Market Stock Unit Practices in the Technology Sector

While historically technology companies relied heavily on stock options to provide long-term incentives to their executives, in recent years an alternative vehicle – full-value awards with vesting tied to stock price performance – has gained broad acceptance. These awards – known as market stock units ("MSUs") – avoid many of the perceived drawbacks of traditional stock options while, at the same time, directly linking the number of shares earned to stock price performance, thereby creating an effective link between executive and shareholder interests.

Typically, an MSU is an award granted for a target number of shares, with the actual number of shares earned determined based on the company's stock price performance (generally, using total shareholder return ("TSR")) relative to an external benchmark (for example, peer group stock price performance, an industry-specific index, or a broader index such as the NASDAQ Stock Market) (a "relative" MSU) or based solely the company's own stock price performance (an "absolute" MSU).

Recently, we conducted a survey of the long-term incentive compensation programs of nearly 100 technology companies to better understand the design and use of relative TSR MSUs. This Thoughtful Pay Alert summarizes our key findings about this increasingly popular equity vehicle.

Market Stock Units – Advantages

Relative MSUs possess several advantages over other equity vehicles. Specifically, they:

- Enable multi-year performance periods without the attendant challenges of long-term financial goal-setting or forecasting
- Promote greater transparency around the selected performance measure without having to deal with disclosure of target performance levels
- Provide better retentive impact than stock options or performance share awards tied to financial objectives (in other words, the performance goals are less likely to become moot given relative measurement); they are also less sensitive to broad market fluctuations than stock options (since performance is relative)
- Capture investors' opportunity cost of investing in a company relative to the broader sector/market
- Can be designed to preserve some or all of the leverage associated with stock options (through upside potential and payment in shares)
- Avoid redundancy or overlap with annual bonus plan goals
- Decrease unproductive dilution (that is, the size of the awards is reduced if relative performance is poor)

For a more detailed discussion of the evolution of MSUs and a detailed analysis of their benefits, administrative complexities, and design considerations, see our Thoughtful Pay Alert, Executive Long Term Incentives: Making the Jump to Market Stock Units (May 10, 2012).

Companies Reviewed

To better understand current practices with respect to the use of MSUs, we reviewed the most recent publicly-available disclosures of 97 technology companies in the hardware, software, and semiconductor sectors as of September 7, 2016. Given the growing acceptance of this equity vehicle, as well as the diverse life cycles of technology companies generally, these companies varied dramatically in size, with annual revenues ranging from $50 million to $215 billion and market capitalizations ranging from $188 million to nearly $600 billion. While more than a third of these companies (36 companies) are headquartered in the San Francisco Bay Area, the remaining companies are located throughout the United States.

General Market Practices

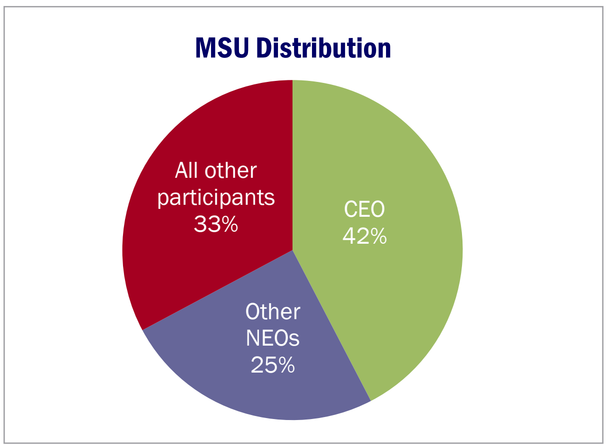
Program Participation

At each of the surveyed companies, we found that the Chief Executive Officer and each of the other named executive officers had received one or more MSU awards during one

Market Stock Unit Practices in the Technology Sector (continued)

or more of the last three completed fiscal years. In many of these cases, it was disclosed that the MSUs were granted to more than just the named executive officer group. In our experience, this practice is entirely consistent with the objective of using performance-based awards to motivate those individuals who have the greatest ability to impact the company's overall results.

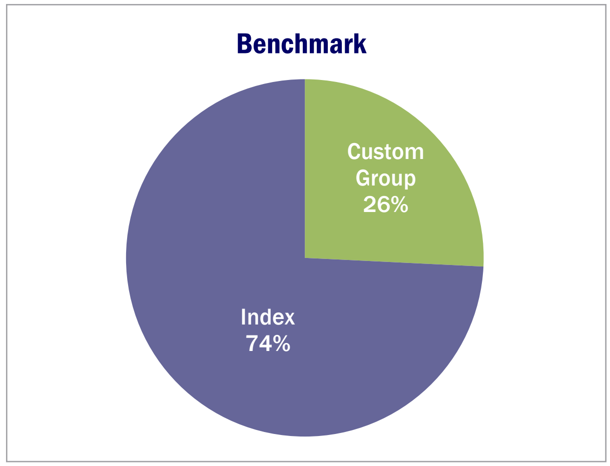
We also learned that, during the last completed fiscal year, two-thirds (67%) of the aggregate value of the MSU awards granted were granted to the Chief Executive Officer and the other named executive officers. Further, approximately 42% of the MSU award value, on average, was awarded to the Chief Executive Officer.



Selection of Comparator Group

As noted above, typically relative TSR MSU programs measure company performance over a multi-year period against an external benchmark. Our study found that most companies (74%) use a third-party independently-constructed index for this purpose to ensure both a robust sample size and a transparent selection process and to facilitate program communication and administration.

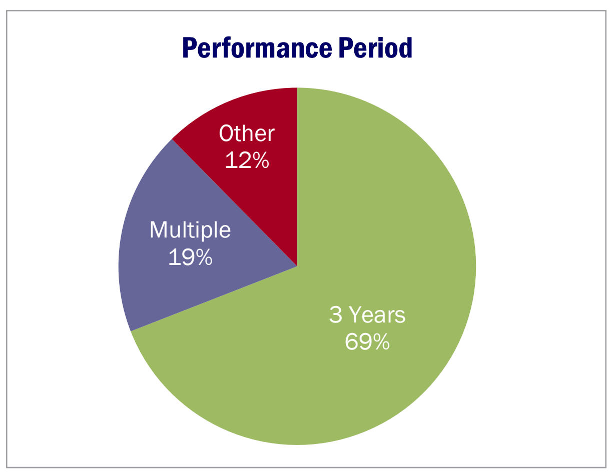
Of the companies using an independently-constructed index, Standard & Poor's industry segments (29% of companies) were the most commonly-used (for example, the Standard & Poor's Semiconductor Index). Nearly half (47%) of the surveyed companies that use an independently-constructed index use some form of a Standard & Poor's Index (either a specific segment or the Standard & Poor's 500).



Program Design

With respect to plan design, we identified the following common characteristics among the relative TSR MSU programs that we reviewed.

- **Performance period** – Nearly 70% of the surveyed companies (67 companies) are using a single three-year performance period for their awards. After that, 19% of the surveyed companies use a cumulative performance period structure (that is, a one-year, a cumulative two-year, and a cumulative three-year performance period). The remaining companies use assorted single year performance periods (typically, one year, two years, or four years).



- **Measurement approach** – Just over 70% (actually 72%) of the surveyed companies (68 companies) are using “percentile ranking” (as opposed to “percentage of index performance”) as the methodology for comparing performance at the end of the performance period. (Notably, nine of these companies use TSR as a performance “modifier,” rather than as the principal performance measure.)

  Of the 59 companies which use TSR as the principal performance measure, 24% of these companies (14 companies) require that performance exceed the 50th percentile of the comparator group for target payment to be earned. Further 41% of these companies (23 companies) require that performance equal or exceed 90% of the comparator group for any maximum payment to be made.

- **Negative performance** – Thirty percent of the surveyed companies (25 companies) limit payments in the event that a company’s absolute TSR is negative. Further, 84% of these 25 companies (21 companies) “cap” this payment at 100% of the target performance level.

Coordination with Other Equity Awards

In addition to the foregoing, we also identified the following noteworthy items:

- More than half (52%) of the 88 companies that employ TSR as the principal performance measure for their MSU program (46 companies) granted MSUs as their sole performance-based long-term incentive compensation award for their executive officer (with the remaining 42 companies granting multiple types of performance-based LTI awards).
- Eighty-five percent of the surveyed companies (82 companies) granted time-based restricted stock unit awards in addition to MSUs to their executive officers; and
- Thirty-eight percent of the surveyed companies (37 companies) granted stock options in addition to MSUs to their executive officers.

Final Observations

We believe that many companies have found, and will continue to find, MSUs to be a valuable addition to their long-term incentive award portfolio for their executive officers. Over the long term, executive compensation – and particularly equity compensation – should be closely aligned with shareholder value creation. In support of this goal, MSUs are a useful tool that should be considered as one element of a balanced, thoughtful approach to your executive total reward strategy.

About the Authors

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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, 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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