SHEARMAN & STERLING

2023 Proxy Season Quick Reference Guide

The 2023 proxy season is just around the corner. This quick reference guide, which is intended to supplement Shearman & Sterling's 20th Annual *Corporate Governance & Executive Compensation Survey*, summarizes themes from the 2022 proxy season and developing trends to consider for 2023. It also identifies possible future changes in disclosure rules that public companies should consider for the upcoming proxy season.

SHAREHOLDER PROPOSALS

The 2022 proxy season was marked by a significant increase in shareholder proposals that went to vote, with a record 941 proposals submitted and with a record 562 proposals proceeding to vote. The overall increase in submissions was primarily driven by the continued increase in ESG proposals.

Increasing emphasis on shareholder engagement and changes to the Securities and Exchange Commission (SEC) approach to allowing exclusion of proposals played a role in the larger number of proposals that went to vote, evidenced by 40% fewer successful no action letters seeking exclusion. This was the first proxy season following the issuance of SLB 14L, which repealed earlier staff guidance that had provided more opportunities to exclude ESG proposals and made the "micromanagement" test a potent tool for exclusion under 14a-8(i)(7). SLB 14L substantially limits the ability to rely on the ordinary business and economic relevance bases for exclusion if a significant social policy issue is implicated by a proposal. In addition, SLB 14L significantly scales back the micromanagement prong of the ordinary business exemption, making it more difficult to exclude proposals on that basis. Investor support for these proposals, however, was more muted than in the 2021 proxy season against a backdrop of economic turbulence and geopolitical instability in 2022. BlackRock, for example, highlighted the importance of maintaining flexibility for management to address climate related objectives given adverse market conditions and the need to focus on long-term shareholder value creation.

Looking ahead to the 2023 proxy season, companies should be mindful that while institutional investors were less supportive of the more prescriptive ESG shareholder proposals in 2022, there is still significant institutional support for enhanced reporting and transparency, which may lead to additional activism, especially if the SEC's climate change proposal is delayed or faces significant litigation headwinds. Also, ISS and Glass Lewis have both increased their standards for climate change accountability for the 2023 proxy season. It will be important for companies to monitor what shareholders and proxy advisory firms are signaling and emphasize engagement given the greater likelihood that ESG-related proposals will make it to a vote.

PAY VERSUS PERFORMANCE

On August 25, 2022, the SEC announced its adoption of the long-awaited "pay versus performance" rules under the Dodd-Frank Act. Codified in Item 402(v) of Regulation S-K of the Exchange Act, the new rules require covered listed companies to disclose the relationship between compensation paid to named executive officers and the company's financial performance pursuant to specific disclosure obligations that are first applicable this proxy season.

For large domestic filers with fiscal years ending on or after December 16, 2022, pay versus performance disclosure will be required in proxy statements filed in 2023.

The pay versus performance rules require three key elements of disclosure: (1) a new pay versus performance table providing comparative data eventually over a five-year period (three years in the first year of disclosure and four in the second year); (2) graphic or narrative descriptions of the relationship between "compensation actually paid" (CAP) and each of the performance measures disclosed in the table; and (3) a tabular list of three of the most important financial performance measures used to link CAP to company performance for the most recent year shown in the table and up to four additional performance measures (which can be non-financial) used to link CAP to company performance for the same year. This list need not be ranked, nor are results on these measures required to be disclosed.

The new table requires for each covered year (2022, 2021 and 2020 for this proxy season) disclosure of: CAP and total compensation as reported in the company's summary compensation table for the company's principal executive officer; average CAP and average total compensation for the company's other named executive officers; cumulative total shareholder returns (TSR); peer group cumulative TSR; net income; and a "company selected measure" (CSM) (which is the most important financial performance measure in the company's view used to link CAP to company performance). A key decision point for companies in preparing the table is selecting the CSM.

Calculating CAP requires adjusting total compensation as reported in the company's summary compensation table by modifying the pension and equity award values. This is a formulaic adjustment, but it may take substantial time to prepare and may also require the services of outside valuation consultants. Peer group cumulative TSR may be based on either the same peer group used by the company for purposes of the stock performance graph of Item 201(e) of Regulation S-K or a peer group disclosed in the company's Compensation Discussion & Analysis as used for setting compensation. Companies obligated to comply with new pay versus performance rules should plan accordingly by selecting the performance measures to be included in this new disclosure, putting in place a system for calculating CAP, briefing boards and management about the disclosure requirements and monitoring for additional SEC guidance.

UNIVERSAL PROXY

On August 31, 2022, the SEC rules mandating the use of a universal proxy card in contested director elections became effective. The new rule permits activists in contested director elections to include their nominees on the company's proxy card, rather than preparing and mailing their own proxy card. This allows stockholders voting in contested director elections to pick and choose among company and activist director nominees, rather than selecting one slate of directors or the other.

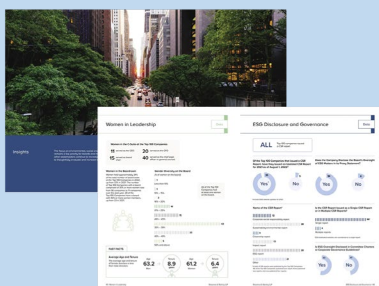
The new rules require parties seeking to take advantage of a universal proxy card to meet a number of related requirements, such as notice periods and minimum solicitation thresholds, which generally are aligned with existing practices or alternately would not be challenging to satisfy. ISS and Glass Lewis have hailed the universal proxy card for the greater flexibility it affords shareholders in picking nominees from both sides, but have stated that their overall approach to assessing proxy contests will stay the same. Thus, activists will still have to make strong arguments for change to win support.

We do not expect the existence of a universal proxy card to encourage experienced and well-funded activists to launch more campaigns, but it is possible that the significant reduction in cost to get dissident candidates on a ballot will shift the focus of proxy campaigns from competing slates of directors to competing candidates.

This can provide opportunities for new activists, like ESG-focused investors and groups, to consider putting a nominee on the board, or using the threat of it, as part of their engagement toolkit.

The new rules may also spur more contested elections, and the ability of stockholders to pick one or two dissident nominees while otherwise voting for incumbents arguably raises the likelihood of activists winning minority slates on boards. This change in focus may heighten attention on the qualifications of individual directors, as activist campaigns may seek to unseat incumbents they view as vulnerable.

To prepare, public companies should review their bylaws to ensure their advance notice bylaw requires comply with the requirements of the new rule. For example, companies should consider amendments to bylaws to reflect the notice and solicitation threshold requirements associated with use of the universal proxy card and require more information about the parties the shareholder is actually collaborating with in connection with the solicitation. It is important to implement these changes before an activist has taken the first steps toward a possible campaign. Finally, some companies, as part of a response to universal proxy, have implemented bylaw changes that impose significant requirements on any party seeking to nominate a candidate for election to the board. We have seen and we expect to continue to see negative stakeholder reactions to these types of bylaw changes.



Shearman & Sterling's 20th Annual *Corporate Governance & Executive Compensation Survey*

Please also see our 20th Annual *Corporate Governance & Executive Compensation Survey*, where we review the major themes from the 2022 proxy season and analyze the associated data to provide detailed insights for the coming proxy season. A copy is available here.

OFFICER EXCULPATION

As of August 1, 2022, Delaware General Corporation Law permits companies to limit or eliminate personal liability of corporate officers for claims of breach of fiduciary duty of care. Delaware has long allowed companies to exculpate directors from claims of breach of fiduciary duty of care, if permitted by the articles of incorporation. This amendment is seen as remedying this inconsistent approach to director and officer exculpation under Delaware law.

The officers covered by the new provision include the company's president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer, chief accounting officer, the company's most highly compensated executive officers identified in SEC filings and certain other officers who have consented to be identified as an officer and to service of process.

The new officer exculpation provisions come with important qualifications. Most fundamentally, companies may not exculpate officers for breaches of the duty of loyalty, acts not in good faith or that involve intentional misconduct, knowing violations of the law, or receipt of improper personal benefits. Further, liability for officers may be eliminated only in claims brought directly by stockholders, so officers remain liable to actions brought by or in the right of the corporation through, for example, derivative claims.

Adoption of officer exculpation provisions will require an amendment to a company's certificate of incorporation. Therefore, companies seeking to take advantage of the amendment will have to seek stockholder approval for the changes and must make a strong case to their stockholders.

Proxy advisory firms have struck a cautious tone in response to the amendment. Both ISS and Glass Lewis currently vote on a case-by-case basis on proposals to indemnify officers. ISS recommends against entirely eliminating monetary liability of directors and officers for duty of care violations, whereas Glass Lewis recommends against such indemnification as it applies to certain corporate officers. Although we recommend that companies consider implementing the necessary amendment to the articles of incorporation, we suggest discussing any potential changes with key institutional investors and monitoring market approach.

CLAWBACK RULE

On November 28, 2022, new Rule 10D-1 under the Exchange Act, the long-awaited Dodd-Frank Act clawback rule, was published in the Federal Register. The stock exchanges must issue listing rules enacting the provisions of the SEC rule by February 26, 2023, and those rules must become effective by November 28, 2023. While the exchanges have not yet released draft rules and new rules are not expected to be in effect for this proxy season, listed companies should socialize the SEC rule with their board and executives and begin to review their current clawback polices to identify any gaps between the company's current policy and the requirements of the final SEC rules.

The SEC's final clawback rules require all listed companies (including smaller reporting companies and foreign private issuers) to adopt a clawback policy subjecting incentive payments made to current and former executive officers to recoupment in the event the company is required to prepare an accounting restatement due to material noncompliance with securities laws. Specifically, if upon filing an accounting restatement (big "R" or little "r"), there has been any incentive award granted to executive officers within the previous three years based on financial information that is modified in the restatement, any incentive payment received beyond that which the executive would have received had the information been correct initially must be repaid to the company.

Importantly, if an incentive payment is based on performance against metrics that are later revealed to be inaccurate, the company has an obligation to recoup the payment even if the officer was not at fault for the restatement. Companies generally do not have discretion whether to obtain the payments from the executive or not—this rule creates an affirmative duty to recoup, subject only to limited exceptions. Failure to comply may lead to delisting from an exchange.

Companies will be required to disclose their clawback policy as an exhibit attached to their annual report and will be required to disclose any overpayments subject to recoupment along with the outstanding balance on each overpayment (meaning, any amount for which recoupment is required but the applicable executive officer has not yet returned the funds).

Links to Institutional Investors' Most Recently Published Proxy Voting Guidelines

- Amundi
- BlackRock
- Capital Group
- Cohen & Steers
- Fidelity
- Goldman Sachs
- J.P. Morgan
- Janus Henderson Investors
- State Street
- T. Rowe Price
- Vanguard
- Wellington

Proxy Drafting and Annual Meeting Housekeeping Checklist

- ✓ **Corporate Governance and Executive Compensation Highlights**. Consider how to frame the executive proxy and CD&A summaries in a manner that presents the key portions of the governance and compensation story in a compelling and visually appealing manner. Highlights may include good governance practices, recent governance changes, board and executive diversity metrics, workforce relations priorities and significant compensation actions.

- ✓ **Risk Management**. Consider whether the disclosures in the proxy statement related to the board's oversight of risk management reflect the key risks facing the company, including evaluations of compensation plans by the compensation committee and cyber and data security matters. Keep in mind that the SEC proposed rules on climate and cybersecurity disclosures have outlined new disclosure requirements related to board oversight over these risks. Board oversight of risk is an area of current focus for the SEC (*see* sidebar). In particular, the proposed climate disclosure rules are expected to include requirements to outline the board's oversight of the setting climate related targets and goals.

- ✓ **New Disclosures**. As highlighted above, there is now pay versus performance disclosure that needs to be included in proxy statements filed in 2023 (for companies with a fiscal year ending on or after December 16, 2022). Fast on its heels will be new disclosures pursuant to the 10b5-1 rules and disclosures related to clawbacks.

- ✓ **Electronic Filing of "Glossy" Annual Reports**. In 2022, the SEC amended its EDGAR filing requirements to require "glossy" annual reports sent to shareholders to be filed with EDGAR in PDF format starting in January 2023. The amendments also require the electronic filing of reports on Form 11-K and Form 6-K.

- ✓ **Equity Grant Timing**. The SEC has provided guidance on how to account for and disclose equity compensation awards granted shortly before certain MNPI is released. Recent amendments adopted by the SEC suggest that the SEC may begin looking more closely at the timing of MNPI releases in relation to equity grants.

- ✓ **Director Skills Matrix**. Consider reviewing and updating the director skills matrix to ensure it includes the skills and experiences that are relevant for the company, such as experience in cybersecurity, data privacy, technology, human capital, climate and sustainability as highlighted above, along with demographic diversity information. Keep in mind that certain institutional investors and proxy advisory firms are increasingly expecting a matrix of director skills, experience and attributes that covers a broader range of factors. Although the SEC's proposed amendments to its rules related to climate and cybersecurity disclosures will not be effective for the 2023 proxy season, both proposals included disclosure requirements related to director experience in cybersecurity and climate-related matters. The SEC has also indicated that a new rule proposal is expected related to board diversity disclosures.

SPOTLIGHT: BOARD LEADERSHIP DISCLOSURE

In 2022, the SEC initiated a focus on disclosures included in proxy statements related to board leadership structure and the role of the board in risk oversight. The inclusion of disclosure in these areas is required under Item 407(h) of Regulation S-K, but the SEC's focus was on the extent and adequacy of Company disclosures. In 2022, over 30 companies received comment letters requesting more robust discussion around board leadership structure and the board's role in risk oversight.

The overall theme of the SEC's comment letters was on asking companies to consider providing disclosure that related specifically to a company's circumstances, rather than more generalized statements. The SEC appeared to be seeking a better understanding as to how decisions on structure and oversight were tailored to address a company's unique challenges. Some of the key areas the SEC sought to have included were enhanced discussion around the decision to separate or combine the chair and CEO roles, the role of a lead independent director and the associated scope of responsibilities, how responsibility for risk is allocated between the board and its committees and the board's process in evaluating and managing risks, including the development of its framework and structure. For each of these areas, the SEC identified several questions to be addressed in the disclosure, focusing on how decisions were made and their related rationale and perceived impact.

As we head into the 2023 proxy season, companies should revisit their existing disclosure in light of the SEC's focus this past year. It will be important to consider whether the disclosure related to board leadership and risk oversight provides a more individualized picture of the company's specific circumstances and related decisions. The 2009 adopting release for Item 407(h), which notes this disclosure "should provide important information to investors about how a company perceives the role of its board", can be a useful guide, but a review of a sampling of the comment and response letters may ultimately be more instructive in better understanding what the SEC may be looking for in the proxy statement.

Proxy Drafting and Annual Meeting Housekeeping Checklist (cont.)

- ✓ **Say on Pay and Say on Pay Frequency**. Determine whether the 2023 proxy statement should include either a "say-on-pay" and/or "say-on-frequency" shareholder vote. Note that for companies that have had to hold say-on-frequency votes since the inception of the say on pay rules, 2023 will be a sixth year that necessitates a new say-on-frequency vote.

- ✓ **Corporate Governance Guidelines**. Review corporate governance guidelines to assess whether they continue to align with information presented in the governance section of the proxy statement. For example, consider updating to reflect changes to board diversity, risk management and board oversight over cybersecurity, climate, sustainability and human capital.

- ✓ **Board Committee Charters**. Review each of the board committee charters to ensure that they appropriately allocate responsibility among the board committees for cybersecurity and information security, climate and sustainability and human capital. Where it is intended that more than one committee cover aspects of a particular issue, make sure there is not conflict among the charters. Assess whether diversity considerations are appropriately reflected in attributes identified for director nominees in the nominating/governance committee charter.

- ✓ **D&O Questionnaires**. Ensure D&O questionnaires are up to date and consider including questions regarding board demographics to be able to respond to rating surveys and assessments and to address director skills matrices. Also, update the D&O questionnaire to identify that information, particularly demographic information, will be used for proxy statement and related disclosures.

- ✓ **Compensation Committee Independence**. Review the compensation committee members' independence under NYSE and Nasdaq listing standards, ISS's affiliated outside director test and under Section 16 of the Securities Exchange Act.

- ✓ **Perquisite Disclosure**. Review perquisite disclosure. Inaccurate perquisite disclosure has resulted in an increased number of SEC enforcement actions in recent years. The mere fact that a benefit is provided for a business reason is not sufficient to conclude that the benefit is not a perquisite. To the extent applicable, ensure compliance with the SEC's guidance on COVID-19 perquisite analysis.

- ✓ **ESG Compensation Metrics**. Consider ESG compensation metrics and alignment with the SEC's proposed climate-related disclosures—see After Years of Debate, Climate Change Impact Reporting Gets Real. For companies that include ESG metrics in their incentive plans, make sure appropriate disclosure is provided, including a thorough description of how qualitative ESG performance metrics will be assessed.

- ✓ **Equity Plan Adoptions or Amendments**. If adopting or amending an equity compensation plan, make sure that any disclosure complies with Item 10 of Schedule 14A, the plan provides adequate limits on director compensation (including any cash compensation) and be mindful of changes to burn rate calculations within the ISS Equity Plan Scorecard that will take effect for meetings held on or after February 1, 2023.

SPOTLIGHT: OPTION REPRICINGS & EXCHANGES

With the recent economic downturn, companies that have historically granted stock options may find their outstanding options are "underwater," (i.e., where the exercise or strike price of the option is greater than the current trading value of the company's stock). In a competitive labor market, underwater stock options can create motivation and retention risks. To combat these risks, companies may wish to explore repricing options or option exchange programs. However, repricing and exchange programs can create a number of legal, regulatory, tax and employee and shareholder relations issues that companies must consider.

An option repricing can be effectuated by an amendment to an option award agreement or through a termination of the existing grant and the issuance of a new grant, potentially coupled with a cash award or full value stock award. When repricing or re-granting options, attention must be paid to the requirements of the applicable plan (particularly whether shareholder approval is required) and ensuring the option remains exempt from or in compliance with Section 409A of the U.S. Internal Revenue Code. If an equity plan prohibits an option repricing without shareholder approval, NYSE or NASDAQ-listed companies must obtain shareholder approval to reprice options. Shareholders may not support option repricing if it allows employees to recoup stock value while shareholders continue to bear the loss.

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Proxy Drafting and Annual Meeting Housekeeping Checklist (cont.)

- **Stock Ownership Policies**. In 2021, ISS updated its guidance on stock ownership policies, reflecting that it will no longer credit policies that count unearned performance awards or unexercised options for ownership.
- **Institutional Investor and Proxy Advisory Firm Guidelines**. Review updates to the voting policies of applicable major investors, ISS and Glass Lewis. Additionally, ISS compensation policy changes for the 2023 season have recently been released that should be considered when preparing for this proxy season.
- **Alternative Pay Disclosures**. Consider whether to include (or continue to include) alternative pay disclosures—such as realized or realizable pay—in light of the addition of the new pay versus performance table and being mindful that shareholders may ask questions to the extent these disclosures are omitted or modified in future years.
- **Shareholder Engagement**. Consider how you are describing engagement efforts in the proxy statement, particularly where voting results from the last annual meeting indicate developing investor concerns.
- **Non-GAAP Financial Measures**. To the extent included in the proxy, including the CD&A, other than with respect to performance target levels, disclosure requirements regarding the use of non-GAAP financial measures (equal prominence, explanation and reconciliation) must be met. The SEC recently issued new CD&Is that indicate areas of staff focus.
- **HSR Thresholds and Filing Fee Amendments**. Use proxy preparation time to check on compliance on other matters, such as HSR reporting requirements. HSR reporting thresholds for both persons and entities are expected to be updated in late January 2023. Additionally, the filing fees for smaller acquisitions have been lowered while the fees for larger deals, in particular deals valued at more than $1 billion, have been increased significantly, from the current highest filing fee of $280,000 to a maximum of $2.25 million.
- **Hedging Policy Disclosure Rules**. Hedging policy disclosure has now been required for a few proxy seasons; even for those companies without a hedging policy in place. The SEC may begin to take a closer look at these disclosures.
- **Ensure Compliance with Local Laws**. Many states and localities have passed new legislation covering areas such as diversity, taxation, restrictive covenants, privacy, equal pay and pay transparency. Consider how changes in applicable laws impact company policy and practice to ensure compliance.
- **Related Party Rules**. For NYSE listed companies, the definition of “related party transaction” was revised to bring it in line with Item 404 of Regulation S-K, reinstating a transaction value and materiality threshold. Companies should review their related party transaction policies and procedures and, for NYSE listed companies, confirm the appropriate definition is being used.
- **Changes to Forms 4 and 5**. Prepare for upcoming changes to Forms 4 and 5 that take effect on April 1, 2023 and will require identifying transactions made pursuant to a plan that is intended to satisfy the affirmative defense conditions of Rule 10b5-1(c) and the disclosure of gifts within two business days of the gift transaction.

SPOTLIGHT: OPTION REPRICINGS & EXCHANGES (CONT.)

There are additional factors to consider for programs that are designed as exchanges (i.e., if optionholders are presented with the choice of whether to exchange their underwater options), including determining whether the exchange qualifies as a “tender offer” under the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and Rule 13e-4 of the Exchange Act.

Shareholder advisory firms will analyze whether to recommend option repricing proposals under their respective rubrics. ISS recommends waiting at least one year after any precipitous drop in stock price before repricing options, and requires executive officers and directors to be excluded from any repricing plan in order to receive a favorable recommendation. And while the exchanges permit listed companies to adopt equity plans that authorize option repricing without shareholder approval, ISS considers such a plan to be a “problematic pay practice” that could result in a negative recommendation from ISS on shareholder votes to approve a plan.

Stock option repricing and exchange programs can be an effective strategy to counteract motivational and retentive concerns that may arise from underwater options, but they should not be implemented before first consulting legal, tax and accounting advisors.

Key Contacts

Looking Ahead

The SEC has recently proposed and enacted various rules that may impact a company's proxy disclosure practices in future years (including proposals on climate and cybersecurity disclosure) and further human capital disclosure rules may be on the horizon. Companies should begin to think about how the proposed rule on share repurchases and the recently finalized rule on 10b5-1 plans may impact their future reporting seasons. Our publication should be helpful in this review: SEC Changes Requirements for Rule 10b5-1 Plans.

Richard Alsop
Partner
New York
T: +1 212 848 7333
richard.alsop
@shearman.com

John J. Cannon III
Partner
New York
T: +1 212 848 8159
jcannon
@shearman.com

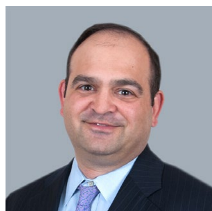
George Casey
Partner
New York
T: +1 212 848 8787
george.casey
@shearman.com

Chris Forrester
Partner
Menlo Park
T: +1 650 838 3772
chris.forrester
@shearman.com

Harald Halbhuber
Partner
New York
T: +1 212 848 7150
harald.halbhuber
@shearman.com

Emily Leitch
Partner
Houston
T: +1 713 354 4845
emily.leitch
@shearman.com

Doreen E. Lilienfeld
Partner
New York
T: +1 212 848 7171
dlilienfeld
@shearman.com



Daniel Litowitz
Partner
New York
T: +1 212 848 7784
daniel.litowitz
@shearman.com

Gillian Emmett Moldowan
Partner
New York
T: +1 212 848 5356
gillian.moldowan
@shearman.com

Lona Nallengara
Partner
New York
T: +1 212 848 8414
lona.nallengara
@shearman.com

Bill Nelson
Partner
Houston
T: +1 713 354 4880
bill.nelson
@shearman.com

Scott Petepiece
Partner
New York
T: +1 212 848 8576
spetepiece
@shearman.com

Melisa Brower
Associate
New York
T: +1 212 848 5070
melisa.brower
@shearman.com

Karen Mann
Associate
New York
T: +1 212 848 5239
karen.mann
@shearman.com

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