

MDE Executive Wealth Services

Stock Option and Equity Compensation Planning

Equity compensation, such as stock option and restricted stock awards, are potentially the most valuable, yet least understood, element of corporate executive compensation. The MDE Group, Inc. has long recognized the extraordinary wealth building potential of stock options, along with other elements of executive compensation. As such, we have made optimization of stock options and executive compensation a major focus of our executive client service model since our founding in 1987. Over the years, we have developed significant expertise in helping executives to maximize value and minimize risks associated with their stock awards and coordinating strategies with a holistic, long-term plan.

MDE's strategic equity compensation perspectives drive our unique financial planning process and are coordinated with tactical income tax minimization, cash flow analysis and comprehensive strategies for retirement, estate, intergenerational wealth transfer, and charitable giving. Effective and disciplined implementation of these techniques over the years has accounted for approximately eighty five percent of the some \$1.6 billion in accumulated wealth currently entrusted to MDE by our active and retired executive clients. This discussion is focused on MDE's unique approach to stock option planning and executive wealth creation.

Stock Option Exercise Planning

When to exercise stock options is the most important decision relative to the ultimate value that an executive realizes from this important element of compensation. MDE helps our clients to plan when to exercise with a proprietary analytic framework using concepts we pioneered and refer to as "Interest Free Loan" and "The Option Multiplier". MDE's analytic framework is a combined strategic and tactical economic value model focused on the executive's potential after-tax wealth creation. Unlike other stock option valuation models, such as Black-Scholes, MDE's model provides a practical, understandable and real world framework around which executives can make intelligent and informed decisions. Black-Scholes specifically tends to be more useful in relative value and total compensation competitive analysis than for stock option exercise planning.

Interest Free Loan

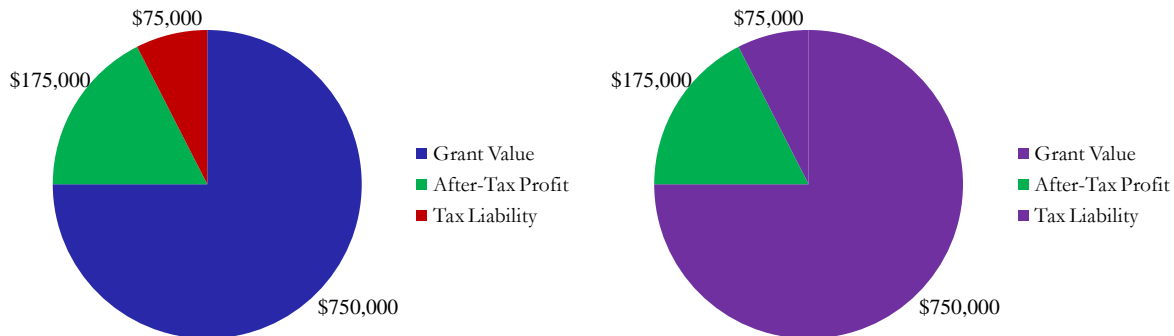
A stock option is valuable because of the leverage inherent in its structure. This leverage can be thought of as an interest free loan from an executive's company in the amount of the original value of the underlying stock at the time of grant. As the stock appreciates in value, the amount of this loan is increased by the income tax that would be payable if the option were to be exercised. The executive gets the benefit of the leverage on the interest free loan as long as the option is held, but has to repay the original grant price and the deferred tax upon exercise. (The executive also forgoes the receipt of the dividends on the underlying stock while the option is held.)

For example, an option granted on 10,000 shares at a price of \$75 per share is comparable to a loan from the company of \$750,000 (10,000 shares times \$75 per share) invested in the company's stock.

If the stock appreciates by 30% to \$100 per share, then the effective amount of the stock grant increases to \$1,000,000 (10,000 shares times \$100 per share).

If the executive were to exercise the option at this point and liquidate the shares, the proceeds would be \$250,000 or \$175,000 after 30% income tax on the gain.

\$1,000,000 Stock Value Components Illustrated



The Option Multiplier

The total amount of the interest-free loan has grown to \$825,000 (the original \$750,000 grant value plus the \$75,000 of tax which doesn't need to be paid until the time of exercise).

While the option remains unexercised, the full \$1,000,000 of stock value is at work on the executive's behalf. After exercise and sale, there would be only the \$175,000 of after-tax profit available to invest for future growth.

Since the benefit of the interest free loan is lost upon exercise, any asset in which the option exercise proceeds are invested must outperform the company's stock by a substantial amount. The multiple by which an alternative investment's rate of return on the after-tax profit would have to outperform the company's stock over a given investment period is MDE's Option Multiplier. In this example, The Option Multiplier is 5.7 (\$1,000,000 Stock Value divided by \$175,000 After Tax Profit). To justify exercising the option, an alternative investment would have to increase in value by 5.7 times the rate of appreciation of the company's stock over any time period. As the stock value increases during the 10-year life of the option, The Option Multiplier decreases as more "in-the-money" profit is at risk.

The loss of leverage when exercising an option and the risk in a company's stock must be analyzed against carefully developed financial goals and income tax considerations to identify the appropriate exercise strategy. Exercise strategies that maximize value and minimize risk consider the declining relative value of the leverage, the stock valuation and volatility and the executive's status and tenure in the organization. These considerations must also be made in coordination with an executive's financial goals, e.g., income tax minimization, cash flow and goal planning, retirement planning, estate planning, intergenerational wealth transfer planning and charitable giving, to establish the right tactical and strategic planning. This type of holistic wealth management planning is the core of MDE's Executive Wealth Services.

Exercise Planning

As a stock grows over time, the interest free loan decreases as a percentage of the stock value because proportionately more of the stock value belongs to the executive. Over this same time, The Option Multiplier decreases, meaning that the amount by which an alternate investment would have to outperform the company's stock decreases, and therefore makes an exercise more attractive. By the time The Option Multiplier approaches 2, an executive has benefited significantly from holding the option and the benefits of exercising and diversifying out of the company's stock become more attractive.

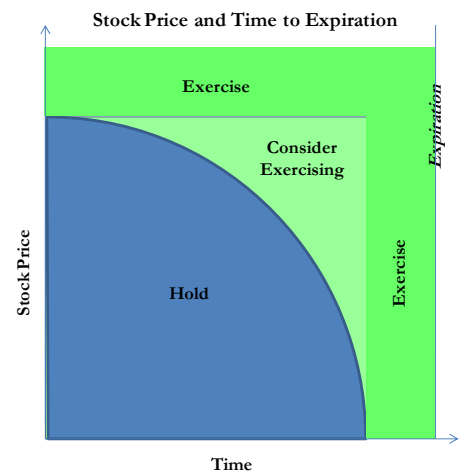
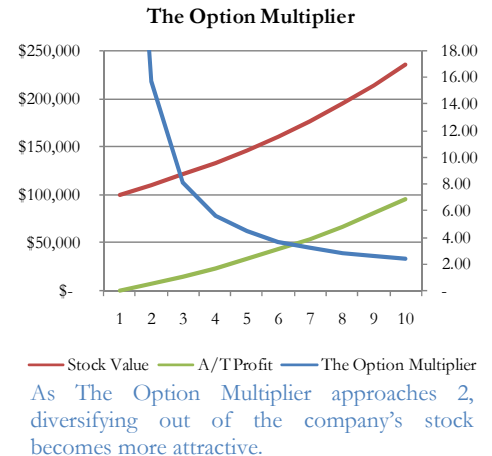
As a starting point for developing an option strategy for a steadily growing stock, beginning to average out of the shares over 4 quarters starting in the option's eighth year may be best strategy to maximize value. This timing also helps an executive to avoid being forced to exercise at a time when the company's stock price may be temporarily depressed.

However, as we all know, most stock does not follow a steady growth pattern. For this reason, it is important to be flexible and continually monitor the relationship between the value of the interest free loan and how much time is left prior to the expiration of the option. Whenever the stock is very high relative to the grant price of the option, or the expiration of the option is approaching, a tactical exercise plan needs to be put in place. This tactical plan needs to be coordinated with an executive's tax and long-term planning to maximize value and minimize risk of continuing to hold the option.

Exercise Restrictions and SEC Rule 10b5-1

Corporate insiders may be restricted from exercising options or trading any shares at certain times when material nonpublic information exists. These restrictions may hamper an executive's ability to execute a strategic stock option exercise plan. SEC rule 10b5-1 creates an opportunity for insiders to establish, in advance, a strategic exercise/trading policy without violating SEC regulations, as long as the executive does not enter into the plan while in possession of material nonpublic information.

MDE has the expertise to develop and implement strategic option exercise and share liquidation plans to maximize value and minimize risk.



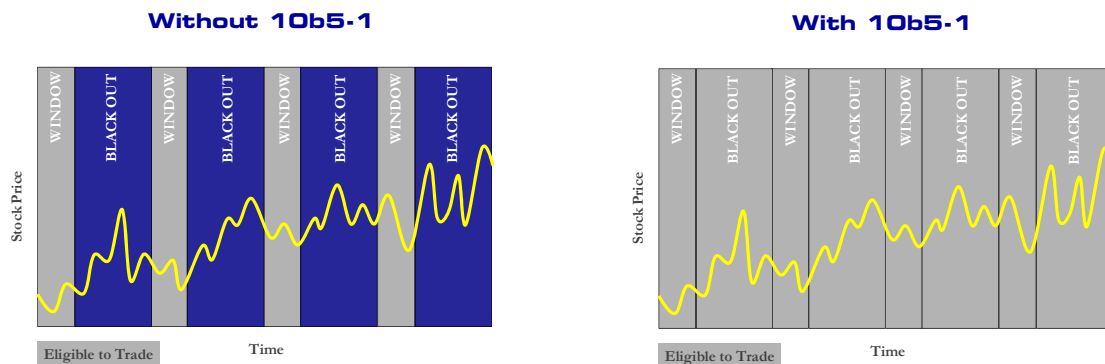
Whenever the stock price is relatively high or an option's expiration approaches, it is time to develop a tactical exercise plan.

Plan Example

An executive plans to retire in 3 years after which he will be required to exercise all of his outstanding options within 90 days. His company's stock is expected to achieve stable growth through the period.

The executive establishes a 10b5-1 plan to implement a strategy of exercising options and liquidating one twelfth of his shares per month for the twelve months prior to his retirement date.

The programmed schedule allows him to minimize the risk that he would be forced to exercise his options when the company's stock is in a temporary decline. In other words, he is averaging out of this concentrated position within guidelines compliant with SEC regulations.



Income Tax Planning

From an economic perspective, it rarely makes sense to exercise an option and hold the resulting shares, due to the loss of leverage. Therefore, it is important not to allow near-term tax minimization to drive the strategic exercise planning process. The benefit of future appreciation being taxed at capital gains tax rates rarely makes up for this loss of leverage. Income tax minimization strategies are best evaluated only after an exercise plan has been put in place based upon the relationship between leverage and time to expiration of the option.

Options on highly appreciating and volatile stocks require special consideration and there are customized strategies that can be employed in these situations.

What to do with Concentrated Positions?

As a result of option exercises, trading restrictions, restricted stock lapses, 401k/deferred account balances, and stock ownership guidelines, executives often end up over-concentrated in their company's stock. There are many techniques that MDE may evaluate to help our clients with diversification or other risk reduction strategies around the concentrated position.

Diversification strategies may include immediate liquidation, staged sales, exchange traded fund participation, planned giving, and more sophisticated traded option based strategies. In addition, hedging strategies exist to temper the risks of continuing to hold concentrated shares and to monetize positions to increase liquidity without selling shares. MDE is prepared to assist our

executive clients in evaluating the benefits and costs of these strategies and to implement them in the appropriate situations.

Other Stock Option Plan Features

Each company's stock option plan differs and may contain other plan features that require specific analysis and consideration in developing tactical implementation and strategic stock option planning.

Following are several examples:

Transferable Options

If a company's stock option plan contains terms which permit transfer, under changes to Rule 16b-3 and IRS rulings, tax strategies are available which allow the transfer of non-statutory stock options via gifts to children or other family members. By transferring an option before the value of the underlying stock appreciates, the benefits may be a lower estate and gift tax. More sophisticated transfer techniques may also be available, such as family limited partnerships, LLC's and Grantor Retained Annuity Trusts (GRATS). Upon exercise after transfer, the executive may still be responsible for the tax on the resulting income from the exercise of the option, further maximizing the value of the transfer and reducing the size of the executive's taxable estate. However, some tax planning techniques which may have previously been available have come under the scrutiny of the IRS and should be carefully reviewed.

Tradable Options

One of the key differences between the stock options an executive receives as an incentive award from a company and traditional options sold on an exchange is that the options granted by a company as part of a compensation package are normally not tradable. However, some companies have begun to grant tradable compensatory options to provide executives with even greater flexibility. The tradable price of these grants can be linked to the Black-Scholes value and, therefore, that stock option valuation measure becomes more important in the planning for these options. The assumptions used in calculating the Black-Scholes value of these shares can significantly affect the strategy we might suggest. MDE is expert at leading our clients through the development of value maximizing, risk minimizing strategies where the choice exists to trade options away.

Performance Options

Many company stock option plans may contain provisions that accelerate vesting or increase award size upon attainment of certain goals. This feature combines the characteristics of ordinary stock options with those of traditional long-term incentive or bonus plans and may create unique planning challenges for executives.

Contact Information

The MDE Group, Inc.
465 South Street
Morristown, NJ 07960
Tel: (973) 206-7100
Fax: (973) 206 7101
www.mdegroupp.com
info@mdegroupp.com