Aon Hewitt
Radford

October 2015

Seeking a New Share Authorization? Don't Ignore the Shifting Governance Environment.

ISS' new method of evaluating share authorization plans, in additional to evolving institutional investor policies, will make passage of your next share authorization plan more difficult.

Increased scrutiny and shareholder activism have made the corporate share authorization proposal process more complex than ever before. Companies who need shareholder approval for new or amended stock plans are facing the challenge of balancing the business needs of the company against the various corporate governance demands of proxy advisory firms (e.g., Institutional Shareholder Services, Inc. or ISS, Glass Lewis & Co. or Glass Lewis), top institutional shareholders, and activist investors like pension, labor and hedge funds. Unlike in previous years, passing ISS' and Glass Lewis' equity plan evaluation framework no longer ensures high voting results. In recent years, we've seen more institutional investors develop their own proxy voting guidelines around share authorizations that can diverge from the proxy advisory firms— and can potentially limit the size of share authorizations.

One of the biggest disconnects that can occur between investors' policies and ISS' policies is regarding dilution calculations. Specifically, ISS' new equity plan scorecard (EPSC) approach still evaluates the combined "cost" of a company's new and existing share authorizations and all outstanding equity awards against certain acceptable industry "cost" benchmarks (i.e., relative to "shareholder value transfer" cost caps). In determining cost, ISS will assign different dollar valuations to appreciation type awards and full value awards. However, many investors require compliance with a specific "simple" or "full" dilution cap (which can be an absolute threshold or a relative threshold based upon industry and/or size). This analysis counts all awards on a one-for-one basis and effectively limits the number of new shares a company can request regardless of perceived economic value transfer.

A high-profile example of the conflict between the ISS guidelines and dilution parameters enforced by investors took place during the 2014 proxy season. Wintergreen Advisers led a campaign against Coca-Cola Company's share request of 500 million new shares, based on the premise the share request was too dilutive to shareholders. In the end, Coca-Cola's new share request received support from both ISS and Glass Lewis, but only received 83.2% shareholder votes in support due to perceived dilution concerns from investors. This situation has become increasingly common over the past few proxy seasons, as investor-specific standards have deviated from ISS and Glass Lewis guidelines.

Given the increased complexity of the share authorization process, companies should develop a strategy for dealing with the requirements of the various proxy advisory firms and top company shareholders before asking for a new or amended share authorization. But before doing this, a company should first analyze its current equity plan practices and needs.

Evaluating Equity Plan Practices

In order to gauge the feasibility and the business need for new share authorization, a company should be cognizant of the following issues:

- What is the existing share pool?
- Are there enough shares to make another regular-cycle annual long-term incentive grant?
- Is it really necessary to go back for more shares this year?
- Is cash compensation a suitable alternative for delivering all or some long-term incentives?
- What are the current and projected overhang levels?
- What is the number and average remaining term of outstanding stock options or stock appreciation rights, and are they are above/underwater? Do you anticipate a significant decrease in the number of outstanding stock options or stock appreciation rights due to exercise, forfeiture, expiration, etc.?
- How many full-value awards are outstanding (e.g., restricted stock, performance awards)? If performance-based, what is the likelihood of achieving any award payout based on year-to-date performance?
- Do you anticipate any significant decrease in the number of outstanding full-value awards due to vesting and payout, forfeiture, etc.?
- What is the current burn rate (both ISS-adjusted and unadjusted)?
- Is it sustainable for the company to continue its historical grant practices going forward?
- What are the features of existing plans?
- Does going back for shares provide an opportunity to amend or propose a new long-term incentive plan to allow for increased flexibility (e.g., utilize a fungible share pool or implement an omnibus incentive plan)?

Answers to these questions should help a company to determine when and if they should go to shareholders with a new share authorization proposal.

Proxy Advisory Firm Guidelines

While we’ve stated that institutional investors can deviate from proxy advisory firms in their evaluation of share authorization plans, many institutional investors still follow proxy advisory firms’ vote recommendations on executive compensation proposals. Currently, a large number of these institutional investors strongly follow or at least consider vote recommendations provided by ISS and Glass Lewis. An increasing number of institutional investors also utilize information and vote recommendations from other less prominent proxy advisory firms (e.g., Egan-Jones Ratings & Analytics Co.). In order to obtain a favorable vote recommendation from proxy advisory firms, the equity plan must comply with various policies and related governance guidelines. The following sections summarize the proxy voting guidelines for the two most widely used proxy advisory firms: ISS and Glass Lewis.

ISS Equity Plan Policies

A large number of investors rely on advice and services provided by ISS. Although not everyone agrees with ISS' positions and policies, many institutions rely on ISS' vote recommendations because they do not have the internal staff or resources to research and analyze each proxy proposal. Some institutions have even adopted an outright policy to follow the ISS vote recommendations without question, in an effort to limit their own fiduciary liability. However, now that the Securities and Exchange Commission (SEC) has formally communicated that investors are not required to vote on all shares and/or on every proxy proposal, reliance on proxy advisory firms may decrease in the near future (see SEC Legal Bulletin No. 20 for more information).

In late 2014, ISS adopted a new comprehensive scorecard approach for equity compensation plan evaluation effective for shareholder meetings as of February 1, 2015. Instead of a series of "pass/fail" tests, the new equity plan scorecard (EPSC) considers a range of positive and negative factors relating to plan cost, plan features, and grant practices. The specific factors and weightings are dependent on the company's size or status. In analyzing an equity plan proposal, ISS takes the following steps:

Step 1: Classify an issuer in one of the following buckets:

- S&P 500
- Russell 3000 index (excluding S&P 500 companies)
- Non-Russell 3000
- Recent IPOs or Bankruptcy Emergent companies

These buckets will determine the appropriate "model" that will apply to the specific company. The S&P 500 and Russell 3000 models utilize all of the factors in Step 2. The non-Russell 3000 model assesses plan cost and plan features but only the burn rate and duration factors under the grant practices pillar. The IPO/Bankruptcy model utilizes all of the plan cost and plan features factors but none of the grant practices factors.

Step 2: Assign "points" to the company based on the following factors:

- Plan Cost
  - New Shares + Available Shares
  - New Shares + Available Shares + Overhang
- Plan Features
  - Change in Control Single-Trigger Vesting
  - Liberal Share Recycling – Full Value Awards
  - Liberal Share Recycling – Stock Options Awards
  - Minimum Vesting Requirement
  - Full Discretion to Accelerate Vesting (non CIC related)
- Grant Practices
  - 3-Year Average Burn Rate
  - Estimated Plan Duration

- CEO's Grant Vesting Period
- Proportion of Performance-based Stock Awarded to the CEO
- Equity Clawback Policy
- Holding Period Requirement

A score of 53 or higher will generally result in a positive recommendation, absent any overriding factors in step 3.

Step 3: Evaluate if the company has any of the following egregious features:

- A liberal change-of-control definition that could result in vesting of awards by any trigger other than a full double trigger
- Permits repricing or cash buyout of underwater options or SARs without shareholder approval
- The plan is a vehicle for problematic pay practices or a pay-for-performance disconnect
- Other egregious plan features or company practices such tax gross-ups related to plan awards or provision for reload options

The presence of any of the above will result in a negative recommendation on an equity plan proposal, regardless of the score generated under the plan cost, plan features, and grant practices pillars.

ISS' equity plan policies and problematic pay practice policies are updated on an annual basis (typically in the fall of each year). Such policies continue to evolve and become more restrictive year over year. Therefore, depending on the timing of the share authorization proposal, a company should ensure that it is working with ISS' most current policies and guidelines.

Glass Lewis Equity Plan Policies

After ISS, Glass Lewis is considered by many to be the next most widely used proxy advisory firm. Despite a sizeable gap between ISS' and Glass Lewis' influence from a total market perspective, there have been numerous situations where the Glass Lewis recommendation has been highly influential to a company's overall voting results.

Unlike ISS, Glass Lewis does not publicly provide many details regarding its equity plan policies and guidelines. Generally, Glass Lewis evaluates stock option and other equity-based compensation plans based on the following principles:

- Rationale for the additional shares
- Expected share duration (Glass Lewis prefers a share pool duration of four years or less)
- Cost of the plan as a percentage of financial results, and relative to the peer group and the value of the business
- Historical pace of grants
- Value received by option grantees compared with the financial results of the business
- Value of the plan on a per-employee basis compared with programs at peer companies
- Share counting provision (plans should not include a reverse fungible ratio)
- Repricing provision (plans should prohibit option repricing)

- Evergreen provision (plans should not include an automatic share pool replenishment provision)
- Reload provision (plans should not include any stock option reload provision)

Institutional Investor Voting Guidelines

When seeking shareholder approval for a new share authorization, companies should also familiarize themselves with the proxy voting guidelines of their top institutional shareholders. As previously noted, some of these institutions simply follow the vote recommendations of a proxy advisory firm; however, other institutional investors consider the research information and vote recommendations from proxy advisory firms, but do not necessarily strictly rely on or follow those firm's vote recommendations.

Determining whether an institutional shareholder follows a proxy advisory firm's vote recommendations is not always an easy task. While a large number of institutions publicly disclose all of their proxy voting guidelines, many institutions do not. Of those institutions who publicly disclose all of their applicable proxy voting guidelines, the most common provisions include, but are not limited to the following:

- Acceptable level of dilution (e.g., 10% to 15% not considered excessive)
- Repricing language requirements
- Burn rate requirements
- Concentration ratio requirements
- Overall plan cost requirements
- Prohibition on liberal share counting provisions
- Prohibition on option backdating
- Double-trigger equity vesting requirements
- Prohibition on discounted options
- Opposition to evergreen replenishment features and reload provisions
- Minimum equity vesting requirements

To learn more about participating in a Radford survey, please contact our team. To speak with a member of our compensation consulting group, please write to consulting@radford.com.

Author Contact Information

Chris Fischer
Partner
Aon Hewitt
+1.847.442.3476
chris.fischer@aonhewitt.com

Dave Eaton
Associate Partner
Aon Hewitt
+1.415.486.7232
dave.eaton@aonhewitt.com

Laura Wanlass
Associate Partner
Aon Hewitt
+1.847.771.6263
laura.wanlass@aonhewitt.com

Ryan Sanchez
Director
Aon Hewitt
+1.215.255.1967
ryan.sanchez@aonhewitt.com

About Radford

Radford delivers compensation data and advice to technology and life sciences companies. We empower the world's most innovative organizations, at every stage of development, to hire, engage and retain the top talent they need to do amazing things. Today, our surveys provide in-depth compensation insights in more than 80 countries to over 2,700 participating organizations, and our consultants work with hundreds of firms annually to design rewards programs for boards of directors, executives, employees and sales professionals. Radford is part of Aon Hewitt, a business unit of Aon plc (NYSE: AON). For more information on Radford, please visit radford.com.

About Aon Hewitt

Aon Hewitt empowers organizations and individuals to secure a better future through innovative talent, retirement and health solutions. We advise, design and execute a wide range of solutions that enable clients to cultivate talent to drive organizational and personal performance and growth, navigate retirement risk while providing new levels of financial security, and redefine health solutions for greater choice, affordability and wellness. Aon Hewitt is the global leader in human resource solutions, with over 30,000 professionals in 90 countries serving more than 20,000 clients worldwide. For more information on Aon Hewitt, please visit aonhewitt.com.

This article provides general information for reference purposes only. Readers should not use this article as a replacement for legal, tax, accounting or consulting advice that is specific to the facts and circumstances of their business. We encourage readers to consult with appropriate advisors before acting on any of the information contained in this article.

The contents of this article may not be reused, reprinted or redistributed without the expressed written consent of Radford. To use information in this article, please write to our team.

© 2015 Aon plc. All rights reserved