



Global Equity Trends: What the Market Data Really Tells Us

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Fred Whittlesey

Fred Whittlesey is Senior Vice President of Aon's U.S. Compensation Consulting Group and leads the Pacific Northwest practice. He specializes in executive, incentive, and equity-based compensation and quantitative approaches to HR. He has 20 years of experience including consulting roles with Towers Perrin, KPMG, and his own firm Compensation and Performance Management, Inc. and led the global compensation function at Broadcom Corporation and Amazon.com.

Fred is an active contributor to the compensation profession, serving as a course designer and instructor for WorldatWork's Executive Compensation and Accounting & Finance courses and as a frequent speaker and author for professional organizations. He is co-founder and former member of the Board of Directors of the Global Equity Organization (GEO), Chair of the Advisory Board of the Certified Equity Professional (CEP) Institute for 2004, and a founding member and former Advisory Board member of the National Association of Stock Plan Professionals (NASPP).

Fred received his MBA from UCLA and graduated Phi Beta Kappa and Magna Cum Laude from San Diego State University with a BA in industrial-organizational psychology. He is a Certified Equity Professional (CEP) and a Certified Compensation Professional (CCP).



Pierre Geoffrion

Pierre Geoffrion is Senior Vice President of Aon Consulting in Canada. He leads the Canadian Eastern Region Human Capital practice.

Pierre specializes in executive, incentive and equity-based compensation. He has 24 years of experience including consulting roles with Towers Perrin, T.E. Financial Consultants and Deloitte Touche.

He is very active in the community. He was President of Quebec chapter of the Canadian Association of Financial Planners and also served as a director on the Board of the Quebec Order of Chartered Administrators. He also is involved in many charitable organisations.

He graduated from Concordia with a B.Com. in accounting and finance. Pierre is a Chartered Accountant and a Fellow in financial planning.



Today's Discussion

- Summary of the current buzz...and a translation
- Reasons for the disagreement
- Environment in the US and Canada
- What the data says
- Data collection, cleansing, reporting, interpretation
- What the data really tells us



Summary of the Current Buzz

- Employers will reduce equity grants because of option expensing
- Companies are shifting from options to restricted stock
- Companies are introducing innovative programs in response to these issues
 - Microsoft
 - IBM
 - PeopleSoft
 - TD Bank Financial Group
- Shareholder pressures are in reaction to Enron, et al
- Dilution and overhang are (also) a concern
- Excessive executive compensation is driving these trends

But if you read between the lines...

- Employers will *not* reduce equity grants because of option expensing
- Companies are *not* shifting from options to restricted stock
- Companies are *not* introducing innovative programs in response to these issues (*yet*)
 - Microsoft – *unique situation*
 - IBM – *hold your applause...old ideas, cosmetic changes*
 - PeopleSoft – *reaction to a direct threat*
 - TD Bank Financial Group – *pressures from institutional investors*
- Shareholder pressures are *getting more attention* in reaction the Enron, et al
- Dilution and overhang are *the primary* concern
- Excessive executive compensation *makes a good headline to draw attention to these so-called* trends

Let Us Translate For You...

- Employers will **revisit compensation strategy** due to option expensing
 - But this will only reveal greater issues that need attention
- Companies will **consider alternatives to options, including restricted stock**
 - Share conservation is the driving metric
 - Market upside is the key variable
- Some companies are **visibly communicating new plans for unique reasons**
 - Microsoft – the newest public utility
 - IBM – check it off the list...reduce option expense, encourage ownership
 - PeopleSoft – please vote for us
 - TD Bank Financial Group – attempting to keep up with other banks

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Let Us Translate For You...

- Shareholder pressures are **finally requiring Board accountability** due to Enron, et al
 - Audit Committees are now doing their job
 - Compensation Committees are next under the microscope
- Dilution and overhang are also **the primary** concern with equity plans
 - Reduced run rates are the compensation equivalent of the 1990's safe sex movement
- Excessive executive compensation is **just one factor** driving these trends
- **And...consultants love to stir the pot and get quoted in the media**
 - "Pay is going up...and down"

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Reasons for the Data Disagreement

- Politicizing FAS123/15X and IFRS2
- Buying off institutional investors with token actions
- Inaccurate reporting by journalists
- Companies
 - must disclose accurately what they did
 - do not necessarily disclose what they will do
 - do not need to disclose what they are considering
- Analysis and interpretation of data can confirm any hypothesis

Environment in the USA

- Institutional shareholders exhibiting new levels of aggressive micro-management of plan design
 - They're really looking at the data – *their* data
- FASB ED issued in March continues the controversy
 - CEOs' protest march: "Hell, no, we won't expense"
- No major change in tax structure for compensation
 - Capital gains and dividends rarely an issue in pay design
- Fundamental change in the Zeitgeist
 - Options are bad
 - Restricted stock is good
 - Performance-based shares are better but too difficult for now
 - Equity is bad, cash is good

Environment in Canada

- Institutional shareholders are aggressive
 - Teacher's refuses 70% of option plans proposed to them
- Beginning in 2004 we must expense options
 - Prospective application for companies who expensed in 2003
 - Valuing of expense based on Black-Scholes or binomial with discretion as to underlying assumptions
- No change in tax laws for compensation
 - Still not able to use restricted stock
- Canadian Zeitgeist
 - Options are bad but plain vanilla options are really bad
 - Performance-based options are more prevalent
 - Performance units & performance unit shares are popular

Where the Data Comes From

- Radford International Surveys –26 countries
- Aon Canadian National Survey
- Daily monitoring of 10K, proxy statements, 20-Fs
- Daily consulting experience in the boardroom

What the Data Says

- The Canadian Aon National Survey
 - Trend showing more long-term incentives among participants
 - More companies using stock options as a means to LTI
 - The median total grant values have been
 - Stable in small to medium sized companies
 - Lower in large companies
 - Larger portion of overall long term incentives paid in cash plans
 - Extensive use of DSUs (Deferred Share Units)

What the Data Says

- Run rates declining
 - Total compensation values being maintained through shift to full value awards and other “twists”
 - Annualized award values are being maintained
- Continuing significant differences between “guideline” and “actual”
- Means and medians becoming less useful

What the Data Says

- “Actual” practices being complicated by the rapidly changing allocation of options
 - Country differentials
 - City differentials
 - Performance differentiation
 - Shift from new hire to “post-hire” and periodic grants
 - Shift from annual grants to annual reviews

What the Data Says

- Many of the pay-cut/no-option headlines don't capture other plan values
 - Restricted stock and RSUs
 - LTI cash plans
 - Supplemental benefits: “long-term” but not “incentives”
- Plan complexity, starting at the executive level and trickling down, is increasing
 - Plan design
 - Plan operation

Data Collection Issues

- Time lag
 - Boom and bust in 1999-2002 data
 - Radical changes in practices occurring during 2004 collection
- Reporting person's knowledge
 - Is it RS, RSU, Performance Share?
- Assumptions about grant patterns and conditions
 - What is “ongoing” - always “perfectly annual”?
 - Performance differentiation?
 - **Vesting schedule – the looming issue**

Data Collection Issues

- Intricacies of “non-ongoing” grants
 - New hire
 - Promotion
 - Retention
- Behind-the-scenes data
 - One-time programs such as all-employee option exchange programs, especially 6+1 straddling reporting years
 - The “plan” and then the “arrangements”

Data Cleansing Issues

- Treatment of “outliers”
 - Often assumed to be “wrong” or “misleading”
 - May really represent the cutting edge
 - But cutting edge makes the data bleed
- Examples
 - CEOs with base salary of US\$1 per year, with mega-grants of options and/or restricted stock
 - Large “one-time grants” of restricted stock that cover previously granted underwater options plus future services
 - “Checkerboard pay” – alternating options, restricted shares, LTI awards and payouts, special awards

Data Reporting Issues

Option Grant Valuation

- Face value (grant value)
 - Share price influence
- Option pricing models
 - Black-Scholes highly sensitive to volatility and term
 - Binomial still in “pioneer days” for compensation
 - Some just decide what to do: Citigroup 25% discount
- Net present value of gain
 - Difficult to obtain agreement on growth and discount rates
- Percent of shares outstanding
 - A good control measure but not a dollar amount
 - Critical in private/pre-IPO companies and in run-rate driven situations

Data Reporting Issues

Option Activity Valuation

- Dollar value vesting
 - Some view as “pay for this year”
- Value realized
 - Media views as “pay for this year”....combined with grants
- Unvested value
 - Future projection of “dollar value vesting”

Data Reporting Issues

Other Grant Valuation

- Full value grants
 - Pricing models ignore growth
 - Current granting strategies rely on face value vs. targeted value
- Performance-based grants are improperly captured under prevailing models

Example: Performance must exceed peer median TSR
Probability is 50% that grant will be worth \$0
If TSR > median, will be more valuable:

- Number of shares is greater
- Share price will be greater, by definition

Yet, we value the grant at “face value”

Data Reporting Issues

Other Grant Valuation

- Cash LTIs
 - Payments vs. targets
 - Inflated targets to allow “negative discretion”
 - under US IRC 162(m)
- Deferrals of cash compensation into shares: “Mid-term incentives (MTIs)”
 - No category available in most surveys
 - Grants typically reflect both deferral amount and premium (additional pay)

Data Reporting Issues

Valuation issues of the future

- Insider status
 - Grants to insiders have a lower fair value
- Blackout list employees
 - Grants to blackout employees have a lower fair value
 - Grant value changes when added to/deleted from the list
- Employee demographics
 - If mandatory employment duration < option term, lower fair value
 - Age and other demographic factors influence option value

What the Data Really Tells Us

- The radical changes in equity program design require behind-the-scenes scrutiny to all market data
 - Survey data
 - Regulatory filings
 - Anecdotal reports
- The radical changes in equity program design are moving faster than most data gathering and analysis
 - Option exchanges and repricing
 - Off-cycle awards
 - Year-to-year “lumpy” data
 - Checkerboard pay

What the Data Really Tells Us

- The interaction of changes in share price and pricing model assumptions require close scrutiny to the raw data
 - Full scrutiny of data elements is required: price, model assumptions, share base
- Companies are experimenting and evaluating alternatives in the US
 - Options remain “plain vanilla” until accounting changes
 - Restricted shares are a bridge to new full value plans
 - Annual cash deferrals into shares/units diffuses some concerns

In Closing

- Compensation decisions that rely solely on “market data” during this transition period will be flawed
- Current data gathering and analysis methods lead to incorrect conclusions about competitive practice and compensation value
- Changes in accounting rules may drive some toward further distortion
- Emerging analytical techniques are critical to producing data that tells the real story



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Any Questions?

Thank You

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