

October 18, 2018

ISS 2019 Benchmark Policy Consultation

This morning, Institutional Shareholder Services Inc. ("ISS") released its 2019 Benchmark Policy Consultation requesting feedback from interested market constituents on new or potential changes to its proxy voting policies. Comments are **due by 5:00 P.M. ET on November 1, 2018** and will be taken into consideration as ISS formulates its policy updates. We expect ISS will finalize and publish these updates in mid-November.

For the U.S. and Canadian markets, ISS is soliciting feedback on policies related to board gender diversity and the financial performance assessment section of ISS' pay-for-performance model. Market participants who wish to comment on ISS' draft policies or read more about which areas ISS wishes to solicit feedback on can find more information [here](#).

Board Gender Diversity (U.S.)

ISS' current benchmark guidelines do not mandate adverse recommendations for director elections related to board gender diversity.

Beginning on or after February 1, 2020, for Russell 3000 or S&P 1500 constituents, ISS will generally recommend that shareholders withhold votes from the nominating committee chair (or other directors responsible for board nominations) at companies with no female directors on the board.

ISS highlights various mitigating factors for companies without any female directors, including but not limited to a firm commitment—in a public filing—to add at least one female director before the next annual meeting, or the presence of at least one female director in the immediately preceding annual meeting. ISS estimates that 10% of Russell 3000 constituents will be impacted by the proposed policy at the time of implementation (note: there is significant overlap between the Russell 3000 and the S&P 1500 indices).

Institutional shareholders that Kingsdale has spoken to have all re-iterated that board gender diversity is top-of-mind for the 2019 proxy season. Given the one-year grace period and commitment to add one female director the following year, we anticipate that U.S. issuers have sufficient time to recruit at least one female director and mitigate ISS' potential concerns.

Board Gender Diversity (Canada)

For the Canadian market, as stated previously in their 2018 benchmark guidelines, ISS has proposed to expand the scope of its existing gender diversity policy. Currently, if a S&P/TSX company has not adopted a formal written gender diversity policy and no female directors serve on the board, ISS will, with some exceptions, recommend that shareholders withhold votes from the nominating committee chair, the chair of the committee responsible for director nominations, or the chair of the board in its absence. For the

formal policy to be acceptable to ISS, it would need to be “robust” and have a clear commitment to increase board gender diversity and, in our experience, include specific targets to be achieved within a reasonable time period.

For meetings on or after February 1, 2019, ISS is proposing to expand its policy application to “widely-held” companies on the TSX, an internal ISS designation based on the number of ISS clients that hold the specific securities. ISS notes that approximately 43% of non-S&P/TSX Composite Index constituents have no female directors.

The proxy advisor’s proposed changes are in-line with what was previously stated in ISS’ 2018 benchmark guidelines. We expect that the expansion in coverage to non-Composite Index issuers will ignite another wave of board refreshments with a focus on gender. Based on Kingsdale’s estimates, this policy application could affect approximately 150 additional companies.

Pay-for-Performance (U.S. and Canada)

Historically, ISS has applied its two-step quantitative and qualitative assessment when evaluating pay-for-performance alignment for companies covered under its assessment methodology. The quantitative test originally used Total Shareholder Returns (“TSR”) as the sole performance measure. Beginning in 2018, ISS introduced the Financial Performance Assessment (“FPA”) as a secondary screen. Depending on the industry, FPA metrics could include ROA, ROE, ROIC, EBITDA growth and/or Cash Flow growth. Issuers who received an initial low (bordering medium) or medium degree of concern under ISS’ primary screens were eligible to be upgraded or downgraded based on results of the FPA.

Furthermore, ISS proposes to update its secondary FPA screen by replacing existing unadjusted GAAP accounting measures with Economic Value Added (“EVA”) based measures. Specifically, ISS proposes that ROA, ROE, and ROIC (capital productivity and profitability measures) be replaced with a three-year EVA Spread and EVA Margin and EBITDA growth and Cash Flow growth (company progress measures) be replaced with EVA Momentum (denominated by capital and sales). For reference, the EVA-based metrics that ISS proposes are generally defined as follows:

$$\text{EVA Spread} = \text{EVA/Capital Invested} = \text{ROIC} - \text{WACC}$$

$$\text{EVA Margin} = \text{EVA/Sales}$$

$$\text{EVA Momentum} = \Delta\text{EVA/Trailing Sales}$$

Each EVA metric will be weighted equally and the weightings will be the same for all companies in all industries. Importantly, ISS notes that EVA data will be provided to issuers for their own company in advance of the annual meeting and ISS analysis.

Based on ISS back-testing during the 2018 proxy season, fewer than 5% of companies with a low concern level were upgraded to a medium concern. A very similar number of medium concern companies were downgraded to a low concern.

Kingsdale’s internal testing has demonstrated that approximately 12% of our clients have been affected by the FPA assessment either through an upgrade or downgrade of the primary screens. This concurs with ISS’ view that a small number of companies would be impacted by this change. As of now, ISS’ primary TSR-based screens and its holistic qualitative review will still play significantly more important roles to ISS’ compensation analysis and recommendations. As ISS is proposing to make its EVA-based data points available for issuers to review ahead of time, Kingsdale will work with issuers to review the data to ensure accuracy. Despite ISS’ introduction of EVA-based metrics, traditional institutional investors may still rely on other GAAP-based financial metrics for a more holistic view.

We believe it will still be up to the issuer to tell its pay-for-performance story within the information circular/proxy statement and demonstrate that pay is aligned with performance using measures that make sense for the issuer.

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