Director Pay Outliers: Who is ISS Identifying and Why?

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When ISS first announced they would be evaluating director compensation and recommending against the re-election of the directors/committee members responsible for setting director pay, many observers were surprised and curious why ISS would bother with director compensation at all. Director compensation programs have become substantially more homogenous in recent years, with often little variation in the types of retainers and fees provided within a given industry. More importantly, director compensation levels have become substantially more compressed, with the range (in dollars) between quartiles becoming increasingly narrow in many industries.

So, the questions that linger—particularly from directors that participate in homogenous and compressed pay programs—are who are these outliers that ISS has begun to identify and what types of director fees are resulting in outlier compensation?

Now that ISS has clarified their final methodology for evaluation and has begun to comment on the outliers identified in 2019 proxy reviews, the types of director fees which result in outlier director compensation have become clearer. Furthermore, the types of outlier director compensation—for which companies may or may not be able to offer compelling rationale—is evident in recent research completed by Pearl Meyer. Specifically, we have identified director pay outliers (pay in the top 3%) among Industrials (GICS 20) companies in the Russell 3000 index.

It's becoming clear that outliers will be categorized into two buckets, those that may be able to provide a compelling rationale for outlier compensation and those that may not. ISS' position on what may qualify as compelling rationale is based on feedback from investors. We reviewed detail from Main Data Group on 2018 proxy filings for Industrials companies in the Russell 3000 to see how many board members, board chairs, and lead directors received outlier compensation, and what types of director fees or other compensation positioned these directors in the top 3%.

The overall findings of our research were generally consistent with what we expected to find:

- Among the 467 Industrials sector companies in the Russell 3000, 27 had one or more board members with outlier compensation (72 of 2430 board members were outliers, or 3%).
    - When excluding companies that also belong to the S&P 500 (and would be evaluated by ISS against the S&P 500), the number of outlier companies drops by almost half, to 14.
- The companies with outlier compensation were larger from a revenue size perspective.
    - Because the ISS evaluation is based on indices, which include companies across a wide range in revenue size, a larger company within a given index is more likely to have directors be identified as outliers (given that director pay tends to be correlated with company size).
- It matters which index the company is a member of, and will be evaluated against, particularly for companies in the S&P 500. The 97th percentile director compensation for the S&P 500 is significantly higher than the other indices.
    - Of the non-S&P 500 index comparisons, the Russell 3000 (full group) has the highest 97th percentile director compensation levels. The combined S&P 400/S&P 600 index and the Russell 3000 (excluding S&P indices) have the lowest 97th percentile director compensation levels.

In looking at the types of director fees resulting in outlier board member compensation levels, we found a surprising number of outliers for which the rationale could likely be explained in the proxy:

- More than half of the 14 companies with outlier director compensation (one or more board members) could likely provide a compelling rationale for the positioning above the 97th percentile. Reasons for the outlier positioning included (from most to least prevalent):
    - A board member was board chair for part of the year and received chair retainers for a portion of the year;
    - A board member was newly elected and received both an initial equity retainer and the annual retainer in the same year;
    - A board member received special fees related to work on a transaction;
    - A newly elected board member received a significant initial equity retainer;
    - A board member received consulting fees; and
    - Payment of dividend equivalents.

- Less than half of the 14 companies (four of 14) with outlier director compensation simply provided excessive director compensation (over the 97th percentile) and would likely not be able to provide a compelling rationale. Reasons for the excessive director compensation included:
    - High cash or equity retainers or meeting fees; and
    - High equity retainer value resulting from a fixed number of shares or options.

ISS will evaluate compensation for directors serving in board leadership roles separately, given these directors typically receive additional compensation for the additional responsibilities. We also looked at the Industrials data to see how many board chairs and lead directors were provided outlier compensation, and which types of outlier compensation were provided:

- We identified five board chairs with outlier compensation and for two of those, a compelling rationale could likely be provided:
    - High additional cash or equity retainers for the chair role;
    - Charitable gift matching included in other compensation; and
    - Special fees related to work on a transaction.
- In a similar fashion we also identified five lead directors with outlier compensation and for two of those, a compelling rationale could likely be provided:
    - High additional cash or equity retainers for the lead director role;
    - Charitable gift matching, included in other compensation; and
    - High equity retainer value resulting from a fixed number of shares or options.

It appears based on the outliers we've identified in the Industrials data that:

- Approximately half of the companies will likely be able to provide a reasonable explanation for the outlier compensation;
- Many of the types of outlier compensation were non-recurring and would only impact a single year of director compensation; and
- The number of directors that were outliers simply due to high compensation levels was lower than expected.

We expect our findings among Industrials companies to be indicative of outliers in other industries. However, note that certain sectors may have a greater number of outliers which cannot be rationalized.

We suspect that ISS will refine their approach over time, potentially even using the same ISS-selected peer group used for CEO pay and performance reviews. This would, in most cases, provide a more meaningful comparison of director pay based on size and industry group, which generally impacts director pay levels.

We continue to recommend that companies monitor their director pay, as compared to both the company's compensation peer group and to the ISS indices against which director pay is evaluated. (Pearl Meyer has an analytics tool that can quickly help you identify potential outlier compensation.) If outlier compensation is identified, the company should be prepared to explain this in the proxy and provide a compelling rationale!

About the Author

Matt Depp is a vice president in the Charlotte office of Pearl Meyer. He serves as a project manager on client engagements and manages executive and board of director compensation reviews, incentive plan design and modeling, equity plan share requests, and severance and change-in-control calculations.

About Pearl Meyer

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