ISS Modifies Pay-for-Performance Assessment and Issues Guidance on Select Compensation Policies

Institutional Shareholder Services (ISS) has issued updated FAQs on certain compensation matters and equity plan proposals and has modified its pay-for-performance evaluation methodology.

These updates represent an incremental change to existing ISS proxy voting policies for U.S.-listed companies and are effective for shareholder meetings occurring on or after February 1, 2023.

ISS's updates cover the following three areas: (i) evaluation of certain executive compensation practices, (ii) pay-for-performance assessment and (iii) equity plan proposals, each of which is summarized below.

I. Evaluation of Certain Executive Compensation Practices

ISS has revised its policies in the following areas relating to executive compensation:

A. **CEO Transition Pay, Including Inducement and Make-Whole Payments.** ISS has clarified that concerns about the magnitude of inducement and make-whole payments may be mitigated based on the presence of certain positive award features (such as performance-based vesting conditions for inducement awards and limitations on award vesting in the event of a termination) and certain other mitigating factors (such as sufficient disclosure on how the award was sized and structured). In addition, ISS clarified that a make-whole award's value should be not greater than the value of the forfeited awards. ISS generally does not expect make-whole awards to be performance-based. Lastly, ISS expects elevated pay levels in the year of hire to normalize in the following year.

B. **Modifier Metrics in Incentive-Based Compensation.** ISS has clarified its position on the use of payout modifiers. ISS expects a company to disclose a payout modifier's applicable goals, the achieved performance level, and the impact on payout levels. ISS will view negatively modifier metrics that (i) allow for a significant increase in a payout or (ii) contribute to an overemphasis of committee discretion within the pay program. ISS leaves undefined "significant" increase.

C. **Overly Complex Pay Programs.** ISS may raise concerns about a pay program that contains overly complex design elements, particularly when ISS has identified a quantitative pay-for-performance misalignment. For example, ISS notes that it may raise concerns about "disproportionately large number of metrics, modifiers, and/or award vehicles, complicated vesting, or award determination formulas, or convoluted pay program disclosure without clear and compelling rationale."

D. Pay Increases Intended to Offset Forgone Compensation Due to CARES Act Restrictions. ISS will generally view negatively one-time awards or other significant increases in executive pay opportunities intended to offset or replace forgone compensation due to prior CARES Act caps on compensation.

E. Assessment of the New "Pay Versus Performance" Disclosures. ISS will not consider the newly required pay-versus-performance disclosure ("PvP Disclosure") in its *quantitative* pay-for-performance assessment. However, ISS may consider a company's PvP Disclosure in its *qualitative* evaluation, particularly for companies that exhibit a quantitative pay-for-performance misalignment. ISS notes that ISS research reports on a Russell 3000 company will display certain elements from the company's PvP Disclosure.

II. Pay-for-Performance Assessment

ISS's CEO pay-for-performance assessment directly influences its recommendation on a company's say on pay proposal. The pay-for-performance assessment consists of two parts: (i) a quantitative assessment and (ii) a qualitative assessment. ISS has made minor and highly technical modifications to its quantitative assessment that may result in a slight increase in the number of companies found to have a CEO pay misalignment.

If ISS's quantitative assessment shows a CEO pay misalignment, ISS would conduct a qualitative assessment under which it considers a number of factors that show whether a company's pay practices facilitates or mitigates the pay misalignment. ISS has expanded the list of factors to include a company's recent pay program changes and/or any forward-looking commitments

III. Policy on Equity Plan Proposals

ISS has modified its policy on evaluating equity plan proposals in the following respects:

A. Modification to Threshold Score Required to Receive ISS FOR Recommendation. ISS evaluates equity plan proposals under its Equity Plan Scorecard (EPSC) model. ISS has slightly increased the threshold score that a company must receive under the EPSC model for ISS to recommend FOR a company's equity plan proposal.

B. Clawback Policy Assessment. One of the factors assessed and scored under the EPSC model is the adequacy of a company's disclosed clawback policy. ISS has clarified that a company's clawback policy will receive a positive score if the policy allows for recovery of all or most equity-based compensation paid to a company's named executive officers, *including both time-based and performance-based vesting equity awards*, upon certain financial restatements.

C. Change in Burn Rate Calculation Methodology. Beginning in 2023, ISS will calculate a company's three-year average burn rate under a new methodology that assigns a value to each award type and a company's shares outstanding to calculate a "value-adjusted" burn rate (see Meridian Client Update dated December 13, 2022).

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