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Executive Compensation & Employee Benefits Group

Client Alert

ISS Issues Preliminary FAQs Regarding Compensation Policies & COVID-19

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On October 15, 2020, Institutional Shareholder Services ("ISS") issued preliminary Frequently Asked Questions (FAQs) on U.S. compensation policies and the COVID-19 pandemic. The FAQs follow the initial COVID-related guidance issued by ISS in April 2020. ISS noted that it endeavored to provide this FAQ ahead of its regular annual FAQ update (typically issued in December) in order to provide investors, companies and their advisors advance notice of ISS' position on these issues. A summary of the new FAQ is provided below.

Evaluating Changes to Compensation Programs

Bonus/Annual Incentive Programs

Consistent with its preliminary guidance issued in April 2020, ISS expects that many companies will make adjustments to annual incentive programs (including changes to metrics, targets and measurement periods) in response to the pandemic. Although such changes would be viewed negatively under normal circumstances, the FAQ notes that such actions may be viewed as a "reasonable response", so long as the justifications and rationale are clearly disclosed and the resulting outcomes appear reasonable.

Emphasizing the importance of disclosure, the FAQ provides a non-exhaustive list of key disclosure items that ISS will take into account in connection with its qualitative review of incentive programs, including: (i) the specific challenges that were incurred as a result of the pandemic, how those challenges impacted the existing program and how the changes are not reflective of poor management performance, (ii) a rationale for why a particular approach was taken over another (e.g., mid-year changes vs. one-time discretionary awards) and how that approach furthers investors' interests, (iii) performance-based considerations for one-time awards, and (iv) a discussion of how the resulting payouts appropriately reflect both executive and company performance. Companies that have designed 2021 annual incentive programs are encouraged to disclose information about positive changes, which may carry mitigating weight in ISS' qualitative evaluation.

Notably, the FAQ provides that (i) disclosure should clarify or estimate how the resulting payouts compare to what would have been paid under the original program design and (ii) above-target payouts under modified programs will be closely scrutinized.

Equity/Long-Term Incentives

ISS notes that investor feedback indicates that LTI programs are designed to "smooth performance over a long-term period" and therefore should not be altered based on short-term market volatility. Accordingly, it appears that ISS may be less flexible in its approach with respect to changes made to long-term incentive (LTI) cycles that are currently in progress. The FAQ notes that changes to in-cycle LTI programs will generally be viewed negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment.

However, ISS' approach may differ for LTI awards made in 2020. The FAQ notes that although investors generally do not expect to see drastic changes to LTI programs absent a fundamental change in business strategy, "modest" alterations for LTI cycles that commenced in 2020 may be viewed as reasonable. For example, a transition to relative or qualitative metrics may be viewed as reasonable, whereas more "drastic" changes, such as shifts to time-based vesting or short-term measurement periods, would continue to be viewed negatively. Consistent with the overall theme of the FAQ, ISS notes that any LTI modifications should be clearly explained to allow investors to evaluate the compensation committee's actions and rationale.

Retention/One-Time Awards/Replacement Awards

The FAQs note that ISS understands that some companies may grant one-time awards to address concerns resulting from the pandemic, and provides more detailed guidance on how ISS expects such awards to be structured and disclosed. Specifically, one-time awards:

- should be "reasonable in magnitude";
- should include vesting conditions that are performance-based and long-term;
- should be clearly linked to the underlying concern(s) that the award was designed to address; and
- should include shareholder-friendly "guardrails" to help mitigate windfall scenarios (such as limitations on termination-related vesting).

Disclosure of such awards should include a clear rationale for the award (including magnitude and structure) and describe how the award furthers investors' interests. The FAQ makes clear that boilerplate language regarding "retention concerns" will not be acceptable.

The FAQs note that investors do not expect companies to grant one-time awards merely as a replacement for forfeited performance-based awards. Companies that do make one-time awards in consideration of forfeited incentives (whether for fairness considerations, accounting for lower realized pay, etc.) will need to explain how such awards do not "merely insulate" executives from lower pay.

Other Changes to ISS' Policies for 2021

Responsiveness Policy

As part of ISS' responsiveness policy, companies that receive less than 70% support on the prior year's say-on-pay proposal are expected to disclose any actions or changes the company made to pay programs to address investors' concerns. The FAQ notes that if a company is unable to implement such changes due to the pandemic, the proxy statement should specifically disclose how the pandemic impeded the company's ability to address shareholders' concerns and, if appropriate, disclose a longer-term plan on how it intends to address investors' concerns going forward.

Equity Plan Scorecard (EPSC)/Problematic Pay Practices (PPP)/Option Re-Pricing

Although no changes to these polices were specifically made in response to the pandemic, the FAQ notes the following:

- The passing EPSC score for the S&P 500 will increase to 57 points. The passing EPSC score for the Russell 3000 will increase to 55 points. For all other EPSC models, the passing score will remain 53 points.
- ISS' PPP policies will be consistent with prior years.
- There are no changes for U.S. policies on option repricing programs, which case-by-case approach generally opposes repricings that occur within one year of a precipitous drop in the company's stock price. If boards undertake repricing actions without seeking prior shareholder approval, the directors' actions will remain subject to scrutiny under the U.S. policies on board accountability.

Key Takeaways

- Adequate disclosure will be critical for companies who modified or adjusted 2020 compensation. The FAQ makes clear that robust disclosure regarding rationale, investor impact, terms, conditions and reasoning will be an essential aspect of ISS' review. The FAQ also makes clear that generic, boilerplate language will not be acceptable; therefore, companies should begin to develop disclosure highlights as early as possible this proxy season.

- The FAQ deals with the qualitative aspect of ISS' pay-for-performance evaluation. As in past years, the leading focus will likely be on the quantitative aspect, and ISS will perform a more in-depth qualitative review in situations where a company's quantitative screen results in concerns/misalignment.

- Companies who received low levels of support on prior years' say-on-pay votes will still need to provide the requisite level of disclosure and shareholder engagement required in prior years in order to address ISS' board/committee responsiveness policy. Where a committee has not taken steps to address investor feedback received in response to a low say-on-pay proposal, the proxy statement will need to clearly explain how the pandemic prevented those changes from being implemented and provide a specific plan for implementing investor concerns going forward.

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Please feel free to discuss any aspects of this Client Alert with your regular Milbank contacts or any member of our Executive Compensation & Employee Benefits Group.