

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

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On October 15, 2020, ISS released a series of [preliminary FAQs](#) on its approach to analyzing pay decisions relating to the COVID-19 pandemic. These FAQs provide general guidance on how ISS Research may approach COVID-related pay decisions in the context of ISS' pay-for-performance qualitative evaluation. ISS makes clear that the responses to the FAQs should not be construed as a guarantee as to how ISS will consider any particular situation.

This post describes each topic covered by ISS' preliminary FAQs and summarizes ISS' related guidance. ISS typically releases its final FAQs in December of each year after it releases its updated benchmark voting policies, typically in November of each year.

The preliminary FAQs follow ISS' April 2020 [COVID-19 FAQs](#) (discussed in our [previous post](#)), both of which emphasize the importance of clear and adequate disclosure for companies that adjusted 2020 compensation.

Temporary Salary Reductions

ISS' view will depend on the total pay impact. Consider whether target incentive payout opportunities are also decreased.

Because base salaries tend to make up a small portion of total pay for executives, how much mitigating weight ISS will give to a temporary salary reduction depends on the extent of the decrease in total pay. A reduction will be considered more meaningful if target incentive payout opportunities are also decreased to reflect the reduced salary.

Changes to Bonus / Annual Incentive Programs

ISS may view some otherwise problematic changes as reasonable this year so long as the justification and rationale for the changes are clearly disclosed and the outcomes appear reasonable.

- Generally. Some companies may look to modify their annual incentive programs this year, including changes to metrics, performance targets and measurement periods. Others, particularly those companies significantly impacted by the pandemic, may suspend their annual programs and instead make one-time discretionary payments. While considered by ISS to be problematic under normal circumstances, ISS may view these actions (separately or in combination) as a reasonable response to the extraordinary circumstances of the current economic downturn; *provided* that companies clearly disclose their rationale and the resulting outcomes seem reasonable.
- What Companies Should Disclose. ISS will continue to evaluate incentive programs on a case-by-case basis as usual, but additional disclosure will be needed to evaluate annual program changes and/or discretionary awards. ISS' recommended disclosures include:
 - Specific challenges incurred due to the pandemic; how those challenges rendered the original program design obsolete or the original performance targets impossible to achieve; how the changes are not reflective of poor management performance;

- For mid-year changes, why this approach was taken (vs. the alternative approach of one-time discretionary awards) and how the actions further investors' interests;
 - For one-time discretionary awards, which should still be performance-based, the underlying performance criteria (generic descriptions such as "strong leadership during challenging times" will likely be insufficient);
 - How resulting payouts appropriately reflect executive and company annual performance; how the resulting payouts compare with what would have been paid under the original design (above-target payouts will be closely scrutinized); and
 - Any positive changes to next year's (2021) annual incentive program, if determined (such changes may carry mitigating weight in ISS' qualitative evaluation).
- Lowering Annual Incentive Targets below Prior Year Levels. Lower performance expectations due to external factors, such as pandemic-related operational impacts, may be a reasonable explanation for lowering a financial or operational target below the prior year's performance level. Still, companies should disclose how the board considered the corresponding payout opportunity (especially if payout opportunities are not reduced along with targets).

Changes to Equity / Long-Term Incentive Cycles in Progress

ISS will generally view changes to in-progress long-term incentive cycles negatively, but may view modest alterations to awards granted in the most recent year as reasonable.

- Generally. Changes to in-progress cycles (e.g., fiscal years 2018-2020 or fiscal years 2019-2021) will generally be viewed negatively, especially for companies with a quantitative pay-for-performance misalignment. This is consistent with investor feedback that long-term incentives should not be altered after the beginning of a cycle based on short-term market shock.
- Go-Forward Cycle Beginning 2020. More drastic changes, such as shifts to predominantly time-vesting or short-term measurement periods, will continue to be viewed negatively. However, more modest changes, such as shifts to relative or qualitative metrics, may be considered reasonable when there is unclear long-term financial forecasting. Companies should provide disclosure sufficient to allow investors to evaluate the compensation committee's actions and rationale.

COVID-Related Retention or Other One-Time Awards

Companies should not grant retention or other one-time awards as a replacement for forfeited performance-based compensation, but one-time awards may be appropriate if companies structure the awards properly and provide sufficient disclosure.

- Generally. Some companies may grant one-time awards, including executive retention awards, to address the unprecedented challenges of the COVID-19 pandemic. ISS' view of these awards will depend on the award structure and the quality of a company's disclosure.
 - Structure. Awards should be reasonable in size, isolated in practice and include shareholder-friendly safeguards to avoid windfalls, such as limitations on termination-related vesting. Vesting conditions should be long-term, strongly performance-based and clearly linked to the underlying concerns the award seeks to address.
 - Disclosure. Companies should disclose a clear rationale for any awards (including size and structure) and describe how the award furthers investors' interests. As in prior years, boilerplate language discussing "retention concerns" will not be sufficient.
- When Granted in the Context of a Forfeited Incentive. If one-time awards are granted in the year in which incentives are forfeited (or the following year), companies will need to explain their decision-making process and how the awards further investors' interests. Companies that indicate that one-time awards were granted, for example, in consideration of forfeited incentives, for fairness considerations or due to lowered realizable pay should also explain how these awards do not simply shield executives from lower pay.

ISS Responsiveness Policy for Say-on-Pay

ISS' responsiveness policy relating to Say-on-Pay recommendations will generally stay the same, but ISS will consider company disclosure of the ways in which the pandemic may have impeded a company's ability to address shareholder concerns.

- Background. ISS' responsiveness policy (described in ISS' current [U.S. Proxy Voting Guidelines](#)) reviews three factors when a company receives less than 70% Say-on-Pay support: (1) disclosure of board's shareholder engagement, (2) disclosure of feedback from dissenting investors and (3) actions or changes made to address investors' concerns.
- COVID-Related Changes. ISS has not introduced any policy modifications for the first or second factors described above. However, if a company is unable to implement changes or delays changes intended to address investors' concerns due to the pandemic, the company should disclose specifically how the pandemic has impeded the company's ability to address shareholders' concerns. If program changes are delayed, or do not fully address shareholder feedback, the company should disclose a longer-term plan describing how it intends to address investors' concerns.

Equity Plan Scorecard (EPSC), Problematic Pay Practices and Option Repricing Policies

There will generally be no COVID-related changes to ISS' EPSC, problematic pay practices policies or option repricing policies.

- EPSC. ISS is not making any changes to the EPSC (described in ISS' current [U.S. Proxy Voting Guidelines](#) and current [U.S. Equity Compensation Plans FAQs](#)) specific to the pandemic, but the passing scores for the 2021 policy year will change. The passing scores for the S&P 500 and Russell 3000 EPSC models will increase to 57 and 55 points, respectively. All other EPSC models' passing scores will remain at 53 points.
- Problematic Pay Practices. ISS' problematic pay practices policies (described in ISS' current [U.S. Proxy Voting Guidelines](#) and current [U.S. Compensation Policies FAQs](#)), which generally identify problematic contractual provisions in executive agreements, will not change.
- Option Repricing. ISS' U.S. option repricing policies (described in ISS' current [U.S. Proxy Voting Guidelines](#), [U.S. Equity Compensation Plans FAQs](#) and [U.S. Compensation Policies FAQs](#)) will not change. These policies take a case-by-case approach, but generally oppose repricings that occur within one year of a precipitous drop in stock price. If boards undertake repricings without seeking shareholder approval, the directors' actions will still be reviewed under ISS' U.S. policies on board accountability (described in ISS' current [U.S. Proxy Voting Guidelines](#)).

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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