TWIN CITIES COMPENSATION NETWORK

FUTURE ISSUES FOR COMPENSATION PROFESSIONALS TO CONSIDER

November 17, 2006

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TOPICS TO EXPLORE. . .

A. THE NEW COMPENSATION COMMITTEE REPORT

B. LEVERAGED RESTRICTED STOCK AWARDS

C. POTENTIAL COMPENSATION VULNERABILITIES

A. THE NEW COMPENSATION COMMITTEE REPORT

- New **Compensation Discussion and Analysis ("CD&A) Report** replaces **Compensation Committee Report (CCR)**
  - ⇒ Management report, filed and subject to CEO/CFO liability
  - ⇒ Describes executive compensation program and provides context for the SCT and other tables that follow
- New CCR requires only the following statements:
  1. Whether the compensation committee has reviewed and discussed the Compensation Discussion and Analysis report with management, and
  2. Based on this review and discussions, whether the compensation committee recommended to the Board of Directors that the CD&A be included in the company's annual report on Form 10-K and proxy statement*

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* John W. White, Director, Division of Corporate Finance, SEC, October 3, 2006, CFO Executive Board

A. THE NEW CCR (Cont'd.)

- We suggest consideration of an **Expanded CCR** to affirm the compensation committee's role and responsibility for executive compensation, and to frame pay-for-performance debate:

    1. Decisions on CEO Pay

    2. Pay-for-Performance Analyses

    3. Compensation Committee Governance

A. THE NEW CCR (Cont'd.)

1. DECISIONS ON CEO PAY

- Old rules required CCR to describe its decisions on CEO pay for prior year

  ⇒ Not explicitly required in new rules

- So, consider continuing this lapsed requirement in the new CCR

A. THE NEW CCR (Cont'd.)

2. PAY-FOR-PERFORMANCE ANALYSES

- Critics of CEO pay and executive compensation have defined the relationship between "pay" and "performance" and found no relationship; therefore, they claim pay is "out of control"
- These critical comparisons will worsen under the new rules, feeding ammunition to those who attack our system of public ownership of private enterprise
- Reason – critics will focus on "total" compensation in the new SCT, and such total is composed of elements that are not performance pay:
  - ⇒ Stock option grant values
  - ⇒ Performance share grant values
  - ⇒ Increases in pension values
  - ⇒ Special benefits and perks

A. THE NEW CCR (Cont'd.)

2. PAY-FOR-PERFORMANCE ANALYSES (Cont'd.)

- Suggest Compensation Committee help shareholders understand the CEO pay *does* align with performance by providing two supplemental analyses in the expanded CCR:

    1. Performance-Based Compensation Earned by CEO for 2006

    2. Accrued Gains/Losses on Stock Options and Unvested Restricted/Performance Stock for CEO for 2006

- See related document, "The New Compensation Committee Report"

A. THE NEW CCR (Cont'd.)

3. COMPENSATION COMMITTEE GOVERNANCE

- New SEC rules require description of compensation committee's processes and procedures for executive pay determination, including:
  - ⇒ Scope of authority,
  - ⇒ Extent of delegations,
  - ⇒ Role of executive officers in determining or recommending amount or form of executive compensation, and
  - ⇒ Role of any compensation consultants retained by committee
- This information should be included in expanded CCR

B. LEVERAGED RESTRICTED STOCK AWARDS

- Employee stock options are the greatest equity derivative ever invented
- But FAS 123R requirement to expense option grant date values makes them financially inefficient for many companies
  - ⇒ High fixed cost, amortized over vesting period regardless of performance
  - ⇒ Many employees discount the value of options (prefer RSUs)
  - ⇒ If underwater, retention value disappears but cost continues
  - ⇒ Tax deduction imperiled if options expire underwater

B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- In a time of option expensing, the only reason to grant options is to provide *market leverage* to management
  - ⇒ Market leverage is a valid compensation objective
- What's needed is a new equity device that provides market leverage while retaining some retention and motivational value in flat or down markets
- Our candidate – **Leveraged Restricted Stock Awards**

B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- LRSA is a hybrid stock option/restricted stock award
- LRSA is earned by continued employment (time vesting), just like plain vanilla RSA
- But number of shares earned is increased or decreased by price appreciation/depreciation over the vesting period by formula

B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- Formula is:

  NV = **NG** plus or minus (**NG** times Δ **FMV**), where,

  NV is Number LRSAs Vested,

  NG is Number LRSAs Granted,

  Δ FMV is Percentage Change in Market Price During Vesting Period

- Range of LRSA earnout is 0-200%
  - ⇒ 0% earnout at 100% depreciation
  - ⇒ 200% earnout at 100% appreciation

B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- Example:

  NG is 1,000 LRSAs

  FMV at grant is $30

  FMV at vesting is $45

  Therefore, Δ **FMV** is 50%

  1,000 LRSAs granted plus (50% x 1,000) is **1,500 LRSAs vested**

B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

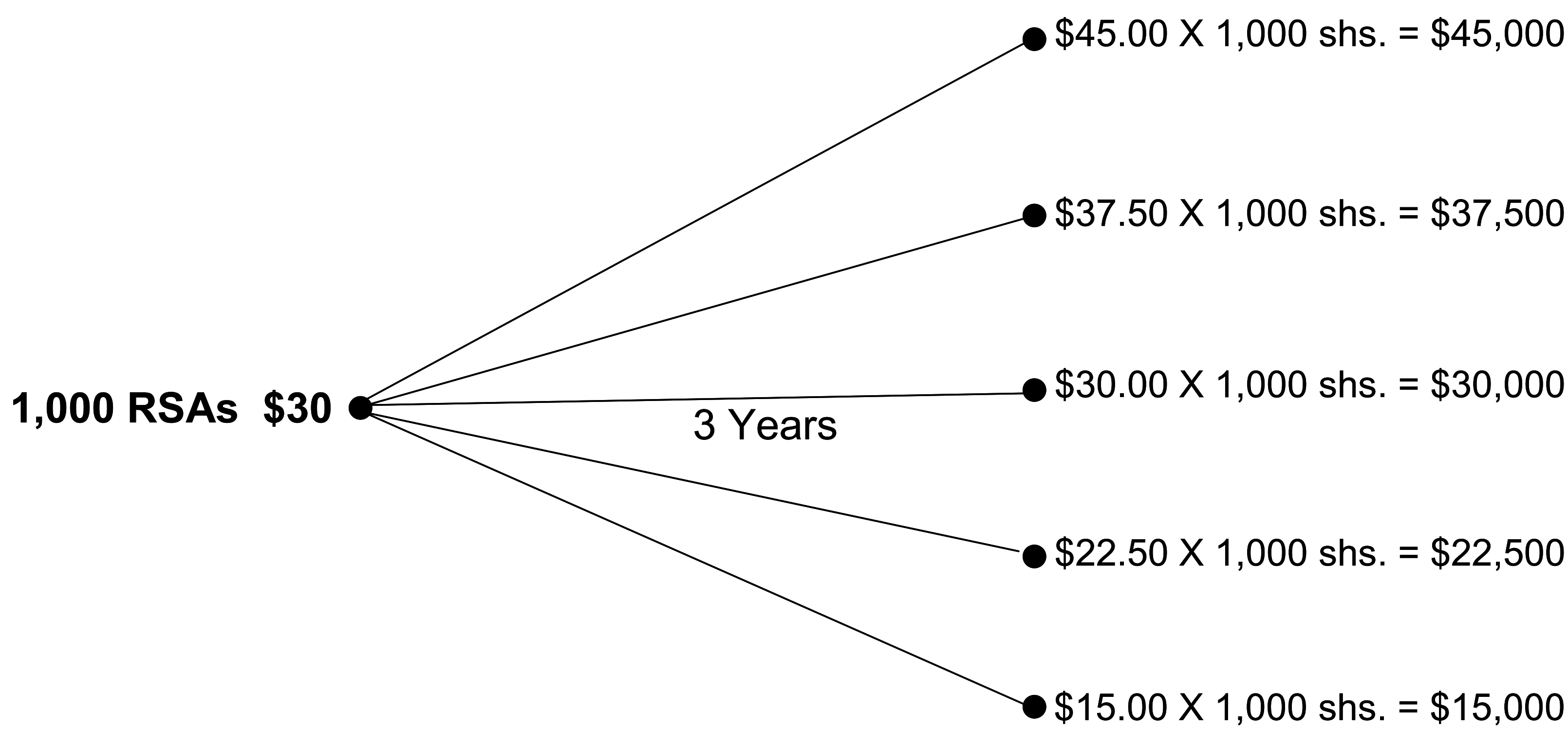
- Conversely, if Δ **FMV** had been negative 50%, half of the LRSA award would have been forfeited

- FAS 123R accounting should be fixed at grant, with number of LRSAs earned at vesting not trued up (market-based condition)

  $\Rightarrow$ Sunk expense, just like options

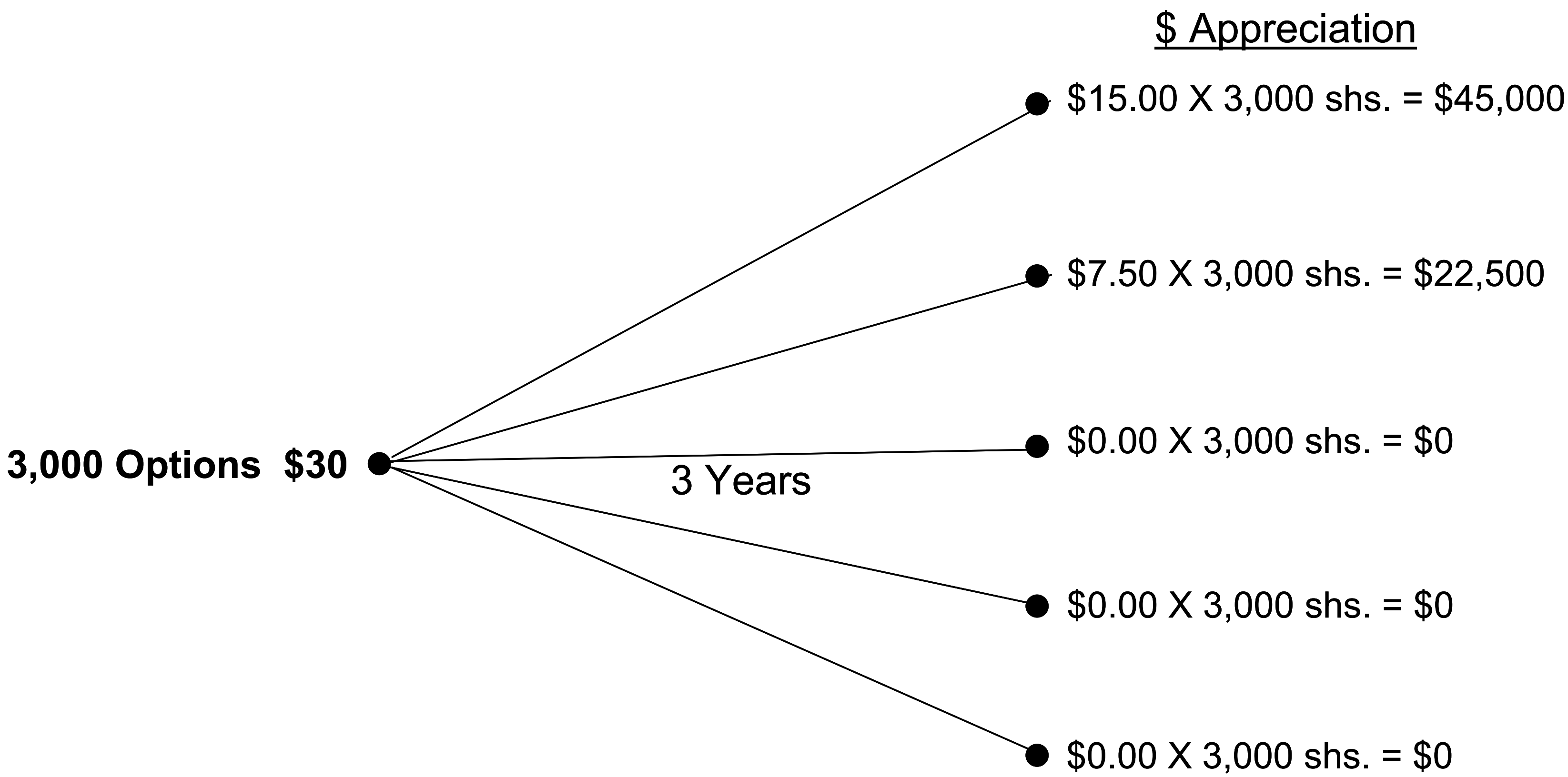
B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

❖ Base Case 1 – Plain Vanilla RSA



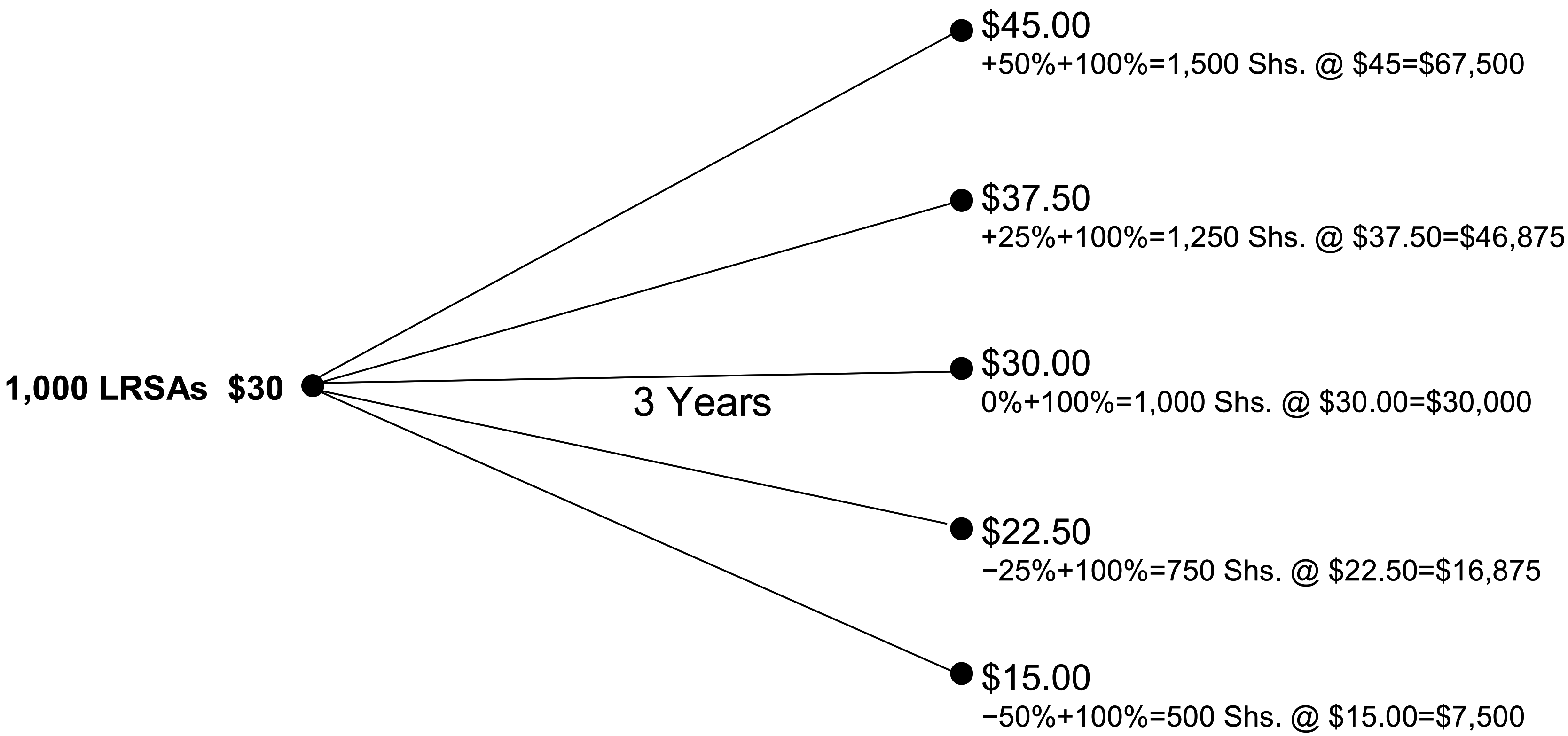
B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- Base Case 2 – Plain Vanilla Stock Options (3:1)



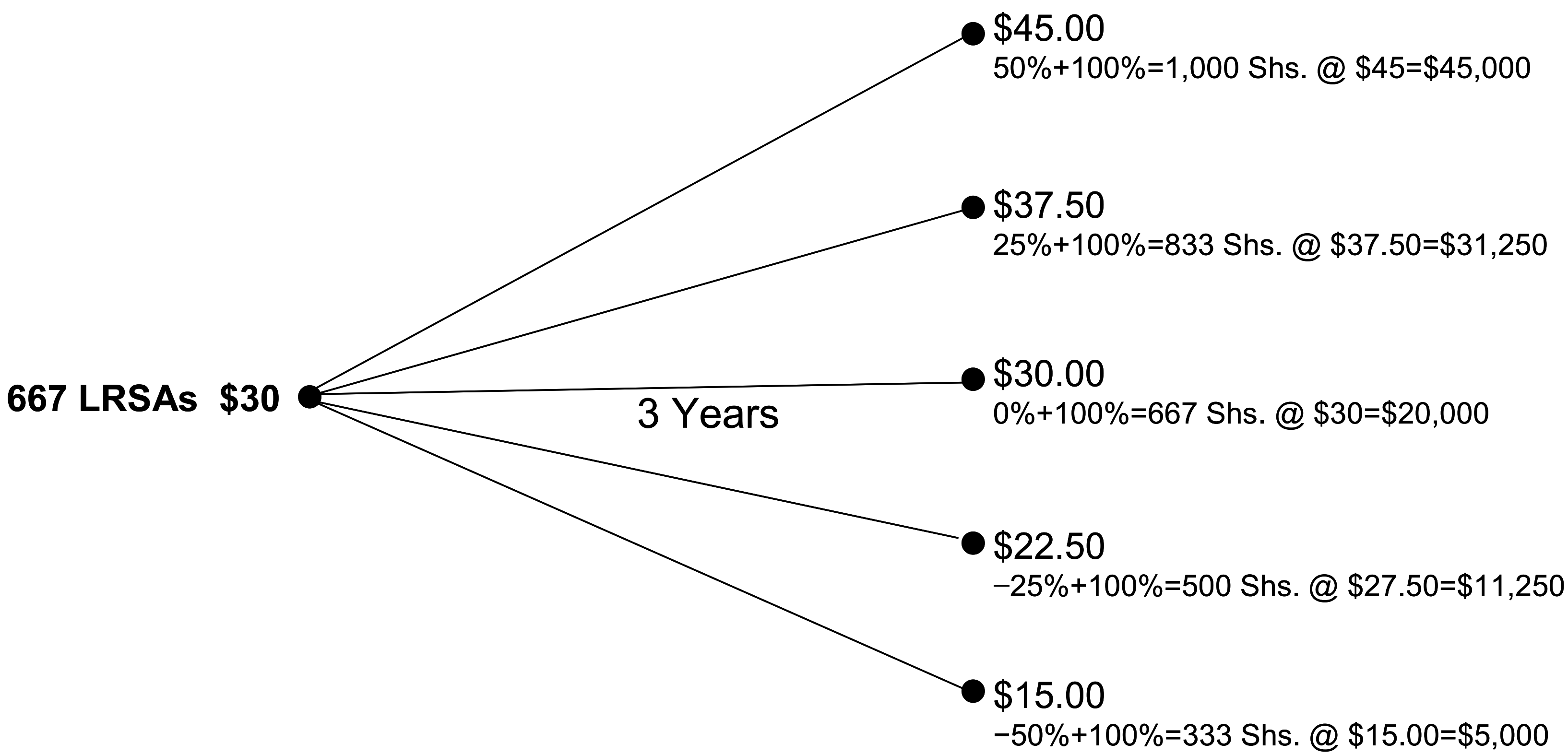
B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

❖ Leveraged Restricted Stock Award (LRSA)



B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- But $30,000 is too much to earn for 0% appreciation, so reduce the grant by **one third**

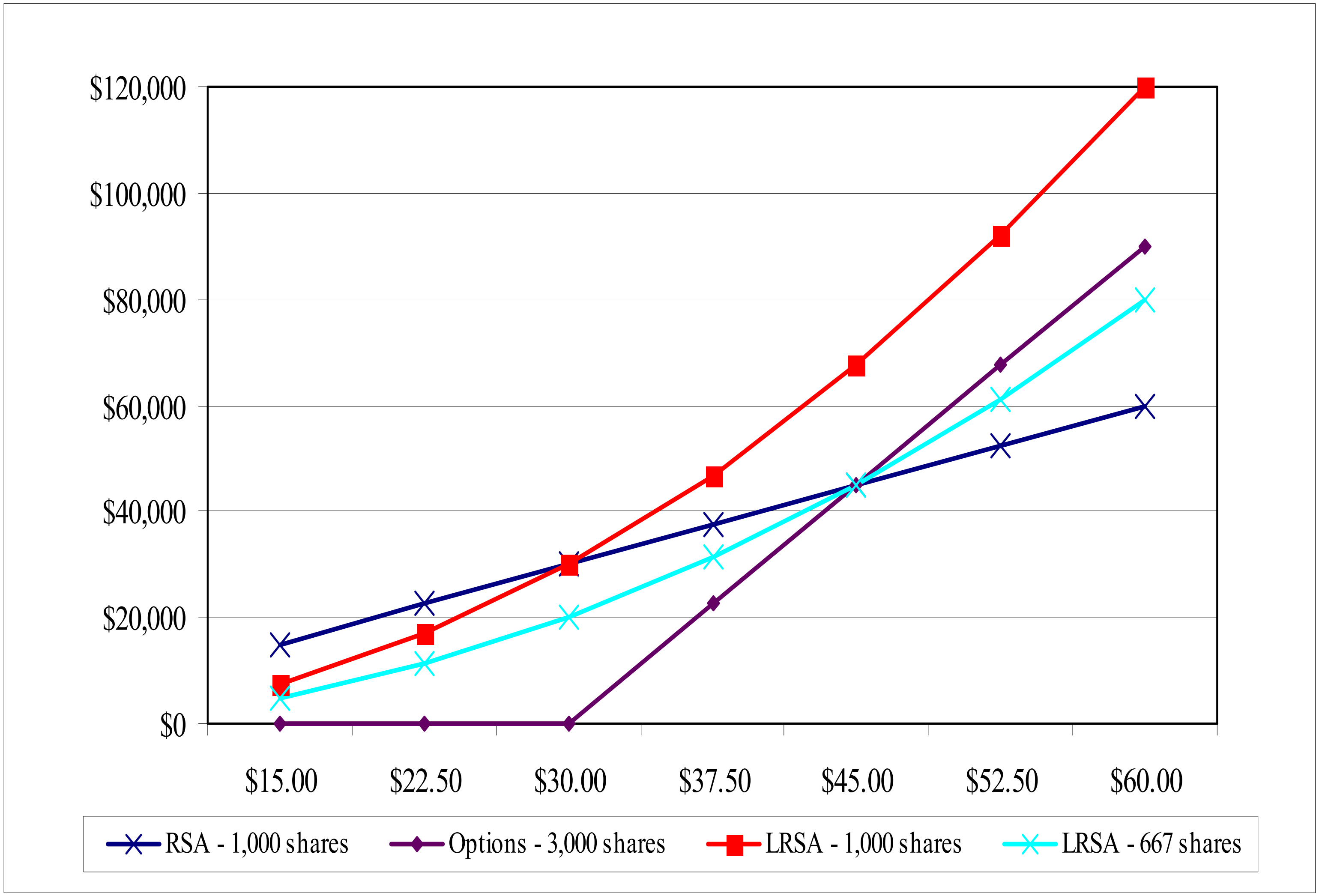


B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)

- Comparison of Outcomes

Vesting Price	RSA (1,000 shs.)	Option (3,000 shs.)	LRSA (1,000 shs.)	LRSA (667 shs.)
$60.00	$60,000	$90,000	$120,000	$80,000
$52.50	52,500	67,500	91,875	61,250
$45.00	45,000	45,000	67,500	45,000
$37.50	37,500	22,500	46,875	31,250
$30.00	30,000	0	30,000	20,000
$22.50	22,500	0	16,875	11,250
$15.00	15,000	0	7,500	5,000

B. LEVERAGED RESTRICTED STOCK AWARDS (Cont'd.)



C. POTENTIAL COMPENSATION VULNERABILITIES

- Why did no one anticipate the stock option backdating scandal and alert the compensation community to the risk?
- Are HR/compensation professionals complicit in initiating or supporting bad practices, or are they defenders of high ethical standards?
- What are other potential compensation risks and vulnerabilities out there waiting to be discovered and attacked?
- What can you do to identify problem areas and protect your company?

C. POTENTIAL COMPENSATION VULNERABILITIES (Cont'd.)

What Happened?

- Change in ethical standards
- Switch to "principles-based" standards from "rule-based" standards
- Emergence of new decision paradigm – "The ends do not justify the means if the means are legal but not right"
  - ⇒ What's right trumps what's legal
- Common thread of vulnerabilities: Placing the interests of executives/employees ahead of the interests of the company and its shareholders

C. POTENTIAL COMPENSATION VULNERABILITIES (Cont'd.)

Fraudulent Actions

1. Doctoring compensation committee minutes to change decisions more favorable to management

2. Paying management more than called for by compensation committee decisions

   ⇒ Payroll instructions not signed by compensation committee chair

3. Awarding incentives not justified by or reconciled to financial statements

   ⇒ No reconciliation to GAAP or certification by CFO

4. Claiming tax deductions for top 5 pay without full compliance with IRC 162(m)

5. Doctoring flight logs to make personal travel appear as business travel

C. POTENTIAL COMPENSATION VULNERABILITIES (Cont'd.)

Actions of Questionable Ethics

1. Making special compensation arrangements with management to win their support for corporate transactions (mergers and buyouts)

2. Granting options or equity after a company tragedy

3. Maintaining attractive health, welfare and retirement benefits for executives when cutting them back or eliminating them for other salaried employees

4. Amending shareholder-approved incentive or equity plan in a way that meets NYSE/NASD requirements, but is a clear and significant deviation from what shareholders approved

5. Mega equity grants to new CEO before public announcement

C. POTENTIAL COMPENSATION VULNERABILITIES (Cont'd.)

Actions of Questionable Ethics (Cont'd.)

6. Implementing SEC 10b5(c)(1) selling programs but then stopping them based on inside information
7. Unreasonable tax imputation and reimbursement policies for personal use of corporate aircraft
   - ⇒ E.g., SIFL rates, security excuse and tax grossups
8. Corporate aircraft use for outside board meetings characterized as business use, while pocketing the fees
9. Screening potential consultants to compensation committee for bias against current program
10. "Springloading" equity grants to achieve a lower option price/expense

C. POTENTIAL COMPENSATION VULNERABILITIES (Cont'd.)

11. Misuse of survey statistics to support executive pay decisions not otherwise supportable
12. Canceling and reissuing underwater options
13. Other?

C. POTENTIAL COMPENSATION VULNERABILITIES (Cont'd.)

NOTABLE QUOTES

- **Warren Buffett** – "So, at Berkshire, let's start with what is legal, but always go on what we would feel comfortable about being printed on the front page of our local paper, and *never* proceed forward simply on the basis of the fact that other people are doing it."

  ⇒ Internal memo, September 27, 2006

- **Ben Stein** – "Is there any higher goal at all for management than serving the stockholders openly and honestly? Is "competitiveness" even a meaningful word, compared with honesty and integrity in serving the owners of the company? What can "competitiveness" mean in this context?"

  ⇒ New York Times, October 29, 2006

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