SESSION III

3.1

Hot Topics and Practical Guidance Conference Session: Keeping Up with the Joneses: The Hottest Equity Compensation Issues Today

Presented by

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Keeping Up with the Joneses: The Hottest Equity Compensation Issues Today

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Today's Audience

- Public companies
- Plan administrators
- Attorneys
- Private companies?
- Others?

Today's Objectives

- Introduce today's hottest equity compensation issues, policies and award/plan terms
- Show how to implement them
- Provide real world examples that worked well ... and those that didn’t!

Today's Agenda

- The Six Hottest Topics
  1. Responsible equity practices
  2. Managing tax withholding
  3. Post-termination strategies
  4. Performance equity vehicles
  5. Fixing stock option backdating
  6. ESPPs instead of stock option plans

No. 1 Hottest Topic: Responsible Equity Practices

- Stock selling policies
  - "Hold until" and "minimum ownership" policies
  - Anti-hedging policies
  - Clawback provisions or policies
  - Rule 10b5-1 trading plans

"Hold Until" and "Minimum Ownership" Policies

- What is the idea?
  - "Hold until" policy prohibits selling equity compensation shares until performance goals or vesting met
  - "Minimum ownership" policy states guidelines or requirements for insiders' company stock ownership
    - Also called "stock ownership guidelines"

"Hold Until" and "Minimum Ownership" Policies

- Why adopt these innovations?
  - Align insider and shareholder interests
  - Must disclose in CD&A if material
  - Institutional shareholders
    - No proposals in 2007

"Hold Until" and "Minimum Ownership" Policies

- Drafting considerations
  - Time period
  - Ownership levels
  - Who is covered?
  - Exceptions
  - Penalties for noncompliance

"Hold Until" and "Minimum Ownership" Policies

- What disclosure required?
  - In the past, not much
  - Now in CD&A
- See materials for sample disclosures

Who Is Using "Hold Until" and "Minimum Ownership" Policies?

- At Fortune 500 companies*
  - Executive stock ownership guidelines increased from 54.9% in 2004 to 63.8% in 2005
  - Executive holding requirements increased from 14.1% in 2004 to 20.2% in 2005
    - Majority had both
  - Most use multiple of base salary with median multiple
    - CEOs = 5x base salary in 2005
    - Other C-level execs = 3x
    - Most VP-level execs = 1x

*From a study by Equilar, Inc. of fiscal year 2005 disclosures (published in October 2006)

Anti-Hedging Policies

- Many companies currently considering prohibiting hedging activities
  - Usually covered under insider trading policy

Anti-Hedging Policies

- What Are Hedging Transactions?
  - Also called monetization transactions
  - zero-cost collars
  - forward sale contracts
  - other instruments designed to limit an employee's economic risk associated with beneficial ownership of the company's stock

Anti-Hedging Policies

- Should Insider Trading Policy prohibit hedging transactions?
  - Maybe
  - Many don't prohibit, but discourage and require pre-clearance

Anti-Hedging Policies

- Sample language for Insider Trading Policy
- Other resources:
  - NASPP
  - thecorporatecounsel.net

Anti-Hedging Policies

- Who has adopted anti-hedging policies?
  - Many companies
  - See list in materials

Anti-Hedging Policies

- What disclosure required?
  - For NEOs discuss in CD&A
    - if material
- SEC proposal to require insiders to disclose any shares subject to hedging arrangements
  - not adopted in final rules

Clawback Provisions or Policies

- "Clawback" means to recover compensation in certain circumstances
  - Formal clawback provisions in executive contracts
    - operate automatically
  - Policy to review compensation paid in light of discovered circumstances on a case by case basis and attempt to recover compensation
    - difficult to enforce policy without risking litigation

Why Use Clawback Provisions or Policies?

- Historically used to recover shares
  - Termination for cause
  - Post-termination competition
- Newer issues
  - Sarbox Sections 304 and 1103
  - Increasing SEC enforcement action
    - Financial restatements
    - exploding option backdating issues
  - Shareholder derivative lawsuits

Clawback Provisions or Policies

- What are the limitations?
  - Requires careful drafting
  - May not be enforceable

Clawback Drafting Considerations

- Forfeiture only vs. forfeiture and recapture
- Defining prohibited behavior
- Competition
- Sarbanes-Oxley
- For cause termination
- Other disloyal acts

Clawback Drafting Considerations

- Length of post-employment restriction
- Limitation on length of reach-back
- Types of benefits recaptured
- Notice and opportunity to cure
- Early discovery requirement

Clawback Provisions or Policies: Sample Language

- Clawback provision language for award
- Rebuttal to shareholder clawback proposal
  - Honeywell
- "No clawback policy" disclosure
  - Sunoco

Clawback Provisions or Policies

- Who Is Using Clawbacks?
  - Fortune 100 companies in 2007
    - 42.1% disclosed clawback policy
    - up from 17.6% in 2006
  - Shareholder proposals
    - Included in 5 Fortune 100 proxies

Clawback Provisions or Policies

Companies that Adopted or Amended Clawback Policies	
Calendar 2006	**Calendar 2007**
Alcoa	Comcast
Boeing	Intel
Caterpillar	Time Warner
General Motors	UnitedHealth
JP Morgan	Verizon
Johnson & Johnson	
Sprint	
United Parcel Service	
Washington Mutual	

Source: Equilar, Inc.

Rule 10b5-1 Trading Plans

- Rule 10b5-1 provides method for affirmative defense to insider trading liability

Rule 10b5-1 Trading Plans

- What is required for Rule 10b5-1 trading plan?
  - Enter into a binding contract
  - Provide written instructions to another person
  - Adopt a written trading plan
  - Meet specific other requirements

Rule 10b5-1 Trading Plans

- Should companies permit, require or prohibit Rule 10b5-1 Plans?
  - No one-size-fits-all answer
- Require company review or approval of Rule 10b5-1 Plans?
  - Generally a good idea
  - But each broker requires its own form

Rule 10b5-1 Trading Plans

- Securities and Other Issues
  - "Springing" Rule 10b5-1 plan
  - Waiting period
  - Modifications and terminations

Rule 10b5-1 Trading Plans

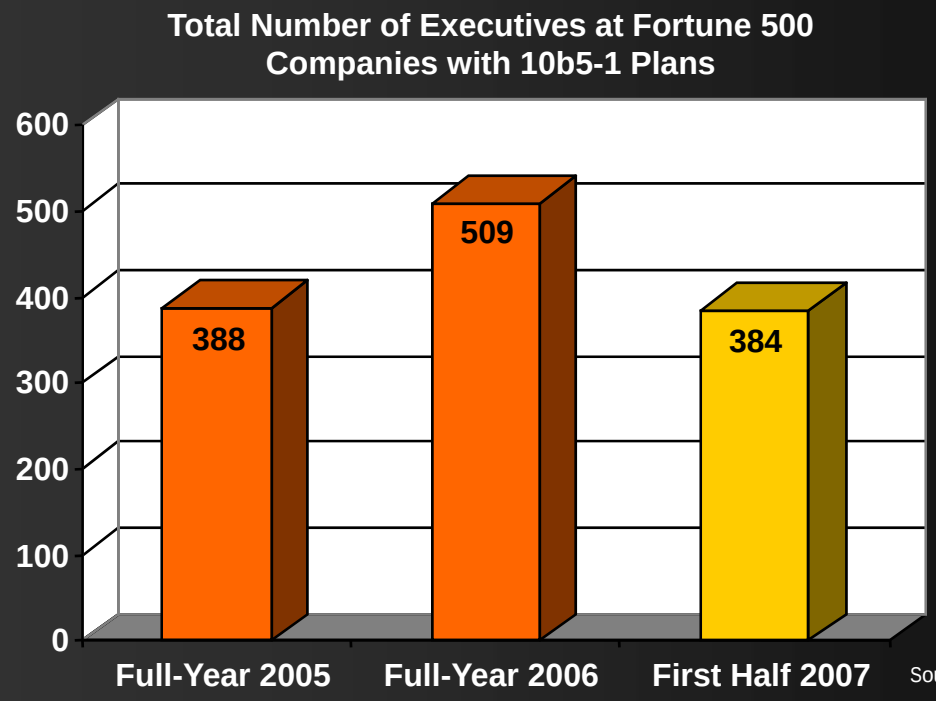
- Recent developments
  - Study by Dr. Alan Jagolinzer of the Stanford Business School in 2006
    - significant Rule 10b5-1 trading plan selling by insiders before bad news
    - sparked an SEC investigation into Rule 10b5-1 trading plans
  - Former Qwest CEO conviction

Rule 10b5-1 Trading Plans

- Who is using these plans?
  - Fortune 500 companies with executives using Rule 10b5-1 plans
    - Increased from 25.6% to 28.7% from 2005 to 2006
    - 25.2% in first half of 2007
- Sample language in materials

Executives with 10b5-1 Plans

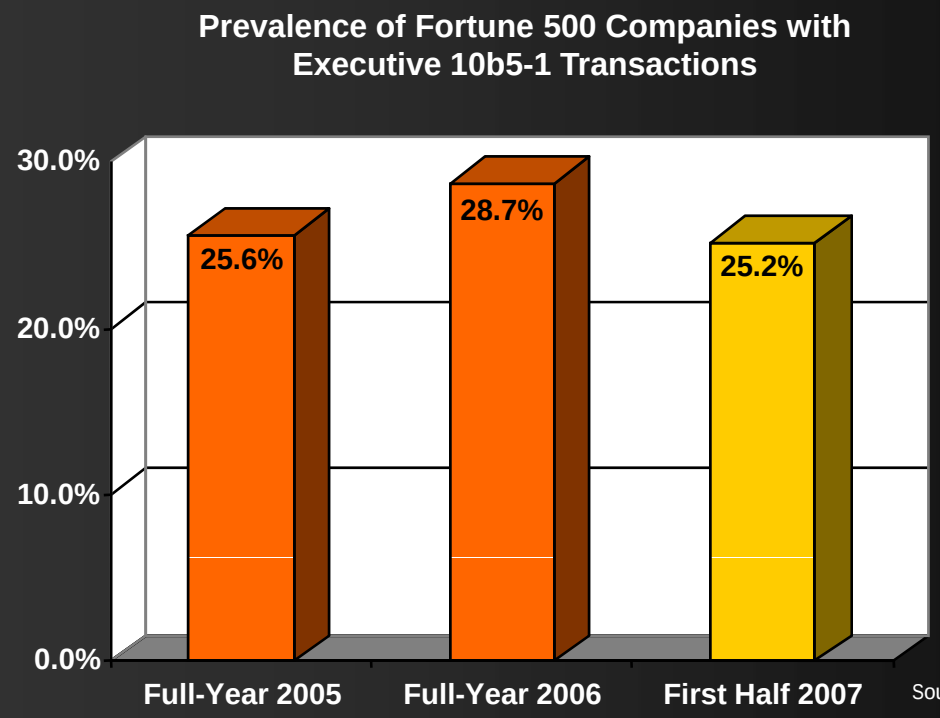
- From 2005 to 2006, Fortune 500 company executives completing transactions pursuant to a Rule 10b5-1 plan increased 31.2%



Source: Equilar, Inc.

Prevalence of Executive 10b5-1 Plans

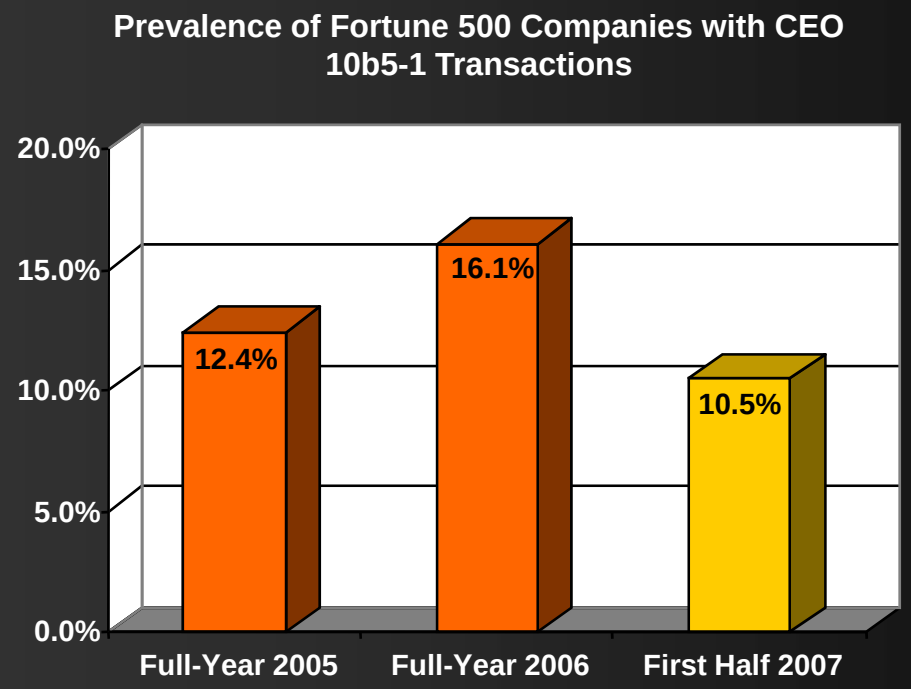
- From 2005 to 2006, Fortune 500 companies with active Rule 10b5-1 plans for executives increased from 25.6% to 28.7%



Source: Equilar, Inc.

Prevalence of CEO 10b5-1 Plans

- From 2005 to 2006, Fortune 500 companies with active Rule 10b5-1 plans for executives increased from 12.4% to 16.1%



Source: Equilar, Inc.

No. 2 Hottest Topic: Managing Tax Withholding

- Using Rule 10b5-1 trading plans for tax withholding
  - Can permit...or require
  - Restricted stock and units present special challenges

Using Rule 10b5-1 Plans for Tax Withholding

- Restricted stock
  - Tax withholding due at vesting
- Restricted stock units
  - Tax withholding at vesting
  - or when entitled to receive shares, if later than vesting
    - Section 409A issues with delayed delivery

Using Rule 10b5-1 Plans for Tax Withholding

- Permit or require?
  - Executives
  - Non-executive employees
- Administration benefits
- Communication challenges
- Sample language

Using Rule 10b5-1 Plans for Tax Withholding

- Which companies require Rule 10b5-1 plans for tax withholding obligations?
  - Amazon.com
  - Microsoft
  - First Energy
  - Likely many others!

Other Alternatives for Tax Withholding?

- Laundry list approach
- Delay delivery

No. 3 Hottest Topic: Post-Termination Strategies

- Acceleration of Vesting
- Post-Termination Exercise Provisions

Acceleration of Vesting

- Common for executives
  - Especially CEOs
  - Full acceleration of stock and option awards most prevalent
    - in both severance and CIC scenarios
  - In CIC, no disclosures indicate any Fortune 100 CEO will forfeit unvested stock or option awards

Acceleration of Vesting

CEO Acceleration	Options Severance	Stock Severance	Options Change-In-Control	Stock Change-In-Control
Full	35.9%	40.0%	79.1%	88.1%
Partial	23.1%	22.5%	7.5%	9.0%
Continued Vest	10.3%	12.5%	-	-
Forfeited	20.5%	20.0%	-	-
Not Disclosed	10.3%	5.0%	13.4%	2.9%

Source: Equilar, Inc.

Post-Termination Exercise Provisions: What is New?

- Section 409A limitations eased
  - End of original term or 10 years
  - Longer if exercise would violate securities laws
  - But can't extend if option is discounted
    - including if remediated through fixed exercise dates

Post-Termination Exercise Provisions

- General PTEP alternatives
  - Extend exercise period
  - Continue providing services as consultant or “part time” employee
  - Pros and cons
    - Chart in materials

Post-Termination Exercise Provisions: What is New?

- Solutions when Form S-8 is not available
  - Automatic tolling
    - See sample language
  - Cash out award
  - Cash bonus for release
  - Find a new securities law exemption

No. 4 Hottest Topic: Performance Equity Vehicles

- Award size determined based on performance v. performance-accelerated vesting
- Why adopt this innovation?
- What are the limitations?
- Common performance goals
- Who is using performance awards?

Performance Equity Vehicles

- Why adopt this innovation?
  - Strong link to performance
  - Moderate downside protection for executive
  - Minimizes unproductive dilution
  - Minimizes FAS 123R earnings effect

Performance Equity Vehicles

- Must disclose NEO performance goals?
  - Required in CD&A
  - Confidential treatment standard
    - Substantial risk of competitive harm
  - Disclose how difficult and how likely

Performance Equity Vehicles

- Section 162(m) deductibility
  - Stock options generally deductible
    - Plan must comply with regs
  - Other equity awards deductible only if "performance-based"
    - Many requirements
    - Easy to get it wrong

Performance Equity Vehicles

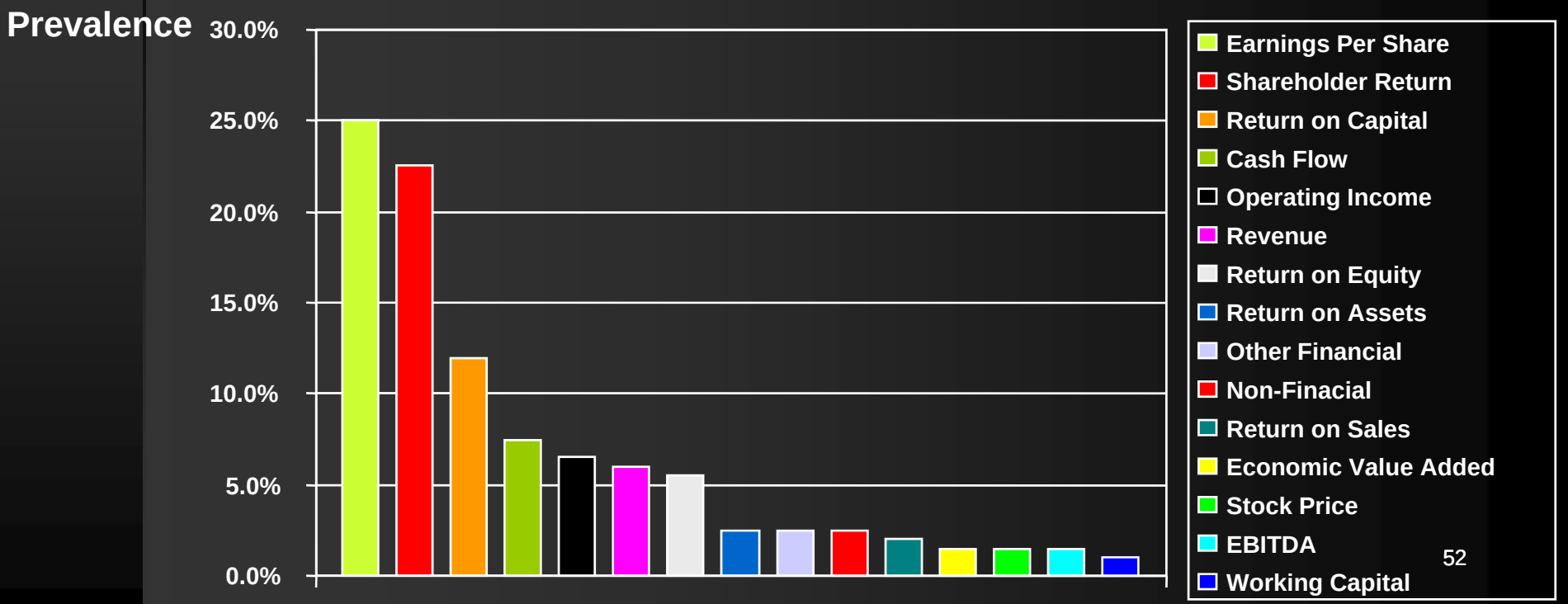
- What are the limitations?
  - Difficulty setting reasonable long term goals
  - Institutional shareholder standards
  - Tax withholding difficulties
    - Timing presents challenge
    - Can use same strategies discussed for restricted stock and units

Performance Equity Vehicles

- Common performance goals for equity awards
  - Financial goals
    - EPS
    - Shareholder return
  - Non-financial goals
    - 3% of companies reporting use

Prevalence of Performance Equity Metrics

- Among all metrics cited for performance equity awards, EPS, TSR, ROC/ROIC, Cash Flow, and Operating Income appeared most frequently
- Performance equity awards had an average of 1.7 performance measures



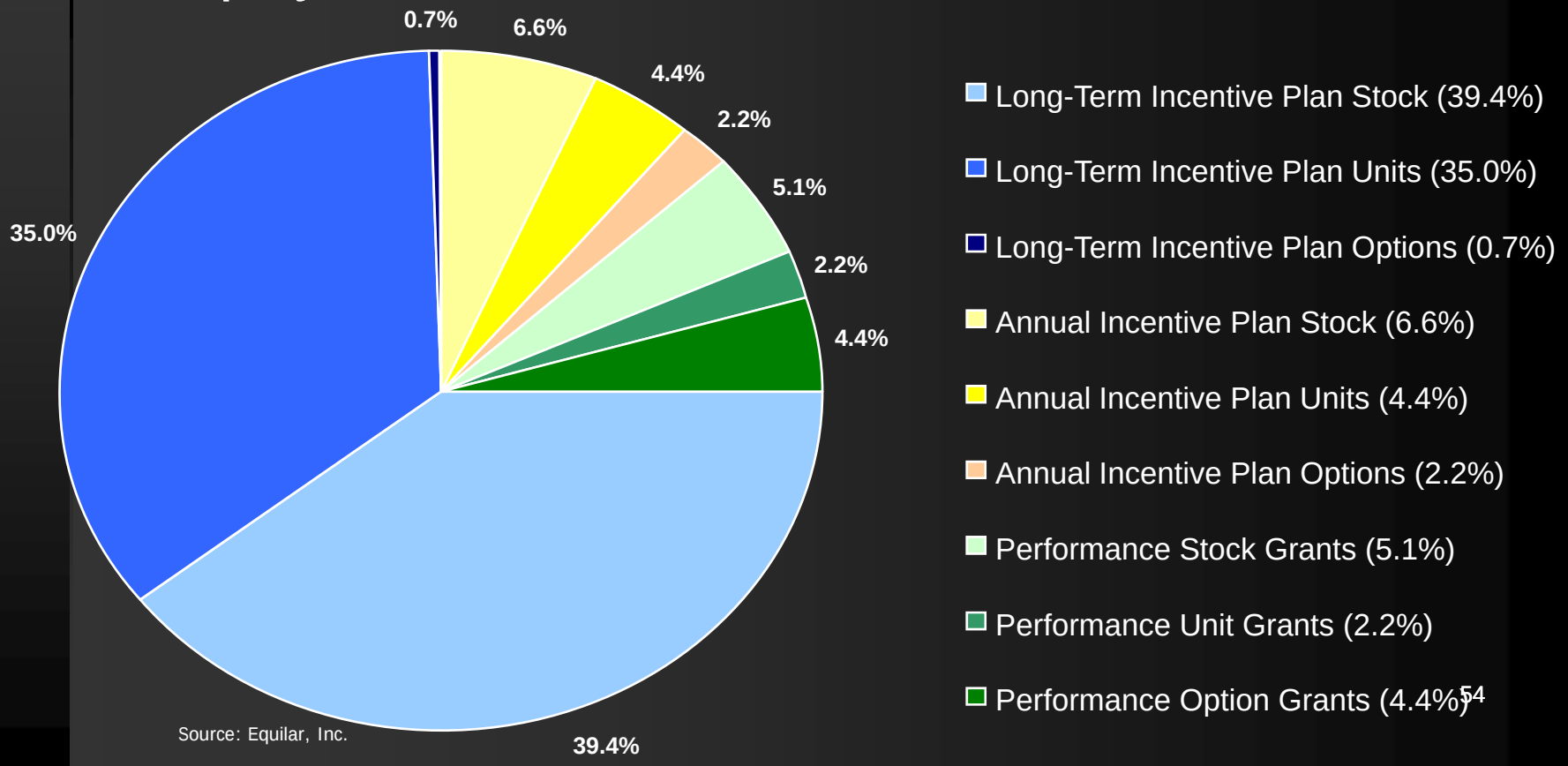
Source: Equilar, Inc.

Who Is Using Performance Equity Vehicles?

- Since FAS 123R changed accounting consequences, many companies have begun to use them, including
  - Alcoa
  - Bristol Myers Squibb
  - Comcast
  - Eastman Kodak
  - Home Depot
  - Sprint
  - Washington Mutual

What is Performance Equity?

- 61.3% of S&P 500 companies award performance equity to CEO



No. 5 Hottest Topic: Fixing Stock Option Backdating

- Options held by
  - Section 16 insiders
  - Other employees
- Practical considerations
- What are other companies doing?

Fixing Stock Option Backdating: Section 409A

- Options held by Section 16 insiders
  - Section 16 status at grant
    - Transition period ended 2006 year end
  - Section 16 status prior to or after grant
    - Transition period ends 2007 year end
    - *Can't participate in broad based tender offer*

Fixing Stock Option Backdating: Section 409A

- Options held by other employees
  - Current employees
    - Reprice upwards
    - Fix exercise dates
    - Cancel option?

Each solution poses securities and tax issues

Fixing Stock Option Backdating: Section 409A

- Options held by other employees
  - Former employees
    - If they lapse “naturally” during 2007
    - Provide cash – but not for cancellation
    - Fix exercise dates

Fixing Stock Option Backdating

- Practical considerations
  - Maintain reasonable expectations
    - Make sure participants understand uncertainty of "fixes"
  - Administrative capabilities
    - Can you handle the volume?
  - Keep the solution simple
  - Communication challenges

Fixing Stock Option Backdating

- What are other companies doing?
  - Private company statistics unknown
  - For public companies who first encountered this, see chart in materials
    - Note that many of these happened before SEC verbalized restrictions on former employees, officers and directors and before issues with prompt payment

No. 6 Hottest Topic: ESPPs to Replace Option Plans?

- What is the idea?
  - Use ESPP as an effective, yet lower-cost, equity compensation vehicle

Principles Supporting Idea

- Purposes of equity compensation package
  - Attract
  - Retain
  - Motivate
- Perceived value of equity compensation benefits should be greater than or equal to accompanying compensation cost

Background: FAS 123R Compensation Expense

- Charge for 24-month ESPP is *less* than for 10-year stock option
  - Accounting Example under FTB 97-1
  - Expense for six-month offering with look-back if market value is $10 on enrollment date:

15% discount:	$1.50
Look-back -- 85% of call option:	$1.22*
No share limit --15% of put option:	.20*
	$2.92

* Assumes 50% volatility, no dividends, and 1.5% risk-free interest rate.

Background: FAS 123R Compensation Expense

Look-Back Period	ESPP Cost Per $10 Share					
	15% Discount		10% Discount		5% Discount	
	No Limit	Limit	No Limit	Limit	No Limit	Limit
24 months	$4.33	$3.94	$3.84	$3.58	$3.36	$3.23
18 months	$3.95	$3.61	$3.46	$3.24	$2.98	$2.87
12 months	$3.51	$3.23	$3.02	$2.83	$2.53	$2.43
6 months	$2.92	$2.72	$2.43	$2.29	$1.93	$1.86
None	$1.70	$1.50	$1.13	$1.00	$0.00	$0.00

Interest rate applicable to the 10-year option was adjusted commensurately with the expected term. All estimates are for illustration purposes only.

Background: FAS 123R Compensation Expense

- Compare cost with per share fair value of stock option with 10-year maximum term:
  - $4.20 for 4-year expected term
  - $6.50 for 10-year expected term

ESPP Trends

- Trends have shown that most companies have adopted “safe-harbor” ESPPs
  - No look-back
  - 5% discount on purchase date

Changes to ESPPs to Reduce Compensation Cost

- Shorten offering period (e.g., 24 months to 6 months)
- Reduce discount (e.g., from 15% to 5%)
- Exclude employees
  - Highly compensated
  - Part-time and Seasonal
  - 2-year wait
- Eliminate the look-back
- Reduce eligible “earnings” definition

ESPP Trends

- Time to re-think traditional equity grant practices and model?
  - F.W. Cook's Principles for Reform:
    - Transparency
      - Pre-announce grant dates and values
    - Fair Value
      - Fixed Award Exercise Dates
    - Pay-for-Performance
      - Hmmm…

ESPPs to Replace Option Plans?

- Qualified Section 423 ESPP has limited flexibility
  - Discrimination
  - Term
  - Discount

Non-Section 423 ESPPs: Possible Features

- >27 month look-back
- > 15% discount
- Flexible purchase dates/schedules
  - subject to Section 409A
- No payroll withholding
- Selective awards
- Vesting
- Company match
- Auto-enrollment

Section 423 vs. Non-Section 423 ESPPs

- Term of purchase right
- Exercise or purchase dates
- Vesting
- Methods of exercise
- Enrollment

Section 423 vs. Non-Section 423 ESPPs

- Permitted discrimination
- Discount from FMV
- Company match as alternative
- SRO requirements

When Appropriate?

- Possibly appropriate if:
  - Flat or declining stock price with no short-term expected rebound
  - Large “overhang”
  - Alternative to Restricted Stock or Restricted Stock Units?
  - Companies interested in highly predictable grant and exercise schedules
    - "transparency"
- Companies interested in decreasing compensation cost

ESPPs to Replace Option Plans?

- Has this idea caught on?

…not yet

Questions?

Conclusion

- Understanding trends in new equity compensation policies and award/plan provisions will help you keep your company prepared for our ever-changing legal and accounting environment . . . even if you don't "early adopt"

- **IMPORTANT TAX INFORMATION:** This communication is not intended or written to be used, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer under the Internal Revenue Code of 1986, as amended.

Keeping Up with the Joneses:
The Hottest Equity Compensation Issues Today

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SIX HOT TRENDS THAT SHOULD NOT BE IGNORED

Another year, another couple dozen changes to the laws and top practices in equity compensation—and your head hasn't stopped spinning since last year! Never fear—from among the myriad recent innovations and on-going developments in hot topics this year, we are bringing you what we think are the six hottest trends today:

1. embracing responsible equity practices;
2. managing tax withholding issue for full value and performance awards;
3. post-termination strategies;
4. performance equity vehicles;
5. fixing the fallout from stock option backdating; and
6. ESPPs as an alternative to stock option plans.

Our goal is to give you practical advice on implementing these cutting-edge innovations, including with respect to employment, securities, tax and corporate law issues, as well as accounting treatment and shareholder perception. This paper supplements our presentation with more detail to flesh-out our suggestions for your equity compensation programs.

We are not covering CD&A or the SEC's other compensation disclosure requirements in any detail in this session. For recent sample of public company equity grant practices disclosure, see the Equity Grant Practices Disclosure compiled by Equilar, Inc., attached to this paper as **Appendix E**. For more information on those requirements, see the *Executive Compensation Disclosure Handbook: A Practical Guide to the SEC's New Rules* (revised February 2007, Thompson/West), which is available in soft copy at no cost on RR Donnelley's Real Corporate Lawyer website at www.realcorporate.lawyer.com/pdfs/execcomphandbook.pdf.

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THE SIX HOTTEST TRENDS

I. Embracing Responsible Equity Practices

Companies face heightened shareholder pressure to improve the alignment of executive and director interests with shareholder interests. In an effort to address shareholder concerns, companies are increasingly using stock selling policies to

- increase the management's equity stake in the companies they oversee,
- recover excessive or inappropriate amounts of equity compensation when management's actions haven't served the shareholders' interests and
- increase transparency in management's personal sales of company securities.

Stock selling policies can cover a broad range of issues. Today, hold until/minimum ownership policies, anti-hedging policies, clawbacks and Rule 10b5-1 trading plans remain among the hottest topics for equity compensation. We're updating you with information about the latest developments and statistics and which companies have implemented them, so you can look at the disclosures and plan language to determine how to put these types of stock selling policies to work for you—or compare your disclosure if you already have them in place.

A. "Hold Until" and "Minimum Ownership" Policies

1. What Is the Idea?

A "hold until" policy prohibits individuals from selling shares acquired pursuant to equity compensation awards until certain milestones are reached or time frames have passed. A "minimum ownership" policy (sometimes called "stock ownership guidelines") is a policy, adopted by the board of directors or its corporate governance committee, that states the company's guidelines or requirements for ownership of the company's stock, generally by management and/or board members (whether acquired pursuant to compensatory awards or on the open market). Often, these two policies are coupled with a more comprehensive stock ownership policy. These types of policies typically should be embodied in a written document.

2. Why Adopt This Innovation?

These policies are a means of aligning executive and director interests with those of shareholders, by requiring executives to retain shares issued to them in connection with equity compensation. The Securities and Exchange Commission's new compensation disclosure rules call for a description of any ownership requirements as part of the new Compensation Discussion and Analysis section, indicating the materiality of such a policy to the shareholders. That said, if stockholder proposals are any indication of interest in this issue, stockholders are happy with the current status quo. Preliminary results for the 2007 proxy season show from Institutional Shareholder Services show that no proposals addressed an obligation for executives to hold shares purchased pursuant to stock options. Perhaps the

lack of shareholder proposals is a reflection of the widespread adoption of these policies already by many public companies.

If you were facing a shareholder proposal on this issue (there were at least three such proposals in 2006), note that ISS generally recommends voting "against" shareholder proposals that mandate a minimum amount of stock that directors must own in order to qualify as a director or remain on the board. While stock ownership is desired, ISS argues that the company, rather than the shareholders, should determine the appropriate ownership requirements. However, ISS recommends voting "for," on a case by case basis, proposals asking the company to adopt a holding or retention period for executives, taking into account any existing stock ownership requirements or holding period requirements already in place, as well as the actual ownership levels of executives.

In addition, it is worth noting certain companies imposed "hold until" policies as part of their program to minimize option expense with the transition to FAS 123R. Specifically, for companies that accelerated option vesting, many required the optionees to hold shares purchased under the award until the award's intended vesting dates.

3. Drafting Considerations

a. Applicable Time Periods and Ownership Levels

The time period and/or ownership level selected may be driven in part by the company's goals for the policy as well as by guidelines established by institutional shareholders. Common time periods include:

- Until specified ownership level is reached
- Until value of shares acquired equals a multiple of base salary or annual board fees
- % of shares acquired pursuant to a specific type of compensatory award
- % of all shares acquired
- Retirement (most commonly applied to directors)
- Termination of employment
- Specified number of years (typically not more than 5 years)
- Attainment of certain performance milestones
- Original vesting date (for FAS 123R-accelerated awards)

Setting ownership levels at a dollar value, or a percentage of a director's annual fees or an executive's annual salary (or total compensation), involves an element of market volatility, requiring insiders to acquire more shares when the stock price falls and potentially permitting them to sell when the stock price rises.

With respect to setting ownership levels, companies may need to consider the guidelines established by their institutional stockholders. In its 2006 proxy voting guidelines, ISS had recommended a minimum of three times the annual cash retainers for non-employee directors and a seven-to-ten times requirement for Chief Executive Officers, with scaled down multiples for other executives. TIAA-CREF's 2007 Policy Statement on Corporate Governance stated that "[d]irectors should have a direct, personal and meaningful investment

in the common stock of the company," although "[t]he definition of a meaningful investment will vary depending on the directors' individual circumstances." TIAA-CREF advocates payment of directors at least partially in stock or restricted stock, and discourages using stock options as a form of director compensation. TIAA-CREF also advocates for requirements that "stock obtained through exercise of options be held by executives for substantial periods of time, apart from partial sales permitted to meet tax liabilities caused by such exercise. Companies should establish holding periods commensurate with pay level and seniority."

A company implementing a minimum ownership policy must determine how long the affected individual has to reach the minimum ownership level. And according to a 2005 study by Mercer Consulting, the most common compliance period for directors is five years from the date of initial election or appointment to the board.

Finally, a company needs to determine what type of shares or equity awards will count toward "ownership" levels. Unexercised stock options do not typically "count" as stock ownership for purposes of these policies—and some commentators and institutional shareholders take the position that they should not. However, some companies argue that vested options should count as ownership, as they represent a material right to purchase shares. As those options become further in the money, the executive has an incentive to purchase and then sell the shares at a gain. Companies argue that any additional period in which the executive holds those vested but unexercised stock options is a period at which the executive's potential gain is at risk and therefore his or her interests are aligned with shareholders.

b. Affected Individuals and Awards

A company implementing a "hold until" or minimum ownership policy will need to consider how deeply the policy will apply. While one might commonly see directors and the named executive officers subject to these policies, it is less common to see the policies applied beyond "Section 16 officers". The NASPP 2004 Stock Plan Design and Administration Survey indicates that of the 38% of participating companies who reported implementing ownership guidelines, only 6% report applying the policy to all equity plan participants. Companies may select one time period for directors and a different time period for officers.

Companies may also choose to limit the policy's application based on how the shares were acquired. The Mercer 350 Report (Nov 2005) indicates that companies are more than twice as likely to subject option shares to these policies than performance shares.

c. Exceptions to the Policies

These policies may include exceptions for non-compliance. These exceptions can include permission to transfer shares in connection with estate planning or charitable contributions, permission to use shares to pay the exercise price or withholding obligations associated with a compensatory award, and permission to sell shares in the event of hardship. If a "hold until" policy has few or no exceptions, it may be desirable to phase-in the "hold until" policy for new officers and directors to give them time to achieve the minimum level of ownership. However, it is important to ensure that the exceptions do not render the policy meaningless.

d. Penalties for Noncompliance

A company implementing a "hold until" or minimum ownership policy will need to consider who will monitor compliance with the policy, how frequently compliance will be monitored, and the most effective mechanism for penalizing non-compliance without jeopardizing the original intent of the program. Some companies suspend equity compensation grants to non-compliant executives until the minimum ownership level has been met. Others prohibit the executive from selling any stock acquired through the vesting of restricted share awards or the exercise of options as a means to achieve compliance with these policies. Still other companies pay future compensation in shares of stock, or require the deferral of compensation into stock units, until minimum ownership levels are met.

Applying a penalty, such as a reduction or forfeiture of future compensation, may adversely impact the relationship between the executive or director and the company, without contributing the original goal of aligning the executive's interests with those of the shareholders. Instead, it may be preferable to require the executive to purchase new shares on the open market or defer future compensation into company equity or to have the company restructure future cash compensation into equity compensation.

4. What Must a Company Disclose About its Stock Ownership Policies?

In the past, not much. Prior to the change in the SEC reporting requirements, stock ownership guidelines had not commonly been made public—except in the case of board responses to shareholder proposals on the topic—which made reliable data difficult to collect and prevented outsiders from monitoring enforcement. And, historically, few of the corporate governance policies posted on company websites addressed this issue, and fewer state a required minimum stock ownership for insiders. As a result, the best information shareholders had was actual stock ownership for named executive officers and directors as required to be disclosed in the tables each year in a company's proxy statement or annual report.

However, the data is now readily available as a result of the first year of reporting under the revised SEC compensation disclosure rules—particularly the requirement that the CD&A discuss material factors such as stock ownership guidelines that apply to named executive officers, if any, including the amount and form of ownership required.

5. Who Has Implemented These Policies and What Policies Have They Adopted?

The Mercer 350 Report (Nov 2005) indicates that between 2002 and 2004, the percentage of companies implementing "hold until" policies rose from 10.9% to 18.6%. The Mercer 350 Report also indicates that between 2002 and 2005, the percentage of companies imposing ownership guidelines on directors rose from 25% to 48%, and on officers from 54% to 67%. Several other studies show that nearly half of large companies now maintain them for executive officers and about a third of these companies maintain them for directors.

The data found by Equilar, Inc. for Fortune 500 companies one year later remains consistent with Mercer's findings. According to a study by Equilar of fiscal year 2005 disclosures (published in October 2006):

- Ownership Guideline Prevalence: The prevalence of publicly disclosed executive stock ownership guidelines at Fortune 500 companies increased from 54.9% in fiscal year 2004 to 63.8% in fiscal year 2005.

- Holding Requirement Prevalence: The prevalence of publicly disclosed executive holding requirements at Fortune 500 companies also increased, climbing from 14.1% in 2004 to 20.2% in 2005. In both 2004 and 2005, the majority of executive holding requirements were used in conjunction with ownership guidelines. In fact, from 2004 to 2005, the prevalence of Fortune 500 companies with holding requirements and no ownership guidelines decreased slightly, falling from 2.9% to 2.7%, respectively.

- Ownership Guideline Design Trends: In both 2004 and 2005, over three-fourths of executive ownership guidelines defined target ownership levels as a multiple of base salary. The prevalence of ownership guidelines remained relatively constant in these two years—78.0% in 2004 and 75.8% in 2005. The next most common ownership guideline structure defines ownership targets as a fixed number of shares. The prevalence of this design type also remained relatively constant in these two years—10.6% in fiscal year 2004 and 11.8% in fiscal year 2005.

- Target Ownership Levels: Required ownership levels tend to correspond to overall job responsibility. Among companies that define ownership goals as a multiple of base salary, the median multiple for Executive Chairmen and CEOs was five times base salary in fiscal year 2005, followed by three times for other C-level executives and one times for most VP-level executives.

a. Recent Company Disclosure About Stock Ownership Policies

Although the disclosure of ownership guidelines became quite prevalent in fiscal years 2004 and 2005, the advent of revamped SEC compensation disclosure rules has generated a wealth of new, more detailed, information surrounding ownership policies. This year, with all of the great disclosure at our disposal, we're able to give you much greater detail on these policies. Here are some highlights from disclosures in this past proxy season:

- Agilent: Agilent's stock ownership guidelines provide that the President and Chief Executive Officer should attain an investment level in Agilent's stock equal to five times annual salary, including direct ownership of at least 20,000 shares of Agilent stock. All other executive officers should attain an investment level equal to three times annual salary, including direct ownership of at least 15,000 shares for the Chief Financial Officer and at least 10,000 shares for all other executive officers. In each case, these ownership levels must be attained by the later of five years from election to their executive officer positions or the end of fiscal year 2007 for those who were executive officers prior to 2002.

- Alcoa: The chief executive officer is required to own 160,000 shares of Alcoa common stock and each of the other named executive officers is required to own 50,000 shares. Amounts invested in the Alcoa stock fund of the Alcoa Savings Plan, as well as share equivalent units in the company's Deferred Compensation Plan and stock awards and earned performance share awards, are counted as ownership in assessing compliance with the guidelines. Unexercised stock options and unearned performance share awards are not counted toward the guidelines.

- Boeing: The stock ownership guidelines require that, within a three-year period, executives should attain and maintain an investment position in Boeing stock and stock units of the following: CEO: 6x base salary; Executive Vice Presidents and Senior Vice Presidents: 4x base salary; Vice Presidents: 1x or 2x base salary based on executive grade. In addition to directly owned stock, restricted stock and stock units, deferred stock units and shares held in our savings plans are included in calculating ownership levels. Unvested Performance Shares, unvested Performance Awards and unexercised stock options do not count toward the ownership guidelines.

- Bristol Myers Squibb: Executives are expected to use the shares obtained on the exercise of their stock options, after satisfying the cost of exercise and taxes, to establish a significant level of direct ownership. Under the company's guidelines, the CEO must retain shares upon the exercise of options with a value of eight times his base salary prior to selling any of the net shares obtained upon exercise. The other Named Executive Officers must retain shares with a value of five times their base salary prior to selling any of the net shares obtained upon exercise. Even after these ownership thresholds are satisfied, executives must retain 75% of all net shares obtained as a result of subsequent option exercises for at least two years. These same share retention guidelines apply to restricted stock and restricted stock unit awards.

- Caterpillar: Previously, NEOs were required to own a number of shares equal to the average number of equity options and SARs awarded to them in the last five years. Twenty-five percent of vested unexercised awards counted toward the ownership requirement. Failure to meet these guidelines resulted in automatic grant reductions, absent compelling personal circumstances that prevented an employee from meeting his or her targeted ownership requirement. However, the committee approved new target ownership requirements in December 2005 so that beginning in 2007, NEOs are required to own a number of shares at least equal to 50% of the average number of options and SARs awarded in the last five years. However, only 10% of vested unexercised options and SARs will count toward target ownership. In 2008, no vested unexercised awards will count toward ownership for the NEOs.

- Comcast: The Chief Executive Officer is required to own stock in an amount equal to at least five times base salary. The other named executive officers are required to own stock in amounts ranging from three to four times base salary. "Ownership" for purposes of this policy is defined to include stock owned directly or indirectly by the named executive officer and shares credited to the executive under the employee stock purchase plan,

which must be held for 180 days from the date credited. In addition, 60% of each of the following types of ownership also counts: shares owned under the 401(k) plan, deferred shares under the restricted stock plan, and the difference between the market price and exercise price of vested stock options.

- ConAgra: ConAgra Foods' directors may not sell any of their ConAgra Foods stock until they cease to be a director, and an executive officer can sell ConAgra Foods stock only during the quarterly insider trading windows each year and only if stock retention guidelines are met. The stock ownership guidelines for all executive officers, all senior operating officers and certain other officers were adopted in 2006 and call for ownership at the level of six times base salary for the chief executive officer and between one-half and four times base salary for other executive officers.

- Eastman Kodak: A director is not permitted to exercise any stock options or sell any restricted shares granted to him or her by the Company unless and until the director owns shares of stock in the Company (either outright or through phantom stock units in the directors' deferred compensation plan) that have a value equal to at least five times the then maximum amount of the annual retainer, which may be taken in cash by the director (currently, this amount is $200,000). In addition, all executive officers are required to retain a specified percentage of shares attributable to stock option exercises or the vesting or earn-out of full value shares (such as restricted shares or Leadership Stock) until they attain specified ownership levels, which are expressed below as a multiple of base salary. To the extent that an executive has not satisfied his or her share ownership level, any restricted stock units awarded under the company's Leadership Stock program or EXCEL bonus paid in shares above an executive's target must be retained by the executive. Restricted stock, restricted stock units, any shares held in the executive's account under Kodak's Employee Stock Ownership Plan or Savings and Investment Plan, and any "phantom stock" selected by an executive as an investment option in the Executive Deferred Compensation Plan count toward meeting the executive's share ownership requirement. The Named Executive Officers have the following share ownership requirements: CEO: 5x salary and 100% retention ratio; all other named officers: 2x-3x salary and 75% retention ratio.

- Electronic Arts: In fiscal 2004, the Board of Directors implemented EA stock ownership requirements for all Section 16 executive officers. These ownership requirements are based on multiples of the executive's base pay, ranging from one to six times the executive's annual salary depending on the executive's level within the organization. In some cases, the ownership requirements are phased in on the basis of the executive's tenure.

- Exxon: For senior executives, more than half the total amount of restricted stock granted to such executives may not be sold or transferred until after the executive retires.

- General Motors: Each non-employee director is required to own stock, share units, or other equity equivalents equal in value to five times the value of his or her annual retainer within five years of joining the Board or the adoption of this ownership requirement in

2004. The Directors and Corporate Governance Committee may exercise its discretion in enforcing the guideline when the value of accumulated Common Stock or share units or the size of the required holding is unduly affected by the price of Common Stock or changes in director compensation. Once a director satisfies the minimum ownership requirement (now $1 million), he or she will remain qualified if he or she continues to own at least the same number of shares or units, regardless of changes in the market value of the stock. Compliance is measured by reference to a three-year average stock price to take into consideration the volatility of the stock market and the long-term holding requirement. In addition, the non-employee directors are also prohibited during their term of service from selling any Common Stock or other securities issued by GM, except for cashless exercise of stock options granted prior to 2003, when options were eliminated from director compensation. The company has also established stock ownership guidelines for the Named Executive Officers: CEO is 7x base salary; vice chairman is 5x base salary; EVP is 4x base salary; group vice president is 3x base salary. Compliance is measured by reference to a three-year average stock price in order to take into consideration the volatility of the stock market and the long-term holding requirement. Executives are provided an appropriate amount of time to meet the guidelines following appointment. In addition, the Corporation exercises some discretion in enforcing the guideline when the accumulation of Common Stock is affected by the price of Common Stock, the lack of compensation plan payouts, or modifications to benefit plans.

- Genworth Financial Inc.: Each non-management director is expected to hold at least $300,000 worth of Genworth common stock and/or DSUs while serving as a director of Genworth. Each non-management director has five years from the date he or she becomes a non-management director to attain this ownership threshold.

- Home Depot. The Company's Executive Stock Ownership Guidelines require executive officers of the Company to hold shares of common stock with a value equal to a specified multiple of base salary. Shares owned outright, restricted stock, deferred shares, deferred stock units and shares acquired pursuant to the Employee Stock Purchase Plan, FutureBuilder Plan and the Restoration Plan are counted towards this requirement. MIP and LTIP incentives are paid in Company stock to any executive who fails to satisfy these requirements. Newly hired and promoted executives have four years to satisfy the requirements. The multiples for specific positions are 6x base salary for the CEO, 4x base salary for EVPs, and 3x base salary for division presidents and SVPs.

- Honeywell: The Committee adopted minimum stock ownership guidelines in May 2003 for all Honeywell officers. Under these guidelines, the CEO must hold shares of Common Stock equal in value to six times his current annual base salary. Other executive officers (including the named executive officers other than the CEO) are required to own shares equal in value to four times their current base salary, with the remaining officers having an ownership threshold set at two times base salary. Shares used in determining whether these guidelines are met include shares held personally, share equivalents held in qualified and nonqualified retirement accounts, and restricted units. Officers have five years to meet these guidelines. In addition, the stock ownership guidelines call for

officers to hold for at least one year the "net shares" from restricted unit vesting (with respect to restricted units granted after the adoption of the stock ownership guidelines) or the "net gain shares" of Common Stock that they receive by exercising stock options. "Net shares" means the number of shares obtained from restricted unit vesting, less the number of shares the officer sells to pay withholding taxes. "Net gain shares" means the number of shares obtained by exercising the option, less the number of shares the officer sells to cover the exercise price of the options and pay the Company withholding taxes. After the one-year holding period, officers may sell net shares or net gain shares, provided that following any sale, they continue to hold shares of Common Stock in excess of the prescribed minimum ownership level.

- Intel: The ownership guidelines specify a number of shares that Intel's executive officers must accumulate and hold within five years of the later of the effective date of the guidelines or the date of appointment or promotion as an officer. The specific share requirements range from 35,000 to 250,000, with the higher guidelines applicable to executive officers having the highest levels of responsibility. Stock options and unvested RSUs do not count toward satisfying these ownership guidelines.

- International Paper: All officers are expected to hold a minimum number of shares of our common stock based on a multiple of base pay: CEO is 5x base pay; EVP is 3x base pay; SVP is 2x base pay and VP is 1x base pay. Ownership includes shares acquired through stock option exercises; shares awarded under the PSP that are vested; shares awarded under the PSP that are "banked"; shares held in our tax-qualified Salaried Savings Plan; share equivalents held in our non-qualified Deferred Compensation Savings Plan; shares purchased on the open market; and indirect ownership of shares held by the officer's spouse or children residing with the officer. An officer may not sell any shares without Committee approval until he or she reaches the applicable minimum holding requirement and, thereafter, may not sell more than 20% of his or her shares, excluding the cashless exercise of stock options in any one calendar year, without the prior approval of the chief executive officer and, in the case of executive and senior vice presidents, without Committee approval. The Board must approve any such exception for the chief executive officer. Discretion to grant an exception to the stock ownership requirement or disposition limit might be exercised in the case of personal or financial hardship or other specific emergency need. These restrictions do not apply to an officer in the 12-month period preceding his or her planned retirement. An officer is expected to meet these ownership requirements within four years of his or her election, appointment, or promotion.

- Johnson & Johnson: In 2006, the Board of Directors approved stock ownership guidelines for Directors and executive officers to further align their interests with the interests of the Company's shareholders. Under these guidelines, the Chairman/CEO will be required to directly or indirectly own Company Common Stock equal in value to five times his or her annual salary, and the other executive officers will be required to own stock equal to three times his or her annual base salary. Non-Employee Directors will be required to own stock equal to three times his or her annual retainer, in addition to the stock initially granted upon joining the Board. The Board may designate other executive

officers to be subject to specific stock ownership thresholds. Stock ownership for the purpose of these guidelines does not include shares underlying unvested stock options. Individuals subject to these guidelines will be required to achieve the relevant ownership threshold within five years after first becoming subject to the guidelines. If an individual becomes subject to a higher ownership threshold due to promotion or increase in base salary, that individual will be expected to meet the higher ownership threshold within three years. The Nominating and Corporate Governance Committee of the Board will review compliance with these guidelines on an annual basis.

- Lockheed: The Board adopted stock ownership guidelines for directors. Directors are expected to own shares or stock units equal to two times the annual retainer within five years of joining the Board. Until a director has achieved these stock ownership guidelines, a director is expected to select common stock units as the form of any annual equity compensation award received as part of their director fees. Lockheed Martin also established Stock Ownership Guidelines for Key Employees, as follows: CEO is 5x base salary and 3x base salary for all other executives. Ownership is satisfied by shares owned directly; shares owned by a spouse or trust; shares represented by monies invested in 401(k) Company common stock funds or comparable plans; share equivalents as represented by income deferred to the Company Stock Investment Option of the DMICP; and unvested restricted shares and RSUs. The executives are asked to report on progress toward attainment of our stock ownership goals during the annual DMICP deferral election period, in increments of 25% of goal, and asked to indicate when they will achieve the next higher level toward their goal.

- Motorola: The Board requires Motorola's senior leadership team and all other senior and executive vice presidents (approximately 45 executives) to maintain prescribed levels of Motorola stock ownership. The stock ownership guidelines set a minimum level of ownership of: Common Stock with a value equal to 4 times base salary for the CEO; the lesser of Common Stock with a value equal to 3 times base salary or 50,000 shares or units for executive vice presidents; and the lesser of Common Stock with a value equal to 2 times base salary or 25,000 shares or units for senior vice presidents.

- Pfizer: Disclosures for Pfizer include a tabular breakdown of current ownership levels for each named executive officer and indicate each officer's progress towards achieving required ownership levels as of the most recent fiscal year end, as well as this disclosure:

  > The Company maintains stock ownership requirements for its Named Executive Officers and other executives. “Stock ownership” is defined to include stock owned by the officer directly, stock owned indirectly through the Company's Savings Plan, restricted stock and restricted stock units, units with respect to the deferral of annual incentive awards or the supplemental saving plan and stock awarded under any performance-contingent share award grant and subsequently deferred. Under the current guidelines of the stock ownership program established by the Committee, employee Directors (currently, Mr. Kindler) are required to own Company common stock equal in value to at least five times their annual salaries. This program also extends to the other Named Executive Officers and other elected Corporate Officers,

who are ultimately required to own Company common stock equal in value to at least four times their annual salaries. All other participants in the Executive Long-Term Incentive Program are required to own an amount equal in value to three times their annual salaries. The Committee has also established milestone guidelines that are used to monitor progress toward meeting the targets as described above, over a five-year period. Under these milestone guidelines, Mr. Kindler's ownership requirement is currently four times his salary.

The Committee has determined that, as of December 31, 2006, all Named Executive Officers have met their ownership milestones (as shown below) and all other employees covered by the stock ownership program have met or are making significant progress toward meeting their milestones.

- Sprint: In August 2005, Sprint adopted stock ownership guidelines for executive officers, other members of the senior management team and the outside directors. The guidelines require that the CEO hold shares of our common stock with a value equal to five times his base salary, and that the other named executive officers hold shares of our common stock with a value equal to three times their respective base salaries. Persons subject to the stock ownership guidelines have five years to achieve the ownership requirement beginning on the later of January 1, 2006 and the date on which the person becomes subject to the ownership guidelines. Eligible shares and share equivalents counted toward ownership include: common or preferred stock; restricted stock and RSUs; intrinsic value of vested, in-the-money stock options; and share units held in various deferred compensation plans.

- United Parcel Service. Target ownership for all members of the Management Committee, except the CEO, is six times annual salary. The target for the CEO is ten times annual salary. The target for non-employee directors is three times their annual retainer. Shares owned outright, deferred units and RSUs are regarded as owned for purposes of calculating ownership. Existing executives and directors have five years from the adoption of the guidelines in 2003 to accumulate the required shares. The Compensation Committee reviews the guidelines annually and monitors the executive officers' progress toward meeting the guidelines.

- UnitedHealth. Each executive officer beneficially own within three years of the adoption of the policy or his or her election or appointment as an executive officer for the first time, whichever is later, a number of shares of the Company's common stock with a fair market value equal to or in excess of a specified multiple of the individual's base salary, as follows: CEO is 5x base salary and all other executive officers are 2x base salary. Sock options and SARs do not count toward satisfaction of the ownership requirements, regardless of their vesting status. The Compensation Committee will review compliance with this requirement on an annual basis.

- Verizon. The company approved guidelines that require the CEO to maintain a multiple of at least five times base salary and require the other named executive officers to maintain a multiple of at least four times base salary. The ownership levels for all other

senior management employees are based on their salary level, and range from at least four times to one times base salary. Shares counted towards these guidelines include any shares held by the executive directly or through a broker, shares held through the Verizon 401(k) plan or the Verizon nonqualified savings plan, PSUs, and RSUs

- Washington Mutual. Under the guidelines, our CEO must hold a number of the Company's shares of common stock with a value of at least ten times his base salary, and our other Named Executives must hold shares worth at least four times their base salary. Shares of unvested restricted stock can be used to satisfy the ownership guidelines, as can amounts deferred under the Company's Deferred Compensation Plan to the extent that those balances are invested in the plan's earnings method based on the Company's stock price. Newly hired executives are given a period of time to satisfy the guidelines.

B. Anti-Hedging Policies

Companies should regularly review their insider trading policies and consider whether the permitted and prohibited trading, among other things, reflect the company's intentions. One of the hottest topics companies are currently considering relates to prohibiting hedging activities, a topic which most companies cover under their insider trading policy. The SEC had proposed to require insiders to disclose any shares subject to hedging arrangements, but did not include this requirement in the final rules. Companies are required to describe in the new CD&A, to the extent material to understanding named executive officer compensation, any policies regarding named executive officers hedging the economic risk of their equity ownership.

1. What Are Hedging Transactions?

Hedging or monetization transactions include zero-cost collars, forward sale contracts and other instruments designed to limit an employee's economic risk associated with beneficial ownership of the company's stock. Hedging transactions can serve legitimate business and tax interests for employees who have large holdings of company securities. However, because such transactions permit an employee to retain ownership of company stock while limiting the risks and rewards of such ownership, the employee's interests may no longer be aligned with those of the company's other shareholders. Hedging transactions are also complex and require a careful analysis of securities reporting and disclosure requirements.

2. Should a Company's Insider Trading Policy Prohibit Hedging Transactions?

Many companies' insider trading policies do not prohibit insiders or employees from engaging in hedging transactions. However, these companies generally discourage all employees, including insiders, from engaging in hedging transactions and require them to submit a pre-clearance request sufficiently far in advance (i.e., at least two weeks) before an employee or insider proposes to enter into a hedging transaction to permit the company to carefully review the transaction.

3. Sample "Anti-Hedging" Language for Insider Trading Policies

Sample language:

Certain forms of hedging or monetization transactions, such as zero-cost collars and forward sale contracts, involve the establishment of a short position in the Company's securities and limit or eliminate your ability to profit from an increase in the value of the Company's securities. **[Alternative:** Therefore, you are prohibited from engaging in any hedging or monetization transactions involving Company securities.**] [Alternative:** Such transactions are complex and involve many aspects of the federal securities laws, including filing and disclosure requirements. Therefore, the Company requires that if you wish to enter into such an arrangement, you must first pre-clear the proposed transaction with the compliance officer. Any request for pre-clearance must be submitted at least two weeks prior to the proposed execution of documents evidencing the proposed transaction.**]**

4. Who Has Adopted Anti-Hedging Policies?

Based on information disclosed on thecorporatecounsel.net and additional information collected by Equilar, Inc., a compensation research firm, for its Fortune 500 stock ownership guidelines database, a number of companies have adopted anti-hedging policies for executive officers and directors:

- Aetna, Inc.
- AG Edwards
- Agilent Technologies, Inc.
- AirNet Systems, Inc.
- American Express
- Assured Guaranty
- Atlas Pipeline Partners GP, LLC
- Charles River Laboratories International
- Commercial Metals
- Intel Corp
- ISIS Pharmaceuticals
- Marathon Oil Corp
- OfficeMax
- Pfizer, Inc.
- WellPoint, Inc.

a. Recent Company Disclosure About Having Anti-Hedging Policies

A number of companies provided enhanced disclosure about their anti-hedging policies, generally in their most recent proxy statements filed with the SEC:

- OfficeMax (from Form 8-K filed on May 1, 2007):

On April 26, 2007, the OfficeMax Incorporated ("OfficeMax") board of directors approved an anti-hedging policy which will be incorporated by amendment into OfficeMax's Code of Business Conduct and Ethics. The text of the policy follows:

> The Company considers it inappropriate for any director, officer, or other employee to enter into speculative transactions in OfficeMax securities. Therefore, this insider trading policy also prohibits the purchase or sale of puts, calls, options, or other derivative securities based on the Company's securities. This prohibition also includes hedging or monetization transactions, such as forward sale contracts, in which the stockholder continues to own the underlying security without all the risks or rewards of ownership. Finally, directors, officers, and other employees may not purchase OfficeMax securities on margin, or borrow against any account in which Company securities are held (except for employee loans from OfficeMax Savings Plan accounts). The prohibitions in this paragraph do not apply to the exercise of stock options granted as part of a Company incentive plan.

- Kraft Foods (from proxy statement filed on March 13, 2007):

  The Company's current policy imposes limits on the timing and types of transactions in Kraft securities permitted by Section 16 officers ("officers"). Among other restrictions, the policy:
  - Allows officers to trade Company securities only during window periods (following earnings releases) and only after they have pre-cleared transactions;
  - Prohibits short selling of Company stock or "selling against the box" (failing to deliver sold securities);
  - Prohibits officers (and any member of the officer's family sharing the household) from transactions in puts, calls or other derivative Company securities on an exchange or in any other organized market, as well as any other derivative or hedging transactions on Company securities.

- Assured Guaranty (from proxy statement filed on March 26, 2007):

  Our guidelines do not mandate a time frame by which this ownership must be attained, but Mr. Frederico, Mr. Mills, Mr. Michener and Mr. Schozer must retain 100% of their after-tax receipt of Company stock until they reach their ownership goal. Mr. Bailenson must retain at least 50% of his after-tax receipt of Company stock until he reaches his ownership goal.

  In addition, in February 2007, the Company amended its stock trading policy to prohibit hedging with respect to Company stock so as to be consistent with its stock ownership philosophy.

- IBM (from proxy statement filed on March 12, 2007):

  The Company does not allow any member of the I&VT, including all named executive officers, to enter into any derivative transaction on IBM stock (e.g., any short-sale, forward, market option, collar, etc.).

- Sunoco Inc. (from proxy statement filed on March 9, 2007):

  Sunoco employees are prohibited from entering into short sales, or purchasing, selling, or exercising any puts, calls or similar instruments pertaining to Company securities. This does not include Sunoco stock options exercised in accordance with the terms of the Company's stock option plan.

- Umpqua Holdings Corp (from proxy statement filed on March 14, 2007):

  Our share ownership guidelines are posted on our website in the Statement of Governance Principles. Directors and executive officers are authorized to sell no more than 15,000 shares per calendar year, unless he or she obtains authorization in a hardship situation from the Audit and Compliance Committee. In addition to this cap, a director or officer may sell shares to cover the exercise price and estimated taxes associated with an option exercise. Our policy also prohibits directors and executives from engaging in transactions in which they may profit from short term speculative swings in the market value of Umpqua stock. These prohibited transactions include "short sales" (selling borrowed securities which the seller hopes can be purchased at a lower price in the future); "short sales against the box" (selling owned, but not delivered securities); "put" and "call" options (publicly available rights to sell or buy Umpqua shares at a specific price within a specified period of time) and derivative transactions, such as non-recourse loans secured by Company stock.

- Mediacom Communications Corp (from proxy statement filed on April 30, 2007):

  Policies Regarding Hedging. Our policy prohibits any named executive officer from buying or selling any company securities or options or derivatives with respect to company securities without obtaining prior approval from our General Counsel, Chief Financial Officer and, when appropriate, outside counsel. This assures that the executives will not trade in our securities at a time when in possession of inside information. We do not have a policy that specifically prohibits our named executive officers from hedging the economic risk of stock ownership in the company. However, federal securities laws prohibit our named executive officers from selling "short" our stock.

- Macquarie Infrastructure CO Trust (from proxy statement filed on April 23, 2007):

  We do not have any separate policy that requires our executive officers to maintain a minimum shareholding in our trust stock, although Mr. Stokes is subject to minimum shareholding requirements with respect to Macquarie Bank Limited stock and restrictions on hedging. Our internal policies prohibit our officers and directors, among others, from

engaging in hedging or derivative transactions, engaging in speculations or short sales and using margin loans or pledges with respect to our securities.

b. Recent Company Disclosure About *Not* Having an Anti-Hedging Policy

Another company had some interesting disclosure about *not* having a policy that prohibits hedging:

- Fifth Third Bancorp (from proxy statement filed on March 9, 2007):

  Although the Company does not prohibit its Executive Officers from hedging shares of the Company's common stock, any hedged shares are excluded from the calculation of Executive Officers' ownership levels when analyzing progress toward meeting the stock ownership guidelines. The Company's insider trading policy prohibits trading during designated blackout periods and requires approval by the Legal Department prior to any trade.

C. Clawback Provisions or Policies

A clawback is a means to recover compensation in the event of certain behaviors or events. Some companies insert formal clawback provisions into executive contracts—in which case, the clawback is a term of the contract and can operate automatically. Other companies adopt a policy that calls for the company to review compensation paid in light of newly discovered circumstances, and, on a case by case basis, make a decision as to whether to attempt to recover the compensation. However, in the absence of a statutory or contractual basis for these clawback rights, companies may find themselves unable to enforce their policies without risking litigation.

1. Why Use Clawbacks Now?

The practice of including clawback provisions in equity awards is not, in and of itself, innovative. However, we are increasingly seeing companies employ clawback provisions in situations beyond recovery of shares on termination for cause or for post-termination competition (historically the most common uses). Most notably, the clawback features of Sections 304 and 1103 of the Sarbanes-Oxley Act of 2002, increasing enforcement action by the SEC in connection with financial restatements and exploding option backdating issues (including shareholder derivative lawsuits), have led to a number of companies seeking, or being forced to seek, recovery of compensation paid to executives in light of accounting restatements and option backdating issues. Companies such as Brocade, Conseco, Fannie Mae, Gemstar-TV Guide, HealthSouth, Nortel, Qwest, Raytheon and Viacom have disclosed that their executives have been asked or forced to return compensation, including equity compensation, in connection with these types of situations. While inserting a clawback provision into an equity award is not a guarantee that a company can avoid costly litigation (e.g. HealthSouth), it is another weapon in the arsenal that may encourage swifter resolution of the problem. A recent New York Times article, dated March 25, 2007, called *Making Managers Pay, Literally*, by Gretchen Morgenson, highlights the utility of these provisions.

In addition, the adoption of a formal clawback policy or inclusion of a contractual clawback provision in a compensation plan sends a message to shareholders that the company is taking its corporate governance seriously. The SEC included in its list of suggested items to cover in the new CD&A, if material, the company's policies and decisions on adjusting or recovering awards or payments if the company restates or otherwise adjusts the relevant company performance measures in a manner that would reduce the size of an award or payment.

Companies may wish to adopt a clawback policy now, before shareholder proposals appear in the next proxy season. Shareholders are clearly voicing their preference for clawback policies via shareholder proposals. Georgeson reported at least 10 proposals seeking the adoption or enhancement of a clawback policy in the 2006 proxy season. None of those proposals passed, although a handful received a not-immaterial level of support (upwards of 30%). For the 2007 proxy season, ISS reports that at least nine companies were subject to shareholder proposals seeking the adoption or modification of a clawback policy: Allegheny Energy, Boeing, Bristol Myers Squibb, Exxon Mobile, General Motors, Home Depot, Honeywell, Motorola and Wyeth. At this point, it does not appear that any of these proposals passed and only a handful received even double digit votes in favor of the proposal. However, the energy expended defending against these proposals may be better spent with an offensive attack through the adoption of clawback guidelines. ISS has a policy to vote on a case by case basis for these proposals, factoring in whether the company has a history of earnings restatements and whether they have currently have a clawback policy in place (even if it is not as robust as some stockholders might wish). Consistent with this voting policy, ISS recommended voting FOR the shareholder proposals at Exxon (a very minimal policy per 2007 proxy), Motorola (no policy per 2007 proxy) and Wyeth (no policy per 2007 proxy). TIAA-CREF's 2007 Policy Statement on Corporate Governance stated that "[c]ompensation plans and policies should specify conditions for the recovery (clawback) of incentive or equity awards based upon reported results that have been subsequently restated and that have resulted in unjust enrichment of named executive officers."

2. What Are the Limitations to Using Clawbacks?

Careful drafting is required for an enforceable clawback. Many will likely recall the Ninth Circuit's 1999 decision upholding a comprehensive non-competition clawback in *IBM v. Bajorak*, and employers, employees, employment lawyers and courts continue to disagree as to whether the Ninth Circuit incorrectly applied the state law prohibitions on unlawful restraints on competition. This issue has continued to be litigated in California, most recently in *Edwards v. Arthur Andersen LLP*, which found that the "narrow restraint" exception to Section 16600 of the California Business and Professions Code, articulated in *IBM v. Barjorek*, is not a proper application of California law. As of the date of this paper, *Edwards v. Arthur Andersen LLP* is still pending before the California Supreme Court, with amicus briefs piling up on both sides of this important question.

Opponents of the practice also cited the potential for abuse through selective enforcement or the inherent unfairness of taking back compensation after it is earned. If equity compensation is considered a "wage" under applicable wage and hour laws, the requirement that an employee return "earned" compensation can give rise to wage claims.

Ongoing experience with drafting and applying a variety of these clauses, however, suggests that, if properly structured, they can balance these concerns against the legitimate rights of an employer.

3. What Are the Drafting Considerations?

a. Forfeiture Only vs. Forfeiture and Recapture

A threshold drafting question is: what effect will the clause have on the benefits provided under the award agreement? The prohibited employee behavior (competition, solicitation of employees, etc.) may result only in forfeiture of the portion of the award that remains outstanding, or it may also permit the employer to recapture benefits already gained. For example, an option agreement that gives an employee three months after termination of employment to exercise vested options, can be drafted so as to provide the employer the right to deny the exercise if it discovers the employee has gone to work for a competitor immediately after termination. Of course, this provision may simply have the effect of causing the shrewd employee to exercise before termination. The addition of a recapture provision may deter the employee from joining the competitor and may prevent an employee from simply exercising before termination. If deterrence is unsuccessful, the employer will at least have the contractual right to recover the shares acquired upon exercise (or the option profits if the shares were sold).

However, the question remains as to how to recover shares or profits from an employee who has long since sold the shares and spent the profits, or even how to recover "unjust enrichment" from current employees in respect of clawback provisions that operate in the event of a financial restatement. Care should be taken to determine the most likely effective means to achieve recovery. Escrowing all shares exercised or profits received in the post-termination period may be an unrealistic method depending on the size of the employee population covered by the clawback provision. Litigation can be costly and may not be effective. A right to recover against current and future compensation can be helpful, but only if the employee remains employed at the time of recovery or is otherwise receiving on-going severance benefits.

b. Defining Prohibited Behavior

The next question is how to define the specific types of behavior that will trigger the clause. The most common ones are:

c. Competition

Prohibiting the employee from working in a competing business is frequently the principal objective. This requires crafting a formulation that is reasonably likely to be enforceable, tailored to the business, broad enough to protect the employer and narrow enough to protect the employee from arbitrary assertion by the employer. Related prohibited acts typically include solicitation of former colleagues, disclosure of trade secrets and refusal to assign inventions.

d. Sarbanes-Oxley Clawbacks

Section 304 of the Sarbanes-Oxley Act provides for the forfeiture of bonuses and profits when executive misconduct has resulted in a restatement of accounts due to material noncompliance with reporting requirements. Section 1103 of Sarbanes-Oxley provide for the recovery of extraordinary payments. Some companies have begun to include corresponding contractual provisions in their equity agreements with senior executives. Many companies have used this statutory requirement as the foundation for their clawback policy.

e. For Cause Termination

Some clauses trigger a forfeiture or profits recapture upon termination by the employer for "cause." In this instance, it is necessary to define the types of behavior justifying termination for cause rather narrowly to avoid arbitrary assertion of the clause. Even with a narrow definition, it may be perceived as unfair to recapture benefits fully earned and paid out prior to termination, no matter how egregious the conduct was that resulted in termination.

f. Other Disloyal Acts

Perhaps the most controversial trigger is one that broadly proscribes any other conduct that is against the employer's best interests. On the one hand, this may be the only provision an employer has to deal with an unusual situation that could not be foreseen when the instrument was drafted. On the other, it is the one most susceptible to arbitrary application and therefore litigation. Placing the power to exercise this authority in the hands of the full Board of Directors or a specified committee, or giving the employee express administrative rights of appeal, provides some protection against arbitrary assertion.

g. Length of Post-Employment Restriction

How long after leaving employment must the employee avoid the prohibited behavior? A period of one to three years is typical, depending on the applicable state law, custom in the industry, the useful life of information the employee might be taking and a variety of other factors.

h. Limitation on Length of Reach-Back

Many clauses limit the period of time covered by the recapture provision. For example, only option gains realized in the last 12 months may be subject to recapture. Care should be taken to consider whether the recapture provision exceeds the permitted time frame under state law prohibitions on unlawful restraints on competition or exceed the statute of limitations on the underlying bad act.

i. Types of Benefits Recaptured

Sometimes the recapture provision will only apply to certain types of benefits. For example, a provision in an option agreement could reach back not only to gains on that option, but could also reach back to the value of other options, restricted stock or even performance awards that vested during the recapture period. An escrow provision with respect to shares

or profits subject to recapture can facilitate the operation of the provision but may be unmanageable when applied broadly across the company's employee population. The provision might also allow the company to recover the value of the recaptured benefits from current or future cash or equity compensation to be paid to the employee.

h. Notice and Opportunity to Cure

Another employee protection requires the plan administrator to give an offending employee or former employee a notice describing the prohibited behavior and a period of, say, 30 days to cure.

j. Early Discovery Requirement

The clause may also require that such a notice be given within a specified period of time after the prohibited behavior began or after the company learned of such behavior. This requirement protects an employee from belated assertion of a claim long after the behavior should have or did come to the employer's attention.

4. Sample Clawback Provision Language for Award

Sample language:

Impact of Restatement of Financial Statements Upon Award. If any of the Company's financial statements are required to be restated resulting from errors, omissions or fraud, the Committee may (in its sole discretion, but acting in good faith) direct that the Company recover all or a portion of this Award with respect to any fiscal year of the Company the financial results of which are negatively affected by such restatement. The amount to be recovered from the Participant shall be the amount by which this Award exceeded the amount that would have been payable to the Participant had the financial statements been initially filed as restated, or any greater or lesser amount (including, but not limited to, the entire award) that the Committee shall determine. In no event shall the amount to be recovered by the Company be less than the amount required to be repaid or recovered as a matter of law. The Committee shall determine whether the Company shall effect any such recovery (i) by seeking repayment from the Participant, (ii) by reducing (subject to applicable law and the terms and conditions of the applicable plan, program or arrangement) the amount that would otherwise be payable to the Participant under any compensatory plan, program or arrangement maintained by the Company or any of its affiliates, (iii) by withholding payment of future increases in compensation (including the payment of any discretionary bonus amount) or grants of compensatory awards that would otherwise have been made in accordance with the Company's otherwise applicable compensation practices, or (iv) by any combination of the foregoing.

5. Sample Rebuttal to Shareholder Clawback Proposal—Honeywell

Sample language:

Board of Directors' Recommendation—The Board of Directors recommends that the shareowners vote AGAINST this proposal for the following reasons:

The Corporate Governance and Responsibility Committee (the "Committee") of the Board of Directors consists entirely of independent, non-employee directors and is primarily responsible for analyzing corporate governance issues and making recommendations to the full Board. Each year, the Committee reviews the shareowner proposals that are considered at our annual meeting, and the Committee's recommendations are then presented to and considered by the full Board. At the 2006 Annual Meeting of Shareowners, approximately 48% of the votes cast (including abstentions) supported a proposal on this topic.

The Board of Directors believes that the concerns raised in both last year's and this year's proposal have already been addressed, to the extent warranted and equitable, through an amendment to the Company's Corporate Governance Guidelines adopted by the Board in December 2006. Under the amended Guidelines, in the event of a significant restatement of financial results (a "Restatement"), the Board can seek to recoup incentive compensation paid to senior executives (the executive officers and certain other officers of the Company) if and to the extent that (i) the amount of incentive compensation was calculated based upon the achievement of financial results that were subsequently reduced due to a Restatement, (ii) the senior executive engaged in misconduct and (iii) the amount of incentive compensation that would have been awarded to the senior executive had the financial results been properly reported would have been lower than the amount actually awarded. The complete text of the amended Corporate Governance Guidelines is posted on our website at www.honeywell.com (see "Investor Relations; Corporate Governance").

It is also important to keep in mind that the Sarbanes-Oxley Act requires that, in the case of accounting restatements due to material non-compliance with financial reporting requirements as a result of misconduct, the CEO and CFO must reimburse the Company for any incentive-based or equity-based compensation and any profits from the sale of the Company's securities during the 12-month period following initial publication of the financial statements that had to be restated. The CEO and CFO are also required to certify the accuracy and completeness of SEC filings containing the Company's financial statements and the effectiveness of the Company's internal control over financial reporting.

The Board believes that the proposal is unworkable because it is vague and overreaching. The proposal would apply to restatements and write-offs that are not caused by misconduct or non- compliance with financial reporting requirements. It would also apply to all senior executives, regardless of their knowledge of or responsibility for the underlying cause of the restatement or write-off. By potentially subjecting each senior executive's performance-based compensation to the risk of forfeiture in circumstances where the Board would not deem it appropriate to pursue recoupment, the proposal would have the unintended effect of placing the Company at a competitive disadvantage in recruiting qualified executive talent. Furthermore, the assertions made in the proposal regarding CEO compensation arrangements are inappropriate vitriolic statements that bear no relevance to the subject of the proposal.

For the reasons stated above, your Board of Directors recommends a vote AGAINST this proposal.

6. Sample Clawback "No Policy" Disclosure—Sunoco

Sample language:

The Company does not have a "clawback" policy. If the Company is required to restate its earnings as a result of noncompliance with a financial reporting requirement due to misconduct, under Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"), the CEO and the Chief Financial Officer ("CFO") would have to reimburse the Company for any bonus or other incentive-based or equity-based compensation received by them from the Company during the 12-month period following the first filing with the SEC of the financial document that embodied the financial reporting requirement, and any profits realized from the sale of Sunoco stock during that 12-month period, to the extent required by SOX.

7. Who Is Using Clawbacks?

Based on the review of proxies filed in the 2007 proxy season, Equilar determined that 42.1% of Fortune 100 companies disclosed a clawback policy in their proxy—up from 17.6% of companies in 2006. Then again, this increase doesn't necessarily mean that these companies didn't previously have the policies in place—it may simply be a reflection that the companies are only now disclosing the existence. In addition, five proxy statements filed by Fortune 100 companies in the recent proxy season included shareholder proposals seeking the adoption of a clawback policy.

The following companies adopted or amended their clawback policies in 2006:

- Alcoa
- Boeing
- Caterpillar
- General Motors
- JP Morgan
- Johnson & Johnson
- Sprint
- United Parcel Service
- Washington Mutual

And these companies did so in 2007:

- Comcast
- Intel
- Time Warner

- UnitedHealth
- Verizon

a. Recent Company Disclosure About Clawback Policies

With all of the great disclosure at our disposal thanks to the new SEC rules, we had a large number of clawback policies to choose from as examples. In addition, some companies have even added their clawback policies to their governance documents that are available on their websites. Here are some highlights, including when some of these companies adopted their policies and the resolutions used to adopt those policies:

- Alcoa: Cash incentive compensation may be recovered by the company if misconduct by an executive officer contributed to the company's having to restate all or a portion of its financial statements. In addition, the 2004 Alcoa Stock Incentive Plan contains a provision that permits cancellation or suspension of equity awards if a recipient takes any action in the judgment of the Compensation and Benefits Committee that is not in the best interests of the company.

- Allegheny Energy: The Board adopted a policy in October 2006 that provides:

  > RESOLVED, that it is the Board of Directors' policy that the Company will, to the extent permitted by governing law, require reimbursement of any bonus paid to certain specified officers after April 1, 2007 where: a) the payment was predicated upon the achievement of certain financial results that were subsequently the subject of a restatement, b) in the Board's view the specified officer engaged in fraud or intentional misconduct that caused or partially caused the need for the restatement and c) a lower payment would have been made to the specified officer based upon the restated financial results. In each such case, the Company will seek to recover the individual specified officer's entire annual bonus for the relevant period. This policy does not purport to limit Section 304 of the Sarbanes-Oxley Act in any way, but any monies recovered under this policy shall be deemed by the Company to have been recovered under Section 304 of the Sarbanes-Oxley Act.
  >
  > RESOLVED FURTHER, for purposes of this policy, the term "specified officers" includes the Company's Chief Executive Officer, Chief Financial Officer, Chief Operating Officer—Generation, President of Allegheny Power, General Counsel, Vice President—Human Resources, any other officer who is a Named Executive Officer and any other officer who may be designated as a specified officer by the Board under this policy. The term "bonus" means a payout under the Company's Annual Incentive Plan.

  Allegheny Energy has an additional policy on the forfeiture of bonuses and other compensation if the Board determines that knowing misconduct by the CEO or CFO has occurred and caused our financial results to be restated. In this situation, the Board will take steps to secure reimbursement from the responsible CEO or CFO of (a) any bonus or incentive-based or equity-based compensation received by the responsible officer from us during the 12-month period following the first public issuance or filing with the SEC of

the financial document containing the error and (b) any net profits realized by the responsible officer from the sale of our securities during the same 12-month period.

- Boeing: Pursuant to a policy adopted by the Board of Directors in 2006, we will seek reimbursement of annual or long-term incentive payments to an executive officer if the Board determines that the executive engaged in intentional misconduct that caused or substantially caused the need for a substantial restatement of financial results and a lower payment would have been made to the executive based on the restated financial results. This policy is contained in our Corporate Governance Principles and may be viewed on our website at **www.boeing.com**.

- Bristol Myers Squibb: The company maintains clawback provisions relating to stock option, restricted stock and long-term performance awards. Under these clawback provisions, executives that violate non-competition or non-solicitation agreements, or otherwise act in a manner detrimental to the company's interests, forfeit any outstanding awards as of the date such violation is discovered and have to return any gains realized in the twelve months prior to the violation. In 2005, the Board adopted a policy wherein the Board will seek reimbursement of annual incentives paid to an executive if such executive engaged in misconduct that caused or partially caused a restatement of financial results. In such an event, the company will seek to claw back the executive's entire annual incentive for the relevant period, plus a reasonable rate of interest. This policy may be viewed on the company's website at www.bms.com.

- Caterpillar: The company has a policy that allows the company to recoup executive officer bonuses in the event of a financial restatement

- Comcast: In 2007, upon the recommendation of the Compensation Committee and the Governance and Directors Nominating Committee, our Board adopted an incentive compensation recoupment policy. The policy provides that if it is determined by the Board that gross negligence, intentional misconduct or fraud by one of our executive officers or former executive officers caused or partially caused the restatement of all or a portion of our financial statements, the Board, in its sole discretion, may, to the extent permitted by law and our benefit plans, policies and agreements, and to the extent it determines in its sole judgment that it is in our best interests to do so, require reimbursement of all or a portion of any annual bonus, vested restricted stock or other incentive based compensation granted on or after March 1, 2007 to such executive officer or former executive officer (and/or effect the cancellation of unvested restricted stock), if: (1) the amount or vesting of the incentive based compensation was calculated based upon, or contingent on, the achievement of financial or operating results that were the subject of or affected by the restatement; and (2) the amount or vesting of the incentive based compensation would have been less had the financial statements been correct.

- Edison International: "Each Named Officer's stock option award contains a non-competition requirement. If the Named Officer renders any services for any organization in any business that competes with the Companies' business prior to or during the six-month period following any option exercise, Edison International may rescind such

exercise. In connection with any rescission, the Named Officer is required to return any gain from the option exercise to Edison International."

- Exxon: Restricted stock granted to an executive may be forfeited if an executive engages in activity that is detrimental to the interests of the Company, even if such activity occurs or is discovered after retirement. Note that ISS recommended voting FOR the shareholder proposal this year at Exxon.

- General Motors: In October 2006, the GM Board adopted and announced a policy regarding the recoupment of unearned compensation, applicable to incentive compensation paid to executive officers after January 1, 2007 and unvested portions of awards previously granted, in situations involving financial restatement due to employee fraud, negligence, or intentional misconduct. In line with this, the Committee charter was modified to reflect the new policy and the revised charter and policy were published on GM's Web site, www.gm.com. In addition, we added provisions to all executive incentive and deferred compensation plans to reference Board policies impacting compensation and will require the compensation of all executives covered by this policy to be subject to this recoupment clause.

- Home Depot: The Company's Board has adopted the following policy to recoup incentive based compensation from executive officers, including the CEO and CFO:

  To the extent permitted by law, if the Board of Directors, or a committee thereof, determines that any bonus, incentive payment, equity award or other compensation has been awarded or received by an executive officer of the Company, as defined by Rule 16a-1(f) of the Securities Exchange Act of 1934, as amended, and that such compensation was based on any financial results or operating metrics that were satisfied as a result of such officer's knowing or intentional fraudulent or illegal conduct, then the Board or a committee thereof, shall recover from the officer such compensation (in whole or in part) as it deems appropriate under the circumstances. Further, following a restatement of the Company's financial statements, the Company shall recover any compensation received by the CEO and CFO that is required to be recovered by Section 304 of Sarbanes-Oxley Act of 2002. In determining whether to recover a payment, the Board shall take into account such considerations as it deems appropriate, including whether the assertion of a claim may violate applicable law or prejudice the interests of the Company in any related proceeding or investigation. The Board shall have sole discretion in determining whether an officer's conduct has or has not met any particular standard of conduct under law or Company policy.

- Honeywell: The Company's Corporate Governance Guidelines, adopted by the Board in December 2006, provide that in the event of a significant restatement of financial results (a "Restatement"), the Board can seek to recoup incentive compensation paid to senior executives (the executive officers and certain other officers of the Company) if and to the extent that (i) the amount of incentive compensation was calculated based upon the achievement of financial results that were subsequently reduced due to a Restatement, (ii) the senior executive engaged in misconduct and (iii) the amount of incentive compensation that would have been awarded to the senior executive had the financial

results been properly reported would have been lower than the amount actually awarded. The complete text of the amended Corporate Governance Guidelines is posted on our website at www.honeywell.com (see "Investor Relations; Corporate Governance").

- IBM: The Company's equity plans and agreements provide that awards will be cancelled and that certain gains must be repaid if an executive engages in activity that is detrimental to the Company, such as performing services for a competitor, disclosing confidential information or violating the Company's Business Conduct Guidelines. Annual cash incentive payments are also conditioned on compliance with these Guidelines. Approximately 400 of our key executives (including each of the named executive officers) have agreed to a non-competition, non-solicitation agreement that prevents them from working for certain competitors within 12 months of leaving IBM or soliciting employees within two years of leaving IBM. The Committee has also implemented a policy for the "clawback" of cash incentive payments in the event an officer's conduct leads to a restatement of the Company's financial results, as follows: To the extent permitted by governing law, the Company will seek to recoup any bonus or incentive paid to any executive officer if (i) the amount of such payment was based on the achievement of certain financial results that were subsequently the subject of a restatement, (ii) the Board determines that such officer engaged in misconduct that resulted in the obligation to restate and (iii) a lower payment would have been made to the officer based upon the restated financial results.
- Intel: In January 2007, the Board of Directors adopted standards for seeking the return (claw-back) from executive officers of cash incentive payments and stock sale proceeds to the extent that they had been inflated due to financial results that later had to be restated. We have added these standards as provisions in the 2007 Executive Officer Incentive Plan and 2006 Equity Incentive Plan as proposed. Under the 2007 Executive Officer Incentive Plan, if Intel's financial statements are the subject of a restatement due to error or misconduct, the Board will seek reimbursement of excess annual incentive cash payments to executive officers for the relevant performance periods, whether or not the executive officers engaged in any misconduct. Excess incentive cash compensation means the positive difference, if any, between the payment made to the executive officer and the payment that would have been made to the executive officer had the multiplier been calculated based on the company's financial statements as restated. Under the 2006 Equity Incentive Plan, if an executive officer engaged in an act of embezzlement, fraud, or breach of fiduciary duty that contributed to the obligation for Intel to restate its financial statements, the officer will be required to repay proceeds from the sale of shares issued upon exercise of a stock option or stock appreciation right (SAR), or vesting of restricted stock or RSU, occurring during the 12-month period following the first public issuance or filing with the SEC of the financial statements required to be restated, in an amount determined appropriate by the Committee to reflect the effect of the restatement on Intel's financial statements. These remedies would be in addition to any actions imposed by law enforcement agencies, regulators, or other authorities.

- International Paper: The Long-Term Incentive Compensation Plan contains a claw back provision relating to our long-term equity awards: stock options, service-based restricted stock awards and performance-based restricted stock awards. Under this claw back

provision, if our financial statements are required to be restated as a result of errors, omission, or fraud, the Committee may, in its discretion, based on the facts and circumstances surrounding the restatement, direct that we recover all or a portion of an equity award from one or more executives with respect to any fiscal year in which our financial results are negatively affected by such restatement. To do this, we may pursue various ways to recover from one or more executives: (i) seek repayment from the executive; (ii) reduce the amount that would otherwise be payable to the executive under another Company benefit plan; (iii) withhold future equity grants, bonus awards, or salary increases; or (iv) take any combination of these actions.

- Johnson & Johnson: In 2006, the Board adopted a compensation recoupment policy. Under this policy, in the event of a material restatement of the Company's financial results, the Board will review the facts and circumstances that led to the requirement for the restatement and will take actions it deems necessary and appropriate. The Board will consider whether any executive officer received compensation based on the original financial statements because it appeared he or she achieved financial performance targets that in fact were not achieved based on the restatement. The Board will also consider the accountability of any executive officer whose acts or omissions were responsible in whole or in part for the events that led to the restatement and whether such actions or omissions constituted misconduct. The actions the Board could elect to take against a particular executive officer, depending on all facts and circumstances as determined during their review, include: the recoupment of all or part of any bonus or other compensation paid to the executive officer that was based upon achievement of financial results that were subsequently restated; disciplinary actions, up to and including termination; and/or the pursuit of other available remedies

- Kellogg: "Recoupment of Option Awards. We maintain clawback provisions relating to stock option exercises. Under these clawback provisions, if an executive voluntarily leaves our employment to work for a competitor within one year after any option exercise, then the executive must repay to Kellogg any gains realized from such exercise (but reduced by any tax withholding or tax obligations)."

- KeyCorp: "Clawback provisions. If an employee engages in "harmful activity" prior to, or within six months after, that individual ceases to work for KeyCorp, then (1) any profits he or she realizes upon exercising any covered option on or after one year prior to termination of employment must be paid back to Key, and (2) he or she must forfeit all unexercised covered options. Harmful activity is broadly defined to include wrongfully using or disclosing, or failing to return, confidential KeyCorp information, as well as soliciting KeyCorp clients or hiring KeyCorp employees."

- Kraft: "Policy on Recoupment of Executive Incentive Compensation in the Event of Certain Restatements: If the Board of Directors or an appropriate Committee of the Board determines that, as a result of a restatement of the Company's financial statements, an executive received more compensation than the executive would have received absent the incorrect financial statements, then the Board or Committee, in its discretion, may take such actions as it deems necessary or appropriate to address the events that gave rise to

the restatement and to prevent its recurrence. Such actions may include, to the extent permitted by applicable law: (1) Requiring partial or full repayment of any bonus or other incentive compensation paid to the executive; (2) Requiring repayment of any gains realized on the exercise of stock options or on the open-market sale of vested shares; (3) Causing the partial or full cancellation of restricted stock or deferred stock awards and outstanding stock options; (4) Adjusting the future compensation of such executive; and (5) Dismissing or initiating legal action against the executive, as the Board or Committee determines to be in the best interests of the Company."

- Microsoft: The Committee has adopted an executive compensation recovery policy applicable to executive officers and the principal accounting officer. Under this policy, the Company may recover incentive income that was based on achievement of quantitative performance targets if an executive officer engaged in intentional misconduct that resulted in an increase in his or her incentive income. Incentive income includes income related to annual bonuses and SPSAs.

- Sprint: In December 2006, our board adopted a "clawback" policy. The policy provides that, in addition to any other remedies available to us under applicable law, we may recover (in whole or in part) any bonus, incentive payment, commission, equity-based award or other compensation received by certain executives, including our named executive officers, if the board or any committee of the board determines that such bonus, incentive payment, commission, equity-based award or other compensation is or was based on any financial results or operating metrics that were impacted by the officer's knowing or intentional fraudulent or illegal conduct, and our board or a committee of the board determines that recovery is appropriate. We intend to incorporate this policy into our short and long-term incentive plans, and awards granted under those plans, beginning in 2007.

- Time Warner: In February 2007, the Board of Directors adopted a policy regarding the recovery of executive compensation under certain circumstances. This policy reinforces the Company's commitment to the Standards of Business Conduct, which each employee is expected to follow, and furthers the concept of performance-based compensation as part of the compensation philosophy. Under the policy, if the Board of Directors determines that an executive officer or a Division CEO intentionally caused a material financial misstatement, which resulted in artificially inflated executive compensation, the Board will determine the appropriate actions to take to remedy the misconduct, prevent its recurrence and to take action with respect to the executive.

- United Parcel Service: In 2006, the Compensation Committee adopted a recoupment policy with respect to equity awards to our executive officers. Pursuant to this policy, if financial results used to determine the amount of an award are materially restated and an executive engaged in fraud or intentional misconduct, we will seek repayment or recovery of the award, as appropriate.

- UnitedHealth: The Board of Directors, acting upon the recommendation of the Compensation Committee, adopted a clawback policy in 2007 with the following key provisions:

  Material Restatements The clawback policy applies to a defined list of approximately 30 members of senior management, including all executive officers, and applies to both incentive cash and equity compensation. Any designated executive must repay the Company the entire amount of his or her annual or long-term cash incentive payment if the Board determines that he or she has engaged in fraud or misconduct that caused, in whole or in part, a material restatement of the Company's financial statements and the executive would have received a lower annual or long-term cash incentive payment if it had been based on the restated financial results. If it is determined that a designated executive has engaged in fraud that causes, in whole or in part, a material restatement of the Company's financial statements, the Company will cancel his or her then-outstanding vested and unvested options/SARs or other unvested equity awards subject to the clawback policy, and the executive must return to the Company all gains from equity awards realized during the twelve-month period following the filing of the incorrect financial statements.

  Violation of Noncompetition Covenants The clawback policy with respect to violations of noncompetition covenants, applies to a broader group of executives, and applies only to equity compensation. The policy requires cancellation of unvested options/SARs or other unvested equity awards and forfeiture of all equity awards which vested within one year prior to termination of employment or anytime thereafter if the employee violates a restrictive covenant

- United Technologies: "Protecting UTC's Interests: The executive compensation program imposes certain requirements intended to protect UTC's interests: (1) Forfeiture of awards and "clawback" of gains realized from long-term incentive awards in the event of misconduct as defined in the LTIP; (2) Covenants for ELG participants strictly limiting proprietary information disclosure, competitive activities and solicitation of UTC employees; and (3) Mandatory share ownership guidelines of five times base salary for the Chief Executive Officer and three times base salary for other ELG participants.

- Washington Mutual: The Company maintains claw-back provisions within its form agreements for stock options and restricted stock awards made in 2006 and beyond. These agreements also contain provisions assigning intellectual property rights to the Company. In accordance with these provisions, Named Executives who violate non-solicitation agreements (with respect to customers and employees) will forfeit all of their outstanding equity awards whether or not they have vested, as of the date of the violation or the date of the Company's discovery of the violation. In addition, the Named Executives would be required to return to the Company any gains realized on Company stock or options obtained under these awards if the gain is realized during the 12 months preceding the violation. The Company first implemented these provisions in 2006 to protect its intellectual property and human capital and to help ensure that the Named Executives act in the Company's best interests and the best interests of its shareholders

D. Rule 10b5-1 Trading Plans

SEC Rule 10b5-1, which was adopted in late 2000, provides a method for a person to assert an affirmative defense to insider trading liability. While some recent developments have raised issues about misuse of these plans, they remain an effective tool for insiders looking to diversify their holdings.

1. What Is Required to Establish a Rule 10b5-1 Trading Plan?

The insider seeking the affirmative defense with respect to the trading activity must enter into a binding contract, provide written instructions to another person or adopt a written trading plan. Rule 10b5-1 includes a number of additional requirements.

- The insider must do this with not in possession of any material nonpublic information about the issuer.
- The contract, instructions or plan must specify the price, date and timing the trading activity (which can be by specified or determinable by written formula or algorithm).
- The plan must prevent the insider from exercising any subsequent influence over how, when or whether to effect purchases or sales, but instructions may grant some discretion to the other party.
- Once the plan is in place, the insider must be able to demonstrate that the purchases or sales were made pursuant to the plan.
- The insider must avoid entering into any type of corresponding or hedging arrangement.
- The insider must enter into the Rule 10b5-1 plan in good faith.

2. Should Companies Permit Rule 10b5-1 Plans . . . or Require Them?

There is no one-size-fits-all answer to this question. Each company should analyze its equity compensation programs and trading practices of its employees and insiders and any signs of interest in establishing trading plans, decide what will work best for that specific company, and periodically revisit the issue when circumstances change.

If a company permits employees and/or insiders to use Rule 10b5-1 plans, the company's insider trading policy should address the company's policy on these plans, at a minimum. The company should also consider adopting Rule 10b5-1 Plan Guidelines that set out the parameters for these plans. Some companies permit Rule 10b5-1 plans only for to executive officers and directors, who are more likely to be financially sophisticated and able to understand the risks and requirements. Most companies generally permit Rule 10b5-1 plans, but do not broadly disseminate information about the availability of these plans among employees.

3. Should the Company Require Company Review or Approval of Rule 10b5-1 Plan?

Again, there is no one-size-fits-all answer to this question. Although the company is not technically required to have any role in Rule 10b5-1 plans, the company should be aware of all Rule 10b5-1 plans for employees and insiders to facilitate compliance for planned purchases and sales under the company's insider trading policy, as well as with other applicable disclosure and reporting requirements. Most companies designate a compliance officer to review all Rule 10b5-1 plans, while some require company approval in advance or dictate specific terms. The level of involvement and staffing for each company will depend on how frequently insiders and employees use these plans, among other things.

Be aware that most brokers, especially larger firms, have their own form of Rule 10b5-1 trading plan and will require insiders to use the broker's form when adopting these plans with the broker.

4. Securities and Other Issues

Some additional issues complicate using Rule 10b5-1 plans. For insiders who are perpetually in possession of material non-public information, Rule 10b5-1 plans are technically not available. However, some practitioners advocate reading the requirements to mean that the insider is only required not to be in possession of the *same* material non-public information at the time the insider enters into the Rule 10b5-1 plan and at the time of the trades conducted under the plan. The SEC has declined to endorse this interpretation.

Although not technically required, most practitioners mandate some delay between the date an insider enters into a Rule 10b5-1 plan and the date of the first transaction under that plan, and prohibit any changes to the plan, although they will generally permit insiders to terminate an existing Rule 10b5-1 plan. However, brokers frequently mandate a minimum delay between the date an insider enters into a Rule 10b5-1 plan and the date of the first transaction under that plan. In addition, some brokers completely prohibit any termination of a Rule 10b5-1 plan.

Companies face challenges in administering their Rule 10b5-1 plans as well. Should the company require company-approval for all Rule 10b5-1 plans? Who at the company should review and approve the plans? Should the company refuse to review or approve Rule 10b5-1 plans? There are no one-size-fits-all answers to these questions. Companies that require these plans for a broad group may need to set up a team of paralegals to handle review and/or facilitate the general counsel's approval. Companies that permit these plans only for Section 16 insider, or who have very low participation in these plans, may conclude that the general counsel can review and approve each. Each company should develop policies and procedures that fit its specific circumstances and the trading behaviors of its insiders and employees.

5. Recent Developments that Raise Issues for Rule 10b5-1 Trading Plans

An academic study by Dr. Alan Jagolinzer of the Stanford Business School released in 2006 found significant selling by insiders under Rule 10b5-1 trading plans in advance of bad news, which sparked an SEC investigation into Rule 10b5-1 trading plans. Supporting that these plans provide a defense only when the meet the requirements, Joseph Nacchio, the former CEO of Qwest was convicted for insider trading in a criminal proceeding even though he used a Rule 10b5-1 trading plan.

Rule 10b5-1 trading plans can include a number of provisions designed to prevent abuse. Emerging best practices include longer cooling off periods (e.g., entering into the plan in an open trading window and requiring trading to commence no earlier than the next open trading window). Another safeguard is to prohibit insiders from terminating an existing Rule 10b5-1 trading plan other than during an open trading window.

And for the ultimate in bulletproofing for planned sales by insiders that goes far beyond the restrictions of a Rule 10b5-1 trading plan—the blind trust. These are irrevocable grantor trusts with at least two-year terms and independent corporate trustees, and were one of the methods used for planned sales by insiders before Rule 10b5-1 was adopted. Using a blind trust for planned sales is certainly safer than a Rule 10b5-1 trading plan, but it is also more expensive to administer and eliminates all of the insider's flexibility. Only time will tell if the blind trust really comes back into vogue for planned selling by insiders.

If you decide to impose your own specific limitations and/or requirements on Rule 10b5-1 trading plans that your insiders enter into with respect to company stock, be sure you communicate these limitations and/or requirements to your insiders.

6. Sample Rule 10b5-1 Trading Plan Policy Language for Insider Trading Policy

Sample language:

Trades by covered persons in the Company's securities that are executed pursuant to an approved 10b5-1 plan are not subject to the prohibition on trading on the basis of material nonpublic information contained in the Insider Trading Policy or to the restrictions set forth above relating to pre-clearance procedures and blackout periods.

Rule 10b5-1 provides an affirmative defense from insider trading liability under the federal securities laws for trading plans that meet certain requirements. In general, a 10b5-1 plan must be entered into before you are aware of material nonpublic information. Once the plan is adopted, you must not exercise any influence over the amount of securities to be traded, the price at which they are to be traded or the date of the trade. The plan must either specify (including by formula) the amount, pricing and timing of transactions in advance or delegate discretion on those matters to an independent third party.

The Company requires that all 10b5-1 plans be approved in writing in advance by the compliance officer. 10b5-1 plans generally may not be adopted during a blackout period and

may only be adopted before the person adopting the plan is aware of material nonpublic information.

7. Who Is Using These Plans?

In a recent study of Rule 10b5-1 trading plan use among executives at Fortune 500 companies, Equilar, Inc. identified the following trends:

- The total number of Fortune 500 executives executing at least one transaction pursuant to a Rule 10b5-1 plan increased by 31.2% from 2005 to 2006; climbing from 388 individuals to 509 individuals. Through the first half of calendar year 2007, 384 executives at Fortune 500 firms completed a transaction pursuant to a pre-arranged stock trading plan.

- The average number of executives per Fortune 500 company using 10b5-1 plans increased from 3.1 to 3.7 from 2005 to 2006.

- From 2005 to 2006, the prevalence of Fortune 500 companies with executives using 10b5-1 plans increased from 25.6% to 28.7%. In the first six months of 2007, 25.2% of Fortune 500 companies had at least one executive utilize a 10b5-1 plan to sell shares.

- From 2005 to 2006, the prevalence of Fortune 500 companies with a CEO who completed a transaction pursuant to a Rule 10b5-1 trading plan increased from 12.4% to 16.1%.

Equilar identified the following recent examples of Rule 10b5-1 trading plan disclosure in Form 8-K filings:

- St. Jude Medical Inc. (Form 8-K filed on January 31, 2007)
- Build A Bear Workshop Inc. (Form 8-K filed on March 2, 2007)
- Centex Corp. (Form 8-K filed on March 13, 2007)
- Dun & Bradstreet Corp. (Form 8-K filed on May 21, 2007)
- Integra LifeSciences Holdings Corp (Form 8-K filed on June 14, 2007)
- Spectrum Brands, Inc. (Form 8-K filed on June 15, 2007)

II. Managing Tax Withholding Issues for Full Value and Performance Awards

Even if you already understand the benefits of diversifying out of straight option programs into full value and performance-based equity awards, you may not be prepared for the practical tax withholding traps. Companies are using a number of clever approaches to minimize the disruption to payroll, stock plan administration and employees while still satisfying tax withholding obligations, avoiding deferred compensation problems and minimizing the company's costs (both out-of-pocket cash and accounting charges).

For those of you still weighing the pros and cons of restricted stock as compared to restricted stock units, or who would appreciate a quick primer on when the various income and employment taxes are due in connection with the granting, vesting, delivery and sale of shares under these two forms of equity award, as well as the timing of obligations to file Form 4s with the SEC, we point you to the memorandum in the supplemental materials included as **Appendix A** to this paper regarding the use of restricted stock and restricted stock units.

A. Using Rule 10b5-1 Plans for Tax Withholding

Companies can permit or require equity compensation plan participants to enter into a Rule 10b5-1 trading plan to sell shares subject to equity compensation awards on the open market to cover the participant's tax withholding obligations. Option holders already typically instruct brokers to sell shares to cover applicable tax withholding requirements in the context of broker-assisted cashless exercise of nonqualified stock options. For some other types of equity compensation that have been growing more popular, providing an effective means for the participant to pay the tax withholding obligations presents greater challenges.

1. Special Challenges for Tax Withholding Obligations for Restricted Stock and Units

With restricted stock, the company is generally required to withhold for tax obligations when the restricted stock vests. The tax withholding amount is due on the vesting date, and the company must deposit the funds promptly into its tax withholding account. The treatment for restricted stock units is the same, except that the tax withholding amount is due on the date the share are entitled to be issued, which is usually the vesting date, but could be set up at grant to be a later date (subject to the applicable requirements under Internal Revenue Section 409A). This means that the company must collect the payment from the participant on the vesting date (or the issue date for restricted stock units that have a later issue date), rather than deducting the amount from the next payroll, etc. If vesting occurs on a single date for a large number of participants, collecting cash or checks for all participants could present significant administrative challenges.

One alternative is for the company to repurchase or retain shares subject to the portion of the restricted stock or units that vest. For restricted stock this "repurchase" triggers disclosure obligations for the company on its next periodic report, the company must withhold shares with a value of no more than the applicable minimum statutory tax withholding rate under FAS 123R (which becomes very complicated in non-US jurisdictions that do not have a fixed

minimum tax withholding rate) and the company must have the cash to cover the withholding obligation. The amount a company would be required to "self-fund" can be difficult to determine in advance if the company has a volatile stock price and can be extremely expensive for a company that does not have sufficient reserves of cash necessary to pay the required withholding to the governmental authorities (either because of the size of the tax obligation for any one individual or the number of individuals as to whom withholding is required).

Using Rule 10b5-1 plans eliminates all of these issues, although under either alternative the insiders must report the disposition of the shares on Form 4 However, for companies who intend to, or are likely to, conduct a follow-on offering of stock to the public, Rule 10b5-1 plans may not be a practical means to effectuate withholding, as some lawyers take the position that all such plans must be revoked in connection with such follow-on offerings in order to comply with applicable securities laws. Such revocation can leave executives in quite a bind when tax time comes. As a result, it may be advisable to ensure that any form of restricted stock award that contemplates the use of a Rule 10b5-1 plan as the primary or first means for satisfying tax withholding also provide for a laundry list of other permitted means (discussed below) of satisfying tax withholding should the Rule 10b5-1 plan subsequently be unavailable.

2. Should Companies Permit Rule 10b5-1 Plans For Tax Withholding . . . Or Require Them?

For restricted stock or unit awards to participants who are not executive officers or directors, some companies are requiring that participants agree to sell shares under a Rule 10b5-1 plan as a condition to the award, and are building the Rule 10b5-1 plan directly into the award document. Other companies permit even rank-and-file participants to elect from among a variety of methods for satisfying tax withholding obligations. Companies that use Rule 10b5-1 plans for tax withholding generally permit Section 16 officer and others likely to be in possession of material non-public information to elect to enter into a Rule 10b5-1 plan to sell share to satisfy their tax withholding obligations separate from the award documents to provide flexibility.

Another issue you will need to address is whether to provide for consistent treatment of all awards, all awards to a particular participant or all vesting events for a specific restricted stock or unit award. Finally, participants who also want to enter into Rule 10b5-1 trading plans for other purposes, will have to be thoughtful about how their Rule 10b5-1 trading plans entered into for tax withholding could affect their other trading plans.

The key here is communication: be sure your participants are aware of what will happen when their awards vest.

3. Sample Award Language to Create an Automatic Rule 10b5-1 Plan for Tax Withholding

Sample Language:

Your acceptance of this Award constitutes your instruction and authorization to the Company and any brokerage firm determined acceptable to the Company for such purpose to sell on your behalf a whole number of Shares from those Shares issuable to you in payment of Vested Units as the Company determines to be appropriate to generate cash proceeds sufficient to satisfy the Tax Withholding Obligation. Such Shares will be sold on the day the Tax Withholding Obligation arises (e.g., a Vesting Date) or as soon thereafter as practicable. You will be responsible for all brokerage fees and other costs of sale, and you agree to indemnify and hold the Company harmless from any losses, costs, damages, or expenses relating to any such sale. To the extent the proceeds of such sale exceed your Tax Withholding Obligation, the Company agrees to pay such excess in cash to you through payroll as soon as practicable. You acknowledge that the Company or its designee is under no obligation to arrange for such sale at any particular price, and that the proceeds of any such sale may not be sufficient to satisfy your Tax Withholding Obligation. Accordingly, you agree to pay to the Company as soon as practicable, including through additional payroll withholding, any amount of the Tax Withholding Obligation that is not satisfied by the sale of Shares described above.

You acknowledge that this Section __ is intended to comply with the requirements of Rule 10b5-1(c)(1)(i)(B) under the Exchange Act, and to be interpreted to comply with the requirements of Rule 10b5-1(c), and that you are not aware of any material, nonpublic information with respect to the Company or any securities of the Company as of the date of this Agreement.

4. Sample Language for Insiders to Elect to Create a Rule 10b5-1 Plan for Tax Withholding:

Sample Language:

In connection with your acceptance of this Award, you agree to execute an Authorization in the form attached as Appendix 1 to this Agreement to select one of the following:

(a) **Sell to Cover.** By selecting this alternative, you elect to satisfy your Tax Withholding Obligation by providing for Shares to be automatically sold on your behalf to cover your Tax Withholding Obligation, and you instruct and authorize the Company and the brokerage firm determined acceptable to the Company for such purpose to sell on your behalf a whole number of Shares from those Shares issuable to you in payment of Vested Units as the Company determines to be appropriate to generate cash proceeds sufficient to satisfy the Tax Withholding Obligation. Such Shares will be sold on the day the Tax Withholding Obligation arises (e.g., a Vesting Date) or as soon thereafter as practicable. You will be responsible for all brokerage fees and other costs of sale, and you agree to indemnify and hold the Company harmless from any losses, costs, damages, or expenses relating to any such sale. To the extent the proceeds of such sale exceed your Tax Withholding Obligation,

the Company agrees to pay such excess in cash to you through payroll as soon as practicable. You acknowledge that the Company or its designee is under no obligation to arrange for such sale at any particular price, and that the proceeds of any such sale may not be sufficient to satisfy your Tax Withholding Obligation. Accordingly, you agree to pay to the Company as soon as practicable, including through additional payroll withholding, any amount of the Tax Withholding Obligation that is not satisfied by the sale of Shares described above.

(b) **Withhold Shares.** By selecting this alternative, you elect to satisfy your Tax Withholding Obligation by authorizing the Company to retain a number of Shares that would otherwise be issuable upon vesting of your Units that have a value on the Vesting Date sufficient to satisfy the minimum applicable Tax Withholding Obligation.

Once made, your election pursuant to this Section __ will be irrevocable and will govern payment of your Tax Withholding Obligation for all future Vesting Dates for this Award.

5. Which Companies Require Rule 10b5-1 Plans for Tax Withholding Obligations?

The 2006 Benchmarking Survey by The Society of Corporate Secretaries and Governance Professionals revealed that 223 of 305 companies responding do not require Rule 10b5-1 plans to handle the sale of stock at vesting to cover the tax liability, 20 companies require them and 62 companies did not respond. Of these companies, 19 use a designated broker for these plans, 33 do not and 253 did not respond.

Among the companies that require this method are:

- Amazon.com
- Microsoft
- First Energy

B. Using a "Laundry List" Approach for Tax Withholding

As noted above, there are limitations on the usefulness of Rule 10b5-1 plans for tax withholding. As a result, some companies stick with the laundry list approach – allowing for every possible form of tax withholding conceivable. Some companies who have concerns about the use of certain methods, and include them only as a safety net, designate a preferred or first avenue means of tax withholding, and then carefully specify the order and conditions under which the other means will be used. Other companies simply reserve the ability to use those methods. Finally, some companies include all of the forms of withholding they will permit, and then leave it in the employee's discretion which method will be used, with the only limitations being those imposed by the accounting rules on the use of share withholding in excess of the amount necessary to satisfy minimum statutory withholding. The laundry list method still requires insiders to report any disposition of shares used for tax withholding on Form 4, but can help maintain more flexibility for the insider as compared to a default Rule 10b5-1 trading plan.

1. Sample Language—Laundry List Tax Withholding

Sample Language:

Tax Withholding. The Participant hereby agrees to make adequate provision for any sums required to satisfy the applicable federal, state, local and foreign employment, social insurance, payroll, income and other tax withholding obligations of the Company or any Affiliate (the "Tax Obligations") that arise in connection with this Award. The satisfaction of the Tax Obligations shall occur at the time the Participant receives a distribution of Common Stock or other property pursuant to this Award, or at any time prior to such time or thereafter as reasonably requested by the Company and/or any Affiliate in accordance with applicable law. The Participant hereby authorizes the Company, at its sole discretion and subject to any limitations under applicable law, to satisfy any such Tax Obligations by (1) in the event the RSU is to be settled in part in cash rather than settled in full in Shares, withholding from the cash to be distributed to the Participant in settlement of this Award, (2) permitting the Participant to enter into a "same day sale" commitment with a broker-dealer that is a member of the National Association of Securities Dealers (an "NASD Dealer") whereby the Participant irrevocably elects to sell a portion of the Shares to be delivered under the Award to satisfy the applicable Tax Obligations and whereby the NASD Dealer irrevocably commits upon receipt of such Shares to forward the proceeds necessary to satisfy the Tax Obligations directly to the Company and/or its Affiliates, and (3) withholding Shares that are otherwise to be issued and delivered to the Participant under this Award in satisfaction of the Tax Obligations; ***provided, however***, that the amount of the Shares so withheld pursuant to alternative (3) shall not exceed the amount necessary to satisfy the required Tax Obligations using the minimum statutory withholding rates that are applicable to this kind of income. In addition, to the extent this Award is not settled in cash, the Company is authorized to satisfy any Tax Obligations by withholding for the Tax Obligations from wages and other cash compensation payable to the Participant or by causing the Participant to tender a cash payment to the Company if the Committee determines in good faith at the time the Tax Obligations arises that withholding pursuant to the foregoing alternatives (2) and (3) above are not in the best interest of the Company or the

Participant. In the event the Tax Obligations arises prior to the delivery to the Participant of Common Stock or it is determined after the delivery of Shares or other property that the amount of the Tax Obligations was greater than the amount withheld by the Company and/or any Affiliate, the Participant shall indemnify and hold the Company and its Affiliates harmless from any failure by the Company and/or any Affiliate to withhold the proper amount. The Company may refuse to deliver the Shares if the Participant fails to comply with the Participant's obligations in connection with the Tax Obligations as described in this paragraph.

C. Delaying Delivery of Shares

Companies can also provide in the terms of the award at grant that if the award would vest at a time when the holder would not be permitted to sell shares into the market to cover the tax withholding obligation (i.e., during a black-out period or closed trading window), the shares will not be delivered until the holder would be permitted to sell shares into the market to cover taxes. However, to avoid adverse tax consequences under Section 409A, it is imperative t build in a hard stop for deliver – i.e., in no event later than the end of the short term deferral period under Section 409A. The company will likely still want to include a flexible list of permitted means to cover withholding obligations, so that if such hard stop date arrives and the individual is prohibited from trading in the company's securities at that time, the individual can cover his applicable tax withholding obligation with the least possible imposition on the company.

1. Sample Language—Delay of Delivery

Sample Language:

Issuance. As soon as practicable following the applicable vesting date of any portion of the RSU, the Company shall issue to you a certificate (which may be in electronic form) for the applicable number of underlying shares of Common Stock that so vested, subject, however, to your satisfaction of the applicable withholding obligations. Notwithstanding the foregoing, in the event that you are subject to the Company's Insider Trading Policy (or any successor policy) and any shares covered by your RSU vest and would be delivered on a day (the "***Original Delivery Date***") that does not occur during a "window period" applicable to you (as determined by the Company in accordance with such policy), then such shares shall not be delivered on such Original Delivery Date and shall instead be delivered on the earlier of (i) the first day of the next "window period" applicable to you pursuant to such policy and (ii) March 15 of the calendar year immediately after the calendar year in which the applicable vesting date occurs.

III. Post-Termination Issues

Have you figured out what to do regarding post-termination acceleration of vesting and extension of exercise periods? The adoption of FAS 123R has some companies reweighing the value of acceleration as compared to the hit to the books. Code Section 409A caused quite a bit of frustration, followed by confusion and some relief, over the ability to extend post-termination exercise periods. These changes can make the difficult issues of terminations even more stressful for the employee and human resources.

A. Acceleration of Vesting

Special treatment of equity awards upon termination of employment is fairly common among executives. In a recent study by Equilar, the severance arrangements for CEOs of Fortune 50 companies provided for vesting modifications for stock options 59.1% of the time and for stock awards 63.6% of the time. Full vesting of awards upon termination appeared in 40.9% of the severance arrangements and partial or pro-rated vesting of awards upon termination appeared in approximately 10% of the arrangements.

The decision to allow for accelerated vesting is a material term of the award, so the board or compensation committee ideally should approve that term at the outset of the employee's employment, either through approval of an employment agreement that contains these terms, or specifically providing for such acceleration at the time awards are granted.

One emerging trend relates to building in more flexibility with respect to portions of an award that are unvested when employment terminates. If a company and executive are negotiating for accelerated vesting as the employee is on the way out the door, it is critical to keep in mind any provision in the stock plan or award that calls for the immediate termination of unvested shares on the last day of continuous service. Accounting, tax, plan and disclosure issues arise if the unvested award technically terminated under the plan as of the last day of employment, and final terms on the acceleration of vesting are not negotiated or approved until after that last day of employment. Such "acceleration" may be deemed by your auditors, the SEC or the IRS as a post-termination grant. Some argue that the award is "suspended" (notwithstanding the express plan terms), but this metaphysical argument is a risky one in this era of increased attention to corporate formalities in regard to stock options and stock awards.

One alternative to address this issue is to provide in the stock plan or award agreement that all shares subject to the award expire, to the extent unexercised, as of the last day of the post-termination exercise period rather than on the last day of employment or service. This clearly preserves the right to accelerate the existing award within a reasonable period of time following termination – as the award legitimately remains outstanding following termination even as to unvested shares. This approach also makes the life of your stock plan administrator easier, because it does not require two separate adjustments to the employee's stock plan account—i.e., one on the termination date as to unvested shares and one on the last day of the post-termination exercise period as to vested shares. A contractual limitation that only vested shares can be exercised or will be issued should be legally sufficient to avoid meritorious claims of a right to exercise the unvested shares. More importantly, it allows for

a post-termination negotiation period between the executive and the company to come to terms on whether, and the extent to which, vesting will be accelerated and to have any such decision approved by the board or compensation committee. Of course, it is almost always easier to negotiate these provisions at the commencement of the employment relationship!

B. Post-Termination Exercise Provisions

Most of us probably glance right past the post-termination exercise provisions in our stock plans and award agreements—until a termination event occurs and someone has a question, request, demand or claim. We take it for granted that we have a well-crafted termination provision that (1) encourages retention and positive and orderly transitions of employment, (2) rewards long-term employees with extended exercise periods and (3) provides flexibility to use the award as a "bargaining chip" in a difficult termination. A good refresher for those of us who do blindly page through our option agreements (and a useful primer for newcomers to the field of equity compensation) is Chapter 17 of The Stock Options Book, 7th ed. (copyright 2006) by Alisa J. Baker and the National Center for Employee Ownership. You can find a copy of that chapter at the NASPP's website as attached to last year's conference materials for Keeping Up With The Joneses!

However, this presentation is about innovations, so we are assuming that your existing provisions comply with applicable discrimination and blue sky laws, meet the ISO requirements (to the extent desired) and result in accounting consequences that are satisfactory to your board and shareholders. Instead, we focus on the messiest and most frequent post-termination issues gracing our desks lately: modifications to post-termination exercise provisions that comply with Internal Revenue Code Section 409A and the need to extend the post-termination period indefinitely due to securities law compliance issues.

1. Section 409A and Modifications to Post-Termination Exercise Provisions

The request for an extended exercise period following termination is not new. However, with the advent of Section 409A, modifying awards to provide for extended exercise periods has become much more complicated than simply determining if the plan permits it or if the modification will disqualify the option from ISO status.

Under the proposed regulations for Section 409A, the decision after grant to permit the extension of the post-termination exercise period would have been a material modification disqualifying the option from the exemption from the deferred compensation rules. However, the final regulations under Section 409A allow extensions of exempt options (incentive stock options or nonqualified stock options granted with no discount or deferral feature—including options that were originally granted at a discount but subsequently repriced upward to "cure" the options of their discount within the permitted cure period) until the earlier of the end of the optionee's original term or 10 years after the grant date (and even longer of the option is underwater at the time of the extension or the exercise would violate applicable securities laws). Companies who have switched to a 6 or 7 year term for options may want to consider whether their historical practice of post-termination exercise period

extensions suggest that a reversion to a 10 year term for the benefit of their employees outweighs the associated accounting expense.

Regardless of whet the original term is, in order to effectuate such an extension, the company's board or compensation committee will need to approve an amendment of the outstanding equity awards to specify the length and nature of the extension. This amendment can be done following termination in the post-termination exercise period.

However, companies may not always want to take advantage of this flexibility due to the potential affect on accounting expense or because of concerns regarding overhang and so we're often asked about the possibility of delaying the termination date (and therefore the expiration of the post-termination exercise period) through conversion to part-time or consultancy status.

a. Delay the Termination Date

Companies need to be aware of the costs and benefits of extending an option as opposed to allowing the employee to continue on via "garden leave" or a bona fide consulting or part-time employment arrangement. If the terms can be mutually agreed upon and the employment, tax and other legal risks associated with continuing the relationship beyond the originally intended date are understood, a company and employee might choose to delay the termination date until a more option-friendly date. However, this strategy poses numerous legal risks. In addition, care should be taken in reviewing the stock plan documents to determine whether a change in status to become a consultant would be deemed a termination of service. The following table summarizes these costs and benefits.

	Benefit to Company	Benefit to Employee	Risk/Cost to Company	Risk/Cost to Employee
Extend post-termination exercise period	Clean termination at intended date	Creates desired result of allowing exercise at a later date	Accounting charge Need to approve amendment to option (CC or board)	If option was an ISO, may lose ISO status
Delay termination date via bona fide transition period	May avoid adverse accounting costs of other alternatives Executive provides necessary transition assistance	Creates desired result of allowing exercise at a later date Continued status as employee	Auditors may not respect structure, depending on level and kind of services and compensation provided (e.g., continued vesting; cash comp at rate based on prior pay) Implementing a formal program suggests this is a form of severance rather than a bona fide transition based on business needs Obligation to continue to pay at least minimum wage/minimum exempt salary and permit continued participation in benefit plans —not as severance—due to provision of bona fide services Potential liability to Company under respondeat superior Release signed on date of agreement not effective as to claims arising during transition period, and employee has no incentive to sign subsequent release absent significant additional compensation Employee has less incentive to find a new position (as it may violate company policies prohibiting secondary employment and so result in termination of transition period and exercisability of options) If employee is allowed to work for another employer, issues over ownership of IP may arise	Personal liability for 409A taxes (20% federal and 20% state) if deferred compensation amounts (e.g., severance) aren't paid out when level of bona fide services drops below 20% of pre-termination levels

2 Extensions and Other Solutions When Exercise Is Prohibited

Additional post-termination exercise complications arise when the issue is not a simple request for an extension because the departing employee is not yet sure whether to take the plunge and purchase the company stock, but rather because the departing employee is prohibited from exercising his options in the existing post-termination exercise window due to factors beyond his control. These factors may include the unavailability of Rule 701 or the Form S-8 registration statement (either because of on-going financial restatements, the determination that the option was granted outside of the stock plan because of option misdating issues, or worse, because the company's stock has been delisted). Similarly, there may be times when a departing officer or director cannot exercise an option within the proscribed post-termination period because doing so would trigger Section 16 short-swing profits liability.

Section 409A recognizes these complications and has provided flexibility for amendments to options to address these considerations. It is not deemed to be an extension of a stock right if the expiration of the stock right is tolled while the holder cannot exercise the stock right because such an exercise would violate an applicable Federal, state, local, or foreign law, or would jeopardize the ability of the service recipient to continue as a going concern, provided that the period during which the stock right may be exercised is not extended more than 30 days after the exercise of the stock right first would no longer violate an applicable Federal, state, local, and foreign laws or would first no longer jeopardize the ability of the service recipient to continue as a going concern.

Even with this flexibility, the company or the employee has to be vigilant in monitoring when the original post-termination exercise period will expire. Many unfortunate optionees did not realize their options had expired during the closed window and there is very little that can be done to fix that problem. In addition, companies find it frustrating to do monthly board or committee consents to extend the post-termination exercise periods of the dozens, if not hundreds, of optionees who have options expiring while the company's financials are being restated. Some companies were fortunate that their existing plans have language providing for the automatic tolling of the post-termination exercise period until an exercise may be completed in compliance with applicable securities laws (see below), so that individual extensions are not necessary. These provisions can be crafted so as to comply with the requirements of Section 409A.

However, many plans, especially older plans, tend not to have such helpful language and a "fix" would need to be implemented on a case by case basis to permit an extension of the post-termination exercise period. Note that any amendment of an existing award to provide for such extension may affect the option's status as an ISO, and may therefore require the optionee's consent. As a result, when reviewing your plan terms or amending existing options, consider whether such an amendment would require the consent of your optionees and draft accordingly.

a. Sample "Automatic Tolling" Language

Sample language:

Extension of Termination Date. If the exercise of the Option following the termination of the Optionholder's Continuous Service (other than upon the Optionholder's death or Disability) would be prohibited at any time solely because the issuance of shares of Common Stock would violate the registration requirements under the Securities Act, then the Option shall terminate on the earlier of (i) the expiration of the term of the Option or (ii) the expiration of a period of three (3) months after the termination of the Optionholder's Continuous Service during which the exercise of the Option would not be in violation of such registration requirements.

b. Offer to Cash-Out the Award

When an automatic tolling provision is not available, and the company cannot otherwise extend the award, the company may still be able to cash out the award. Note, however, that if this solution becomes a pattern or practice, there is the risk that such a series of offers can be (i) a violation of the tender offer rules, (ii) lead to cries of unfair or disparate and discriminatory treatment by option holders who aren't offered this alternative and (iii) implicate ERISA's severance plan rules. Also, it's important to remember that if the expiring option is subject to Section 409A, an offer to cash out the option will likely trigger immediate taxation of the option except in exceptional circumstances where such a cash out is deemed a permitted termination and liquidation of a deferred compensation plan. More information such permitted cancellations is provided below in Section V of this paper.

c. Offer Cash in Consideration of a Release

Some companies may choose to offer a valued departing employee cash severance as part of a regular termination package to smooth over the fact that the option will expire without being exercised. It is important to be clear that such severance is not offered in consideration for the cancellation of the award or the agreement from the departing employee to not exercise option. This "parting gift," if judiciously and infrequently offered, carries less of a risk of implicating the tender offer rules than simply offering to cash out the option. As with the general offer to cash out the award, this solution can give rise to cries of "why not me too?!" and may implicate the ERISA severance plan rules. However, it can be a useful solution if the Form S-8 registration statement is not likely to be available by the end of the original post-termination exercise period. Of course, if the company beats expectations with respect to straightening out financial statements or relisting ahead of schedule, such that the departing employee can complete an exercise within his original post-termination exercise period, this cash severance offer would potentially result in double benefit to employee.

d. Find an Alternative Securities Law Exemption

If a company's Form S-8 registration statement becomes unavailable as a result of stock option backdating or other issues that prevent the company from staying current in its SEC

filings, there are a number of exemptions from the federal securities registrations requirements that may cover equity compensation transactions. The exemption for transactions with existing shareholders where no additional consideration is paid could cover an exchange of problematic Section 409A securities for new securities that are free of those issues (e.g., cash settled SARs). If all of the affected equity compensation program participants reside in a single state, Securities Act Section 3(a)(9) may exempt transactions involving issuing securities to those participants. If the participants are accredited investors, Securities Act Section 4(2) and safe harbors adopted under that section pursuant to Regulation D may exempt issuances of securities to participants. However, in each of these scenarios, the participant will hold restricted securities that cannot be sold without registration or another applicable exemptions. The safe harbor for resales of restricted stock under Rule 144 will require the participant to hold the securities for at least one year before selling, among other requirements. In addition, the participant can't rely on Rule 144 if the company hasn't filed current financial statements.

Private and delisted (or unlisted) public companies must also comply with state "blue sky" laws and regulations, which generally likewise require offers and sales or securities to be registered, unless they comply with an available exemption from the registration requirements. Some states have self-executing exemptions that parallel the federal exemptions outlined above, but others require filings and the payment of fees, and may require substantive state review of the proposed or completed transactions.

IV. Performance Equity Vehicles

Shareholders and investor advocates are increasingly calling for the use of performance-contingent equity compensation. Shareholder proposals regarding executive compensation in proxies in 2007 were dominated by demands for "pay for performance". Critics argue that traditional time based vesting of stock awards represent only a royalty on the passage of time, tying compensation to the performance of the stock market in general, rather than to the performance of the company. Even inside companies, compensation committees worry that traditional time based vesting of stock options serve as windfalls to executives who serve during bull markets and penalties to executives who serve during bear markets.

The solution: performance-based awards. By performance-based awards, we mean both awards that are granted in an amount dependent upon performance (e.g., if EBITDA exceeds target levels, the CEO will be granted 100 shares of fully vested restricted stock) as well as awards that accelerate time-based vesting based on performance (e.g., if EBITDA exceeds target levels for 2008 by 30%, and notwithstanding the standard four-year cliff vesting on the option, the CEO will vest in 100% of his option at the close of 2008). Companies are increasingly granting compensatory equity awards tied to reaching preset milestones, in order to incentivize executive behavior toward certain goals.

Based on the data available from the 2007 proxy season, Equilar determined that 61.3% of S&P 500 companies award performance equity to their CEOs. Has your company switched yet?

A. Why Adopt This Innovation?

1. Strong Link to Performance

Requiring the company and/or the employee to achieve specific performance goals as a condition to receiving value under an equity compensation award responds to shareholder concerns by linking pay-outs directly to performance. This link is strengthened where award size is determined based on performance, as opposed to performance being an accelerator to time based vesting.

2. Moderate Downside Protection for the Executive

To the extent a participant cannot realize any value from a performance-based award until the performance conditions are satisfied, the executive will have the opportunity to realize value from these award only if the performance goals are met. Some plans retain the flexibility to decrease the performance targets in the case of unforeseen circumstances in order to offer moderate downsize protection for the executive. However, the new SEC disclosure requirements impose an obligation to discuss how often and why such decisions are made, so companies may be less inclined to take advantage of this flexibility given the increasing light that will be shed on their decisions. As an alternative, use of a time-based award that vests faster based on performance milestones can offer the downside protection necessary to keep an executive motivated and not seeking greener ($$) pastures.

3. Minimizes Unproductive Dilution

Awards that are granted upon achievement of performance goals limit unproductive dilution to other shareholders by preventing the issuance of shares unless and until the milestones are met. Awards that are granted with vesting subject to achievement of performance milestones will be calculated in the number of shares subject to outstanding awards, and companies should consider whether shares that are forfeited for failure to vest will be returned to the applicable stock plan reserve.

4. Minimizes the Earnings Impact Under FAS 123R

FAS 123R requires companies to recognize expense with respect to performance vesting awards where the performance condition not a market condition (i.e., tied to stock price) only when the performance becomes *probable*. (For awards with only a market condition, the company must calculate the value of the award and recognize it irrespective of forfeiture or failure to satisfy the vesting conditions.) This means that for a performance-vesting award (unlike for a time-vesting award, for which the company must recognize expense over the vesting period irrespective of whether the options are underwater or the stock value is decreasing, etc.) a company will not recognize any expense until the performance becomes probable. This improves the probability that the award will result in value to the participant that more closely corresponds to the expense recognized by the company. That said, it's important to consider the ease of monitoring the performance condition selected, as adjustments are made up and down each reporting period in the case of performance vesting awards to reflect the current estimate of forfeitures and the actual number of shares that vest.

5. Can Performance Goals for NEOs Still Be Kept Confidential?

The SEC's new compensation disclosure rules generally require specific disclosure of performance goals for named executive officers if the terms are material to understanding the compensation arrangement, unless disclosing the goals would cause substantial competitive harm to the company. The SEC clarified that the standard for omitting the actual goal is the same as the standard for requesting confidential treatment (although the company doesn't actually have to apply for confidential treatment to omit the actual goal). However, the SEC did relieve companies from the obligation to comply with Regulation G for any non-GAAP financial measures disclosed in connection with the performance goals.

If the SEC questions the appropriateness of the omission, the SEC can require that the company support its claim, and can require disclosure of goals that it finds do not merit confidential treatment. That said, preliminary feedback from the SEC for the 2007 proxy season indicated disappointment in the nature and level of disclosures, and it will be interesting to see the results of the announced SEC audit of proxy disclosures for the largest reporting companies that is expected for this fall.

6. Deductibility Under Section 162(m)

Performance awards can be granted so as to be deductible under Section 162(m) of the Code. Although options are deemed to be performance-based for purposes of Section 162(m), other types of awards require that the general business criteria upon which a compensation

committee will establish specific performance goals be set forth in the plan and approved by shareholders. In general, only performance conditions that can operate mechanically meet Section 162(m) standards, but a plan can provide for many different performance criteria, allowing the compensation committee to specifically tailor goals to each executive and as facts and circumstances change from year to year. In addition, the compensation committee must establish the performance goals for awards within the first quarter of the applicable performance period (i.e., during the first fiscal quarter for a fiscal year goal).

It is also critical to pay attention not only to what performance metrics are set forth in your plan, but also how results will be calculated. For example, if you determine achievement of certain goals on a non-GAAP basis, be sure that your plan doesn't indicate that all goals will be measured according to GAAP!

In addition to the criteria to be used, the plan that is approved by shareholders must also specify the maximum number of awards that can be granted to an individual under the plan in a specified time frame (e.g., no more than 100,000 shares may be granted in a calendar year to an employee as a performance stock award). For those companies who will be operating in the "grace" period after an initial public offering and prior to going back to shareholders for reapproval of the plan within four years following the IPO, be sure the number limits you include will be sufficient to account for "inflation" in the size of stock awards that may occur over the next four years. A good rule of thumb is to set the limit at the size of award you might need to induce a new CEO to join (or to motivate your current CEO to stay) five years from the date of plan adoption.

Finally, it should be noted that performance based awards that comply with Section 162(m) of the Code are particularly inflexible once they have been granted. Some companies have addressed this by setting relatively easy targets to meet, with discretion to reduce the number actually "earned" under the original formula based on additional performance factors or in the complete discretion of the compensation committee. This exercise of "negative discretion" is technically allowed under Section 162(m)—i.e., the compensation committees cannot increase the value of awards after they are granted based on performance, but they can make discretionary reductions.

However, the use of negative discretion should be practiced carefully given the new SEC disclosure rules. Companies need to discuss in their CD&A how often and why negative discretion is used. In addition, to the extent a company did not explain the actual performance targets being used under its plans in the CD&A, the company must indicate how hard it is to reach the target. If the company consistently reduces the size of awards that are otherwise "earned" upon meeting performance targets, the company will likely find itself in a difficult position of defending assertions they made in prior proxies over how difficult it was believed to be to reach the established performance targets.

Finally, remember that the IRS has made compliance with Section 162(m) a key point for its audits of companies for 2007 and the indefinite future. Make sure that any discretion provided for in your plans strictly complies with the regulations under Section 162(m)!

B. What Are the Limitations on Performance Awards?

Creating meaningful incentives using performance goals remains a key challenge for compensation committees and human resources professionals. Why? Read on….

1. Difficulty Setting Reasonable Long Term Goals

It can be difficult to strike the balance between a goal that inspires performance and one that is so unattainable as to render the award meaningless. This balance is even more difficult if the market is particularly volatile. In addition, performance based awards can lead to anomalous results when the performance factors fail to reflect or anticipate the impact of significant transactions or other unexpected events.

2. Institutional Shareholder Standards

Some institutional shareholders are looking for the equity plans of companies in which they invest to include very specific minimum vesting requirements. Perhaps the most common of these that many companies have encountered recently is Fidelity's requirement for 3-year vesting on all full-value awards (except for a de minimis amount), unless they are performance based (in which case a one-year minimum vesting schedule applies). At least one institutional investor (Dimensional Fund Advisors) is purported to always vote against equity plan proposals, irrespective of their terms. Be sure you know who your institutional investors are, and if you have an equity plan up for shareholder approval, or if your executive compensation has been drawing unwelcome "no" voting recommendations for compensation committee members, consider engaging a compensation consultant or proxy solicitation firm to advise you on the recent proxy voting behavior of your institutional investors in these areas.

3. Tax Withholding Difficulties

Award agreements should clearly address the recipient's obligations with respect to payment of par value (if necessary) and withholding taxes. Where performance milestones may be reached when a company's trading window is closed, an executive can end up in a difficult position—required to pay withholding taxes due upon vesting, but unable to sell shares to cover this obligation. Some companies have addressed this through the use of a non-qualified deferred compensation plan that satisfies the requirements of Section 409A. Others have tried to use performance goals that are only able to be determined shortly before the opening of a trading window (e.g., end of year financial results that are determined and certified within a few days prior to public disclosure and the opening of a trading window). Still other companies have addressed this through the use of a Rule 10b5-1 trading plan for tax withholding (as further described above).

C. Common Performance Goals

Companies use a variety of performance goals for equity awards. In 2005, commonly used goals (as reported in The Mercer 350 Report (May 2006)) included: total shareholder return (41%), earnings per share (41%), return on investment or capital (21%), sales (14%), return on equity (13%), operating income (9%) and cash flows (8%). Little seems to have changed

in the past year. In Equilar's review of data from the 2007 proxy season (i.e., 2006 performance goals), far and away the most common performance metrics for *equity* awards were earnings per share (25% of companies reporting) and shareholder return (approximately 23.5% of companies reporting). These were followed by return on capital, cash flow, operating income revenue and return on equity. Non-financial goals made up a meager 3% of the performance targets.

Some of the more interesting non-financial goals, and how the company was able to describe them in their proxy, are set forth in the supplemental materials included as **Appendix B** to this paper: Unique Performance Equity Metrics. The non-financial goals include the following:

- AMR Corp (American Airlines): The corporate objectives for the years 2004 through 2007 are consistent with the objectives of our Turnaround Plan and include: (a) keeping safety our top priority; (b) raising external capital, maintaining a minimum amount of cash and building a strong balance sheet; (c) meeting our pension funding obligations; (d) continuing to lower our non-fuel costs and implementing measures to conserve fuel; (e) improving customer service and dependability rankings; (f) improving revenues and business results through employee collaboration and other means; (g) enhancing our image and customer loyalty; (h) continuing to successfully advocate on industry legislative and regulatory issues; (i) focusing on a positive work environment and promoting diversity; (j) promoting employee commitment to the employee standards of conduct and compliance with laws and regulations; (k) meeting financial goals and returning to and sustaining profitability; and (l) various other factors that the Compensation Committee may determine are important or appropriate.

- Best Buy: Talent Management—Measures progress on identifying, assessing and developing leadership capabilities based on three factors: (i) development, (ii) talent preparedness and (iii) diversity. The scores for each of the three factors are averaged to determine an overall score.

- FPL Group (Florida Power & Light): (i) plant availability, (ii) nuclear industry composite performance index, (iii) service unavailability, (iv) employee safety as measured through OSHA reports, (v) "significant" environmental violations and (vi) customer satisfaction.

- Textron: Leadership Initiatives: corporate key business objectives focused on improving the operations of the company in areas such as company strategy, customer focus, talent management, Textron Six Sigma, supply chain, compliance and information technology.

D. Who Is Using Performance Equity Awards?

Many companies have began using performance equity awards once the accounting consequences changed with the adoption of FAS 123R. Here is a sample of companies that use performance equity awards, and some information about their awards:

- Alcoa: Restricted stock and options based on return on capital (including against peer group)

- Bristol Myers Squibb: Performance shares based on earnings per share, cumulative sales and total shareholder return.

- Comcast: Performance condition to RSUs granted to our named executive officers: the RSUs only vest each year if we have achieved specified consolidated operating cash flow growth.

- Eastman Kodak: Leadership shares and performance shares: amount of leadership shares determined based on performance in designated period based on digital earnings from operations (DEFO) and amount of performance shares based on digital operating margin. DEFO is a non-GAAP performance metric that measures total earnings of the Company's digital strategic products included within earnings from continuing operations, before: 1) restructuring charges, 2) interest, 3) other income charges and 4) income taxes. Shares are then subject to time based vesting (one to two years).

- Home Depot: On February 22, 2007, the Chief Executive Officer received an award of $2.5 million in performance vested options. Mr. Blake's stock options will vest only after the Company's stock price has increased 25% over the grant date price for at least 30 consecutive trading days (the "Target Closing Stock Price"). There is also a minimum one-year vesting period from the grant date in order for these options to become exercisable. The options expire on the earlier of: (a) termination of Mr. Blake's employment, (b) five years from the grant date if the Target Closing Stock Price has not been achieved, or (c) ten years from the grant date.

- Sprint: RSUs based on consolidated adjusted OIBDA margin of core operations and cumulative free cash flow from operations.

- Washington Mutual: Restricted stock and performance shares based on long term shareholder return and performance relative to peers.

V. Fixing the Fallout from Option Backdating

As you must be aware by now, Section 409A of the Internal Revenue Code applies to any portion of a stock option granted (whether intentionally or inadvertently) with an exercise price that is less than the fair market value of the underlying stock on the grant date and that was not vested before January 1, 2005 and that was not exercised prior to January 1, 2006.

Typically, if a company has a problem with discounted options under 409A, the cause is not an intentional use of a discounted exercise price or a fiendish plot to scam stockholders in order to enrich the officers. Rather, it tends to be as a result of various imperfect grant practices that are lumped together under the term "backdating". For those of you who are new to the field of equity compensation and have been living without newspapers or cable TV for the last 18 months, and who therefore want a primer on what option backdating is and how to spot it, we point you to the supplemental materials provided with this paper, including Alisa Baker's informative Chapter 14: 2006 Hot Topic: Option Backdating from the 2007 edition of the NCEO book: "The Stock Options Book," which is attached as **Appendix D** to this paper, and the excerpt from last year's presentation: Keeping Up With The Joneses!, which is attached as **Appendix C** to this paper.

For those of you who have been stuck battling with your accountants and your tax auditors over whether the grant date of an option for tax purposes really is the same as the grant date for accounting purposes, and who are otherwise struggling to figure out how to fix the stock options that may or may not be discounted before the IRS's transition period expires on December 31, 2007, this section of the paper is for you!

As you have probably determined already, any "fix" or backdating options implicates accounting, securities laws, plan language and tax issues. More often than not, the tax laws and the securities laws are at odds over how a fix can be effectuated.

This section of the paper is designed to clarify what laws and practical considerations affect your ability to cure your "potentially discounted" options and provide suggestions on the most efficient way to fix your problems before the December 31, 2007 deadline. Remember—all tender offers need to be commenced by December 3 – i.e., 20 business days prior to December 31!

A. Options Held By Section 16 Reporting Persons

So, there is good news and bad news….

1. Section 16 Status at Grant

The bad news first: there's really nothing that can be done now to cure some options, specifically, those:

- held by individuals who were subject to Section 16(a) of the Exchange Act at the time the discounted options were granted,

- that are for the stock of a company that had a class of common stock that was required to be registered under Section 12 of the Exchange Act at the time of grant and

- as to which the company has reported or expects to report a financial expense in respect of the discounted option as a result of its mispricing.

To avoid repeating ourselves, we'll just refer to these as discounted options held by Section 16 insiders.

Some shareholder groups are demanding that these options be repriced up as part of the settlement of shareholder derivative actions—so that executives will not profit from their "misdeeds"—but repricing them in 2007 or later will not relieve the executive of the taxation under Section 409A. Pursuant to Notice 2006-79, to the extent a stock option held by a Section 16 insider remains "uncured" for purposes of (and is otherwise "not in compliance" with the rules on deferred compensation under) Section 409A as of December 31, 2006, the company had an obligation to report the deferral of income under that option on the Form W-2 that was filed in January 2007 for that individual, and the company will continue to have an obligation to report the deferral under that option on each Form W-2 thereafter as and when shares subject to that option vest and in the year(s) of exercise.

At best, a company can offer a tax gross up to executives who are left holding these "tainted" options. However, most companies are loathe to make such payments given the shareholder optics, and do so only in the case of an executive who had no involvement in the option granting process and no knowledge of or opportunity to cure any impropriety.

2. Section 16 Status Prior to or After Grant

Now for the good news: if an individual was not subject to Section 16 at the time of grant, or if the company did not have a class of common stock that was required to be registered under Section 12 of the Exchange Act at the time of grant, or, if notwithstanding the existence of the two foregoing circumstances, the company has not reported, and does not reasonably expect to report, a financial expense due to the pricing of the discounted option (e.g., it was an intentionally discounted option and a the accounting expense was appropriately accounted for at grant), then the individual's discounted option can still be brought into compliance before the end of 2007. As a result, the strategies listed below for "Other Employees" can be applied to these executives through individually negotiated amendments to their stock options. And under informal SEC guidance from the last time companies went through rounds of repricing following the dot-com bust, offers to exchange or amend awards for executive officers and/or directors should not implicate the tender offer rules (unlike for non-executive employees, as discussed further below).

Now for more bad news: it may not be possible to remediate Section 16 insiders' options as part of their broad-based employee tender offer (discussed in greater detail below). In the SEC's global exemptive order that was issued on March 26, 2007 to Chordiant Software regarding Section 409A tender offers (http://www.sec.gov/divisions/corpfin/cf-noaction/2007/chordiant032607-13e-4.htm), the SEC made it clear that in order to rely on the global exemptive order, the tender offer cannot be made to a company's current or former

executive officers and directors. The SEC has taken a sharp view of option backdating, remaining rather skeptical of claims that the mispricing of options was inadvertent, or that executives had no idea that the misdating or mispricing practices were occurring. As a result, the SEC has limited the availability of exemptive relief in the context of remedial tender offers.

However, relief may be available as to certain individuals who were not officers at the time of grant but who subsequently became an executive officer, or who were only an executive officer for a brief period of time prior to grant (such as during a transition period between a departing executive and his or her replacement), *and* who had no control or authority over the option granting process that resulted in the misdated options. In order to possibly obtain such relief, a company will need to submit a specific request for no-action/exemptive relief to the SEC, a process that can take anywhere from two-to-six weeks, depending on the facts and circumstances.

Note that if a company chooses not to include an executive officer in the tender offer, and instead rely on the Chordiant global exemptive relief, the company must be mindful that any cure offered to the executive outside of the tender offer may be deemed integrated with the tender offer. Care should be taken to comply with the rules regarding offers made outside of the tender offer on the class of securities at issue (i.e., the common stock of the company). Some companies have addressed this by individually negotiating the offer to amend the executive's option well in advance of, or long after, the time of the tender offer. Other companies have satisfied themselves that they have made an offer to the executive of a materially different form of cure—e.g., the tender offer may provide for upward repricing, whereas the executive is only permitted the ability to select a fixed date for exercise.

B. Options Held by Other Employees

Once again, we have good news and bad news. Let's do good news first.

1. Current Employees

The good news: in Notice 2006-79, the IRS and Treasury Department extended the period in which discounted stock options held by non-Section 16 insiders could be cured or brought into compliance with Section 409A through December 31, 2007. As a result, companies still have two months and 21 days after the date of this presentation to effect their cure—and three ways to fix them!

a. Reprice Upwards

Companies can "fix" discounted stock options that are otherwise subject to Section 409A by increasing the exercise price of the portion of each discounted stock option that is subject to Section 409A so that the exercise price is equal to the fair market value of the underlying stock on the applicable stock option grant date. By repricing the stock options to the grant date fair market value, the option is no longer subject to Section 409A as a result of the original discount. In addition, for those companies facing a decrease in their current trading price from the price at the time of grant, it is possible under Section 409A to have the repricing upwards be to the lower of the fair market value on the date of grant or the fair

market value on the date the option is amended. In effect, the company repriced the stock option all the way up to the original grant date fair market value, and then conducted a repricing back down to today's fair market value. Of course, companies must make sure their stock plan allows for such a downward repricing without shareholder approval, and should carefully consider the accounting consequences of such an offer.

Companies can compensate the option holder for the change in exercise price by paying a cash bonus or making an additional grant of stock options or restricted stock. The compensation does not have to be in an amount equal to the increase in the exercise price. Some companies have chosen to offer a bonus only as to the "in the money" options or options that had a limited price increase. Other companies, like Juniper, added a "kicker" or interest-like payment the bonus.

However, under the applicable Section 409A transition guidance, if the offer of compensation is, implicitly or explicitly, part of the offer to amend the option, the company must arrange to pay any cash bonus in a designated later tax year and any stock options or restricted stock offered as consideration for the repricing cannot be granted and/or vest during the year in which the option is amended. Some companies, like TD Ameritrade, have addressed this by providing a cash bonus well in advance of, and regardless of participation in, a repricing cure. Providing a bonus in advance of the offer can help avoid the securities and tax issues associated with option repricing bonuses, and also can help keep employee morale high while the company works through the issues associated with launching a cure. If a company is considering offering a cash bonus after the offer has concluded, it is critical that the cash bonus be kept separate from the offer. The company must make sure not hint, suggest or otherwise communicate to the employees that a cash bonus is forthcoming. Any such encouragement or communication may be deemed part of the offer, and may bring about the accompanying tax issues and, as further described immediately below, securities law issues.

i. Securities Law Limitations

Most companies do not have the contractual right under their stock plans to unilaterally increase the exercise price of the discounted options. Therefore, if a company offers optionees the ability to amend their discounted stock options to increase the exercise price, the company must evaluate whether the offer is subject to the tender offer rules under the Exchange Act. Even private companies are not exempt from this analysis. In general, if a company is making this offer to more than a handful of optionees on terms that are not individually negotiated, the tender offer rules likely apply. This means, among other things, that the offer must be kept open for 20 business days (that means the offer must start no later than December 3, 2007!) and that any consideration paid in the tender offer is subject to the prompt payment rules. Companies must also determine if they can rely on Exemptive Order for Issuer Exchange Offers that are Conducted for Compensatory Purposes issued on March 21, 2001 (http://www.sec.gov/divisions/corpfin/cf-noaction/repricingorder.htm), which provides a necessary exemption from the "all holders" and "best price" rules under the tender offer rules.

In addition, if the company plans to offer a bonus (stock or cash) in consideration for the repricing, the company must determine if it can rely on global exemptive order issued on March 26, 2007 to Chordiant Software (http://www.sec.gov/divisions/corpfin/cf-noaction/2007/chordiant032607-13e-4.htm) which provides a necessary but limited exemption from the "prompt payment" rules. Specifically, Rule 13e-4(f)(5) of the Exchange Act and Rule 14e-1 of the Exchange Act require that consideration offered in a tender offer be paid promptly after termination of the offer. Absent the exemptive relief, issuers could not delay the payment of the cash consideration in a Section 409A repricing until January 2008—a delay required under Section 409A in order to avoid the cash payment from being deemed deferred compensation subject to adverse taxation. The SEC has granted limited relief from the "prompt payment" rules as follows: a company may delay the payment of cash consideration offered in an option repricing tender offer provided that:

- the option repricing tender offer is made to current employees of an issuer for compensatory purposes in order to address the potential materially adverse personal tax treatment of certain options under Section 409A;
- the delay in the payment of any cash consideration offered in the option repricing tender offer is required by the provisions of Section 409A;
- the issuer's employees are granted a contractual right to the payment of the cash consideration and the cash consideration is paid as soon as practicable, generally the first regular payroll pay-date, in January 2008;
- the vesting and exercisability provisions of an employee's options will not be affected by the option repricing tender offer;
- the offer is not being made to an issuer's former or current executive officers or directors; and
- the issuer determines that, aside from the prompt payment issue, it may rely on the relief granted by the staff of the Division of Corporation Finance pursuant to the Exemptive Order for Issuer Exchange Offers that are Conducted for Compensatory Purposes issued on March 21, 2001.

It is essential to note that this relief

(1) applies only to cash payments,

(2) the cash payments must be made in January 2008 and

(3) the cash payments can't be subject to vesting.

If a company wishes to use stock as consideration for the repricing, a separate request for no action/exemptive relief will need to be submitted to the SEC regarding the need to delay vesting or granting of a stock award until January 2008.

Note that delaying the granting of a stock award poses additional issues under the securities laws. Specifically, because the exemptive relief requires that the employee have a

contractual right to that award, what happens if the employee terminates after the conclusion of the offer but prior to the grant date? The company will not be able to register subsequently granted option shares on a Form S-8 registration statement. So is the company willing and able to maintain a registration statement on Form S-3 or Form S-1?

With regard to vesting, we note that a recent no action letter was granted to HCC Insurance Holdings, Inc. for a Section 409A repricing that allows for vesting of the cash payment to the extent it relates to unvested option shares (http://www.sec.gov/divisions/corpfin/cf-noaction/2007/hcc061207-13e-4.htm). However, this was not global exemptive relief. Therefore, any company wishing to provide for vesting of the cash payment must submit its own request for no action relief to the SEC.

ii. Accounting Implications

More good news: the amendment of the discounted options to increase the exercise price to the original grant date fair market value should not result in a financial charge. According to FAS 123R, a company modifying an award under FAS 123R would incur non-cash compensation cost for any incremental difference in fair value between the new award and the old award, measuring the old award's fair value immediately before the modification. The repriced awards should result in a lower fair value than the original awards, and thus, the modification would not be expected to result in an accounting consequence.

iii. Benefits of Repricing

By engaging in a repricing, not only are these "fixed" options then exempt from the reporting requirements of deferred compensation and the onerous adverse taxation under Section 409A, these options can subsequently be amended in the same ways as incentive stock options and other exempt options without triggering Section 409A. For example, a company can subsequently amend one of these "fixed" options in order to extend the post-termination exercise period till the end of the original 10-year term or accelerate the vesting on a termination of employment without running afoul of the rules on acceleration of the timing of payments. In effect, the slate is wiped clean.

iv. Drawbacks of Repricing

Aside from the securities law issues noted above, there is one material drawback to this solution: the company must be able to determine, with reasonable certainty, the appropriate date of grant for the option and the actual fair market value of the common stock on the applicable date of grant. For companies facing grant documentation that is conflicting and/or incomplete, determining the actual grant date can be a labor intensive process, the results of which are not any more certain than throwing a dart at a wall calendar. For options that were granted prior to a public market for the company's securities, determining the fair market value is part science, part art and part "best guess". While an after the fact valuation can provide some comfort on the appropriate fair market value, many companies are not comfortable with the level of uncertainty resulting from a subsequent valuation process.

b. Set Specific Exercise Dates

Another method for addressing discounted options is to modify the affected portion of the discounted stock options to comply with the rules governing deferred compensation. Specifically, the option is amended to provide for the time of payment by establishing specific exercise dates for the portion of the option that is subject to Section 409A and is not otherwise "grandfathered" from the adverse taxation. The permissible dates can be an entire calendar year (e.g., all of 2008) or the period of the year remaining after the occurrence of a specified event allowable under Section 409A (e.g., the remainder of the year in which termination, death or disability occurs). For exercise in connection with termination, care must be taken to address the issues associated with the imposition of a 6-month delay for "key employees". It may be preferable to disallow a termination trigger for individuals who are likely to be "key employees" at the time of termination.

It is critical to note that the fixed exercise date selected cannot be in the year in which the amendment is made. Therefore, the earliest year an optionee could select at this time is 2008. However, the election could specify that exercise will be allowed prior to such fixed year in the event of another qualifying event, such as a change-in-control (using the Section 409A definition) or death. In that case, if the optionee selected 2008 as his year of exercise, and the company underwent a qualifying change-in-control in 2007, the optionee would be able to exercise his option in connection with the change-in-control.

It is also important to note that an optionee may not select a date that is later than the ordinary expiration of the option's term. For example, if an option's normal 10-year term will expire in December 2007, an optionee cannot take advantage of this solution because there is no future year in which the option can be exercised. Similarly, if an optionee's option would expire at the end of the original 10-year term on July 1, 2008, the optionee can elect 2008 as the year of exercise, but may not exercise the option after July 1, 2008.

Some companies use this alternative as a means to comply with the short-term deferral exception under Section 409A. Specifically, the optionee agrees that the option can only be exercised in a future year as to a portion that vests in that future year. In that case, the option can only be exercised on or after the vesting date and only until March 15 of the year following the year in which the option vests. This solution provides a relatively narrow window in which to exercise options that vest late in the year—which can be a difficult restriction for individuals who are subject to the company's insider trading policy or who may otherwise be in possession of material non-public information during the limited period of exercise. Of course, it also provides a very large window for options vesting early in a calendar year.

i. Securities Law Limitations

As with repricing, most companies do not have the contractual right under their stock plans to unilaterally change the exercisability of outstanding stock options. Therefore, the company must consider the tender offer rules (described above) when offering this alternative to optionees. It is not clear whether this alternative implicates the issues of applicability to terminated employees under Form S-8 (described in greater detail below), although there

seems to be a good argument that this type of amendment is not equivalent to the granting of a new option and so the option should remain covered by the original Form S-8 registration statement.

ii. Accounting Implications

More good news: as with repricing, this type of amendment should not result in any additional expense for financial accounting purposes. Under FAS 123R, a company modifying an award would incur non-cash compensation cost for any incremental difference in fair value between the new award and the old award, measuring the old award's fair value immediately before the modification. The amended option should result in a lower fair value than the original awards, and thus, the modification would not be expected to result in an accounting consequence. But be sure to check with your auditors to be sure they agree!

iii. Benefits of Fixing Exercise Dates

The benefit of maintaining the discount can outweigh the inconvenience of the new restrictions on exercise, particularly if the amount by which the exercise price would need to be increased is quite large and if the company does not have the financial means or desire to provide a cash "make whole" payment equal to the price increase. As noted above, this solution is also advantageous if a company cannot determine with reasonable certainty the appropriate grant date for the mispriced option or the fair market value on the grant date.

iv. Drawbacks of Fixing Exercise Dates

Fixing an option's exercise date significantly changes the option's economics and eliminates much of the flexibility to decide when to exercise the option to maximize gain. In addition, the option is still subject to Section 409A—meaning that subsequent amendments to the option (including vesting acceleration, post-termination exercise period extensions or negotiated amendments to treatment upon a change of control) must be carefully analyzed to determine if they result in an impermissible modification to the elections governing the time and form of payment.

Furthermore, under existing guidance, this alternative cannot be used if the option is not able to be exercised in more than one year. For example, if an optionee has tendered his resignation, effective October 30, 2007 and his option has only a 30-day post-termination exercise period, he cannot use this alternative, as the option cannot, under its existing terms, be exercised in 2008. And, unless the option is repriced to full fair market value, the post-termination exercise period cannot be extended without that amendment triggering adverse consequences under Section 409A, as fixing the exercise dates does not exempt the option from Section 409A—the option remains subject to Section 409A but is deemed to comply with the rules on deferral elections.

The fact that the option remains subject to Section 409A raises another issue—if an optionee holds more than one discounted option, and he or she has exercised in 2006 or 2007 any part of the discounted options that was not grandfathered under, or otherwise exempt from, Section 409A, the plan aggregation rules under Section 409A result in all that optionee's discounted options being "tainted." And in that instance under the transition guidance, this

solution is not available because the company will be deemed to have violated its good faith compliance requirement with respect to that optionee and this type of "plan." Similarly, if an optionee has elected this solution and, after amendment, exercises his amended option in a manner that violates his election (either accidentally or intentionally), then all of the optionee's options that were amended to provide for fixed exercise dates will be "tainted" and again be subject to adverse taxation under Section 409A.

c. Cancel the Option? Perhaps...

In certain limited situations, Section 409A still allows for the cancellation of a plan or award providing for the deferral of compensation. Specifically, Treasury Regulation 1.409A-3(j)(4)(ix) provides for certain limited rights to terminate and liquidate a plan. The most likely available right involves terminations in connection with a change-in-control. In order to qualify for this exception, the company must terminate all agreements, arrangements and programs with respect to which deferrals of compensation are treated as having been deferred under a single plan under Section 1.409A-1(c)(2) as to each participant that experienced the change-in-control event, and all amounts must be paid within 12 months after the date the service recipient irrevocably takes all necessary action to terminate and liquidate the agreements, programs and other arrangements. In a merger situation where all options are being cashed out—and can be cashed out without optionee consent in accordance with the terms of the plan—this solution can be quite handy. However, a company must ensure that the cash out of the options is not subject to an escrow or earn out provision that would extend beyond the 12-month payment date requirement.

2. Terminated Employees

The bad news first: the SEC has indicated informally that it interprets the rules governing the use of Form S-8 as prohibiting the company's ability to rely on Form S-8 for the upward repricing of options held by terminated employees—regardless of whether the repricing is done as part of a tender offer or as part of an individually negotiated agreement. Form S-8 is available for the grant of stock options to current employees, and for the exercise of existing options held by former employees who were employees at the time of grant. The SEC views the upward repricing of the stock option as the grant of a new option—even if under the terms of the applicable plan the upward repricing is deemed an amendment of the option. Specifically, the SEC views the increase in price as a fundamental change to the option equivalent to the grant of a new option.

As a result, the company must either register the shares subject to the amended stock option on a Form S-3 or Form S-1 registration statement, or rely on an exemption from registration such as Rule 3(a)(9) of the Securities Act. In cases where a company has not timely made its filings due to a restatement of financials (e.g., such as is commonly the case with option backdating), the company may be ineligible to use a Form S-3 registration statement, and the costs of filing a Form S-1 registration statement may be prohibitive or may far exceed the costs of simply offering to gross up the affected employees for their 409A tax burden.

The good news—sort of: as a result of these securities law difficulties, companies are left with three possible solutions:

a. Let the Option Lapse in Accordance with its Terms in 2007

Under this alternative, a company is relying on the "good faith operation" provisions of Section 409A. Specifically, an option that has not been exercised during the transition period and that can still be cured during the transition period (i.e., this does not apply to options granted to Section 16 insiders) is technically being operated in good faith compliance with Section 409A. If such an option expires in accordance with its own terms during the transition period, there should be no Section 409A tax to the individual and nothing for the company to report on the employee's Form W-2 for 2007.

b. Offer the Terminated Optionee Some Cash

Provided the company is not offering cash, either implicitly or explicitly, in exchange for the cancellation of the option or an agreement by the employee to not exercise the option, a company can pay the employee, on a current or deferred basis, cash compensation. The cash payment can be a gross up of any Section 409A tax incurred by the optionee on exercise or simply an amount offered as a bonus. The promise of a Section 409A tax gross up can be exceedingly expensive, as the amount of the tax incurred will depend in part on the price of the company's common stock on the date of exercise. In addition, for those employees located in California, the tax consequences will be doubled as a result of California's adoption of Section 409A as a state tax law.

In these situations, a company may wish to set a cap on the amount of the gross up to be paid. Some companies may set the cap based on the company's common stock on the date of termination. A bonus can be an amount equal to the additional tax preparation fees a former employee is likely to incur in dealing with reporting the exercise of an option subject to Section 409A on his or her tax return, or another amount, such as a multiple of base pay. In effect, the company is simply offering this employee severance. In either case, a company is wise to consider requiring a release of claims in connection with the payment, given the general increased likelihood of litigation in connection with discounted options.

c. Set Fixed Exercise Dates? Perhaps...

As noted above, under existing guidance, the election to fix an exercise date for the option only works if the option is reasonably able to be exercised in more than one year. Therefore, for optionees who terminated more than a few months prior to the end of 2007, this alternative may not be available given the length of their post-termination exercise periods as set forth in their option agreements. However, for those “fortunate” enough to be terminated close to the end of 2007, they may be able to pick 2008 as their exercise year. As noted above, it is not clear whether the SEC would view this solution as implicating the availability of Form S-8 (as with option repricing). However, this type of amendment does not seem to strike at the fundamental nature of the option in the same way that repricing does, and so there seems to be a good argument that this type of amendment is not equivalent to the granting of a new option. When in doubt, bring this issue to the attention of your general counsel or outside law firm and ask for their confirmation as to whether this solution will work.

C. Practical Considerations

1. Maintain Reasonable Expectation in Communications

In most cases, companies truly want to rectify the problem for employees, and are eager to keep morale high while the restatement process is completed. Above all, companies must be careful to keep expectations reasonable and not promise a solution or alternative without having fully committed to offering it. The class action filed by former McAfee employees highlights the danger of making promises to employees that a company may not later be able to fulfill. In that instance, seven former McAfee employees claimed the company promised, and then rescinded the promise, to give the former workers a 90-day extension on their window to exercise their stock options in light of the former workers' inability to exercise due to the on-going restatement process.

Note also that any written communications discussing a solution may be deemed a pre-tender offer communication. Pre-tender offer communications require filing the written materials (even emails!) with the SEC on the appropriate form (SC TO-C).

2. Ensure Administrative Capabilities

It is critical that your staff, stock plan software and third party vendors are all prepared to deal with the monumental task of amending dozens, if not hundreds, of stock options. Obviously, time is of the essence in finalizing stock option solutions before December 31, 2007. However, a company's human resources staff, stock plan administrators and internal finance team must be ready to deal with the mass of paperwork and communications that are necessary to run a tender offer. A few extra days can make the difference between a well run tender offer and an offer that is pushed through too quickly and that results in ineffective employee elections or an SEC-mandated restart of the 20-business day clock.

In addition, many stock plan administration websites are not prepared to deal with the necessary slicing and dicing of data to show employees how their options were amended—including any amendments that result in a limited period in which options can be exercised. Make sure that your stock plan administrator can provide your optionees with real time, accurate data on whether they can exercise their stock options following amendment, and the price they need to pay as to each tranche. If your provider cannot handle the necessary modifications with certainty, consider hiring temporary stock plan staff to manually process exercise paperwork of optionees who have amended their stock options—and be sure to block exercises via your stock plan website if the website cannot properly administer the amended options and prevent exercises in violation of fixed date elections.

3. Keep it Simple!

You will have many choices to make in designing your tender offer. You will likely want to bend over backwards to make things right for your employees. But remember—the more complicated the tender offer, the less likely the employees will understand it, the less likely they will participate, and the more likely the solution may end up failing. Keep it simple! For example, when considering whether to permit employees to tender less than all of their discounted options, consider the ramifications for both the company and the employee to

having discounted options remain outstanding after the tender offer closes, especially in light of the dollars, time and energy spent in conducting the tender offer.

4. Don't Neglect Your Communication Strategy

As noted above, the better your employees understand the problem and the solution, the greater your return on the time, energy and dollars spent on fixing the problem—both in terms of employee participation and employee morale. Consider using a pre-tender offer communication to keep employees apprised of the efforts toward reaching a solution and to remind employees to consider not exercising options when any closed trading window is about to open prior to the tender offer. Make sure you have planned enough "roll out" educational sessions at the start of the tender offer to minimize wasted time by employees who can't understand the 60-page document that just landed in their inbox. Make sure the person conducting your educational sessions truly understands the program and understands the limitations on his or her ability to answer questions. The company and its representatives should not be answering individual tax questions or advising employees on whether they, as individuals, should participate given their specific circumstances. If your HR person or general counsel is not fluent in the issues and solutions of Section 409A, consider bringing in your outside counsel or hiring a consultant from one of the big tax auditing firms to give the presentation (e.g., Deloitte Tax was involved in numerous employee education sessions, as is evident from the presentation slides filed as exhibits to many of the publicly filed tender offers). Such a third party educator also has the benefit of being one step removed from the company—minimizing the risk that an employee feels he or she has been told by the company to participate. Be sure to file with the SEC the forms of follow up email communications that you intend to send to employees. You will want to send out emails to remind people in the days prior to the close of the offer to submit their election form and you don't want to be caught at the end of the offer having to file new documents, which might restart the tender offer clock!

D. What Are Other Companies Doing?

Many of the companies who were on the bleeding edge of this problem have already conducted their cure program. For those of you who are just finishing up your financial restatement process or—gasp!—are just realizing you have a problem, the following table showing the strategies chosen by those who blazed the path before you may be helpful. In reviewing this table, it is important to remember that prior to January 2007, most companies were not aware that former employees could not participate in the tender offer and the SEC had not started mandating the exclusion of former employees until January 2007. For those of you who are curious as to when this development arose, check out Broc Romanek's blog from January 2, 2007 (http://www.thecorporatecounsel.net/blog/archive/2007_01.html—scroll all the way to the bottom).

Name	Approx. Date of Program	Must you tender all eligible options?	Reprice Up	Cash Bonus	Bonus subject to vesting?	Restrictions on exercise of "cured" option?	Cancellation of Tainted Option	Fixed Date	Date Selection	Multiple Dates Permitted?
Adobe	Dec. 2006	No	Yes	Yes	No	No	No	N/A	N/A	N/A
AirNet Communications	Dec. 2005	Yes	No	N/A	N/A	Yes	No	Yes	Mar. 15, 2011	No—only one specific date
American Tower	Feb. 2007	No	Surrender Securities for cash	N/A	N/A	No	N/A	N/A	N/A	N/A
Amkor Tech	Nov. 2006	No	Yes	Yes	No	No	No	N/A	N/A	N/A
Apple	Mar. 2007	Yes	Yes	Yes	No	No	No	N/A	N/A	N/A
Blue Coat	May, 2007	No	Yes	Yes	No	No	No	N/A	N/A	N/A
Broadcom	Mar. 2007	No	Yes	Yes—100%	No	No	Underwater options are cancelled	N/A	N/A	N/A
Brocade	Summer 2006	No	Yes	Yes—aggregate increase or BS value	No		Yes—as to options receiving BS bonus	N/A	N/A	N/A

Name	Approx. Date of Program	Must you tender all eligible options?	Reprice Up	Cash Bonus	Bonus subject to vesting?	Restrictions on exercise of "cured" option?	Cancellation of Tainted Option	Fixed Date	Date Selection	Multiple Dates Permitted?
CA	Nov. 2006	Yes	Yes—to higher of current FMV or discounted strike price	No	N/A	Repriced option subject to cliff vesting 6 months from date of repricing	Yes—cancelled and regranted at new price	N/A	N/A	N/A
Cheesecake Factory	Feb. 2007	Yes	Yes	No	N/A	No	No	N/A	N/A	N/A
Chordiant	Mar. 2007	Yes	Yes	Yes	No	No	No	N/A	N/A	N/A
Clorox	Fall 2006	Yes	Yes	Yes	Only as to unvested part of option	No	No	N/A	N/A	N/A
CNET	Mar. 2007	No	Yes	Yes	No	No	No	N/A	N/A	N/A
Conor Medsystems	Dec. 2006	No	No	No	No	Yes	No	Yes	Short term deferral period	Yes
Gap	Dec. 2005	No	Yes	Yes—if in the money	Only as to unvested part of option	No	Yes—cancelled and regranted at new price	N/A	N/A	N/A

Name	Approx. Date of Program	Must you tender all eligible options?	Reprice Up	Cash Bonus	Bonus subject to vesting?	Restrictions on exercise of "cured" option?	Cancellation of Tainted Option	Fixed Date	Date Selection	Multiple Dates Permitted?
Hewlett-Packard	Nov. 2006	Yes	Yes	Yes, if "in the money" options w/original exercise price < $52.00	No	No	No	N/A	N/A	N/A
Juniper	Mar. 2007	Yes	Yes	Yes—105% of increase	No	No	No	N/A	N/A	N/A
KLA-Tencor (1) 1982, 2000 and 2004 Plans	Feb. 2007	No	Yes	Yes	No	No	No	N/A	N/A	N/A
KLA-Tencor (2) Just 2004 Equity Incentive Plan	May. 2007	No	Yes	Yes	No	No	No	N/A	N/A	N/A
L-3	Nov. 2006	No	Yes	Yes	No	No	No	N/A	N/A	N/A
Medarex	Mar. 2007	Yes	Yes	No	No	No	No	N/A	N/A	N/A
Mercury Interactive	Nov. 2006	No	Yes—options unvested as of HP merger	Yes	No	No	No	N/A	N/A	N/A

Name	Approx. Date of Program	Must you tender all eligible options?	Reprice Up	Cash Bonus	Bonus subject to vesting?	Restrictions on exercise of "cured" option?	Cancellation of Tainted Option	Fixed Date	Date Selection	Multiple Dates Permitted?
Microtune	Feb. 2007	No	Yes	Yes, if in the money	No	No	No	N/A	N/A	N/A
Monster	Mar. 2007	No	Yes	Yes	No	No	No	N/A	N/A	N/A
NVIDIA	Dec. 2006	No	No	No	No	Yes	No	Yes	Employee choice	Yes
Orbital sciences	Jan. 2007	No	Yes	No	No	No	No	N/A	N/A	N/A
Progress Software	Dec. 2006	No	Yes	Yes—100%	Unvested share bonus vests in up to four installments	No	No	N/A	N/A	N/A
Sanmina	Mar. 2007	No	New Option	No	No	One year "cliff," then vesting on an annual basis over three years	Yes	N/A	N/A	N/A
Sigma Designs	May. 2007	No	Yes	Yes—100%	No	No	No	N/A	N/A	N/A
Staples	June. 2007	Yes	Yes	Yes—except mgmt	No	No	No	N/A	N/A	N/A
Synopsys	Mar. 2007	Yes	Yes	No	No	No	No	N/A	N/A	N/A

Name	Approx. Date of Program	Must you tender all eligible options?	Reprice Up	Cash Bonus	Bonus subject to vesting?	Restrictions on exercise of "cured" option?	Cancellation of Tainted Option	Fixed Date	Date Selection	Multiple Dates Permitted?
TD Ameritrade	Feb. 2007	Yes	Yes	Bonus paid in Dec. 2006 before March 2007 TO	No	No	No	N/A	N/A	N/A
Walt Disney (Pixar Options)	Apr. 2007	Yes	Yes	Yes	No	No	No	N/A	N/A	N/A

VI. ESPP—An Alternative to Stock Option Plans?

A. What Is the Idea?

Imagine the typical situation—it's time to evaluate your company's equity program and suggest refinements for the next year. Your management team has reiterated to you the goals of your program: attract, retain and motivate….oh, and don't forget to keep accounting and administrative costs to a minimum, all while ensuring the granting practices pass muster under the ever-increasing scrutiny of investors!

What do you do? You turn to your trusty archived copies of *The Corporate Executive* and the January-February 2007 edition catches your eye: have you considered replacing your broad-based stock incentive program with an ESPP? What would your management team think of this radical proposal? What do you need to consider to bring this before them?

First, you need to prioritize the goals your management team has handed down to you. The ESPP as a replacement for a broad-based stock option or restricted stock program can be as simple as sticking with your existing qualified Internal Revenue Code Section 423 plan or as complicated as taking that standard plan, adding or subtracting a look-back, eliminating the fixed exercise dates, providing for offering dates on the dates that match your existing "best practice" grant schedule, changing the forms of payment used to mirror the various types of option consideration and allowing for post-termination exercise periods…and then adding a non-qualified purchase plan on top of the standard plan, pursuant to which you add a company matching contribution, vesting and a means to address tax withholding.

Clearly, with such a variety of drafting and administrative choices, it is easy to lose sight of the goal of administrative efficiency. So it is paramount to prioritize your goals in order to craft a plan with features meet your specific needs.

B. Identifying Your Goals

1. Accounting

As noted in *The Corporate Executive*, a key goal of any stock compensation program should be to provide a benefit that employees perceive to be at least as valuable, if not more valuable, than the accompanying FAS 123R earnings charge. As you no doubt are aware, companies are required to expense their ESPPs—just like other option-based equity awards—unless the ESPP fits within a limited safe harbor (5% discount, no look-back and a limit on the number of shares that can be purchased in the offering). This accounting development caused a flurry of amendments to and cancellations of ESPP programs throughout the country—just look at the NCEO survey data cited in *The NASPP Advisor* (September-October 2006)—just over half of survey respondents anticipated modifying their plans to eliminate the lookback, 9% had discontinued their ESPP, 3% anticipated ending their ESPP and 9% were still undecided as to what to do.

However, now that the furor has died down over the FAS 123R changes, companies are realizing that the FAS 123R compensation cost associated with "traditional" Section 423 ESPP is generally less than "traditional" 10-year stock options with a similar strike price[1]:

Look-Back Period	ESPP Cost Per $10 Share					
	15% Discount		10% Discount		5% Discount	
	No Limit[2]	Limit	No Limit	Limit	No Limit	Limit
24 months	$4.33	$3.94	$3.84	$3.58	$3.36	$3.23
18 months	$3.95	$3.61	$3.46	$3.24	$2.98	$2.87
12 months	$3.51	$3.23	$3.02	$2.83	$2.53	$2.43
6 months	$2.92	$2.72	$2.43	$2.29	$1.93	$1.86
None	$1.70	$1.50	$1.13	$1.00	$0.00	$0.00

Compare these costs with the per share fair value of an option with a $10 exercise price and 10-year maximum term—$4.20 (4-year expected term) to $6.50 (10-year expected term)—and replacing your broad-based equity program with a straight-forward "old fashioned" Section 423 plan seems like a no-brainer from an accounting perspective.

However, you have other goals, no doubt, beyond managing accounting expenses and adding on the laundry list of features noted above—such as extended exercise periods and a non-compensatory parallel plan with a company match—will add to the accounting costs. Obviously, any employer match (in some cases, up to 25% of the employee's contribution) can quickly add to the accounting cost of the program, as well as burn through additional shares in the plan's reserve.

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[1] All estimates are for illustration purposes only. Assumes 50% volatility, no dividends, and 1.5% risk-free interest rate. Interest rate applicable to the 10-year option was adjusted commensurately with the expected term.

[2] Refers to the lack of a per-purchase period or per-person limit on the number of shares that can be purchased under the ESPP.

2. Administration

As noted above, and in *The Corporate Executive*, the "new" ESPP can be as simple or as complicated as you wish. For those companies with a sophisticated stock plan administrative function, the design elements may increase the perceived value of the plan to employees and aid in the goals of attracting, retaining and motivating employees. As noted below, some of these features minimize the administrative burden of maintaining the ESPP as the sole equity plan. However, some of these features can also dramatically increase the administrative burden, bringing it to a level that equals or perhaps exceeds the burden under a traditional stock plan.

a. Timing of Grants

The typical ESPP has a new offering period beginning at regular intervals, typically every 6 or 12 months (but in no event more than every 27 months). In replacing your regular new hire and annual grants with an ESPP, it should not be too great of an administrative burden to simply revise the existing offering schedule to coincide with your grant timing policy (you have adopted one, haven't you?). One of the great benefits of an ESPP, both from the employee's and the stockholder's perspective is the transparency in grant timing—everyone knows when the pre-announced offering period will start, and generally those decisions are made well in advance of the actual start date, such that there is little chance for manipulating the grant date to coincide with (or dodge) the dissemination of material inside information and far less risk of administrative errors such as misdated board consents or use of the wrong date's fair market value. Less time will likely be spent by stock plan administrative staff administering the ESPP than it would otherwise spend coordinating the approvals of discretionary stock awards, preparing individual option grant notices and communicating the grants to optionees.

Employees appreciate the certainty of knowing that they will receive a new "option" at least yearly (or at least as often as you commence your offering periods) and that option will always be "in the money"—something that is not a guarantee under traditional discretionary option programs. The stock plan administrators can then spend less time answering questions from individual employees as to why they did not get a grant in a particular year or haggling with new hires over the timing of their initial option grant.

Of course, the converse to the certainty in the timing of grants under the ESPP is the lack of flexibility to address unusual or special situations. New hires will only be eligible to participate as of the next regular offering date—unless a plan is drafted to allow for them to join an on-going offering at the price on their date of entry. Such flexibility obviously adds administrative costs to the plan—not only in terms of extra paperwork to fill out but also in additional offering prices to track. In addition, since all regular employees are eligible to participate in a standard Section 423 ESPP, all employees will receive equity awards each year under the plan—regardless of their individual performance level. Some suggest addressing this through an additional non-compensatory ESPP or making special option or restricted stock grants outside of the ESPP—but again, this adds to the administrative complexity of the program.

b. Eliminating Fixed Exercise Dates

The Internal Revenue Code does not require fixed exercise dates for ESPPs—Section 423 simply requires that the offering not exceed 27 months. So it is possible to grant a Section 423 ESPP option that can remain exercisable until that 27th month and that can be exercised at any time within that period. In order to maintain the retention value of the ESPP option, a company would likely want to impose vesting—e.g., the ESPP option is granted on the standard fixed offering date, vests 6 or 9 or 12 months after grant, and can then be exercised at the employee's discretion up until the 27 month expiration date. On the date the employee selects for exercise, the purchase price could be as low as 85% of the lower of the fair market value on the purchase date or the fair market value on the offering date. This flexibility may help ease the transition to the new ESPP program in the minds of your employees.

However, with the added flexibility the administrative ease of the traditional ESPP purchase mechanism is lost. In addition, this flexibility sacrifices another benefit of traditional ESPP fixed purchase dates—i.e., employees in a traditional Section 423 plan can focus their energies on their duties and not on the trading price of the company's stock, as the purchase will be made on a definite date that is beyond their control. By allowing the employee flexibility in setting their purchase date, the employee is more likely to be distracted from his or her duties by monitoring the stock price in order to time his or her purchase to a perceived low in the trading price.

Further, this discretion in the purchase raises insider trading issues associated with traditional stock options. Purchases under the ESPP will need to be subject to the company's insider trading policy, to the extent it regularly applies to rank and file employees. This application of the policy may result in all purchases being confined to an open trading window, in which case the flexibility in setting a purchase date is minimized and the administrative hassle of monitoring hundreds of ESPP purchases is no less than in monitoring hundreds of regular option exercises. Finally, this flexibility may be an unwanted burden for executive participants who may regularly be in possession of material inside information—it is possible that an executive could be in possession of material information throughout the 27-month life of the ESPP option.

Finally, it's imperative to remember that fixed purchase dates must be used with a non-423 ESPP. Section 409A will apply to an ESPP that does not meet the requirements of Section 423. In order to comply with Section 409A and avoid adverse taxation thereunder, the purchase dates in the non-Section 423 ESPP must be fixed in a manner that satisfies the time of payment rules under Section 409A.

c. Vesting in a Company Match

As noted above, vesting can be layered into a Section 423 ESPP that has no fixed exercise date. In addition, for the non-Section 423 ESPPs, vesting in a company match can provide an important retention mechanism. Non-Section 423 ESPPs can provide for a company matching contribution, because these plans are not subject to the requirement in Section 423 that the employee pay for at least 85% of the value of the shares purchased. In effect, via a

matching contribution, or via a greater discount in the purchase price of the shares, the company can provide additional compensation to employees participating in the non-Section 423 ESPP. A matching contribution provides a greater incentive to participate in the plan and may be a useful tool in attracting potential employees to your company.

In addition, the size of the match can be tailored based on factors determined by the company. Higher performing employees can receive a larger match. The size of the match can be dependent upon performance levels achieved during the offering period. The size of the match can also be negotiated as part of the new hire package with a potential employee. By allowing for discretion in the size of the match, the company can tailor the non-Section 423 ESPP to attract employees and motivate and reward performance. Note, however, that for discounts in excess of 75% (i.e., the employee pays less than 25% of the value of the shares), the Internal Revenue Service may view the entire award as a stock bonus and tax it accordingly.

As with a matching contribution under a traditional 401(k) plan, a company can impose vesting on shares purchased under a non-Section 423 ESPP with the company's matching contribution. The employee would be fully vested in shares purchased with his or her contributions, as the employee would have effectively already vested in those shares by virtue of the requirement of the employee to stay employed through the purchase date. The employee would then have to remain employed by the company for a pre-determined period after purchase in order to vest in the shares purchased with the company's match.

Of course, this retention and motivation device necessarily adds back in a layer of administrative obligation—determining the appropriate match level, tracking performance over the offering period, tracking vesting dates and dealing with the forfeiture of shares in the event of a termination of service. The company will also need to address whether and how shares will vest during a leave of absence or other break or change in the nature of service.

In addition, any match or increase in the discount will result in an increased accounting expense. For example, increasing discount by 66% (from 15% to 25% through a company match) can increase the compensation cost by 23% (from 43% of the actual cost of the share to 53% of the actual cost of the share). A company will need to draw its own conclusions as to whether this increase in accounting cost is more than offset by the employee's perceived value of the match and the loss of a regular stock option grant.

d. Withholding Issues

One of the administrative benefits of a Section 423 ESPP is that companies are relieved of all withholding obligations (e.g., income, Social Security and Medicare) in connection with the purchase or subsequent disposition of shares acquired under such plans (although companies must report to the IRS any ordinary income recognized as a result of a disposition and it appears that Pennsylvania may require withholding in connection with purchases under an ESPP). If a company decides to implement a non-Section 423 ESPP as part of its program, the entire spread is taxable income (e.g., just like a non-qualified option). The company will need to determine a means to cover the withholding obligation at purchase—an issue that is complicated where the purchase price is not paid via a Regulation T same day sale.

e. Post-Termination Exercise Windows

Section 423 allows ESPP options to be exercisable for up to three months following termination of employment. Traditional ESPPs tend not to take advantage of this flexibility, in part because of the administrative burden of tracking who terminates within the three month window and maintaining an account for contributions by the terminated employee, and in part because the ESPP was a short-term supplemental elected benefit (as compared to regular discretionary option awards, which an employee may have held onto for up to 10 years at the time of termination. Where regular discretionary grants are to be replaced with ESPP participation, allowing for continued participation for the limited period following termination may help ease the transition in the minds of employees, especially where the termination decision is likely to be made by the company. Remember, however, that with a Section 423 ESPP, all employees need to be treated equally under the plan, so that the post-termination exercise period would need to be applied consistently across participants. Greater flexibility in setting post-termination exercise periods would be available with the non-Section 423 ESPP. However, the post-termination exercise period would need to be determined in advance in accordance with the requirements of Section 409A. In addition, providing for varying post-termination exercise periods clearly adds to the administrative burden of tracking options granted under the plan.

f. Different Forms of Consideration

Section 423 does not require the use of payroll deductions as the form of payment for ESPP purchases. However, most companies tend to use payroll deductions largely for the convenience, but also as a means to address the size of ESPP options—i.e., the number of shares that can be purchased pursuant to an ESPP option is directly related to the amount of contributions accumulated on the purchase date. If other forms of consideration are permitted—such as a cashless exercise pursuant to a program authorized under Regulation T (i.e., a broker assisted same day sale)—the company will need to otherwise set the limit on the number of shares that are subject to the option. This number must be determined in a manner that satisfies the equal rights and privileges rules of Section 423, to the extent the plan is intended to comply with those rules. Additionally, the number should be determined with the plan reserve in mind, in order to ensure adequate shares in the plan reserve to cover awards outstanding on any purchase date.

Adding additional forms of contribution toward purchase obviously increases the administrative burden of the plan. Stock plan administration must prepare the necessary forms of contribution paperwork, track contributions and conduct the necessary educational sessions to employees to explain the requirements and limitations on the use of these forms of payment. If employees are allowed to contribute via personal check, the company must address the issues of the date by which checks must be submitted and what to do when the check subsequently "bounces" after the purchase of the shares or when the employee forgets to tender the check by the required date (as one could imagine might be the case for employees on a leave of absence or extended vacation on or around the time of the purchase date). In the case of a Regulation T program, stock plan administration must designate a broker for use in a Regulation T program who can coordinate the purchase and sale of shares under the ESPP option in a manner that satisfies the requirements of Sarbanes-Oxley for

those executives who are subject to the limitations therein on company-sponsored loans. Stock plan administration will also need to remind employees that exercise via a Regulation T program is a disqualifying disposition of the ESPP shares as to the shares used to pay the purchase price. If employees are allowed to use previously purchased ESPP shares of company common stock, the tender of such shares will not be a disqualifying disposition to the extent that the shares have been held for the requisite holding periods (i.e., more than two years after grant and more than one year after purchase). Note that an immaculate "net" exercise is not likely allowed under Section 423 (see *The Corporate Executive* from May-June 2006).

g. Automatic Enrollment

Many companies implemented automatic enrollment in their traditional ESPPs for the initial offering period that commenced with the company's initial public offering, in order to not run afoul of the securities laws. These "IPO" offerings provide for the use of payroll deductions as the means of contribution only if affirmatively elected by the participant after the commencement of the offering period following the IPO, with contributions otherwise made via personal check on or before the purchase date. Automatic enrollment may make sense in subsequent offering periods where companies take advantage of the flexibility offer the additional forms of employee contributions noted above. Automatic enrollment may help facilitate employee participation in the program, something that may otherwise decline for employees who do not fully understand the company's transition to an ESPP-only equity compensation program or who otherwise shun participation in an ESPP because of the requirement to pay for the ESPP shares on a current basis (i.e., through on-going payroll deductions). It should be noted that automatic enrollment does increase the accounting costs of the ESPP, as the company must still take the charge for employees who affirmatively "opt out" of the offering (although not for those employees whose employment is terminated prior to the purchase date—see *The Corporate Executive*, January-February 2007).

h. Fewer Form 4s

Provided the Section 423 ESPP is structured with fixed exercise dates, the granting of the ESPP option and the exercise of the ESPP option, should be non-reportable events.

SEC Rule 16b-3(c), which applies to "tax-conditioned plans," exempts from Section 16(b) any acquisition under to an employer-sponsored plan that meets the definition of a "stock purchase plan." Rule 16b-3(b)(5) defines "stock purchase plan" to mean "an employee benefit plan that satisfies the coverage and participation requirements of Sections 423(b)(3) and 423(b)(5), or Section 410, of the Internal Revenue Code." All Section 423 ESPPs fall within this definition of a "stock purchase plan." (Measure coverage and participation requirements by reference to employees eligible to participate, not by employees actually participating, under SEC Telephone Interpretations Manual, No. R.31 (July 1997).) Rule 16a-3(f)(1)(i)(B) also exempts from the reporting requirements acquisitions of securities in transactions exempted from Section 16(b) by virtue of Rule 16b-3(c).

For stock plan administrators who are responsible for the preparation and filing of their officers' Section 16 filings, this small benefit may be a welcome relief. Of course, upon the

next filing of a Form 4 or Form 5, the shares purchased by the executive under the ESPP would have to be reflected in the column showing shares owned by the executive, and any subsequent sale of the shares would be a transaction subject to matching and subject to reporting on a Form 4. So, for those executives who have a practice of selling ESPP shares at the time of purchase, there may be no administrative savings here.

3. Employee Perceptions

In evaluating the transition from a regular equity incentive program to an ESPP-only program, the perception of the transition in the eyes of the employees is paramount. As noted above in the discussions of the various features, employees may see both value and detriment in the switch.

Companies can focus on the continuity of the grant program—i.e., the regular offering periods as opposed to the discretionary nature of awards and the extent to which the ESPP's structure results in internal pay equity as between officers and rank and file employees. In an era where equity compensation can be a source of the exponentially increasing difference between officer and employee pay, employees may appreciate the effect that an ESPP-only equity program has on correcting this disparity. In addition, companies can focus on the fact that unlike traditional options, these ESPP options will rarely, if ever, be underwater. This characteristic may be particularly appealing, and serve as a much needed morale booster, if a company has been facing volatile or decreasing stock prices. Finally, a clear discussion of other features that are added for the benefit of the employees (e.g., a new post-termination exercise period, a company match) may help ease the transition and add perceived or real value.

Of course, employees are likely to focus on the takeaway of the standard option or restricted stock grant—something that many employees have come to expect as a valuable part of their total compensation package, especially executives. However, it may be the executives who are in the best position to bring about a change in the attitude of their employees regarding total compensation. Clearly, a company's executives must embrace this radical new form of equity compensation program, and be able to clearly explain the purpose and the benefits to employees. It is essentially a shift in the company's compensation philosophy, an undertaking that requires carefully designed employee communications beyond rolling out the program. A company must have a thoughtfully designed follow up education program to teach employees how to maximize their benefits under the new program—whether through achieving certain performance milestones in order to vest in a match or explaining how a discretionary exercise feature works.

In addition, a company should consider whether switching to an ESPP fosters a focus by employees on short term changes in stock price, rather than long term growth for shareholders. For example, many employees traditionally flip their ESPP shares shortly after purchase, in order to capture as much as possible of the 15% discount, whereas employees may not be as quick to flip option shares that have recently vested, given that no actual money is yet at risk in the award. As a result, a traditional stock option with a 10 year term may present a different incentive to an employee than an ESPP option that is purchased with an employee's own dollars 6 months after grant.

4. Shareholder Perceptions

In addition to considering your employees' perceptions of the transition to an ESPP-only program, you will need to consider the perception of your stockholders. For ESPPs that continue with the traditional fixed offering dates and fixed purchase dates, stockholders will appreciate the transparency and predictability of these plans—factors considered by ISS in voting for or against continuing board membership of directors on the compensation committee. The use of a fixed pricing mechanism in an ESPP—i.e., a clear formula based on a defined purchase date, without the risks associated with administration of a discretionary program based on potentially misdated board consents—can ease investor fears over option backdating. Investors will also appreciate features in an ESPP that link the size or vesting of an award to company performance. Finally, for those companies who have faced difficulty in seeking shareholder approval of increases to stock plan reserves due to high levels of overhang, ESPPs have the benefit of regular turnover of the outstanding options.

Of course, to the extent that your new ESPP program provides for discretionary exercise dates, discounts in excess of 15%, non-Section 423 ESPPs that provide for selective employee participation, your shareholder approval issues may not go away. ISS voting guidelines for 2007 for qualified ESPPs show that votes should be cast on a case-by-case basis, with a "FOR" vote provided the plans (1) provide a discount of not more than 15%, (2) provide for an offering period of not more than 27 months and (3) provide for a share reserve of not more than 10% of the company's outstanding shares. ISS voting guidelines for 2007 for non-qualified ESPPs show that votes should be cast on a case-by-case basis, with a "FOR" vote provided the plans (1) provide for broad-based participation (i.e., all employees of the company but excluding 5% owners), (2) provide for a limit on employee contributions—either in the form of a fixed dollar amount or a percentage of base salary, (3) provide for a matching company contribution of not more than 25% of the employee's contribution and (4) if there is a matching company contribution, provide for no discount from the stock price on the date of purchase. An interesting question is whether ISS will start to impose its traditional equity incentive plan voting standards on ESPPs that are put into place to replace the traditional equity plans, especially where those ESPPs integrate features that are specifically designed to mirror features under traditional equity plans. Preliminary conversations with ISS representatives at the time this paper was written suggest that the more these “new” ESPPs look like traditional stock plans, the more likely they are to use the traditional shareholder value transfer test as part of their voting analysis.

C. Has This Idea Caught On?

Not yet. So far as we know, no one has adopted this innovation to date. In fact, data from the Equilar study of information disclosed by Russell 3000 companies in proxies containing additional share requests for new and amended plans during the first half of calendar years 2005 and 2006 (the Equilar 2006 Employee Stock Purchase Plan Report) shows that companies are ratcheting back the number of shares offered pursuant to ESPPs, with approximately 2/3rds of the companies surveyed requesting 2% or less of the total shares outstanding as part of their new or amended plan, and with only 2.9% of the companies surveyed including an evergreen in their ESPP. We do note that Jack in the Box adopted a

non-Section 423 ESPP in their 2006 proxy, although it does not appear that this is intended to replace its broad based equity plans.

Appendix A

Memorandum on Restricted Stock and Restricted Stock Units

1. INTRODUCTION

This memorandum compares the use of restricted stock awards and restricted stock units ("***RSUs***") as equity compensation vehicles for directors, including the administrative, tax, securities, corporate governance, accounting and shareholder approval issues associated with these two types of awards. This memorandum concludes with a discussion of the current trends in granting these awards to directors. A reference chart comparing restricted stock and RSUs is attached hereto as Exhibit A.

2. DEFINING RESTRICTED STOCK AND RSUS

A. RESTRICTED STOCK

(i) *Description of the Award*. An award of restricted stock is the issuance of shares on the date of grant, without any payment for the shares by the recipient (other than payment of the par value, if required by applicable law, as discussed below). The award is reflected in a restricted stock unit award agreement, which contains the material terms of the award, which both the company and the recipient sign[3]. Shares of restricted stock are counted against the authorized share pool when granted and may or may not be added back to the share pool if forfeited prior to vesting.

Shares of restricted stock may be granted fully vested, or subject to time-based or performance-based vesting. If an award of restricted stock is subject to time-based vesting, then upon the termination of the recipient's continued service, the company will have the right to reacquire all of the unvested shares at no cost to the company (other than the par value paid by the recipient, if applicable). Typically, unvested shares are held in an escrow account until they vest to facilitate the reacquisition of such shares by the company in the event of forfeiture. As the shares vest, share certificates may be delivered to the recipient or his or her personal brokerage account.

As the recipient of an award of restricted stock is the holder of record of the shares, he or she is typically entitled to exercise all of the rights of an ordinary shareholder from the date of grant. These rights include voting rights and the right to receive dividends paid in respect of the restricted stock. Typically, any dividends paid in respect of unvested shares will be held in escrow and will be subject to the vesting conditions applicable to the original shares.

(ii) *Tax Liability*. In general, the recipient will recognize ordinary income at the time the shares of restricted stock vest in an amount equal to the excess of the fair market value of the

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[3] If recipients intend to make a "Section 83(b) election" (discussed below), timely preparation of the award agreement is critical, as the recipient's window runs from the date of grant, not from the date no which he or she receives the award paperwork.

stock ***on the vesting date*** over the price paid, if any, to acquire the restricted stock. Upon a subsequent sale of the restricted stock, the recipient will recognize a capital gain or loss equal to the difference between the sale price and the amount of ordinary income recognized at vesting. Such capital gain or loss will be long-term or short-term depending on whether the stock is held ***from the vesting date*** for more than one year.

Notwithstanding the foregoing, the recipient could choose to recognize the ordinary income associated with the award of restricted stock at the time of the grant by making an election under Section 83(b) of the Internal Revenue Code of 1986, as amended (the "***Code***"). By making a "***Section 83(b) election***" within 30 days after the grant of the unvested shares of restricted stock, the recipient would recognize as ordinary income an amount equal to the difference between the fair market value of all of the shares of restricted stock on the date of grant over the price paid (if any) for those shares, and his or her capital gains holding period would commence at such time. If any of the unvested shares of restricted stock are later reacquired by the company upon a termination of service, the recipient would not be entitled to a credit against ordinary income for the taxes paid in connection with the Section 83(b) election. Note that a Section 83(b) election is rarely used in respect of restricted stock, because the election gives rise to an immediate obligation to pay ordinary income taxes on shares of stock that may ultimately be forfeited or that may end up having a lower fair market value on the original vesting dates when taxes would otherwise be due.

(iii) *Withholding*. The company will be required to withhold applicable income and employment taxes as and when the ordinary income is recognized (i.e., on each vesting date or at the time the Section 83(b) election is made). The award recipient may satisfy the withholding obligation by (i) writing a check directly to the company, (ii) selling a portion of the vested shares necessary to cover the applicable taxes and remitting the proceeds to the company, (iii) instructing the company to withholding against other income, or, (iv) if permitted by the company, surrendering to the company that number of shares of restricted stock necessary to cover the applicable taxes. Note that if (i) a company remits the applicable withholding taxes on behalf of the director prior to receiving funds from the him or her (or his or her broker) or (ii) a company releases vested shares from escrow to the director prior to his or her satisfaction of the withholding obligation, such actions could be deemed to be loan arrangements in violation of Section 402 of the Sarbanes-Oxley Act.

If the vesting event that triggers withholding occurs during a black-out or closed trading window, the award recipient will not be able to satisfy the required withholding obligations through the sale of shares on the open market, and, due to the aforementioned concerns regarding Sarbanes-Oxley, the company may not be able to loan or advance those funds to officers. Some companies address this issue by providing that the restricted stock will not vest during a closed trading window. However, this delayed vesting feature creates an additional or prolonged risk of forfeiture (e.g., if the individual terminates during the extended vesting period) and may give rise to adverse tax consequences under Section 409A of the Code[4]. As a result, many companies opt for

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[4] Internal Revenue Code §409A, enacted on October 22, 2004, contains new rules for a broad range of plans and arrangements that constitute deferred compensation plans, including rules regarding distributions and penalties for noncompliance. If a plan or arrangement subject to §409A fails to comply with the requirements under §409A, then (i) all compensation deferred under the plan or arrangement for an affected participant will become includible in the participant's gross income for the taxable year in which the failure occurs, to the extent such compensation is not subject to a substantial risk of forfeiture, (ii) interest at the underpayment rate plus 1% will be imposed on the underpayments that would have occurred had the compensation been includible in income when first

quarterly or annual vesting, with vesting dates pegged to anticipated open windows. By comparison, RSUs may vest on the originally intended schedule, with delivery (and therefore taxation) deferred until the trading window reopens (as further discussed below).

(iv) *Securities Law Compliance & Disclosures*. A Form 4 must be filed at the time the award is granted; vesting does not trigger additional filing obligations. Note that if the award recipient surrenders shares of restricted stock necessary to cover the applicable withholding taxes, as described above, this may create a separate Section 16 reportable event. If a duly appointed committee approves the grant, or the minimum six-month holding period is satisfied, the award should be exempt from Section 16(b) liability.

In the annual proxy, restricted stock awards will be disclosed as a dollar figure in the appropriate disclosure tables, calculated as the grant date fair value of the award, as determined pursuant to FAS 123R for financial statement reporting purposes. In addition, the number of shares made subject to the award and any other material details regarding the award (including whether dividends will be paid in respect of the award) will also be disclosed in supplemental tables and in the narrative disclosure that accompanies these tables. Restricted stock is considered beneficially owned by the recipient for purposes of Item 403 of Reg. S-K.

(vi) *Par Value*. Under Delaware General Corporation Law, recipients of stock awards must pay at least par value for their stock awards. With appropriate documentation and corporate authorizations, it is permissible to provide for the payment of the par value either in cash or past services rendered. Specifically, in granting a restricted stock award, the board of directors should make clear in the resolutions authorizing the award whether past services are being used to cover the par value obligation. The award agreements should also clearly address the recipient's obligations with respect to payment of par value.

B. RSUs

(i) *Description of the Award*. An RSU award is a contractual right to receive a specified number of shares of the common stock of a company (or an equivalent settlement in cash), without any payment by the recipient (other than payment of the par value, if required by applicable law). The award is reflected in a restricted stock unit award agreement, which contains the material terms of the award, which both the company and the recipient sign. No shares are issued until the later of vesting or a deferred delivery date; instead, a company makes a bookkeeping entry reflecting the shares subject to the RSU award, and shares made subject to RSUs are counted against the authorized share pool when granted. If and when an RSU award is forfeited, shares that were never delivered to the award holder will be added back to the share pool.

These rights are generally subject to time-based or performance-based vesting, and may contain a deferral feature to delay the issuance of the shares beyond the vesting date. If an RSU award is subject to time-based vesting, then upon the termination of the recipient's continued service, the company has no obligation to issue any shares in respect of the unvested portion of the award. As no unvested shares are delivered to the award recipient, the bookkeeping entry is reversed and there is no repurchase or reacquisition process.

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deferred, or if later, when not subject to a substantial risk of forfeiture, and (iii) the amount required to be included in income would be subject to an additional 20% tax.

If the RSU award permits or requires a deferral of the issuance of vested shares, the promise to deliver the stock subject to the award will constitute a deferred compensation arrangement under Section 409A of the Code, unless the deferral does not extend beyond 2½ months after the end of the calendar year in which the RSU vests (or, if later, 2½ months after the end of the fiscal year of the employer in which the RSU vests). This 2½ month period is referred to as the "short-term deferral" exception for Section 409A.

If the short-term deferral exception is not available, and if the RSU recipient is required, or has elected, to defer receipt of the shares beyond the vesting date, then delivery of the shares must comply with requirements of Section 409A, including requirements as to the timing of the deferral election and the ultimate distribution of the shares. First, under the final regulations for Section 409A, if the short-term deferral exception is not available, the recipient's deferral election must occur within 30 days after the date of grant of the RSU, and may only be made if the RSU will not vest in whole or in part for at least 12 months after the election date. If some part of the RSU will vest within 12 months after the date of the participant's deferral election, any election to defer delivery of the shares must have been made prior to the beginning of the taxable year in which the grant was made. Once the deferral election is made, there are significant limitations on the ability to subsequently revise the election. Second, the deferral issuance date must occur at a time (or times) fixed in the award agreement, or upon certain events (such as a qualifying change of control or in connection with a termination of service) as are permitted under the provisions of Section 409A of the Code[5]. Care should be taken in crafting these deferral and distribution provisions, as recipients who hold awards that do not meet the new Section 409A requirements are subject to significant taxes and penalties[6].

As the recipient of an RSU award has not been issued the shares subject to his or her award prior to vesting (or later, if subject to a deferral feature), he or she is not the holder of record with respect to the shares that are subject to the RSU ***until such shares are vested and issued***. As a result, he or she is typically not entitled to exercise any of the rights of an ordinary shareholder (such as voting rights) with respect to those shares. However, some companies expressly provide for the right of an RSU-holder to be credited with dividends paid in respect of the unvested and unissued shares subject to the award (with such dividends subject to vesting or escrow conditions). These "dividend equivalents" are noted in the bookkeeping account for the recipient, and typically are "reinvested" into additional RSUs (subject to the same terms and conditions, including vesting) as the original RSU award.

(ii) *Tax Liability*. In general, the recipient of an RSU that is not subject to a deferral feature will recognize ordinary income at the time the shares subject to the award vest (and therefore are issued) – just like with awards of restricted stock. The amount of income recognized is equal to the excess of the fair market value of the stock on the date of issuance over the price paid, if any, to acquire the shares. Upon a subsequent sale of the shares, the recipient will recognize a capital gain or loss equal to the difference between the sale price and the amount of ordinary income recognized at vesting. Such capital gain or loss will be long-term or short-term depending on whether the stock is held from the vesting date for more than one year.

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[5] Note that issuance in connection with a termination of employment may need to be delayed by 6 months if the director is a "specified employee" of the company, as defined in Section 409A.

[6] See Footnote (2).

However, if an RSU award is subject to a properly designed deferral feature, the recipient will recognize ordinary income ***at the time the shares*** of restricted stock subject to the award ***are issued*** in an amount equal to the excess of the fair market value of the stock on the date of issuance over the price paid, if any, to acquire the shares. Upon a subsequent sale of the shares, the recipient will recognize a capital gain or loss equal to the difference between the sale price and the amount of ordinary income recognized at issuance. Such capital gain or loss will be long-term or short-term depending on whether the stock is held ***from the date of issuance*** for more than one year.

(iii) *Withholding*. The company will be required to withhold applicable income and employment taxes on the ordinary income recognized at the time such income is recognized (i.e., at the later of vesting or issuance)[7]. This withholding obligation is usually satisfied by the same methods as described above with respect to restricted stock. As noted above, RSU awards have the advantage over restricted stock awards in that RSUs can be structured to provide for the deferral of the delivery of the shares subject to the award if the vesting event will occur during a black-out or closed trading window. In this way, the individual can delay the taxable event until the issuance of the shares, so that he or she may freely sell the shares when issued in order to cover the withholding obligation.

(iv) *Shareholder Approval*. Nasdaq has issued guidance that RSUs are substantially equivalent to awards of restricted stock. As a result, the amendment of a stock plan that currently permits awards of restricted stock to now provide for the award of RSUs should not require additional shareholder approval.

(v) *Securities Law Compliance & Disclosures*. A Form 4 must be filed at the time the award is granted; neither vesting nor delivery triggers additional filing obligations (unless the RSU award is settled in cash, in which case settlement triggers additional reporting). If a duly appointed committee approves the grant, or the minimum six-month holding period is satisfied, the award should be exempt from Section 16(b) liability.

As with restricted stock awards, RSUs will be disclosed as a dollar figure in the annual proxy statement in the appropriate disclosure tables, with the figure calculated as the grant date fair value of the award, as determined pursuant to FAS 123R for financial statement reporting purposes. In addition, the number of shares underlying the RSU award and any other material details regarding the award (including whether dividends will be paid in respect of the award) will also be disclosed in supplemental tables and in the narrative disclosure that accompanies these tables. Unlike restricted stock, shares subject to RSUs are generally not considered beneficially owned by the recipient for purposes of Item 403 of Reg. S-K.

(vi) *Accounting*. Generally, under FAS 123R, for RSU awards that are subject to time-based vesting, the discount to current fair market value on the date of grant will result in a compensation charge to earnings over the vesting period. An additional charge to earnings may apply with respect to dividend equivalents.

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[7] Note that although RSUs are not subject to income tax until the underlying shares are issued, RSUs are subject to FICA (including the Medicare tax) and FUTA upon vesting. See IRC §3121(v)(2) and Treasury Regulation §31.3121(v)(2)-1(a)(2).

(vii) *Par Value*. As with restricted stock awards, the recipient will need to pay the par value of the shares, to the extent required by law, at the time the shares are issued. The award agreement should clearly address the recipient's obligations with respect to payment of par value.

3. TRENDS AND RECOMMENDATIONS

Both restricted stock awards and RSUs provide real value to the recipient, regardless of whether the value of a company's shares rise during the performance period. With both types of awards, the number of shares subject to these "full value" awards tends to be smaller than with stock option awards, which has the benefit of reducing the dilutive effect of operating a compensatory stock plan. Historically, companies that used full value awards as part of the compensation for directors preferred restricted stock over RSUs, due in part to the perception that restricted stock awards were easier than RSUs to communicate and to administer.

While the use of RSUs as a form of director compensation is still less prevalent than the use of restricted stock, RSUs are gaining popularity among public companies. In a survey that was conducted this spring by Equilar, Inc., a compensation research firm, of the director compensation practices of each of the companies in the S+P 500, it was found that the use of RSUs as part of the mix of director compensation increased from 25% to 35% of all S+P 500 companies, whereas the use of restricted stock stayed relatively steady (growing from approximately 38% to 41% of all S+P 500 companies). The increasing attractiveness of RSUs may be attributed to the flexibility in the deferral of taxation and therefore the potential to avoid or minimize the possibility of certain adverse securities law and corporate governance consequences, as noted above. In addition, award recipients and plan administrators are now better understanding the operation of RSU awards, including the operation of the deferral mechanisms and the ability to credit dividends to the underlying shares. While RSU recipients do not have the voting rights that holders of unvested restricted stock awards would have, the RSU holder is in the same position as the holder of an unvested or unexercised stock option. Note that any newly implemented RSU program should maintain flexibility to address any issues that arise in the issuance of the final regulations under Section 409A of the Code.

CIRCULAR 230 DISCLAIMER

The forgoing tax advice was not intended or written to be used by you for the purpose of avoiding tax penalties that may be imposed on you. Under the Internal Revenue Service's Circular 230, formal legal opinions meeting certain standards are necessary to avoid tax penalties.

Exhibit A

	Restricted Stock	Restricted Stock Units
Concept:	Shares of stock, subject to a substantial risk of forfeiture and to restrictions on transferability, are issued at the time of grant, typically without cost to the recipient (other than payment of the par value).	Units, not representing an actual ownership interest, are granted, representing a right to receive a specified number of shares of stock, subject to forfeiture conditions designed to mimic the treatment of restricted stock. Upon vesting, or a qualifying deferred delivery date, shares are typically issued without cost to the recipient (other than payment of the par value).
General Characteristics:	Unvested shares are subject to legends detailing vesting/transfer restrictions. Shares are often held by the company in escrow. Restrictive legends are removed, and shares are transferred, when the restrictions lapse. Restricted stockholder has ownership rights, including dividend and voting rights, during the period of restriction. Dividends accrue on vested and unvested shares and are either paid currently or reinvested in shares of restricted stock (dividends on unvested shares are generally held in escrow).	Instead of issuing unvested shares, a bookkeeping account is created for each holder of RSUs. RSUs do not have ownership rights, including dividend and voting rights, prior to issuance. Dividend equivalents may be paid on vested and unvested RSUs, with such equivalents credited to the account and generally reinvested into additional RSUs.
Share Counting:	Shares are counted against the authorized share pool when granted.	RSUs are counted against the authorized share pool when granted.
Federal Tax Considerations — Individual:	Generally not subject to §409A. No taxable income on the date of grant if the stock is subject to vesting or transfer restrictions, assuming no Section 83(b) election was made. Ordinary income recognized on the earlier of the shares becoming transferable or vested, in an amount equal to the spread between the fair market value on such date and the price paid for the shares (if any). Dividends received during the restriction period are taxed as wages (ordinary income) when received.	Not subject to §409A if award satisfies the short term deferral rules. No taxable income on the date of grant. Section 83(b) elections not applicable. Ordinary income recognized on the later of vesting or issuance (if deferral is compliant with Section 409A), in an amount equal to the spread between the fair market value on such date and the price paid for the shares (if any). Dividend equivalents received during the restriction period are taxed as wages (ordinary income) when received (which may be after the dividend payment date).

	Restricted Stock	Restricted Stock Units
Withholding Obligation:	Arises upon vesting. It may be difficult under Section 409A to delay vesting in the event of a black-out or closed trading window.	Arises upon the later of vesting or delivery (although FICA & FUTA obligation arises upon vesting). Delivery of shares may be deferred in the event of a black-out or closed trading window.
Federal Income Tax Considerations—Company:	Tax deduction in the same amount and at the same time as the individual recognizes ordinary income. For executive officers subject to the $1 million deduction limitation under Code Section 162(m)[8], deductibility of restricted stock may be limited or eliminated.	Tax deduction in the same amount and at the same time as the individual recognizes ordinary income. For executive officers subject to the $1 million deduction limitation under Code Section 162(m), deductibility of RSUs may be limited or eliminated.
Securities Law Compliance & Disclosures:	A Form 4 must be filed at the time the award is granted; vesting does not trigger additional filing obligations. If a duly appointed committee approves the grant, or the minimum six-month holding period is satisfied, the award is exempt from Section 16(b) liability. Value and size of award disclosed in proxy based on FAS 123R measurement. Restricted stock is considered beneficially owned for outside directors named executive officers and for all executive officers as a group.	A Form 4 must be filed at the time the award is granting; neither vesting nor delivery triggers additional filing obligations (unless settled in cash). If a duly appointed committee approves the grant, or the minimum six-month holding period is satisfied, the award is exempt from Section 16(b) liability. Value and size of award disclosed in proxy based on FAS 123R measurement. Shares subject to RSUs are not considered beneficially owned for outside directors named executive officers and for all executive officers as a group.

[8] Internal Revenue Code §162(m) denies a business expense deduction to any publicly held corporation to the extent that compensation paid to any of the executive officers named in the summary compensation table (generally the CEO and the four other highest paid executive officers) exceeds $1 million, unless the compensation qualifies as "performance-based." Given the more favorable accounting treatment for performance-based equity awards under FAS 123R (as compared with the predecessor rules in APB 25), it is increasingly common for restricted stock awards and RSUs to be granted subject to performance-based vesting and under a plan that will qualify such awards as performance-based compensation and thus deductible without regard to this Code limitation.

Plan Amendment Required:	No.	Yes, but would not require additional shareholder approval.
Accounting:	Generally, under FAS 123R, for restricted stock awards that are subject to time-based vesting, the discount to current fair market value on the date of grant will result in a compensation charge to earnings over the vesting period.	Generally, under FAS 123R, for RSU awards that are subject to time-based vesting, the discount to current fair market value on the date of grant will result in a compensation charge to earnings over the vesting period. An additional charge to earnings may apply with respect to dividend equivalents.

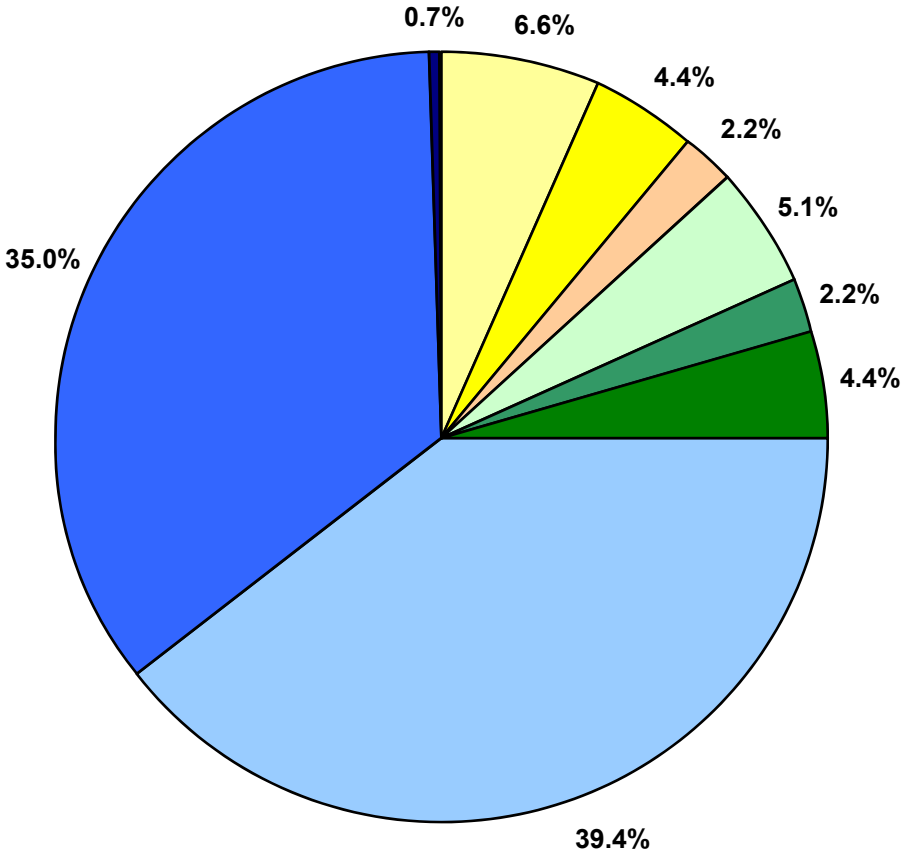
Appendix B

Unique Performance Equity Metrics

PERFORMANCE EQUITY

What is Performance Equity?

61.3 percent of S&P 500 companies award performance equity to their CEO. The following chart provides a breakdown of these awards:



Long-Term Incentive Plan Examples

- **STOCK**
  AT&T Inc. – DEF 14A filed on March 22, 2007

  The CEO, Edward E. Whitacre, Jr., received a target award of 866,453 restricted shares with a 3-year performance period focusing on return on invested capital and total shareholder return.

- **UNITS**
  Boston Scientific Corp. – DEF 14A filed on March 27, 2007

  The CEO, James R. Tobin, received a threshold award of 200,000 deferred stock units with a 4-year performance period, where performance is measured by reaching specific stock price targets. The earned units payout as shares at the end of the performance period.

- **OPTIONS**
  Transocean Inc. – DEF 14A filed on April 2, 2007

  The CEO, Robert L. Long, received a target award of 62,966 options that vest after a 2-year performance period determined by total shareholder return and cash flow return on capital ("unleveraged after-tax cash flow return on tangible capital"). One-third of the number of earned options vest on the date of the Committee meeting held after the end of the two-year performance period while the remainder vests in equal amounts at each of the first two anniversaries of that meeting.

Annual Incentive Plan Examples

- **STOCK**
  Corning Inc. – DEF 14A filed on March 13, 2007

  The CEO, Wendell P. Weeks, was granted a target award of 123,000 restricted shares with a one-year performance period based off the Company's adjusted earnings per share and operating cash flow levels. These shares, if earned, remain unvested for 2 additional years (beyond the original performance period).

- **UNITS**
  Eastman Kodak. – DEF 14A filed on March 30, 2007

  The CEO, Antonio M. Perez, was granted a target award of 31,875 restricted stock units with a one-year performance period based off the Company's digital operating margin ("a percentage obtained by dividing "digital earnings from operations" by "digital revenue"). Earned units would payout as shares of stock. The shares, if earned, remain unvested for 1 an additional year (beyond the original performance period).

- **OPTIONS**
  Alcoa Inc. – DEF 14A filed on February 26, 2007

  The CEO, Alain J. P. Belda, received a target award of 327,464 options which are based off a 1-year performance period looking at return on capital.

Performance Grant Examples

- **STOCK**
  PG&E Corp. – DEF 14A filed on March 13, 2007

  The CEO, Peter A. Darbee, received an award of 48,705 restricted shares with a 5-year vesting period, which can accelerate to 3-years if the Company's TSR ranks in the top quartile of their peer group.

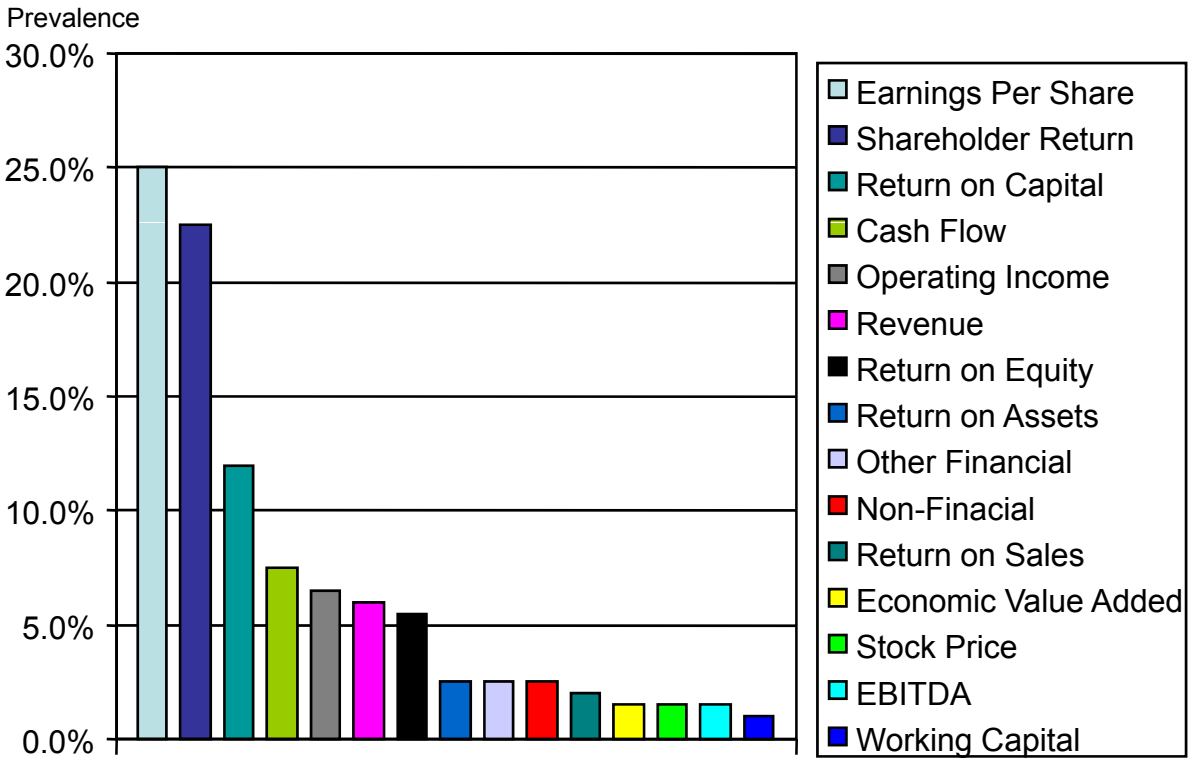
- **UNITS**
  Avon Products Inc. – DEF 14A filed on March 23, 2007

  The CEO, Andrea Jung, received an award of 90,604 restricted stock units that will vest 3-years after grant subject to the satisfaction of cumulative revenue and operating profit measures. This award is paid out in shares after 3 years.

- **OPTIONS**
  Hartford Financial Services Group Inc. – DEF 14A filed on April 2, 2007

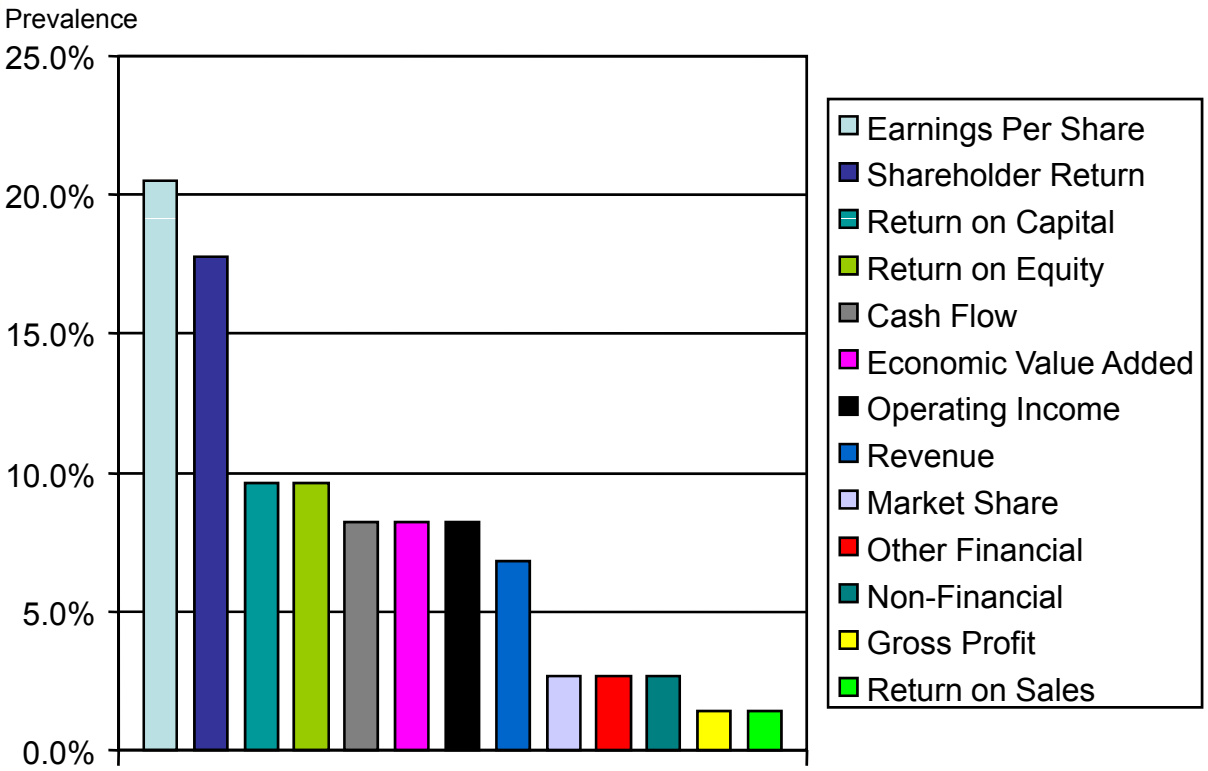
  The CEO, Ramani Ayer, received an award of 71,750 options that can vest in 3-years if certain stock price performance targets are achieved–namely when the closing price of the underlying stock equals or exceeds 125% of the option exercise price.

Prevalence of Performance Equity Metrics



- Among all metrics cited for performance equity awards, EPS, TSR, ROC/ROIC, Cash Flow, and Operating Income appeared most frequently.
- Performance equity awards had an average of 1.7 performance measures.

Prevalence of Long-Term Cash Metrics



- Among all metrics cited for long-term cash awards, EPS, TSR, ROC/ROIC, ROE, and Cash Flow appeared most frequently.
- Long-term cash awards had an average of 1.8 performance measures.

Relative Benchmarks Example

Dupont E I De Nemours – DEF 14A filed on April 2, 2007:

- The PSU program ensures both stockholder alignment and focus on business priorities, by clearly communicating what is most important in driving business performance and ultimately creating stockholder value. The Company believes a PSU program focusing on revenue growth and ROIC creates specific alignment with objectives for balanced growth, profitability and capital management. **Given the longer-term nature of DuPont's goals and the limitations inherent in setting targets into the future, the Company measures results against the Peer Group (as defined on page 20).**

- At the conclusion of the performance cycle, payouts can range from 0% to 200% of the target grant based on pre-established, performance-based corporate objectives in both **revenue growth and ROIC versus the Peer Group over the three-year performance period**. Potential payout scenarios are presented in the table below.

		DuPont Annualized Revenue Growth vs. Peers				
		< 25th Percentile	25th to 40th Percentile	40th to 60th Percentile	60th to 75th Percentile	> 75th Percentile
DuPont ROIC Vs. Peers	> 75th Percentile	50%	90%	135%	165%	200%
	60th to 75th Percentile	0%	65%	110%	135%	165%
	40th to 60th Percentile	0%	40%	90%	110%	135%
	25th to 40th Percentile	0%	25%	40%	65%	90%
	< 25th Percentile	0%	0%	0%	0%	0%

TREATMENT OF EQUITY

F100: CEO Treatment of Equity

CEO Acceleration	Options Severance	Stock Severance	Options Change-In-Control	Stock Change-In-Control
Full	**35.9%**	**40.0%**	**79.1%**	**88.1%**
Partial	23.1%	22.5%	7.5%	9.0%
Continued Vest	10.3%	12.5%	-	-
Forfeited	20.5%	20.0%	-	-
Not Disclosed	10.3%	5.0%	13.4%	2.9%

Source: Equilar, Inc.

- For CEOs with agreements or incentive plans that discuss the treatment of equity upon termination, full acceleration of stock and option awards is the most prevalent outcome in both severance and CIC scenarios.

- In CIC scenarios, no CEOs are required to forfeit stock or option awards.

CLAWBACKS

F100: Clawbacks on the Rise

- In 2007, 42.1 percent of Fortune 100 companies disclosed a clawback policy in their proxy; up from 17.6 percent of companies in 2006.

- In addition, five Fortune 100 proxies included shareholder proposals seeking the adoption of a clawback policy.

F100: Recent Clawback Adopters

- The following companies adopted or amended their clawback policies in 2006 or 2007:

Calendar 2006	Calendar 2007
Alcoa	Comcast
Boeing	Intel
Caterpillar	Time Warner
General Motors	UnitedHealth
JP Morgan	Verizon
Johnson & Johnson	
Sprint	
United Parcel Service	
Washington Mutual	

Time Warner Inc. (Restatement-Based Policy)

- "In February 2007, the Board of Directors adopted a policy regarding the recovery of executive compensation under certain circumstances. This policy reinforces the Company's commitment to the Standards of Business Conduct, which each employee is expected to follow, and furthers the concept of performance-based compensation as part of the compensation philosophy.

  Under the policy, if the Board of Directors determines that an executive officer or a Division CEO intentionally caused a material financial misstatement, which resulted in artificially inflated executive compensation, the Board will determine the appropriate actions to take to remedy the misconduct, prevent its recurrence and to take action with respect to the executive."

Sunoco Inc. (SOX Section 304)

- "The Company does not have a "clawback" policy. If the Company is required to restate its earnings as a result of noncompliance with a financial reporting requirement due to misconduct, under Section 304 of the Sarbanes-Oxley Act of 2002 ("SOX"), the CEO and the Chief Financial Officer ("CFO") would have to reimburse the Company for any bonus or other incentive-based or equity-based compensation received by them from the Company during the 12-month period following the first filing with the SEC of the financial document that embodied the financial reporting requirement, and any profits realized from the sale of Sunoco stock during that 12-month period, to the extent required by SOX."

Appendix C

Fundamentals of Stock Option Backdating

(From materials for the "Keeping Up With the Joneses" session at the NASPP 2006 National Conference, October 11, 2006)

I. Introduction

According to recent statistics, more than 120 companies have announced investigations into, or confirmation of, deficiencies with their option granting practices and at least 40 public company executives have been fired or have resigned as a result of option granting issues. In addition, the Securities and Exchange Commission and the United States Department of Justice are conducting or have conducted at least 50 investigations into such matters. Recent developments demonstrate that these problems continue to escalate and foreshadow additional waves of option-related problems for companies beyond those currently under scrutiny.

For virtually any public company that has used stock options as a significant part of its incentive and compensation programs over the last decade, even if not yet involved in an investigation, the increasing media coverage is prompting inquiries from analysts, investors, board members, auditors and government agencies. The stakes are very high as deficient or improper stock option practices can cascade into restatements, tax liability, breach of contract or claims in equity by optionees, SEC enforcement and securities class actions, as well as possible criminal exposure. In addition, under the new compensation disclosure rules that became effective for the 2007 proxy season, public companies have had to explain their option granting practices in the new CD&A and disclose specific information about pricing and timing issues for stock options granted to named executive officers in 2006.

Private companies should not imagine they are sheltered from this storm. Any private company contemplating a financing, an acquisition by a public company or an initial public offering will face scrutiny and possibly may be asked to make representations regarding its option granting practices. Fear that the SEC will force a company to take a "cheap stock" charge as part of the IPO process is now the least of a private company's worries, as private companies with equity compensation programs now face increasing scrutiny from investors, potential acquisition partners and regulators and risk potential tax liability, securities law violations, claims by optionees and employee morale issues.

All companies with equity compensation programs should examine their practices for granting and modifying equity award, including with respect to both currently outstanding awards and any other awards reflected in previously filed financial statements. If a company's internal investigation uncovers any of these practices, the next step is to quantify the potential magnitude of any issues by analyzing the numbers of shares involved and the potential accounting charge and other potential liability involved with the grants or modifications.

II. What Does "Option Backdating" Mean?

While some of the most glaring cases under investigation involved clear wrongdoing — like actual fraudulent stock option backdating and falsifying documents — many involve practices that were widely considered acceptable and may not, in and of themselves, be illegal, but that are now coming under increased scrutiny.

A. Backdating

1. Definition

Plain and simple, "backdating" means deliberately selecting a grant date earlier than the date the stock option grant was actually approved for the purpose of using the lower stock price on that earlier date for the stock option exercise price.

2. How to Identify Backdating

As a first step to check for backdating, run an analysis that compares purported stock option grant dates to historical stock prices. If grant dates generally occur at historically low stock prices, this may indicate a backdating issue. This is the evaluation method used in a May 2005 paper for Management Science by Professor Erik Lie of the University of Iowa cited in *The Wall Street Journal*'s March 18, 2006 article, "The Perfect Payday." Companies should assume that plaintiffs' lawyers and others looking at these issues, like the SEC, analysts and institutional investors, will perform this analysis.

B. Misdating

1. Definition

What some might chalk up to a lack of attention to details, "misdating" means documenting stock options with grant dates that are different than the date the stock options were actually approved, but inadvertently, rather than intentionally, likely the result of poor administrative procedures and controls.

2. How to Identify Misdating

To check for misdating, compare: (1) grant dates contained in actual stock option agreements; (2) grant dates shown in the company's stock option records; and (3) evidence demonstrating the date on which the stock option grants were actually approved (which could include board or committee meeting minutes and any revisions thereto, contemporaneous email or fax records for written consents or officer approval under delegated authority). Pay particular attention to the effective dates of unanimous written consents as compared to the purported grant dates and the dates the directors actually signed the consents.

C. Spring-loading

1. Definition

A potentially less-innocent practice, "spring-loading" refers to intentionally granting stock options before announcing good news to take advantage of the relatively lower stock price before the expected stock price increase when the good news is announced.

2. How to Identify Spring-loading

As a first step to identify spring-loading, review the dates for historical stock option grants, including "mass grants" (grants to many employees on a single date) or grants involving a large number of shares to one or a small number of executives, especially those that occurred on different days year-to-year. Also perform analysis suggested above for "backdating" and compare the stock prices on grant dates to prices shortly after these dates. If stock prices typically increase following grant dates, review announcements made shortly after grant dates and any documents that shed light on how and why timing occurred.

D. Bullet-dodging

1. Definition

Similar to "spring-loading," "bullet-dodging" means intentionally delaying granting stock options until after the announcement of bad news to take advantage of the relatively lower stock price after the expected stock price decrease when the bad news is announced.

2. How to Identify Bullet-dodging

As a first step to identify bullet-dodging, perform same review and analysis suggested above for "spring-loading." If stock prices typically decline before grant dates, review announcements made shortly before grant dates and any documents that shed light on how and why timing occurred.

E. Forward-dating

1. Definition

A not uncommon practice, "forward-dating" means approving stock option awards with grant dates after the approval date. Forward-dating may be practiced to attempt to secure an anticipated lower price in the future, or may be intended to achieve other, less-suspect aims (e.g., commencement of employment after the date of board action or after a planned earnings release).

2. How to Identify Forward-dating

To identify forward-dating, perform same review and analysis suggested above for "spring-loading." If stock prices typically decline before grant dates, review announcements made

shortly before grant dates and any documents that shed light on how and why timing occurred.

F. 30-day Pricing

1. Definition

A practice that caused difficulties for Microsoft just a few years ago, "30-day pricing" can refer to either (1) using a trailing 30-day average to determine the fair market value when the stock plan called for the use of a specific measurement date or (2) picking the best price in a prior 30-day window. The latter practice was used by Microsoft in the 1990s, and was widely adopted by others.

2. How to Identify 30-day Pricing

To identify 30-day pricing, review the terms of the stock plan for the official procedure for determining strike prices, and run an analysis that compares stock option grant dates to historical stock prices. If the strike price does not match the appropriate historical data called for under the terms of the plan, this may indicate a 30-day pricing issue.

G. Anything Else?

In addition to the specific practices outlined above that could result in stock options being granted with a discounted exercise price, other stock option granting practices could result in the stock options having been granted on a contingent basis, or without a fixed number of shares or exercise price. As investigations continue, we expect that other euphemisms for problematic stock option practices will make their way into our vocabulary.

II. Other Practices to Look For . . . and Avoid

In the current environment, some of the practices that were not traditionally viewed as problematic are now coming under scrutiny. While the SEC and/or auditors may ultimately agree that these practices were okay, companies should review and document both their historical and current stock option granting practices now. The practices outlined in this section are common, but potentially problematic.

A. Approving Grants by Written Consent

Stock option grants approved by written consent may involve stock option issues where the written consent was signed by one or more of the directors on a date other than the grant date. While a consent signed *after* the purported grant date raises more serious questions regarding equity compensation internal controls, even a consent signed before the purported grant date could cause problems if it does not identify the later grant date or an event (like a new hire start date) that matches the purported grant date.

B. Inconsistent or Manipulative New Hire or Promotion Grant Practices

Stock options granted to new hires, or in connection with promotions, raise potential issues when the grant date differs from the date on which the new hire commenced employment, or the promotion became effective — especially where the stock price on the grant date is lower, or where the company's practices for new hire and/or promotion stock option grants are inconsistent.

C. Approving Grants of Unallocated Shares

"Mass" or "block" grants refer to grants, for example, a board or committee approved stock option grants for a total "bulk" number of shares, but did not approve the specific allocation to individual employees, and then the CEO or other executive officer allocated the shares among individual employees on a later date or dates, but used the date of the board or committee approval as the "grant date." This practice generally raises internal controls issues, but may also raise backdating issues where the stock price is lower on the "grant date" than on the later date when the shares are allocated.

D. Modifying Allocations

This refers to the situation where the board or committee approved a block of grants, with allocations of a fixed number of shares specified among employees, but the actual award documentation deviates from the allocation specified with respect to the number of shares allocated to a given individual, but uses the approval date as the "grant date." The discrepancy may indicate that the grants were not properly approved, and may also raise backdating issues.

E. Modifying Outstanding Options

Amending outstanding stock options, for example to change the vesting schedule or extend the post-termination exercise period, can also be problematic where the modification is not treated appropriately, or where required approval is not obtained and/or documented.

III. What Problems Flow From Backdating?

Stock option practices that caused stock options to be granted with an exercise price lower than the fair value of the underlying stock on the actual grant date, or that caused stock options to be granted on a contingent basis, or without a fixed number of shares or exercise price, for example, can lead to financial statement restatements, tax liability, breach of contract claims or claims in equity by optionees, SEC enforcement and securities class actions, as well as possible criminal exposure. In addition, under the new compensation disclosure rules that will be effective for 2006 disclosure, public companies will generally have to explain their option granting practices in the new CD&A and disclose specific information about pricing and timing issues for stock options granted to named executive officers in 2006.

A. Accounting Issues

1. Basic Rules

Under APB 25 (which governed accounting treatment of stock options before the recently adopted FAS 123R), any stock option granted with an exercise price lower than the stock price on the actual grant date (including through backdating, misdating or 30-day pricing, for example) triggered a one-time compensation expense on the grant date equal to the spread multiplied by the number of shares subject to the option. In addition, if a company inadvertently granted stock options that did not qualify for "fixed" accounting treatment under APB 25 (for example, where stock options were effectively granted, and then treated as not granted until a later date to take advantage of a drop in stock price, which in effect "repriced" the stock options), then those stock options required variable accounting treatment under APB 25, which requires that the company remeasure the value of stock options at the end of each quarter while the stock options remain outstanding and recognize any incremental increase in value. If these unrecognized charges turn out to be material to a company's financial statements for the periods in which the options were granted, the company may need to restate its financial statements for each period affected by the charges.

2. Applying the Rules

One of the threshold accounting issues that companies need to determine is when the grants were actually made. If backdating issues are suspected, auditors are likely to scrutinize the grant dates of each award made during the period at issue, and will not simply take as fact the dates on the option paperwork or the "effective as of" date of the board consent. Questions arise if unanimous written consents were signed at various times (or some signatures can't be located!), if board members made notes in the margins of consents altering terms, or if the number of shares actually granted differs from the number in the exhibit to the board resolutions. In addition, grant dates for tax purposes may differ from grant dates for accounting purposes.

3. Time Consuming Process

Given the sheer amount of information that must be gathered, reviewed and approved by company executives, lawyer and auditors, it is not surprising that restating the financials to address option dating issues can take months. For companies who discover option dating irregularities only as they prepare their financial statements in the weeks before a public reporting event, delisting is a real concern. Which brings us to the next issue—securities law.

B. Securities Issues

1. Internal Controls

Stock option practices issues (including any and all of those described above) can implicate the adequacy of a company's internal control over financial reporting and disclosure controls and procedures, as well as the CEO and CFO certifications of these controls and the information reported in the company's periodic reports. They also raise issues regarding the

company's disclosures to its auditors and could trigger potential CEO and CFO disgorgement of compensation if the company's financial statements are restated and the misstatements are due to "misconduct" (see the discussion below on "clawbacks" for more information).

2. Public Disclosures

If a company's plan prohibits discounted stock options, and the company concludes that it must treat the discounted stock options as having been granted outside of its plan(s), then the company should have described the material terms of these stock options as part of its equity compensation plan disclosure under Regulation S-K Item 201(d) and filed a copies of them with its periodic reports.

In addition, the company's public disclosures relating to its stock options and stock option practices may have been materially inaccurate or misleading, as may be the reports filed by the insiders to report these stock option grants.

Furthermore, under the SEC's new compensation disclosure rules, companies are required to disclose in the new CD&A section their stock option granting practices. Disclosure should include the reasons why a company selects particular grant dates and strike price measurement dates for stock awards, if and how grant dates are coordinated with the release of information to the public, whether the board takes into account the potential release of information in determining the terms of the grants, and how these practices relate to the company's business purposes.

3. CEO and CFO Certification of Periodic Reports

The most immediate procedural question for public company executives — and especially for the CEO and CFO who certify the company's SEC filings — is confirming that the financial information to be included in its upcoming quarterly report on Form 10-Q is accurate in all material respects. Even if executives are confident that there are no issues with stock options granted during the current quarter, problems with earlier grants that would trigger restatement of prior period financial statements could also affect the current quarter's financial statements.

Companies under investigation for stock option practices issues, or who are conducting an internal evaluation (like Apple Computer), may conclude that they have problems significant enough to mandate delaying filing their upcoming SEC reports until they can correct the financial statements to be included in them, or until they can assure the CEO and CFO that no material changes are needed. Companies who have not yet completed their internal evaluation of stock option practices should contact outside counsel regarding evaluation and whether they should consider delaying filing their upcoming SEC reports.

Sample language:

Consider Modifying Sub-Certification to CEO and CFO Certification for Upcoming SEC Reports. Companies who have not completed their internal investigations or otherwise have not yet finished addressing stock option practices issues should consider modifying the sub-certification forms that support the CEO and CFO certifications filed with the SEC to cover stock option practices issues.

For example, companies could add to sub-certification forms language like the following: "To my knowledge, there have not been any irregularities in the company's stock option practices, and (a) all stock options were granted on the dates indicated in the stock option documentation; (b) no stock option grants were backdated or misdated; and (c) no stock option grants were timed to take advantage of pending announcements, either favorable or unfavorable."

4. Form S-8 Registration Statements

If stock options are viewed as having been granted outside of a company's plan, they may not be covered by any Form S-8 registration statement, and any exercise and sale would have to comply with an exemption from the registration requirement. In addition, Form S-8 (and other) registration statements may not be available during periods when the company has announced that investors should not rely on the company's previously reported financial results. Public companies must decide how to treat awards that are likely to expire (e.g. upon termination of employment) and public companies must determine how to administer their Section 423 ESPP while the Form S-8 registration statement has been taken down due to option backdating issues.

C. Tax Issues

1. Section 162(m)

Stock options that turn out not to have been granted with exercise prices greater than or equal to the underlying stock's grant date fair market value (including through the methods described above) may not qualify for the performance-based exception to the $1 million limit on deductible compensation under Section 162(m) of the Internal Revenue Code. Depending upon the specific facts, the IRS could disallow deductions taken in the past with respect to discounted options exercised by named executive officers and may prohibit deductions expected to be taken in the future.

2. Section 409A

To the extent that any stock options that turn out not to have been granted with exercise prices greater than or equal to the underlying stock's grant date fair market value (including through the methods described above) were not fully vested before January 1, 2005, or to the extent that vested options were materially modified after October 4, 2004, Section 409A of the Internal Revenue Code will apply to that portion of the option. Unless these options are appropriately amended to comply with Section 409A, each option holder will face significant

adverse federal income tax consequences, including a 20% additional tax, and the company will likewise be required to report income and withhold for tax withholding obligations.

3. Section 422

Stock options designated as "incentive stock options" that were actually granted with discounted exercise prices may need to be treated as nonqualified stock options if the company cannot demonstrate that the exercise prices were greater than or equal to the underlying stock's grant date fair market value based on a "good faith" valuation of the stock per the ISO rules. The ISO/NSO status of these options affects the tax treatment to the company and to the option holder at exercise, and recharacterizing the options could raise issues regarding tax withholding violations if and when these options were exercised, miscalculation by the option holder of his or her "alternative minimum tax" liability and corporate tax deductions for prior years that the company did not take. Correcting tax treatment issues becomes complicated with respect to options exercised by former employees who have little incentive to work with the company to correct withholding issues.

D. Authorization Issues

Many stock option plans provide that the per share exercise price of an option must be at least 100% the fair market value of a share of stock on the date of grant. Stock options that turn out to be discounted may need to be treated as though they had been granted outside of the plan. Stock options not granted under a plan raise shareholder approval issues under stock exchange and ISO rules, state blue sky compliance issues and issues regarding the availability or validity to these stock options of the plan's Form S-8 registration statement, among other issues. In addition, some companies may not be able to demonstrate that they obtained necessary corporate approval for stock option grants, which may mean the options can't be treated as granted under the plan, were granted *ultra vires,* or are otherwise voidable. In this instance, employees may have legal claims based on detrimental reliance and apparent authority. The potential authorization issues, claims in equity and breach of contract claims will vary based on the terms of the plan, the specific option agreement and other option-related documentation (e.g., prospectuses) and the state in which the company is incorporated, as well as other relevant facts.

E. Other Issues

Problems regarding a company's stock option practices, whether intentional or inadvertent, raise questions about whether the company had (and has) appropriate corporate governance and procedures. If a company's plan prohibits discounted stock options, and the company concludes that it must treat the discounted stock options as having been granted outside of its plan(s), these grants likely violated the applicable stock exchange shareholder approval requirements and may constitute a listing violation that could jeopardize the company's listing. Option backdating issues adversely impact employee morale and give rise to retention issues. A company's insurance may not cover claims involving alleged stock option irregularities, including claims in connection with private securities litigation and costs related to governmental investigations.

IV. How Can You Fix Option Dating Irregularities?

Performing the analyses outlined above can help identify apparent problems related to timing issues — or suggest that no issues exist.

A. Even Identifying Potential Issues May Prove Challenging

Practical challenges to getting to the bottom of any potential issues include: (1) for clearly illegal practices, the people who were involved are not likely to come forward with evidence that implicates them and, if those people are no longer employees, current staff may not even be aware of the prior illegal acts; (2) for other practices under scrutiny, people may not be aware that the practice occurred or that such practice may present an issue today; and (3) documentation may be poor and may not reflect information now considered critical, such as the dates when actions were taken.

Appendix D

Chapter 14: 2006 Hot Topic: Option Backdating

The Stock Options Book

Eighth Edition

Alisa J. Baker

The National Center for Employee Ownership
Oakland, California

This publication is designed to provide accurate and authoritative information regarding the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

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CHAPTER 14

2006 Hot Topic: Option Backdating

Contents

In 2006, stock options had another moment in the sun as the *scandale du jour* when newspapers, commentators, and ultimately the government turned their attention to a suspicious trend among public companies: that of granting options (frequently to top executives) at the lowest fair market value available during any option granting cycle.[1]

1. The *Wall Street Journal* broke the story with its article "Perfect Payday," by Charles Forelle and James Bandler, on March 18, 2006. Other newspapers were quick to follow on. By mid-year, the option backdating scandal was a regular feature in the national press. See, e.g., Carolyn Said, "Options Scandal Grew out of 1990s Strategy," *San Francisco Chronicle,* July 30, 2006; Adam Lashinsky, "Why Options Backdating Is a Big Deal," *Fortune,* July 26, 2006; and David Leonhardt, "Turning Back The Clock On Backdating," *New York Times,* July 26, 2006.

Although company plans and SEC filings consistently represented that these options were granted at fair market value on the date of grant, a 2006 academic paper[2] questioned whether such disproportionately employee-favorable results could be reasonably expected to have occurred without manipulation of grant dates. As of November 3, 2006, the *Wall Street Journal* (which broke the story in early 2006) reported that more than 120 companies had been subject to option backdating investigations by internal audit committees and/or the SEC,[3] with more than 50 companies under investigation by the Department of Justice (DOJ) for possible criminal conduct. As a result, by late 2006 more than 40 executives had been fired or resigned in connection with option backdating, employee exercises under many stock plans had been suspended, and numerous shareholder derivative actions had been filed on this issue.[4]

As of November 2006, the end of this story is a long way from being written. In the meantime, anyone who works with or advises on equity compensation plans must understand the scope of the problem at hand. This chapter describes the different practices that have been grouped together as "option backdating"; reviews the securities law, tax, and corporate issues raised by the practice; suggests ways of dealing with prior backdating; and proposes best-practices procedures for avoiding the issue in the future.

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2. Randall Heron and Erik Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?" July 14, 2006, available at www.biz.uiowa.edu/faculty/elie/Grants%207-14-2006.pdf; and Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science*, May 2005, available from www.biz.uiowa.edu/faculty/elie/Grants-MS.pdf. Lie and Heron estimate that manipulations occurred in at least 30% of executive grants between 1996 and 2005.

3. See "Perfect Payday Options Scorecard," regularly updated by the *Wall Street Journal* with news and information on companies and executives under investigation, available online at online.wsj.com/public/resources/documents/info-optionsscore06-full.html.

4. Employee lawsuits were just beginning to emerge. See Kathleen Pender, "Hidden Victims of Stock Option Backdating," *San Francisco Chronicle*, October 26, 2006.

14.1 What Is Option Backdating?

The phrase "option backdating" has historically referred to the practice of representing that an option was granted at an earlier date than the actual date of grant so as to take advantage of the lower fair market value on that earlier date. In other words, the plan committee—either the board of directors or its compensation committee—would complete the action required to grant the option (e.g., the corporate resolution or unanimous written consent) on a later date than the fair market value date, but would knowingly date—and price—the option grant as of the earlier date when the fair market value was lower.

> **Example 1**: *Intentional Backdating*. Company's plan states that all options will be granted at fair market value determined as of the date of grant. In January, management recommends a list of employee options with a strike price of $10 per share, the fair market value on January 1. The compensation committee meets monthly on the 30th of each month. On January 30, when the fair market value is $12 per share, the committee approves the list of options with a unanimous written consent. The consent states that the approval is "as of" January 1, and the option grant date is stated as January 1, with a strike price of $10 per share.

Variations on intentional backdating may include: approval with the date left blank and filled in once the lowest price is ascertained; approval for a group of unallocated options that are treated as granted on the date of approval or the date of allocation, depending on when the share price is lower; or approval for new-hire grants on a date prior to the actual first date of employment.

Once option backdating became a topic of national interest, however, the definition of "backdating" was expanded to comprise a number of practices other than that in Example 1. Those practices—inadvertent backdating, grant timing techniques, and price averaging—are described below.

14.1.1 Inadvertent Backdating: Misdating and Sloppy Administration

Option backdating need not be intentional. In fact, many of the option backdating investigations have determined that sloppy administrative procedures frequently led to backdated grants that were neither intended

by, nor obvious to, the plan committee. Such procedures include waiting long periods between the date of approval and the date of documentation; mistakenly leaving eligible optionees off of the granting list but including them anyway when the approval and grants are papered; and getting approval at random times from a one-person plan administration committee.

> **Example 2**: *Inadvertent Misdating.* Company's plan states that all options will be granted at fair market value as of the date of grant. The plan committee is a single-member committee appointed by the board. Management provides the plan committee on January 15 with a written consent dated that day that lists optionees who started employment during the previous month. The fair market value on January 15 is $10 per share. The plan committee gets around to signing off on the list on February 1, when the fair market value is $12 per share, and returns the list to the plan administrator for documentation. The plan administrator, seeing that the consent was dated January 15, generates option documents with a January 15 date and a $10 per share strike price, even though the actual grant date was February 1.

14.1.2 Grant Timing: Spring-loading, Forward-dating, and Bullet-Dodging

Is every method of granting that is pegged to a low point on the trading cycle necessarily unlawful? In cases of "spring-loading," "forward-dating," and "bullet-dodging," the plan committee purposefully times option grants to points in the trading cycle when it assumes that the fair market value will be comparatively low. Spring-loading refers to granting options prior to the anticipated announcement of good news, while bullet-dodging is the reverse: granting options after the announcement of bad news. Forward-dating refers to approving an option in advance of its stated grant date, anticipating that the fair market value will have dropped as of that grant date. In each of these instances, the strike price is demonstrably the fair market value on the date of grant.

Whether or not this practice should be considered to be a form of intentional backdating under the final SEC rules on executive compensation and related-persons disclosure will certainly depend on the amount (and manner) in which it is disclosed.[5] Through the eyes of

5. See section 7.5 and SEC's Compensation Discussion and Analysis (CD&A) rules, which require disclosure of granting philosophy.

institutional investors (and from a shareholder relations perspective), these techniques may appear unduly generous to employees.[6] However prior to 2006, there was no requirement to disclose the philosophy underlying the plan committee's granting procedures. This means that there is no reason that grant-timing techniques in and of themselves—if observed consistently, documented properly, and (after 2006) disclosed to shareholders—should be considered to be on a par with intentional backdating.

> **Example 3**: *Grant Timing*. Company's plan states that all options will be granted at fair market value as of the date of grant. Management annually recommends performance grants for all employees in September, prior to the announcement of Q3 earnings, when trading in company's stock is historically at its calendar year low. On September 15, when the fair market value of the stock is $10 per share, the plan committee approves the grants. On October 15, Q3 earnings are released and the stock price rises to $15 per share. There is no question that $10 per share was the fair market value on the date of grant and that the plan committee approval (and all option grants) were properly documented.

14.1.3 Price Averaging: 30-Day Pricing

In the 1990s, Microsoft adopted the practice of granting options at a fair market value formula determined by looking back over a 30-day window period, selecting the lowest fair market value during the window, and using that value as the strike price for all options granted during the window. Although this method was ultimately rejected by the IRS, it was picked up by other companies and (unless expressly authorized by the company's plan) is most likely a form of backdating.[7] Another variation on price averaging is to use a trailing 30-day average to deter-

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6. See, e.g., opinions expressed by Institutional Shareholder Services (ISS) in "An Investor Guide to the Stock Option Timing Scandal," July 2006, and other policy documents, available online at www.issproxy.com/optionsbackdating/index.jsp

7. Micrel, Inc., which used this form of pricing, is a target of option backdating investigations. See Eric Dash, "Inquiry into Stock Option Pricing Casts A Wide Net," *New York Times,* June 19, 2006. Note that originally, Deloitte & Touche approved this 30-day window method, but then withdrew its approval in 2005.

mine fair market value, even when the plan calls for fair market value *on the date of grant*.

> **Example 4**: *Price Averaging*. Company's plan states that all options will be granted at fair market value determined as of the date of grant. As a genera rule, at the end of each calendar month, management provides the plan committee with a list of option grants for new employees hired during the preceding month. Company's stock is volatile, and can vary widely over a 30-day period. Accordingly, the plan committee has a practice of granting monthly options at the trailing average closing price over the preceding 30-day period. During the month of January, closing prices range from $10 to $18, with the trailing average price at $13.50. On January 30, the closing price is $15. All new-hire grants are priced at $13.50 per share.

14.2 Consequences of Backdating

As discussed throughout this text, option backdating may cause a domino effect of serious problems for the issuer. Those problems can be tracked through as follows:

- *Invalid Options:* Most plans—as approved by the stockholders—require options to be priced at fair market value (or at a specific maximum discount from value) on the date of grant. If options are not so priced, they are invalid under the plan and may (in many cases) be subject to rescission.
- *Corporate Governance Violations:* From the corporate governance perspective, the shareholders have approved the plan on its stated terms. A failure to follow those terms results in a governance violation. In other words, even if it is permissible to grant a discount option under the plan, granting such an option by subterfuge would not be permissible. Any method that represents the fair market value at grant (either through using a date other than the date on which the plan committee action was completed, or using price averaging to determine fair market value) would be unauthorized for corporate governance purposes.
- *Adverse Tax Consequences:* Options granted at a strike price lower than fair market value—if such price is not set in good faith—will be disqualified from treatment as ISOs for tax purposes, and, if clas-

sified as discount NSOs, may be subject to adverse tax consequences for the optionee and disallowed tax deductions for the company.

- *Adverse Accounting Consequences:* Backdating (particularly if it occurred while the company was accounting for equity compensation under APB 25 rather than under FAS 123) may result in accounting errors that cause material misstatements of the company's financial statements, requiring the company to restate financials for years previously filed with the SEC.
- *Securities Law Violations:* The requirement to restate prior financials generally leads to late (or suspended) filing of current SEC reports (10-Qs, 10-Ks, etc). A period of late or suspended SEC filings will result in any documents that incorporate such SEC filings by reference—in particular, the S-8 registration statement covering the option plan—to be invalid until all restatements (and SEC investigations) are complete, leading to a "bad" S-8 registration statement and subsequent blackout of employee option exercises under the plan.
- *Lawsuits:* Finally, all of the affected constituencies—regulators, stockholders, and optionees—can be expected to pursue legal remedies for the problems raised by backdating, including criminal actions, shareholder derivative suits, and optionee civil suits (in contract and fraud claims).

This section briefly discusses the tax, accounting and securities laws issues raised above.

14.2.1 Tax Consequences

The backdating practices above may implicate one or more of three tax Code provisions: Section 162(m), Section 422, and Section 409A.[8]

- *Section 162(m):* As further discussed in chapter 9, Section 162(m) imposes a $1 million cap on corporate deductions for compensation paid to certain executive officers. As a general rule, options granted at no less than fair market value on the date of grant will qualify

8. Each of these Code sections is discussed more fully elsewhere in this book.

for the performance-based exception to the cap. However, options that are determined to be discounted as a result of backdating may no longer be eligible for this exception, leading the IRS to disallow previous deductions if such discounted options would have resulted in compensation in excess of the $1 million cap.

- *Section 422:* As further discussed in chapter 3, Section 422 requires that ISOs be granted at no less than fair market value on the date of grant. Although Section 422(c) sets out a safe harbor for good-faith determinations of fair market value, valuations based on intentional backdating are unlikely to be viewed by the IRS as having been made in good faith. If an ISO is disqualified and treated as a discounted NSO, optionees may have complicated tax consequences (including recapture—if possible—of pre-paid AMT, back taxes to the year of exercise, and even capital gains recalculations). From the company's perspective, there may be back withholding taxes due (as well as lost corporate tax deductions that may not be able to be captured). Former employees are unlikely to cooperate in correcting these issues.
- *Section 409A:* As further discussed in chapter 2, Section 409A treats options granted at a discount as "nonqualified deferred compensation." To the extent that such discounted options vest after December 31, 2004 (or were materially modified after October 4, 2004), both regular taxes and a 20% excise tax may apply at the time the option vests. The company may have reporting and withholding obligations going forward with respect to the amounts subject to Section 409A (although such obligations will not be enforced until the final regulations are issued).[9]

14.2.2 Accounting Consequences

Prior to the effective date of FAS 123(R) in 2005, most companies accounted for options under APB 25. That accounting standard provided that employee options granted under a plan were subject to either "fixed"

9. Note that while the proposed regulations permit certain fixes for this issue through January 1, 2008, the company will need to determine when—and whether—to take the risk that fixing the option is more costly than leaving it as an audit risk.

or "variable" plan accounting treatment. Generally, under APB 25 an option granted at fair market value on the date of grant did not result in an expense on the company's financial statements. However, options granted at a discount to fair market value on the date of grant gave rise to a one-time "fixed" compensation expense equal to the amount of the discount. Moreover, a discounted option could be subject to variable-plan accounting treatment if, for example, it underwent multiple repricings during its term. Under variable-plan accounting, an expense was required to be taken on a recurring basis (by measuring the discount at the end of each quarter that the option remained outstanding) until the option was exercised or expired.

A company that engaged in significant backdating at a time when it was accounting for options under APB 25 faces the very real possibility that it materially misstated its financials during those years. As we have seen, this possibility has caused many companies to undertake internal audits and inform the SEC (and the public) that they are reviewing prior financials with an expectation of restating and re-filing for years prior to 2002. During the time that financial statements are being reviewed, current SEC filings will generally be suspended (see below).[10]

14.2.3 Securities Law Consequences

The gravity of the securities law implications of backdating cannot be overstated. Although the SEC has taken pains to assure the public that it will distinguish between "nefarious" and "innocuous" backdating practices in its enforcement efforts,[11] the potential impact of materially misstating financial statements includes invalid registration statements, suspension of trading, stock exchange de-listing, enforcement of CEO/CFO clawback requirements, and criminal investigations based on information revealed in the disclosure process. Moreover, as issues raised by backdating are disclosed to the public in SEC filings, compa-

10. FAS 123(R) sets out criteria for establishing grant date for accounting purposes in Appendix E. See also FAS 123(R)-2 (Oct. 18, 2005) interpreting the concept of "mutual understanding" for these purposes.

11. See speech before the International Corporate Governance Network by SEC Commissioner Paul Atkins on July 6, 2006, available online at www.sec.gov/news/speech/2006/spch070606psa.htm.

nies are likely to experience increased market volatility and decreased shareholder (and employee) confidence.

The most significant securities law consequences include faulty SEC filings, CEO/CFO certification issues, and Form S-8 registration problems.

- *Issues with SEC Filings:* As discussed above, most employee plans provide that options must be granted at fair market value. Generally, if discounted grants are authorized in a plan, the maximum discount from fair market value is specifically limited (e.g., to 15%) and subject to the requirement that it be disclosed at the date of grant. If a shareholder-approved plan does not authorize discount options, then any backdated options granted by the company must be treated for securities law purposes as having been granted outside of the plan. Prior to adoption of new SEC disclosure rules in 2006, Item 201(d) of Regulation S-K provided that the material terms of a discounted option were required to be filed in equity plan disclosures under Regulation S-K Item 201(d). Copies of the options should also have been filed with the company's regular periodic reports. In addition, as noted above, if backdating led to material misstatement of financials, any public disclosures of the company that included those financials (i.e., all periodic reports, proxy statements, and registration statements), as well as reports of changes in beneficial ownership by insiders, may have been inaccurate or misleading. Any one of these issues alone could lead to the severe consequences noted above.
- *CEO/CFO Certification Issues:* Since the 2002 effective date of the Sarbanes-Oxley Act, the CEO and CFO have been required to certify that the financial statements accompanying their companies' 10-Qs and 10-Ks are accurate in all material respects. False certifications by these officers open them up to securities and criminal law sanctions. Rather than risk filing additional false certifications, many companies have concluded that they must delay their SEC filings (e.g., 10-Qs, 10-Ks) until the underlying financials have been closely reviewed and, if necessary, corrected. Again, delaying such filings—while imperative—may lead to serious consequences in the marketplace.

- *Form S-8 Registration Statement Issues:* Like all other filings that incorporate financial statements by reference, the validity of a stock plan's S-8 registration will be called into question as a result of backdating. Further, if public filings are delayed or suspended, it is likely that no other exemption from registration (such as Rule 144) will be available to permit option exercises under the plan. Accordingly, a company may believe it is necessary to suspend all activity under its employee equity plans until the backdating issues are resolved and SEC filings are brought into compliance. This action, even when authorized by the compliance provisions of the plan, raises legal issues for optionees who are unable to exercise their vested options because they leave (or are terminated) during the self-imposed blackout period.

14.3 Addressing Prior Year Backdating

As of this writing (in November 2006), companies that are the focus of SEC and DOJ investigations are faced with the enormous task of auditing prior financial statements and stock granting practices to determine the extent to which option backdating may have affected their SEC filings. If the expense attributable to undisclosed discount options is found to be material, these companies will be required to restate their financials. In such cases, new shareholder plan approvals—and potentially stock exchange delisting pending such approvals—may be necessary. Addressing this type of audit requires cooperation and compliance with the government as well as with the company's public accounting and law firms. This chapter does not discuss the legal steps that companies under SEC or DOJ investigation should take to initiate and process internal audits, as there will hopefully be minimal need for this in future years.[12]

12. However, many law firms and consultants have prepared detailed articles giving audit instructions in this regard. National Association of Stock Plan Professionals (NASPP) members can find examples at www.naspp.com/members/Portal/Timing.htm. Also, the Public Company Accounting Oversight Board has made available its guide to "Auditing the Fair Value of Share Options Granted to Employees" (Oct. 17, 2006) in the Staff Questions and Answers area of www.pcaobus.org.

From the tax perspective, it may be possible to provide relief from Section 409A with respect to backdated options. The first step is to determine whether Section 409A is actually an issue for optionees. Even assuming that backdated options must be reclassified as discount options, any option that was vested prior to January 1, 2005, is not at risk under Section 409A (even if discounted). Further, the company has the flexibility to take options out of 409A by accelerating their exercisability in the event of a change in control of the company or an involuntary termination of the optionee. If either of these events presents itself, the company should take advantage of it.

Other ways to avoid adverse Section 409A consequences are:

- *Reprice Options to Actual Grant Date Fair Market Value:* Note that if this modification is offered as a choice to all optionees (i.e., with a cash-out offer or fixed exercise schedule offer, as described below) the SEC will require that the alternative offers be treated as a tender offer (including a filing on Form TO-1, but without requiring compliance with the all-holders and best-price rules). If the modification is unilateral, or for executives/directors only, a tender offer will not be necessary. However, while unilateral modifications may not raise securities law issues, they will certainly raise contract issues with optionees and so should not be entered into lightly.
- *Make Cash-Out Offer:* In connection with a repricing offer, the company may wish to offer a cash bonus (or additional option grant) to make up for the difference in the strike price between the discounted and fair market value option. Alternatively, the company may choose to offer to buy out such options entirely for cash. Under Section 409A, this type of fix is permissible through January 1, 2008. However, the payment may not be made in the same year as the option modification or repricing. For example, an option repricing and bonus offer may be made in 2006, and options cancelled in that year. The bonus, however, may not be paid until January 1, 2007.
- *Impose Fixed Exercise Schedule:* With this technique, discount options are modified to permit exercise on specific dates-certain only. This is more of a theoretical than a practical solution. While a fixed exercise

schedule satisfies the rules of Section 409A, it turns the stock option into an extremely unattractive equity vehicle for the optionee.

14.4 Suggestions for Avoiding Backdating in the Future

With the advent of the new SEC disclosure rules, the opportunities for backdating—whether intentional or inadvertent—are greatly reduced. Under the Compensation Discussion & Analysis (CD&A) requirement imposed by the rules, companies must publicly disclose all of the material factors involved in establishing and implementing stock option granting procedures. Such disclosures must be in plain English and must cover all of the factors that could lead to option discounting.[13] Moreover, since 2002 the requirement to report option grants to insiders within a very short time frame also tends to eliminate the ability to manipulate pricing.[14]

Even with these regulatory safeguards in place, however, companies would be well advised to scrutinize their plan administration procedures. The best approach will be to establish clear, consistent granting procedures that are not subject to discretionary variation and that make it easy to identify specific grant dates. In the event variation from the norm occurs, it should be clearly documented and the underlying reason for the variation should be explained.

Best practices for these option granting purposes might include:

- *Establish Written Granting Policy*: In connection with SEC disclosure rules, work with the compensation committee (or plan committee) to prepare a description of the underlying principles for option granting at all levels under the company's equity compensation plans.
- *Require Observance of Specific Corporate Formalities:* These could include delegation of granting authority to a committee of more than one uninterested director, obtaining of consent in a meeting rather than as a unanimous written consent, immediate documentation

13. See section 7.5.

14. See description of Form 3 and 4 filing requirements in section 7.4.2.

of the resolutions adopted by the committee, and having a policy of communicating information to the plan administrator as soon as possible after the grant has been completed.

- *Establish Regular Granting Schedule:* Adhere to a normal schedule (monthly, quarterly, annually, etc.) for specific types of grants (e.g., new hire, performance). Deviate infrequently from the schedule, and then only with full explanation. If grant timing concerns are a trigger point for shareholders, it may be necessary to ensure that the schedule minimizes the possibility of spring-loading or bullet-dodging.
- *Establish Specific Written Criteria for Setting Fair Market Value:* There may be very little discretion here, however, depending on what the plan itself says about how fair market value must be determined. Authority and manner of setting the price should be clearly delineated.
- *Ensure That Stock Administration Procedures are Reliable:* Immediate reconciliation of stock plan records—in both database and minute books—is essential. Any red flags should be explored with counsel immediately. Timely issuance of paperwork is key, as is tracking and paying attention to all Section 16 reporting requirements.
- *Implement Ongoing Audit Procedures:* Companies should monitor their own granting activities with an internal audit on no less than a quarterly basis. Such audits will ensure that granting guidelines are being followed, reports timely filed, reconciliations made, and issues flagged on a real-time basis.

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EQUITY GRANT PRACTICES DISCLOSURE

- **Baker Hughes Inc.**
  DEF 14A filed on March 6, 2007

  "Options generally are granted semi-annually, at the same time as grants to the general eligible employee population, in January and July prior to the release of our earnings. Option grants are made at Compensation Committee meetings scheduled in advance to meet appropriate deadlines for compensation related decisions. Our practice is that the exercise price for each stock option is the market value on the date of grant. Under our long-term incentive program, the Option Price shall not be less than the Fair Market Value of the shares on the date of grant."

- **Freeport McMoran Cooper & Gold Inc.**
  DEF 14A filed on June 5, 2007

  "**Timing of Option Grants:** To the extent stock options are awarded in a given year, the committee's practice has been to grant such awards at its first meeting of that year, which is usually held in January or February. At this meeting, the committee finalizes its compensation decisions for the year, including setting the annual salary for the executive officers, determining long-term incentive awards for the year, and confirming payouts under the company's annual incentive programs. Each August, the board establishes a meeting schedule for itself and its committees for the next calendar year. Thus, this meeting is scheduled approximately five months in advance, and is scheduled to fall within the window period following the release of the company's earnings for the fourth quarter of the previous year. In January 2007, the committee formally approved a written policy stating that it will approve all regular equity awards at its first or second meeting of the fiscal year in which an award is to be made, and that to the extent the committee approves any out-of-cycle awards at other times during the year, such awards will be made during an open window period during which our executive officers and directors are permitted to trade company securities.

  "**Determination of Option Exercise Price:** Under our incentive plans, the exercise price of each stock option cannot be less than the fair market value of a share of our common stock on the grant date. Historically, we have used the average of the high and low sale price on the grant date to determine fair market value. In January 2007, the committee prospectively revised its policies to provide that for purposes of our stock incentive plans, the fair market value of our common stock will be determined by reference to the closing sale price on the grant date.

- **Lockheed Martin Corp.**
  DEF 14A filed on March 16, 2007

  "Policy Regarding Timing of Option and Other Equity Grants: The IPA Plan allows the Committee to set a date in the future as the date of grant of an award. If the Committee's action occurs in close proximity to release of our annual earnings, the Committee's practice has been to designate as the date of grant a future date at least 48 hours following the release of our annual earnings. The closing price for our stock on the NYSE on the date specified as the date of grant is the exercise price for an option award. The Committee's action in February 2006 took place after our release of earnings by more than 48 hours and so this practice was not used during 2006.

  How Grant Sizes Are Determined: Grant sizes are calculated by multiplying the 50% weight we have given to stock options in our executive compensation program by the market value for long-term incentives and dividing that result by the value of a single option as determined under the Black-Scholes methodology. We assign market value based upon information provided by management's outside executive compensation consultant based upon Comparator Group data."

- **McDonalds Corp.**
  DEF 14A filed on April 9, 2007

  "In September 2006, the Company adopted a formal policy with respect to grants of equity compensation awards to our employees and directors, which generally reflects our pre-existing practices. Under the policy, awards may be granted to Company employees and directors only at times when the Company does not have any material nonpublic information. Consistent with the terms of the Company's Amended and Restated 2001 Omnibus Stock Ownership Plan, or the Amended 2001 Plan, and our existing practices, stock options may be granted only with an exercise price at or above the closing market price of the Company's common stock on the date of grant.

  Our broad-based equity grants are generally made at a scheduled meeting of the Committee occurring at approximately the same time each year following the Company's release of financial information and otherwise at a time when we are not in possession of material nonpublic information. In 2006, annual grants were generally made at the Committee's scheduled meeting in February. Our new policy requires that we continue to follow this approach.

  In 2006, the annual equity grant to our CEO was made at the regularly scheduled Compensation Committee meeting in March concurrently with the CEO's performance review and the establishment of his annual goals and objectives by the chairs of the Governance and Compensation Committees. The 2006 grant to the CEO was made when the Company was not in possession of any material nonpublic information. We intend to grant future equity awards to the CEO at the same meeting in which the Committee approves any broad-based equity grant.

  The Compensation Committee may choose to make grants of equity awards outside the annual broad-based grant, including in the case of newly hired employees and in connection with promotions. An Interim Grant Committee of the Board has been delegated authority to make such grants between regularly scheduled meetings of the Compensation Committee, but only to employees who rank below the level of senior vice president. The current members of the Interim Grant Committee are Directors McKenna and Skinner."

- **Schering Plough Corp.**
  DEF 14A filed on April 20, 2007

  "Grant Practices For Stock Options and Other Equity Awards. Schering-Plough's usual practice for stock options and deferred stock units is to make one annual grant per year. The annual grant is awarded on the same date to all eligible employees, including the named executives. Typically the annual grant has occurred during the first half of the year on a regular Board meeting date (these meeting dates are set at least a year in advance). In 2006, the Compensation Committee approved the annual grant on May 19, the date of the Annual Meeting of Shareholders, at which the 2006 Stock Incentive Plan (the plan under which the stock options and deferred stock units were granted) was approved.

  Due to the interest of shareholders in having a set date for the annual grant of stock options, the Compensation Committee recently determined that in the future, the annual grant will be made on the first business day of May. This date was chosen by the Committee because the date falls soon after first quarter earnings are typically announced (in late April); material developments would be expected to have been made public in connection with the earnings press release; and the date is late enough in the year to allow for the performance management process to be completed so that the annual grant can be coordinated with the Schering-Plough total compensation program.

  Performance-contingent share awards, which are part of the long-term performance opportunity, and any other equity grants, will be granted by the Compensation Committee at a regularly scheduled Committee meeting during the first 90 days of each year (these meeting dates are set at least a year in advance). For the 2007-2009 performance period, the award opportunity was granted at the February 26, 2007 meeting. Unlike stock options, where an exercise price is set, the date does not impact the award terms, and this earlier grant date ties into the performance management system, where goals and objectives for the year and longer-term are revisited at the start of the calendar year.

Other stock option grants and deferred stock unit grants are typically made during the year to new hires, for retention and in connection with promotions. Such interim grants to executive officers and other elected corporate officers are approved by the Compensation Committee. The Committee has delegated the authority to approve such interim grants for other non-executive key employees to the CEO. In each case, the grant date for an interim grant is the first business day of the month following the month in which the new hire begins work, the promotion became effective or the retention need becomes known. This timing was chosen to prevent even an appearance that the recipient could manipulate the pricing date, and also to reduce the administrative burden for Schering-Plough personnel that would be created by multiple grant dates.

The stock incentive plans under which all outstanding options were granted and under which options may be granted in the future specify that the option exercise price is always the fair market value of Schering-Plough common shares on the date of grant. The plans define "fair market value" as the New York Stock Exchange closing price on the grant date. Schering-Plough determines the New York Stock Exchange closing price by reference to the New York Stock Exchange web reporting system.

In setting the policy as to the timing of stock option grants, the Committee considered advice from the Committee's compensation consultant, outside counsel, Schering-Plough's Human Resource executives and Schering-Plough's in-house securities lawyers."

- **Target Corp.**
  DEF 14A filed on April 9, 2007

"**Grant Timing Policy:** To ensure that our equity compensation awards are granted appropriately, we have the following practices regarding the timing of equity compensation grants and for stock option exercise price determinations:

  - Stock options and restricted stock units are granted on the date of our regularly scheduled January Compensation Committee meeting. Performance share units are granted on the date of our regularly scheduled March Compensation Committee meeting. Compensation Committee meetings are typically scheduled more than one year in advance.
  - We set the exercise price of stock options at the volume-weighted average trading price of our stock on the grant date. We believe that the volume-weighted average price is a better measure of the fair value of our shares than the closing price on the grant date, as it eliminates the effect of any variations in stock price that may occur in the final minutes of trading if the closing price were used.
  - We have no practice or policy of coordinating or timing the release of company information around our grant dates. Our information releases are handled in a process that is completely separate from our equity grants.
  - On occasion we will make equity compensation grants outside of our annual grant cycle for new hires, promotions and recognition or retention purposes. For grants to executive officers, all such grants are approved by the Compensation Committee with an effective date of grant on or after the date of such approval. If the grant date is after the date of approval, it is on a date that is specified by the Committee at the time of approval."

- **Wm, Wrigley Jr. Co.**
  DEF 14A filed on February 13, 2007

"Stock option award levels are determined based on market data, vary among participants based on their positions within the Company and are granted at the Committee's regularly scheduled May meeting. Newly hired or promoted executives, other than executive officers, receive their award of stock options on the first business day of the month following their hire or promotion. Newly hired executive officers who are eligible to receive options are awarded such options at the next regularly scheduled Committee meeting on or following their hire date.

Options are awarded at the New York Stock Exchange's closing price of the Company's Common Stock on the date of the grant. In certain limited circumstances, the Committee may grant options to an executive at an exercise price in excess of the closing price of the Company's Common Stock on the grant date. The Committee has never granted options with an exercise price that is less than the closing price of the Company's Common Stock on the grant date, nor has it granted options which are priced on a date other than the grant date. In 2006, upon Mr. Perez's hire as the Company's President and Chief Executive Officer, the Committee awarded options to purchase 250,000 shares of the Company's Common Stock to Mr. Perez with an exercise price in excess of the fair market value on the date of the grant. These premium-priced options were awarded in lieu of participation in certain prior long-term stock grant cycles.

The majority of the options granted by the Committee vest at a rate of 25% per year over the first four years of the ten-year option term. Vesting and exercise rights cease upon termination of employment, except in the case of death (subject to a one year limitation), disability or retirement. Prior to the exercise of an option, the holder has no rights as a stockholder with respect to the shares subject to such option, including voting rights and the right to receive dividends or dividend equivalents."

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Keeping Up With the Joneses: The Hottest Equity Compensation Issues Today

The session *Keeping Up with the Joneses: The Hottest Equity Compensation Issues Today* was so popular at last year's Conference that we've reprised it for the 2007 NASPP Conference. We asked Wendy Davis of Cooley Godward Kronish, the session moderator, for a sneak peak at some of the hot issues the panel will analyze.

NASPP: *What are the hottest trends that you are seeing in equity compensation today?*

Wendy Davis: It's a really dynamic time in equity compensation—the changes in the tax laws and annual reporting requirements, and the slightly less recent revisions to the accounting rules, combined with the ever sharper focus of shareholders on compensation generally, have companies taking a fresh, holistic look at their equity compensation programs. When viewed from that perspective, my clients want to talk about performance-based equity compensation, and we are really thinking about how to make these programs work in the most efficient manner possible to incentivize the right behaviors by participants, maximize precious equity plan share reserves, preserve the accounting treatment that makes sense for the company and its shareholders, prevent inadvertent adverse tax consequences to the individual (under Section 409A) and the company (under Section 162(m)—if desired), and do so in a way that can be communicated simply and clearly to shareholders in compliance with the new disclosure rules without sacrificing the confidentiality of the company's performance information.

Another hot issue that almost inevitably arises in revisiting the company's equity compensation policies is ownership requirements—which can mean minimum ownership requirements and/or hold-until policies. Whether conceived of internally as a means to further incentivize performance over a longer period, or, as is increasingly the case, as requested or demanded by shareholders, companies need to ask themselves if these policies should be part of their equity program, and if not, have a fully conceived understanding of why—especially given the new CD&A requirements.

Finally, it almost goes without saying, §409A is hot. Every company should be reviewing their stock plans and granting practices, and training their human resource and stock plan administrators to understand what they can and can't do under the final §409A regulations. The final regs give us so much flexibility to take care of even the most unusual situations—and I'm thinking of termination-related amendments, modifications in connection with mergers and acquisitions, and performance-based equity—but you have to understand how to work with those regs. And, of course, we have a limited window of time to address options that may have been granted at a discount from fair market value, so it's imperative to do your spring cleaning here.

NASPP: *Responsible equity practices are a hot issue right now; what can companies do to ensure that their equity plans are responsible?*

Davis: The most important way to ensure that a company has a "responsible" equity plan and practices has to be having clear ground rules and making sure everyone involved knows those ground rules. Now is a great time to audit your plan and tighten up weak spots given the major changes in applicable law (and this means more than adding a §409A savings clause). But, what the plan says is really secondary to making sure everyone from the stock plan administrators up to the board members understand what can be granted and when. It is the responsibility of everyone involved to be thinking about the proposed grants that cross their desks and whether those grants satisfy the terms of the plans and the company's granting policies. To that end, it's imperative to have a well thought out grant policy and to do lots of training and, as time passes, refresher training sessions.

NASPP: *What is the future of non-qualified deferred compensation plans and SERPs; are these plans headed towards extinction?*

Davis: It's easy to argue that executive compensation is grossly excessive and that §409A makes non-qualified deferred compensation a landmine to be avoided at all costs, but I do think these plans can serve the legitimate interests of companies and shareholders as part of a well-thought out, reasonable executive compensation program. And the final §409A regs aren't a death sentence for deferred compensation—they simply require thoughtful, pro-active structuring. There's really quite a lot of room for innovative, responsible compensation and that can include NQDC/SERPs.

NASPP: *Do you think ESPPs have potential as a viable replacement to broad-based stock option and award programs?*

Davis: This is a really great question and one that our group at Cooley has been spending some time this spring reviewing. ESPPs have the obvious benefit of providing a transparent, broad-based equity plan with (ideally) a seamless administrative function that can be tailored to fit the needs of a company through "add on" policies like hold-until policies.

In addition, by retaining most of the classic Section 423 structure and administration, but deviating from the §423 rules (with the understanding of the resulting tax consequences), you can create a supplemental ESPP to provide additional incentive/equity compensation to management.

It may be an appealing alternative for companies who worry about the difficulties of implementing a stock granting policy in the current climate and who like the simplicity and leverage of an option-like equity program. In addition, a company may like the appeal of relying exclusively on an ESPP for non-executive equity compensation but providing supplemental full value awards to execs through a more traditional equity incentive plan.

Either way, I do think this kind of shift will require a well-thought out communication, education and administrative program. Employees who are used to standard option grants will need to become comfortable with this shift—which may be especially confusing given the move away from ESPPs after FAS 123(R).