



How to Navigate with the Compass: ISS' 2007 U.S. Voting Policy Updates

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Independent Board and Management Advisors





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Effective Dates of New Policies

- On November 15, 2006, Institutional Shareholder Services (ISS) issued updates to its U.S. Corporate Governance, Canadian, and International Proxy Voting Policies
 - The policy updates are available at ISS' Policy Gateway at <http://www.issproxy.com/policy/index.jsp>
- ISS also revised its Corporate Governance Quotient (CGQ) ratings criteria to bring them more in line with these updated policies, effective November 13, 2006
 - The following rating criteria were added for US issuers:
 - Majority voting
 - Financial restatement
 - Options backdating
 - Director withhold recommendations
 - More information about ISS' CGQ ratings can be found at <http://www.isscorporateservices.com/ratings/cgq.html>



New/Revised Compensation Policies

- The compensation policies that were changed include:
 - Binomial Model: Updates to Shareholder Value Transfer (SVT) Calculation Methodology
 - Burn Rate Policy
 - Poor Pay Practices
 - Options Backdating
 - Performance-Based Equity Shareholder Proposals
 - Repricing Proposals brought by Management
- Additional Changes to the ISSue Compass model Announced by ISS Corporate Services on December 19, 2006
 - **Transferable stock options** (TSOs) will no longer be assessed a higher valuation; may note the existence of TSOs in its qualitative analysis of a plan
 - Impact: Decreases SVT
 - **Dividends or dividend equivalents** paid on awards that are full value awards (FVAs) will not result in a higher valuation; dividends or dividend equivalents **on stock options and/or SARs** will result in a **higher valuation** for such awards under the model
 - Impact: Generally, Decreases SVT

New/Revised Compensation Policies

- **Binomial Model: Updates to SVT Calculation Methodology**
 - **Valuation of FVAs** – valued at a company's 200-day average stock price as of the ISS lock-in date
 - Impact: Increased SVT Cost under the ISS model
 - **Forfeiture Rate Discount for Options** – Option values will no longer be discounted for a company's 3-year average forfeiture rate
 - Impact: Increased SVT Cost under the ISS model
 - **Market Capitalization** – Determined using only the common shares outstanding and the 200-day average stock price; the inclusion of common share equivalents (convertible debt, convertible equity and warrants) has been eliminated
 - Impact: Increased SVT Cost under the ISS model, if a company has common share equivalents
 - **Rounding of SVT, VPD, and Allowable Caps** – SVT, Voting Power Dilution (VPD), and the Allowable Cap (AC) will be rounded (up or down) to the nearest whole number; also, where $SVT = AC$, a proposal will now pass the ISS SVT test
 - Impact: Generally benefits companies, because they will be able to have a higher SVT than under the old policy and still be able to pass the ISSue Compass model

New/Revised Compensation Policies

- *The impact of these changes will be magnified by the recent downward trend in SVT*

Trends in Average Shareholder Value Transfer by Industry

Industry	GICS	Avg SVT %				2003 – 2006 Change
		2003	2004	2005	2006	
Energy	1010	8.31	9.74	7.31	7.96	-0.35
Materials	1510	9.47	7.99	9.00	8.38	-1.09
Capital Goods	2010	11.19	12.07	11.46	11.44	0.25
Commercial Services & Supplies	2020	16.88	12.88	12.95	11.79	-5.09
Transportation	2030	11.74	9.25	8.44	NA	NA
Automobiles & Components	2510	8.56	9.68	8.70	9.66	1.10
Consumer Durables & Apparel	2520	12.56	12.88	10.27	12.38	-0.17
Consumer Services	2530	12.36	10.73	11.05	10.18	-2.18
Media	2540	12.63	9.63	9.90	8.49	-4.14
Retailing	2550	13.48	12.76	11.17	9.84	-3.64
Food & Staples Retailing, Food Beverage & Tobacco, Household & Personal Products	30XX	9.50	11.01	7.95	10.91	1.41
Health Care Equipment & Services	3510	15.82	16.26	13.19	12.75	-3.07
Pharmaceuticals & Biotechnology	3520	17.15	16.16	14.59	14.41	-2.73
Banks	4010	8.31	7.67	9.11	10.12	1.81
Diversified Financials	4020	21.06	12.73	10.75	12.30	-8.76
Insurance	4030	7.27	7.40	7.51	8.52	1.25
Real Estate	4040	5.07	5.09	5.18	4.56	-0.51
Software & Services	4510	22.48	22.49	17.09	16.79	-5.69
Technology Hardware & Equipment	4520	19.18	15.95	13.58	13.12	-6.06
Semiconductors & Semiconductor Equipment	4530	18.43	15.13	14.44	14.01	-4.42
Telecommunication Services	5010	10.37	11.17	7.97	12.91	2.54
Utilities	5510	4.19	6.61	4.11	4.91	0.73

Source: *Solution Update: Enhancements to Compensation Model for 2007 Season*, ISS Corporate Services, Inc., December 19, 2006, p. 9.

New/Revised Compensation Policies

Trends in SVT Cost of Firms in S&P 500 Index

Percentile	SVT Cost (%) at Each Specific Percentile				
	2002	2003	2004	2005	2006 YTD
90 th	15.98	12.04	11.84	12.02	10.38
80 th	12.29	10.48	10.29	10.25	9.16
70 th	9.99	8.54	9.05	9.14	8.63
60 th	8.81	7.53	7.53	8.08	7.81
50th	7.22	6.58	6.83	7.09	7.16
40 th	6.49	6.00	5.88	6.17	6.48
30 th	5.76	5.22	5.23	5.30	5.45
20 th	5.20	4.56	4.61	4.36	4.80
10 th	3.98	3.36	3.75	3.64	3.72

Source: *Solution Update: Enhancements to Compensation Model for 2007 Season*, ISS Corporate Services, Inc., December 19, 2006, p. 8.

New/Revised Compensation Policies

● Burn Rate Policy

- ISS issued an updated Burn Rate Table for the 2007 Proxy Season
- Burn Rate Formula:
 - Annual Burn Rate = (A + B) / C, where:
 - A = # Stock options and SARs granted
 - B = # FVAs granted x FVA Premium
 - C = # of Common Shares Outstanding at Fiscal Year End
 - ISS measures the Annual Burn Rate for each of the past three years and averages them together to determine a company's three-year average burn rate
 - The FVA Premium is determined using a company's 200-day volatility as of the Lock-In date that is then annualized and this chart:

FVA Premium Chart

Volatility Characteristics	Annual Stock Price Volatility	Premium
High annual volatility	53% and higher	1 FVA counts as 1.5 options
Moderate annual volatility	25% – 52%	1 FVA counts as 2.0 options
Low annual volatility	Less than 25%	1 FVA counts as 4.0 options

- Under this policy, ISS will recommend a vote AGAINST an equity compensation plan if a company's 3-year average burn rate is greater than **both**
 - Its GICS code industry group's mean 3-year average burn rate *plus* one standard deviation [as in set out in the following table], **and**
 - 2% of common shares outstanding

New/Revised Compensation Policies

ISS 2007 Burn Rate Table

GICS	Description	Russell 3000 Companies			Non-Russell 3000 Companies		
		Mean	Standard Deviation (STDEV)	Mean + STDEV	Mean	STDEV	Mean + STDEV
1010	Energy	1.37%	0.92%	2.29%	1.76%	2.01%	3.77%
1510	Materials	1.23%	0.62%	1.85% [†]	2.21%	2.15%	4.36%
2010	Capital Goods	1.60%	0.98%	2.57%	2.34%	1.98%	4.32%
2020	Commercial Services & Supplies	2.39%	1.42%	3.81%	2.25%	1.93%	4.18%
2030	Transportation	1.30%	1.01%	2.31%	1.92%	1.95%	3.86%
2510	Automobiles & Components	1.93%	0.98%	2.90%	2.37%	2.32%	4.69%
2520	Consumer Durables & Apparel	1.97%	1.12%	3.09%	2.02%	1.68%	3.70%
2530	Hotels Restaurants & Leisure	2.22%	1.19%	3.41%	2.29%	1.88%	4.17%
2540	Media	1.78%	0.92%	2.70%	3.26%	2.36%	5.62%
2550	Retailing	1.95%	1.10%	3.05%	2.92%	2.21%	5.14%
3010, 3020, 3030	Food & Staples Retailing	1.66%	1.25%	2.91%	1.90%	2.00%	3.90%
3510	Health Care Equipment & Services	2.87%	1.32%	4.19%	3.51%	2.31%	5.81%
3520	Pharmaceuticals & Biotechnology	3.12%	1.38%	4.50%	3.96%	2.89%	6.85%
4010	Banks	1.31%	0.89%	2.20%	1.15%	1.10%	2.25%
4020	Diversified Financials	2.13%	1.64%	3.76%	4.84%	5.03%	9.87%
4030	Insurance	1.34%	0.88%	2.22%	1.60%	1.96%	3.56%
4040	Real Estate	1.21%	1.02%	2.23%	1.21%	1.02%	2.23%
4510	Software & Services	3.77%	2.05%	5.82%	5.33%	3.13%	8.46%
4520	Technology Hardware & Equipment	3.05%	1.65%	4.70%	3.58%	2.34%	5.92%
4530	Semiconductors & Semiconductor Equipment	3.76%	1.64%	5.40%	4.48%	2.46%	6.94%
5010	Telecommunication Services	1.71%	0.99%	2.70%	2.98%	2.94%	5.92%
5510	Utilities	0.84%	0.51%	1.35% [†]	0.84%	0.51%	1.35% [‡]

Source: ISS US Corporate Governance Policy 2007 Updates, Institutional Shareholder Services, 2006, p. 16.

New/Revised Compensation Policies

● Poor Pay Practices

- ISS may recommend a WITHHOLD vote from the compensation committee and/or the CEO on a CASE-BY-CASE basis if it finds poor pay practices; may consider recommending a WITHHOLD vote from entire board if it was involved in and contributed to the egregious compensation problems
- ISS added a list of **best executive pay practices**, including:
 - ***Employment Contracts*** – only use in limited circumstances and for a short period; should not have automatic renewal features
 - ***Severance Agreements*** – should not be so appealing that they become incentives for executives to be terminated; **should exclude excise tax gross-ups**; use severance multiples of 3x or less; use pro-rated target/average historical bonus; should not be triggered by failure to renew an employment contract or termination due to poor performance
 - ***Change-in-Control Payments*** – should only be made when there is a significant change in company ownership structure coupled with a loss of employment or substantial change in job duties; **should exclude excise tax gross-ups**; should prevent acceleration of vesting of equity awards unless a double trigger is used
 - ***SERPs*** – should not have sweeteners, e.g., additional years of service, inclusion of variable pay; pension formulas should not use extraordinary bonuses



New/Revised Compensation Policies

- ISS' examples of **poor pay practices**:
 - Egregious employment contracts (multi-year guarantees for bonuses and grants)
 - Excessive perks, e.g., tax gross-ups for personal use of corporate aircraft
 - Huge bonus payouts without justifiable performance linkage or proper disclosure
 - Performance metrics that are changed during the performance period without adequate explanation of the action and the link to performance
 - Egregious pension/SERP payouts
 - New CEO awarded an overly generous new hire package
 - Excessive severance provisions
 - Change in control payouts without loss of job or substantial diminution of duties
 - Internal pay disparity
 - Options backdating
 - Other excessive compensation payouts or poor pay practices at the company



New/Revised Compensation Policies

● Options Backdating

- On a CASE-BY-CASE basis, ISS may WITHHOLD votes from a compensation committee at a company that engaged in backdating, depending on the severity of the practices and the subsequent corrective actions on the part of the board
- Factors ISS will consider:
 - Reason and motive for the options backdating issue
 - Length of time of options backdating
 - Size of restatement due to options backdating
 - Corrective actions taken
 - Adoption of a grant policy that prohibits backdating, and creation of a fixed grant schedule or window period for equity grants going forward



New/Revised Compensation Policies

● Performance-based Equity Shareholder Proposals

- If a shareholder proposal requests that a significant amount of future long-term incentive compensation awarded to senior executives shall be performance-based and requests that the board adopt and disclose challenging performance metrics to shareholders, ISS will apply a 2 step process in evaluating the proposal:
 - ISS generally will recommend FOR such a shareholder proposal, unless it is overly restrictive or the company has demonstrated that it is using a “substantial” portion of performance-based awards for its top executives
 - ISS does not consider typical, at-the-money, stock options with time-based vesting and performance accelerated vesting awards to be performance-based
 - Premium-priced options should have a minimum 25% premium to be performance-based
 - ISS will assess the rigor of the company’s performance-based equity program. ISS will generally support the proposal if:
 - The company has set the bar too low
 - Target performance results in an above-target payout, or
 - The company does not disclose the performance metric of the performance-based equity program



New/Revised Compensation Policies

- Repricing Proposals Brought by Management
 - ISS revised this policy to add to the list of things it will consider:
 - The intent, rationale, and timing of the repricing proposal
 - Why the board is choosing to conduct an exchange program at this point
 - Any decline in the stock price upon which the repricing is predicated should not have happened within the past year
 - Surrendered options should have been granted at least 2 to 3 years prior
 - The exercise price of the surrendered options should be above the 52-week high for the stock price

Other Policy Changes

- Other policies that ISS introduced or revised as part of the 2007 Policy Updates include:
 - **Majority Vote Standard for Director Elections (Shareholder Proposal)** – ISS will generally recommend FOR precatory and binding resolutions requesting that the board change the company’s bylaws to stipulate that directors need to be elected with an affirmative majority of votes cast, provided it does not conflict with the state law where the company is incorporated.
 - **Majority Vote Standard: No Carve-out for Plurality Voting in Contested Situations** – ISS will outline each company’s vote standard for directors (plurality or majority), and the presence or absence of a director resignation policy. If a company has a majority standard but no carve-out for plurality voting in contested elections, ISS will include cautionary language that, in the future, ISS may recommend withholds against the boards of such companies, if such a carve-out is permissible under applicable state law
 - **Performance Test for Directors** – New framework announced which looks at four performance measures (with weights given to each as indicated):
 - 5-year, relative Total Shareholder Return within each 4-digit GICS group (50%)
 - Sales growth (16.66%), EBITDA growth (16.66%), and pre-tax operating Return on Invested Capital (16.66%), all on a relative basis within each 4-digit GICS group
 - Time weighting: 40% on trailing 12 months; 60% on 48 months prior to that



Thank You !

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