

Client Alert

January 23, 2008

ISS 2008 Policy Updates Effective February 1, 2008

This Client Alert discusses the significant changes described in the 2008 U.S. Corporate Governance Policy updates issued in December by ISS Governance Services, a unit of RiskMetrics Group (ISS). These changes will be of major interest to Boards, given ISS's highly influential role in the proxy voting process through its analysis of companies' proxy statements and corporate governance structure. Certain companies whose equity use or compensation arrangements formerly would have been viewed negatively may obtain some relief through specific changes adopted in the 2008 policy updates.

These updated guidelines, which include compensation-related corporate governance issues, are effective for shareholder meetings on or after February 1, 2008.

I. **Say on Pay: Advisory Votes on Executive Compensation Management Proposals**

ISS views "say on pay" as a growing trend and expects to see over 100 such shareholder proposals in 2008. ISS's policy is to support shareholder proposals that seek non-binding shareholder ratification of the compensation paid to the Named Executive Officers and the accompanying narrative disclosure provided to explain the Summary Compensation Table in each company's proxy statement. The first management-sponsored proposal seeking an advisory vote on executive compensation is expected to be on AFLAC's 2008 proxy ballot, anticipated to be mailed in mid-March.

ISS's 2008 update includes a new framework of five general global principles to be used on a case-by-case basis to determine their position on management-sponsored "say on pay" proposals:

- **Maintain appropriate pay-for-performance alignment, with emphasis on long-term shareholder value** – This includes the link between pay and performance; the mix of fixed and variable pay; performance goals; and equity-based plan costs
- **Avoid "pay for failure" risks** – This includes the use and appropriateness of long or indefinite employment contracts, excessive severance packages and guaranteed compensation
- **Maintain an independent and effective compensation committee** – Directors should have appropriate skills, knowledge, experience, and a sound process for compensation decision-making, including access to independent advice

- **Provide clear and comprehensive compensation disclosures** – Disclosures should be informative, timely, and enable full and fair evaluations of executive pay practices
- **Avoid inappropriate pay to non-executive directors** – Board compensation should not compromise members' independence or ability to make appropriate decisions regarding executive pay and performance

For U.S. companies, ISS has additional criteria it may utilize in determining its position on a management-sponsored "say on pay" proposal:

- **Relative considerations** – Includes assessment of performance metrics; evaluation of compensation peer groups; alignment of company performance and executive compensation trends; and internal pay equity between the CEO and other executives
- **Design considerations** – Includes balance between fixed and performance-based pay; perquisite practices; severance pay packages; SERPS; and excessive burn rates
- **Communication considerations** – Includes the quality of the Compensation Discussion and Analysis (CD&A), particularly the disclosure of performance targets, as well as the board's response to majority-supported shareholder proposals related to executive pay

PM&P Observation: U.S. companies opting to include "say on pay" management-sponsored proposals on their annual meeting agendas won't get an automatic pass from ISS simply for being on the governance forefront

PM&P Observation: ISS has commented that U.S. investors are very focused on issues related to pay-for-performance practices and will be looking to compensation committees to exercise good stewardship

II. Updated Poor Pay and Exemplary Pay Practices

ISS may issue a withhold vote recommendation for compensation committee members, the CEO, or the full board if it deems a company to have "poor pay practices," as well as recommend a vote against a related equity compensation plan. ISS lists examples of what it considers to be poor pay practices for 2008, with italicized items indicating a policy update or clarification from last year:

- **Egregious employment contracts** – includes contracts containing multi-year guarantees for *salary increases*, bonuses and equity grants
- **Excessive perquisites that dominate compensation** – includes overly generous cost or reimbursement of taxes for personal use of corporate *aircraft*, *personal security systems*,

car allowances, or other excessive arrangements. Base salary will be used as the relative measure to determine if certain perquisites are excessive

- **Abnormally large bonus payouts without justifiable link to performance or proper disclosure** – includes change, cancellation or replacement of performance metrics during the performance period without adequate explanation of the action and the link to performance
- **Egregious pension/SERP payouts** – includes additional years of service credit that result in significant payouts and/or inclusion of performance-based equity awards in the pension calculation
- **Excessive severance and/or change in control provisions** – includes: (i) cash payouts in excess of 3X base plus bonus; (ii) severance paid for failure to perform; (iii) single trigger change in control (CIC) payouts; and (iv) perquisites for former executives such as car allowances, personal use of corporate aircraft or other inappropriate arrangements
- **Poor disclosure practices** – includes: (i) unclear explanation of how the CEO is involved in the pay setting process (ii) retrospective performance targets and (iii) lack of disclosure and explanation of the methodology used for benchmarking practices and/or peer group selection
- **Internal pay disparity** – excessive differential between total pay for CEO and next highest paid named executive officer
- **Stock option backdating**
- **Overly generous new hire package for CEO** – includes excessive “make whole” provisions and/or any of the above poor pay practices

At the same time, ISS also provided an updated list of what it will view as exemplary pay practices:

- **Employment contracts** – Should have: (i) short terms (ii) no automatic renewal features and (iii) a specified termination date
- **Severance agreements** – Should: (i) exclude tax gross-ups (ii) use reasonable formulas (e.g., up to 3x multiples, pro-rated target/average (rather than maximum) historical bonus) and (iii) not permit payments for failure to renew, or for termination under questionable events or due to poor performance
- **Change in control payments** – Should: (i) accelerate and/or be payable only upon a double-trigger event (i.e., when there is a CIC coupled with loss of employment) and (ii) exclude excise tax gross-ups
- **SERPs** – Should exclude additional years of service credit and variable pay from formula
- **Deferred compensation** – Should not have above-market returns or guaranteed minimum returns

- **Disclosure practices** – CD&A should be written in “plain English,” using tables and charts to help the average investor understand program details and rationales, and include performance target information

PM&P Observation: The list of “poor pay practices” is not exhaustive. ISS will be looking for what it deems to be other excessive compensation payouts or poor pay practices at each company. Conversely, failing to adhere to the exemplary pay practices listed will not in itself result in a withhold vote recommendation

III. **Binomial Model: Stock Option Overhang Cost and New Exception**

ISS utilizes a binomial option pricing model to determine the “cost” of equity awards to shareholders, referred to as Shareholder Value Transfer (SVT). Total SVT is based on the sum of: the number of new shares proposed for a plan; all shares currently available for future grants under all equity compensation plans; and the number of shares granted but not yet exercised. The total SVT cost of a company’s equity compensation program is then measured against an “allowable” cost, which reflects the company’s performance, market capitalization and industry.

Typically, options have a ten-year term and are exercised within five to six years. Some companies with good performance have high SVT that is largely attributable to employees who hold options that are well in-the-money for a prolonged period of time. Such high SVT can pose a problem for companies seeking to replenish an equity compensation plan or adopt a new plan if the high overhang pushes the SVT cost over the allowable cap.

ISS will consider, on a case-by-case basis, a carve-out of a portion of the cost of the unexercised in-the-money options when a high level of overhang is attributable to in-the-money options outstanding in excess of six years. This carve-out may be applied where the following favorable characteristics are present:

- **Positive company performance** – Sustained positive stock performance, based on one- and five-year absolute TSR performance, as well as relative TSR performance compared to peer companies
- **Sufficient overhang disclosure** – The company must clearly disclose how much overhang is related to in-the-money options outstanding for more than six years as opposed to more recently issued options, vesting provisions, and distribution of grants among NEOs
- **Reasonable dilution attributable to equity compensation** – Based on the estimated duration of the new shares requested (i.e., how many years the share replenishment is likely to last, based on the company’s past grant patterns), ISS will determine if the company is requesting too many shares at one time

- **Good overall compensation practices** – ISS will look at the company’s overall compensation practices, the distribution of equity grants to senior executives, and the existence of poor pay practices

PM&P Observation: This change clearly favors companies with long-term positive performance that previously were penalized on the SVT test only because their executives had chosen to hold on to their options longer than expected. Unfortunately, it remains unclear how consistently and frequently ISS will grant this carve-out as it examines programs on a case-by-base basis

IV. Burn Rate Updates

Calculation

ISS recommends against equity-based compensation plans if the company’s average three-year burn rate exceeds its industry group’s mean by more than one standard deviation and is more than 2% of common shares outstanding, even if the total plan cost is within the allowable SVT cap.

Prior to 2008, the burn rate converted full-value share awards to option equivalents, based on three categories of multipliers that corresponded to stock price volatility. The burn rate was calculated by dividing the number of shares granted by the total common shares outstanding as of fiscal year-end for each of the three years, then averaging these three quotients.

To add more precision to the calculation, ISS has made two changes to the burn rate calculation and methodology:

- The denominator will be the weighted average common shares outstanding for the three years (rather than common shares outstanding as of fiscal year-end) and
- Six (rather than three) categories of volatility will be used, as follows:

Annual Stock Price Volatility	Multipliers
54.6% and higher	1 full-value award will count as 1.5 option shares
36.1% or higher and less than 54.6%	1 full-value award will count as 2.0 option shares
24.9% or higher and less than 36.1%	1 full-value award will count as 2.5 option shares
16.5% or higher and less than 24.9%	1 full-value award will count as 3.0 option shares
7.9% or higher and less than 16.5%	1 full-value award will count as 3.5 option shares
Less than 7.9%	1 full-value award will count as 4.0 option shares

PM&P Observation: The updated methodology will be more precise for companies that have swings in shares outstanding during the year due to buybacks or stock issuances. Having more levels of volatility in the formula will likewise smooth over distribution for full-value shares based on actual volatility

Updated Burn Rate Table

ISS annually updates its burn rate table by industry group. Following is a comparison of the 2007 and 2008 burn rate tables for Russell 3000 and non-Russell 3000 companies:

GCIS	Description	Russell 3000		Non-Russell 3000	
		2008 Mean Plus Standard Deviation	2007 Mean Plus Standard Deviation	2008 Mean Plus Standard Deviation	2007 Mean Plus Standard Deviation
1010	Energy	3.09%	2.29%	4.43%	3.77%
1510	Materials	1.93%	1.85%	4.49%	4.36%
2010	Capital Goods	2.55%	2.57%	4.39%	4.32%
2020	Commercial Services & Supplies	4.05%	3.81%	4.23%	4.18%
2030	Transportation	2.80%	2.31%	4.10%	3.86%
2510	Automobiles & Components	2.99%	2.90%	3.78%	4.69%
2520	Consumer Durables & Apparel	3.33%	3.09%	4.04%	3.70%
2530	Hotels Restaurants & Leisure	3.33%	3.41%	4.25%	4.17%
2540	Media	3.27%	2.70%	5.93%	5.62%
2550	Retailing	2.90%	3.05%	5.80%	5.14%
3010, 3020, 3030	Food & Staples Retailing	2.92%	2.91%	3.85%	3.90%
3510	Health Care Equipment & Services	4.57%	4.19%	6.40%	5.81%
3520	Pharmaceuticals & Biotechnology	4.96%	4.50%	8.69%	6.85%
4010	Banks	2.15%	2.20%	2.19%	2.25%
4020	Diversified Financials	4.52%	3.76%	9.71%	9.87%
4030	Insurance	2.14%	2.22%	4.35%	3.56%
4040	Real Estate	1.85%	2.23%	2.02%	2.23%
4510	Software & Services	6.11%	5.82%	9.27%	8.46%
4520	Technology Hardware & Equipment	4.80%	4.70%	5.83%	5.92%
4530	Semiconductors & Semiconductor Equipment	5.59%	5.40%	6.81%	6.94%
5010	Telecommunication Services	2.80%	2.70%	5.10%	5.92%
5510	Utilities	1.22%	1.35%	1.25%	1.35%

V. Conclusion

The changes being implemented by ISS for the 2008 proxy season, while complex, may prove beneficial to some companies with highly specific equity use or compensation considerations that formerly were more likely to be judged negatively. These include the new provision for a cost carve-out for unexercised long-term in-the-money stock options that cause relatively high SVT, as well as the more precise manner in which ISS will calculate burn rates going forward.



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