

SMITH INTERNATIONAL INC

Form DEF 14A

March 30, 2006

**Table of Contents**

OMB APPROVAL

---

OMB Number: 3235-0059  
Expires: February 28, 2006  
Estimated  
average burden  
hours per  
response 12.75

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**SCHEDULE 14A**

Proxy Statement Pursuant to Section 14(a) of the Securities  
Exchange Act of 1934 (Amendment No. )

Filed by the Registrant   
Filed by a Party other than the Registrant

Check the appropriate box:

- Preliminary Proxy Statement
- Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**
- Definitive Proxy Statement
- Definitive Additional Materials
- Soliciting Material Pursuant to §240.14a-12

**Smith International, Inc.**

---

(Name of Registrant as Specified In Its Charter)

---

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

- No fee required.
- Fee computed on table below per Exchange Act Rules 14a-6(i)(4) and 0-11.

1) Title of each class of securities to which transaction applies:

---

2) Aggregate number of securities to which transaction applies:

---

3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (set forth the amount on which the filing fee is calculated and state how it was determined):

---

4) Proposed maximum aggregate value of transaction:

---

5) Total fee paid:

---

o Fee paid previously with preliminary materials.

---

o Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

1) Amount Previously Paid:

---

2) Form, Schedule or Registration Statement No.:

---

3) Filing Party:

---

4) Date Filed:

---

SEC 1913 (02-02)

**Persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.**

---

**Table of Contents**

**NOTICE OF ANNUAL MEETING OF STOCKHOLDERS**  
**April 25, 2006**

To Our Stockholders:

The Annual Meeting of Stockholders (the Annual Meeting ) of Smith International, Inc. (the Company ) will be held on **Tuesday, April 25, 2006**, at 9:00 a.m. local time, at 700 King Street, Wilmington, Delaware, to consider and take action on the following:

1. Election of two directors: Robert Kelley and Doug Rock, each for a term of three years;
2. Approval of the Smith International, Inc. Executive Officer Annual Incentive Plan effective January 1, 2006; and
3. Ratification of Deloitte & Touche LLP as independent registered public accounting firm for 2006.

**Your Board of Directors recommends a vote FOR Proposals 1, 2, and 3.**

The Board of Directors has fixed the close of business on March 1, 2006 as the record date for determining stockholders who are entitled to notice of and to vote at the meeting.

By Order of the Board of Directors

Richard E. Chandler, Jr.  
*Secretary*

Houston, Texas  
March 30, 2006

**YOUR VOTE IS IMPORTANT.**

Please vote your proxy promptly so that your shares will be represented, even if you plan to attend the Annual Meeting. You can vote by Internet, by telephone, or by using the proxy card that is enclosed. Please see your proxy card for specific instructions on how to vote.

---

**PROXY STATEMENT  
TABLE OF CONTENTS**

	<b>Page</b>
<b><u>General Information About Voting</u></b>	1
<b><u>Proposal 1: Election of Directors</u></b>	2
<u>Nominees</u>	3
<u>Directors Continuing in Office</u>	4
<u>Directors Not Continuing in Office</u>	6
<u>Stock Ownership of Directors and Executive Officers</u>	6
<u>Information about the Board of Directors and its Committees</u>	7
<u>Corporate Governance</u>	10
<u>Audit Committee Report</u>	11
<u>Executive Compensation</u>	13
<u>Compensation and Benefits Committee Report on Executive Compensation</u>	13
<u>Comparison of Five-Year Cumulative Total Return</u>	17
<u>Executive Compensation Tables</u>	18
<u>I. Summary Compensation Table</u>	18
<u>II. Aggregated Option Exercises in 2005 and December 31, 2005 Option Values</u>	20
<u>III. Equity Compensation Plan Information</u>	20
<u>Retirement Benefits and Employment Contracts</u>	20
<u>Additional Information about Our Directors and Executive Officers</u>	23
<u>Stock Ownership of Certain Beneficial Owners</u>	25
<b><u>Proposal 2: Approval of Smith International, Inc. Executive Officer Annual Incentive Plan</u></b>	26
<b><u>Proposal 3: Ratification of Deloitte &amp; Touche LLP as Independent Registered Public Accounting Firm</u></b>	27
<b><u>Other Business</u></b>	29
<b><u>Stockholders Proposals</u></b>	29
<b><u>Annual Report and Financial Information</u></b>	29
<u>Appendix A Audit Committee Charter</u>	A-1
<u>Appendix B Smith International, Inc. Executive Officer Annual Incentive Plan effective January 1, 2006</u>	B-1

---

**Table of Contents**

P. O. Box 60068  
Houston TX 77205-0068  
**PROXY STATEMENT**

The Board of Directors of Smith International, Inc. is soliciting your proxy to vote your shares of common stock at the 2006 Annual Meeting. We are distributing this Proxy Statement and the accompanying proxy card beginning on or about March 30, 2006. We, our, Smith and the Company each refers to Smith International, Inc. We solicit proxies give all stockholders of record an opportunity to vote on matters that will be presented at the Annual Meeting. In this Proxy Statement, you will find information to assist you in voting your shares. **Your vote is very important.**

*Note: All information presented in this proxy statement gives effect to a two-for-one stock dividend distributed on August 24, 2005.*

**General Information About Voting**

**Who can vote.**

You are entitled to vote your shares of our common stock ( Common Stock ) if our records show that you held your shares as of March 1, 2006. At the close of business on March 1, 2006, a total of 201,426,503 shares of Common Stock were outstanding and entitled to vote. Each share of Common Stock has one vote. The enclosed proxy card shows the number of shares that you are entitled to vote.

**How you can vote.**

You may vote your shares as follows:

- (1) in person at the Annual Meeting;
- (2) by telephone (see the enclosed proxy card for instructions);
- (3) by Internet (see the enclosed proxy card for instructions); or
- (4) by mail by signing, dating and mailing the enclosed proxy card.

If you vote by proxy, the individuals named on the proxy card (your proxies) will vote your shares in the manner you indicate. You can specify on your proxy card whether your shares should be voted for all of the nominees for director or your vote may be withheld with respect to one or more of the nominees. You can also specify whether you approve, disapprove or abstain from the other proposals. If your Common Stock is held by a broker, bank or other nominee (in street name ), you will receive instructions from them that you must follow in order to have your shares voted. If you hold your shares in street name and you wish to vote in person at the Annual Meeting, you will need to obtain a proxy from the broker or nominee that holds your shares. If the meeting is adjourned, your Common Stock will be voted as specified on your proxy card on the new meeting date, unless you have revoked your proxy instructions.

Whether or not you plan to attend the meeting, we encourage you to vote by proxy as soon as possible.

If you hold your shares in more than one type of account or your shares are registered differently, you may receive more than one proxy card. We encourage you to vote each proxy card that you receive.

**If you sign and return your proxy card without indicating your voting instructions, your shares will be voted FOR the election of all nominees for director as set forth under Election of Directors below and FOR Proposals 2 and 3.**

**Table of Contents**

**How to revoke or change your vote.**

You can revoke or change your proxy at any time before it is exercised by:

- (1) delivering written notice of revocation to Smith's Corporate Secretary in time for him to receive it before the Annual Meeting;
- (2) voting again by telephone, Internet or mail; or
- (3) voting in person at the Annual Meeting.

Attendance at the Annual Meeting will not by itself revoke a previously granted proxy. If you hold your shares in street name and you wish to change your vote at the Annual Meeting, you will need to obtain a proxy from the broker or nominee that holds your shares.

**Number of votes required.**

Directors must be elected by a plurality of the votes cast at the meeting. This means that the two nominees receiving the greatest number of votes will be elected. The affirmative vote of a majority of the shares represented at the meeting and entitled to vote on a particular matter is required to approve Proposals 2 and 3. The Annual Meeting will be held if the holders of a majority of the outstanding shares of Common Stock entitled to vote (a quorum) are present at the meeting in person or by proxy. If you have returned valid proxy instructions or attend the meeting in person, your Common Stock will be counted for the purpose of determining whether there is a quorum, even if you wish to abstain from voting on some or all matters introduced at the meeting. Broker non-votes also count for quorum purposes. If you hold your Common Stock in street name, generally the nominee may only vote the Common Stock that it holds for you according to your instructions. However, if the nominee has not received your instructions within ten days of the meeting, it may vote on matters that the New York Stock Exchange determines to be routine. If the nominee cannot vote on a particular matter because it is not routine, there is a broker non-vote on that matter. Broker non-votes do not count as votes for or against any proposal; however, an abstention counts as a vote against a proposal. Abstentions and broker non-votes have no effect on the outcome of the election of directors.

**Other matters to be acted upon at the meeting.**

We do not know of any other matters that will be presented at the Annual Meeting, other than those mentioned in this Proxy Statement.

**Cost of this proxy solicitation.**

We will pay the cost of solicitation of proxies including preparing, printing and mailing this Proxy Statement. We have retained Morrow & Co. to help us in soliciting proxies for a fee of \$7,000, plus reasonable out-of-pocket costs and expenses. We will also reimburse brokers, banks and other nominees for their costs in sending proxy materials to beneficial owners of our Common Stock. Other proxy solicitation expenses that we will pay include those for preparation, mailing, returning and tabulating the proxies.

**PROPOSAL 1: ELECTION OF DIRECTORS**

At the 2006 Annual Meeting, stockholders will elect two persons as Class II directors to hold office until the 2009 Annual Meeting, or until they are succeeded by other qualified directors who have been appointed or elected. The nominees are Robert Kelley and Doug Rock.

Directors must be elected by a plurality of the votes cast at the meeting. This means that the two nominees receiving the greatest number of votes will be elected. Votes withheld for any director will not be counted. We will vote your shares as you specify on your proxy card. If you properly execute and return your proxy card (in paper form, electronically via the Internet or by telephone), but don't specify how you want your shares voted, we will vote them *for the election of all of the nominees listed below.*

**Table of Contents**

Each of the nominees are current members of the Board of Directors and have consented to serve if elected. Although management does not contemplate the possibility, in the event any nominee is not a candidate or is unable to serve as a director at the time of the election, the proxies will vote for any nominee who is designated by the present Board of Directors to fill the vacancy.

A brief biography of all directors is presented below:

**NOMINEES**

Directors to be elected to Class II for a term expiring in 2009:

**ROBERT KELLEY**

Age: 60

Director Since: 2005

Recent Business Experience: Since 2001, Mr. Kelley has served as the President of Kellco Investments, a private investment company. From 1986 to 2001, Mr. Kelley served in several senior management roles including Chairman, President and Chief Executive Officer of Noble Affiliates, Inc. Prior to 1986, he was President and Chief Executive Officer of Samedan Oil Corporation, a subsidiary of Noble Energy Inc.

Committee Membership: Audit Committee

Other Directorships: Cabot Oil and Gas Corporation; Lone Star Technologies Inc.; OGE Energy Corp.

**DOUG ROCK**

Age: 59

Director Since: 1987

Recent Business Experience: Mr. Rock was elected Chairman of the Board of Directors on February 26, 1991. Mr. Rock has been with the Company since 1974 and has been Chief Executive Officer, President and Chief Operating Officer since March 31, 1989.

Other Directorships: Moneygram International, Inc.; CE Franklin Ltd.

**THE BOARD OF DIRECTORS RECOMMENDS THAT YOU VOTE FOR THE ELECTION OF ALL NOMINEES FOR DIRECTOR.**



**Table of Contents**

**DIRECTORS CONTINUING IN OFFICE**

Class III directors to continue in office until 2007:

**JAMES R. GIBBS**

Age: 61

Director Since: 1990

Recent Business Experience: Mr. Gibbs is the Chairman of the Board, President & Chief Executive Officer of Frontier Oil Corporation (formerly Wainoco Oil Corporation). He was President and Chief Operating Officer of Frontier from January 1, 1987 to April 1, 1992, at which time he assumed the additional position of Chief Executive Officer. He was elected Chairman of the Board of Frontier in April 1999. He joined Frontier Oil Corporation in February 1982 as Vice President of Finance and Administration, and was appointed Executive Vice President in September 1985.

Committee Membership: Chairman, Compensation and Benefits Committee; Chairman, Nominating and Corporate Governance Committee.

Other Directorships: Frontier Oil Corporation; Veritas DGC Inc.; advisory director of Frost Bank-Houston

**JERRY W. NEELY**

Age: 69

Director Since: 1977

Recent Business Experience: Mr. Neely held a number of positions with the Company from 1965 to 1987. He was President from February 1976 to December 1977, at which time he assumed the additional positions of Chairman of the Board and Chief Executive Officer and served in those capacities until December 1987. Since that time, Mr. Neely has been a private investor.

Committee Membership: Audit Committee; Nominating and Corporate Governance Committee.

Other Directorships: Member of the Board of Trustees of the University of Southern California



**Table of Contents**

Class I directors to continue in office until 2008:

**G. CLYDE BUCK**

Age:	68
Director Since:	1992
Recent Business Experience:	Mr. Buck has extensive experience in energy-related matters. He received a B.A. in economics from Williams College and a M.B.A. from Harvard. He is currently Senior Vice President and Managing Director Corporate Finance of the investment banking firm of Sanders Morris Harris Inc., a position he has held since April 1998. From 1983 to 1998, Mr. Buck was a Managing Director in the Houston corporate finance office of Dain Rauscher Incorporated.
Committee Membership:	Compensation and Benefits Committee; Nominating and Corporate Governance Committee.
Other Directorships:	Frontier Oil Corporation

**LOREN K. CARROLL**

Age:	62
Director Since:	1987
Recent Business Experience:	Mr. Carroll joined the Company in December 1984 as Vice President and Chief Financial Officer. In January 1988 he was appointed Executive Vice President and Chief Financial Officer and served in that capacity until March 1989. Mr. Carroll rejoined the Company in 1992 as Executive Vice President and Chief Financial Officer and continues to hold the office of Executive Vice President of the Company. On March 16, 1994, Mr. Carroll was named the President and Chief Executive Officer of M-I SWACO, a company in which the Company holds a 60% interest. On March 15, 2006, the Company announced the retirement of Mr. Carroll from M-I SWACO, effective April 30, 2006.
Other Directorships:	Fleetwood Enterprises, Inc.; Veritas DGC Inc.

**DOD A. FRASER**

Age:	55
Director Since:	2004
Recent Business Experience:	Mr. Fraser is the President of Sackett Partners Incorporated, a consulting company. Mr. Fraser established Sackett Partners in 2000 upon retiring from a 27-year career in investment banking. From 1995 to 2000, Mr. Fraser was with The Chase Manhattan Bank, now JP Morgan Chase, where he was Managing Director, Group Executive of the global oil and gas group. Prior to that, Mr. Fraser was General Partner of Lazard Freres & Co., which he joined in 1978.
Committee Membership:	Audit Committee; Compensation and Benefits Committee.
Other Directorships:	Forest Oil Corporation; Terra Industries, Inc.

**Table of Contents****DIRECTORS NOT CONTINUING IN OFFICE****BENJAMIN F. BAILAR**

Age:	71
Director Since:	1993
Recent Business Experience:	Mr. Bailar is the Dean and H. Joe Nelson, III Professor of Administration Emeritus of Jesse H. Jones Graduate School of Administration of Rice University, where he held that position from September 1987 through June 1997.
Committee Membership:	Chairman, Audit Committee; Compensation and Benefits Committee.
Other Directorships:	Dana Corporation; Trustee of the Philatelic Foundation

**Stock Ownership of Directors and Executive Officers**

The following table shows the number of shares of Common Stock beneficially owned as of March 15, 2006 by each director or nominee for director, the executive officers named in the Summary Compensation Table included later in this Proxy Statement and all directors and executive officers as a group. Except as otherwise indicated, the persons listed below have sole voting power and investment power relating to the shares shown.

**Security Ownership of Directors and Executive Officers**

Name of Individual	Common Stock Beneficially Owned	
	No. of Shares(1)(2)	Percent of Class
Benjamin F. Bailar(3)	25,698	*
G. Clyde Buck(3)	63,298	*
Loren K. Carroll	469,612	*
Margaret K. Dorman(4)	199,351	*
Dod A. Fraser	6,670	*
James R. Gibbs(3)(5)	27,298	*
Robert Kelley	2,156	*
Jerry W. Neely(3)(6)	1,071,118	*
Doug Rock	833,579	*
Neal S. Sutton	87,512	*
Richard A. Werner(4)	9,018	*
All directors and executive officers as a group (19 persons)(4)	3,003,970	1.4

\* Less than 1%

(1) The amounts reported do not include the shares of Common Stock to be issued to each outside director on or about April 19, 2006 under the Smith International, Inc. Stock Plan for Outside Directors (the Stock Plan). The

shares to be issued will be based on the closing price of the Company's Common Stock on the date of such issuance and will be a number of shares to give each outside director equity compensation of approximately \$75,000.

- (2) The amounts reported include shares of Common Stock that could be acquired on or before May 14, 2006 through the exercise of stock options as follows: Mr. Rock: 353,400 shares; Mr. Carroll:

6

---

**Table of Contents**

380,500 shares; Mr. Sutton: 83,500 shares; Ms. Dorman: 189,000 shares; Mr. Werner: 4,000 shares; and all directors and executive officers as a group: 1,173,882 shares.

- (3) The amounts reported do not include 24,000 restricted stock units held by each of Messrs. Bailar, Buck, Gibbs and Neely. Each such restricted stock unit represents a contingent right to receive one share of Common Stock and were granted to each of Messrs. Bailar, Buck, Gibbs and Neely in 1999 in connection with the termination of the Directors Retirement Plan. Messrs. Bailar, Buck, Gibbs and Neely currently have no voting or investment power with respect to the related shares of Common Stock, which will not be issued until the restricted stock units vest upon retirement after ten years of service as a director.
- (4) The amounts reported include shares of Common Stock allocated to accounts under a 401(k) plan as follows: Ms. Dorman: 4,827 shares; Mr. Werner: 1,460 shares; and all directors and executive officers as a group: 30,194 shares.
- (5) The amounts reported include 2,000 shares held by Mrs. Gibbs and 1,600 shares held in a trust for the benefit of their child where Mrs. Gibbs is a co-trustee.
- (6) The amounts reported include 980,778 shares held by the Neely Family Trust and 50,340 by a Family Trust for the benefit of the Neely children.

**Information about the Board of Directors and its Committees**

**The Board.** Our Board of Directors currently consists of eight directors as described in Proposal 1: Election of Directors. The current Board members and nominees for election include six independent directors and two members of our senior management. Upon retirement from M-I SWACO, effective April 30, 2006, Mr. Carroll will no longer be considered a member of senior management but will remain a director. Benjamin F. Bailar has reached retirement age pursuant to our Corporate Governance Guidelines and is, therefore, not standing for re-election as a director. Upon completion of Mr. Bailar's service on the Board, the Board will reduce its size to seven members. The primary responsibilities of the Board of Directors are oversight, counseling and direction to senior management in the long-term interests of Smith and its stockholders. The Board's detailed responsibilities include:

regularly evaluating the performance of the Chief Executive Officer and other senior executives;

planning for succession with respect to the position of Chief Executive Officer and monitoring management's succession planning for other senior executives;

reviewing and, where appropriate, approving Smith's major financial objectives, strategic and operating plans and actions;

overseeing the conduct of Smith's business to evaluate whether the business is being properly managed; and

overseeing the processes for maintaining Smith's integrity with regard to its financial statements and other public disclosures and compliance with law and ethics.

The Board of Directors has delegated to the Chief Executive Officer, working with Smith's other executive officers, the authority and responsibility for managing Smith's business in a manner consistent with Smith's standards and practices, and in accordance with any specific plans, instructions or directions of the Board. The Chief Executive Officer and management are responsible for seeking the advice and, in appropriate situations, the approval of the Board with respect to extraordinary actions to be undertaken by Smith.

The Board and its committees meet throughout the year on a set schedule, and also hold special meetings and act by written consent from time to time as appropriate. Board agendas include regularly scheduled sessions for the independent directors to meet without management present. The Board has not designated a Lead Director to chair executive sessions of the non-management directors. The non-management directors designate a chair at the beginning

of any such executive session. Stockholders and employees who wish to communicate with the non-management directors may do so by contacting Smith's Corporate Secretary at

7

---



**Table of Contents**

411 North Sam Houston Parkway, Suite 600, Houston, Texas 77060. Smith's Corporate Secretary will then relay all communications to the appropriate non-management director.

The Board of Directors held seven meetings during 2005. All directors attended at least 75% of the meetings of the Board of Directors and of all committees on which they served. The Company does not have a policy regarding directors' attendance at annual meetings. No directors attended the prior year's annual meeting.

**Committees of the Board.** The Board has delegated various responsibilities and authority to different Board Committees as described in this section of the Proxy Statement.

*Audit Committee.* Messrs. Bailar (Chairman), Fraser, Kelley and Neely are the current members of the Audit Committee. The Audit Committee's primary duties and responsibilities are to:

assist the Board in its general oversight of Smith's auditing, financial reporting and internal control functions;

appoint, compensate and oversee the work of Smith's independent registered public accounting firm; and

recommend the firm that the Company should retain as its independent registered public accounting firm.

All members of the Audit Committee are non-employee directors and the Board of Directors has made the determination that all members are financially literate and all members qualify as audit committee financial experts. It is anticipated that Mr. Fraser will replace Mr. Bailar as Chairman after the Annual Meeting.

During 2005, the Audit Committee met twelve times, including telephone meetings, to discuss relevant accounting, auditing, internal control and disclosure matters. The Committee operates under a formal charter adopted by the Board of Directors that governs its duties and standards of performance. The full text of the charter is attached as Appendix A hereto and is published on our website at [www.smith.com](http://www.smith.com) under the Investor Relations caption and link to Governance. The responsibilities and activities of the Audit Committee are described in greater detail in the Audit Committee Report that follows.

*Compensation and Benefits Committee.* Messrs. Gibbs (Chairman), Bailar, Buck, and Fraser are the current members of the Compensation and Benefits Committee. This Committee held six meetings during 2005. The Compensation and Benefits Committee's primary duties and responsibilities are to:

review the Company's executive compensation and employee benefits plans and programs, including their establishment, modification and administration; and

administer the Company's incentive compensation plans.

The Committee operates under a formal charter adopted by the Board of Directors that governs its duties and standards of performance. The full text of the charter is published on our website at [www.smith.com](http://www.smith.com) under the Investor Relations caption and link to Governance. The responsibilities and activities of the Compensation and Benefits Committee are described in greater detail in the Compensation and Benefits Committee Report that follows.

*Nominating and Corporate Governance Committee.* Messrs. Gibbs (Chairman), Buck and Neely are the current members of the Nominating and Corporate Governance Committee. The Nominating and Corporate Governance Committee is composed solely of independent directors, as defined in the New York Stock Exchange current listing standards. During 2005, the Committee held five meetings. The Nominating and Corporate Governance Committee's primary duties and responsibilities are to:

assist the Board of Directors and management in developing and maintaining best practices in corporate governance;

**Table of Contents**

identify and review the qualifications of director candidates and make recommendations for Board membership;

administer a process to measure the effectiveness of the Board;

recommend to the Board the criteria by which directors will be held accountable;

make recommendations to the Board regarding the agenda for the Company's annual meetings of stockholders; and

review stockholder proposals and make recommendations to the Board regarding action on such proposals.

The Nominating and Corporate Governance Committee will consider nominees proposed by stockholders. To recommend a prospective nominee for the Nominating and Corporate Governance Committee's consideration, you may submit the candidate's name and qualifications to Smith's Corporate Secretary at 411 North Sam Houston Parkway, Suite 600, Houston, Texas 77060. Recommendations from stockholders for nominees must be received by Smith's Corporate Secretary not later than the date set forth under the section "Stockholders' Proposals" that follows.

The process for identifying and evaluating director nominees includes the following steps:

(1) the Nominating and Corporate Governance Committee, Chairman of the Board or other Board members identify a need to fill vacancies or add newly created directorships;

(2) the Chairman of the Nominating and Corporate Governance Committee initiates a search and seeks input from Board members and senior management and, if necessary, hires a search firm or obtains advice from legal or other advisors;

(3) director candidates, including any candidates properly proposed by stockholders in accordance with the Company's Bylaws, are identified and presented to the Nominating and Corporate Governance Committee;

(4) initial interviews of candidates are conducted by the Chairman of the Nominating and Corporate Governance Committee;

(5) the Nominating and Corporate Governance Committee meets to consider and approve final candidate(s) and conduct further interviews as necessary; and

(6) the Nominating and Corporate Governance Committee makes recommendations to the full Board for inclusion in the slate of directors at the annual meeting.

The evaluation process will be the same whether the nominee is recommended by a stockholder or by a member of the Board of Directors. The Nominating and Corporate Governance Committee is responsible for establishing the selection criteria for candidates from time to time and reviewing with the Board such criteria and the appropriate skills and characteristics required of Board members in the context of the then current make-up of the Board. At a minimum, the Nominating and Corporate Governance Committee must be satisfied that each nominee for director has the necessary business and/or professional knowledge and experience relevant to the Company, its business and the goals and perspectives of its stockholders; is well regarded in the community, with a long term, good reputation for high ethical standards; has good common sense and judgment; has a positive record of accomplishment in present and prior positions; has an excellent reputation for preparation, attendance, participation, interest and initiative on other boards on which he or she may serve; and has the time, energy, interest and willingness to become involved in the Company and its future.

The Nominating and Corporate Governance Committee operates under a formal charter adopted by the Board of Directors that governs its duties and standards of performance. The full text of the charter is published on our website at [www.smith.com](http://www.smith.com) under the "Investor Relations" caption and link to "Governance".



**Table of Contents**

**Directors Compensation.** Employee directors receive no additional compensation other than their normal salary for serving on the Board or its committees. Non-employee directors receive \$45,000 annually and \$2,000 for each Board meeting attended. In addition, they are paid \$10,000 per year for chairing a committee (other than the chairman of the Audit Committee who is paid \$15,000 per year) and \$2,000 for each committee meeting attended even if they are not members of such committee. Expenses for Company-related business travel are either paid or reimbursed by the Company. Outside directors also receive an initial grant of shares, upon first election or appointment, along with an annual grant of shares of Common Stock, each with a value of approximately \$75,000.

**Non-Employee Director Programs.** The Company terminated its Directors Retirement Plan in 1998. The Company issued restricted stock unit grants to each of the non-employee directors in 1999 to fund the actuarial value of their accrued benefits under the retirement plan. These grants of 24,000 shares (adjusted for the two-for-one stock splits on June 20, 2002 and August 24, 2005) will vest upon retirement after ten years of service as a director. Cash dividends are not paid and do not accrue on the unvested units.

**Compensation Committee Interlocks and Insider Participation.** During 2005, Messrs. Bailar, Buck, Fraser and Gibbs served as members of the Company's Compensation and Benefits Committee. None of such persons served as an employee or officer of the Company during 2005 or was formerly an officer of the Company or any of our subsidiaries. No executive officer served as a director or member of the compensation committee of another entity, one of whose executive officers served as a member of the Company's Compensation and Benefits Committee or as a director of the Company.

**CORPORATE GOVERNANCE**

**Corporate Governance Guidelines.** The Board has adopted the Smith International, Inc. Corporate Governance Guidelines. These guidelines outline the functions of the Board, director qualifications and responsibilities, and various processes and procedures designed to ensure effective and responsive governance. The guidelines are reviewed from time to time in response to changing regulatory requirements and best practices and are revised accordingly. The full text of the guidelines is published on our website at [www.smith.com](http://www.smith.com) under the Investor Relations caption and link to Governance .

**Code of Business Conduct.** All of our officers, employees and directors are required to comply with our Code of Business Conduct and Ethics to help ensure that our business is conducted in accordance with the highest standards of ethical behavior. Our Code of Business Conduct and Ethics covers all areas of professional conduct, including customer relationships, conflicts of interest, insider trading, financial disclosure, intellectual property and confidential information, as well as requiring strict adherence to all laws and regulations applicable to our business. Employees are required to report any violations or suspected violations of the code by using Smith's ethics hotline. The code includes an anti-retaliation statement. The full text of the Code of Business Conduct and Ethics is published on our website at [www.smith.com](http://www.smith.com) under the Investor Relations caption and link to Governance .

**Table of Contents**

**AUDIT COMMITTEE REPORT**

Smith's Audit Committee is composed solely of independent directors, as defined in the New York Stock Exchange's current listing standards and Section 10A(m)(3) of the Securities Exchange Act of 1934 (the Exchange Act), and it operates under a written charter adopted by the Board of Directors. Committee members may not simultaneously serve on the audit committee of more than two other public companies unless such service is approved by the Board. The composition of the Audit Committee, the attributes of its members and its responsibilities, as reflected in its charter, are intended to be in accordance with applicable requirements for corporate audit committees. The Audit Committee reviews and assesses the adequacy of its charter on an annual basis.

During fiscal year 2005, the Audit Committee was composed of four directors: Messrs. Bailar (Chairman), Gibbs (until October 19, 2005), Fraser and Neely. Mr. Kelley replaced Mr. Gibbs as a member of the Audit Committee on October 19, 2005. Each member of the Audit Committee is financially literate and all members meet the definition of an audit committee financial expert as promulgated by the Securities and Exchange Commission (the SEC). If elected to continue serving on Smith's Board, Mr. Kelley will continue to serve as a member of the Audit Committee. It is anticipated that Mr. Fraser will replace Mr. Bailar as Chairman after the Annual Meeting.

As described more fully in its charter, the purpose of the Audit Committee is to assist the Board in its general oversight of Smith's financial reporting, internal controls and audit functions. Management is responsible for the preparation, presentation and integrity of the Company's financial statements, accounting and financial reporting principles, internal controls and procedures designed to ensure compliance with accounting standards, applicable laws and regulations. Smith has a full-time Internal Audit Department that reports to the Audit Committee and to management. This department is responsible for objectively reviewing and evaluating compliance with the Company's policies and procedures. Deloitte & Touche LLP, Smith's independent registered public accounting firm, is responsible for performing an independent audit of the consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). In accordance with the Sarbanes-Oxley Act of 2002, the Audit Committee has ultimate authority and responsibility to select, compensate, evaluate and, when appropriate, replace Smith's independent registered public accounting firm.

The Audit Committee members are not professional accountants or auditors, and their functions are not intended to duplicate or to certify the activities of management and the independent registered public accounting firm, nor can the Audit Committee certify that the independent registered public accounting firm is independent under applicable rules. The Audit Committee serves a board-level oversight role, in which it provides advice, counsel and direction to management and the auditors on the basis of the information it receives, discussions with management and the auditors, and the experience of the Audit Committee's members in business, financial and accounting matters. The Audit Committee has the authority to engage its own outside advisers, including experts in particular areas of accounting, as it determines appropriate, apart from counsel or advisers hired by management.

During 2005, the Audit Committee met twelve times, including telephone meetings, to discuss relevant accounting, auditing, internal control and disclosure matters. The Audit Committee also discussed the interim financial information of the Company prior to its release to the public and the results of the Statement on Auditing Standards (SAS) No. 100 reviews performed by the Company's independent registered public accountants. The Audit Committee's meetings were conducted with members of management, representatives of the Company's independent registered public accounting firm and, in certain instances, the Company's internal auditors. During these meetings, the Audit Committee discussed with the Company's internal auditors and independent registered public accountants the overall scope and plans for their respective audits. The Audit Committee reviewed the results of their examinations and their evaluation of the Company's internal controls, with certain matters discussed in the absence of Company management. During the year, the Audit Committee also discussed with the Company's independent registered public accountants all matters required by the standards of the Public Company Accounting Oversight Board (United States), including those described in SAS No. 61, as amended, Communication with Audit Committees.

**Table of Contents**

The Audit Committee obtained a formal written statement from Deloitte & Touche LLP required by Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees* disclosing that they are independent with respect to the Company within the meaning of the Securities Act as administered by the SEC and the requirements of the Independence Standards Board. The Audit Committee discussed with Deloitte & Touche LLP any relationships that may have an impact on their objectivity and independence and satisfied itself as to Deloitte & Touche's independence. The Committee also considered whether certain non-audit services provided by Deloitte & Touche LLP were compatible with maintaining Deloitte & Touche's independence. The Audit Committee approved, among other things, the amount of fees to be paid to Deloitte & Touche LLP for audit and non-audit services as well as audit-related fees paid to other public accounting firms.

In accordance with existing Audit Committee policy and the more recent requirements of the Sarbanes-Oxley Act, all services to be provided by Deloitte & Touche LLP, as well as audit-related services provided by other public accounting firms, are subject to pre-approval by the Audit Committee. The Chairman of the Audit Committee has been delegated the authority to pre-approve audit and non-audit services, up to a specified dollar amount, with such pre-approvals subsequently approved by the full Audit Committee. Typically, however, the Audit Committee itself reviews the matters to be approved. The Sarbanes-Oxley Act of 2002 prohibits an issuer from obtaining certain non-audit services from its independent registered public accounting firm so as to avoid certain potential conflicts of interest. Smith has not obtained any of these services from Deloitte & Touche LLP, and Smith is able to obtain such services from other service providers at competitive rates. See *Proposal 3: Ratification of Deloitte & Touche LLP as Independent Registered Public Accounting Firm* for more information regarding fees paid to Deloitte & Touche LLP for services in fiscal years 2005 and 2004.

The Audit Committee reviewed and discussed the audits of the Company's internal controls over financial reporting and its consolidated financial statements as of and for the year ended December 31, 2005 with management and the independent registered public accountants. Based on the above-mentioned review and discussions, and subject to the limitations on the Audit Committee's role and responsibilities described above and in the Audit Committee charter, the Audit Committee recommended to the Board of Directors that the Company's audited consolidated financial statements be included in its Annual Report on Form 10-K for the fiscal year ended December 31, 2005 for filing with the SEC.

Audit Committee

Benjamin F. Bailar, *Chairman*

Dod A. Fraser

Robert Kelley

Jerry W. Neely

12

---

**Table of Contents**

**EXECUTIVE COMPENSATION**

**Compensation and Benefits Committee Report on Executive Compensation**

**Compensation Policies**

The Company's executive compensation program is designed to help the Company attract, motivate and retain the executive resources that the Company needs to maximize its return to stockholders. The objective of the Company's compensation program for key management positions is to provide compensation packages that are consistent with competitive market norms for companies similar in size, activity and complexity to the Company, and which align the interests of senior management with the Company's stockholders.

The Compensation and Benefits Committee (the Compensation Committee), administers the executive compensation programs of the Company and determines the compensation of senior management pursuant to a written charter, which is available on the Company's website. The Compensation Committee consists solely of independent directors, as defined in the New York Stock Exchange current listing standards. An independent compensation consultant has been selected and retained by the Compensation Committee to advise on all executive compensation matters.

The Company's executive compensation program is structured and implemented to provide competitive compensation opportunities and various incentive award payments based on Company and individual performance, as well as to link compensation to financial targets that affect short and long term share price performance. The Compensation Committee administers all of the Company's executive compensation programs, including the design of the programs and the measurement of their effectiveness. The Compensation Committee also reviews and approves all salary arrangements and other payments to executives, evaluates their performance and considers other related matters.

**Tax Considerations**

Section 162(m) of the Internal Revenue Code limits the allowable tax deduction that may be taken by the Company for compensation paid to the Chief Executive Officer and the four other highest paid executive officers named in the Summary Compensation Table. The limit is \$1 million for each executive per year, provided that compensation payable solely upon the attainment of pre-established performance goals, established by a committee of outside directors pursuant to a plan approved by the Company's stockholders, is excluded from the limitation. The Compensation Committee reviews and establishes compensation for any executive officer whose compensation might exceed \$1 million in any year. The Compensation Committee consists of four members, Messrs. Bailar, Buck, Fraser and Gibbs, who are outside directors as defined in Section 162(m) and its regulations. The Compensation Committee will continue to analyze the Company's executive compensation practices and plans on an ongoing basis with respect to compliance with Section 162(m). Where it deems advisable, the Compensation Committee will consider appropriate action to maintain the tax deductibility of its executive compensation. However, we reserve the right to award compensation that does not meet the requirements of Section 162(m) if we determine that such awards are necessary to provide a competitive compensation package. See *Annual Incentive Compensation* below for further information.

**Types of Compensation**

There are two main types of compensation:

(1) *Annual Compensation*. This includes base salary, perquisites and annual incentives in the form of bonuses. The Company awards bonuses only when the Company's financial performance during the year meets a certain level required under the annual incentive plan.

(2) *Long-Term Compensation*. This includes stock options, restricted stock and other long-term incentive awards based on Common Stock. The value of these awards depends upon the Company's performance and future stock value.

**Table of Contents****Factors Considered in Determining Compensation**

The Compensation Committee wants the compensation of the Company's executives to be competitive within the worldwide energy industry. The Compensation Committee estimates an executive's competitive level of total compensation based on information from a variety of sources, including proxy statements of other companies, special surveys and the Committee's compensation consultant. The companies that are part of the Peer Group described in the Performance Graph are some of the companies used by the Compensation Committee in establishing both base salary and performance-based targeted incentive compensation. The sources used by the Compensation Committee are larger than the Peer Group, but are all in the energy industry. The Compensation Committee then compares the industry information with the Peer Group and with the Company's compensation levels to determine both base salary and incentive compensation.

*Annual Compensation*

Annual compensation for the Company's executives includes salary, bonus and perquisites. This is similar to the compensation programs of most leading companies.

The Compensation Committee annually reviews each executive's base salary. The Compensation Committee targets salaries slightly above the median of the range of compensation paid by similar companies. The Compensation Committee also looks at the specific job duties, the executive's achievements and other criteria. Increases in base salary are primarily the result of individual performance, which may include meeting specific goals established by the Compensation Committee. The criteria used in evaluating individual performance vary depending on the executive's function, but generally include leadership inside and outside the Company; advancing the Company's interests with customers, vendors and in other business relationships; product quality and development; advancement in skills and responsibility; and past financial results. In 2005, all executive officers received merit increases and no executive officer received total perquisites exceeding \$50,000.

*Annual Incentive Compensation*

The annual incentive plan promotes the Company's pay-for-performance philosophy by providing executives with direct financial incentives in the form of cash awards that are paid based on the achievement of performance objectives established for the fiscal year. At or prior to the beginning of each fiscal year, the Compensation Committee sets corporate goals for that fiscal year based upon financial objectives deemed appropriate by the Compensation Committee. These objectives may include earnings per share, profit after tax, return on assets, return on net capital employed, return on stockholder equity and other financial objectives for the year. Where executives have strategic business unit responsibilities, their goals are based on financial performance measures of that business unit. No bonus is paid to corporate executives unless certain threshold Company performance levels set by the Compensation Committee are reached. Business unit executives must meet certain threshold performance levels in their business unit's annual incentive plan in order to receive a bonus.

At or prior to the beginning of each fiscal year, the Compensation Committee sets targets for each executive relating to annual incentive compensation. The target incentive awards for 2005 for eligible Company executives were based on various Company, business unit and individual performance measures. The Compensation Committee does not use a specific formula for weighing individual performance. Instead, individuals are assessed based upon how they contributed to the Company's business success in their respective areas of responsibility. Awards were made in 2006 under the annual incentive plan for fiscal year 2005 to all eligible executives.

At the Annual Meeting, the stockholders will be asked to approve the Smith International, Inc. Executive Officer Annual Incentive Plan effective January 1, 2006 (the Plan). The Plan will establish criteria for executive officer cash bonus awards that contain performance objectives. If approved by the stockholders, annual incentive awards granted pursuant to the Plan generally will not be subject to the tax deduction limits of Section 162(m) of the Internal Revenue Code.



**Table of Contents***Long-Term Incentive Compensation Program*

The Compensation Committee strongly believes that the grant of significant annual equity awards further links the interests of senior management and the Company's stockholders. Each year, the Compensation Committee, in consultation with its independent compensation advisor, determines the total amount of shares of Common Stock to be made available to the Company's executives through awards of stock options, restricted stock and other long-term incentive awards. These amounts vary each year and are based upon what the Compensation Committee believes is appropriate. The Compensation Committee considers an executive's total compensation package, including the amount of stock options and/or restricted stock previously awarded. Other important factors are the desire to create stockholder value, encourage equity ownership, provide an appropriate link to stockholder interests and provide long-term incentive award opportunities in the same range as similar companies in the Company's industry. At the executive level, the Compensation Committee placed particular emphasis on performance-based incentive awards during 2005.

*Chief Executive Officer Compensation*

The Compensation Committee determines the pay level for the Chief Executive Officer, considering both a pay-for-performance philosophy and market rates of compensation for similar positions. A significant portion of compensation for the Chief Executive Officer is based upon the Company's performance. Mr. Rock's compensation is determined using substantially the same criteria utilized to determine compensation for other executive officers, as discussed earlier in this report. Based on this review and analysis, the Compensation Committee believes Mr. Rock's compensation in the aggregate to be reasonable and not excessive. Specific actions taken by the Compensation Committee regarding Mr. Rock's compensation are summarized below.

*Base Salary* The Compensation Committee reviewed Mr. Rock's base salary at its December 2005 meeting and increased it to \$1,100,000, an increase of 10% over fiscal year 2005. In setting Mr. Rock's base salary for fiscal year 2006, the Compensation Committee reviewed the recommendations by the independent compensation consultant and market comparisons as well as the Company's financial results and other relevant factors for 2005 and prior years.

*Annual Incentive* The Compensation Committee independently reviewed the bonus objectives for fiscal year 2005 set by the Compensation Committee in December 2004 against the Company's fiscal year financial performance. For fiscal year 2005, Mr. Rock earned an annual bonus in the amount of \$2,000,000, which was paid in 2006.

*Equity Incentives* In April 2005, after the stockholders approved the Company's 1989 Long-Term Incentive Compensation Plan, as amended and restated effective January 1, 2005, Mr. Rock was awarded 77,742 performance-based restricted stock units, which carry a cost of \$1.00 per share. Based on the Company's attainment of performance criteria for the 2005 fiscal year, this award was increased to 89,403 units. The units vest in equal installments over a three-year period, beginning in December 2005.

On December 6, 2005, at the recommendation of the Compensation Committee, the Company awarded Mr. Rock 137,500 performance-based restricted stock units. This award could be increased by up to 15% or decreased to zero dependent upon the return on equity achieved by the Company during the 2006 fiscal year. The restricted stock units, if any, will vest in equal installments over a three-year period and are subject to continued employment.

The awards to Mr. Rock in 2005 account for 15.1% of the total equity incentives awarded to all employees of the Company during the year.

**Table of Contents**

**Summary**

The Compensation Committee believes that the compensation program for the executives of the Company is comparable with compensation programs provided by other companies in the energy industry and serves the best interests of the Company's stockholders. The Compensation Committee also believes that annual performance pay is appropriately linked to individual performance, annual financial performance of the Company and stockholder value.

Compensation and Benefits Committee:

James R. Gibbs, *Chairman*

Benjamin F. Bailar

G. Clyde Buck

Dod A. Fraser

16

---

**Table of Contents**

**Comparison of Five-Year Cumulative Total Return**

The following line graph compares the cumulative total stockholder return of the Company's Common Stock against the cumulative total return of the S&P 500 Index and our Peer Group for each of the five years in the period starting December 31, 2000 and ending December 31, 2005. Our Peer Group consists of the following companies in the same general line of business as the Company: Baker Hughes Incorporated, BJ Services Company, Cooper Cameron Corporation, Halliburton Company, National Oilwell Varco, Inc. (from March 11, 2005 until December 31, 2005), Schlumberger Limited, Varco International, Inc. (from December 31,