Skadden

Executive Compensation and Benefits Alert

March 3, 2015

If you have any questions regarding the matters discussed in this memorandum, please contact any of the attorneys listed on Page 4, or call your regular Skadden contact.

ISS Issues 'Frequently Asked Questions' Guidance for 2015

As part of its ongoing rollout of its 2015 policy updates, Institutional Shareholder Services (ISS) has issued "Frequently Asked Questions" guidance with respect to both its 2015 Compensation Policies and its new equity plan approval rules (which ISS has named the Equity Plan Scorecard). The following summarizes key aspects of the guidance.

Equity Plan Scorecard

The adoption of the Equity Plan Scorecard signals a significant change in the ISS approach to equity compensation plan proposals and is effective with respect to proposals included in annual shareholder meetings held on or after February 1, 2015. For companies intending to present new, restated or amended equity compensation plans to shareholders for approval during this proxy season, an understanding of the Equity Plan Scorecard system is critical to maximize the chances of a "for" recommendation from ISS.

Under the prior approach, ISS would issue an "against" recommendation if the plan failed any one of a series of pass/fail tests: whether the cost of the company's equity plans, taking into account the new plan or share increase proposal, was reasonable, based on a proprietary ISS measurement of shareholder value transfer (SVT); whether the company's three-year burn rate exceeded an ISS-determined cap; whether the company had a pay-for-performance misalignment; and whether the plan contained certain problematic features (*e.g.*, it permitted repricing).

The Equity Plan Scorecard represents a shift to a more holistic analysis under which the plan can earn points based on the following three categories of factors:

- ***Plan Cost*** — measures SVT relative to peers (determined by ISS based on industry and market capitalization), calculated in two ways: first, based on only new shares requested plus shares remaining for future grants; and second, based on new shares requested plus shares remaining for future grants, *plus* outstanding unvested/unexercised grants. Scoring is not binary, but rather, is scaled, such that companies can receive a range of points.

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- ***Plan Features*** — penalizes the following plan features: single-trigger vesting on a change in control; broad discretionary vesting authority; liberal share recycling (*e.g.*, returning to the plan shares withheld to cover taxes or exercise price); and the absence of a minimum vesting period of at least one year for grants made under the plan. In response to our inquiries, ISS has stated that a plan may carve out 5 percent of shares from the minimum vesting requirement and still receive full points. Each of these is binary, such that a company will receive either full points or no points for each item.
- ***Grant Practices*** — analyzes the following items:
  - **three-year burn rate relative to the company's index and industr**y, with scaled scoring, such that a range of points may be awarded (forward-looking burn rate commitments will no longer be accepted, but past burn rate commitments must be honored);
  - **period required for full vesting of the most recent chief executive officer equity grant within the prior three years**, with full points for vesting over more than four years, half points for vesting over a period of three years to four years (or where no award has been granted in the prior three years), and no points for full vesting in fewer than three years;
  - **estimated duration of the plan** (based on the sum of shares remaining available and the new shares requested, divided by the three-year annual burn rate), with full points for a plan duration of five years or less, half points for a duration more than five years but not greater than six years, and no points for a duration of longer than six years;
  - **proportion of the CEO's most recent equity grant within the prior three years that is subject to performance conditions** (as reported in the Grant of Plan-Based Awards table in the company's annual proxy), with full points for 50 percent or more, half points for 33 percent up to 50 percent and no points for less than 33 percent (note that ISS does not consider time-vesting options to be performance-based);
  - **whether the company has a clawback policy that includes equity grants**, with scoring on a binary basis; and
  - **whether the company has established post-exercise/vesting holding periods for shares received**, with full points for a holding period of at least 12 months or to the end of employment, half points for a period of less than 12 months or until stock ownership guidelines are met, and no points if there is no holding period or the company is silent on the matter.

A score of 53 points out of a maximum of 100 points is required in order to pass, absent any overriding factors. The weightings with respect to the three categories described above are as follows:

- for companies in the S&P 500 and Russell 3000, the point weightings in the three categories above are 45/20/35;
- for companies outside the Russell 3000, the point weightings are 45/30/25, and the grant practices analysis will focus only on burn rate and plan duration; and
- for companies that have had an IPO or emerged from bankruptcy within the prior three fiscal years, the weighting is 60/40/0, with grant practices being disregarded.

Importantly, ISS has not provided any information in the FAQs as to the number of points within each of the three categories that are allocated to each individual item.

The Equity Plan Scorecard model will not apply to stand-alone nonemployee director plans, which will be evaluated based only on shareholder value transfer. However, shares under such plans will be incorporated into the Plan Cost calculation when plans subject to Equity Plan Scorecard are on the ballot.

Even if a plan has a passing score, certain factors may nonetheless result in a negative recommendation:

- a liberal change in control definition (for example, a definition that triggers on shareholder approval of a transaction rather than consummation) coupled with potential single-trigger vesting;
- repricing or cash buyout of underwater options or stock appreciation rights;
- if the plan is a vehicle for a problematic pay practice or pay-for-performance disconnect; or
- if any other features or practices are deemed to be detrimental to the interests of shareholders (for example, tax gross-ups related to awards or the grant of automatic reload options).

Plans being presented for shareholder approval only so that the awards will constitute performance-based compensation for purposes of Section 162(m) of the Internal Revenue Code will generally not receive an Equity Plan Scorecard review and will receive a favorable recommendation, provided that the compensation committee of the company's board of directors is independent by ISS standards. However, plans being presented for 162(m) approval for the first time following an IPO or bankruptcy will be subject to a full Equity Plan Scorecard review.

General Compensation Policy FAQs — Updates for 2015

While the 2015 FAQs generally follow the FAQs that were issued in 2014, there are a few items worthy of note:

- If a company has stated in the past that it has adopted a biennial or triennial frequency for "Say on Pay" and does not put a Say on Pay proposal on the ballot on schedule, it may result in "against" or "withhold" recommendations against incumbent compensation committee members or, if the circumstances warrant, the full board of directors.
- While employment agreements with "evergreen" automatic renewal features are not viewed as a best practice by ISS, if such an agreement renews without being amended in a manner that would negatively impact shareholder interests, it will be evaluated holistically along with the company's other compensation practices rather than automatically triggering concern.
- If an executive's severance and/or change-in-control benefits are provided under a separate plan or agreement that runs indefinitely, but the executive has a separate employment agreement that is extended or modified, ISS has indicated that it may view the modification or extension as also being a modification or extension of the severance or change-in-control arrangement. Although not stated explicitly, this could imply that any historical provisions in the severance or change-in-control arrangement (*e.g.*, gross-up provisions) could become subject to fresh scrutiny.

If you have any questions regarding these new ISS updates or your compensation programs more generally, please do not hesitate to reach out to the attorneys listed on this mailing.

Attorney contacts appear on the next page.

If you have any questions regarding the matters discussed in this memorandum, please contact any of the attorneys listed below or call your regular Skadden contact.

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