Sneak Preview: How ISS Dictates Equity Plan Design

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INTRODUCTION

Equity—which includes stock options, restricted stock, and performance-based share awards—is a common element of compensation for employees and executives of public companies. A typical equity plan provides a company with a fixed number of shares that can be used for compensation purposes over a multiple-year period and gives the board of directors the authority to determine how the shares are ultimately allocated to employees. Because equity plans dilute the ownership of existing shareholders, the Securities and Exchange Commission (SEC) requires that they be approved by a shareholder vote. On average, public companies request shareholder approval for a new equity plan every four to six years.[1] In industries that use equity compensation more heavily, such as technology, firms typically request shareholder approval of new plans every two to three years.[2]

For a variety of reasons, proxy advisory firms (the largest of which are Institutional Shareholder Services and Glass, Lewis & Co.) are highly influential in the design and approval of equity plans. First, institutional investors have little economic incentive to incur the research costs necessary to develop proprietary voting policies. In effect, proxy research suffers from a "free-rider" problem common to many voting situations. The average institutional investor owns a small fraction of a public company's outstanding shares. While each investor bears the total cost of their research into proxy matters, the benefits of researching "correct" voting decisions are shared across all shareholders. As a result, the average institutional investor has little incentive to bear the costs of researching idiosyncratic firm issues across a diversified portfolio of investments when they only stand to receive a small fraction of the benefit.

Second, in 2003, the SEC began to require that registered institutional investors develop and disclose their proxy voting policies, *and* disclose their votes on all shareholder ballot items.[3] The rule was intended to create greater transparency into the voting process and to ensure that institutional investors act without conflict of interest.[4] At the same time, the SEC clarified that the use of voting policies developed by an independent, third-party agency (such as a proxy advisor) would be viewed as being non-conflicted:

> *An independent [investment] adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interest. In essence, the recommendations of a third party that is in fact independent of an investment advisor may cleanse the vote of the adviser's conflict.*[5]

This clarification, in effect, gave institutional investors an incentive to follow the recommendations of third-party advisory firms rather than develop their own policies that might be deemed to be subject to conflicts. As a result, the proxy voting guidelines of third-party firms have become a cost-effective means of satisfying fiduciary and regulatory voting obligations for institutional investors. Many institutional investors vote in near-perfect lockstep with the recommendations of proxy advisory firms, including in the area of equity plans (see Exhibit 1).

For these reasons, proxy advisory firms have considerable influence over the outcomes of compensation-related proxy proposals. For example, Morgan, Paulson, and Wolf (2006) find that a negative vote recommendation on compensation-related issues decreases shareholder support by 20 percent.[6] Bethel and Gillan (2002) and Cai, Garner, and Walking (2009) find that a negative recommendation can influence the outcome of a vote by 13.6 percent to 20.6 percent, and 19 percent, respectively.[7]

There is also a growing body of evidence that proxy advisory firms have influence over companies' decisions in compensation design. Over 70 percent of companies report that their compensation programs are influenced by the policies and guidelines of proxy advisory firms.[8] Larcker, McCall, and Ormazabal (forthcoming) find that corporations constrain stock option repricing programs to meet the guidelines of proxy advisory firms. Importantly, they also find that these choices are value decreasing.[9] In a separate study, Larcker, McCall, and Ormazabal (2013) find that corporations change their executive compensation programs to garner a favorable "say on pay" recommendation from proxy advisory firms, and that these changes are also value decreasing for shareholders.[10]

SHAREHOLDER VALUE TRANSFER (SVT)

Intuitional Shareholder Services (ISS) uses a variety of tests to determine its recommendation on equity plan proposals. These include an evaluation of the cost of the plan, the degree to which it dilutes shareholder interests, and whether the plan or the company's compensation program in general include features that ISS deems "problematic." ISS recommends against a plan if its total cost is "unreasonable," if the company's dilution rate exceeds a "burn rate" cap, or if the plan contains features that violate the firm's standards.[11]

To determine whether the cost of a company's equity plan is reasonable, ISS uses a proprietary metric called Shareholder Value Transfer (SVT). SVT is a measure of the value of equity grants that are currently outstanding as well as the potential value of awards that can be made in the future under both existing and the proposed equity plans. It is expressed both as a dollar amount and as a percentage of the company's market capitalization. A company's equity plan is deemed to be unreasonable if its SVT metric exceeds a firm-specific "allowable cap" determined by a proprietary calculation.[12]

Because of the influence that ISS has over voting outcomes and because there is little discretion in its recommendations on equity plans (i.e., ISS makes a negative recommendation if the allowable cap is exceeded), companies have considerable incentive to remain below their SVT caps. That said, it is very difficult for a company on its own to know *in advance* whether or not it will remain below its SVT cap following a new equity plan. While ISS discloses its SVT methodology in broad terms, it does not disclose the actual allowable caps nor does it disclose details on how it calculates a firm's allowable cap (see Exhibit 2). A company seeking shareholder approval of an equity plan is not able to determine the SVT cap until the ISS report including the recommendation on the plan vote is published. Instead, ISS *sells* early access to this information through its subsidiary ISS Corporate Services as a product called Compass. According to the ISS website:

> *The Compass tool helps corporate secretaries and compensation professionals who design executive and director pay plans balance company and shareholder needs…. Compass makes it easy to determine the cost of your plan and show whether plan costs are in line with shareholder expectations; test various grant combinations to arrive at a plan or plan amendment that meets multiple needs; [and] benchmark plan cost to industry pay levels, company size and performance.*[13]

In short, Compass allows corporate clients to input the details of a pending equity plan proposal into its model to determine the number of shares that can be requested before the plan exceeds the allowable cap (which would generate a negative vote recommendation) prior to the firm filing its proxy statement. This service is not inexpensive. Access costs between $23,500 and $29,500 per proxy filing, depending on company size, and firms are prohibited by the terms of the contract with ISS from disclosing to shareholders that they used Compass to determine their plan design.[14]

There is considerable evidence that companies pay attention to their SVT caps and rely on this information to design their equity plans. Among a sample of 4,230 company observations between 2004 and 2010, a full 34.1 percent (1,444) proposed equity plans that would put the company within 1 percent of their SVT cap (see Exhibit 3).[15] *This is highly improbable based on chance alone.* Furthermore, by a greater than 20-to-1 margin, companies within this sample requested equity that would put them slightly *below* the cap rather than slightly *above*; 1,380 company observations are less than 1 percent below the cap while only 64 are less than 1 percent above the cap. These figures suggest that companies are acquiring their allowable cap figure from ISS and designing their equity plans to fall just below this number.[16]

The sale of equity plan data is likely a highly profitable business for ISS. If all 1,380 occurrences acquired allowable cap data from ISS, ISS would have generated revenue of between $32.4 million and $40.7 million based on list prices for the Compass product. Because ISS incurs the cost of data collection on behalf of its institutional investor clients and independent of its sale to corporate clients, revenue from the Compass product is basically pure profit.

In October 2013, the NASDAQ OMX petitioned the SEC to require proxy advisors to publicly disclose their methodologies and conflicts of interest before institutional investors are allowed to rely on their policy guidelines to satisfy their fiduciary voting obligations:

> *[W]e request that future reliance on such relief be conditioned on disclosure by the Firms of: (i) the models, formulas and methodologies pursuant to which they evaluate and make recommendations regarding how shareholders should vote on matters presented to them for a vote; and (ii) all relationships that may give rise to conflicts of interest.*[17]

WHY THIS MATTERS

1. Institutional Shareholder Services has long had considerable influence over the voting decisions of institutional investors. A growing body of evidence now suggests that they are also influential in the design of corporate compensation plans. In effect, ISS has emerged as a self-appointed regulator of equity plans. Should market participants be concerned with this trend?
2. The data in Exhibit 3 suggest that companies design their equity plans to very closely approximate ISS's SVT thresholds. At the same time, the SVT model has not been validated by independent research. Without transparent disclosure and rigorous study, how can shareholders be sure that ISS's SVT thresholds are "correct"?
3. The Compass product, which repackages research data collected for institutional investors and makes this data available to corporate clients for the design of their equity plans, imposes a costly and largely arbitrary constraint on firms seeking additional shares. Does the profit motive from the sale of the Compass product affect ISS's incentive to be transparent about the computation and disclosure of SVT thresholds?
4. Recent research suggests that the recommendations of proxy advisory firms do not necessarily increase value for shareholders and, in fact, might decrease value. Given the influence that proxy voting guidelines have on institutional voting outcomes, should institutional investors bear responsibility for evaluating the shareholder value impact of the voting guidelines that they adopt?
5. The ISS Corporate Services contract prohibits shareholders from learning that a company acquired the ISS SVT allowable cap and used that data in its plan design. Without more transparent disclosure, how can shareholders be sure equity plan proposals request the "right" amount of equity for employees? Could opportunistic management teams use advance knowledge of the ISS limits to increase their plan requests and extract extra compensation? ■

[1] Among a sample of 4,821 companies during the years 2001-2010, 21.5 percent made no submissions for a new equity plan, 29.6 percent made one request, 20.2 percent made two requests, and 28.7 percent made three or more requests. Source: Christopher Armstrong, Ian Gow, and David Larcker, "The Efficacy of Shareholder Voting: Evidence from Equity Compensation Plans," *Journal of Accounting Research* (forthcoming).

[2] Recent studies of 150 Bay Area technology firms by Compensia, Inc.

found that 48 firms sought approval of new/amended plans in 2013, 48 sought approval in 2012 and 49 sought approval in 2011. Source: Compensia, Employee Stock Plan Proposals at the Bay Area 150.

[3] Securities Exchange Commission, "Disclosure of proxy voting policies and proxy voting records by registered management investment companies," Release No. 25922 (Jan. 31, 2003).

[4] A conflict might arise when an institutional investor that owns shares in a public company also provides services to manage that company's investment assets (e.g., in its 401(k) pension fund). In this case, the institutional investor might be reluctant to vote against company management for fear of losing the revenue from these services.

[5] Securities and Exchange Commission, "Egan-Jones Proxy Services: No Action Letter," (May 27, 2004). See also, SEC, "Institutional Shareholder Services, Inc.: No Action Letter," (Sep. 15, 2004).

[6] Angela Morgan, Annette Paulson, and Jack Wolf, "The Evolution of Shareholder Voting for Executive Compensation Schemes," *Journal of Corporate Finance* (2006).

[7] Jennifer E. Bethel and Stuart L. Gillan, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* (2002); Jie Cai, Jacqueline L. Garner, and Ralph A. Walking, "Electing Directors," *Journal of Finance* (2009).

[8] The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (2012). Available at: http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

[9] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Exchanges," *Journal of Accounting and Economics* (forthcoming).

[10] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms," Rock Center for Corporate Governance at Stanford University working paper (May 2013). Available at: http://ssrn.com/abstract=2101453.

[11] The "burn rate" caps are computed annually, by industry, and disclosed publicly in the proxy voting guidelines. In some cases where the burn rate cap has been exceeded in the past, ISS will recommend in favor of plans containing an explicit commitment to not exceed the cap in the future. Some institutional investors have criteria similar to a "burn rate" cap in their proxy voting guidelines. For example, Fidelity Group of Mutual Funds will generally vote against equity award plans if the company's average three year burn rate is greater than 1.5% for a Large-Capitalization Company, 2.5% for a Small-Capitalization Company, or 3.5% for a Micro-Capitalization Company; and if there are no circumstances specific to the company or plans that lead FMR [Fidelity Management & Research] to conclude the burn rate is acceptable. Other features deemed problematic by ISS include stock option repricing without shareholder consent, high concentration of grants to senior executives, internal pay inequity, and poor "pay for performance." Sources: Institutional Shareholder Services, 2013 U.S. Proxy Voting Summary Guidelines; and Fidelity Funds' Proxy Voting Guidelines (Nov. 2012).

[12] Institutional Shareholder Services, ISS Benchmark 2012: Equity-Based & Other Incentive Compensation: Cost of Equity Plans.

[13] ISS Corporate Services, "Equity Plan Design Services" (Oct. 2013). Available at: http://www.isscorporateservices.com/equity-plan-design-services.

[14] Its contract states that "subscriber may not disclose publicly (including via its proxy statement) that it has acquired products or services from ICS [ISS Corporate Services]." Source: ISS Corporate Services, General Terms and Conditions for Services.

[15] ISS Proxy Recommendation Reports (2004-2010). Calculation by the authors.

[16] Note that it is not clear which way companies adjust the plans to comply with the allowable cap. Companies might decrease the amount of equity requested to remain below their caps, in which case they are withholding potentially valuable incentives from employees. Or, they might increase the size of their plans to more closely approach their caps, in which case shareholders are bearing unnecessary agency costs in the form of excessive compensation.

[17] NASDAQ OMX, "Re: Petition Related to Proxy Advisory Firms," (Oct. 8, 2013). Available at: http://www.sec.gov/rules/petitions/2013/petn4-666.pdf.

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EXHIBIT 1 — INFLUENCE OF ISS RECOMMENDATIONS ON EQUITY PLAN VOTES

SELECTED FUNDS WITH HIGH CORRESPONDENCE TO ISS EQUITY PLAN RECOMMENDATIONS

Institutional Investor	# Equity Plan Votes	# Votes With ISS	% Vote with ISS
Fifth Third Asset Management	219	219	100.0%
E*Trade Funds	273	273	100.0%
Fred Alger Management	291	291	100.0%
Huntington Asset Advisors	390	390	100.0%
ProShare Advisors	2299	2295	99.8%
ProFund Advisors	2801	2793	99.7%
First Trust Advisors	550	547	99.5%
Variable Annuity Life Insurance Company	1349	1339	99.3%
Rafferty Asset Management	490	486	99.2%
SEI Investment Management Corporation	1191	1181	99.2%
Dimensional Funds Advisors	5824	5749	98.7%
AIG SunAmerica Asset Management	1531	1507	98.4%
New York Life Investment Management	1173	1132	96.5%
Wells Fargo Funds Management	1232	1187	96.3%
ING Funds	3406	3138	92.1%
American Century Investment Management	2162	1977	91.4%

Source: ISS Voting Analytics, 2003-2012.

EXHIBIT 2 — INSTITUTIONAL SHAREHOLDER SERVICES: CALCULATION OF SVT

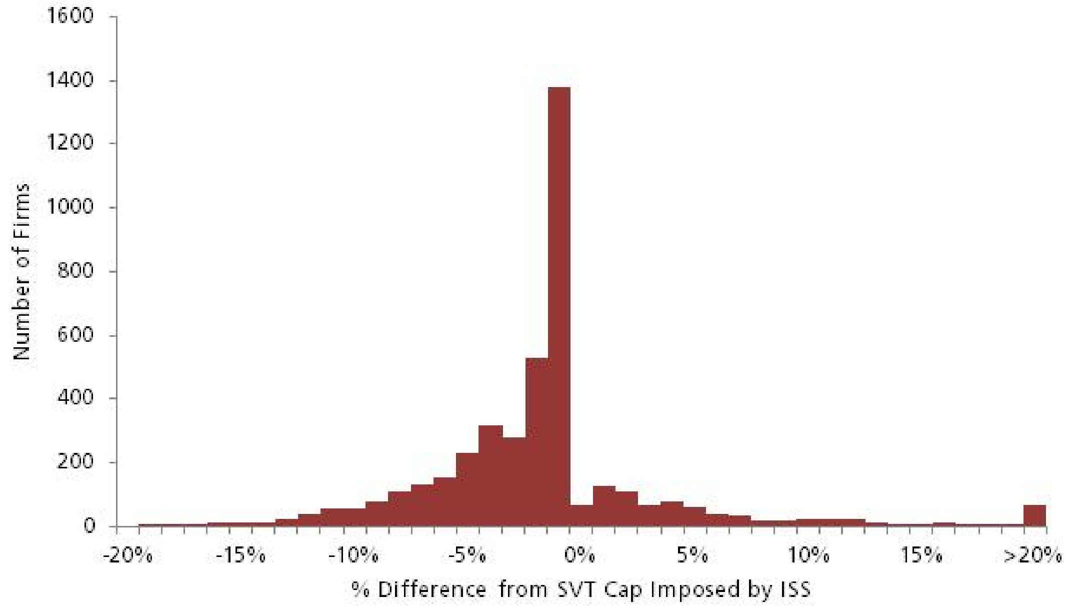
COST OF EQUITY PLANS

The cost of the equity plans is expressed as Shareholder Value Transfer (SVT), which is measured using a binomial option pricing model that assesses the amount of shareholders' equity flowing out of the company to employees and directors. SVT is expressed as both a dollar amount and as a percentage of market value, and includes the new shares proposed, shares available under existing plans, and shares granted but unexercised. All award types are valued. For omnibus plans, unless limitations are placed on the most expensive types of awards (for example, full value awards), the assumption is made that all awards to be granted will be the most expensive types. See discussion of specific types of awards.

The Shareholder Value Transfer is reasonable if it falls below the company-specific allowable cap. The allowable cap is determined as follows: The top quartile performers in each industry group (using the Global Industry Classification Standard: GICS) are identified. Benchmark SVT levels for each industry are established based on these top performers' historic SVT. Regression analyses are run on each industry group to identify the variables most strongly correlated to SVT. The benchmark industry SVT level is then adjusted upwards or downwards for the specific company by plugging the company-specific performance measures, size and cash compensation into the industry cap equations to arrive at the company's allowable cap.

Source: Institutional Shareholder Services, 2013 U.S. Proxy Voting Summary Guidelines.

EXHIBIT 3 — RELATION BETWEEN COMPANY EQUITY PLAN REQUESTS AND SVT CAPS



Source: ISS Proxy Recommendation Reports (2004-2010). Calculation by the authors.