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ISS Releases 2015 Draft Policy Updates for Comment – Equity Plan Scorecard Revealed

On October 15, Institutional Shareholder Services ("ISS") released its 2015 draft policy updates, which will apply to annual meetings held on or after February 1, 2015, and opened a comment period that will extend through October 29. The only U.S. compensation policy update pertains to the new equity plan scorecard, which involves a multi-faceted evaluation with less weight placed on plan cost than under the current policy. Final updates are expected to be released on or around November 7.[1]

ISS is proposing a more nuanced multi-factor approach to evaluating equity plan proposals in contrast to the current approach, which consists of a series of stand-alone pass/fail tests (e.g., shareholder value transfer ("SVT") plan cost and burn rate) and the presence of certain "egregious" plan features (e.g., stock option repricing without shareholder approval). As stated in the release, the goals of the new approach are to:

- Consider a range of positive and negative factors to determine vote recommendations;
- Select factors based on (1) feedback from clients and other market constituents, (2) recognition of a growing body of "best" practices in equity compensation, and (3) internal analysis of correlations with total shareholder return ("TSR") performance and plan proposal vote results;
- Establish burn-rate and Equity Plan Scorecard ("EPSC") factor weightings in keeping with company size for three market index groups; and
- Ensure that plans associated with certain highly negative features (e.g., ability to reprice stock options without shareholder approval) or practices (e.g., pay-for-performance disconnects driven by excessive equity grants) will receive a negative recommendation.

The EPSC comprises three components for: (1) plan cost, (2) plan features, and (3) grant practices. Equity plans will be evaluated based on membership in one of three indices plus a category for recent IPOs or bankruptcy emergent companies, which exists as a separate SVT plan cost category under the current policy. The three indices are the S&P 500, the Russell 3000 (excluding S&P 500 companies), and the Non-Russell 3000.

Plan Cost – SVT plan cost will continue to be evaluated based on market cap size versus the relevant GICS industry classification within each index/category, but will be assessed on two bases rather than one:

- The first SVT calculation is unchanged and takes into account new shares requested plus shares remaining available for future grants plus outstanding unvested/unexercised grants.

[1] The draft policy updates can be found at http://www.issgovernance.com/policy-gateway/2015-benchmark-policy-consultation/.

- The second SVT calculation is new and will consider only new shares requested plus shares remaining available. The current option overhang carve-out policy, which considers the SVT plan cost attributable to long-held deep in-the-money options, will be eliminated.

Also, the current treatment of "liberal share recycling" (i.e., the ability to add back shares withheld to pay the exercise price of a stock option or settle withholding taxes owed at exercise of a stock option or stock appreciation right) will be eliminated from the SVT plan cost calculation, but will be evaluated as a plan feature.

Plan Features – Four plan features will be considered, which are:

- Automatic "single-trigger" award vesting upon a change in control ("CIC"),
- Discretionary vesting authority,
- Liberal share recycling on various award types, and
- Minimum vesting periods.

Grant Practices – Six grant practices will be considered, which are:

- The company's three-year burn rate relative to its GICS industry peers within its index group (versus a pass/fail test under the current policy);
- Vesting requirements in the most recent CEO equity grants;
- The estimated duration of the plan based on the sum of shares remaining available and new shares requested, divided by the average annual shares granted in the prior three years;
- The proportion of the CEO's most recent equity grants subject to performance conditions;
- Whether the company maintains a claw-back policy; and
- Whether the company has established post-exercise/vesting share-holding requirements.

The potential to make a future burn-rate commitment if a company has granted shares over the prior three years in excess of its industry burn-rate cap will be eliminated under the new scorecard approach because historical burn-rate comparisons will no longer have pass/fail implications for the vote recommendation.

The new EPSC will allow positive plan features and grant practices to mitigate negative plan features and grant practices as well as SVT plan cost in excess of the allowable cap. Conversely, an equity plan with an SVT plan cost below the allowable cap could receive a negative vote recommendation if there are a sufficient number of negative scorecard factors. Certain "egregious" plan features will continue to trigger an automatic negative vote recommendation regardless of SVT plan cost and the presence of positive scorecard factors. ISS does not expect the new policy to change the number of plan proposals receiving negative vote recommendations from approximately 30% currently.

Comments can be submitted on any aspect of the proposed approach, but are specifically requested on two issues:

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

Those interested in submitting comments, which will be considered by ISS as it finalizes updates to its voting policies, should do so via email to policy@issgovernance.com by October 29.

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General questions about this letter can be addressed to Wendy Hilburn at 212-299-3707 or wjhilburn@fwcook.com. Copies of this letter and other related materials are available on our website at www.fwcook.com.