

Panel II. Proxy Season Review

1. Review of 2009 Shareholder Proposals
2. Implementation of Say-on-Pay
3. Shareholder Access
4. Handling Underwater Stock Options
5. Proposed Rulemaking on Executive Compensation Disclosure

Review of 2009 Shareholder Proposals

- View from the SEC
 - Overview of 2009 Proposal Season
 - Commentary on Issues
 - Suggestions for Submitting No-Action Letters

- View from Company Counsel
 - Problematic Issues in Addressing Proposals
 - Recommendations in Responding to Proposals
 - Outcome on Proposals at Annual Meetings

Implementation of Say on Pay

- Overview of 2009 Say on Pay Proposals
 - Proxy rule requirements
 - Subject of vote phrased in a variety of ways
- Implementation of a Say on Pay Proposal
 - Alaska Air experience
 - Recommendations for points to consider
- The Future of Say on Pay
 - Divergence or harmonization
 - Voluntary or mandated
 - Possible effects on the voting process

PROPOSAL 3. ADVISORY VOTE REGARDING THE COMPENSATION OF THE COMPANY'S NAMED EXECUTIVE OFFICERS

In March 2009, the Board of Directors announced its decision to become one of the first public companies in the nation to voluntarily solicit stockholder input on executive pay.

With this proposal, the Board of Directors gives the stockholders of the Company the opportunity to vote on the following advisory resolution:

RESOLVED, that the stockholders hereby ratify the compensation of the named executive officers set forth in the Summary Compensation Table and the accompanying footnotes included in the Company's proxy statement (but not

including the Compensation Discussion and Analysis).

See the Summary Compensation Table and accompanying footnotes on page 36.

The stockholder vote will not be binding on the Company and will not be construed as overruling a decision by the Board or creating or implying any fiduciary duty by the Board. However, the Compensation Committee will take into account the outcome of the vote when considering future executive compensation arrangements.

**THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE *FOR* THE RATIFICATION
OF THE COMPENSATION OF THE NAMED EXECUTIVE OFFICERS.**

Proxy Access

- State Corporation Act Approach: Permissive Bylaws for Nominations and Expenses
 - *CA, Inc. v. AFSME Employee Pension Plan*, 953. A2d 227 (Del 2008)
 - Delaware: DGCL §112 and 113
 - ABA Committee Proposed Model Business Corporation Act: MBCA §2.06 and 10.20
 - Washington WBCA Proposal
 - North Dakota Publicly Traded Corporations Act

Proxy Access (Cont.)

- SEC Proposed Rules (Press Release 5/20/09)
 - New Rule 14a-11 – Include Shareholder Nominees in Company Proxy Materials
 - Amended Rule 14a-8(i)(8) – Allowing Shareholder Proposals
- New Rule 14a-11:
 - Applicable to all reporting companies (except debt only)
 - Eligible shareholders: 1% (LAF), 3% (AF), 5% (Others)
 - One year holding period, can aggregate
 - Short slate – not for change in control (greater of one director or 25% of board)

Proxy Access (Cont.)

- Senator Schumer – Shareholder Bill of Rights Act of 2009
 - Proxy Access – (Tie with SEC Proposed Rule 14a-11)
 - Federal Corporate Governance Law:
 - No classified boards
 - Mandatory majority voting
 - Independent board chairs
 - Say of pay votes
 - Board risk management committees

Handling Underwater Stock Options

Devin Stockfish, *Starbucks Corporation*

Sue Morgan, *Perkins Coie LLP*

Overview

- Options are intended to
 - Motivate employees
 - Retain employees

- Purpose of Repricing Underwater options
 - Provide renewed incentives to employees
 - Reduce option "overhang" by replacing underwater stock options with a lesser number of options with a lower exercise price
 - Recapture value from compensation costs being incurred for underwater stock options

Overview (Cont.)

- What are companies doing?
 - In 2008, 50 public companies did option exchanges
 - As of the end of April 2009, 40 companies have filed exchange offers
 - About 80 more have made filings indicating they are considering an exchange offer

Considerations for Option Exchange Programs

- *Shareholder approval:*
 - Nasdaq / NYSE
 - Equity plan
 - ISS / RiskMetrics, institutional investors
- *Structure:*
 - Type of replacement awards (options; RSUs; cash)
 - Exchange ratios (value-for-value; one-for-one)
 - Eligibility (exclusion of directors, NEOs, others)
 - New vesting periods; new term

Considerations (Cont.)

- *Accounting / Tax Issues:* Compensation expense; ISOs
- *International:* Non-U.S. tax, securities, employment law issues
- *Communications:*
 - Educating communicators on "rules of the road"
 - Messaging to institutional and other investors for shareholder approval
 - Communication and education plan for employees

Considerations (Cont.)

- *Timing:*
 - Board and compensation committee approval
 - Shareholder approval
 - Blackout periods
- *Costs:* Consultants, auditors, attorneys, RiskMetrics/Institutional Shareholder Services (RMG/ISS), printing, third party depository and information agent
- *Legal:*
 - Employment Law
 - Tender offer rules
 - Tax issues
 - SEC disclosure

Goals Drive Rationale / Design

- What are the goals of the exchange program?
 - Retention / morale
 - Share conservation
 - Move toward new instrument / more balanced “portfolio”
- How far underwater are your options?
- How long have they been underwater?
- How long until expiration?
- Has turnover increased?

Shareholder Approval

- Do you need it?
 - What does your plan say?
 - Does your stock exchange (NASDAQ / NYSE) require it?
 - If plan does not specifically allow (“exchange” or “repricing”).
Can't be silent on the issue.
- If you don't need it, should you get it?
 - For shareholder relations / proxy advisory firm issues
- Is preliminary proxy statement required?

Know Your Shareholders

- Who owns your stock?
 - Majority shareholder – consult with them
 - Closely held?
 - Institutional shareholders
 - Who do they listen to?
 - Proxy advisory firms
 - RMG/ISS
 - Glass Lewis
- Get proxy solicitor involved early

Know Your Shareholders: RMG/ISS

- Compensation Committee:
 - Will recommend vote AGAINST OR WITHHOLD from members of the compensation committee
 - Who approved and/or implemented repricing without shareholder approval
 - Even if repricing without shareholder approval permitted under equity plan
 - Recommendation (currently) applies only in comp committee election next following repricing
- Equity Plans:
 - Will recommend vote AGAINST equity plans
 - that expressly permit repricing without prior shareholder approval,
 - even if the cost of the plan is reasonable

Review Your Plans: Returning Shares

- Are cancelled shares returned to the plan?
 - Depends on terms of the plan
 - Are “cancelled” shares returned to reserve?
 - RMG/ISS prefers shares to be retired
 - Permanently decreasing dilution, not just temporarily, overhang
 - More ISS clients pushing for retirement
- What else does your plan say about exchanges?

Structure: Which Options to Include?

- 2009 Risk Metrics ISS Governance Services Guidelines
 - Require you exchange only options with prices above the 52-week high
 - Options more than one-year old (see page 43 of the guidelines)
 - *http://www.riskmetrics.com/policy/2009/policy_information*

Structure: Include Officers & Directors?

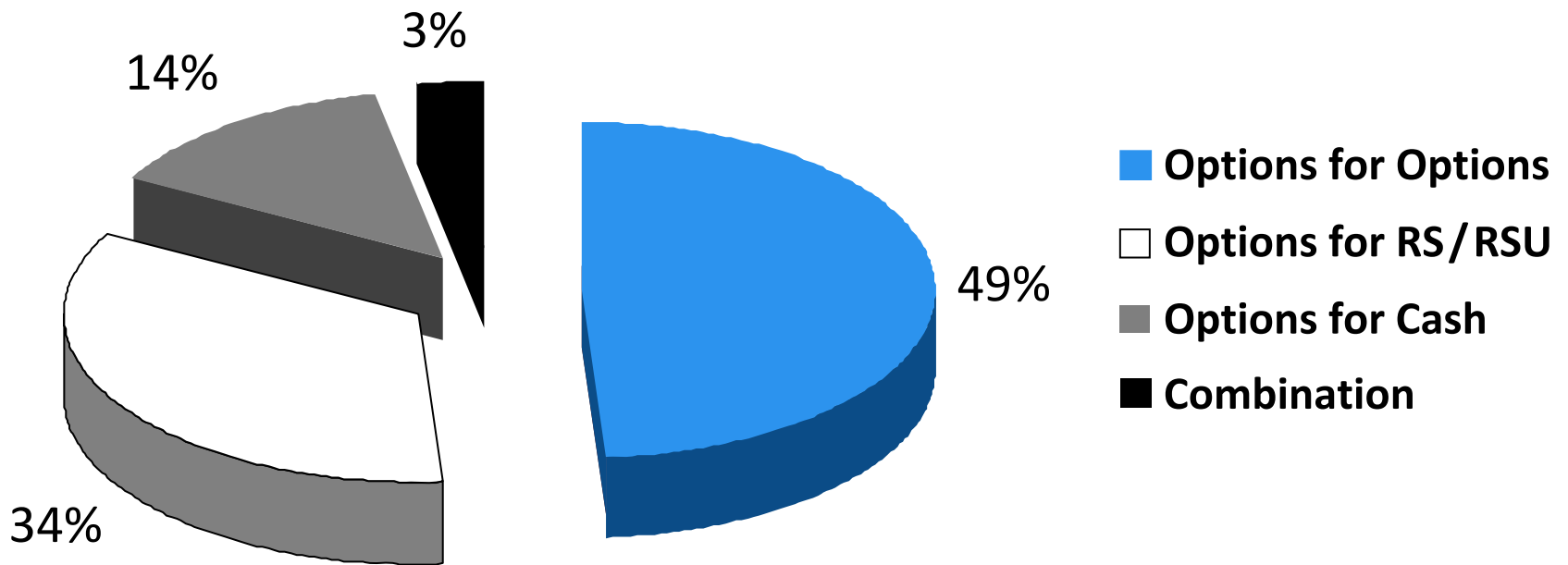
- Choices:
 - Exclude
 - Make exchange terms less favorable
 - Different ratio
 - Longer vesting
 - Premium price
- RMG/ISS:
 - Participation:
 - Exclude directors and named executive officers

Structure: What Type of Exchange?

- Option-for-option
- Option-for-RS/RSU
- Option-for-Cash
- Options-for-option OR -RSUs
 - Participant choice?
- Value-for-Value
- Arbitrary Ratio

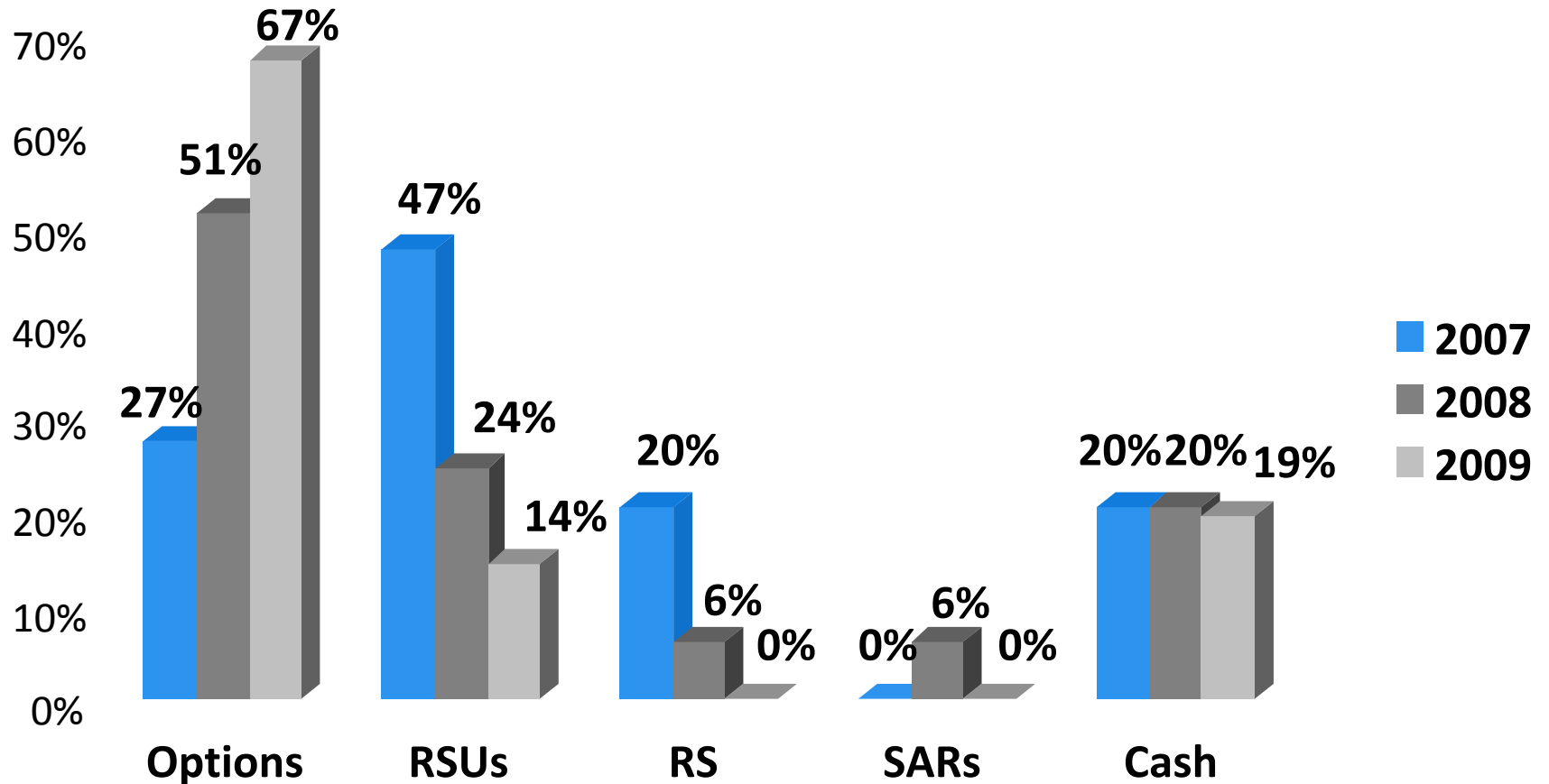
Structure: Type: Data

Percent of companies studied using each of the three primary exchange types



* Radford data from www.underwaterexchange.com, used with permission.

Structure: Type: Data (Cont.)



* Perkins Coie research data. Percentages may not add up to 100% where company offered more than one type of exchange choice.

Structure: Type: Options for Options

Advantages	Disadvantages
<ul style="list-style-type: none">■ Ease of communication■ Reduce burn rate, overhang and dilution■ Some plans allow without shareholder approval<ul style="list-style-type: none">● Becoming much less common■ Retain the leverage of an option	<ul style="list-style-type: none">■ May cause negative employee reaction:<ul style="list-style-type: none">● Employee skepticism toward options if share price decline extended■ New options may also fall underwater

Structure: Type: Options for RS / RSUs

Advantages	Disadvantages
<ul style="list-style-type: none">■ Can't fall underwater<ul style="list-style-type: none">● Less volatile■ Rebalances portfolio■ Larger reduction in overhang, burn rate and dilution<ul style="list-style-type: none">● Fungible share counting?■ Can further reduce dilution if shares withheld for taxes	<ul style="list-style-type: none">■ RS / RSUs<ul style="list-style-type: none">● No cash inflow for price● Fixed taxable event■ Employee upside reduced by fewer shares issued – “less leverage”■ Some plans may not allow without shareholder approval■ May exceed full-value share limit in plan

Structure: Type: Options for Cash

Advantages	Disadvantages
<ul style="list-style-type: none">■ <u>Biggest</u> reduction to overhang, burn rate and dilution■ No more underwater options■ Immediate value to ppts.■ No shareholder approval required■ Accelerates expense into current period	<ul style="list-style-type: none">■ Company cash outlay■ No cash inflow for price■ No leverage (stock growth)■ No alignment of employee and shareholder interests■ No retention and attraction features (vesting may be an issue)■ Fixed taxable event■ Potential “all holders / best price” issues■ Accelerates expense into current period

Structure: Exchange Ratio

Type	Advantages	Disadvantages
Value-for-Value	<ul style="list-style-type: none">▪ Usually Minimal incremental expense▪ Reduce burn rate, overhang and dilution▪ ISS favors▪ Gives each participant “same deal”	<ul style="list-style-type: none">▪ Harder to communicate▪ Different exchange ratios for different grants, sometimes many▪ If grant is far underwater, result can seem “unfair” (1 for 40?)▪ More manual effort to enter into administration system, depending on how you change vesting
Arbitrary Ratio	<ul style="list-style-type: none">▪ Usually reduces burn rate, etc. less▪ If ratio is not too high, gives participants more value	<ul style="list-style-type: none">▪ Easy to communicate▪ Can cause significant incremental expense

Structure: Impose Additional Vesting?

- Choices
 - No change
 - FLSA issue for non-exempt employees
 - Reset to full new vest period
 - Reset to shorter vest period
 - Different vesting for vested vs. unvested shares
- RMG/ISS
 - Vesting:
 - Is the new award subject to vesting?
 - No specific vesting in mind, just “additional”

Structure: Replacement Option Term?

- Choices
 - No change
 - Keep original expiration date
 - May be problematic if not much term remains (especially if additional vesting imposed)
 - Reset
 - Reduce
- RMG/ISS
 - The term should remain the same as that of the replaced option (no additional time to exercise)
 - Can be weighted-average, not grant-by-grant
 - FAQ says longer term okay if value-for-value

Accounting Impact

- FAS 123R
 - 6 month + 1 day delay no longer required – no variable accounting
 - Continue to account for original award, plus account for “incremental cost” of replacement award
 - Incremental cost = excess of “fair value” of replacement or repriced award (measured immediately after repricing) over “fair value” of original award (measured immediately before repricing)
 - "Concurrent" exchange

Accounting: Value-for-value Exchange

- Determining Ratio(s)
 - Compute current value of options to be exchanged
 - Each different option = unique ratio
 - Many companies use “bands” of grant prices
 - Grant price between \$30 and \$40 = ratio of 3:1
 - Grant year 2005 = ratio of 2:1
 - Sometimes based on year of grant (similar prices, expected term, etc.)
 - Easier to communicate
 - Limits number of ratios, reduces effort

The Starbucks Experience

- *Eligibility:*
 - Options with strike price above **52-week high** (\$19) granted more than **17 months** prior to commencement of exchange offer
 - U.S. & international employees **other than senior leadership team**
- *Program Design:*
 - "**Value-for-value**" option exchange (i.e., fair value of new stock options approximately equal to the fair value of the stock options that are surrendered for exchange; number of new stock options dependent on the exercise price(s) of the eligible stock options surrendered for exchange and applicable exchange ratios.
 - New stock options subject to a **two-year vesting period**
 - **New stock options will have a term of seven years** (rather than typical ten-year terms)

The Starbucks Experience (Cont.)

- *Exchange Ratios:*
 - Set to ensure that the exchange offer was "value-for-value" and approximately accounting expense neutral to Starbucks

If the Per Share Exercise Price of an Eligible Stock Option Grant Is	The Exchange Ratio Is (Eligible Stock Options to New Stock Options)
\$19.01 to \$24.99	2.01 - to - 1
\$25.00 to \$29.99	3.19 - to - 1
\$30.00 to \$34.99	3.54 - to - 1
\$35.00 and above	4.44 - to - 1

Legal Issues: Employment Law

- Treatment of non-exempt employees
 - Worker Economic Opportunity Act – option gain included in “regular rate” of pay for purposes of FLSA overtime rules unless:
 - Not exercisable for 6 months or
 - Death
 - Disability
 - “Retirement”
 - Change in Control

Legal Issues: Tender Offer Rules

- Why you have to do a Tender Offer:
 - Section 13e-4 of Exchange Act
 - Exception: No investment decision (e.g., reduce exercise price of NQs with no other change in terms)
 - Exception for individually negotiated arrangements to a small group of people (10 people?)
 - Timing issues if material non-public information (such as corporate transactions)

Legal Issues: Tender Offer Rules (Cont.)

- What a TO means:
 - Tender offer rules require public filing of Schedule TO plus all written communications
 - Schedule TO must be amended with any non-filed communications
 - Caution regarding pre-commencement communications (some need to be filed)
 - Keep open for 20 business days
 - Allow changes to elections
 - Confirmations on elections and changes
 - If consideration offered or percentage of securities sought increased or decreased, offer must remain open at least ten business days from date the change is published

Legal Issues: Tender Offer Rules (Cont.)

- 2001 Global Exemptive order: Exempts repricings from tender offer "all holders" and "best price" rules if meet four tests:
 - Conducted for compensatory purposes in accordance with the company's compensation policies and practices
 - S-8 eligible, options issued under Rule 405 employee benefit plan
 - Disclosure of essential features including risks
 - Comply with all other tender offer rules

Legal Issues: Tender Offer Rules (Cont.)

- SEC Comment Process
 - Comments typically provided within five to seven days
 - May require filing of amendment to Schedule TO-I and exchange offer document
 - Generally no redistribution required
 - Usually does not delay the tender offer/add to the period the offer must remain open, unless
 - Change consideration or percentage participation (ten business days)
 - For certain material changes (e.g., waiver of a condition) SEC may require tender offer to remain open for at least five additional business days

Legal Issues: Tender Offer Rules (Cont.)

- Recent SEC Comments
 - Material terms, including exchange ratio, must be known before expiration of offer
 - Conditions of offer must be satisfied by expiration date
 - Conditions for must be specific
 - Exclusion of non-U.S. or other employees must be tied to compensation policies and practices
 - Possible restrictions on options-for-cash exchanges

Legal Issues: Tax Issues

- Incentive Stock Option (“ISO”) rules
 - \$100,000 limit for year of repricing includes canceled options which would have vested in that year
 - May result in loss of ISO status for some repriced options
 - If offer open more than 30 days, lose ISO status for options not tendered
- 162(m) Rules
 - Repriced options count against 162(m) per – participant limit as additional grants
 - If replacement grant is time-based RSUs, do not qualify as performance-based

SEC Disclosure Requirements

- Summary Compensation Table
 - Incremental fair value of replacement award must be included
 - As accrued over the fiscal years covered by the table
- Grants of Plan-Based Awards Table
 - Replacement grant included in table
 - incremental value of the replacement grant disclosed in “Grant Date Fair Value” column
- Description of exchange program must form part of the narrative discussion accompanying the tables

SEC Disclosure Requirements (Cont.)

- CD&A must address reasons for exchange and conformity to the company's stated compensation philosophy if the NEO's participate
- Cancellation of underwater options and receipt of any replacement grants must be reported by Section 16 insiders
 - Form 4 report
 - Filed within two business days after the exchange
- Cancellation of option and receipt of replacement grant should qualify for one of the exemptions under SEC Rule 16(b)-3
 - So that there are no deemed purchases or sales of securities for Section 16(b) short-swing trading purposes

Practical Tips

- Start the planning process early
- Engage the right advisors, consultants, third party vendors (and make sure they are talking to each other)
- Consult your auditors early in the process
- Consider engaging RiskMetrics for modeling to ensure design of your exchange program will receive RMG/ISS recommendation
- Consider engaging third party vendor to act as depositary and information agent (particularly if you have a large employee base that will participate in the exchange)

Practical Tips (Cont.)

- Confirm with your stock option plan administrator that its systems will support the requisite tax and accounting reporting for an option exchange (it's possible that a work around may need to be developed)
- Develop a plan for communications relating to the exchange program and make sure that all of the communicators (internal and external communications groups, IR, human resources, etc.) and executives understand the restrictions / limitations imposed by the tender offer rules
- Monitor evolving SEC comment letter positions

SEC Proposed Rulemaking on Executive Compensation Disclosure

- View from the SEC
- View from Company Counsel