Equity Plan Scorecard (U.S.)

Background and Overview

As issues around cost transparency and best practices in equity-based compensation have evolved in recent years, ISS proposes updates to its Equity Plans policy in order to provide for a more nuanced consideration of equity plan proposals. As an alternative to applying a series of standalone tests (focused on cost and certain egregious practices) to determine when a proposal warrants an "Against" recommendation, the proposed approach will incorporate a model that takes into account multiple factors, both positive and negative, related to plan features and historical grant practices.

Feedback from clients and corporate issuers in recent years, beginning with the 2011-2012 ISS policy cycle, indicates strong support for the proposed approach, which incorporates the following key goals:

- Consider a range of factors, positive and negative, 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 TSR performance and plan proposal vote results.
- Establish burn-rate and Equity Plan Scorecard ("EPSC") factor weightings in keeping with company size (based on three market index groups).
- Ensure that plans associated with certain highly negative features (e.g., ability to reprice stock options without shareholder approval) or practices (pay-for-performance disconnects driven by excessive equity grants) will receive a negative recommendation.

Key Changes under Consideration

ISS proposes to use a "scorecard" model that considers a range of positive and negative factors, rather than a series of "pass/fail" tests as applied in the existing policy, to evaluate equity incentive plan proposals. A company's total EPSC score will generally determine whether a "For" or "Against" recommendation is warranted.

Key features of the proposed EPSC include the following:

(i) Scorecard factors evaluated will fall under three main categories:

1) Plan Cost: The total potential cost of the company’s equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer (SVT) in relation to peers. SVT will be calculated for both (a) new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants, and (b) only on new shares requested plus shares remaining for future grants.
2) Plan Features:
    - Automatic single-triggered award vesting upon a CIC;
    - Discretionary vesting authority;
    - Liberal share recycling on various award types; and
    - Minimum vesting period for grants made under the plan.
3) Grant Practices:

- The company's three-year burn rate relative to its industry/market cap peers;
- Vesting requirements in most recent CEO equity grants;
- 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 CEO's most recent equity grants/awards subject to performance conditions;
- Whether the company maintains a claw-back policy; and
- Whether the company has established post exercise/vesting share-holding requirements.

(ii) Scorecard factors and weightings will be keyed to company size and status: S&P 500, Russell 3000 (excludes S&P500), Non-Russell 3000, and Recent IPOs or Bankruptcy Emergent companies.

(iii) The dual cost measurement approach would eliminate ISS' option overhang carve-out policy.

(iv) "Liberal share recycling" provisions will be evaluated as a plan feature rather than incorporated in SVT calculations.

(v) Burn rate benchmarks will be calibrated for respective index groups: (a) S&P500, (b) Russell 3000 (excluding S&P500), and (c) Non-Russell 3000; the relevant GICS industry classification will be used within each index group.

(vi) The company's burn rate will be considered as part of the Scorecard evaluation, based on a range relative to its peers; this will eliminate any potential for commitments from companies to adhere to specific future burn rate caps (i.e., will eliminate "burn rate commitments").

Intent and Impact

The proposed EPSC policy on equity plan proposals introduces a more nuanced approach around traditional cost evaluation by considering a range of plan features and grant practices that reflect growing investor awareness of aspects such as performance-conditioned awards, risk-mitigating mechanisms, and reasonable plan duration. While some highly egregious features will continue to result in negative recommendations regardless of other factors (e.g., authority to reprice options without seeking shareholder approval), EPSC recommendations will largely be based on a combination of factors related to (1) cost, (2) plan features, and (3) grant practices. For example, a plan where cost is nominally higher than a company's allowable cap may receive a favorable recommendation if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may ultimately receive a negative recommendation if a preponderance of scorecard factors is negative.

The proposed policy is not designed to increase or decrease the number of companies that would receive adverse vote recommendations. While ISS has historically recommended against approximately 30 percent of equity plan proposals each year under existing policy (ranging from 30 percent to 42 percent during the period from 2005 to 2013), the vast majority of plan proposals receive the requisite number of votes to pass. In the aftermath of the 2008-2009 financial "meltdown," no more than nine equity plan proposals have failed to garner majority support each year (2010 through 2013), compared with 22 failed plans in 2005. With the strong market recovery, investors may be more critical of equity transfers to management, especially in the absence of shareholder friendly plan features and grant practices. A scorecard approach will enable evaluation of equity plan proposals in consideration of a range of best practices.

Request for Comment

While we appreciate any comments on this topic, ISS seeks specific feedback on the following issues.

1. Are there certain factors outlined above in our proposed scorecard approach that should be more heavily weighted when evaluating equity plan proposals? Please specify and explain.

2. Do you see any unintended consequences from shifting to a scorecard approach? If yes, please specify.

To submit a comment, please send via email to policy@issgovernance.com. Please indicate your name and organization for attribution. While ISS will consider all feedback that it receives, comments will not be published without attribution.

All comments received will be published as received, unless otherwise requested in the body of the email submission.