



## **Governance Research Service 2004 Background Report A:**

# **MANAGEMENT PROPOSALS ON EXECUTIVE COMPENSATION PLANS**

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- Recent Developments, p. 2
- Background on regulatory developments impacting management pay, p. 6
- Stock-based plan proposals, p. 11
- Executive bonus plan proposals, p. 14
- Voting on management compensation plans, p. 16
- Proxy voting guidelines, p. 26
  - Appendix A: Definitions, p 36
  - Appendix B: How IRRC Calculates Dilution, p 39
  - Appendix C: Section 16b, p 40
  - Appendix D: Summary of Section 162(m) Regulations, p 41
  - Appendix E: Summary of NYSE and NASD requirements regarding shareholder approval of plans, p. 44

### **Executive Summary**

IRRC tracked a total of 199 new executive stock option plan proposals in 2003 at S&P Super 1,500 companies, which encompasses the S&P 500, the S&P 400 MidCap and the S&P 600 SmallCap indices. The weighted average shareholder opposition to new stock option plans was 21.4 percent, essentially unchanged from 2002 levels.

Potential dilution remains a prominent concern among shareholders when voting on executive stock incentive plans. In 2003 IRRC collected voting results for 363 proposals to either adopt a new executive stock option plan or add shares to an existing one. Ten percent received at least 40 percent voting opposition; the weighted-average total potential dilution at those 36 companies was 33.2 percent, compared with just 12.4 percent opposition to all the plans on average.

In 2003, IRRC tracked four proposals within the S&P 1500, either to adopt a new executive stock option plan or add shares to an existing one, that failed to receive necessary shareholder support to pass. Three of these four proposals had overall company dilution levels above the 75<sup>th</sup> percentile of their respective industry peer group. Two of the failed proposals had three-year option grant rates (“run rates”) that exceeded the 75<sup>th</sup> percentile of their peer group. None of the companies chose to submit modified proposals at subsequent special meetings in 2003.

IRRC tracked 82 new bonus plan proposals from the S&P Super 1,500 companies in 2003, where companies sought shareholder approval in connection to Internal Revenue Service Code Section 162(m). That provision, which imposes a limit on the tax deductibility of compensation in excess of \$1 million paid to any of a company’s top five executives, exempts certain “performance-based” compensation paid out according to plans approved by shareholders (as explained more fully in Appendix D). Of the 82 new bonus plans, 68 established annual performance periods, seven established long-term performance periods (usually three years), and seven more allowed for both annual and long-term performance periods. Opposition rates to bonus plan proposals continue to be low, with average shareholder opposition of only 7.5 percent in 2003 among the 71 proposals for which IRRC has voting results as this report is prepared.

## **Recent developments**

***Stock incentive plan approval by shareholders:*** Most stock based grants and option awards have been approved by shareholders. But in some cases, under old listing requirements, companies could avoid submitting plans to shareholders by making them “broadly based.” In June 2003, the SEC approved amended listing standards for the New York Stock Exchange (NYSE) and the Nasdaq that generally require all plans and material amendments to be submitted for a vote by shareholders. The SEC granted accelerated approval of similar reforms for Amex listed companies in October 2003.

The revised listing standards at both the New York Stock Exchange and the Nasdaq allow for certain exemptions. The NYSE exempts “inducement awards” granted in connection with a new hire. In the case of a merger, the NYSE does not require acquiring companies to seek approval of plan shares that were previously approved by the target company’s shareholders. Plans qualifying under Section 401(a) of the IRS code are exempt, as are employee stock purchase plans qualifying under Section 423 (although these plans are typically presented to shareholders due to IRS requirements). Furthermore, existing NYSE plans that have never been approved by shareholders are grandfathered under the new requirements unless the company intends to make a material revision expanding the scope of the plan, such as adding shares to the plan’s reserve, increasing award types, extending the term of the plan, or deleting provisions prohibiting repricing. (The new NYSE standards also establish that if a plan is silent on the issue of repricing, it does not allow for repricing. Therefore, shareholders must have the opportunity to vote on a repricing program in such cases.) For plans with lives of more than 10 years or no termination date, the definition of “material revision” expands to include formulaic grants as well as share reserve increases via automatic share replenishment provisions. Nasdaq’s new listing standards are very similar to those of the NYSE, but there are some subtle differences. For one, Nasdaq does not consider a plan that is silent on repricing to prohibit it. At the same time, the Nasdaq standards consider a plan amendment to allow for repricing to be a material amendment.

Although its impact may not be seen immediately, the prohibition of new non-shareholder approved plans may eventually have a meaningful impact on potential dilution. According to IRRC’s 2004 *Stock Plan Dilution* study, shares from non-approved plans contributed three percentage points to overall average potential dilution of 17 percent among S&P 1500 companies.

**Table 1: Shareholder approval of equity plans—summary of new listing rules**

Exchange	Summary of listing rules
<p><b>NYSE</b></p>	<p>To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans. Shareholders must also be given the opportunity to vote on “material revisions” to existing plans, such as:</p> <ul style="list-style-type: none"> <li>• Adding shares, participants, award types, or years to the plan,</li> <li>• Changing the method of determining the exercise price</li> <li>• Any option bailout program related to a plan that is either silent on or prohibits bailouts</li> </ul> <p>The following are eligible for exemption:</p> <ul style="list-style-type: none"> <li>• inducement awards for new hires,</li> <li>• plans related to mergers or acquisitions</li> <li>• tax qualified employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans;</li> <li>• plans available to shareholders generally, such as dividend reinvestment plans</li> </ul> <p>A plan with an automatic share replenishment feature and a term of more than ten years requires shareholder approval of each periodic share increase.</p> <p>A plan involving formulaic automatic grants and a term of more than ten years requires shareholder approval of each grant.</p> <p>A plan with no limit on shares reserved must receive shareholder approval for each award granted thereunder.</p> <p>Note: Uninstructed broker votes are not eligible to vote on stock compensation proposals.</p>
<p><b>NASD</b></p>	<p>Shareholder approval is required when a stock option or purchase plan is to be established or materially amended or other arrangement made pursuant to which options or stock may be acquired. Material amendments include:</p> <ul style="list-style-type: none"> <li>• Adding shares, participants, award types, or years to the plan,</li> <li>• Reducing the exercise or purchase price of awards</li> <li>• Amending the plan to permit option bailouts</li> </ul> <p>The following are eligible for exemption:</p> <ul style="list-style-type: none"> <li>• inducement awards for new hires</li> <li>• tax qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans;</li> <li>• plans related to mergers or acquisitions; or</li> <li>• plans available to shareholders generally, such as dividend reinvestment plans</li> </ul> <p>A plan with an automatic share replenishment feature and a term of more than ten years requires shareholder approval of each periodic share increase.</p> <p>A plan involving formulaic automatic grants and a term of more than ten years requires shareholder approval of each grant.</p> <p>A plan with no limit on shares reserved must receive shareholder approval for each award granted thereunder.</p> <p>Note: The Nasdaq amendments did not need to address the issue of uninstructed broker votes because such activity had already been prohibited.</p>

Exchange	Summary of listing rules
Amex	With regard to shareholder approval of stock plans, Amex has adopted requirements and exemptions very similar to those of the NYSE and Nasdaq. The SEC approved the changes at Amex in October 2003, and cited that the proposal was “essential” to the harmonization of requirements for equity compensation plans between the three major exchanges.

**Option expensing:** The question of if and how to require companies to expense the cost of stock option grants has received a great deal of attention, especially in the aftermath of several business scandals that underscored what some investors perceive as the overuse and abuse of stock option compensation.

Unless blocked by Congress, it is expected that the Financial Accounting Standards Board will begin requiring companies to expense options using the “fair value” method starting with fiscal years beginning after December 15, 2004. The fair value method generally uses the Black-Scholes value of an option on its date of grant. Currently, unless a company elects to adopt FAS 123 (i.e., expense all stock-based compensation), at-the-money stock options have no impact on earnings; companies need only to include a footnote in their statements detailing the theoretical impact on earnings if the fair value method had been in place.

Opponents of mandatory option expensing, led by members of the technology and venture capital industries, lobbied Congress in 2003 for relief from the FASB’s decision. The anti-expensing lobby points out that options play a crucial role in attracting talent, particularly in start-up companies with limited cash, available for compensation. Some members of these industries argue that option expensing would increase labor costs and thereby indirectly encourage companies to locate jobs in foreign countries with lower labor costs. Another complaint made by the anti-expensing lobby is the inherent uncertainty that comes with estimating the value of a derivative.

Currently there are two proposals related to option expensing on Capitol Hill. One would force the FASB to delay the implementation of any new rule requiring option expensing, while the other would require expensing only of options granted to certain executives. In March 2003, Rep. David Dreier (R-CA) introduced the Broad-Based Stock Option Plan Transparency Act of 2003 (H.R. 1372) that would place a three-year moratorium on any new FASB standards. The bill was referred to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises on March 31. The Senate version, sponsored by John Ensign (R-Nevada) was submitted in May 2003 and has been referred to the Senate Committee on Banking, Housing and Urban Affairs.

In Nov. 2003 Senator Mike Enzi (R-Wyoming) sponsored a bill that would make a compromise on the issue. The Stock Option Accounting Reform Act (S.1890) would require companies to expense only those options granted to the top five executives. The bill was referred to the Committee on Banking, Housing and Urban Affairs. The House version, proposed by Richard Baker (R-LA) was referred to the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises.

The FASB attempted to require option expensing in 1994 but backed down under pressure from the Senate. Although the board seems committed to implementing an expensing requirement this time, there appears to be little enthusiasm for the FASB’s plans in the executive branch. In January 2004, SEC Commissioner Paul Atkins voiced his personal opposition to the FASB’s

proposed mandatory expensing. SEC Chairman Bill Donaldson, considered a reformer on many governance issues, has not endorsed mandatory expensing.

Whether in preparation for changes in FASB standards or for other reasons, 101 companies in the S&P 1500 had either begun expensing options or announced the intention to do so as of December 2003.

**Stock Option Repricing:** IRRC tracked 88 companies announcing an option “bailout” arrangement in 2003, compared with 98 during 2002 and 181 in 2001. IRRC uses the term ‘option bailout’ to capture company actions since July 1, 2000, which, while possibly not considered to be repricings under the FASB’s definitions, serve similar purposes as repricings. Most significantly, option bailouts include instances when companies cancel existing options, only to grant new options on a date that is at least six months and one day from the date of cancellation (“six and one”), thereby avoiding any accounting penalties as defined by the FASB. Bailouts also include, in addition to straight repricing, incidences when companies replace option grants with shares of restricted stock—a restricted stock swap.

Of the 88 companies enacting bailouts in 2003, almost half allowed at least one of the top five executives to participate. Sixty-three percent of the recorded bailouts used the “six and one” method.

IRRC tracked only 25 companies asking for shareholder approval of bailout programs in 2003. Interestingly, shareholders do not typically oppose option bailouts when management asks for permission. Only one of the 25 proposals had any difficulty passing in 2003. The final tally of the bailout proposal at **Electroglass** was 50 percent voting for; 42 percent voting against; 8 percent abstaining. The terms of the Electroglass bailout were not especially unusual—a “six and one” program in which neither executive officers nor directors were eligible to participate. The exchange ratio varied from one new option for every 1.25 options exchanged to one new option for every four options exchanged.

One of the largest bailouts in history occurred in 2003 at **Microsoft**, which made the switch from using option grants to restricted stock units during the year. In connection with that move, the company enacted a bailout program through which more than 18,000 employees sold 345 million underwater options for cash to J.P. Morgan Chase for a total potential payout of up to \$382 million.

**Martha Stewart Living Omnimedia** executed two bailouts in 2003—one for vice-presidents and the other for non-executive employees. The company’s vice presidents tendered 4.3 million underwater options for approximately 1 million restricted stock units, while non-executive employees tendered 575,000 underwater options for \$1.1 million in cash.

Option bailout programs are most commonly associated with the technology sector, but the list from 2003 includes some old-economy names as well, including airlines **Delta** and **Northwest**, paper producer **Georgia-Pacific** and retailer **BJ’s Wholesale Club**.

**Corporate Loans:** With the implementation of the Sarbanes-Oxley Act in August 2002 corporations are now banned from making loans to executives and non-employee directors. In the past, some stock option plans allowed executives to pay for an option exercise with a promissory note or loan from the company. Sometimes the loans were made at below-market rates or were forgiven over time, which registered numerous shareholder complaints.

***Change in Pay Practices:*** As the likelihood that companies will be required to expense all stock option grants looms, executive pay trends are expected to shift towards greater use of restricted stock rather than options. The shift from stock options to restricted stock may benefit both companies and employees. In poor market conditions, employees would benefit from restricted stock awards despite declining stock prices, since restricted stock still maintains some value while stock options would be deemed “under water”. Furthermore, since one share of restricted stock is worth more than an option to purchase a share, fewer shares are needed to produce the same total value as past option grants. Investors may therefore expect potential equity dilution levels to decrease over time. In addition, activists are pressing companies to ensure that restricted share awards include significant vesting periods (e.g., minimum three years) and, to a large degree, condition vesting on the attainment of pre-set performance goals.

## **Background on regulatory developments impacting management pay**

### **Broad-based stock option plans**

The revised listing requirements issued by the major exchanges in June 2003 culminated a reform movement that began in April 1998 when the NYSE enacted a rule exempting companies from obtaining shareholder approval for certain “broadly based” stock incentive plans. After institutional investors raised concerns with the policy, the NYSE opened a comment period to review recommended possible changes. The exchange also established a task force comprised of its various constituent groups to review the comments and recommend possible changes. In October 1998 a revised policy was put in place on a pilot basis until September 2000. The revised plan tightened the criteria for exemption as a broadly based plan, but did not address a number of institutional investors’ concerns, including setting an overall maximum dilution level for all plans.

Over the following two years the task force abandoned its plans to set a dilution threshold and instead focused efforts on requiring clearer and more consistent disclosure information concerning stock option plans. Specifically, it recommended that information on the number of shares authorized and outstanding and the terms and price of such options should be included in proxy statements. In addition, the task force proposed that shareholder approval be required for all stock plans that include directors or officers. However, companies may have non-shareholder-approved plans not open to directors or officers equivalent to 10 percent of reserved shares for the shareholder-approved total.

The SEC’s decision in December 2001 to require a new standardized table for equity compensation played a significant role in raising the profile of the dilution issue, and particularly that of non-shareholder approved plans. The table includes the number and weighted average price of outstanding options, warrants and rights as well as the number of securities available for future issuance under existing equity compensation plans. In addition, the standardized table requires separate lines for shareholder-approved plans and non-shareholder approved plans. Companies must also include additional information regarding their equity compensation plans and arrangements in footnotes to the table. These additional items of disclosure may include a description of annual replenishment provisions contained in the plans or details of options, warrant and rights assumed in connection with a merger or acquisition transaction. Companies must also briefly describe in narrative form the material features of each non-shareholder approved equity compensation plan.

## Option Expensing

The SEC has statutory authority to establish accounting standards for public companies, but has historically looked to the Financial Accounting Standards Board for leadership in establishing and improving accounting standards. Current Financial Accounting Standards Board (FASB) rules permit companies to report stock option grants in one of two ways. Under APB 25, the “intrinsic value” method (used by most publicly traded companies) measures compensation cost as the excess of the market price of the stock at the grant date over the exercise price. Since most stock options are granted at 100 percent of fair market value on the grant date, companies using the “intrinsic value” method of stock option accounting essentially have a “zero” charge against their earnings. The second method, the “fair value” method under FAS 123, determines compensation cost based on the fair value of the award, using Black-Scholes or similar methodology, and recognizes it as an expense in the income statement. Under FAS 123, all companies are required to disclose the fair value of all options granted. Companies using the intrinsic value accounting method (APB 25) must include in a footnote to their annual reports an estimate of the fair value of options and their theoretical impact on earnings per share.

Although the FASB had publicly advocated accounting for options using the fair value method, few companies elected to do so until after the corporate scandals of Enron, Global Crossing, WorldCom, and others. In December 2002 the FASB issued a statement providing for three methods for transition for voluntary option expensing. The same statement amended disclosure requirements to provide for more prominent disclosures in financial statements.

In March 2003, FASB voted to reconsider stock option accounting, with the intent to devise a new rule that will require companies to take a charge for the “fair value” of stock option grants on their income statements. The FASB tentatively decided on April 22 to require companies to recognize stock-based compensation as an expense in their income statements. The FASB also pointed out that it disagreed with those who feel that the cost of options should only be reflected in diluted earnings per share. A proposed rule mandating fair value expensing is expected in the first quarter of 2004. The requirement is scheduled to take effect in 2005.

Arguments supporting mandatory expensing:

- Proponents argue that expensing stock options would more accurately reflect the company’s earnings.
- The proponents also cite a recent Standard & Poor’s report, noting that “the compelling logic advanced by S&P’s for including stock option costs in earnings statements is that these stock grants are components of executive compensation plans, and like other compensation components, such as salaries, cash bonuses and other compensation benefits, should be included as expenses in the calculation of operational earnings.”
- Furthermore, proponents believe expensing options would rein in what many consider to be the excessive and irresponsible use of stock options as compensation for executives. Many believe that the extensive use of stock options in executive and director compensation packages may encourage corporate leaders and their boards to “cook the books” in order to achieve rapid short term stock appreciation and realize significant gains in their option grants, rather than acting responsibly to support the long-term growth of the companies they manage. Proponents cite the numerous recent accounting scandals at Enron, Worldcom, and others as examples of stock options run amuck.

- Requiring an earnings charge for stock options would erase the accounting “advantage” they currently have versus other, performance-linked stock-based incentives that result in earnings charges under APB 25.

Arguments against mandatory expensing:

- Opponents argue that expensing stock options will ultimately hurt rank-and-file employees and do little to curb accounting scandals. Companies are more likely to cut back on option grants if they are considered an expense, and such cutbacks will probably come from grants to regular employees. A survey conducted by Mercer Human Resource Consulting found that one-third of the companies surveyed would reduce the number of options granted to employees if options are required to be expensed, and 31 percent said they would reduce the number of individuals who receive stock options.
- There is no reliable, accurate and standard way to calculate the value of stock options, opponents state. The Black-Scholes method for valuing options was designed to price tradable options with short lives and no vesting restrictions, and is heavily dependent upon speculative assumptions. In addition, opponents say that options are not a company expense, but rather a cost incurred by shareholders in the form of dilution, which is reflected in lower earnings per share.
- There would be a significant shock to the overall equities market if option expensing became mandatory and the investing community had not already factored the cost of stock options (using pro forma footnotes currently required) into its valuations.

## Corporate Loans

With the implementation of the Sarbanes-Oxley Act in August 2002, corporations are banned from making loans to executives and non-employee directors. In the past, some stock option plans allowed executives to pay for an option exercise with a promissory note or loan from the company. Sometimes the loans were made at below-market rates or were forgiven over time, which registered numerous shareholder complaints. Loans existing on July 30, 2002 are grandfathered out of the Act if they are not modified or renewed. A study released by the Corporate Library, in December 2002, found that over one-third of the nation’s largest companies.

Delaware Court Chancellor William B. Chandler III and Vice Chancellor Leo E. Strine Jr., who serve on one of the most pre-eminent courts in the nation for adjudicating issues related to corporate law, have criticized this aspect of the Sarbanes-Oxley Act in an article entitled “The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State.” The authors pose the question of whether the recent reforms constitute a “shadow corporate law” distinct from the state statutory system. They write that the federal regulatory structure traditionally has been concerned with disclosure and securities registration, leaving issues regarding transactions and board conduct to state legislatures. While overlaps inevitably have occurred, the judges say the reforms have been the furthest incursion into state corporate laws. The Sarbanes-Oxley ban on corporate loans to directors is their prime example. Previously, state law would have regulated this type of transaction. Now, there is an outright ban that has been determined at the federal level, they say. The authors are clearly worried about this precedent. In a “slippery slope” argument, they ask: “If the federal government can now regulate director loans, what will stop them from regulating ‘interested party’ transactions or other forms of corporate action?”

An interesting note is the number of companies that continue to include provisions for loans in new option plan proposals, despite the recent ruling prohibiting them. Thirty-five of the 199 new

stock incentive plans tracked by IRRC 2003 allowed for loans to plan participants to cover exercise prices. Perhaps these companies are anticipating changes in regulation during the life of the plan.

## Compensation Trends

IRRC expects to see a stronger gravitation towards restricted stock in the coming year. With the strong possibility of companies being required to expense stock options, some companies have already begun to consider alternatives to options. Restricted stock's key difference from options is the ability to retain value even in declining markets. Yet restricted stock remains popular among many corporate governance advocates for a number of reasons. First, the valuation methodology for restricted stock is much less contentious than methodology for stock option valuation. Second, restricted stock awards can be given minimum holding periods to ensure that the holder does not benefit from short-term stock price volatility. Third, firms need to issue fewer shares of restricted stock to "equal" the estimated value of a stock option grant. Therefore, the predominant use of restricted stock instead of options tends to result in lower overall equity dilution than with the predominant use of options.

There are indicators pointing towards greater use of restricted stock. During 2003, 82 percent of the newly proposed stock incentive plans permitted restricted stock awards. Furthermore, during calendar 2003 IRRC tracked 20 companies amending existing plans for the specific purpose of permitting restricted stock awards. The trend gained special attention in July 2003 when Microsoft announced its intention to cease granting stock options altogether and instead rely on restricted stock awards. A 2003 study by PriceWaterhouseCoopers reported the number of companies using restricted stock increased by 15 percent over 2002 levels.

CEO pay data collected in 2003 may not fully reflect the degree to which companies are moving towards restricted stock because the information pertains to fiscal 2002 activities. As of fiscal 2002, the percentage of companies awarding restricted stock to their CEO remained low at 25 percent, up only 4 percentage points over fiscal 2000 levels. However, 77 percent of companies granted options to the CEO in fiscal 2002, which is down two percentage points from fiscal 2000 levels. As illustrated in Table 2, the median restricted stock award value increased by only 6.2 percent over the last three fiscal years, the median number of option awards increased by 12.7 percent.

**Table 2: Trends in CEO Pay among S&P 1500 companies**

<b>Median:</b>	<b>FY 02</b>	<b>FY 01</b>	<b>FY 00</b>
Salary	\$630,024	\$600,000	\$592,319
Annual Bonus	\$581,938	\$500,000	\$510,000
Stock options (# of underlying shares)	169,055	162,500	150,000
Stock options (\$ value of above options as calculated by IRRC)	\$1,359,180	\$1,341,333	\$1,150,958
Restricted stock awards (\$)	\$812,100	\$782,100	\$764,750
Long-term incentive plan payouts	\$806,870	\$519,747	\$550,000
Net realizable gains from exercise of options <sup>^</sup>	\$1,390,200	\$1,743,303	\$1,920,323

<sup>^</sup> Medians exclude zeros.

## Stock Option Repricing

Current Financial Accounting Standards Board (FASB) rule clarifications were designed to make it prohibitively expensive for companies to replace or reprice underwater stock options. The new interpretation of APB Opinion No. 25, Accounting for Stock Issued to Employees, which took effect July 1, 2000, says all stock option repricing will result in variable award accounting from the date of repricing until the date of exercise. The rules also apply to a cancellation of stock options and their replacement with new shares within a 6-month period. They apply to all modifications of awards that occurred after Dec. 15, 1998. According to the rule changes, companies would have to apply variable accounting for new options that are granted in connection with the cancellation of outstanding out-of-the-money options if either of the following occur:

- new stock options with a lower exercise price are granted within six months before or after cancellation of the old stock options; or
- new stock options with a lower exercise price are granted outside the six-month before/after window period, but either (1) the company agrees to compensate the optionee for increases in stock price during that period, or (2) the company and optionee agree to cancel the old stock options at some future date.

FASB also has clarified that variable accounting is required only for up to the number of new shares granted that are equal to the number of old shares cancelled.

IRRC tracked 88 companies announcing an option bailout arrangement in 2003. Of those companies enacting bailouts in 2003, 47 percent allowed at least one of the top five executives to participate. Sixty-three percent of the recorded bailouts used the “six and one” method. IRRC tracked 98 companies that disclosed an option bailout arrangement during 2002 and 181 that did so in 2001. IRRC uses the term ‘option bailout’ to capture company actions since July 1, 2000, which, while possibly not considered to be repricings under Financial Accounting Standards Board (FASB) definitions, serve similar purposes as repricings. Significantly, option bailouts include instances when companies cancel existing options, only to grant new options on a date that is at least six months and one day from the date of cancellation (six and one), thereby avoiding any accounting penalties as defined by FASB. Bailouts also include, in addition to straight repricing, incidences when companies replace option grants with shares of restricted stock—a restricted stock swap.

IRRC tracked 25 companies asking for shareholder approval of bailout programs in 2003. Shareholders do not appear to be strongly opposed to option bailouts when management asks for permission to do so. Only one of the 25 proposals had difficult passing in 2003. The final tally of the bailout proposal at **Electroglas** was 50 percent voting for; 42 percent voting against; 8 percent abstaining. The terms of the Electroglas bailout were not especially unusual—a “six and one” program in which neither executive officers nor directors were eligible to participate. The exchange ratio varied from one new option for every 1.25 options exchanged to one new option for every four options exchanged. Perhaps the strongest reason behind the unusual amount of opposition witnessed at Electroglas was the influence of the State of Wisconsin Investment Board (SWIB), which at the time held 15 percent of the company’s outstanding common stock. During the past several years, SWIB has taken initiative on the repricing issue, submitting numerous proposals to companies requesting that underwater stock options not be repriced or replaced without prior shareholder approval. Many of the targeted companies agreed to a ‘no repricing policy’ and accordingly SWIB withdrew its proposals.

## Using this report

To accommodate varying client needs, IRRC has divided the remainder of this report into four parts. The first of these sections, *Management Compensation Proposals*, focuses on stock compensation trends and the structure of stock and bonus plans that were proposed for executives in 2003 at companies tracked by IRRC. The following section, *Voting on Management Compensation Plans in 2003*, discusses voting results on stock option and bonus plans. Finally, *Proxy Voting Guidelines* details key considerations used by institutional investors in developing voting guidelines for compensation proposals. Throughout this report, unless otherwise indicated, numerical data concerning compensation plans for 1997 through 2003 is based on an approximate 1,500-company universe comprised of Standard & Poor's 500 index, the S&P 400 MidCap index, and the S&P 600 SmallCap index, which are collectively referred to as the "S&P 1500." Data for 1996, unless otherwise indicated, is based on IRRC's research universe for that year, which consisted of a similarly sized group of approximately 1,500 companies but with a somewhat different composition from that of the S&P 1500. Voting opposition is expressed as a percentage of votes cast, and includes abstentions.

Appendix A provides a glossary of compensation terms. Appendix B explains how IRRC calculates dilution. Appendix C summarizes Section 16b of the Securities Exchange Act of 1934. Appendix D provides a summary of Section 162(m) of the Internal Revenue Service Code.

## Stock-based plan proposals

### Stock incentive plans

The trend since the late 1980s toward paying employees, especially high-level executives, a significant portion of pay in stock-based forms of compensation rather than cash led to proxy voters seeing a growing number of stock option plan proposals on their ballot cards during the 1990s. Proposals to adopt or reserve additional shares under stock option plans, stock award plans and employee stock purchase plans appear to have peaked in the late 1990s and then diminished in recent years (see Table 3).

In 2003 the frequency of stock-based proposals contracted to 2001 levels. Although some analysts had predicted an influx of plan proposals in 2003 in anticipation of the SEC's adoption of exchange rules necessitating shareholder approval of many plans that were previously exempt, it appears that many companies took a "wait and see" approach to the SEC's decision, which was not handed down until after the spring proxy season of 2003. Now that stricter standards for shareholder approval of plans have been implemented, companies are expected to submit more stock plans for shareholder approval in 2004.

The SEC has required companies to disclose all shares reserved under shareholder-approved and non-shareholder approved stock plans since December 2001. According to the 2004 edition of IRRC's *Stock Plan Dilution* study, approximately one-fifth of the average S&P 1,500 company's potential dilution is caused by stock plans not approved by shareholders.

**Table 3: Number of proposals to adopt new stock plans or add shares to existing plans 1995-2003**

Year	Option plans (adopt plan/add shares)	Purchase plans (adopt plan/add shares)	Award plans (adopt plan/add shares)	Total
2003	199/164	47/93	9/4	516
2002	227/197	56/76	7/4	567
2001	185/195	63/67	8/0	518
2000	198/218	67/62	5/0	550
1999	210/209	55/78	8/0	560
1998	248/213	62/64	11/8	606
1997	284/222	53/53	31/3	646
1996	239/198	45/43	19/8	552
1995	234/165	53/8	43/48	551

In addition to satisfying many corporate governance activists' calls to tie pay to performance, several other factors fueled the proliferation of stock and options in executive compensation. First, market-value options granted under shareholder-approved plans meet the criteria in IRC Section 162(m) as "performance-based compensation" (thus exempt from the \$1 million deduction limit). Second is the fact that option grants, compared with cash wages, have a lesser impact on company-reported profits. Under current accounting standards, companies only need to include in a footnote to their annual reports an estimate of the fair value of options and their theoretical impact on earnings per share. The Financial Accounting Standards Board is expected to require option expensing in 2005. A survey conducted by Mercer Human Resource Consulting found that one-third of the companies surveyed would reduce the number of options granted to employees if options grants are required to be expensed, and 31 percent said they would reduce the number of individuals who receive stock options.

In fact, companies are already scaling back their use of option grants. According to the 2004 edition of IRRC's *Stock Plan Dilution* study, the average 1-year run rate now stands at 2.5 percent, down from 2.9 percent for the 2003 study. IRRC calculates the run-rate by dividing the number of options granted during the previous fiscal year by the number of common shares outstanding as of the annual meeting's record date.

### **Features of stock incentive plans in 2003**

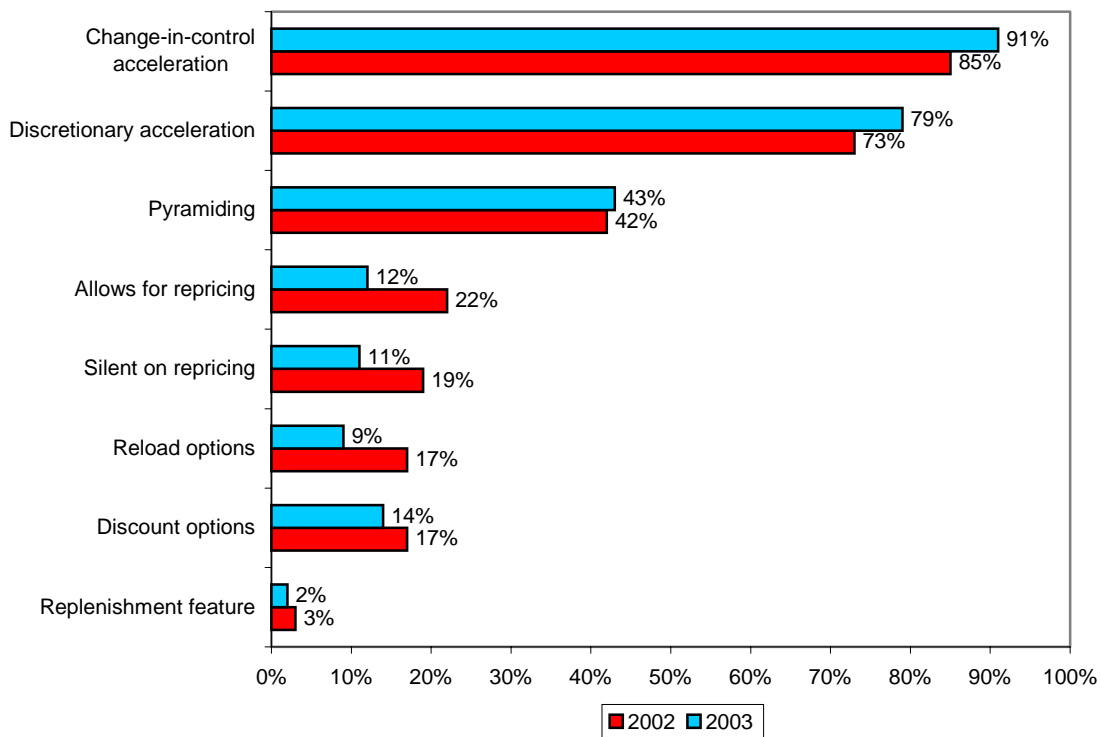
The most notable development for stock incentive plans in 2003 was increased prevalence of restricted stock. In 2003, 82 percent of 199 new stock incentive plans permitted awards of time-lapsing restricted stock; in 2002, only 71 percent of new incentive plans permitted restricted stock awards. In 2003 IRRC tracked 20 companies amending existing incentive plans for the specific purpose of authorizing time-lapsing restricted stock awards.

**Figure 1** compares key characteristics of new stock incentive plans in 2002 and 2003. Provisions providing for the acceleration of outstanding awards in the event of a change-in-control of the company are gaining prevalence. Committee discretion to accelerate the vesting of outstanding awards for reasons other than a change-in-control is also on the rise.

The percentage of new plans permitting pyramiding remained almost unchanged from 2002 levels. Pyramiding refers to the practice of allowing options to be exercised via a series of stock-swap transactions, beginning with a small number of previously owned shares and then

using shares received in each successive transaction until the entire option is exercised. IRRC presumes that any plan that permits options to be exercised with shares owned less than six months potentially permits pyramiding. Other controversial plan features remaining relatively stable since 2002 are discount options and replenishment features. A discount option has an exercise price below the underlying shares' fair market value on the date of grant. A replenishment, or "evergreen" feature, provides for automatic periodic increases in a plan's share reserve. Despite the convenience they afford for plan administrators, plans with replenishment features often carry a negative perception among shareholders due to the high potential dilution caused by such provisions. IRRC tracked only four new plans in 2003 that contained a replenishment feature.

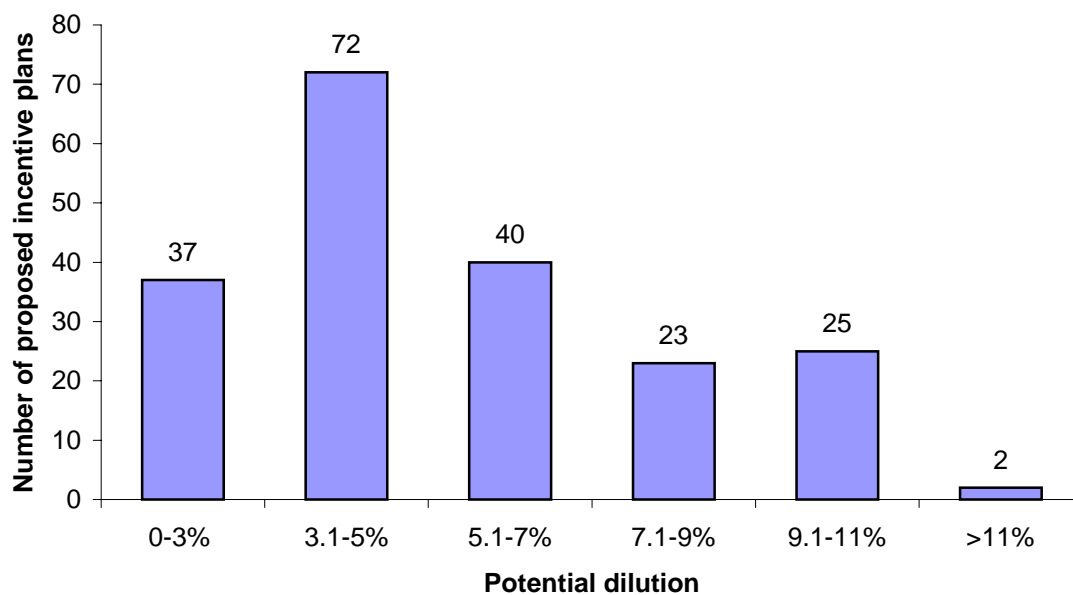
As shown in Figure 1, the prevalence of new plans silent on the issue of repricing/replacing underwater options without prior shareholder approval dropped considerably in 2003, along with those that specifically allow for underwater option bailout programs. Conversely, 78 percent of the 199 new stock incentive plans in 2003 specifically prohibit the repricing/replacement of underwater options. Another feature in decline is reload options, which automatically "re-load" plan participants who exercise options with new grants.



**Figure 1: Key features of new stock option plans—2003 vs. 2002**

*Potential dilution* is a key factor used by investors in evaluating a stock option plan. As new shares under the plan are granted in the form of restricted stock and as stock options are exercised, the shares issued dilute existing shareholders' voting power as well as earnings per share. IRRC measures the potential dilution associated with a stock plan proposal by dividing the number of shares proposed to be reserved under a compensation plan by total outstanding common shares.

**Figure 2** shows the distribution of dilution levels among the 199 new stock option plans proposed in 2003. 101 of the 199 proposals added less than 5 percentage points to the company’s total potential dilution. The potential dilution of stock plan proposals typically stays below 5 percent due to stock exchange rules that have allowed brokers and other intermediaries to cast ballots on so-called “routine” voting items. A proposal to approve a plan involving less than 5 percent of the outstanding stock is considered routine. For proposals involving dilution over 5 percent, the missing broker non-votes (i.e., those where the customer has not provided voting instructions to the broker) can constitute a sizable portion of abstentions from the vote—enough to cause some close calls to fail. As a result, companies are apt to keep dilution of stock plan proposals below this threshold to ensure the votes of shares held by brokers, who typically vote in favor of management. In 2003, new stock exchange listing rules eliminated broker non-votes on all stock compensation proposals.



**Figure 2: Distribution of potential dilution caused by new stock incentive plans in 2003**

The *median* potential dilution of 199 proposals to adopt new executive stock incentive plans was 4.9 percent in 2003. The weighted *average* potential dilution was 5.2 percent.

## Executive bonus plan proposals

### Section 162(m)

Under Section 162(m) of the Internal Revenue Service Code, effective as of 1994, any compensation that qualifies as performance-based pay is tax deductible, while “nonperformance-based pay” in excess of \$1 million paid to certain top executives is generally not deductible as a compensation expense. In order for cash bonuses to qualify as performance-based, a company must obtain shareholder approval of the plan’s performance criteria and either the specific formula for bonus awards or the maximum award allowed under the plan. A summary of the provisions of Section 162(m) is set forth in *Appendix D*. (Note that additional requirements

under Section 162(m) stipulate that an independent compensation committee must ratify, in writing, that the performance goals generating the bonuses have been attained.)

Based on IRRC’s review of compensation committee reports, most companies report that they have crafted their executive compensation plans to conform to the criteria for tax deductibility but also reserve leeway to enter into future arrangements that may not meet the criteria.

## Bonus plans

Enactment of Section 162(m) has resulted in a general increase in the number of bonus plans submitted for shareholder approval. As shown in **Table 4**, 2003 marks the first increase in the number of new bonus plans since they peaked in 1999.

**Table 4: Number of new bonus plan proposals by type, 1996-2003**

Year	Annual only	Long-term only	Annual and long-term	Total plans
2003	68	7	7	82
2002	64	8	3	75
2001	84	6	3	93
2000	103	18	8	129
1999	128	25	5	158
1998	69	18	3	90
1997	94	14	7	115
1996	113	22	10	145

Bonus plans that reward executives based on achievement of annual performance goals remain the most common bonus compensation plan. Long-term bonus plans, which usually have a three-year performance period, are used less frequently. In 2003, IRRC tracked 82 proposals for new bonus plans. Of those, 68 were annual bonus plans, seven were long-term bonus plans, and seven more combined annual and long-term bonus plans.

Most companies award only cash under bonus plans, but the percentage of companies allowing for a combination of cash and stock awards may be growing. In 1994, approximately 26 percent of the S&P 500 bonus plans studied awarded a combination of cash and stock. By contrast, 35 percent of the S&P 500 companies that proposed new annual bonus plans in 2003 allowed for a combination of cash and stock.

Nearly all bonus plan proposals include some description of performance criteria that the board or its compensation committee uses to determine the size of bonus awards. The list of criteria commonly includes financial benchmarks such as earnings per share, return on equity and net income, as well as more qualitative measures such as customer satisfaction.

Because Section 162(m) does not stipulate what performance criteria will suffice for bonus awards to be deemed “performance-based,” the information on this subject that companies disclose varies widely—the regulation requires disclosure of the criteria that may be used to govern bonus awards, but not specific goals (which are considered confidential business information). As a result, shareholders may find voting on bonus plans confusing. Of the new annual bonus plans proposed at S&P 500 companies in 2003, 25 percent had a specific formula for determining future awards.

**Limits on bonus awards:** Maximum award amounts paid to bonus plan participants may be expressed as a percentage of base salary, as a dollar amount, or as a percentage of a bonus pool. If

a company bases the maximum amount to be paid over a performance period on a percentage of base salary, it also must set a maximum dollar amount for the performance period, or the base salary rate on which it is based must be fixed at the beginning of the period. These qualifications prevent the compensation committee from circumventing the rule by raising an executive's salary in order to increase the potential bonus amount.

Plans that use a percentage of a bonus pool for a maximum will qualify as performance-based if the proxy statement discloses the formula used to establish the pool and the maximum percentage of the bonus pool that may be awarded to any participant. In addition, the sum of the maximum percentages for each participant may not exceed 100 percent. For example, a plan will qualify if it creates a bonus pool of 2.0 percent of net income, and awards the CEO a maximum of 20 percent of the bonus pool and the sum of maximum proportions awardable to all other participants does not exceed 80 percent. If the maximum award is not sufficiently predictable, the plan will not qualify.

Only few bonus plans use a "pool" system from which each participant receives an aggregate amount determined by the administrator. In 2003, only 19 percent of new annual bonus plans used the pool method.

**Table 5** provides a summary of the annual limits either expressed as a percentage of salary or by dollar amount, which were adopted among companies in the S&P 500 from 2000 through 2003.

**Table 5: Limits in annual bonus plans proposed by S&P 500 companies, 2000-2003**

	2003	2002	2001	2000
<b>Expressed as percentage of salary:</b>				
Number of plans with % of salary limit	7	4	13	10
Average max percent of base salary	214	238	195	170
Lowest percent of base salary limit	150	200	80	48
Highest percent of base salary limit	300	300	300	300
<b>Expressed in dollar amounts:</b>				
Number of plans with dollar limit	28	23	32	34
Average max dollar limit	\$6,950,000	\$4,980,000	\$4,200,000	\$3,500,000
Lowest dollar limit	\$1,000,000	\$2,000,000	\$1,000,000	\$1,000,000
Highest dollar limit	\$35,000,000	\$15,000,000	\$12,000,000	\$10,000,000

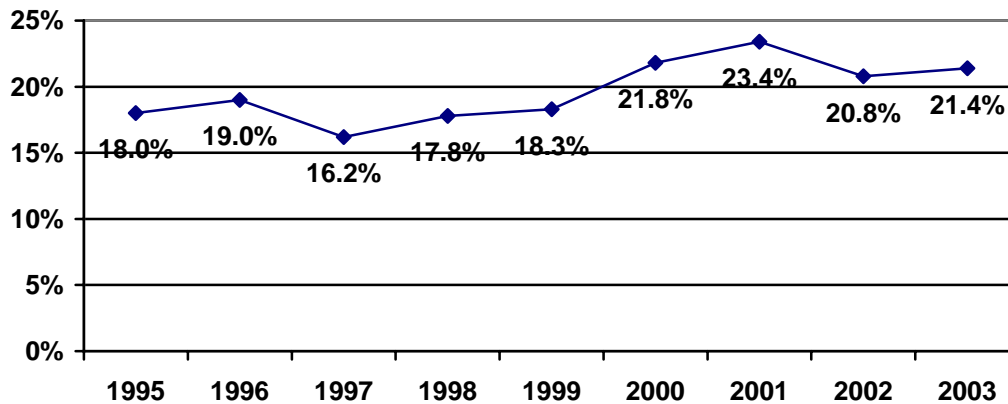
As indicated in **Table 5**, most bonus plans at S&P 500 companies express award limits as a dollar amount rather than a percentage of salary. Although the top base salary percentage limits have remained stable, at 300 percent, for several years, the highest dollar amount maximums have risen steadily and took a huge leap in 2003, along with the average dollar maximum. This increase is due in large part to two companies: **Hewlett Packard**, which set its maximum payout at \$30 million, and **Goldman Sachs Group**, which established a maximum of \$35 million.

## Voting on stock-based plans

### Stock incentive plans

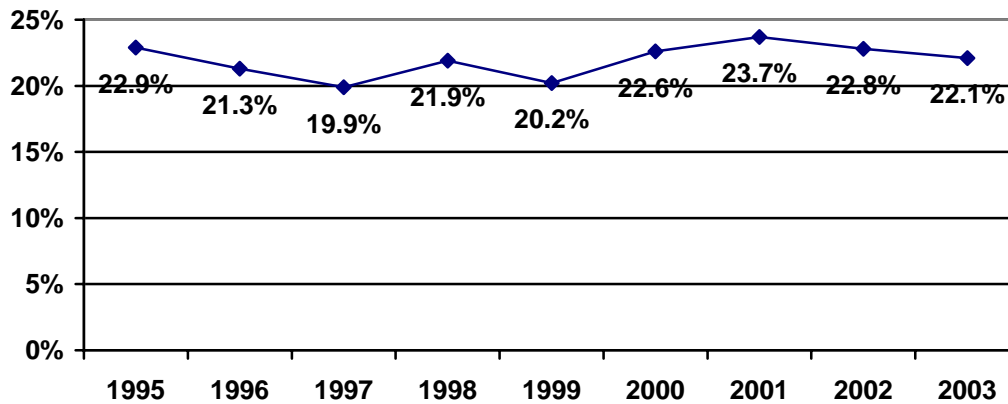
In 2003, shareholders voted on 199 proposals to adopt new executive stock option plans proposed by management at Super S&P 1,500 firms and an additional 164 proposals seeking to add shares to existing plans. IRRC obtained voting results from 174 of the 199 new option plan proposals and 146 of the 164 proposals that sought to add shares to existing plans.

As shown in **Figure 3**, shareholder opposition rose steadily in the late 1990s and peaked at 23.4 percent opposition in 2001. Shareholders were less stringent regarding new option plans in the late 90's, due in part to rising market values.



**Figure 3: Average opposition to new stock incentive plan proposals, 1995-2003**

Proposals to add shares to existing stock option plans typically receive slightly higher opposition than requests to adopt new plans. As illustrated in **Figure 4**, shareholder hostility to re-fueling also peaked in 2001, at an average vote of 23.7 percent against such proposals and has declined to 22.1 percent opposition in 2003.



**Figure 4: Average percentage of votes cast against proposals to re-fuel stock incentive plans in 1995-2003**

### Failed stock plans

Each year there are a few stock incentive plans that fail to garner enough support to pass. An analysis of failed stock plans confirms that potential dilution is a key factor in determining votes on stock plan proposals.

In 2003, IRRC tracked four failed proposals within the S&P 1,500, either to adopt a stock incentive plan or add shares to an existing one. Two proposals presumably faced opposition based on the following factors:

- **Activision's** proposed adoption of the 2003 Incentive Plan received 74.4 percent opposition. Shares reserved under the plan posed a potential dilution of over 10 percent. The company's overall potential dilution stood at 41 percent, which was higher than the 75<sup>th</sup> percentile of the company's peer group. Furthermore, the company's three-year average option grant rate exceeded the peer group's 75<sup>th</sup> percentile. The plan allowed for discounted options as well as reload options. More than one-third of the total options granted to employees during the previous fiscal year went to the company's top five executives. The company's stock price had fallen more than 50 percent during the previous fiscal year.
- **Vertex Pharmaceuticals'** proposal to add shares to the 1996 Stock and Option Plan was defeated with opposition representing 65.2 percent. The proposal carried a potential dilution of approximately 8 percent. Overall dilution reached 31 percent, which placed the company over the 75<sup>th</sup> percentile of its peer group. The plan allowed for acceleration of vesting at the discretion of the compensation committee. The company's stock price had fallen by 36 percent during the previous fiscal year. In addition, the company had added shares to the plan two times in 2001.

Failed proposals at the following two companies were more surprising in the absence of any glaring issues with regard to the plan or the company's overall performance:

- **Sysco's** 2003 Stock Incentive Plan received 58.0 percent opposition. The company's total potential dilution of 18.7 percent exceeded the peer group average's 75<sup>th</sup> percentile, but the proposal itself posed potential dilution of only about 4 percent. The company's three-year average option grant rate also exceeded the 75<sup>th</sup> percentile, but the company granted only 3 percent of total options to the top five executives during the previous fiscal year. The company's stock price increased over 10 percent for the previous fiscal year.
- **Maverick Tube's** 2003 Employee Stock Option Plan met with 52.3 percent opposition. The plan allowed for accelerated vesting at the compensation committee's discretion, but the plan had no other controversial features. During the previous fiscal year, the company's top five executives received 79 percent of the total options granted to employees, but that was because of the company's low overall option grant rate, which was less than half of the peer group median. The company's stock price was flat for the previous fiscal year, during which time the S&P 500 fell by over 20 percent.

## Withdrawn proposals

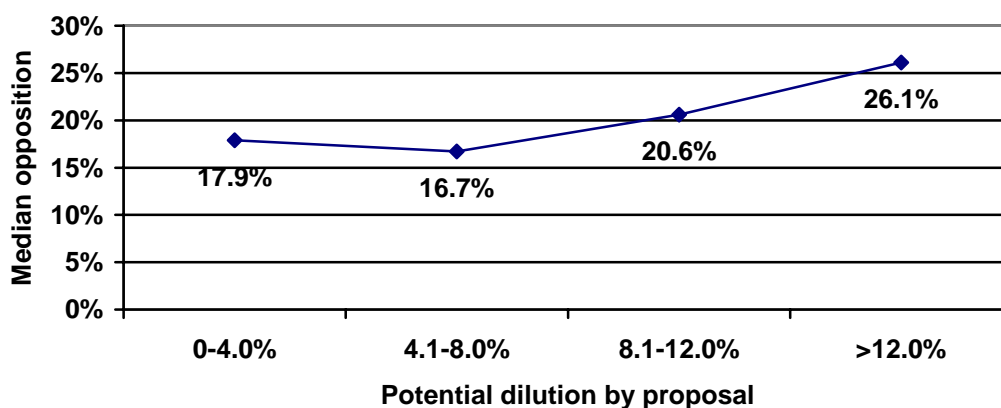
**Mercury Interactive** withdrew a proposal to adopt a new incentive plan in the face of public opposition from labor fund shareowners. The plan would have had an initial reserve of 10 million shares, representing 11.7 percent of outstanding common stock. If the proposal had passed, the company's total potential dilution would have exceeded the peer group's 75<sup>th</sup> percentile by more than 16 percentage points. Later in the year, the company submitted a less contentious proposal at a special meeting to add 3 million shares to an existing plan.

**SPX** withdrew a proposal to adopt an incentive plan in spite of the fact that it had zero potential dilution; two pre-existing plans would have supplied the proposed plan's share reserve. Shareholders may have been voting not against the plan itself, but the decision made by the compensation committee during the previous fiscal year to award the CEO 1 million shares of restricted stock. Another possible voting factor was the company's total potential dilution, which exceeded the peer group's 75<sup>th</sup> percentile by almost 14 percentage points.

## Potential dilution and opposition

Potential dilution remains a significant factor among shareholders when voting on stock plans. Although there are certainly other factors that influence voting decisions, high potential dilution generally results in higher opposition. Potential dilution may be determined using slightly different methods; a description of how IRRC calculates dilution is contained in **Appendix B**. Some investors analyze only the potential dilution represented by a proposal ("proposed dilution") when determining their voting decisions. Other proxy voters consider *total* potential dilution, which includes proposed dilution plus total outstanding options and shares available for grant under existing plans.

**Figure 5** illustrates how higher potential dilution caused by the actual proposal tends to result in higher opposition from shareholders. In 2003 the median opposition to new stock incentive plans, among those companies for which IRRC could retain voting results, was 17.8 percent. In 2002, the median was 20.8 percent.



**Figure 5: Median opposition to new stock incentive plans, by total potential dilution, 2003**

Median potential dilution caused by the 199 proposals to adopt new incentive plans was 4.9 percent in 2003. The median *total* potential dilution among those same companies was 18.1 percent, down slightly from 2002's median of 18.7 percent of outstanding shares, but significantly higher than 2001's median of 16.0 percent and 2000's median of 16.8 percent.

The median total potential dilution among S&P 500 companies submitting stock plans was 16.9 percent, up from 16.2 percent in 2002, and 14.9 percent in 2001.

Industry considerations typically shape companies' total potential dilution from stock plans. Many shareholders tolerate higher potential dilution levels based on a company's industry and growth stage, with dilution higher than 15 percent acceptable for high growth companies.

As IRRC's *Potential Dilution: 2004* study indicates, certain economic sectors are characterized by higher potential dilution. For example, information technology firms say they conserve cash necessary to reinvest in the company, thus compensating employees by awarding a large number of options. As seen in **Table 6**, S&P 1500 companies in the information technology sector had the highest average and median total potential dilution.

**Table 6: Total potential dilution by economic sector**

Economic sector	# of companies	Average dilution (%)	Median dilution (%)
Consumer Discretionary	276	15.2	16.4
Consumer Staples	72	13.4	13.3
Energy	75	8.9	11.2
Financials	197	16.6	14.0
Health Care	137	14.8	19.1
Industrials	256	14.0	15.8
Information Technology	253	25.7	24.8
Materials	98	14.0	15.1
Telecom. Services	16	15.1	13.6

<b>Economic sector</b>	<b># of companies</b>	<b>Average dilution (%)</b>	<b>Median dilution (%)</b>
Utilities	86	9.4	8.8
All companies	1,466	17.0	16.3

Source: *Stock Plan Dilution 2004*

### **Other plan features**

Opposition to option plans also is correlated with certain plan features. A discussion of the most common features that elicit investor attention follows.

**Evergreen plans:** Over the last several years, shareholders have registered strong opposition to evergreen stock plans, which periodically increase the amount of shares available for award each year according to a pre-determined formula. These plans can be highly dilutive to outstanding equity, and draw high opposition as expected, as shown in Table 7. In 2003, IRRC tracked only four proposals among S&P 1,500 companies to adopt a plan with a replenishment feature. Only two of the four companies actually *drafted* an evergreen plan in 2003. Zimmer Holdings adopted its plan without seeking shareholder approval in 2001 when the company was spun-off from Bristol-Myers Squibb. Westamerica Bancorporation's plan was considered an "adoption" by IRRC because the company simultaneously sought to add shares and extend the plan's termination date.

The majority of evergreen plans reserve a specified percentage of outstanding shares each year, but have an established termination date. The highest opposition to a proposal with a replenishment feature in 2003 was at **Goldman Sachs Group**, which adopted a plan with an initial reserve of 250 million shares and a 5 percent replenishment for a five-year period beginning in 2008.

**Table 7: Stock Plan Proposals in 2003 with Evergreen Features**

Company name	Replenishment		Annual replenishment (% of outst. common, unless noted)	Cap	Overall company dilution (%)	Opposition
	Begins in	will end in				
Goldman Sachs Group	2008	2012	5.0 percent	-	98.0	43.8
Zimmer Holdings	2001	2006	1.9 percent	-	18.6	21.3
Westamerica Bancorporation	1995	2013	2.0 percent or 675,000 shares		35.1	35.4
Jefferies Group	2003	2013	-	Total potential dilution = 30 percent	30.0	40.2

\* IRRC considered Zimmer Holdings' plan to be the adoption of a new plan because

It appears that companies have become sensitive to investors' views on evergreen provisions especially those with no specified termination date. The number of such new plans tracked by IRRC is relatively small: nine in 1994, four in 1995, five in 1996, three in 1997, four in 1998, two in 1999, no new plans in 2000, one plan in 2001 and three in 2002. All four of the evergreen plans tracked in 2003 had termination dates.

In 2004, investors may notice an increase in proposals to add shares to existing plans with replenishment features. Under the new stock exchange listing requirements, any plan with a replenishment feature and a term of more than ten years must now have shareholder approval for each periodic share increase.

**Discount options:** Discounted options—those priced at less than fair market value on the grant date—garner frequent complaints from shareholders who claim that these awards are inappropriate incentives. Critics argue that the incentive value of the awards to increase the stock price is weakened significantly if the awards already are in-the-money on the grant date. Note that discount-priced options do not qualify as performance-based under Section 162(m), unless they are granted in exchange for other performance-based compensation.

Companies generally limit the grant of discount options to situations in which plan participants forgo forms of cash compensation. Many institutional investors, while generally opposed to plans that permit grants of discount options, have accepted provisions that restrict discounting at reasonable levels to situations where stock is issued in lieu of cash.

The number of new plans permitting options to be priced at less than fair market value continued to slide in 2003. About 15 percent of new plans in 2003 permitted discount options, versus 18 percent of new plans permitted discount options in 2002, compared with 23 percent in 2001. According to IRRC data, about a quarter of the new plans proposed between 1994 through 1998 contained provisions for discount options. Of the 29 proposed plans that allowed for discount options in 2003, 21 permitted total committee discretion; seven allowed for prices as low as 85 percent of fair market value; and one allowed for exercise prices as low as 75 percent of fair market value.

Shareholders continued to register higher than average opposition to new plans allowing discount options. Twenty-nine new plans allowing discount options received average opposition of 24.5

percent in 2003. Thirty-eight new plans allowing discount options that were proposed in 2002 were opposed by 28.0 percent of votes cast on average. In 2001, shareholder opposition averaged 27.7 percent of the votes cast against plans that permitted discount options, compared with 27.2 percent of the votes cast in 2000, and 23.6 percent in 1999.

**Repricing provisions:** When the market price of the stock underlying outstanding stock options dips below their exercise price, the options are said to be “underwater” and of no value to the holder. Some companies reset exercise prices in such circumstances, generally equal to the market price at the time of the repricing. Companies that do so state that leaving options underwater puts the company at risk of losing key employees, and also that repricing is necessary to restore the incentive value of stock options.

Companies may adjust “out-of-the-money” options in two ways: They may cancel outstanding underwater options and *replace* them with new, lower-priced options, or they may amend outstanding underwater options and *reprice* them at lower prices. Both actions are commonly referred to as “repricing.” Financial Accounting Standards Board (FASB) rule clarifications have made it expensive, from an accounting perspective, for companies to replace or reprice underwater stock options. The current interpretation of APB Opinion No. 25, Accounting for Stock Issued to Employees, which took effect July 1, 2000, says that stock option repricing will result in variable award accounting from the date of repricing until the date of exercise. The rules also apply to a cancellation of stock options and their replacement with new option shares within a six-month period. (See the earlier discussion of Option Repricing.)

Some shareholders have expressed objection to repricing by voting against plans that allow administrators to adjust underwater options or by voting against stock plans proposed by companies that repriced options during the last year. In 2003, average voter opposition was 23.3 percent for the 24 proposals that had language allowing for option bailouts. In 2002, average voter opposition was 28 percent against 50 new plans that permitted bailouts. In 2001, average opposition to such plans was 27.8 percent of votes cast, up from 27.0 percent in 2000, 23.2 percent in 1999, 23.4 percent in 1998, 18.3 percent in 1997, and 19 percent in 1996.

In past years, new stock option plans proposed by companies that had repriced underwater options during the prior fiscal year have encountered notable opposition. In 2002, IRRC tracked four companies proposing new stock option plans after repricing underwater options in the previous year. These four companies garnered average opposition of 36.9 percent. In 2003, IRRC tracked two companies, Wolverine Tube and Lucent Technologies, which sought to adopt a new plan the year after carrying out a bailout program. The Wolverine Tube proposal received 24.7 percent opposition, while the Lucent plan received 14.5 percent opposition.

Repricing is addressed in various ways in proposed stock option plan documents. Some plan texts expressly authorize the practice while others are silent on the issue. Still others contain language sufficiently broad to be read as granting administrators the discretion to reprice underwater options—for instance, when plan text gives them power, among other things, to “amend outstanding awards.” The proportion of new executive stock option plans with such language, plus those that expressly permit repricing, has been steadily declining over the past several years. In 2003, only 12 percent specifically allowed for some type of bailout; in 2002, 22 percent of new plans permitted repricing, compared with 29 percent of all new plan proposals in 2001, 30 percent in 2000, 35 percent in 1999, 32 percent in 1998, 35 percent in 1997, 33 percent in 1996 and 39 percent in 1995. On the other hand—perhaps in response to shareholder concerns—IRRC has observed a booming percentage of plans that expressly forbid option repricing without

shareholder approval; approximately 59 percent of new proposed option plans in 2002 clearly prohibited repricing of options. In 2003, 77.9 percent of new plans made specific a prohibition.

New stock exchange listing rules stipulate that companies must obtain shareholder approval of any proposed repricing unless the plan under which the underwater options were granted expressly permits that action. In other words, plans that are silent on repricing are deemed to prohibit it.

***Time-lapsing restricted stock and restricted stock plans:*** Time-lapsing restricted stock awards, defined as grants of shares that vest over specified time periods, have been criticized by some shareholders as giveaways, since the awards have value regardless of whether the stock appreciates. Time-based restricted shares also do not qualify for exemption from the Section 162(m) million-dollar deduction cap (unless they are awarded as the payment for performance-based compensation).

There were only 13 proposals in 2003 to adopt or add shares to a stand-alone stock award plan in 2003. (These types of plans do not allow for stock options.) IRRC tracked 11 such proposals in 2002, compared with eight in 2001, five in 2000, eight in 1999, 11 in 1998 and 31 in 1997. Restricted stock awards also may be granted pursuant to a stock option plan. Approximately 83 percent of new stock incentive plans proposed in 2003 authorized restricted share awards. This number was at 71 percent in 2002.

Shareholder concern about plans that offer time-lapsing restricted stock typically do not translate into remarkably high “no” votes. Stock award plans usually garner opposition from approximately 5 percent of votes cast. Stock incentive plans with restricted stock awards garner somewhat more opposition. In 2003, 165 out of 1999 new incentive plans allowed for restricted stock awards. Of those proposals which IRRC has results for, the average support was 21.5 percent, virtually unchanged since last year. In 2002, 161 plans that permitted restricted stock grants garnered an average of 21.4 percent voter opposition.

***Reload options:*** Reload options are grants of new options that cover the number of shares tendered to the company to exercise an outstanding award. Critics argue that these awards allow executives to lock in stock price gains and protect them from falling prices. Companies say they increase executive stock ownership.

The proportion of new stock plans that specifically provide for reload options has remained fairly steady for several years: between 12 percent and 17 percent from 1995 through 2001, with 18 percent of new plans authorizing the grant of reload options in 2002. Only 9 percent of new plans authorized reload options in 2003 however. Opposition to those plans was 23.8 percent. Opposition to new incentive plans permitting reload options was 21.4 percent in 2002.

***Change-in-control provisions:*** Change-in-control arrangements are among the more common features of stock option plans. Such provisions allow for favorable treatment of existing executives’ unvested holdings of options and other awards, often enabling them to become immediately exercisable in the event of a change-in-control of the company, such as a merger or acquisition. Ninety-one percent of all new stock incentive plans had change-in-control provisions in 2003. Approximately 86 percent of all new plans proposed in 2002 contained change-in-control provisions, compared with 87 percent in 2001, 83 percent in 2000 and 84 percent in 1999. Voting results on plans with these provisions indicate that they have become relatively standard and accepted features of proposed new plans.

Shareholders have expressed reservations about change-of-control provisions, however, when they provide for acceleration of award vesting upon shareholder approval of a transaction, since in some cases the transaction may never be consummated (a merger subject to regulatory approval, for example). Investor pressure on Sprint motivated the company to change the payout trigger in its plan following its aborted merger with WorldCom a few years ago.

### Significant ‘no’ votes

**Table 8** details 36 proposals to adopt new stock option plans or to request additional shares for reserve. Each of these proposals was opposed by more than 40 percent of the votes cast. The “no vote” column includes abstentions and votes against the proposals and is expressed as a percentage of votes cast. Note that proposals to simultaneously add shares *and* extend the term of an existing plan are treated as new plan proposals by IRRC.

**Table 8: Stock Plan Proposals Receiving > 40 Percent Opposition in 2003**

Company	Plan dilution	Total dilution	Allows bailout?	Allows discount options?	Total opposition
Activision	10.2	41.3			74.4
Vertex Pharmaceuticals	7.8	30.6			65.2
Sysco	3.9	18.7			58.0
Maverick Tube	2.5	6.9			52.3
ICU Medical	10.9	87.5			49.3
Adobe Systems	0.0	35.3			49.3
Superior Industries International	11.3	17.4	TRUE	TRUE	48.9
Centex	4.8	21.9			48.4
THQ	10.4	34.1			47.3
Yum Brands	5.0	28.8			46.6
Gartner	8.4	63.1			46.3
Knight Transportation	2.7	7.5		TRUE	45.9
Sepracor	1.8	20.2	TRUE		45.9
Biosite	4.7	39.9		TRUE	45.9
Haggar	9.0	34.3			45.8
Cytec Industries	4.7	24.6			45.4
Plantronics	2.3	32.4			45.1
IDEC Pharmaceuticals	3.7	23.7			44.8
Enesco Group	10.8	32.4			44.6
Ansys	7.5	37.2		TRUE	44.2
Quiksilver	2.9	20.1		TRUE	44.2
Cooper Cameron	2.7	20.8			44.1
Goldman Sachs Group	78.0	98.0	TRUE	TRUE	43.8
MapInfo	1.3	27.2	TRUE		43.7
Tech Data	6.2	23.8			43.0
Nabors Industries	2.4	26.8			42.5
Gap	3.4	22.2		TRUE	42.3
Air Products and Chemicals	4.0	17.5			42.2
Jefferies Group	n/a	30.0			41.7

<b>Company</b>	<b>Plan dilution</b>	<b>Total dilution</b>	<b>Allows bailout?</b>	<b>Allows discount options?</b>	<b>Total opposition</b>
Swift Transportation	6.0	19.4			41.7
St. Mary Land & Exploration	4.1	17.5	TRUE		41.7
Osteotech	7.3	22.3	TRUE	TRUE	41.5
Standard Microsystems	4.3	36.1			41.4
Take-Two Interactive Software	2.4	19.9	TRUE		40.9
ESS Technology	2.6	36.3	TRUE	TRUE	40.7
Photon Dynamics	2.5	23.4			40.1

## Bonus Plans

Section 162(m) is not stringent on the amount of detail companies should provide in bonus plan proposals to qualify under that section's shareholder approval requirement. As a result, the information provided in these proposals varies, and shareholders may find it difficult to systematically evaluate them.

Companies generally receive solid shareholder support for bonus plan proposals. At the time this report was prepared, IRRC had obtained voting results for 71 of 82 bonus plan proposals in 2003. Of the 71 plans, average shareholder opposition to annual bonus plans was 7.3 percent. Average opposition to long-term bonus plans was 8.1 percent. Finally, the average opposition to plans combining both annual and long-term functions was 6.8 percent. One reason for strong shareholder support of bonus plans is that shareholders are reluctant to vote against these types of proposals, since their failure to receive shareholder approval could mean denying the company the ability to claim a tax deduction for significant portions of top executives' pay.

**Table 9** lists the three companies whose proposed bonus plans received more than 20 percent opposition from shareholders. Low support for these proposals may represent shareholders' dissatisfaction with management's performance as much as the plan itself.

**Table 9: Bonus Plan Proposals Receiving Significant Opposition in 2003**

<b>Company</b>	<b>Opposition</b>	<b>Maximum individual bonus limit per performance period</b>
Longs Drug Stores	34.3	300 percent of salary
Janus Capital	22.5	\$15 million annual/\$10 million long-term
Anthem	20.5	\$15 million annual

## Proxy voting guidelines

### Stock Option Plans

Management-proposed compensation plans are the most frequent non-routine voting item shareholders face. They also may rank as the most complicated proposals for which to develop guidelines. But developing workable guidelines for these issues is critical to institutional investors, because poorly constructed guidelines could increase substantially the proxy voting workload by generating too many case-by-case votes.

Stock options, performance shares and time-lapsing restricted shares are part of an arsenal of tools used by companies to attract, retain and motivate executives. Underlying that purpose is the theory that giving executives an equity stake in the company aligns their interests with those of the shareholders. However, these plans can contain some features that could have a negative impact on the incentive nature of the underlying awards.

Many shareholders apply a “sniff test” approach to evaluating stock plan proposals for executives. This involves applying one or several tests to proposed plans and making a case-by-case determination of the vote based on the results. For example, some may consider voting against a proposal if total company dilution exceeds a certain level, if the underlying plan allows discount options, allows time-lapsing restricted stock and/or gives the plan administrators the authority to replace or reprice underwater options. If several of these features are present, some voters also may evaluate the composition of the board’s compensation committee and assess the company’s financial performance and past pay practices before making a final determination whether or not to vote for the proposal.

Many funds have explicit guidelines relating to specific features of the compensation proposals. Some of these key considerations, along with the related pros and cons, are listed below. While most investors evaluate plans solely based on shareholder-unfriendly features—such as excessive dilution—companies and compensation consultants argue that shareholders should give “bonus points” to proposals that contain shareholder-positive provisions—such as mandatory premium-priced options.

## **Dilution**

When stock options are exercised, a company’s profits and assets are spread over a larger number of shares, and each individual owner’s claim on property and assets is diluted correspondingly. The exercising of options also reduces short-term per-share profitability. In addition to diluting per-share earnings, exercising options can shift the balance of voting power. Many investors look at the potential dilution of earnings or voting power as key factors when evaluating stock-based compensation plans.

The dilutive effect of a stock plan on voting power is especially important at companies that have supermajority voting requirements. If a corporation’s charter requires an 80 percent supermajority to approve a merger, and company insiders own 15 percent of the voting power, for example, then a stock plan that allows executives to acquire another 5 percent of the outstanding shares potentially gives insiders control of the company.

IRRC evaluates dilution three ways: (1) by only new proposed shares to an equity compensation plan; (2) by total plans, including proposed, available and outstanding shares under all company plans (“overhang”) and (4) by per-year dilution represented by the proposed shares divided by the plan length.

Calculating dilution of the proposed plan is the easiest and most consistent approach, since the necessary information is always readily available in the proxy statement and 10K. Using total overhang provides an understanding of the dilution caused by all company-sponsored programs. However, such a guideline has been more difficult to apply consistently, due to SEC disclosure loopholes. However, IRRC’s dilution calculation has become more comprehensive with the recent implementation of a new rule by the SEC regarding requirements for companies to clearly detail the number of shares granted and available for future awards under all company plans (including nonshareholder-approved plans).

Many institutional investors evaluate dilution to include all plans. In their Policy Statement on Corporate Governance, TIAA-CREF considers voting against a plan if the total potential equity dilution exceeds 15 percent over the duration of the plan(s) or 2 percent in any one year. TIAA-CREF would increase the threshold to 25 percent for companies in human-capital-intensive industries in which coverage extends through at least middle management levels. In addition, the threshold would be 20 percent for companies at the lower range of market equity capitalization. (For more information on how IRRC calculates dilution, see Appendix B.)

Some shareholders are not concerned about dilution from option plans, because options only deliver value if the stock price appreciates—this has been particularly true at high-growth companies, such as those in the technology sector. Also, a company may use the proceeds it receives from option exercises to invest in plants and equipment or to repurchase shares on the open market in order to control share dilution. Restricted stock awards and discount options are clearly more dilutive to earnings, since executives pay nothing or a minimal amount for the shares. Other shareholders may loosen their dilution thresholds in order to reduce the number of proposals they vote against.

## **Other provisions**

***Option bailouts:*** An option is “underwater,” or “out-of-the-money” when the market price of the underlying stock is less than the option’s exercise price. Companies with a significant number of outstanding options may decide to “bail out” the option holders. Companies carrying out this maneuver today usually cancel outstanding underwater options and grant 1) at-the-money options, 2) other stock-based awards, or 3) cash. While companies see bailouts as necessary to retain and motivate the workforce, many shareholders view bailout programs as unfair, given that regular shareholders are not afforded a second chance on their depreciated investments. Many investors have policies of opposing stock option plan proposals if the plan allows the administrators to execute a bailout program without prior shareholder approval. Another method for protesting bailouts is to vote against any plan proposals if the company has recently carried out such a program.

The new listing requirements at the major exchanges will reduce the number of companies executing option bailouts without prior shareholder approval. The NYSE standards provide that the deletion of a plan provision requiring shareholder approval of bailouts is a material revision, which mandates a vote by shareholders. Furthermore, under the NYSE requirements a plan that does not specifically allow for bailouts without shareholder approval is assumed to prohibit such activity. Nasdaq standards hold that a plan amendment to allow bailouts is a material amendment necessitating shareholder approval. Nasdaq recommends that companies use language that clarifies a plan’s position on bailouts, but does not assume that “silent” plans effectively prohibit bailouts.

The Financial Accounting Standards Board (FASB) has made it expensive, from an accounting perspective, for companies to replace or reprice underwater stock options. Interpretation 44 of APB Opinion No. 25, Accounting for Stock Issued to Employees, which took effect July 1, 2000, says that stock option repricing will result in variable award accounting from the date of repricing until the date of exercise. The rules also apply to a cancellation of stock options and their replacement with new option shares within a six-month period.

The Council of Institutional Investors, Calpers and TIAA-CREF all have weighed in on the issue of repricing. The Council says that “unless submitted to shareholders for approval, no

‘underwater’ options should be repriced or replaced and no discount options should be awarded.” Calpers says “All material changes to existing equity-based compensation plans, including reprings of any form, shall be shareholder approved.” Finally, TIAA-CREF says it would flag a proposal if an option plan gives the company the ability to lower the exercise price of options already awarded where the market price of the stock has declined below the original exercise price. TIAA-CREF would consider if the company has not repriced options in the past or has excluded senior executives from any repricing and has tied any repricing to a significant reduction in the total number of outstanding options.

**Change-in-control provisions:** After the takeover wars of the 1980s, and with the re-emergence of merger and acquisition activity in the 1990s, most stock incentive plans now include provisions that allow executives to cash in their options if a change in control occurs. These provisions, ostensibly designed to protect employees from financial hardship due to an unexpected change in control, may be construed as antitakeover measures because they usually increase the cost of acquiring the company when they are activated.

Change in control provisions have become relatively standard features of proposed stock option plans. In 2003, nearly 90 percent of the 199 proposed new stock option plans for executives included change-in-control language. CIC provisions in stock plans may include a variety of potential measures, such as:

- Making all unvested options immediately exercisable if a change in control occurs.
- Accelerating the vesting of any options held by employees who lose their jobs without cause or who resign for good reason following a change in control.
- Cashing out outstanding options for the difference between the market and exercise prices at the time of a change in control.
- Lifting restrictions on restricted stock grants and performance awards so that executives can take full possession of outstanding awards.

In addition, some plans offer “limited stock appreciation rights,” which effectively allow optionees to cash-out their grants upon a change of control. Like a stock appreciation right, a limited stock appreciation right is granted at the time the option is granted; unlike a stock appreciation right, it is exercisable only in the event of a change in control. When exercisable, a limited stock appreciation right entitles the holder to the difference in cash between the offeror’s price and the exercise price. Some plans also authorize the substitution or replacement of existing grants for grants of the surviving company in a change-in-control transaction.

One important consideration in change-in-control provisions is whether the protections would be triggered upon consummation of the transaction or, alternately, upon shareholder approval of the transaction. In the latter case, award vesting and/or payout could be triggered although the transaction may never occur (e.g., a merger subject to regulatory approval). While most shareholders tolerate general change-in-control provisions, they are more likely to object if the provision calls for automatic vesting merely upon shareholder approval of a transaction.

**Vesting:** Vesting requirements generally are attached to stock options and time-lapsing restricted stock awards. Some shareholders may consider the vesting requirements attached to stock awards when voting on stock plans. Generally, the minimum vesting requirement is six months, although many shareholders believe vesting should take longer to encourage a focus on long-term performance.

Although in the minority, an increasing number of companies are granting restricted stock awards and stock options that contain performance-accelerated vesting provisions. For example,

performance accelerating restricted stock (PARS) and performance accelerating stock options (PARSOPS) are time-lapsing grants that may enjoy accelerated vesting if specific performance goals are achieved. PARS and PARSOPS qualify for fixed accounting treatment while incorporating a performance component (which ordinarily results in variable accounting treatment); thus, many companies favor them over pure performance-based stock awards.

### **Award types**

**Discount options:** Another factor that concerns many shareholders is the minimum allowable exercise price of option awards. An option is usually priced on the grant date. Incentive options must have a minimum exercise price of 100 percent of the fair market value of the company's stock on the grant date to qualify for special tax treatment. While nonqualified options have no such minimum, most—but certainly not all—companies self-impose the same minimum price.

Options that are granted with below-market exercise prices are said to be granted “in-the-money.”

Some shareholders have criticized in-the-money options. Opponents say corporate executives should not receive preferential treatment and that discounted options do not give management enough incentive to work to increase share value. These awards defeat the purpose of aligning shareholder and executive interests, according to critics. Note that options with a discount exercise price also do not qualify for exemption from the Section 162(m) deduction cap.

Many shareholders have policies of voting against proposals if the underlying plan allows options to be priced at less than market value. TIAA-CREF votes against stock plan proposals that have an unspecified exercise price or allow exercise prices below 85 percent of fair market value on the date of grant.

**Time-lapsing restricted stock:** Although less common than stock options, time-lapsing restricted stock is another popular equity-based award typically used as a retention tool by companies. Time-lapsing restricted stock awards are conditional grants of the company's common stock that have a minimum holding period before the executive can sell the stock. The required holding period can vary widely but often runs three years. Holders of restricted stock generally can vote the stock and are entitled to dividends.

Time-based restricted stock does not qualify as “performance-based” compensation under Section 162(m), and its use initially declined after the tax regulation took effect in 1994. A recent rise in the use of restricted stock may be attributable, in part, to the low market risk associated with the awards. The shares have either no purchase price or a minimal one, so an executive is compensated even if the market price does not rise. In a volatile market, some companies may make greater use of time-lapsing restricted stock because options can lose their incentive value if the market price drops. Compensation consultants say restricted stock is especially useful in depressed industries where management turnover is a problem. The holding period associated with restricted awards requires the executive to stick around in order to receive the full value of the award.

Some shareholders criticize these awards as “giveaways,” because the restricted shares have value whether or not the stock price appreciates. These critics say the awards solely reward tenure with the company, instead of rewarding strong company performance. However, some investors have begun to advocate prudent use of restricted stock, in lieu of options, to retain and reward key employees.

**Reload options:** Another award technique is the “reload” option. Reload options are granted when an executive exercises options by exchanging shares that he or she already owns. The new reload option covers the number of shares equal to the number exchanged in the exercise. The new option is issued at the market price on the reload date and may be held for the remainder of the original option’s term.

Consultants Frederic W. Cook & Co., which helped pioneer reload options, says **Norwest** may have been the first company to introduce reload options, in late 1989. Since then, IRRC has tracked an increasing number of companies with reload options in their plans. Cook says some observers believe that once the concept is better understood, “reloads could become a more-or-less standard provision of option grants.” The proportion of new stock option plans that included reload options has increased somewhat, from 11.5 percent in 1995, to 17.0 percent in 2002.

Critics of reload options argue that they allow executives to lock in gains in the stock price while being protected from the downside risk of declining stock prices. Frederic W. Cook says reload options are not intended to increase executives’ compensation. Their purpose, Cook says, is to increase executive stock ownership by encouraging early option exercise through share-for-share exchange; to start dividends, voting, proxy disclosure and other ownership rights sooner; to limit the downside risk of options by enabling executives to lock in option profits in company shares; and to have an essentially neutral impact on company costs and dilution.

TIAA-CREF would vote against a proposal that allowed reload options unless the plan limits the frequency with which reloads can be used, provides for a reload only if market price increases a specified percent, and prohibits resale of the shares for which options were reloaded.

**How reload options work:** The charts below illustrate how reload options work (without accounting for taxes). Executive Jane Smith owns 800 shares of company stock and is granted an option to purchase 1,000 shares at an exercise price of \$40 per share. Two years later, the stock has risen to \$50 per share, and Smith exercises her option using the 800 shares she owns (market value = \$40,000) to cover the purchase of 1,000 option shares at \$40 per share. As illustrated in Table 10, Smith then owns 1,000 shares with a market value of \$50,000, and she receives a reload option for 800 shares with an aggregate exercise price of \$40,000 (at \$50 per share) and a term of eight years. Three years later, when the stock is trading at \$80 per share, Smith exercises her 800 reload options, using 500 of her owned shares (worth \$40,000) to pay the exercise price. Following that transaction, Smith owns 1,300 shares outright (500 + 800), worth \$104,000--and under many plans, she could receive a new reload option covering 500 shares, at \$80 per share.

If the plan at Smith’s company did not provide for reload options, and she simply exercised her 1,000-share grant after five years, her net ownership position would be the same—she could use 500 of her owned shares to pay the exercise price and would then hold 1,300 shares worth \$104,000. Smith would not, however, retain the upside potential of a new option (the reload) to replace the 500 shares she used to pay the exercise price.

**Table 10: Reloads in a Rising Market**

	<i>Before Exercise</i>			<i>After Exercise</i>		
		<b># of Shares</b>	<b>Net Value</b>		<b># of Shares</b>	<b>Net Value</b>
<b>Year 2:</b>	<i>Shares Held</i>	800	\$40,000	<i>Shares Held</i>	1,000	\$50,000
<b>Stock Price = \$50/share</b>	<i>Options Held</i>	1,000 @ \$40	\$10,000	<i>Options Held (reloads)</i>	800 @ \$50	\$0
	<i>Total</i>		\$50,000	<i>Total</i>		\$50,000
<b>Year 5</b>	<i>Shares Held</i>	1,000	\$80,000	<i>Shares Held</i>	1,300	\$104,000
<b>Stock price = \$80/share</b>	<i>Options Held</i>	800 @ \$50	\$24,000	<i>Options Held (reloads)</i>	500	\$0
	<i>Total</i>		\$104,000			\$104,000

The scenario is significantly different in a falling market, however, as illustrated in Table 11. If Smith executed the same transaction described above two years after the grant, she would again hold shares worth \$50,000 plus a reload option covering 800 shares, exercisable at \$50 per share. But if the stock declines to \$30 in year five, Smith's 1,000 owned shares would be worth \$30,000 (although her reload option would be worthless). Absent the reloads, Smith would have only her original 800 shares (now worth \$24,000), and an underwater option with no intrinsic value. Thus, in this declining stock price scenario, the reload options that encouraged Smith to exercise early to capture option gains resulted in an additional \$6,000 value.

**Table 11: Reloads in a Falling Market**

	<i>Before Exercise</i>			<i>After Exercise</i>		
		<b># of Shares</b>	<b>Net Value</b>		<b># of Shares</b>	<b>Net Value</b>
<b>Year 2:</b>	<i>Shares Held</i>	800	\$40,000	<i>Shares Held</i>	1,000	\$50,000
<b>Stock Price = \$50/share</b>	<i>Options Held</i>	1,000 @ \$40	\$10,000	<i>Options Held (reloads)</i>	800 @ \$50	\$0
	<i>Total</i>		\$50,000	<i>Total</i>		\$50,000
<b>Year 5</b>	<i>Shares Held</i>	1,000	\$30,000			
<b>Stock price = \$30/share</b>	<i>Options Held (reloads)</i>	800 @ \$50	\$0			
	<i>Total</i>		\$30,000			

**Stock appreciation rights:** Stock appreciation rights (SARs) are similar to stock options, except that upon the exercise of SARs the executive simply receives the spread between the market price and the exercise price. This spread may be paid in cash or stock. SARs were designed to enable executives whose ability to sell shares after exercising options was formerly limited by regulatory restrictions that are no longer applicable. SARs are subject to variable accounting treatment under APB 25, which has also limited their use.

SARs have been criticized by some shareholders as undermining the goal of increased stock ownership. The awards are tied indirectly to the stock, critics say, because the executives immediately may pocket the cash gain without being required to continue to hold the shares in the company. With the prospect of mandatory adoption of FAS 123 ("fair value" expensing of all

stock-based compensation), some observers predict that SARs settled in stock will largely replace stock option grants at many companies.

## **Plan structure**

***Evergreen plans:*** First tracked by IRRC in 1991, these plans provide for automatic funding replenishment, usually by reserving a specified, but usually low, percentage of the outstanding shares for award each year. A minority of evergreen plans also do not specify a termination date and are thus truly "evergreen". These types of plans are frequently omnibus plans.

Many shareholders have opposed evergreen plan structures. Critics say company-sponsored, stock-based incentive plans should come up for renewal with shareholders. Although the proposed annual dilution may be low, shareholders may risk "creeping dilution" of more significant levels. Companies say these plans maximize the compensation committee's flexibility and save the company from the burdens and costs of obtaining shareholder approval to add additional shares to a plan. Those with a perpetual life means that shareholders are required only to approve the plans once.

Evergreen plans have met relatively high levels of opposition in recent years. TIAA-CREF considers voting against plans that contain an evergreen feature.

***Omnibus plans:*** Comprehensive omnibus stock option plans, first noted by IRRC in 1989, authorize the use of a number of stock-based compensation vehicles. Some plans delegate so much discretion to the compensation committee on the forms and terms of awards that some shareholders have called them "blank check stock option plans." An omnibus plan is defined by IRRC as one that authorizes five or more award types or gives plan administrators a high degree of discretionary power to grant "other stock-based awards."

Omnibus plans usually bestow a high degree of discretionary authority on plan administrators. Phrases such as "other stock-based awards" are frequently added to the long list of award types available to participants. Many of the plans contain change-in-control provisions and allow discounted grants. In addition to allowing a high degree of discretion, these plans often reserve a sizable percentage of outstanding shares for award.

Some shareholders oppose omnibus plans because they say they are overly generous and they give plan administrators too much discretion to grant a variety of stock awards. Critics say that, depending on market trends, some forms of stock-based compensation offer less risk to executives. Many companies say they propose omnibus option plans because they want a high degree of flexibility and do not want to submit plan amendments to shareholders for each market bounce or regulatory change.

## **Payment features**

***Pyramiding:*** "Pyramiding" is a technique by which executives may exercise their options in a rapid succession of transactions, beginning with as few as one share of stock. These transactions convert the difference between exercise price and market price into additional shares with no cash outlay, except for amounts needed to pay for fractional shares. **Black & Decker** has described pyramiding in its proxy statement this way:

The stock-for-stock payment method permits an optionee to start with one or more shares of common stock and possibly exercise an option in full (no matter how many shares are covered

by the option) by means of a succession of partial exercise transactions in which the optionee uses the shares obtained on each exercise to purchase a larger number of shares on the next exercise. Whether the optionee exercises the entire option by using this pyramiding technique or by delivering sufficient shares of common stock to accomplish full stock-for-stock payment in a single transaction, the net increase in the shares of common stock held by the optionee will be identical. In both cases, the corporation receives consideration of value equal to that required under the option agreement and the optionee has a net gain in common stock holdings with a value equal to the appreciation or “spread” realized under the options.

IRRC defines pyramiding as any plan that allows executives to exercise options using stock that has not been held for a minimum holding period. For tax reasons, many plans require executives who exercise their options by tendering shares to use only “mature” shares (i.e., those held at least six months). The percentage of proposed new option plans for executives allowing pyramiding has remained relatively constant over the last three years. About 42 percent of the proposed new stock option plans in 2002 could allow pyramiding.

Critics have argued that pyramiding minimizes the risks to executives, since they are not required to risk any cash for the new shares. Supporters of pyramiding say it helps make options more affordable to the holder and ultimately serves to increase stock holdings.

***Company loans and grants:*** In the past some stock option plans allow executives to pay for an option exercise with a promissory note or loan from the company. Sometimes the loans are made at below-market rates. Some shareholders complain that loans—particularly those with favorable interest rates—are unfair, since these special financing arrangements are not available to all shareholders. However, in August 2002, the Sarbanes-Oxley act was implemented. This act, among other things, bans corporations from making loans to executives and non-employee directors. About 27 percent of the proposed new stock option plans for executives tracked by IRRC in 2002 allowed companies to provide loans for option exercises. An interesting note is the number of companies that continue to include provisions for loans in new option plan proposals, despite the recent ruling prohibiting them. IRRC has tracked 14 of 66 new option plan proposals by companies with annual meetings after November 2002, which permit company loans. Of the 13 proposals, three were from companies in the S&P Super 1,500. Included in the plan text of many of the companies, which continue to permit loans in new option plan proposals, are terms stating “where permitted by applicable law,” thus providing said company with flexibility to permit loans if the ban is ever withdrawn.

***Cashless exercise:*** So-called “cashless” option exercises (sometimes called “brokered” exercises) were enacted by the Federal Reserve Board’s 1988 amendment to Regulation T, which governs margin lending by stockbrokers. The amended rule allows option holders to transact their exercise through a broker with the company’s cooperation. When the employee wants to exercise his or her option, the broker purchases the shares from the company, by paying the shares’ exercise price, and immediately sells the shares at the current market price. The profit—the difference between the exercise purchase price and the market sale price—goes to the executive after commission costs are deducted. The executive thus earns the same profit (less commission) he would have earned if he had bought and sold the shares directly. The issue of whether the Sarbanes-Oxley prohibition on company loans effectively prohibits brokered exercises is not fully clear; some analysts believe that SARs settled in stock will replace this exercise method as more companies adopt option expensing.

## BONUS PLANS

Voting on short- and long-term bonus plans that are proposed in order to conform to Section 162(m) creates a catch-22 for shareholders. If a plan is not approved, the company may use the plan, but will not benefit from a related tax deduction. Some shareholders have complained that the legislation responsible for Section 162(m) was poorly constructed, and the required disclosed information is unhelpful or inconsequential. In addition, it is difficult for shareholders to establish a broad guideline or guidelines for voting on cash bonus plans that are tailored to meet specific corporate needs. There seems to be no generic approach available to shareholders in determining guidelines.

Shareholders also have raised concerns about companies' ability to use downward discretion in awarding bonuses. Under the regulation, compensation committees may not grant an executive a higher bonus than is determined by their formula, but they may lower an executive's bonus based on discretionary criteria. This has led many companies to establish high maximum bonus levels, in order to provide flexibility for "negative discretion." The practice makes it difficult for shareholders to estimate the size of the bonus that may actually be granted, however.

The following "red flags" may trigger "no" votes by some shareholders:

- Plans that have maximum awards past a certain threshold that the shareholders establish.
- Long-term incentive plans in which the performance criteria are not stock-based.
- Plans that give broad discretion to the compensation committee to choose performance criteria or that list many different performance criteria from which the committee may choose.
- Plans submitted from a company that has had poor overall performance for the past few years or poor total returns to shareholders or other lagging performance measures.
- Plans submitted by a company that has had total returns to shareholders that have steadily fallen the past five years, although the executives' bonuses have risen steadily.

IRRC's *SmartVoter* (voting guideline software) includes the following guideline choices for both annual and long-term bonus plans: Vote against the plan if (1) the maximum per-employee payout is not disclosed; (2) the maximum per-employee bonus payable is more than XX percent of a participant's base salary; (3) the maximum per-employee bonus payable is more than \$XX; (4) the performance criteria is not disclosed. *SmartVoter* users enter their own "cut-off" percentages and dollar amount.

In addition to bonus plans, shareholders also must determine proposed stock option plan limits with regard to Section 162(m). Stock plan limits are expressed in annual, aggregate or periodic form, and their potential net future value can vary greatly among companies with the same fixed-share limits. Therefore, shareholders may wish to evaluate the potential future net value of the option limit, using a valuation model of their choice. IRRC generally calculates potential net value by assuming that the company's stock appreciates at a rate of 10 percent per year over a 10-year option term, using the closing stock price on the company's fiscal year end.

Calpers considers the following criteria when voting on management bonus plans designed to maintain deductibility for non-deferred compensation in excess of \$1 million for the top five corporate officers:

- Vote FOR amendments to include administrative features or place a cap on annual grants any one participant may receive.

- Vote FOR amendments to add performance goals to existing compensation plans.
- Vote FOR cash or cash-and-stock bonus plans.
- Vote on a CASE-BY-CASE basis on amendments to increase shares reserved. Only those plans with acceptable dilution will be approved.

## Appendix A: Definitions

**Acceleration:** Provisions causing all outstanding awards—whether or not vesting requirements have been met—to become fully exercisable. This clause frequently is triggered by a change-in-control event, such as a merger.

**At-the-money awards:** Awards that are priced at the current market value on the grant date. For example, options with an exercise price of 100 percent of the market value on the award date were awarded at the money.

**Cashless exercise:** Under Regulation T, which governs margin lending by stockbrokers, executives may arrange to have their brokers exercise their option shares by paying the company the exercise price and then immediately selling the shares in the open market. The net gain, less commission costs, is given to the executives.

**Cashouts:** Paying cash to award holders for the difference between some market-based price and the awards' exercise price. This clause is frequently triggered by a change-in-control event.

**Concentration:** The percentage of the previous fiscal year's total option awards that were awarded to the named executives.

**Dilution:** When options are exercised or restricted shares are awarded, a company's assets, cash flow and profits are spread over the increased number of shares. The dilution caused by option awards may be less than restricted shares or stock awards because executives must pay the company money to exercise their shares. The company may then use the proceeds in ways that enhance shareholder value, such as investments, capital expenditures or stock repurchases.

**Discount options:** Options priced at less than the fair market value on the grant date.

**Dividend equivalents:** Units that accrue to option holders based on dividends declared and paid on shares covered by outstanding underlying options. When the option is exercised, the option holder receives cash or additional stock in exchange for the value of the dividend units.

**Duration:** The expected life of a proposed stock option plan based on the previous fiscal year's total option awards.

**Evergreen stock option plans:** First noted by IRRC in 1991, these plans provide for automatic funding replenishment, usually by reserving a specified—but usually low—percentage of the outstanding shares for award each year. Frequently, shares that are not the subject of an award may be carried over for future grants.

**Exercise price:** The price at which an option holder may purchase the shares underlying the option.

**Incentive (qualified) stock options:** As defined under section 422(b) of the tax code, options that qualify for preferential tax treatment. These options must be priced at fair market value. The option holder is not taxed on these options at the time of the grant or the time of the exercise. Instead, the applicable tax is deferred until the stock received under the option is sold and is then calculated based on the capital gains rate. This tax-favored nature of incentive stock options to executives is offset, however, by a loss of the deduction to the company. For an incentive option to qualify for such tax treatment, it must satisfy a number of conditions stipulated in Section 422A of the Internal Revenue Code, including:

- The stock option plan must indicate the total number of shares that may be issued and identify the employees or class of employees that qualify.
- The plan must be approved by shareholders within 12 months before or after its adoption by the board of directors.
- Options must be granted within 10 years of adoption or shareholder approval, whichever is first, and

granted options must be exercised within 10 years of the grant.

- The exercise price of the option may not be less than the market price of the stock at the time the option is granted.
- No individual may exercise incentive options worth more than \$100,000 in a single year.

Under current accounting regulations, a company generally is not required to take any charges to its reported earnings for a stock option grant.

***In-the-money awards:*** Options priced at less than the fair market value on the grant date.

***Limited stock appreciation rights (LSARs):*** A variation on stock appreciation rights (see following page) that are exercisable only in the event of certain changes in control of the issuing corporation.

***Nonqualified stock options:*** Loosely defined by the Internal Revenue Service as any compensatory stock option that does not qualify as a statutory (incentive) stock option. For tax purposes, the option holder generally is taxed on the exercise date for the difference between the fair market value and the exercise price. Any gain upon the exercise is taxed as ordinary income. Any subsequent sale of the stock will be treated as a capital gain or loss. A company may take a tax deduction for compensation paid when the executive recognizes income upon exercising the award. The IRS reasons that because nonqualified stock options are treated much the same as any compensation payment, companies are entitled to an ordinary and necessary business expense deduction on the exercise date. However, companies are not required to record an expense on their income statements for these awards.

***Omnibus stock option plans:*** Stock option plans that delegate great discretion to plan administrators on the types and terms of awards. IRRC labels a plan an omnibus plan if it authorizes five or more types of awards.

***Out-of-the-money awards:*** Awards priced at more than the market price on the grant date.

***Overhang:*** The sum of outstanding options and shares remaining available for future grants under a company's stock plans, expressed as a percentage of total outstanding common shares.

***Performance shares:*** Stock awards with vesting requirements based on the attainment of long-term corporate financial results or individual performance goals. Payments may be made in cash or stock.

***Phantom stock:*** Bonus units that correspond in number to the value of a specified number of shares. When these units mature, the payoff is based on the current value of the company's stock and paid in cash or stock.

***Premium-priced options:*** Options priced at more than the market price on the grant date.

***Pyramiding:*** The practice of using shares obtained from the exercise of each option to purchase additional shares covered under the option. In these transactions, executives exercise their options without using any cash.

***Reload options:*** Additional options that are granted when executives use shares to exercise their options. With reload options, executives exercising their options with stock will receive new options for the number of shares exchanged in the exercise. For example, if an executive exercises an option to purchase 1,000 shares by turning in 500 shares he already owns, he will receive a reload option to buy 500 shares. Reload options are issued at the market price on the reload date and may be held for the remainder of the original option's term.

***Replacing underwater options:*** The practice of canceling outstanding underwater options and replacing them with new, lower priced options.

**Repricing underwater options:** The practice of repricing outstanding underwater options at new lower market prices.

**Stock appreciation rights:** SARs are granted for a specified number of shares with a per-share exercise price. Upon exercise, the holder receives the difference between the market price and the exercise price, which may be paid in cash or shares of stock. Tandem SARs are granted with an incentive or nonqualified stock option, and allow the holder to exercise either the option or the SAR.

**Stock grant run rate:** The average annual number of aggregate option shares granted by a company (typically over a three-year period), expressed as a percentage of total outstanding common shares.

**Strike price:** The price per share at which the option holder may exercise the option (the exercise price).

**Time-lapsing restricted stock:** Conditional grants of company stock that have some minimum holding period before the executive may sell the stock. In the meantime, executives holding restricted stock are entitled to vote the shares and receive dividends.

**Underwater options:** Options with exercise prices that are higher than the stock's current fair market value.

**Vesting:** Requirements—such as time periods or performance goals—that must be achieved before the executive may exercise an option or sell a time-lapsing restricted stock or performance share.

## Appendix B: How IRRC calculates dilution

When reporting on stock option plans, IRRC tries to provide as much information on dilution as can be found in a company's proxy statement and 10K. With the recent implementation of the SECs ruling on disclosure information for equity compensation plans, dilution calculation has simplified. According to the new rule, companies are required to disclose all shares reserved under equity compensation plans, listed separately for shareholder approved and non-shareholder approved compensation plans. This information will be required yearly in annual reports on Forms 10-K and 10-KSB. In addition, the information must also be included in a company's proxy or information statement in years which the company is submitting a compensation plan for shareholder approval. The new equity table must include the number and weighted average price of outstanding options, warrants and rights as well as the number of securities available for future issuance under existing equity compensation plans.

Using the equity compensation plan table, IRRC captures (1) the number of shares available for future grants under the companies shareholder approved and non-shareholder approved plans as well as (2) the number of shares subject to outstanding options under the companies shareholder approved and non-shareholder approved plans. Total "**overhang**" is determined by dividing the sum of newly reserved shares, shares available, and shares subject to options outstanding by the shares of common stock outstanding.

$$\text{Total overhang (\%)} = \frac{(\text{New shares} + \text{Available shares} + \text{Outstanding options})}{\text{Total common shares outstanding}}$$

IRRC considers new shares as any shares that are reserved in the adoption of a new equity compensation plan or added to an existing plan in the most recent fiscal year.

For example company X, which has 24,427,236 common shares outstanding, proposed a stock option plan to be voted on at its 2003 annual meeting. The plan, under which 2 million shares were to be reserved, authorizes option grants to executives and non-employee directors. Included in the company's proxy or 10K will be the new equity compensation plan table. Shares listed as available and outstanding will be included from this table when calculating the overall potential dilution. The following dilution chart (which is included in IRRC's company proxy report for company X) shows newly proposed shares, shares currently available for future grants and shares subject to outstanding option grants under the company's shareholder approved and non-shareholder approved equity compensation plans, and dilution figures.

<b>Dilution on 24,427,236 outstanding shares:</b>				
	<b>New</b>	<b>Available</b>	<b>Unexercised</b>	<b>Dilution</b>
<b>Plan</b>	<b>shares</b>	<b>shares</b>	<b>options</b>	<b>(percent)</b>
2003 Stock Option Plan	2,000,000*	0	0	8.2
Shareholder approved plans	0	493,850	706,150	4.9
Non-shareholder approved plans	0	0	1,465,602	6.0
		<b><i>Overall minimum dilution</i></b>		<b><i>19.1</i></b>

\*new shares under proposed plan

From the above chart, shareholders can see that the potential dilution just from the proposed plan was 8.2 percent, while the company's total potential dilution more than doubled to 19.1 percent. Institutions may have guidelines on dilution that use only proposed plan dilution, or they may use the overall total potential dilution for their voting guidelines.

Often companies do not have non-shareholder approved equity compensation plans in place. IRRC notes this by including the 'Non-shareholder approved plans' line in the company proxy report, but captures zeros for available and outstanding share amounts.

## Appendix C: Section 16b

### Shareholder approval and SEC Rule 16b-3

Rules promulgated under Section 16b of the Securities Exchange Act of 1934 are designed to prevent insiders from unfairly using confidential information to profit from short-term trading in their companies' securities. Under Section 16b rules, profits realized by insiders from buying and selling any of their company's equity securities within a six-month period—so called “short-swing profits”—are subject to disgorgement back to the company. The section defines insiders as company directors or officers and beneficial holders of more than 10 percent of any class of equity securities.

By its terms, Section 16b applies to stock options and other equity-based awards and derivative securities issued to executives as part of their compensation package. SEC Rule 16b-3 is a crucial provision in the area of executive compensation because it establishes the conditions that companies and their executives must satisfy in order to exempt their compensation-related transactions from Section 16b's formidable disgorgement provisions.

In an effort to simplify these requirements for companies, the SEC promulgated a revised Rule 16b-3, which became effective Aug. 15, 1996. Under this rule, grants or awards are exempt if any one of the following three conditions are met:

- approval by the board of directors or a committee of two or more non-employee directors;
- approval by shareholders; and
- satisfaction of a six-month holding period following the date of acquisition.

(Transactions pursuant to specified tax-conditioned plans, such as employee thrift, stock purchase or excess benefit plans, are exempt.)

In announcing the changes, the SEC said its rationale in simplifying the exemptions was that transactions between a company and its insiders that are intended as compensation do not pose the opportunities for insider abuse that Section 16b was originally designed to curtail.

Previously, Rule 16b-3 required that the grant or award be made under a written plan approved by shareholders and set forth a definable limit on the shares available under the plan. The revised rule eliminated the transferability prohibition on stock options and derivative securities, allowing for more attractive estate planning opportunities for executives. IRRRC has tracked a number of companies that now provide for the transfer of stock options. Another effect of the Rule 16b-3 revision was elimination of the need for the directors administering executive plans to qualify as “disinterested” according to the SEC's definition, which has resulted in more discretion under many director stock plans.

Notwithstanding these changes, companies still have considerable incentive to continue seeking shareholder approval and independent—as opposed to simply “non-employee”—director administration of their stock-based benefit plans. Shareholder approval of most stock-based benefit plans is a condition for listing on the major stock exchanges. It is also a requirement for qualifying for an exemption from the \$1 million deductibility limit under Section 162(m) of the tax code. State corporate laws, as well as a company's own bylaws, are other potential reasons for seeking shareholder approval. Finally, principles of better corporate governance and investor relations may influence a company's decision in this area. The major stock exchanges currently are considering revisions to rules regarding “broad-based” stock plans, which are exempt from the shareholder-approval requirements.

## Appendix D: Summary of 162(m) regulations

The \$1 million deductibility limit for executive compensation was enacted on Aug. 6, 1993, as part of the Omnibus Budget Reconciliation Act. The regulations under the statute are set forth in Section 162(m) of the Internal Revenue Service Code. The regulations have been amended several times. The following discussion of the regulations incorporates all amendments to date.

Section 162(m)'s deduction cap applies to certain compensation paid to the five highest-paid executives (including the CEO) of publicly traded companies with at least \$5 million in assets and 500 or more shareholders. The company must still employ the five executives at the end of the year. Therefore, executives who leave before the end of the year are not included in the group subject to the \$1 million deductibility cap and, as a result, their golden parachute and golden handshake payouts are exempt from the limit.

The following types of compensation are deductible under Section 162(m):

- Compensation payable under a written employment agreement that was in effect before Feb. 17, 1993, and has not been materially altered.
- Bona fide commission income.
- Payments that consist of benefits provided to an employee that are excludable from gross income (covered in section 3121(a)(1) through section 3121(a)(5)(D) of the tax code).
- Payments made to or from a tax-qualified plan (described in section 3121(v)(1) and including 401(k) salary reduction contributions).
- Compensation that is deferred until the employee is no longer one of the top five executives (which, in most cases, would be retirement).
- Performance-based compensation.

### Performance-based compensation

The most immediate results of the tax law were companies scrambling to qualify stock option plans and bonus plans as performance-based compensation. In order for compensation to qualify as “performance-based,” the following four conditions had to be satisfied:

**One:** *Compensation must be paid solely on the attainment of one or more performance goals.* In the case of stock plans, options or stock appreciation rights priced at least at market value on the grant date generally will qualify for the exemption, provided shareholders have approved the maximum number of shares that may be awarded to certain classes of employees. Time-lapsing restricted stock awards and discount stock options do not qualify as performance-based compensation.

**Two:** *The performance goals must be set by a compensation committee comprised solely of two or more “outside directors” as defined by the Internal Revenue Service.* (See next page for definition.) The IRS specified that performance goals must be pre-established, with substantially uncertain objectives (meaning a third party armed with the relevant facts should be able to determine the payout), and in writing. Companies are not required to disclose strategically sensitive information to shareholders and competitors. A performance goal will be considered pre-established if it is set in writing no later than 90 days after the start of the performance period; in no event will a performance goal be considered pre-established if it is established after 25 percent of the performance period has elapsed. For a bonus to be tax-deductible, it must be based on a substantially uncertain performance goal. The IRS says a goal based on a percentage of total sales is NOT substantially uncertain because it is virtually certain that the company will have some sales. However, a bonus based on a pre-established increase in corporate sales will qualify as uncertain, as will a goal based on corporate profitability.

**Three:** *The material terms under which the compensation is to be paid, including the performance goals, must be disclosed to and approved by shareholders before payment.* While the performance measures must be disclosed, companies need not reveal the specific performance targets. However, companies

must disclose the maximum allowable payout per employee if specific targets are not established. According to the regulations, if a company bases the maximum amount to be paid over a performance period on a percentage of base salary, it must also set a maximum dollar amount for the performance period, or fix executive salaries at the beginning of their period. If a plan uses a percentage of a bonus pool for a maximum, the proxy statement must disclose both the formula used to establish the bonus pool and the maximum percentage of the bonus pool that may be awarded, in order to qualify. If the maximum award is not sufficiently predictable, the plan will not qualify. The terms must be approved by shareholders at least once every five years.

The IRS also stymied compensation committee flexibility to increase bonuses. Although it gave committees the discretion to *reduce* bonuses, even if performance goals are met, it specified that they cannot increase bonuses arbitrarily without losing the deductibility. Also, the IRS limited compensation committees' discretion to change performance targets. If shareholders approve a plan that gives broad discretion to the committee to change performance targets subsequently without shareholder approval, the committee must resubmit the plan for approval at least every five years.

*Four: Before payment, the compensation committee must certify that the performance goals were met.*

## **Outside directors**

The IRS's definition of an outside director has been at the center of much controversy. It is more restrictive than the New York Stock Exchange's independent director definition, SEC proxy "interlocking" directorship disclosure rules, and rules regarding disinterested status in connection with SEC Rule 16b-3 exemption. Although the IRS has amended its definition somewhat to make it less restrictive, it is still controversial.

For purposes of tax deductibility, the IRS defines "outside directors" as those who are not:

- Current company employees or officers.
- Former company officers.
- Former employees who received compensation from the company for prior service during the last year (other than that received from a retirement or savings plan).
- Recipients of compensation for services or goods, either directly or indirectly, provided in "any capacity other than as a director."

Under the IRS's original definition, a director would not be considered an outside director (and therefore would not be eligible to serve on a compensation committee) if the director or his employer provided goods or services to the company equal to \$60,000 a year, or 5 percent of the company's gross income, whichever was less. Critics said this low threshold would make it virtually impossible for many executives to serve on compensation committees. The IRS ceded the point and in its Dec. 2, 1995, revisions of the rules it provided that the limit will be a straight 5 percent of gross revenue, except where the remuneration is for "personal services," such as those rendered by lawyers, accountants and investment bankers. In that case, the old test—the lesser of 5 percent of gross revenue or \$60,000—will still apply.

The rules will be applied on a look-back basis; if payments exceed the *de minimis* level for one year, the individual will not qualify as an outside director the next. Companies had until the first shareholders' meeting at which directors are elected after Jan. 1, 1996, to bring their compensation committees into compliance with the IRS's outside director definition. Before Jan. 1, 1996, a director who was "disinterested" within the meaning of Rule 16b-3 of the Securities Exchange Act—a broad definition that attaches to all directors who are not actual participants in a stock option plan—satisfied the regulations' requirements for an outside director.

## **Other final regulations provisions**

*Dividend equivalents:* According to the IRS, a question was raised about whether nonperformance-based dividend equivalents paid on performance-based stock options (options granted at least fair market value) would nullify both awards as qualifying as performance-based. The final regulations provide that such

dividend equivalents will not cause the compensation paid upon exercise of the options to be nonperformance-based as long as that the payment of the dividend equivalents is not conditioned upon the employee exercising the option. If the payment of the dividend is conditioned upon the employee exercising the option, the dividend effectively reduces the exercise price, thereby causing the option to be nonperformance-based upon its exercise.

*Bonus pools:* In some cases, companies using a bonus pool to award cash bonuses have released information about the amount payable under the pool to each participant as a percentage of the bonus pool and the total of the percentages have exceeded 100 percent. In this case, it is impossible to award each individual the stated percentage, and it is impossible for a third party to determine the maximum amount to be paid to each party. Accordingly, the regulations clarified that when the compensation to be paid to each employee is stated in terms of a percentage of the bonus pool, the sum of the percentages cannot exceed 100 percent. In addition, the exercise of negative discretion with respect to one employee cannot increase the amount payable to another employee. However, the IRS said it recognized that some companies had interpreted the rule differently, and therefore the 100 percent bonus pool rule will not be applied to any compensation paid before Jan. 1, 2001, under a bonus pool based on performance in any period that began before Dec. 20, 1995.

*Outside directors:* The regulations clarified that a former officer of either a spun-off or liquidated company that formerly was a member of the affiliated company meets the definition of an outside director for the affiliated company.

*Employee contracts:* The original regulations provide that any compensation paid under an employee agreement entered into before Feb. 17, 1993, will be deductible under transition provisions. However, once the contract expires or is significantly modified, it does not qualify for deduction and must be treated as a new contract. The final regulations clarify that if the original contract gave the employee the discretion of extending the contract, the contract will not be treated as a new contract if the employee decides to extend the contract date.

*Percentage of base salary maximums:* The IRS's amended regulations enacted in December 1994, said that maximum awards stated as a percentage of base salary would not qualify for tax deductions because the compensation committee would have the discretion to raise salaries in order to raise bonuses. A percentage of base salary and a maximum dollar amount is acceptable. The new regulations clarify that a percentage of base salary may be used as a maximum without a dollar amount *if*, at the time the performance goal is established, the dollar amount of salary or base pay upon which the bonus will be based is fixed. (Presumably, a shareholder could determine a maximum bonus at the end of each year by taking the maximum percentage of the salary in the proxy statement.) In addition, the final regulations provide that the dollar amount disclosure used with a percentage of base salary applies only to plans approved by shareholders after April 30, 1995.

## Appendix E: Summary of NYSE and NASD requirements regarding shareholder approval of plans

Exchange	Summary of listing rules
<p><b>NYSE</b></p>	<p>To increase shareholder control over equity-compensation plans, shareholders must be given the opportunity to vote on all equity-compensation plans. Shareholders must also be given the opportunity to vote on “material revisions” to existing plans, such as:</p> <ul style="list-style-type: none"> <li>• Adding shares, participants, award types, or years to the plan,</li> <li>• Changing the method of determining the exercise price</li> <li>• Any option bailout program related to a plan that is either silent on or prohibits bailouts</li> </ul> <p>The following are eligible for exemption:</p> <ul style="list-style-type: none"> <li>• inducement awards for new hires,</li> <li>• plans related to mergers or acquisitions</li> <li>• tax qualified employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans;</li> <li>• plans available to shareholders generally, such as dividend reinvestment plans</li> </ul> <p>A plan with an automatic share replenishment feature and a term of more than ten years requires shareholder approval of each periodic share increase.</p> <p>A plan involving formulaic automatic grants and a term of more than ten years requires shareholder approval of each grant.</p> <p>A plan with no limit on shares reserved must receive shareholder approval for each award granted thereunder.</p> <p>Note: Uninstructed broker votes are not eligible to vote on stock compensation proposals.</p>
<p><b>NASD</b></p>	<p>Shareholder approval is required when a stock option or purchase plan is to be established or materially amended or other arrangement made pursuant to which options or stock may be acquired. Material amendments include:</p> <ul style="list-style-type: none"> <li>• Adding shares, participants, award types, or years to the plan,</li> <li>• Reducing the exercise or purchase price of awards</li> <li>• Amending the plan to permit option bailouts</li> </ul> <p>The following are eligible for exemption:</p> <ul style="list-style-type: none"> <li>• inducement awards for new hires</li> <li>• tax qualified, non-discriminatory employee benefit plans (e.g., plans that meet the requirements of Section 401(a) or 423 of the Internal Revenue Code) or parallel nonqualified plans;</li> <li>• plans related to mergers or acquisitions; or</li> <li>• plans available to shareholders generally, such as dividend reinvestment plans</li> </ul> <p>A plan with an automatic share replenishment feature and a term of more than ten years requires shareholder approval of each periodic share increase.</p> <p>A plan involving formulaic automatic grants and a term of more than ten years requires shareholder approval of each grant.</p> <p>A plan with no limit on shares reserved must receive shareholder approval for each award granted thereunder.</p>

<b>Exchange</b>	Summary of listing rules
	Note: The Nasdaq amendments did not need to address the issue of uninstructed broker votes because such activity had already been prohibited.