Kingsdale Market Update

November 17, 2017

ISS 2018 Benchmark Policy Update (U.S.)

On November 16, 2017, Institutional Shareholder Services Inc. ("ISS") released its 2018 Benchmark Proxy Voting Guidelines Updates **to be applied for shareholder meetings taking place on or after February 1, 2018**. The restated guidelines, certain FAQs and an updated white paper on ISS' enhanced quantitative screening methodology are expected to be published in the next few weeks.

In the U.S. market, ISS made the following key updates to its benchmark guidelines:

(1) adverse vote recommendation on directors responsible for excessive non-employee director pay starting in 2019;

(2) adverse vote recommendation on directors every year at companies with long-term poison pills not approved by shareholders (case-by-case for short-term pills);

(3) a case-by-case approach with more clarity on gender pay gap shareholder proposals;

(4) expanded criteria to assess climate change risk shareholder proposals;

(5) incorporating the three-year Relative Financial Performance Assessment into its quantitative pay for performance methodology as the fourth test;

(6) new director categorizations as Executive Director, Non-Executive Non-Independent Director and Independent Director without any impact to vote recommendations;

(7) boards with no gender diversity to be highlighted without any adverse recommendation;

(8) poor attendance for new directors who serve on the board for only part of the year; and

(9) codification of policies on pledging, special purpose acquisition companies, classified boards and say on pay frequency.

ISS sought public comments on items (1) to (3) three weeks ago on October 26, 2017. Items (5) and (6) also apply to Canadian companies. Items (7) to (9) are either minor changes or codifications of its current policies.

(1) Director Election on Non-Employee Director (NED) Compensation

ISS' current benchmark guidelines only broadly address NED compensation by stating that companies should avoid inappropriate pay for NEDs.

Starting in 2019, ISS may recommend against directors who are responsible for approving/setting NED compensation when there is a pattern (i.e. two or more years) of excessive NED pay magnitude without disclosing a compelling rationale or other mitigating factors.

Kingsdale Insight: No changes have been made to the draft policy. Investors have shown a growing interest in NED pay as the magnitude has steadily increased over years. The new ISS policy is still vague on what is considered "excessive" NED pay and only results in adverse recommendations when there is a pattern over multiple years. As a result, there would be no impact on vote recommendations in 2018. We expect ISS may screen outliers using average/median NED pay. Accordingly, issuers should self-assess NED pay against peers.

(2) Director Election on Shareholder Rights Plans (Poison Pills)

ISS has simplified the policy and will vote against/withhold from all nominees if the company has a poison pill that was not approved by shareholders. ISS also clarified that the approval must be by public shareholders only and approval prior to a company's becoming public is insufficient.

However, ISS will adopt a case-by-case approach on nominees if the board adopts an initial pill with a term of one year or less, depending on the disclosed rationale for the adoption, and other factors as relevant (such as a commitment to put any renewal to a shareholder vote).

Kingsdale Insight: Changes have been made to the draft policy to treat long-term pills and short-term pills, making the final policy less stringent. Overall, the tightened policy changes strengthen ISS' principle that poison pills should be approved by shareholders. The fact that ISS continues to assess short-term pill adoption on a case-by-case basis with more emphasis on rationale may be reflective of ISS' balanced approach that shorter term pills are generally less onerous as a takeover defense when compared to longer term pills, and may in some cases provide the board with a valuable tool to maximize shareholder value in the event of an opportunistic offer. Notwithstanding, when considering adoption of a pill, Issuers should simultaneously contemplate a commitment or policy that puts a newly-adopted pill to a binding shareholder vote.

(3) Gender Pay Gap Shareholder Proposals

ISS is adopting a new case-by-case policy to address shareholder proposals seeking disclosures related to a company's gender pay gap by examining the following three considerations:

- The company's current policies and disclosure related to: i) its diversity and inclusion policies and practices, and ii) its compensation philosophy and fair and equitable compensation practices;
- Whether the company has been the subject of recent controversy, litigation, or regulatory actions related to gender pay gap issues; and
- Whether the company's reporting regarding gender pay gap policies or initiatives is lagging its peers.

Kingsdale Insight: No changes have been made to the draft policy. Over the past few years, unsatisfied by the gender pay gap, shareholders have increasingly filed more proposals at companies in the technology, financial services, insurance, healthcare and telecom industries, requesting that companies report whether a gender pay gap exists, and if so, what measures will be taken to address the gap. It appears that such campaigns will continue. With this new policy, issuers now have better visibility to ISS' approach which can help self-assessment of internal policies and practices. Keeping with peers' disclosure in this regard will also fend off such proposals.

(4) Climate Change Risk Shareholder Proposals

ISS is updating its policy on climate change risk shareholder proposals to expand its review over the company's process for identifying, measuring, and managing financial, physical, or regulatory risks in addition to the disclosure of such risks.

Kingsdale Insight: This update, which is not vetted, better aligns the policy with the recommendations of the Task Force on Climate-Related Financial Disclosures, which explicitly seek transparency around the board and management's role in assessing and managing climate-related risks and opportunities. Encouraged by the successful climate change proposals in 2017, proponents are expected to continue the momentum next year. However, the expanded scope of review won't change ISS' current approach to generally support shareholder proposals seeking disclosure of climate change risks.

(5) Pay for Performance Quantitative Methodology

ISS will add a fourth test to its quantitative pay for performance screening for 2018 by examining the alignment of pay and financial performance. The new test, Relative Financial Performance Assessment (RFPA), introduced first in 2017 for information purposes only, compares the company's rankings to a peer group selected by ISS with respect to (i) CEO pay and (ii) financial performance in three or four metrics (which will vary depending on industry), in each case as measured over three years. Details of this new test will be provided by ISS in an updated white paper.

Kingsdale Insight: While this new policy didn't go through the public consultation process, we are not surprised by its introduction. The RFPA test will enhance ISS' quantitative screening by providing performance perspectives in addition to total shareholder return (TSR), which was solely relied on by ISS before. The fundamental principle of this test is no different from the current Relative Degree of Alignment (RDA) test but uses a combination of financial metrics rather than a single TSR metric. The reduction of the number financial performance metrics from six or seven to three or four is also positive. More metrics, while complicated, are not necessarily better. We further expect that ISS will not use TSR as one of the financial performance metrics to avoid the overlap between the RFPA test and the RDA test. In a few weeks, we will know the thresholds for concern levels under the RFPA but believe two "medium" level of concerns or one "high" level of concern will continue to translate into an overall "high" level of concern under the quantitative test. With one more test in the quantitative screening, issuers should be aware that chances of having concerns may increase.

(6) Director Independence Classification

The current three categories of Inside Director, Affiliated Director and Independent Outside Director will be changed to Executive Director, Non-Independent Non-Executive Director and Independent Director. While most Inside Directors will be categorized as Executive Directors, the directors considered Insiders due to their controlling interest in the company will be moved to the Non-Independent Non-Executive Director category. This reclassification does not result in any vote recommendation changes, as under the old and new ISS categorizations, the directors are considered non-independent.

Kingsdale Insight: This change is to harmonize ISS' categorization of directors across the market by using a uniform nomenclature.

Gender Diversity: As part of a board composition principle, ISS will highlight boards with no gender diversity but will not make voting recommendations on that basis at this time. This is different from ISS' Canadian policy where gender diversity will actually be used to formulate voting recommendations.

Director Attendance: Poor attendance by new directors who serve on the board for only part of the year will be exempt from negative recommendations

Codifications of Existing Approaches:

- Pledging of company shares is evaluated on a case-by-case basis, examining its magnitude and rationale, and efforts to wind it down.
- Special purpose acquisition company extension proposals are examined on the basis of the length of the request, any pending transactions, any equity kicker, and prior extension requests.
- State laws that mandate classified boards are a basis for perennial negative director recommendations unless the company has opted out of those laws.
- Say-on-pay frequency proposals must be on the ballot when required by regulation to avoid negative director recommendations.

If you have any questions about this update, please feel free to contact Kingsdale's experts listed below to discuss directly.

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