ISS Updates FAQs on U.S. Compensation Policies and Covid-Related Pay Decisions For 2022 Proxy Season

Following the onset of the global COVID-19 pandemic in the spring of 2020, Institutional Shareholder Services ("ISS") published guidance during the year on the impacts of the pandemic, including general guidance in October 2020 in the form of a series of Frequently Asked Questions ("FAQs") as to how ISS would analyze COVID-related pay decisions as part of its qualitative evaluation of executive compensation practices.

In an update to these FAQs, ISS has confirmed that its qualitative evaluation of a company's executive compensation program will take into consideration the impact on the company's operations as a result of the pandemic. And, as in the past, an elevated concern from the pay-for-performance quantitative screen or Say-on-Pay support below 70% in the previous year will continue to result in a more in-depth qualitative review of the company's compensation program, policies, and practices.

The topics covered by the updated FAQs are similar to those addressed in the original October 2020 guidance.

COVID-Related Retention or Other One-Time Awards

Noting that investors may find retention or other one-time awards to be appropriate in some situations, ISS' overall position with respect to retention or other one-time awards has not changed. As with one-time awards granted outside the context of the pandemic, a company granting a one-time award should clearly disclose the award's rationale (including magnitude and structure), as well as provide an explanation of how the award advances investors' interests. ISS will not view general "boilerplate" language regarding "retention concerns" as an adequate rationale (notwithstanding that competitiveness for key talent in the current labor market in the technology sector is very strong). Further, the awards should be reasonable in magnitude and reflect an isolated practice. In other words, a company's repeated use of one-time awards in consecutive years will be viewed as especially problematic. In addition, the award's vesting requirements should be long-term and strongly performance-based. Finally, the award should contain shareholder-friendly guardrails to avoid "windfall" scenarios, including limitations on termination of employment-related vesting.

Retention or Other One-Time Awards Granted in the Context of a Forfeited Incentive

While acknowledging that many investors recognize that well-structured retention or other "one-time" awards may be appropriate, ISS does not believe that investors will expect companies to grant such awards merely as a replacement for forfeited performance-based awards. Consequently, to the extent one-time awards are granted in the year (or following year) in which incentive awards are forfeited, companies will be expected to explain the specific issues driving the decision to grant the awards and how the awards further investors' interests. Granting one-time awards to replace forfeited incentive awards and/or to insulate executives from lower pay outcomes will be viewed as a problematic pay practice.

Temporary Salary Reductions for Executives

Initially, ISS notes that while used extensively in 2020, many companies' temporary base salary reductions were lifted before 2021. Nonetheless, temporary salary reductions in 2021 will continue to be given mitigating weight to the extent they decrease total pay. ISS further states that any such action will be considered more meaningful if the target incentive payout opportunities are decreased to reflect the reduced salary.

COVID-Related Changes to Annual Bonus/Incentive Plans

Since the 2022 proxy season will mark the third proxy season and second year of executive compensation proxy disclosure occurring under pandemic conditions, ISS declares that the "surprise" element of the pandemic in early 2020 is generally no longer applicable (notwithstanding the continued surges we have seen in the pandemic over time). Thus, many investors believe that in 2021 companies should have been able to return to traditional pre-

ISS Updates FAQs on U.S. Compensation Policies and Covid-Related Pay Decisions For 2022 Proxy Season (continued)

pandemic annual bonus/incentive plan structures (that is, plans based predominantly on objective and transparent metrics that used pre-established target levels). As a result, as in pre-pandemic years, any mid-year changes to the performance metrics, related targets levels, and/or measurement periods, or plans that heavily emphasize the use of discretionary or subjective factors to determine award payouts will generally be viewed negatively by ISS, particularly if a company exhibits a quantitative pay-for-performance misalignment.

Still, ISS acknowledges that, in some instances, lower pre-established performance targets (as compared to 2020) or modest year-over-year increases in the weighting of discretionary or subjective factors in a plan may be viewed as reasonable for companies that continued to incur severe economic impacts and uncertainties as a result of the pandemic in 2021. As was the case under ISS' original guidance, a company should clearly explain in its compensation disclosure how it set its performance targets and the rationale for any other changes to its incentive compensation programs to enable investors to evaluate the compensation committee's actions.

Disclosure That Would Assist Investors in Evaluating Changes to Annual Bonus/Incentive Plans

Although mid-year adjustments to annual bonus/incentive plans will generally be viewed negatively, where a company makes a mid-year adjustment to the terms of its plan, ISS indicates that investors expect that additional disclosure will be provided to assist them in their evaluation of the changes (that is, to ensure that any changes to the performance levels are not a sign of insufficient plan goal rigor). This includes an explanation of why such changes were necessary, including the specific pandemic-related challenges the company faced and how those challenges rendered the original plan design obsolete or the original performance target levels less probable to achieve.

ISS goes on to caution, however, that while such additional disclosure will be useful for investors, its inclusion in the Compensation Discussion and Analysis will not necessarily mitigate concerns regarding mid-year plan adjustments. Consequently, ISS may still find such concerns to be significant enough to cause them to lean towards an "against" recommendation for a say-on-pay proposal.

COVID-Related Changes to Annual Bonus/Incentive Plan That Result in Lowering of Performance Target Levels Below Prior Year Performance Levels

In evaluating the rigor of an annual bonus/incentive plan, ISS indicates that lower performance expectations that reflect external factors (such as operational impacts due to the pandemic) may be a reasonable explanation for lower goal-setting. This guidance has not changed from the prior year. Still, ISS notes that if a company is using a lower performance target level, it should provide disclosure that addresses the board of directors' rationale for the lower target and how the board considered corresponding payout opportunities, particularly if such payout opportunities are not proportionately reduced.

COVID-Related Changes to Equity/Long-Term Incentive Plans

As before, ISS will view changes to in-progress long-term incentive cycles negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment. Modest alterations to go-forward cycles (that is, awards granted for the cycle beginning in 2021) may be viewed as reasonable, particularly where a company continues to incur severe negative impacts over a long-term period. ISS cites some movement from quantitative to qualitative performance metrics or a modest increase in the proportion of time-vesting awards as examples of potentially reasonable changes. As expected, more drastic changes, such as shifts to long-term incentive awards with predominantly time-based vesting requirements or short-term measurement periods, will likely continue to be viewed negatively. Consequently, if a company has made or is considering making such a change to its long-term incentive program, it will be incumbent on the company to clearly explain any changes to the program so that investors can evaluate the compensation committee's actions and rationale.

Forward-Looking Disclosure of Compensation Program Changes Beyond the Year in Review

Based on its feedback from investors, ISS believes that boards of directors are now in a better position to return to the traditional

ISS Updates FAQs on U.S. Compensation Policies and Covid-Related Pay Decisions For 2022 Proxy Season (continued)

long-term incentive compensation programs that were in place prior to the pandemic. Thus, where a company made a COVID-related change to its compensation program that normally would be viewed as concerning from a "pay-for-performance" standpoint, ISS recommends that the company provide clear and detailed disclosure of its intention to return to a strongly performance-based incentive program going forward, which it may view as a mitigating factor in its analysis. The significance given to such forward-looking disclosure will generally be dependent on the level of detail provided in the Compensation Discussion and Analysis and the extent to which the disclosed changes are meaningfully positive.

ISS' Responsiveness Policy in Light of Shareholder Opposition to COVID-19 Pay Decisions

Under ISS' long-standing policy, where a company receives less than 70% support on a say-on-pay proposal, ISS reviews three factors under its responsiveness policy:

- the disclosure of the board's shareholder engagement efforts;
- the disclosure of the specific feedback received from dissenting shareholders; and
- any actions or changes made to the company's pay programs and practices to address shareholders' concerns.

As before, the expectations with respect to the first two factors will remain consistent with prior years. Going forward, with respect to the third factor, ISS' responsiveness policy will return to its pre-pandemic application. Under this factor, a company must demonstrate actions that address investors' feedback. This includes negative feedback stemming from one-time COVID-related pay decisions. In ISS' view, in such a case, a responsive board of directors could make a commitment not to repeat the action that shareholders viewed as problematic.

ISS' Equity Plan Scorecard (EPSC), Problematic Pay Practices, or Option Repricing Policies in Light of COVID-19

As was the case in 2020, ISS does not plan to make any changes to these policies specifically related to the COVID-19 pandemic.

Where to Find the Updated FAQs

To access the updated ISS FAQs on its U.S. compensation policies and the COVID-19 pandemic, please see the following

Need Assistance?

Compensia has extensive experience in assisting companies in addressing the impact of the COVID-19 pandemic on their executive compensation programs. If you would like assistance in determining how ISS' Governance Research Department will analyze certain issues related to your executive compensation program resulting from the pandemic in the context of preparing its 2022 proxy analyses and determining voting recommendations for U.S. companies, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, 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.

ISS Updates FAQs on U.S. Compensation Policies and Covid-Related Pay Decisions For 2022 Proxy Season (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Offices

Silicon Valley
50 W San Fernando Street
Suite 1350
San Jose, California 95113
408.876.4025

San Francisco
One Embarcadero Center
Suite 2830
San Francisco, California 94111
415.462.2990

Principals

Thomas G. Brown, Chairman
tbrown@compensia.com
408.876.4023

Ralph Barry
rbarry@compensia.com
858.603.2288

Erik Beucler
ebeucler@compensia.com
408.907.4314

Mark A. Borges
mborges@compensia.com
415.462.2995

Jason Borrevik
jborrevik@compensia.com
408.876.4035

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Aaron Johansen
ajohansen@compensia.com
408.907.4310

Peter Kimball
pkimball@compensia.com
202.321.1234

Lori Koenig
lkoenig@compensia.com
415.462.0231

Tom LaWer
tlawer@compensia.com
408.907.4309

Greg Loehmann
gloehmann@compensia.com
408.907.4319