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U.S. Stock Compensation: Goodbye to One Size Fits All?

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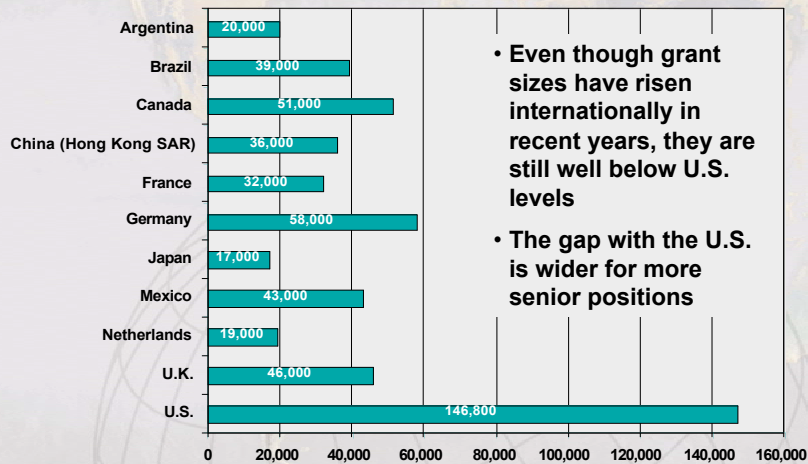


U.S. companies typically grant the same LTI plans worldwide

- Same vehicle
- Same plan terms
- Same participation
- Same award levels

But since U.S. grant levels are the highest in the world...

HR Director — 2003 Long-Term Incentive Values (US\$)



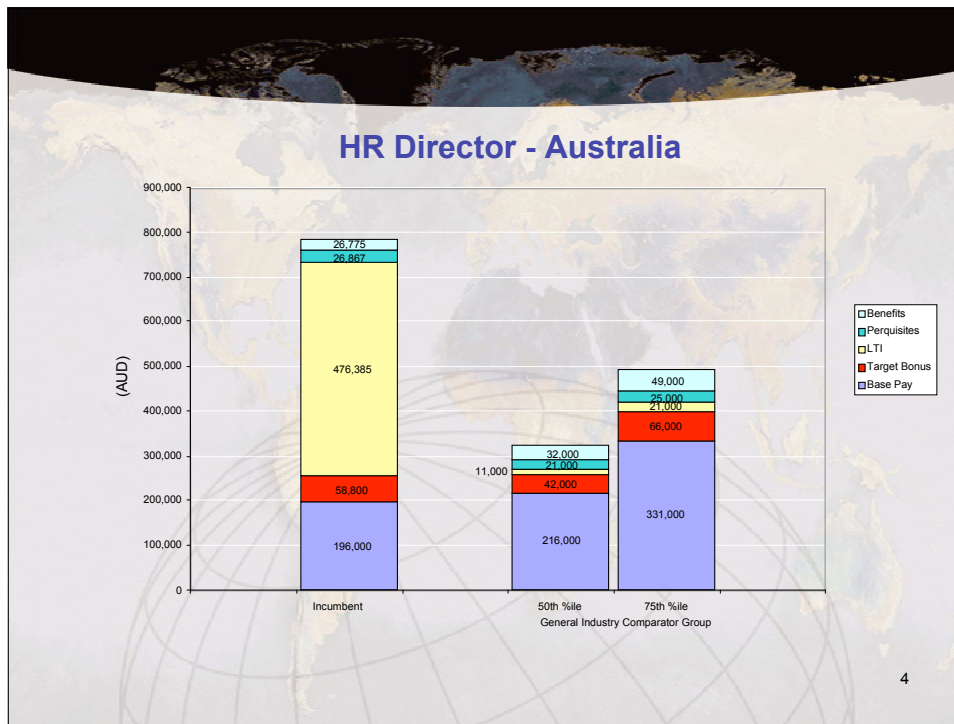
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...U.S. companies overpay by local market standards...

- Higher expected values than locally
- Wider participation than locally
- Total direct compensation mix over-emphasizes long-term, corporate and stock price performance
- Denomination in dollars can be problematic

The talent pool internationally is wider than employees of other US subsidiaries

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Extending typical U.S. plan terms to all worldwide can be problematic

- Terms and conditions are shaped by the U.S. tax, accounting and regulatory environment
- Can be disadvantageous to employees and/or employers outside U.S.:
 - Taxation at grant/vesting
 - Acquired rights

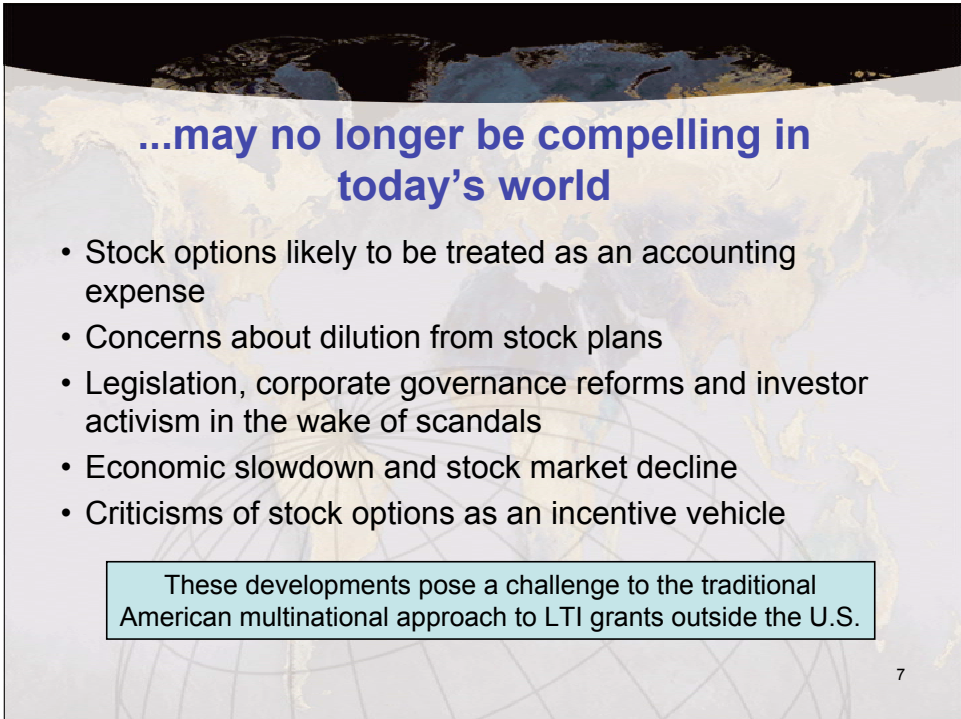
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The reasons why U.S. companies take a “one size fits all” approach...

- Is easier to administer
- Encourages single culture among global cadre
- Facilitates the mobility of executives worldwide
- Allows companies to compete in the global war for talent
- Avoids any potential “political” conflict
- Has had no accounting cost implications, using options
- Is what other U.S. competitors do
- Is the approach the CEO wants!

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...may no longer be compelling in today's world

- Stock options likely to be treated as an accounting expense
- Concerns about dilution from stock plans
- Legislation, corporate governance reforms and investor activism in the wake of scandals
- Economic slowdown and stock market decline
- Criticisms of stock options as an incentive vehicle

These developments pose a challenge to the traditional American multinational approach to LTI grants outside the U.S.

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A world map with a grid overlay, showing continents in light yellow and oceans in light blue. The map is centered on the Atlantic Ocean.

In response, many companies are likely to conserve share usage...

- Some have restricted participation and reduced grant award sizes, and we expect more to follow
- A major driver: stock option expensing
 - FASB Draft
 - Leading companies voluntarily expensing

Expensing options will lead companies to seek to control that cost

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In response, many companies are likely to conserve share usage...

- Another substantial pressure is investors' concerns about excessive stock dilution
 - Negative shareholder votes
 - Key battleground

Concerns about dilution will also result in companies limiting their equity awards, particularly stock options

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...And outside the U.S. is one place to look for savings

- As noted, many U.S. companies' LTI grants levels are over-competitive
- Grant policy to non-U.S. employees is therefore an important area to investigate when reviewing participation and award size

Stock option grants that overpay international employees by local market standards may no longer be desirable or defensible

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Similarly, U.S. companies may introduce new LTI vehicles...

- Some U.S. companies have introduced long-term incentive vehicles other than stock options
- “Death of options” is greatly exaggerated
- Alternative plan types under consideration include:
 - Restricted stock/units
 - Performance share plan
 - Performance cash plan
 - Stock appreciation rights (SARs)
 - Phantom options
 - Performance-based options

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A world map with a grid overlay, showing continents and oceans in a light blue and yellow color scheme. The map is centered on the Atlantic Ocean.

Similarly, U.S. companies may introduce new LTI vehicles...

- Expensing options will make for a more “level playing field”
- Underwater option concerns may be alleviated
- Options have been criticized for not being sufficiently performance-oriented
- Certain vehicles (e.g., restricted stock) arguably provide a more direct ownership stake than options

Continued...

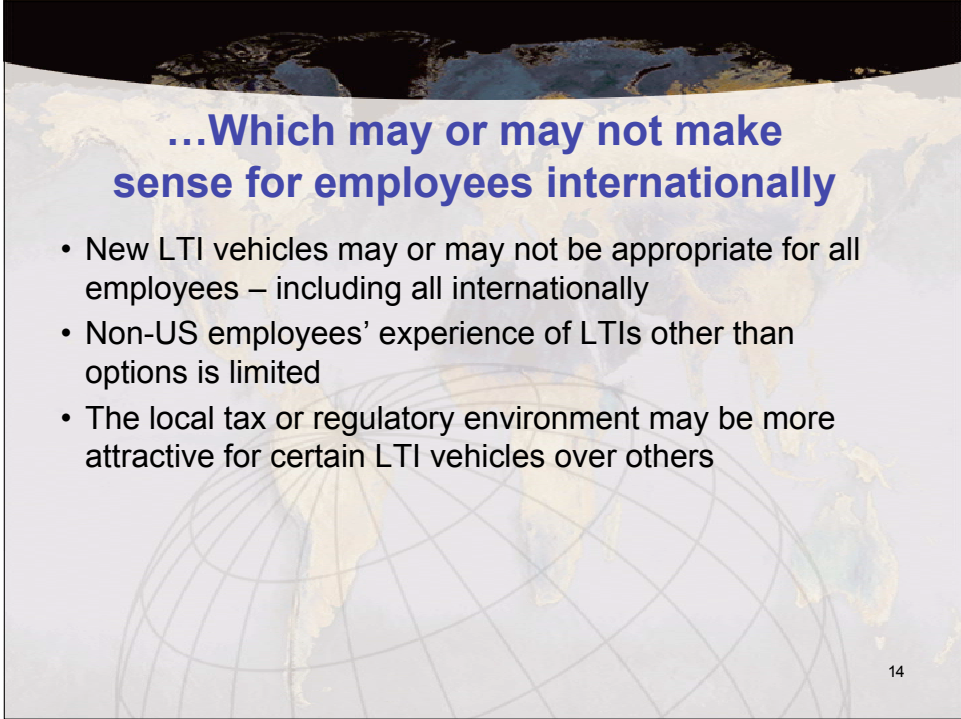
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Similarly, U.S. companies may introduce new LTI vehicles...

- With restricted stock or performance shares, a smaller number of shares can deliver the same expected value as stock options
- Participants may place a higher “perceived value” on other plan awards
 - More control with operating measures
 - Less than 1:1 exchange with option Black-Scholes value

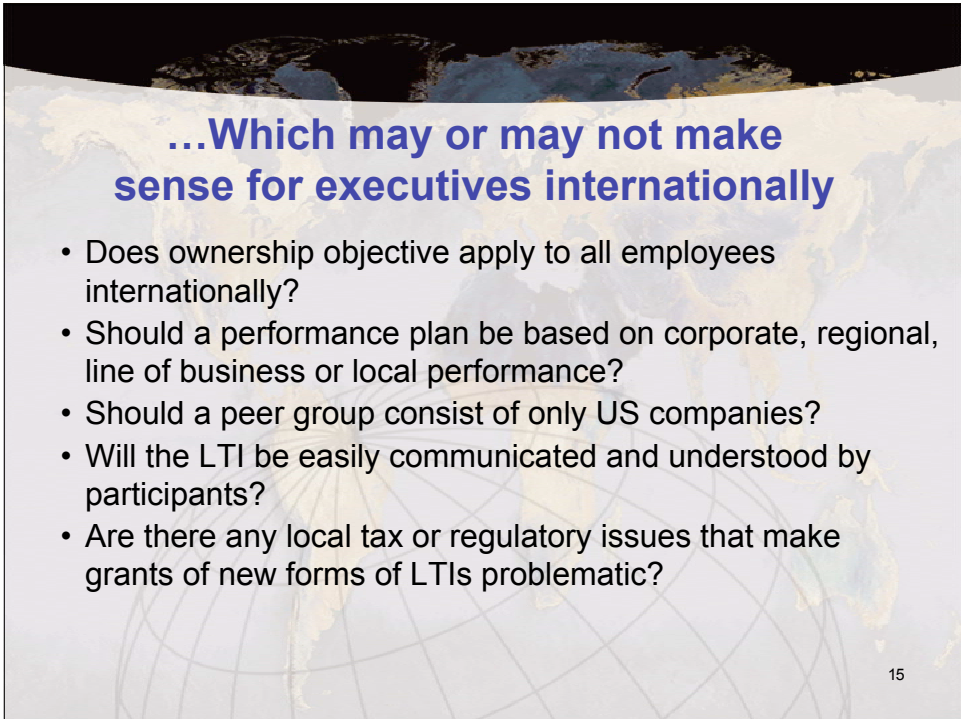
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...Which may or may not make sense for employees internationally

- New LTI vehicles may or may not be appropriate for all employees – including all internationally
- Non-US employees' experience of LTIs other than options is limited
- The local tax or regulatory environment may be more attractive for certain LTI vehicles over others

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A world map with a grid overlay, showing continents and oceans. The map is centered on the Atlantic Ocean.

...Which may or may not make sense for executives internationally

- Does ownership objective apply to all employees internationally?
- Should a performance plan be based on corporate, regional, line of business or local performance?
- Should a peer group consist of only US companies?
- Will the LTI be easily communicated and understood by participants?
- Are there any local tax or regulatory issues that make grants of new forms of LTIs problematic?

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For example, the taxation of equity vehicles varies by country...

Country	Stock Options	Restricted Stock
Australia	Exercise	Vesting
Austria	Exercise	Vesting
Belgium	Grant	Grant
Brazil	Exercise	Vesting
Canada	Exercise/Sale	Grant
France	Sale	Grant
Germany	Exercise	Grant
India	Sale	Sale
Italy	Exercise/Sale	Grant
Japan	Exercise	Grant
Netherlands	Vesting/Exercise	Grant/Vesting
Switzerland	Grant/Vesting	Grant
United Kingdom	Exercise/Sale	Vesting
United States	Exercise/Sale	Vesting

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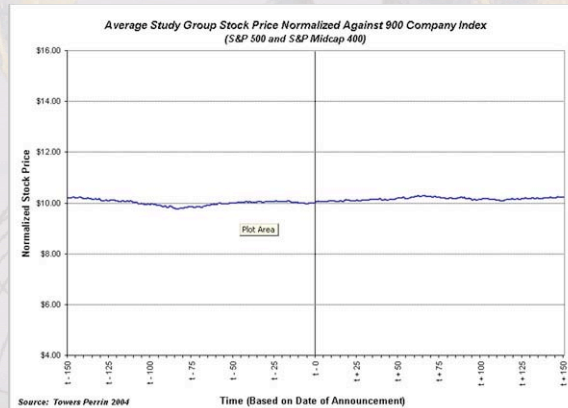
...So it's best to look before you leap

- Tax, legal and accounting rules differ
- Other issues to consider:
 - Administration
 - Reporting and withholding
 - Charge back agreements
 - Local labor laws
- A plan design that takes into account local culture, market practices, tax and regulatory issues may serve to better attract and retain local talent

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Don't throw out the global baby with the bathwater...

- Accounting shouldn't affect stock valuation:



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Don't throw out the global baby with the bathwater...

- And some of the reasons for maintaining some degree of global consistency may still be persuasive
 - Encourage a global team outlook among employees
 - Maintain internal equity, especially among the top executive cadre
 - Facilitate international transfers

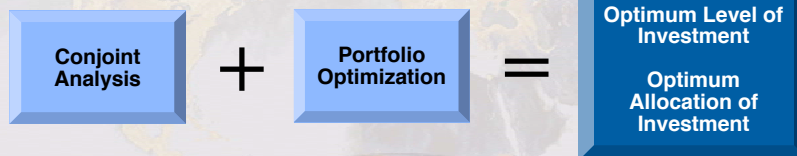
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...But rather, consider alternatives

- U.S. companies are exploring policies that:
 - Are in-between “all get U.S.” and “all get local market”
 - Differentiate by organization and geography
 - Place LTIs in the context of total rewards (including cash, equity, benefits and perquisites)
 - Take into account employees’ “perceived value”

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...But rather, consider alternatives



- Is a surveying method used for many years in marketing to capture subjective preferences
- Asks employees to make trade-offs among program features as opposed to assessing the features individually
- Is a more reliable forecast of behavior than traditional survey methods

- Reflects cost constraints on investment
- Develops an efficient frontier of optimum allocation of investments
- Determines optimum investment level on the basis of program costs and perceived value of compensation elements

Optimum solution may be to:

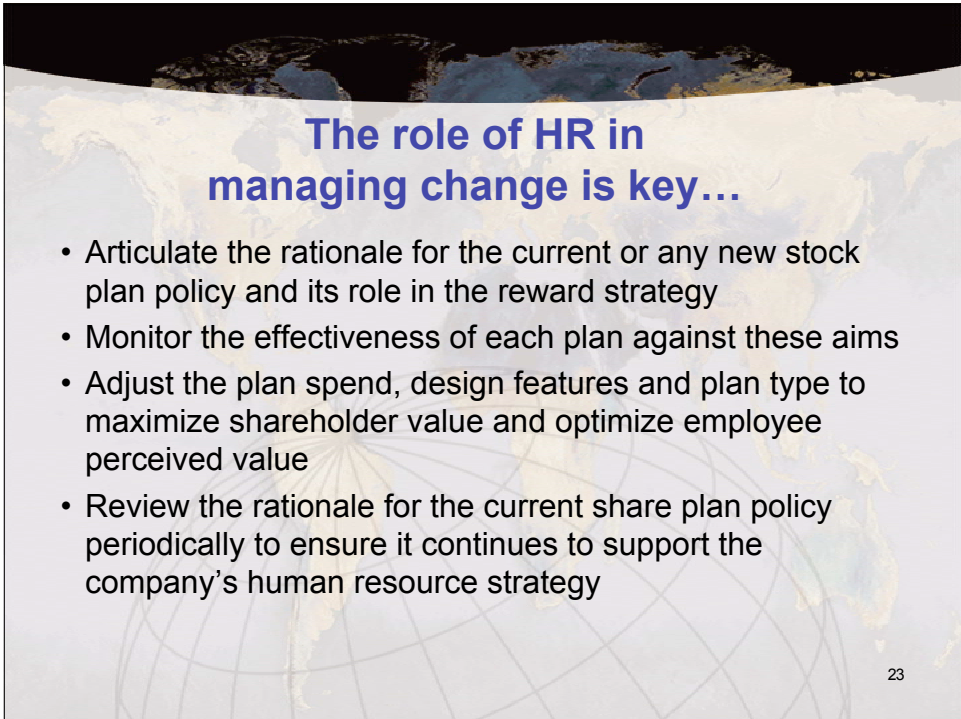
- Improve perceived value of long-term incentives by changing allocation while maintaining the current level of investment
- Maintain current level of perceived value at lower level of investment by changing allocation
- Increase investment and perceived value to economically efficient level



Case Studies

- Two recent experiences:
 - Major conglomerate
 - Fortune 50 industrial firm

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The role of HR in managing change is key...

- Articulate the rationale for the current or any new stock plan policy and its role in the reward strategy
- Monitor the effectiveness of each plan against these aims
- Adjust the plan spend, design features and plan type to maximize shareholder value and optimize employee perceived value
- Review the rationale for the current share plan policy periodically to ensure it continues to support the company's human resource strategy

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...Especially with regard to communication

- It is not a simple matter to change or withdraw option benefits from those who have received them
 - “We value share ownership...as long as the accounting is favorable”
- Consider the “displacement” value beforehand
 - If a plan is valued, employees will seek a comparable value in exchange
- The importance of a communication strategy cannot be overemphasized

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Goodbye to “One Size Fits All”?

- Yes, simplistic, monolithic approaches are not able to withstand many of today’s challenges
- But a move to a completely local approach would mean fragmentation
- Better to seek a balance

Ironically, what may be a challenge to the extension of stock compensation worldwide may force us to better articulate the case for its use

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Any Questions?

Thank You

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