ISS Updates Proxy Voting Policies
Effective February 1

Institutional Shareholder Services ("ISS") provides research and advisory services to assist institutional investors in their evaluation of proxy proposals so that such investors cast votes that protect and enhance shareholder value. ISS develops policy guidelines and proxy analyses, provides consulting services to clients who vote proxies, and offers voting agent services. The ISS Proxy Voting Manual is a reference manual designed to recommend to institutional shareholders, especially ERISA managers, how to satisfy their obligations as shareholders and vote their stock to enhance long-term portfolio value.

Institutional shareholders routinely use ISS recommendations, or a recommendation from another proxy voting advisory service, to vote their stock holdings. Companies should know and understand their shareholder base and which shareholder advisory service their institutional shareholders may use. It is important that companies that have a large institutional shareholder base understand the ISS policies, rules and recommendations and the flexibility of those recommendations.

The ISS Corporate Governance Policy Committee annually reviews its current voting policies in light of the latest trends and developments in corporate governance. ISS has revised several of its proxy voting policies for the 2004 proxy season. These changes will be implemented for all U.S. domiciled companies with meeting dates on or after February 1, 2004. ISS will distribute the related updates and changes to the ISS Proxy Voting Manual by January 31, 2004. The following is apparent from this year’s revisions:

- ISS made a number of changes to align its policies with the new NYSE and NASDAQ corporate governance listing standards. Unfortunately, however, the ISS policies, in too many instances, go beyond the new listing requirements and add not only more complexity, but a whole new layer of governance rules for companies to address;
- The new ISS policies are very detailed; and
- If the SEC’s proposed proxy rules giving shareholders greater ability to include their director nominees in the company’s proxy statement go forward, then the occurrence of one or both of the following triggering events in 2004 will trigger the company’s obligation to include in its proxy materials for 2005 and 2006 one or more board nominees, depending on the size of the board, proposed by holders of at least five percent of the shares (owned for at least two years):

  (i) When 35% or more of votes cast at a shareholders’ meeting with respect to one or more director nominees are “withhold” votes; or
When a shareholder proposal asking for open access, which is submitted by holders of at least one percent of the shares (owned for at least one year), is approved by a majority of the votes cast at the 2004 annual meeting.

The proposed proxy rules, if adopted, would make an ISS recommendation that shareholders “withhold” votes increasingly potent. ISS indicates, however, as discussed below, that it will encourage shareholder proposals requesting open access to the company's proxy only where there is a valid complaint concerning board or director conduct.

The following is an explanation of the ISS policy changes for this year. It is important, however, to read these updates in conjunction with the ISS policies that remain in effect.

**Board Issues**

1. **Board Independence**

In 2003, ISS recommended that shareholders WITHHOLD votes from affiliated outsiders, as well as insiders, that sat on the audit, compensation, and nominating committees or if the company did not have one of these committees. ISS, in keeping with the new NYSE and NASDAQ listing rules, approved by the SEC on November 4, 2003, now recommends that shareholders WITHHOLD votes from insiders and affiliated outsiders on boards that are not at least a majority independent.

2. **Clarifications Regarding the Definition of Independent Director**

ISS is clarifying its definition of inside and affiliated directors to include a broader number of relationships.

A director is an “**insider director**” if he or she is:

- An employee of the company or its affiliates,
- A non-employee officer of the company if he is among the five most highly compensated individuals,
- Listed as a Section 16 officer in the Form 10-K or proxy statement,
- Interim CEO,
- The beneficial owner of more than 50 percent of the company’s voting power (this may be aggregated if voting power is distributed among more than one member of a defined group).

A director is an “**affiliated director**” if he or she is:

- A former executive of the company or its affiliates,
- Former interim CEO if the service was longer than one year or if the service was between six months and a year and the compensation was high relative to that of the other directors (five times their pay) or in line with a CEO’s compensation,
- Former executive of an acquired firm,

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1 “Affiliate” includes a subsidiary, sibling company or parent company.
2 “Executives” (officers subject to Section 16 of the Exchange Act of 1934) include the chief executive, operating, financial, legal, technology, and accounting officers of a company (including the president, treasurer, secretary, controller, any vice president in charge of a principal business unit, division, or function, and any other officer who performs policy-making functions). Corporate secretaries and general counsels not listed as officers and not employed by the company will be considered affiliated outsiders.
• Executive of a former parent or predecessor firm at the time the company was sold or split off from the parent/predecessor,

• Executive, former executive, general or limited partner of a joint venture or partnership with the company,

• Relative of current employee of company or its affiliates,

• Relative of a former executive of company or its affiliates,

• Currently provides (or a relative provides) professional services to the company or its affiliates or to its officers,

• Employed by (or a relative is employed by) a significant customer or supplier;¹

• Has (or a relative has) any transactional relationship with the company or its affiliates excluding investments in the company through a private placement;²

• Has a contractual/guaranteed board seat and is party to a voting agreement to vote in line with management on proposals being brought to shareholders,

• Has (or a relative has) an interlocking relationship as defined by the SEC involving members of the board of directors or its Compensation and Stock Option Committee;³

• Founder of the company but not currently an employee,

• Is (or a relative is) a trustee, director or employee of a charitable or non-profit organization that receives grants or endowments from the company or its affiliates;²

• Board attestation that an outside director is not independent.

A director is an “independent director” if the director has no connection to the company other than the board seat.

If a non-employee director is deemed non-independent based on the relevant listing standards or board attestation, ISS will categorize the director as an “affiliated outsider.” ISS will continue to use the NASDAQ dollar test in its affiliated outsider definition.

3. Clarifications Regarding Routine Director Elections

ISS currently recommends voting for the routine election of directors unless there are (1) clear concerns about the past performance of the company or the board; (2) the board fails to meet minimum corporate governance standards; or (3) there are specific concerns about the individual, such as criminal wrongdoing or breach of fiduciary responsibilities. ISS is clarifying its policy on director elections and implementing a more targeted policy to recommend against the routine election of directors. ISS recommends that shareholders vote AGAINST the routine election of directors at companies that have exhibited the practices below:

• The absence of adequate or timely disclosure

• Questionable finances or restatements

• Questionable transactions with conflicts of interest

¹ If the company makes or receives annual payments exceeding the greater of $200,000 or five percent (5%) of the recipient's gross revenues. The recipient is the party receiving the financial proceeds from the transaction.

² Interlocks include: (a) executive officers serving as directors on each other's compensation or similar committees (or, in the absence of such a committee, on the board) or (b) executive officers sitting on each other's boards and at least one serves on the other's compensation or similar committees (or, in the absence of such a committee, on the board).

³ Applies to all U.S. and global companies.
• Any record of abuses against minority shareholder interests
• Bundling of director elections, and/or
• Any other egregious corporate governance practices.

4. Overboarded Directors

ISS currently does not have a rule regarding the number of board seats held by a director. ISS is changing its policy to provide that ISS will recommend WITHHOLDING votes from directors who sit on more than six (6) boards, in light of ISS’ belief that directors who are overextended may jeopardize their ability to serve as effective representatives of shareholders.

5. Separating Chairman/CEO Positions

ISS generally recommends voting FOR shareholder proposals to separate the Chairman of the Board and CEO positions, unless the company has a strong countervailing governance structure. ISS will continue to support shareholder proposals to separate the Chairman and CEO, however, if the CEO and Chairman positions are not separated, ISS requires the following to counterbalance the combined Chairman/CEO:

• A designated lead director, elected by and from the independent board members with clearly delineated duties, which, at a minimum should include:
  – Presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors,
  – Serves as liaison between the chairman and the independent directors,
  – Approves information sent to the board,
  – Approves meeting agendas for the board,
  – Approves meeting schedules to assure that there is sufficient time for discussion of all agenda items,
  – Has the authority to call meetings of the independent directors,
  – If requested by major shareholders, ensures that he is available for consultation and direct communication.

• 2/3 independent board
• All independent key committees (audit, nominating, compensation)
• Established governance guidelines

6. Open Access (Shareholder Resolution)

On October 8, 2003 the SEC proposed new proxy rules to give significant, long-term shareholders greater ability to include their director nominees in management’s proxy statement.

The SEC proposal includes a two-step, two-year process. In the first year (2004), one of two triggering events must occur:

• One or more directors receive withhold votes of 35 percent or more of the votes cast; or
• A shareholder proposal asking for open access, which is submitted by holders of at least one percent of the shares (owned for at least one year), is approved by a majority of the votes cast.

If either of these two “triggering events” occurs, then for the following two years (2005 and 2006), the company would be required to include in its proxy materials one or more board nominees, depending on the size of the board, proposed by holders of at least five percent of the shares (owned for at least two years).
ISS will examine shareholder proposals asking for open access to the company’s proxy statement on a CASE-BY-CASE basis, taking into account:

- The ownership threshold proposed in the resolution; and
- The proponent’s rationale for the proposal at the targeted company in terms of board and director conduct.

ISS believes that shareholders should use this mechanism responsibly, and will encourage proponents to target companies where there is a valid complaint.

7. Mandatory Holding Periods (Shareholder Resolution)

ISS currently supports shareholder proposals asking companies to adopt a holding period for their executives to hold stock after option exercise, unless the company already has some type of holding period.

ISS is amending its policy to take a CASE-BY-CASE approach on shareholder proposals asking companies to adopt holding periods for their executives, taking into account:

- Whether the company has any holding period or officer ownership requirements in place, including:
  - Rigorous stock ownership guidelines, or
  - A short-term holding period requirement (six months to one year) coupled with a significant long-term ownership requirement, or
  - A meaningful retention ratio
- Actual officer stock ownership and to what degree it meets or exceeds the proponent’s suggested holding period or the company’s own stock ownership or retention requirements.

ISS notes that average CEO ownership requirements tend to be five times salary accumulated over five years, and suggests that a more rigorous requirement would be seven to ten times for the CEO, scaled down for other executives. ISS believes that a meaningful retention ratio (on a net proceeds basis) would be at least 50 percent for full tenure.

Compensation Issues

1. Employee Share Purchase Plans

ISS believes that broad-based share ownership among employees helps align the interests of employees with those of shareholders, but that reasonable limits should be placed on the discounts companies offer to employees that participate in such plans. ISS currently allows up to 5% dilution on separate employee share purchase plans, and does not provide any guidance concerning discounts. In 2004, ISS will approve of broad-based employee share purchase plans with dilution up to 10% of outstanding share capital, as long as discounts do not exceed 15%.

If market practice dictates a discount in excess of 15%, then the dilution allowed by ISS will be adjusted downward proportionately. For example, if a company offers discounts of 30%, the allowable dilution will be 5%. Allowable dilution on discounts between 15% and 30% will be determined on a pro rata basis. These limits only apply to share purchase plans, not stock option or restricted share plans.

2. Performance-Based Options (Shareholder Resolution)

ISS is amending its policy to recommend that shareholders vote FOR shareholder proposals advocating the use of performance-based equity awards (indexed options, premium-priced options, performance-vested awards), unless:
• The proposal is overly restrictive (e.g., awards to all employees must be performance-based or all awards to top executives must be a particular type, such as indexed options), or

• The company demonstrates that it is using a “substantial” portion of performance-based awards for its top executives.

“Top executives” refers to the top five most highly compensated officers. A “substantial” portion of performance-based awards would be at least 50 percent of the shares awarded to those executives.

3. Supplemental Executive Retirement Plans (SERPs) (Shareholder Resolution)

SERPs are non-qualified, executive-only retirement plans under which the company provides an additional retirement benefit to supplement what is offered under the employee-wide plan where contribution levels are capped.

ISS currently takes a case-by-case approach to shareholder proposals seeking shareholder approval of SERPs. ISS is amending its policy to recommend that shareholders vote FOR shareholder proposals requesting that extraordinary benefits contained in SERP agreements be put to a shareholder vote unless the company’s executive pension plans do not contain excessive benefits beyond what is offered under employee-wide plans.

4. Pension Plan Accounting/Executive Compensation (Shareholder Resolution)

ISS is amending its policy to recommend that shareholders vote FOR shareholder proposals to exclude pension fund income in the calculation of earnings used in determining executive bonuses/compensation. According to ISS, pension fund income can distort operating performance, which should be the basis for determining executive bonuses/compensation rather than gains from defined benefit plans.

5. Equity-Based Compensation Plans

ISS will continue to use its quantitative analysis in determining its vote recommendation on equity-based compensation plans. Under ISS’ current methodology, if the proposed cost (shareholder value transfer and voting power dilution) of the company’s plans is above ISS’ allowable cap for that company, an AGAINST vote is recommended. If the proposed cost is below the allowable cap, a FOR vote is recommended unless the plan violates ISS’ repricing guidelines. If a company has a history of repricing or has the express ability to reprice underwater stock options without shareholder approval under the proposed plan, ISS recommends a vote against the plan – even in cases where the plan is considered acceptable based on the quantitative analysis.

ISS will continue to apply this methodology, but for Russell 3000 companies ISS will also apply a pay-for-performance overlay in assessing equity-based compensation plans. ISS is also modifying its repricing override for listed companies to conform with changes to the NYSE and NASDAQ listing rules. ISS’ amended policy for 2004 is as follows:

• ISS will recommend AGAINST a plan if the cost exceeds the allowable cap.

• ISS will recommend FOR a plan if the cost is reasonable (below the cap) unless:
  – The plan expressly permits repricing without shareholder approval for listed companies,
  – There is a disconnect between the CEO’s pay and performance (an increase in pay and a decrease in performance), the main source for the pay increase is equity-based, and the CEO participates in the plan being voted on. Specifically, if the company has negative one- and three-year
total shareholder returns, and its CEO also had an increase in total direct compensation (TDC)\(^6\) from the prior year, it would signify a disconnect in pay and performance. If more than half of the increase in total direct compensation is attributable to the equity component, ISS would generally recommend that shareholders vote AGAINST the equity plan in which the CEO participates.

In the case of a disconnect between the CEO’s pay and performance (as explained above), ISS will also recommend that shareholders WITHHOLD votes from the Compensation Committee members.

### Audit Issues

1. **Shareholder Proposals for Auditor Rotation**

   ISS currently recommends that shareholders vote for shareholder proposals asking for audit firm rotation, unless the rotation period is so short (less than five years) that it would be unduly burdensome to the company. ISS is amending its policy to vote CASE-BY-CASE on auditor rotation proposals, given that recent studies indicate that regular rotation of the audit firm may negatively affect audit quality and service while increasing expense. ISS will examine what process a company has in place to systematically review their auditor and correct any audit-related issues that may arise, including:

   - Tenure of the audit firm
   - Establishment and disclosure of a renewal process whereby the auditor is regularly evaluated for both audit quality and competitive price
   - Length of the rotation period advocated in the proposal
   - Significant audit-related issues.

   According to ISS, an effective review mechanism would lessen the need for auditor rotation as independent oversight is already being exercised.

2. **Non-Audit Fees**

   Non-audit fees generally include all fees billed to the company by its principal accountant for all services other than those services rendered for or reasonably related to the performance of the audit and review of the company’s financial statements. ISS advocates better disclosure and separation of audit and non-audit fees and will consider voting against auditor remuneration and/or ratification in the following year (2005) if non-audit fees exceed audit and audit-related fees or if the separate fees remain undisclosed. ISS believes that itemized audit and non-audit fees should be disclosed by every company, and moreover, that auditors and audit committee members should be held accountable whenever non-audit fees exceed audit fees or if the fees are not disclosed.

### Other Issues

**Social and Environmental Issues**

1. **Amend Equal Employment Opportunity (EEO) Statement to Include Reference to Sexual Orientation**

   ISS is amending its policy to recommend that shareholders vote FOR such proposals, unless the change would result in excessive costs for the company.

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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, face value of restricted stock and face value of actual long-term incentive plan payouts.
2. Environmental-Economic Risk Proposals

ISS will take a CASE-BY-CASE approach to proposals requesting reports assessing economic risks of environmental pollution or climate change, taking into account whether the company has clearly disclosed the following in its public documents:

- Approximate costs of complying with current or proposed environmental laws
- Steps the company is taking to reduce greenhouse gases or other environmental pollutants
- Measurements of the company’s emissions levels
- Reduction targets or goals for environmental pollutants including greenhouse gases.

We Can Help

Katten Muchin Zavis Rosenman is available to discuss the ISS policy updates and their potential implications for your company. Please direct questions concerning the ISS policy updates to one of the co-chairs of Katten Muchin Zavis Rosenman’s Securities Practice:

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