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**Shareholder Voting on Stock Plans for Executives
ISS's Stock Plan Valuation Model on the Web**

The approval of executive stock plans by shareholders is increasingly influenced by Institutional Shareholder Services ("ISS"), a Washington-based firm that advises its clients, who are institutional shareholders, on how to vote on proposals in proxy statements. ISS advises its clients to vote for or against a stock-based plan depending on whether the associated cost and dilutive impact of the plan falls within what they perceive as an acceptable level compared to an industry-specific comparison group. In addition, ISS will comment on other plan features regarding reasonableness and linkage to performance in its report to clients.

The evaluation and recommendation process by ISS has been an area of consternation for many companies largely because ISS's philosophy and methodology has been complex and not easily understood. As a result, many companies incur substantial time and expense designing a new stock plan only to have the plan evaluated negatively or unsupported by ISS. In many instances, a negative vote could have been avoided by a small change to a plan's language which would have materially reduced the associated cost calculated by ISS.

In response to growing corporate interest in understanding their proxy voting policies, ISS has recently opened access to its proprietary model for valuing stock-based incentive plans. The model, ISSue Compass, is available through ISS's website for a fee to companies and their consultants. It allows companies to test their stock plans to determine in advance how ISS is likely to recommend that its clients vote on the proposal. Through an interactive process, companies may test alternative design features and make changes that increase the likelihood of receiving a favorable recommendation from ISS.

The value of this service was experienced during a recent test of a proposed new plan using the ISSue Compass website model which demonstrated the impact of a small change in plan language. The company's plan did not specify a maximum award term for non-qualified options, even though their historical and expected practice was to use a 10-year term. ISS values plans according to their language, i.e., what companies are permitted to do, not what they may actually be doing. Therefore, ISS assumed a maximum option term of 20 years, which significantly increased the potential cost of the plan and resulted in a negative vote recommendation. When a 10-year maximum term was substituted, the plan's cost was reduced by more than 1 % of total market value, qualifying the plan for a positive vote recommendation.

ISS calculates a plan's cost by measuring the total value and the number of (1) new shares being reserved under new or amended plans, (2) shares still available for grant under prior and continuing plans, and (3) grants outstanding, where the value is communicated as a percent of total market capitalization. This resulting measure is referred to as the shareholder value transfer (SVT). ISS also calculates from the plan the voting power dilution (VPD) on a fully diluted basis. SVT is a dollar-based cost, expressed as a percent of total market

capitalization, that measures the amount of shareholder value that could be transferred from the company to employees as equity is issued. Shares reserved under the plan for which approval is sought are valued, along with shares available under all continuing plans, including director and broad-based stock plans and outstanding grants, to compute SVT. VPD measures the relative reduction in voting power as options are exercised or grants vest and existing shareholders' proportional ownership in the company is diluted.

Each company's combined SVT and VPD is compared to an allowable cap expressed as a percentage of a company's market capitalization, i.e., stock price times shares outstanding. The cap is company specific and is determined on an annual basis by first grouping similar industry types within a primary SIC¹ code. Each company within the SIC grouping is pegged by market capitalization into either a small, mid, or large category. Within each of the three categories, ISS identifies the top quartile performing companies, measured by relative five-year total shareholder return and computes their SVT. ISS then runs multiple regression analyses to determine the independent variables of company size and performance that have the strongest correlation to SVT (the dependent variable). Those independent variables with the strongest correlation are used in the industry-specific regression formula, which will vary by industry and size grouping. The industry-specific regression formula is then used to determine the company-specific SVT cap for each company in that industry and size grouping. ISS's philosophy assumes that if the top performing companies are able to attract and retain their employees for a given amount of dilution, other companies in that industry should be able to compensate their employees within a similar budget.

In computing SVT, ISS uses a binomial model composed of 14 separate components which incorporates more of the features associated to publicly traded options, i.e., probability of early exercise, than does the less complex Black-Scholes model. They also value the plans based on "worst-case" assumptions. For example, plans which provide for awards of options and full-value grant types (e.g., restricted stock and performance shares), but do not specify a limit on the number of reserved shares which may be granted as full-value awards, will be valued assuming all the shares are granted as full-value awards. However, if a plan has an internal limit on the number of full-value shares that can be granted, ISS will only value full-value awards up to that limit, with the remaining shares valued as options, which are a lower-cost grant type.

To calculate overall cost, SVT is weighted ninety-five percent and VPD is weighted five percent. The combined result equals the total cost of the plan, which is then compared to the allowable cap expressed as a percent of total shareholder value. If the combined result is less than the allowable cap, ISS will recommend voting for the plan, but if it is over the cap they will recommend against the plan.

Regardless of cost, however, ISS will automatically recommend a vote against if (1) a plan permits open-ended share replenishment by using option exercise proceeds or other sources to repurchase shares on the market, (2) the company has a history of repricing underwater options without prior shareholder approval (this situation can be reversed if the company states it will no longer reprice unless shareholder approval is received), or (3) the plan expressly allows repricing without shareholder approval. ISS also comments in its recommendation to clients on the qualitative aspects of a plan. Some examples are the payment terms under the plan, vesting and performance requirements, eligible participants, i.e., whether the plan is broad-based or not, and details about the directors who administer the plan and their affiliations with the company. However, these issues do not have a major impact on ISS's recommendations.

¹ Standard Industry Classification, a four-digit system established by the Office of Management and Budget's Standard Industry Classification Codes whereby a company may be identified according to its business activity

The cost to use the Compass software varies according to market capitalization of the company using it, the number of compensation plans that the company will evaluate, and the number of sensitivity runs, or trials, the company will perform with the model.

<u>Service Type</u>	<u>Small-Cap</u> (<\$250 million)	<u>Mid-Cap</u> (\$251-799 million)	<u>Large-Cap</u> (>\$800 million)
Single Plan / Single Run	\$5,000	\$6,000	\$7,000
Multiple Plans / Single Run	\$6,000	\$7,000	\$8,000
Single Plan / Multiple Runs	\$10,000	\$14,000	\$16,000
Multiple Plans / Multiple Runs	\$16,000	\$18,000	\$20,000

Given the increasing sensitivity around negative shareholder votes on new or amended stock plans and ISS's growing role in both an advisory and agency capacity, we believe the release of this software will have a significant impact on stock compensation and shareholder votes. The software is best suited for testing basic types of stock option and other stock plans. Plans with features such as price hurdles or performance vesting cannot be valued using the model and would require an ISS staff member to review the plan. Also, plans with tracking stock or two-class voting stock and recent IPO/PPO companies cannot be evaluated independently by ISSue Compass.

Because of our firm's experience with the software and understanding of ISS's stock plan voting guidelines, ISS is allowing us to pass through a ten percent discount off the ISSue Compass regular price, listed in the chart above, to our clients. Companies interested in exploring this with us further may contact Lori Roth in Chicago, Wendy Hilburn in New York, or Krista Read in Los Angeles. Jill Lyons of ISS may also be contacted directly at (301) 215-9574.



General questions regarding this subject may be addressed to Lori Roth in Chicago, or any member of our firm in New York at (212) 986-6330; in Chicago at (312) 332-0910 or in Los Angeles at (310) 277-4852.