ISS Publishes Compensation and Equity Plan FAQs and Burn Rate Tables for 2022 Proxy Season

Just prior to the holidays, Institutional Shareholder Services ("ISS") has published several supplemental documents that elaborate on its U.S. executive compensation benchmark policy guidelines for 2022. These documents include FAQs for both its U.S. compensation and equity plan policies (including updated equity burn rate tables for the 2022 proxy season).

This Thoughtful Pay Alert summarizes the key new ISS FAQs for its executive compensation and equity plan-related policies. A summary of ISS' benchmark policy changes for 2022 is available at the following link. These updates will be effective for annual meetings of shareholders taking place on or after February 1, 2022.

Executive Compensation Policy FAQs

ISS made no significant changes to its U.S. benchmark voting policy guidelines covering executive compensation matters for the 2022 proxy season. (See our Thoughtful Pay Alert, *ISS Issues 2022 Benchmark Voting Policy Updates* (December 17, 2021).) As a result, there have been just four additions to its updated executive compensation policy FAQs.

Management Proposals Seeking Separate Shareholder Approval of Individual Equity Awards

In recent years, there has been an increase in front-loaded, multi-year equity awards to senior executives, which often provide for large payouts where, over a multi-year period, there has been a significant increase in the company's stock price or overall market capitalization or achievement of long-term financial performance goals. In some instances, companies have submitted these awards for shareholder approval as part of the authorization process. ISS has indicated that it will generally evaluate proposals seeking approval of individual equity awards on a case-by-case basis, taking into account a variety of pay-for-performance considerations and other factors, which may include (without limitation):

- The transparency and clarity of the company's disclosure;
- The magnitude of the pay opportunities;
- The prevalence and rigor of the performance vesting criteria;
- The existence of shareholder-friendly guardrails and termination and/or change-in-control provisions;
- The estimated cost of the award and/or its dilutive impact; and
- Any other factors that it deems relevant.

ISS goes on to state that exceptionally large awards and "front-loaded" awards in this context will be subject to heightened "pay-for-performance" considerations, as is the case with its approach to analyzing such awards in the context of the qualitative pay-for-performance evaluation.

"Pay-for-Performance" Methodology – Quantitative Screens

As we know, ISS evaluates the alignment between a company's executive compensation program and its financial performance using a methodology that includes an initial quantitative assessment (consisting of four "screens" or tests) of the relationship between the compensation of a company's CEO and its stock price/financial performance. ISS has made no changes to the three primary screens (the Relative Degree of Alignment ("RDA") test, the Multiple of Median ("MOM") test, or the Pay-TSR Alignment ("PTA") test for 2022. For annual meetings of shareholders on or after Feb. 1, 2022, ISS made slight updates to the "Eligible for FPA Adjustment" thresholds under the Financial Performance assessment test. Those adjustments are discussed in detail in ISS' Pay-for-Performance Mechanics white paper.

COVID-Related Pay Decisions

Given the exceptional circumstances of the COVID-19 pandemic and its impact on the operations of many companies,

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ISS notes that it will continue to consider a company's individual circumstances as part of its qualitative evaluation of its executive compensation program. In this regard, ISS has changed its approach somewhat when it evaluates a company's pay decisions, and changes to existing incentive compensation plans, that were impacted by the pandemic. This updated guidance can be found in ISS' U.S. Compensation Policies and the COVID-19 Pandemic FAQ (Updated for 2022).

Shareholder Advisory Vote on "Golden Parachutes"

Among the various shareholder advisory votes on executive compensation added by the Dodd-Frank Act is the so-called "Say-on-Golden Parachutes" vote under Section 14A(b) the Securities Exchange Act of 1934. Essentially, that vote is required when shareholders are being asked to approve certain corporate transactions, such as an acquisition, merger, consolidation, or proposed sale or other disposition of all or substantially all the assets of the company. ISS has added a question to its discussion of "Say-on-Golden-Parachute" votes to highlight the practices that are most likely to lead to an "against" vote recommendation on these proposals. The following practices are considered to carry significant weight and will likely result in an adverse "Say-on-Golden-Parachute" vote recommendation, in and of themselves:

- "Golden parachute" excise tax gross-ups are estimated to be paid (based on amounts reported in the golden parachute tables of the merger proxy statement);
- Cash severance payments are triggered solely by the occurrence of a change in control (i.e., "single trigger"), without disclosure indicating the executive will incur a termination in connection with the transaction; and
- "Single-trigger" acceleration of performance-based awards at an above-target level without the disclosure of a compelling rationale for this result.

Equity Compensation Plan FAQs

Changes to Burn Rate Methodology

Although ISS made no changes to the factors, weightings or passing scores for any of the Equity Plan Scorecard ("EPSC") models for 2022, it did update its burn rate guidance, consistent with its recent announcement of a significant change to its burn rate methodology beginning in 2023.

In the FAQs, ISS describes its current burn rate methodology, which will continue to be in use for annual meetings of shareholders on or after February 1, 2022. In this regard, ISS has once again published the burn rate benchmarks applicable for these meetings in an appendix to the FAQs. (The burn rate benchmarks are included as part of this Thoughtful Pay Alert.)

For annual meetings of shareholders on or after February 1, 2023, the currently methodology is being replaced. Instead, the EPSC burn rate factor will use a "Value Adjusted Burn Rate" ("VABR"), with benchmarks calculated as the greater of: (1) an industry-specific threshold based on three-year burn rates within the company's GICS group segmented by S&P 500, Russell 3000 index (less the S&P 500) and non-Russell 3000 index; and (2) a de minimis threshold established separately for each of the S&P 500, the Russell 3000 index less the S&P 500, and the non-Russell 3000 index.

In a separate FAQ, ISS sets out the VABR formula as follows:

Annual Value-Adjusted Burn Rate = ((# of options * option's dollar value using a Black-Scholes model) + (# of full-value awards * stock price)) / (Weighted average common shares * stock price).

Beginning with annual meetings on or after Feb. 1, 2022, the EPSC evaluation will display a company's VABR that will be shown alongside the current multiplier-based adjusted burn rate. For 2022 meetings, the VABR will be displayed for informational purposes only and will not affect the EPSC evaluation or score (although, as noted above, it is expected to replace the existing EPSC burn rate factor beginning in 2023). ISS promises that it will be providing more information on this change after the 2022 proxy season.

Compensation Recovery ("Clawback") Policies

In order to receive EPSC points for a clawback policy, ISS indicates that the policy should authorize recovery upon a financial restatement and cover all or most equity-based

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compensation for all named executive officers. ISS goes on to confirm that the company will not receive credit for a clawback policy that contains only the limited requirements specified under the Sarbanes-Oxley Act, nor if the company discloses that it will establish a clawback policy only after the finalization of applicable rules under the Dodd-Frank Act. With its recent reopening of the comment process on Section 954 of the Dodd-Frank Act, it's likely that we will see the SEC propose and/or adopt a final rule on clawback policies later this year, which will trigger further ISS action in this area.

Burn Rate Tables

Each year, ISS updates its burn rate tables and stated benchmarks for S&P 500, Russell 3000 (excluding the S&P 500), and non-Russell 3000 companies for the upcoming proxy season. Generally, ISS measures "burn rate" using the total number of equity awards (full value stock awards and stock options) granted in a given year (or earned for performance-based awards if sufficient disclosure) and expresses the computation as a percentage of the number of common shares outstanding. These tables set ISS' burn rate benchmarks (based on one standard deviation above the industry mean) using Standard & Poor's global industry classification standard ("GICS") codes as assigned to each company.

ISS' updated 2022 burn rate tables (which will be the last time this methodology is used by ISS) are set forth in the Exhibit to this article.

The burn rate benchmark is primarily used by ISS as part of its EPSC evaluations. The specific benchmark for each industry sector is a point in the middle of the sliding scale. Full credit is given to companies with burn rates at 50% of the burn rate benchmark or less. Companies with burn rates above 50% of the burn rate benchmark will earn partial (or even negative) credit based on a sliding scale.

If a company grants both full value stock awards and stock options, ISS applies a premium or "multiplier" to the full value awards for the past three fiscal years to equate them economically with stock options. For 2022, this premium or "multiplier," is unchanged from prior years as follows:

Stock Price Volatility	Multiplier (Full Value Awards to Option Shares)
54.6% or higher	1 full value award = 1.5 option shares
36.1% or higher and less than 54.6%	1 full value award = 2.0 option shares
24.9% or higher and less than 36.1%	1 full value award = 2.5 option shares
16.5% or higher and less than 24.9%	1 full value award = 3.0 option shares
7.9% or higher and less than 16.5%	1 full value award = 3.5 option shares
Less than 7.9%	1 full value award = 4.0 option shares

Observations

While ISS' burn rate methodology remains the same as in 2021, overall the 2022 burn rate benchmarks for key technology and life science industry sectors are generally down from the prior year. This is due in part to ISS' benchmark methodology which covers the practices at companies in 2018 to 2020 and does not reflect the uptick in equity spend that we have observed in 2021 at many clients.

S&P 500

GICS	Description	2022 Burn Rate Benchmark	2021 Burn Rate Benchmark	Absolute Δ from 2021
45	Information Technology	3.87%	3.87%	No Change
35	Healthcare	2.90%	2.22%	+0.68%
50	Media & Entertainment	3.46%	3.42%	+0.04%

Russell 3000

GICS	Description	2022 Burn Rate Benchmark	2021 Burn Rate Benchmark	Absolute Δ from 2021
4510	Software & Services	8.66%	9.24%	-0.58%
4520	Technology Hardware & Equipment	6.32%	6.57%	-0.25%
4530	Semiconductor & Semiconductor Equipment	5.91%	6.23%	-0.32%
3510	Healthcare Equipment & Services	6.18%	5.69%	+0.49%
3520	Pharmaceuticals & Biotechnology	7.65%	7.91%	-0.26%
5020	Media & Entertainment	7.85%	6.62%	+1.23%

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Non-Russell 3000				
GICS	Description	2022 Burn Rate Benchmark	2021 Burn Rate Benchmark	Absolute Δ from 2021
4510	Software & Services	10.22%	10.45%	-0.23%
4520	Technology Hardware & Equipment	7.26%	6.41%	+0.85%
4530	Semiconductor & Semiconductor Equipment	6.00%	6.30%	-0.30%
3510	Healthcare Equipment & Services	9.36%	9.91%	-0.55%
3520	Pharmaceuticals & Biotechnology	9.08%	9.46%	-0.38%
5020	Media & Entertainment	7.88%	6.27%	+1.61%

Companies should consider these updated benchmarks as one factor in their annual equity strategy review. Due to the lower benchmarks above in many groupings, companies that developed equity budgets for 2022 with consideration of the then-current 2021 limits may have less flexibility with their equity compensation plans than originally anticipated (depending on program goals, equity plan funding, competitive needs, etc.).

Further Information

To obtain a copy of each of the materials discussed in this article, please click on the applicable link:

- ISS 2022 U.S. Executive Compensation Policies FAQs
- ISS 2022 U.S. Equity Compensation Plans FAQs
- ISS 2022 U.S. Pay-for-Performance Mechanics

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact Jason Borrevik at 408.876.4035 or jborrevik@compensia.com, Mark A. Borges at 415.462.2995 or mborges@compensia.com, or Peter Kimball at 202.321.1234 or pkimball@compensia.com.

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EXHIBIT

ISS 2022 Burn Rate Limits

GICS	Description	S&P 500	Absolute Δ from 2021	R3000 (Ex. S&P 500)	Absolute Δ from 2021	Non-R3000	Absolute Δ from 2021
1010	Energy	2.00%	0.00%	3.89%	0.65%	6.32%	0.65%
1510	Materials	2.00%	0.00%	3.64%	0.77%	5.59%	-0.09%
2010	Capital Goods	2.00%	0.00%	3.24%	0.41%	7.15%	-0.67%
2020	Commercial & Professional Services	2.00%	0.00%	3.76%	0.19%	9.15%	1.73%
2030	Transportation	2.00%	0.00%	2.59%	-0.04%	4.31%	-2.00%
2510	Automobiles & Components	2.51%	0.10%	3.30%	0.46%	6.91%	2.00%
2520	Consumer Durables & Apparel	2.51%	0.10%	5.36%	2.00%	8.34%	2.00%
2530	Consumer Services	2.51%	0.10%	3.70%	0.06%	4.62%	-1.65%
2540	Media (moved to GICS 5020)	–	–	–	–	–	–
2550	Retailing	2.51%	0.10%	5.34%	-0.66%	10.45%	2.00%
3010	Food & Staples Retailing	2.00%	0.00%	5.78%	2.00%	7.92%	-0.99%
3020	Food Beverage & Tobacco	2.00%	0.00%	2.66%	-0.59%	7.92%	-0.99%
3030	Household & Personal Goods	2.00%	0.00%	4.63%	-0.42%	7.92%	-0.99%
3510	Health Care Equipment & Services	2.90%	0.68%	6.18%	0.49%	9.36%	-0.55%
3520	Pharmaceuticals & Biotechnology	2.90%	0.68%	7.65%	-0.26%	9.08%	-0.38%
4010	Banks	2.24%	0.03%	2.00%	0.00%	4.22%	-0.89%
4020	Diversified Financials	2.24%	0.03%	7.06%	0.01%	4.22%	-0.89%
4030	Insurance	2.24%	0.03%	3.18%	0.32%	4.22%	-0.89%
4510	Software & Services	3.87%	0.00%	8.66%	-0.58%	10.22%	-0.23%
4520	Technology Hardware & Equipment	3.87%	0.00%	6.32%	-0.25%	7.26%	0.85%
4530	Semiconductor & Semi Equipment	3.87%	0.00%	5.91%	-0.32%	6.00%	-0.30%
5010	Telecommunication Services	3.46%	0.04%	5.50%	-0.34%	7.88%	1.61%
5020	Media & Entertainment	3.46%	0.04%	7.85%	1.23%	7.88%	1.61%
5510	Utilities	2.00%	0.00%	2.64%	0.64%	3.21%	1.18%
6010	Real Estate	2.00%	0.00%	2.24%	0.09%	3.81%	0.74%

NOTE:
Full value award volatility multipliers/buckets remain unchanged