



# **Balancing Creativity and Compliance in Equity Plan Design**

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Orange County NASPP Chapter  
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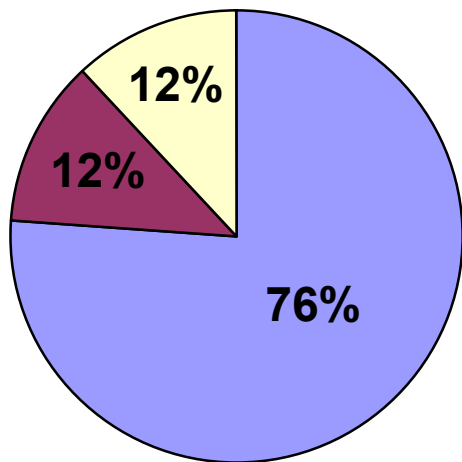
# Changes in Equity Plans – Recent Surveys

Changing mix of equity vehicles

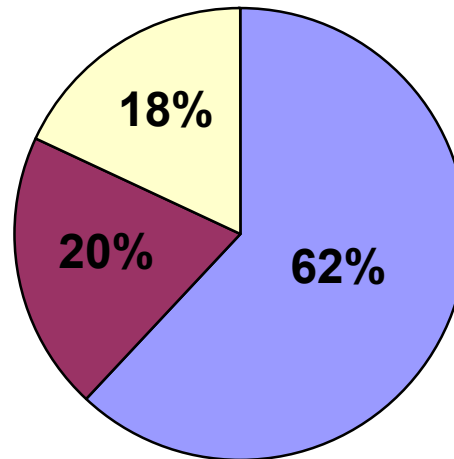
- Size and participation of stock options decreasing
- Increased prevalence in grants of restricted shares, stock-settled SARs, performance shares

## CEO Long-Term Incentive Mix

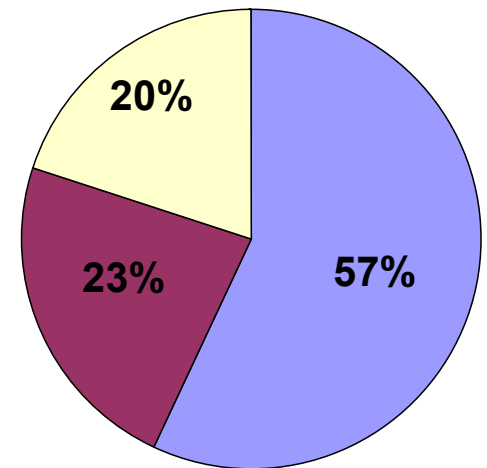
2002



2003



2004



Stock Options

Restricted Stock

Performance Shares/Units

Source: Mercer HR Consulting

# Drivers of Change



## Internal Drivers

- Special circumstances
- Attain specific goals
- Company's stage of life
- Conservation of shares
- Retention



## External Drivers

- Institutional shareholders
- Regulations
  - FAS 123(R)
  - IRC 409(A)
- Stock market performance
- Labor market

# Survey of Institutional Shareholders by Vivient Consulting and Pensions & Investments



## Proxy Voting

- 68% regularly engage in proxy voting
- 30% regularly engage in voting against Board-sponsored equity/bonus plans



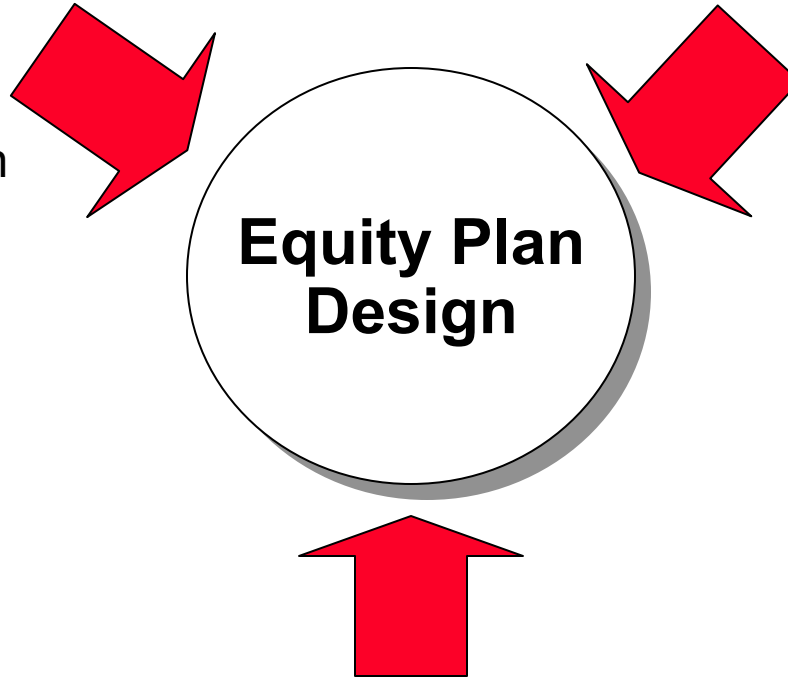
## Important/Very Important

- Executive compensation policies
- Using a pay-for-performance system to compensate top executives
- Requiring executives to hold their equity grants for a minimum period

# Considerations and Constraints

## Internal Company Considerations

- Expense
- Share conservation
- Tax treatment
- Internal equity
- Strategy
- Culture



## External Compliance

- Accounting
  - FASB 123(R)
- Tax
  - IRC 409(A)
  - Section 162(m)
  - Section 280(G)
- SEC/Legal requirements
  - SOX
  - Securities Law

## Conforming Peer Practices

- “Best-practices” pay & governance
- Competitive opportunity
- LTI trends
- Dilution/equity overhang

# Balancing compliance and creativity



## Compliance

- Different perspectives
- Regulations
- Opting out

## Creativity

- Holistic long-term incentive approach
- Customized

# Board's Desired Equity Plan– the Five C's

## Customized

- Meets objectives
- Takes into account company's situation and constraints

## Communicated

- Is transparent to shareholders
- Understood by participants

## Compliant

- Satisfies regulatory requirements
- Follows good corporate governance and executive compensation “best practices”



## Competitive

- Falls within competitive range
- Stays within mandated guidelines
- Is affordable

## Compelling

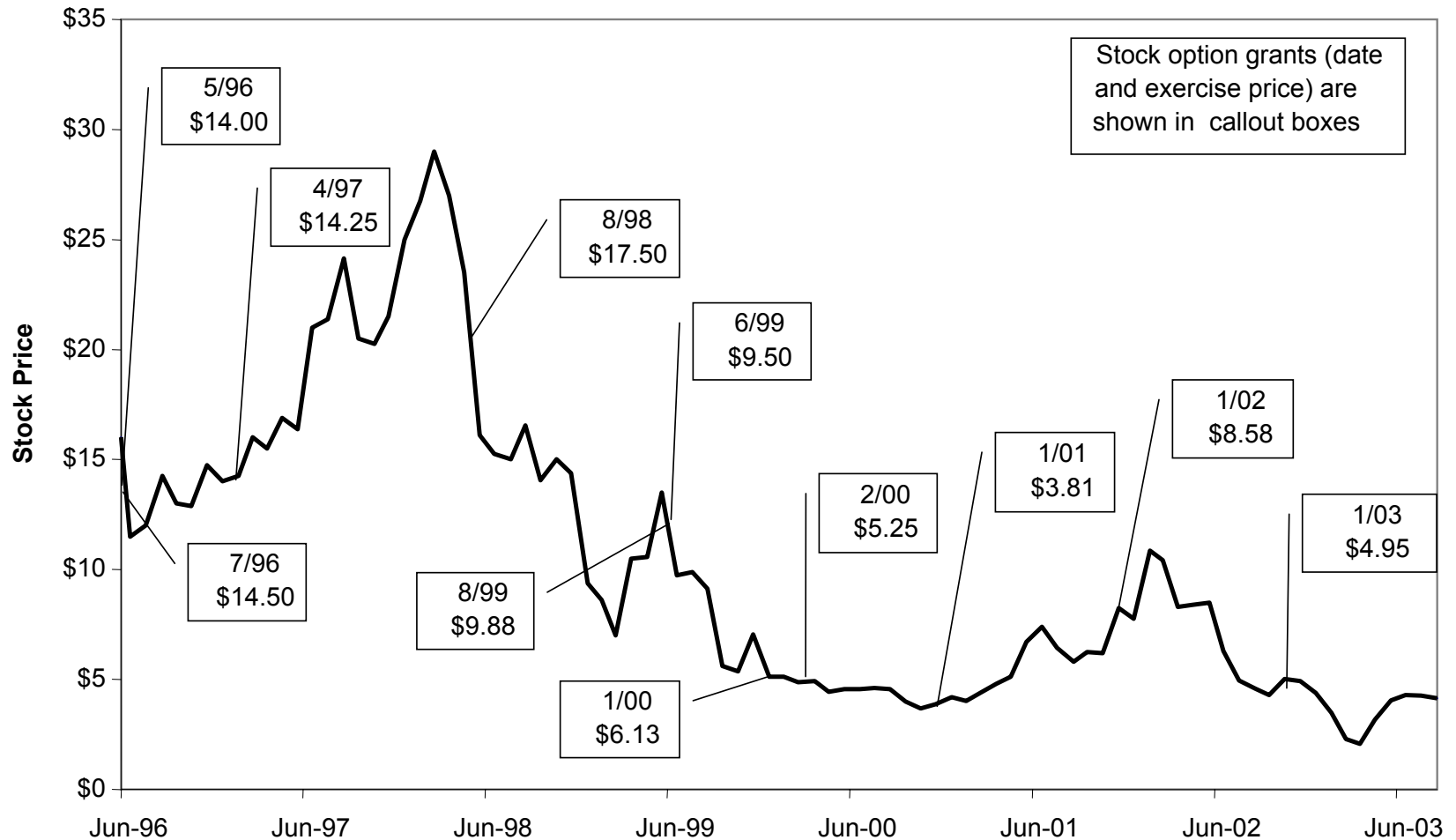
- Pays for performance
- Has high perception value

# Customized

- What is the Company's situation/context?
  - TransCo.
  - FAS-driven inquiry
  - Company turn-around situation
  - Establish new growth platform, declining base business
  - Squeezed margins, depressed stock price

# TransCo. Stock Performance

## Stock Prices and Option Grants



## Customized – *cont'd*

- What are the key objectives of the Plan?
  - Focus/motivate executives to achieve new strategy
  - Key metrics: revenue growth, revenue mix, profitability
  - Provide greater motivational value than stock options, which are deeply underwater
- Which equity vehicle is appropriate?
  - Share conservation an issue

# Evaluating equity vehicle – pros and cons

<u>Objective</u>	<u>Stock Options</u>	<u>Restricted Stock</u>
Conserves shares	<input type="radio"/>	<input checked="" type="radio"/>
Is cost effective ( <i>accounting-basis</i> )	<input checked="" type="radio"/>	<input type="radio"/>
Is simple to understand	<input checked="" type="radio"/>	<input checked="" type="radio"/>
Provides significant upside opportunity	<input checked="" type="radio"/>	<input type="radio"/>
Links executive interest to shareholder interest	<input checked="" type="radio"/>	<input checked="" type="radio"/>
Promotes retention	<input type="radio"/>	<input checked="" type="radio"/>
Encourages stock ownership	<input type="radio"/>	<input checked="" type="radio"/>
Exposes executive to investment risk	<input type="radio"/>	<input type="radio"/>

*Completely Satisfies Objective*  
  *Partially Satisfies Objective*  
  *Does Not Satisfy Objective*

# Competitive

- **What should be the opportunity?**
  - Benchmark to a composite peer group (revenue/industry, data from proxy & survey)
  - Cash positioning in third quartile; total direct compensation positioning below median
  - Opportunity to grant additional equity subject to share affordability
- **In aggregate, what is the overall expense and dilution/equity of the program?**
  - Current situation: market levels of overhang, however high underwater o/s grants, low availability of shares
  - Need to go to shareholders for additional authorization

# Compelling

- What should be the pay-for-performance profile?
  - Balance retention vs. performance requirements
  - Annual time-based restricted stock grant
  - Three-year, front-loaded, service-based restricted stock grant

## Vesting Accelerator Matrix

(The percentage of the total restricted stock grant that vests)

Profit Margin	Revenue				(Annual growth) (\$MM)
	5.0%	10.0%	15.0%	20.0%	
	<b>\$434</b>	<b>\$499</b>	<b>\$570</b>	<b>\$648</b>	
<b>1.5%</b>	15%	29%	43%	58%	
<b>2.0%</b>	25%	39%	53%	68%	
<b>2.5%</b>	35%	49%	63%	78%	
<b>3.0%</b>	45%	59%	73%	88%	
<b>3.5%</b>	55%	69%	83%	98%	
<b>4.0%</b>	65%	79%	93%	100%	
<b>4.5%</b>	75%	89%	100%	100%	
<b>5.0%</b>	85%	99%	100%	100%	

If % of new business revenue is 50% or more for revenue of less than \$500MM, an additional 30% of restricted stock will vest

# Compelling

- What is the perception value of the program?
  - Separate program for executives than all other employees
    - ◆ Equity optimization
    - ◆ All constituents
      - Shareholders
      - Board
      - Executives
      - Employees

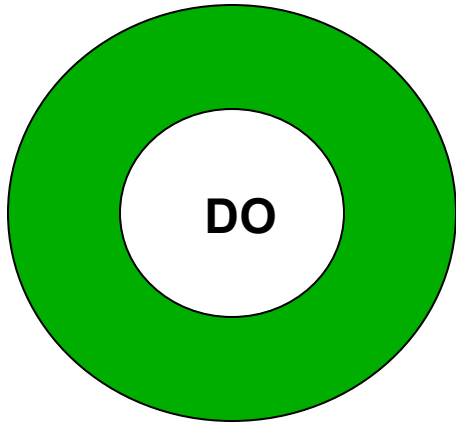


# Compliance

- **What are the key regulations?**
  - Impact of FAS 123?
  - Deductibility under Section 162(m)
  - Now need to review plan in light of Section 409(A)
  - Sarbanes Oxley

# Communication

- **What shareholder approvals/communications are required?**
  - Proxy disclosure
  - Shareholder approval required for plan and additional shares
- **How should the plan be communicated internally?**
  - Executive meetings/discussions
  - Plan description and documents



- Consider your company's unique situation and needs
- Identify the constraints ahead of time and how to address them
- Be broad in defining the constituents and how they might be affected
- Balance creativity with transparency
- Allow enough time for design



- Allow compliance regulations to strangle creativity or overly complicate plans
- Automatically discount the use of equity vehicles
- Blindly follow the trends of the day