G & C Middleton Ltd

Could Co-Investment Plans be the answer to simplifying Executive Reward?

Over the last 20 years or so, the value of executive reward has increased exponentially whilst also becoming more complex. Many different approaches have been tried but none have stood the test of time.

There is now a growing sense that traditional Long Term Incentive Plans (LTIPs) are just too difficult and don't work - they are far too complex and it is too difficult to set meaningful long-term performance conditions that satisfy investors (many of whom have opposing views on which measures are best) whilst retaining line of sight to those things executives can influence. The Appendix gives a brief history for information. Pressure is also growing for even longer performance periods, 5 years or more. This exacerbates the problem of setting such targets, but also few investors themselves have performance horizons this long. How often have companies been criticised by shareholders and the press for generous vesting of a 3 year LTIP during a "bad" year – ignoring the fact that performance over the 3 year period must have been good!

Perhaps the best way to align executives' interests with shareholders is simply to ensure they build up a significant stake in the company, working from the premise that executives who hold a significant stake in their company will act more like shareholders than employees. The main questions then are how to deliver these shares and at what level?

Restricted stock, combined with deferral of a significant proportion of the annual bonus into shares, is now being touted as a potential replacement to traditional LTIPs. With forfeiture on leaving, suitable holding periods (including after leaving) and onerous minimum shareholding requirements, this is seen as a simple mechanism to deliver shares to executives.

The problem is that investors are not yet fully bought into the idea of restricted stock due to the lack of performance conditions, but at least they will now consider it. Grant levels would have to be reduced dramatically when compared to traditional LTIPs to take account of the certainty of payment, which will naturally reduce the upside potential. Grant levels could also be linked to individual and corporate performance, to alleviate for the lack of performance conditions.

Interestingly, this approach looks remarkably like a good old-fashioned share matching plan ("SMP"). These used to be quite popular a few years back but died out as more onerous performance conditions were attached to the matching shares, pressure was applied to increase the deferral period, and they were often operated alongside a traditional LTIP, so were seen by executives as the cause of them not being able to take their hard-earned bonus immediately.

With the environment having changed somewhat, perhaps this is the time to take a fresh look at such plans. In particular:

- With most annual bonus plans now already requiring some element of deferral, introducing an SMP may not have the negative connotations of the past and may be seen as a good thing.
- There is an automatic alignment of short-term and long-term performance, since it is the annual bonus that determines the amount available to be invested and thus the amount of matching shares to be awarded.
- Shareholder consideration of the merits of restricted stock (without performance conditions) may make such plans more acceptable, especially if they were the only LTIP operated.

Co-Investment Plan

Companies already spend a lot of time and effort on designing appropriate performance measures for their annual bonus plans, taking account of individual and company performance and behaviour. Building on this, the basic concept of co-investment can be very powerful - if the executive is prepared to invest in their company (by way of investing part of their annual bonus into shares), then the company is prepared to invest in them (by awarding matching shares). With such an approach, you can roll the annual bonus plan and LTIP into a single Co-Investment Plan. A simple example will help to explain.

An example

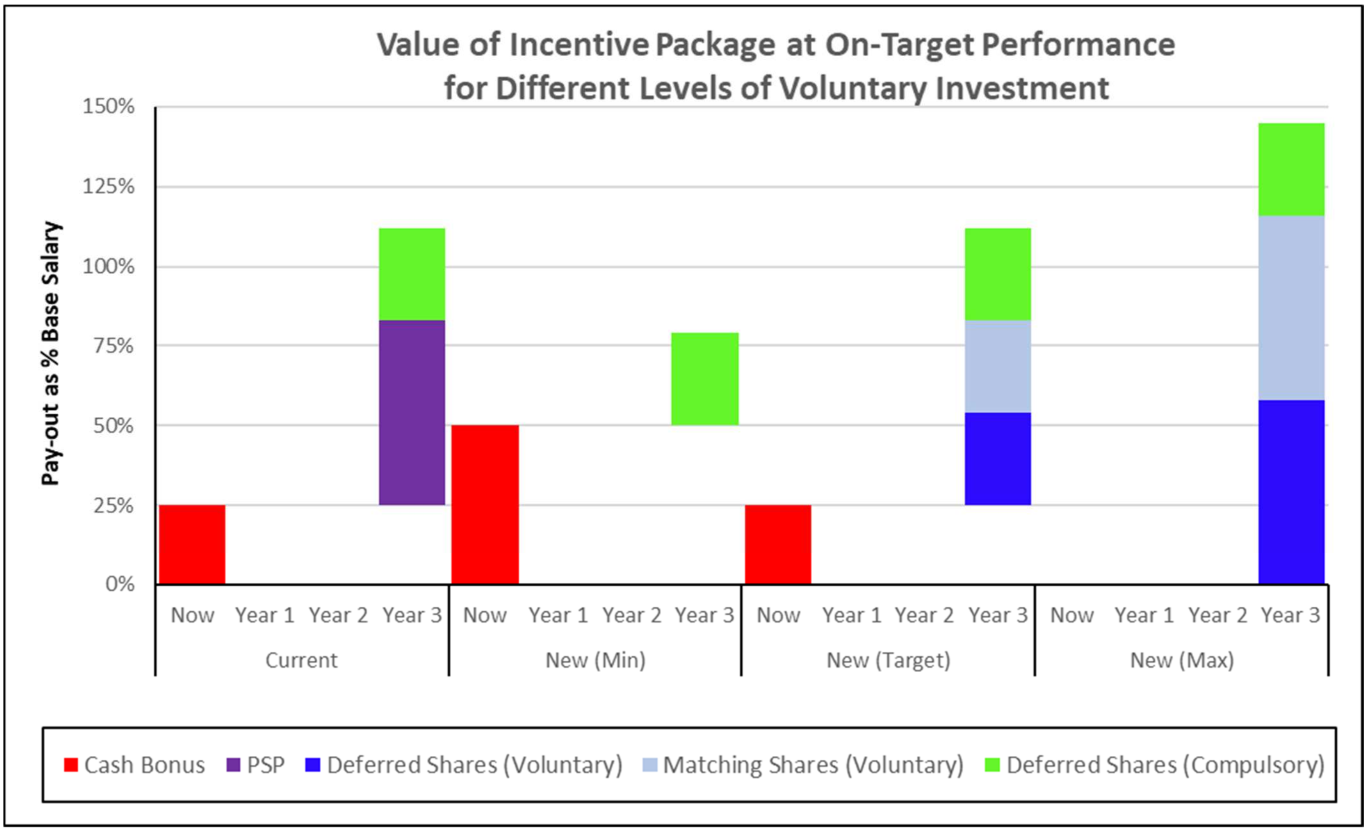
Take an executive with an existing incentive package offering:

- Short Term: annual bonus of maximum 100% of salary, with half deferred into shares for 3 years.
- Long term: performance shares of 100% of salary each year, with 3-year performance condition.

Compare this to a new package comprising a single Co-Investment Plan (CIP) with a maximum annual Incentive of 150% of salary, 1/3rd compulsorily deferred into shares for 3 years and the opportunity to voluntarily invest the rest of the annual incentive into shares for 3 years with a 1:1 match of Matching Shares. There are no performance conditions on these matching shares apart from forfeiture should the executive leave before 3 years.

The graph below compares the gross pay-out (ignoring tax complications) for the grants of PSP and deferred shares that are made in the year under 4 scenarios as follows:

1. Current package
2. New Package (Min): executive chooses not to voluntary invest
3. New package (Target): executive chooses to invest half the remaining annual incentive
4. New package (Max): executive chooses to invest all the remaining annual incentive



The annual bonus targets and PSP targets are assumed to pay-out at half the maximum amount (ie traditional on-target assumption) and share price growth (including reinvested dividends) of 5% pa.

This shows:

- *New (Target)* - the new package with target voluntary investment of half the remaining annual incentive (ie 1/3rd compulsory invested, 1/3rd taken now and 1/3rd voluntarily invested) pays out the same as the current plan.
- *New (Min)* - Should the executive choose to invest less, his immediate pay-out is higher but the total pay-out is much less.
- *New (Max)* - Vice-versa, should the executive invest all the annual incentive, the immediate pay-out is less, but the total pay-out is more.

Thus, the executive is rewarded more should he/she voluntarily invest in the company than if he/she doesn't.

The main advantages of a Co-Investment Plans over traditional LTIPs are:

1. There is only one incentive plan.
2. You only need the performance targets to set the annual incentive pay-out - there is no need for additional performance conditions on the matching shares as everything feeds off the annual incentive pay-out.
3. It has tremendous flexibility to deal with different design aspects (split vesting, holding periods, malus, clawbacks etc)
4. You could even have matching shares on compulsory deferral, but this is likely to require some performance condition to be attached.
5. It rewards executives who perform (by way of their annual incentive outcome) and those willing to invest in the company.
6. The package can be further geared by increasing the match, although again this is likely to have to be coupled with some level of performance condition.
7. It is a simple way to deliver shares to the executive to align their interests with shareholders and link the gifts of shares to performance. If this is coupled with extended holding periods and minimum shareholding requirements, it achieves the desired aims of creating significant executive shareholders.

The challenges are:

1. It puts even greater pressure on the design and setting of the annual incentive targets. This is probably no bad thing and will encourage companies to see their annual targets as just one year of a multi-year strategy.
2. Over time, Investors may forget the stated aims of the plan and apply pressure to introduce performance conditions on the matching shares. A possible way around this is to have a discretionary value underpin, whereby the remuneration committee will need to be satisfied that there has not been a significant deterioration in company performance over the vesting period.
3. Should the annual incentive not pay out, then the executive receives no variable reward for that year. Some companies may argue that this will create retention problems.

   The converse argument is that if the company had got its annual incentive targets right and the plan didn't pay-out, then the executive doesn't deserve any variable reward and the company shouldn't be concerned about retention – but rather see it as an opportunity to replace underperforming executives!

4. It is likely to increase pressure for companies to be more open about their incentive targets, and to have a greater spread of pay-outs. This will give shareholders the opportunity to scrutinise the targets set and satisfy themselves that they are sufficiently stretching to justify the rewards being paid, which in turn will put added pressure on the company to get it right. Are the targets really that market sensitive or do companies just use this as an excuse so that they don't have to disclose them in advance and then be held to them?
5. In the year of joining, no LTIP grants are made until the following year when the annual bonus pays out. An award of restricted stock (perhaps in line with the on-target annual bonus) could be made purely for retention purposes.

Given the desire to extend the period for which executives have to hold the shares, holding periods could easily be added to the CIP. For example, vesting could remain at 3 years but an additional 2 year holding period could be applied, which would also apply after leaving to ensure there is no acceleration of pay-out on leaving.

Conclusion

There is a growing sense that traditional incentive plan designs don't work and that the best way to align executives' interests with shareholders is to ensure they build up a significant stake in the company. A Co-Investment Plan combines the annual bonus and LTIP into a single plan to create a simple means to deliver shares to executives aligned to their performance, the company' performance and their personal willingness to invest their own money in the company they work for, demonstrating their loyalty and confidence in the company's prospects.

Surely shareholders would support this wholeheartedly!

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APPENDIX - A Brief History of LTIP Design

There is no holy grail of incentive design – different companies will have different needs. But the basic principle of rewarding executives for performance – sharing the spoils of their toil with the owners of the company – remain. The key challenges are quantum, alignment to performance and line of sight.

Over the last 20 years or so, numerous changes have been made to try to align executive reward with long term performance. We've seen:

- the introduction of performance conditions on share options
- the resultant rise and fall of share options,
- a drift away from multiple long-term Incentive Plans ("LTIPs")
- deferral of annual incentives into shares
- introduction of ever increasing holding periods
- multiple, complex performance conditions
- the fall from grace of Share Matching Plans
- a (slow) move towards restricted stock

Whilst some of this continual change can be put down to tax changes, much of it has been driven by the changing attitudes of institutional investors and the increasing influence of shareholder voting advisory bodies. No doubt they will argue that this has been in response to executive greed and a lack of alignment between pay and performance. Competitive pressures and incessant benchmarking have ratcheted up executive pay to stratospheric levels - an unintended consequence of improved disclosure and transparency – to the point where Governments are considering legislation to cap "excessive" executive pay. This has already happened in financial services in response to the banking crisis with the introduction of the cap on variable pay to once times fixed pay (twice with shareholder approval). Did it not occur to regulators that this would simply drive up fixed pay?

Executive Share Options

The basic premise of the traditional share option is to share the growth in value of the company with those having the greatest influence on that growth. Tax incentives were provided to encourage their use, both for executives and employees in general. The trouble is that share price is as much influenced by general market movements and market sentiment as it is by the underlying performance of the company. Consequently, when markets fall, share options become worthless; when markets rise, investors may not feel the performance of the company warrants the pay-outs to executives. This was further exacerbated by the 10 year life of a share option – if you wait long enough surely they would generate some gain – but investors (quite rightly) didn't see a mediocre gain over a 10 year period as sufficient. Thus the introduction of performance conditions (usually 3 year EPS), which originally could be retested over successive periods. When retesting was deemed unacceptable, share options began to be seen as a lottery over which the executive had little control, and were especially vulnerable to market falls, of which there have been several (the 1987 crash, dot com bubble and the banking crisis to name but a few).

Performance Shares

Consequently, the demise of the executive share option saw the rise to the traditional LTIP, or Performance Share Plan, whereby the executive would be granted actual shares for free but only if certain performance measures were achieved over a specified period. This resolved the problem of market falls, as performance shares still had value even if share price falls. The problem was that the investment community couldn't agree on the appropriate measures. Some were still wed to EPS or some other measure of the company' financial performance, some preferred absolute Total Shareholder Return (TSR) to reflect the return to shareholders, others preferred relative TSR to better reflect the value added by the company management relative to other companies. None are perfect, and all have their problems. This put companies in a difficult position, especially if it had several major shareholders with opposing views. Thus the rise of plans with suites of performance conditions, with some companies even adopting a balance score card approach.

Share Matching Plans

The traditional approach of having an annual bonus plan completely separate from the LTIPs used to be very common. Not surprising executives tended to concentrate their attention on the annual bonus plan (as it was shorter term and more closely aligned to things they had direct control over); the LTIPs were thought of as a kind of lottery win when they pay out. To alleviate this problem, some companies introduced share matching plans, whereby if the executive voluntarily chose to defer some of their after-tax bonus into shares, the company would match the shares deferred. These matching shares were subject to forfeiture if the executive left employment before the end of the deferral period. To improve take up rates, the match could be quite generous – even up to 2:1. Investors objected to the lack of performance conditions on the matching shares, so companies were forced to introduce them which obviously undermined the attractiveness of voluntary deferral. Consequently, the matches became more generous, even rising to a 2:1 match on a gross basis (which equates to a net match of 3.4:1 when higher tax rate and NI was 41%). Such plans were usually operated alongside other LTIPs; some companies operated all three at the same time (share matching plans, share options and performance shares plan), which somewhat undermined the concept of linking the annual bonus to longer term performance.

Investors objected to this approach, and also to annual bonuses paying wholly in cash, especially as bonus levels rose rapidly, pay-outs rarely fell below target and companies refused to explain how the pay-outs were structured for fear of giving away confidential, market sensitive information. Consequently, we saw the rise of the deferred bonus plan, where part of the bonus was automatically deferred into shares for a period. Companies with share matching plans simply introduced the concept of compulsory deferral of part of the annual bonus with voluntary deferral on the rest – both attracting matching shares. Again, shareholders objected to the addition of matching shares to compulsory deferral, so the match was removed. Consequently, share matching plans were phased out.

Minimum Shareholding Requirements

As the generosity of executive share-based reward increased, so investors demanded minimum shareholding requirements. Executives were required to build up a significant shareholding in the company (eg 100% or 200% of base salary) before they could sell any vested shares to benefit from any gain. Even with such a simple concept as this, complications were added whereby two levels of minimum shareholding were set such that until you reach the first level, no shares could be sold on vesting (apart from those required to meet any tax liability). Once the first level was reached, half of any net gain could be sold, until eventually the full level was reached when executives could do as they pleased.

Split Vesting & Holding Periods

The final complexity added in recent years is investors' desires to see ever longer deferral/vesting periods – 5 or 7 years rather than the traditional 3 years. We thus saw an increase in the prevalence of split vesting, whereby even if the performance condition remains at 3 years, only a proportion of the shares vest on 3 years with the remainder vesting over a further 1 or two years. Another approach is to introduce holding periods whereby, even once the shares vest, only sufficient shares required to pay any tax on vesting can be sold and the remainder have to be held for a "holding" period (usually to extend the deferral period to a total of 5 years). Some companies combine the two, adopting split vesting with holding periods so that none of the shares are released until after 5 years or more.

Profit Sharing Plans

At its simplest level, a company could operate a profit share plan whereby, each year, a profit share pool is created and then delivered to eligible executives according to contribution, part in cash and part in deferred shares (perhaps with forfeiture and additional holding periods). This is the basis of Share Investment Plan operated for the whole workforce. For executives, the challenge is to design profit share measures that align to both short-term and long-term performance and to work out how to measure individual contribution. It's not impossible, but it is a very different approach to those currently operated.

Current Approach

As recent history has shown, it is almost impossible to design an executive incentive package that meets everyone's (often conflicting) views and stands the test of time. Recent trends have moved towards a consensus design (outside of financial services) of:

- Short Term Incentive: An annual bonus with compulsory deferral of part of this into shares for say 3 or more years. Many now have forfeiture on leaving before 3 years and a 2 year holding period thereafter; coupled with
- Long Term Incentive: Performance shares with a 3 or 5 year performance condition made up of numerous performance measures, with a further 2 year holding period if a 3 year performance period is used.

But you still have to determine appropriate long-term performance conditions that satisfy shareholders whilst also motivating executives so that they value the LTIP awards before they vest.

Financial Services

In financial services, the criticism of "old style" executive reward packages have some merit, with executives encouraged to take unacceptable levels of risk for stratospheric short-term rewards which bore little alignment to the longer-term prospects or performance of the company, with their resultant actions cited as contributing factors to the company's downfall for which they had been handsomely rewarded.

Companies were slow to react, citing numerous reasons normally around remaining competitive in a global market for talent. As a consequence of the Banking crisis, the European Banking Authority issued several European Directives which the UK regulators have implemented. Several iterations have taken place such that the regime now is ridiculously complicated with five sets of rules for different types of firms, each having different rules depending on level, role and size of firm, and seem to change every year! For the most senior and highest paid roles in the largest firms, the latest rules require:

- Overall cap on variable reward to limit it to once times (twice with shareholder approval) fixed pay
- Requirement for at least 60% of variable reward to be deferred for 7 years, with vesting no faster than pro-rata after year 3.
- At least 50% of any variable reward to be paid in shares (or equivalents)
- No dividends to be paid on deferred shares (which, perversely, creates a conflict of interest between executives and shareholders)
- Performance measures to be "risk adjusted"
- Onerous malus and clawback requirements for up to 10 years from date of award

It's unlikely that we have seen the last of these changes.

