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ISS Issues Final Policy Updates for 2022 and Updated FAQs on COVID-19 Related Pay Matters

On December 7, 2021, Institutional Shareholder Services (ISS) issued final policy updates on climate, gender and racial/ethnic board diversity topics. ISS also issued updated guidance on the application of their proxy voting policies in light of the COVID-19 pandemic.

ISS Policy Updates for 2022

ISS issued the following key policy updates for 2022 (unless otherwise indicated).

- **Burn Rate Methodology,** Beginning in 2023, ISS will evaluate a company's equity plan proposal under its existing policy, but will calculate the company's 3-year average burn rate under a new methodology. ISS will calculate a company's burn rate as follows:

$$\frac{\text{(\# of options granted} \times \text{Black-Scholes value) + (\# of full-value awards granted/vested}^{1} \times \text{stock price)}}{\text{Weighted-average common shares outstanding at fiscal year-end} \times \text{stock price}}$$

  ISS's 2022 policy update does not indicate what stock price should be used to calculate burn rate. We believe that ISS will ultimately decide to use the 200-day trailing average stock price as of December 1 for annual meetings that occur between March 1 and May 31. In future policy updates, ISS will likely clarify the correct stock price to use in calculating burn rate.

  Currently, ISS calculates burn rate using a multiplier to full-value awards based on annual volatility. ISS states that the new methodology for calculating burn rate "will more accurately measure the value of recently granted equity awards using a methodology that more precisely measures the value of option grants."

[1] In calculating a company's three-year average burn rate, currently ISS counts share usage for full-value awards based on the type of award. For example, ISS includes in its calculation of burn rate the number of shares underlying time-based full-value awards *granted* in each of the most recent three fiscal years. For performance-based full-value awards, ISS includes in its calculation of burn rate the number of shares *vested/earned* in each of the most recent three fiscal years if the company discloses that information. However, if a company only discloses the number of performance-based full-value awards granted each year, then ISS will include that number to calculate a company's three-year average burn rate.

- **Board Gender Diversity**. ISS adopted a U.S. board gender diversity policy in 2019, which went into effect in February 2020, for companies in the Russell 3000 or S&P 1500 indices. ISS will generally recommend AGAINST the nominating committee chair (or other members of the committee on a case-by-case basis) if a company does not have any female directors serving on its board of directors, absent mitigating factors. This ISS policy will be extended to all companies covered under U.S. policy, which will become effective 2023.

- **Racial/Ethnic Board Diversity**. Last year, ISS adopted a U.S. board racial/ethnic diversity policy, which goes into effect for the 2022 proxy season, for companies in the Russell 3000 or S&P 1500 indices. ISS will generally recommend AGAINST the nominating committee chair (or other directors on a case-by-case basis) if a company does not have any apparent racial or ethnic minorities serving on its board of directors, absent mitigating factors. Mitigating factors include the presence of a racial and/or ethnic minority on the board at the preceding annual meeting and a firm commitment to appoint at least one racial and/or ethnic diverse member within a year.

- **Shareholder Proposals on Racial Equity Audits**. ISS has adopted a policy under which it will evaluate shareholder proposals on racial equity audits on a case-by-case approach. ISS will consider the following criteria to determine whether such an audit would likely be beneficial to shareholders:

  — The company's established internal process or framework for addressing racial inequity and discrimination;

  — Whether the company has issued a public statement related to their racial justice efforts in recent years, or has committed to internal policy review;

  — Whether the company has engaged with impacted communities, stakeholders and civil rights experts;

  — The company's track record in recent years of racial justice measures and outreach externally;

  — Whether the company has been the subject of recent controversy, litigation or regulatory actions related to racial inequity or discrimination; and

  — Whether the company's actions are aligned with market norms on civil rights, and racial or ethnic diversity.

- **Management Proposals on Climate Transition Actions Plans**. ISS has codified the framework developed over the last year for analyzing management proposals on management-offered climate transition plans. The policy provides the following non-exhaustive list of factors ISS will consider when analyzing such proposals:

  — The extent to which the company's climate related disclosures are in line with Task Force on Climate-related Financial Disclosures (TCFD) recommendations and meet other market standards;

  — Disclosure of its operational and supply chain greenhouse gas (GHG) emissions;

  — The completeness and rigor of the company's short-, medium- and long-term targets for reducing operational and supply chain GHG emissions;

  — Whether the company has sought and approved third-party approval that its targets are science-based;

  — Whether the company's climate data has received third-party assurance;

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— Whether the company has made a commitment to be “net zero” for operational and supply chain emissions by 2050;

— Whether the company discloses a commitment to report on the implementation of its plan in subsequent years;

— Disclosure of how the company’s lobbying activities and its capital expenditures align with company strategy;

— Whether there are specific industry decarbonization challenges; and

— The company’s related commitment, disclosure and performance compared to its industry peers.

- **Shareholder Proposals on Seeking Companies to Publish Climate Transition Action Plans**. Under the new policy updates, ISS will evaluate on a case-by-case basis shareholder proposals asking companies to publish a climate action plan and to put it to a regular shareholder vote. ISS claims that this will allow for consistency of assessment across markets. The policy provides the following non-exhaustive list of factors ISS will consider when analyzing such proposals:

— The completeness and rigor of the company’s climate-related disclosure;

— The company’s actual GHG emissions performance;

— Whether the company has been the subject of recent significant violations, fines, litigation or controversy related to its GHG emissions; and

— Whether the proposal’s request is unduly burdensome (scope or timeframe) or overly prescriptive.

- **Board Accountability on Climate**. The ISS policy updates for 2022 introduce a board accountability policy for assessing the world’s most significant GHG-emitting companies. The new policy is applicable to the 167 companies currently identified as the Climate Action 100+ Focus Group. Under this policy, ISS will recommend against incumbent directors – usually the appropriate committee chair in the first year – in cases where the company does not have both minimum criteria of disclosure as required under the TCFD and quantitative GHG emission reduction targets covering at least a significant portion of the company’s direct emissions.

ISS Updated Policy Guidance on COVID-19

ISS’s updated guidance provides insights into how ISS will assess 2021 pay decisions (and disclosed 2022 decisions) impacted by the COVID-19 pandemic and disclosed during the 2022 proxy season. The updated guidance is consistent with prior guidance (see Meridian Client Update dated November 5, 2020), except for the following changes:

- *Changes to In-flight Annual Incentive Program*s. ISS will negatively view: (i) any mid-year changes to annual incentive award metrics, performance targets and/or measurement periods; and (ii) annual incentive programs that heavily emphasize discretionary or subjective criteria. However, lowering performance targets (as compared to 2020) and/or making modest year-over-year increases in the weighting of subjective or discretionary factors may be viewed reasonable for companies that continued to incur severe economic impacts and uncertainties in 2021 as a result of the pandemic.

- *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: (i) the disclosure of the company's shareholder engagement efforts; (ii) the disclosure of the specific feedback received from investors on concerns that led them to vote against the proposal; and (iii) any actions or changes made to pay programs and practices to address investors' concerns.

  If ISS finds that a compensation committee's responsiveness was insufficient, ISS may recommend shareholders vote AGAINST (or WITHHOLD from) the members of the compensation committee (or potentially the full Board). With respect to the third factor, the responsiveness policy will return to its pre-pandemic application. Companies must demonstrate actions that address investors' feedback, including negative feedback related to one-time COVID-related pay decisions. In such a case, ISS notes that a responsive board could make a commitment not to repeat the action that shareholders viewed as problematic.

ISS policy on the following key matters related to COVID-related pay decisions is the same as prior guidance, which will remain in place for 2022:

- 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 long-term incentive awards (2019 or 2020 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., 2021 grants) 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 (e.g., heavier weight on relative or qualitative metrics or modest increases in the proportion of time-based equity), particularly for a company that continues to incur severe negative impacts from the pandemic, as long as an adequate 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.

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