



INSTITUTIONAL SHAREHOLDER SERVICES

Setting the Bar for Equity-Based Compensation

A Summary of ISS's Compensation Guidelines¹

Stock-based incentive plans are among the **most economically significant issues** upon which shareholders are entitled to vote. In addition, they are on the short list of frequently used management proposals, appearing on approximately **45 percent** of all proxies. Effective investment management of the proxy asset requires consistent measurement and evaluation of the potential cost of each plan.

ISS's proprietary approach to evaluating equity incentive proposals is unique in the industry, using quantitative criteria that measure the total cost to shareholders if a plan is passed. This methodology revolves around two basic questions: **1. How much will the plan cost? 2. Is the cost reasonable?** If the cost is deemed to be reasonable, then ISS will support the proposal. **However, there are three other supplemental policies relating to equity incentive plan proposals that can result in a recommendation AGAINST a proposal even if the plan cost is deemed reasonable.** These policies relate to a) the ability to reprice underwater stock options without shareholder approval, b) CEO compensation relative to company performance, and c) the company's three-year average burn rate. See page 3 for a discussion of these supplemental policies to the shareholder value transfer methodology.

1. HOW MUCH WILL THE PLAN COST?

Our approach measures two primary costs:

- **Shareholder Value Transfer (SVT)**

SVT is measured using a binomial model that assesses the amount of shareholders' equity flowing out of the company to employees and directors as options are exercised. An estimated dollar value for each award is determined by factoring award features into an option pricing model to determine the potential plan cost. No award types are deemed negative; rather some award types are more costly and use up the company's allowable budget faster². This approach affords the board flexibility to structure its incentive programs, while shareholders are ensured that plan costs are linked to performance

ISS analyses express SVT in dollar terms and as a percentage of market value (i.e., 200-day average share price times shares outstanding, including convertible debt, convertible equity and warrants).

Proposals to approve or amend stock-based incentive plans are evaluated in conjunction with all previously adopted plans to provide an overall snapshot of the company's compensation system. Therefore, shares reserved under a new plan or amendment are valued together with shares available for grant under all continuing plans and shares granted but unexercised. (See page 5 for an example.)

¹ These policies will apply to all shareholder meetings on or after Feb. 15, 2005. Updated industry groupings apply to all shareholder meetings on or after March 1, 2005.

² New for 2005 is a policy that plans that include certain "net share counting" provisions will be given a higher valuation in the binomial model – with the plan being valued as if all shares will be issued as "full-value" awards. These share counting provisions include the ability in a plan to recycle shares tendered by an option holder to pay the exercise price of an option, shares withheld for taxes, or shares repurchased by the company on the open market using option exercise proceeds. In addition, if stock-settled SARs are permitted by a plan and only the net shares issued count against the share reserve then a higher valuation will be assigned to the plan.



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- **Voting Power Dilution (VPD)**

VPD is measured using a division equation that assesses the relative reduction in voting power as options are exercised and existing shareholders' proportional ownership is diluted. For instance,

$$\frac{A + B + C}{A + B + C + D}$$

Where: A = shares reserved for new plan/amendment
B = shares available under continuing plans
C = granted but unexercised shares, all plans
D = shares outstanding, plus convertible debt, convertible equity, and warrants

Combining the costs:

These two costs are combined by assigning a 95-percent weight to SVT and a 5-percent weight to VPD. Note that equity analysts typically value voting rights at approximately five percent of the company's market value. (See page 5 for an example.)

2. IS THE COST REASONABLE?

After determining how much the plan will cost, ISS evaluates whether the cost is reasonable by comparing the cost to an **allowable cap**. The allowable cap is industry-specific, market cap-based, and pegged to the average amount paid by companies performing in the top quartile of their peer groupings. *Such a benchmark suggests that if the top performing companies in a given industry are able to attract and retain their employees for a given amount, most other companies in that industry should be able to compensate their employees within the same budget.*

To determine allowable caps ISS analysts:

- **Establish an industry classification**, using Global Industry Classification Standard (GICS) groups.
- **Identify top quartile performers** within each peer grouping based on five-year total shareholder returns.
- **Establish normative SVT levels** for each industry using ISS's historic data of the amount of SVT authorized for issue at each top quartile-ranked company.
- **Formulate industry-specific cap equations** by identifying those variables having the strongest correlation to SVT. Regression analysis tests are run on 44 different variables, including company size, market-based performance metrics, and accounting-based performance metrics³. The benchmark SVT level for companies performing in the top quartile of each industry is then adjusted upward or downward by plugging company-specific performance, size, and cash compensation data into the industry-specific cap equation.

ISS limits the percentage of companies receiving an against vote recommendation as a result of this quantitative analysis to not more than 30 percent of companies reviewed in each industry. The actual percentage receiving against vote recommendations is determined by analyzing how requests for SVT are clustered in a given industry.

Determining the Vote Recommendation — For or Against:

Vote recommendations are primarily driven by the quantitative analysis outlined above. If the proposed cost is above the allowable cap, an **AGAINST** vote is recommended. If the proposed cost is below the allowable cap, a **FOR** vote is recommended **unless** there are concerns relating to one of the three supplemental policies.

³ Details on the 44 variables used for creating allowable cap equations can be found in the ISS Proxy Voting Manual.



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Supplemental Policies

A) Repricing Guidelines

Listing standards of the NYSE and AMEX prohibit a company from repricing underwater stock options without shareholder approval unless the company's stock option plan expressly authorizes such an action without shareholder approval⁴. If the company has the express ability to reprice underwater stock options without first securing shareholder approval under the proposed plan, ISS will recommend a vote against the plan — even in cases where the plan is considered acceptable based on the quantitative analysis.

If the company has a history of repricing options without shareholder approval, ISS will recommend AGAINST the proposal, unless the plan specifically prohibits repricing or if applicable listing standards would preclude the company from repricing options without shareholder approval.

B) CEO Pay Vs. Performance

ISS will recommend against compensation proposals where the company has sustained poor total shareholder returns (TSR) over the past one- and three-year periods and the CEO's total direct compensation (TDC⁵) has been increased in the past year. Continuing in 2005, companies with TSR over the past 1- **AND** 3-fiscal year periods of less than 0% will be screened for this policy. Companies in this group that have provided **any** increase in TDC to their CEO in the past year will be targeted for potential negative vote recommendations. The specific performance triggers for applying this policy will be reviewed on an annual basis. Generally, ISS will only recommend against compensation proposals where there is a pay vs. performance concern and more than 50 percent of the increase in the CEO's TDC is attributable to equity-based awards and the CEO is a participant in the plan under consideration. Note that ISS may also withhold votes from Compensation Committee members when the CEO has had an increase in TDC in the past year and the company's TSRs fall below the 1- and 3-year thresholds. However, a company can avoid triggering a negative vote recommendation as a result of the pay for performance policy if the compensation committee members can demonstrate through additional disclosure of improved committee performance⁶.

C) Three-year Average Burn Rate

New for 2005 is a review of a company's burn rate⁷ over the past three fiscal years relative to industry peers. ISS will recommend an AGAINST vote on equity proposals when the company's three-year average burn rate exceeds 2% AND exceeds an amount that is one standard deviation in excess of the industry mean. For the purposes of benchmarking burn rate by industry group ISS divides companies into two segments, one for companies in the Russell 3000 Index and another for companies outside the Russell 3000.

⁴ Interpretive Guidance from NASDAQ seems to indicate that companies whose plans are silent on the issue of repricing do have the authority to reprice underwater stock options without shareholder approval. ISS has been unable to definitively confirm NASDAQ's position on this issue. Until this can be clarified ISS will be recommending AGAINST the equity proposals of NASDAQ companies who have a history of repricing where the plan document does not contain a prohibition on repricing without shareholder approval.

⁵ 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, face value of restricted stock and face value of actual long-term incentive plan payouts as disclosed in the proxy statement.

⁶ The requirements for this supplemental disclosure can be found in the ISS Proxy Voting Manual.

⁷ Burn rate is defined as the gross number of equity awards granted in a given year divided by the common shares outstanding at the end of the fiscal year. Shares cancelled or forfeited are not excluded from the calculation.



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Companies that exceed the allowable burn rate thresholds can avoid a negative vote recommendation from ISS by publicly committing (in a public filing) to maintain a burn rate over the next three fiscal years of equal to or less than the industry mean calculated by ISS at the time of the proposal.

Restricted shares or other “full-value” awards granted will be counted against the burn rate based on a multiplier. This multiplier is based on the company’s annual stock price volatility.

Company Characteristics	Annual Stock Price Volatility	Multiplier
High Volatility	53% or greater	1.5 to 1
Medium Volatility	25% to 52.99%	2.0 to 1
Low Volatility	25% or lower	4.0 to 1

The allowable burn rate levels by industry and index segment are detailed in the table below. This table will apply for all shareholder meetings in 2005 and will be updated for meetings occurring in 2006.

GICS	GICS Description	Russell 3000			Non-Russell 3000		
		Mean	Standard Deviation	Mean + Standard Deviation	Mean	Standard Deviation	Mean + Standard Deviation
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	Food & Staples Retailing	1.98%	1.50%	3.48%	3.37%	3.32%	6.68%
3020	Food & Staples Retailing	1.98%	1.50%	3.48%	3.37%	3.32%	6.68%
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 & Equipment	4.00%	2.69%	6.68%	5.87%	4.25%	10.12%
4530	Semiconductors & Semiconductor Equipment	5.12%	2.86%	7.97%	6.79%	3.95%	10.74%
5010	Telecommunication	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%



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Example A:

ISS's Binomial Model for Measuring SVT

Incentive stock options, nonqualified stock options, premium priced options and stock appreciation rights typically have an exercise price which is paid at the time of exercise and represents a cash payment that flows back to the company. The profit spread, or the difference between the exercise price and the market price, represents a transfer of shareholders' equity to the executive. Restricted stock, and performance shares with unspecified performance goals and hurdle rates are more costly award types that are valued as an option with an exercise price of \$0. A cost associated with the time value of money is also factored into the valuation to account for the potential future appreciation of the stock over the remaining term of the award.

An estimated dollar value for each award is determined by using a 120-step binomial model (each step represents 30 days and matches the 30-day T-bill used as the risk-free interest rate; 120 30-day periods represent the typical ten-year term of an option).

The model has 13 inputs. Eight of these inputs account for the core valuation and ranked by sensitivity are:

- 1) dividend yield
- 2) stock volatility
- 3) stock price
- 4) option exercise price
- 5) risk-free interest rate
- 6) expected forfeiture rate
- 7) option term
- 8) expected stock return

The remaining five variables — 9) vesting provisions, 10) employee's nonoption wealth, 11) employee's risk aversion, 12) employee's tax rate, and 13) earnings dilution — result in minor adjustments to the core valuation.

Example B:

Combining the Costs (Shareholder Value Transfer and Voting Power Dilution)

Current stock price:	\$36.00	Shares outstanding (record date):	18,000,000		
200-day avg. stock price:	\$33.00	Warrants, convertible debt, and equity:	0		
Market value:	\$594,000,000	Total share allocation from plans:	<u>2,700,000</u>		
Stock's first trade date:	10/2/84	Fully diluted shares outstanding:	20,700,000		
					VPD - Fully Diluted Basis
	Share Allocation	Average Award Value	SVT (\$)	SVT - % of Market Value	
Reserved for this plan	1,200,000	x \$23.00	= 27,600,000	4.65%	5.80%
Under existing plans:					
available to grant	659,000	x \$18.00	= 11,862,000	2.00%	3.18%
granted but unexercised	<u>841,000</u>	x \$15.25	<u>= 12,825,250</u>	<u>2.16%</u>	<u>4.06%</u>
Total	2,700,000		\$52,287,250	8.81%	13.04%
Total cost to shareholders			(8.81%*95%) +	(13.04%*5%)	= 9.02%



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Industry Groups for the ISS Compensation Model⁸

Code	Industry Group Name
1010	Energy
1510	Materials
2010	Capital Goods
2020	Commercial Services & Supplies
2030	Transportation
2510	Automobiles & Components
2520	Consumer Durables & Apparel
2530	Hotels, Restaurants & Leisure
2540	Media
2550	Retailing
3010	Food & Staples Retailing
3020	Food, Beverage & Tobacco
3030	Household & Personal Products
3510	Health Care Equipment & Services
3520	Pharmaceuticals & Biotechnology
4010	Banks
4020	Diversified Financials
4030	Insurance
4040	Real Estate
4510	Software & Services
4520	Technology Hardware & Equipment
4530	Semiconductors & Semiconductor Equipment
5010	Telecommunication Services
5510	Utilities
NA	IPO (companies that have been public for less than 3 years)

⁸ ISS uses the Global Industry Classification Standard, which is maintained by Standard and Poor's and Morgan Stanley Capital International. For more information on the GICS methodology, please refer to:

<http://www2.standardandpoors.com/NASApp/cs/ContentServer?pagename=sp/Page/IndicesGICSPg&r=1&l=EN&b=10>



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Data Download Procedures for ISS Option Pricing Model

In order to perform option valuations and generate company-specific allowable caps, ISS download company specific data points from an outside vendor. These inputs include the 200-day average stock price, stock price volatility, risk-free interest rate, and other market- and accounting-based performance factors.

ISS will download the option pricing model inputs for all companies four times per year, December 1, March 1, June 1, and September 1. The inputs used for a company's stock option plan evaluation by the U.S. Research Department will depend on the shareholder meeting date for the company in accordance with the following table.

Shareholder Meeting Date	Data Download Date
March 1 to May 31	December 1
June 1 to August 31	March 1
September 1 to November 30	June 1
December 1 to February 29	September 1

*A complete discussion of ISS's voting guidelines on compensation, as well as all issues brought to a shareholder vote, is available in **The ISS Proxy Voting Manual**.*