

Essex § Partners

A Division of Keystone Partners



Executive Compensation – “Something’s happening here ...”

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Session Overview

- I. The Primary Drivers of Change**
- II. The Trends and Responses**
- III. The Implications**
- IV. Questions and Discussion**

I. The Primary Drivers of Change

- | | |
|-------------------------------------|---|
| 1. Public scrutiny – | ISS, TIAA-CREF and more Media “feasts” |
| 2. Expensing stock options – | FAS 123(R) |
| 3. Deferred compensation – | IRS 409(A) |
| 4. Full disclosure – | SEC proposes changes to proxy filings |
| 5. Increasing compensation – | Attract and retain talent |

I. The Primary Drivers of Change

Highlights of the changes in regulations:

FAS 123(R):

- 1. The “Fair Value” of stock options is a corporate expense as they become vested – 2006 full implementation.**
- 2. The “cost” is determined by an acceptable valuation methodology – Black-Scholes, Binominal Lattice, others.**
 - Expected term – How long people will keep them.
 - Volatility – Trading range for the stock.
 - Vesting Periods – Establishes the “projected” cost
 - Record Keeping – Reconcile expensed with actual experience.
- 3. The changes have almost leveled the playing field with other equity ownership vehicles. Which is the most “cost-effective?”**

I. The Primary Drivers of Change

Highlights of the changes in regulations:

IRS 409A:

- 1. Expands the definition of “nonqualified deferred compensation.” More requirements on what and when it is considered deferred. The penalty is expensive.**
- 2. Elections for deferred compensation:**
 - Service based – before the beginning of the calendar year.
 - Performance based – 6 months before the end of the period.
- 3. Applies to many forms of compensation (may include):**
 - Salary and bonus deferrals
 - Stock appreciation rights (SARs) – settled in cash or stock
 - Restricted stock units (RSU’s but not restricted stock)
 - Long-term Incentive Plans (cash), retention payments
 - Severance and change of control arrangements

I. The Primary Drivers of Change

Highlights of the changes in regulations:

SEC Proposed Regulations on “Full Disclosure:”

- 1. Primary principles of the new disclosure requirements:**
 - A. *Simplify the information* – so people can understand it.**
 - B. *Include everything* – move from footnote to table**
 - C. *Do the math* – calculate the total “tab”**
- 2. If approved, it will phase in over 3 years and likely to apply to all current and future “deals.”**
- 3. Introduces new terms:**
 - NEO – “Named Executive Officer”**
 - PEO – “Principal Executive Officer” (aka CEO)**
 - PFO – “Principal Financial Officer” (aka CFO)**

I. The Primary Drivers of Change

Highlights of the changes in regulations:

SEC Proposed New Disclosure Requirements:

Primary Table:

- ✓ Total (Direct) Compensation
- ✓ Salary
- ✓ Bonus
- ✓ Full Value Stock Awards
- ✓ Value of Stock Option Awards (in dollars – options, SARs, etc.)
- ✓ Non-Stock Incentive Compensation (RSU, phantom, cash, etc.)
- ✓ All Other Compensation (pension accruals, deferred compensation earnings, perquisites, insurance premiums, tax gross ups, etc.)

I. The Primary Drivers of Change

Highlights of the changes in regulations:

SEC Proposed New Disclosure Requirements:

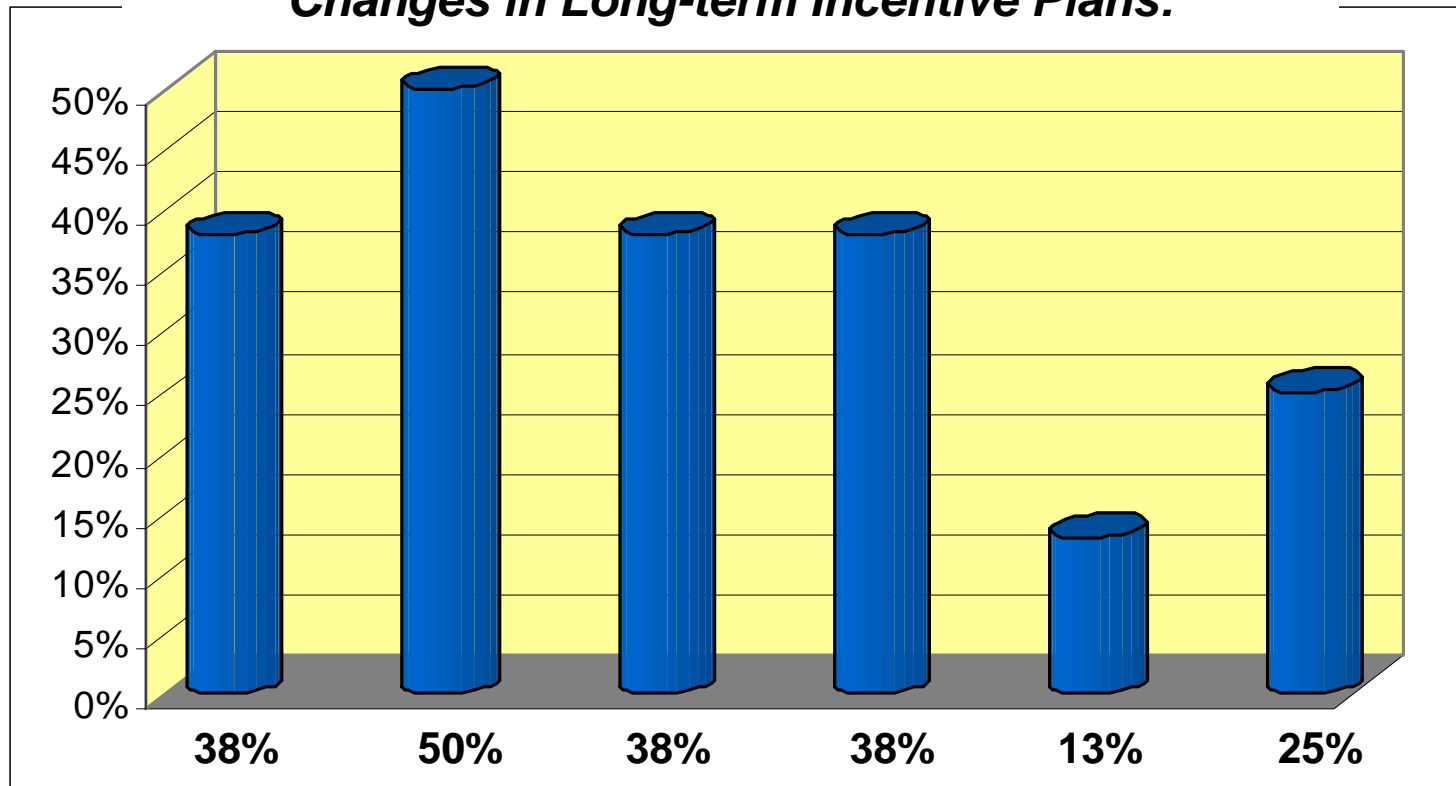
Supplemental Tables:

- ✓ **Performance based grant awards**
- ✓ **All other equity award grants (not performance based)**
- ✓ **Retirement benefits and post-employment compensation**
- ✓ **Deferred compensation**
- ✓ **Severance and change of control arrangements**
- ✓ **Plan descriptions – “Plain English” no boilerplate**

II. The Trends and Responses

So . . . What is happening now?

Changes in Long-term Incentive Plans:



No change

Decreasing
number of
options
awarded

Decreasing
number of
people
receiving

Converting
value to
other
equity
vehicles

Converting
value to other
cash comp.
vehicles


Still
considering
alternatives

Source: "2005 Wilson Group Survey of Changes in Variable Compensation Plans"

II. The Trends and Responses

So . . . What is happening now?

Top Executives	Use -- No Change	Started or Increasing	Eliminated or Decreasing	Changed Plan's Structure	Do Not Use
Individual Incentives	56%		4%	16%	24%
Unit based Incentives	29%			10%	61%
Profit Sharing	25%	6%		6%	63%
Stock Options	44%		25%		29%
Restricted Stock - Time Based	6%	13%	6%	6%	69%
Restricted Stock - Performance	6%	19%		6%	80%
Stock Appreciation Rights	13%		6%		81%
Long-term Cash	27%	5%	5%		63%
Non-Qual. Deferred Comp.	41%	5%		5%	49%
Sign on-Hiring Bonus	67%	8%	4%		21%
Retention Bonus	33%	10%			62%
Spot Bonus	35%	5%	5%		55%

 This shows the programs that are starting, being eliminated/reduced, or are changing (over 10%)

II. The Trends and Responses

1. Expanding the use of “alternative” equity vehicles.

Stock Option – Restricted Stock – RSU – SAR – LTIP

2. Increasing the “performance” requirements.

Types of Metrics – Frame of Reference – Goals – Weighting

3. Assessing the effectiveness: “ROI” and “ROE.”

Return on Investment – versus – Return on Effort

III. The Implications

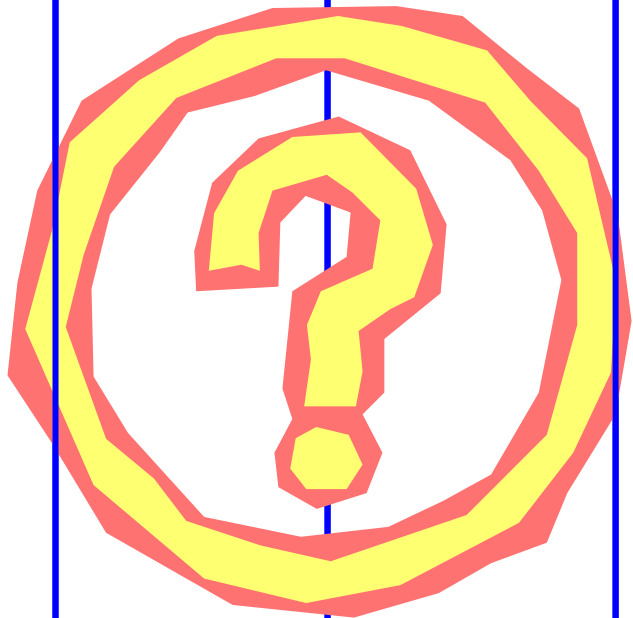
What companies are (or should be) doing:

- 1. The philosophy is no longer just “boiler plate.”
It needs to provide a meaningful framework for making decisions and assessing program effectiveness.**
- 2. The measures you select are more important than ever.
They not only determine the amount, they will be visible to shareholders and employees.**
- 3. The vehicles you use will impact the perceived and true value.**

III. The Implications

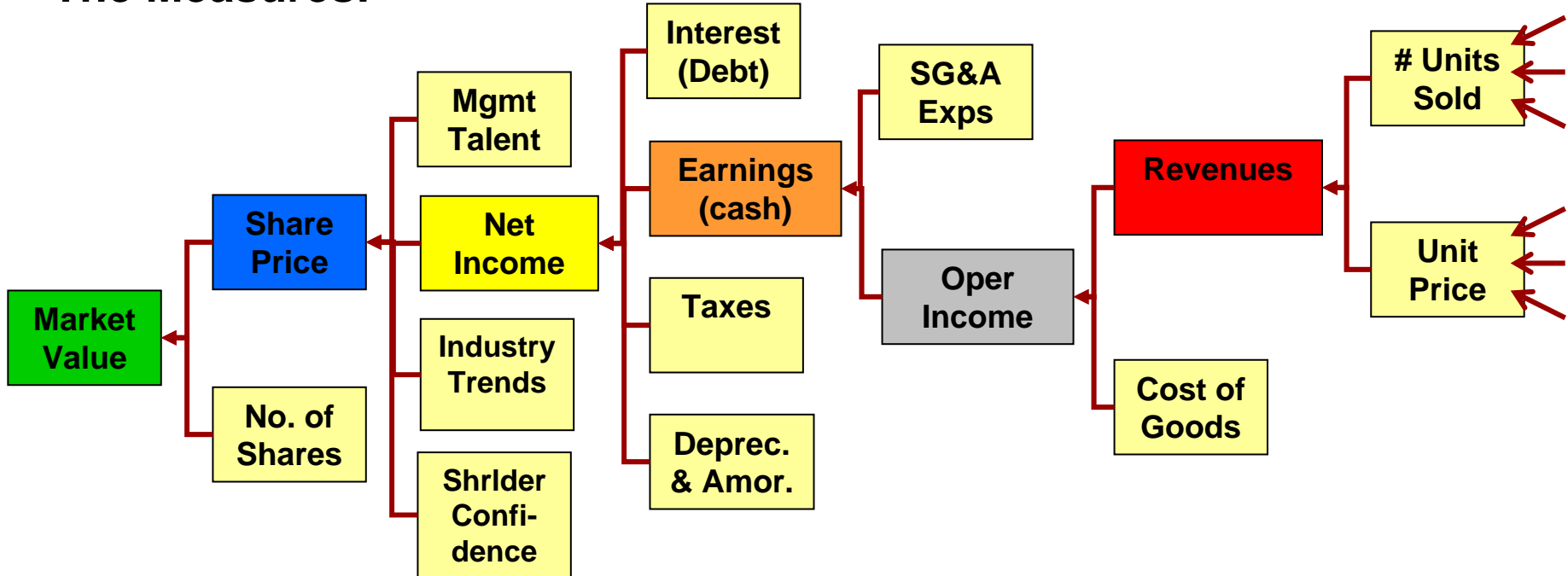
The Philosophy:

1. Primary objectives for each element
2. Who is included in what type of plan
3. Your market reference and desired position
4. Distribution of your "Total Direct Compensation \$\$"
5. Opportunities and Requirements

<i>Start-up Venture</i>	<i>Emerging Growth</i>	<i>Market Dominate</i>	<i>Turnaround – Transform</i>
			

III. The Implications

The Measures:



1. Where should you focus attention and desired behaviors?
2. What is your frame of reference – past results, desired results or external benchmark practices?
3. What should be the relative weighting of the measures for each executive?

III. The Implications

The Vehicles:

Compare Stock Options to Restricted Stock

Assumptions: Exercise or Grant Price is \$20.00 per share
3 year vesting term for the equity award
Executive 1 was awarded 10,000 stock options
Executive 2 was awarded 2,600 restricted shares (4:1)

Scenario A: Share price grows to \$27 per share (35%)

Scenario B: Share price grows to \$40 per share (100%)

Scenario C: Share price declines to \$10 per share (-50%)

III. The Implications

The Vehicles:

<u>Scenario A: \$20 - \$27/shr</u>	
Stock option:	Restricted stock:
10,000 SO's	\$2,600 SO's
X	X
<u>\$7.00 Gain</u>	<u>\$27.00 per shr.</u>
\$70,000 Value	\$70,200 Value

<u>Scenario B: \$20 - \$35/shr</u>	
Stock option:	Restricted stock:
10,000 SO's	\$2,600 SO's
X	X
<u>\$15.00 Gain</u>	<u>\$35.00 per shr.</u>
\$150,000 Value	\$91,000 Value

<u>Scenario C: \$20 - \$15/shr</u>	
Stock option:	Restricted stock:
10,000 SO's	\$2,600 SO's
X	X
<u>\$0.00 Loss</u>	<u>\$15.00 per shr.</u>
\$ 0.00 Value	\$39,000 Value

1. Which would you prefer – options or restricted stock?
2. Which would shareholders prefer?
3. What else should be considered in this decision?

IV. Discussion Questions

What will the future hold?

1. Will these changes increase or decrease shareholder confidence on executive compensation?
2. Will Boards, Compensation Committees and Executives have more or less accountability? Will this job get easier or harder?
3. Will executive compensation increase or decrease?
4. Will these efforts create better alignment between executive compensation and company performance?
5. Will the number and types of executive compensation plans increase or decrease?

A Thought to Remember

***“Measures give rewards relevance,
and rewards give measures meaning.”***

-- Thomas B. Wilson
*“Innovative Reward Systems
for the Changing Workplace”
(McGraw-Hill, 2003)*



Our Mission:

“We help our clients assess, design and implement their total performance compensation systems so they can more rapidly and effectively implement their strategic plans and create a high performance organization.”

- ✓ Develop Total Rewards Strategies to focus time and money
- ✓ Link Executives and Boards of Directors with the Strategy and Shareholders
- ✓ Utilize Sales Incentives to Build Market Leadership
- ✓ Build Performance Driven Incentive Programs – Cash and Equity Based
- ✓ Create Performance/Competency Focused Base Pay Programs
- ✓ Make Performance Recognition Special
- ✓ Re-engineer the Performance Management Process

Available Resources:

- ✓ *Innovative Reward Systems for the Changing Workplace* (McGraw-Hill, revised 2003).
- ✓ *Rewards that Drive High Performance: Success Stories from Leading Organizations*
- ✓ *Variable Cash Compensation: 2005 Survey of Trends and Practices*
- ✓ *Survey on What is Changing for 2006 – Total Variable Compensation Plans*
- ✓ *FAS 123(R) -- What Are Your Options Now?*

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