ISS Issues 2023 Benchmark Voting Policy Updates, Compensation and Equity Plan FAQs And Burn Rate Tables

Earlier this month, Institutional Shareholder Services ("ISS") published its annual updates to its U.S. benchmark voting policy guidelines for the 2023 proxy season, as well as several supplemental documents that elaborate on its U.S. executive compensation benchmark policy guidelines for 2023. These documents include Frequently Asked Questions ("FAQs") for both its U.S. compensation and equity plan policies (including an updated equity burn rate table for the 2023 proxy season). The updates cover a range of topical areas, including ESG metrics in compensation programs, gender diversity, unequal voting rights, and problematic governance structures. The updates also clarify or modify responses to several other areas, including problematic pay practices, the new "Value Adjusted Burn Rate" methodology, and ESG compensation-related proposals.

Updates that we believe are most meaningful to our technology and life sciences clients include the following:

- For companies that anticipate submitting equity compensation plans for shareholder approval at their 2023 annual meetings, several new equity plan-related changes are in effect, including the implementation of updated industry burn rate benchmarks and an increase in the threshold number of points for a favorable vote recommendation under its Equity Plan Scorecard ("EPSC") for all companies;
- The list of "problematic pay practices" that may result in an unfavorable vote recommendation has been expanded to include the payment of severance when a named executive officer's termination of employment is not clearly disclosed as an involuntary termination;
- The magnitude of "inducement" and/or "make-whole" awards provided in connection with the hiring of a new executive will not raise concerns where the disclosure of the award structure explains the reasons for the award, including its positive features for the company; and
- Updates to governance-related policies that will result in increased prevalence of unfavorable vote recommendations for directors at companies with multi-class share structures and, in the case of companies that held their initial public offerings subsequent to February 1, 2015, disfavored governance practices, including classified boards and supermajority vote requirements to amend organizational documents

In addition, ISS has indicated that it will be updating its Financial Performance Assessment ("FPA") methodology used in its "pay-for-performance" analysis for 2023, such that the potential for FPA-driven adjustments to overall quantitative concern outcomes will be expanded to cover more companies beyond only those with borderline "low" or "medium" concern issues. Details regarding this change to the methodology are to be published in January 2023.

This Thoughtful Pay Alert summarizes these updates, among others, in the corporate governance and executive compensation areas likely to be of interest to technology and life sciences companies, as well as the most relevant FAQs. It also includes a revised burn rate table calculated using ISS' new Value-Adjusted Burn Rate ("VABR") methodology.

ISS' updated policies will generally be effective for annual meetings of shareholders taking place on or after February 1, 2023.

Executive Compensation Policies

ESG Metrics in Compensation Programs

ISS' updates in this area – made in the context of its approach to evaluating compensation-related shareholder proposals – do not change its general deference to the board of directors to determine the most appropriate metrics for measuring performance – whether financial, operational, or environmental, social, or governance ("ESG") -oriented. However, in affirming that clear disclosure about the compensation committee's rationale and considerations for selecting specific measures may benefit shareholders, it made a few notable changes to the matters considered when assessing proposals aimed at linking ESG performance criteria to executive compensation:

- The policy removes "the degree to which industry peers have incorporated similar non-financial performance criteria into compensation programs," and adds
- "the degree to which the board or compensation committee already discloses information on whether it has considered related ESG criteria" as a consideration.

ISS does not provide a rationale for these changes, but the revision to remove consideration of peer practices strikes us as a positive update that aligns with ISS' board deference approach to metric selection.

Corporate Governance Policies

Problematic Governance Structures

ISS' problematic governance structures policy applies to companies that went public on or after February 1, 2015. The policy as revised is now explicit that any problematic governance structures in place at such companies (including classified boards and supermajority vote

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requirements) must fully "sunset" (that is, be eliminated) within no more than seven years from the date of the IPO. In the absence of such a sunset provision, ISS will recommend against all directors (except new nominees) at companies with classified boards or supermajority vote requirements at their upcoming 2023 annual meetings. Further, unless the problematic provision is eliminated, it will vote on a case-by-case basis on the structure in subsequent years. Few companies that have gone public in recent years with classified boards or supermajority vote requirements have adopted sunset provisions. Accordingly, companies that maintain these structures and seek to avoid significant adverse director support at their upcoming annual meeting should take note of the firm seven-year sunset expectation now in place.

While this policy change clarifies the time horizon for which ISS will deem a sunset provision to be reasonable, it leaves some ambiguity in terms of the ongoing application of this policy. By introducing a specific date rather than focusing on "newly public companies," it appears to be establishing a dividing line going forward in terms of treatment of companies that IPO'ed prior to 2015 and those that did so subsequent to February 1st of that year.

Amendments to Quorum Requirements

Due to changes in broker voting practices in recent years, companies with lower institutional shareholder ownership (generally smaller companies) have had increased difficulty achieving the quorums necessary to convene their annual meetings. In response to these challenges, ISS has updated its policy regarding proposals to reduce quorum requirements for shareholder meetings, which previously provided it would vote against proposals seeking to reduce the quorum below a majority of the shares outstanding, to provide a framework for which ISS will recommend in favor of such proposals (or not vote against directors at companies that unilaterally lowered their quorum requirements). Companies with heavy retail share ownership that have seen a decline in voting in recent years or have struggled to achieve quorum should take note of this potentially helpful policy change.

Civil Rights Audits

Civil rights audit proposals represent a relatively new focus area for shareholder proponents, but one that has gained rapid traction with institutional shareholders. ISS has updated its policy to adjust the criteria it considers in its case-by-case approach to formulating vote recommendations on these proposals. Specifically, it has added evaluation of the adequacy of a company's disclosure of "workforce diversity and inclusion metrics and goals," and removed consideration of whether a company's actions are aligned with market norms on civil rights and racial or ethnic diversity, noting that in practice market norms have not been a significant point of analysis for these proposals. In view of the increased prevalence and high average support for these proposals – approaching 50% in the 2022 proxy season – the addition of workforce diversity disclosure here is yet another factor that compensation committees should be mindful of when weighing the form and composition of a company's workforce diversity data and goals.

Previously Announced Policies That Become Effective in 2023

Board Gender Diversity

Previously applicable to only S&P 1500 and Russell 3000 companies, in 2023 all U.S. companies (as well as foreign private issuers) must have at least one female member or ISS will recommend a vote against the chair of the nominating and governance committee.

Unequal Voting Rights

Since 2016, ISS has opposed multi-class stock structures at newly public companies (absent a commitment to "sunset" the structure within a reasonable period of time following the IPO), but did not oppose the practice at long-standing companies. As previously announced, for 2023 ISS' grandfathering of companies with long-standing dual class capital structures that carry unequal voting rights is expiring. As a result, unless the structure is reversed, removed, or subject to a reasonable sunset provision of no more than seven years from the IPO date, ISS will recommend an unfavorable vote for all directors at companies with dual class capital structures (except new nominees). An exception to this policy continues to apply where superior voting shares are de minimis, which ISS now explicitly defines as less than 5% of the total voting power.

Value Adjusted Burn Rate

Following a one-year transition period for the application of ISS' new VABR methodology, new burn rate industry benchmarks are in effect for the 2023 proxy season. For more information on this new methodology, see "Burn Rate Table" below. Any company expecting to have an equity compensation plan proposal on the ballot at its 2023 annual meeting should take note of this change in methodology. Further, we recommend that all companies begin tracking their equity usage under this new methodology.

Executive Compensation Policy FAQs

While ISS made no significant changes to its U.S. benchmark voting policy guidelines covering executive compensation matters for the 2023 proxy season, it has updated a number of its executive compensation policy FAQs.

Pay-For-Performance Evaluations

While there are no changes to the three primary screens (relative degree of alignment ("RDA"), multiple of median ("MOM"), and Pay-TSR Alignment ("TPA")) for 2023, for annual meetings held on or after February 1, 2023, there are updates to the methodology for the Financial Performance Assessment ("FPA") screen as well as the "Eligible for FPA Adjustment" thresholds. The FPA changes for 2023 will be covered in an update to ISS' "Pay-for-Performance Mechanics" white paper to be published in January.

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Impact of Financial Performance Assessment

As introduced, the FPA screen potentially impacted the overall quantitative concern level for companies which were (i) a "medium" concern under any of the three primary screens (RDA, MOM, or PTA), or (ii) a "low" concern but bordering on the "medium" concern threshold under any of the primary screens. However, beginning with annual meetings on or after February 1, 2023, potential FPA adjustments will expand to cover more companies beyond only those with borderline "low" concern and "medium" concern issues. Under the updated FPA methodology, certain "high" concern companies with strong FPA performance may become "medium" concerns, while certain "medium" concern companies may become "high" concerns if their FPA performance is poor. Specific details regarding these changes to the FPA screen for 2023 will be covered in the update to ISS' "Pay-for-Performance Mechanics" white paper to be published in January. ISS has said that back-testing indicates that less than 10% of all companies subject to the quantitative screen will have their overall quantitative concern level modified by the updated FPA methodology.

Factors Considered in Qualitative Review of "Pay-for-Performance" Analysis

ISS has updated the factors that it considers in conducting the qualitative review of its "pay-for-performance" analysis to include the following:

- The complexity of the pay program;
- Any risks associated with the pay program design;
- Financial or operational results, both absolute and relative to peers, including clear disclosure in the proxy statement of any adjustments made for incentive plan purposes; and
- Recent pay program changes and/or any forward-looking commitments.

ISS also notes that, in conducting its qualitative review, it primarily reviews the company's proxy statement. Accordingly, information that is not fully disclosed in the proxy statement may not receive mitigating weight in ISS' "pay-for-performance" analysis.

CEO Transition Pay

ISS believes that when there is an executive transition, investors are generally comfortable with a temporarily increased pay package for the incoming executive, particularly when that executive has been externally hired from another organization. This temporary change to the compensation structure may include "inducement" awards, as well as "make-whole" awards, which replace forfeited compensation opportunities from the executive's prior employment. Companies must clearly disclose the portion of awards that are attributable to "inducement" or "sign-on" awards versus those that are strictly "make-whole" awards. ISS goes on to state that the presence of these awards may mitigate concerns regarding pay magnitude if a review of the award structure and disclosure reveals positive features. However, if pay levels are elevated in the transition year, ISS expects those compensation levels to normalize following the CEO transition.

"Inducement" awards should be predominantly performance-based and structured with appropriate shareholder-friendly guardrails (for example, limitations on award vesting in the event of a termination of employment). A company should also disclose how it determined the size and structure of these awards to be in shareholders' best interests.

For "make-whole" awards (which need not be performance-based), a company should disclose that the new award is economically equivalent to what was forfeited, as well as the award's termination provisions and any other relevant information to allow shareholders to assess the award.

Modifiers in Incentive-Based Compensation

As with primary metrics for incentive compensation programs, ISS takes the position that companies should provide clear disclosure around the mechanics of a modifier metric, including its applicable goals, the achieved performance level, and impact on payouts. In addition, companies should clearly disclose the limitations that a modifier metric has on payouts (for example, "may increase or decrease the total bonus payout by up to 15%"). Modifier metrics that allow for a significant increase in a payout or do not disclose the percentage by which a payout can be increased may be viewed negatively, as will modifier metrics that contribute to an overemphasis of compensation committee discretion within the pay program.

Overly Complex Compensation Programs

ISS believes that compensation program structures and/or disclosures that are overly complex may impede shareholders' ability to evaluate the link between pay and performance and may reduce transparency into what the program aims to incentivize. Consequently, ISS may raise concerns when a pay program contains overly complex features, particularly when a quantitative "pay-for-performance" misalignment is identified. For example, a disproportionately large number of metrics, modifiers, and/or award vehicles, complicated vesting or award determination formulas, or convoluted pay program disclosure without a clear and compelling rationale may be viewed as a concern.

Problematic Pay Practices

ISS has updated and clarified its list of problematic pay practices that carry significant weight and, accordingly, may result in an unfavorable vote recommendation to include the following:

- Repricing or replacing of underwater stock options/SARS held by named executive officers or directors without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options) (previously, this practice encompassed any repricing and not just ones involving named executive officers or directors); and

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- Severance payments made when the termination is not clearly disclosed as involuntary (for example, a termination of employment without cause or resignation for good reason).

SEC's New "Pay-Versus-Performance" Disclosure Requirement

In response to the SEC's adoption of final rules to implement the requirements of Section 953(a) of the Dodd-Frank Act, ISS research reports will display certain elements from the company's disclosed "Pay-Versus-Performance" table, including the Summary Compensation Table total pay figure for the CEO, the Compensation Actually Paid value, the company's TSR, the peer group's TSR, the company's most important financial performance measure, and the other disclosed important metrics for determining CEO pay. While this information will be displayed for all companies subject to ISS' quantitative "pay-for-performance" screen, the new information will not be incorporated into the screen. The new disclosures may be considered during the qualitative evaluation, particularly for companies that exhibit a quantitative "pay-for-performance" misalignment.

COVID-Related Compensation Decisions

ISS believes that boards of directors are now in a position to return to traditional pre-pandemic incentive compensation program structures. Accordingly, as in pre-pandemic years, any mid-year changes to annual incentive plan metrics, performance targets, and/or measurement periods, or programs that heavily emphasize discretionary or subjective criteria, will generally be viewed negatively. Changes to in-progress long-term incentive award cycles or shifts to predominantly time-based vesting incentives or short-term measurement periods also will generally be viewed negatively. The expectations regarding one-time awards and the compensation committee's responsiveness to a low Say-on-Pay vote result are to be consistent with pre-pandemic years. Any COVID-related pay changes or decisions should be accompanied by clear disclosure to assist shareholders' evaluation of the decisions.

Equity Compensation Plan FAQs

Changes to Equity Plan Scorecard (EPSC") Scoring

Effective for annual meetings held as of February 1, 2023, the threshold passing scores will increase for the S&P 500 model (from 57 points to 59 points), the Russell 3000 model (from 55 points to 57 points), and the Non-Russell 3000 model (from 53 points to 55 points). (For all other models, the threshold passing score is 53.) Other than the burn rate factor update (as described below), there are no new factors or factor score adjustments for 2023.

ISS has also clarified that the factors in the three EPSC model categories (plan cost, plan features, and grant practices) are not weighed equally. Each factor is assigned a maximum number of potential points, which may vary by model. Most factors are binary, but certain ones may generate partial points or negative points. For all models, the total maximum points that may be earned is 100. The only factor change for the 2023 proxy season involves the Burn Rate factor.

Clawback Policies Under the EPSC

To receive EPSC points for the clawback policy factor, the policy should authorize recovery upon a financial restatement and cover all or most equity-based compensation for all named executive officers (including both time-based and performance-vesting equity awards). Consequently, a clawback policy that only complies with the minimum requirements of the final SEC rule under the Dodd-Frank Act will not receive any EPSC points.

Consideration of Burn Rate When Reviewing a Stock Plan Proposal

A company's three-year average adjusted burn rate as a percentage of weighted average common shares outstanding, as compared to a benchmark, is a scored factor in certain EPSC models. Beginning with annual meetings held on or after February 1, 2023, the burn rate factor will use the VABR calculation (as described in more detail below). The VABR benchmarks are calculated as the approximately 86th percentile of the three-year burn rates within the company's two-digit or four-digit GICS group, segmented by the S&P 500 index, Russell 3000 index (less the S&P 500), and non-Russell 3000 index (subject to a de minimis benchmark threshold for each index).

If a company's index membership or GICS classification has changed within the last three years, ISS will presume that the newest classification or index membership appropriately reflects the company's current circumstances and burn rate benchmarks applicable to similar companies under the newer classification will be applied. However, recent changes occurring after the company's most recent quarterly data download will generally not change its applicable EPSC model.

Calculation of common shares outstanding ("CSO") and market capitalization for share value transfer ("SVT") purposes when economic proposals are on the annual meeting agenda

When there is an economic transaction (such as a merger, acquisition, or financing transaction) under consideration, ISS first will consider whether the implementation of the equity compensation plan proposal is contingent on the consummation of the transaction. If the answer is yes, the equity plan proposal will be analyzed on a post-transaction basis and the common shares issuable in the economic transaction will be included in the company's CSO and market capitalization. Where the answer is no, then the shares issuable in the transaction will be included in the company's CSO and market capitalization only if ISS recommends support for the transaction. In other words, if ISS does not support the transaction, the shares issuable will not be included in either CSO or market capitalization.

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For proposals concerning the potential issuances of common stock, including for the purpose of satisfying the NYSE or NASDAQ "20% rule" requirement, the shares issuable will only be included in its CSO and market capitalization if the company discloses that the shares will be issued upon or shortly following shareholder approval of the proposal.

Burn Rate Table

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. These tables set ISS' burn rate benchmarks using Standard & Poor's global industry classification standard ("GICS") codes as assigned to each company.

As announced in 2021, ISS will be using its new burn rate methodology, the VABR methodology, for the 2023 proxy season, starting with annual meetings held on or after February 1, 2023.
As described in more detail in our Thoughtful Pay Alert, *ISS Issues 2022 Benchmark Voting Policy Updates* (December 17, 2021), the VABR methodology calculates burn rate by using the actual stock price for full-value awards, and the Black-Scholes value for stock options. The denominator (common shares outstanding) will also be valued using a company's actual stock price. Specifically, the annual VABR equals (i) the number of options multiplied by the option's dollar value (based on a Black-Scholes option pricing model) plus (ii) the number of full-value awards multiplied by the stock price divided (iii) by the weighted average common shares outstanding multiplied by the stock price.

The updated 2023 burn rate table (applying the VABR methodology) is set forth in an Exhibit to this Thoughtful Pay Alert.

The burn rate benchmark is primarily used by ISS as part of its EPSC evaluation. 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.

Observations. Given the downward stock price pressure experienced by many technology and life sciences companies during 2022, burn rates will be a factor to closely consider for any company planning to put an equity compensation plan proposal forward at its 2023 annual meeting. In the current environment, advanced preparations may be the key to maximizing shareholder support for the plan proposal.

Further Information

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

- ISS 2023 Benchmark Policy Updates – Executive Summary
- ISS 2023 Proxy Voting Guidelines Benchmark Policy Recommendations
- ISS 2023 U.S. Executive Compensation Policies FAQs:
- ISS 2023 U.S. Equity Compensation Plans FAQs:

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 Hannah Orowitz at 332-867-0566 or horowitz@compensia.com.

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EXHIBIT

ISS 2023 Value-Adjusted Burn Rate Benchmarks

GICS	Description	S&P 500	R3000 (Ex. S&P 500)	Non-R3000
1010	Energy	0.86%	2.29%	4.06%
1510	Materials	0.77%	1.33%	4.09%
2010	Capital Goods	0.77%	1.71%	4.72%
2020	Commercial & Professional Services	0.77%	2.08%	4.99%
2030	Transportation	0.77%	1.77%	3.55%
2510	Automobiles & Components	1.18%	1.94%	4.48%
2520	Consumer Durables & Apparel	1.18%	2.06%	3.86%
2530	Consumer Services	1.18%	2.06%	4.24%
2550	Retailing	1.18%	3.19%	7.27%
3010	Food & Staples Retailing	0.77%	1.74%	9.11%
3020	Food Beverage & Tobacco	0.77%	1.74%	9.11%
3030	Household & Personal Goods	0.77%	1.74%	9.11%
3510	Health Care Equipment & Services	0.90%	3.76%	8.69%
3520	Pharmaceuticals & Biotechnology	0.90%	5.36%	7.43%
4010	Banks	0.89%	1.05%	1.23%
4020	Diversified Financials	0.89%	3.61%	4.24%
4030	Insurance	0.89%	1.50%	1.83%
4510	Software & Services	1.94%	5.27%	9.86%
4520	Technology Hardware & Equipment	1.94%	3.85%	5.27%
4530	Semiconductor & Semi Equipment	1.94%	3.95%	4.73%
5010	Telecommunication Services	1.52%	2.92%	5.46%
5020	Media & Entertainment	1.52%	4.24%	5.46%
5510	Utilities	0.77%	1.05%	2.74%
6010	Real Estate	0.77%	1.15%	2.35%

NOTES:
De minimis 0.77% burn rate for S&P 500
De minimis 1.05% burn rate for Russell 3000 (excluding the S&P 500)
De minimis 1.23% burn rate for non-Russell 3000

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

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