Equity-Based Compensation Plans (U.S. and Canada)

Background

In the United States and Canada, listing requirements and tax regulations lead companies to submit most equity compensation plans to shareholders for approval. These plans typically specify features of potential awards, such as the types of equity vehicles permitted, vesting provisions, termination and change-in-control provisions, potential performance metrics, and provisions permitting or prohibiting stock option repricing. The plans also contain parameters for how equity will be used under the plan, such as the number of shares reserved for use under the plan, limits on individual and overall awards on an annual basis, how different award types will be charged against the reserve, and whether shares that are forfeited or exercised are returned to the plan.

In recent years, very few equity plans – typically fewer than 10 proposals out of more than 1,000 submitted annually – have failed to receive majority support from shareholders. Support is not, however, evenly distributed, with about 20 percent of U.S. equity plans receiving less than 80 percent support from shareholders in the first half of 2013.

In ISS' 2013-2014 policy survey, 75 percent of investor respondents indicated that performance conditions on awards are very important in their evaluation of compensation plans, with 64 percent and 57 percent also citing cost and plan features as "very important." While the majority of investor respondents (57 percent) rated plan administration (e.g., historical usage of shares/burn rate) as "somewhat important," several investor participants in ISS' policy roundtables cited burn rate as a topic of increasing interest. In general, issuer respondents to the policy survey rated these factors as less important than investors.

The picture painted by recent voting results and investor feedback is further complicated by the significant changes in the governance and executive compensation landscape over the past decade, including option expensing, a dramatic shift in the mix of equity awards away from options and towards performance-based full value awards, and the advent of say-on-pay as an additional channel for investors to provide feedback on executive compensation. In that context, ISS is undertaking a fresh examination of its approach to evaluating equity plans.

Current ISS Benchmark Policy

ISS has historically evaluated a number of facets of these plans when submitted for shareholder approval, with recommendations against the plan if:

- The total cost of the company's equity plans is unreasonable relative to peers (as measured by Shareholder Value Transfer – based on the total potential value of the company's outstanding awards, authorized shares, and newly requested shares);
- The plan does not expressly prohibit option repricing without shareholder approval;

- The company's three year historical "burn rate" – average number of shares granted annually as a percent of shares outstanding – is greater than one standard deviation higher than its industry mean;
- The plan has a liberal change-of-control definition where equity vesting will or may be accelerated without requiring consummation of an actual change in control;
- Equity awards to executives have contributed to a pay-for-performance misalignment; or
- The plan is a vehicle for problematic pay practices.

Any of these factors can independently lead to a recommendation against the plan, and factors do not balance against one another: e.g., a plan's low historical burn rate would not mitigate against high total cost. Additionally, potentially beneficial features such as a requirement for performance conditions on awards, double-trigger acceleration upon change-in-control, or robust vesting requirements do not typically factor into ISS' analysis of equity plan proposals.

Policy Directions

ISS has been evaluating a number of potential approaches to its benchmark U.S. policy regarding equity plans for 2015 or beyond. At a high level, these approaches are:

A. Maintain the current approach that evaluates the factors listed above.

B. Adopt a "balanced scorecard" approach that allows the weighting of multiple factors in a holistic evaluation of the equity plan. For instance, historical equity grants might elevate a company's burn rate and SVT, but these cost concerns may be counterbalanced by a relatively small new share request and a declining burn rate trend.

Request for Comment/Feedback

Please feel free to add any additional information or comments on this policy. In addition, ISS is specifically seeking feedback on the following:

1. Please specify which evaluation approach above (A or B) best reflects the views of your organization.
2. When assessing compensation plans submitted for shareholder approval, how does your organization weigh the following factors?
    a. Cost – e.g., SVT
    b. Dilution
    c. Administration – e.g., historical burn rate, performance conditions of grants made under the plan.
    d. Plan features – e.g., vesting and termination provisions, repricing provisions, plan provisions requiring performance conditions on awards.
    e. Other (please specify)
3. What positive factors, if any, can counterbalance high cost, dilution, or burn rate?
4. Investor Respondents: Are there particular factors that would trigger votes against an equity plan regardless of other features?
5. Investor Respondents: If there are concerns regarding pay-for-performance or problematic pay practices related to equity-based compensation, is a vote against the equity plan an appropriate action?

To submit a comment, please send via email to policy@issgovernance.com. Please indicate your name and organization.