Key Governance Trends in Early to Mid 2023

KINGSDALE Advisors

July 2023

Executive Summary

This executive summary provides an overview of the five key governance trends Kingsdale Advisors observed in early to mid 2023, highlighting important findings related to auditor ratification, Say on Pay resolutions, shareholder proposals and evolving investor voting policy. These trends are shaping the landscape of corporate governance and warrant attention from companies and stakeholders.

1. Auditor Ratification

Shareholder support for ratifying external auditing firms is declining. 33 companies in the S&P/TSX Composite Index received less than 90% shareholder support.

2. Say on Pay

Average shareholder support for Say-on-Pay resolutions is 91.1%. As of May 25, GL issued over six times more "Against" recommendations than ISS.

3. Shareholder Proposals

Shareholder proposals tied to climate and diversity continue to be placed on the ballots of a small number of Canadian public companies. Third-party racial equity audit proposals appeared on the ballot in Canada for the first time in 2023 but has not garnered majority support yet.

4. Evolving Investor Voting Policy

While ISS and GL still carry weight in proxy voting, merely securing a positive recommendation from them may not suffice. The trend of asset managers devolving voting power to institutional clients also highlights the importance of shareholder engagement.

5. Cyber Risk Oversight

Proxy advisors introduced new policies in 2023 to address cybersecurity governance. Companies are encouraged to update their cybersecurity governance policies and allocate proper resources.

Auditor Ratification

1

Decreased Support

As of May 2023, 33 out of 158 companies in the S&P/TSX Composite Index received less than 90% support for their auditor ratification proposal[1], which already exceeds the totals from 2022 and 2021.

2

Big Four Accounting Firms Highlighted

Clients of the Big 4 accounting firms are being impacted: Deloitte is the auditor for 10 of these 33 issuers, Ernst & Young is the auditor for 9, KPMG is for 7 of the 33, and PwC is for 7 of them.

3

Lower Proxy Advisory Influence

ISS supported all 33 of these auditor ratification resolutions, while GL supported 32 of them. This shows that institutional shareholders are adopting their own voting policies to promote audit firm rotation.

[1] Data sourced from ISS Corporate Solutions as of May 18, 2023.

Auditor Ratification

Two factors for consideration:

1

Lengthy Tenure

Most shareholders considered it to be >20 years

2

Non-audit Service Spending

Shareholders may see an increase in non-audit service spending as compromising independence

In Canada

Audit firm rotation is not currently required in Canada.

Firms in Canada use key audit partner rotation to promote independence.

Kingsdale's Takeaway:

Forcing auditor rotation may be unnecessary, costly and disruptive for Canadian companies. Doing so may not materially change or improve the results of an external audit; it may even lead to increased audit risk.

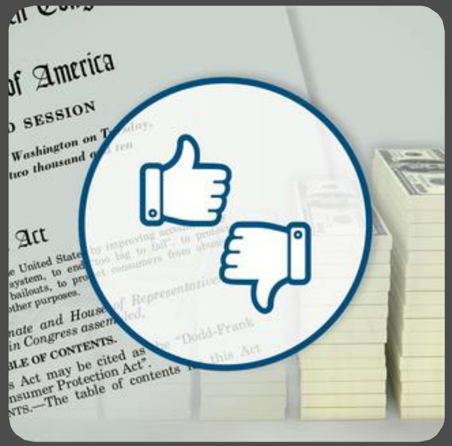
Some head office locations do not have the presence of all of the Big Four accounting firms which limits their flexibility with respect to auditor rotation.

We recommend issuers engage in transparent communications with shareholders and ensure proper disclosure by keeping abreast of any updates in their shareholders' voting policies regarding auditor ratification.

Say on Pay

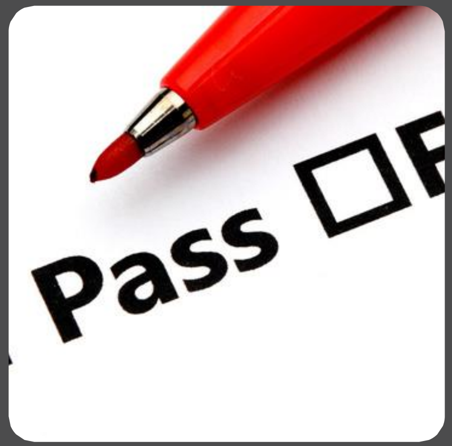
Shareholder Support[2]

As of May 25, 2023, out of the 160 companies in the Canadian market that had a say-on-pay resolution, the average level of shareholder support is 91.1%, which is similar to that of 2022 (91.7%).



Proxy Advisors' Recommendations

GL issued 27 "Against" recommendations on say-on-pay resolutions so far in calendar 2023[3], as compared to 22 negative recommendations during all of calendar 2022., which exceeds ISS' four negative recommendations.



Inadequate Support

Three Canadian companies failed their Say-on-Pay proposal, while 14 passed but achieved less than 80% shareholder support, meaning that the proxy advisors expect these companies to engage with their investors to solicit feedback and respond to their concerns in practice and through disclosure. The number is similar to that of last year (where three companies failed the proposal and 19 passed with less than 80% support in calendar 2022).

[2] As defined by ISS' definition of a Canadian company based on how it applies its policies.
[3] GL recommendations are sourced from Insightia. ISS recommendations are sourced from ICS.

Shareholder Proposals (Canada)

Shareholder proposals tied to climate and diversity continue to be placed on the ballots of a small number of Canadian public companies.

46

out of 46 shareholder proposals that have been opposed by Management have not passed the vote.

14

shareholder proposals received support over 20%, which is the minimum level of support that investors and proxy advisors expect would prompt a company to engage with its shareholders and respond to their concerns in practice and through disclosure.

43

negative recommendations were issued by ISS, while GL has issued 40 negative recommendations. GL supported two proposals related to climate change, three proposals related to racial equity audits, and one proposal related to a request to implement an advisory Say-on-Pay vote.

The one shareholder proposal that was supported by Management (for Cenovus Energy Inc. to report on lobbying and policy advocacy with its net-zero goal) was overwhelmingly supported by 99.5% of shareholders, as well as by ISS and GL.

Shareholder Proposals (Canada)

Third-party racial equity audit proposals appeared on the ballot in Canada for the first time in 2023.

No Majority Support Yet

These proposals were voted on at Royal Bank of Canada (supported by 42.2% of shareholders), Bank of Montreal (supported by 38.1% of shareholders) and CGI Inc. (supported by 15.9% of shareholders).

Racial Equity Audit in Bank Sector

Three other Canadian banks have already committed to conducting a third-party racial equity audit: Toronto-Dominion Bank, Canadian Imperial Bank of Commerce and National Bank of Canada. We expect that RBC and BMO may feel pressure to do the same, even though the shareholder proposals did not achieve majority support.

GL supported three shareholder proposals related to racial equity audits while ISS did not support any of the proposals

Maintaining Approval Levels

While ISS and GL still carry weight in proxy voting, they are no longer the sole influencers – and obtaining a favourable recommendation from both may not be enough. A majority of the 10 largest asset managers have one or more policies that are stricter than ISS/GL benchmark policies, generally related to overboarding or tenure. In addition, pension funds and European investors are increasingly voting against directors based on strict diversity policies or similar.

	Sample Voting Policies of Institutional Investors	Sample Voting Policies of ISS/GL
Director Commitment and Tenure	Considers a non-executive director "overboarded": Typically 4-5 with some as low as 3. Some institutions have implemented their own voting policies focused on lengthy director tenure that may impact director results because either an individual's tenure or the overall average board tenure is considered excessive.	ISS and GL will generally recommend withholding votes for non--executive director nominees who serve on more than five public company boards.
Auditor Policy	Institutional investors may vote AGAINST the auditor and audit committee members if non-audit fees exceed audit-related fees. Some encourage the practice of putting the audit contract out to tender periodically (ranges from every 10, 15 or 20 years).	Neither ISS or Glass Lewis have specific tenure or tender timelines for external auditors. ISS will recommend voting FOR proposals to ratify auditors unless non-audit fees paid to the auditor is more than audit fees and audit-related fees. GL will recommend voting AGAINST the auditor and the Chair of auditing committee when the total of audit and audit-related fees is less than 50% total fees.

Why Maintaining Approval Levels in the High 90's across all Resolutions Will Be Challenging - What Future Success Looks Like

Related to the proliferation of institution-specific voting policies has been the devolution of voting policies by large asset managers. Starting in 2022, the "Big Three" BlackRock, State Street Global Advisors and Vanguard introduced "pass-through voting", enabling their investors to exercise discretion[4] in voting on proposals on their investments held in the funds. With this initiative comes a shift in the dynamics of voting activities, as the power to vote has gradually shifted from asset managers to their underlying institutions.

According to BlackRock's latest Voting Choice Whitepaper, early voting trends indicate a preference for these investors to select from a range of third-party proxy voting policies. Given these institutions are choosing to make their own voting decisions, they are likely to pick from the dozen or so specialty proxy voting policies or craft their own voting policies, all of which are stricter than the benchmarks.

This devolution creates a number of challenges. The investor institutions generally have no public filing obligations the way asset owners would. Most do not have internal governance teams so are not well versed in governance best practices and do not post proxy voting policies or voting records. Most have chosen more stringent policies.

Kingsdale's Takeaway

The impact of institution-specific voting policies and the devolution of voting by fund managers on issuers is two-fold: i) support levels are being permanently reset downwards ii) investors are not as visible so there is less chance of engagement to understand their thinking. For these reasons, voter turnout and each engagement with those institutions that are visible becomes that more much valuable in this changing environment.

[4] It's all about choice | Empowering investors through BlackRock Voting Choice. (n.d.). https://www.blackrock.com/corporate/literature/publication/its-all-about-choice.pdf

Cyber Risk Oversight

GL introduced a new section in 2023 to address cybersecurity governance. According to GL, cyber risk is material for all companies and expects all companies to disclose in their proxy circulars details regarding the role of the board in overseeing issues related to cybersecurity.

As regulatory attention increases, shareholders are also paying closer attention and looking for disclosures on board members cybersecurity expertise as they consider their investments as well as their votes on the election of directors.

Kingsdale's Takeaway

Companies should align cybersecurity governance policies and practices with strategic business plans, enterprise-risk management program, AI and IT applications, business culture, and brand reputation. Companies should also ensure that the boards receive regular and proactive reports on cybersecurity and cyber resilience issues, have a thorough cybersecurity oversight and allocate proper resources to cybersecurity risks.

Due to increased attention to cybersecurity issues from proxy advisors and shareholders, it is to be anticipated that the activists will begin to highlight cyber security vulnerabilities and companies should be ready to address their concerns. We recommend companies to continue refreshing their board and expanding its director search to include cybersecurity expertise and upskilling the current board or committee to understand and address cyber risk.

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