ISS Seeks Comment on New Equity Plan "Scorecard" Policy

Institutional Shareholder Services ("ISS") is soliciting comment on a proposed new methodology for formulating its voting recommendations on equity compensation plans proposals, which will be implemented for the upcoming 2015 proxy season. This Thoughtful Pay Alert summarizes what we currently know about the pending new policy.

Background

For the past 12 months, ISS has been indicating that it intends to update the methodology that it uses to formulate its voting recommendations for equity compensation plan proposals (whether the proposal involves the adoption of a new equity plan or an increase to the share reserve of an existing equity plan) in time for the 2015 proxy season.

Currently, ISS applies a series of "pass/fail" tests to determine whether to recommend a vote "for" or "against" an equity 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 are considered "egregious" (such as a provision permitting option repricing without shareholder approval) can also result in an "against" vote recommendation. With the exception of the SVT test, typically companies can pre-determine whether they will pass or fail these tests and adjust their voting strategy accordingly.

Proposed New Policy

Last week, ISS announced that, going forward, it intends to employ an "equity plan scorecard" ("EPSC") approach when evaluating equity plan proposals. Under this methodology, ISS will evaluate equity plans "holistically," analyzing multiple factors, both positive and negative, to generate a total score that will determine either a "for" or "against" vote recommendation for a plan proposal. While ISS has not disclosed all of the details of the EPSC, the key features of the policy include the following:

Five Points That Technology and Life Sciences Companies Should Know About ISS' New Equity Plan Scorecard Policy

1. **The new policy 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, generating a total score that will determine either a "for" or "against" vote recommendation.
2. **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.** We expect that ISS will offer a new fee-based service to assist companies in navigating the new policy.
3. **ISS is seeking comment on the new policy until October 29th.** It is expected that the final policy will be announced in early November and will be effective for annual meetings of shareholders held on or after February 1, 2015.
4. **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 and restrictions on share recycling) to ensure a favorable vote recommendation.
5. **Companies planning to submit or considering an equity plan proposal in 2015 need to evaluate the proposal through the lens of the new policy now.**

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Three Main Categories of Factors Considered

- **Plan Cost**: ISS will continue to assess the total potential cost of a company's equity plans relative to its peers (as determined based on industry and market capitalization), using its SVT model. SVT will be calculated both including and excluding outstanding unvested and/or unexercised awards. (This represents a notable change from current practice where ISS determines SVT on a total equity "overhang" basis only.)
- **Plan Features**: ISS will look for the presence of certain plan features, such as
  - Ability to reprice or exchange options without shareholder approval (Generally, this will result in an "against" vote recommendation on its own);
  - Automatic "single-trigger" award vesting upon a change in control;
  - Discretionary vesting authority;
  - Liberal share recycling on various award types; and
  - Minimum vesting periods for awards made under the plan.
- **Grant Practices**: ISS will evaluate the following data points
  - The company's three-year burn rate relative to its peers (as determined based on industry and/or market capitalization);
  - Vesting requirements in the most recent equity awards granted to the Chief Executive Officer;
  - The estimated duration of the plan based on the sum of shares remaining available 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 ("clawback") policy; and
  - Whether the company has established post-exercise/vesting shareholding requirements.

ESPC Computation

ISS has indicated that its scorecard factors and weightings will be keyed to each company's size and status; that is, whether it is a member of the Standard & Poors' 500 or the Russell 3000 (excluding the S&P 500), a non-Russell 3000 company, or a recent IPO or bankruptcy emergent company. In addition, burn rate benchmarks will be calibrated for the respective index groups (S&P 500, Russell 3000 (excluding the S&P 500), and non-Russell 3000). Finally, the relevant GICS industry classification will be used within each index group.

Effective Date

We expect ISS to publish its final voting policies for the 2015 proxy season in early November, with such policies to be effective for annual meetings of shareholders held on or after February 1, 2015.

Observations

As is apparent from the prior description, the proposed "scorecard" approach represents a significant departure from ISS' current practice of using stand-alone tests to make its voting recommendations. Perhaps most notably, in spite of ISS' statement that the new methodology will result in a "more nuanced" analysis of equity plan proposals, the new policy will make it more difficult, at least initially, for companies to predict how ISS will analyze their equity plan. Further, since ISS has yet to reveal the details of the new approach, it is unclear how specific plan features will be treated. While ISS has sought to allay concerns about the new policy by stating that it does not expect the policy to increase or decrease the number of companies receiving unfavorable vote recommendations, such a fundamental change will undoubtedly change the way companies proceed with future proposals.

ISS' move towards a less flexible approach to analyzing equity plan proposals, particularly as it relates to the evaluation of plan administration and grant practices, will create several challenges for technology and life sciences companies. Notably, many of ISS' "best practices" in the "Plan Features" category involve features (such as minimum vesting features, a prohibition on discretionary acceleration of vesting, and share holding requirements) that are not typically found in the plans of technology or life sciences compa-

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nies. Thus, it remains to be seen how the absence of such features will affect their equity plan scores.

Nor will such companies be able to make a prospective burn rate commitment to overcome a concern about excessive dilution. As a result, companies will need to completely reassess their strategies for designing their equity plans and determining their share reserve requests. Many observers expect companies to feel pressure to retain ISS' consulting services to help "guide" them through the new policy, which (at least in theory) they will expect to improve the chances for a favorable vote recommendation.

We also anticipate that, given the uncertainty surrounding the new policy, some companies will seek to minimize the risk of a failed vote by submitting more conservative plan proposals (with relatively modest share reserve requests) to their shareholders, coupled with a broader, more aggressive outreach effort. This may lead to smaller (one or two-year budgets) and more frequent share requests.

Request for Comment

ISS is seeking comment on two specific issues involving its proposed new equity plan "scorecard" methodology:

- Are there certain factors outlined in the proposed scorecard approach that should be more heavily weighted when evaluating equity plan proposals?
- Will there be any unintended consequences from shifting to a scorecard approach?

Submit comments via email to policy@issgovernance.com by October 29th. ISS intends to publish all of the feedback that it receives, but will not publish any comment that does not include the name and organizational affiliation of the submitter.

For More Information

Additional information about ISS' proposed new equity plan scorecard methodology is available at www.issgovernance.com.

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. ■

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