KEEPING YOUR SHARE POOL CLEAN IN A MESSY ECONOMY

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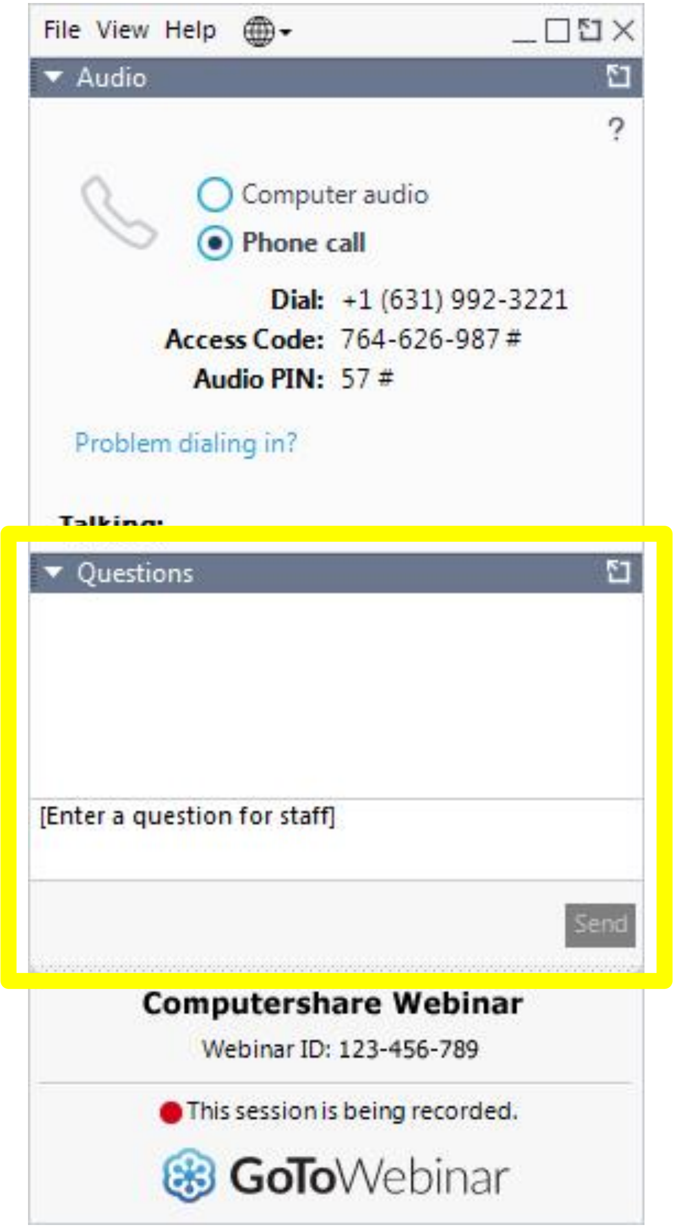

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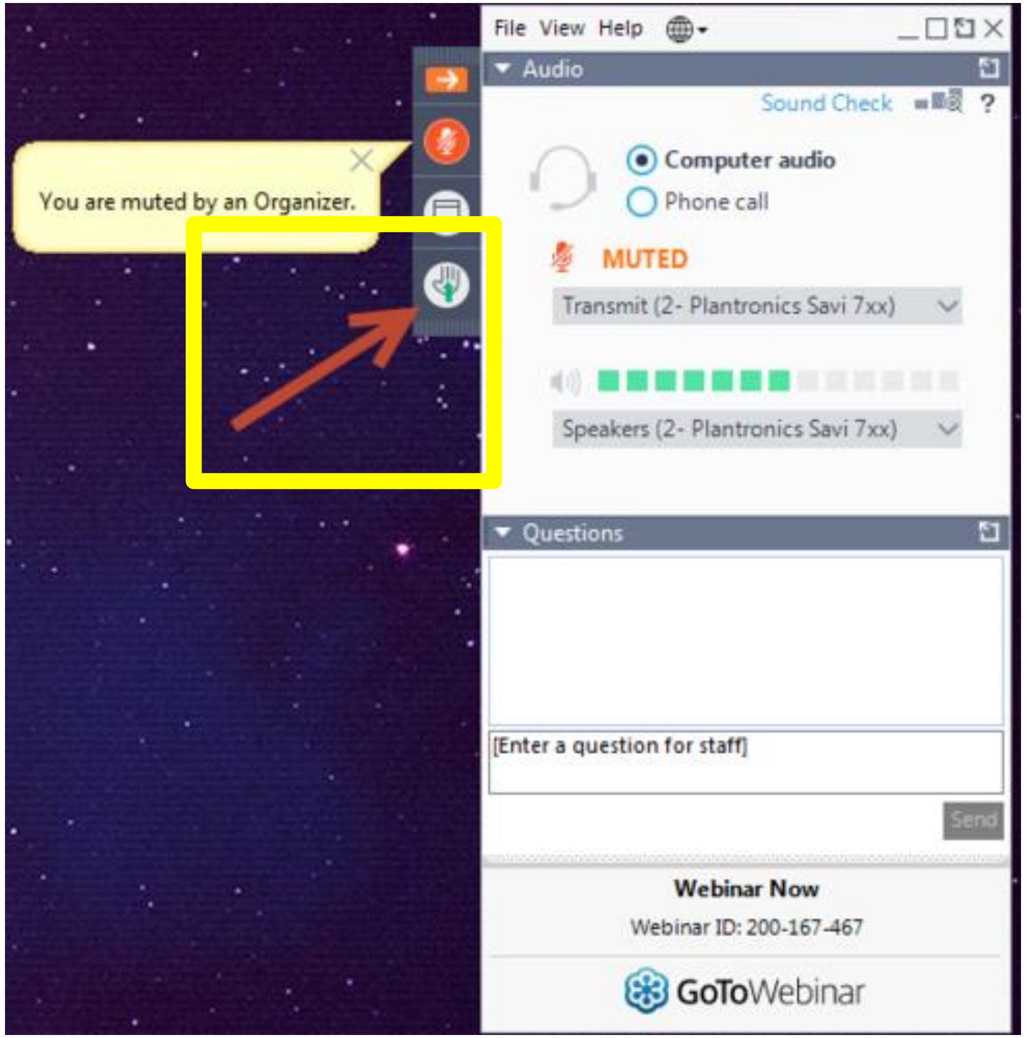

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Introductions

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Agenda

1 **Defining the Problems**

2 **Short-Term Problems & Targeted Fixes**

3 **Longer-Term Creative Solutions**

4 **Wrap Up**

Learning Objectives

- ✓ Discuss how share pools work and best practices in tracking share burn
- ✓ Explore examples of stock price volatility resulting in excessively fast share pool depletion
- ✓ Consider alternative grant calibration approaches to mitigate pool depletion
- ✓ Investigate alternative award vehicles that conserve or avoid using equity altogether

Polling Question #1

How does your firm track share pool depletion for scaled (e.g., 0%-200%) performance awards? (Check all that apply)

A. We track them assuming maximum payout

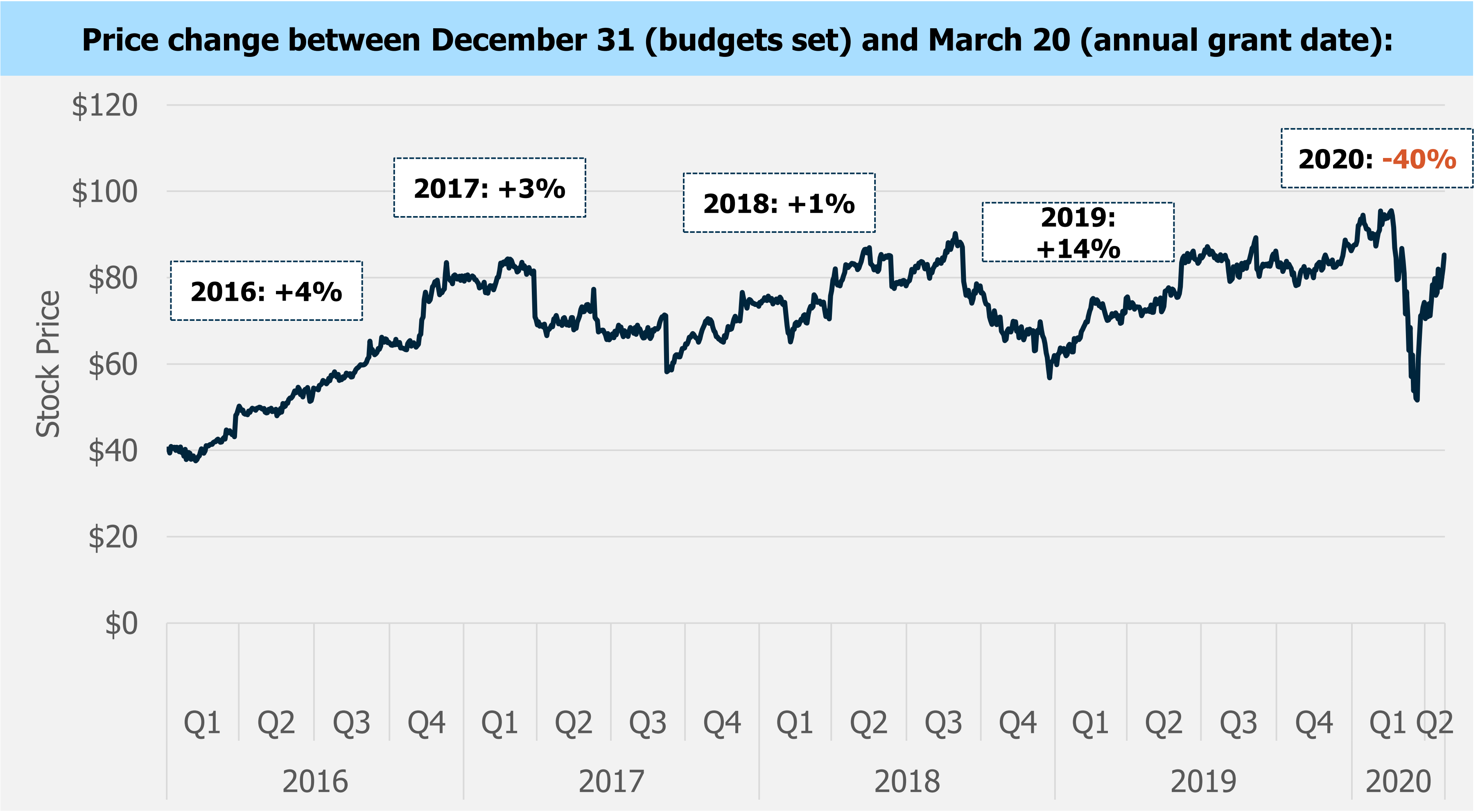
B. We track them assuming target payout

C. We track them assuming current-expected payout

D. We do not track them until actual payout

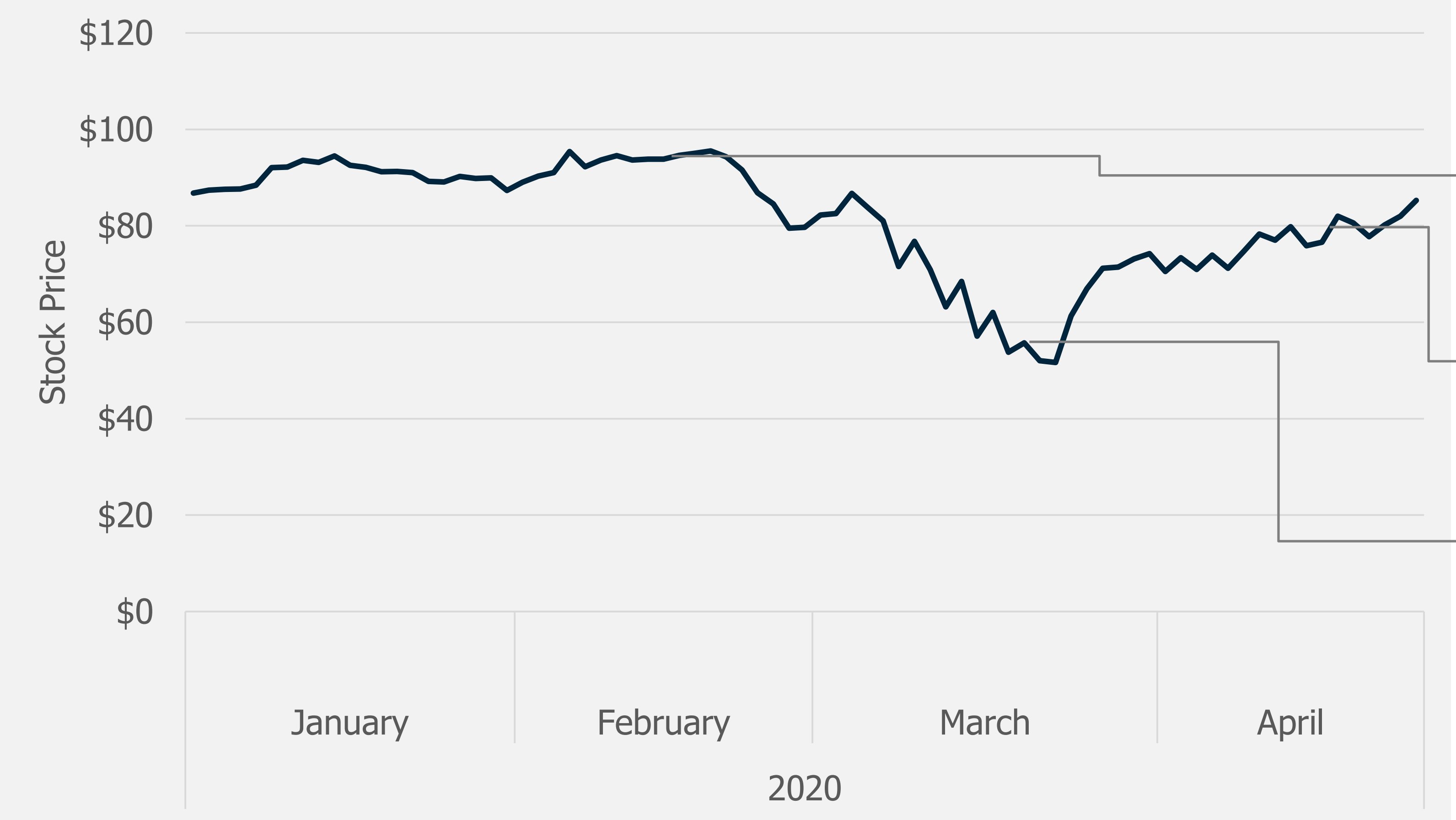
E. Not sure or Not Applicable (vendor, private, don’t issue these, etc.)

Volatility and Share Pool Management



Grant Timing Differences

What does granting low mean?
What does granting high mean?



Target LTI = $1 million

Price = $85 | Shares = ~11,800

*February 20 Grant Date: **-11%** usage*

Price = $95 | Shares = ~10,500

*April 20 Grant Date: **+6%** usage*

Price = $80 | Shares = ~12,500

*March 20 Grant Date: **+55%** usage*

Price = $55 | Shares = ~18,100

Polling Question #2

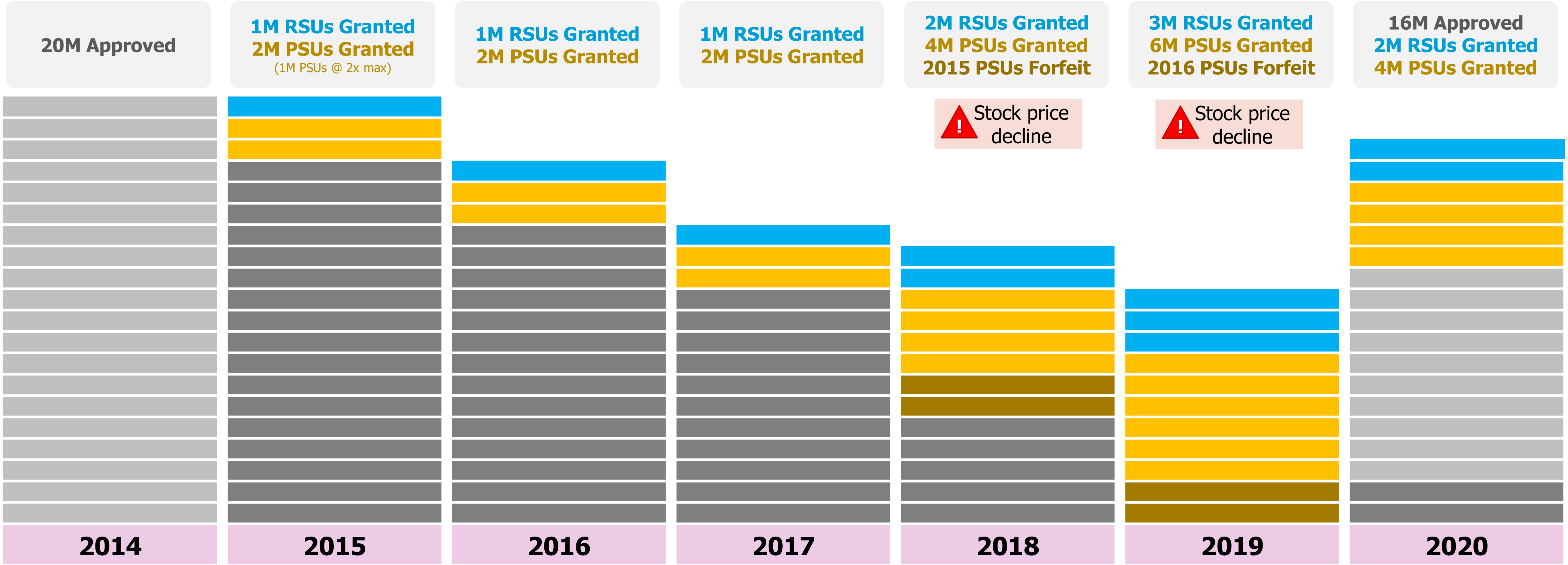
Are you considering changing the timing of your upcoming grant due to stock price volatility?

A. Yes

B. No

C. Not sure or Not Applicable (vendor, private, etc.) or something else

Share Pool Tracking



Share Pool Tracking Notes
- Options and RSUs are counted against share pool as number granted
- Performance awards should be tracked assuming max payout
- Forfeitures due to termination or performance are added back
- Net-settled options or shares are <u>not</u> added back

Best Practices
- Keep 2 sets of share pool records: conservative and estimated actual
- Monitor burn rate and other key metrics
- Stay ahead of new share requests – the process can be long
- Routinely scenario-test projections against stock price volatility

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Not Enough Shares, Not Enough Time

What if:
- **You don't have enough shares for an upcoming grant, AND**
- **You don't have enough time to get shareholder approval for more shares**

Solution Category 1: Bridge to Approval

A

Partial / Staggered Grants

Part of the grant is issued now, with the remainder to be granted after approval

B

Promises of Future Grants

Delay the grant date, committing to issuing grants in full post-approval

C

Temporarily Cash-Settled Grants

Issue cash-settled grants that auto-convert to share-settled upon approval

Not Enough Shares, Not Enough Time

What if:
- **You don't have enough shares for an upcoming grant, AND**
- **You don't have enough time to get shareholder approval for more shares**

Solution Category 2: Avoid Approval Altogether

A

Inducement Grants

Grants for executive new hires can be outside shareholder-approved plans

B

Cash-Settled Grants

Issue grants that do not settle in shares at all and pay out in cash

C

Recapture Shares via Modification

Execute option exchange or similar program to capture overhang shares

Administrative Checklist

Regardless of your decision, please keep the following in mind:

- ✓ Reach out to your stock plan administrator as soon as possible to make them aware of any substantive changes to your awards
- ✓ Ensure your administrator can support the design of your awards
- ✓ Communications are key – Work with your administrator to develop a communications plan that is simple and effective

Determining Grant Sizes in a Volatile Market

The Issue

- Most companies use some form of "value-based" convention to set shares
- In normal times, these conventions often lead to minimal differences
- In a volatile market, these conventions can lead to radically different sizes
- Some methodologies may lead to employee disconnects

Example: $60,000 grant

- Use average Feb price ($12)
  - 5,000 shares ($60,000/$12)
- Use March spot price ($8)
  - 7,500 shares ($60,000/$8)

Alternatives	Benefits	Downsides
1 Use the grant-date spot price	▪ Intended grant value matches exactly to value conveyed at grant	▪ Potentially high share burn ▪ High sensitivity to exact grant date
2 Use a trailing-average price	▪ Balances up-to-date information with smoothing of sensitivity to grant date	▪ Risks perception as a "take" if an 11th hour departure from past practice
3 Revert to a price from a past date	▪ Consistent with prior grant ▪ Fully insulates from recent events	▪ Risks perception as arbitrary ▪ Ignores other movement in last year
4 Keep consistent convention	▪ Immune from arbitrary perception ▪ No risks from 11th hour policy change	▪ Potentially high share burn ▪ Not responsive to unique situation

Polling Question #3

What approach does your company use for determining grant sizes?

A. Target dollar value divided by spot stock price (regardless of fair value)

B. Target dollar value divided by grant-date fair value (if different from stock price)

C. Target dollar value divided by trailing average price

D. Target dollar value divided by some other estimate of value (e.g. constant factor, target price, prior year price)

E. Not sure or Not Applicable (vendor, private, etc.) or something else

Share Pool Concerns? Use Cash Instead!

Cash-Denominated and Cash-Settled

- Start with target dollar value
- Can be service- or performance-based
- No linkage to stock price (less leverage)
- Can be designed with more leverage
- Vested value based on payout only

Stock-Denominated and Cash-Settled

- Start with target dollar value
- Convert into number of units or options
- Can be service- or performance-based
- More leverage given linkage to stock price
- Vested value based on payout & stock price

Prevalence and Best Practices

- Tend to be more common below the executive level
- Share pool constraints can lead to an uptick in cash awards
- Not as common due to expense volatility from variable accounting
- Can leverage the settlement option within plan agreements

Option Exchange Overview

What is an option exchange?

When options go underwater they lose their retentive value…

Exchange lets employees surrender underwater options for a lesser number of new awards

Many design choices: *we maintain a database of 234 option exchanges covering all flavors and firm characteristics:*

Design Question	Choices and Considerations
Option eligibility	▪ Tied to a strike price (e.g., strike price > 52-week high) or grant date
Participant eligibility	▪ CEO/NEO participation most controversial (but still common)
Exchange vehicle	▪ Choice between options, RSUs/RSAs, and cash
Vesting schedule	▪ Decision to continue or restart vesting
Contractual term	▪ Decision to maintain or extend term of new option awards
Exchange bands	▪ Number of bands (distinct ratios) to balance cost and clarity
Exchange ratio	▪ 1:1, value-for-value or other non 1:1

Decision-Making Criteria

Legal

- Considered an investment decision, which requires adherence to SEC tender offer (TO) process
- Shareholder approval likely required based on plan and exchange listing rules

Accounting and Proxy

- Potentially benign – can structure to be cost-neutral or any degree of incremental cost desired
- Record incremental cost as new award in SCT and GOPBA Table

Shareholders

- Proxy advisors have strict criteria governing when they will endorse
- More favorable exchange terms will require proxy solicitation

Managing Employee Share Purchase Plans

The Issue

- ***ESPPs alleviate many company and employee concerns during periods of volatility and uncertainty:***
- Supports ownership culture and aligns incentives with shareholders
- Insulates employees from market volatility, especially with lookback or rollover/reset
- Not over-dilutive due to purchase contributions and share limits
- But there are a few special considerations for managing a plan during volatile periods to drive positive outcomes and mitigate negative outcomes

Considerations

	Consideration	Notes
1	Running out of shares in current plan	▪ If insufficient shares available at purchase, pro rata purchase and refund ▪ Communicate to avoid unfair perception
2	Obtaining shareholder approval for new plan or refreshed share pool	▪ ESPP approval is largely non-controversial, unlike share plans ▪ ISS approves 423-qualified plans with shares up to 10% of float, and many reasonable nonqualified plans too
3	Unexpected share limit triggers	▪ Share limits (either plan or IRS limits) easy to hit in down market ▪ Outcomes similar to insufficient shares
4	Implementing automatic rollover feature	▪ Ensures employees are all in the most favorable offering ▪ Maximum volatility insulation and upside

Polling Question #4

How have employees changed behavior with respect to your ESPP during the current crisis?

A. We have seen more interest / participation than normal

B. We have seen less participation / more withdrawals than normal

C. Behavior seems roughly the same (neither withholding increases nor withdrawals)

D. We don’t have an ESPP

E. Not sure or Not Applicable (vendor, private, etc.)

Parting Thoughts

1. No matter your concern level, kick the tires on your share pool and tracking process. Share pools are easy to manage on "autopilot" during a bull market, but that can cause nasty surprises in a downturn.

2. If you're in a short-term bind, be creative with working toward a solution. It's not one-size-fits-all, but there's often an answer that's acceptable and fair to all stakeholders.

3. If you're altogether unable to grant as much as desired over a longer term, consider alternative plans like cash LTI and an ESPP. These plans offer many of the same benefits with fewer constraints.

4. For any large undertakings, ensure that the right cross-functional team is there from the start. Option exchanges, share plan requests, and new plan implementations affect numerous stakeholders differently.

5. Modeling is key. Know the effect of design and modification decisions on your pool. And stress-test your numbers across scenarios and edge cases…we've learned that sometimes those edge cases actually happen.