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ISS & Glass Lewis Release 2017 Proxy Guideline Updates (CND & US)

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Client Alert

Institutional Shareholders Services ("ISS") and Glass Lewis ("GL") recently released updates to their 2017 voting guidelines for Canada and the U.S. The updated guidelines from ISS will apply to shareholder meetings for publicly-traded companies on or after February 1, 2017, while the ones from Glass Lewis will apply to meetings held on or after January 1, 2017. This memo provides a summary of policy updates on compensation-related and board-related topics in each of the two countries.

Key Policy Highlights

- ISS announced changes to their pay-for-performance ("P4P") methodology (applies to U.S. and Canada): ISS will augment their current P4P analysis with a comparison of company performance relative to peers across six financial metrics
- ISS peer group methodology for Canadian companies will now consider the pay peers selected and disclosed by issuers
- Director compensation practices in Canada have come into the spotlight: ISS will recommend against directors responsible for setting pay where a company's director compensation practice is viewed to pose independence risks or otherwise appear problematic (e.g., appointment grants)
- Refined guidelines on director overboarding (ISS and GL) will come into full effect for 2017 proxy season in Canada and the US
- Glass Lewis is firming its policy on board responsiveness to failed say-on-pay votes in Canada
- ISS and Glass Lewis have formalized a number of other policies that focus on director accountability and independence

Canada: 2017 Compensation-Related Policy Updates

ISS: Pay-for-Performance

- **Updated Policy**: ISS has augmented its current P4P analysis with a comparison of a company's performance relative to peers across six financial metrics – return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth, cash flow from operations growth
    - The new financial metrics will be measured over a three-year performance period and the weight on each metric will vary by industry
- **Implication:** The current quantitative pay-for-performance test will continue to rely solely on relative TSR to evaluate pay-for-performance concern levels. For 2017, company performance under the new metrics may be considered as part of ISS' qualitative analysis and "its consideration may mitigate or heighten identified pay-for-performance concerns"

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The introduction of additional metrics was backed by many institutional shareholders, and will be a welcome change for many issuers. Companies with weak relative TSR could potentially mitigate a poor pay-for-performance score on the supplemental financial and operational metrics

ISS: Peer Group Methodology

- **Updated Policy**: ISS will now consider the pay peers selected and disclosed by an issuer
- **Implication:** Companies should expect to see more overlap between the ISS and company selected peer groups (note: ISS will not include in their peer group any company-disclosed peers that are domiciled outside of Canada or beyond ISS' size parameters). Issuers with annual general meetings between February 1, 2017 and September 15, 2017 and that have made changes to their peer group in 2016 will have the opportunity to submit their self-selected peer group to ISS from November 28 to December 9, 2016

ISS: Director Compensation Practices (TSX-listed only)

- **New Policy**: ISS has established a new policy that will result in negative recommendations against the election of directors responsible for setting compensation (or board chair) if a company's director pay practices pose independence risks or otherwise appear problematic, including:
  - Excessive sign-on or "inducement" grants to new directors
  - Granting of performance equity to directors
- **Implication**: ISS is taking a firmer stance on forms of director pay believed to interfere with a director's independent judgment. The increased scrutiny came in light of recent director "inducement" grants (e.g., one Canadian company granted $1MM of appointment grants in 2016). While there has been recognition in recent years of the evolving role and increasing workload of directors, shareholders are becoming wary of outsized or performance-based pay that may pose undue risk to the company and its shareholders, including potential interference with director independence. Members of compensation/governance/HR committees should assess whether problematic pay practices exist within their pay programs

GL: Board Responsiveness to Failed Advisory Vote

- **New Policy**: GL has adopted a new guideline whereby they will recommend against members of the compensation committee of companies that fail to adequately address shareholder concerns subsequent to a failed say-on-pay vote.
- **Implication**: The importance of Board-led shareholder engagement initiatives is emphasized by this new policy

GL: Equity Compensation Plans

- **Updated Policy**: GL will generally recommend against equity compensation plans that provide full-value awards (e.g. RSUs and PSUs) seeking a share limit above the rolling maximum of 5% of the company's share capital.
- **Implication:** full-value award plans have become more common in recent years, replacing or supplementing stock option plans (which typically required issuing a greater number of shares, given the lower inherent value of stock options). Boards should ensure plan limits are adjusted to account for this shift (note: GL will not automatically recommend against 5% fixed reserve plans)

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Canada: 2017 Board-Related Policy Updates

Director Overboarding

- ISS and Glass Lewis, subsequent to the one-year grace period in 2016, have formalized their definitions of "overboarded" director. Policies on director overboarding will take effect in 2017, with each proxy advisor issuing recommendations against directors who exceed the established thresholds
- **ISS will consider a director is overboarded if he/she:**
  - Serves on more than 4 public-company boards (1 board for CEOs) and has attended less than 75% of board/committee meetings
- **Glass Lewis will consider a director is overboarded if he/she:**
  - Serves on more than 5 public-company boards (2 for CEOs)
  - GL will also consider other factors (e.g., size and location of the companies, tenure, attendance, etc.)
  - GL will assess directors who sit on a mix of TSX and TSXV boards on a case-by-case basis
- **Implication**: 2017 marks the end of the one-year grace period for overboarded directors. Going forward, both proxy advisors will recommend against the election of directors who exceed the proxy advisors' thresholds on board commitment. However, both ISS and Glass Lewis, in making their recommendation, may consider any disclosed rationale for continued service on the board

ISS: Excessive Audit Fees

- ISS will recommend against the election of audit committee members and auditor ratification proposals if non-audit fees paid to the auditor exceed the sum of audit and related fees, and tax compliance and preparation fees

ISS: Director Independence

- ISS has clarified its definition of director independence in terms of related party transactions – directors with transactional, professional, financial, and charitable relationships occurring any time between the beginning of the most recently completed fiscal year and the AGM will not be considered independent

Shareholder Right Plan

- ISS and Glass Lewis have updated their respective policies on shareholder right plans to align with the new regulation under the Canadian Securities Administrators which requires a minimum bid period for all non-exempt takeover bids
  - ISS minimum period greater than 105 days (with board discretion to reduce, but in no event to less than 35 days)
  - GL minimum period of 105 days

GL: Gender Pay Equity (Shareholder Initiative)

- GL has a new policy for shareholder resolutions which will require increased disclosure on the company's efforts to ensure gender pay equity (case-by-case basis)

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US: 2017 Compensation-Related Policy Updates

ISS: Equity Compensation Plan Proposals (on Amendments)

- ISS is updating its Equity Plan Scorecard (EPSC) for evaluating equity compensation plans amendments:
  - ISS prohibits the payment of dividends on unvested awards (until payout)
  - Going forward, ISS will only give credit if the plan contains a minimum vesting requirement of at least one year, which cannot be overridden in award agreements
  - For proposals to amend non-employee director equity plans, ISS is expanding its list of qualitative factors if the proposal exceeds the shareholder value transfer ("SVT") limits

ISS: Say-on-pay at Cross-Market Companies

- For U.S. domestic issuers organized abroad, ISS announced that it will base its recommendations on say-on-pay proposals required by a foreign jurisdiction

ISS: Amending Director Compensation

- ISS is codifying its policy addressing shareholder ratification of director pay programs. Going forward, ISS will evaluate eight qualitative factors relating to the relative magnitude, structure, and disclosure of director pay

US: 2017 Board-Related Policy Updates

ISS: Director Overboarding

- **ISS will consider a director is overboarded if he/she:**
  - Serves on more than 5 public-company boards (2 board for CEOs)

ISS: Director Elections at Companies that Restrict Shareholders' Right to Amend the Bylaws

- ISS has adopted a new policy whereby it will recommend against the election of directors, generally the governance committee members, at companies whose charters prohibit binding shareholder proposals, place ownership requirements on shareholder proponents above those of Rule 14a-8, or unduly restrict shareholders' ability to amend the bylaws

ISS: Director Elections at Newly Public Companies

- ISS is broadening its existing policy to include multi-class capital structures without identical voting rights as an adverse provision, generally warranting negative director vote recommendations
- ISS will also require a reasonable sunset provision on any shareholder-adverse provisions and will no longer evaluate a company's commitment to put such provisions to a shareholder vote within three years

GL: Board Evaluation and Refreshment

- Glass Lewis has clarified its approach to board evaluation, succession planning and refreshment to place greater emphasis on the alignment of director skills with company strategy (versus relying on term and age limits)

GL: Governance Following an IPO or Spin-off

- GL has clarified its approach for reviewing the terms of the company's governing documents in order to determine whether shareholder rights are being severely restricted from the outset; GL will consider recommending against directors that served at the time of the governing documents' adoption, depending on the severity of the concern

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- Specific areas of governance to be reviewed include anti-takeover mechanisms, supermajority vote requirements, and general shareholder rights (e.g., ability of shareholders to remove directors and call special meetings)
- GL will provide a one-year grace period before making recommendations on the basis of governance standards

Concluding Thoughts

Proxy advisor recommendations are widely believed to have a material impact on the voting results at shareholder meetings. Issuers will need to be mindful of the policy updates from ISS and Glass Lewis and be aware of the potential implications of these policies. Having said that, based on Hugessen's experience, there is an increasing willingness, particularly among institutional shareholders, to assess company compensation programs on a nuanced case-by-case basis. This further underscores the importance of providing clear, transparent disclosure and maintaining open communication with shareholders.

To learn more, please contact:

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