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ISS Issues Final Policy Updates for 2023 Proxy Season

Institutional Shareholder Services (ISS) has issued final voting policy updates for the 2023 proxy season. Key U.S. company policy changes focus on governance and board accountability, executive compensation, ESG and capitalization issues.[1] These amendments are effective for meetings on or after February 1, 2023. ISS indicates that it will issue any FAQs on its voting policies in January 2023, as is consistent with historical practice.

Governance and Board Accountability-Related Updates

- ***Unequal Voting Rights*.** ISS has, since 2015, had a policy to recommend against the boards at newly public companies that have a common stock structure with unequal voting rights without a sunset of less than seven years from the date of IPO. As previously announced, ISS will extend this policy to all covered companies in 2023. Further, the exception for companies with a seven-year sunset is only available to newly public companies (i.e., companies that emerge from bankruptcy, SPAC transactions, spin-offs, direct listings and those who complete a traditional IPO). Other exceptions include (i) limited partnerships and the operating partnership units of REITs, (ii) companies where the super-voting shares represent less than 5% of total voting power and (iii) those companies where there is sufficient protection for minority shareholders, e.g., if minority shareholders are given a regular binding vote on whether the capital structure should stay. ISS previously clarified that unequal vote structures include high/low vote stock, classes of shares that are not entitled to vote on all the same ballot items or nominees and stock with time-phased voting rights ("loyalty shares").

- ***Problematic Governance Structures at Newly Public Companies*.** Under the current policy, ISS will generally recommend against one or more directors (except for new nominees, who are considered on a case-by-case basis) at companies with their first annual meeting after February 1, 2015, if the company went public with a "problematic" governance structure (including, among other "egregious" provisions, supermajority vote requirements to amend charter or bylaws or a classified board structure). The complete elimination of the problematic structure by no later than seven years from the date of going public would be a mitigating factor. So, for example, a phased destaggering of a classified board would have to be completed within seven years of going public to avoid a negative vote recommendation.

- ***Exculpation of Officers*.** In August 2022, the Delaware General Corporation Law was amended to permit Delaware corporations to limit or eliminate the personal liability of officers for certain claims involving a breach of the duty of care. For 2023, ISS has adopted a new policy to recommend, on a case-by-case basis, proposals providing for officer exculpation, taking into account specified factors, such as whether the provision would eliminate officer liability for violations of the duty of care or the duty of loyalty. Such exculpation should be limited to the company's president, chief executive officer, chief operating officer, chief financial officer, chief legal officer, controller, treasurer or chief accounting officer, "named executive officers" in the company's SEC filings and individuals who agree to be identified as officers of the corporation. As with director exculpation, Delaware law does not permit officers to be exculpated for breaches of the duty of loyalty, acts or

[1] In addition to the updated U.S. voting policies, ISS also issued updates to its policies for other Americas and global regions. For all these updates, see the ISS website.

omissions not in good faith or that involve intentional misconduct or a knowing violation of law, any transaction in which the officer derived an improper personal benefit or for derivative claims. Other states (including, for example, Nevada) allow companies to limit the liability of directors and officers even for violations of the duty of loyalty, and ISS will generally recommend against these types of exculpation provisions.

- ***Poison Pills.*** For 2023, ISS has explicitly listed the trigger threshold and company market capitalization (including absolute level and sudden changes) as considerations in evaluating whether to vote against a board that adopts a short-term pill without putting it to a shareholder vote. When looking at the trigger for the pill, ISS does not differentiate between the level for a 13D versus a 13G filer, but focuses on the lower trigger. In adopting these changes, ISS noted that the low triggers of recent pills (e.g., 10% or even 5%) imply that pills are morphing from antitakeover to activism defense protections, and while shareholders have a clear interest in preventing an opportunistic takeover at an inadequate price, this must be balanced against the potential for an inordinately low trigger to entrench underperforming boards and management teams.

- ***Fee Shifting Provisions*****.** ISS is updating its policy on unilaterally adopted bylaw and charter provisions to expressly provide that ISS will recommend against directors (except new nominees, who are considered case-by-case) where the board adopts a fee-shifting provision (i.e., a provision requiring that a shareholder who sues the company unsuccessfully pay all litigation expenses of the defendant corporation and its directors and officers) or another provision deemed "egregious."

- ***Board Gender Diversity.*** As previously announced, the existing ISS policy to recommend against the nominating committee chair (or other directors on a case-by-case basis) at boards with no women directors will be extended to all companies (not just Russell 3000 and S&P 1500 companies). As is currently the case, an exception will be made if there was at least one woman on the board at the prior annual meeting and the board makes a firm commitment to return to a gender-diverse status within a year.

- ***Board Accountability on Climate.*** In 2022, ISS added a policy for the U.S. (and also for select other markets) providing that for companies that are significant greenhouse gas (GHG) emitters (i.e., those in the Climate Action 100+ Focus Group), ISS would recommend against the chair of the responsible committee (or other directors on a case-by-case basis) if ISS determines that the company is not taking the "minimum steps" needed to understand, assess and mitigate risks related to climate change to the company and the larger economy. "Minimum steps" required satisfaction of the following criteria: (i) detailed disclosure of climate-related risks (such as in accordance with the Task Force on Climate-related Financial Disclosures) and (ii) "appropriate GHG emissions reduction targets," which in 2022 meant any well-defined GHG reduction targets (and did not need to include Scope 3 emissions), but should cover at least a significant portion of the company's direct emissions. For 2023, ISS will define "appropriate GHG emissions reductions targets" to be "medium-term GHG reduction targets or Net Zero-by-2050 GHG reduction targets for a company's operations (Scope 1) and electricity use (Scope 2)," and that such targets should cover the vast majority (i.e., 95%) of the company's direct emissions. While ISS will apply the same analysis framework for all Climate Action 100+ Focus Group companies globally, there will be "differentiated implementation of any negative vote recommendations based on relevant market and company factors."

- ***Quorum Requirements*****.** ISS is changing from a generally against recommendation to a case-by-case approach for proposals to reduce shareholder meeting quorum requirements below a majority of shares outstanding. ISS will take into consideration (i) the new quorum threshold requested; (ii) the rationale presented for the reduction; (iii) the market capitalization of the company (size, inclusion in indices); (iv) the company's ownership structure; (v) previous voting turnout attempts to achieve quorum; (vi) any provisions or commitments to restore quorum to a majority of shares outstanding, should voter turnout improve sufficiently; and (vii) other factors as appropriate. In general, ISS prefers a quorum threshold as close to a majority of shares outstanding as is achievable. This new policy is meant to address that a growing number of smaller companies are unable to establish a quorum as several large brokerage firms no longer provide discretionary or proportionate broker voting on their client shares and, hence, such shares are not considered present at the meeting. Additionally, ISS will recommend on a case-by-case basis directors who "unilaterally lower" the quorum requirements below a majority of the shares outstanding, taking into consideration the factors listed above.

Executive Compensation-Related Updates

- ***Severance Payments*.** ISS has amended its problematic pay practices policy to make explicit that severance payments received by an executive when the termination is not clearly disclosed as involuntary (e.g., a termination without cause or resignation for good reason) carry significant weight as a problematic pay practice that may result in an adverse vote recommendation. The new policy also clarifies that (i) ISS's approach to evaluating problematic pay practices is not confined to "non-performance-based pay elements," and (ii) the examples of problematic pay practices identified in the policy language are not exhaustive, and directs issuers to ISS's U.S. Compensation Policies FAQs for more detail.

- ***Value-Adjusted Burn Rate***. As previously announced, in 2023, ISS will move from its Volatility Multiplier burn rate method for equity and other incentive plan approvals to a "Value-Adjusted Burn Rate" calculation based on the actual stock price for full-value awards and the Black-Scholes value for stock options for valuation of recently granted equity awards.

ESG-Related Updates

- ***Political Expenditures and Lobbying "Congruency" Proposals.*** For 2023, ISS is introducing a new policy on shareholder proposals requesting additional disclosure of a company's alignment between its political contributions, lobbying and electioneering spending and its publicly stated values and policies, including climate lobbying congruency to its climate goals. The new policy will provide more visibility to the market on the assessment of such shareholder proposals and codify the case-by-case approach adopted in the 2022 proxy season. Factors to be considered under the new policy are: (i) the company's policies, management, board oversight, governance processes, and level of disclosure related to direct political contributions, lobbying activities and payments to trade associations, political action committees or other groups that may be used for political purposes; (ii) the company's disclosure regarding the reasons for its support of candidates for public offices, the reasons for support of and participation in trade associations or other groups that may make political contributions and other political activities; (iii) any incongruencies between a company's direct and indirect political expenditures and its publicly stated values and priorities; and (iv) recent significant controversies related to the company's direct and indirect lobbying, political contributions or political activities. In addition, the new policy provides that ISS will generally vote on a case-by-case basis on proposals requesting comparison of a company's political spending to objectives that can mitigate material risks for the company, such as limiting global warming.

- ***Racial Equity and/or Civil Rights Audits*.** ISS is amending the factors it will consider when making recommendations on racial equity and/or civil rights audits to include consideration of whether the company adequately discloses workforce diversity and inclusion metrics and goals and to remove from consideration whether the company's actions are aligned with market norms on civil rights, and racial or ethnic diversity.

- ***ESG Compensation*.** ISS's current policy is to recommend on a case-by-case basis on stockholder proposals that seek a report or additional disclosure by the issuer on its approach, policies and practices on incorporating environmental and social (E&S) criteria into its executive compensation strategy. ISS is updating the factors it considers in making its recommendations to eliminate the explicit comparison against industry peers' incorporation of similar non-financial performance criteria in their executive compensation practices and to include the degree to which the board or compensation committee already discloses information on whether it has considered related E&S criteria (in place of whether the company has management systems and oversight mechanisms in place regarding its E&S performance). The changes clarify that the policy considers that the board or compensation committee is generally in the best position to determine performance metrics, whether financial- or ESG-specific, while affirming that improved disclosure about the rationale and considerations of pay metrics may benefit shareholders.

- ***Global Approach to E&S Issues*.** ISS has clarified two of the seven factors to be considered when making a recommendation under its common global approach to E&S proposals to codify its current approach. Specifically, regarding the factor relating to legislation or government regulation, the updated language focuses on whether the regulation or legislation is likely to occur. Further, ISS clarifies that, in examining whether there are significant controversies, fines, penalties or litigation associated with the company's practices, ISS will focus on the issue raised by the proposal.

Capitalization

- ***Share Issuance Mandates.*** For U.S. domestic issuers incorporated outside of the U.S., listed solely on a U.S. exchange and who are required by their country of incorporation to seek approval for all share issuance, ISS has introduced a policy to recommend for resolutions to authorize the issuance of common shares up to 20% of currently issued common share capital, where not tied to a specific transaction or financing proposal. This increases to 50% for pre-revenue or other early stage companies heavily reliant on periodic equity financing, with the burden of proof on the company to establish that it has a need for the higher limit. This policy is intended to reflect the expectations and concerns of investors in the U.S. market. Dual-listed companies that are required to comply with listing rules in the country of incorporation will be evaluated under the policy for that market. These authorizations must be renewed on an annual basis.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

David S. Huntington
+1-212-373-3124
dhuntington@paulweiss.com

Christodoulos Kaoutzanis
+1-212-373-3445
ckaoutzanis@paulweiss.com

John C. Kennedy
+1-212-373-3025
jkennedy@paulweiss.com

Jean M. McLoughlin
+1-212-373-3135
jmcloughlin@paulweiss.com

Raphael M. Russo
+1-212-373-3309
rrusso@paulweiss.com

Laura C. Turano
+1-212-373-3659
lturano@paulweiss.com

Frances F. Mi
+1-212-373-3185
fmi@paulweiss.com

David G. Curran
+1-212-373-2558
dcurran@paulweiss.com

Practice Management Consultant Jane Danek and Legal Consultant Cara G. Fay contributed to this memorandum.