2023 Proxy Season Review: Part 2

Compensation and Current Developments

September 5, 2023

Say-on-Pay Voting:

- Public companies perform strongly, with overall support levels averaging 88% among the S&P 500 and 90% among the Russell 3000; after a significant increase in failed votes in prior years, failed votes decrease by approximately one third
- In the first year of pay versus performance disclosure, alignment of CEO pay with relative total shareholder return remains the most important quantitative factor underlying ISS negative recommendations
- Performance-based awards with non-rigorous performance goals or outdated performance metrics becomes most important qualitative factor underlying ISS negative recommendations; the three S&P 500 companies with failed votes in both 2022 and 2023 all received ISS criticism on this basis

Equity Compensation Plan Voting:

- Shareholder support for equity compensation plans decreases slightly (to 89% from 91%), with five failed votes among the Russell 3000 (vs. two in 2022)

Current Developments:

- Officer exculpation proposals aligned with the recently amended Delaware General Corporation Law go to a vote at 269 companies through H1 2023 and receive very high levels of shareholder support (average of 90% of votes cast)
- Over 200 companies in the S&P 500 adopt enhanced advance notice bylaws following the SEC's adoption of the universal proxy rules; litigation and shareholder proposals reacting to such bylaw updates have been generally unsuccessful
- Corresponding with shareholder focus on director qualification, the percentage with less than 90% support continues to increase and more directors fail to achieve majority support

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INTRODUCTION

Our annual proxy season review memo summarizes significant developments relating to the 2023 U.S. annual meeting proxy season. Our review comprises two parts. Part 1, which focuses on Rule 14a-8 shareholder proposals, was published on August 11, 2023 and is available here. This is Part 2, which covers compensation-related matters and current developments. We will also host our annual webinar on September 14th to discuss 2023 proxy season developments (register for the webinar here).

The data on say-on-pay negative recommendations derives from ISS and FactSet information and SEC disclosure summarizing the rationales with respect to the negative recommendations issued by ISS at annual meetings of Russell 3000 and S&P 500 companies through June 30, 2023. We estimate that around 90% of U.S. public companies held their 2023 annual meetings by that date. For a discussion of U.S. proxy contests and other shareholder activist campaigns, see our publication, dated December 13, 2022, entitled "2022 U.S. Shareholder Activism and Activist Settlement Agreements Review."

More generally, for a comprehensive discussion of U.S. public company governance, disclosure, and compensation, see the *Public Company Deskbook: Complying with Federal Governance and Disclosure Requirements* (Practising Law Institute) by our colleagues Marc Trevino and Benjamin Weiner, available at 1-800-260-4754 (1-212-824-5700 from outside the United States) or http://www.pli.edu.

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PART 2. COMPENSATION-RELATED MATTERS AND CURRENT DEVELOPMENTS

A. COMPANIES RECEIVE STRONG SUPPORT IN SAY-ON-PAY VOTING

Executive compensation was a key topic during companies' shareholder engagement in 2023. This was the first proxy season after the new pay versus performance rules became effective, and companies were required to provide additional disclosures in their proxy statements that highlight the alignment (or misalignment) between company performance and executive compensation.[1] Shareholders expressed their unwillingness to accept discretionary awards that they accepted at the height of the COVID-19 pandemic and sharpened their focus on executive compensation in light of economic turbulence. Several high profile companies announced significant reductions in compensation for their top executives, in some cases following news of company-wide lay-offs. Furthermore, although the majority of the S&P 500 already link executive compensation with some form of environmental, social and governance ("ESG") performance metric, shareholders also continued to engage with companies on the selection and weight of such metrics, as well as performance against such metrics (see Section G.2 of Part 1 of this memo).

However, neither the pay versus performance disclosures nor the robust engagement between companies and shareholders on compensation had a negative impact on say-on-pay voting results, which remained strong. The number of failed votes decreased by approximately one third compared to 2022 both among the S&P 500 (11 vs. 19 in 2022) and broader Russell 3000 (44 vs. 72 in 2022),[2] with 98% of proposals passing in both indices. The decrease in failed votes is especially significant considering the trend from 2018 to 2022, during which time the number of failed votes more than doubled among the S&P 500 and increased by close to 20% among the Russell 3000.

The following table summarizes say-on-pay voting results for full-year 2022 and through H1 2023.

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1 Under the new requirements, issuers must provide disclosure with respect to: (1) the principal executive officer's ("PEO") total and "actual" compensation, (2) the average of the non-PEO named executive officers' total and "actual" compensation, (3) the total shareholder returns of the issuer and its peers, (4) the issuer's net income, and (5) an issuer-selected measure representing the most important financial performance measure it uses to link "actual" compensation to company performance. Issuers must also disclose an unranked list of three to seven of the most important measures it uses to link "actual" compensation to company performance. For a more detailed discussion of the required pay versus performance disclosures, see our publication, dated September 1, 2022, entitled "SEC Adopts Pay-Versus-Performance Disclosure Rule".

2 Year-over-year comparison does not factor in changes in the composition of the indices or the fact that some companies do not conduct annual say-on-pay voting.

	Russell 3000		S&P 500	
	H1 2023	2022	H1 2023	2022
Percentage passed (majority support)	***98%***	***97%***	***98%***	***96%***
Percentage with >70% support	***93%***	***92%***	***93%***	***90%***
Percentage with ISS "Against" recommendations	***12%***	***14%***	***9%***	***12%***
Average support with ISS "For" recommendations	***94%***	***94%***	***92%***	***92%***
Average support with ISS "Against" recommendations	***68%***	***64%***	***60%***	***54%***

Average shareholder support remained unchanged at 88% among S&P 500 companies (consistent with 2022) and 90% among the broader Russell 3000 (compared to 89% in 2022). In addition, there continued to be significant year-over-year turnover in failed votes. Of the 17 S&P 500 companies with failing say-on-pay votes in 2022 and that had their 2023 votes in H1 2023, 14 achieved majority support in 2023 (compared to 14 out of 18 in 2022). This turnover suggests that companies (particularly those in the S&P 500) with failed votes are generally continuing to succeed in implementing changes that result in better say-on-pay outcomes in the subsequent year.

Only three of the 11 S&P 500 companies that failed say-on-pay in 2023 had failed votes in the prior year (compared to four out of 18 in 2022, as well as three additional companies that failed in 2022 and had support levels below 70% in the prior year).[3] All three companies in the S&P 500 with failing say-on-pay votes in both 2022 and 2023 were criticized by ISS for having non-rigorous performance standards for compensation, which may be indicative of the significance that shareholders attribute to this criteria.[4] Of the 72 companies in the Russell 3000 with failing say-on-pay votes in 2022 and that had their 2023 votes in H1 2023, 47 achieved majority support in 2023, and 38 had support levels over 70%. Of the 44 companies in the Russell 3000 that failed say-on-pay votes in 2023 to date, nine had failed votes in the prior year and six additional companies had support levels below 70% in the prior year (compared to 10 and 17 out of 72 in 2022, respectively).

As further discussed below, the focus areas in ISS's recommendations generally aligned with those highlighted in shareholder engagement.[5] The most significant factors underlying ISS's negative

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[3] If a company receives less than 70% shareholder support for its say-on-pay vote, ISS will conduct a qualitative review of the compensation committee's responsiveness to shareholder opposition at the next annual meeting, which could lead to negative recommendations against the members of the compensation committee.

[4] The three S&P 500 companies that failed their say-on-pay vote in both 2022 and 2023 were CME Group, ServiceNow and Netflix. In all cases, ISS cited some of the same concerns in both 2022 and 2023, suggesting that in subsequent years ISS will focus on areas of concerns previously cited.

[5] As noted in Section G of Part 1, a large number of shareholder engagements on compensation matters did not lead to a formal Rule 14a-8 proposal in H1 2023. A notable exception was the topic of severance arrangements, on which John Chevedden submitted 44 proposals in H1 2023 (averaging only 25% of votes cast) and which did not seem to be a focus area of ISS.

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recommendations were the alignment between CEO pay and shareholder return, as well as performance-based awards with non-rigorous performance goals or outdated performance metrics. ISS—whose negative recommendations continued to have a meaningful impact on say-on-pay voting results—is likely to remain focused on these elements in 2024 in light of the current economic uncertainty.

B. OVERALL ISS APPROACH ON SAY-ON-PAY EVALUATION[6]

When making a recommendation on a say-on-pay proposal, ISS uses a multipronged approach to assess executive compensation.[7] An analysis of ISS's 2023 negative recommendations for S&P 500 companies suggests that the most important criterion continues to be the pay-for-performance assessment, with 90% of the negative recommendation reports indicating high concern on this issue (vs. over three quarters in 2022). High concern with respect to compensation committee responsiveness was also sufficient to trigger a negative recommendation.

ISS will recommend a vote against a company's say-on-pay proposals if any of the following is true:

- there is a significant misalignment between CEO pay and company performance (pay-for-performance), as discussed in detail in Section C below;
- the company maintains significant problematic pay practices (for example, excessive change-in-control or severance packages, benchmarking compensation above peer medians, repricing or backdating of options, or excessive perquisites or tax gross-ups); or
- the board's communication with and responsiveness to shareholders are significantly poor.

ISS applies these standards by assigning companies a "high", "medium" or "low" level of concern for each of the five evaluation criteria listed in the following table, which shows the number of "high concerns" under each criterion for S&P 500 companies that received a negative say-on-pay recommendation from ISS during each of H1 2022 and H1 2023:[8]

[6] This section compares data on proposals for shareholder meetings held through H1 2022 and H1 2023.

[7] Glass Lewis's executive compensation assessment policy appears to be less formulaic than ISS's, though Glass Lewis publicly discloses fewer details on its policy than does ISS. Based on Glass Lewis's published information, it evaluates compensation based on five factors: overall compensation design and structure, implementation and effectiveness of compensation programs, disclosure of executive compensation policies and procedures, amounts paid to executives, and the link between pay and performance. In evaluating pay-for-performance, Glass Lewis looks at the compensation of the top five executive officers, not just the CEO. In addition, Glass Lewis looks at performance measures other than total shareholder return—it measures performance based on a variety of financial measures and industry-specific performance indicators.

[8] The numbers for the categories add up to more than the total because some companies received "high concern" in more than one category.

S&P 500 Companies with Negative ISS Recommendations	*H1 2023*	*H1 2022*
Total with negative recommendations	43	50
Number that had "high concern" on:		
• Pay-for-Performance	39	40
• Compensation Committee Communication and Responsiveness	10	12
• Severance/Change-in-Control Arrangements	2	5
• Non-Performance-Based Pay Elements	2	3
• Peer Group Benchmarking	1	2

As the above table illustrates, although pay-for-performance is just one factor in the overall compensation assessment, it remains the main factor correlating to ISS's negative recommendation on the say-on-pay vote, as has been the case in recent years. Consistent with 2022, ISS also maintained its focus on compensation committee communication and responsiveness in 2023. This continued focus by ISS highlights the importance of engagement by public companies with their shareholders on matters relating to compensation.[9] Of the 10 companies that received both a negative recommendation and a high concern rating on compensation committee communication and responsiveness, two received a rating of low concern with respect to pay-for-performance (and another two received a low initial quantitative concern rating with respect to pay-for-performance). For three of these 10 companies, compensation committee communication and responsiveness was the only category in which the issuer received a high concern rating.[10]

Although severance was the main focus of compensation-related Rule 14a-8 proposals this proxy season (see Section G.1 of Part 1 of this memo), severance/change-in-control arrangements did not form a significant basis for negative ISS recommendations. ISS ascribed high concern to only two companies with negative recommendations on this basis in 2023 (vs. five in 2022 and eight in 2021).

C. ISS PAY-FOR-PERFORMANCE ANALYSIS

A more detailed discussion of ISS's pay-for-performance policies and how they were applied in 2023 follows.

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[9] ISS policies emphasize the importance of clear communication with shareholders on compensation issues, particularly for companies that receive low support for say-on-pay proposals. *See* ISS United States Compensation Policies Frequently Asked Questions (Dec. 16, 2022), *available at* https://www.issgovernance.com/file/policy/active/americas/US-Compensation-Policies-FAQ.pdf ("When a say-on-pay proposal receives less than 70% support of votes cast (for and against), ISS will conduct a qualitative review of the compensation committee's responsiveness . . . tak[ing] into consideration . . . disclosure of details on the breadth of engagement . . . [and] disclosure of specific feedback received from investors on concerns that led them to vote against the proposal").

[10] The three companies comprise Paycom, Philip Morris and Biogen. ISS narratives for Paycom and Biogen emphasized inadequate responses to low say-on-pay votes in prior years.

Since the 2012 proxy season, ISS's methodology for evaluating the pay-for-performance prong of its executive compensation assessment begins with a quantitative analysis of both relative and absolute alignment of pay-for-performance.[11] Even if a company receives a low concern rating through this quantitative pay-for-performance model, ISS will still review all of the company's Compensation Discussion and Analysis sections and incentive programs to highlight noteworthy issues to investors. Problematic incentive designs, such as multi-year guaranteed payments, discretionary pay components, inappropriate perquisites, or lack of rigorous goals are generally addressed in the qualitative analysis and may result in a high overall concern with respect to pay-for-performance despite a low initial quantitative concern level.[12]

1. Components of Quantitative Analysis

ISS's quantitative pay-for-performance screen uses four measures, which were slightly modified in January 2023:

- ***Relative Degree of Alignment, or RDA (relative alignment of CEO pay and total shareholder return over three years).*** The metric that is given the greatest weight in the quantitative assessment is the alignment of CEO pay and TSR,[13] relative to a comparison group of 12-24 companies selected by ISS on the basis of size, industry, market capitalization and other factors. To determine RDA, the company's percentile ranks are calculated for three-year average pay and for annualized three-year TSR performance. The RDA measure is equal to the difference between the ranks: the performance rank minus the pay rank. The threshold for receiving high concern is a difference of 60 percentile points or more. This metric continued to be the strongest predictor of ISS recommendations and of overall voting results. Of the 43 S&P 500 companies that received a negative ISS recommendation on say-on-pay, 15 received a "high concern" for RDA (compared to 28 out of 50 companies in 2022).
- ***Multiple of Median, or MOM (relative CEO pay to peer group median over one year).*** This metric considers pay independent of company performance. This metric is calculated by dividing the company's one-year CEO pay by the median pay for the comparison group. ISS's scoring system may trigger a "high concern" if this multiple is 3.00x or higher for S&P 500 companies (3.33x or higher for non-S&P 500 companies). ISS research reports also include a three-year MOM; the three-year MOM is not part of the quantitative screen methodology but may inform ISS's qualitative evaluation.
- ***Pay-TSR Alignment, or PTA (absolute alignment of CEO pay and TSR over five years).*** The third component measures alignment between the long-term trend in the CEO's pay and the company's shareholder returns. This does not depend on year-by-year sensitivity of CEO pay to changes in TSR, but instead compares the slopes of weighted linear regressions for

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[11] Technical information and guidance on ISS's say-on-pay methodology is available at https://www.issgovernance.com/file/policy/active/americas/Pay-for-Performance-Mechanics.pdf.

[12] *See* ISS Pay-for-Performance Mechanics: ISS' Quantitative and Qualitative Approach (Jan. 16, 2023), *available at* https://www.issgovernance.com/file/policy/active/americas/Pay-for-Performance-Mechanics.pdf.

[13] TSR measures how much an investment in the stock would have changed over the relevant period, assuming the reinvestment of dividends.

pay and for shareholder returns over a five-year period. A high concern may be triggered if the CEO pay trend slope exceeds the TSR trend slope by 45 percentage points or more.

- ***Financial Performance Assessment, or FPA (relative alignment of CEO pay and financial performance over three years).*** The FPA relative measure is applied as a secondary measure after the three primary screens above are calculated. It compares the percentile ranks of a company's CEO pay and financial performance across four Economic Value Added (EVA) metrics, relative to an ISS-derived comparison group, over the prior two-year or three-year period. The FPA requires a minimum two-year period of CEO pay and EVA data; if insufficient data exists for either metric, the FPA screen will be excluded. The FPA screen generally utilizes four equally weighted EVA-based metrics: (1) EVA margin; (2) EVA spread; (3) EVA momentum vs. sales; and (4) EVA momentum vs. capital.

The medium concern and high concern thresholds for non-S&P 500 companies are summarized below.

Primary Quantitative Measure	*Medium Concern Threshold*	*High Concern Threshold*
Relative Degree of Alignment	-50	-60
Multiple of Median	2.33x	3.33x
Pay-TSR Alignment	-30%	-45%

For S&P 500 companies, the MOM medium and high concern thresholds are slightly lower, likely due to greater investor scrutiny on CEO compensation among large-cap companies. The medium concern and high concern thresholds for S&P 500 companies are summarized below.

Primary Quantitative Measure	*Medium Concern Threshold*	*High Concern Threshold*
Relative Degree of Alignment	-50	-60
Multiple of Median	2.00x	3.00x
Pay-TSR Alignment	-30%	-45%

Based on the preceding, ISS will assign an initial quantitative score (ISS may deem multiple "medium concern" levels as the equivalent of an overall "high" quantitative concern). ISS then applies the FPA score as a potential modifier. The FPA could modify the initial score (a) if a company has a "medium concern", (b) if a company has a "low concern" that borders on a "medium concern" threshold under one of the three primary measures, and (c) for meetings after February 1, 2023, if a company has only one individual elevated concern ("medium" or "high") under the three primary measures (e.g., certain "medium concern" companies with poor FPA performance may become "high concerns").[14]

2. 2023 Results of ISS Quantitative Analysis

So far this year, nine companies out of the 43 that received a negative recommendation on their say-on-pay proposals did so despite attracting only "low" overall concern on the quantitative screen (vs. 13 out of 50 in 2022 and 19 out of 45 in 2021). Only two of these companies received a negative recommendation

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[14] *See* ISS Pay-for-Performance Mechanics: ISS' Quantitative and Qualitative Approach (Jan. 16, 2023), *available at* https://www.issgovernance.com/file/policy/active/americas/Pay-for-Performance-Mechanics.pdf.

despite attracting "low" overall concern on both the quantitative and qualitative screens (vs. six in 2022 and 14 in 2021). These results appear to suggest that, in issuing a negative recommendation against a company's say-on-pay proposal, ISS continues to place a greater emphasis on its quantitative factors. FPA seems to have had a slightly greater impact on ISS's analysis of the pay-for-performance concerns it identified in 2023 compared to prior years, impacting ISS's concern level with respect to five companies that were moved from "low" to "medium" concern (vs. three companies in 2022 and four in 2021) and two companies that were moved from "medium" to "high" concern under ISS's updated policy. Thirty-one of the companies that received a negative recommendation remained at the same level of concern as they were following the RDA, MOM, and PTA tests.

3. ISS Qualitative Analysis

Under ISS's policies, the qualitative review takes into account a range of factors, including:

- the ratio of performance- to time-based incentive awards;
- the overall ratio of performance-based compensation to fixed or discretionary pay;
- the transparency and clarity of disclosure;
- the complexity of the pay program;
- any risks associated with the pay program design;
- the emphasis of objective and transparent metrics;
- the rigor of performance goals;
- the application of compensation committee discretion;
- the magnitude of pay opportunities;
- the company's peer group benchmarking practices;
- financial/operational results, both absolute and relative to peers, including clear disclosure in the proxy of any adjustments made for incentive plan purposes;
- special circumstances such as CEO and executive turnovers or unusual grant practices (e.g., biannual awards, special one-time grants);
- recent pay program changes and/or any forward-looking commitments;
- realizable and realized pay compared to granted pay; and
- any other factors ISS deems to be relevant.

Based on our review of the narrative in the relevant ISS reports, performance-based awards with non-rigorous performance goals or outdated, previously-outperformed performance metrics became the most important qualitative factor underlying ISS negative recommendations this year. Out of the 43 S&P 500 companies with negative ISS recommendations, the number of companies that ISS criticized on the basis of this qualitative factor doubled year over year to 24 (vs. 12 of 50 in 2022). In 2023, the inclusion of limited, opaque, or undisclosed performance goals—the most important qualitative factors in prior years—also continued to have a significant impact on say-on-pay recommendations for S&P 500 companies.

This concern was discussed by ISS for 24 companies that received negative ISS recommendations (vs. 27 of 50 in 2022). The other concerns ISS identified generally fell into the following categories (with most companies receiving more than one of these concerns):

- ***The use of above-target payouts.*** ISS referenced the existence of payouts that exceeded the company's target for 20 of the 43 S&P 500 companies (vs. 21 of 50 in 2022). In many cases, ISS viewed these above-target payouts as suggestive of weak performance standards, or, at least, the need for the company to closely examine its performance standards.
- ***Large perquisites.*** ISS identified 19 of the 43 S&P 500 companies as providing excessive perquisites (vs. 17 of 50 in 2022). ISS specifically mentioned aircraft use in at least seven of these cases. Other frequently mentioned perquisites include security services and car services.
- ***The use of above-median peer group benchmarking practices.*** ISS identified 19 of the 43 S&P 500 companies as using above-median peer group benchmarking practices (vs. six of 50 in 2022). Specifically, ISS criticized the provision of compensation above the median level of the company's identified peer group and the selection of a peer group with a greater average revenue than the company.
- ***Sizeable compensation.*** ISS cited the broad provision of outsized compensation, including through large base salaries and one-time, special cash or equity awards, by 18 of the 43 S&P 500 companies (vs. 18 of 50 in 2022).
- ***The use of subjective criteria for determining compensation.*** ISS cited the use of subjective criteria for the determination of a bonus or the ability to use discretion to increase an executive's compensation as a negative factor for 16 of the 43 S&P 500 companies (vs. 16 of 50 in 2022). ISS generally viewed the use of discretion by companies as a means of excusing lackluster performance.
- ***The use of time-based incentive awards rather than performance-based incentive awards.*** ISS identified this concern at 13 of the 43 S&P 500 companies (vs. 12 of 50 companies in 2022). The failure by ISS to consider time-based vesting awards to be a robust measure of performance has been the subject of criticism because time-based equity awards can give holders a stake in the performance of the company and align the interests of executives with those of shareholders. However, awards granted subject to performance-based conditions are considered to be a matter of good governance.
- ***The use of retention or recruitment awards resulting in high CEO pay.*** ISS cited 12 of the 43 S&P 500 companies for providing large retention or recruitment awards that resulted in excessive compensation to their CEOs (vs. eight of 50 companies in 2022).
- ***Lack of board engagement, outreach or responsiveness regarding shareholders' compensation concerns.*** ISS referenced the lack of board engagement, outreach or responsiveness with respect to shareholders' compensation concerns from the prior year for 10 of the 43 S&P 500 companies (vs. 10 of 50 in 2022). In multiple cases, ISS noted that companies had adequately engaged with shareholders regarding their compensation concerns but declined to adjust executive compensation to reflect such concerns.

ISS has indicated that, while it will not consider the new pay versus performance disclosure in its quantitative screen, it will do so in the qualitative analysis. In particular, ISS has said that its research reports will display certain elements from the pay versus performance table, including the Summary Compensation Table total pay figure for the CEO, the Compensation Actually Paid value, the company's TSR, the peer group's TSR, the company's most important financial metric and the other disclosed

important metrics for determining CEO pay.[15] Interestingly, the new disclosures do not seem to have impacted ISS's analysis, since ISS did not specifically mention any compensation items highlighted in pay versus performance disclosures in its analysis for say-on-pay recommendations. ISS did note that three of the companies for which it provided negative recommendations failed to comply with the disclosure requirement, but this was not a factor in ISS's decision to make the negative recommendations.

D. SAY-ON-PAY FREQUENCY[16]

Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010, the SEC issued rules requiring companies to include in their 2011 proxy statements an advisory "say-on-frequency" vote to determine whether say-on-pay votes will occur every one, two or three years. Companies are required to hold say-on-frequency votes at least every six years, meaning that most companies held a second vote at their 2017 annual meeting and a third vote at their 2023 annual meeting.

Management exhibited an overwhelming preference for annual say-on-pay votes in 2023, recommending annual votes at 97% of the S&P 500 companies (vs. 94% in 2017). Of the 26 S&P 500 companies in 2017 that recommended triennial say-on-pay voting, only half maintained the same recommendation in 2023.[17] No S&P 500 companies recommended biannual votes in either 2017 or 2023.

	"SAY-ON-FREQUENCY" SHAREHOLDER VOTES IN THE S&P 500			
	1 Year		***3 Years***	
	H1 2023	***2017***	***H1 2023***	***2017***
Percentage with <50% support	3%	5%	98%	*96%*
Percentage with >90% support	96%	51%	1%	*1%*

Shareholders also strongly preferred annual say-on-pay voting. Most notably, and as the table above demonstrates, the number of S&P 500 companies where greater than 90% of shareholders voted in favor of annual say-on-pay votes increased from 51% in 2017 to 96% in 2023. As was the case in 2017, shareholders disfavored triennial voting.

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15 ISS United States Compensation Policies: Frequently Asked Questions (Dec. 16, 2022), *available at* https://www.issgovernance.com/file/policy/latest/americas/US-Compensation-Policies-FAQ.pdf.

16 This section compares data on proposals for shareholder meetings held through full-year 2017 and H1 2023.

17 The companies that recommended a triennial vote emphasized long-term performance. *See*, *e.g.*, Tyson Foods' definitive proxy statement filed on December 21, 2022.

E. EQUITY COMPENSATION PLAN VOTING[18]

	ADOPTION OR AMENDMENT OF OMNIBUS STOCK PLANS			
	Russell 3000		S&P 500	
	H1 2023	2022	H1 2023	2022
Number of proposals voted on	**564**	541	**82**	*83*
Percentage with ISS "against" recommendations	**29%**	26%	**10%**	*8%*
Average level of support with ISS "for" recommendations	**93%**	93%	**93%**	*94%*
Average level of support with ISS "against" recommendations	**74%**	79%	**70%**	*73%*
Number of failed proposals (<50% support)	**5**	2	**0**	*0*

U.S.-listed companies generally are required under stock exchange rules to obtain shareholder approval for the plans under which they award executive compensation to employees, directors or other service providers.[19] Because shareholders generally support the use of equity compensation by public companies as a means to align the interests of employees with those of investors, in most cases these proposals are uncontroversial and pass by a wide margin. The average support levels for these proposals are typically around 90%.

Since 2015, ISS has applied an "equity scorecard" approach to assessing equity plans. The scorecard method considers factors under three main categories:[20]

- ***Plan cost.*** Cost is calculated as the Shareholder Value Transfer relative to industry/market-cap peers; this measures the dilutive effect of the new shares requested as well as shares remaining for issuance under existing plans (often called "dilution" or "overhang"), and is calculated both with and without outstanding unvested awards.
- ***Plan features.*** Specifically, penalizing lack of minimum vesting periods, broad discretionary vesting authority, liberal share recycling, lack of specific disclosure regarding change-in-control provisions, and the ability to pay dividends prior to the vesting of the underlying award.
- ***Grant practices.*** Specifically, three-year "burn rate" relative to market and industry peers, among other factors.

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18 This section compares data on proposals for shareholder meetings held through full-year 2022 and H1 2023.

19 *See* Section 303A.08 of the NYSE Listed Company Manual; Nasdaq Stock Market Rule 5635.

20 ISS's current equity plan scorecard approach is described in its United States Equity Compensation Plans Frequently Asked Questions, *available at* https://www.issgovernance.com/file/policy/active/americas/US-Equity-Compensation-Plans-FAQ.pdf. For meetings prior to February 1, 2023, the passing score was 53 for all models except the S&P 500 model, which had a passing score of 57, and the Russell 3000 model, which had a passing score of 55. Effective for meetings as of February 1, 2023, the passing score is 55 for all models except the S&P 500 model, which has a passing score of 59, and the Russell 3000 model, which has a passing score of 57. Certain egregious equity plan features may result in a negative ISS recommendation, regardless of the "equity scorecard." These egregious features include, for example, "a liberal [change-of-control] definition that could result in vesting of awards by any trigger other than a full double trigger."

ISS recommended against approximately 29% of equity plan proposals in the case of Russell 3000 companies in 2023 (vs. 26% in 2022), but recommended against only 10% in the case of S&P 500 companies (vs. 8% in 2022). For many of these companies, ISS cited broad discretionary accelerated vesting authority, excessive plan cost, excessive burn rate and liberal share recycling among the reasons for its negative recommendation. Despite the negative recommendations, all of the proposals at S&P 500 companies (and all but five proposals at Russell 3000 companies) received majority support.[21]

Even though ISS recommendations did not seem to impact passing rates, they continued to have a fairly significant impact on voting results: in 2023, the average support level for equity plan proposals at S&P 500 companies was 93% when ISS recommended "for" approval and 70% when ISS recommended "against" (vs. 94% and 73% in 2022).

F. CURRENT DEVELOPMENTS

Officer Exculpation. The Delaware legislature amended Section 102(b)(7) of the Delaware General Corporation Law in August 2022 to allow corporations to exculpate (i.e., eliminate or limit the personal liability of) certain officers for monetary damages arising out of breaches of their fiduciary duties of care. (Before this change, Delaware only allowed exculpation of directors.) A valid exculpation provision under the amended Delaware law may only cover (1) the CEO, President, Chief Operating Officer, Chief Financial Officer, Chief Legal Officer, Controller, Treasurer and/or Chief Accounting Officer, (2) any "named executive officer" in the company's SEC filings and (3) anyone who consents in a written agreement with the company to being identified as an officer for purposes of accepting service of process. Similar to director exculpation, officer exculpation may not extend to actions involving breach of the duty of loyalty, acts in bad faith or involving intentional misconduct or a knowing violation of law, or transactions involving improper personal benefit. In addition, officers may not be exculpated from claims brought directly by the company or derivative suits brought by stockholders, which may be covered by director exculpation.

To provide for officer exculpation as permitted by the amended Section 102(b)(7), Delaware corporations would need to amend their charters to include specific language to that effect, which charter amendment must be approved by shareholders. For meetings through H1 2023, 269 U.S. public companies put an officer exculpation proposal to a vote, including 31 companies in the S&P 500. Out of these proposals, 84% met the applicable threshold for charter amendments under the company's organizational documents (typically a majority or supermajority of the company's outstanding shares).

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[21] According to ISS, proposals to adopt or amend omnibus stock plans failed to receive greater than 50% shareholder support at five Russell 3000 issuers: Compass Minerals (49.7%), United Natural Foods (49.2%), Utah Medical Products (42%), Aurinia Pharmaceuticals (44%) and GrowGeneration (27%). ISS recommended against the first three proposals.

ISS and Glass Lewis adopted policies regarding officer exculpation early in the proxy season. ISS's policy is to recommend on a "case-by-case" basis, although it has noted that exculpation arrangements "are likely to become commonplace with respect to officers, and the failure to provide indemnification and limited liability could potentially put a company at a disadvantage in recruiting or retaining executives." In contrast, Glass Lewis's policy is to generally recommend against officer exculpation proposals, unless the board can justify officer exculpation with a "compelling rationale" (e.g., concrete rather than hypothetical examples of challenges in recruiting or retaining executives) and the amendment is "reasonable". Consistent with their policies, Glass Lewis generally recommended against officer exculpation proposals this year while ISS recommended against only 19% of proposals.

Across the board, regardless of whether the proposal ultimately reached the charter amendement threshold or whether proxy advisors supported the proposal, officer exculpation proposals received high support among shareholders that voted, as shown in the table below. In each case where a proposal failed to pass under the applicable threshold for charter amendments, the determining factor was a low percentage of voted shares and a high volume of broker non-votes.

	VOTES CAST IN FAVOR OF OFFICER EXCULPATION PROPOSALS	
	Average	***Median***
Overall	90%	90%
Proposals passing amendment threshold	91%	91%
Proposals failing amendment threshold	84%	93%
Proposals with positive ISS recommendation	90%	90%
Proposals with negative ISS recommendation	90%	93%

In light of the voting results in the first proxy season following the effectiveness of Delaware's legislative change to permit officer exculpation, companies that have not adopted a corresponding charter amendment should explore the appropriateness and desirability of such amendment. Since charter amendments require the filing of a preliminary proxy statement, companies should consider this topic early in their proxy cycle in order to build extra time into their proxy timeline if they intend to adopt an officer exculpation charter amendment.

Advance Notice Bylaws. The SEC adopted the universal proxy rules on November 17, 2021, which, among other things, required the use of a "universal proxy card" by both the target company and the dissident shareholder(s) in director election contests beginning in September 2022.[22] Since the universal proxy rules took effect, over 200 companies in the S&P 500 have adopted enhanced advance notice bylaws (1) to reflect the new requirements and (2) in anticipation of a potential uptick in activism.

[22] For a more detailed discussion of universal proxy rules, see our publication, dated November 18, 2021, entitled "SEC Mandates Universal Proxy Cards in Contested Director Elections".

Specifically, these bylaw updates include provisions to increase corporate transparency—such as additional information requirements or requirements to complete a company's form of D&O questionnaires—that are intended to allow a company to obtain enough information from all director nominees to provide the board and shareholders with the benefit of a well-considered nomination process. Companies are also clarifying nomination procedures to avoid shareholder confusion, including reserving the white proxy card for the company and clarifying the board's ability to address deficiencies (e.g., failure to provide certifications required by the universal proxy rules or to update information required under the bylaws).

In response to companies' adoption of enhanced advance notice bylaws and the use of such bylaws to disqualify nominees, several shareholders have brought lawsuits in Delaware. The guidance from the Delaware court as to the validity of specific bylaws provisions has been somewhat limited, since many of these cases have been withdrawn after the company agreed to waive the disputed deficiency and allow the dissident nominee(s) to stand for election. Shareholders have also filed lawsuits to require companies to reopen their advance notice deadlines after the company experienced a "material change in circumstances" post-deadline, but these lawsuits have generally been unsuccessful.

In addition, 21 companies received so-called "fair elections" proposals demanding shareholder approval of any advance notice bylaw amendments that (1) require the nomination of candidates more than 90 days before the annual meeting, (2) impose new disclosure requirements for director nominees, including disclosures related to past and future plans or (3) require nominating shareholders to disclose limited partners or business associates, except to the extent such investors own more than 5% of the target company's shares. As further discussed in Section E.3 of Part 1 of this memo, these proposals failed to garner meaningful support from shareholders (average support of 14% of votes cast) or ISS (which recommended against all such proposals). However, proponents have indicated that they may continue to engage with companies on unilaterally adopted advance notice bylaws with provisions the proponents view as "inequitably restrict[ing] shareholders' right to nominate directors."

The recent lawsuits, proposals and related corporate governance commentary associated with advance notice bylaw amendments highlight that such amendments should be (1) made without any connection to any ongoing activist campaign (i.e., "on a clear day"), (2) consistent with the view of the Delaware courts that advance notice bylaws should not interfere with or frustrate shareholders' right to nominate or elect directors, and (3) appropriate in light of the company's shareholder base, requirements for its own nominees and other relevant circumstances.

Lower Support for Directors and Focus on Director Qualifications. Although shareholder support for director nominees remained high in uncontested elections (averaging 95% of votes cast among the S&P 500 vs. 96% in H1 2022, and 94% of votes cast among the Russell 3000 in both H1 2023 and H1 2022), a larger number of directors failed to receive a majority of votes cast (eight among the S&P 500 vs. five in

H1 2022, and 119 among the Russell 3000 vs. 89 in H1 2022). Similarly, the percentage of directors with less than 90% support continued to rise among the Russell 3000 (to 17% vs. 16% in H1 2022) but remained unchanged among the S&P 500 (9% in both H1 2023 and H1 2022). The director voting results may be correlated with a greater emphasis on director qualifications in light of the universal proxy rules and recent SEC rulemaking. For example, institutional investors such as State Street have indicated that they look to director qualifications as an indiciation of independent board decision-making, focusing on whether directors have "adequate skills to provide effective oversight of corporate strategy, operations, and risks, including environmental and social issues." Anecdotally, investors have also been focused on the disclosures in companies' skills matrices, especially where a company has had a recent controversy related to an area where one or more director was identified as an expert. As companies prepare for the upcoming proxy season, it will be important to demonstrate to shareholders that a company's board has the necessary range of skills and experiences to exercise effective oversight of material risks and opportunities in light of rapidly changing market conditions.

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