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BLOG

2022 Proxy Season: A Look Ahead to Executive Compensation Issues and Considerations

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Autumn’s chill has settled in, which means the 2022 proxy season is just around the corner. Given (1) the continuing impact of the COVID-19 pandemic and related supply chain issues and (2) the unprecedented interest in issues surrounding executive compensation, it is important to prepare early to avoid any unanticipated hitches and take advantage of opportunities to proactively address compensation matters through effective proxy disclosures, well-executed shareholder engagement, and informed compensation committee actions.

This alert sets forth some key matters to consider as public companies and their compensation committees begin to prepare for the 2022 proxy season and compensation decisions. Emerging Growth Companies (EGCs) and Smaller Reporting Companies (SRCs) should note that some of the rules and issues discussed here may not apply, and should reach out to their Winston & Strawn team member for further details.

ISS Survey Results and Upcoming Policy Changes

Earlier this month, the proxy advisory firm Institutional Shareholder Services (ISS) published the results of its Annual Benchmark Policy Survey. Based on input from various key stakeholders (e.g., institutional shareholders, corporate directors, market constituents, etc.), the survey results summarize feedback on a range of policy issues, including several that are relevant to executive compensation and the upcoming proxy season.

- Unsurprisingly, the survey results showed a continued interest in environmental, social, and governance (ESG) issues, with over half of investor respondents indicating that nonfinancial ESG metrics are an appropriate means of incentivizing executives if they are specific and measurable with targets that are transparently communicated. Interestingly, about a third of investors indicated that ESG metrics could still be effective even if *not* financially measurable.

- The survey results also revealed heightened interest in including a longer-term perspective on CEO pay. Currently, ISS’s quantitative pay-for-performance screen includes a measure that evaluates one-year CEO pay as a multiple of CEO peer median. A majority of survey respondents agreed that inclusion of a longer-term perspective on CEO pay quantum would be helpful.

- In addition, the survey showed that midcycle changes to long-term incentive programs are still viewed by over half of investor respondents as “problematic” based on a view that long-term incentives should not be adjusted based on short-term market disruptions. However, forty percent said this may be reasonable for companies that have experienced long-term negative impacts from the pandemic.

Companies and compensation committees should continue to monitor ISS’s policy updates following the release of survey results. ISS will soon release key draft policy updates and open a public comment period on any proposed changes. The new policy updates are expected to be announced in November and published in December and would be applicable to shareholder meetings occurring after February 1, 2022.

In addition to this year’s policy survey and updating process, as a reminder, last year, ISS released a series of COVID-19-specific FAQs. Companies should review these FAQs, as some will remain relevant for companies that made modifications to their 2021 compensation programs related to COVID-19.

2021 Say-on-Pay Results and Shareholder Engagement

The 2021 proxy season presented a number of challenges for many companies, with compensation committees facing difficult decisions, balancing (1) the need to retain and incentivize executives during a difficult business environment (particularly in certain industries) with (2) the risk of losing key shareholder support. While failed say-on-pay results remained infrequent in 2021, actions taken by compensation committees led to some negative ISS recommendations and lower voting results on some say-on-pay proposals, with some companies falling below the key 70% level, below which ISS significantly increases its scrutiny of company responsiveness in the following year’s proxy statement. (Glass Lewis, another influential proxy advisory firm, utilizes an 80% threshold for this purpose.)

Companies that received low say-on-pay voting results in 2021 should consider steps that can be taken now to address relevant issues for the upcoming proxy season, including a game plan for shareholder engagement as well as advance planning for clear and effective CD&A disclosure of any changes made to address concerns raised by proxy advisors and investors.

- *Shareholder Engagement*. It is generally a best practice to meet with and solicit feedback from key stakeholders in advance of proxy season, and this is even more important for companies dealing with low say-on-pay results from last year. This usually requires coordination among the company’s investor relations team, proxy solicitors, legal department, and the board (and compensation committee) and senior management. A well-executed action plan for shareholder outreach and engagement should include (i) reviewing proxy advisors’ reports from last year’s proxy to identify key issues flagged as concerns, (ii) reviewing and understanding how the company’s peer group is addressing executive compensation matters, (iii) reviewing the company’s shareholder base and determining which shareholders the company will want to engage with, (iv) planning for shareholder meetings with key talking points to address, and (v) coordinating a response with both the engagement team and the compensation committee following shareholder meetings.

- *Upcoming Disclosure*. It will also be important for companies with low say-on-pay results to clearly and effectively disclose in this year’s CD&A the rationale for 2021 compensation decisions, as well as any changes the committee made to address shareholder concerns, including through shareholder outreach and engagement. In addition, companies and compensation committees should engage with advisors early to anticipate proxy advisor say-on-pay voting recommendations for the upcoming proxy season, considering both the quantitative assessments and qualitative evaluations that these firms will conduct.

Equity Compensation Plan Approval

Companies that plan to propose new equity compensation plans or to amend existing equity plans, including to increase shares available for grant, should start the process for plan drafting and proxy disclosure. As a reminder, in determining whether to recommend “for” or “against” an equity compensation plan proposal, ISS applies its own “equity plan scorecard.” Specifically, the ISS scorecard evaluates three key pillars: (i) plan cost, (ii) plan features, and (iii) the company’s historical grant practices.

Companies should review their equity compensation plan proposals with their independent compensation consultants and assess whether such proposals are likely to receive a positive score card result and favorable ISS recommendation when considering issues like the size of the plan's share pool and the company's overhang and burn rate. While a negative ISS recommendation will not necessarily lead to a negative vote result (and shareholders generally vote in favor of these proposals by a large margin and continued to do so in 2021), a negative recommendation can have an impact, and companies should plan accordingly.

Other Proxy Disclosure Considerations

COVID-19 Adjustments. In addition to companies dealing with low say-on-pay vote results from last year, any company that has made COVID-19-related adjustments to 2021 compensation will need to address these matters in this year's CD&A, as was the case last proxy season. Companies need to carefully craft this disclosure with clear and effective explanations of the rationale for any changes made to compensation programs. Furthermore, note that ISS gives points to companies that clarified the temporary nature of COVID-related adjustments and was generally more amenable to changes to short-term as compared to long-term incentives.

Prospective Disclosure. While the 2022 proxy statements will be focused on disclosing and explaining named executive officer compensation for 2021, companies should also consider whether to prospectively disclose compensation determinations for 2022. Disclosure of key updates to executive compensation programs for 2022 allows some companies to better capture the nexus between company performance and executive compensation in their proxy statements and may help demonstrate responsiveness to feedback from proxy advisory firms and shareholders. This may be particularly important for companies that anticipate the need for further COVID-19 modifications in 2022 performance plans and want to foreshadow those changes in the 2022 proxy rather than introducing those adjustments for the first time in the 2023 proxy.

CEO Pay Ratio Disclosure. Companies are likely familiar with the requirement to disclose in their proxy statement a ratio comparing their CEO's total compensation (which covers all the components of total compensation disclosed in proxy statements, including base salary, bonus, and equity and non-equity incentive) to the total compensation of a median employee. Although companies may refer to the same median employee for up to three years, companies that have undergone significant changes to their workforces or their employees' compensation may need to redetermine a median employee sooner. As in 2020, companies making workforce adjustments in 2021 related to COVID-19 or otherwise should prepare for any required adjustments to their pay ratio disclosure as early as possible.

Perquisite Disclosure. As always, companies should take care to fully and accurately disclose in their proxy statements perquisites (which can include items like personal travel using company aircraft and club memberships) granted to their named executives and required to be included as part of "all other compensation." This issue remains an SEC enforcement priority, and companies should assume that perquisite disclosures will be carefully scrutinized. Accordingly, companies should take inventory of all executive perquisite programs and take extra care to ensure that executive perquisites are properly identified and accurately disclosed, including through effective internal controls.

Human Capital Management Disclosure. Human capital management disclosure continues to be an area of focus for public companies. Such disclosures relate to a company's employees, talent planning, training, and work environment. Last year, companies added new disclosures relating to human capital management in their 10-Ks in response to SEC rules that became effective in November 2020. In its spring regulatory agenda, the SEC indicated that new proposed rules on human capital management disclosure may be released as early as this month. Many companies have already begun voluntarily reporting on human capital initiatives in their proxy statements in addition to their required 10-K disclosure, and we would expect this trend to continue, particularly given the SEC's focus on this area.

Executive Compensation Framework for 2022

As we know, many companies made changes to executive compensation programs in 2020 to address challenges posed by COVID-19. These included delays in setting, or adjustments to, performance goals or an inability to set goals, particularly for annual incentive plans. Some companies relied more on discretionary bonuses or shifted from performance-based stock grants to time-vesting grants such as RSUs.

For some of these companies, 2021 marked a return or partial return to pre-COVID-19 compensation programs. For others, challenges remained, and these will certainly need to be addressed in the upcoming proxy season. Compensation committees will need to further assess any ongoing impact of COVID-19 on business performance, including the impact on 2021 awards, as well as 2022 compensation programs. Advance planning and discussions with management and advisors will help committees make informed decisions.

As noted above, it is important for companies and their compensation committees to understand how their peer group companies are addressing executive compensation issues. We also expect that companies will be paying closer attention not only to peer group companies but also to their competitors for executive talent and employee talent generally, given the tight labor market.

We may see increasing interest in incorporating nonfinancial metrics into performance-based executive compensation programs. This can help incentivize executives in situations where financial goals are difficult to set. As noted above, ESG initiatives and disclosures continue to be front and center, and we may see growing interest in building ESG metrics into performance awards, both for annual incentive plans and long-term incentive awards.

Another development to keep in mind is the legislative trend toward limiting the use of restrictive covenants (e.g., noncompetition covenants) in employment agreements. While some states, such as California, have limited the use of restrictive covenants in employment agreements for many years, others, such as Illinois, have joined this trend within the past year. The White House has also indicated an interest in this issue with President Biden's Executive Order encouraging the Federal Trade Commission (FTC) to review companies' use of noncompete provisions and other provisions or agreements limiting workers' mobility.

Compensation Committee Charters and Clawback Policies

As part of the annual review of charters and corporate governance policies, every compensation committee (in coordination with the board and the legal department) should consider whether any revisions or additional responsibilities in the committee's charter are appropriate. In recent years, we have seen committees update their charters—including, in many cases, a change to the name of the compensation committee to reflect a broader focus on human capital management (beyond senior executive compensation), including diversity and inclusion initiatives—and we would expect this trend to continue. Compensation committees should also review their charters to ensure that they appropriately set forth the committee's responsibilities (and that the committee is appropriately addressing these responsibilities) and consider whether any changes are warranted.

Clawback policies have been an area of focus for public companies since the SEC proposed rules in 2015 to implement the clawback provision of the Dodd–Frank Act. The proposed rules were never finalized, and while many companies have held off on revising their policies pending further action from the SEC, some have proceeded to adopt changes that expand the flexibility provided to compensation committees. These include changes with respect to clawing back compensation that was paid based on results that are later modified (without requiring a restatement), clawing back compensation when an executive engages in certain "bad conduct," and recouping severance or forfeiting future severance amounts in certain situations. As an update, the proposed SEC rules may be making a comeback—the SEC announced earlier this month that it is reopening the comment period for its 2015 proposed rule. The new comment period is expected to remain open through mid-November. While we would not expect any final action to be taken on this in 2021, it is possible there could be final rules adopted in 2022. Companies and their compensation committees should continue to monitor the proposed rules and consider how existing policies may need to be revised in light of the proposed rules and other recent trends in clawback policies.

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Proxy season is coming up quickly, and now is the time for companies and compensation committees to begin planning and coordinating with internal teams and external advisors.

Please contact a member of the Winston & Strawn Employee Benefits and Executive Compensation Practice Group or your Winston relationship attorney for further information.

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