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ADVISOR BLOG

ISS and Director Compensation: New Rules and Associated Predictions

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As I mentioned in my summer director pay blog, ISS intends to take a more active role in evaluating the reasonableness of public company director compensation. While some of the expected issues I noted with their evaluation approach have not changed, ISS did issue final policy guidance that was intended to clarify their methodology. It included a few slight changes, along with one additional year of relief for companies to get their programs in order.

The final rules are summarized as follows:

- ISS will analyze director compensation in order to identify companies that “consistently” (defined as two or more years in a row) compensate directors at the top 2-3% of all comparable directors. (Note: this is a slightly more limited range than the top 5% previously outlined.)
- The nature of the director’s role, specifically non-executive chairs and lead directors, will be taken into consideration in the comparisons.
- The frame of reference for comparing directors will be the same two-digit GICS code within the same industry grouping.
- The possible index groupings are S&P 500, combined S&P 400 and S&P 600, remainder of the Russell 3000 Index, and the Russell 3000-Extended.
- Companies that are identified in this screening process and do not provide a compelling rationale for their pay positioning are subject to potential withhold vote recommendations. The negative vote recommendations will be aimed at the directors that approve the compensation arrangements.

The policy further provides that certain circumstances may mitigate concern regarding otherwise “high” director pay, including “onboarding” grants for new directors, special committee payments, pay for “specialized scientific expertise,” and payments in connection with separate consulting agreements.

Given this new area of focus for ISS, we attempt to anticipate the likely outcomes. My perspective is that two significant things will happen in 2019. All public companies will evaluate their program against these standards and those at or near the top 10% will likely make changes to normalize or reduce their pay.

Longer term, the following may take place:

1. The frequency of benchmarking and reviewing director pay will increase.
2. The range of director pay will narrow.
3. Director pay growth will slow over time. Interestingly this will come in a time when director pay should actually increase commensurate with the increasing depth and breadth of their oversight and time commitment.
4. ISS will push companies to hold a voluntary “say-on-director-pay” to avoid negative vote recommendations on specific directors.
5. More companies will hold a voluntary director say-on-pay to insulate directors.
6. ISS will create more sophisticated tools to evaluate the new director pay proxy proposals, and in parallel, offer additional consulting services to help companies avoid an “Against” vote on director pay.

On the last point, recall that not long-ago ISS suggested a CEO pay and performance disconnect existed when CEO pay went up and TSR went down in a given year. Now they have a complex, multi-factorial model for assessing CEO pay and performance using a variety of timeframes, frames of reference, and performance standards, and show no sign of slowing down on complex enhancements to the models. I expect that director pay will present them with the next boon for their business.

Clearly, it will be important for boards to understand how their compensation arrangement stacks up against this new evaluation framework, and to take the opportunity to revisit the overall approach and rationale for the pay program. Companies that evaluate director pay on a less than annual frequency may choose to do reviews more often.

Companies that are positioned in the higher percentiles should discuss whether they should be proactive about making changes to reduce possible criticisms or take a “wait-and-see” approach, and how to disclose the rationale for their current program.

Certainly this is a topic for continued monitoring as director pay arrangements and ISS’s evaluation practices evolve over time.

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.

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