ISS Issues 2015 Policy Updates

Institutional Shareholder Services ("ISS") has updated its U.S. corporate governance benchmark policy guidelines for 2015. This year's updates cover one significant compensation-related item - a new "scorecard" approach to evaluate employee stock plan proposals. These changes will be reflected in the corporate governance and executive compensation policies that ISS will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2015 proxy season.

The ISS' Benchmark U.S. Corporate Governance Policies updates are available at www.issgovernance.com.

The updated policies are effective for shareholder meetings held on or after February 1, 2015.

Significance of Policies

As a long-time advisor to the institutional investor community, ISS is the bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on corporate governance and executive compensation policies and practices. The standards for U.S.-based companies, which are contained in a policy statement published in advance of each year's proxy season, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors, the "Say-on-Pay" vote, the approval of employee stock plans, and other proposals submitted for shareholder action at annual shareholders' meetings, as well as to analyze companies' corporate governance and executive compensation policies and practices.

While most technology and life sciences companies focus on the policy updates that affect their corporate governance structure and executive compensation programs, these updates actually encompass a broad range of governance, social, and environmental matters as well. For example, this year's policy updates also address ISS' analysis of shareholder proposals seeking an independent chair for the board of directors, as well as company proposals seeking shareholder approval of litigation-related by-law provisions.

This article summarizes the policy update for employee stock plan proposals.

Four Things Technology and Life Sciences Companies Should Know About ISS New Equity Plan Policy

- **The new policy, which is effective for annual meetings occurring on or after February 1, 2015, replaces the current "pass/fail" tests for equity plan proposals with a "scorecard" approach that analyzes plans in three main categories: plan cost, plan features, and grant practices.** This approach will involve an assessment of both positive and negative factors about a plan proposal, generating a total score that will determine either a "for" or "against" vote recommendation.
- **The new policy's "holistic" approach will make vote recommendations on plan proposals less predictable.** Companies will now likely be confronted with more of a "black box" when submitting an equity plan for shareholder approval. ISS is offering a fee-based service (which may cost $20,000 or more) to assist companies in navigating the new policy.
- **Technology and life sciences companies will likely face more pressure to "homogenize" the terms of their equity plans and related grant practices.** This may lead to less flexibility than in past years as companies adopt plan features (such as minimum vesting conditions, restrictions on share recycling and a prohibition on accelerated vesting) to ensure a favorable vote recommendation.
- **The new policy will likely result in technology and life sciences companies seeking smaller share reserve increases more frequently (that is, every one or two years).**

Employee Stock Plan Proposals

Background

For the 2014 proxy season and prior years, ISS applied a series of "pass/fail" tests to determine whether to recommend a vote "for" or "against" an employee stock plan proposal. While these tests largely focus on the total "cost" of the plan (based on ISS' Shareholder Value Transfer ("SVT") model which assesses the relative economics of the plan versus the market), certain specified plan features which were considered "egregious" (such as a provision permitting option repricing without shareholder approval) could also result in an "against" vote recommendation. Typically, companies could determine in advance whether they would pass or fail these tests (and even engage ISS to calculate their SVT) and adjust their voting strategy accordingly.

New Policy

As characterized by ISS, the new policy is intended to provide for a "more nuanced consideration" of employee stock plan proposals. The new scorecard methodology (the "Equity Plan Scorecard" or "EPSC") considers a range of positive and negative factors, rather than a series of pass/fail tests, to evaluate employee stock plan proposals. According to ISS, this "holistic" consideration of a range of plan features and grant practices, such as the use of performance-based awards, the presence (or absence) of risk-mitigation features and policies, and a prudent plan of distribution to executives and other employees, reflect growing investor awareness of the interrelatedness of various data points when evaluating an employee stock plan. Generally, the total EPSC score will determine whether ISS recommends "for" or "against" an employee stock plan proposal.

While some "highly egregious" plan features will continue to result in "against" recommendations regardless of other factors (see below), vote recommendations will largely be based on a combination of factors related to (i) plan cost, (ii) plan features, and (iii) grant practices. For example, a plan with a cost that is nominally higher than a company's allowable cap may receive a favorable recommendation if sufficient positive factors are present. Conversely, a plan with a cost that is nominally lower than the allowable cap may ultimately receive an unfavorable recommendation if a preponderance of the scorecard factors is negative.

Under the new policy, ISS will:

- Use three index groups and GICS codes to determine "burn rate" benchmarks (the index/industry mean and one standard deviation above the mean, along with a 2% de minimis benchmark) and factor weightings:
  - The Standard & Poors' 500;
  - The Russell 3000 (excluding the S&P 500); and
  - Non-Russell 3000 companies.

ISS plans to develop an additional version of the model for companies that recently completed their initial public offering of securities or emerged from bankruptcy. Consistent with its current policy, the "burn rate" factor will not apply to this version of the model.

- Use individual scorecards for each index group (the S&P 500, the Russell 3000, non-Russell 3000 companies, and IPO/bankruptcy emergent companies).
- Measure the SVT cost of the plan using both of the following calculations:
  - The company's total new and previously reserved employee stock plan shares plus outstanding equity awards ("A+B+C shares"), and
  - Only the new share request plus previously reserved but ungranted shares ("A+B shares");
- Eliminate stock option "overhang" carve-outs, in light of the additional SVT evaluation factor for only A+B shares; and
- Eliminate consideration of "liberal share recycling" provisions from the SVT cost calculations; instead, share recycling for different award types will be scored as a negative plan feature.

EPSC Pillars

The EPSC methodology considers factors that fall under three general categories or "pillars": Plan Cost, Plan Features, and Grant Practices. Some of the key factors considered under each pillar are as follows:

Plan Cost. This pillar evaluates the total estimated cost of a company's employee stock plans (excluding employee stock purchase plans) relative to its industry/market cap peers. This cost is determined using the company's estimated SVT (that is, the estimated value going to executives and other employees) in relation to its peers and considers both:

- SVT based on A+B+C shares; and
- SVT based only on A+B shares.

As under its prior policy, unless limits are placed on the number of full value shares that may be awarded under a plan (that is, a "fungible share" provision), ISS will assume that all awards will be granted as full value awards. An employee stock plan's SVT will be considered reasonable if it falls below a company-specific "allowable cap." ISS has not yet disclosed the relative weightings of these SVT calculations in each category.

Plan Features. The presence (or absence) of any of the following features in an employee stock plan will be taken into consideration:

- Automatic "single-trigger" award vesting upon a change in control of the company (-);
- Discretionary vesting authority (without regard to whether there has been a change in control) (-);
- Liberal share recycling on various award types (-); and
- Minimum vesting period for awards made under the plan (+).

Grant Practices. The following award practices will be considered:

- The company's three year burn rate relative to its index group peers;
- Vesting conditions contained in the most recent equity awards granted to the company's Chief Executive Officer (over up to the past three years);
- The estimated duration of the plan based on the sum of shares remaining available for issuance and the new shares requested, divided by the average annual shares granted in the prior three years;
- The proportion of the Chief Executive Officer's most recent equity awards subject to performance conditions;
- Whether the company maintains a compensation recovery ("claw-back") policy;
- Whether the company has established post-exercise/vesting stock holding requirements.

It is expected that these changes will eliminate companies' ability to make forward-looking burn rate commitments.

EPSC Pillar Weightings

Each of the three EPSC "pillars" will be weighted based on a company's index group (the Standard & Poors' 500, the Russell 3000 (excluding the S&P 500), non-Russell 3000 companies, and recent IPO/bankruptcy emergent companies). We understand that for companies in the Standard & Poors' 500 and then other Russell 3000 companies, the EPSC pillars will be weighted as follows:

- Plan cost – 45%;
- Plan features – 20%; and
- Grant practices – 35%.

"Highly Egregious" Plan Features

ISS will vote against an employee stock plan proposal if the combination of the foregoing factors indicates that the plan is not, overall, in shareholders' interests, or if any of the following apply:

- Equity awards may vest in connection with a liberal change-in-control definition;
- The employee stock plan permits the repricing or cash buyout of "underwater" stock options without shareholder approval (either by expressly permitting it – for NYSE-listed and Nasdaq-listed companies -- or by not prohibiting it when the company has a history of repricing – for non-listed companies);
- The employee stock plan is a vehicle for problematic pay practices(such as inclusion of a Section 280G excise tax "gross-up" provision for plan awards) or a pay-for-performance disconnect; or
- Any other plan features are determined to have a significant negative impact on shareholder interests.

Observations. The new "scorecard" methodology represents a significant departure from ISS' prior policy of stand-alone "pass/fail" tests. While a more nuanced approach to evaluating employee stock plan proposals is certainly a step forward, at this point the new policy is tantamount to a "black box."

At a high level, the new policy is not difficult to explain - ISS will assign a specific number of points to each of the factors in its three "pillars," calculate a resulting score in each pillar, and add them together for a total score. If the total score is above the threshold established for a favorable vote recommendation, then ISS will recommend "for" the employee stock plan (unless a plan feature or situation exists (such as a provision permitting option repricing without shareholder approval or a severe "pay-for-performance" disconnect) that triggers an automatic "override").

Nonetheless, the methodology will undoubtedly make it more difficult for technology and life sciences companies to ascertain in advance the likelihood of a favorable vote recommendation on their employee stock plan proposal. At a minimum, it will take time to determine how specific plan features and award practices will be scored under the new policy, as well as the interplay between these factors in different scenarios. Further, a number of the putative "best practices" in the "Plan Features" category are not typically included in the employee stock plans of technology and life science companies (for example, minimum vesting features, a prohibition on discretionary acceleration of equity award vesting, stock holding requirements). While companies should gain experience with the intricacies of the new policy over time, it may take multiple proxy cycles before a general understanding of the scope and impact of the policy emerge.

ISS has made available to companies an updated "Compass" software tool that they can use to assess their status under the new policy. Companies with existing licenses for ISS' "Compass" tools with annual meetings taking place after February 1, 2015 will be "grandfathered" into this new tool. Until we learn more about the policy, companies seeking certainty as to the prospects for their employee stock plan proposal may be forced to purchase access to the ISS tool.

What's Next?

ISS has indicated that a more detailed policy summary and an updated "Frequently-Asked Questions" document will be published in December 2014 that contain additional guidance related to the new employee stock plan policy. In addition, ISS will be publishing updated "burn rates" in December for each GICS industry/index group.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

ISS Issues 2015 Policy Updates (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Jason Borrevik
jborrevik@compensia.com
408.876.4035

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Erik Beucler
ebeucler@compensia.com
408.907.4314

Amanda Feyerabend
afeyerabend@compensia.com
415.462.2988

Greg Loehmann
gloehmann@compensia.com
408.907.4319

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Mathew T. Quarles
mquarles@compensia.com
323.919.7338