Long-term compensation alternatives

Stock options are out of favour and the best-known alternatives aren't really long-term at all. When it comes to executive pay, what's a long-term oriented board to do? Try these ideas on for size

By Ken Hugessen with Bridget McKellar

Corporate boards and management teams of public issuers often bemoan the challenge of making effective long-term strategic business decisions in the face of short-term pressure from financial markets and investors to deliver quarterly results. Recently, however, there has been growing support in the business and investment communities to encourage focus on longer-term decision-making. A number of influential shareholders and organizations are publicly encouraging boards and management to refocus on long-term strategy, including: BlackRock, Inc., Canada Pension Plan Investment Board, McKinsey & Co., the Global Network of Director Institutes, the Institute of Corporate Directors and the National Association of Corporate Directors.

At the same time, there is recognition of a need to better align executive compensation time horizons with this longer-term focus. The traditional "longer" long-term compensation instrument (stock options) has largely fallen out of favour with shareholder and proxy advisory groups. As a result, many organizations have moved away from options to other "long-term" incentives—particularly, restricted share units (RSUs) or performance share units (PSUs). But where stock options typically had seven-to-10-year terms, for tax reasons the most common deferral period for RSUs/PSUs is three years—arguably leaving a "gap" in incentive time horizons.

Given these realities, boards may feel in a bit of a bind—there is desire and external pressure to extend vesting periods and long-term focus of compensation, but limitations exist which can make execution challenging. The good news is that there are alternative incentive compensation structures which take a longer-term focus without disadvantaging participants from a tax perspective or raising the ire of shareholders. We'd like to highlight three such alternatives:

1. Treasury-settled equity awards. Instead of share unit awards which settle in cash, issuers can settle awards through the issuance of equity from treasury. This type of program can remove the three-year limit that cash programs are subject to. Additionally, such a program allows participants to build up real equity ownership in the company. *Example: Valeant Pharmaceuticals (TSX:VRX) has a treasury-settled PSU program that vests and pays out over six years.*

2. After-tax shares with selling restrictions. While most equity compensation plans are structured to ensure that taxes are not payable by participants until amounts are settled, it is possible to have participants pay the tax at grant date instead. The company will typically add a selling restriction that shares cannot be sold for a period of time (e.g. seven years). Note, the value used for determining the amount of tax paid can often be at a substantial discount from current market prices to reflect these restriction on sales among other things. Since taxes are paid at the outset, any incremental gains are capital gains to the recipient. *Example: ARC Resources Ltd. (TSX:ARX) has a restricted share program where awards vest over 10 years and are taxed at the time of grant rather than at the time payments are received.*

3. Stock options with longer-term vesting, exercise or selling restrictions. Stock options can be introduced with longer exercise or selling restrictions, or after-exercise share retention requirements. This would allow companies to continue taking advantage of a well-understood instrument, while addressing some of the concerns that the shareholder community has with stock options (especially the view that they reward volatility and incent excessive risk-taking). *Example: Manulife Financial Corp. (TSX:MFC) has restricted new stock option exercises until after the fifth anniversary and expects executives to hold them for the full 10-year term. Interestingly, the exercise restriction is "de-linked" from the vesting provisions (i.e., an option can be vested, but not exercisable).*

> The good news for boards: there are alternative compensation structures beyond options which take a longer-term focus without disadvantaging participants from a tax perspective or raising the ire of shareholders

Not all of these alternatives will work for every company and many factors will determine which alternative, if any, are suitable. But as shareholders seek greater focus on long-term results, it is only reasonable to consider lengthening long-term incentive performance periods to reflect this new direction.

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