DIRECTOR COMPENSATION

"Follow That Bandwagon!"

Director compensation continues to evolve. We have seen director pension arrangements arrive and depart (1980s), stock options have had their time in the spotlight (1990s through the mid-2000s), and now meeting fees are waning. The clear trend and dictate of proxy advisory firms is to eliminate meeting fees, set pay at median, and pay at least 50% of the total in the form of shares held until retirement from the board. However, before we jump onto that bandwagon headed down the path of least resistance, perhaps we should consider for a moment reasons for paying directors in a specific form or amount.

Annual comparisons of director pay levels have led to a focus on an elusive "median director compensation level." As one-half of companies find they are below median, they increase director pay and find a corresponding increase in the new average pay level. Unlike the fictional Lake Wobegon, we can't all be above average. Rather, since the required level of reputation risk, personal energy, and talent commitment varies dramatically between boards, so too should remuneration.

The trend in form of pay, from options (incentive) to shares (investment), is easily understood in the context of the director's role. An unintended consequence of options is that they can pit directors against all other investors with respect to the timing of exercise. While options may reward equity growth, they are inherently biased against dividends and can, under certain circumstances, provide an imbalanced reward for risk since the investment downside is limited to any embedded gains. More important, as a reward for price appreciation, the concept of any incentive may work directly against the director's role—to provide risk oversight on behalf of investors.

Executive management is tasked with developing long-term strategies, executing those strategies, and managing the day-to-day enterprise. With the separation of capital and management inherent in our modern capitalist environment, the role of the board should be focused on ensuring the risks taken and strategies employed by management are reasonable, that controls are in place to avoid misuse of investors' assets, and that the best executive talent is in place to lead the effort.

By establishing incentives for directors, we are distorting the balance in their assessment of risks by encouraging results without a corresponding risk offset. Incenting directors to improve performance may also unintentionally encourage boards to interject themselves into areas rightfully in management's domain, at the expense of the board fulfilling its core responsibilities. On another front, what most analyses of director pay seem to avoid is any consideration of a director's role in light of the value proposition companies communicate to their investors. Clearly, the board of a company held by a private equity fund will have a different role than a board of a company held primarily by retail investors. Similarly, an investor in early-stage pharma will have dramatically different expectations of the board than the same investor viewing a commercial real estate REIT investment. Just as the role of the board member should reflect these investor expectations, so should the pay.

Without belaboring the point any further, we have to ask, "How should directors be paid in the modern environment?" Clearly, each board is unique and must refine its objectives and define its role vis-à-vis investors and management. The role of a board of an immature, fast-growing company will clearly be different than that of a mature company. Chances are that the management team and the investors will look quite different as well. However, the concept of how to pay the board remains unchanged.

In summary, we believe boards should:

1. Pay an amount that reflects the board's talent needs, as well as the level of reputational risk and commitment asked of the directors; this may involve paying well above or below industry standards when appropriate.

2. Pay in a form that reflects the board's mission and does not create an imbalance with respect to risk oversight.

3. Implement ownership and shareholding guidelines that are consistent with the company's message to investors.

This simply suggests the use of common sense, taking a fresh look at intent prior to racing to the trend. After all, it was Albert Einstein who observed, "The man who follows the crowd will normally go no further than the crowd."

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