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TRENDS & ISSUES

Boards Beware: The Unexpected Bias in ISS' Guidelines for Director Pay

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There is a possible director compensation issue that we want to make companies aware of and some early data analysis indicates the issue may be even more complicated than we anticipated.

In the fall of 2017, Institutional Shareholder Services (ISS) proposed enhancements to their U.S. Voting policies to include potential "adverse vote recommendations for board committee members who are responsible for approving/setting [non-employee director] compensation when there is a pattern (i.e. two or more consecutive years) of excessive [non-employee director] pay magnitude without a compelling rationale or other mitigating factors."

This proposed enhancement was codified into their 2018 voting policy document. Voting policy FAQs issued for the new policy year provide some additional clarity, suggesting ISS may identify outliers based on a comparison of company "individual non-employee director pay totals to the median of all non-employee directors at companies in the same index and industry." Further, they effectively define "excessive" as compensation figures above the top 5% of all comparable directors.

While boards were given a pass in 2018, the policy will fully go into effect for 2019. With that as a backdrop, Pearl Meyer worked with Main Data Group to analyze a broad set of director compensation information to try and better understand where companies may be at risk.

Our analysis shows some potentially surprising results that may catch some companies off guard. While we believe it's important to carefully calibrate your board's director compensation philosophy and the corresponding pay strategy—and be able to articulate clearly why it best serves the company—you should be aware of some areas that could raise immediate red flags with ISS.

1. **Pay compression:** Within comparable industry and index grouping, director pay data is remarkably compressed. This means that relatively small changes in director compensation can have a dramatic impact on a company's overall percentile positioning and could put a company at risk of being in the top 5% of ISS' groupings. For example, the median individual director compensation total for S&P 500 companies in the GICS Materials classification (15) was $262,000 and the 95th percentile was $340,500, a difference of only $78,500 (30%). The difference within the GICS Consumer Staples, Household, and Personal Products classification (3030) is even more compressed at just over $40,000 (14%).
2. **Industry bias:** We are encouraged that ISS will look at industry groupings to determine the market for comparison purposes. However, how ISS defines "industry" will be very important to the outcome. Take healthcare for instance. The 95th percentile for the Healthcare two-digit GICS code (35) is $528,000. However, there are two distinctly different sectors within this broader industry: Healthcare Equipment and Services; and Pharmaceuticals, Biotechnology, and Life Sciences. The 95th percentile for the four-digit GICS code that houses most biotechnology companies (3520) is $619,000, while Healthcare and Equipment (3510) is $372,000. An analysis of the top 5% of companies in the two-digit healthcare index show 92% are either biotechnology or related companies. This emphasizes that as a board, establishing pay levels based on general industry information (or even broad industry groups) could create future risk.
3. **Size bias:** Like industry, index can play an important role in the outcome of ISS' analysis. Based on previous reports and the ISS guidance to date, we anticipate that ISS will have fairly few "index" groupings, which could create risk for certain company types. Interestingly, it is not as simple as assuming the largest companies are at the most risk because they pay the highest. Our analysis found numerous examples where the 95th percentile director compensation in a particular index was higher than its larger index counterpart, for example in the energy industry (GICS 10) the 95th percentile compensation among S&P 600 firms is $711,182, while among S&P 500 firms, compensation is substantially lower at $448,042. Further, many companies are part of multiple indices, and depending on which index ISS chooses to select can have varying results. For a telecommunications company in the Russell 1000 and S&P 500, the line of demarcation for ISS establishing "excessive" director pay would be $488,000 and $408,000, respectively.
4. **Program features bias:** There are also a number of director compensation plan features that could put a company at risk relative to the ISS evaluation. Generally, these features can be grouped into two categories: (1) features that lead to greater pay variability, and (2) board leadership strategies. Features that could lead to pay variability include but are not limited to: (1) using per-meeting fees coupled with a multi-year period with increased meeting frequency (e.g., large acquisition or turnaround), (2) having a practice of targeting a fixed number of shares or options as opposed to a targeted equity retainer value, and (3) having special committees with significant pay. The board's leadership structure could also present challenges, particularly if the company has a highly paid non-executive chair of the board or multiple leadership roles such as a non-executive board chair and vice-chair.

Although these are minority practices, they could lead to issues for some companies.

There are things that companies can do to mitigate the potential for an ISS surprise. We believe the following would be opportunistic exercises for every board to undertake:

1. **Re-evaluate or establish your director compensation philosophy.** Has the board formally discussed and documented the objectives of the director compensation program? Established which market frames of reference are to be used in determining pay? Where pay should be positioned in the market range and why? While these are all items that are likely to begin appearing in company proxy disclosures starting in 2019, they should be on your annual board agenda for review and discussion. Regardless of new ISS tests, defining (or validating) your board pay strategy is an important exercise in a company's overall governance. However, we know increased proxy advisor scrutiny is coming and from our perspective it would be prudent to formalize these philosophical tenants in advance of proxy disclosure season.
2. **Understand your company's director compensation pay positioning.** Now is a good time to analyze where your company falls relative to the market on director compensation, particularly in a fashion that is identical to how the companies are required to report director compensation per SEC proxy disclosure rules. Additionally, we advise comparing your company's pay data to multiple reference points for completeness. Not only should a company use their compensation peer group, but also broader industry and index benchmarks, as well as size-adjusted general industry data. Understanding if the company is positioned high in the market range under any one scenario will be helpful in anticipating potential challenges and responding accordingly.
3. **Review the program design through a proxy advisory lens.** In addition to typical program design discussions, review your company's director pay structure to understand if there are potential features that would present risk in the ISS evaluation. High on the list would be using per-meeting fees or establishing fixed equity grant guidelines that target a number of instruments as opposed to a value. Consider stress-testing those elements against the competitive market to understand what levels of meeting frequency or share price appreciation (or both) could result in high relative pay. Additionally, consider potential enhancements to the program that would be well received by ISS, such as stock ownership or holding requirements.
4. **Enhance your director pay disclosures.** Currently, most companies simply disclose the details of the director compensation policy and the required SEC tabular compensation information. Our belief is that many companies will adopt enhanced director pay disclosures to bolster support from ISS on director elections. Carrying out items one through three above should put the company in excellent position to disclose the pay philosophy, process, market competitiveness, and rationale for the program.

There are important details regarding ISS' evaluation that have yet to be disclosed, such as the valuation approach for director stock option grants and determining exactly which index and industry groupings will be used, but we do know enough now to be able to identify areas of heightened risk.

If you are a director reading this and are responsible for setting director pay, we suggest working with your advisor and/or management to accomplish the items above. If you are a director, but not on the committee responsible for setting director compensation, please pass this on to the appropriate colleague. If you are an executive, send this to the individual on the executive management team that is responsible for working with the board on director compensation matters.

About the Author

Terry Newth is a managing director in the Boston office of Pearl Meyer, where he consults on the design, development and assessment of executive compensation programs that support each organization's business objectives, long term business strategy and organizational culture. His clients range from Fortune 500 organizations to pre-IPOs to private and family-owned companies in a wide range of industries. Mr. Newth's areas of expertise include pay strategy and philosophy development, market-based pay studies, incentive plan design, severance and CIC arrangements, outside director pay, transaction-related compensation, CD&A and supporting table disclosures, corporate governance and share plan authorizations.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, and Los Angeles.

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