

Kingsdale Client Update

November 8, 2016

Market Update: ISS Pay for Performance Methodology Update

On November 8, 2016, Institutional Shareholder Services Inc. (“ISS”) released an update to their pay for performance methodology covering the U.S., Canadian, and European markets taking effect February 1, 2017.

United States

- ISS has introduced a new standardized pay for performance test comparing a subject company CEO’s pay and financial performance relative to ISS peers (an enhanced version of the current Relative Degree of Alignment (“RDA”) test which looks at three-year average CEO compensation against three-year annualized total shareholder returns relative to an ISS defined peer group).
- The six new financial performance metrics that will supplement the currently used Total Shareholder Return (“TSR”) metric are: (i) Return on Equity, (ii) Return on Assets, (iii) Return on Invested Capital, (iv) Revenue Growth, (v) EBITDA Growth, and (vi) Cash Flow (From Operations) Growth. ISS will use a weighted average of these metrics and the metrics and weightings will be based on the subject company’s four digit Global Industry Classification Standard industry group.
- Both pay and financial performance ranking inputs for the new test will be included in the ISS reports but will not impact the initial quantitative screening results for the 2017 proxy season (the data may be referenced in the qualitative review leading to mitigated or heightened pay for performance concerns).
- The legacy RDA test will continue to be used for the 2017 proxy season and a concern level will only be considered when there is a minimum of two years of pay and TSR data (companies with one-year of data or no data will receive an N/A concern).

What this means for our clients:

Kingsdale will continue to closely monitor updates from ISS going forward and provide our clients with timely information. The seven metrics in the new ISS standardized test add a new layer of complexity to ISS’ pay for performance quantitative screen. This is more consistent with proxy adviser Glass Lewis & Co., LLC’s (“Glass Lewis”) quantitative pay for performance test which evaluates pay against five metrics rather than seven: (i) Total Shareholder Returns, (ii) EPS Growth, (iii) Change in Operating Cash Flows, (iv) Return on Assets, and (v) Return on Equity. While both ISS and Glass Lewis are considering a wide range of financial performance metrics, this does not mean that companies will need to rush to adopt such metrics in their short- or long-term incentive plans. We believe that companies should use metrics that truly drive performance and that are applicable to their industry and business circumstances (i.e. not a one-size-fits-all approach). Whichever metrics our clients use, Kingsdale can assist with crafting the right message that resonates with shareholders within the proxy statement. While ISS’ shift to a wider range of metrics is driven by feedback from institutional investors and other market constituents who have indicated a desire to see some detail regarding financial performance related to pay, a company’s own disclosure measuring their financial performance in the proxy statement (even if the same seven financial performance metrics are used) will still differ from ISS’ measurement of a company’s performance. This is because ISS may use

different weightings and time frames in their proprietary model whereas a company may measure themselves relative to a different peer group than ISS' defined peers.

Canada

- Similar to the U.S., a new standardized test will be introduced in the Canadian market and will continue to apply to S&P/TSX Composite Index constituents as well as companies with a Say on Pay vote.
- The legacy RDA test will continue to be used for the 2017 proxy season (with information from the new standardized test potentially influencing ISS' qualitative review). For the legacy RDA test, a concern level will only be considered when there is a minimum of two years of pay and TSR data (companies with one-year of data or no data will receive an N/A concern).
- Similar to the U.S. market, ISS will now consider a subject company's self-determined peers for pay benchmarking when constructing the ISS defined peer group used in the relative quantitative tests (RDA and Multiple of Median test).
- The peer universe for the Canadian market will include only companies domiciled in Canada.
- **Companies subject to the ISS pay for performance quantitative test and with annual general meetings between February 1, 2017 and September 15, 2017 can inform ISS of changes to their self-determined peer groups for the upcoming season through the Governance Analytics platform between November 28, 2016 and December 9, 2016 (issuers without a Governance Analytics platform account can request one through contactus@isscorporatesolutions.com, or Kingsdale can assist with this process).**

What this means for our clients:

Kingsdale will work with clients to submit peer group changes to ISS, if applicable. Clients considering peer group changes will now find the conversation much more pertinent given ISS' new consideration. We expect that the consideration of a company's self-disclosed peer group will further align the ISS defined peer group with that of a subject company's self-determined peers but given that the peer universe only includes Canadian domiciled companies, clients with global peer groups may still find that the ISS defined peer group will differ significantly.

If you have any questions about this update, please feel free to contact Victor Li or Jackie Cheung directly to discuss.

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