

Integrating and Encompassing Corporate Governance Standards Into Your Global Equity Program

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Agenda

- UK Framework - Regulatory
- US Framework – Ad Hoc
- Areas of Risk
 - Compliance/Legal
 - Operational Processes - Equity Plan Audits
 - Reputation
- Best Practices



The UK Corporate Governance Environment

- The Combined Code – published in July 2003 and revised in June 2006
- The Directors' Remuneration Report Regulations 2002
- The Companies Acts 1985 and 2006
- UK Listing Authority rules
- Institutional investor guidelines published by Association of British Insurers, National Association of Pension Funds, Pensions Investment Research Consultants



The UK Combined Code

- **Comply or explain!** - all companies listed on the UK Stock Exchange (not AIM) have to state in their annual report how they have applied the principles of the Code and if not, why not. Two of the main principles deal with directors' remuneration and these are:
 - Levels and make-up of remuneration should be sufficient to attract retain and motivate directors of the required quality but companies should not pay more than is necessary and a *significant* proportion of executive remuneration should be structured to link rewards to corporate and individual performance (Main Principle B.1)
 - There should be a formal and transparent procedure for developing policy on executive remuneration and for fixing the remuneration packages of individual directors. No director should be involved in deciding his own remuneration (Main Principle B.2)

The Directors' Remuneration Regs 2002

- The Regs came into force in August 2002 and apply to all UK registered companies with shares listed on The London Stock Exchange, the New York Stock Exchange, NASDAQ and the main European Exchanges
- Companies have to publish an annual report on directors' remuneration containing specific information (some of which has to be certified by the company's auditors).
- The report has to be put to shareholders for approval and must state the future policy for remunerating directors and for options and LTIP awards there has to be disclosed for each director:
 - A detailed summary of the chosen performance conditions and why they were chosen
 - A summary of the methods used to assess performance and why those methods were chosen

The Directors' Remuneration Regs 2002 - Contents of the Remuneration Report cont'd

- If external benchmarking is used, details of the index or comparator companies
- A description and explanation of any significant amendment proposed to existing entitlements to options and LTIP awards
- An explanation if any options and LTIP awards are not subject to performance conditions
- A statement of the relative importance of each element of the remuneration package
- A performance graph showing the company's total shareholder return over the preceding five years compared to a specified index
- Details of individual option grants and LTIP awards including:
 - Award and vesting dates
 - The number of shares involved
 - Option exercise prices
 - The performance criteria
 - The market prices of the shares at award and exercise/vesting dates and the highest and lowest in between

UK Listing Authority Rules

- Some inconsistencies with the Directors' Remuneration Report Regs but largely the same. The annual report & accounts must include for each director:
 - The number of shares under option or comprised in LTIP awards at the beginning and end of the year
 - The number of options which were granted or exercised or which lapsed during the year
 - The exercise prices, the dates on which they can be exercised and the expiry date
 - The market price of the shares at the date of exercise
- Shares subject to LTIP awards at the beginning and end of the year
- LTIP awards made and vested during the year
- The number of shares received and their market prices

UK Companies Acts Requirements

- Individuals with 3% or more of a company's shares have to notify the company of any increase or decrease in that interest including rights to acquire existing shares (but not rights to subscribe for new shares)
- Directors must notify companies of their interests in shares and changes in those interests and companies have to keep a register of directors' interests
- LSE and AIM companies must notify the Regulatory Information Service by the end of the business day on which they receive information
- The annual report & accounts must contain details of directors' shareholdings and any options
- If they are options to subscribe for new shares, the number, the exercise price and the exercise period must be disclosed

Summary of UK Institutional Investor Guidelines for Options and LTIP Awards

- Equity-based incentives should link long-term reward to long-term performance
- Vesting should be based on performance conditions which support the strategic objectives of the company measured over a period of at least 3 years
- All new plans and significant amendments to existing plans must be approved by shareholders
- The operation of plans should not result in excessive dilution for existing shareholders – 10% in ten years under all plans and 5% in 10 years for executive plans (unless targets are very stretching) is the norm
- Chairmen and other non-execs should not have options or similar awards based on share price and/or corporate performance since it compromises their independence
- Executive directors and senior executives should be encouraged to build up meaningful shareholdings

US Corporate Governance Framework

- No complete/consolidated body of “regulatory” guidance
 - Mostly ad hoc through provisions here and there
 - Sarbanes-Oxley Act requirements
 - Institutional Shareholder Services scrutiny
 - National Stock Exchange requirements and reform
 - SEC Proxy Disclosure Rules
 - Key words: disclosure and transparency
 - Reflects an increasing recognition of the potential importance of the differing incentives and possible conflicts of interest among the board, executives, outside monitors and shareholders

US Corporate Governance Framework

- In the US, the emphasis is on achieving the right balance
 - Compensation Committees found themselves in the unfortunate position of trying to balance the expectations of executives (who they have direct interface with) and the needs and fiduciary duty to the company and its shareholders
 - If the Compensation Committee provides too much compensation, then they fail the “appropriateness” or “reasonableness” test expected by the shareholders
 - If the Compensation Committee fails to offer enough compensation, then they run the risk of losing the most critical employees to the organization
 - As such, there is no right answer but everything needs to be considered from an optics standpoint

Areas of Risk – Compliance/Legal

- Companies need to be aware of all the UK rules and US practice
- Crucial to have the right people on the compensation/remuneration committee
- Crucial that compensation professionals and compensation/remuneration committee members stay fully up to speed on evolving corporate governance rules and practices, for example:
 - EU Prospectus Directive
 - EU Age Discrimination Directive
 - SEC Proxy Disclosure Rules – disclosing grant and backdating practices
- Fiduciary Training
- External advice

Areas of Risk – Compliance/Legal

- Compliance Check – you can be hurt by what you do not know
 - Securities, Tax, Exchange Control
 - Know where the committee's current knowledge strengths and weaknesses are
- Compensation/remuneration committees have a critical role to play and are very much in the spotlight – non-execs are therefore very exposed
- Training is crucial
 - It costs money but substantially reduces the risk of violation and legal exposure
 - Each member cannot be an expert in everything so fully utilize outside resources (attorney, consultants, accountants) – they can provide valuable insight into what other committees are doing
 - Being proactive with respect to education will ensure a means for improving strategy, broader design perspectives/improvements and a global understanding of the factors which impinge on those decisions (public perception, legal, financial, etc.)
 - Provide a handbook with an overview of substantive areas of law (US IRC Section 162(m), proxy disclosure rules)
 - Provide training for new compensation/remuneration committee members

Areas of Risk – Operational Processes

- Who assists in meeting corporate governance standards in equity arrangements? Identify the “team.”
 - It is not just the members of the compensation/remuneration committee.
 - Do not underestimate the value that management can bring to the table. They can help achieve a balance between corporate governance and HR resources. They are typically closer to the issues but should be utilized while keeping independence in mind.
 - Should there be a “compensation expert” on the compensation committee much like the “financial expert” on the audit committee?
- Identify each “team” member’s role and responsibilities
 - Collecting and recording information
 - Processing information
 - Summarizing information
 - Reporting information
 - Maintaining and monitoring information

Areas of Risk – Operational Processes

- Audit the equity grant process
 - Is the source of information on which the grant is based reliable?
 - Is there appropriate authorization of the grant?
 - Verify proper delegation of grant authority
 - State law
 - Plan document
 - Compensation Committee charter
 - Tax and securities law considerations
 - Limit number of authorized agents
 - Specify limitations (individual and maximum number of shares, minimum vesting)
 - Do the final drafted documents mirror the intent of the compensation committee? How do we know that?
 - Is there an audit trail and backup documentation for transactions, corrections, etc.?
 - Does the grant comply with all legal rules and other regulations?
 - Are all grants consistently handled and processed?
- Flowchart or checklist the processes to ensure the appropriate controls and procedures are in place

Areas of Risk - Reputation

- Compliance with regulatory rules – public exposure of violations can be more damaging than the magnitude of the violation itself
- Failure to keep an ongoing dialogue with shareholders – without it companies risk opposition and even the voting down of plans and votes of no confidence – it does happen!
- External advisors and lack of independence
- Performance standards – performance conditions should be a stretch to avoid a perception of targets being too easily achieved – there is much bad press in the UK and/or US about perceived rewards for poor performance



Best Practices – Choose the Right People to Be on the Compensation/Remuneration Committee

- Select committee members for technical competencies in certain areas (or train them to provide those technical competencies)
- Select committee members who understand the business and understand the industry incentives needed to attain long-term business objectives
- Independent external advisors – should they be consulted or should they be committee members?



Best Practices – Focus on Due Diligence

- Understand (or help the compensation/remuneration committee understand) the equity proposal from an internal and external perspective – it is no longer acceptable to just follow management's opinions and directive
- Assess the financial, operational and human capital impact to the current programs and processes
 - Incentive programs need to be monitored and reviewed for changing circumstances, reasonableness, law changes, etc. on a set cycle. The key is to have a multi-year agenda with a defined cycle to identify issues before they become problems
- Determine the primary and secondary risks to your company's position on any equity proposal
- Carefully document discussions and decisions relating to any proposal

Best Practices – Adopt New (Formal) Grant Policies

- Avoid/modify procedures for unanimous written consents
- Establish regular times for committee meetings and grants
- Tighten controls over delegated stock option awards
- Consider alternatives to stock options
- Adopt meaningful stock ownership and retention guidelines
- Prohibit hedging
- Consider company-imposed sanctions upon executives for filing Form 4 late where delay is attributable to executive
- Include clawback/forfeiture provisions for "bad acts" and "bad leavers"
- Cross-reference compliance with state law, Compensation/Remuneration Committee charter, and Section 16

Best Practices – Demonstrate Strong Linkage Between Pay and Performance

- Performance goals should reflect continuous improvement in some way on the achievements of prior periods
- Metrics and goals should be clearly linked to corporate strategy execution
- Performance relative to comparator companies should be incorporated into incentive plans either in goal setting or in performance measurement
 - Choose appropriate comparator group (e.g., an index or basket of comparator companies)
- Companies should double-check that payouts look reasonable given relative financial/market performance
- Enhanced discussions of the achievements behind the payouts, even without specific targets/results can aid outsider's understanding of the rationale

Questions?

Thank you for your participation