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EXECUTIVE COMPENSATION & CORPORATE GOVERNANCE

CLIENT PUBLICATION

January 12, 2015

ISS Publishes FAQs on Equity Plan Scorecard

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On December 22, 2014, Institutional Shareholder Services Inc. ("ISS") released a set of Frequently Asked Questions ("FAQs") that explain ISS's new approach to evaluating management equity compensation plan proposals[1]. ISS believes that its new approach – the Equity Plan Scorecard ("EPSC") – allows for more nuanced consideration of equity incentive programs than did its prior method for evaluating equity plan proposals. The EPSC considers a range of positive and negative factors related to such proposals as opposed to ISS's prior approach which used a series of pass/fail tests focused on the plan's estimated cost to shareholders. Under the EPSC, ISS will continue to provide a negative recommendation for plans that contain certain features that are viewed as "egregious" (such as the right to reprice stock options without shareholder approval). The EPSC is applicable to all shareholder meetings on and after February 1, 2015.

The Three Pillars

The EPSC evaluates factors grouped into three "pillars": Plan Cost, Plan Features and Grant Practices.

Plan Cost

The Plan Cost pillar considers the total potential cost to a company's shareholders of an equity plan relative to plan costs associated with the sponsoring company's industry or market peers. Cost is measured using ISS's proprietary Shareholder Value Transfer ("SVT") model. SVT represents the estimated cost of shares issued under a company's equity incentive plans, taking into account full value shares and stock options, if applicable. ISS's model measures SVT relative to two benchmarks: (1) new shares requested, combined with

[1] Our client publication summarizing the 2015 updates to ISS's voting policies can be found at: http://www.shearman.com/~/media/Files/NewsInsights/Publications/2014/11/ISS Publishes 2015 Proxy Voting Guideline Updates ECEB 111214.pdf. The FAQs themselves can be found at: http://www.issgovernance.com/file/policy/2015faqusequityplanscorecard.pdf.

shares remaining for future grants and outstanding unvested/unexercised grants and (2) only new shares requested plus shares remaining for future grants. The second measure reduces the impact of grant overhang, in recognition that grant overhang expense may reflect long-term positive stock performance, longer vesting periods or employee belief in future stock performance. According to ISS, use of the second measure eliminates the need to carve out option overhang.[2]

The relationship of these two SVT measures is weighed against the company's ISS benchmark SVT. ISS benchmark SVT is derived from an analysis of the company's GICS industry group, market cap size and operational and financial metrics that ISS identified as correlated with total shareholder return ("TSR") performance in the industry.

Plan Features

The Plan Features pillar considers the following factors, the presence of which may have a negative impact on the EPSC score, depending on the company's size and circumstances: (1) automatic single-triggered award vesting upon a change in control; (2) broad discretionary authority to accelerate the vesting of an award unrelated to a change in control, death or disability; (3) liberal share recycling policies (notably, allowing shares withheld or tendered for taxes or to pay the exercise price of an award to be available for re-grant); and (4) the absence of a minimum required vesting period of at least one year.

Grant Practices

The Grant Practices pillar is an amalgam of factors related to the past and future operation of the plan and the terms of the company's plan awards and equity grant policies. The factors in this pillar are the following:

- The company's three-year average burn rate relative to the comparative burn rate of its industry and its index peers (point values are scaled based on comparison to peers).
- Vesting schedules under the CEO's most recent equity grants during the prior three years, with longer vesting schedules resulting in more points.
- The plan's estimated duration, with shorter duration resulting in more points.
- The proportion of the CEO's most recent equity awards/grants subject to performance conditions, with higher proportions resulting in more points.
- Clawback policies that include equity grants, with full points being awarded if such a policy exists.
- Post-exercise or post-vesting shareholding requirements, with longer holding periods resulting in more points.

The FAQs provide additional details regarding certain factors considered in the Grant Practices pillar:

- The minimum burn rate benchmark for each industry group will be 2%. ISS will no longer accept burn rate commitments.
- The proportion of a CEO's equity grants that are deemed performance-conditioned will be based on the ISS valuation of awards reported in the Grants of Plan-Based Awards table. Stock options and stock appreciation rights subject to

[2] Under ISS's prior policies, companies with sustained positive stock performance and high overhang costs attributable to in the money options that were outstanding for more than six years were able to carve out these options from the overhang calculation, as long as the dilution attributable to the new share request was reasonable and the company exhibited sound compensation practices.

time-based vesting will not be considered performance-conditioned unless the vesting or value received depends on attainment of specific performance goals, or if ISS determines that the exercise price is "at a substantial and meaningful premium to the grant date fair market value."

- A plan's duration is calculated by adding the number of new shares requested and the shares remaining available for issuance, and dividing the sum by the average annual burn rate over the past three years. The EPSC adjusts this calculation in situations where full value awards count against the share reserve at a higher rate than appreciation awards.

Scoring Method

The EPSC uses three different scoring models, depending on the type of company. Each of these models weights the three pillars differently. There is a model used for S&P 500 and Russell 3000 companies, another for Non-Russell 3000 companies and a third for companies that recently underwent an IPO or emerged from bankruptcy. These models weight the three pillars as follows:

Pillar	Type of Company	Maximum Pillar Score[3]
Plan Cost	S&P 500 and Russell 3000	45
	Non-Russell 3000	45
	Post-IPO/Bankruptcy	60
Plan Features	S&P 500 and Russell 3000	20
	Non-Russell 3000	30
	Post-IPO/Bankruptcy	40
Grant Practices	S&P 500 and Russell 3000	35
	Non-Russell 3000	25
	Post-IPO/Bankruptcy	0

Generally, the total EPSC score will determine whether ISS recommends voting for or against a proposal. The maximum number of points that may be accrued is 100. A score of 53 points is required to result in a positive recommendation on a plan proposal.

Each EPSC pillar contains multiple factors, each of which is assigned a maximum number of points. ISS notes that the factors are not equally weighted, but it has not disclosed the weighting for the individual factors. Certain EPSC factors are binary, and some may generate partial points. Point values granted for SVT are scaled based on the company's SVT versus ISS's SVT benchmarks. Partial points are also available for the factors of estimated plan duration, CEO's grant vesting period, CEO's proportion of performance-conditioned awards and shareholding periods. Binary factors include single-trigger change in control vesting, liberal share recycling, minimum vesting requirements, discretion to accelerate awards (outside of a change in control context) and clawback policies.[4]

[3] The Non-Russell 3000 model includes only the burn rate and duration factors in the Grant Practices pillar. The IPO/Bankruptcy model does not include any Grant Practices factors.

[4] The Point Allocation System is included as an Appendix at the end of this memo.

Despite the EPSC score, ISS may still recommend against a proposal that features certain egregious characteristics. These characteristics include liberal change of control definitions (such as one defining a “change of control” to include shareholder approval of a merger or other transaction rather than the transaction’s consummation), the ability to reprice options without shareholder approval, the plan’s nature as a vehicle for problematic pay practices or a pay-for-performance disconnect and any other plan features or company practices that are deemed detrimental to shareholder interests which may, on a case-by-case basis, include tax gross-ups related to plan awards or provisions for reload options.

Proposals Subject to the EPSC

The FAQs clarify that only proposals to approve or amend stock option plans, restricted stock plans, omnibus stock plans, and stock-settled stock appreciation rights plans will be evaluated under the EPSC. Proposals related to stand-alone non-employee director plans will not be evaluated using the EPSC, but will remain subject to ISS’s current case-by-case evaluation method. However, when a proposal that will be evaluated using the EPSC is also on the ballot, the shares available under the non-employee director plan will be incorporated into the Plan Cost pillar for the EPSC analysis.

Additionally, the FAQs indicate that plans submitted to shareholders for approval solely to comply with Section 162(m) of the Internal Revenue Code that do not increase the number of shares available for awards under the plan will usually receive positive recommendations. However, to receive such a recommendation, the compensation committee (or other administering committee) must be composed exclusively of directors who are independent under ISS’s standards. If the proposal includes additional plan amendments, those amendments will be analyzed to determine whether they affect shareholder interests positively or negatively based on an evaluation determined by ISS as it deems appropriate.

The FAQs also establish somewhat reticulated rules to determine voting recommendations when multiple plans are submitted at the same time for shareholder approval.

Limitations of ISS Guidance

The EPSC is a proprietary ISS model. While the ISS guidance provides a useful outline of the EPSC factors and scoring methodology, the guidance is not sufficient to allow companies to determine independently whether a proposal will reach the minimum threshold of 53 points, or even how much benefit will be derived from conforming to certain of the recommended plan features.

In addition, certain factors considered in the EPSC are backward-looking, such as burn rate relative to a company’s peers, the CEO’s vesting schedule and the proportion of the CEO’s awards that are subject to performance conditions. Companies will therefore have limited ability at the time a plan is submitted for approval to modify these factors in order to improve EPSC scores for equity plan proposals. This, in turn, will likely result in the need for longer term planning, particularly related to grants and award terms, in anticipation of the need to make future submissions. Companies may be in better positions to evaluate the impact of EPSC factors after the completion of the first proxy season during which the EPSC will be used, particularly if ISS issues a detailed EPSC scorecard in its report.[5]

[5] ISS also maintains an independent consulting division that companies may retain to evaluate their proxy proposals. Presumably, this consulting division will have access to the propriety EPSC model.

Conclusion

ISS has consistently noted that the EPSC is not designed to increase or decrease the number of companies receiving negative vote recommendations. Companies that will be placing equity plans up for shareholder approval in 2015, however, must consider whether the EPSC will alter expected ISS recommendations and, consequently, whether plan modifications will be required. In reviewing their plans, companies should pay particular attention to outlying terms which have historically not presented impediments to a positive ISS recommendation such as share recycling and broad discretionary vesting authority. Moreover, companies should consider whether adopting certain plan amendments, such as a minimum vesting requirement, will increase their EPSC score. At the end of the day, given the numerous factors comprising the EPSC, each plan must be considered on a case-by-case basis.

Appendix: EPSC Point Allocation System

Factor	Definition	Scoring Basis
SVT – A + B + C Shares	Company's 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
CIC Single Trigger	Automatic vesting of outstanding awards upon a change in control	Yes – no points No – full points
Liberal Share Recycling – FV	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
Minimum Vesting Requirement	Does the plan stipulate a minimum vesting period of at least one year for any award?	No or vesting period < 1 year – no points Vesting period =/> 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
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 </= 6 years – ½ 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	Vesting period > 4 years – full points Vesting period =/> 3 </=4 years (or no award in prior 3 years) – ½ of full points Vesting period < 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 upon achievement of a disclosed goal	50% or more – full points 33% < 50% – ½ 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

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Factor	Definition	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 12 months or to the end of employment – full points < 12 months or until ownership guidelines met – ½ of full points No holding period/silent – no points

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