SULLIVAN & CROMWELL LLP

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ISS Releases FAQ on U.S. Compensation Policies and the COVID-19 Pandemic

Adjustments to annual incentive programs such as changes to metrics, performance targets or measurement periods or replacement with one-time discretionary payments may be viewed as reasonable responses

Particular scrutiny on above target payouts under modified annual incentive programs and changes to currently in-progress equity or long-term incentive cycles

INTRODUCTION

On October 15, 2020, Institutional Shareholder Services (ISS) released general, preliminary guidance as to how ISS U.S. Benchmark Research may approach pay decisions related to the COVID-19 pandemic in the context of ISS' pay-for-performance qualitative evaluation.[1] Consistent with existing ISS policy, an elevated concern in ISS' quantitative screen will result in this more in-depth qualitative review. The guidance was shaped by feedback from discussions with investors at roundtables and ISS' annual policy survey. ISS indicated that this FAQ provides preliminary guidance ahead of ISS' regular annual FAQ update in December.

A. COMPENSATION PRACTICES

The FAQ identified the following policies with respect to compensation changes and awards:

- ***Salary Reductions***. Temporary salary reductions will be given mitigating weight in ISS' qualitative evaluation to the extent they decrease total pay. ISS will consider an action more meaningful if targeted incentive payout opportunities are also decreased to reflect reduced salary.

- ***Changes to Bonus Programs***.
  - ISS may consider certain actions – including adjustments to annual incentive programs (*e.g.*, changes to metrics, performance targets and measurement periods), suspension of annual incentive programs in favor of making one-time discretionary payments, or some combination of these approaches – to be reasonable responses to the current economic downturn, assuming the justifications and rationale for such actions are clearly disclosed and the outcomes reasonable. ISS will closely scrutinize above-target payouts under annual incentive programs that have changed.
  - For companies that lower the financial or operational targets applicable to annual incentive programs below the prior year's target levels, ISS has indicated that lower performance expectations that are based on external factors (*e.g.*, operational impacts from COVID-19) may be viewed as reasonable. The company should disclose how the board considered the corresponding payout opportunities, particularly if payout opportunities are not commensurately reduced.
- ***Changes to In-Process Long-Term Cycles***. ISS will negatively view changes to currently in-progress equity or long-term incentive cycles (*e.g.*, FY 2018-2020 or FY 2019-2021), particularly for companies with a quantitative pay-for-performance misalignment.
- ***2020 Long-Term Awards***. ISS indicated that it generally does not expect to see drastic changes to the 2020 long-term incentive program (*e.g.*, shifts to predominantly time-vesting awards or short-term measurement periods) unless there is a fundamental change to the company's underlying business strategy. ISS noted, however, that modest changes (*e.g.*, movement to relative or qualitative performance metrics) could be seen as reasonable, although companies should clearly explain any modifications to the program.
- ***One-Time Awards***.
  - Companies that awarded COVID-related retention or other one-time awards should clearly disclose the rationale for those awards (including the magnitude and structure) and describe how the awards further the interests of investors, while avoiding boilerplate disclosure. ISS stressed that awards should be reasonable in terms of magnitude and an isolated practice, and the vesting conditions for any such awards should be long-term, performance-based and focused on any underlying concerns the award is intended to address. In addition, ISS notes that the terms of one-time awards should contain shareholder-friendly "guardrails" (*e.g.*, limitations on termination-triggered vesting) to avoid potential windfalls.
  - If a retention or one-time award is granted in the context of a forfeited award, ISS expects companies to explain the specific issues driving the grant and how the award furthers the interests of investors. For example, if a company indicates that one-time awards were granted in lieu of forfeited incentives or in light of fairness considerations or lowered realizable pay, the company will need to explain how the award does more than insulate executives from lower pay.

B. DISCLOSURE OF BONUS PROGRAM CHANGES

The FAQ encourages additional disclosure to help investors evaluate annual incentive program changes or discretionary awards. Examples of key disclosure items included in the guidance are: (i) specific challenges resulting from COVID-19 and how those challenges made the original annual incentive program design and/or performance targets obsolete or impossible to achieve, and how changes are not driven instead by poor management performance; (ii) for companies making mid-year changes, as opposed to one-time discretionary awards, why the approach was selected and how those actions further the interests of investors; (iii) underlying criteria (including performance-based considerations) applicable to one-time discretionary awards; (iv) a discussion of how award payouts reflect both executive and company annual performance, and how the resulting payouts compare to what would have been paid pursuant to the original program; and (v) companies that have designed an annual incentive program for 2021 are encouraged to disclose information about positive changes, which may carry mitigating weight in ISS' qualitative evaluation.

C. CHANGES TO OTHER ISS POLICIES

The FAQ reflect a change to ISS' responsiveness policy in light of COVID-19. ISS' responsiveness policy reviews three factors when a company receives less than 70% support on the prior year's say-on-pay proposal: (1) disclosure of the board's shareholder engagement efforts; (2) disclosure of specific feedback received from dissenting investors; and (3) actions or changes made to pay programs and practices to address investors' concerns. As a result of COVID-19, ISS has adjusted its expectations in relation to the third factor. If a company is unable to implement changes due to COVID-19, its proxy statement should disclose specifically how COVID-19 has interfered with the company's ability to address investors' concerns. If changes to the pay program are delayed or do not fully address investor feedback, the company should disclose a longer-term plan as to how it intends to address shareholders' concerns.

ISS did not change its Equity Plan Scorecard (EPSC), Problematic Pay Practices (PPP) or option repricing policies. However, the guidance states that, for the 2021 policy year, the passing score for the S&P 500 EPSC model will increase to 57 points and for the Russell 3000 EPSC model to 55 points. The passing score for all other EPSC models will stay at 53 points. The PPP policies and option repricing policies will remain consistent with prior years.

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ENDNOTES

1 The full ISS policy guidance on the U.S. compensation policies and the COVID-19 pandemic is available at https://www.issgovernance.com/file/policy/active/americas/US-Preliminary-Compensation-Policies-FAQ-regarding-COVID.pdf. For additional information regarding prior ISS policy guidance on the impact of the COVID-19 pandemic, including policies regarding virtual-only meetings, compensation-related issues, defensive measures and director attendance amid the COVID-19 pandemic, see our memorandum to clients "ISS Announces Policy Guidance on the Impact of the COVID-19 Pandemic", dated April 9, 2020.

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