ISS Issues FAQs on U.S. Compensation Policies and COVID-19 Pandemic

Institutional Shareholder Services ("ISS") has just published general guidance in the form of a series of Frequently Asked Questions ("FAQs") as to how ISS U.S. Benchmark Research may approach COVID-related pay decisions as part of its pay-for-performance qualitative evaluation. Given the highly disruptive and ongoing nature of the pandemic, ISS issued the FAQs ahead of its regular annual FAQ update in December based on feedback from direct discussions with investors (as well as its annual policy survey) to provide information as early as possible to investors, companies, and advisors on these issues.

As has been ISS' regular practice, an elevated concern from its quantitative CEO pay-for-performance screen will continue to result in a more in-depth qualitative review of a company's executive compensation program and practices. ISS notes, however, that the qualitative evaluation will take into consideration the impact of the pandemic on a company's operations.

The topics covered by the FAQs are as follows:

Temporary Salary Reductions for Executives

Temporary salary reductions will be given mitigating weight to the extent that they decrease an executive's total compensation. In other words, a reduction that represents a larger portion of an executive's total pay will be given greater weight than the same reduction that represents a smaller portion of his or her total pay. In addition, the action will be considered more meaningful if target incentive award payment opportunities are also decreased to reflect the reduced salary.

COVID-Related Changes to Annual Incentive Plans

ISS expects many companies to make adjustments to their annual incentive plans, which may include, in the case of formulaic plans, changing the performance metrics, performance targets, and/or performance periods. It also anticipates that some companies may suspend their annual incentive plans entirely and instead make one-time discretionary awards. While such actions, either on their own or in combination, would be considered problematic under normal circumstances, given the extraordinary circumstances of the current economic downturn, ISS may view such actions to be a reasonable response so long as the justification and rationale for the changes are clearly disclosed, and the resulting outcomes are reasonable.

Necessary Disclosure to Fully Evaluate COVID-Related Changes to Annual Incentive Plans

While ISS intends to evaluate incentive plan structures and outcomes on a case-by-case basis as part of its qualitative review, it notes that investors will expect additional disclosure in order to evaluate annual incentive plan changes or discretionary awards. Key disclosure items that would help investors evaluate COVID-related changes to annual incentive plans include (but are not limited to) the following:

- The specific challenges incurred as a result of the pandemic and how such challenges rendered the original program design obsolete or the original performance targets impossible to achieve. ISS cautions that the disclosure should address how the changes are not reflective of poor management performance.
- For companies making mid-year changes rather than one-time discretionary awards, an explanation as to why that specific approach was taken (rather than the alternative approach) and how such actions further investors' interests.
- One-time discretionary awards should still be based on performance considerations and a company should disclose the underlying criteria, even if not based on the original performance metrics or targets. Generic descriptions (such as "strong leadership during challenging times") will not be considered adequate explanations.
- A company should discuss how the resulting payments appropriately reflect both executive and company annual performance. The disclosure should clarify how the resulting payments compare with what would have been paid under the

original plan design. ISS cautions that above-target payments under changed plans will be closely scrutinized.

- ISS encourages companies that have designed the following year's (2021) annual incentive plan to disclose information about positive changes, which may carry mitigating weight in its qualitative evaluation. We believe that many companies will take advantage of this suggestion as a way of reassuring shareholders that the changes made to the prior year's annual incentive plan (or, alternatively, the exercise of discretion to determine the award payment) was just a one-time occurrence and that going forward they will return to their typical annual incentive plan structure.

ISS' Analysis Where COVID-Related Changes to an Annual Incentive Plan Result in a Lowering of the Financial or Operational Targets Below the Prior Year's Performance Levels

Investors have indicated to ISS that lower performance expectations that reflect external factors (such as operational impacts due to the pandemic) may be a reasonable explanation for lower goal setting, rather than a sign of insufficient plan goal rigor. Even so, ISS notes that a lower performance target should be accompanied by disclosure as to how the board considered corresponding payment opportunities, particularly if such payment opportunities are not commensurately reduced.

COVID-Related Changes to Equity/Long-Term Incentive Cycles that are Currently in Progress (e.g., Fiscal 2018 – 2020 or Fiscal 2019 – 2021)

Based on investor feedback, ISS notes that these programs should be designed to smooth performance over a long-term period and not be altered after the beginning of the cycle based on a short-term market shock. Consequently, ISS will generally view changes to in-progress cycles negatively, particularly for companies that show a quantitative pay-for-performance misalignment.

ISS' Approach for Long-Term Incentives that Were Awarded in the Most Recent Year (e.g., the go-forward cycle beginning in 2020)

Accordingly to ISS, investors generally do not expect to see drastic changes (such as a shift to predominantly time-based equity or short-term performance periods) to the long-term incentive program for award cycles beginning in 2020 unless the underlying business strategy has fundamentally changed. More modest alterations to the incentive program (such as moving to relative or qualitative metrics in the event of unclear long-term financial forecasting), however, could be viewed as reasonable. Finally, companies should clearly explain any changes to the program, to allow investors to evaluate the compensation committee's actions and rationale. We note that this FAQ assumes a multi-year performance period. Many technology companies design their long-term incentives using a one-year performance period with any earned shares subject to a multi-year time-based vesting requirement. In these situations, we believe that ISS may be more amenable to changes to the performance metrics, targets, or scaling since the "performance" aspect of the awards is similar to an annual incentive plan.

COVID-Related Retention or Other One-Time Awards

Retention or other one-time awards may be appropriate in some situations. As with one-time awards granted outside the context of the pandemic, a company granting a one-time award should clearly disclose the award's rationale (including magnitude and structure), as well as describe how the award furthers investors' interests. "Boilerplate" language regarding "retention concerns" will not be viewed as sufficient rationale. In addition, the award's vesting requirements should be long-term, strongly performance-based, and clearly linked to the underlying concerns the award seeks to address. Finally, the award should contain shareholder-friendly guardrails to avoid windfall scenarios, including limitations on termination-related vesting.

Retention or Other One-Time Awards Granted in the Context of a Forfeited Incentive

To the extent one-time awards are granted during the year (or following year) in which incentives are forfeited, a company will be expected to explain the specific issues influencing the decision to grant the awards and how the awards further investors' interests. Companies that indicate that one-time awards were granted in consideration of forfeited incentives, for fairness considerations, lowered realizable pay, etc., will also need to explain how such awards do not merely insulate executives from lower pay.

ISS' Responsiveness Policy in Light of COVID-19

Where a company receives less than 70% support on its say-on-pay proposal, ISS' responsiveness policy reviews three factors:

- the disclosure of the board's shareholder engagement efforts;
- the disclosure of the specific feedback received from dissenting shareholders; and
- any actions or changes made to pay programs and practices to address shareholders' concerns.

While the first two factors remain the same, if a company is unable to implement changes due to the pandemic, the proxy statement should disclose specifically how the pandemic has impeded the company's ability to address shareholders' concerns, as well as the company's longer-term plan for addressing those concerns.

ISS' Equity Plan Scorecard (EPSC), Problematic Pay Practices, or Option Repricing Policies in Light of COVID-19

ISS does not plan to make any changes to these policies specifically related to the pandemic. However, for 2021, the passing score for the S&P 500 EPSC model will increase to 57 points, while the passing score for the Russell 3000 EPSC model will increase to 55 points. The passing score for the other EPSC models will remain at 53 points.

ISS' PPP policies, which generally flag problematic contractual provisions in executive agreements, will be consistent with prior years. Also, there are no changes for U.S. policies on option repricing programs, where the current case-by-case approach generally opposes repricings that occur within one year of a precipitous drop in a company's stock price.

Where to Find the FAQs

To access the ISS FAQs on its U.S. compensation policies and the COVID-19 pandemic, please see the following link.

Need Assistance?

Compensia has extensive experience in assisting companies in addressing the impact of the COVID-19 pandemic on their executive compensation programs. If you would like assistance in determining how ISS' Global Research Department will analyze certain issues related to your executive compensation program resulting from the pandemic, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jason Borrevik at 408.876.4035 or Mark A. Borges at 415.462.2995.

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