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New York • Chicago • Los Angeles

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ISS 2002 POLICY CHANGES

Institutional Shareholder Services ("ISS") recently released changes to its 2002 policy guidelines for voting recommendations on proxy analyses performed after March 1, 2002. This timing will cover essentially all calendar year companies. The most significant changes in the compensation area concern three "bright-line" tests for option repricings. Also, a new policy has been adopted on performance-based stock options.

Repricings Put to a Shareholder Vote

In prior years, ISS qualitatively evaluated option repricing proposals according to criteria of importance to its client base of institutional investors. These are:

- Stock Price Volatility – Trading patterns should not be so volatile that option value is likely to be restored in the near term
  - Investors do not favor "knee-jerk" reactions to short-term price dips; stock price declines should be substantial and sustained
- Rationale – Management should present a clear explanation why the repricing is necessary and whether the events leading up to the stock price decline were beyond management's control
  - Investors do not favor a repricing if the stock price decline is due to poor management performance, but rather because the industry sector is out of favor
- Value-for-Value Exchange – Equal value exchanges are preferred over share-for-share exchanges
- Option Term – New options should keep the old options' remaining terms rather than having restored full terms, e.g., ten years
- Option Vesting – Vesting should be restarted or a blackout period imposed on option exercises of repriced vested options
- Participants – Repricings should be limited to lower-level employees whose actions may have less direct bearing on stock price
  - Investors prefer to see top executives and directors excluded; if included, there should be limitations on their exchanges compared to exchanges for lower-level employees

Beginning in 2002, ISS' evaluations will be more stringent. We have been told by ISS that it is not certain in every case that its new guidelines will be automatically and rigidly applied, but violation of any one of three "bright-line" tests carries a high risk of a recommendation to vote against the proposal. First, ISS will now run the terms of repricings through its binomial model to ensure the exchange is on a value-for-value basis, i.e., the "value" of the new awards to be granted should equal or be less than the "value" of the old awards given up. Second, directors and top five named executive officers should be excluded. Third is management's rationale for the repricing, including a decline in stock price that is substantial and sustained.

Repricing Definition

In addition to vote recommendations on repricing proposals, ISS will recommend voting against any requests for new shares if (1) a stock plan expressly permits option repricing without shareholder approval or (2) a company has a history of repricing without shareholder approval and its stock plan does not have an express prohibition against future repricings without shareholder approval. This guideline will prevail even if the "cost" of the share request is within ISS' calculated "allowable cap." For 2002, ISS has clarified that the following will constitute repricings under its guidelines:

- Reduction in exercise price of outstanding options
- Cancellation and regrant of options at lower exercise prices
    - Including six-month and one-day cancellations/regrants that avoid accounting charges and "bullet" options (options with long vesting schedules and accelerated vesting if the participant agrees to cancel an underwater option six months and one day after receiving the new option)
- Substitution of restricted stock for underwater options
- Buyback of underwater options and issuance of new awards

Performance-Based Stock Options

ISS is supportive of the concept of performance-based stock options, but does not favor shareholder proposals that are rigid in requiring that *all* option awards must be performance-based or that *all* option participants, including lower-level non-executive employees, should receive only performance-based stock options. (Performance-based stock options are defined as indexed, premium-priced, and performance-vesting stock options.) ISS believes that companies need flexibility to grant conventional options so as not to be at a competitive disadvantage.

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This letter is intended to alert compensation professionals about developments that may affect their companies. General questions about ISS' policy guidelines may be addressed to Wendy Hilburn at (212) 986-6330. This letter and other published materials are available on our website, www.fwcook.com.