COMPENSATION COMMITTEE LEADERSHIP NETWORK
ViewPoints

January 11, 2016

TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

A focus on the board: assessment, refreshment, and pay

On December 2–3, members of the Compensation Committee Leadership Network (CCLN) met in New York to discuss a range of topics related to public company board service. In one session, members were joined by George Anderson, leader of Spencer Stuart's board effectiveness practice, for a conversation about board composition, evaluation, and renewal. In another, Wachtell Lipton Rosen & Katz partner David Katz joined members to discuss director compensation. This *ViewPoints* summarizes those discussions.[1]

Assessing and refreshing the board

Boards must ensure that, collectively, they have the skills (e.g., marketing, digital technology), experience (e.g., doing business in China), and networks (e.g., with key customer groups or regulators) to succeed. Investors and other stakeholders are increasingly scrutinizing board composition and, where they see capability gaps, demanding improvement. At this meeting, CCLN members addressed how their boards keep their membership fresh and aligned with the strategic challenges facing their companies.

Board composition

A recent report from PwC noted, "At its core, board composition is under pressure to evolve. In order to be well-positioned to oversee long-term value creation, directors know their boards need the right expertise and experience – including directors with diverse backgrounds."[2] CCLN members discussed the current state of director succession and the value of adding directors with different perspectives to a board.

Investors and other stakeholders are paying more attention to board composition. Several factors are driving this new focus:

- **Low board turnover.** Current average director tenure at S&P 500 companies is 8.5 years and 21% of boards have an average member tenure of 11 years or greater.[3] This has caused investors to question whether too many directors are lingering too long on boards.[4] Some investors are acting on this concern: State Street Global Advisors adopted a policy of assessing a company's average board tenure, with an option to vote against directors if the average tenure is longer than the market average.[5]
- **Performance of companies with newer directors.** In a published study, Mr. Anderson and a co-author found that companies that replaced three or four directors over a three-year period outperformed both peers who made no changes and those who made more changes, suggesting an optimal rate of turnover.[6] This correlation puts board refreshment on stakeholders' radar.

---

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

[2] PwC, *Governing for the Long Term: Looking Down the Road with an Eye on the Rear-View Mirror* (PricewaterhouseCoopers, 2015), 6.

[3] Spencer Stuart, *Board Index 2015* (Chicago: Spencer Stuart, 2015), 16.

[4] EY Center for Board Matters, *2014 Proxy Season Review,* Let's Talk: Governance, no. 7 (London: Ernst & Young LLP, 2014), 3.

[5] Rakhi Kumar, *Addressing the Need for Board Refreshment and Director Succession in Investee Companies* (State Street, February 2015).

[6] George M. Anderson and David Chun, "How Much Board Turnover Is Best?" *Harvard Business Review,* April 2014.

- **Limited information about succession plans.** Director succession is usually addressed publicly only after a vacancy has been filled with a new director. It is uncommon for companies to communicate with investors about board succession plans or ongoing searches.

While activist investors usually launch their campaigns because of share performance or financial issues, they often highlight issues like board composition to gain the support of other shareholders.[7] For example, activists frequently raise concerns that a board lacks certain skills or expertise – such as experience in a particular industry – and identify their own nominees to fill those gaps.[8]

Ninety-five percent of directors surveyed for the recent PwC report listed diversity as an important director attribute.[9] Likewise, the majority of participants in Institutional Shareholder Services' 2014–15 policy survey said they consider diversity when evaluating boards.[10] Investors have intervened at even the largest public companies to show dissatisfaction with board makeup. For example, two of Apple's shareholders publicly criticized the board because, at the time, seven of its eight directors were white males over the age of 50.[11]

Members discussed ways to widen the range of skills, backgrounds, and thinking styles on a board. Mr. Anderson noted that slow turnover creates a challenge for boards looking to diversify: *"Reduced turnover means that all of the board's needs, including diversity and domain expertise, can end up being concentrated in a single director search. In many cases, a board succession plan can be helpful in ensuring the board ultimately has the skills and attributes it needs without having to try to find the single person who has every quality identified."*

CCLN members discussed three key areas where pressure is mounting to diversify the board:

- **Age.** One consideration as boards look to expand their overall skills is whether to add younger directors. In the past decade, the average age of an independent director on an S&P 500 board has crept up from 60.5 to 63.1 years, and retirement ages have also risen.[12] Members said that younger directors bring a unique and valuable perspective that should be represented in the boardroom.

- **Gender.** A number of groups are working to pressure companies to add more female directors and to help them identify qualified candidates.[13] Thirty-one percent of new directors in 2015 were women, up from 21% in 2010; additionally, 97% of S&P 500 companies now have at least one female director and 73% have two or more.[14] And because female directors are younger and have less tenure than their male counterparts, signs point to a future with greater gender balance.[15] Furthermore, the move toward

---

[7] EY Center for Board Matters, *2014 Proxy Season Review,* 2.

[8] Joann S. Lublin, "Field Experience Helps Win Board Seats," *Wall Street Journal,* September 23, 2014.

[9] PwC, *Governing for the Long Term,* 9.

[10] Institutional Shareholder Services, *2014-2015 Policy Survey Summary of Results* (Institutional Shareholder Services, 2014), 6.

[11] Adam Satariano, "Apple Facing Criticism About Diversity Changes Bylaws," *Bloomberg*, January 6, 2014.

[12] Spencer Stuart, *Board Index 2015,* 5.

[13] For example, the Thirty Percent Coalition seeks to have women hold 30% of US board seats by the end of 2015. See *"Increase the Pace of Gender Diversity in the Boardroom,"* Thirty Percent Coalition, accessed November 22, 2015.

[14] Spencer Stuart, *Board Index 2015,* 6, 16.

[15] PwC, *Trends Shaping Governance and the Board of the Future: PwC's 2014 Annual Corporate Directors Survey* (PricewaterhouseCoopers, 2014), 6.

gender equity pays off: one study concluded that companies with female directors outperform those with all-male boards.[16]

- **Race and ethnicity.** Members said that their boards are committed to increasing their racial and ethnic diversity. According to PwC's 2015 survey, 30% of directors consider racial diversity a very important attribute.[17] One member said that boards that want to add racial and ethnic diversity may need to consider candidates with different backgrounds than those they have recruited in the past: *"The biggest challenge to diversifying boards is convincing directors that we don't need a current or former CEO. If you broaden the pool of potential backgrounds, you can open board service up to a whole new group of people."*

CCLN members added that in recent searches, their boards have sought to diversify boardroom conversations by adding directors with different professional experience. In particular, members debated the merits of recruiting directors with technology expertise, either because the company's core business relies more heavily on technology than before or because of cybersecurity concerns. One member said, *"We need someone on the board who knows enough about information technology to make sure management is doing things right."* Others preferred relying on outside resources for technology advice, particularly with regard to cybersecurity. One explained, *"Third parties can stay refreshed on these topics better than someone who actually joins a board."* Mr. Anderson cautioned members to consider a candidate's entire skill set and not just specific domain knowledge: *"Directors with cybersecurity expertise are most successful when they also bring other experience that makes them a good candidate for the board."*

Assessment and turnover

Faced with increased scrutiny, boards are taking a number of steps to make sure that they are composed of the right people with the right skills. Many corporate boards are in the middle of cultural transformations where directors stay at companies only if their contributions warrant it – not necessarily until they reach retirement age.[18] Members discussed some of the various methods that boards have adopted to evaluate individual and collective performance and refresh their boards.

Evaluations

Nearly every public company board conducts some form of self-evaluation, and most directors believe their boards' self-assessments have become more effective – but most also say that it is difficult to be frank in these evaluations.[19] One way to deal with this difficulty is to have external firms conduct the evaluation, a practice that many expect to become more common.[20] One member explained the benefits of using an outside party to perform a board assessment: *"When they gave us feedback, we listened. It helped us identify some big-*

---

[16] David Prosser, "The Secret of Top Performing Companies: More Women on the Board," *Forbes*, September 25, 2014.

[17] PwC, *Governing for the Long Term*, 7.

[18] EY Center for Board Matters, *2014 Proxy Season Review*, 3.

[19] PwC, *Trends Shaping Governance and the Board of the Future: PwC's 2014 Annual Corporate Directors Survey*, 7.

[20] Joann Lublin, "'Board Doctors' Help Supervise the Supervisors," *Wall Street Journal*, February 17, 2015.

picture issues with the board that we needed to resolve. It would be hard to have someone on the board do that."

While evaluations have historically focused on the performance of the board or its committees as a whole, a growing number of boards evaluate directors individually as part of the process. In 2015, 33% of S&P 500 companies conducted annual evaluations of individual directors, up from 24% in 2010.[21] One member explained, *"It takes a chair with guts to put every director through an individual assessment. Boards need to be prepared to make tough decisions as a result of these assessments."* Mr. Anderson said that individual assessments are particularly valuable when they identify clear, actionable areas for improvement: *"We find that directors who have gone through these assessments are incredibly responsive to feedback on their individual performance."*

A review by the Council of Institutional Investors found that while most US companies only disclose the fact that the board has an evaluation process, some investors are eager for more information about the process: "Such disclosure is an indication that a board is willing to think critically about its own performance on a regular basis and tackle any weaknesses."[22] ISS's QuickScore 3.0 considers not only whether a board conducts an annual evaluation but also whether the evaluation policy is disclosed to investors.[23]

Dealing with underperforming directors

Although boards are conducting more robust evaluations, their impact on individual directors may not be strong enough. Mr. Anderson noted that according to the 2015 PwC survey, nearly 40% of directors believe that at least one of their board colleagues should be replaced.[24] One member opined, *"Assessments are a useful instrument to help us get better, but they are not, as currently constituted, an effective way to take someone off a board."* Another added, *"The hard part is asking someone to leave, not figuring out if they are good enough."* Part of the challenge of removing a director is the collegial nature of board service. One member explained, *"In an executive operating role, the hierarchy is more pronounced. On a board, the chair is not the boss."*

Members also discussed some of the reasons why boards are compelled to ask a director to leave. In some cases, members said, a director is too busy with other responsibilities to make a meaningful contribution, but it is more common that a director is a poor fit due to cultural reasons. One member said, *"Most directors understand the basic requirements of board service. When someone goes astray, it is usually caused by friction about the protocols of the board and how it operates, not a dereliction of duty."* Mr. Anderson added, *"When we review our placements that don't work out, the number-one reason is a lack of cultural fit. It is important to define the style of the board – beyond just saying it is collegial – to help determine whether a new director will be a good addition."*

---

[21] Spencer Stuart, *Board Index 2015*, 29.

[22] Council of Institutional Investors, *Best Disclosure: Board Evaluation* (Washington, DC: Council of Institutional Investors, 2014), 2.

[23] Institutional Shareholder Services, *QuickScore 3.0: Factors by Region* (Institutional Shareholder Services, 2014).

[24] PwC, *Governing for the Long Term*, 8.

Age and tenure limits

The most common way that boards ensure turnover is through setting a mandatory retirement age. Over the past decade, the number of S&P 500 boards with a mandatory retirement age has remained stable at around 75%; however, 34% of boards now set the age at 75 or older, up from only 8% a decade ago.[25] Mr. Anderson added that reaching the retirement age remains the top reason why directors leave public company boards. Members, however, suggested that maintaining an age limit is not always the best method of refreshing a board. One said, *"You can end up with some directors who have been around too long, even if they haven't yet reached the age limit."*

As noted above, some investors are focusing on director tenure, asserting that directors with lengthy tenure effectively lose their independence from management. Term limits provide a solution for this concern, yet only 3% of S&P 500 companies explicitly include a director term limit in their governance guidelines.[26] Recently, the board of General Electric decided to implement a 15-year limit for directors.[27] In addition, some directors, when joining a board, informally agree that they will only serve for a specified term.[28]

Some CCLN members suggested that tenure limits can be more effective than age limits in keeping a board fresh. One member who serves on a board with a tenure limit said, *"It works very well. We always find strong people who bring new perspectives. It refreshes the board."* Members also identified the model in the United Kingdom, where boards must either limit director tenure to nine years or explain why longer tenured directors are still independent, as an effective route to board renewal.

Compensation committee strategy sessions

Members discussed the value of holding an annual or periodic compensation committee off-site meeting to ensure that their compensation plans remain linked to the company's long-term goals. These meetings are typically held outside the board's normal meeting cycle and away from company headquarters. One member whose committee holds an annual session explained, *"We seldom have time to get everything done in the right level of detail at our regular committee meetings. Our off-site brings together the compensation committee, our independent consultant, the CEO, and the company's senior human resources professionals to look at trends in a more granular way."*

Members added that sessions like these provide an opportunity to think creatively about whether their current compensation philosophy remains the most effective way to meet the committee's mandate. For example, members said that they have used strategy sessions to reconsider the peer group they use to benchmark executive compensation, assess the merits of adding new metrics to short- or long-term plans, or test management's goal-setting process.

---

[25] Spencer Stuart, *Board Index 2015*, 7.
[26] Spencer Stuart, *Board Index 2015*, 5.
[27] Amanda Gerut, "GE Bucks Trend by Adopting Term Limits," *Agenda*, December 14, 2015.
[28] Joann S. Lublin, "For Older Board Members, the Pressure to Move On," *Wall Street Journal*, December 23, 2014.

Setting director pay

The responsibilities and risks of board services have undeniably changed in the past decade. So too, in many cases, has independent director pay. The average independent director compensation at S&P 500 companies in 2015 was $277,237, an increase of 29% since 2010.[29] Recent lawsuits have drawn attention to director compensation and raised questions about the conflict of directors setting their own pay.[30] At this meeting, CCLN members discussed lessons from recent litigation and shared practices for setting and changing director pay.

Director pay litigation

A series of recent shareholder lawsuits has increased external scrutiny of director compensation. Plaintiffs have targeted the boards of a number of high-profile companies, including Facebook and Goldman Sachs, with allegations that director pay is too high and that the process for setting it is subject to an inherent conflict.[31] Members discussed the implications of a recent decision in *Calma v. Templeton*, where the Delaware Chancery Court refused to dismiss a claim that the board of directors at Citrix Systems breached its fiduciary duty when setting equity compensation for its independent directors.[32]

In *Calma*, the Delaware court ruled that the Citrix directors' compensation was subject to the entire-fairness standard (where the board must prove that its decision was in the best interest of the shareholders), rather than the more permissive business judgment rule (where decisions made with the good-faith belief that they are in the best interest of the shareholders receive deference), because directors face a conflict of interest when deciding what to pay themselves.[33] Mr. Katz explained that this ruling adds scrutiny to the process boards use to evaluate and revise director compensation: *"Failing to follow a defined process can lead to problems in litigation. It is a good idea to review director compensation annually, like you do with executive compensation, even if you do the review and decide not to make any changes."*

The *Calma* case also has implications for the equity plans that are used to fund director share grants. While the Citrix directors' equity compensation was drawn from a plan that was ratified by the company's shareholders, the court found that the plan lacked meaningful limits since each director could conceivably receive up to 1 million shares, valued at about $55 million, each year.[34] Mr. Katz said that boards should consider including stricter annual limits in their share plans, including sub-limits for directors: *"You can better protect yourself by including sub-limits in the plans that are approved by shareholders. Additionally, limits on the dollar amount of equity a director can earn per year are preferable to limits on the number of shares, because variability in share price could make a share limit less meaningful over time."*

---

[29] Spencer Stuart, *Board Index 2015*, 29.

[30] David A. Katz and Laura A. McIntosh, "Dealing with Director Compensation," *New York Law Journal*, May 21, 2015.

[31] Steven Davidoff Solomon, "How Much to Pay a Director? There's No Clear Answer," *Dealbook* (blog), *New York Times*, November 10, 2015; Matt Chiappardi, "Goldman Sachs Investor Sues Over 'Excessive' Director Pay," *Law360*, June 9, 2015.

[32] David A. Katz and Laura A. McIntosh, "Dealing with Director Compensation," *New York Law Journal*, May 21, 2015.

[33] Ibid.

[34] Ibid.

Director pay oversight

Members discussed their boards' processes for establishing and changing director pay. In some cases, director pay is the province of the compensation committee, while in others the responsibility falls to the nominating and governance committee. (Occasionally the two committees share responsibility.) Even when the compensation committee is not responsible for director compensation, members said that there might still be a role for the compensation committee chair. One explained, *"As the compensation committee chair, I also serve on the nominating committee. It makes for a more seamless transition, especially when we need to get our compensation consultant involved since I am the one with the strongest relationship with the consultant."* Members added that the preferred practice, regardless of which committee has initial responsibility for director pay, is to have the full board review and approve the committee's decisions.

Members emphasized that a more regular review of director pay does not mean a shift from paying directors for service to paying for performance. While the equity component of director pay necessarily means that some of their compensation is tied to performance, members said it is important to distinguish the incentives for directors from those for executives. One member said, *"We are there to oversee the company for the long term. Our compensation shouldn't be tied to year-to-year performance on specific metrics."*

Members also discussed the following issues that their boards consider when setting director pay:

- **Per-meeting versus fixed pay.** Most large, public companies pay an additional retainer to directors who take on a leadership role, such as lead director or chair of the audit or compensation committee.[35] Per-meeting fees, however, are on the decline.[36]
- **Cash versus equity.** At Fortune 100 companies, equity grants account for 60% of director compensation, with the remainder divided between cash retainers (34%) and committee fees (6%).[37] This mix of cash and equity has been relatively stable since the start of this decade, though equity has gradually become a larger percentage as per-meeting fees have become less popular.[38] Members added that at some companies, directors can choose to be compensated by a mix of cash and equity or all in equity – and in some cases there is a premium for taking all equity. However, Meridian's Jane Romweber cautioned members that providing such a premium without a solid justification could subject the board to increased scrutiny.
- **Holding requirements.** Most companies require directors to buy and hold some portion of company stock. In the most common scenario, a director is required to acquire equity valued at five times his or her annual retainer within five years of joining the board.[39]
- **Equity vehicles.** At most large, public companies, the equity portion of directors' compensation almost always consists of full-value grants. This is a change from earlier this century, when stock options were

---

[35] Steve Pakela and John Sinkular, "Trends in Board of Director Compensation," *Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), April 13, 2015.

[36] Meridian Compensation Partners, *2015 Trends in Outside Director Compensation*, 5.

[37] Ibid.

[38] Ibid.

[39] Ibid., 6.

the dominant form of director equity compensation. Equity grants are usually issued as restricted stock, with units that vest between six months and three years from the grant date, or as deferred stock units that vest when the director leaves the board.[40] Some members questioned whether it was necessary to defer equity grants until retirement. One contended, *"Between holding requirements and restricted grants, directors' interests are already aligned with the company for the long term. If we want to add directors with different profiles, we don't want to reduce the pool of interested candidates by making their pay illiquid."*

Working with outside compensation consultants

Members said that the relationship between compensation committees and consultants is most effective when all parties (including management) communicate openly and understand the ground rules. Meridian's Ms. Romweber said, *"Consultants can be most helpful when we have clear direction and early knowledge of meeting agendas and management proposals and presentations. Involving us early allows us to give our best advice while minimizing conflicts with management."* Meridian's John Anderson added, *"The chair and the consultant should be engaged in an ongoing dialogue about the committee's needs. Good relationships are built on good discipline."*

Members emphasized the importance of a consultant who is completely loyal to the board. One member said, *"It can be a tough line to walk because consultants rely heavily on management for information, but it is critical that they think independently and have a point of view, even if management doesn't like that point of view."* Another added, *"A change in CEOs presents a real test of the consultant's independence. If the advice changes when they start working with new people in management that could be a sign of a problem."*

Peer groups

One of the critical factors that nearly every board considers when setting director pay is director compensation at peer companies. Some members said that their boards try set director pay somewhere near the 50th percentile of a group of like-sized companies. Some critics claim, however, that boards do not use appropriate peer groups when benchmarking director compensation. For example, in the *Calma* case, the plaintiff criticized the Citrix board for using a peer group that included much larger companies, including Amazon, Google, and Microsoft.[41]

In some cases, directors benchmark their pay against the same peer group or groups that the board uses to benchmark executive compensation. This approach provides a degree of uniformity and may make it harder to argue that the board has a conflict of interest. Before the meeting, one member said, *"We use the same peer groups that we use for our executives because it is appropriate and consistent for our company."*

---

[40] Meridian Compensation Partners, *2015 Trends in Outside Director Compensation*, 6; Pakela and Sinkular, "Trends in Board of Director Compensation."

[41] Matt Chiappardi, "Citrix Director Pay Claims Get Go-Ahead From Del. Chancery," *Law360*, April 30, 2015.

In most cases, however, the board considers a unique peer group to benchmark director pay, recognizing that the market for directors is different than the one for CEOs and other senior executives. Members said their director peer groups are much more focused on comparing pay at similarly sized companies. One member explained, *"We want diversity of industry experience on our board, so our [industry-specific peer group] that we use for executives is not as relevant for board members."*

Mr. Katz advised that boards also be aware of how their compensation compares with not only the peer groups they use to set director pay but also the peer groups they use for executives and the peer groups assigned to the company by proxy advisory firms. *"It is important to run these calculations, so that the board is aware of them. If you choose to disregard them, you should do so knowingly,"* he said. Members acknowledged that this point is important when – as is usually the case – boards do not publicly disclose the makeup of the peer group they use for director pay.

★★★★★★

Boards face a wide range of pressures as they seek to add value to their companies. In some cases, this means thinking harder about the backgrounds and skills needed to compose the right board for a company's future. In others, it means responding to criticism about director pay or independence. In 2016, we look forward to continuing the conversation about ways for directors to provide and demonstrate value to their constituents.

About this document

Appendix: Contributing members

The following members participated in the meeting:

- John Anderson, Meridian Compensation Partners
- Erroll Davis, Union Pacific
- Roxanne Decyk, Orbital ATK
- Karen Horn, Eli Lilly
- Bill Kerr, Interpublic Group
- Mary McDowell, Autodesk
- Fig Newton, Torchmark
- Jane Romweber, Meridian Compensation Partners
- Linda Wolf, Wal-Mart
- John Wulff, Moody's

The following members took part in pre- or post-meeting discussions:

- Mel Lagomasino, The Cola-Cola Company and Avon Products
- Steve Reinemund, Marriott