Davis Polk

ISS Releases Policy Application Guidance For COVID-19's Impact

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On Wednesday, April 8, 2020, Institutional Shareholder Services Inc. (ISS) issued **guidance** on voting policies of various corporate governance-related issues that are likely to be implicated by the coronavirus (COVID-19) pandemic during the 2020 proxy season. The guidance does not introduce any new formal policies. Rather, the guidance provides ISS's perspective on selected market developments and application of several of its existing **policies relevant to the U.S. markets**. Importantly, the guidance sheds some light on which company-specific and market-specific facts and circumstances are more likely to influence the proxy advisor's determinations during and following the pandemic.

EXECUTIVE SUMMARY

The guidance makes three points relevant to the U.S. markets that are particularly worth noting:

- With regard to poison pills, ISS recognizes that "[a] severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justification in most cases for adopting a pill of less than one year in duration … ." ISS emphasizes that boards should disclose a detailed rationale for the duration chosen and any decisions to delay or failure to seek shareholder approval for plan durations exceeding one year.
- ISS will generally continue to follow its benchmark policy frameworks to assess changes to compensation program performance measures and option repricings. While contemporaneous disclosure relating to a company's decision to modify its compensation program may not be required, ISS encourages boards to provide shareholders with disclosure now to afford greater insights into the board's rationale and circumstances at the time changes are made.
- With respect to share repurchases, ISS's policies generally recommend voting for the establishment of share repurchase authorities, provided certain conditions are met. However, ISS warns that actually conducting buybacks under these uncertain economic times and heightened public scrutiny of buybacks would invite ISS's future scrutiny regarding the board's ability to manage risk.

KEY TAKEAWAYS

While the guidance includes perspectives and information targeting both global and designated geographic markets, the key issues relevant to the U.S. markets are divided into three broad categories and summarized below: (1) **annual shareholder meetings**, including meeting postponements/use of electronic communications, virtual-only meetings, poison pills, director attendance and director and senior management changes due to the pandemic; (2) **compensation matters**, including changes to performance metrics, goals or targets and option repricings and (3) **capital structure and payouts**, including share repurchases (buybacks) and capital raising through share issuances and private placements.

I. Annual Shareholder Meetings

A. Meeting Postponements and Use of Electronic Communication. ISS recognizes that there have already been widespread postponements of annual shareholder meetings. In addition, with health and safety concerns abound and social distancing mandates, many companies are seeking alternatives to in-person meetings. Where applicable laws permit such alternatives, ISS will make a positive note when companies and boards utilize webcasts, conference calls and other electronic communication media to engage with shareholders and investors, even if the meetings require postponement.

B. Virtual Meetings. ISS does not have a U.S. policy regarding “virtual-only” meetings and does not plan to adopt one because of the pandemic. Nonetheless, ISS encourages boards that opt to hold “virtual-only” meetings to disclose clearly the rationale for the decision (i.e., it is related to COVID-19) and, as permitted by law, to strive to provide shareholders with a meaningful opportunity to participate as fully as possible, including the ability to pose questions to and engage with directors and senior management.

C. Poison Pills and Other Defensive Measures. ISS acknowledges that, “[a] severe stock price decline as a result of the COVID-19 pandemic is likely to be considered valid justification in most cases for adopting a pill of less than one year in duration … .” ISS will employ its existing case-by-case approach to short-term poison pills with a term of less than one year and generally consider (1) the disclosed rationale for the plan adoption, such as any immediate threats, and (2) other relevant factors, such as a commitment to put any future renewal of the pill to a shareholder vote. ISS will also review specific provisions (e.g., triggers, duration/term, “qualified offer” provisions, and waivers for passive investors). ISS emphasizes that boards should provide detailed disclosure regarding the duration chosen or on any decisions to delay or failure to seek shareholder approval for plan durations exceeding one year. Among other factors, ISS will evaluate the triggers within the context of the rationale provided and the duration of the plan adopted.

D. Attendance at Board and Committee Meetings. Under the current U.S. policy, ISS generally votes against or withholds from directors who attended less than 75% of the aggregate of their board and committee meetings unless an acceptable reason for the absences is disclosed. A negative recommendation may also be made if the proxy disclosure is unclear or insufficient for ISS to determine whether a director met the 75% threshold. Director nominees who served less than a year and seek reelection are generally exempt from the attendance policy.

While federal securities laws and many state corporation laws permit boards to meet by telephonic or electronic means, ill directors may be unable to participate in meetings. While ISS recognizes disclosure regarding a director’s health raises privacy considerations, disclosure regarding the absence should nonetheless be sufficient to allow shareholders and investors to make informed voting decisions.

E. Changes to the Board of Directors or Senior Management. ISS will use its existing case-by-case approach to evaluate the rationale for director and senior management changes. ISS recognizes that the pandemic may necessitate that a board fill vacant director positions to replace incapacitated or disabled directors or to “urgently add critical expertise.” ISS believes that “boards should have broad discretion during this crisis to ensure that they have the right team in place and [the proxy advisor] will adjust the application of [its] policies as appropriate for the exceptional circumstances of the current pandemic.” ISS believes that its existing methodologies allow sufficient flexibility with regard to policies on board composition, director independence, board diversity and potential overboarding and other attributes. ISS states that it also has flexible policies applicable to filling senior management positions, including having a board member temporarily fill a senior executive role.

II. Compensation

A. Change in Metrics / Shift in Goals or Targets. ISS expects to see many companies announce plans to materially change their performance metrics, goals or targets used in *short-term compensation plans* given the economic impact of the COVID-19 pandemic. Even though board decisions to make such adjustments to 2020 compensation programs would generally need to be disclosed to and considered by shareholders at next year’s annual shareholder meeting (i.e., the company’s 2021 meeting), ISS encourages companies to provide *contemporaneous* disclosure this year to provide shareholders with greater insight into the board’s rationale and circumstances at the time changes are made.

For *long-term compensation plans*, ISS will consider any midstream changes to long-term awards on a case-by-case basis to determine if directors exercised appropriate discretion and provided sufficient disclosure regarding the rationale for changes ISS notes, though, that its benchmark voting policies generally do not support changes to midstream awards covering multi-year periods. Structural changes to long-term plans to account for the new economic environment will continue to be assessed under ISS’s existing benchmark policy frameworks.

B. Option Repricing. ISS acknowledges that current circumstances may lead some companies to consider repricing, replacing, exchanging or canceling and re-granting underwater stock options (each, a “repricing action” as discussed below). If boards take repricing actions *without seeking shareholder approval or ratification*, ISS will continue to apply its benchmark policy board accountability provision. Under the **U.S. policy**, this means that ISS will generally recommend “against” or “withhold” votes against the compensation committee, and potentially the entire board, if the company conducts a repricing action without shareholder approval.

If boards *do seek shareholder approval or ratification* of repricing actions at their 2020 meetings, ISS will continue to apply its case-by-case policy approach for the applicable market. Under the **U.S. policy**, ISS will examine, among other factors, whether (i) the design is shareholder value neutral (i.e., a value-for-value exchange), (ii) surrendered options are not added back to the plan’s share reserve, (iii) replacement awards do not vest immediately and (iv) executive officers and directors are excluded. ISS will generally oppose a repricing that occurs within one year of a precipitous drop in the company's stock price.

In an upcoming client memorandum, we plan to discuss strategies for addressing underwater stock options in further detail.

III. Capital Structure and Payouts

A. Share Repurchases (Buybacks). During the pandemic, ISS will generally continue its existing policy of favorably recommending vote support for repurchase authorities in absence of regulatory restrictions or serious concerns related to the company. Moreover, the limits must be customary for the U.S. market. However, ISS warns companies that decide to conduct a share repurchase in the upcoming months that ISS will evaluate (presumably around the time of the next annual shareholder meeting in 2021) whether by authorizing the conduction of a buyback "the board[s] managed risks in a responsible fashion… ."

ISS observes that in the midst of the current pandemic "repurchases are anything but routine." Moreover, share repurchases have received heightened public scrutiny in the wake of financial market plunges caused by the pandemic. ISS warns that boards that undertake repurchases may attract intense criticism and reputational damage, which may be further exacerbated at companies where a workforce reduction or downsizing has occurred. Although ISS understands that boards may be tempted to establish repurchase authorities to provide future flexibility, ISS believes directors should carefully consider the potential reputational, regulatory and business risks before moving ahead, even with shareholder approval.

Companies that receive a direct loan under the CARES Act and certain other borrowers may be limited in their ability to do a buyback.

B. Capital Raisings. ISS's current benchmark voting policies provide for case-by-case evaluations of proposals seeking "to increase authorized common or preferred stock, share issuances, private placements and other related proposals, subject only to any market-specific rules or guidance."

i. Share Issuances. ISS's existing policy framework will be applied to general authorization and share issuance requests, and adapted to account for any regulatory relaxations or new guidance as a result of the crisis. ISS's U.S. policies already consider company-specific factors that include the following:

- Disclosure in the proxy statement (or other disclosure documents) of the specific purpose for the proposed increase;
- The risks to shareholders of not approving the request;
- The size and potential dilutive impact of the request combined with any market-specific guidelines on limits and preemptive rights; and
- Whether the shares requested are blank check preferred shares that can be used for anti-takeover purposes.

In exceptional circumstances such as the current pandemic and based on clear and compelling justification shown by the board of a company's underlying need, ISS's existing policies may result in favorable voting recommendations for proposals that exceed any normal market-specific limits on size and potential dilution.

ii. Private Placements. ISS will continue to use a case-by-case approach with regard to private placement issuances, considering factors such as:

- The rationale for the private placement issuance;
- The potential dilution to existing shareholders;
- The discount/premium in the issuance price relative to the unaffected share price before the private placement announcement;
- Any conflicts of interest;

- Consideration of alternatives;
- The market’s reaction to the proposed private placement since announcement; and
- The existence of exceptional circumstances, such as (a) the company is expected to go out of business or file for bankruptcy protection if the private placement is not approved, or (b) the company’s auditor or management has indicated that the company has going-concern issues.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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