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Meridian Client Update

ISS Updates Policy Guidance on COVID-19

Institutional Shareholder Services (ISS) recently issued updated guidance on the application of their proxy voting policies in light of the COVID-19 pandemic ("Updated Guidance"). The Updated Guidance provides insights into how ISS will assess 2020 pay decisions (and disclosed 2021 decisions) impacted by the COVID-19 pandemic and disclosed during the 2021 proxy season.

The Updated Guidance is more specific than ISS's initial COVID-19 guidance issued in April 2020 (see Meridian Client Update dated April 15, 2020). In its April 2020 guidance, ISS did not modify any of its proxy voting policies. At that time, ISS believed its proxy voting policies were sufficiently flexible for its analysts to appropriately take into account the current circumstances when formulating vote recommendations.

The Updated Guidance provides a framework from which ISS will take into consideration the impact of the pandemic on company operations when evaluating 2020 compensation decisions.

Key Takeaways

- Reductions in base salary that reduce total executive pay could mitigate other concerns regarding executive compensation, as base salaries represent a small proportion of total pay
- Changes to in-flight annual incentive programs (e.g., changes to metrics, targets, measurement periods, or discretionary payouts) may be viewed as "a reasonable response so long as the justifications and rationale are clearly disclosed, and the resulting outcomes appear reasonable"

  — Above-target payouts under changed programs will be closely scrutinized

  — Discretionary awards should be based on performance-based considerations
- Changes to in-flight long-term incentive awards (2018 or 2019 grants) generally will be viewed negatively, particularly for companies that exhibit a quantitative pay-for-performance misalignment
- Changes to recently approved performance grants (e.g., 2020 grants) or future awards that result in a significant shift to time-based equity or use of shorter measurement periods will be viewed negatively by ISS
- Changes to recently approved equity grants may be viewed as reasonable under certain circumstances (e.g., heavier weight on relative or qualitative metrics– assuming an appropriate rationale is provided)
- Grants of retention and one-time equity awards may be viewed as reasonable if such grants are "reasonable in magnitude and an isolated practice," contain strong performance-based vesting conditions, include limitations on termination-related vesting and are not granted as replacement for forfeited performance awards

Temporary Salary Reductions

ISS may view temporary salary reductions for executive officers (including the chief executive officer) that decrease total pay as a mitigating factor in the qualitative pay-for-performance assessment component of its Say on Pay evaluation. It is unclear how much weight ISS will give to this practice. However, ISS will consider such actions to be “more meaningful” if targeted incentive payout opportunities were decreased to reflect the reduced salary.

Changes to In-Flight Annual Incentive Programs

ISS expects that many companies will be making changes to in-flight annual incentive programs, such as suspension of programs, changes to metrics, targets or measurement periods, or discretionary payouts. In light of the extraordinary circumstances of the current economic downturn, ISS may view such actions to be **a reasonable response** as long as “the justifications and rationale are clearly disclosed, and the resulting outcomes appear reasonable.” However, ISS will closely scrutinize above-target payouts under changed programs.

Disclosure of Annual Incentive Program Changes

In order for investors (and ISS) to evaluate the need for changes to annual incentive programs, ISS encourages companies to disclose the following:

- Specific challenges incurred as a result of the pandemic and how those challenges impacted the original plan design/targets (i.e., how they rendered the original program design obsolete or the original performance targets impossible to achieve, and how the changes are not reflective of poor management performance);
- Why the specific change to the annual incentive program was taken (versus other alternatives) and how the change “furthered investors’ interests”;
- How payouts reflect both executive and company performance; and
- How payouts compare to what they would have been under original program design.

ISS notes that investors are likely to find generic rationales for discretionary awards (e.g., the need to reward "strong leadership during challenging times") to be insufficient.

ISS Evaluation of Performance Goal Rigor

As a component of its qualitative pay-for-performance analysis, ISS will evaluate the rigor of performance goals. Generally, ISS will view a company's annual incentive program to lack rigorous performance goals if the target level is lower than the prior year’s actual performance level. In light of the COVID-19 pandemic, ISS has relaxed this standard, but with important disclosure requirements.

Lowering of financial or operational targets under an annual incentive program below the prior year's performance levels may be reasonable if reflective of lower performance expectations due to external factors, such as the pandemic’s impact on a company’s operations. However, if a company lowers its performance targets, ISS expects a company to disclose how the board considered corresponding annual incentive payout opportunities, particularly if a company does not commensurately reduce payout opportunities.

Changes to 2021 Annual Incentive Programs

ISS encourages a company that makes changes to its annual incentive program for 2021 to voluntarily provide detailed disclosures of these changes in the 2021 proxy, which may carry mitigating weight in ISS's qualitative pay-for-performance analysis in 2021.

Changes to In-Flight Long-Term Incentive Programs

ISS will generally view negatively any changes to in-flight long-term incentive (LTI) awards (i.e., 2018 or 2019 grants), particularly for companies that exhibit a quantitative pay-for-performance misalignment. ISS believes that the long-term incentives should cover performance over multiple years and "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."

ISS may be less critical of modest changes to recently approved LTI awards (e.g., 2020 grants) or future awards. However, ISS would negatively view significant changes to an LTI program, such as shifts to predominantly time-vesting equity or short-term measurement periods. ISS expects a company's proxy disclosure to explain the nature and rationale for changes to the LTI program.

Retention and One-Time Awards

ISS recognizes that some companies may grant retention or one-time awards to address concerns arising from the pandemic. To the extent provided, ISS believes that retention and one-time awards should have the following characteristics:

- Be "reasonable in magnitude and an isolated practice";
- Contain vesting conditions that are "strongly performance-based and clearly linked to the underlying concerns the award aims to address"; and
- Contain "shareholder-friendly guardrails to avoid windfall scenarios," including limitations on termination-related vesting.

Replacement Awards

ISS believes that retention and one-time awards should not be granted as a replacement for forfeited performance-based awards. If a company grants one-time awards in the year (or the following year) in which incentives are forfeited, ISS would expect a company to disclose (1) the rationale for the awards (e.g., fairness, lowered realizable pay), (2) how the awards further investors' interests, and (3) how the awards do not insulate executives from lower pay.

Compensation Committee Responsiveness to Prior Year's Say on Pay Vote

Under current ISS policy, if a company's Say on Pay proposal receives less than 70% support, ISS will evaluate the compensation committee's responsiveness to shareholder opposition at the next annual meeting. In its evaluation of a compensation committee's responsiveness, ISS will primarily take into consideration the following factors: (1) the disclosure of the company's shareholder engagement efforts, (2) the disclosure of the specific feedback received from investors on concerns that led them to vote against the proposal, and (3) any actions or changes made to pay programs and practices to address investors' concerns. If ISS finds that a compensation committee's responsive was insufficient, ISS may recommend shareholders vote AGAINST (or WITHHOLD from) the members of the compensation committee (or potentially the full Board).

ISS standard for evaluating the first two factors will remain consistent with prior years. With respect to the third factor (changes to pay programs), if a company is unable to implement changes due to the pandemic, the company's proxy statement should disclose how the pandemic has impeded its ability to address shareholders' concerns. If a company changes or delays pay program changes, or does not fully address shareholder feedback, the company should disclose a longer-term plan on how it intends to address investors' concerns.

Equity Plan Scorecard Evaluation

ISS will determine its vote recommendation on an equity plan proposal based on the outcome of the following three-tiered analysis (referred to as the "Equity Plan Scorecard" or "EPSC" model): (i) plan cost, (ii) plan features, and (iii) company grant practices. The analysis will yield a specific point score up to a maximum score of 100. Generally, ISS will issue a positive vote recommendation on an equity plan proposal if a company's point score equals or exceeds a threshold score. For annual meetings held on or after February 1, 2021, the threshold score for a positive vote recommendation will increase from 55 points to 57 points for S&P 500 companies and from 53 points to 55 points for Russell 3000 companies.

Meridian Comment. The Updated Guidance represents an improvement over ISS's initial and limited guidance issued earlier in April 2020. It provides public companies a fairly comprehensive view on how ISS will evaluate and consider pandemic-related changes in salary, annual incentives and long-term incentives. We expect ISS's reviews and commentary will be more in-depth in instances where their quantitative pay-for-performance tests indicate a high or medium concern or a significant pay-for-performance misalignment. In addition, the Updated Guidance alerts companies as to the necessity to make robust disclosures on any pandemic-related changes, a timely reminder with proxy season just around the corner.

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