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EXEQUITY

Independent Board and Management Advisors

Client Alert

ISS Issues FAQs on 2015 U.S. Equity Plan Scorecard Policy

On December 22, 2014, ISS released Frequently Asked Questions on its 2015 U.S. Equity Plan Scorecard Policy (FAQs)[1] just in time for Christmas. Sadly, it looks like the Grinch may have gotten to the FAQs before release because some of the items that ISS had suggested were going to be covered were given short shrift by the explanations.

The FAQs address 20 questions concerning the Equity Plan Scorecard (EPSC) Policy that ISS released for the 2015 proxy season. The EPSC Policy will be used to evaluate new and amended stock option plans, restricted stock plans, omnibus plans, and stock-settled stock appreciation rights plans put to a shareholder vote on and after February 1, 2015. The questions fall into three categories: General Questions, Fact-Related Questions, and Methodology-Related Questions.

Weighting of the EPSC "Pillars"

One of the first questions addresses how the EPSC Policy differs for various groups of companies: S&P 500 companies, Russell 3000 companies (excluding S&P 500), Non-Russell 3000 companies, and IPO/Bankruptcy companies. Basically, ISS will place different weights on the three pillars (plan cost, plan features, and grant practices) for the various groups as follows:

Company Group	Plan Cost	Plan Features	Grant Practices	Comment
S&P 500 and Russell 3000 companies	45	20	35	
Non-Russell 3000 companies	45	30	25	By placing greater weight on plan features, ISS is trying to influence plan design of smaller public companies. Only the burn rate and plan duration factors are used in the Grant Practices pillar.
IPO/bankruptcy companies*	60	40	0	Given that IPO/bankruptcy companies do not have sufficient history of grants to analyze, ISS could only assess plan cost and features.

* IPO/bankruptcy companies are those companies that either went public or emerged from bankruptcy within the prior three fiscal years.

[1] 2015 U.S. Equity Plan Scorecard, Frequently Asked Questions, Effective for Meetings on or after February 1, 2015, Published December 22, 2014, available at: http://www.issgovernance.com/file/policy/2015faqusequityplanscorecard.pdf

Points Needed to "Pass" the EPSC Policy

A total of 53 points out of the 100 available is necessary for ISS to recommend in favor of an equity plan proposal. However, if certain issues exist (see "Overriding Factors that Cause ISS to Oppose Plan Proposals" below), then regardless of the total EPSC points, ISS will recommend against the proposal.

Overriding Factors That Cause ISS to Oppose Plan Proposals

Specifically, the following items (referred to as "Overriding Factors" by ISS) will cause ISS to oppose an equity plan proposal:

- A liberal change-in-control (CIC) definition that could result in vesting of awards by any trigger other than a full double trigger (e.g., both a transaction and a qualifying employment termination);

  ***Note**: This factor is focused on the **definition** of a CIC, so a plan that does not have a liberal CIC definition will **not** automatically be opposed by ISS.*

- The plan permits repricing or cash buyout of underwater stock options or stock appreciation rights (SARs) without shareholder approval;
- The plan is a vehicle for "problematic" pay practices or a pay-for-performance disconnect; or
- Any other plan features or company practices are deemed detrimental to shareholder interests, which could include, on a case-by-case basis, tax gross-ups related to plan awards or provision for reload stock options.

Scoring of the Various Factors Under the Three Pillars

The chart below details the various factors under the three pillars and shows what ISS has said about the points for each factor, and, if available, how companies can maximize their points under a particular factor. As is described in the narrative following the table, ISS has not yet provided point allocations to the items listed in the table.

	Factor	Definition	Scoring
Plan Cost	SVT—A+B+C Shares ***Note:** SVT = Shareholder Value Transfer*	Company's SVT for new shares requested + shares remaining available + outstanding grants and awards; relative to peers.	**Scaled Points** (see discussion below, but full points are awarded when plan costs are at or less than 65% of the ISS allowable cap)
	SVT—A+B Shares	Company's SVT for new shares + shares remaining available; relative to peers.	**Scaled Points** (see discussion below, but full points are awarded when plan costs are at or less than 65% of the ISS allowable cap)

	Factor	Definition	Scoring
Plan Features	CIC Single Trigger	Does the plan provide for the automatic vesting of outstanding equity awards upon a CIC alone?	**Full Points**: No **No Points**: Yes
Plan Features	Liberal Share Recycling—FVAs	Does the plan add back to the share authorization certain shares not issued or tendered to the company related to the vesting of full value awards (FVAs)?	**Full Points**: No **No Points**: Yes
Plan Features	Liberal Share Recycling—Options and SARs	Does the plan add back to the share authorization certain shares not issued or tendered to the company related to stock option or SAR exercises or tax withholding obligations, or only count the net number of shares issued against the share authorization?	**Full Points**: No **No Points**: Yes
Plan Features	Minimum Vesting Period	Does the plan stipulate a minimum vesting period of at least one year for any award?	**Full Points**: >= 1 year **No Points**: < 1 year or no vesting
Plan Features	Full Discretion to Accelerate (Non-CIC)	May the plan administrator accelerate vesting of an award (unrelated to a CIC, death, or disability)?	**Full Points**: No **No Points**: Yes
Grant Practices	3-Year Average Burn Rate	Company's 3-year average burn rate relative to industry and index peers.	**Scaled Points** (see discussion below, but maximum points are achieved when the burn rate is at or less than the industry and index peers)
Grant Practices	Estimated Plan Duration	Estimated time that the proposed share authorization (inclusive of shares remaining available) will last, based on company's 3-year average burn rate activity (in contrast to the 3-year average burn rate factor, there is no full-value multiplier applied to this calculation unless the company's plan has a fungible share design where full value awards count against the share reserve at a higher rate).	**Full Points:** =/< 5 years **½ of Full Points:** > 5 years to </= 6 years **No Points:** > 6 years
Grant Practices	CEO's Grant Vesting Period	Period required for full vesting of the most recent equity awards (stock options, restricted shares, performance shares) to the CEO within the prior three years (note that the penalty for more rapid vesting applies not only to options and restricted shares, but also to awards deemed by ISS to be "performance-based").	**Full Points:** > 4 years **½ of Full Points:** =/> 3 years to </= 4 years (or no award in prior 3 years) **No Points:** < 3 years
Grant Practices	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 (i.e., long-term performance cash awards do not count and thus, there is no credit for these types of awards, as there is no credit for stock options and restricted stock).	**Full Points:** 50%+ **½ of Full Points:** 33% to < 50% **No Points:** > 33%
Grant Practices	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?	**Full Points:** Yes **No Points:** No

Factor	Definition	Scoring
Holding Period	Does the company require shares received from awards under the plan to be held for a specified period following their vesting/exercise?	**Full Points:** At least 12 months or to end of employment **½ of Full Points:** < 12 months (or until ownership guidelines met) **No Points:** No holding period/silent

How Many Points Are Assigned to Each Factor?

ISS does ***not reveal*** the number of ***points*** that are assigned to each factor under the three pillars of the EPSC Policy or even how much weight is given to the various factors under each pillar. However, given that 35 points are assigned to the Grant Practices pillar for the S&P 500 and Russell 3000, and 25 points for the Non-Russell 3000 companies, which are only evaluated for the burn rate and duration factors in that pillar, may suggest that the other factors have significantly less weight (combined, perhaps 10 points).

Commentary: *Without such information, trying to get a rough understanding of how many points a company would receive under the Plan Features and Grant Practices pillars of the EPSC Policy will be difficult. Companies are quite familiar with the notion that the only way that they can determine their SVT allowable cap (proprietary ISS number) is to pay for access to the ISS model. Companies could often get a general sense of where they were likely to come out under the old ISS equity plan policy and could then purchase the model if it was likely additional shares could be requested. With the EPSC Policy, this pre-model purchase assessment will be very difficult to undertake and likely will lead to these possible responses from companies: (1) more companies will buy the model and then be frustrated to discover that they may not be able to request additional shares, (2) companies will be under increased pressure to adopt ISS-favored plan features and grant practices, (3) companies will be more conservative in their share requests to keep plan costs down and have a plan with a shorter share duration, or (4) companies will ignore the ISS model and design preferences, construct plan proposals that match their needs and strategies, and then launch shareholder education and outreach efforts for their equity plan proposals. Only time will tell how institutional shareholders will use the ISS vote recommendations, as many have their own policies in place which often focus on overhang or run rate. It is also important to keep in mind that very few plan proposals currently fail the shareholder vote, even with an ISS recommendation against the plan, and the biggest reason for failure to achieve majority support for a plan is excessive dilution.*

SVT Cost

ISS has indicated that the scoring for SVT cost versus the SVT A/B/C and SVT A/B benchmarks (equivalent to the allowable caps under the prior equity plan policy) will be judged on a sliding scale. ISS also indicated that in order to maximize the number of points for purposes of the EPSC Policy, total SVT costs should be at or less than approximately 65% of the SVT benchmarks.

Commentary: *This represents a significant change in ISS policy with respect to the assessment of the cost of a proposed plan. Before, if the SVT cost came in under the allowable cap, the burn rate was under the burn rate cap (or the company made a public commitment to maintain its burn rate at the cap for the next three years), and there were no "overriding factors," ISS would support the plan. The EPSC Policy* *will make it much more difficult for plans to pass the ISS policy (obviously ISS will point out that with the scorecard approach, even if points are not maximized under the Plan Cost pillar, companies can pick up points under plan features and grant practices which they could not before).*

The changes ISS has wrought are more extensive than even this change to SVT. Under the prior equity plan policy, SVT was rounded—both allowable caps and SVT costs. Consequently, companies could have an SVT cost that exceeded their allowable cap by up to 49 basis points and still pass the SVT cost test (e.g., up to an SVT of 7.49% with an allowable cap of 7%). ISS has done away with rounding of SVT under the EPSC Policy. This change, coupled with the relative scoring which anchors maximum plan points under the EPSC Policy at 65% of the allowable cap, makes it even more difficult for companies to get ISS to approve the same size share authorizations as in years past. Given the relative scoring nature of the SVT analysis, coupled with the Grant Practices pillar which considers the potential duration of a plan proposal, it is quite likely that the size of equity plan proposal requests will decrease going forward. We have already seen this as the allowable caps under the old equity plan policy declined over the past several years, but the EPSC Policy likely will accelerate this trend.

Stock Option Carve-Outs No Longer Available

The FAQs state that ISS will no longer “carve out” in-the-money options and SARs that have been outstanding for a significant period of time. ISS believes that the dual SVT approach under the EPSC Policy eliminates the need for such carve-outs.

Burn Rate

ISS also indicated in the FAQs that EPSC points for burn rates will be scored relative to the ISS burn rate cap for a company. ISS introduced a new group for the Burn Rate benchmarks, S&P 500 companies, so the three burn rate groups for 2015 are:

- S&P 500 companies;
- Russell 3000 companies (excluding S&P 500 companies); and
- Non-Russell 3000 companies (compared to just Russell 3000 and Non-Russell 3000 company groups that have existed since the burn rate policy was first introduced).

Like with SVT, ISS indicated that maximum EPSC points for the Burn Rate analysis will occur when a company is substantially below the burn rate cap, i.e., at or below 50% of the company’s ISS burn rate cap.

Commentary: *This again represents a significant departure from past practice and likely will cause many companies to be in a suboptimal position vis-à-vis this factor under the EPSC Policy. ISS’s response could be that this is a scorecard and burn rate is only one of many factors. Although ISS does not specifically indicate the number of points represented by the burn rate factor under the Grant Practices pillar of the EPSC Policy, we suspect that it and plan duration, which relates to burn rate, are the most heavily weighted factors in that pillar.*

While this could be viewed as being better for companies since it departs from the strictly binary nature of the prior burn rate policy, we believe this change in burn rate analysis and scoring will ultimately be another thorn in companies’ sides, as many of the companies we have assisted with ISS equity plan proposal analysis during the past several years had burn rates that were well above 50% of their ISS burn *rate caps. See the Appendix for the final ISS Burn Rate benchmarks (formerly referred to as "caps") for the 2015 proxy season as well as the burn rates necessary to maximize points under the EPSC Policy.*

Burn Rate Commitments No Longer Available

The FAQs also state that ISS will no longer accept burn rate commitments. ISS believes the scorecard approach only considers burn rate as one of many factors under the EPSC Policy, and since exceeding the applicable burn rate cap no longer automatically causes ISS to recommend against a plan proposal, there is no need for a "remedy," which allowed companies to commit to maintaining their three-year average burn rate going forward at or below their industry group's burn rate cap.

Commentary*: Companies that still have time left under a burn rate commitment should plan on continuing to meet that obligation going forward.*

Non-Employee Director Plans

The FAQs also indicate that non-employee director plans generally will not be subject to the EPSC Policy, but ISS will conduct a standard plan cost analysis using its SVT model of such proposed plans. ISS stated when an equity plan proposal that is subject to the EPSC Policy is in the proxy along with a non-employee director plan proposal, the shares from the non-employee director plan proposal will be included in the other plan proposal's plan cost analysis under the EPSC Policy.

Commentary: *It is not clear whether non-employee director plans subject to the SVT analysis will be subject to the two separate SVT caps, i.e., one for shares available under existing and continuing plans as well as shares being requested (SVT A/B), and another for those shares plus the shares subject to outstanding equity awards (SVT A/B/C).*

Section 162(m) Proposals

The FAQs also clarify that proposals that are only seeking approval in order to qualify grants as "performance-based" for purposes of Internal Revenue Code Section 162(m) will generally receive favorable vote recommendations and will not be evaluated under the EPSC Policy. However, such proposals cannot seek share increases or the EPSC Policy will be applied. Additionally, if the proposal includes additional plan amendments, ISS will analyze such amendments to determine if they are, on balance, positive or negative with respect to shareholders' interests. In doing so, ISS will determine the appropriate evaluative framework and recommendation accordingly.

ISS also reiterated its position that the general EPSC Policy exemption with respect to Section 162(m) proposals will not apply to companies that are taking their plans to public company shareholders for the first time (i.e., after having gone public, which could be the case where a plan is approved prior to a company going public and it then qualifies for one of the transition periods under Section 162(m) before requiring public company shareholder (re-)approval). In such cases, ISS will apply its new EPSC Policy to such proposals.

Commentary: *The FAQ on Section 162(m) proposals reiterates the existing interpretations and guidance offered under the prior equity plan policy. The key is that if a company needs to seek re-approval of a plan for purposes of Section 162(m), and wants to ensure ISS support for the proposal, it should limit the proposal to simply those items necessary for Section 162(m) qualification and leave off any of the "minor" changes that companies tend to identify after having worked with their plan for a bit. Those amendments may not need shareholder approval under stock exchange rules and adding them may, in fact, jeopardize a positive ISS vote recommendation.*

If you have any questions about this ***Client Alert***, please contact Ed Hauder ((847) 996-3990 or Edward.Hauder@exqty.com) or any of the following:

Ben Burney	(847) 996-3970	Ben.Burney@exqty.com
David Cahn	(847) 996-3965	David.Cahn@exqty.com
Robbi Fox	(847) 948-8655	Robbi.Fox@exqty.com
Mark Gordon	(925) 478-8294	Mark.Gordon@exqty.com
Jeff Hyman	(203) 210-7046	Jeff.Hyman@exqty.com
Lynn Joy	(847) 996-3963	Lynn.Joy@exqty.com
Stacey Joy	(847) 996-3969	Stacey.Joy@exqty.com
Chad Mitchell	(949) 748-6169	Chad.Mitchell@exqty.com
Jeff Pullen	(847) 996-3967	Jeff.Pullen@exqty.com
Dianna Purcell	(718) 273-7444	Dianna.Purcell@exqty.com
Bob Reilley	(856) 206-9852	Bob.Reilley@exqty.com
Mike Sorensen	(847) 996-3996	Mike.Sorensen@exqty.com
Ross Zimmerman	(847) 996-3999	Ross.Zimmerman@exqty.com

Illinois Office (Headquarters) – 1870 West Winchester Road, Suite 141 ● Libertyville, IL 60048
California Offices – 650 Town Center Drive, Suite 830 ● Costa Mesa, CA 92626
– 2840 Comistas Drive ● Walnut Creek, CA 94598
Connecticut Office – 108 Pine Ridge Road ● Wilton, CT 06897
New Jersey Office – 309 Fellowship Road, Suite 200 ● Mt. Laurel, NJ 08054
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Appendix: ISS 2015 Burn Rate Benchmarks

S&P 500

GICS	Description	Mean	Standard Deviation	Industry Benchmark*	Burn Rate to Maximize EPSC Points
10	Energy	1.19%	0.56%	2.00%	1.00%
15	Materials	1.25%	0.71%	2.00%	1.00%
20	Industrials	1.44%	0.69%	2.13%	1.07%
25	Consumer Discretionary	1.66%	0.84%	2.50%	1.25%
30	Consumer Staples	1.42%	0.69%	2.11%	1.06%
35	Health Care	1.99%	0.83%	2.82%	1.41%
40	Financials	1.79%	1.46%	3.25%	1.63%
45	Information Technology	3.24%	1.49%	4.73%	2.37%
50	Telecommunication Services	0.95%	0.33%	2.00%	1.00%
55	Utilities	0.82%	0.38%	2.00%	1.00%

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn rate benchmark changes are limited to a maximum of two (2) percentage points plus or minus the prior year's burn rate benchmark.

Russell 3000 (Excluding the S&P 500)

GICS	Description	Mean	Standard Deviation	Industry Benchmark*	Burn Rate to Maximize EPSC Points
1010	Energy	2.55%	2.48%	5.03%	2.52%
1510	Materials	1.60%	1.31%	2.91%	1.46%
2010	Capital Goods	1.93%	1.22%	3.15%	1.58%
2020	Commercial & Professional Services	2.86%	1.70%	4.56%	2.28%
2030	Transportation	1.84%	2.07%	3.91%	1.96%
2510	Automobiles & Components	2.02%	1.35%	3.37%	1.69%
2520	Consumer Durables & Apparel	2.32%	1.57%	3.89%	1.95%
2530	Consumer Services	2.58%	1.63%	4.21%	2.11%
2540	Media	2.65%	2.52%	5.17%	2.59%
2550	Retailing	2.65%	1.81%	4.46%	2.23%
3010, 3020, 3030	Consumer Staples	1.73%	1.42%	3.15%	1.58%
3510	Health Care Equipment & Services	3.28%	1.85%	5.13%	2.57%
3520	Pharmaceuticals & Biotechnology	3.78%	2.21%	5.99%	3.00%
4010	Banks	1.67%	1.67%	3.34%	1.67%
4020	Diversified Financials	4.56%	4.43%	8.99%	4.50%
4030	Insurance	2.04%	1.80%	3.84%	1.92%
4040	Real Estate	1.40%	1.31%	2.71%	1.36%
4510	Software & Services	4.97%	2.91%	7.88%	3.94%
4520	Technology Hardware & Equipment	3.65%	2.20%	5.85%	2.93%
4530	Semiconductor Equipment	4.75%	2.15%	6.90%	3.45%
5010	Telecommunication Services	3.03%	1.51%	4.54%	2.27%
5510	Utilities	0.84%	0.54%	2.00%	1.00%

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn rate benchmark changes are limited to a maximum of two (2) percentage points plus or minus the prior year's burn rate benchmark.

Non-Russell 3000

GICS	Description	Mean	Standard Deviation	Industry Benchmark*	Burn Rate to Maximize EPSC Points
1010	Energy	2.51%	3.72%	6.23%	3.12%
1510	Materials	3.09%	3.89%	6.98%	3.49%
2010	Capital Goods	3.54%	3.96%	7.50%	3.75%
2020	Commercial & Professional Services	3.88%	3.64%	7.52%	3.76%
2030	Transportation	1.73%	2.14%	3.87%	1.94%
2510	Automobiles & Components	2.19%	2.02%	4.21%	2.11%
2520	Consumer Durables & Apparel	2.83%	3.05%	5.88%	2.94%
2530	Consumer Services	2.71%	3.00%	5.71%	2.86%
2540	Media	2.70%	2.49%	5.19%	2.60%
2550	Retailing	3.79%	2.72%	6.51%	3.26%
3010, 3020, 3030	Consumer Staples	2.36%	2.96%	5.32%	2.66%
3510	Health Care Equipment & Services	4.56%	3.91%	8.47%	4.24%
3520	Pharmaceuticals & Biotechnology	4.86%	3.86%	8.72%	4.36%
4010	Banks	1.20%	1.80%	3.00%	1.50%
4020	Diversified Financials	2.28%	4.11%	6.39%	3.20%
4030	Insurance	1.06%	1.68%	2.74%	1.37%
4040	Real Estate	0.93%	1.44%	2.37%	1.19%
4510	Software & Services	4.62%	3.70%	8.32%	4.16%
4520	Technology Hardware & Equipment	4.07%	3.91%	7.98%	3.99%
4530	Semiconductor Equipment	4.44%	4.26%	8.70%	4.35%
5010	Telecommunication Services	3.67%	3.66%	7.33%	3.67%
5510	Utilities	1.81%	2.21%	4.02%	2.01%

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn rate benchmark changes are limited to a maximum of two (2) percentage points plus or minus the prior year's burn rate benchmark.