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ISS's Equity Plan Scorecard: A New Era in Public Company Equity Compensation Plans

By: Ariadna Alvarez and Edward S. Sarnowski
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Publicly-traded companies often establish equity compensation plans to incentivize executives and directors and align their interests with the interests of the company. Because issuing shares under an equity compensation plan could dilute the interests of the company's shareholders, the New York Stock Exchange and the NASDAQ Stock Market generally require shareholders to approve equity compensation plans, as well as any material amendments to such plans.

Proxy advisory firms, including Institutional Shareholder Services, Inc. ("ISS"), are influential in the proxy voting process, and their analysis and recommendations affect the votes of the shareholders of publicly-traded companies. In recent years, proxy advisory firms have more closely scrutinized equity compensation plans before recommending that shareholders vote for approval of an equity compensation plan.

In late 2014, ISS, the largest proxy advisory firm, significantly changed the manner in which it evaluates equity compensation plans by implementing its Equity Plan Scorecard (the "Scorecard"). The Scorecard is predicated on detailed guidelines used by ISS when determining if it will recommend that shareholders vote for approval of an equity compensation plan and should be considered by publicly-traded companies when designing or amending their equity compensation plans. The plans subject to the Scorecard include stock option plans, restricted stock plans, omnibus equity plans, and stock-settled stock appreciation rights plans.

I. Background

In the past, ISS recommended voting "Against" an equity compensation plan if the plan failed any one of a group of pass/fail tests. With the adoption of the Scorecard, ISS began basing its recommendation on its analysis of three broad categories: (a) plan cost; (b) plan features; and (c) grant practices. ISS refers to these categories as the "three pillars" of the Scorecard. Each pillar includes specific scoring factors used to evaluate equity compensation plan proposals, each of which are described in ISS's U.S. Summary Proxy Voting Guidelines and other documents ISS has published, such as the 2016 U.S. Equity Plan Scorecard Frequently Asked Questions, which was most recently updated on November 20, 2015, for shareholder meetings to be held on or after February 1, 2016 (the "2016 Scorecard FAQ").

Generally, in order for ISS to recommend that shareholders vote "For" approval of an equity compensation plan, the plan must score 53 out of 100 possible points under ISS's Scorecard analysis. However, there are special circumstances where ISS may deviate from Scorecard results. For example, ISS may recommend that shareholders vote "Against" a proposal to adopt an equity compensation plan that scored 53 or greater points if the plan contains certain egregious provisions, which are addressed in Section III.D. below. On the other hand, ISS may recommend that shareholders vote "For" proposals to approve positive amendments to equity compensation plans regardless of Scorecard results.

II. Summary of the Three Pillars

As mentioned above, the Scorecard created three broad categories or "pillars" under which equity compensation plans are evaluated. Each pillar is assigned a specific weight in ISS's evaluation, as described below. The weight assigned to each pillar varies depending on the classification of the company sponsoring the plan.

A. Plan Cost Pillar

The "Plan Cost" pillar considers the estimated total cost of the equity compensation plan compared to the industry and peers of the company and is weighed as follows:

- 45% of the total points available for S&P 500 Companies, Russell 3000 Companies, and Non-Russell 3000 Companies
- 50% of the total points available for "Special Cases" Russell 3000 Companies and "Special Cases" S&P 500 Companies (the "Special Cases" involve companies that recently completed an initial public offering or emerged from bankruptcy)
- 60% of the total points available for "Special Cases" Non-Russell 3000 Companies

B. Plan Features Pillar

The "Plan Features" pillar considers whether the equity compensation plan's design includes certain negative factors, such as: (i) provisions allowing single-trigger vesting upon a change-in-control of the company; (ii) broad discretionary vesting authority for the Board of Directors; (iii) allowing liberal share recycling; and (iv) the absence of a minimum vesting schedule for grants. The "Plan Features" pillar is weighted as follows:

- 20% of the total points available for S&P 500 Companies and Russell 3000 Companies
- 30% of the total points available for Non-Russell 3000 Companies
- 35% of the total points available for "Special Cases" Russell 3000 Companies and "Special Cases" S&P 500 Companies
- 40% for the total points available for "Special Cases" Non-Russell 3000 Companies

C. Grant Practices Pillar

The "Grant Practices" pillar considers the company's three-year burn rate in comparison with the industry and peers of the company, the plan's estimated duration, the design of grants to the Chief Executive Officer and clawback policies, and is weighted as follows:

- 35% of the total points available for S&P 500 Companies and Russell 3000 Companies
- 25% of the total points available for Non-Russell 3000 Companies
- 15% of the total points available for "Special Cases" Russell 3000 Companies and "Special Cases" S&P 500 Companies

- 0% for “Special Cases” Non-Russell Companies

III. Summary of the Scoring Factors

The following tables are included in Question No. 11 of the 2016 Scorecard FAQ published by ISS and summarize the scoring factors that are included among the three pillars.

A. Scoring Factors for Plan Cost Pillar

ISS Scoring Factor	ISS’s Definition	ISS’s Scoring Basis
SVT – A+B+C Shares	Company’s Shareholder Value Transfer (“SVT”) relative to peers – based on new shares requested + shares remaining available + outstanding grants and awards	Scaled depending on company SVT versus ISS’s SVT benchmarks
SVT – A+B Shares	Company’s SVT relative to peers – based on new shares requested + shares remaining available	Scaled as above

B. Scoring Factors for Plan Features Pillar

ISS Scoring Factor	ISS’s Definition	ISS’s Scoring Basis
CIC Equity Vesting	Vesting/Payout provisions for outstanding awards upon a change in control	Full points for: • Time-based awards: no acceleration or accelerate if not assumed/converted, AND • Performance-based awards: forfeited, terminated, paid prorata and/or based on actual performance No points for: automatic acceleration of time-based equity or above-target vesting of performance awards Half of full points for: other
Liberal Share Recycling – Full Value Awards	Certain shares not issued (or tendered to the company) related to full value share vesting may be re-granted	Yes – No Points No – Full Points
Liberal Share Recycling – Options	Certain shares not issued (or tendered to the company) related to option or SAR exercises or tax withholding obligations may be re-granted; or, only shares ultimately issued pursuant to grants of SARs count against the plan’s share reserve, rather than the SARs originally granted	Yes – No Points No – Full Points

ISS Scoring Factor	ISS's Definition	ISS's Scoring Basis
Minimum Vesting Requirement	Does the plan stipulate a minimum vesting period of at least one year for at least one award type?	No or vesting period less than 1 year – No Points Vesting period greater than or equal to 1 year – Full Points
Full Discretion to Accelerate (Non- CIC)	May the plan administrator accelerate vesting of an award (unrelated to a CIC, death, or disability)?	Yes – No Points No – Full Points

C. <u>Scoring Factors for Grant Practices Pillar</u>

ISS Scoring Factor	ISS's Definition	ISS's Scoring Basis
3-Year Average Burn-Rate	Company's 3-year average burn rate (as a percentage of common shares outstanding) relative to industry and index peers	Scaled depending on company's burn rate versus ISS's benchmarks
Estimated Plan Duration	Estimated time that the proposed share reserve (new shares plus existing reserve) will last, based on company's 3-year average burn rate activity	Duration less than or equal to 5 years – Full Points Duration greater than 5 years but less than or equal to 6 years – Half of the Full Points Duration greater than 6 years – No Points
CEO's Grant Vesting Period	Period required for full vesting of the most recent equity awards (stock options, restricted shares, and performance shares) received by the CEO within the prior 3 years	Vesting Period greater than 4 years – Full Points Vesting Period greater than or equal to 3 years and less than or equal to 4 years (or no award in the prior 3 years) – Half of the Full Points Vesting Period less than 3 years – No Points
CEO's Proportion of Performance-Conditioned Awards	Proportion of the CEO's most recent fiscal year equity awards (with a 3-year look-back) that is conditioned on achievement of a disclosed goal	50% or more – Full Points Between 33% and 50% -- Half of Full Points Less than 33% -- No Points
Clawback Policy	Does the company have a policy that would authorize recovery of gains from all or most equity awards in the event of certain financial restatements?	Yes – Full points No – No points

ISS Scoring Factor	ISS's Definition	ISS's Scoring Basis
Holding Period	Does the company require shares received from grants under the plan to be held for a specified period following their vesting/exercise?	At least 36 months or to end of employment – Full Points At least 12 months (or until ownership guidelines met) – Half of Full points No holding period/silent – No Points

D. Overriding Factors Related to "Egregious" Plan Features

In addition to evaluating the scoring factors described above, ISS has also identified certain plan features that it has determined constitute "egregious" practices that will result in ISS automatically recommending that shareholders vote "Against" an equity compensation plan proposal. The four "egregious" plan features identified in the 2016 Scorecard FAQ are:

- A liberal change in control definition that could result in vesting without a double-trigger,
- A plan provision allowing repricing or cash buy-outs of underwater options or stock appreciation rights without shareholder approval,
- A plan that is a vehicle for problematic pay practices, or that promotes a pay-for-performance disconnect, and
- Any other plan feature or practice deemed detrimental to shareholders, including tax gross-ups on plan awards or reload provisions.

IV. 2015 Year in Review

The results reported by ISS in connection with its use of the Scorecard through September 4, 2015, reveal that, generally, the design of certain features of equity compensation plans submitted for shareholder approval in 2015 seem to have been influenced by and are therefore more closely aligned with the Scorecard and guidance from ISS.

The data collected for S&P 500 and Russell 3000 companies through September 4, 2015, as presented by ISS to the Chicago chapter of the National Association of Stock Plan Professionals on December 2, 2015, shows that 86% of the equity compensation plans of S&P 500 and Russell 3000 companies reviewed by ISS received Scorecard points for prohibiting single-trigger vesting, 80% received points for prohibiting liberal share counting of appreciation awards, and 79% received points for prohibiting liberal share counting of full value awards. Almost half of the plans of S&P 500 and Russell 3000 companies scored by ISS through September 4, 2015, received Scorecard points for including minimum vesting requirements.

Additionally, the rate at which ISS has recommended that shareholders vote "For" equity compensation plan proposals has been high in 2015. Regarding the first 645 equity plans reviewed under the Scorecard model for S&P 500 and Russell 3000 companies in 2015, ISS issued a favorable recommendation for 541 and a negative recommendation for 104, which equates to favorable recommendations for 83.8% of the plans evaluated that are sponsored by S&P 500 and Russell 3000 companies. This percentage has increased from 79.6% in 2014.

ISS also reported during its presentation on December 2, 2015, that the most common reasons for issuing recommendations that shareholders vote "Against" equity compensation plan proposals included, among others, excessive plan costs, plan provisions allowing repricing, and liberal change in control provisions. Sponsors of equity incentive plans should, therefore, focus on these factors when reviewing their equity incentive plans.

V. Issues to Monitor in 2016

A. Will the High Rate of "For" Recommendations Continue?

As discussed above, in 2015, most equity compensation plans submitted to a shareholder vote on or after February 1, 2015, received "For" recommendations from ISS and were ultimately approved by shareholders. ISS could continue to make changes to the Scorecard's scoring factors similar to how ISS has tweaked its other scoring systems in the past, and as a result, it could become more difficult to obtain "For" recommendations from ISS as it continues to modify the Scorecard's methodology. Companies should continue to monitor the number of "For" recommendations by ISS as the Scorecard is utilized in its second year and consider whether ISS's adjustments to the scoring factors described in the 2016 Scorecard FAQ and the changes to ISS's confidential, proprietary point allocation materially shift the scoring landscape and lead to a lower rate of "For" recommendations as the Scorecard evolves.

B. Evolution of Plan Provisions

As the Scorecard's second year progresses and additional equity compensation plans are reviewed under Scorecard analysis, companies should monitor the analysis and commentary (both from ISS and outside observers) regarding which terms and conditions of equity compensation plans are removed from or added to plans ostensibly in an effort to obtain increased points from ISS. For example, as discussed in Section IV above, while 86% of S&P 500 and Russell 3000 companies whose plans were scored by ISS through September 4, 2015, received points for the "CIC Single Trigger" scoring factor (now known as the "CIC Equity Vesting" scoring factor) and 80% and 79% received points for the "Liberal Share Recycling – Options" and "Liberal Share Recycling - FV" scoring factors through September 4, 2015, only 49% received points for the "Minimum Vesting Requirement" scoring factor and merely 18% received points for the "Full Discretion to Accelerate (Non-CIC)" scoring factor. The high rate of "For" recommendations despite the low rate of implementation of certain plan provisions tied to certain scoring factors seems to suggest that companies may forgo certain plan provisions and continue to receive "For" recommendations from ISS (assuming, however, that the plan contains none of the egregious plan features described in Section III.D. above and scores 53 points or more on the Scorecard).

C. Response to Modified "CIC Equity Vesting" Scoring Factor

As described in Section III.B. above, for equity compensation plans proposed to be approved at shareholder meetings occurring on or after February 1, 2016, the changes to the scoring factor in the "Plan Features" pillar that is now known as "CIC Equity Vesting" will likely cause companies to more specifically address how performance-based awards are treated if a change-in-control occurs in order to receive full points for this factor. This is noteworthy, because the "CIC Equity Vesting" factor (formerly known as "Automatic Single-Trigger Vesting") was a higher scored factor in 2015 based on anecdotal evidence, so we anticipate that companies will modify plans subject to shareholder approval in 2016 in order to receive full points for the "CIC Equity Vesting" scoring factor. Additionally, this scoring factor change could affect

the documentation of certain equity awards because companies tend to address vesting upon a change-in-control in an award agreement rather than in an equity compensation plan, and plans that would have received "full points" for this scoring factor in 2015 may receive "half points" or "no points" in 2016 if the plan (rather than the award agreement) does not specifically account for the treatment of performance-based awards upon a change-in-control of the company.

D. Response to Modified "Post-Vesting/Exercise Holding Period" Factor

As described in Section III.C. above, the mandatory holding period was increased from 12 months to 36 months. For plans subject to shareholder approval at meetings on or after February 1, 2016, full points will not be awarded for the "Post-Vesting/Exercise Holding Period" scoring factor unless the holding period is at least 36 months or until the end of employment. A holding period of 12 months (or until share ownership), which would have garnered full points in the 2015 iteration of the Scorecard, only nets a company half points, and no holding period (or failing to prescribe a holding period at all) will result in no points. It is possible that companies may not follow ISS's changes to this scoring factor because some view mandatory holding periods as arbitrary and unnecessary and consider a heightened 36 month mandatory holding period could be a significant, undesirable burden on executives. On the other hand, a 36 month mandatory holding period after vesting would be in line with the three year lookback period under the SEC's recently proposed rules requiring companies to adopt clawback policies on executive compensation, as required by Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

E. Modify Form 10-K, Proxy Statement, and Other Disclosure

In the wake of the implementation of the Scorecard, some companies have begun to provide new or additional information in Form 10-K, proxy statements, and other filings and disclosures regarding key plan features and equity awards to potentially expedite and ease ISS's review of material information concerning equity awards and equity compensation plans and, ideally, cause ISS to properly score the company's plan. To the extent that a company's historical Form 10-K's or proxy statement disclosure regarding its equity compensation plan(s) is not "Scorecard-friendly," it may be prudent to revisit and retool that disclosure to more closely comport with the Scorecard's pillars and scoring factors and utilize certain buzzwords and terms of art that are integral to the Scorecard.

F. Will Minimum Vesting Requirements Change?

The "Minimum Vesting Requirement" scoring factor in the Scorecard's the "Plan Features" pillar awards full points if the plan stipulates a minimum vesting period of at least one year for at least one type of award, and no points for a minimum vesting period of less than one year (or none at all). As currently drafted, the minimum vesting requirement can apply to a single award type in order to satisfy the scoring criteria and receive full points (subject to exceptions for death, disability, a change-in-control, and a carve out for 5% of shares authorized for grant). Many expected that ISS would modify this scoring factor for 2016 to require all award types to have a minimum vesting period of one year or more in order for the company to get full points for the scoring factor, but that change was not included in the 2016 Scorecard FAQ.

G. Register for ISS Equity Plan Data Verification Portal if Submitting Plan for Approval

If a company intends to submit an equity compensation plan for shareholder approval at its next annual

meeting in 2016, it would be prudent to consider registering for the ISS Equity Plan Data Verification Portal and for the company to familiarize itself with the metrics that ISS will consider when scoring the company's equity compensation plan. As background, the Equity Plan Data Verification Portal is a service provided by ISS that gives companies an opportunity to ensure that the most timely and accurate data is used by ISS in its analysis and recommendation with respect to a company's equity compensation plan. The Equity Plan Data Verification process begins after ISS has collected all relevant data for a company's equity compensation plan proposal and has completed a data profile for the ISS proxy research team, and it essentially gives companies an opportunity to preview, and if necessary update, the data that ISS's vote recommendation will be based on.

VI. Conclusion

As this article outlines, the Scorecard is more nuanced and detailed than ISS's prior pass/fail tests used to analyze equity compensation plans submitted for shareholder approval. The specificity of the Scorecard, coupled with the influence of ISS in the marketplace, could prompt changes to "best practices" in equity compensation plan design. If a company intends to submit an equity compensation plan for shareholder approval in 2016, we encourage the company to familiarize itself with the Scorecard early in the plan design process and to consider taking advantage of the resources offered by ISS (such as the Equity Plan Data Verification Portal) and to reach out to the company's legal professionals, consultants, and other advisors at the early stages of the plan design process.

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