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ISS Considers New Director Withhold Vote Policies for Lack of Racial/Ethnic Diversity and Failing to Oversee Environmental and Social Risks

Institutional Shareholder Services (ISS) has released proposed 2021 voting policy updates, with a comment period that runs through October 26, 2020. The new Board Diversity and E&S Risk Oversight proposals are addressed below. Final policies should be announced by mid-November 2020. Tighter director overboarding rules were not proposed.

Board Diversity. As investors increase their scrutiny and expectations of public companies with respect to diversity and inclusion, ISS is proposing a two-pronged and phased-in approach for board-level ethnic and racial diversity. The new approach follows ISS' 2020 policy survey results in which 61% of investor respondents stated that: "Boards should aim to reflect the company's customer base and the broader societies in which they operate by including directors drawn from racial and ethnic minority groups."

Beginning in 2021, ISS would highlight in research reports the U.S. companies that "lack racial and ethnic diversity (or lack disclosure of such)," like ISS already does with respect to gender. ISS believes this will spur further company-investor engagement on such matters. The policy would reach the broader Russell 3000 universe as well as S&P 1500 index constituents. Aggregate (vs. director-by-director) diversity statistics disclosed by a company would be considered but only to the extent racial and/or ethnic diversity is specifically presented.

Beginning with the 2022 proxy season, ISS would apply a new withhold-the-vote policy (similar to their gender diversity policies), generally recommending against the chair of the nominating committee (or other relevant directors on a case-by-case basis) where there are no identified ethnic or racially diverse board members. Mitigating factors would include firm commitments to increase such diversity. This one-year phase-in/grace period that would enable companies to enhance diversity over the coming year may not hold, as ISS is soliciting comments on whether the phase-in is too short or too long. ISS is expected to continue to recommend in favor of shareholder proposals regarding board diversity matters (*e.g.*, proposals urging adoption of the Rooney Rule, seeking skills matrix disclosure that includes diversity attributes, etc.), and many shareholders and companies have been – or will be – increasing engagement efforts addressing board diversity topics.

As to the broader workforce, more investors are contemplating submitting shareholder proposals reaching enterprise-wide diversity, inclusion and human capital-related matters. ISS is expected to continue to recommend in favor of such proposals, including those seeking reporting of comprehensive workforce diversity data (whether EEO-1 level or the equivalent), gender or racial/ethnic pay gaps and broader human

capital management reporting, especially where companies are lagging peers or have not made meaningful disclosures to date.

An increasing number of institutional investors, large and small and indexed and actively managed funds alike, now vote in favor of board and workforce diversity-related proposals, resulting in their passage, and are intensifying their engagement with, and expectations of, companies as to these issues. Whether spurred by investor requests or broader social and corporate awareness of systemic racial and ethnic disparities and injustices, companies are increasingly making proactive disclosures and taking proactive actions to address diversity-related matters effectively, secure shareholder support and be responsive to employee and stakeholder expectations.

E&S Risk Oversight. ISS is proposing making explicit that "demonstrably poor risk oversight of environmental and social issues, including climate change" may result in ISS recommending withhold votes against individual directors, specific board committee matters or the whole board. Companies in a "highly impactful sector" will receive heightened scrutiny, as will companies who are "not taking steps to reduce environmental and social risks that are likely to have a large negative impact on future company operations."

ESG as a means to enhance corporate resiliency and drive substantive action may now be embedded within ISS analyses, resulting in withhold votes "against directors who fail to make their companies more resilient" and ISS viewing "neglecting to take meaningful steps to increase the resilience of companies" as equivalent to a failure of risk oversight, including with respect to climate change. Notably, ISS is also considering establishing forward-looking criteria that would enable ISS to "proactively identify boards that fail to prepare for foreseeable future risks," rather than solely applying voting policies in a retrospective fashion.

We have previously addressed how risk oversight expectations are evolving, not only in terms of management-level systems, but also with respect to board and board committee structures and practices for navigating potential *Caremark* liability, business risks, reputational threats and heightened investor expectations.

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