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The Future of Options

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Today's Speakers



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- **Background**
 - Back to Basics
 - Accounting and Expense
 - Status of Options in 2009

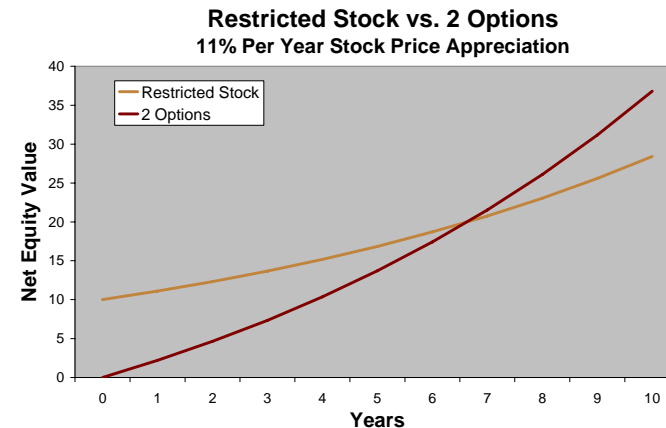
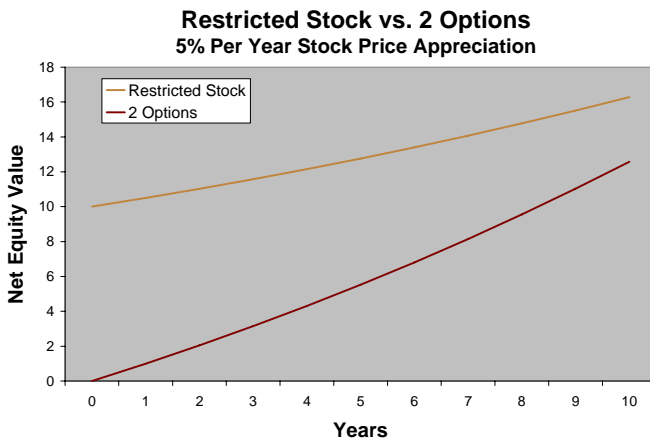
- **Underwater Options and Repricings/Exchanges**
 - Basics and Prevalence
 - Diagnostic Approach & Process
 - Alternative Solutions
 - Technical Issues
 - » Legal Issues
 - » Tax and Accounting
 - » Shareholder Approvals
 - Examples

- **Closing Thoughts on the Future of Options**

Options – Back to Basics

The Good...

- **Linkage to the shareholder**
 - Most direct link to shareholder value creation and direct pay-for-performance alignment
 - Gains realized from options mirror shareholder experience (in a rising market)
- **Upside potential (typical option grant compared to equal value restricted stock grant)**



And the Not So Good...

- **Dilution**
 - Options require more shares than full value grants to deliver equivalent value
- **Accounting**
 - Favorable accounting of options lost with adoption of FAS 123R

Accounting and Expense

▪ Onset of option accounting

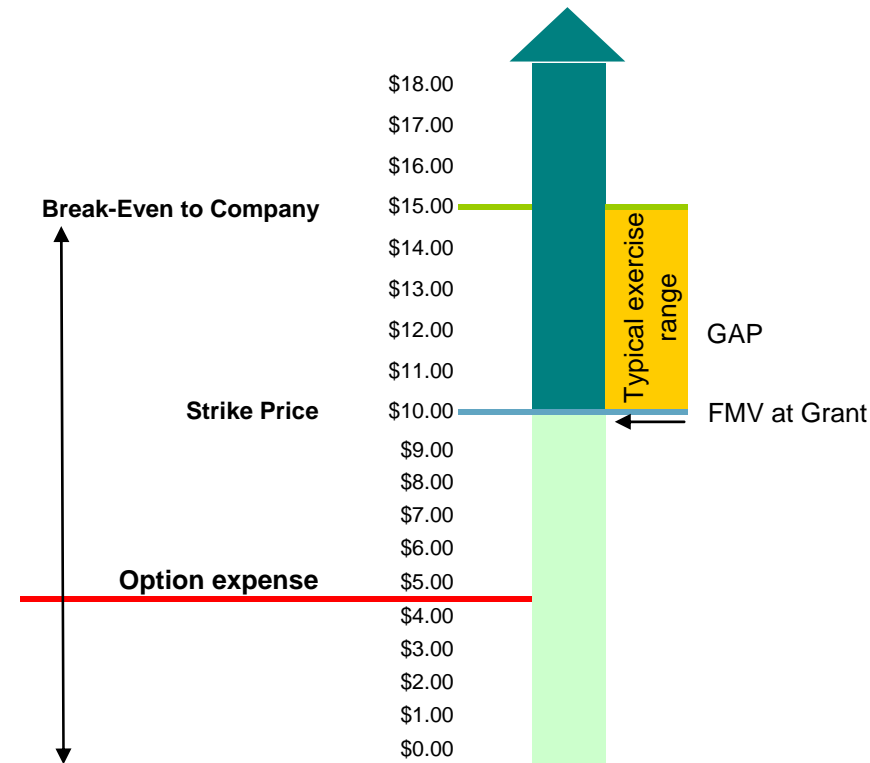
- Under APB25 and intrinsic accounting options were free
- FAS123R implemented fair value accounting, and for the first time options bore the cost or expense, which was later to be reconciled (U.S. accounting rules) with the corresponding compensation expense

▪ Impact of option expense on the value model

- Options at grant have no value but bear an expense to the company at the time of grant (value model to the right):
 - » Strike price of \$10.00
 - » Present value of \$5.00 (Black-Scholes or Binomial)
 - » Company expense \$5.00

Company gets an efficient outcome (where the value delivered meets or exceeds the expense) when the value grows by \$5.00, thus to a \$15.00 fair market value level.

 - » Option strike price \$10.00
 - » Employees tend to exercise any “in the money” value and very often exercise before reaching the break even value of \$15.00



- A share of restricted stock at \$10.00 is worth \$10.00, with a charge to earnings of \$10.00. Therefore, any value realized by the grantee is in the value range to the grantor. For many organizations, this conundrum has moved employee or broad-based programs to the use of full value shares.

- **There has been a historic decline in option use**
 - General bias based on value (option cost v. value model)
 - Declining acceptable standard for overhang
 - Opinions about the use of options are seldom neutral

- **... But their merits still exist**
 - Employees can sit on inside build-up for vested (unexercised) options but not restricted stock
 - Options are still cheap and offer the most upside, but at a cost (in terms of dilution)
 - Options can take on many forms and provide flexibility
 - Options remain advantageous for certain cultures/industry sectors
 - » Small caps
 - » Privately held firms; phantom options
 - » Large cap broad-based grantors
 - » Low dilution programs and/or large purchasing power with share set-aside

- **Market Influences Often Dictate Popularity of Options**
 - Outcomes in a bear or flat trending market
 - Implications for the turnaround

- **What is an underwater stock option (UWO)?**
 - Strike price > current stock price
 - Prevalence (*from 12/08 Equilar report, Executive Compensation Trends*)
 - » In 12/07, less than 50% of CEO options were underwater
 - » In 12/08, over 95% of Fortune 500 CEO options were underwater
 - » In 12/08 approximately 75% of *all* options were underwater

- **What is an Exchange/Repricing?**
 - Surrender of UWOs for restricted stock, stock options, cash or a mix of the above
 - Prevalence of Exchanges/Repricings
 - » Proposals: >100 in last 2 years; >50 studied in 2008; over 24 by 2nd Qtr in 2009
 - » Significant activities in 2008 among high technology, life sciences and services
 - » General industry lagged significantly in requests in 2008 but is potentially increasing in 2009
 - » With a flat trending market at best, issue and forces to consider will grow

An Internal Diagnostic – Is an Exchange Right for Your Company?

DISSECT THE PROBLEM

- **Extent of the issue in the organization below the executives**
 - How much value, percent of total shares, dilution?
 - Do shares need to be freed up for future/ongoing grants?
 - Has long-term reward strategy changed since the grants?

- **Who is to be covered?**
 - Historically, shareholder requests were broad-based and shareholders were lenient
 - Institutional shareholders will often vote against requests that include (in this order) directors, NEOs and other 16b executives
 - RiskMetrics Group (RMG), formerly Institutional Shareholder Services (ISS), will typically recommend against transactions that include directors or executive officers

- **Scope, complexity - how bad?**
 - Time remaining on grants, value, percent of shares tied up
 - How many different grants/tranches are involved, or do they significantly inhibit the ability to authorize more shares?
 - Employee expectations, risk vs. reward potential, efficacy
 - Are the impacted shares deeply underwater based on analysis of historic volatility?
 - What does the plan say regarding time, expense, filing/tender offer and related?
 - Exchange and RMG implications of internal issue and solutions
 - Is the magnitude significant enough to take the action vs. doing nothing?

An Internal Diagnostic – Is an Exchange Right for Your Company?

- **If executives' UWOs are to be involved in the program**
 - Choices are more limited – exchange, shareholder and RMG approvals
 - » Higher strike price and longer vesting
 - » Premium priced – new strike higher than 52-week high
 - » Not as favorable a ratio for same grant date and value as non-executives
 - » Voting history of institutional holders
 - Related issues
 - » Management culpability with current price
 - » Management getting a better deal than shareholder and no offsetting dilution improvement

- **Time Commitments and Cost**
 - Exchange offers are very labor intensive
 - Timing of communications, filings, offer periods must be carefully planned
 - Will time, cost and the resulting efforts be perceived as providing value to the grantees?

- **Delivering on Expectations**
 - Will management, the compensation committee and the board be comfortable that the grantees will see the offer as having value and participate in sufficient number to justify time and expense vs. *status quo*?

Illustrative Exchange Process

1. First Hurdle – How big is the problem?

- Present Value: grant prices are so underwater that in-the-money is a long way out
- Magnitude: a large percentage of the plan or total shares outstanding are underwater
- Incentive Value: the current perception of any value has been lost
- Purchasing Power: the current share balance is insufficient to address the issue while keeping up annual grants
- Dilution: the current level of dilution does not offer the flexibility for additional grants on top of the UWOs
- Final Check: the value perception of the grantee is clearly understood by management and the compensation committee AND is less than the (remaining) expense; would the additional expense/earnings charge (if any) merit a change

2. The Valuation Process – Steps to calculating the exchange ratio

- Determine the value (Black-Scholes or Binomial) of each existing underwater grant
- Dissect the grants into price ranges
- Calculate the weighted average of the values for each price range
- Determine the exchange ratio (assuming value neutral) for each range
- Using exchange options or RSAs determine the net effect on share usage

3. What is the presumed PV of the UWOs to a typical manager, professional, or technologist?

- Average tenured manager holds \$x discounted value in/against a face value of \$y
- Typical technologist holds \$x discounted value against face value of \$y
- If multiple grants and different prices are involved, are any of the groups adversely impacted?

Addressing the Issue (cont'd)

4. Is the resulting potential impact similar across a significant percentage of grantees?

- Would vesting schedule change?
- What about impact to terminations, retirement, etc.?

5. Would a value-neutral exchange offer be widely perceived as a good thing? If yes, go to next step. If no, AND a new annual grant is not in the offing, seriously consider no action. If a new annual grant is being made, would this affect the decision to accept a value neutral offer?

- Alternatives to an exchange include:
 - » Normal grant with no exchange (do nothing differently)
 - » Accelerate the timing of the next award
 - » Provide larger-than-normal grant at next normal award time

6. Other

- Are multiple grants involved that may not be addressable by one solution, and is the resulting potential impact similar across a significant percentage of grantees?
- Since previously vested UWOs exchanged for new shares will have to meet new vesting schedule, is that a problem?
- If all shares retired that are not exchanged go out of the plan, is there still sufficient purchasing power?
- Does the solution still make sense if all directors and executive officers are excluded?
- Timing?

▪ **Historical Practice**

- 1-to-1 exchange with a new lower strike price
- Accounting rules, exchanges and institutional investors created negative implications for this practice
- What we refer to from this point as “repricings” are better defined as exchange offers. While technically considered repricings, the use of the term throughout this presentation implies that the exchange or repricing will be a value-for-value exchange and not simply a reissue of the same number of shares at a new (lower) strike price.

▪ **Value-for-Value Exchanges**

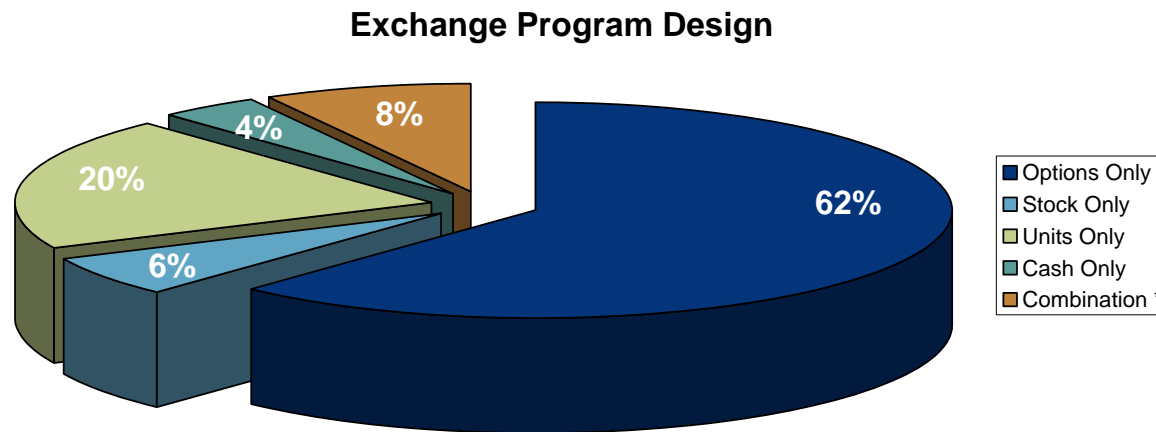
- Have emerged as best practice for repricing
- The only route to go for approval (by shareholders and RMG)
- Are harder to sell to employees and to some executives (if included in program)

▪ **Repricing Currencies**

- **Options** → replacing the UWOs with new options of an equal value
- **Restricted Stock or RSUs** → replacing the UWOs with full value shares or share equivalents
- **Cash Buy-outs** → providing a one-time cash buyout for the value of the UWOs

▪ Exchange Requests by Type

Among all completed, active, and proposed option exchange programs in 2008, 62% exchange UWOs solely for new options. Another 26% exchange options solely for full-value shares (including both stock and units). The following chart displays the prevalence of common option exchange design types in 2008 (source: Equilar 12/08):



Solutions (continued)

SOLUTION OPTIONS FOR ▼	PROCESS	PRECUSORS	POSITIVES	NEGATIVES	ACCTG HIGHLIGHTS & REGULATORY / OTHER
New Options	New options in exchange ratio of 1 per each 2+ old options with new strike price	Are UWO strike prices greater than 52wk high? Share availability is not an issue as it will burn the most shares *	Will decrease dilution and be anti-dilutive to shareholder	Considered a material modification Employees may not see, trust or understand basis for exchange ratio	If new value is less than or equal to original, no additional/ incremental accounting charges on top of ongoing expense
Restricted Stock	New full value restricted stock in much higher exchange ratio depending on vesting and terms	Determining exchange ratio is easier to explain as value of full value shares is their value at grant May have to involve a higher exchange ratio for executives, directors (if included) as with options	Uses even fewer shares Provides immediate recognizable value to the grantee Strong retention prior to vest or lifting of restrictions Viewed favorably by employees when executives don't get that opportunity More shareholder acceptable due to decreased dilution	Restricted shares are taxable when they vest and do not allow the continued inside build-up between vesting and exercise Communications Employee will tend to sell shares as opposed to hold in-the-\$ vested options With big stock increase in FMV, can be negative	Additional incremental charges may apply if not value neutral Use of RSUs adds flexibility to options post grant
Cash	Cash equivalent of PV is offered – not a tender offer but has same approval tenets	May be best where values and/or volume of shares would generate meaningful payout. Not a solution for executives	Immediate value conferred for UWOs No more UW issues for this grant Shares are retired Good when ongoing LTIs are being granted	Works against ownership strategy After tax (at time of payment) value can be perceived as minimal Cash outflow	Still considered a repricing by RMG Implementation of a cash offer (>1 time) could taint future awards making them liability awards

* For executives, the new strike price should be greater than the 52-week high as a starter

Tender Offers

- **Value-for-value exchanges require participating employees to make an investment decision to “tender” one option award in exchange for another option award with different terms (such as different number of options or different vesting schedules)**
 - Exception for individual negotiation with a small number of shareholders (e.g., 10 or fewer employees)

- **Requires companies to comply with Tender Offer (TO) rules**

- **Must file a *Schedule TO*, which is subject to review and comment by SEC**
 - Detailed summary of the terms of the exchange offer
 - Communications about the offer
 - » All discussions with employees, whether written or oral, must be filed on the date of the communication

- **Company Must Keep TO open for 20 Business Days**
 - Allowing changes to elections and a process to confirm all final choices

Disclosure

- **Presented as a proposal for shareholder approval as part of either the annual meeting agenda or at a special meeting**
- **Proxy statement should explain rationale for the option exchange:**
 - Why it is necessary?
 - Why it is being instituted at this point in time?
 - Why is the option exchange in shareholders' best interests?
- **Once approved by shareholders, additional filings will be necessary in order for the exchange program to be instituted**
 - Form 8-K: Notifying shareholders of a material event and disclosing the company's intent to institute the exchange offer program
 - Form 4: For Section 16 employees, both the cancellation of UWO and new option grant must be reported on Form 4 (exchange constitutes change in beneficial ownership)
 - Financial Footnotes: Description of exchange must be included in footnotes to financial statements
 - CD&A: Discussion of exchange in following year CD&A
 - GBPAT: Reporting of associated expenses in Grants of Plan-Based Awards Table in the following year's proxy

Accounting

- **Compensation cost (SFAS 123R) should be considered when setting an exchange ratio**

- **Grant date fair value of the original award, plus the incremental value of the modification (new award/replacement cash)**
 - Company can take “credit” for portion of original grant value that has already been expensed
 - Incremental value from the modification is determined at the exchange date
 - Value-for-value exchanges should have zero value

- **Remaining expense accrual occurs over vesting period in effect after the exchange, if any**

Section 409A

- **Option exchange treated as a cancellation and new grant**
- **No 409A issue if new exercise price is equal to or greater than current FMV**
 - If there is a series of repricings, however, it could indicate for Section 409A that the exercise price was never fixed at the time of grant and the repricing would no longer be exempt from 409A
 - » Could result in substantial excise tax

Incentive Stock Options

- **Option exchange considered cancellation and concurrent grant**
 - Recalculation of \$100,000 limitation
 - 2-year holding period would restart upon new grant
 - If offer to reprice outstanding more than 30 days after offer, ISO deemed to have been modified as of the offer date
 - » Could result in disqualification of ISOs held by employees who do not even participate in the exchange

- **Shareholder approval is “best practice” and generally required**
- **NYSE and Nasdaq companies must first obtain shareholder approval of a repricing, unless the plan expressly permits the company to reprice options**
 - If plan does not specifically permit the repricing (rare), it is considered to prohibit it (even if silent)
 - Repricing is a material amendment requiring shareholder approval
- **NYSE and Nasdaq define a “repricing” as**
 - Lowering the strike price of an option after it is granted;
 - Cancelling an UWO in exchange for another option, restricted stock or other equity
 - Exception for merger, acquisition, spin-off
 - Any other action that is treated as a repricing under GAAP
- **Straight repurchase for cash may not require shareholder approval under NYSE or Nasdaq**
 - However, most advisors still strongly suggest shareholder approval for cash exchange offers. RMG will potentially “withhold” votes from directors on Compensation Committees offering an exchange without a shareholder vote

RiskMetrics Group (RMG)

- **RMG opposes repricing unless its guidelines are met**
 - Overall, the repricing *must* be subject to shareholder vote, even when not required by the exchange
 - RMG also considers the design of the repricing program
 - RMG guidelines consider cash buyouts to be “repricings”

- **If guidelines are not met, RMG will recommend:**
 - “Against” repricing, even when submitted for shareholder vote
 - “Against” the next time the company’s equity plans are up for vote
 - “Withhold” on nomination of Compensation Committee members

RiskMetrics Group (RMG) (cont'd)

- **RMG evaluates proposals on a case by base basis giving consideration to:**
 - Participation: RMG will vote against a program that includes named executive officers and/or non-employee Directors
 - Historical trading patterns: The stock price should not be so volatile that the options are likely to be back in-the-money over the near term
 - Rational for the exchange: The company's rational must
 - » Draw a clear picture of the events leading up to the decline in the stock's price
 - » Establish that the decline in value was beyond management's control – e.g., was the decline industry-wide?
 - » Explain why the exchange is being proposed at this particular time – exchanges proposed within one year of sharp price declines will receive additional scrutiny
 - » Market deterioration alone is not acceptable
 - Type of exchange: Is it value for value? RMG will vote against an option exchange program if the value of new awards exceeds the value of options surrendered

- **RMG will also consider the following factors:**
 - Vesting: Should not vest immediately and there should be a sufficient black-out period, even if the surrendered options were vested
 - Term: Should be the same as surrendered shares and not extended
 - Exercise Price: Should be set at fair market value or at a premium to market
 - Re-Issuance of Options: If surrendered shares are added back to the pool, RMG will vote against the program if three-year average burn rate is above an industry cap

▪ Fidelity Management & Research guidance

- Participation: Whether the proposal excludes senior management and directors
- Dilution: Whether the initial exchange or repricing exceeds FMR's dilution thresholds
- Value: Whether the exchange or repricing proposal is value-neutral to shareholders, based upon an acceptable pricing model
- Relative Performance: How the company's relative performance compares to relevant peers in the industry or industries
- Industry Factors: How economic or other external conditions affected the competitive industry or industries
- Other: Any other facts or circumstances relevant to determining shareholders' best interests

Pricing and Exchange Scenarios Impact on Share Usage and Overhang

- Table 1 shows a simple example of a stock, now \$20.00 share, with underwater options valued at \$5.00

Scenario	UWO Value	New Option Value	Full Value RSA	Exchange Ratio
Options for Options	\$5.00	\$10.00	-	2:1
Options for RSAs	\$5.00	-	\$20.00	4:1
Options for Cash	\$5.00	-	-	\$5.00 per share

- Table 2 shows in more detail a similar example with shares freed up and the resulting impact on dilution. The example shows a \$15.00 strike price on 1,000,000 shares of 2,000,000 NQSOs outstanding in grants on a 15,000,000 share outstanding pool (an initial dilution of 13.33%). This example shows a current price of \$10.00.

Scenario	Old Strike Price	Value of UWOs	New Strike Price	Value of New Share	Current Price for RSA Grant	Exchange Ratio	Total Shares Required	Resulting Total Dilution of Equity Plans
Options for Options	\$15.00	\$3.00	\$10.00	\$6.00	-	2:1	500,000	10.00%
Options for RSAs	\$15.00	\$3.00	-	Full Value	\$10.00	3.33:1	333,333	8.89%
Options for Cash	\$15.00	\$3.00	-	-	-	\$3.00	0	6.67%

- Table 3 example covers a full value exchange offer solution involving full value restricted stock (RSAs) where multiple UWO grants are involved and an exchange value has been calculated for three different groupings of grant price.

Earlier Grant Price Range	Value of UWOs	Number of Shares Tied-Up	Restricted Stock at Grant	Exchange Ratio	Net Dilution (CSO 100mm)
20.00	\$0.86	250,000	43,189	5.8 : 1	-0.2%
15.00	\$1.15	750,000	173,169	4.3 : 1	-0.6%
10.00	\$1.63	1,250,000	408,740	3.0 : 1	-0.8%
Total		2,250,000	625,098	3.6 : 1	-1.6%

Accounting Implications and Approach for Range of UWO Price Ranges

- Table 4** shows the impact of extending the term on the new grants to a ten year term compared to remaining term – showing no difference in resulting dilution (except for longer tie-up of shares, e.g. caution for options for options), but significantly higher exchange offer per share of the under water options.

	Exchange Scenarios for 3.5mm UWOs			
	Options (6-yr Term)	Options (10-yr Term)	Restricted Stock	Cash
New Shares Required	2,238,601	1,759,564	1,144,500	\$5,722,500
Exchange Ratio	1.5 : 1	2 : 1	3 : 1	n/a
Net Change in Dilution	-1.26%	-1.74%	-2.36%	-3.50%
Shares Retired	1,261,399	1,740,436	2,355,500	3,500,000
ASSUMPTIONS				

Common Shares Outstanding: 100,000,000
 Value per Outstanding Option: \$1.635
 Average Exercise Price: \$10.00
 Underlying Price : \$ 5.00

Remaining term: 6 years
 Volatility: 50%
 Dividend yield: 0%

Corresponding risk-free rates:
 6-year rate 3.19%
 10-year rate 3.84%

Closing Thoughts on the Future of Options

▪ Trends and Predictions

- Option usage will increase in the near term
- Increase in use of fungible plans via share requests
- Value perceptions will eventually improve with a cooperative market
- Solution on options is really not a legislative or compliance issue, but more often philosophical

Reassessing Your Long-Term Award Strategy:

- **Assess the role of options**
 - High expectations from executives and employees
 - Are options to be granted, valued and communicated as any other LTI currency?
 - Can they serve a different role?

- **Options require a longer-term perspective when compared with other common incentive vehicles such as restricted stock or annual bonuses**
 - U.S. reward culture is not as long-term as other cultures
 - Run-ups are the basis for expectations, while down-turns create issues that need to be fixed
 - Is this perspective changeable?

Closing Thoughts on the Future of Options (cont'd)

- **Longer vesting period**
 - Longer vesting periods allow for more value creation
 - Will/may create a different expectation of capital accumulation
 - Can the pushing out of vesting add another dimension to the reward culture?
 - Will locking up the shares longer be worth the gamble?

- **Longer line of sight**
 - With a longer vest period and longer line of sight, value build-up will be enhanced
 - Expense and dilution tied up over time is the trade-off for greater value and retention

- **Paradigm shift in the role of NQSOs for executives and employees**

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Thursday, September 24, 2009, 2 p.m. ET

Spotlight on Change-in-Control Agreements

Margaret Black, Managing Director, Pearl Meyer & Partners

Dan Wetzel, Managing Director, Pearl Meyer & Partners

Deborah Lifshay, Managing Director, Pearl Meyer & Partners

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Thought of a Question After the Presentation?

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