FIVE REASONS TO LIKE PERFORMANCE SHARES (AND ONE REASON TO THINK TWICE)

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From Goldman Sachs to American Airlines, equity compensation continues to be a hot topic.

Many of today's discussions are focusing on how to link long-term incentive awards with performance. This is particularly important since shareholders are interested in how companies are positioning themselves for recovery as the economy stabilizes.

Defining performance shares

> The common feature of all performance share grants is a specified goal or metric that must be achieved. The goal of performance shares is to tie managers to the interests of shareholders. The manager receives the shares as compensation for meeting targets, as opposed to stock-option plans where employees receive stock options as part of their usual compensation package.

In response to the impact of the economy and ongoing legislative and regulatory focus on executive pay, companies are strengthening how their incentive compensation programs align with business strategies to reinforce payouts that are commensurate with performance.

One of every two organizations has now introduced or plans to introduce new financial performance measures to their 2010 annual incentive program, according to a new survey by Mercer.[1] The Mercer survey showed that one-third of organizations have introduced new financial measures to their annual incentive plans while another 17% introduced non-financial measures.

Companies want to set credible goals that will motivate employees and satisfy stakeholders, but goal-setting remains a challenge with the economic outlook still uncertain. What does this long-term trend of pay for performance mean to highly compensated executives and increasing numbers of mid-level managers?

PERFORMANCE SHARES OFFER DISTINCTIVE BENEFITS TO COMPANIES, SHAREHOLDERS, EXECUTIVES AND THE PUBLIC ALIKE

We believe there are five distinctive reasons why members on the senior team should embrace performance shares – and one important reason companies should avoid them.

REASON #1: TRANSPARENCY LETS YOU SEE WHERE YOU ARE GOING

Transparency regarding pay in corporate governance is just as good for the senior executive as it is for the board of governors, the shareholder, and the public.

Companies that readily embrace a clear, public-facing response to pay concerns have been enjoying a favorable response from all of their core constituencies – including regulators.

These firms are also avoiding headlines like these:

- "Executive compensation at American Airlines raise eyebrows" *Tulsa World* 4/20/10
- "A question for Citi's board: why was Prince given a parting bonus?" *New York Times* 4/6/10
- "After WaMu collapse, CEO walked off with $25 million" *Seattle Post Intelligencer* 4/14/10

Given these pressures and increased transparency, U.S. companies seek to clearly align executive pay with performance, while sustaining employee motivation and engagement. The alternative is stark: further loss of credibility in the eyes of the public, increasingly onerous disclosure requirements, and the potential for significant loss of top talent.

For conscientious senior executives, performance shares send a strong signal that a company is trying to improve the alignment of pay, performance, and long-term shareholder value – in other words, that company is trying harder to become a better corporate citizen.

> *Executives who deliver above-average performance are earning significantly more than those who don't deliver. And many executives are losing great amounts of wealth when their companies perform poorly. Both are shareholder-friendly outcomes.*

REASON #2: PERFORMANCE SHARES CAN BE OFFERED BEYOND THE C-SUITE LEVEL

GRANTS COME IN A MUCH GREATER VARIETY THAN STOCK OPTIONS OR TIME-VESTED RESTRICTED STOCK.

Performance shares may not be the sole preserve of the C suite set in the near future, too.

Increasing numbers of companies are granting performance shares to middle management performers as well, steering a clear course to greater participation in an organization's long-term success.

These grants come in a much greater variety than stock options or time-vested restricted stock. The structure and details of these grants, in fact, are so flexible and vary so much that a grant will almost certainly be different than other grants at other companies.

A growing number of companies are making stock grants that base an executive's incentive on more than continued employment or an increase in the company's stock price. As companies view various types of stock compensation as different elements in the same portfolio, executives can expect to see more grants of performance shares along with standard restricted stock (or RSUs) and stock options.

Performance shares at-a-glance	
Primary use	Motivate executives to reach pre-defined benchmarks.
Companies	Publicly traded (generally).
Recipients	C-Suite level executives and, increasingly, middle management.
Other beneficiaries	Especially shareholders, who like it when payouts occur only when goals are met.
Accounting, legal and tax factors	• Performance share plans require some complex accounting. • Value of market-based goals cannot be reversed if missed. • Nonmarket-based goals require probability calculations. • Challenges are possible from shareholders and recipients regarding meeting and issuing of performance goals. • Income and taxes due at vesting.
Communications challenges	Understanding and management of performance criteria takes some effort.
Administrative challenges	• Must carefully monitor goals against awards. • Important to follow standard Restricted Stock Unit (RSU) issues, too.

MEASUREMENT OF EQUITY PLANS BASED ON PERFORMANCE SHARES IS BECOMING INCREASINGLY STANDARDIZED

REASON #3: CREDIBLE MEASUREMENTS

If climbing the corporate ladder is a game, the game gets clearer with a performance shares rule book.

One of the challenges, though, is tracking potential gains. While the structure (and even the definition) of performance share grants can vary, the common feature is a specified goal or metric that must be achieved before one can profit from the grant.

Usually, more details appear in a grant agreement than in a stock plan. Tracking progress may be difficult when company-specific goals are relatively intangible or subjective, as in "customer satisfaction" or "leadership development."

Still, measurement of equity plans based on performance shares is becoming increasingly standardized through a tool known as Relative Total Shareholder Return (Relative TSR). Looking into the international markets, close to 90% of companies use Relative TSR as one of the performance metrics to link executive rewards with shareholder value.

This accounting device is emerging as the most common performance metric for several reasons:

- **Consistent accounting consequence** in that the accounting charge is fixed, regardless of future payout.
- **Easy to track** and readily measurable at any time for regular and frequent feedback to plan participants and the Board.
- **Ongoing transparency** for participants, with a clear line of sight into rewards as opposed to perhaps murkier internal performance measures.

Most companies opt for a three-year performance period[2]

Performance period	**Percentage of companies**
Two years	5%
Three years	86%
Four years	6%
Other period	3%

AS “SAY ON PAY” BECOMES INCREASINGLY POPULAR, PERFORMANCE SHARES LIKEWISE GROW IN STATURE.

REASON #4: OVERSIGHT HAS ITS ASSURANCES

Many companies regularly receive shareholder proposals for inclusion in the companies’ proxy materials which seek to change executive compensation practices.

Such requests have included a provision called “Say on pay,”[3] which has already gained some traction as a method by which shareholders can exert influence on the structure of executive compensation arrangements.

For example, last November, Microsoft Corporation’s board of directors approved a "say on pay" plan to allow its shareholders the ability to cast a nonbinding advisory vote on the company's senior executive compensation plan every three years. Around the same time, a narrow majority of shareholders of Cisco Systems Inc. approved a proposal to vote on that company’s executive compensation plan.

As “Say on pay” increasingly becomes a way for shareholders to make their voices heard on compensation policy, performance shares likewise grow in stature as a positive outcome to a mutual need.

REASON #5: EXCEPTIONAL PERFORMANCE = EXCEPTIONAL UPSIDE POTENTIAL

Performance share grants with payouts that, for exceptional performance, may exceed the target (e.g., 150%, or 7,500 shares after an original target award of 5,000) can provide an upside potential similar to that of stock options.

At American Airlines, for example, half of the performance share award to senior executives is based on Relative TSR by comparison to the company's major US airline competitors during a three-year measurement period. The other half of the performance share award is based on the achievement of corporate objectives (e.g., in safety, positive work environment, financial goals) set by the company's compensation committee.

ONE REASON TO THINK TWICE: PERFORMANCE STANDARDS MAY BE TOO DIFFICULT TO SET

Some companies have looked at performance shares and said “no thanks.”

In businesses that involve highly qualitative research and analysis, product development and delivery may be just too speculative and uncertain.

Outcomes may not be knowable over the course of a year – or many years. Such companies may determine that performance goals are too difficult to set, while others realize that the achievement of their goals is unlikely.

LOOKING AHEAD

While the past few years have presented many challenges for companies and executives in how they balance compensation plans with corporate results, one trend seems irrefutable: the growing recognition that long-term incentive-based compensation has a permanent place on the executive compensation menu.

It’s more than likely that the use of performance shares will continue to gain favor in the years ahead.

The research firm, Frederic W. Cook & Co. (FWC), has been tracking the acceptance of performance shares and has shown that they have continued to rise in popularity when compared to other equity compensation alternatives.

Including findings from 250 surveyed companies in its 2009 Top 250 Report, FWC said that performance shares acceptance has been one of “most interesting trends” in the executive compensation field.

The proof was in the numbers: The use of performance shares rose 63% through year-end 2009.

[1] http://www.mercer.com/summary.htm?idContent=1366845

[2] https://www.mystockoptions.com/articles/index.cfm/ObjectID/29BB3D75-7EFC-42CD-80580F01D3B20... 1/26/2010

[3] MAPI Manufacturers Alliance Issue in Brief March 9, 2010