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**Ten Equity Compensation Issues That
Affect All Stock Plan Managers
(That Maybe No One Told You About)
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Agenda

- » Why We're Discussing This
- » The Ten Issues
- » Your Next Steps

Why We're Discussing This

- What we're accustomed to now
 - FAS123R
 - IRC 409A
 - ISS voting policy
 - Proxy CD&A
- The New Era of Influences on Equity Plan Design
 - Dodd-Frank
 - Say-on-Pay
 - CEO pay-for-performance disclosure
 - CEO pay ratio disclosure
 - Clawbacks
 - ISS GRId, pay-for-performance

The 10 things you need to know

1. Compensation Committee
2. Consultant independence
3. Institutional shareholders
4. Proxy advisors
5. Say-on-pay
6. Peer groups
7. Market data
8. Performance awards and relative assessments
9. Clawbacks
10. CEO Pay Ratio

1. How your Compensation Committee operates

Issues:

- » Board of Directors = part-time job
 - › Multiple Board memberships
- » Compensation Committee = part-time job in part-time job
 - › Multiple committee memberships for independent Directors
- » McKinsey Study: Survey of Board members
 - › Board members work an average of 28 days per year
 - › Feel they need to work 38 days per year (+36%) to do job well
 - › Feel they're only paid for 25 days per year

1. How your Compensation Committee operates

Issues (continued):

- Internal issues
 - Binder sent in advance of meeting - thick
 - Ambitious agendas and fixed time slot
 - Continual change of data from what was presented previously
- External issues
 - One eye on the CD&A and say-on-pay
 - Risk aversion due to litigation
 - Concerns about media coverage and misinterpretation
 - Fear of a “withhold” vote damaging Board career

1. How your Compensation Committee operates

Outcomes:

- » Focus on external reference points – ISS, peers
- » References to other Boards on which they serve
- » Over-weighted anecdotal data points due to familiarity
- » Incremental, safe, supportable decisions
- » Increasingly micro-managing plan design with limited time
- » Reliant on independent consultant recommendations and “blessing”

1. How your Compensation Committee operates

What it means for the Stock Department:

- Absolute perfection on grant reports
 - Most errors and omissions will not be spotted at the Committee meeting
 - Extra scrutiny on Section 16 grants
- Committee approval – “must” vs. “nice to have”
 - Check the Committee Charter, ask General Counsel
- Increased sensitivity to Board members – personal information requests and service
- Well-documented approval process rigidly followed
- Don't get burned with Edgar CCC trouble
 - Numbers are unique to the individual Board member
 - Coordinate with other companies where Board member serves

2. How “consultant independence” affects plan design at your company

Issues:

- Dodd-Frank requirement: SEC direction to stock exchanges (rules pending)
 - Committee must consider consultant independence factors
- Company must disclose
 - Whether Committee retained an adviser
 - Existence of any conflict raised any conflict of interest
- Media coverage of egregious conflicts
- Independence flip side = disconnect from Company, business, management
- Named in say-on-pay lawsuits and seeking indemnification!

2. How “consultant independence” affects plan design at your company

Outcomes:

- » Focus on compliance, risk, consistency
- » May overweight ISS, shareholder perspectives at expense of business strategy and talent management needs
- » Often an attitude of “top five only”
- » Disconnected compensation strategy for top group vs. employee population
- » Apply top executive solutions downward to create perception of consistency
- » Often provide cursory recommendations that require management to design and implement

3. Which shareholders hold your shares, and what they think about equity compensation

Issues:

- “Institutional Shareholders” are corporate entities with large amounts to invest in companies, such as
 - Brokerages and mutual funds
 - State Pension Funds
 - University endowments
 - Union Pension Funds
- Other investors include:
 - Investment firms (venture capital, private equity)
 - Independent investors (hedge funds, wealthy individuals)
 - “Retail investors” (you and me)

3. Which shareholders hold your shares, and what they think about equity compensation

Issues (continued):

- These large shareholders constitute the major voting blocks in many companies
- Determine voting outcome on proposals for more shares in the equity plan, new equity plan, and say-on-pay
- Many conduct independent analysis of your company's executive and equity pay practices
- Your peer companies and competitors may have a very different shareholder base with more or less stringent shareholder-driven requirements

3. Which shareholders hold your shares, and what they think about equity compensation

Outcomes:

- You may be able to do things that your competitors cannot due to your shareholder base...and vice versa
- Investor communications that focus on equity compensation may be
 - Simple (with a small number of large and friendly shareholders)
 - Difficult (with dozens of shareholders who are large for you, but you're not large for them)
 - Nearly impossible (with a retail shareholder base that doesn't vote)

3. Which shareholders hold your shares, and what they think about equity compensation

What it means for the Stock Department:

- Get the facts... know who owns the company and how much
 - Translate this so you know what it means for your company
 - Not all institutions are created equal...Fidelity burn rates vs. ISS burn rates
 - The “Google” effect... be armed to explain to employees why your company can’t do the same thing as Google
- Voting matters
 - (Generally) institutional investors vote, retail investors don’t
 - Companies with broad retail ownership may still need to address institutional concerns for positive voting outcomes

4. Proxy advisors' view of your company, and the influence they have on your shareholders

Issues:

- Independent professional service firms such as
 - Institutional Shareholder Services (ISS)
 - Governance Metrics International/Corporate Library
 - Glass Lewis
- Self-appointed evaluators of companies' corporate governance practices
 - Sell their opinions to guide investors' voting
- Combination of highly-formulaic standards and vague "policies"
- Contradictions among proxy advisors' and institutional investors' policies = impossible to satisfy all

4. Proxy advisors' view of your company, and the influence they have on your shareholders

Outcomes:

- Companies unevenly affected based on shareholder base and those shareholders' policies and/or advisers
- Total compensation strategy (e.g., low cash and high equity) constrained by uniform dilution standards
- Uniform standards by industry ignore differences in business strategy, business model, growth rates
 - High growth firms offering larger new hire grants vs. shrinking firms with layoffs, high forfeiture rates
- Increasing resources required to monitor, contest, and lobby against advisers' voting recommendations

4. Proxy advisors' view of your company, and the influence they have on your shareholders

What it means for the Stock Department:

- Get the facts... how does your company rate? Who is responsible for this relationship? Is trouble on the horizon?
- Be prepared to respond quickly to data requests when trouble is brewing
- Understand the nuances of new/modified plans and how your system will accommodate (i.e., fungible share pools, revised share counting provisions)
- Improve your proxy advisory fluency:
 - › <http://blog.issgovernance.com/gov/>
 - › <http://blog.thecorporatelibrary.com/>

5. The say-on-pay voting outcome for your company, and your peers, this year

Issues:

- First year that investors were allowed to vote on companies' executive pay practices
 - Single vote on overall program, no specifics
- Only 40 firms failed the vote (<50% yes)
 - Many had “close calls” (51% to 70% yes)
- Pressure to respond to voting outcomes or “two strikes” rule
 - Vote against all Compensation Committee members next year
 - Maybe vote against entire Board

5. The say-on-pay voting outcome for your company, and your peers, this year

Outcomes:

- Companies failing, or threatened with failing, the vote made or will likely make piecemeal changes to their executive and equity pay programs – creating vagaries in “market data”
 - Performance conditions on shares *and options*
 - Policies on repricing, modifications, discretion
 - Pressure to be “formulaic”
 - Pressure to incorporate TSR as a performance measure
- These changes may introduce, or further, differences between executive equity compensation structures and those of the rest of the employee population

5. The say-on-pay voting outcome for your company, and your peers, this year

What it means for the Stock Department:

- Move beyond “Who cares about an advisory vote?”
 - Not all press is good press
- Change is in the air...say-on-pay may trigger a re-examination of equity, possibly triggering new system requirements, processes, and communications
- Sweetening the pot – modifications to outstanding awards to help ensure a positive vote: administrative and accounting issues
- Know what’s “good” (challenging targets, negative discretion, double triggers) and “bad” (repricing, liberal CIC, giveaway performance targets)
 - Expect more good, less bad

6. Who is in your proxy peer group(s), why, and how that may dictate your equity program design

Issues:

- Peer groups have emerged as a staple of competitive comparisons for executive pay and equity compensation
 - ISS burn rate table (industry)
 - ISS GICS group comparisons for Share Value Transfer (top quartile performers in industry)
 - Company proxy CD&A (self-selected)
- Company peer groups are a key reference point for Committees and external constituents
 - ISS and others have progressed from opining on pay versus peers to critiquing the peer group construction and profile

6. Who is in your proxy peer group(s), why, and how that may dictate your equity program design

Outcomes:

- Convergence toward the group “norm” as reflected in summary statistics
 - Occurred in UK due to shareholder pressure, then shareholders criticized uniformity of companies’ plan designs!
 - Emulating peers’ practices from last year may be copying practices now know to fail and being changed
- Companies within a peer group may vary greatly in structural and operating characteristics indicating need for differentiated plan
 - Strategy and life cycle phase
 - Degree of vertical integration, outsourcing
 - Core business strategy

6. Who is in your proxy peer group(s), why, and how that may dictate your equity program design

What it means for the Stock Department:

- Keep it straight
 - Document various peer groups (ISS, CD&A, Performance)
 - Include what happens upon a change in a Performance Peer Group
 - Acquisition, in-group merger, out-of-group merger, bankruptcy, major divestiture
 - Does the Plan specify this, or does it require Committee action?
 - Check out the proxies of your peers... their executive compensation practices may soon be yours

7. The market data being referenced by consultants and HR that don't reflect true market practices

Issues:

- Increased program complexity is not always captured in the peer group analysis leading to flawed conclusions about “market practice” – for example:
 - “Prevalence” of performance awards versus actual amount of pay subject to those awards with multiple-award LTI programs (options + RSUs + performance awards)
 - Performance awards are of lower value due to performance conditions (vs. RSUs)
 - Options granted at a lower strike price result in “less pay” than options granted at a higher strike price

7. The market data being referenced by consultants and HR that don't reflect true market practices

Issues (continued):

- Many aspects of pay program design and operation are not captured in survey data, for example:
 - Grant date fair value is the “pay amount” but goals are missed on a performance award and a modification is made resulting in a payout
 - “Footnote pay” in proxies often doesn't appear in automated databases

7. The market data being referenced by consultants and HR that don't reflect true market practices

Outcomes:

- Pay analysis is inconsistent with managers' and employees' anecdotal data points from
 - Their friends
 - Candidates
 - Prospective employers
 - Conferences
 - Media
- Increase in “special deals” and “one-offs” to deal with gap between reported market and actual market

7. The market data being referenced by consultants and HR that don't reflect true market practices

What it means for the Stock Department:

- Create (with HR and Comp) and deliver a consistent message about pay philosophy and market data
- Proceed with caution
 - ▶ Encourage a more comprehensive understanding of “trends” and “market data” before enacting sweeping change

8. Why performance awards, and relative assessments, are inevitable for your company and how to get out in front of the design process

Issues:

- US is following UK and Euro trend of performance conditions on all executive equity awards
- Committees are asking “why not for everyone- like with stock options?”
- Several years of experience provide lessons on plan design and operation
- Various providers are “selling” performance awards – and certain types of performance awards – as a cure-all

8. Why performance awards, and relative assessments, are inevitable for your company and how to get out in front of the design process

Issues:

- Market data now supporting performance awards as a “new norm”
- Performance criteria provide another “checklist item” for governance scoring

8. Why performance awards, and relative assessments, are inevitable for your company and how to get out in front of the design process

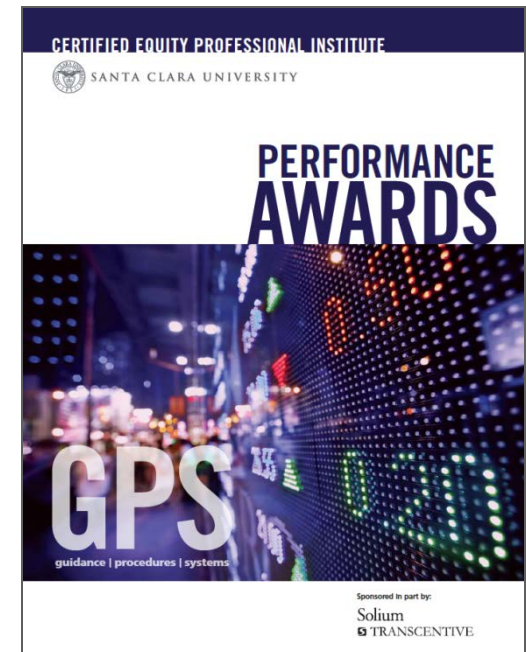
Outcomes:

- » Cursory plan design occurring
 - » Committees and executives are unaware of the leap in complexity from options and RSUs to performance awards
- » Systems unable to handle performance awards
- » Flaws in design are requiring post-grant fixes

8. Why performance awards, and relative assessments, are inevitable for your company and how to get out in front of the design process

What it means for the Stock Department:

- Increase your knowledge about performance awards and your capacity for tracking, communicating, financial reporting.
 - Small plan design changes = big administrative changes
- Insert yourself into the process... establishing the vest date, managing the financial reporting, providing for tax payments... make your needs known
- Petition for increased communication/education budget



9. Why clawbacks will create uncertainty around equity awards

Issues:

- Dodd-Frank Act requires stock exchanges to require clawback policy (“compensation recovery”) – executive officers – current and former
 - If company has to restate financial statements
 - Based on error, not based on intent
- Applies to “incentive-based compensation” awarded during preceding 3-year period
 - Includes stock options
- Clawback is for the amount paid *in excess* of what would have been paid under the restated financials

9. Why clawbacks will create uncertainty around equity awards

Outcomes:

- Waiting for SEC to issues rules – now first half of 2012
- Implementation of clawbacks will change officer-level equity plan participants' perception of value
 - Bonus and stock options can be clawed back
 - Salary and pension cannot
- Calculation difficulty TBD
 - Question: How much of the stock price increase was due to the inaccurate financial information?
- Recovery difficulty TBD
 - Options exercised, shares sold
 - Employee no longer employed at the company

9. Why clawbacks will create uncertainty around equity awards

What it means for the Stock Department:

- Fundamental shift in policy... only 32% of companies were using clawbacks*
- Review of grant agreements and current clawback language
- Changes to holding requirements to facilitate clawback
- Enforceability?
 - US existing grants
 - US new grants
 - Non-US existing grants
 - Non-US new grants

*2010 Deloitte NASPP Stock Plan Design Survey

10. What you're going to have to do to support the "CEO Pay Ratio" calculation (and potential "alternative" calculations)

Issues:

- Dodd-Frank requirement
- Ratio of CEO pay to median employee pay - worldwide
- Requires Summary Compensation Table method
 - Base, bonus, NEIP, stock options, stock awards
 - Changes in pension and NQDC value
 - "All other compensation"
- Still waiting for SEC regulations – first half 2012
 - May not be effective until 2013 proxy season for most companies
- Companies will begin voluntary disclosure and/or early calculations

10. What you're going to have to do to support the "CEO Pay Ratio" calculation (and potential "alternative" calculations)

Outcomes:

- Basic calculation will be straightforward for plan managers
- Alternative calculations will be generated for dialogue with investors and proxy advisors, and CD&A
 - Realizable pay vs. fair value
 - Realized pay vs. fair value
 - Adding ESPP to calculation (not a SCT item)

10. What you're going to have to do to support the "CEO Pay Ratio" calculation (and potential "alternative" calculations)

What it means for the Stock Department:

- Another report...
- And, yet, another report...and another...
- It's true – the stock component may be the easiest due to single source, consistent currency, and accessible reports
 - But, the stock component is the largest, thus increased sensitivity and urgency
- Address in employee communications
- Will the future introduce new award designs to minimize the equity impact on the pay ratio

Now What?

- » Understand these issues
 - » Be able to deliver a 25-word description of each issue
- » Ensure that your manager, and their manager, knows that you understand these issues
- » Plan now for 2012 proxy statement and investor communications
- » Provide initial calculations and list of implementation issues now
- » Consider how to translate volumes of data into a compelling single slide to get management's attention – partner with HR and Finance
- » Learn to translate stock department issues into the framework of concerns of the Compensation Committee
 - » Risk management, governance, media attention

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