



RADFORD ALERT

ISS Releases New Burn Rate Limits for 2014

Earlier this week, Institutional Shareholder Services (ISS) released updated burn rate limits for 2014, following up on its broader policy announcements in November and early December. With this release, ISS has now provided fresh guidance on burn rate caps for both Russell 3000 and non-Russell 3000 companies in all industries, including the technology and life sciences sectors. Burn rates, a measure of the pace at which companies use (or burn) shares available for grant in their equity compensation plans, are an important factor for investors concerned about shareholder dilution. ISS’ new burn rate guidelines go into effect for companies with shareholder meetings on or after February 1, 2014.

ISS uses burn rates as one of several metrics to evaluate company requests to approve or amend equity compensation plans, and will recommend voting against stock plan proposals when a company’s three-year average burn rate exceeds the ISS-prescribed cap for a company’s respective industry. Industry caps are calculated and revised by ISS on an annual basis and are based on an industry’s mean (average) burn rate plus one standard deviation (σ).

When determining company-specific burn rates, ISS considers “gross burn rate,” which is calculated as total options and restricted shares (or RSUs) granted divided by a company’s weighted-average total common shares outstanding. Unlike “net burn rate” calculations, cancelled or forfeited equity awards are excluded from consideration. ISS also considers performance shares, but not when they are granted. Performance shares enter into the equation only after they are earned. To convert full-value shares granted into option-equivalents before running final burn rate calculations, ISS also applies a multiplier based on stock price volatility as follows to allow for cross company comparisons. There has been no update to this aspect of the policy:

Company 200-Day Stock Price Volatility	Multiplier
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

Technology and Life Sciences Companies to Face Tighter Limits

Across most of the technology and life sciences sectors, the new ISS burn rate limits introduced for 2014 portend further tightening of equity compensation programs. For both Russell 3000 and non-Russell 3000 companies, burn rate caps in 2014 will be lower in six of seven technology and life sciences industries. In some cases, the reductions are significant, and in excess of one full percentage point.

The following table illustrates the nearly ubiquitous downward trajectory of ISS burn rate limits across the technology and life sciences sectors.

ISS Industries		Russell 3000 Companies			Non-Russell 3000 Companies		
GICS Code**	Description	2013 Burn Rate Cap	2014 Burn Rate Cap	Change	2013 Burn Rate Cap	2014 Burn Rate Cap	Change
1010	Energy	4.57%	4.30%	↓	9.46%	*7.46%	↓
3510	Health Care Equipment & Services	5.09%	4.82%	↓	9.92%	9.08%	↓
3520	Pharmaceuticals & Biotechnology	6.70%	5.91%	↓	10.58%	8.98%	↓
4510	Software & Services	7.26%	7.25%	↓	9.58%	9.14%	↓
4520	Technology Hardware & Equipment	5.77%	5.49%	↓	8.53%	8.91%	↑
4530	Semiconductor Equipment	6.58%	6.72%	↑	10.55%	9.75%	↓
5010	Telecommunication Services	4.85%	4.22%	↓	8.75%	7.54%	↓

* The cap is generally the Mean + Standard Deviation, subject to a minimum cap of 2% (de minimis allowance) and maximum +/- 2 percentage points deviation relative to prior year burn rate cap for same industry/index group.

** The GICS code classification system is produced by S&P and is used by ISS to define industry classifications.

Additional Equity Plan Considerations

Clients should note that burn rate caps are only one factor considered by ISS when evaluating equity-based and other incentive plans up for shareholder approval. ISS will very likely vote against equity plans if any one of the following issues is found to exist:

- The total cost of the company's equity plans is "unreasonable," as measured by ISS' shareholder value transfer metric (SVT);
- The equity plan expressly permits the re-pricing of stock options or stock appreciation rights (including the exchange of underwater options) without prior shareholder approval;
- A pay-for-performance misalignment is found for the company's CEO, especially where a significant portion of the CEO's "misaligned" pay is determined to result from non-performance-based equity awards;
- The company's three-year gross burn rate exceeds the burn rate cap of its industry group;
- The equity plan has a liberal change-of-control definition, where for example, equity awards are accelerated due to the announcement or commencement of a tender offer, a "potential" takeover, or an approved merger rather as opposed to a fully completed change-of-control; or
- The equity plan is a vehicle for problematic pay practices.

Full 2014 ISS Burn Rate Cap Table

The full 2014 ISS burn rate cap table for both Russell 3000 and non-Russell companies is reproduced below. For reference, Radford clients typically appear in GICS codes 1010, 3510, 3520, 4510, 4520, 4530 and 5010.

ISS Industries		Russell 3000 Companies			Non-Russell 3000 Companies		
GICS Code**	Description	Mean	Standard Deviation	2014 Burn Rate Cap	Mean	Standard Deviation	2014 Burn Rate Cap
1010	Energy	2.14%	2.16%	4.30%	2.66%	3.60%	*7.46%
1510	Materials	1.55%	1.30%	2.85%	3.20%	4.65%	7.85%
2010	Capital Goods	1.81%	1.39%	3.20%	3.28%	4.88%	8.16%
2020	Commercial Services & Supplies	2.55%	1.82%	4.37%	3.68%	3.65%	7.33%
2030	Transportation	1.53%	1.80%	3.33%	1.71%	1.98%	3.69%
2510	Automobiles & Components	1.78%	2.03%	3.81%	2.74%	3.21%	5.95%
2520	Consumer Durables & Apparel	2.48%	1.80%	4.28%	3.37%	4.24%	7.61%
2530	Consumer Services	2.55%	1.61%	4.16%	2.16%	2.12%	4.28%
2540	Media	2.45%	1.98%	4.43%	3.23%	2.24%	5.47%
2550	Retailing	2.41%	1.75%	4.16%	3.39%	3.21%	6.60%
3010, 3020, 3030	Consumer Staples	1.59%	1.18%	2.77%	2.13%	2.32%	4.45%
3510	Health Care Equipment & Services	3.00%	1.82%	4.82%	4.81%	4.27%	9.08%
3520	Pharmaceuticals & Biotechnology	3.65%	2.26%	5.91%	4.87%	4.11%	8.98%
4010	Banks	1.48%	1.65%	3.13%	1.12%	1.67%	2.79%
4020	Diversified Financials	3.65%	5.09%	8.74%	2.74%	4.43%	*7.56%
4030	Insurance	1.75%	1.55%	3.30%	1.05%	1.53%	2.58%
4040	Real Estate	1.36%	1.50%	2.86%	1.12%	1.56%	2.68%
4510	Software & Services	4.56%	2.69%	7.25%	5.26%	3.88%	9.14%
4520	Technology Hardware & Equipment	3.50%	1.99%	5.49%	3.96%	4.95%	8.91%
4530	Semiconductor Equipment	4.34%	2.38%	6.72%	4.67%	5.08%	9.75%
5010	Telecommunication Services	2.59%	1.63%	4.22%	3.57%	3.97%	7.54%
5510	Utilities	0.82%	0.47%	*2.00%	1.76%	1.90%	3.66%

* The cap is generally the Mean + Standard Deviation, subject to a minimum cap of 2% (de minimis allowance) and maximum +/- 2 percentage points deviation relative to prior year burn rate cap for same industry/index group.

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Next Steps

For additional information on the latest ISS policy releases, clients can visit the ISS Policy Gateway here:
http://www.issgovernance.com/policy/2014/policy_information.

For assistance with burn rate, shareholder value transfer and equity usage modeling, please contact Radford's [Valuation Services](#) or [Compensation Consulting](#) teams.

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