



Executive Compensation and Benefits Alert

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Avoiding an ISS Negative Recommendation: Considerations for Companies Seeking Shareholder Approval of Equity Incentive Plan Proposals

As the 2017 proxy season approaches, companies may be preparing to solicit shareholder approval for a new, or an amendment to an existing, equity incentive plan. In doing so, in addition to considering business needs, companies must keep in mind the positions of proxy advisory firms — particularly Institutional Shareholder Services (ISS) and Glass Lewis — if those firms’ recommendations have a significant influence on the company’s shareholder base. In addition, as ISS positions tend to drive market practice, even companies with a shareholder base not heavily influenced by ISS should be aware of its policies.

We set out below a helpful summary of the considerations taken into account by ISS, which follows, at least relative to Glass Lewis, a relatively regimented evaluation process. ISS considerations are set forth in its Equity Plan Scorecard (EPSC). The EPSC is updated periodically by, among other things, annual revisions to a set of frequently asked questions (the most recent of which, from December 2016, is available [here](#)). ISS’ consulting arm also periodically publishes what it calls a “primer” on the EPSC methodology. The most recent FAQs and primer (and the description of the EPSC set out below) are applicable to plan approvals sought at shareholder meetings occurring on or after February 1, 2017.

Glass Lewis has its own analytical tools for determining whether to recommend that shareholders approve a new equity plan or an increase in the number of shares reserved for issuance under an existing plan. While Glass Lewis does not disclose the details of its models, the goal of its analysis generally is to determine whether the proposed plan is more than one standard deviation away from the average peer group plan with respect to various measures, and whether the proposed plan exceeds any absolute limits in the model.

The description of the EPSC below is applicable only to companies in the S&P 500 and Russell 3000. For those familiar with the current scorecard, the summary is followed by a digest of the changes first applicable to meetings occurring on or after February 1, 2017. Special rules apply under the EPSC to companies that are not in the Russell 3000 or that otherwise fall into a “special cases” category (recent IPOs, spinoffs and bankruptcy emergent companies that do not disclose at least three years of grant data). Such companies should be sure to consider the EPSC model applicable to them.

To What Proposals Does the EPSC Apply?

The EPSC applies to proposals for the approval of stock option plans, restricted stock plans, omnibus stock plans and stock-settled stock appreciation rights plans.

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The EPSC also applies to amendments to such plans that would or could increase the potential expense of the plan from a shareholder's perspective (e.g., by requesting new shares and/or a plan extension).

Importantly, the EPSC does *not* apply to stand-alone nonemployee director plans. Such plans are instead subject to an ISS cost evaluation based on burn rate and what ISS calls "shareholder value transfer" (SVT).

Plans being amended *without* a request for additional shares (or other modification deemed to potentially increase cost) will receive a recommendation based on an analysis of the overall impact of the amendments — *i.e.*, whether they are deemed to be overall beneficial or contrary to shareholders' interests. In these cases, the EPSC score will not determine ISS' recommendation, although the applicable ISS report will set forth the EPSC result for informational purposes. If the proposed amendments are bundled with a material new share request (or are otherwise deemed to potentially increase cost) or shareholders did not previously have an opportunity to vote in respect of a plan (for example, for a previously private company), ISS' recommendation will consider both the EPSC score as well as an analysis of the overall impact of the amendments; in such cases, however, the EPSC score will be the more heavily weighted consideration.

Proposals seeking shareholder approval *only* to ensure the tax deductibility of awards pursuant to Section 162(m) of the Internal Revenue Code will generally receive a favorable recommendation. Where such an approval request is bundled with other requests, however, the rubric described in the preceding paragraph will apply.

The EPSC in General

The EPSC considers a range of positive and negative factors, rather than a series of "pass/fail" tests, to evaluate equity plan proposals. Factors are grouped under three "pillars": Plan Cost, Plan Features and Grant Practices. Each factor has a maximum potential score (*i.e.*, weighting), with 53 out of a maximum 100 total potential points required to "pass" the EPSC model. As described below, however, there are certain "egregious" features that will result in a negative recommendation even where there is an otherwise passing score.

- **Plan Cost (45 percent)** measures SVT relative to peers (determined based on industry and market capitalization), calculated in two ways: first, new shares requested plus shares remaining for future grants (from all active plans), plus outstanding unvested/unexercised grants; and, second, based only on new shares requested plus shares remaining for future grants (from all active plans). In determining SVT, a fungible share pool plan (where a full value award "counts" for more shares than an option/SAR) is analyzed under two scenarios: Under the first scenario, all new shares requested are treated as full value awards; under the second, all new shares requested are treated as stock options, with appropriate adjustment of the number reserved

according to the ratio provided in the plan document. ISS then utilizes the more costly scenario in its evaluation of the cost of the plan under the EPSC.

- **Plan Features (20 percent)** evaluates the following plan features: nature of vesting in connection with a change in control; extent of discretionary vesting authority; extent of liberal share recycling (e.g., returning to the plan shares withheld on vesting to cover taxes); absence of minimum required vesting of at least one year; and the ability to pay dividends prior to the vesting of the underlying award.
- **Grant Practices (35 percent)** focuses on three-year average burn rate relative to peers; vesting requirements in the most recent CEO equity grants (based on a three-year lookback); estimated duration of the plan (based on the company's three-year average burn rate); proportion of the CEO's most recent equity grants subject to performance conditions (again, based on a three-year lookback); whether the company has a clawback policy; and whether the company has established post-exercise/vesting holding periods for the shares received.

By contrast to the pass/fail test regime applicable before the EPSC, a low score in one area under the EPSC can be offset by a high score in another. As such, a plan with a cost that is somewhat higher than that of peers could potentially still receive a "for" recommendation if Plan Features and Grant Practices considerations are sufficiently positive. Conversely, a lower-cost plan may not receive a "for" recommendation if the plan includes enough problematic provisions or if past grant practices raise concerns.

ISS does not publicize how many points are attributed to each of the various pillar components and instead scores them pursuant to its "proprietary scoring model." It does, however, indicate the circumstances in which full, partial or no points will be available for a given component (see Appendix A).

ISS adds up the individual pillar scores to arrive at a final EPSC score. If this score is at least 53 points and the plan has no "egregious" features (which are discussed in the next section below), ISS generally will recommend "for" the proposal. However, in its qualitative review of proposed equity plan amendments, even if there is no request for additional shares, ISS will seek to determine whether any proposed amendments materially impact any existing "shareholder-friendly" plan provisions or if any new proposed amendments are detrimental to shareholders. If ISS makes such a determination, ISS may not support the equity plan proposal even if the plan otherwise achieves a passing score under the EPSC.

ISS has specifically noted in this regard that its separate CEO "pay-for-performance" assessment (which is used to evaluate a company's executive compensation (say-on-pay) advisory vote) can result in an "against" recommendation on an equity plan proposal where a significant portion of the CEO's pay is attributable to

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equity awards and the CEO has historically received a significant portion of grants under the plan considered.

What Are 'Egregious' Plan Features Under the EPSC?

As noted above, "egregious" features in an equity plan will result in ISS issuing an "against" recommendation, regardless of other EPSC factors. The following is a list of features ISS has identified as egregious for this purpose, though it warns that this list is nonexhaustive:

- A liberal change in control definition (including, for example, shareholder approval of a merger or other transaction rather than its consummation) that could result in vesting of awards by any trigger other than a full double trigger;
- If the plan would permit repricing or a cash buyout of underwater options or SARs without shareholder approval;
- If the plan is a vehicle for problematic pay practices or a pay-for-performance misalignment; or
- If any other plan features or company practices are deemed detrimental to shareholder interests (including, on a case-by-case basis, tax gross-ups related to plan awards or provision for reload options where the feature was not previously approved by shareholders).

Treatment of Performance Award Burn Rates

In recent years, there has been an increase in the prevalence of performance-based vesting awards, which are subject to special and important burn-rate rules under the EPSC. In short, for purposes of its burn-rate determination, ISS will count both time- and performance-based awards in the year in which they are granted, unless the company provides tabular disclosure detailing performance-based awards granted and earned in each year for the past three years, in which case ISS will instead count performance-based awards when they are earned. Companies should continue to make the additional disclosure each year after initially providing it, even if there is no equity plan on the ballot, if they want ISS to evaluate performance awards in a similar fashion in subsequent years.

For performance awards that include a time-vesting period following the performance period, the shares will generally be counted at the end of the time-vesting period. If, however, a company only discloses the shares earned as of the completion of the performance period and not at the end of the time-vesting period, the shares will be counted when earned.

What Changes Were Made to the EPSC for 2017?

For those generally familiar with the EPSC as currently in effect, an understanding of the changes first applicable for shareholder meetings on or after February 1, 2017, may prove helpful. These changes, which are summarized below, are reflected in the description of the EPSC set out above.

- A new factor was added to the Plan Features pillar. The new factor evaluates the payment of dividends on unvested awards. Full points will be earned if the equity plan expressly prohibits, for all award types, the payment of dividends before the vesting of the underlying award; accrual of dividends payable upon vesting is acceptable, however. No points will be earned if this prohibition is absent or incomplete (*i.e.*, not applicable to all award types). A company's general practice (not formally reflected in the plan document) of not paying dividends until vesting will not suffice. Previously, the ISS policy was limited to restricting dividends on unearned performance awards only.
- The minimum vesting factor has been updated so that full points are awarded only if the plan specifies a minimum vesting period of one year for *all* equity awards. Also, no points will be earned if the plan allows for the administrator, through individual award agreements or other mechanisms, to reduce or eliminate the one-year vesting requirement beyond the allowable carve-out. As in previous years, the minimum vesting restriction must apply to at least 95 percent of all equity awards granted under the plan to receive credit (allowing a 5 percent "carve-out"). As such, it appears that a full discretionary vesting provision could cause a company to receive no points for both the "minimum vesting requirement" and "full discretion to accelerate" factors under the Plan Features pillar.
- For companies with between 33 and 36 months of trading history, the EPSC will be based on whether the company has disclosed three years of burn rate data. Companies with 32 or fewer months of trading history will continue to be evaluated under the separate "special cases" model.
- Certain factor scores were adjusted under ISS' proprietary scoring model. As noted above, however, the specifics of that scoring model are not publicized by ISS, and accordingly it is not possible to evaluate the significance of the changes. The potential for a maximum 100 points and requirement for a score of at least 53 points were not changed.

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Given the analytical complexity and, at least in the case of ISS, the specificity of proxy advisory firm evaluation models for evaluating shareholder proposals relative to equity incentive plans, companies should engage early in the process with internal finance and equity specialists, as well as external legal counsel and compensation consultants, in order to confirm that the plan documentation and number of shares are appropriate and that the proposal is likely to receive a "for" recommendation from the advisory firms.

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Appendix A

EPSC Factors & Point Allocation System

Factor	Definition	Scoring Basis
Plan Cost		
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' SVT benchmarks
SVT – A+B Shares	Company's Shareholder Value Transfer (SVT) relative to peers – based on new shares requested + shares remaining available	Scaled as above
Plan Features		
CIC Equity Vesting	Vesting/payout provisions for outstanding awards upon a change in control	<p>Full points for:</p> <ul style="list-style-type: none"> - Time-based awards: no acceleration or accelerate if not assumed/converted, AND - Performance-based awards: no acceleration, forfeited/terminated, or vesting that is adjusted for actual performance and/or the fractional performance period ("pro rata") <p>No points for: automatic acceleration of time-based equity or above-target vesting of performance awards</p> <p>Half of full points for: other provisions</p>
Liberal Share Recycling – FV	Certain shares not issued (or tendered to the company) related to full value share vesting may be regranted	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 regranted; 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
Minimum Vesting Requirement	Does the plan stipulate a minimum vesting period of at least one year for all equity award types?	<p>No or vesting period < 1 year – no points</p> <p>Vesting period =/> 1 year – full points</p> <p>No points if the plan allows for individual award agreements or other mechanisms to reduce or eliminate the minimum vesting requirement</p>
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
Dividends Paid on Unvested Awards	Does the plan expressly prohibit the payment of dividends on unvested awards for all award types?	Yes – full points No – no points

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Factor	Definition	Scoring Basis
Grant Practices		
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 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 <= 5 years – full points Duration >5 and <= 6 years – 1/2 of full points; Duration > 6 years – no points
CEO's Grant Vesting Period	Period required for full vesting of the most recent equity awards (stock options, restricted shares, performance shares) received by the CEO within the prior 3 years; performance awards are considered separately from time-vesting awards	Vesting Period > 4 years – full points; Vesting Period >= 3 years and <= 4 – 1/2 of full points Vesting Period < 3 years – no points; No points for: no performance awards granted in the prior 3 years; 1/2 of full points for: no time-based options and restricted shares granted in the prior 3 years
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; 33% < 50% – 1/2 of full points; < 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
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 until end of employment – full points Less than 36 months or until share ownership guidelines met – 1/2 of full points No holding period/silent – no points

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