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A Proxy Season and Annual Report Guide to 2022

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Summary

The 2022 proxy season will continue to be affected by the aftershocks of the COVID-19 pandemic, and will be predominantly shaped by the landmark events of the 2021 proxy season, where ESG matters moved from unconventional to the mainstream, and women held a historic amount of board seats of the Russell 3000 companies. Companies should continue to review and ensure compliance with the modernization of Regulation S-K, Nasdaq's board diversity rule (if applicable), and continue to revise and update ESG disclosures and reports to keep in line with those in their industry and industry peer group.

Introduction

The continuation of the COVID-19 pandemic and tumultuous economic lockdowns of 2020 resulted in a 2021 proxy season that, unsurprisingly, could be summed up by three letters: ESG. Voting behavior continued to emphasize the importance of Environmental, Social, and Governance proposal issues and disclosures. Looking forward, issuers are faced with the cessation of the London interbank offered rate, or LIBOR (truly the end of an era), and some concrete disclosure guidance from the SEC regarding to human capital, and, likely, rules relating to environmental issues. The following guide comprises:

- A review of the 2021 proxy season;
- A summary of potential trends to the 2022 proxy season as we continue to see emphasis on ESG by both institutional and retail investors;
- A summary of amendments and guidance made to relevant regulations; and
- Potential implications of the 2021 proxy season on the upcoming 2022 proxy season and considerations for company boards and management teams o consider when drafting their proxy statements and Annual Reports on Form 10-K.

2021 in Review

The lingering effects of the pandemic could still be felt during the peak proxy season. Perhaps as a result of shareholders experiencing an entire cycle with the implications of COVID-19, shareholder proposals considered such impacts, whereas the 2020 proxy season dealt with proposals that were generally submitted before the shadow of COVID-19 came to fruition. Notably, COVID-19-related travel and capacity restrictions dramatically increased the 2020 proxy season trend of virtual shareholders' meetings. And, despite the trend of virtual meetings, shareholder proposal submissions rose significantly in 2021, up 11% from 2020 to 802.

Up from 21 proposals last year, the 34 proposals surrounding the E and S of ESG in this 2021 proxy season garnered never-before-seen support levels (over 80%), with topics ranging from political spending, climate change, and diversity. Average shareholder support for environmental proposals increased from 31% in 2020 to 42% in 2021, and support for social proposals from 28% to 31%.

In terms of Governance, the evolving priorities of institutional investors were evident in 2021 vote outcomes on director elections and pay proposals. The push for diversity disclosures by Vanguard and Institutional Shareholder Services (ISS) at the beginning of 2021[1] are finally coming to fruition, with the disclosure of diversity beyond gender increasing dramatically: Nearly 59% of companies in the S&P 500 disclosed the percentage of racial/ethnic diversity on the board, versus just 29% the year prior. Of course, the new diversity rules from various states and Nasdaq Inc. continue to help raise the diversity disclosure bar.

Additionally, there was a 25% increase in the number of directors failing to get majority shareholder support, and the number of say-on-pay proposal failures in the S&P 500 nearly doubled. Notably, activist investor Engine No. 1 led the fight in unseating three Exxon Mobil directors in a revolutionary proxy fight – the first contest of its kind tied to the global energy transition and paving the way for the merging of "E" and "G."

Human capital management was a growing concern for investors. Proposals on this subject rose 28% from 2020, averaging 45% support. These proposals generally centered on a desire for companies to provide more information concerning the diversity of their workforces, and the requirement of mandatory arbitration for employees. The likelihood of these proposals continuing in the 2022 proxy season is high, given the continued disclosure by companies on human capital management in their MD&A sections on Form 10-K.

New topics of "E" and "S" proposals dealt with access to COVID-19 medicine, say on climate advisory votes, and racial audits, all of which did well for their first year (reaching around 30% vote averages). This should come as no surprise, however, given the signals from major institutional investors, such as Vanguard and BlackRock, that they would support such resolutions starting with the 2021 proxy season. Institutional investors also indicated they will hold board members accountable for inadequate attention to material environmental and social risks.

ESG Gains Momentum

2021 was a monumental year in ESG matters, a topic that moved from unconventional to mainstream given the emphasis by institutional investors, retail investors, stakeholders, and beyond. Given such emphasis, boards of directors continued to spend 2021 emphasizing their commitment to ESG matters and ESG disclosures. Overall, however, it seems that investors want higher-quality ESG data and a clearer regulatory landscape, which is what they will likely get in 2022. Below are some

highlights for the 2021 proxy season, broken down by category:

Environmental

Overall, 12 environmental proposals passed in 2021, over a 100% increase from 2020. Five environmental proposals passed in 2020, and none passed in 2019. A substantial amount of proposals revolved around climate-related disclosures, specifically: climate-related lobbying efforts, increased reporting on contributions to, or measures addressing, climate change, and requests for companies to adopt greenhouse gas emissions targets. Those proposals that passed garnered anywhere between 57% and 98% shareholder support.

Investors also continued to demand board accountability on climate-related issues. For example, investors sent a strong message about the importance of climate-related matters when they supported activist investor Engine No. 1 in successfully unseating three of 12 Exxon directors in a short-slate proxy contest. This increase and accountability should come as no surprise, given the increased focus of institutional investors on climate-related issues.[2]

Social

Social proposals increased notably, up 37% from the 2020 proxy season. Of the five most popular topics in 2021, the number one topic revolved around anti-discrimination and diversity. Companies clearly understood this investor desire to receive this information, as the disclosure of board racial/ethnic diversity among Fortune 100 companies increased to 86%, up from 54% in the 2020 proxy season.

The number of public companies sharing this type of information is likely to expand beyond the Fortune 100, given the SEC's August approval of the Nasdaq board diversity proposal.

More information regarding the Nasdaq diversity rule can be found below, and in Dinsmore's client alert here.

Overall, human capital management - or recruiting, hiring and managing workforces - represents a growing concern for investors. Proposals on this topic received an average of 45% support, up from 28% in 2020. Proposals which garnered the most support addressed: Board diversity, executive diversity, workplace diversity, mandatory arbitration of employment-related claims, worker safety, and political spending disclosure. The most significant vote shifts were in the proposals related to political activity, such as lobbying and political spending.

Governance

The number of corporate governance-related proposals submitted and voted on during the 2021 proxy season increased nominally compared to 2020 – a 7% increase, and the number receiving majority support increased, rather than decreased (compared to 2020), with 38 in 2021 compared to 27 in 2020. Governance-related proposals covered the following topics: The right to act by written consent, separation of chair and CEO, majority voting (usually paired with board declassification), and proposals relating to special meeting rights.

Similar to prior years, there were fewer withdrawals of governance-related proposals as compared to environmental and social proposals. Notably, institutional investors were not shy in recommending

and voting against incumbent directors: BlackRock voted against 255 directors for climate-related concerns, compared with 53 in 2020.

Director Elections - Support Declines

Average support of director elections has hovered around 96% over the past four years. The proportion of Russell 3000 Index directors who received less than 80% support reached a multi-year high, and thus, average support fell to 93.5% in 2021. Lack of board racial and ethnic diversity factored into these results.

ISS Voting Policy for the 2021 proxy season provided that ISS would recommend a vote against or withhold from directors individually, committee members, or the entire board, due to:

- Material failures in governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards sufficient to raise substantial doubt regarding their ability to effectively oversee management and serve the best interests of shareholders at any company.

The Voting Policy also provides that ISS will generally recommend a vote against or withhold from the chair of the nominating committee at companies where there are no women on the company's board of directors. When ISS first announced this policy in 2019, it indicated that 2020 would be a transitional year, allowing companies time to commit to adding female directors. According to the 50/50 Women on Boards Gender Diversity Index 2021, as of June 2021, women hold an *historic* 25.6% of the Russell 3000 company board seats, up from 22.6% in 2020.

2021 in Process

Proxy Advisory Firm Changes

In July 2020, the SEC adopted final principles-based rules that require proxy voting advice businesses (PVABs) to take certain actions to maintain a statutory exemption from the information and filing requirements of the federal proxy rules. Specifically, PVABs must comply with certain disclosure and procedural requirements, including the disclosure of material conflicts of interest in their proxy advice, and adopt and publicly disclose certain written policies and procedures reasonably designed to ensure that:

- Public companies that are the subject of proxy voting advice have such advice made available to them at or prior to the time when such advice is disseminated to the PVAB's clients; and
- The PVAB provides its clients with a mechanism by which they can reasonably be expected to become aware of any written statements regarding its proxy voting advice by public companies that are the subject of such advice, in a timely manner before the shareholder meeting (or, if no meeting, before the votes, consents, or authorizations may be used to effect the proposed action).

These amendments became effective on Nov. 2, 2020. However, PVABs were given until Dec. 1, 2021 to comply with new conditions to exemptions from the proxy rules' information and filing requirements that proxy advisory typically have relied upon. Subsequently, in June 2021, SEC Chair Gary Gensler issued a public statement directing staff "to consider whether to recommend further regulatory action regarding proxy voting advice." The SEC's Division of Corporation Finance issued a public statement indicating it will not recommend enforcement action based on the amendments or the related guidance for a "reasonable period of time" after any reopening by ISS of its litigation challenging the amendments and guidance, which litigation is currently being held in abeyance.

Modernization of Regulation S-K

On Aug. 26, 2020, the SEC adopted amendments to modernize its rules requiring disclosures regarding companies' descriptions of business, legal proceedings, and risk factors. In relevant part, the final amendments include, as a disclosure topic, a description of the registrant's human capital resources to the extent such disclosures would be material to an understanding of the registrant's business. Given the principles-based approach, there was substantial variation in implementation of this disclosure requirement in 2021 Annual Reports on Form 10-K. Generally, the pandemic was addressed by most companies. However, topics varied, ranging from workers' health and safety, remote working, and sometimes diversity, to equity and inclusion with respect to the workplace.

In 2021, the SEC announced that it was targeting the fall of 2021 for proposed amendments to enhance human capital discussions; however, this deadline was not met. Companies should be on the lookout for a final amendment in 2022 and monitor potential rulemaking.

To prepare for 2022, companies should review precedents in their industry and industry peer group to determine whether they need to expand on human capital disclosures provided in 2021. For example, some companies may determine it is appropriate to discuss vaccine policies and others may discuss return-to-the-office or hybrid-work policies. Alternatively, some sectors of the job market are experiencing higher-than-average turnover rates and difficulties with retention.

Nasdaq's Board Diversity Rule

In the wake of the pandemic and social justice movements in 2020, the call for diversifying corporate boards intensified throughout 2020 and 2021. On Aug. 6, 2021, the SEC approved Nasdaq's proposal to amend its listing standards to promote greater board diversity and to require board diversity disclosures for Nasdaq-listed companies. A more detailed review of this rule can be found in Dinsmore's client alert here, but the highlights are as follows:

- Nasdaq-listed companies will be required to:
    - Publicly disclose board-level diversity statistics on an annual basis using a standardized matrix template under Nasdaq Rule 5606 (the Board Diversity Matrix Rule); and
    - Have or disclose why they do not have a minimum of two diverse board members under Nasdaq Rule 5605(f) (the Board Diversity or Disclosure Rule).
- Nasdaq Rule 5606 will require companies to disclose, in a standardized matrix set forth in the rule or in a substantially similar format, (i) the total number of company board members and

(ii) how those board members self-identify regarding gender, predefined race, and ethnicity categories and LGBTQ+ status. Nasdaq sample matrices are published here.

All Nasdaq-listed companies must comply with the board diversity matrix disclosure by the latter of (i) Aug. 8, 2022, or (ii) the date the company files its proxy statement for its 2022 annual meeting of shareholders. If the company does not file a proxy statement, the board diversity matrix disclosure must be filed in its annual report on Form 10-K or 20-F. Companies should consider whether their director questionnaires will need to be revised to elicit the information required under the new rules or standards.

Proxy Statement Matters and Proxy Season

Assess ESG Business, Disclosure and Reporting Practices

As investors and the SEC became increasingly focused on ESG disclosures throughout 2021, companies should continue to assess their current ESG business, disclosure and reporting practices and determine whether changes are warranted. ESG-related disclosures in the proxy statement have increased exponentially in recent years.It is fully expected that the 2022 season will bring further mandated ESG-related disclosures and more detailed communications with stakeholders—not only pertaining to governance, but also environmental and social issues as well. In fact, 77% of investors surveyed by Ernst and Young said that, over the next two years, “they will devote considerable time and attention to evaluating physical risk implications when they make asset allocations and selection decision.”[3] And, given the amendments to Exchange Act Rule 14a-8 applicable for the 2022 proxy season (described below), ESG, and specifically shareholder focus/proposals on ESG, is not going away any time soon.

In the past, SEC staff excluded proposals that requested companies adopt time frames or targets to address ESG issues. However, in a Nov. 3, 2021 bulletin, SEC staff indicated that shareholder proposals “raising human capital management issues with a broad societal impact,” as well as proposals that request “companies adopt time frames or targets to address climate change” are no longer likely excludable under the amendments to Exchange Act Rule 14a-8.[4]

Given such guidance, we expect to see an unprecedented number of shareholder proposals related to ESG. Some expected highlights of the 2022 proxy season, and considerations as it relates to 2022 ESG disclosure, are as follows:

- **Environmental**: In September 2021, the SEC sent comment letters to a handful of companies in various industries seeking additional information about their climate-related disclosures (or lack thereof), referring the SEC’s 2010 Guidance Regarding Disclosure Related to Climate Change.[5] Also in September 2021, the SEC posted a Sample Letter to Companies Regarding Climate Change Disclosures in which it asked companies to explain *why* certain climate-related disclosures were included in corporate social responsibility reports, but not SEC filings. Given this guidance, coupled with the likelihood that the volume of climate-related disclosure is likely to increase in the coming years, companies should pay special attention to disclosure controls currently in place, and be on the lookout for new SEC rule proposals related to climate change.
    - *ISS*: ISS released its first-ever Climate Survey[6] focused on minimum criteria for boards in overseeing climate-related risks, shareholder voting rights with respect to

climate transition plans, and the importance of net zero goals and other climate risk management criteria.

The 2022 proxy season is likely to bring additional say on climate proposals, and a continued increase in shareholder support as it relates to environmental proposals.

- **Social:** Investors, including institutional investors, continue to push companies to proactively address racial equality within their workforces. Given the willingness consumers have shown to boycott companies that are perceived as lagging in diversity and inclusion, going into 2022, we expect one of the major subjects in shareholder proposals will be the link between leadership and workforce diversity. Investors remain focused not only on what the company is doing, but how it is doing it, particularly with respect to health and safety, supply-chain management, and adopting sustainable business practices for both the short and long term.

- **Governance:** While director support by the average investor remains statistically unchanged (and generally very high), 2021 was a record year for the number of directors receiving less than 80% support. In our view, this trend is a reflection of general investor frustration over the lack of board oversight on ESG-related issues. Additionally, in the latest governance policy updates for 2022 released by ISS, one of the main focus areas for the proxy advisory firm is "board accountability," specifically as it relates to unequal voting rights and climate accountability. For example, ISS states that a "problematic capital structure" in which a company has a multi-class capital structure with classes having unequal voting rights is cause to vote against or withhold from the entire board. Many large and iconic U.S. companies, such as Alphabet Inc., Meta Platforms, Inc. and the New York Times Company, among others, have such asymmetric voting rights.

COVID-19 Disclosures in Annual Reports

Disclosure Guidance

The staff issued an extensive amount of guidance with respect to COVID-19-related disruptions, which include a range of questions for companies to consider when evaluating the impacts of the pandemic. Companies should ensure review of any specific COVID-19-related disclosures made in either their proxies of Form 10-K to determine if any changes have been made, or if such information is still material to an investment or voting decision, such as executive-compensation changes, risk-factor revisions, transition to telework, supply chain and distribution adjustments, and suspension/modification of operations for health and safety.

Other Proxy and Annual Report Matters

Shareholder Proposal Developments

In 2020, the SEC adopted controversial rule amendments altering the shareholder proposal submission (and re-submission) framework, which are currently effective and apply to any shareholder proposal submitted for inclusion in a company's proxy statement for an annual or special meeting to be held on or after Jan. 1, 2022. [7] These amendments considerably increase the requirements for submitting and resubmitting shareholder proposals under Exchange Act Rule 14a-8. The rule amendments are intended "to modernize and enhance the efficiency and integrity of the

shareholder-proposal process for the benefit of all shareholders." While the Division of Corporation Finance is considering recommending that the SEC propose amendments to Rule 14a-8, the 2020 amendments are applicable to the 2022 proxy season. Therefore, companies should be mindful of the changes for shareholder proposals, which address the following three areas:

1. The ownership thresholds for submission of shareholder proposals have been increased to:
    1. $2,000 of the company's securities for at least three years;
    2. $15,000 of the company's securities for at least two years; or
    3. $25,000 of the company's securities for at least one year.
2. Shareholders will no longer be permitted to aggregate holdings to meet the ownership thresholds; and
3. The voting thresholds for resubmission of a proposal have been increased from 3%, 6%, and 10% for matters previously voted on once, twice, or three or more times in the last five years to thresholds of 5%, 15%, and 25% for those respective periods.

There is a transition period with respect to ownership thresholds that will allow shareholders that meet specified conditions to rely on the current $2,000/one-year ownership threshold for proposals submitted for shareholders' meetings being held prior to Jan. 1, 2023.

The SEC also adopted the following changes:

- Rule 14a-8(c) was amended to update the "one proposal" rule to clarify that a single person may not submit multiple proposals at the same shareholders' meeting, whether the person submits a proposal as a shareholder or as a representative of a shareholder.
- Rule 14a-8(b) was amended to, among other things:
    - Require a proponent to be available to meet with the company regarding the shareholder proposal; and
    - Require a proponent to provide specified information about any representative the proponent is using to submit a proposal or to act on the proponent's behalf.

Recommendations for Companies Adopting a fFramework for ESG

As discussed in last year's proxy guide, companies choosing to provide ESG disclosures beyond what is required, or who are adopting a framework for ESG, should carefully consider the feasibility of such standards and commitments adopted to ensure they are able to meet such standards. Whatever the format, and as with any public disclosure, companies should ensure their ESG disclosures are subject to robust controls, procedures, and oversight. ESG-related disclosures are subject to federal securities laws to the extent they are materially inaccurate or misleading, and consequently could have legal, regulatory, and reputational consequences to the extent such disclosures are inconsistent with company actions or industry standards. Additional considerations consist of the following:

- Appoint a team tasked with monitoring ESG disclosures and commitments;
- Identify existing ESG commitments to establish a baseline;
- Implement a procedure or control to monitor ESG disclosures of peer firms;
- Craft ESG disclosures which are noteworthy to investors' investment and voting decisions; and
- Remember the speed at which the internet works and the speed of social media responses.

Risk Factors

Risk-factor disclosure continues to be an important feature of the annual report. Consider last year's rule change which required risk factors to be organized under relevant headings, and that generic disclosures are to be placed at the end of the risk factor section under the caption "General Risk Factors." Moreover, if the risk-factor discussion exceeds 15 pages, a risk-factor summary of not more than two pages is needed.

Cybersecurity: The SEC's regulatory agenda targeted the fall of 2021 for proposed rules to enhance issuer disclosures regarding cybersecurity risk governance. While this proposed rulemaking never arrived, companies should be cognizant that cybersecurity incidents continue to plague businesses both large and small, and continue to grow in sophistication and prevalence, and thus remain a significant risk factor that most companies must address in their Form 10-Ks. The mere discussion of cybersecurity issues can be helpful from a shareholder and customer perspective, if only to demonstrate that the company is aware of the potential impact of cybersecurity risks and is taking it into consideration. Further in this regard, we note that it is the rare company that has not experienced some cybersecurity incident.

Climate Change: Companies should consider updating their risk-factor disclosures to include how they are impacted by climate change, given the SEC's and investors' interest in such topic.

LIBOR: Particularly for financial institutions, the transition away from LIBOR should be considered in addressing, updating, or elaborating on a current risk-factor disclosure. The SEC staff has provided comments requesting the inclusion of such a risk factor, and the discussion of how the discontinuation of LIBOR could affect a company's liquidity and results of operations.

MD&A

The SEC's January 2020 amendments to management's discussion and analysis (MD&A) of financial condition and results of operation set forth in Item 303 of Regulation S-K became effective Feb. 10, 2021. Because companies were given until their first fiscal year ending on or after Aug. 9, 2021 to comply with the amended MD&A rules, most companies will need to prepare and ensure their MD&A is in compliance with the amended requirements for the 2022 season. The most significant changes to Item 303 of Regulation S-K are as follows:

- Addition of a new paragraph (a) to Item 303 to clarify the objective of MD&A (though this requires no specific disclosure heading addressing such objective);

- **Capital Resources:** Now requires disclosure of material cash requirements, including commitments for capital expenditures, the anticipated source of funds needed to satisfy these cash requirements and the general purpose of the cash requirements.

- **Results of Operations**: Now requires disclosure of known events that are reasonably likely to cause a material change in the relationship between costs and revenues; disclosure of reasons underlying material changes in net sales or revenues; and elimination of specific disclosure with respect to the impact of inflation and changing prices.

- **Off Balance Sheet Arrangements:** Revisions to the disclosure now have an instruction requiring companies to discuss commitments and obligations arising from arrangements with unconsolidated entities or people who have, or are reasonably likely to have, a material current or future effect on their financial condition, changes in financial condition, revenues or expense, results of operations, liquidity, cash requirements or capital resources.

- **Tabular Disclosure of Contractual Obligations**: This disclosure is eliminated. However, disclosure of material cash requirements from known contractual and other obligations as part of a liquidity and capital resources discussion is now required in MD&A.

- **Codification of SEC guidance related to:** Critical Audit Matters or CAMs and underlying reasons for material changes in line items in quantitative and qualitative terms.

Virtual Meetings

Given the overall positive experience most companies and investors had in 2021 with virtual or hybrid meetings, we expect that trend to continue in 2022 and beyond. Initially, a company needs to decide if its 2022 annual meeting will be physical, virtual, or hybrid. The status of the pandemic and proposals presented at the annual meeting could factor into a company's decision. If a virtual format is chosen, companies must familiarize themselves with any and all applicable laws and governance requirements surrounding virtual meetings, and proxy statements should include "robust disclosure that facilitate informed shareholder voting." Generally, companies should consider:

- Whether any revisions to proxy statement disclosures regarding virtual meeting practices would be appropriate to clarify procedures for shareholders to virtually attend and vote at meetings;

- Explaining how to handle technical glitches that may occur during the meeting;[8]

- Describing Q&A sessions and how those would be handled (e.g., before or after voting), and ensuring a tracking system;

- Implementing telephonic or internet-based help lines for shareholder support during the meetings, and ensuring the virtual meeting website is open to log in prior to the start of the meeting; and

- To the extent companies relied on executive orders or temporary rules for the conduct of their annual virtual meetings during 2021, determining whether there have been any changes to those orders or rules.

FOOTNOTES

[1] *Vanguard Investment Stewardship Perspectives, Board Diversity*, https://about.vanguard.com/investment-stewardship/perspectives-and-commentary/persp_board_diversity.pdf.

[2] State Street, Vanguard, BlackRock.

[3] https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/assurance/assurance-pdfs/ey-institutional-investor-survey.pdf.

[4] https://www.sec.gov/corpfin/staff-legal-bulletin-14l-shareholder-proposals

[5] Release No. 33-9106 (Feb. 2, 2010).

[6] https://www.issgovernance.com/file/publications/2021-climate-survey-summary-of-results.pdf

[7] https://www.sec.gov/rules/final/2020/34-89964.pdf (September 23, 2020)

[8] Note: Regulations FD applies in a virtual meeting context and where a technical difficulty occurs. If a company becomes aware that some participants at a virtual meeting did not hear part of the meeting, the company will need to run an analysis to determine whether material nonpublic information was involved.

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