# Stock Price Performance Shares

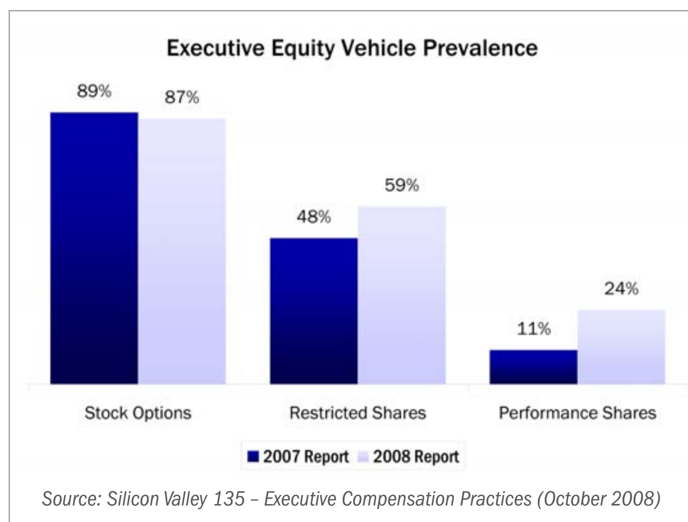
## A New Approach to Long-Term Incentives for Executives

The ongoing global economic crisis has brought to a head many long-festering criticisms of executive compensation: How much is too much? Are we truly aligning executive pay with shareholder interests? Should shareholders have a direct voice in setting executive compensation?

The crisis has also increased political attention on executive pay, as evidenced by the recently enacted American Recovery and Reinvestment Act and the broader reforms (such as "Say on Pay," nonqualified deferred compensation limits, and compensation recovery policies) expected later this year. On a more practical level, however, companies are wrestling with how to provide effective long-term incentives to their executives in the current environment (both economic and political). The key questions that they (and you) may be facing include the following: Do stock options still work? Are restricted stock units ("RSUs") a better alternative? Is now the time to introduce performance shares?

### Current Practices

Historically, technology companies relied almost exclusively on stock options to fund the long-term incentive programs for their executives (many would contend that the Silicon Valley was built on the back of stock options). With the adoption of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ("SFAS123(R)"), and its "fair value" accounting requirement, and ever-increasing investor focus on dilution, the use of restricted stock has increased significantly over the last few years. Shareholder pressure to better link pay and performance has also led to an increased use of performance shares (that is, shares of stock that may be earned based on corporate financial and/or operational performance). Today, many companies are using a "portfolio" approach in their long-term incentive programs, as evidenced by the following table:




Source: Silicon Valley 135 – Executive Compensation Practices (October 2008)

### The Vulnerabilities of Options and RSUs

By providing a mix of equity vehicles, companies are trying to compensate for the shortcomings of these traditional equity vehicles. Stock options provide superior leverage and rewards in a rising stock market (primarily due to the generally larger award sizes relative to RSUs), but are inherently fragile in a down market (since they measure absolute stock price performance

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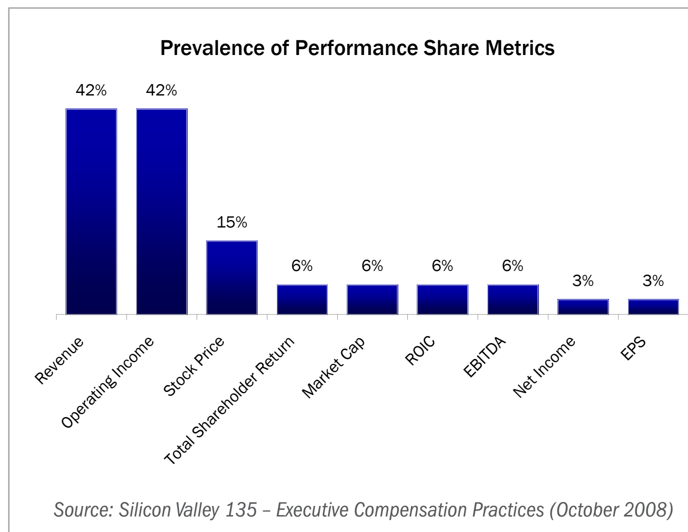
above the exercise price). The current environment certainly bears this out, as we witness a steady stream of companies announcing stock option exchange programs to "fix" options that are no longer providing meaningful incentives. In many ways, RSUs represent the flip-side of stock options. Generally, they provide significantly less leverage than other equity vehicles, but are very robust (that is, they deliver value in almost any market scenario). However, the very virtues of RSUs are also their shortcoming: the absence of leverage tempers the motivational incentives provided, and their robustness leads to the (not wholly unfair) criticism that they can amount to "pay for failure."

### The Case for Performance Shares

Performance shares offer a balance between these two vehicles—providing more leverage than RSUs (that is, the better the performance, the more shares earned) and a better pay for performance link than stock options. To date, however, most performance share programs have been predicated on achievement against one or more operating metrics (for example, revenues or various profit measures,), as illustrated by the following table:




*Source: Silicon Valley 135 – Executive Compensation Practices (October 2008)*

In the current environment, where there is little visibility into the current quarter, let alone what year-end or multi-year results will look like, many companies are finding it difficult to adopt or renew performance share programs. Other companies are considering amendments to their performance share program as their performance metrics become outdated or unattainable (even though many of these amendments may conflict with the proxy voting guidelines of major institutional shareholders and the proxy advisory firms, such as RiskMetrics Group). Conventional performance share programs also suffer from a number of other potential vulnerabilities:

- The performance metrics may be redundant with the company's annual incentive plan
- The motivation and/or retention incentives may decline if the performance objectives look unlikely to be achieved (that is, for different reasons, performance shares may be as fragile as stock options)
- The link to shareholder value creation is indirect (they assume that operational performance will translate into shareholder value creation and/or preservation)
- The program may trigger SEC disclosure obligations that may conflict with the company's desired "guidance" to Wall Street

### "Stock Price" Performance Shares

In response to these issues, we have been assisting clients with the consideration and adoption of "stock price" performance shares. Essentially, stock price performance shares are shares of stock that are earned based on changes in a company's stock price performance over a fixed

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## Stock Price Performance Shares – A New Approach to Long-Term Incentives for Executives (continued)

period. Typically, awards are granted for a target number of shares, but the actual number of shares earned will fluctuate (up or down) depending on the company's stock price performance relative to an external benchmark (for example, peer group stock price performance or the performance of an industry-specific index or a broader market index, such as the NASDAQ Composite Index).

Stock price performance shares offer a number of distinct advantages over other equity vehicles:

- They are significantly less fragile than stock options and conventional performance shares, thus providing strong motivation and/or retention incentives in a volatile stock market
- The link to shareholder value creation and/or preservation is direct (that is, performance against a bad business plan will not drive high levels of reward)
- Forecasting or performance goal-setting is not required
- Since payouts can be earned for performance that exceeds target levels, stock option levels of leverage can be achieved

### About the Author

The author of this Thoughtful Pay Alert is Tom Brown, a principal with Compensia. If you have questions concerning this Alert or stock price performance shares, Tom can be reached at 408.876.4023 or tbrown@compensia.com.

### Need Assistance?

Compensia has had significant experience in advising technology and life science companies on designing performance-based incentive compensation programs. If you have any questions on implementing a performance-based incentive compensation program, or specific types of equity-based incentive arrangements, please feel free to contact us. ■

### About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.


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