

---

## 2014 Updates to ISS' Canadian Proxy Voting Guidelines

---

### Introduction

Prior to each proxy season, proxy advisory firm Institutional Shareholders Services ("ISS") releases updates to its Corporate Governance Policies, specific to each market (e.g., Canada, United States). In addition to this year's [policy updates](#) (released November 21, 2013), ISS has also announced an [extended consultation period](#) to receive comments on a number of additional subjects.

**Policy Updates:** There are numerous minor updates to ISS' Canadian Corporate Governance Policy that span each of the four areas of governance assessed by ISS in order to arrive at their vote recommendations (i.e., compensation, board, shareholder rights, and audit). We note that many of the updates are situation-specific and may not apply to all issuers. That said, three issues stand out as particularly relevant for many issuers:

- 1) The Relative Degree of Alignment test in the pay-for-performance evaluation will use a single three-year test, instead of the current weighted one and three-year approach
- 2) A say-on-pay ("SOP") vote of less than 70% is the established threshold for "significant opposition" requiring a higher level of response and engagement from issuers
- 3) Directors serving on more than 6 public company boards and active CEOs on more than two public company boards will not be supported if accompanied by low attendance

**Extended Consultation Period:** ISS has separately announced a significant change to its market outreach process, which currently invites market participants to provide feedback on proposed updates to its proxy voting guidelines in October. Two of the seven issues published for comment are applicable to the Canadian market:

- Director tenure: while ISS is reluctant to set firm limits on tenure when making voting recommendations, they acknowledge that a majority of investors consider long tenure to be problematic
- Equity-based compensation plans: ISS is reviewing its current approach to assessing these plans whereby a single facet (e.g. cost, amendment provisions, director participation, etc.) can result in a fail when recommending for a new share reserve. This may prove beneficial for many issuers, but could result in yet another black box used to determine vote recommendations.

**Summary of ISS' 2014 Canadian Proxy Voting Guideline Updates***Compensation:*

## 1) Pay-for-Performance Evaluation

Key Change: The methodology for calculating the relative degree of alignment (measuring the difference between a company's relative total shareholder return rank and the CEO's relative total pay rank) has moved from a blended one- and three-year score to a single three-year measurement to reduce the emphasis on short-term results.

Implication: Issuers who have recently turned in a strong year of performance after one or two years of underperformance should consider emphasizing this recent performance turnaround in the Compensation Discussion and Analysis ("CD&A").

## 2) Board Responsiveness to SOP results

Key Change: Clarifies the level of support that is representative of "significant opposition" to a SOP vote as less than 70% of votes cast.

Implication: While Hugessen recommends that shareholder engagement be an annual process the board undertakes, issuers should provide fulsome disclosure relating to any and all remediation steps following "significant opposition" to a SOP, or where the level of support has dropped materially year-over-year (e.g., a drop >15%).

## 3) Non-Employee Director Participation in Equity Compensation Plans

Key Change: Creates separate annual individual limits on non-employee director participation in equity plans of \$100,000 for option plans and \$150,000 for share award plans that do not contemplate granting options. (ISS will also vote against an equity compensation plan which provides for, on aggregate, in excess of 1% of outstanding shares).

Implication: While this policy primarily applies to treasury based-equity plans on an agenda, directors may wish to undertake a review of their director compensation program in terms of the form and level of compensation.

## 4) Option Repricing Proposals

Key Change: Clarifies that each of the following scenarios constitute a repricing, which will generally not be supported: "reduction in exercise price or purchase price, extension of terms for outstanding options, cancellation and reissuance of options, substitution of options with other awards".

December 2013

Implication: While responsibly drafted option plans prohibit repricing, directors may wish to suggest the following when considering any potential option repricing proposal: i) a “value-for-value” exchange, ii) excluding the Named Executive Officers and directors, iii) removing repriced options from the plan’s share reserve once exercised, iv) instituting a cap on option usage going forward, and/or v) submitting for shareholder approval.

*Board Composition and Audit Practices:*

1) Definition of Director Independence

Key Change: Minor clarifications to definitions of an “Independent Director”, “Inside Director”, and “Affiliated Outside Director”, in particular for control blocks and interim executives.

Implication: Boards with an interim CEO or controlling share block in place may wish to review the clarified independence requirements.

2) Persistent Problematic Audit Related Practices

New Policy: Recommend against members of the audit committee and/or full board if problematic accounting practices causing “serious concern” (defined as: “accounting fraud; misapplication of applicable accounting standards; or material weaknesses identified in the internal control process”) are identified.

Implication: This new policy increases the focus on board accountability. Should a company have any of the identified problematic audit practices, the Company’s proxy and/or Annual Information Form should transparently disclose the sequence of events leading to the finding, assessment / description of severity, breadth and duration of the issues, and steps taken to-date to remediate the issue and steps to prevent future occurrences.

3) Voting on Directors for Egregious Actions:

Key Change: Provides examples of what ISS considers to be a failure of risk oversight, including: “bribery; large or serial fines or sanctions from regulatory bodies; significant adverse legal judgements or settlements; or hedging of company stock” by directors or officers.

Implication: Boards may wish to more actively consider adopting an anti-hedging policy.

December 2013

4) Board Responsiveness to Director Elections and Shareholder Proposals

New Policy: Recommend against individual directors, committee members, or an entire board as a result of a board's failure to act on a majority of withheld votes from director nominees, or a majority supported shareholder proposal.

Implication: If director elections or shareholder proposals receive the stated level of support, boards should seriously consider any appropriate actions and fully disclose why or why not such actions were undertaken / completed by the following shareholder meeting.

5) Director Overboarding

Key Change: Withhold recommendations on directors deemed to be "overboarded" (CEOs: >2 outside public company boards; non-CEOs: >6 public company boards) and who have attended <75% of board and committee meetings within the past year if the company has not adopted a majority voting policy (a pattern of low attendance is required if a majority voting policy has been adopted).

Implication: Directors who sit on numerous boards may want to reconsider their directorships in light of the increasing workload for directors and their recent attendance levels.

*Shareholder Rights & Defences:*

1) Advance Notice Requirement for Director Nominations

Key Change: Clarified that either of the following provisions will result in a recommendation against an advance notice requirement: i) the board may only waive a portion of the advance notice provision under the policy/by-law, in its discretion; ii) the company requires any proposed nominee to agree (in writing) that he/she will comply with all policies of the company that are applicable to directors.

Implication: Given the growing number of proxy contests in Canada in recent years, shareholders support advance notice requirements that reduce the likelihood of stealth contests, although not at the cost of needlessly handcuffing shareholder-nominated directors. Directors may wish to review policies to ensure that the provisions do not go beyond the stated purpose of the policy.

2) Enhanced Shareholder Meeting Quorum for Contested Director Election

New policy: ISS will not support a higher quorum for those shareholder meetings where a majority of current board members might be replaced. A higher "threshold" is inconsistent with

December 2013

the notion that all voting items should carry equal importance and therefore should be approved under the same quorum requirement.

Implication: Directors should carefully consider the motivation for proposing enhanced quorum requirements.

### **Extended Consultation Period**

Based on the results of ISS' 2013-2014 Policy Survey, ISS is seeking comments on the potential direction that future policy updates (i.e., 2015 and beyond) may take. An additional comment period has been opened (closes February 2014) to gather additional market feedback.

This shift from a seasonal to a year-round process provides a longer policy development process to continue reviewing emerging trends that may become a focus of investors in the coming years. Of the seven published topics, two would be applicable to the Canadian market:

#### 1) Director Tenure

ISS does not currently consider director tenure as a factor for determining its voting recommendation in director elections. A significant majority (74%) of investor respondents indicated that long director tenure is problematic (long-serving directors are more likely to be associated with governance problems as they may lack independence and objectivity). However, upon further discussions with investor participants, ISS notes reluctance in setting firm limits on tenure.

#### 2) Equity-Based Compensation Plans

ISS is considering moving towards a "scorecard approach" in forming its voting recommendations on equity-based compensation plans, whereby no one single factor could constitute a failure, as the policy is currently structured. ISS currently places significance on a plan's shareholder value transfer, with multiple problematic provisions also acting as deal-breakers (i.e. resulting in a recommendation against). Under the alternative proposal, ISS will apply a more holistic approach by weighing various considerations such as the costs, dilution, provisions, administration, usage, etc.

*To learn more, please contact:*

<i>Toronto:</i>	<i>Michelle Tan</i>	<i>416-868-4421</i>	<a href="mailto:mtan@hugessen.com">mtan@hugessen.com</a>
<i>Calgary:</i>	<i>Erin Poeta</i>	<i>403-441-6294</i>	<a href="mailto:epoeta@hugessen.com">epoeta@hugessen.com</a>

© 2013 by Hugessen Consulting Inc. All rights reserved.