THOUGHTFUL PAY SURVEY™

Corporate Governance and the Compensation Committee

Survey Results Report

May 2005

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Introduction

The corporate scandals of the past few years have intensified scrutiny of executive pay practices in publicly traded companies. Increasingly, shareholders are demanding accountability for executive compensation decisions and taking steps (through proxy voting and/or litigation) to ensure that their voices are heard. The challenge of balancing the concerns of shareholders on the one hand with executives' desires to be appropriately rewarded for their efforts on the other falls squarely upon the Compensation Committee.

Almost two years ago, *Compensia* was formed specifically to help Compensation Committees and senior management teams navigate this evolving landscape. During this time, we have received numerous inquiries regarding the key concerns of shareholders and Compensation Committee members. Some of these questions include: What constitutes an appropriate peer group? How does the company ensure proper alignment of pay and performance? With the looming expensing of stock options, should the structure of equity compensation be altered? Should the Compensation Committee have its own outside advisors?

In response to these weighty concerns, we have conducted an inaugural survey to identify, primarily in high-tech companies, the emerging trends and practices of Compensation Committees in the current environment. Our goal was twofold: to understand the Committee members' various points at issue as they struggle to perfect executive compensation programs, and to begin generating a policy of best practices.

Our task comprised of contacting West Coast high-technology and life sciences companies, with annual revenues of less than $3 billion, and inviting their Compensation Committee members to participate in this study. In addition, we expanded the scope of our research by including our existing clients that are outside the high-technology/life sciences space and/or the annual revenue range.

In order to cover a broad range of executive compensation issues and to recognize the usual time constraints plaguing most Compensation Committee members, we limited the scope of our survey to 13 high-level questions in the following areas:

- Compensation Committee process for managing executive pay
- Executive pay strategy
- Equity compensation matters
- CEO performance evaluation
- Board of Director compensation
- Other areas of concern

Many participants expressed an interest in receiving more detailed information about the areas addressed above. To meet these numerous requests, and to build up our database of emerging/best practices, *Compensia* intends to conduct future surveys that will delve deeper into these matters of importance. On a final note, we want to thank everyone who participated in this study. We greatly appreciate your time and effort in completing the questionnaire. We hope that our report, in summarizing the results of our queries, is informative, useful, and timely.

Note: In some cases, survey response percentages may not equal 100% due to rounding.

For questions about these survey results, please contact Michael Benkowitz
at (415) 462 2996 or mbenkowitz@compensia.com.

Executive Summary

The highlights of the survey are summarized below in topical order:

Compensation Committee Process	▪ The role and activity level of the Compensation Committee are increasing. Three out of four of companies discuss, at the Compensation Committee level, each of the 18 compensation/human resource issues queried by Compensia. ▪ Most Compensation Committees do not retain or exercise full approval authority on compensation items. The typical practice is to recommend an action to the full Board (of independent directors). ▪ Responsibility for establishing Board of Director compensation levels has not yet shifted to the Governance Committee. Eighty-four percent (84%) of companies discuss this issue within the Compensation Committee.
Executive Pay Strategy	▪ Industry group and direct business competitors are consistently ranked in the top three as criteria for establishing a peer group. Revenue size, arguably the biggest predictor of executive compensation levels (outside life sciences industry), was cited as a top three criteria by only 41% of Committee members. ▪ Companies generally target total compensation levels above the 50th percentile (67% of companies), but this is usually achieved by maintaining fixed compensation (salary) at market median levels and increasing the leverage of variable components (short-term incentive and equity awards). ▪ Compensation Committee members generally agree that executive pay and performance is aligned (>90% of respondents). A slightly smaller, though significant, majority (76%) believe that executives “share the pain” with shareholders in low-performing years.
Equity Compensation	▪ Compensation Committees must reassess their equity strategy in light of new accounting rules and the current shareholder environment. Attraction/retention, providing competitive pay opportunities and aligning equity awards to performance were cited as the most important equity program objectives. Managing burn rate and minimizing accounting expense were listed as a top priority by fewer than 1/3 of participants. ▪ The vast majority of Committees will consider the continued use of stock options in an expensing environment. Seventy-one percent (71%) of Committee members said they would consider restricted stock for executives. A surprising 42% also said they would consider cash-based long-term incentive awards.
CEO Performance Evaluation	▪ Ninety-six percent (96%) of Committees evaluate CEO performance and 61% have implemented a formal process. ▪ The results of the performance evaluation influence variable pay decisions (short-term incentive award and equity grant) more frequently than salary increases.
Board of Director Compensation	▪ Compensation Committee members generally believe that their Board compensation packages are adequate and agree that companies should differentiate pay based on committee service (audit vs. other committees) and role (chair vs. member). Seventy-one percent (71%) of Committee members also liked the idea of delivering equity via restricted stock rather than through stock options. ▪ Committee members were more evenly split on the issue of whether to pay committee compensation via retainers or meeting fees, as well as the use of performance-based pay.
Other Areas of Concern	▪ Committee members indicated that the biggest areas of concern at their respective companies are attracting and retaining executive talent, aligning executive pay with company performance and shareholder value creation, and equity strategy/accounting issues.

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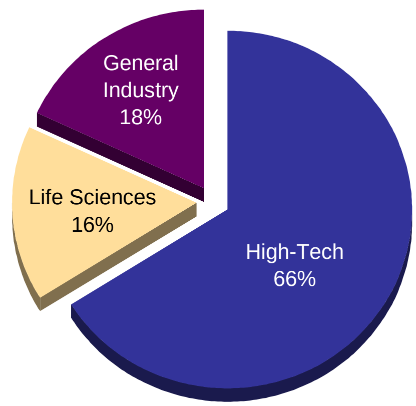
Participant Profile

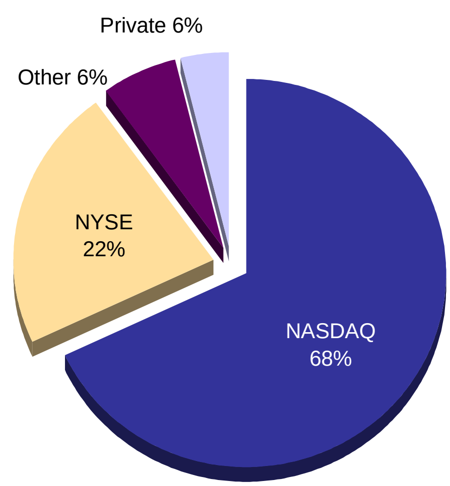
Compensia received survey responses from 55 Compensation Committee members representing 51 companies. Sixty-six percent (66%) of respondents represent high-technology companies, 16% represent biotech companies and the remaining 18% represent general industry firms. [Figure 1]

Figure 1 – Industry Representation



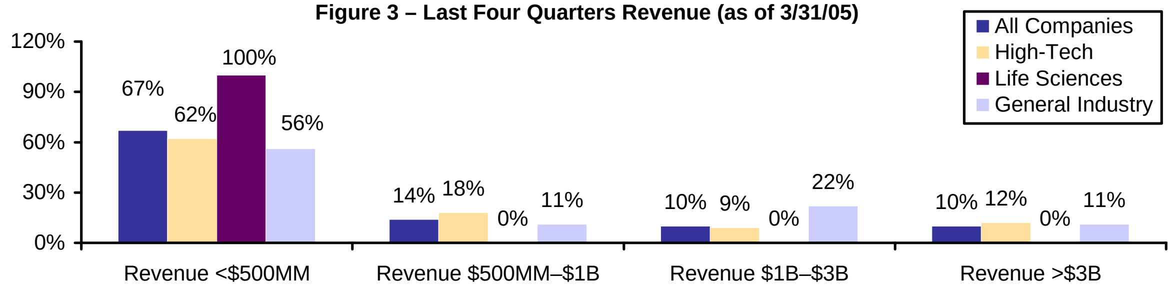
Ninety-six percent (96%) of the companies in the survey are publicly traded. Sixty-eight percent (68%) are listed on the NASDAQ and 22% are listed on the NYSE. [Figure 2]

Figure 2 – Exchange



The median revenue size of all companies is $216.6 million. However, as depicted in Figure 3, there is wide dispersion.

Figure 3 – Last Four Quarters Revenue (as of 3/31/05)



Compensation Committee Process

Corporate governance standards enacted by the major stock exchanges in 2003, coupled with the heightened scrutiny of executive compensation practices by institutional shareholders and their advisors (e.g., ISS, Glass Lewis, etc.), have prompted many Compensation Committees to develop and/or formalize their process for managing executive pay. This typically includes creating a detailed charter outlining the purview and decision rights of the Compensation Committee, developing a meeting calendar and agenda for the year, conducting self-evaluations, and retaining outside advisors to support the Committee. Our initial set of survey questions focused on how Compensation Committees have established these processes.

First, we asked Committee members to state their level of authority and decision rights in 18 areas of compensation/human resources. The results are consistent with what we have observed through our consulting assignments: that Compensation Committees are becoming more involved, to varying degrees, in the executive and broad-based employee pay and human resources programs. Of the 18 areas listed in the survey questionnaire, each was discussed at the Committee level by at least 75% of companies. [Figure 4]

Figure 4 – Compensation Committee's Decision Rights, or Level of Authority with Respect to the Following Compensation/HR Areas

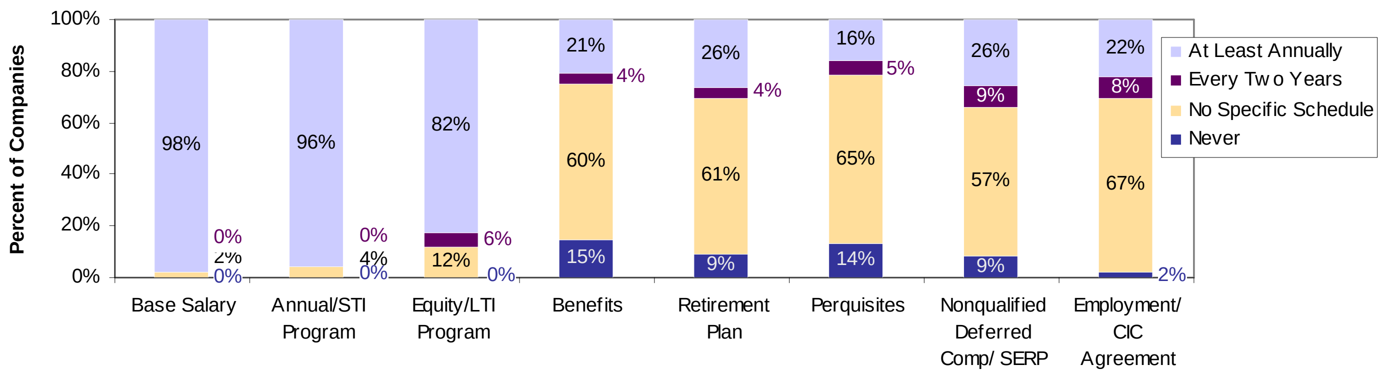
	Full Approval	Recommends for Board Approval	Reviews Only	None	Not Sure (excluded from results)
CEO compensation	27%	73%	0%	0%	0%
Top 5 executives' compensation	43%	53%	4%	0%	0%
Other Section 16(b) officers' compensation	42%	32%	26%	0%	0%
Other executive's compensation	18%	18%	56%	8%	0%
CEO performance evaluation	40%	40%	6%	14%	2%
Exec annual/STI plan design	45%	55%	0%	0%	0%
Exec equity/LTI plan design	38%	60%	2%	0%	2%
Supplemental executive benefits	37%	49%	14%	0%	0%
Exec employment and/or CIC agreements	35%	56%	2%	6%	6%
Mgmt succession planning and/or removal of execs	17%	50%	25%	8%	4%
Merit salary pool for all employees	29%	41%	29%	2%	4%
Non-exec annual/STI plan	16%	28%	44%	12%	2%
Non-exec equity/LTI plan design	25%	54%	17%	4%	4%
Non-exec equity grant guidelines	31%	35%	31%	2%	4%
Individual non-exec equity awards	31%	20%	35%	14%	4%
Broadly available benefits	14%	29%	43%	14%	4%
ESPP design	17%	52%	19%	13%	4%
BOD compensation	14%	67%	2%	16%	2%

By and large, it appears that most Committees either do not retain or do not exercise full approval authority with respect to compensation issues that require Board/Committee-level approval. Rather, the Committee recommends an action to the full Board. For example, 73% of participants indicated that the Committee does not approve the compensation arrangement for the CEO, but does make a recommendation to the full Board (of independent directors).

The decision rights for Board of Director compensation is another area of interest. Prevailing thinking is that the process for establishing Board pay should fall under the Governance Committee's charter. Indeed, it has been our experience that many companies are transitioning this item from the Compensation Committee to the Governance Committee. However, 84% of respondents indicate that the Compensation Committee is still heavily involved in the Board compensation process.

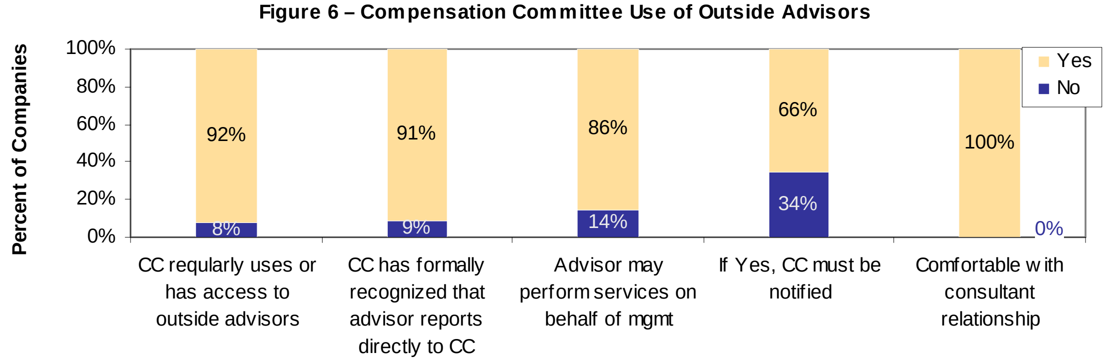
We asked Committee members how frequently they review the various executive compensation programs. Not surprisingly, the direct pay programs (base salary, short-term incentive and equity/long-term incentive) are generally reviewed on an annual basis. Other reward programs such as benefits, retirement and deferred compensation programs, and contractual arrangements are reviewed more sporadically. [Figure 5] However, with the SEC and other shareholder advocacy groups calling for increased disclosure of executive pay practices, (such as the value of termination/change-in-control arrangements) we expect that Compensation Committees will begin to review the non-direct compensation elements more frequently.

Figure 5 – Frequency with Which the Compensation Committee Reviews Executive Compensation Program



The final "process" question we explored with Committee members was the use of, and relationship with, outside advisors. This has been a hotly debated issue, as many companies are wondering: i) whether the Compensation Committee should have its own outside advisor; and ii) how this relationship should be structured vis-à-vis management. When asked about the use of outside advisors, 92% of Compensation Committees indicated they regularly use, or have access to, outside advisors. A similar percentage stated that there has been a formal recognition that the advisor reports to the Compensation Committee. Interestingly, despite calls from executive compensation critics to create a "firewall" between the Committee and management, 88% of Committees allow their advisor to perform consulting services for management. However, in most cases Committee consent and/or notification is required. [Figure 6] It is our view that both the survey results and the practices of responding companies reflect the best practice for using outside advisors.

Figure 6 – Compensation Committee Use of Outside Advisors



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Executive Pay Strategy

The intense scrutiny of executive compensation practices is fundamentally a critique of executive pay strategy. More specifically, the criticism is in three key areas of the compensation philosophy: i) the peer group used to benchmark pay levels; ii) the pay positioning against the peer group; and iii) the alignment of pay (or lack thereof) with company performance and shareholder value creation. We asked participants to provide information relating to each of these areas.

Compensation Committee members were asked to rank, in order of importance, the criteria used to develop the executive compensation peer group for their respective companies. We summarized responses based on whether the particular criterion was ranked as one of the top three most important factors for peer group composition. Industry groups and direct business competitors were cited as one of the top three most important criteria by 73% and 71% of participants, respectively. Fifty-four percent (54%) of Committee members ranked talent competitors in the top three. Only 41% of respondents listed revenue size as a top three criteria. This is surprising because this factor, more than any other, drives executive compensation levels (outside life sciences industry). [Figures 7.1–7.2]

Figure 7.1 – Ranking of Top Three Criteria for Establishing Peer Groups

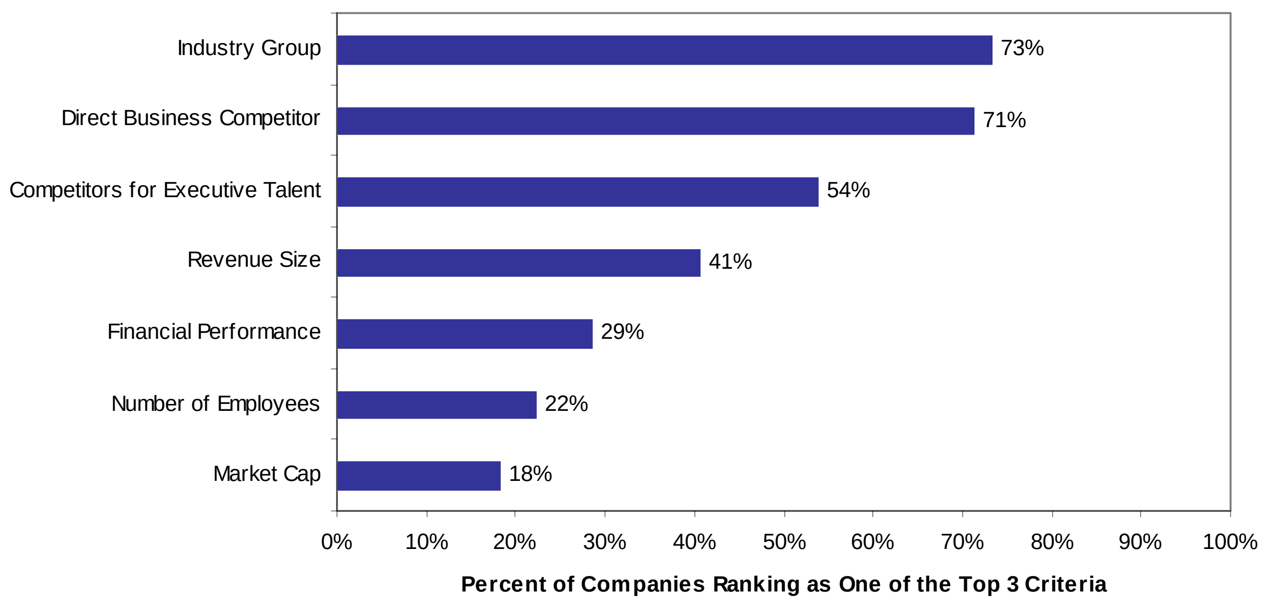
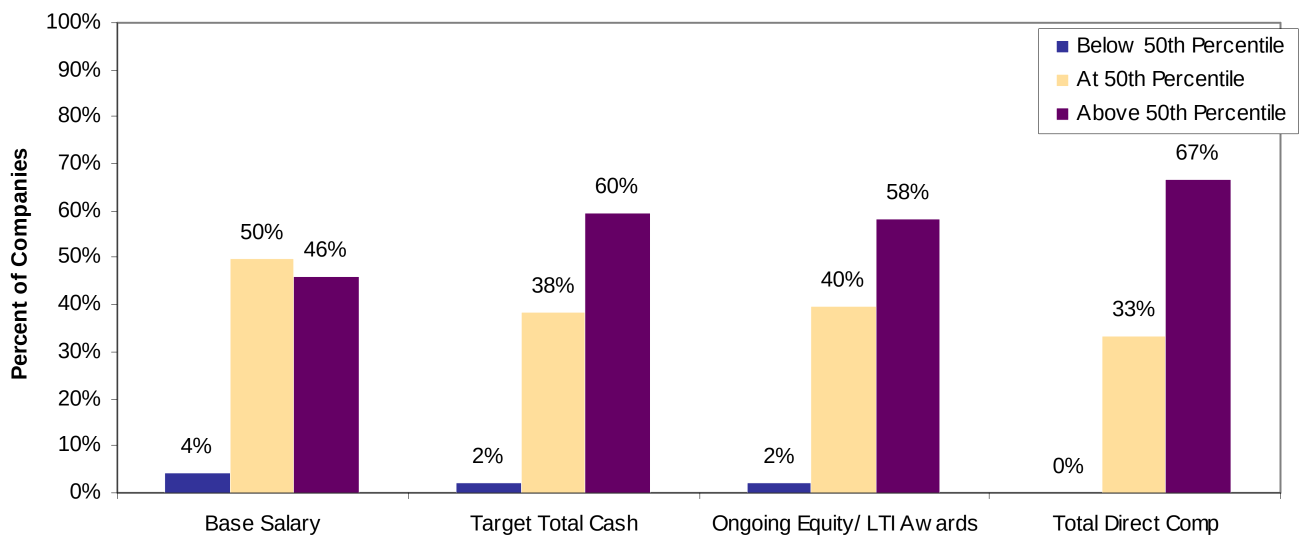


Figure 7.2 – Establishment of Peer Group Criteria

	Rank Order								
	1	2	3	4	5	6	7	8	NA
Market Cap	0%	6%	12%	16%	24%	18%	12%	2%	8%
Number of Employees	2%	4%	16%	6%	16%	10%	29%	4%	12%
Financial Performance	6%	8%	14%	14%	12%	16%	18%	2%	8%
Revenue Size	10%	24%	6%	29%	16%	10%	2%	2%	0%
Competitors for Executive Talent	20%	18%	16%	16%	8%	12%	2%	4%	4%
Direct Business Competitor	39%	18%	14%	12%	4%	4%	2%	4%	2%
Industry Group	33%	29%	12%	10%	8%	6%	0%	2%	0%
Other	0%	0%	0%	0%	0%	50%	0%	50%	0%

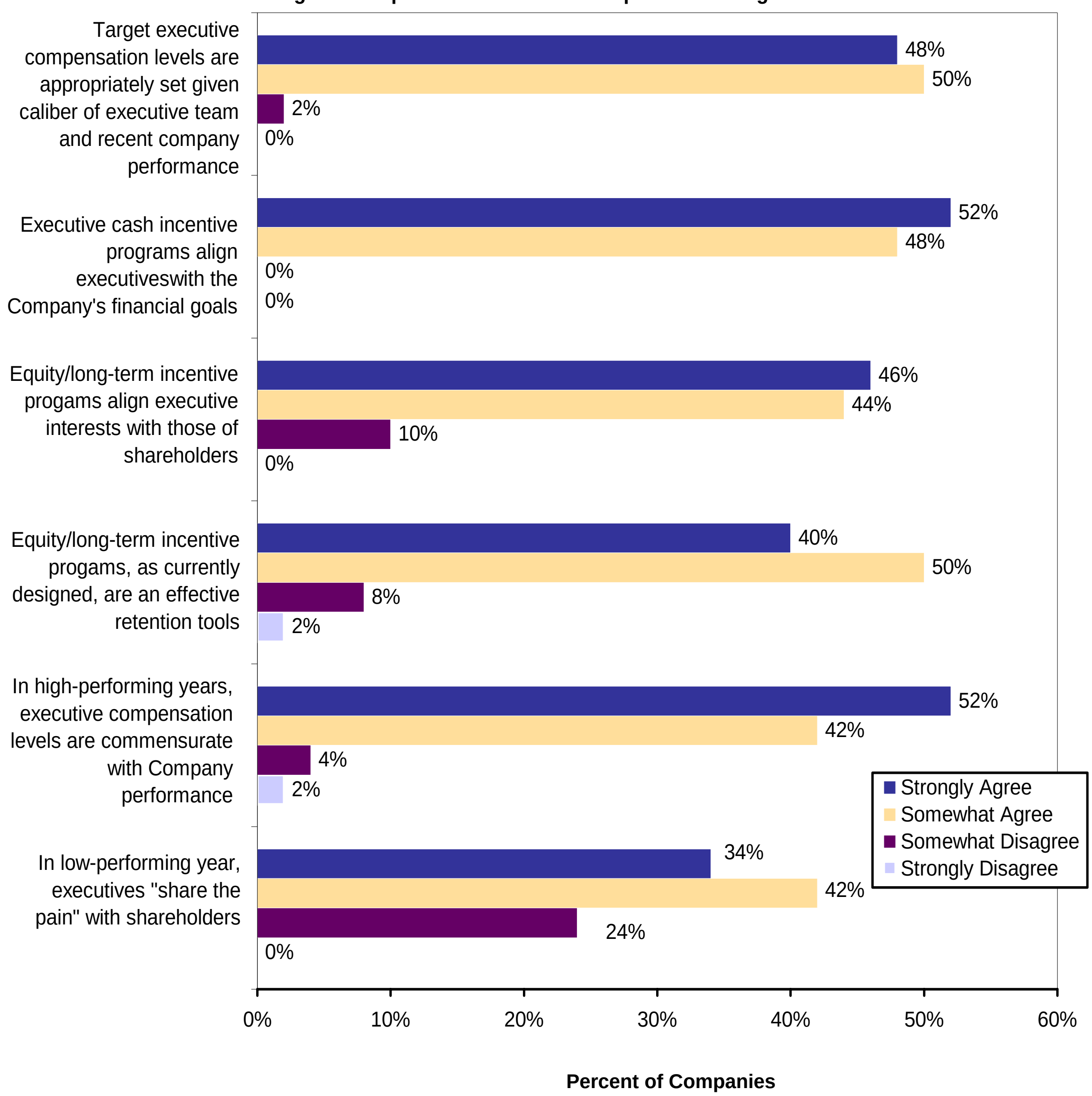
In terms of target pay position, or the market percentile against which each element of compensation is set, companies generally indicated a compensation structure supportive of a pay-for-performance philosophy. Slightly more than half (54%) of the respondents set base salary (fixed compensation) at or below the 50th percentile of the peer group, while approximately 60% of companies established the variable components of pay (annual incentive and equity awards) above the 50th percentile. Sixty-seven percent (67%) of companies aspire to deliver total direct compensation (base plus annual bonus plus value of equity awards) above the 50th percentile. [Figure 8]

Figure 8 – Executive Compensation Target Pay Positioning (Relative to 50th Percentile)



The final question is, frankly, the genesis of much of the criticism of executive compensation. It involves the execution of the pay philosophy to ensure that the compensation earned by executives is aligned with company performance, shareholder value creation, and other compensation program objectives. When asked the extent to which they agree or disagree with several statements regarding the linkage of pay and performance, over 90% said that the structure of the executive compensation program was aligned with company performance, retention objectives, and shareholder interests. Similarly, 94% of Committee members believe their executives are appropriately rewarded in high-performing years. A smaller, though still significant, majority (76%) generally agreed that executives "share the pain" with shareholders in low-performing years. [Figure 9]

Figure 9 – Opinion of Executive Compensation Program



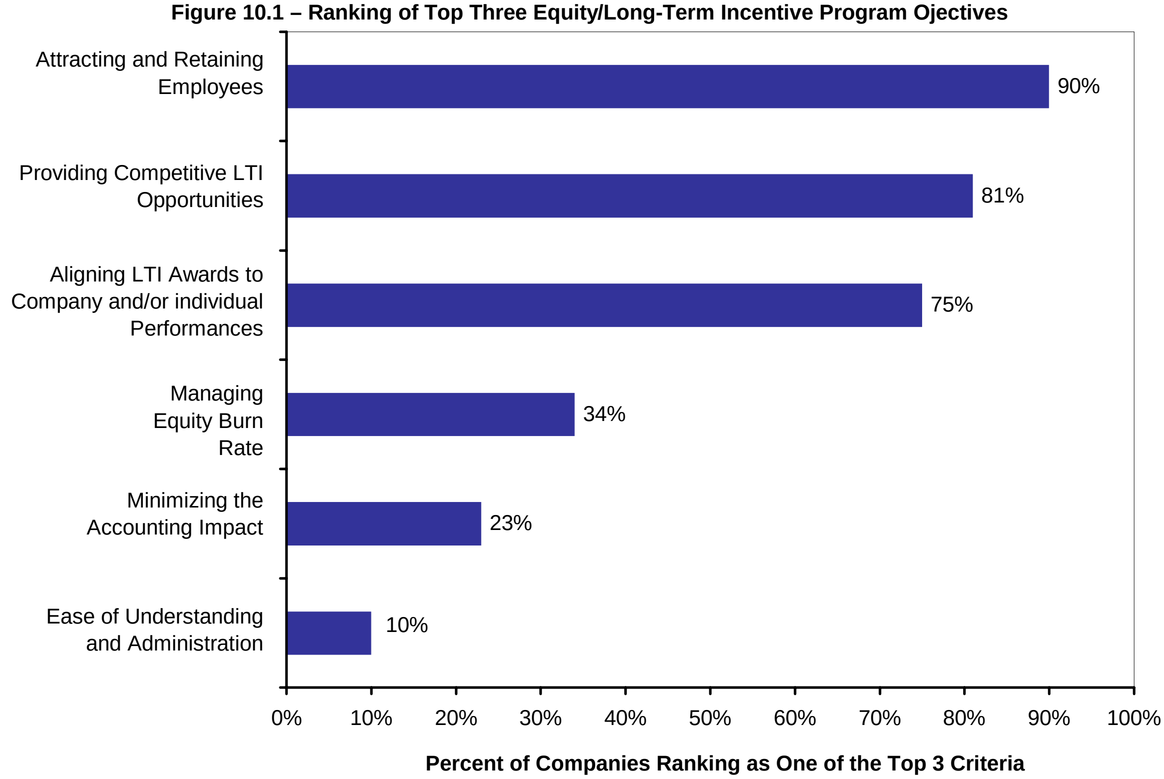
Equity Compensation

One of the biggest issues many companies and Compensation Committees are wrestling with this year is how to appropriately structure their executive and broad-based employee equity programs in light of the new accounting regulations. [The Financial Accounting Standards Board (FASB) adopted SFAS 123R in December 2004 which would require companies to recognize an income statement expense for all equity-based awards, including stock options which were previously exempt from expense recognition if granted at fair market value.[1]]

Because of the favorable accounting treatment previously afforded stock options, many companies used this vehicle as their primary long-term incentive tool. This change in accounting rules, coupled with calls by institutional shareholders over the past few years to reduce equity usage, has prompted companies to rethink the use of stock options along with their fundamental equity strategy.

In the context of the new accounting paradigm and current shareholder environment, we asked Compensation Committee members to rank, in order of importance, six common equity program objectives. As with the peer group criteria in the previous section, we summarized responses based on whether the particularly criterion was ranked as one of the top three most important equity program objectives. Attracting and retaining employees, providing competitive compensation opportunities, and aligning equity awards to performance were cited as top priorities by the vast majority of Compensation Committee members. The much more highly publicized issues of managing burn rate and minimizing accounting expenses were cited as top priorities by only 34% and 23% of respondents, respectively. [Figures 10.1–10.2]

Figure 10.1 – Ranking of Top Three Equity/Long-Term Incentive Program Ojectives



[1] In April 2005, the SEC delayed the effective date of the new accounting standard to fiscal years beginning after June 15, 2005.

Figure 10.2 – Equity/Long-Term Incentive Program Design Objectives

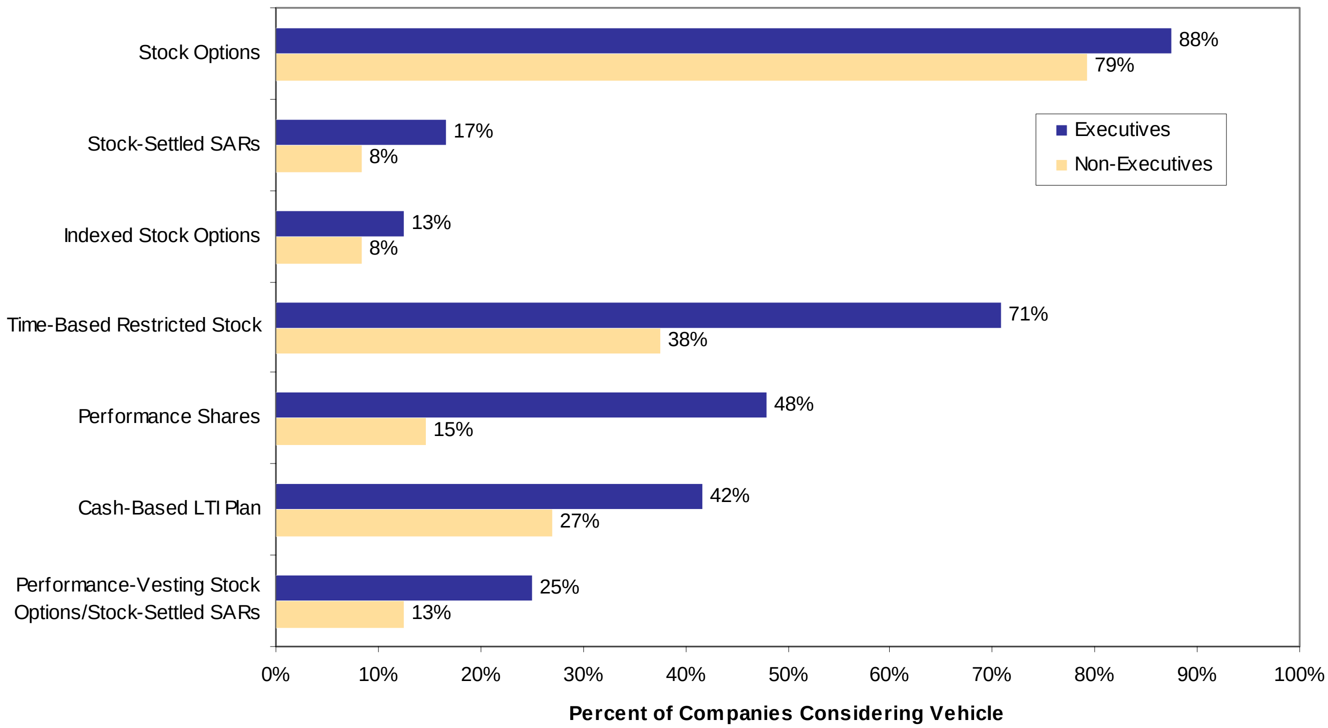
	Rank Order							
	1	2	3	4	5	6	7	NA
Managing equity burn rate within acceptable shareholder norms	4%	19%	11%	34%	19%	9%	4%	0%
Minimizing the accounting impact (assuming FASB's proposal to expense stock options is implemented)	4%	8%	10%	17%	38%	19%	4%	0%
Providing competitive equity/ long-term incentive opportunities to executives and key employees	27%	31%	23%	8%	6%	2%	2%	0%
Aligning equity/ long-term incentive awards to specific company and/or individual performance	23%	29%	23%	10%	6%	0%	4%	4%
Attracting and retaining executive and key employee talent	50%	19%	21%	2%	2%	4%	2%	0%
Ease of understanding and administration	0%	4%	6%	17%	21%	42%	4%	6%

Based on their stated equity program objectives and knowledge of alternative equity/long-term incentive vehicles, we also asked Committee members to indicate which vehicles were being considered for use among executives and non-executives. The following table summarizes the vehicles from which Committee members were asked to choose:

Vehicle	Description
Stock Options	▪ A right to purchase stock at a specified price during a specified period
Stock-Settled SARs	▪ Operate in a manner similar to a stock option ▪ Right to receive stock equal in value to the spread between fair market value and the exercise price upon exercise
Indexed Options	▪ A stock option with a variable exercise price which is reset periodically based on stock price performance of a comparison index (e.g., group of peer companies, S&P 500, etc.) ▪ Upon exercise, awards are settled in cash or stock
Time-Based Restricted Shares	▪ Full-value shares of stock that vest over time based on continued employment (or vesting may be accelerated based on attainment of performance goals)
Performance Shares	▪ Full-value stock that vest only upon the attainment of pre-established performance goals ▪ Awards are paid in stock
Cash-Based LTI Plan	▪ Matrix or unit plan with pre-established goals and payout opportunities (similar to an annual incentive plan but performance is measured over a longer time period) ▪ All awards settled in cash
Performance Vesting Options/Stock-Settled SARs	▪ Full-value shares that cliff vest at time of retirement or at pre-determined period (e.g., 10 years from date of grant) ▪ Stock Options/Stock-Settled SARs that vest only upon the attainment of pre-established performance goals

Approximately 80%+ indicated that continued use of stock options is being considered for both executives and non-executives. The next most oft-cited equity vehicle being considered for executives and non-executives is time-based restricted stock (71% and 38%, respectively). A surprisingly large number of companies (42%) indicated they were considering the use of cash-based long-term incentives for their executives. [Figure 11]

Figure 11 – Equity Vehicle Considerations



Also worth noting is that the results for stock-settled SARs may be misleading. At the time many respondents completed the survey, it appeared that stock-settled SARs may not be attractive under the new nonqualified deferred compensation regulations. Subsequently, the IRS has issued guidance indicating that these awards will not be considered nonqualified deferred compensation if granted at fair market value. We expect that several companies interested in using appreciation equity vehicles will move to stock-settled SARs.

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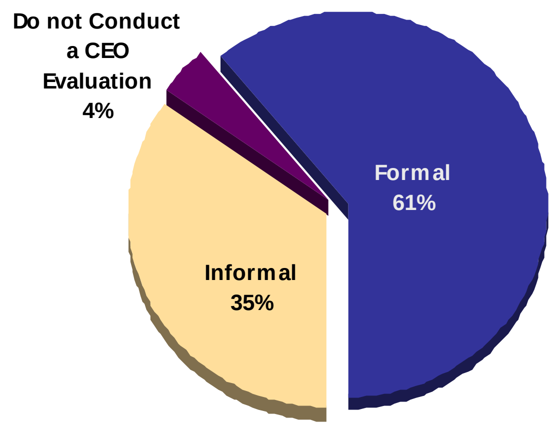
CEO Performance Evaluation

One process issue that deserves separate treatment is the CEO performance evaluation. Until recently, many Compensation Committees either did not conduct an evaluation of the CEO's performance or utilized a very informal process. Because CEO pay is often the focal point and lightning rod of shareholder and executive compensation critics, this procedure has started to change. Committees are implementing a more formal evaluation process to ensure proper alignment between pay and performance.

Figure 12 – CEO Evaluation Process



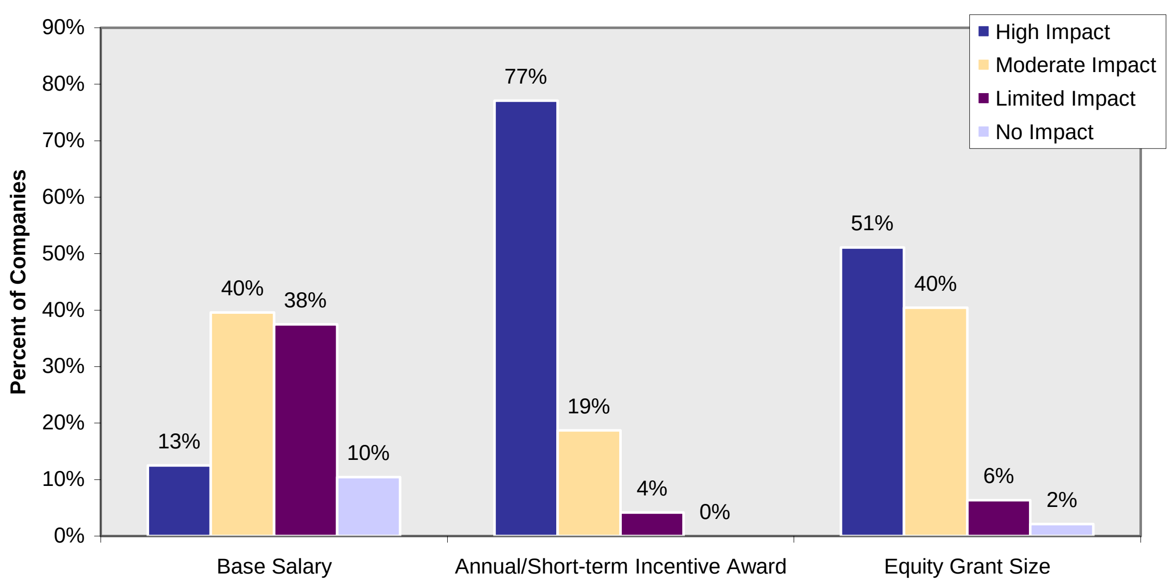
Ninety-six percent (96%) of companies reported that they conduct a CEO performance evaluation and 61% indicated that a formal process has been developed to facilitate the evaluation. [Figure 12] Overall business performance and development/achievement toward the business strategy were cited as the two most important factors in the evaluation process. Building leadership capabilities and overall CEO leadership were also highly ranked. [Figure 13]

Figure 13– Importance of evaluation criteria for the CEO

	Extremely Important	—	Somewhat Important	—	Not Important
Overall Business Performance	83%	15%	2%	0%	0%
Development & achievement towards long-term business strategy	74%	26%	0%	0%	0%
Building leadership capabilities	42%	42%	15%	2%	0%
CEO leadership performance	60%	38%	2%	0%	0%
Board and governance leadership	15%	46%	33%	4%	2%

The results of the CEO evaluation are influencing compensation decisions, particularly with respect to variable pay components. Ninety-six (96%) of Compensation Committee members indicated that the performance evaluation moderately or highly impacted the CEO's short-term incentive award. A similar percentage (91%) said that the evaluation impacted the size of the CEO's equity grant. [Figure 14]

Figure 14 – Impact of Performance Evaluation on Compensation

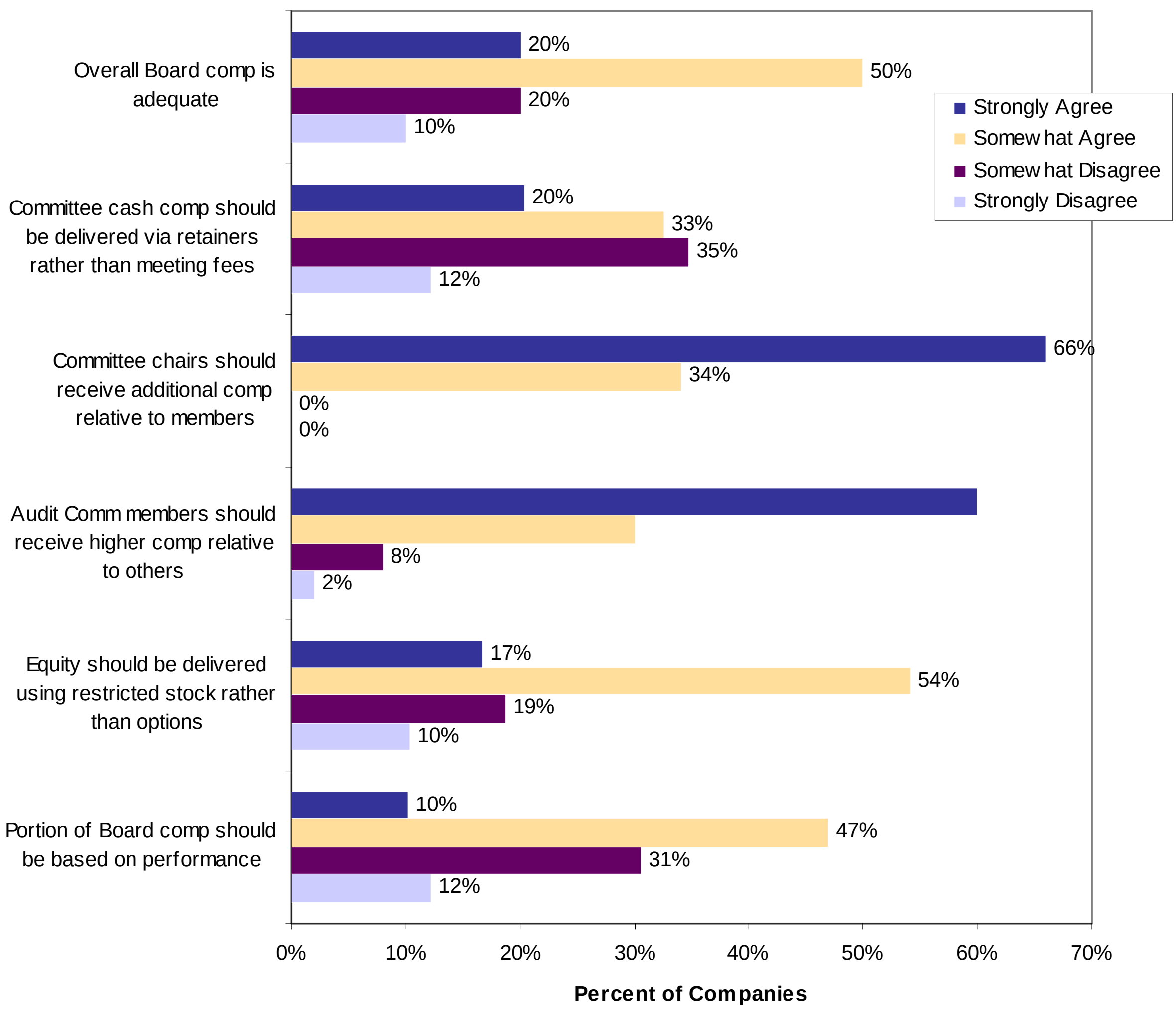


Board of Director Compensation

In response to corporate governance reforms, increased liability, and additional time commitments, the compensation of outside Directors has changed significantly over the past few years. This change is especially evident in the high-technology and life sciences industries that historically utilized a homogenous, equity-laden pay model. These companies are now increasing the value of the overall pay package, enhancing or introducing cash compensation, and differentiating pay based on committee service and role.

We asked Compensation Committee members several opinion questions regarding Board of Director compensation. Seventy-percent (70%) of Committee members strongly or somewhat agree that the overall Board compensation program is adequate. A significant majority also agreed that companies should differentiate pay for Committee Chairs vs. Committee members and that the Audit Committee should receive a premium relative to other committees. Participants were relatively split on the issues of whether to deliver Committee compensation via retainers or meeting fees (with a slight majority in favor of retainers) and the use of performance-based pay. Fifty-seven percent (57%) strongly or somewhat agree that Board compensation should be performance based. Interestingly, though, there was a significant preference (71% of participants) for receiving equity via restricted stock, which is less of a performance-oriented vehicle than stock options. [Figure 15]

Figure 15 – Opinion of Board of Director's Compensation Program



Other Areas of Concern

The final survey question asked participants to list their top concerns about executive compensation and their role as a Compensation Committee member. Attracting and retaining executive talent, aligning executive pay with company performance and shareholder value creation, and equity strategy/accounting issues were cited the most frequently by Committee members (17%, 16% and 12% respectively). [Figure 16]

Figure 16 – Top Issues/Concerns

	Percent	Count
Attract and Retain	17%	14
Pay for Performance	16%	13
Accounting	12%	10
Equity design	12%	10
Fairness	7%	6
Compliance	7%	6
Alignment with shareholder value	5%	4
Competitiveness	5%	4
Compensation to motivate	5%	4
Role of CC	4%	3
CEO evaluation and succession planning	4%	3
Board Comp	2%	2
Bonus plan	2%	2

Related to this, participants expressed an interest in receiving more information about, and/or participating in, additional surveys that will treat these issues more extensively. Compensia will be facilitating seminars, publishing white papers, and conducting surveys later this year, and into 2006, in response to these requests.

Participant List

Align Technology	Macromedia
Apple	McGrath RentCorp
Boeing	Napster
Captiva Software	Neurocrine
Catalyst Semiconductor	Pemstar
Chicos	Peregrine Systems
Ciena	Pinnacle Systems
Cole Taylor Bank	Polycom
Communications Systems	Protein Design Labs
Comverse Technology	REMEC
Cypress Bioscience	Sanmina-SCI
Ditech Communications	Scientific Learning
Egenera	Semtech
E-Loan	Silicon Graphics (SGI)
Frontier Oil	Spectrum Pharmaceuticals
Gensym	Supertex
Global Power Equipment Group	Sybase
IMPAC Medical Systems	SYNNEX
Informatica	Tekelec
Interwave	Tessera Technologies
Intuit	Therma-Wave
IRF	Thoratec
j2 Global Communications	UTStarcom
Jabil Circuits	VISX
Knight Ridder	XOMA
LECG	

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management. Formed in 2003 by a group of leading executive compensation experts with more than 60 years of experience, our mission is to offer Thoughtful Pay™ solutions in an ever-changing executive compensation landscape. We define our Thoughtful Pay™ solution by six guiding principles:

Effectiveness	Pay programs are aligned with the Company's compensation philosophy and business strategy, appropriately rewarding performance.
Balance	Compensation delivered balances the interests of the executive, other employees and shareholders given industry and specific business performance.
Market Competitiveness	Reward opportunities are consistent with business and labor market peers of comparable size and performance
Transparency	Rules of the game are clearly communicated to and understood by all constituencies and the "line of sight" between actions and rewards is clear.
Independence	Compensation programs are designed and approved by Compensation Committee
Simplicity	Program design features are easy to understand, explain and administer

In short, we partner with companies to promote the attraction, retention and motivation of key management talent in a manner that is responsible to, and aligned with shareholders. We offer a full range of consulting services to meet this objective:

- Compensation Committee advisors
- Total rewards strategy
- Comparable pay and performance benchmark
- Compensation program review/audit
- Equity (long-term compensation strategy)
- Stock ownership retention
- Employment/change-in-control succession arrangements
- Merger and acquisition/restructure incentives
- Board of Directors compensation
- Litigation support

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