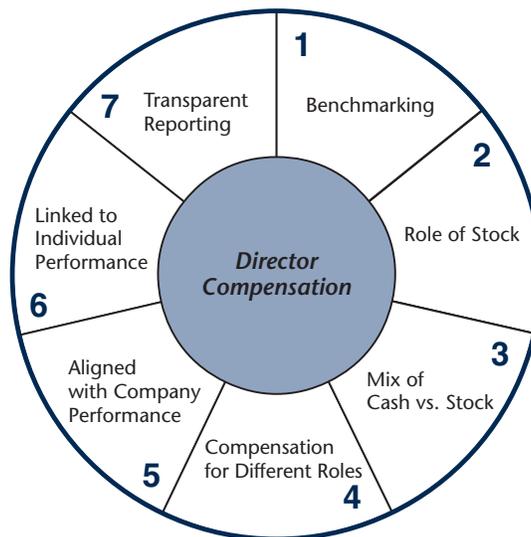
We publish *Board Effectiveness Insights* periodically to encourage dialogue on strengthening board effectiveness. We welcome your suggestions, thoughts, and agreement or disagreement. Please visit [www.bepartners.com](http://www.bepartners.com) for more details and other chapters of *Board Effectiveness Insights*.

## DIRECTOR COMPENSATION

In recognition of the changing roles and time challenges of directors, companies are reviewing director compensation to bring it in line with the increased risk, responsibility, and work load.

Board Effectiveness Partners (BEP) feels that it is timely to examine the core principles and evolving best practices surrounding director compensation.

This issue of *Board Effectiveness Insights* focuses on seven key considerations for director compensation policies.



From BEP's perspective, director compensation can and should be a competitive differentiator:

- ▶ attracting and retaining directors who are the best-of-the-best, and
- ▶ focusing director priorities and aligning them with the priorities of shareholders.

History will likely record 2003 to 2005 as a watershed period for boards and directors. Corporations worldwide have significantly revamped governance policies and director roles to comply with extensive legislative and regulatory requirements, as well as demands by shareholders for unimpeachable stewardship of the public's resources.

No matter how appropriate compensation changes may be, and in principle most are totally appropriate, directors are adjusting their own pay, upward. To protect shareholder value, this becomes a balancing challenge for the board . . . attracting, retaining, and rewarding competent and objective directors with fair and market-competitive compensation, while remaining prudent.

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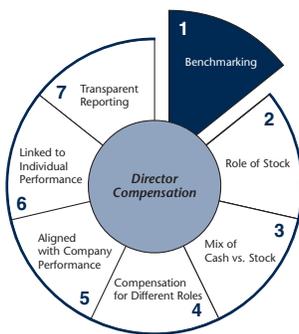
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BEP respects as reference resources the comprehensive surveys published annually by Pearl Meyer & Partners ([www.pearlmeyer.com](http://www.pearlmeyer.com)) and Frederic W. Cook & Co., Inc. ([www.fwcook.com](http://www.fwcook.com)).



Reputation risk is a prevalent concern among directors. After a lifetime of carefully building their reputations, directors are wary of the devastating impact of unseen risk.

As a first step, companies have addressed some basic and, quite frankly, easier issues:

- ▶ To reflect the increased responsibility and workload of the chairmen of the audit, governance, and compensation committees, their compensation is being singled out for differentially larger increases.
- ▶ To ensure longer planning horizons, equity compensation for directors is beginning to shift from simple options to restricted or deferred shares with long vesting periods.

While necessary and appropriate, these steps do not address the more complex director compensation challenges. For example:

- ▶ In a world where pay-for-performance is common, should directors' compensation be tied to measures of corporate performance beyond stock price alone?
- ▶ Not all directors perform and contribute at the same level. Should we differentially evaluate and reward the performance of individual directors?
- ▶ Directors are representatives of the shareholders. Are we comfortable that directors' performance objectives and rewards are 100% aligned with the shareholders they represent?
- ▶ Is director compensation fully disclosed to shareholders?

### 1. Benchmarking Director Compensation

Traditionally, competitive practice in the marketplace has been the main determinant of director compensation, much as it is an important driver of management pay. The paradigm has been simple:

- ▶ Who are our peers?
- ▶ What are they paying?
- ▶ How do we want to position our compensation levels relative to our peers?

This model works well when the world is standing still long enough to consider sound metrics. However, compensation metrics become more complex when responsibilities and roles are changing.

Many companies are making compensation changes, and the market is moving so rapidly, that this year's measurements will be out of date next year. More than ever before, deeply rooted experience and common sense judgment need to be applied as director compensation is reinvented.

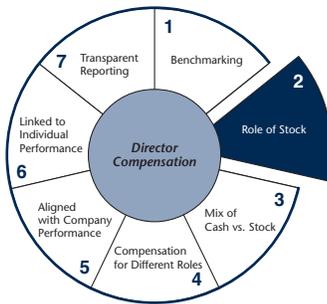
Although the benchmark for director compensation is in flux, BEP has seen some anchor points that support our consulting experience:

- ▶ The need for competent and objective directors is increasing, and recruiting them is more difficult.
- ▶ The economic value of directors is rising with their increasing contributions, risks, and responsibilities.

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Year-over-year increases in directors' compensation have ranged from 7% for the NYSE top 100 to 53% for the NASDAQ top 100. (see *Director Compensation: NASDAQ 100 vs. NYSE 100*, September 2004, Frederic W. Cook & Co., Inc.)

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Although increased equity is a good idea, company loans should be avoided because of the obvious conflicts.

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- ▶ Many companies are reviewing director compensation with an eye toward making adjustments.
- ▶ Shareholders expect compensation increases in line with rank-and-file increases, and disclosed with greater transparency.

The question is: With unreliable data, in a fast-changing environment, how much of an increase, if any, is justified and on what grounds? While there is no one right answer, BEP recommends the following:

- ▶ Be more aggressive than usual. Five or ten percent increases to traditional programs may not be enough to achieve the desired results including attracting high-quality, committed directors and demanding high performance. Companies should not be afraid of being a bit ahead of their competitors, but must be able to justify decisions to shareholders.
- ▶ Look at the specific board and committee roles and responsibilities of directors and adjust their compensation programs accordingly.
- ▶ Link specific board members to specific goals, objectives, and initiatives in the company's annual strategic plan and, in advance, define payout or bonuses for achieving or exceeding performance metrics.
- ▶ Instead of reviewing director compensation every five years or so, keep up to date with current trends in the market through annual or bi-annual reviews.

In answering the question of how much compensation is sound, competitive, and effective, boards must begin by comparing their director compensation and payout policies against the same peer group used to benchmark their executives.

## 2. Changing Role of Stock for Director Compensation

The conventional wisdom is that stock ownership enhances the alignment of directors' economic interests with those of the shareholders. The evolving wisdom is that stock options have an unintended consequence. They can inadvertently motivate narrow and inappropriate short-term thinking because options only emphasize short-term gains.

It is important to keep strategic objectives in focus. For directors, the primary purpose of equity is to align directors' economic interests with those of shareholders, while encouraging directors to approve management's prudent risk-taking focused on sound and sustainable competitive superiority.

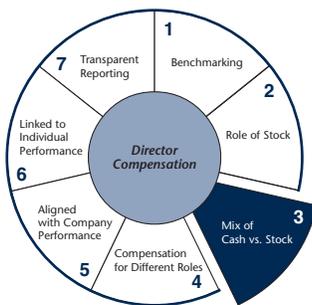
Ownership, where the director has downside as well as upside risk, is the key. Therefore, we can logically conclude that:

- ▶ restricted stock or deferred shares are preferable to options,
- ▶ long vesting and holding periods are a good idea, and
- ▶ directors should be required to purchase at least some amount of equity, perhaps as much as they are granted.

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Director retirement plans are disappearing. They are used by less than 3% of large companies. The reason is simple. They imply an unhealthy permanence to the office of director. Like other policies that undermine director effectiveness, BEP feels that retirement plans have outlived their usefulness.



\* Traditional practice percentages vary by company circumstances but in general are split between cash and options.

**Vesting:** With more director compensation in the form of stock, vesting is seen as an important issue, but again the underlying strategic objective should rule. For directors, shareholder alignment is most important. Therefore:

- ▶ BEP is comfortable with arrangements where director stock grants are immediately vested, but where sale or transfer is prohibited for an extended period, at least five years.
- ▶ Deferring the sale of some portion of the award until directors leave the board can also make sense.
- ▶ BEP encourages giving directors a choice. They could take their retainer in cash or in stock, where the shares are immediately vested but deferred.

**Stock Ownership Guidelines:** Rather than defining vesting periods, the most direct way of increasing share ownership is to simply require that directors not sell, based on ownership levels. A growing number of companies – currently 33% of the largest NYSE companies – are adopting Share Ownership Guidelines that restrict stock sales in order to maintain a pre-defined ownership level . . . typically 5 years' worth of grants.

## 3. Changing Mix of Cash vs. Stock for Director Compensation

The changing view on the role of stock in director compensation has resulted in a significant shift in the mix of cash and stock in director compensation packages. BEP urges our clients to define director compensation in the following three segments. Each segment can be weighted, and tailored over time, to the board's unique culture and director needs.

- ▶ **Annual retainer:** A few companies are moving toward an all-stock model, with no cash compensation, even for annual retainer or meeting fees. While this moves new directors to a significant ownership position quickly, it may be difficult for some directors who need or want the cash.

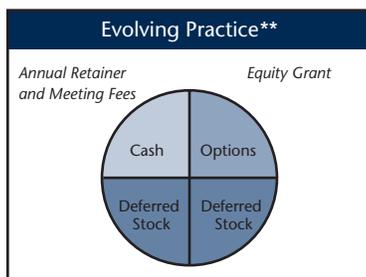
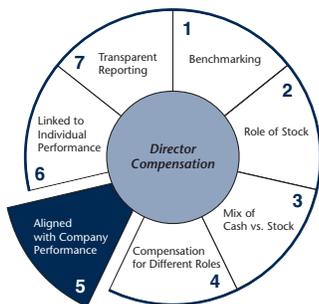
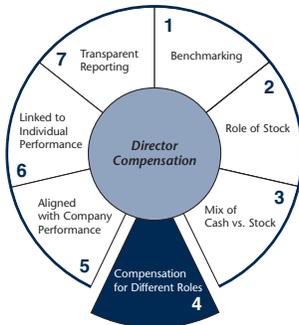
Companies need to examine the situation for current directors to determine how much cash they can replace with stock, usually deferred shares. BEP agrees with an emerging best practice . . . 50% in deferred shares and 50% in cash.

- ▶ **Meeting attendance fees:** The fixed portion of a director compensation package usually includes meeting attendance fees. The rationale has been that fees based on the number of meetings attended reflect the level of work required.

BEP feels that the number of meetings is not a useful measure of a director's contribution. Meeting fees can also motivate some to inflate the frequency of meetings.

If a company includes attendance fees, BEP encourages one annual retainer for committee membership, differentiated to reflect each committee's workload or expertise requirements, which may vary over time.

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\*\* Evolving practice percentages vary widely by company circumstances, but the graph represents BEP's recommendation for a split between cash, options, and deferred or restricted stock.

► **Variable portion of director compensation . . . an equity grant of some kind:** While traditional stock options are out of favor with most governance experts, BEP feels that completely abandoning stock options is an overreaction. Options remain a useful tool. The challenge is finding the right balance between shares and options. For companies with stock options as the primary component of directors' equity compensation, a 50-50 split between shares and options seems reasonable.

#### 4. Different Compensation for Different Roles

BEP feels that director compensation should reflect the unique contribution of individual directors:

- The chairperson of each committee should receive additional compensation reflecting the increased responsibility and work load of that role. It has become common practice to compensate the audit chair in this way.

The practice should be extended to chairpersons of other standing or ad hoc committees responsible for review and recommendations on compensation, governance, mergers, and acquisitions, CEO transition, and legal or public image crisis response.

- Boards should differentiate among committee assignments, rewarding the more arduous responsibilities of committee chairs and committee members with higher levels of compensation.

#### 5. Aligning Director Compensation with Company Performance

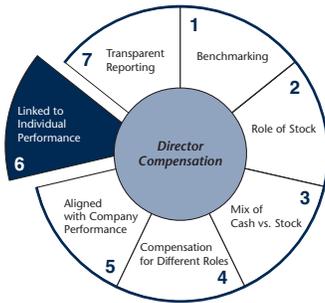
It has been standard practice in executive compensation to use compensation as a reward executives for desired outcomes. In the case of directors, however, how can performance outcomes be defined when attempting to award success?

- Total return to shareholders . . . long term vs. short term?
- Organization stability and executive continuity . . . or courage to prune management to meet new goals with a long-term horizon?
- A winning strategy that leads to growth and prosperity . . . even if a market climb or drop does not equate to director performance?
- Risk mitigation . . . conservative choices or accepting prudent risk for prospective competitive advantage?
- Enhanced corporate citizenship?

In theory at least, tying director compensation to predefined strategic and tactical goals and performance metrics seems to be a logical extension of shareholder alignment.

Having said that, identifying performance metrics that are measurable and aligned with shareholder interest, such as total shareholder return relative to peers, is extremely complex.

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One example of a pay-for-performance plan is to define a bonus for the audit committee members if there is no restatement of financials. The difficulty is tracking this performance measure over an extended time period that validates achieving the goal.



In practice, imposing a pay-for-performance discipline in many boardrooms will be a cultural challenge as well.

BEP believes a portion of director compensation should be tied to long-term company performance, where valid metrics can be defined.

## 6. Linking Director Compensation to Individual Performance

As companies become more focused on developing directors, they are beginning to evaluate individual director performance. BEP encourages performance assessments conducted by the board and governance chairs, not simply peer reviews.

This raises the question of whether companies should be paying individual directors differently based on their performance evaluations. BEP's views as we enter 2005 include:

- ▶ Evaluations are a good step forward, but at the end of the day, they can be too subjective as a compensation criterion for directors.
- ▶ The annual nature of such reviews is based on short-term results, rather than on decisions and actions that may require multiple years to evaluate for benefits to the enterprise.
- ▶ The hardest part of the job for many directors is constructive dissent . . . taking on their colleagues when he or she is confused, concerned, or actually disagrees. We believe that individual compensation is likely to discourage constructive dissent when the major pay criterion is evaluation by peers or the chairman.
- ▶ Individual compensation can reward exceptional individual contribution. However, at its core, a board is a team, and individual pay might undermine the team culture of some boards.
- ▶ BEP believes that the CEO, chairman, and governance chair should collaborate and be aggressive in asking directors with poor evaluations to step down or, at a minimum, not stand for re-election.

Enamored as we are with the concept of individual director responsibility, and as logical as individual compensation may be, BEP feels that paying for individual performance is not yet a viable option for most companies. We will continue to monitor developments and lessons learned in this area.

## 7. Transparent Disclosure of Director Compensation to Shareholders

Some thoughtful governance experts and shareholders are particularly concerned about regulatory filings that disclose only the minimum information required for reporting director compensation.

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More candid and complete reporting on all issues will build investor confidence in directors, which will be critical when that confidence is tested on high-impact issues, including terminating CEOs and addressing hostile or controversial mergers and acquisitions.

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BEP believes board chairmen should capitalize on the important opportunity to strengthen director and board effectiveness. We urge that they periodically engage directors in an open and active dialogue about aligning director and executive compensation, focused on investors' interests and the enterprises' long term, sustainable success and competitive superiority.

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Cars, airplanes, and charitable contributions available to directors are examples of items frequently omitted from reporting.

From BEP's perspective, the unreported costs, or compensation if you will, are, in most instances, insignificant. BEP believes the real cost at stake in the failure to report is measured by needlessly squandered shareholder trust and their confidence in directors' integrity and good judgment.

It seems there may be two primary reasons for the failure to present the full picture of directors' compensation:

- ▶ Companies consider current regulations as ceilings, not floors. If not specifically required to do so, they do not fully disclose.
- ▶ Transparency gives the company less leeway to make changes.

BEP believes reporting transparency is a great opportunity. It is our experience that the more candid and forthcoming the board is on the simple issues, like director compensation, the more likely it is that the directors will be trusted . . . particularly by industry analysts, credit rating services, and governance analysts.

## Summary

BEP believes that it is time to focus on the unique roles and responsibilities of each director and to develop a compensation package that is not simply competitive, but also reflects the distinctive characteristics and requirements of the individual and the organization.

In order to align the economic interest of directors with shareholders, BEP believes that a review of the components of fixed fees and the mix with stock ownership is essential for sustainable director and board effectiveness.

A few key practices will enhance shareholder alignment:

- ▶ provide a significant portion of compensation in shares, preferably deferred,
- ▶ develop share ownership guidelines achieved, at least in part, through purchase, but alternatively achieved through grant retention,
- ▶ tie a portion of director compensation to company performance, where valid long-term metrics can be defined,
- ▶ differentiate the fixed portion of director compensation based on roles, responsibilities and competencies, and
- ▶ disclose the total director compensation package to build credibility.

As always, we need to hear from other experts, our clients and colleagues. We welcome and encourage contrarian views focused on improving director and board effectiveness. Please contact our *Insights* editor, Sharon Carrigan, at 203.801.5000, or [sec@bepartners.com](mailto:sec@bepartners.com)

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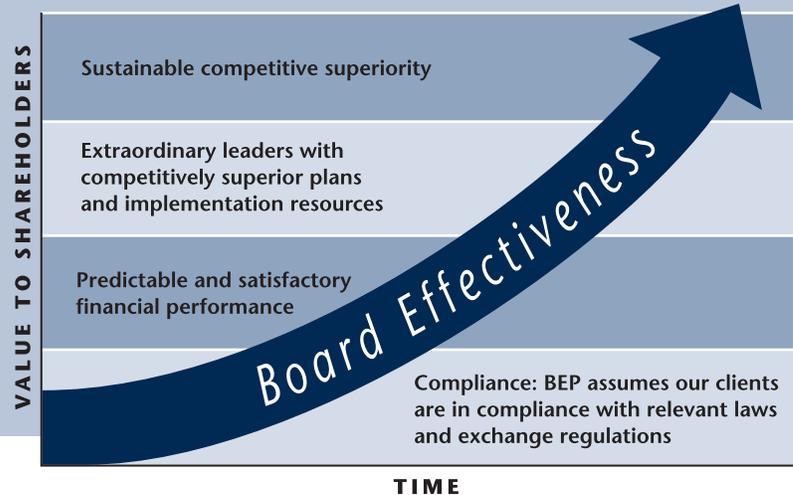
The following is a partial list of the organizations served by BEP's Managing Partners, as consultants or executive leaders, prior to or since forming BEP in 2002:

- American Express
- American International Group
- American Greetings
- Aon
- Apogee Enterprises
- AT&T
- Bank of America
- Bell Laboratories
- Boeing
- Bristol-Myers Squibb
- Capgemini
- Cell Genesys
- Ciena
- Citigroup
- Continental Grain
- Corning
- Covisint
- EFJ
- Fulcrum Analytics
- Genzyme
- Getronics
- Greenwood Publishing Group
- Harmon Solutions Group
- IBM
- Independence Community Bank
- Johnson & Johnson
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- Timex
- United Technologies
- Universal Studios
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- Veronis Suhler Stevenson
- Wharton
- Xerox
- Yankelovich

**Our Firm**

Board Effectiveness Partners (BEP) collaborates with directors and CEOs to objectively analyze and improve the effectiveness of directors and their boards.

BEP's mission is to serve as an analyst, a guide, and catalyst to enhance director and board effectiveness and governance quality.



**Managing Partners**

Each of BEP's Managing Partners has 20 years of experience as CEO, board, or corporate leader, or consultant. With career credentials that range from manufacturing to financial services, and skills ranging from strategy design to implementing change, BEP Managing Partners provide the breadth and depth of professional experience essential to strengthening director and board effectiveness.

**KEVIN ENGLISH** has devoted his career to leading business units, companies, and boards and has improved corporate performance as a CEO and Board Chairman.

**JOHN MCCREIGHT** has dedicated over 37 years to consulting and partnering with CEOs, senior leaders, directors, and defining and implementing large-scale strategic change.

**MARK SCHNEIDERMAN** is a senior-level human resources professional who has held corporate leadership roles, and partnered with senior leadership and boards as a consultant, to facilitate strategy implementation and change management.

**Alliance Partners**

BEP nurtures relationships with over 100 Alliance Partners worldwide. They exemplify preeminence in their fields and complement our core competencies. Our Alliance Partners strengthen our capacity to improve director and board effectiveness.

As an example, BEP's understanding of developments in Europe and the United Kingdom and BEP's ability to partner with our clients worldwide, is enhanced by our relationship with our London-based colleagues, Patrick Haighton and Leslie Dighton, the founder of The Chairman's Club and CRA, a global consultancy.

**Research & Operations Center**

Our Research & Operations Center (ROC) professionals are linked globally to our clients, Alliance Partners, industry experts, and the academic community. We focus daily on monitoring director and board effectiveness facts, opinions, successes, disappointments, lessons learned, and emerging best practices.