10 Tips for Navigating the ISS Equity Plan Maze

When adopting or amending an employee stock plan, companies must spend considerable time and effort addressing the numerous strategic and design issues – the plan's purpose and objectives, award types, eligible participants, liquidity alternatives, tax and accounting treatment – that such an undertaking entails. In recent years, an increasingly important aspect of the process has been determining how shareholders – particularly institutional investors – are likely to respond to the proposed plan since shareholder approval of most employee stock plans is mandatory for exchange-listed companies.

As the principal advisor to the institutional investor community, the evaluation of an employee stock plan by – and accompanying vote recommendation of – Institutional Shareholder Services ("ISS"), the prominent proxy advisory firm, is often the key to the success or failure of the proposed plan. Given the number of institutional shareholders that subscribe to, and follow, ISS' recommendations, it has become incumbent upon most companies to take account of its executive compensation policies when designing and implementing a new employee stock plan, or increasing the number of shares available for issuance under an existing plan.

ISS' Framework for Evaluating Equity Plans

Under its proxy voting guidelines, ISS considers the following factors when making its voting recommendation on an employee stock plan proposal:

- The total "cost" of all of a company's employee stock plans (in other words, their potential dilutive effect);
- The company's historical annual equity expenditures (its "burn rate");
- Whether the plan expressly permits stock option repricings or exchanges without shareholder approval or provides for accelerated vesting of outstanding awards upon a change in control transaction (so-called "single trigger" rights) or similar or other benefits without the actual consummation of a change in control transaction;
- For Russell 3000 companies, the company's "pay-for-performance" history, as reflected in its CEO's total compensation and total shareholder return; and
- Whether the plan is deemed to be a vehicle for problematic pay practices.

For a discussion of these latter two factors, see our Thoughtful Pay Alert, RiskMetrics Issues Policy Updates for 2010 Proxy Season (December 4, 2009).

Over time, most companies have become adept at eliminating provisions from their employee stock plans that may raise a "red flag" and steering clear of ISS' "problematic pay practices." On the other hand, as ISS has revised its methodologies for determining acceptable burn rate and dilution levels from year to year, it has been a constant challenge for companies to comply with what are largely "backwards looking" tests. This was certainly true during the 2010 proxy season.

The Challenge in 2010 (and Beyond)

At the end of 2008, as the global financial crisis continued to worsen, ISS updated its policies for evaluating employee stock plan proposals in 2009 to take account of the increased volatility in the stock market. For example, during 2009 ISS moved to a 400-day volatility sampling period (from its customary 200-day sampling period) to minimize distortions in its equity "cost" model. In addition, to counter potential problems arising from the unpredictable volatility levels, ISS moved to a 90-day, rather than a 200-day, stock price sampling period.

One year later, with market conditions beginning to normalize, ISS reverted back to its previous volatility and stock price sampling periods. While these changes were not a surprise (ISS had indicated that it would base its 2010 standards on the prevailing market conditions at the end of 2009), their impact on satisfying ISS' burn rate and dilution limits is only now beginning to be appreciated. Coupled with these policies' opaqueness and the absence of a well-defined "appeals" process, many companies have struggled to structure their employee stock plan proposals to satisfy ISS' burn rate and dilution policies – or to even identify whether a potential problem exists.

Based on our recent experience in helping clients to better understand and satisfy ISS' proxy voting guidelines for employee stock plans, we offer the following observations about meeting the burn rate and dilution tests.

ISS' Burn Rate Policy

In evaluating an employee stock plan proposal, ISS will look at a company's historical use of equity compensation. Generally, ISS will recommend a vote against an employee stock plan if the company's average three-year burn rate exceeds the greater of:

- the mean plus one standard deviation of the company's global industry classification standard ("GICS") group segmented on the basis of whether or not it is in the Russell 3000 index (as reflected in a provided table); or
- two percent of its weighted common shares outstanding.

For purposes of this policy, a company's annual burn rate is the sum of the number of stock options granted and full value shares awarded during the year, divided by the company's weighted average common shares outstanding during the year. In the case of full value awards, ISS applies a premium or "multiplier" (based on a company's annual stock price volatility) to the full value awards made during the past three years to equate them economically with options. Generally, the higher the stock price volatility, the lower the multiplier. While this premium is based on the company's current annual stock price volatility, it is applied retroactively over the prior three-year period. Consequently, many companies that developed annual equity budgets during that period based on their then-current volatility levels have been penalized by the ISS policy which has assigned them a higher premium for 2010 as their stock prices have leveled off.

The potential problem can be illustrated by the following example:

> Take a Russell 3000 company that is in the technology hardware and equipment sector that, at the beginning of 2009, established an adjusted burn rate target of 5% for the year based on ISS' then-current 5.52% industry burn rate limit and the company's then-current 400-day stock price volatility (assumed to be 58%, which results in a full value award "multiplier" of 1.5:1). In early 2010, the company proposes a new employee stock plan. As part of its review, ISS evaluates the company's historic "burn rate" practices using its updated 2010 industry burn rate limit of 4.79% and an updated 200-day stock price volatility figure (assumed to be 52%, which results in a full value award "multiplier" of 2:1). Both the significant decrease (–13%) in the company's burn rate limit and the increase in the award "multiplier" (which results in full value awards being counted at a 33% higher rate than budgeted) result in ISS taking a retroactive position that the company's 2009 equity expenditure was excessive for its industry even though the equity budget was well below the applicable ISS limits when established. Further, the higher award "multiplier" will apply to any full value awards granted in 2007 and 2008 as well since ISS reviews a company's burn rate over the previous three-year period.

Where a company fails to meet ISS' applicable burn rate cap, it can likely avoid an "against" vote recommendation for an employee stock plan proposal if it commits in a public filing (either a current report on Form 8-K or its definitive proxy statement) to a prospective gross three-year average burn rate equal to a fixed, ISS-approved amount tied to its industry sector, assuming that all of the other conditions for an affirmative vote recommendation have been satisfied. Notably, the company's burn rate may exceed the GICS peer group average in either or both of the first two years, as long as the prospective three-year average burn rate remains below its commitment level. If the company subsequently fails to fulfill its burn rate commitment, ISS will recommend an "against" or "withhold" vote with respect to the directors who serve on the board compensation committee.

Each year, ISS updates its burn rate table and allowable limits for the upcoming proxy season.

Compliance Tips

1. **Burn Rate Limits May Fluctuate in the Short Term**. For 2010, ISS has significantly reduced the applicable burn rate cap across most industry sectors, including the technology and life sciences sectors. Combined

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with its decision to go back to measuring stock price volatility over a 200-day, rather than a 400-day, period (which has led to lower volatilities and, correspondingly, higher premiums or "multipliers" for full-value awards), companies are discovering that the equity budgets they have developed to comply with the then-applicable ISS burn rate policy are no longer compliant (as evidenced by the previous example). Consequently, companies will need to reevaluate their equity budgets under the current ISS policy to see whether they will have a problem satisfying their applicable cap. The outcome of this analysis may not be obvious, as it is possible that burn rate caps may go up in 2011.

2. **Identify Excludable Shares**. ISS permits companies to exclude certain equity awards from its burn rate test – specifically, assumed awards and awards that were granted in substitution for outstanding awards in a merger or other acquisition transaction and awards granted under a shareholder-approved stock option exchange program (as long as such awards are expressly disclosed in a company's annual report on Form 10-K). Consequently, we recommend that you routinely review your equity award disclosure in your annual report on Form 10-K with your legal counsel and other advisors to ensure that any such awards will be excludable from your burn rate calculation.

3. **Disclose Your Performance Shares**. ISS does not factor performance shares into its burn rate test when an award is made. Instead, performance shares are counted when they are earned and/or delivered (as long as the company's public disclosures clearly reflect the earn-out and delivery of these awards). Consequently, if compliance with ISS' burn rate policy is important, a company should review its disclosure practices as they relate to any outstanding performance share awards. Further, companies that are nearing their burn rate cap or have made a prospective burn rate commitment may want to consider using performance share awards with an extended multi-year performance period as an alternative to their conventional equity awards as a way to reduce their ISS burn rate calculation.

4. **Burn Rate Commitments May Be Flexible**. As noted above, if a company fails ISS' burn rate policy, it can still avoid an against vote recommendation if it makes a public commitment to a prospective gross three-year average burn rate limit. For 2010, ISS revised its approach to establishing this prospective burn rate commitment. In response to criticism of its lower burn rate caps, ISS permits companies to select their prospective commitments from the following four approaches, based on their specific industry sector:
   - their 2010 burn rate limit;
   - the average of their 2009 and 2010 burn rate limits;
   - the average of their 2010 and 2011 burn rate limits; or
   - their 2010 burn rate limit for 2010, their 2011 limit for 2011, and their 2012 limit for 2012.

   Obviously, companies face a unique risk with either of the last two approaches as ISS is seeking a public commitment to stay within a burn rate limit that has yet to be determined. Typically, ISS does not publish its annual burn rate limits until November of the preceding year (for example, ISS will publish its 2011 limits in November 2010). A company that agrees to comply with limits to be determined in the future to forestall a current against vote recommendation may find itself unable to execute its equity strategy if these limits turn out to be more restrictive than anticipated.

ISS' Dilution Policy

In evaluating an employee stock plan proposal, ISS uses a cost-based analysis to assess the amount of shareholder equity that may be transferred from a company to its employees under the plan. ISS will recommend a vote against an employee stock plan if it believes that its "cost" is unreasonable.

A plan's cost is expressed in terms of the "shareholder value transfer" ("SVT"), which is measured using a binomial option pricing model that assesses the amount of shareholders' equity flowing out of the company to employees and directors. SVT is expressed as both a dollar amount and as a percentage of a company's market value. When analyzing the cost of a proposed employee stock plan, ISS looks at the total cost of the company's equity compensation program, including the new shares being requested, shares available under all existing employee stock plans, and shares subject to outstanding awards (the so-called "overhang"). All award types are valued (with the possible exception of "in-the-money" stock options that have been outstanding for at least six years). In the case of "omnibus" employee stock plans, unless limitations are placed on the most expensive types of awards (for example, full value awards), ISS will assume that all awards will be granted as the most expensive type for purposes of this calculation.

ISS considers a company's SVT to be reasonable if it falls below a company-specific "allowable cap," that is both industry and performance-based. This "allowable cap" is determined as follows:

- The top quartile performers in each industry group (using the relevant GICS code) are identified.
- Benchmark SVT levels for each industry are established based on these top performers' historic SVT.
- Regression analyses are run on each industry group to identify the variables most strongly correlated to SVT.
- The benchmark industry SVT level is then adjusted upwards or downwards for the specific company by inserting company-specific performance measures, size, and cash compensation into the industry cap equations to arrive at its allowable cap.

ISS considers these company-specific caps to be proprietary. Consequently, this information is not publicly available. A company wishing to verify whether it satisfies its applicable cap must engage ISS for this purpose. (It is important to note that engaging ISS to perform an analysis doesn't guarantee a favorable vote recommendation. ISS' consulting group – which conducts the analysis – is segregated from its research arm - which formulates its voting recommendations. Given the potential expense associated with such an engagement, companies should weigh the probability of the outcome (as discussed in Compliance Tip No. 7) before making this investment.)

Compliance Tips

5. **Understand Impact of Acquisition-Related Awards**. Unlike under its burn rate policy, ISS does not allow companies to exclude acquisition-related awards from its SVT test. Consequently, companies that are actively growing through acquisitions may have a difficult time obtaining ISS' endorsement of any employee stock plan proposal. This will be especially true where a company completes a cash acquisition and its outstanding shares following the transaction do not increase. In this situation, you may need to engage your major shareholders directly to solicit their support to adopt or amend an employee stock plan.

6. **Option Exchanges Aren't Dead**. While stock option exchanges have slowed significantly over the past year, in the right situation an exchange may still be a viable means for reducing overhang attributable to unsalvageable stock options and re-motivating employees. We are aware of many companies that still have a significant number of deeply "underwater" stock options outstanding that will remain outstanding – and serve as impediments for purposes of ISS' policies – for several more years. An exchange can not only "wipe the slate clean," but also give you greater maneuverability in dealing with ISS on future employee stock plan proposals.

7. **Check Before You Spend**. Companies that are unsure of their ISS-determined "allowable cap" should consider informally modeling their potential SVT cost before engaging ISS for that purpose. This is particularly true for companies with significant equity overhangs that need to adopt or amend an employee stock plan. Such modeling, while only an approximation, can give you a clear sense of how you are likely to fare under SVT test, while avoiding the cost of an ISS-generated analysis (which may not be a worthwhile expenditure if your dilution levels are already at or near levels that ISS deems unacceptable). Such informal modeling also may be warranted if a company is concerned as to whether it is nearing its ISS-determined average three-year burn rate limit. We can assist companies that are interested in conducting an informal analysis of their SVT level or burn rate limit.

Overall Observations

In addition to these policy-specific items, here are some broader tips that may be relevant when developing and executing your future equity strategy:

8. **Be Aware of How to Use the System to Your Advantage**. Given the rigidity of the ISS policies, it's important to understand how different equity practices (and award vehicles) can influence your burn rate and dilution levels – and to plan accordingly. By shorten-

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ing vesting schedules, you can reduce your future overhang levels more rapidly (for example, RSUs that vest over a three-year period will come out of the dilution calculation faster than RSUs that vest over a four-year year). Similarly, stock options with shorter terms will reduce overhang more quickly over time (as well as generate lower accounting and SVT costs). RSAs count as shares outstanding from the date of grant which will reduce overhang and burn rate levels as a percentage of a company's outstanding shares, while RSUs only count as shares outstanding as they vest. Of course, while these strategies may improve your ability to satisfy ISS' burn rate and dilution policies, that shouldn't necessarily drive your equity program. Be sure to weigh all of the relative merits and drawbacks of different practices before making a decision that's best for your company, employees, and shareholders.

9. **Do the Math**. It's important to understand the effect that any material change in the total number of shares outstanding may have on your burn rate and dilution levels. If your total shares outstanding increase significantly (as a result, for example, of stock option exercises, the vesting of outstanding RSAs or RSUs, or because of new stock issuances), then your burn rate and overhang will decrease. On the other hand, if the number of shares outstanding decreases significantly (due to, for example, share buybacks), then your burn rate, and overhang, will increase. We recommend that you regularly forecast any potential changes to your total shares outstanding when developing your equity budget.

10. **If Necessary, Engage.** If ISS continues to tighten its dilution and burn rate policies later this year, we expect that many companies, needing to maintain competitive equity strategies, will simply be unable to satisfy their RMG-imposed limits, leading to routine pro forma "against" vote recommendations. Consequently, companies that expect to find themselves in this position will need to consider reaching out directly to their major shareholders to solicit support for reasonable employee stock plan proposals.

As equity pools continue to tighten, the ever-present tension between award size and participation levels will be greater than ever when developing your annual equity budget. If your prospects for a new plan (or a share reserve increase) are problematic, it may be time to begin considering the relative merits (and potential drawbacks) of making meaningful awards to a small group of key employees or smaller awards to a broader group of employees or possibly adding cash-settled long-term incentive awards to your compensation program.

Need Assistance?

Compensia has had 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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