ESG & the Bear: What to Make of the 2022 Proxy Season

August 2022

Executive Summary

The 2022 proxy season was marked by external turbulence with a considerable ESG impact. In the wake of the still ongoing pandemic, companies faced new black swan events such as the war in Ukraine and navigated rising inflation, high oil prices and continued supply chain issues.

Executives, directors and even institutional investors faced unprecedented pressure to opine publicly on external issues such the overturning of Roe v. Wade and controversial state legislation. The Great Resignation and heightened competition for talent continued to pose staffing issues, while awareness of a looming recession led some companies to freeze hiring, potentially impacting ability to achieve near-term DEI targets.

This paper presents a holistic review of the last proxy season, analyzing proxy voting results* from the first half of 2022 to determine trends, while summarizing and reviewing regulatory requirements and macro-trends that continue to impact the ESG investing movement. Our key findings are highlighted below:

Proxy season voting summary

- Average support for uncontested directors and governance-related shareholder proposals in 2022 was similar to 2021 levels.
- Carl Icahn's unsuccessful proxy contest at McDonald's over gestation crates may have established the outer tolerance limits of investors for ESG activism.
- Average shareholder support for say-on-pay continued to trend downward, particularly among large companies, as average CEO pay rose significantly in 2021.
- Average shareholder support for environmental-related shareholder proposals in 2022 was considerably lower than in 2021, though some proposals have become more prescriptive and less palatable for some large shareholders. The number of proposals voted on doubled from the prior year.
- Average shareholder support for social-related shareholder proposals in 2022 declined from 2021, though more proposals received majority support this year. The number voted on increased significantly year-over-year.

ESG developments

- Regulators around the world have mandated more robust ESG disclosure from both companies and institutional investors to combat greenwashing.
- ESG investing is being stress-tested by an increasingly bearish stock market and the anti-ESG movement has become more vocal, with some calling into question the legitimacy of stakeholder capitalism and ESG investing.
- The "Big 3" institutional investors–BlackRock, Vanguard and SSGA–continue to evolve their ESG priorities in efforts to meet their evolving client expectations, with some recalibrating their ESG voting activities.

* All proxy voting data from ISS Voting Analytics. Vote results exclude abstentions.

2022 director and proposal data for S&P 500 and Russell 3000 companies for the period Jan. 1 - June 30, 2022. 2021 director and proposal data for S&P 500 and Russell 3000 companies for the period Jan. 1 - June 30, 2021. 2020 director and proposal data for S&P 500 and Russell 3000 companies for the period Jan. 1 - June 30, 2020.

2022 Proxy Season Summary

Uncontested director support remains consistent with prior years

Average director support in 2022 at S&P 500 companies was 95.8%, relatively flat from 2021's average –96.1%. Vote support for Russell 3000 directors remained flat, dropping slightly from 95% to 94.6%.

The number of directors who failed to garner majority support was also relatively flat. To date, 55 Russell 3000 directors have failed to garner majority support in 2022, compared to 50 directors in 2021. Five of these directors served at larger companies in the S&P 500 (for comparison, four S&P 500 directors failed to receive majority support in 2021).

ISS' negative recommendation rate against Russell 3000 directors (withhold or against recommendations) increased to 14.5% in 2022 from 11.1% in 2021, driven, in part, by newly implemented policies on board racial diversity and climate change oversight. This was accompanied by an uptick in R3K directors receiving at least 20% vote opposition (1,030 compared to 892 in 2021). Concerns with executive pay and E&S issues are among the primary drivers of low director votes. The negative recommendation rate for S&P 500 directors was similar to the prior year (2.3% compared to 2.4% in 2021), and slightly fewer directors received >20% opposition (107 in 2022 compared to 117 in 2021).

ESG-centered contests prove challenging

Carl Icahn launched ESG-themed proxy fights at McDonald's and Kroger based on the ethical treatment of pregnant pigs. Mr. Icahn nominated two board candidates at McDonald's, a firm in which he held just 200 shares valued at around $50,000. ISS noted its reluctance to support a proxy contest *"...predicated on ESG issues in instances where the dissident is economically divorced from the potential impact of its proposals on the company's financial performance."* Following the vote at McDonald's, Mr. Icahn may have concluded a similar outcome at Kroger was likely and withdrew his nominees. In contrast to Engine No 1's successful contest at Exxon, Mr. Icahn's case against McDonald 's focused primarily on ESG principles, rather than connecting ESG to value.

Investors launched "Vote No" campaigns at several large companies based on concerns such as executive pay, board responsiveness and E&S issues. At least one director received more than 10% opposition at Amazon (human capital management concerns), Chevron (climate concerns) and Wendy's (supply chain concerns).

Say-on-pay vote support continues to decline, while CEO pay rises

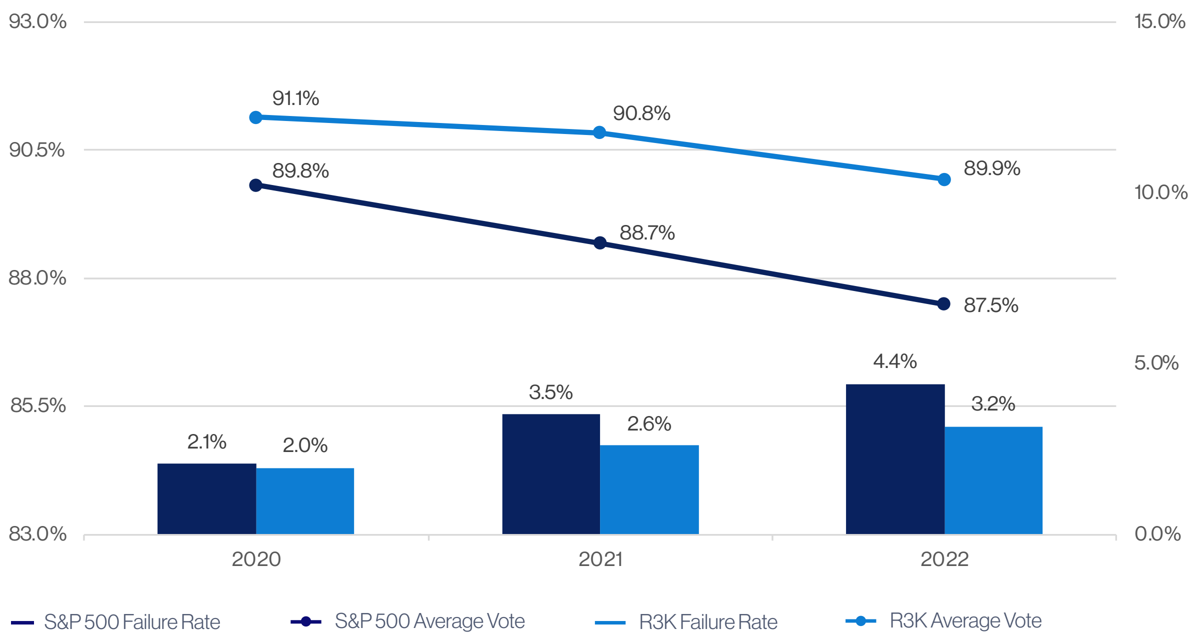
Support for say-on-pay proposals has steadily declined over the past several years while failure rates have increased. At the same time, average CEO pay has continued to grow steadily, outpacing wage increases for broader-based employees.

Average S&P 500 say-on-pay support dropped to 87.5% in 2022 compared to 88.7% in 2021 and 89.8% in 2020. Russell 3000 average vote support dropped from 90.8% in 2021 to 89.6% in 2022. The S&P 500 say-on-pay failure rate increased from 3.5% in 2021 to 4.2% in 2022, while the Russell 3000 failure rate increased from 2.6% in 2021 to 3.2% in 2022. Similarly, ISS recommendations against say-on-pay at S&P 500 companies increased from 7.8% in 2021 to 10.1% in 2022. ISS recommended against 8.9% of Russell 3000 companies in 2022, compared to 6.7% in 2021.

2022 was a record year for CEO pay packages, with average S&P 500 CEO pay growing by 17.1% to $14.5 million. Twelve CEOs received 9 figure pay packages in 2021. The highest CEO pay package in 2021, over $800 million in total pay, went to the CEO of an ad-tech company in the Russell 3000.

As in 2021, pay quantum and sizable one-time awards were key drivers of low and failed votes even when they were strongly performance-based or awarded to well-regarded CEOs.

Say-on-pay vote results



Climate-related shareholder proposals get more prescriptive, receive lower shareholder support

Investors filed a record number of shareholder proposals at S&P 500 companies (137)* in 2022. While only 54 went to a vote, this represented twice as many such proposals voted in 2021 (27). These proposals received less support overall than in 2021: 33% on average in 2022 versus 54% in 2021. However, the lower support levels are not driven by a lack of focus on climate issues, but can be attributed to:

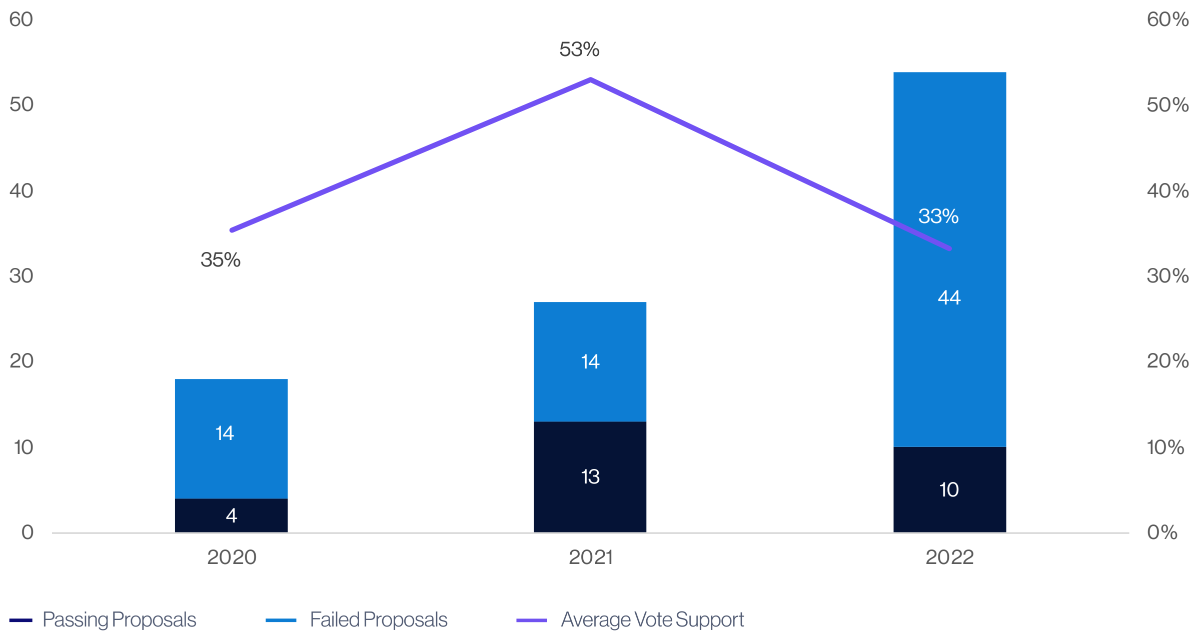
1. Certain climate-related shareholder proposals becoming more prescriptive (and such proposals are less likely to receive a no-action response from the SEC than in the past);
2. Many proposals were withdrawn due to settlements with the target companies;
3. A challenging economy; and
4. Global unrest due to the war in Ukraine.

ISS also supported fewer proposals in 2022 (65%) than in 2021 (84%).

In the first half of 2022, only 10 environmental-related proposals received majority support, compared to 13 in 2021, despite the influx of proposals this year. All passing proposals requested that companies prepare reports, typically on GHG targets or other climate-related issues, rather than adopting new policies. Proposals asking the company to prepare a report on or adopt GHG emissions reduction targets fared much better when Scope 3 was omitted from the request. Proposals asking for banks to eliminate financing for new fossil fuel projects received minimal support. Proposals asking that companies hold a "say-on-climate" vote, common in 2021, were non-existent among S&P 500 companies in 2022.

* Source: per Agenda Week

S&P 500 environmental shareholder proposals



S&P 500 environmental shareholder proposal type

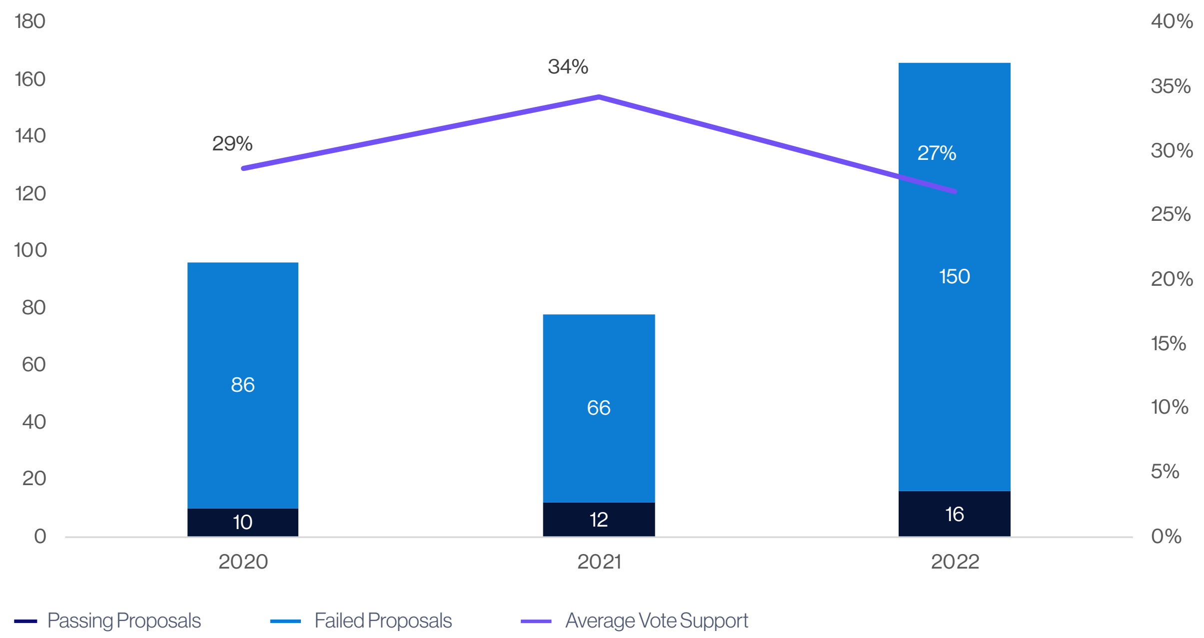
	Total	Number Passing	Average Support
Community-Environmental Impact	4	1	29%
GHG Emissions	20	4	36%
Recycling	6	0	38%
Report on Climate Change	23	5	31%
Report on Environmental Costs	1	0	14%
Total	54	10	33%

More social shareholder proposals passed, but overall support levels declined

The number of social proposals that came to a vote (166) at S&P 500 companies in 2022 more than doubled from 2021 (78). As with the increase in environmental proposals, this is due, in part, to fewer no-action responses from the SEC due to a change in policy, described in greater detail later in this paper.

Total average vote support declined from 34% to 27% and, while more proposals passed in 2022 (16) than in 2021 (12), the percentage of proposals receiving majority support declined considerably (10% compared to 15% last year). Civil rights / racial equity audits, labor issues and political lobbying and contributions received strongest investor support. Like any shareholder proposal, large insider ownership and/or a positive board recommendations can significantly swing results.

S&P 500 social shareholder proposals



S&P 500 social shareholder proposal type

	Total	Number Passing	Average Support
Political Lobbying Disclosure	25	2	34%
Racial Equity and/or Civil Rights Audit	20	6	43%
Political Contributions and Disclosure	18	2	30%
Miscellaneous	15	-	13%
Human Rights Risk Assessment	14	-	26%
Labor Issues - Concealment Clauses, Sick Leave, and Other	13	4	37%
Charitable Contributions	13	-	4%
Review Drug Pricing or Distribution	9	-	27%
Gender Pay Gap	5	2	43%
Report on EEO	5	-	35%
Improve Human Rights Standards or Policies	4	-	33%
Board Diversity	4	-	14%
Report on Pay Disparity	4	-	10%
Operations in High Risk Countries	4	-	8%
Prepare Report on Healthcare Reform	3	-	25%
Facility Safety	2	-	29%
Weapons-Related	2	-	9%
Workplace Sexual Harassment	1	-	22%
Animal Welfare	1	-	17%
Prepare Tobacco-Related Report	1	-	11%
Adopt a Policy on Ideological Board Diversity	1	-	4%
Political Activities and Action	1	-	4%
End of Production of Tobacco Products	1	-	2%
Total	166	16	27%

Governance shareholder proposals focus on special meetings

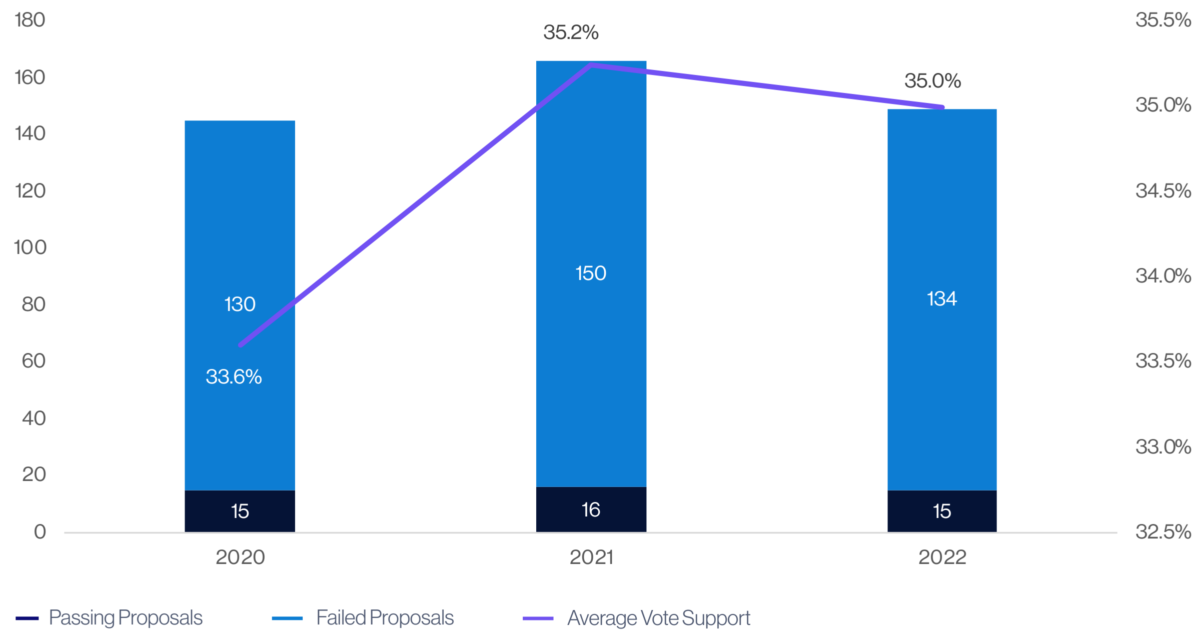
Special meeting proposals (81 in total) led the way in 2022 among S&P 500 companies, with nearly all such proposals seeking to reduce the threshold for an existing special meeting right. Many were sponsored by retail investors, including John Chevedden and Myra Young. ISS recommended in favor of most of these proposals; however, only nine received majority support.

Support for independent chair proposals is trending below the historical norm of 30%. Historically, ISS supports a majority of these proposals, but has opposed 60% of them this year, often citing the robustness of the lead independent director role, lack of governance concerns, and / or strong relative performance. None of these proposals received majority support despite speculation that increased director responsibilities might lead more investors to support separating the CEO and Chair roles.

Several of 2021's most prevalent proposals were rare sights in 2022 agendas, including proposals to allow written consent and amend proxy access rights. Calls for targets to become public benefit entities fell after these proposals fared poorly in 2021.

There were fewer proposals to declassify boards (1), allow majority voting in board elections (3) and eliminate supermajority vote requirements (5), as most companies have adopted such reforms, but these proposals continue to receive high levels of support where they do appear on ballot.

S&P 500 governance shareholder proposals



S&P 500 governance shareholder proposal type

	Total	Pass	Avg.Vote
Special Meeting Proposal	81	7	38%
Independent Chair	33		29%
Adopt Simple Majority Vote	5	5	76%
Amend Proxy Access	5		30%
Include Employees as Board Candidates	5		8%
Written Consent	4	1	43%
Recapitalization - One Share One Vote	4		33%
Require Majority Voting in Board Elections	3	1	26%
Become Public Benefit Corp.	3		2%
Board Declassification	1	1	90%
Adopt Majority Voting to Remove Directors	1		48%
Approve Revision of Transparency Reports	1		32%
Adopt Proxy Access	1		31%
Create a Pandemic Workforce Advisory Council	1		13%
Require More Nominations Than Open Seats	1		1%
Total	149	15	33%

The ESG Landscape

The SEC's 2022 busy ESG agenda

In addition to continued enforcement actions on both companies and asset managers related to alleged "greenwashing," the SEC has or is expected to set forth numerous rules:

- **Final rule on mandatory climate-related disclosures scheduled for year-end.** The draft rule was proposed earlier this year and included qualitative disclosure requirements, quantitative disclosure requirements (including measurement of Scope 3 GHG emissions where material), and external attestation of data. Our analysis of comments found institutional investors expressing strong, if qualified, support for the SEC's initiative, accompanied by concerns relating to specific implementation issues.

- **Final rules on ESG fund names and related ESG disclosures scheduled for year-end.** On May 25th, the SEC proposed two rules that seek to provide the market with greater clarity on how funds incorporate ESG factors into their investment activities. As investors will need more ESG data to comply with the rules, other companies are likely to be impacted as well.

- **Proposed rule on mandatory human-capital management disclosure scheduled for this fall.** After announcing a final ruling on principles-based human capital management disclosure, resulting in widely varied narrative disclosure among companies, the SEC is expected to require more quantitative human capital metrics to provide consistency and comparable data.

- **New guidance on no-action requests to exclude E&S shareholder proposals.** Under guidance set forth last November, successful no-action requests now require companies to demonstrate that the proposal does not raise significant social or ethical issues with **an impact to broader society** rather than raising issues on a company level as before. As such, companies have had relatively limited success omitting ESG shareholder proposals via no-action requests.

Global ESG disclosure regulations and initiatives advanced in 2022

The European Union is expected to finalize mandatory ESG disclosures (the Corporate Sustainability Reporting Directive) by year-end. Rules will apply to many companies headquartered outside of the EU. Other markets around the world have implemented or are contemplating mandatory ESG disclosure of companies (e.g.; China and Australia).

Voluntary disclosure frameworks are also evolving. The IFRS/ISSB is expected to finalize voluntary disclosure frameworks for climate and general ESG issues by year-end, while the Taskforce on Nature-related Financial Disclosure (TNFD) published a beta version of its draft disclosure framework.

The "Anti-ESG" movement mobilizes

As with any major movement, the ESG investing revolution has faced pushback from a variety of figures and groups. States such as Texas and West Virginia have passed laws forbidding doing business with those financial institutions that boycott coal, oil or natural gas companies. In May, former Vice

President Mike Pence penned a Wall Street Journal Op-Ed claiming that *"the woke left is poised to conquer corporate America..."* while Elon Musk called ESG ratings a *"scam"* after Tesla was omitted from the S&P ESG 500 Index due to its concerns about the company's social and governance issues. More *"anti-ESG"* proposals were filed at S&P 500 companies in 2022 (11) than in 2021 (6), this year requesting companies to report on the potential impact of DEI training and focus on non-minority groups. However, these proposals have fared poorly in 2022 with investors, averaging less than 3% vote support and failing to meet the 5% threshold for resubmission in 2023.

ESG fund flows & performance have been mixed in 2022

Flows into U.S. ESG equity funds in 2022 have slowed from the record levels in 2021. The performance of U.S. ESG equity funds in 2022 is mixed as compared to non-ESG equity funds; however, fund flows of European ESG equity funds continue to be positive and performance is relatively strong. Asset managers such as BlackRock and SSGA continue to launch new ESG funds into the marketplace.

Large asset managers speak out on ESG

The three largest asset managers continued to refine their ESG approaches in efforts to meet their evolving client expectations:

- **BlackRock:** BlackRock's 2022 annual CEO letter emphasized that stakeholder capitalism is based on long-term economic value and is not *"woke."* The asset manager emphasized this by issuing policy guidance that it will not support climate-related proposals that are overly prescriptive, resulting in support for 24% of E&S proposals (down from 43% last year). Additionally, BlackRock gave even more proxy voting power to its clients, providing proxy voting options to its clients whereby 25% of equity assets now exercise their own voting rights.

- **Vanguard:** Vanguard's 2022 stewardship report focused on four principles: (i) Board composition; (ii) strategy/risk oversight; (iii) executive compensation; and (iv) shareholder rights. The institutional investor set expectations on hot ESG issues from recent proxy seasons, issuing policy guidance that it does not expect companies to hold annual "Say on Climate" votes, and it does not expect ESG metrics to be included in executive compensation plans.

- **SSGA:** SSGA's annual board letter emphasized the importance of the company's transition to a low-carbon future and board/workforce diversity. The investor issued guidance on expected company climate disclosure and climate transition plans, including voting against boards that lack TCFD-aligned disclosure. Additionally, the asset manager published its expectations on how companies with material exposure to Russia and the Ukraine are managing ESG risks.

Looking Ahead

ESG issues are expected to continue to play a prominent role in the second half of 2022 and next year.

The SEC is expected to continue to be very active on ESG with a continued focus on "greenwashing" from both investors and companies. Multiple rules are also set to be put forth later this year. Despite Mr. Icahn's withdrawal from McDonald's, activists remain increasingly focused on ESG issues, targeting longer tenured directors. Additionally, the universal proxy rule goes into effect this year, potentially providing activists with an advantage, while employees are increasingly vocal about ESG issues and submitting shareholder proposals at their own companies. Further, social issues could continue to have governance implications for public companies. For example, the Supreme Court's decision to overturn Roe v. Wade has raised questions from investors and employees as to how companies will respond to the decision, including whether and how they will ensure access to reproductive healthcare. The U.S. Uyghur Forced Labor Prevention Act took effect in June of 2022, and investors will likely further prioritize human rights issues. The ongoing war in Ukraine and potential for unrest in other parts of the world will further highlight risks relating to supply chain, human rights and employee safety.

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