

Taking Bold and Thoughtful Compensation Action under the Watchful Eye of ISS

By Takis Makridis, David Thomas, Reid Pearson, Rob Main, and Sally Curley

In the second quarter of 2020, ISS provided updated guidance related to the COVID-19 pandemic and how to think about its fallout across voting categories of interest—compensation, of course, being one.

This has raised questions from companies weighing bold action to restore incentives in their long-term incentive plans (LTIPs). We took the most common questions to a number of our friends in the executive compensation and corporate governance community.

Here you'll find commentary from an executive and equity compensation attorney (David Thomas), a proxy solicitor (Reid Pearson), a corporate governance expert (Rob Main), an investor relations and ESG thought leader (Sally J. Curley), and yours truly, Takis. We'll get to everyone's answers in a moment—but first, let's briefly review ISS' guidance and some situations where action might be warranted.

The ISS Guidance

ISS' commentary addresses a handful of important compensation questions:

- ISS signaled some flexibility with respect to the compensation committee adjusting goals on 2020 annual plans, encouraging companies to provide contemporaneous disclosure on the rationale for any changes made.
- In contrast, ISS conveyed a general aversion toward companies modifying outstanding

LTIP awards, while acknowledging they will evaluate any revisions case by case.

- Prospective revisions to LTIP design/structure are fine, such as changing the mix or design of future incentive awards. However, ISS will evaluate revisions under their existing policy views. This suggests it's valid to change metrics and goals used in future awards, but ISS likely would reject a more drastic shift away from using performance metrics.
- ISS reiterated their position on option exchanges, namely that companies must obtain shareholder approval and satisfy the following criteria: (1) there must have been a protracted share price decline that exceeds one year, (2) shares cannot be recycled back into the plan, (3) vesting should be extended on replacement awards, (4) executives and directors must be excluded, and (5) the terms must be value neutral.

In short, the guidance is unsurprising. And for many companies, it's moot because the scope of action they need to take is minimal if not nil.

When Action Might Be Warranted

Other companies, however, may conclude inaction is dangerous. Some of the situations we've encountered include:

Stretched Thin Co.: recently public software as a service company with a thin leadership bench. Many of the executives have enough wealth to let them sit a recession out, but the turnover could set the company too far back to recover against their competitors. Management is conducting an option exchange that is slightly more lucrative than a pure value-for-value one and it seems necessary to include the executives.

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Turning the Corner Ltd.: midcap company in the live entertainment space that was struggling before COVID-19 and identified the need to pivot its business model. COVID-19 has only amplified the necessity. Executives and non-executives alike are struggling with years of low or zero equity payouts, prompting an interest in resetting performance goals.

Plan to Replan Inc.: successful company in the tourism sector that has a history of setting stretch (absolute) performance goals and delivering meaningful shareholder results. Because of the earnings fallout from COVID-19, each outstanding LTIP cycle is tracking at or near a 0% payout. Management is considering reducing goal levels or, as one creative alternative, adding a relative metric as a “kicker” to each outstanding LTIP cycle.

These and many other companies are trying to evaluate what’s reasonable, responsible, and necessary in light of unfolding circumstances. None feels pressed to act immediately, but they’re actively working through design and shareholder issues to chart potential courses of action.

Common Questions about Taking Action

Among companies in situations like these, here are the most common questions that come up, along with answers from our panel:

1. ISS indicates that shifting goals or targets are generally inappropriate, but other actions will be evaluated case by case to see whether directors exercised appropriate discretion. What does that mean in practice? Does it spell an automatic ISS “no” vote if action is taken on outstanding LTIP awards?

David Thomas, Partner, Wilson Sonsini: Although ISS has signaled that they would support decreased goals under certain

circumstances, the guidance they provided didn’t contain enough information to make anyone really certain of how ISS will react. For that reason, unless your shareholder base strictly follows the guidance of ISS, I tend to think that focusing on robust and thoughtful shareholder engagement with respect to your compensation actions might be more fruitful than trying to figure out what might make ISS comfortable.

Sally J. Curley, CEO, Curley Global IR, LLC: In helping investors carry out their fiduciary duty, the key for proxy advisors is whether the board of directors has exercised appropriate oversight and carefully weighed a variety of options vis-à-vis risk and long-term value creation. For example, ISS has raised the topic of an ESG oversight committee of the board.

If it becomes clear to an organization that it can no longer achieve its previously stated goals—as is the case for many during this pandemic—then proxy advisors and shareholders might understand and support goal revisions. A company is likely to be more successful if the rationale behind such a revision is well articulated so that proxy advisors and shareholders gain a better idea of the circumstances unique to that organization.

2. What are some creative alternatives other than reducing goals? For instance, Plan to Replan Inc. is considering adding a relative metric to their outstanding equity awards in the form of a kicker.

Takis Makridis, President and CEO, Equity Methods: We know that proxy advisors and institutional investors don’t want to see flat or growing executive pay alongside employee layoffs and declining shareholder value. Two solutions (among others) we’re seeing work well involve swapping out absolute financial metrics in exchange for a relative metric and adding a relative metric as an additive payout “kicker” to an existing set of absolute metrics.

Sally: Building on Takis’ point, consider implementing more challenging metrics to achieve a

higher payout. For example, if an organization's financial performance is 90% of its post COVID-19 plan, no incentive bonuses are awarded. If the company achieves 120% of plan, modest bonuses are awarded, and the scaling increments from there. At least then, it's clear that the expanded payout opportunity is linked to particularly rigorous performance goals in the post-pandemic economy. In this environment, adding an element of ESG-related metrics tied to compensation is becoming increasingly important.

3. Why not just ask the compensation committee to exercise discretion and adjust payouts?

Takis Makridis: While legally the compensation committee can certainly do this, it's risky from an accounting and proxy perspective. The accounting rules state that broad uses of discretion or instances where subjectivity enters the payout calculus undercut the existence of an accounting grant date. Tainting the accounting grant date could result in variable accounting not only for the award in question, but also any future awards relying on the same plan language. An alternative perspective that auditors may take is to reclassify the act of discretion as an accounting modification.

Net-net, don't view discretion as a panacea for adjusting goals. Some equity plans may make it easier to exercise discretion without tainting the accounting grant date, but in general this path shouldn't be counted on as a vehicle for avoiding conversations with shareholders and proxy advisors.

4. Coming back to ISS' case-by-case evaluation process, what are some of the leading practices for getting buy-in from ISS? Acknowledging that there's no way to guarantee a positive reaction by ISS, how much can companies influence the odds?

Sally: If there's going to be a shareholder vote, early engagement and a strong business case are

key. If metrics have changed significantly, briefing the chair of the compensation committee and having him/her participate on the engagement call would be extremely beneficial to educating the investor / proxy compliance officer. Proxy advisors and institutional investors may be more open to discussing a proposed significant change in compensation if they understand the rationale and hear it directly from the compensation committee chair. It shows oversight and commitment, which helps support the company's case.

Let's suppose Company X sets pre-pandemic goals to target \$1 billion of revenue in order to achieve 100% of its three-year performance share units (PSUs). Company X, however, is in an industry so badly affected by the pandemic that the entire industry now has to shift its business model to adapt. This shift will almost certainly prohibit Company X from achieving \$1 billion in revenue within the option earn-out timeframe. Therefore, Company X could be in the difficult position of having to revise performance metrics or risk losing key talent during a critical time. In companies without a deep bench, this could be particularly problematic.

Even before filing a preliminary proxy, it's important that the compensation committee and full board get feedback from both ISS and Glass Lewis. Proxy advisors evaluate thousands of organizations, and they may be able to share alternative solutions that Company X hasn't considered. From there, the company can determine the best course of action. Of course, compensation consultants play an important role in advising companies in such scenarios.

Ultimately, proxy advisors exist to help investors make an informed decision. It's among their fiduciary duties. Dialogue is the best way for both parties to understand facts, circumstances, and opinions.

Finally, don't forget to assess the financial and tax considerations early on. Failure to do so can create unintended consequences that could surprise shareholders, the Board and the organization.

5. What about the large institutional investors, such as BlackRock, State Street, and Vanguard? Do they issue similar guidance and have their own perspectives? How should shareholder outreach adapt in light of diverse shareholder bases that may not strictly follow ISS' voting recommendations?

Reid Pearson, EVP, Alliance Advisors: Investors that have their own internal guidelines have a standard operating procedure similar to the one ISS and Glass Lewis follow. They perform a quantitative review at first, then follow that up with a qualitative review. Most of these investors apply a case by case approach to compensation decisions. Although I don't expect to see them issue formal guidance, they'll certainly review topics like reducing or resetting goals.

Disclosure will be critical so shareholders can understand the rigor of the changes to the pay program. I also believe shareholder engagement will be very important this fall. Companies will have specific and unique circumstances with respect to their compensation plans for 2020. Spending some time explaining those circumstances will be very important.

Rob Main, Managing Partner and COO, Sustainable Governance Partners: Despite the breadth and depth of the current crisis, we expect institutional investors will analyze and vote on say-on-pay and other compensation issues consistent with their stated voting philosophies and guidelines. In most cases, this means assessing the individual facts and circumstances of the compensation plan and supporting the company when there was alignment between the experience of management and the shareholders. This, however, is a unique year, and a growing chorus of investors is calling for CEOs to "share the pain" and take full or partial pay cuts if employees are furloughed or laid off or if there is a perceived lack of management accountability on material ESG issues. Although company actions taken now won't be voted on until 2021, investors are watching, and will want to discuss recent actions during engagements. So,

we are preparing clients for more holistic discussions this year and encouraging them to provide shareholders with current and long-term perspectives where possible.

6. How can a proxy solicitor help? Stepping back one level, what exactly do they even do?

Reid: Among other things, a solicitor can help a company with:

- Understanding its shareholder base. How much influence does ISS or Glass Lewis have? Who has their own internal guidelines?
- Sorting out vote decisions. Are they made by a governance team or an investment team? Or is it a combined effort of these two groups?
- Shareholder engagement. This can include getting companies ready for presentations, coaching them on the types of questions they might receive, and informing them of each shareholder's hot buttons.
- Projecting the likely outcome of a vote based on the shareholder base as well as company-specific facts and circumstances.

7. ISS's Q2 guidance focused on option exchanges while acknowledging options are less prevalent nowadays. If a company is considering lowering its PSU goals, is it conceivable to offer a PSU exchange where recipients surrender their outstanding PSUs for new PSUs that have new metrics, goal levels, or both? How would proxy advisors think about this?

David: The idea of surrendering outstanding PSUs for PSUs with new goals is absolutely conceivable, but there are a number of considerations that could lead a company to go a different direction. First, I think proxy advisors might be skeptical of such an exchange because the guidance requires sustained poor performance before an option exchange becomes appropriate.

In this case, the length of a sustained downturn might extend beyond the period when you'd need to make changes to restore compensation value. Other considerations that I'd want to examine carefully are:

- Will you need shareholder approval to offer such an exchange?
- Will such an exchange require a formal tender offer filed with the SEC? If so, how much disclosure regarding the viability of the existing metrics and the potential new metrics will be necessary for an informed decision?
- If your PSUs are heavily concentrated among your senior officers, we know proxy advisors will be skeptical. If you're going to omit senior officers because of this skepticism, is it worth risking some potential windfall (if the existing awards turn out to have some value) and just granting additional new PSUs to the folks who aren't senior officers?
- Do your stock plan documents—the ones that shareholders approved or the proxy disclosure provided when the plans were approved—contain anything that says or implies that you won't use discretion to increase the earned value of awards?

Takis: We're seeing more companies interested in adding a kicker to existing PSUs to diversify the ways they can pay out. One idea is to add a relative metric that's additive, such as allowing an addition of 0 to 50% to the payout, not to exceed some ceiling (either the existing maximum payout or something less). This could be a more elegant solution since it bypasses all the hefty tender offer protocols. You'll likely also have decent flexibility to engineer the modification in a way that results in palatable incremental accounting expense.

David: If you've developed an appropriate peer group and picked a metric that's an important measure of business performance, the idea of a potential addition to existing PSU performance for doing better than peers—even if you haven't met the original plan—seems like a great way to

go. I think that there still should be some consequences for falling short of the original goals, so capping at some point below the ceiling seems appropriate from a governance perspective. This approach would avoid having an artificially high number of outstanding awards, like would happen if you just granted another award based entirely on the relative metric you've chosen.

8. It's no surprise that shareholders have little appetite to hear about executive pay needing to be shored up. When a company has a legitimate argument for restoring its equity incentives, how should this story be told in the broader context of the company's place in the market and societal ecosystem?

Rob: While proxy voting teams continue to be policy-driven by nature, there are clearly signals that executive compensation has become a major point of contention for many stakeholders, and all eyes are on the leadership/board response to these concerns. Shareholders, employees, and politicians have called for a reduction in executive pay, especially where employees have been laid off or furloughed. We have also heard thoughtful perspectives from industry leaders on the value of having the right people in the right seats. For instance, according to Sascha Sadan, director of investment stewardship at Legal & General Investment Management, "We do need leadership at the moment. We need good people. The best leaders could end up saving their companies a lot more."

For companies that believe they need to refine their long-term incentive program, investors will want to see three big questions addressed:

- Why is it necessary (*i.e.*, what's the context)?
- How does the refined approach fit better with long-term strategy?
- How does the new program provide more appropriate motivation for key leaders?

Additionally, just as many investors expect executives to share the pain with their employees

today, they'll likely expect employees to be able to share the gain moving forward. This presents companies with an opportunity to think critically about how they use equity as compensation across the business, not just in the most senior ranks. Most investors appreciate that we're experiencing a hundred-year storm, and that thoughtful, measured refinements to better align leader and stakeholder experience should win support from a company's most strategic long-term investors.

Takis: I couldn't agree more that context and explaining your strategy are critical. A few points to consider and address in external messaging include:

- Pre-COVID-19. What was going on before the pandemic hit? Was the industry or your company already struggling? What has the recent history of executive compensation been? How have realized pay levels trended?
- Impact of COVID-19. What has COVID-19's relative impact been on your specific industry and business model? What does a recovery look like?
- Benefit to shareholders. What is the company's longer-run business plan and how has its strategy changed as a result of COVID-19? How does the proposed compensation action help drive that strategy? What does it do outside the executive office?

Be clear in your messaging and creative in the action you take to ensure it's understood as an elegant solution to a genuine and novel situation.

9. Some CEOs or compensation committees may take the view that employees should just be glad to have a job and ideas of retention or motivation risk are unfounded. To what extent should "share the pain" be a guiding principle across the board?

Sally: Even in an economic downturn, the risk of losing key talent is real. In some industries, it

takes years to recruit and build a highly talented, highly skilled workforce. Believing that during a weak economy you won't lose key talent could prove foolhardy.

Employees tend to be motivated by two things: money (and the achievement of more) and recognition (being recognized for valuable contributions). Employees motivated by money will be closely evaluating their incentives. Employees motivated by recognition may believe their opportunities for recognition and advancement are better elsewhere, especially if a tough business model shift lies ahead.

For corporate roles, the pandemic-driven remote work environment has opened up opportunities for employees, and employers, like never before. After the initial uptick in unemployment to roughly 15% in April, we then saw a decline in August to 8%. There are a variety of factors that inform these rates, but there is strong data to suggest that organizations began hiring back as COVID-19-related restrictions were lessened.

One final point: Don't underestimate the emotional attachment employees have to an organization and the risk of losing pockets of talent at different levels. You can turn a company upside down both operationally, financially, and culturally very quickly—particularly in a challenging environment.

David: Although it's tempting to share the pain across the board, I think it's important to keep in mind that all compensation decisions are personal to the people they affect. In other words, across-the-board decisions won't meet your needs with respect to all stakeholders.

Another key principle is that your best talent can realign their incentives by leaving the company. That means it's still tremendously important to motivate and retain these key players, not just to keep them but because others in the organization could view their departures as a bad sign.

Wrap-Up

Our panel touched on a handful of recurring themes:

1. It's not just about ISS—it's about your entire shareholder base and engaging each player in a targeted and customized fashion.
2. Engagement can't be robotic. If you're contemplating bold action, start the shareholder dialogue early to explain why you think the action is needed and then genuinely listen to the responses.
3. There's a whole spectrum of potential incentive restoration strategies and some are much more governance friendly. Critically evaluate all your alternatives.
4. Whereas some companies may be focused on their NEOs, many are also deeply worried about key talent outside the executive suite. In cases where you can exclude NEOs or address their incentive issues separately, you have many more options.
5. Model multiple alternatives and be sure to flex how each one will flow through to the financial statements and proxy.

In tandem with all this discussion of fixing broken incentives, it's not too early to begin looking at next year's annual grant. As a parting thought, here are a few areas to examine:

Performance metric. We're interested in two ideas. First, the current uncertainty is proof positive of the benefit of relative metrics in insulating payouts from exogenous events. Second, pervasive goal-setting uncertainty can create

an argument for strategic metrics related to product development, customer satisfaction, or innovation.

Performance period. Intuition would suggest shortening the performance window in response to heightened goal-setting ambiguity, which is understandable and could be supportable if there's a three-year relative metric that wraps around one-year goals. We expect this to be the path for many companies.

A contrarian and bold alternative, however, is to lengthen the period to four, five, or six years. Longer performance periods provide an expanded runway to escape the shackles of short-term circumstances and focus on what the organization should be doing to emerge stronger in the newly emerging economy. But it's risky to establish even lengthier goals amid such uncertainty, so the circumstances (*e.g.*, a turnaround or business model pivot) will need to support the case.

Payout curve. Intuition would suggest adopting flatter payout curves to provide additional cushion against economic uncertainty—causing the award to begin mimicking a time-based restricted stock unit.

Contrarian approaches, however, are especially worthwhile to consider during novel times. As Rob explained earlier, shareholders want to see executives share the pain while allowing them to share the gain in a recovery. Therefore, a bolder approach is to deliver low payouts at lackluster performance and steeper-than-normal rewards at stretch outcomes. We've seen some interest in payouts above 200% (*e.g.*, expanding up to 250% or 300%) and we think this trend could continue.