

BUCK

Session Two:

Equity Incentive Plans and the 2006 Proxy Season: From Design to Approval

February 22, 2006

explore
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Welcome to Buck Consultants 2006 Webcast Educational Series

- Buck Consultant's webcast series features insights and updates on important compensation and business topics
- Today's session is the 2nd of our series
- Approximately 60-70 minute presentation on equity incentive plans
- Followed by a 20-30 minute question and answer session
- Please direct your questions via e-mail to:
yolanda.vanegas@buckconsultants.com
- Please save the date for our next webcast:

March 1st at 1:00PM EST

***Exploring the Controversial Aspects
of the New SEC Proxy Rules***

Today's Speakers

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Topics for Today's Discussion

Designing Equity Pay Plans

- Emerging trends in equity pay programs
- Share reserves/sub-limits
- Share counting “meter”
- Investor/proxy advisor demands
- Regulatory tips and traps
- ESPPs

Securing Approval of Equity Pay Plans

- Mutual fund vote disclosures
- “Testing the waters” before the meeting
- Shareholder proposals
- Best practices in coordination



Overall Environment and Regulatory Influences for 2006

- Healthy economy
- Increasing executive pay/declining rank-and-file benefits
 - Freezing of DB pensions
 - Delphi decision
- Shareholders gaining influence/employee influence waning
- Option expensing mandated in 2006
- 409A, the “compensation virus”
 - Option gain deferral
 - Discounted options
 - Private company SAR plans
- For 2007, expanded proxy disclosure of executive pay

Emerging Trends in Equity Pay Programs

- More refined option valuations for P&L purposes
 - Black-Scholes remains predominant valuation model
 - Focus on expected term and volatility factors
- Movement from appreciation-only devices to full value shares
- Movement to performance-vesting from time-vesting
 - Financial metrics - EBITDA
 - Share value metrics - TSR
- Lowered eligibility/participation
- “Best Fit” v “Best Practice”
 - End of the “cookie cutter” equity program era
 - Custom-designed ESPPs

Overall Plan Share Reserves/Replenishments

- Wide range for new plan or existing plan replenishment requests:
 - Minimum: 1 year's worth of grants (Intel approach)
 - Middle ground: ISS SVT limit, to receive "thumbs up"
 - Maximum: as much as shareholders will permit with a 51% effective approval
- Prevailing practice: 2 to 5 years' worth of grants, influenced by practical constraints:
 - Program design and eligibility
 - Major shareholder constituencies
 - Compensation Committee approval

Sub-Limits You Need To Consider

- Full value shares – ISS SVT test
 - Full value shares valued significantly higher than options/SARs
 - Consider separate limit on restricted stock awards, RSUs, and PSAs.
- Fungible pool – lower SVT while maintaining flexibility in future equity awards:
 - Plan specifies ratio of full value award impact vis a vis options/SARs
 - Example: an option/SAR award will count against the meter at 1 for 1, while a full value award will count at 3 for 1
 - ISS ISSue Compass model now addresses this concept
- ISOs – separate limit must be specified and counted
- 162(m) – separate per-Named Executive Officer limit within specified timeframe

How Should You “Set” Your Meter?

- Extremely important part of plan
 - Controls rate of usage of plan reserve
 - No regulatory constraints – whatever shareholders approve
- ISS will pay special attention to plan reserves with “liberal” share counting provisions
 - Companies with liberal share counting provisions receive “more utilization”
 - Such companies “should effectively require fewer shares... due to (these replenishment features).”
- ISS treats any option/SAR share reserve eligible for one or more “liberal” share counting provisions as full value shares.

Views of Share Usage

Share Usage Item	Prevailing Practices	ISS	IRS (for ISO sub-limit) ⁽¹⁾
Forfeitures/ cancellations	Shares returned to pool	No impact	Can return to pool
Stock-settled SARs	Net shares count	Liberal	No comment
Stock swaps	Incoming shares added to pool	Liberal	Can return to pool
Shares settled with cash	Shares returned to pool	No impact	No comment
Tax withholding	Shares used returned to pool	Liberal	Can return to pool
Shares purchased w/option proceeds	Not contemplated by plan	Liberal	Unclear

⁽¹⁾ IRS regulation 1.422-2(b)(3)(iii).

ISS Demands - “Thumbs Up” Vote Recommendation

- Shareholder value transfer test:
 - Value of shares requested must not exceed allowable cap
 - Options/SARS valued under proprietary binomial model
 - Full value shares valued as options with \$0 exercise price
 - Allowable value cap, as percent of market capitalization, equals equity plan practices of top quartile companies in your industry
 - Voting dilution no longer considered in analysis
- 3-year average burn rate cannot exceed both 1 standard deviation from mean burn rate of industry and 2% of TCSI&O
- Repricing must be subject to shareholder approval unless it is expressly allowed in the plan

ISS Demands - “Thumbs Up” Vote Recommendation

- No disconnect between CEO pay and performance. Disconnect defined as:
 - Negative 1 and 3-year TSR, and
 - CEO’s TDC has increased from the prior year, and
 - >50% of increase in TDC attributable to equity pay, and
 - CEO will continue to participate in the plan
- For outside director plans, if plan has excessive SVT cost, ISS will recommend “FOR” if company’s overall director pay program satisfies qualitative requirements.

Regulatory Items to Consider

- Financial accounting
 - Share withholding – limited to minimum amount required by tax law
 - Minimum withholding is now 35% on supplemental wages in excess of \$1 million
 - Option pyramiding – no longer required to hold shares for 6 months before using in stock swap in order to avoid variable accounting
 - Performance awards: use of stock-price based goals is complex:
 - Special valuation of award is needed
 - Award is expensed even if \$0 delivered because stock price did not perform as expected (just like a stock option)
- Tax
 - 162(m) – performance goals must be approved every 5 years
 - 162(m) – may be possible to convert time-vested restricted stock to performance-based pay exempt from deduction limit
 - ISOs – separate share counting meter

Current Trends in ESPP Design

- Prevailing ESPP design (15% discount with look-back) is now compensatory under SFAS 123R and will be expensed
 - Permissible limit is 5% discount
 - No look-back or other option feature permitted
- Corporate response is quite varied, falling into four courses of action based on “best fit” as opposed to “best practice”:
 - No change – ESPP is a critical component of employee benefit package and achieving its objective
 - Retain 15% discount/look-back but add share retention period – company accepts P&L hit as long as employees enjoy sustained ownership
 - Retain 15% discount, but eliminate the look-back – generally reduces P&L hit by 50%
 - Reduce discount to 5% cap and eliminate look-back – essentially terminates the plan

How Are Companies Responding?

- “How would we look/explain if disclosure required in 2006?”
- Supplemental performance graphs
- Investor Relations-style proxy presentations
- “Tally sheets” for executive and director pay

[Trends in Shareholder Proposals]

Type of Proposal	2002 Proposals	2003 Proposals	2004 Proposals	2005 Proposals
Board				
Separate Chair/CEO	2	30	36	46 / 29
Board independence	12	5	11	6 / 4
	14	35	47	52 / 33
Anti-takeover				
Declassify board	42	48	38	61 / 43
Redeem/vote on poison pill	50	84	50	52 / 28
	92	132	88	113 / 71
Executive Compensation				
Expensing of options	2	69	34	35 / 11
Restrict executive compensation	8	28	80	23 / 20
Performance-based options	4	60	5	40 / 18
Approve/restrict "golden parachutes"	19	18	26	34 / 22
	33	175	145	132 / 71
2005 New Issue				
Majority vote to elect directors				85 / 60

More Dialogue, Less Confrontation

- Fewer shareholder proposals won majority support:

	2003	2004	2005
Proposals winning majority support	172	138	85

- Fewer “negative” vote recommendations by ISS:

	2003	2004	2005
“Director withhold” recommendations	38%	32%	29%
“Against auditors” recommendations	7%	4%	2%
“Against option plans” recommendations	32%	28%	30%

- More “passing” shareholder proposals were acted upon by management

What Does “Case by Case” Voting Really Mean?

	FIDELITY			PUTNAM			VANGUARD		
	# of Meetings	For	Against	#of Meetings	For	Against	# of Meetings	For	Against
Approve Stock Option Plan	138	53%	46%	34	76%	24%	93	45%	55%
Amend Stock Option Plan	420	46%	52%	78	41%	59%	277	43%	57%
Approve Restricted Stock Plan	51	43%	49%	10	90%	10%	26	73%	27%
Amend Restricted Stock Plan	17	53%	47%	6	100%	0%	14	79%	21%
Approve Omnibus Plan	718	42%	58%	206	68%	32%	523	42%	58%
Amend Omnibus Plan	652	40%	59%	183	42%	57%	514	41%	59%

Source: ISS Voter Analytics: 01/01/04 to 12/31/04

	FIDELITY			PUTNAM			VANGUARD		
	# of Meetings	For	Against	#of Meetings	For	Against	# of Meetings	For	Against
Approve Stock Option Plan	77	51%	49%	30	53%	37%	52	65%	35%
Amend Stock Option Plan	221	51%	49%	50	56%	44%	137	55%	45%
Approve Restricted Stock Plan	39	54%	38%	18	72%	28%	23	78%	22%
Amend Restricted Stock Plan	15	53%	47%	6	67%	33%	12	92%	8%
Approve Omnibus Plan	569	40%	59%	135	38%	62%	404	58%	42%
Amend Omnibus Plan	564	43%	56%	110	32%	68%	409	55%	45%

Source: ISS Voter Analytics: 01/01/05 to 12/31/05

A Quick Primer on the Proxy Advisors

	ISS	Glass, Lewis	Proxy Governance
Coverage Universe	10,000+ U.S. 10,000+ Global	Russell 3000 plus additional 3,000 client-owned companies	Russell 3000 plus additional client-owned companies
Quantitative Methodology	Binomial cost/market cap w several additional screens/overrides	Binomial cost relative to multiple metrics	Case by case -- focus on company financial performance and pay for performance
Corporate consulting	Yes	No	No
Predictability	Somewhat, as you can run their models for equity compensation (Issue Compass); capital stock requests (Capital ISSues); and governance ratings (CGQ)	Multi-factor analysis less predictable – says plan passes these tests, fails other tests, notes qualitative factors they disfavor, then indicates support or opposition	Company-specific approach, with relative financial performance the underlying driver -- thus more leeway for well-performing companies
Contact Information	www.issproxy.com 301-556-0500 (main #) 301-556-0570 (corporate services support line) 301-556-0576 (US research help desk)	www.glasslewis.com 415-678-4279 -- Brittany Wedereit, Director of Proxy Research 415-678-4228 -- Robert McCormick, VP, Proxy Research & Operations	www.proxygovernance.com 703-245-5800 (main #) Shirley Westcott, Managing Director of Policy westcotts@proxygovernance.com; Allie Monaco, Research Director monacoa@proxygovernance.com

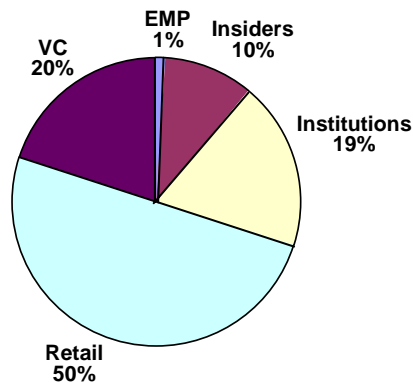
Institutional Investors – Voting vs. Investment Perspective

XYZ Corporation

Rank	Investor	Shares	% O/S	Style	Turnover	City	ISS?	G-L?	Proxy Voter	Phone #	Receptive?
1	Capital Research & Management	96,627,350	5.69	Core Value	Low	LA	No	No	Seneca Judge		No
2	Alliance Capital Management L.P.	55,019,091	3.24	Core Growth	Mod	NYC	Yes	No	Andrew Murphy		Yes
3	Barclays Global Investors, N.A.	49,569,073	2.92	Index	Low	SF	Yes	No	Chad Spittler		No
4	State Street Global Advisors (US)	47,301,042	2.79	Index	Low	Boston	Yes	No	Andrew Letts		Yes
5	Fidelity Management & Research	47,066,704	2.77	GARP	Low	Boston	No	No	Ed Corrao/Walter Donovan		Yes
6	Wellington Management	45,665,160	2.69	Core Value	Mod	Boston	No	No	Linda Selbach		No
7	TCW Asset Management Group	44,394,022	2.61	Core Growth	Mod	LA	No	Yes	Christopher Ainley		Yes
8	Capital Guardian Trust Company	38,542,568	2.27	GARP	Mod	LA	No	No	Sara Lang		Yes
9	Vanguard Group, Inc.	35,756,486	2.11	Index	Low	Malvern	No	No	Gary Cantwell		Yes
10	Capital International Ltd.	23,583,222	1.39	GARP	Mod	London	No	No	Seneca Judge		No
11	Oak Associates, Ltd.	21,835,069	1.29	Growth	Low	Akron	Yes	No	Violet Milenkovic		Yes
12	Janus Capital Management LLC	18,385,941	1.08	Aggres. Gr.	Mod	Denver	No	No	Kelly Kingery		No
13	INVESCO Capital Management	17,423,544	1.03	Core Value	High	Atlanta	Yes	No	Michelle Fenton		Yes
14	Nasdaq-100 Trust (QQQ)	16,325,324	0.96	Index	Low	Rockville	No	No	Jarvis Joseph		No
15	Northern Trust Investments	15,689,738	0.92	Index	Mod	Chicago	Yes	No	Karen Greene		No

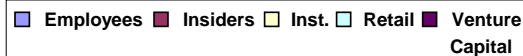
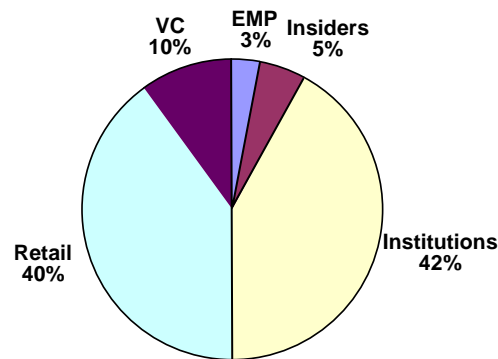
The Full Profile – Proxy Implications

After IPO – Window of Opportunity



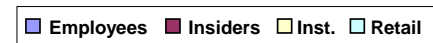
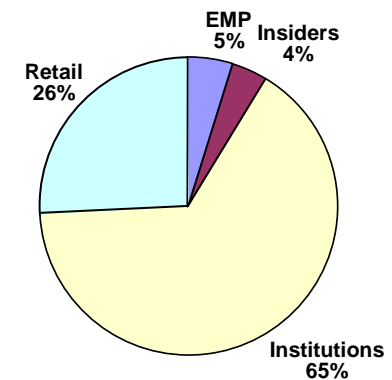
- Push through aggressive compensation programs
- Evergreen stock option plans
- Anti-takeover protections
- Ratify poison pill
- Loss of broker discretionary voting is significant

After Secondary – More Difficult



- Perform overall vote projection
- Retail component is key
- Routine, or aggressive follow up
- Loss of broker discretionary voting is significant

Third Year – Institutional Control



- Anticipate Proxy Advisor recommendations
- Perform overall vote projection
- Leverage IR relationships with analysts and portfolio managers
- Improve your proxy messaging

End of the “Routine Meeting”

- Growing range of reasons investors and advisors “withhold votes” from directors and monitor audit (vs. non-audit) fees
- Withhold votes gain real teeth if majority vote standard becomes implemented
- Proactively advise management and Board of potential causes for director withholds and other negative voting
 - “Shouldn’t you have foreseen this?”
 - “What can we do in advance of next year?”

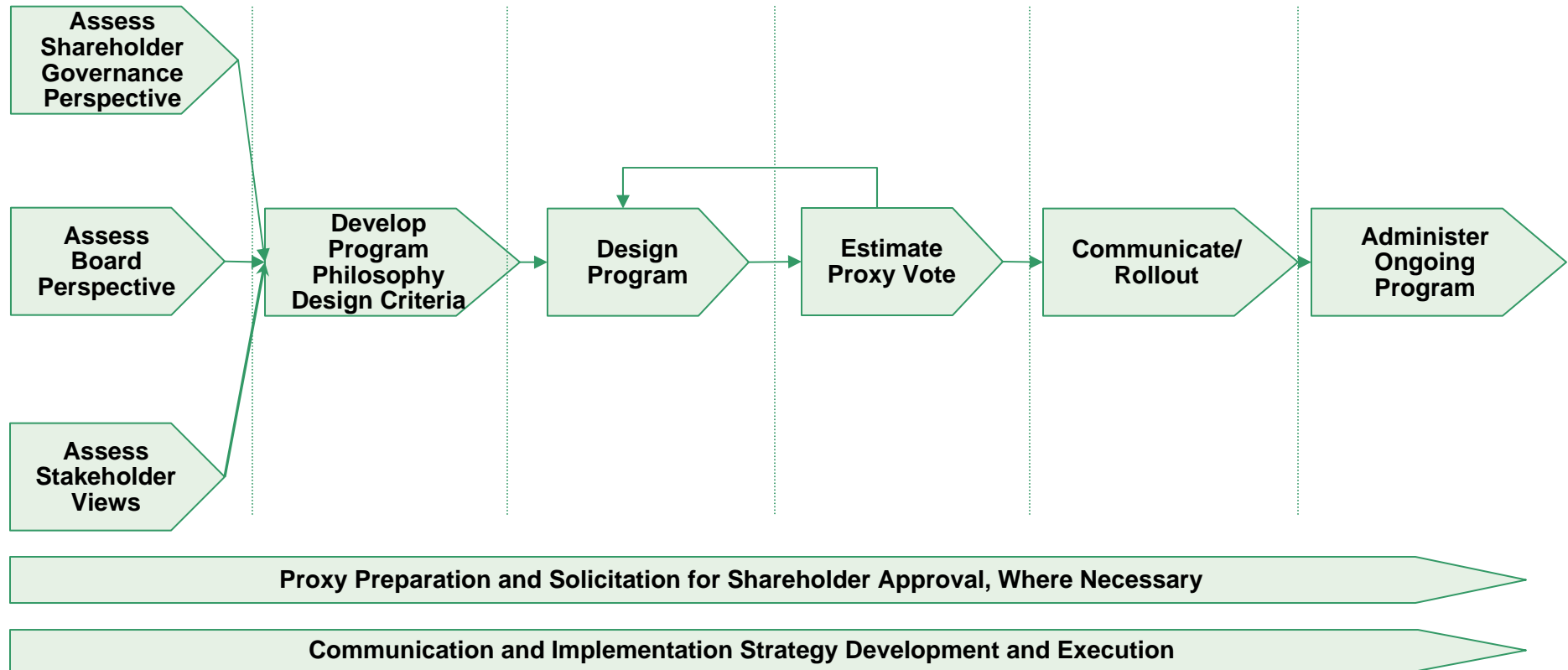
Coordination Is Key – the Internal Team

- Most governance matters, particularly executive compensation, require a coordinated, cross-functional approach
 - CEO and Compensation Committee of the Board
 - Investor Relations
 - Corporate Secretary / Legal
 - Finance
 - Human Resources
 - Corporate Communications
 - Plan Administration

Communication Is Critical

- Review last year's working group (internal and external). Is this the right team for the new environment and related challenges?
 - E.g., law firm, comp consultants, proxy solicitor, IR agency, transfer agent, printers, other
- Review your company programs, plans, policies, and bylaws relative to issues of concern to your investor profile
 - Proactively address governance practices and ensure consistent messaging
 - Investors can seize upon perceived weaknesses or inconsistencies
- Engage investors and their advisors as early as possible
 - Analyze your investor base; previous vote results; degree of proxy advisor influence and corporate governance tolerances
 - Estimated number of companies testing "Issue Compass" model:
 - Q1-2004: 195
 - Q1-2005: 216
 - Q1-2006: ???

What Might the Process Look Like?



[thank you]

Thank You!

Questions?

email now to:

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