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The Proxy Advisors Speak: 2023 Edition

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MANAGING DIRECTOR

As the year comes to a close, we have finally received 2023 policy guidelines from both Glass Lewis (GL), who published a little earlier than usual, and Institutional Shareholder Services (ISS), who published somewhat later than usual. In general, there were very few material changes made on specific compensation-related items for companies in the United States. Updates to these minor changes, and several director-related items, are listed below for reference as the upcoming proxy season approaches.

Institutional Shareholder Services

On November 30, 2022, ISS released a summary of its policy changes applicable to US shareholder meetings, which will go into effect for annual meetings held on or after February 1, 2023. It will also be publishing its final policies in full detail in mid-December and a set of frequently asked questions (FAQs) by the end of January 2023. Below are the key changes and clarifications which relate to executive compensation and board diversity only.

Compensation

1. Clarification of Problematic Pay Practices, Including Certain Severance Pay

Severance received by an executive when the termination is not clearly disclosed as involuntary will be considered a problematic pay practice, which may result in an adverse vote recommendation. ISS has also clarified that the types of pay practices that may result in an adverse vote recommendation are not limited to the examples provided in the policy document. This update codifies ISS' current approach to evaluating severance payments received by an executive when the termination is not clearly disclosed as involuntary.

2. Value-Adjusted Burn Rate (VABR)

Last year ISS announced that it would change its burn rate calculation effective as of February 1, 2023, so this new formula will be effective for the upcoming proxy season.

The VABR = (number of options x option's dollar value using a Black-Scholes model) + (number of full-value awards x stock price) / (Weighted average common shares x stock price).

The VABR replaces ISS' previous methodology using "adjusted annual burn rate," which was calculated as (number of appreciation awards granted + number of full value awards granted x Multiplier) / Weighted average common shares outstanding). ISS believes VABR more accurately reflects burn rate by breaking down different types of equity awards.

3. ESG Proposals Related to Compensation

Currently, ISS generally recommends voting against shareholder proposals seeking to set absolute levels on compensation or otherwise dictate the amount or form of compensation (such as types of compensation elements or metrics) to be used in incentive pay programs. The update notes that the board or compensation committee is generally in the best position to determine the performance metrics, whether they are financial or ESG-specific. However, ISS is explicit that improved disclosure about the committee's rationale and considerations of pay metrics (including those for ESG-related topics) may benefit shareholders.

Board Diversity

For shareholder meetings on or after February 1, 2023, ISS's policy on board gender diversity will be expanded from Russell 3000 and S&P 1500 companies to all US companies. For companies without any women on the board, ISS will generally recommend against the chair of the nominating committee. An exception will be made if there was at least one woman on the board at the preceding annual meeting and the board makes a firm commitment to return to a gender-diverse status within a year. There is also a one-year grace period at companies where there are no women on the board but there is at least one director who self-identifies as non-binary in the disclosure.

Glass Lewis

On November 18, 2022, Glass Lewis released its policy changes applicable to US shareholder meetings starting January 1, 2023. Below are the key changes and clarifications which relate to executive compensation and board diversity only.

Compensation

1. Long-Term Incentive (LTI) Mix Must be More than 50% Performance Based (New)

To align with market trends, GL has increased its threshold for the minimum percentage of the long-term incentive grant that should be performance-based from 33% to 50% and will note as a concern in its voting analysis any programs that fail to meet this threshold. As in past years, GL may refrain from a negative recommendation if there are no other significant issues with the program's design or operation, but may not approve if there is a negative trajectory in the allocation amount. With this change, GL and ISS now both require at least 50% performance-based LTI.

2. Impact of Mega-Grants on Compensation Committee Chair

GL clarified that it will recommend against the chair of the compensation committee when "mega-grants" (usually those over $100 million) have been made and the awards present concerns such as excessive quantum, lack of sufficient performance conditions, and/or are excessively dilutive.

3. One-Time Award Disclosure Guidance

GL expanded discussion on what it considers reasonable disclosure for one-time awards. In addition to providing a thorough description of the awards, including a cogent and convincing explanation of their necessity and why existing awards do not provide sufficient motivation, GL also now expects the discussion to include how the quantum of the award and its structure were determined.

4. Commentary on Front-Loaded and Mega-Grants

GL expanded discussion on front-loaded awards and mega-grants expressing concern regarding the increased restraint placed upon the board to respond to unforeseen factors when front-loaded awards are used. In situations where front-loaded awards are intended to cover a portion of an executive's regular LTI awards, GL will account for the annualized value of the front-loaded portion, and GL expects no supplemental grants during the vesting period of the front-loaded portion.

5. Commentary on Use of Discretion in Short- and Long-Term Incentives

GL added new discussion on compensation committee discretion for incentive payouts, e.g., to account for significant events that would otherwise be excluded from performance results of selected incentive metrics. GL expects disclosure as to how such events were considered in the committee's decisions to exercise discretion or refrain from applying discretion over incentive pay outcomes.

6. Impact of New SEC Pay Versus Performance Rules

The final SEC Pay Versus Performance disclosure requirements will not impact GL's pay for performance methodology in 2023; however, GL may use this new disclosure in its the evaluation of executive pay programs on a qualitative basis.

7. Impact of New SEC Clawback Rules

Between the announcement of SEC final clawback rules and the effective date of exchange listing requirements, GL will continue to raise concerns if the clawback policy only meets Sarbanes-Oxley Act requirements. However, disclosure of early efforts to meet the final rule standards may help to mitigate concerns.

8. Company Responsiveness to Say-on-Pay (SOP)

GL will scrutinize high levels of disinterested shareholders when assessing support for previous years' SOP votes. When evaluating response to low support levels, GL expanded what they consider as robust disclosure, including rationale for not implementing change to pay decisions that drove low support and intentions going forward. GL's threshold for "significant shareholder opposition" remains at more than 20% opposition.

Board Diversity

1. Gender Diversity

As announced in 2022, GL will begin recommending against the chair of the nominating/governance committee (NGC) of Russell 3000 company boards that are not at least 30% gender diverse. GL's existing policy requiring one gender-diverse director will continue to apply for non-Russell 3000 companies. A sufficient rationale or plan to address such lack of diversity, including a timeline to appoint gender-diverse directors (generally by the next annual meeting) may mitigate risk of negative recommendation.

2. Underrepresented Diversity

Beginning in 2023, GL will generally recommend against the NGC chair of a Russell 1000 company with no director from an underrepresented community (relying solely on self-identified information in company proxy statements). A sufficient rationale or plan to address such lack of diversity, including a timeline to appoint gender-diverse directors (generally by the next annual meeting) may mitigate risk of negative recommendation.

3. Disclosure of Director Diversity and Skills

GL will generally recommend against the NGC chair at Russell 1000 companies that fail to include disclosure on (i) the board's percentage of racial/ethnic diversity; (ii) whether the board's definition of diversity explicitly includes gender and/or race/ethnicity; (iii) whether the board has adopted a policy requiring women and minorities to be included in the initial pool of candidates when selecting new director nominees; and (iv) board skills disclosure. GL will now also recommend against the NGC chair at Russell 1000 companies that do not provide any disclosure of individual or aggregate racial/ethnic minority demographic information.

Conclusion

In general, there were few material compensation-related changes that will require action steps for 2023 (or that are even actionable, given that the policy changes are released so late in the year). However, if a company is at risk of not meeting any of the governance concepts described above, the best solution seems to be robust disclosure with sufficient rationale and/or commitments to improve going forward during proxy season.

About the Author

Deborah Lifshey is a managing director at Pearl Meyer, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters.

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