

Executive Compensation

Bulletin

Has Director Pay Found Its Floor?

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With the economy still not quite on stable footing, many companies remain cautious about when and where to spend their compensation dollars. Over the past two years, pay for both employees and executives has come under pressure amid widespread salary freezes, reductions in incentive programs, and curtailments of various perquisites and benefit programs. Mindful of the optics of increasing outside director pay in the face of reductions in pay for employees, companies have been hesitant to drastically alter pay for their directors. As a result, pay increases for U.S. boards of directors have ground to a halt, rising just 1% in the past year.

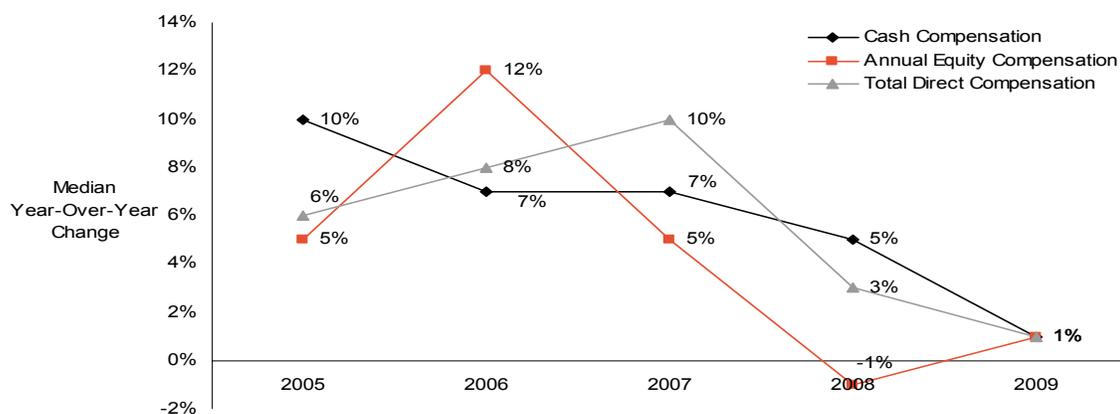
Our latest analysis of director compensation at *Fortune* 500* companies shows little change in the amount of pay directors received in the past year compared to the prior year. Most companies appear to have carried over decisions made during the previous year, such as postponing compensation increases for directors. However, just as many companies have moved to restore employee compensation that was cut during the worst of the economic downturn, most of the handful of companies that reduced pay for directors in fiscal 2008 restored pay to previous levels recently. Of the 17 companies identified in our last analysis that cut pay for directors, over three-quarters (13 companies) have reinstated pay to levels set before the economic collapse.

As *Figure 1* shows, annual cash, equity and total director compensation increased by just 1% each at the median over the past year, continuing the recent trend of decelerating increases in director pay. While pay for directors increased nearly 10% annually during the early years of the past decade, the rate of increase has dropped off significantly in the economic downturn.

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* Our analysis covered compensation for outside directors at 469 publicly owned *Fortune* 500 companies that filed their fiscal-year 2009 proxy statements by June 30, 2010. Data for these companies were then compared against the results obtained from our analysis of 461 *Fortune* 500 companies a year ago.

Figure 1. Median Annual Change in Fortune 500 Director Pay Levels, 2005 – 2009



Total compensation, which includes the annualized portion of one-time awards some directors receive upon joining the board, increased just 0.4% last year, but the increase was just enough to send median total pay for directors over the \$200,000 threshold for the first time. *Figure 2* shows median pay levels and changes versus a year ago for each component of director pay programs.

Figure 2. Median Outside Director Compensation, Fiscal-Year 2009 vs. 2008¹

	2009	2008	% Change
Sales (000,000)	\$8,849	\$10,796	-18%
CASH			
Board Cash Retainer	\$70,000	\$62,250	12%
Board Meeting Fee	\$2,000	\$1,875	7%
Committee Cash Retainer	\$7,000	\$5,000	40%
Committee Meeting Fee	\$1,500	\$1,500	0%
Committee Chair Extra Retainer	\$10,000	\$10,000	0%
Committee Chair Extra Meeting Fee	\$1,000	\$1,000	0%
ANNUAL CASH COMPENSATION²	\$85,000	\$83,875	1%
ANNUAL/RECURRING STOCK³			
<i>Expected Value:</i>			
Common Stock (\$)	\$80,288	\$80,006	0%
Deferred Stock and Phantom Stock (\$)	\$100,000	\$99,710	0%
Restricted Stock (\$)	\$94,999	\$99,933	-5%
Full-Value Stock (\$) ^{3a}	\$100,000	\$99,989	0%
Stock Options (\$)	\$62,500	\$63,750	-2%
ANNUAL/RECURRING STOCK COMPENSATION^{3,4}	\$104,939	\$103,963	1%
TOTAL DIRECT COMPENSATION⁵	\$199,036	\$197,617	1%
ONE-TIME STOCK			
One-Time Stock Grants Annualized ⁶	\$86,808	\$90,450	-4%
TOTAL COMPENSATION (with one-time stock)	\$200,698	\$199,949	0%

See footnotes, page 7

In Search of the Optimal Pay Mix

While aggregate director pay levels may not have changed much over the past year, a closer look at various components of director pay programs reveals continued efforts on the part of companies to find the optimal mix of fixed versus variable fees and cash versus equity compensation. Perhaps most noteworthy is the continuing trend toward eliminating board and committee meeting fees, and in their place adopting pay programs based on fixed retainers for board and committee service.

The percentage of companies paying board meeting fees fell from 44% to 40% over the most recent year. The 40/60 ratio of companies paying board meeting fees versus fixed retainers has flipped in just the past few years. In 2005, 60% of companies paid board meeting fees to directors, while 40% provided fixed retainers. There's also been a decrease in the number of companies paying committee meeting fees — from 48% of those in our analysis of fiscal 2008 proxies to 45% this year. As *Figure 3* shows, the value previously received through meeting fees is now being provided via corresponding increases to board and committee retainers. Of the 21 companies that eliminated board meeting fees in 2009, three-quarters provided a corresponding increase to their annual board cash retainer. A similar percentage of the 16 boards that eliminated committee meeting fees in 2009 provided an increase in the retainer provided for the committee service.

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Figure 3. Outside Director Compensation — Percentile Values and Prevalence¹

	25th	Median	Average	75th	Prevalence
Sales (000,000)	\$5,415	\$8,849	\$18,918	\$17,712	
CASH					
Board Cash Retainer	\$50,000	\$70,000	\$70,052	\$82,375	97%
Board Meeting Fee	\$1,500	\$2,000	\$2,043	\$2,000	40%
Committee Cash Retainer	\$5,000	\$7,000	\$7,400	\$10,000	20%
Committee Meeting Fee	\$1,350	\$1,500	\$1,611	\$2,000	45%
Committee Chair Extra Retainer	\$6,860	\$10,000	\$10,402	\$12,875	88%
Committee Chair Extra Meeting Fee	\$550	\$1,000	\$1,121	\$1,500	3%
ANNUAL CASH COMPENSATION²	\$71,938	\$85,000	\$88,535	\$100,813	98%
ANNUAL/RECURRING STOCK					
<i>Expected Value:</i>					
Common Stock (\$)	\$46,723	\$80,288	\$84,288	\$115,335	16%
Deferred Stock and Phantom Stock (\$)	\$70,010	\$100,000	\$105,350	\$125,000	24%
Restricted Stock (\$)	\$68,656	\$94,999	\$100,846	\$124,998	52%
Full-Value Stock (\$) ^{3a}	\$70,000	\$100,000	\$102,514	\$125,001	89%
Stock Options (\$)	\$38,467	\$62,500	\$80,771	\$111,220	24%
ANNUAL/RECURRING STOCK COMPENSATION (\$)^{3,4}	\$80,012	\$104,939	\$116,472	\$135,663	95%
TOTAL DIRECT COMPENSATION⁵	\$162,560	\$199,036	\$201,579	\$235,002	100%
ONE-TIME STOCK					
One-Time Stock Grants Annualized ⁶	\$6,146	\$10,851	\$15,231	\$16,407	17%
TOTAL COMPENSATION (with one-time stock)	\$164,069	\$200,698	\$204,177	\$238,063	100%

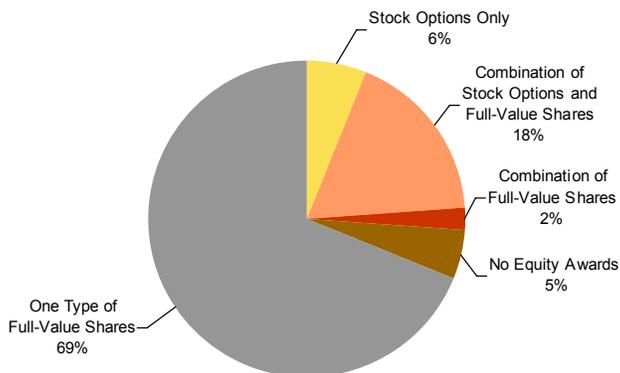
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Most companies continue to move toward a relatively even mix of cash and equity in their director pay programs. At median compensation levels, the mix of pay for directors included 48% cash and 52% equity in 2009, compared to 46% cash and 54% equity in the previous year.

Almost all (95%) of the *Fortune* 500 companies in our new analysis awarded annual or recurring equity grants to directors. The most common approach to providing equity to directors is in the form of a single type of full-value stock grant. Sixty-nine percent of *Fortune* 500 companies (up from 66% the prior year) provided a single type of full-value stock award, most commonly restricted stock or units. *Figure 4* provides a summary of the combination of equity used in pay programs for directors. While just under a quarter of the companies studied include stock options as part of their director pay programs, only 6% continue to use only stock options for the equity component of director pay.

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Figure 4. Stock Compensation to Directors



Director pay programs have been somewhat insulated from the effects of recent volatility in stock prices because most companies grant equity awards based on a fixed value, rather than awarding directors a fixed number of shares. Seventy-eight percent of the *Fortune* 500 companies award grants to directors using a fixed-value approach, while the remaining 22% grant a fixed number of shares to their directors. The fact that most companies grant equity using a fixed-value approach is yet another reason there has been little change in the total pay packages for directors over the past year.

On the belief that stock ownership helps align the interests of directors with those of the company's shareholders, most *Fortune* 500 companies use stock ownership or retention guidelines to boost directors' equity ownership in their companies. In less than a decade, the use of mandated stock ownership requirements for directors has become nearly universal among *Fortune* 500 companies. The percentage of companies with these policies has grown from just 19% in 2003 to 80% in the most recent year. *Figure 5* provides details of the types and amounts of specific ownership requirements commonly used among *Fortune* 500 companies.

Figure 5. Stock Ownership Requirements for Directors

	Type of Stock Ownership Requirement Used		
	Multiple of Retainer	Fixed Number of Shares	Fixed Dollar Value
Prevalence	65%	23%	12%
25th Percentile	3	5,000	\$100,000
50th Percentile	4	7,500	\$250,000
Average	5	10,000	\$240,116
75th Percentile	4	8,222	\$300,000

Summary statistics for each category are based only on the specific type of ownership guideline established by each company from among the three options listed in the table.

Pay for Board Leadership Roles

New proxy disclosure rules took effect in 2010 requiring companies to explain their rationales for combining the roles of board chair and CEO, or splitting those roles between different board members. The disclosure requirements did not endorse one leadership structure over the other and most companies kept their existing board leadership roles in the last reporting period, absent turnover within the CEO or board chair position. In fiscal 2009, 38% of the *Fortune* 500 companies in our analysis operated with a separate chair and CEO, up just one percentage point from the prior year.

Nonexecutive board chairs routinely receive compensation above and beyond that provided for regular board service to compensate them for the additional time and services provided in this role. As shown in *Figure 6*, at the median, the additional incremental pay for nonexecutive chairs is \$150,000, unchanged from the prior year. In total, board chairs receive a median total pay package of approximately \$347,000, or 175% of the pay provided to a typical director.

Figure 6. Compensation for Nonexecutive Board Chairs and Lead Directors

	Nonexecutive Board Chair		Lead Director	
	Total Incremental Compensation	Total Chair Pay Relative to Typical Director	Total Incremental Compensation	Total Lead Director Pay Relative to Typical Director
10th Percentile	\$42,500	126%	\$10,000	105%
25th Percentile	\$90,208	148%	\$15,000	107%
Median	\$150,000	175%	\$20,000	111%
Average	\$171,715	189%	\$25,834	113%
75th Percentile	\$200,000	200%	\$30,000	115%
90th Percentile	\$312,931	252%	\$50,000	126%

Incremental values represent the portion earned by the chair or lead director in excess of fees paid to other directors. Only those companies that pay chairs or lead directors additional compensation are included in the statistics.

At companies that continue to combine the positions of chair and CEO, a lead or presiding director is typically appointed to oversee activities of the independent board members. Companies with non-independent or employee chairs also are likely to have a lead or presiding director. During 2009, 78% of all *Fortune* 500 companies included in our analysis designated by election or selection a lead or presiding director, down from 80% the prior year. While not provided in every case, lead directors often receive an additional retainer in recognition of their role on the board. Just over half (52%) of the companies identifying a lead or presiding director provided additional compensation to the director serving in this role. The value of the additional retainer (\$20,000 at the median) remains unchanged from the prior year.

Provisions of the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) will continue to draw attention to these leadership roles. The act requires companies to disclose in their annual proxy statement the reasons the issuer has chosen the same person to serve as chair and CEO (or in equivalent positions) or different individuals to serve as chair and CEO (or in equivalent positions). These requirements will continue to provide fuel to the debate on what the appropriate board leadership structure should be. (For an overview of the Dodd-Frank Act's executive compensation and governance provisions, see "Executive Compensation Reforms Enacted," *EC Bulletin*, July 22, 2010.)

Just as SOX created new responsibilities for audit committee members, the Dodd-Frank Act may increase the demands placed on compensation committee members in the years ahead.

Committee Pay — Are Raises Ahead for Compensation Committee Members?

As has been widely reported, pay for audit committee members increased relative to fees paid for service on other board committees following enactment of the Sarbanes-Oxley Act (SOX) in 2002, primarily to compensate these directors for the added time requirements and oversight responsibilities associated with service on this committee. As *Figure 7* shows, audit committee members in *Fortune* 500 companies are more likely to receive additional compensation for their service and are paid more than members of other board committees.

Figure 7. Committee Member and Chair Retainers

	Committee Member		Committee Chair	
	% of Companies Paying Retainers for Service	Median Value of Retainer	% of Companies Paying Retainers for Service	Median Value of Retainer
Audit	39%	\$10,000	94%	\$15,000
Compensation	21%	\$7,500	91%	\$10,000
Governance/Nominating	17%	\$6,000	85%	\$10,000

Just as SOX created new responsibilities for audit committee members, the Dodd-Frank Act may increase the demands placed on compensation committee members in the years ahead. Among other changes, the new law imposes new independence standards for compensation committee members and requires companies to conduct nonbinding shareholder advisory votes on executive compensation periodically.

While it's still too early to determine what impact the additional demands placed on compensation committees will have on pay for members of these committees, past experience suggests that when new regulations create more responsibilities and time commitments, pay for directors charged with meeting these new requirements tends to rise. What is clear is that the current state of director pay and committee structures will continue to evolve in light of evolving responsibilities, recruitment challenges and time commitments placed on directors.

Footnotes for Figures 2 and 3:

¹ The 2009 sample consisted of 469 publicly owned companies in the 2010 *Fortune* 500 list that filed their fiscal-year 2009 proxy statements by June 30, 2010. The 2008 sample included 461 public companies in the 2009 *Fortune* 500 list.

² Annual Cash Compensation is calculated as follows:

a. Values reported for Fees Earned or Paid in Cash in the Director Summary Compensation table are identified for each director.

b. Directors in leadership positions receiving supplemental compensation (e.g., board chair, lead director) and chairs of the three primary committees (Audit, Compensation and Nominating/Governance) are removed.

c. The median value is identified for the remaining directors to determine the total cash compensation for "typical" directorial duties.

d. The value of the retainer is eliminated from the total cash compensation for the "typical" director to determine the value, if any, of total variable cash fees.

e. Annual Cash Compensation is the combined value of the annual cash retainer and the median variable cash fees.

³ Stock compensation is determined using ASC 718 values reported in company proxy statements.

a. Full-value stock represents the combined value of all full-value grants, regardless of the form of the award.

⁴ All board/committee meeting fees and retainers that are paid as stock are included under Annual/Recurring Stock Compensation.

⁵ Total Direct Compensation includes Annual Cash Compensation plus Annual/Recurring Stock Compensation.

⁶ One-Time Stock includes initial and discretionary stock-based grants. The values reflect the incremental additional value above that of the annual grant. One-Time Stock grants are annualized over eight years, based on the average term of an outside director as calculated by ISS.

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