



For Shareholders and their Advisors, Pay for Performance Remains a Work in Progress

Introduction

For many board members, executives and shareholders, pay for performance remains a work in progress. Shareholders in particular, along with their advisors, most prominently ISS, have recently focused on long term incentives, making their view known that stock price change alone may not constitute sufficient performance conditioning on long term incentives (e.g. stock options, restricted stock units, etc.) for them to support an issuer's compensation practices. This contrasts with the view held by many directors and executives, that options are intrinsically performance conditioned since there is no reward unless the company's stock price increases and shareholders benefit. Certainly competitive compensation in some industries, and especially among smaller issuers, relies on the use of time vested stock options to provide long term incentive. Since directors are tasked with setting executive compensation policies that serve the interests of both shareholders and management, directors may find they will need to have a view on this issue.

Background

In 2010 we became increasingly aware of an expectation, albeit unwritten, on the part of some institutional shareholders and ISS, that for senior issuers at least half of long term incentive awards should be subject to some performance conditioning in addition to just an increase in stock price. For example, we saw some clients last year, after discussions with ISS, start to include more than just time conditioning on the vesting of at least some portion of long term incentive in order to avoid a negative voting recommendation from ISS on their management Say on Pay resolutions ("MSOP").

More recently, the very public exchange between GE and ISS in the US, discussed below, underscores the issues and the various points of view.

General Electric and ISS

Prior to 2010, GE granted performance vested performance stock units ("PSUs") to its CEO. In 2010, GE moved away from awarding PSUs to its CEO, to the use of time vested stock options which vest over five years, although noting in its March 14th 2011 proxy that it intends to resume the practice in 2011 of granting all of the CEO's equity compensation in PSUs, with disclosed performance goals.

On April 6th 2011, ISS issued a report to its clients recommending a vote against GE's MSOP in respect of GE's 2010 practices. On April 7th, the day after ISS issued its recommendation against the MSOP, GE took the unusual step of filing additional proxy materials that directly countered some of ISS's claims as set out in ISS's report. GE took issue with ISS's view that CEO compensation was insufficiently aligned with performance. Some of the points on which GE challenged ISS's report were that:

- ISS's analysis failed to consider actions taken by GE that aligned pay with performance during the recession.
- ISS's valuation of the CEO's option grant significantly overstates his total compensation.
- ISS's model to value options differs from GE's model and is inconsistent with applicable accounting guidance.

It would seem that not all shareholders were convinced by these arguments.

On April 18th 2011, in a second additional filing prior to its Annual General Meeting held on April 27th, GE announced that it would retroactively apply performance conditions to stock options that had been awarded in March of 2010, as a result of "a number of constructive conversations with [its] shareowners".

Following GE's April 18th announcement, ISS amended its report to recommend a vote in favour. GE's change, and the amended report from ISS, satisfied some shareholders but not all as the MSOP received approximately 80% of the votes. MSOPs in the US are receiving approval levels on average in the low-to mid 90's so it appears that at least some shareholders continue to have concerns about other aspects of GE's compensation program.

This series of events may be relevant to other issuers for the following reasons:

1. GE's change is being viewed by many as a sign that Say on Pay is having an impact and that even just the threat of a negative vote can lead companies to make changes in their compensation policies and practices.
2. Since at least four other companies to date have filed supplementary documents that publicly challenge the rationale for ISS's voting recommendations, including Hewlett-Packard and Disney, we may be seeing a new practice emerging whereby companies aggressively and publicly challenge ISS's criticisms of their compensation plans.
3. ISS's change in MSOP recommendation following the addition of performance conditioning to the options suggests their focus on the use of time vested equity plans. It remains an open question whether the widespread practice of using unconditioned options in conjunction with performance conditioned RSUs (that is, PSUs) will meet the evolving expectations of shareholders and ISS.

Where to from here?

It appears that shareholders and their advisors are moving towards a more demanding view of what constitutes performance conditioned compensation; what should compensation committees and boards be doing? To start, they can take the following steps:

1. **Stay abreast of these developments and form a view as to whether they represent isolated occurrences or a broader trend** – While any change will not be overnight, shareholder pressure to incorporate substantive performance conditioning on long term equity may be increasing, although perhaps not for smaller issuers.
2. **Develop a strategy, as appropriate** – Gradually incorporate performance conditions into some meaningful portion of long term incentive with an ultimate goal of at least 50%. If the situation warrants, consider filing a public response to ISS criticism.
3. **Most challenging, figure out appropriate performance conditions** – The goal should be to balance the following two objectives: provide executives with meaningful line of sight awards and the expectation that they can, for the right performance, be well paid while, at the same time, meet the increasing demands from shareholders and their advisors for more demanding performance conditions on executive pay. Keep in mind also that, facilitated by improved disclosure, shareholders and ISS are focusing more on whether performance targets are meaningful and constitute a real stretch to be achieved.

Conclusion

The increasingly critical eye being placed on the performance conditioning of long term incentives should not be cause for great consternation. Rather, it reinforces the importance of well-thought out pay for performance linkage as compensation committees, boards and management review the effectiveness of incentive design, especially for long term incentive plans.

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