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Meridian Client Update

ISS and Glass Lewis Issue Policy Updates for 2023

Institutional Shareholder Services (ISS) and Glass Lewis recently issued final policy updates on compensation, climate, gender board diversity and other governance matters. These policy updates will go into effect for the 2023 proxy season.

Summarized below are ISS and Glass Lewis policy updates.

ISS Policy Updates for 2023

ISS has revised its proxy voting policies for U.S.-listed companies in the following areas relating to executive compensation and corporate governance:

I. Egregious pay practices – *ISS codified its position that payment of severance to an executive in a voluntary termination or retirement is an "egregious" pay practice.*

II. Proposals on director and officer indemnification, liability protection and exculpation – *As Delaware law was amended concerning personal liability of officers, ISS updated the factors that it considers in evaluating proposals seeking to eliminate director and officer liability*.

III. Shareholder proposals on racial equity audits – *ISS revised the factors that it will consider in evaluating these proposals.*

IV. Shareholder proposals on use of ESG metrics in incentive plan – *ISS expanded and clarified its criteria in evaluating these proposals*.

V. Board accountability on climate – *ISS clarified its existing policy.*

The updates represent an incremental change to existing ISS policies, as well as the implementation of phased-in policies related to (i) its methodology for calculating a company's burn rate and (ii) board gender diversity. These policy updates are effective as of February 1, 2023.

I. Egregious Pay Practices

- **Current policy**. ISS will likely recommend **AGAINST** a company's Say on Pay proposal and/or compensation committee members if the company maintains any egregious pay practice. Egregious pay practices include the provision of extraordinary perquisites or tax gross-ups and a new or materially amended agreement that provide for excessive termination or change-in-control severance payments (generally exceeding 3 times base salary and bonus).

- **New policy**. Egregious pay practices now include the provision of severance benefits to an executive officer without involuntary job loss or a material diminution in duties under a new or materially amended agreement. In application, the new policy will also apply to the payment of severance benefits in the foregoing circumstances regardless of whether the underlying severance arrangements permits such payment. For example, ISS will consider the payment of severance benefits due to an executive's retirement or voluntary termination to be an egregious pay practice even when the underlying severance arrangement solely provides for the payment of severance benefits upon an involuntary termination of employment. This update codifies ISS's approach to evaluating severance payments received by an executive when the termination is not clearly disclosed as involuntary. ISS believes that severance benefits should be provided solely due to an executive's involuntary termination or constructive job loss.

ISS also clarified that the list of egregious pay practices in its policy documents is not intended to be exhaustive.

II. Proposals on Director and Officer Indemnification, Liability Protection and Exculpation

- **Current policy**. ISS will recommend a vote on a case-by-case basis on proposals on director and officer indemnification and liability protection. In its evaluation of such proposals, ISS will consider the extent to which the proposal would:

  — Eliminate director and officer ("D&O") liability for monetary damages for violating the duty of care.

  — Expand coverage beyond just legal expenses to liability for acts that are more serious violations of fiduciary obligation than mere carelessness.

  — Expand the scope of indemnification to provide for mandatory indemnification of company officials in connection with acts that previously the company was permitted to provide indemnification for, at the discretion of the company's board, but that previously the company was not required to indemnify.

- **New policy**. ISS will continue to recommend a vote on a case-by-case basis on proposals relating to D&O indemnification, liability protection or exculpation. However, beginning in 2023, ISS will consider another factor in evaluating such a proposal – namely, ***the extent to which the proposal eliminates directors' and officers' liability for monetary damages for violating the duty of loyalty***. In August 2022, Delaware amended its corporate law to permit a Delaware corporation to limit or eliminate the personal liability of certain officers for claims of breach of the fiduciary duty of care by amending its certificate of incorporation to include exculpatory provisions.

III. Shareholder Proposals on Racial Equity and/or Civil Rights Audits

- **Current policy**. ISS will recommend a vote on ***a case-by-case basis*** on shareholder proposals asking a company to conduct an independent racial equity and/or civil rights audit, taking into account certain enumerated factors.

- **New policy**. ISS will continue to evaluate shareholder proposals on racial equity and/or civil rights audits on ***a case-by-case basis*** taking into consideration four of five existing factors plus one new factor (which is indicated below):

  — Whether the company adequately discloses workforce diversity and inclusion metrics and goals (***new factor***);

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

— Whether the company has issued a public statement related to its 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; and

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

In evaluating such proposals, ISS will no longer consider whether a company's actions are aligned with market norms on civil rights, and racial or ethnic diversity (a factor considered under ISS's current policy).

IV. Shareholder Proposals on Use of ESG Metrics in Incentive Plans

- **Current policy**. ISS will recommend a vote on a ***case-by-case basis*** on shareholder proposals seeking to link, or report on linking, executive compensation to sustainability (environmental and social) criteria, considering certain enumerated factors.

- **New policy**. ISS will continue to recommend a vote on a ***case-by-case basis*** approach in this area taking into consideration three of five existing factors plus one new factor (which is indicated below):

— The degree to which the board or compensation committee already discloses information on whether it has considered related E&S criteria (***new factor***);

— The scope and prescriptive nature of the proposal;

— The company's current level of disclosure regarding its environmental and social performance and governance; and

— Whether the company has significant controversies or regulatory violations regarding social or environmental issues.

In evaluating such proposals, ISS will no longer consider the degree to which industry peers have incorporated similar non-financial performance criteria in their executive compensation practices (a factor considered under ISS's current policy).

In applying the foregoing policy, ISS will generally recommend **AGAINST** shareholder proposals seeking to set absolute levels on compensation or otherwise dictate the amount or form of compensation (such as types of compensation elements or metrics) to be used in incentive pay programs. ISS believes "[a] company's board or compensation committee is generally in the best position to determine the performance metrics, whether they are financial or ESG specific, [but also believes] that improved disclosure about the committee's rationale and considerations of pay metrics (including those for ESG topics) may benefit shareholders."

V. Board Accountability on Climate

- **Current policy**. In 2022, ISS adopted a board accountability policy for assessing the world's most significant GHG-emitting companies. The 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 Task Force on Climate-related Financial Disclosures ("TCFD") and quantitative GHG emission reduction targets covering at least a significant portion of the company's direct emissions.

- **Policy update**. In its 2023 policy updates, ISS clarifies that GHG emission reduction targets should cover a company's operations (Scope 1) and electricity use (Scope 2).

VI. Previously Announced Policy Changes Going Into Effect in 2023

The following previously announced ISS policies with multi-year phase-in periods are going into effect for the 2023 proxy season.

- **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 ISS's U.S. policy, which will become effective 2023.

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

$$\frac{(\text{\# of options granted} \times \text{Black-Scholes value}) + (\text{\# of full-value awards granted/vested}^{1} \times \text{stock price}^{2})}{\text{Weighted-average common shares outstanding at fiscal year-end} \times \text{stock price}^{2}}$$

  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 3-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 3 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 3-year average burn rate.

[2] The stock price used to calculate a company's burn rate will be the 200-day trailing average stock price as of the applicable quarterly date (e.g., December 1 for annual meetings that occur between March 1 and May 31).

Glass Lewis Policy Updates for 2023

Glass Lewis has updated its proxy voting policies for U.S.-listed companies with regard to the following topics:

I. Board diversity

II. Director accountability for risk oversight failures related to environmental and social issues

III. Director accountability for climate-related issues

IV. Director accountability for cyber risk oversight

V. Director overboarding

VI. Executive compensation matters

VII. Miscellaneous other matters

These policy updates are effective as of January 1, 2023.

Summarized below are the Glass Lewis policy updates on each of these topics.

I. Board Diversity

Glass Lewis has adopted the following new policies on board diversity.

- **Board Gender Diversity.** Under its current policy, Glass Lewis will generally recommend AGAINST (i) the chair of the nominating committee of a board that has fewer than two woman directors and (ii) the entire nominating committee of a board that has no women directors. In its 2023 policy update, Glass Lewis transitioned from a fixed-numerical approach to a percentage-based approach in evaluating the adequacy of a company's board gender diversity. Beginning in 2023, Glass Lewis will generally recommend AGAINST the chair of the nominating committee of a board that has less than 30% woman directors for Russell 3000 companies. For companies outside the Russell 3000, Glass Lewis is maintaining its current policyon board gender diversity.

- **Underrepresented Community Diversity**. In its 2023 policy update, Glass Lewis expanded its board diversity policy beyond gender diversity to include individuals from underrepresented communities. Beginning in 2023, Glass Lewis will generally recommend **AGAINST** the chair of the nominating committee of a board that does not have at least one director from an underrepresented community for Russell 1000 companies. Glass Lewis defines "underrepresented community" as an individual who self-identifies as Black, African American, North African, Middle Eastern, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaskan Native, or who self-identifies as gay, lesbian, bisexual, or transgender. For the purposes of this evaluation, Glass Lewis will rely solely on self-identified demographic information as disclosed in a company's proxy statement.

- **Exception to Board Diversity Policies**. Glass Lewis may refrain from recommending that shareholders vote **AGAINST** directors of any company that provides a sufficient rationale or plan to address the lack of diversity on the board, including a timeline to appoint additional female directors (generally by the next annual meeting).

- **State Laws on Board Diversity**. Under its current policy, Glass Lewis will assess whether a company has complied with applicable state laws on board diversity. In particular, Glass Lewis will recommend voting **AGAINST** directors serving on the nominating committee if a company fails to conform to mandatory board compensation requirements included in applicable state laws when they come into effect.

  Due to recent court rulings striking down California's mandatory board composition requirements, Glass Lewis will refrain from recommending **AGAINST** directors due to a company's noncompliance with these requirements during the time-period in which the laws are challenged in state court (the state of California is appealing the lower court's rulings).

- **Disclosure of board diversity and director skills**. Glass Lewis's current policy on disclosure of board diversity and director skills applies to S&P 500 companies.

  In 2023, Glass Lewis expanded this policy to cover both S&P 500 companies and Russell 1000 companies. As described below, Glass Lewis will evaluate the quality of a Russell 1000 company's disclosure on board diversity and director skills.

  — Glass Lewis will rate how a company's proxy statement presents: (i) the board's current percentage of racial/ethnic diversity, (ii) whether the board's definition of diversity explicitly includes gender and/or race/ethnicity, (iii) whether the board has adopted a policy requiring women and minorities to be included in the initial pool of candidates when selecting new director nominees and (iv) board skills disclosure. Such ratings will inform Glass Lewis's assessment of a company's overall governance and may be a contributing factor in its recommendations when Glass Lewis has identified additional board-related concerns.

  — Glass Lewis will generally recommend voting **AGAINST** the chair of the nominating and/or governance committee if a company does not provide any disclosure of individual or aggregate racial/ethnic minority board demographic information.

- **Stock exchange diversity disclosure requirements**. As previously announced last year, Glass Lewis will recommend voting **AGAINST** the chair of the governance committee of any company that does not disclose board diversity statistics prescribed under applicable stock exchange listing rules. The foregoing policy is applicable for Nasdaq-listed companies holding annual meetings held after August 8, 2022.

II. Director Accountability for Risk Oversight Failures Related to Environmental and Social Issues

Under its current policy, Glass Lewis will generally recommend **AGAINST** the governance committee chair of a S&P 500 company that fails to provide explicit disclosure regarding the board's role in overseeing E&S issues.

In 2023, Glass Lewis expanded this policy to cover both S&P 500 companies and Russell 1000 companies.

III. Director Accountability for Climate-Related Issues

Beginning in 2023, Glass Lewis may recommend **AGAINST** directors if a company provides insufficient disclosure regarding (i) climate issues in line with the TCFD requirements or (ii) the board's oversight responsibilities for climate-related issues. This policy is solely applicable to companies with material exposure to climate risk arising from their operations (including the companies identified as the Climate Action 100+ Focus Group).

IV. Director Accountability for Cyber Risk Oversight

Generally, Glass Lewis will not make voting recommendations on the basis of a company's disclosure and oversight related to cybersecurity risk. However, beginning in 2023, Glass Lewis may recommend **AGAINST** appropriate directors of a company that has provided insufficient disclosure or oversight over cyber-related issues when a company has faced a cyber-attack that caused significant harm to shareholders.

V. Director Overboarding

Under its current policy, Glass Lewis will generally recommend voting AGAINST any director who is overboarded. A director is considered to be overboarded under either of the following circumstances:

- A director serves as an executive officer of a public company and serves on more than a total of two public company boards, or
- A director serves on more than five public company boards.

Beginning in 2023, Glass Lewis will establish different overboarding thresholds for executive chairs of a public company and other executive officers of a public company. A director is considered to be overboarded under any of the following circumstances:

- A director serves as an executive officer (other than executive chair) of a public company and serves on more than a total of two public company boards,
- A director serves as an executive chair of a public company and serves on more a total of three public company boards, or
- A director serves on more than five public company boards.

VI. Executive Compensation Matters

Glass Lewis modified or clarified its policies on the following executive compensation policies.

- **Pay versus performance disclosure**. Glass Lewis clarified that a company's pay versus performance disclosure required under the SEC's rule adopted in August 2022 ***will not*** impact Glass Lewis's pay-for-performance model or letter grade. However, the disclosure may be considered on a qualitative basis in Glass Lewis's Say on Pay analysis.
- **Proportion of long-term incentive awards that are performance-based**. Under current Glass Lewis policy, Glass Lewis may recommend **AGAINST** a company's Say on Pay proposal if a company decreases its emphasis on performance-based long-term incentive awards.

  In its 2023 policy updates, Glass Lewis increased the minimum percentage of the long-term incentive awards that should be performance-based from **33% to 50%** to align with market trends. Glass Lewis will raise concerns in its analysis with executive pay programs if less than 50% of an executive's long-term incentive awards are subject to performance-based vesting conditions.

- **Mega-grants**. Under its current policy, Glass Lewis does not assess mega-grants when it issues vote recommendations on compensation committee members.

  Starting in 2023, Glass Lewis will generally recommend **AGAINST** the chair of the compensation committee if the company awards a mega-grant that is excessive in magnitude, lacks sufficient performance conditions and/or is excessively dilutive.

- **One-time awards**. Glass Lewis clarified that it expects a company to disclose how its compensation committee determined the value of a one-time award, the design of the award and the impact on regular compensation arrangements.

- **Mandatory clawback policies**. Under its current policy, Glass Lewis will raise concerns about a company's clawback policy if the policy only meets the requirements of Section 304 of the Sarbanes-Oxley Act.

  In its 2023 policy updates, Glass Lewis clarified that a company's disclosure that it will proactively comply with the SEC rule to adopt a mandatory clawback policy may mitigate Glass Lewis's concerns regarding the scope of the company's then-current clawback policy.

VII. Other Matters

Glass Lewis has adopted the following new policies on certain management and shareholder proposals.

- **Officer Exculpation**. Glass Lewis will evaluate management proposals to amend the certificate of incorporation to include an officer exculpation provision on a ***case-by-case basis***. Glass Lewis will generally recommend **AGAINST** a proposal to adopt an officer exculpation provision *if* the provision would eliminate monetary liability of officers for breaches of the duty of care, unless the company provides a compelling rationale and the provisions are reasonable.

- **Shareholder Proposals Seeking Shareholder Approval of Certain Severance Payments**. Under its current policy, Glass Lewis will generally recommend **FOR** proposals that would require a company to obtain shareholder approval of any severance payments that exceed 2.99 times an executive's base salary and bonus amount. Some shareholder proposals specify that the limitation on such payments should cover both cash payments and the cash value of outstanding equity awards that accelerate upon a termination. What is notable about this is the accelerated value of a senior executive's equity awards would typically exceed proposed limits.

  Several companies, such as General Electric and Verizon, have successfully opposed shareholder proposals seeking to limit severance payments by noting the company had already adopted a severance policy that limits cash severance payments.

  In its 2023 policy updates, Glass Lewis clarifies that it will recommend **AGAINST** such a shareholder proposal if a company has adopted a policy that requires shareholder approval for any *cash* severance payments exceeding 2.99 times the ***sum of an executive's salary and bonus (without regard to the value of accelerated equity awards)***.

- **Shareholder Proposals on Racial Equity/Civil Rights Audits**. Currently, Glass Lewis does not have a policy on shareholder proposals on racial equity and/or civil rights audits. Starting in 2023, Glass Lewis will generally recommend voting **FOR** shareholder proposals on racial equity and/or civil rights audits if the audit would help the company identify and mitigate potentially significant risks. In making such determination, Glass Lewis will assess the following factors: (i) the nature of the company's operations, (ii) the level of disclosure provided by the company and its peers on its internal and external stakeholder impacts and the steps it is taking to mitigate any attendant risks and (iii) any relevant controversies, fines or lawsuits.
- **Disclosure of Shareholder Proposal Proponents.** Currently, Glass Lewis does not have a policy regarding a company's disclosure of the proponent of a shareholder proposal. Beginning in 2023, Glass Lewis will generally recommend voting **AGAINST** the governance committee chair of a company that does not disclose in its proxy statement the identity of the proponent (or lead proponent if multiple proponents have submitted a proposal) of any shareholder proposals.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Governance and Regulatory Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.