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With 2021 soon drawing to a close, we observe a distinct uptick in activity at the SEC, as the regulatory efforts that began shortly after the Presidential Inauguration in January begin to bear fruit. One of the first significant regulatory actions that the SEC took in the realm of public disclosure and corporate governance was to reopen the comment period for the Dodd-Frank Act mandated compensation clawback rules, which have still not been adopted over a decade after Congress told the SEC to do so. The SEC first proposed implementing regulations back in 2015, but apparently did not have the time or the political will to push forward with the final rules until now.

On page 2, we analyze the SEC's recent action to reopen the comment period on the proposed compensation clawback rules which solicits general comments and seeks more specific responses to questions about the scope of the appropriate financial statement restatement trigger for clawbacks and the time period during which the three-year lookback period contemplated by the proposed rule should be measured. Acknowledging that the corporate world pretty much moved on with respect to clawback policies since the Dodd-Frank Act was enacted, the SEC also seeks additional data and analysis regarding various aspects of the proposed rules. With the very short comment period already closed, we can expect to see adoption of a final rules in the near future. Once the SEC adopts the final compensation clawback rules, it will still be necessary for the national securities exchanges to adopt their own listing standards and for the SEC to approve those listing standards, so actual changes to company clawback policies may still be fairly far out in the future.

It is that time of year when we turn our attention to the upcoming proxy season, and the proxy advisory firms ISS and Glass Lewis have recently published their updated voting guidelines for proxy proposals and director elections in 2022. Beginning on page 6, we review many of the key themes covered in those updates, which include changes to analyzing executive compensation programs (including changes to the proxy advisory firms' approach on changes prompted by the COVID-19 pandemic), climate change matters, board diversity and a variety of corporate governance issues. The updates to the proxy advisory firm guidelines are always a bellwether for issues that will be top-of-mind for investors during the upcoming proxy season.

In October 2021, the FASB issued some welcome guidance in the form of ASU No. 2021-07, which is intended to simplify the determination of the fair value of a private company stock option or other stock-settled award on the grant date or the date the award is modified. Beginning on page 14, we discuss the application of this new guidance by private companies.

Finally, the SEC Staff recently issued a new Staff Accounting Bulletin which makes an old topic new again – the issue of "spring-loaded" equity awards. Beginning on page 15, we delve into this blast from the past, which brings about memories of the options backdating scandal from back in the 2000s and the focus on questionable grant practices, such as "spring-loading" and "bullet-dodging." In the new guidance, the Staff indicates that when companies measure compensation actually paid to executives for the purposes of preparing their financial statements, they must consider the impact that any material nonpublic information will have upon release.

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SEC Reopens Comment Period for Compensation Clawback Rules

In October 2021, the SEC announced that it was reopening the comment period for the compensation clawback rules, which had originally been proposed back in July 2015. In the release reopening the comment period, the SEC asks some additional questions, focusing on issues raised by the first round of comments. The SEC provided an extraordinarily short comment period of 30 days, which ended on November 14, 2021, despite numerous pleas for an extension.

Background

Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 added a new Section 10D to the Exchange Act, "Recovery of Erroneously Awarded Compensation Policy." Section 10D directs the SEC to promulgate rules directing the national securities exchanges to prohibit the listing of any security of a company that does not develop and implement a compensation clawback policy. In July 2015, the SEC proposed compensation clawback rules as required by Section 10D, which sought to address the many ambiguities and open issues arising from the vague provisions of Section 954 (see the September-October 2015 issue of *The Corporate Executive* at page 5).

The SEC Reopens Comment Period

In the time since the compensation clawback rules were first proposed, the political winds have shifted back and forth at the SEC. There now appears to be a renewed focus on completing the rulemakings contemplated by Dodd-Frank Act, including the compensation clawback rules, as well as the rules regarding disclosure of pay versus performance and incentive compensation rules for certain financial institutions.

In the October 2021 reopening release, the SEC invited comment on all aspects of the 2015 proposal (see Release No. 33-10998 (October 14, 2021); however, the bulk of the release is devoted to specific issues on which the SEC requests comment. By reviewing these specific issues, one can begin to get an idea of how the SEC might be adding to or modifying the original proposal.

The reopening release acknowledges at the outset that the corporate world has moved on to develop its own best practices regarding clawbacks in the 11 years since enactment of the Dodd-Frank Act, observing that the number of publicly traded companies that adopted a compensation clawback policy was 982 in 2015, 1,321 in 2018 and 2,021 in 2020.

Definition of Accounting Restatement. Section 10D of the Exchange Act would require a company to clawback incentive-based compensation if it "is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws." In the 2015 proposal, the SEC defined an "accounting restatement" for this purpose as "the result of the process of revising previously issued financial statements to reflect the correction of one or more errors that are material to those financial statements." This definition would *not* require a recovery where a company is required to restate its previously issued financial statements in order to correct errors that were not material to those previously issued financial statements, but would result in a material misstatement if (i) the errors were left uncorrected in the current report or (ii) the error correction was recognized in the current period – in other words, what is often referred to as a "little 'r' restatement."

Since the 2015 proposal, the SEC notes that many have expressed concerns that companies may not be making appropriate materiality determinations when accounting errors are identified. Indeed, a trend has been observed toward so-called "revision restatements" or "little 'r' restatements" and away from "big 'R' restatements," where companies have to go back and amend prior SEC reports to correct errors. The SEC acknowledges that a little "r" restatement would allow a company to avoid the application of the clawback provisions that the SEC originally proposed back in 2015.

In the reopening release, the SEC reaffirms its previous guidance that a company's materiality evaluation of an identified unadjusted error should consider the effects of the identified unadjusted error on the applicable financial statements and related footnotes and evaluate quantitative and qualitative factors. However, the SEC also indicates that it is considering whether the term "an accounting restatement due to material noncompliance" should be interpreted to include all required restatements made to correct an error in previously issued financial statements.

This interpretation would include restatements required to correct errors that were *not* material to those previously issued financial statements, but would result in a material misstatement if (i) the errors were left uncorrected in the current report or (ii) the error correction was recognized in the current period. Under such an interpretation, those restatements, as well as restatements to correct errors that are material to the previously issued financial statements, would be considered "an accounting restatement due to material noncompliance" and therefore would result in a clawback recovery analysis.

The SEC also asks whether the new proposed definition or the interpretation set forth above would fail to capture any accounting restatements that are due to material noncompliance.

Finally, in connection with these issues, the SEC asks in the reopening release whether it should:

- Remove the definitions of "accounting restatement" and "material noncompliance," provided in the 2015 proposal and instead rely on existing guidance from the SEC Staff, the Financial Accounting Standards Board, and the International Financial Reporting Standards Foundation; and
- Add check boxes to the cover page of the Form 10-K that indicate separately (a) whether the previously issued financial statements included in the filing include an error correction, and (b) whether any such corrections are restatements that triggered a clawback analysis during the fiscal year, in order to provide greater transparency around restatements.

Defining the Three-Year Lookback Period. As noted above, for purposes of triggering the three-year lookback period, the 2015 proposal would have established the date on which a company is required to prepare an accounting restatement as the earlier of (a) the date the company's board of directors concludes, *or reasonably should have concluded*, that the company's previously issued financial statements contain a material error, or (b) the date a court, regulator or other legally authorized body directs the company to restate its previously issued financial statements to correct a material error. The SEC recognizes that, while clause (b) of the current test would occur on a date certain, the timing of clause (a) is fluid and, perhaps, prone to manipulation.

In response to the uncertainty of the timing of a clause (a) event, the SEC requests comment on two possible revisions. First, the SEC asks whether the clause would be made clearer by simply removing the "or reasonably should have concluded" language. Alternatively, the SEC asks whether it should revise clause (a) so that it reads as follows:

> (a) the date the company's board of directors concludes~~, or reasonably should have concluded,~~ that the company's previously issued financial statements require a restatement to correct an error that is material to the previously issued financial statements or that would result in a material misstatement if (1) the error was left uncorrected in the current report or (2) the error correction was recognized in the current period.

It is not clear that either revision would decisively clarify the measurement date of the beginning of the three-year lookback period, but perhaps commenters will offer further alternatives.

Considerations Related to Companies' Voluntary Adoption of Clawback Policies. As noted above, the reopening release acknowledges

"an observed increase in voluntary adoption of compensation clawback policies in recent years, together with accompanying disclosures about those policies." The SEC recognizes that this reality could impact the potential costs of any changes to the 2015 proposal. The SEC requests comments on a few of these practical matters.

First, given that so many companies already have policies that would satisfy, or easily could be modified to satisfy, the requirements of the 2015 proposal, the SEC asks for estimates or data that would allow it to refine its characterization of costs and benefits of the required clawback policies under the current state of company clawback policies and determine the costs and benefits to investors. The SEC also requests data regarding the characteristics of voluntarily adopted clawback policies (for example, clawback triggers, scope of covered persons, scope of compensation covered, among other characteristics), and data regarding compensation structures that are used by companies (for example, compensation instruments utilized, measures used to award/earn such compensation, among others). Finally, the SEC asks whether the voluntary adoption of clawback policies has resulted in a decrease of incentive-based compensation or an increase in compensation tied to non-financial performance by companies.

Second, the SEC acknowledges that companies already consider whether any misstatement of previously issued financial statements had the effect of increasing management's compensation as part of the materiality analysis relating to errors. And companies adjust future compensation amounts, even in situations where a full financial restatement is not required. In this regard, the SEC asks whether the materiality analyses already being conducted by companies could be leveraged in connection with determining the need for and the amount of any clawback, and whether requiring companies to count additional accounting restatements would affect how the companies conducts their evaluation. The SEC requests data or analysis that will assist it in evaluating the effects of including additional accounting restatements within the scope of the rule, in particular any data that may assist in quantifying the number of additional clawback analyses that would be triggered and the costs and benefits of revising the scope of the rule.

Third, the SEC asks for comments on whether it should apply the compensation clawback rules to payment of incentive-based compensation by listed registered management investment companies and/or business development companies.

Disclosure of the Methodology Used to Estimate the Effect of a Restatement on Stock Price. In the reopening release, the SEC acknowledges that one of the more challenging aspects of the clawback requirements may be calculating the "recoverable amount." According to the SEC, after an accounting restatement, a company would (i) first recalculate the applicable financial reporting measure and the amount of incentive-based compensation based on it, and then (ii) determine whether, based on that financial reporting measure as calculated relying on the original financial statements, the executive received a greater amount of incentive-based compensation than would have been received applying the recalculated financial reporting measure. In many cases, this calculation also may need to consider any discretion that the compensation committee had applied to reduce the amount originally received by an executive.

This calculation problem would be particularly acute for incentive-based compensation based on stock price or total shareholder return, where the amount of erroneously awarded compensation is not subject to mathematical recalculation directly from the information in the accounting restatement. The 2015 proposal did not explicitly require disclosure of how a company calculated the recoverable amount, but did require the company to maintain documentation of the determination of that reasonable estimate and provide such documentation to the relevant stock exchange.

In the reopening release, the SEC recognizes that there are a number of possible methods to reasonably estimate the effect of an accounting restatement on stock price with varying levels of complexity and a range of related costs. The SEC requests comment on whether investors would benefit from additional disclosures, including (i) the determination and methodology that a company used to estimate the effect of stock price or total shareholder return, and (ii) how a company calculated the recoverable amount, including its analysis of the amount of the executive's compensation that is recoverable under the rule, and/or the amount that is not subject to recovery.

Incentive Compensation for Financial Institutions. Another section of the Dodd-Frank Act for which the SEC has not yet promulgated final rules (and that likely would have mandated compensation clawback provisions, albeit only for large financial institutions) is Section 956, "Enhanced Disclosure and Reporting of Compensation Arrangements." Section 956 required "the appropriate Federal regulators" to prescribe regulations or guidelines to require each covered financial institution to disclose the structures of all incentive-based compensation arrangements they offer "sufficient to determine whether the compensation structure" — (A) provides an executive officer, employee, director, or principal shareholder of the covered financial institution with excessive compensation; or (B) could lead to material financial loss to the financial institution."

In February 2011, eight financial regulators combined to issue proposed rules under Section 956. These proposed rules languished after extensive pushback by commenters. Then, in April 2016, six of the original eight financial regulators combined to issue re-proposed rules.

The 2016 proposed rules provided examples of the deferral and clawback requirements that would apply (using the new definitions of "Awarded" and "Vested"). Under the proposed rules, the new mandatory deferral period for incentive-based compensation would have been between two and four years, depending on size of the financial institution and the type of compensation (*e.g.,* long-term incentive compensation or short-term incentive compensation). Executives' compensation amounts would be subject to clawback during the deferral period and, in some cases, beyond.

The 2016 proposed rules also led to extensive pushback by commenters; however, a modified version of these rules seemed headed for adoption until the results of the 2016 election.

By July 2017, the regulatory agendas of the SEC and other agencies had dropped references to work on the proposed or final rules under Section 956 of the Dodd-Frank Act. Indeed, executive compensation practitioners and financial industry experts believed that final rules were no longer necessary under Section 956, because, beginning in 2011, federal regulators had prescribed extensive rules and guidelines addressing the subject matter of Section 956, as required by the statute.

It was a surprise, therefore, when the SEC's Spring 2021 Unified Agenda indicated that the SEC was considering reproposing regulations and guidelines with respect Section 956. Stay tuned.

Whistleblower Update. Readers will recall that the Dodd-Frank Act also added Section 922, "Securities Whistleblower Incentives and Protection." In its fiscal year ending September 30, 2021, the SEC awarded $564 million in total to 108 individuals, including two awards that represent its largest ever. It also processed more claims than in any other year of the program, receiving a record 12,200-plus whistleblower tips. Although the SEC often has broken its prior year's record since launching the program in 2011, the latest results represent a significant acceleration in the pace and size of awards.

This is relevant to a discussion of compensation clawbacks because more whistleblowing has led to more SEC enforcement actions, which could lead to more financial statement restatements, which would then lead to more compensation clawbacks under policies adopted pursuant to the SEC's rules and the exchanges' listing requirements.

Conclusion. The final rules to be promulgated by the SEC – most likely sometime in 2022 –are of paramount interest to companies and executive compensation practitioners. Once the SEC's rules are adopted and effective and the national securities exchanges (*e.g.*, the NYSE and Nasdaq) adopt their listing standards in response to the SEC rules, it is likely that every listed public company will need to make some alterations to its compensation clawback policy (or adopt a clawback policy if none exists) to conform with the final rules and listing standards.

ISS and Glass Lewis Update Proxy Voting Guidelines

The major proxy advisory firms have published updates to their voting policies that will be applicable for the upcoming proxy season. These updates touch on several important areas and provide an indication of the areas that shareholders will focus on during the 2022 proxy season.

ISS recently released the updates to its benchmark proxy voting policies, which will generally be in effect for shareholder meetings on or after February 1, 2022. Overall, there is a focus on climate and board diversity matters in ISS's voting policies. ISS also updated its FAQs on compensation policies during the COVID-19 pandemic. Glass Lewis released its 2022 policy guidelines, which will generally be in effect beginning in 2022. Changes to Glass Lewis's policy guidelines include those involving board diversity, ESG and post-SPAC corporate governance. Glass Lewis also made some clarifying amendments to its existing policies, including a few relating to executive compensation.

Compensation-Related Updates

Linking Executive Pay to Environmental & Social Criteria. Glass Lewis clarified its existing approach on the use of environmental and social (or "E&S") metrics in incentive compensation programs for named executive officers.

While Glass Lewis "highlights the use of E&S metrics in [its] analysis of the advisory vote on executive compensation," Glass Lewis does not have an explicit policy on the inclusion of such E&S metrics or whether E&S metrics should be used in a company's incentive compensation programs. In other words, Glass Lewis leaves it up to the specific company and its compensation committee to decide whether, when and how to use E&S metrics. Glass Lewis notes that the inclusion of E&S metrics in compensation programs should be rooted in each company's unique circumstances.

Where E&S metrics are included in executive compensation, Glass Lewis expects robust disclosure on the rationale for "selecting the specific E&S metrics, the target-setting process and the corresponding payout opportunities," *i.e.*, the disclosure should help connect the dots between the E&S criteria and the company's larger ESG strategy. If a company is using quantitative targets, it should disclose these targets on an "ex-ante basis," or the board should disclose why it is unable to do so. For qualitative E&S metrics, a company should provide its shareholders with a thorough understanding of how these metrics will be, or were, assessed.

Short- and Long-Term Incentives. Glass Lewis clarified its guidance on short-term incentive awards to note that it will consider adjustments to GAAP financial results to assess whether the pay-for-performance element of the incentive award is effective. Glass Lewis wants clear disclosure addressing the basis for any adjustments to metrics or results relating to long-term incentive awards. A company should also explain its use of discretion and any significant changes to the performance plan structures.

Grants of Front-Loaded Awards. Glass Lewis clarified its guidance on front-loaded incentive awards, and will now factor in the impact of the overall size of front-loaded awards on shareholder dilution. However, it will continue to examine the quantum of the award on an annualized basis for the full vesting period of the award.

Burn Rate for Incentive Plans. ISS updated its three-year burn rate calculations for equity-based and other incentive plans, with the aim of making these calculations more accurate. For meetings held on or after February 1, 2023, ISS will use a new "value-adjusted burn rate" for stock plan evaluations. The value-adjusted burn rate benchmarks will be calculated as the greater of: (i) an industry-specific threshold based on three-year burn rates within the company's GICS group segmented by S&P 500, Russell 3000 index (less the S&P 500) and non-Russell 3000 index; and (ii) a *de minimis* threshold established separately for each of the S&P 500, the Russell 3000 index less the S&P 500, and the non-Russell 3000 index. Year-over-year burn-rate benchmark changes will be limited to a predetermined range above or below the prior year's burn-rate benchmark.

The formula for a value-adjusted burn rate is: (# of options * option's dollar value using a Black Scholes model) + (# of full-value awards * stock price)) / (Weighted average common shares * stock price).

Compensation Policies and the COVID-19 Pandemic. In October 2020, ISS published *U.S. Compensation Policies and the COVID-19 Pandemic Frequently Asked Questions* (see the September-October 2020 issue of *The Corporate Executive* at page 5). The ISS guidance was updated in December 2021 to provide general guidance on how the ISS may approach COVID-related pay decisions for the 2022 proxy season, particularly in the context of ISS' pay-for-performance qualitative evaluations. The guidance reflects feedback that ISS received from their 2021 roundtables and policy survey.

Consistent with the prior version of the FAQs, if ISS has an elevated level of concern from its quantitative screen, ISS will then take a more in-depth qualitative review of a company's pay programs and practices. ISS indicates that its "qualitative evaluation will take into consideration the impact on company operations that has resulted from the pandemic."

Salary Changes. While the FAQs continues to note that temporary salary reductions for executives would be more meaningful if it reduced targeted incentive payout opportunities, ISS noted this year that many companies' temporary base salary reductions were rescinded before fiscal 2021.

Changes to Bonus and Annual Incentive Programs. ISS recognizes that the "surprise element of the pandemic in early 2020 is generally no longer applicable." As a result, ISS is generally reverting to its pre-pandemic position of viewing any mid-year changes to metrics, performance targets and/or measurement periods, or programs that heavily use discretionary or subjective criteria, negatively. However, ISS keeps maintains some flexibility for companies that still bear severe economic impacts and uncertainties – "lower pre-set performance targets as compared to 2020 and/or modest year-over-year increase in the weighting of subjective/discretionary factors" may be considered a reasonable response.

Of course, if a company does forge ahead in changing its bonus/annual incentive program, ISS expects such company to clearly justify the necessity of the changes, including how pandemic-related challenges "rendered the original program design obsolete or the original targets impossible to achieve." The disclosure needs to also demonstrate how these changes do not reflect on management's performance.

If a company's COVID-related changes to its bonus/annual incentive programs led to a lowering of its financial or operational targets below the prior year's performance level, there should also be disclosure about the "board's rationale for the lowered target and how the board considered corresponding payout opportunities, especially if the payout opportunities itself aren't commensurately reduced."

Changes to Long-Term Incentive Programs. The updated ISS guidance generally remains consistent with the philosophy that long-term incentives are meant to cover performance over a longer period of time. It generally views any changes to in-progress long-term incentive programs as a result of the pandemic negatively, particularly for companies that seem to exhibit misalignment in their quantitative pay-for-performance elements. ISS express some flexibility for modest alterations to go-forward cycles (including awards granted for the cycle beginning in 2021), especially for companies that continue to incur severe negative impacts over a long period of time. ISS notes that "more drastic shifts, such as moving to short-term or predominantly time-vesting designs, would continue to be viewed negatively." As always with changes to short- and long-term incentive programs, companies should take care to disclose the rationale and justification behind these changes.

Forward-Looking Disclosure of Pay Program Changes. ISS notes, in several places within the FAQs, the prevailing expectation is that companies are more able to return to the traditional pre-pandemic incentive programs. With that context, for companies that made compensation program changes that would have normally been considered "concerning" from a pay-for-performance perspective, ISS will generally consider as a mitigating factor the clear and detailed forward-looking disclosure of a company's intention to return to a strongly performance-based incentive program. However, the significance given to this forward-looking disclosure will generally be dependent on the level of detail of the proxy disclosure, as well as the extent to which the disclosed changes are meaningfully positive.

Retention and One-Time Awards. ISS remains consistent in its position with COVID-19-related retention or other one-time awards: companies that do it should disclose not only the terms and rationale of the award (*i.e.*, magnitude and structure), but also how the award furthers investors' interests. Boilerplate reference to "retention concerns" continues not to be enough for ISS. Awards should also be reasonable in magnitude, vest over a long time period, and be strongly performance based; it should also truly be a one-time award – repeated use of these one-time awards will be problematic. The award should also build in shareholder-friendly guardrails to avoid giving executives a windfall scenario. Granting one-time awards to replace forfeited incentives and/or to guard executives from lower pay will be considered problematic.

Changes to the ISS Responsiveness Policy. If a company receives less than 70 percent support on its say-on-pay proposal, ISS reviews three factors under its responsiveness policy:

- The disclosure of the board's shareholder engagement efforts;
- The disclosure of the specific feedback received from dissenting investors; and
- Any actions or changes made to pay programs and practices to address investors' concerns.

ISS continues to remain consistent with its application of the first two factors, but ISS will revert back to its pre-pandemic application of the third factor. Under ISS's prior guidance, companies were generally able to disclose how the pandemic impeded their ability to address shareholder concerns if the companies were unable to address shareholder feedback due to the pandemic. Companies will now need to demonstrate actions that address investors' concerns. ISS notes that, for example, if a company received negative feedback from a one-time COVID-19-related pay decision, a board can make a commitment that the problematic action will not be repeated.

Changes to the EPSC, PPP, or Option Repricing Policies. There are no changes specifically related to the pandemic regarding the ISS Equity Plan Scorecard (EPSC), Problematic Pay Practices (PPP) or Option Repricing.

Board Diversity

Board Composition. As propelled by recent Nasdaq rule changes (see the July-August 2021 issue of *The Corporate Executive* at page 11) and growing investor expectations, ISS expanded the scope of its existing U.S. board gender diversity policy to generally vote against or withhold from the nominating committee chair or other relevant directors at *all* U.S. companies with no women on the board – in 2019, ISS had limited the scope of its policy to the Russell 3000 and S&P 1500 companies. There will be a one-year grace period ending February 1, 2023 for the companies outside of the Russell 3000 and S&P 1500 indices.

On racial and ethnic board diversity, ISS's policy had a one-year grace period, ending February 1, 2022, for Russell 3000 and S&P 1500 companies in the U.S. to have at least one racially/ethnically diverse director. With the grace period over, this policy will now go into effect in 2022, with ISS voting against the nominating committee chair of Russell 3000 and S&P 1500 boards with no ethnic/racial diversity. An exception will be made if there was ethnic/racial diversity on the board at the preceding annual meeting and the board firmly commits to appointing at least one ethnic/racially diverse member within a year. This policy has not been extended to all companies for the 2022 proxy season.

Glass Lewis has also expanded its policy on board gender diversity. Beginning in 2022, for companies within the Russell 3000 index, Glass Lewis will generally recommend voting against the nominating committee chair if the board has less than two "gender diverse" directors, or the entire nominating committee if there are no gender diverse directors. "Gender diverse" directors are defined as women and directors that identify with a gender other than male or female. Starting on January 1, 2023, Glass Lewis will generally flip to a percentage-based approach of at least 30 percent gender diversity for Russell 3000 companies. Under this policy, Glass Lewis will recommend voting against the nominating committee chair for companies not meeting this percentage threshold. For companies outside of the Russell 3000 index or for those companies with boards of six or fewer total directors, Glass Lewis will continue to require a minimum of one gender diverse director.

The Glass Lewis guidelines also address the impact of evolving state laws on board diversity. For state laws on gender diversity, Glass Lewis will recommend "in accordance with mandatory board composition requirements set forth in applicable state laws" once those laws go into effect. Note that Glass Lewis distinguishes between *mandatory* board composition state laws versus *non-binding* diversity state laws, or those that solely impose disclosure or reporting requirements – it will generally refrain from recommending against a director for the latter. Glass Lewis takes a similar approach for state laws on underrepresented community diversity and will recommend in line with state laws mandating composition requirements for underrepresented community diversity or other non-gender diversity measures once they come into effect.

Diversity Disclosure. Glass Lewis will be assessing the quality of the board diversity and skills disclosures in proxy statements. Beginning in 2022, Glass Lewis may recommend voting against the nominating and/or governance committee chair of S&P 500 companies having "particularly poor" disclosure – which means failing to provide any disclosure in each of these categories:

- The board's current percentage of racial/ethnic diversity;
- Whether the board's definition of diversity explicitly includes gender and/or race/ethnicity;
- 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
- The board's skills disclosure.

For annual meetings of applicable Nasdaq-listed companies held after August 8, 2022, Glass Lewis will recommend voting against the governance committee chair when the Nasdaq-required board diversity disclosure has not been provided. Beginning in 2023, if S&P 500 companies have not provided any disclosure of individual or aggregate racial/ethnic minority board demographic information, Glass Lewis will generally recommend voting against the nominating and/or governance committee chair.

Unequal Voting Rights

ISS first came out with a policy on unequal voting rights for newly public companies in 2015. ISS's stance then was to vote against or withhold from the entire board (except for new nominees) if, prior to or in connection with the IPO, the newly public companies adopted a multi-class, unequal voting structure without a "reasonable" sunset mechanism, which could not be more than seven years from the date of the IPO. With this 2015 policy, ISS would continue to vote against or withhold from incumbent directors in subsequent years unless the unequal voting structure was reversed or removed (although starting in 2022, companies can also put in a reasonable sunset mechanism to avoid a negative recommendation). Notably, companies who had their first shareholder meetings prior to 2015 were exempt from this ISS policy, and ISS is now rescinding that provision, so companies that were previously exempt will be subject to the policy in 2023.

Specifically, from February 1, 2023, ISS will generally vote against or withhold from the responsible directors at *all* U.S. companies with unequal voting rights, although new director nominees will continue to be considered on a case-by-case basis. Exceptions to this policy will generally be limited to newly public companies with a sunset provision of no more than seven years from the IPO date, companies with *de minimis* unequal voting rights, or companies that have sufficient protections for minority shareholders. As part of its 2022 updates, ISS also added companies that have engaged in a de-SPAC transaction as part of the "newly public company" category in its multi-class share/unequal voting rights policy.

Also starting in 2022, Glass Lewis will recommend voting against the governance committee chair at U.S. companies that have a multi-class structure and unequal voting rights without a reasonable sunset period (also generally 7 years or less).

Climate-Related Board Accountability Policy

There continues to be growing momentum with climate issues (see the May-June 2021 issue of *The Corporate Executive* at page 2). ISS will join the fray in 2022, focusing on "significant greenhouse gas emitting companies," which are defined as those on the current Climate Action 100+ Focus Group list (which list of 167 current companies you can find at climateaction100.org). For these specific companies, ISS will recommend voting against the re-election of the incumbent chair of the responsible committee (or other directors on a case-by-case basis) if ISS determines that the company has not been taking "minimum steps" in assessing and mitigating climate change risks.

There are two minimum steps that the companies must take: (i) making detailed climate-related risk disclosures (*e.g.*, by utilizing the TCFD framework); and (ii) setting appropriate quantitative greenhouse gas emissions reduction targets. ISS will consider any well-defined greenhouse reduction targets, and will *not* require Scope 3 greenhouse gas targets, but the targets should cover at least a significant portion of the company's direct emissions.

Environmental & Social Risk Oversight. Beginning in 2022, Glass Lewis will "note as a concern" if Russell 1000 companies' boards do not provide clear disclosure concerning board-level oversight of environmental and/or social issues. Beginning in 2022, Glass Lewis will generally recommend voting against an S&P 500 company's governance committee chair if this explicit board oversight disclosure is missing.

Say-on-Climate Proposals. As expected, ISS is adding new policy provisions for both shareholder and management "say-on-climate" proposals, which are proposals relating to climate transition plans and reports. Overall, ISS will be voting on a case-by-case basis, so readers should prepare for robust, clear disclosure that ties to the relevant ISS criteria discussed below.

For a management-offered climate transition plan proposal, ISS will assess the completeness and rigor of the climate plan to come to a voting recommendation. Key criteria in this ISS assessment include the following, which we've grouped into four categories:

Quality of disclosures

- The extent to which the company's climate related disclosures are in line with TCFD recommendations and meet other market standards;
- Disclosure of the company's operational and supply chain GHG emissions (Scopes 1, 2, and 3);
- Disclosure of how the company's lobbying activities and its capital expenditures align with company strategy; and
- Whether there are specific industry decarbonization challenges;

Rigor of targets

- The completeness and rigor of company's short-, medium-, and long-term targets for reducing operational and supply chain GHG emissions in line with Paris Agreement goals (Scopes 1, 2, and 3 if relevant);

External, scientific validation

- Whether the company has sought and received third-party approval that its targets are science-based; and
- Whether the company's climate data has received third-party assurance;

Commitments

- Whether the company has made a commitment to be "net zero" for operational and supply chain emissions (Scopes 1, 2, and 3) by 2050;
- Whether the company discloses a commitment to report on the implementation of its plan in subsequent years; and
- The company's related commitment, disclosure, and performance compared to its industry peers.

ISS will similarly assess, on a case-by-case basis, shareholder proposals asking companies to publish their emissions report or to put their transition action plans to a vote. The key considerations in this assessment include:

- 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.

Glass Lewis is taking a slightly different approach on shareholder proposals. Glass Lewis clarified in its 2022 ESG guidelines that it will generally oppose say-on-climate shareholder proposals, given its dual concerns that a company's business strategy should sit with boards, and shareholders may be voting on these proposals based on potentially incomplete information. However, when evaluating these proposals, Glass Lewis will make note of and potentially consider:

- The request of the resolution;
- The company's existing climate governance framework, initiatives, and reporting;

- The company's industry and size; and
- The company's exposure to climate-related risks.

Management say-on-climate proposals will be evaluated on a case-by-case basis, similar to the approach taken by ISS. Glass Lewis's assessment will consider:

- The request of the resolution (*e.g.,* whether companies are asking shareholders to approve its disclosure or its strategy);
- The board's role in overseeing the climate strategy;
- The company's industry and size;
- Whether the company's greenhouse gas emission targets and disclosure of those targets appear reasonable in light of its operations and risk profile; and
- Where the company is on its climate reporting journey (*e.g.*, whether the company has been reporting and engaging with shareholders on climate risk for a number of years or if this is a relatively new initiative).

Since this is still a relatively new issue, Glass Lewis encourages shareholder engagement pre- and post-annual meeting.

Racial Equity/Civil Rights Audits. ISS has noted the rise of racial equity or civil rights audit and has introduced a new framework for its recommendations. ISS will vote case-by-case based on the following factors:

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

SPAC Governance. SPACs – which is the term used to refer to a "special purpose acquisition company," or a publicly traded company created for the sole purpose of entering into a business combination with an existing (usually private) company – have been a hot topic over the last few years. With no surprise, Glass Lewis sees the business combination stage of the SPAC process (also referred to as a "de-SPAC transaction") as a private company's "*de-facto* IPO." Glass Lewis is focusing on companies that went through a de-SPAC transaction within the past year, and the overly restrictive governance policies that they may have adopted prior to their *de-facto* IPOs.

In cases where Glass Lewis determines that the then-private company has adopted overly restrictive governing documents with a multi-class share structure and unequal voting rights or an anti-takeover provision, Glass Lewis will generally recommend voting against all members of the board who served at the time of the company becoming publicly traded if such board: (i) did not also submit these restrictive provisions to an advisory shareholder vote at the prior shareholder meeting approving the business combination; (ii) did not also commit to submitting these provisions to a shareholder vote at the company's first shareholder meeting following the company becoming publicly traded; or (iii) did not provide for a reasonable sunset of these provisions (generally three to five years in the case of a classified board or poison pill; or seven years or less in the case of a multi-class share structure).

Unlike operating companies' executives who have their hands full managing an entire business, SPAC executives are primarily involved in identifying acquisition targets for the SPAC. Glass Lewis recognizes this distinction and will only recommend voting against a director who serves as a SPAC executive only if he or she serves on more than five public company boards. ISS did not add a standalone policy for the governance of a company that has engaged in a de-SPAC transaction as part of its 2022 updates. However, ISS did add companies that have engaged in a de-SPAC transaction as part of the "newly public company" category in its multi-class share/unequal voting rights policy.

Capital Stock-Related Changes. ISS also updated its policy on proposals authorizing additional common or preferred stock – the two primary changes include (i) removing the specific dilution limits for companies in the bottom 10 percent of total shareholder returns in the US market, such that all companies have the same dilution limits and (ii) removing the three-year lookback period on capital usage to better capture problematic capital practices, including long-term, non-shareholder-approved poison pills.

Glass Lewis clarified its policy on authorizations/increases in preferred stock – Glass Lewis will generally recommend voting against such authorizations or increases unless a company "discloses a commitment to not use such shares as an anti-takeover defense or in a shareholder rights plan, or discloses a commitment to submit any shareholder rights plan to a shareholder vote prior to its adoption."

Other Glass Lewis Changes

Waiver of Age and Tenure Policies. Beginning in 2022, if a board waives its age/tenure limits for two or more consecutive years, Glass Lewis will generally recommend voting against the nominating and/or governance committee chair, unless the board provides a compelling rationale for continuing to waive its self-imposed age/tenure policies.

Voting Against Committee Chairs. Glass Lewis normally recommends against committee chairs for various issues, including pursuant to the diversity and E&S oversight disclosure policies discussed above. Beginning in 2022, in cases where a committee chair is not up for election due to a staggered board and where Glass Lewis identified multiple concerns, Glass Lewis will generally recommend voting against other members of the committee on a case-by-case basis.

Next Steps

While the governance and board diversity-related updates may not directly affect compensation committees, it is always useful to stay familiar with proxy advisor updates – especially as multiple board committees' responsibilities and duties may intersect for broader ESG topics. Two areas from the 2022 policy updates particularly stand out for compensation committees: climate and human capital oversight.

On the topic of climate, it is clear that the proxy advisory firms (and their clients) are pushing for more board oversight of climate-related risks as well as climate-related disclosures. The push for companies to set and disclose emissions reduction targets and track progress on related climate transition plans may serve as a stronger precursor for committees to tie these target metrics to executive compensation. As reflected in Glass Lewis's policies, the market expectations on tying E&S metrics to executive compensation are still flexible. Given that flexibility, compensation committees should be actively involved with board-level climate-related discussions and overall ESG strategy during this stage. Once a company's larger ESG strategies and targets come into focus, compensation committees will need to consider how those elements factor into executive compensation plan designs (if at all) – and in turn, how the chosen E&S metrics then reinforces and pushes forward the company's overall ESG narrative.

We have seen more compensation committees taking charge of human capital oversight. Human capital oversight includes a broad swath of subtopics, and racial equity/civil rights audits may fall into the purview of compensation committees. Given the recent guidance in Staff Legal Bulletin No. 14L (see the November-December 2021 issue of *The Corporate Counsel* at page 16) and the potential of having more E & S issues on the ballot, it will be helpful for management and compensation committees to review the 2022 ISS policy on racial equity/civil rights audit proposals to assess where the proxy advisory firms' voting recommendations might land on a potential proposal, and if any shareholder engagement targets need to be shifted to account for any vulnerabilities.

In terms of next steps for updates from the proxy advisory firms, ISS is expected to publish its fully updated voting guidelines by late December 2021. Note that ISS is also expected to announce changes to its climate policy and other specialty policies, as well as release its updated FAQs, in January 2022.

Accounting Rules Now Allow Private Companies to Use Section 409A Methodology

In October 2021, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2021-07, which amends Accounting Standards Codification (ASC) 718, *Compensation – Stock Compensation*. ASU 2021-07 is intended to simplify the determination of the fair value of a private company stock option or other stock-settled award on the grant date or date the award is modified.

"Practical Expedient"

ASU 2021-07 allows private companies to adopt what it calls a "practical expedient" to determine the current price input of stock-based awards issued to both employees and non-employees using the "reasonable application of a reasonable valuation method." The characteristics of the practical expedient are the same as those in Treasury Regulation Section 1.409A-1(b)(5)(iv)(B)(2) to describe the reasonable application of a reasonable valuation method for valuing company stock.

ASU 2021-07 lists the following characteristics of the reasonable application of a reasonable valuation method:

1. The date on which the valuation's reasonableness is evaluated is the measurement date.
2. The following factors should be considered in a reasonable valuation:
    a. The value of the tangible and intangible assets of the entity.
    b. The present value of the anticipated future cash flows of the entity.
    c. The market value of stock or equity interests in similar entities engaged in trades or businesses substantially similar to those engaged in by the entity for which stock is to be valued.
    d. Recent arm's-length transactions involving the sale or transfer of the stock or equity interests of the entity.
    e. Other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation is used for other purposes that have a material economic effect on the entity, its stockholders, or its creditors.
    f. The entity's consistent use of a valuation method to determine the value of its stock or assets for other purposes.
3. The scope of information to be considered in a reasonable valuation is all information material to the value of the entity.

4. The following criteria must be met for the use of a previously calculated value to be considered reasonable:
    a. The value is updated for any information available after the date of calculation that may materially affect the value of the entity.
    b. The value is calculated no more than 12 months earlier than the date for which the value is being used.

ASU 2021-07 states that a reasonable valuation performed in accordance with the Treasury Regulations under Section 409A of the Internal Revenue Code is an example of a way to achieve the practical expedient.

A variety of valuation methods could satisfy the "reasonable application of a reasonable valuation method" requirement. ASU 2021-07 states that an independent appraisal will often be the method used by nonpublic entities electing the practical expedient in this requirement because of (i) the presumption of reasonableness associated with that method for tax purposes and (ii) the requirements associated with, and limiting the availability of, other methods that achieve the presumption of reasonableness. However, other valuations, including internal valuations, could have the characteristics described in the practical expedient discussed in ASU 2021-07.

ASU 2021-07 observes that some private companies obtain separate external valuations to satisfy the requirements of both the accounting rules and Section 409A, and other companies use one formal valuation to serve multiple purposes. ASU 2021-07 concludes that obtaining a single valuation that satisfies both requirements using the practical expedient that it allows is an acceptable practice.

Cash-Settled or Liability-Classified Awards

Some stock-based awards, generally those that are settled in cash instead of stock, are classified as liability awards, because those awards may affect an entity's cash balance upon settlement. The practical expedient in ASU 2021-07 is not available for liability-classified awards. Additionally, liability-classified awards are required to be remeasured at the end of each reporting period (*i.e.,* each fiscal year quarter).

Effective Date

The practical expedient in ASU 2021-07 is available to companies prospectively for all qualifying awards granted or modified during fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. ASU 2021-07 allows early adoption, including application in an interim period, for financial statements that have not yet been issued or made available for issuance as of October 25, 2021.

Private companies that elect the practical expedient must do so on as to all stock-settled awards that have the same underlying stock and the same measurement date.

Conclusion

The practical expedient announced in ASU 2021-07 could be a godsend for many private companies making stock awards, as those companies have long ago established Section 409A-compliant procedures to value the company stock underlying their stock awards.

A Blast from the Past: The SEC Issues Guidance on "Spring-Loaded" Awards

In November 2021, the SEC Staff released Staff Accounting Bulletin No. 120, which provides guidance for companies on how to properly recognize and disclose compensation cost for "spring-loaded awards" made to executives. Spring-loaded awards are stock-based compensation arrangements where a company grants stock options or other awards shortly before it announces market-moving information, such as an earnings release with better-than-expected results or the disclosure of a significant transaction.

The SEC and many investors believe that any out-of-cycle awards – and particularly spring-loaded option awards – merit particular scrutiny. The topic originally emerged during the options backdating scandal way back in the 2000s, when a variety of equity award granting practices were drawn into the spotlight, including “spring loading” and “bullet dodging” (bullet dodging occurs when a company delays its option awards until after the release of information that it expects to cause a decrease in its stock price).

The accounting and valuation rules applicable to stock-based compensation awards are contained in ASC Topic 718, *Compensation—Stock Compensation* and a series of Staff Accounting Bulletins. SAB 120, prepared by the SEC’s Office of the Chief Accountant and the Division of Corporation Finance, adds interpretive guidance for public companies to consider when awarding stock options while in possession of material nonpublic information.

The Staff indicates in SAB 120 that, as companies measure compensation actually paid to executives, *they must consider the impact that the material nonpublic information will have upon release*. Specifically, SAB 120 provides additional guidance to companies estimating the fair value of stock-based payments regarding (i) the determination of the current price of the underlying stock, and (ii) the estimation of the expected volatility of the price of the underlying stock for the expected term, when the company is in possession of material nonpublic information.

Under SAB 120, the company and those responsible for financial reporting must evaluate any additional value conveyed to the recipients from the anticipated announcement of material nonpublic information when estimating and reporting (*e.g.,* in the Summary Compensation Table) the grant date fair value of stock awards. As stated in the press release announcing SAB 120, “companies should not grant spring-loaded awards under any mistaken belief that they do not have to reflect any of the additional value conveyed to the recipients from the anticipated announcement of material information when recognizing compensation cost for the awards.”

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- **MM, DL**

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