Frederic W. Cook & Co., Inc.

New York • Chicago • Los Angeles

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# ISS 2005 POLICY CHANGES

Institutional Shareholder Services ("ISS") recently released its 2005 policies for voting recommendations on proxy proposals[1], which include changes from prior policies in several important executive compensation areas. The most significant changes that will be of concern to companies pertain to equity compensation plans covering employees or directors. Other new policies address nonqualified employee stock purchase plans and change-in-control payments in connection with mergers and acquisitions.

## EQUITY COMPENSATION PLANS

ISS will recommend against an equity compensation plan if the proposed cost (i.e., shareholder value transfer and voting power dilution) is above an allowable cap[2] or if the company violates one of two recommendation overrides: (1) the plan explicitly permits repricings without shareholder approval or (2) the company violates ISS' pay-for-performance policy.[3] ISS' new policies include a new recommendation override relating to company burn rates (i.e., run rates) and additional policies on share counting provisions, pay-for-performance, director equity plans, bundled plan amendments and the allowance of third-party transferable stock options.

### *Burn Rate Policy*

ISS has not previously had a policy on burn rates.[4] Under the new policy, ISS will recommend against equity plans for companies that have high three-year average burn rates even if they otherwise have a plan cost within the allowable cap. ISS defines high three-year average burn rate as the following:

1 The 2005 policies apply to annual shareholders' meetings on or after February 15, 2005.

2 ISS has previously determined companies' allowable caps based on primary SIC codes and ISS' internal industry groupings. Beginning in 2005, allowable caps will be based on GICS (Global Industry Classification Standard issued by Standard & Poor and Morgan Stanley Capital International) and 24 industry groupings (plus a 25th grouping for recent IPOs).

3 ISS' pay-for-performance policy is described later in this memo.

4 Burn rate, or run rate, is calculated as the total number of equity awards (in the form of stock awards and stock options) granted in any given year divided by the number of common shares outstanding. The gross number of equity awards is not discounted by cancelled or forfeited shares.

- The company's most recent three-year average burn rate exceeds one standard deviation of its GICS segmented by Russell 3000 index companies and non-Russell 3000 index companies, as shown in the following table, <u>and</u>

- The company's most recent three-year average burn rate exceeds two percent of common shares outstanding

**<u>Proxy Season 2005 Burn Rate Thresholds</u>**

| | | **Russell 3000** | | | **Non-Russell 3000** | | |
|---|---|---|---|---|---|---|---|
| **GICS** | **GICS Description** | **Mean** | **Standard Deviation** | **Mean + Standard Dev.** | **Mean** | **Standard Deviation** | **Mean + Standard Dev.** |
| 1010 | Energy | 1.60% | 1.02% | 2.61% | 2.59% | 2.19% | 4.78% |
| 1510 | Materials | 1.55% | 0.81% | 2.36% | 2.54% | 1.92% | 4.46% |
| 2010 | Capital Goods | 1.86% | 1.19% | 3.05% | 3.23% | 2.93% | 6.17% |
| 2020 | Commercial Services & Supplies | 2.87% | 1.53% | 4.40% | 4.39% | 3.68% | 8.07% |
| 2030 | Transportation | 2.10% | 1.50% | 3.60% | 2.44% | 2.22% | 4.66% |
| 2510 | Automobiles & Components | 2.10% | 1.37% | 3.48% | 2.90% | 2.28% | 5.18% |
| 2520 | Consumer Durables & Apparel | 2.40% | 1.51% | 3.90% | 3.42% | 2.79% | 6.21% |
| 2530 | Hotels Restaurants & Leisure | 2.39% | 1.08% | 3.48% | 3.30% | 2.87% | 6.17% |
| 2540 | Media | 2.34% | 1.50% | 3.84% | 4.12% | 2.89% | 7.01% |
| 2550 | Retailing | 2.89% | 1.95% | 4.84% | 4.26% | 3.50% | 7.75% |
| 3010 to 3030 | Food & Staples Retailing | 1.98% | 1.50% | 3.48% | 3.37% | 3.32% | 6.68% |
| 3510 | Health Care Equipment & Services | 3.24% | 1.96% | 5.20% | 4.55% | 3.24% | 7.79% |
| 3520 | Pharmaceuticals & Biotechnology | 3.60% | 1.72% | 5.32% | 5.77% | 4.15% | 9.92% |
| 4010 | Banks | 1.44% | 1.17% | 2.61% | 1.65% | 1.60% | 3.25% |
| 4020 | Diversified Financials | 3.12% | 2.54% | 5.66% | 5.03% | 3.53% | 8.55% |
| 4030 | Insurance | 1.45% | 0.88% | 2.32% | 2.47% | 1.77% | 4.24% |
| 4040 | Real Estate | 1.01% | 0.89% | 1.90% | 1.51% | 1.50% | 3.01% |
| 4510 | Software & Services | 5.44% | 3.05% | 8.49% | 8.08% | 6.01% | 14.10% |
| 4520 | Technology Hardware & Equip. | 4.00% | 2.69% | 6.68% | 5.87% | 4.25% | 10.12% |
| 4530 | Semiconductors & Semiconductor Equip. | 5.12% | 2.86% | 7.97% | 6.79% | 3.95% | 10.74% |
| 5010 | Telecommunication Services | 2.56% | 2.39% | 4.95% | 4.66% | 3.90% | 8.56% |
| 5510 | Utilities | 0.90% | 0.65% | 1.55% | 3.74% | 4.63% | 8.38% |

For companies that grant both full-value awards and stock options to their employees, ISS will apply a premium on full-value awards to convert them to an option-equivalent share. The guideline for applying the premium will be as follows:

| **Characteristics** | **Annual Stock Price Volatility*** | **Premium** |
|---|---|---|
| High annual volatility | 53% and higher | 1 restricted share for 1.5 option shares |
| Moderate annual volatility | 25% - 52% | 1 restricted share for 2.0 option shares |
| Low annual volatility | Less than 25% | 1 restricted share for 4.0 option shares |

* Based on ISS database

ISS has communicated to Frederic W. Cook & Co. (although it is not included in the ISS 2005 policy updates manual) that companies failing the new burn rate test may still receive a positive ISS recommendation on their equity plan if they commit through a publicly filed disclosure (e.g., annual proxy statement or Form 8-K) to limit their upcoming three-year average burn rate to their GICS mean.

The implication of this change is that companies will need to more closely monitor their burn rates. If a company is at risk of failing the burn rate test, they may cut back their equity grant levels in the year prior to requesting shareholder approval of an equity plan or commit to limiting their burn rate in future years. In practice, we do not expect that many companies will be affected by this guideline based on the high burn rate thresholds applicable for 2005.

***Share Counting Provisions***

Currently, ISS' policy does not address plan provisions for adding shares back to the share reserve in various situations, such as:

1. Cancelled or forfeited shares under prior plans
2. Tendered shares in payment of an option
3. Tendered or withheld shares in payment of taxes
4. Share awards settled in cash
5. Shares repurchased using option proceeds
6. Stock appreciation rights ("SARs") settled in stock where only the net shares delivered with respect to the award are counted against the share reserve

ISS' new policy will be to value stock options and SARs as full-value shares if any of the items 2, 3, 5 or 6 are provisions in the equity plan.

This policy is a significant change from past practice since most equity plans have historically contained some or all of these share counting provisions. Companies will need to decide whether they prefer to eliminate the offending share counting provisions and avoid the full-value plan costing treatment of option shares, or include the replenishment features and request fewer shares as full-value only. The decision should incorporate expectations of future exercise patterns as well as administrative capabilities. Note that whichever decision a company makes, it should ensure that its equity plan share replenishment language is clear to avoid confusion.

***Pay-For-Performance Policy***

ISS' current pay-for-performance policy is violated if (1) there is a disconnect between the CEO's pay and sustained company performance (i.e., an increase in pay and a decrease in performance), (2) more than half of the CEO's pay increase is from equity-based awards <u>and</u> (3) the CEO participates in the proposed plan. Specifically, if the company has negative one- <u>and</u> three-year total shareholder returns[5], but the CEO's total

[5] Total shareholder return is calculated as of the end of the most recent fiscal year.

direct compensation ("TDC")[6] has increased over the prior year, it would signify a disconnect between pay and performance. If more than half of the increase in TDC is attributable to equity compensation, ISS would generally recommend against the equity plan if the CEO participates.

Under ISS' new policy, ISS will generally recommend voting for the compensation committee members and any proposed equity plan even if the pay-for-performance policy is violated if all of the following evidence of improved compensation committee performance is disclosed in the proxy:

- The compensation committee has reviewed all components of the CEO's compensation, including:
    - Salary, bonus and long-term incentives
    - Realized and unrealized equity gains
    - Value of CEO perquisites and benefits
    - Earnings and obligations under the company's nonqualified deferred compensation program
    - Projected obligations under the company's supplemental executive retirement plan (SERP)
- A summary was prepared and reviewed illustrating all of the above amounts that would be paid to the CEO under various scenarios
- Disclosure of all of the above amounts that would be paid under the following scenarios:
    - Termination within the next 12 months
    - "Not for cause" termination in the next 12 months
    - Change-in-control termination in the next 12 months
- The compensation committee commits to provide additional information on the named executive officers' annual and long-term incentive plans for the current year such as performance criteria related to threshold and maximum payouts
- The compensation committee commits to include performance-contingent vesting on at least 50% of the named executive officers' equity grants. Performance criteria should be clearly disclosed
- The compensation committee has the sole authority to hire and terminate outside compensation consultants

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[6] Total direct compensation is defined as the sum of annualized base salary, cash bonus, other annual compensation, all other compensation, present value of stock options (based on a stock option pricing model), face value of restricted stock, and face value of actual long-term incentive plan payouts.

This policy offers an opportunity for companies that would otherwise fail the pay-for-performance guideline to receive a positive vote. However, compliance with these guidelines is quite burdensome and may be impractical.

***Director Equity Plans***

In prior years, ISS has analyzed director-only equity compensation plans in the same manner as plans covering employees. That is, director plans were subject to the same plan costing and allowable cap limits as employee plans. Under ISS' new policy, director-only equity compensation plans that fail ISS' cost analysis may still receive a positive voting recommendation if the company's director compensation program meets all of the following qualitative features are disclosed in its proxy statement:

- Director stock ownership guidelines of a minimum of three times the annual cash retainer
- A minimum vesting or mandatory holding/deferral period on all equity grants of three years
- A balanced mix between cash and equity
  - If the mix has a heavier equity component, the more stringent vesting (i.e., the lesser or five years or the term of directorship) should apply
- No retirement/benefits and perquisites
- Detailed tabular disclosure of cash and equity compensation delivered to each non-employee director for the most recent fiscal year
  - Suggested column headers for the table include: name of each non-employee director, annual retainer, board meeting fees, committee retainer, committee meeting fees and equity grants

This new policy provides an approach for companies with a combined plan cost above the allowable cap to secure ISS' support for additional shares for directors-only grants. However, if a company's director compensation program does not already meet the above criteria, compliance may be burdensome.

*Bundled Plan Amendments*

In the past, all equity plan amendments, other than those pertaining solely to IRC Section 162(m) tax deductibility provisions[7], were subject to ISS' cost analysis. Under the new policy, bundled plan amendments with no increase in plan shares are evaluated on a case-by-case basis giving consideration to the following:

- Do the proposed plan amendments benefit shareholders?
- Are the total costs of the proposed amendments lower than the original plan?
- Are the new plan features an improvement over the old features (e.g., a reduction in option term or shifting towards performance-based awards or performance-based vesting)?

ISS will still subject the equity plan to the cost analysis, but may not recommend against a plan that exceeds the allowable cap if a reduction in cost has been made. This policy will be useful to companies with excessive overhang that have been limited in their ability to amend their equity plans in ways that are positive for both the company and its shareholders without increasing plan costs.

*Third-Party Transferable Stock Options*

Although not included in ISS' 2005 policy updates, ISS has indicated that it will recommend against equity plans that permit third-party transfers of stock options (except to family members or trusts) without shareholder approval. This position is in reaction to Microsoft's transaction in 2003, where its employees were provided a one-time opportunity to transfer their underwater stock options to JPMorgan Chase Bank. There has also been preliminary discussion in the marketplace of granting stock options that may be transferred to a third party, rather than exercised, at any time subsequent to vesting.

Complying with ISS' new position would still permit Microsoft-type transactions to occur as long as shareholder approval is secured. However, options with continuous third-party transferability would become impractical since it is not a one-time event that could receive shareholder approval. Companies will need to weigh the flexibility of third-party transferable options in its equity plan against receiving a negative ISS voting recommendation for the plan.

## EMPLOYEE STOCK PURCHASE PLANS

ISS currently applies the criteria for qualified employee stock purchase plans ("ESPP") to nonqualified plans in determining its voting recommendation. As a result of the changes to the accounting treatment of ESPPs, ISS has developed the following independent guidelines related to nonqualified stock purchase plans:

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7 IRC Section 162(m) limits company tax deductions to $1 million of non-performance based compensation for its named executive officers

- Broad-based participation (i.e., all employees of the company with the exclusion of individuals with 5 percent or more of beneficial ownership of the company)

- Limits on employee contribution, which may be a fixed dollar amount or expressed as a percentage of base salary

- Company matching contribution up to 25 percent of the employee's contribution, which is effectively a discount of 20 percent from market value

- No discount on the stock price on the date of purchase since there is a company matching contribution

## MERGERS & ACQUISITIONS -- CHANGE IN CONTROL PAYMENTS

ISS' recommendation on mergers and acquisitions is determined on a case-by-case basis and includes a variety of factors. Executive compensation provided through change-in-control payments is one aspect of the decision-making process, with pertinent disclosure typically found in the "conflicts of interest" section of the merger proxy materials.

ISS' analysis of change-in-control payments includes whether directors and/or officers have conflicts arising from special employment agreements with the surviving firm, grants of bonuses or stock options, etc., which may motivate them to enter deals that are not in the best interest of the shareholders.

Additionally, ISS balances the positive factors of the proposed merger with the effects of the change-in-control payments. ISS compares these payments to director and officer share ownership, to the size of the premium received by all shareholders and to the aggregate deal size. In cases where ISS determines the change-in-control payments to be particularly excessive, it may issue a negative voting recommendation.

While somewhat vague, this guideline is consistent with the current corporate governance trend to examine and curtail excessive change-in-control payments.

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This letter is intended to alert compensation professionals about developments that may affect their companies. Note that ISS is hosting a conference call for consulting firms on Monday, December 20th to clarify their 2005 policy updates. Frederic W. Cook & Co. will release an update of this memo if ISS' clarifications contradict any of our interpretations. General questions about ISS' policy guidelines may be addressed to David Cole or Wendy Hilburn at (212) 986-6330. This letter and other published materials are available on our website, www.fwcook.com.