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THE GOVERNANCE UPS AND DOWNS OF PERFORMANCE PLANS

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INTRODUCTION

The use of performance equity potentially addresses many of the primary concerns of shareholders and other pay critics in the current corporate governance environment. But truly solving the compensation governance problem requires that all elements of the plan have been designed with other than a "me-too" design approach and operated consistent with the intent of the plan. Without this, performance awards may be creating more governance problems than they are perceived to have solved. The list of issues resolved by performance awards is diminished by the list of emerging issues, and will likely lead to substantial design strategy changes in the next generation of plans and awards.

WHAT ARE PERFORMANCE AWARDS?

Any type of share-based award can be turned into a performance award. Most commonly, performance awards are a "full-value" award of share units with one or more performance objectives determining if, when, and/or how much of the contingent award will vest and be released to the employee. The types of compensation arrangements that fall under the term "performance awards" can include any equity award – stock options, stock appreciation rights, restricted stock units, or restricted stock awards – with one or more explicit performance goals.

The plethora of possible design variations include performance contingencies and acceleration, denomination of the award in dollars or shares (or options), and may include a time-based vesting element in addition to performance features.

The resulting combinations of possible award design features gives us the many labels being used for these awards: performance shares, performance-based restricted stock, performance-accelerated restricted stock, performance units, premium-priced options, performance-vested options, indexed options, performance options, and more.

HISTORY OF PERFORMANCE AWARDS

Performance awards are far from a new idea. Originally introduced in the 1970s to deliver compensation value during what became a 14-year flat stock market, the recent surge in prevalence has been driven by a number of converging factors:

- **ANOTHER FLAT MARKET –** Since the last bull market ended with the "dot com bust" of 2000, equity prices have been highly volatile but current price levels of the major indices are around the levels of 1999, a trend line resembling the time of the origination of performance awards.

- **GROWTH COMPANIES GROW UP –** The maturing of many growth companies and industry sectors resulted in a flattening of stock price growth rates, particularly in the sector using equity compensation most heavily: technology. Stock options can deliver greater compensation in a bull market while restricted stock and restricted stock units, with or without performance goals, may better deliver compensation in a flat or declining market. Interacting with the accounting rule changes, it did not make sense to some companies to recognize an expense for the grant an instrument that may have no value (stock options) when a full value vehicle might deliver more pay for the same or less expense.

- **ACCOUNTING RULE CHANGES "LEVELED THE PLAYING FIELD" –** Performance awards had been subject to variable accounting under APB 25, and as a result created unpredictable and often prohibitively expensive financial impact compared to stock options (which were generally expense-free). With the adoption of FAS123R, evolution to ASC Topic 718, and parallel adoption of IFRS 2, all types of equity awards result in an income statement expense but the expense for performance awards can be "locked in" at the grant date, turning them from one of the most accounting-expensive grants to potentially one of the least expensive.

- **VOLATILITY DOES *NOT* NECESSARILY MAKE OPTIONS MORE VALUABLE –** Despite valuation theory indicating that greater volatility creates greater value for stock options, increased market volatility has resulted in situations where the grant date is a more important factor in the value of the award than the actual company performance. When grant timing is a more important factor than company performance in compensation outcomes, employee inequities are created. This volatility, combined with the flattening of equity markets, created another reason to re-examine the use of options.

- **RSUs TO THE RESCUE –** The expanding use of RSUs was further supported by the implication of options in various financial scandals: first the "dot-com bust" after which the Breeden Report pronounced that options are "bad" but restricted stock is "good," then the global financial crisis of 2008-2009 and the resulting legislation reinforcing the Breeden view. This acceptance of full-value shares laid the groundwork for the current surge in performance equity prevalence.

- **PAY WITHOUT PERFORMANCE –** Alas, the granting of restricted stock and units resulted in considerable compensation to executives at a time when shareholders had experienced significant losses. To many, this seemed as bad, or worse, than the "rising tide lifts all boats" phenomenon when options create compensation value in an underperforming company during a bull market. Associating performance goals with restricted stock awards became viewed as a way to better align executive and shareholder interests, and with the accounting objection neutralized and options drawing mixed reviews, performance plans emerged as the latest tool.

- **GLOBAL CHANGES IN GOVERNANCE –** More rapid changes in governance views in the UK and Europe – partially due to concentrated influence of the concentration of ownership there – led to performance features becomes mandatory for full-value awards AND options. With institutional investors and proxy advisors expanding their influence globally, this change became an important reference point.
- **LINE OF SIGHT –** The ability to specify corporate, business unit, team, and/or individual objectives in a performance plan opens opportunities to strengthen the line of sight and resulting behavioral impact while responding to the continued evolution of corporate governance standards. Though introducing greater complexity, performance equity allows the same creativity used in annual incentive plans.

Add these together, and it is easy to understand why performance awards are high on the list of equity compensation alternatives. The increase in usage of performance awards, stemming from this series of developments around share-based schemes, has provided comfort to many Boards of Directors and Compensation Committees that they have found the "answer" to the multiple challenges with other forms of equity compensation.

But before turning to how the governance issues have arisen and been addressed, we should understand the points of view that have defined the issues. Regardless of the specific design and vehicle involved there is a common set of concerns being addressed in the design process that have centered around concepts of corporate governance.

Principles of Governance

The current debate about corporate governance manifests itself in topics including "excessive" executive pay, pay-for-performance, independence of Boards and Directors and pay consultants, dilution from share-based plans, and more. Before evaluating the role of performance plans in corporate governance, however, we must clarify what governance is, and what "good governance" is.

A search for a definition of "corporate governance" yields numerous definitions and descriptions which center around the concept of a set of processes that govern the way in which a corporation is directed and controlled, and the framework for relationships among the various stakeholders of the corporation. The prominence of various stakeholders in corporate governance priorities varies around the world. As a result, the concept "good corporate governance" is contingent on the stakeholders included. Universally, however, shareholders are at or near the top of the list of stakeholders, and good governance requires that their interests are recognized as the value created by the corporation is allocated to those shareholders, executives, employees, and others.

A large number of organizations and processes have translated these concepts of governance into a variety of polices, standards, and preferences, and these organizations fall into very different categories.

SourceC	Examples
Independent Advisors	Institutional Shareholder Services Governance Metrics International Glass Lewis
Institutional Investors	Fidelity Vanguard Association of British Insurers National Association of Pension Funds
Legislation	Sarbanes-Oxley Dodd-Frank US Tax Code UK Remuneration Code
Regulation	US Securities and Exchange Comissions NYSE, NASDAQ, LSE
Labor Unions	AFL-CIO SEIU United Auto Workers
Litigation	Disney Xxxxx Xxxxx
Media	Wall Street Journal USA Today Financial Times Bloomberg

The outcome of this confluence of organizations and their opinions on equity compensation has produced an extensive though diverse and inconsistent set of criteria. There are common themes, however, that can be the basis for assessing the effectiveness of performance awards in supporting good corporate governance.

What They Like

Standards and policies promulgated by external influencers are converging to a consistent set of standards that are driving perceptions of what constitutes "good governance" for long-term incentive programs. This is a set of solutions that are relatively easy to incorporate in performance awards but are not always designed and implemented in a manner that meets the objectives.

- **PAY FOR POSITIVE RELATIVE TSR AND ABSOLUTE TSR –** These are increasingly common performance measures used in performance plans
- **LOW VOTING DILUTION –** Performance awards can deliver more value with fewer shares
- **LOW EARNINGS DILUTION –** Performance awards can be more accounting-efficient, delivering more compensation per dollar of accounting expense.

- **RELATION OF CEO PAY TO TSR –** With TSR hard-wired into the payout scheme of performance awards, CEO pay is further linked to TSR. And with equity comprising the majority of executive pay in many industries and countries, a strong or exclusive focus on performance awards enables this.
- **RELATION OF CEO PAY TO EMPLOYEE PAY –** With the spread of performance awards downward in the organization, as happened in the days of all-employee stock programs, any upside in CEO pay will be realized to some extent at lower organization levels as well.
- **DISCLOSING PERFORMANCE MEASURES AND GOALS FOR ALL PERFORMANCE-BASED COMPENSATION –** Performance awards using market conditions, particularly relative measures, deal with the sensitivity of publicly disclosing performance targets, an added benefit to the shareholder alignment possible with this structure.
- **PRE-ESTABLISHED PERFORMANCE GOALS WITH NO MODIFICATIONS –** this has been the biggest challenge for many companies, setting multi-year goals for these programs. A number of design alternatives make it possible to set goals and be comfortable that subsequent changes in the environment or business strategy will no render the goals meaningless.
- **162(M) QUALIFICATION –** like annual incentive plans, the rules are clear for ensuring that compensation paid from these plans is deductible to the corporation.
- **RESTRICTION PERIOD OF ONE YEAR OR MORE –** This one is easy; even if multi-year goal-setting is difficult, companies have structured shorter performance periods (1 or 2 years) with subsequent time-based vesting (1 to 3 years).
- **THRESHOLD WITH ZERO PAYOUT BELOW –** Very few plans have a guaranteed "floor" payout – most have a performance threshold below which no award is paid. While the thresholds in many US (e.g., payout for being in at the 25th percentile of the peer group) are less shareholder-friendly than in other countries (e.g., no payout below peer group median performance in the UK), it is still an improvement over RSUs.

What They Don't Like

Equally clear is the evolving list of compensation design features disliked and this is where the design features of many current performance awards create governance issues:

- **DISCONNECT BETWEEN CEO PAY AND STOCK PERFORMANCE –** many performance plans pay at or above target based on performance measures that are not driving share price. This creates a gain for the performance award recipient while the shareholders have experienced a loss. This can happen too with relative TSR plans which pay handsomely for terrible share price performance that just happens to be less terrible than the rest.

- **RESETTING OR CANCELLING GOALS –** While option repricing typically requires shareholder approval, many companies have quietly reset or cancelled performance contingencies on their performance plans, deciding to pay out something despite failing to achieve pre-established goals.
- Payment of dividends/dividend equivalents on unearned or unvested performance awards
- **INCLUSION OF EQUITY AWARDS IN PENSION CALCULATIONS –** This issue evolved as companies shifted more total pay into long-term incentives and some executives perceived that as a "take-away" – money paid in salary and annual incentive was included for the pension calculation but the pay increases were loaded into LTI instead. Some plans corrected for this but it has not been a popular provision with shareholders.
- **ABNORMALLY LARGE PAYOUTS WITHOUT JUSTIFIABLE PERFORMANCE LINKAGE OR PROPER DISCLOSURE –** While disclosure of performance targets, actual performance levels, and resulting payouts has vastly improved, we still see many murky or missing disclosures that leave investors wondering if the performance scheme is based on performance, or is just a scheme.

Just as performance awards can help a company satisfy external constituents "likes" they just as easily can contribute to a program that is viewed among the "dislikes." These continue to evolve each year and many of these positions had not been articulated when the current surge in prevalence of performance awards began.

Governance Issues: The Purported Ups

Performance plans have come a long way in moving pay into better alignment with shareholders. Supporters of the trend cite the many positive outcomes being seen as these plans have been implemented, administered, and paid out. While there are still annual assessments of how these plans stack up against the ever-changing lists of Likes and Dislikes the consensus remains that these programs are a valid solution to the list of complaints about options, RSUs, and annual bonus plans. Performance plans have the potential to create better alignment between shareholders and executives, avoid windfalls, ensure accountability, and myriad other goals.

Yet there is a set of issues brewing that, taking together, raise questions about the progress being made.

Governance Issues: The Real Downs

Ongoing research into the design and operation of these performance plans, supplemented with direct experience with Compensation Committees, conversations with proxy advisors, and theme in academic research, indicate a growing list of concerns with performance awards. Through ongoing consulting activity, direct research, and extensive conversations with equity compensation professionals engaged in the various specialty areas in the field, I have identified twenty unique governance issues, most of which have yet to suffer the media spotlight but individually and collectively pose a threat to the opportunity presented by performance equity awards.

1. **LOWBALL GOALS –** It is difficult, if not impossible, for external parties to assess the degree of difficulty of goals. There is some suspicion that performance targets in many plans lack sufficient "stretch" and are easy to achieve. In one extreme case, a company set a single goal for vesting of the CEO's performance share units: buy a house in a certain geographic area within 18 months. Cloaking relocation benefits in a performance plan is not indicative of good governance. This concern is bolstered by data from one study that found, on average, performance plans are paying out significantly above target. These data confirm that the extreme anecdotal examples may be more the norm than the exception.

2. **VALUATION-BASED COMPENSATION NUMBERS –** With a focus on executive pay as disclosed in public filings, in which performance awards are reported at their accounting-based fair value as well as the threshold, target, and maximum, there is a criticism that the accounting values are creating two governance issues. One, the actuarial science involved in fair value calculations is often used to minimize the fair value and reduce reported compensation expense accordingly. Worse, as these understated numbers in many companies are the basis for determining how many shares or units are needed to reach the desired target compensation, aggressively low valuations create aggressively high performance award grants. The discrepancy between fair value and payout value, particularly in the case of Lowball Goals, is beginning to fuel much skepticism around performance awards.

3. **ANNUAL INCENTIVE PLANS HIDING IN AN "LTI" –** Many companies feel it is too difficult to set multi-year goals required for long-term performance plans in such a volatile business environment. One solution used has been to set a single one-year goal followed by two or three years of time-based vesting on the award delivered based on performance. This is seen as translating a one-year performance requirement into a multi-year long-term incentive (LTI). True, restricted stock units with only time-based vesting also fall into the LTI bucket but there has been some criticism of the hybrid performance/service design. Another variation is successive single-year goals within a multi-year period. The most significant concern is when a company uses the same performance measure(s) for both the annual and the long-term plan, creating a perception of doubling up the STI at the expense of a focus on long-term performance.

4. **RELATIVE TSR – TIMING OF ADOPTION –** Using relative TSR as the sole or one of multiple performance measures is viewed by some as a solution to the many goal-setting, measurement, and shareholder alignment issues. To the extent a company outperforms its peer group on total shareholder return over a given period of time, the argument goes, that must demonstrate that the executives, management team, and/or all employees have produced superior performance. Whether pushing stock price up further than the others in a rising market, or having a stock price that fell not as far as the others in a bear market the company has "outperformed" its peers. The governance issue here is rooted in the timing of the decision to use relative TSR for the next series of grants, and when to abandon TSR for other measures. The issue here should be quite obvious. A company having experienced a significant decline – absolute and relative – is more likely to perform well in the coming years on the relative TSR measure, which a company with a soaring share price may have had its run and, while continuing to satisfy shareholders, underperform on the relative TSR measure.

5. **RELATIVE TSR – PAYOUT WITH NEGATIVE TSR –** Shareholders are beginning to push back on plans that payout when their investments are at a loss. A good example is the group of the largest biopharma companies, which have lost a significant portion of their market value over the past 10 years. Relative TSR is a prevalent measure in performance awards in this group. While biopharma companies are clearly reasonable peers for other biopharma companies, merely being at the top of this value-destroying sector is not viewed as "good performance" by many.

6. **FINANCIAL PERFORMANCE MEASURES THAT DON'T SUPPORT VALUE CREATION –** The strength of TSR-based measures is the argument that this is the "real outcome" for shareholders. But many plans use other measures, often with no use of a TSR measure. A broad variety of revenue, profit, and return measures are used, alone and in combination, and these may or may not be drivers of shareholder value creation. Combined with goal-setting concerns, this can lead to the scenario where "great performance" pays out to company executives at the expense of shareholders.

7. **INTERIM MILESTONE-BASED GOALS –** In certain industry sectors, financial results are not meaningful at the current stage of development for some companies. Biopharmaceutical companies still in the process of developing and obtaining approval of a new drug is the clearest example. Yet many companies are designing performance equity plans with payouts regardless of whether milestones payoff for shareholders. The time delay required to assess this challenges the ability to relate pay to performance. These milestones are arguable better employed as measures in shorter-term plans with achievement of financial results forming the basis for significant long-term opportunity.

8. **NON-GAAP MEASURES –** Notably, the growing use of "adjusted GAAP profit" – a profit figure based on Generally Accepted Accounting Principles then "adjusted" by selectively including and excluding certain accounting items – is creating growing concern. As companies have the flexibility to define "profit" themselves and reward accordingly, there must be some evidence of a relationship between those non-GAAP numbers and share price performance.

9. **VAGUE SUBJECTIVE GOALS –** Many aspects of business performance are necessarily subjectively assessed by the Board of Directors. Some would argue that these are more appropriate for short-term annual incentive programs but they are increasingly appearing in performance equity grants. One company included "achieving synergies" as a key goal in its performance share unit plan.

10. **BOARD/COMMITTEE DISCRETION –** The difficulty of setting multi-year goals in a volatile and uncertain business environment has led some companies' Compensation Committees to include a factor in the plan design allowing them to partially or completely adjust any goal-based performance outcome. While these eliminates the tax deductibility of that grant in the US if it allow for upward as well as downward adjustments, and raises financial reporting questions as well, the core question is whether this improves or diminishes the corporate governance quality of the performance award.

11. **MID-CYCLE MODIFICATIONS TO GOALS –** Companies that did not design a discretionary element into a performance award have in some cases determined that an adjustment to the performance goals is needed to preserve the integrity and meaningfulness of the awards. Given that these adjustments are

almost exclusively to lower the performance level required for payouts, critics are quick to assert that this is merely adjusting the goal to meet the performance level, destroying the pay-for-performance characteristics of the program.

12. **AFTER THE FACT OVERRIDES –** Some companies that neither designed discretion into the measurement process nor deemed it appropriate to make midstream adjustments nevertheless adjusted award payouts after the completion of the performance measurement period. One pre-IPO company established "completing a public offering" among several other performance goals for the CEO's performance award. All of the goals were missed and no IPO was completed, but the company paid out the target level citing "progress made toward the IPO.

13. **TERMINATION PROVISIONS –** The details of the status of performance awards are sometimes given less attention that other aspects of the design process. At one company which was destined for a zero payout under the program, the executives noted the grant provision that provided a target payout in the event of retirement (which was loosely defined in the plan), and simply submitted notice of their retirement to preserve their compensation value. Termination provisions that may make sense for stock options or RSU awards may need to be reconsidered with the multi-year performance requirements of a performance award.

14. **CHANGE IN CONTROL PROVISIONS –** Change in control provisions, which interact with termination provisions, require similar attention to avoid creating inadvertent incentives. While CIC provisions were developed to ensure that senior executives would remain at the company during the uncertainty of a pending merger or acquisition, many CIC provisions, combined with the typical increase in share price resulting from the transaction, can create unintended consequences and windfall payouts. With the amount of litigation being conducted around merger and acquisition transactions, large payouts associated with a purported low sale price will be problematic.

15. **OPTION PRICING MENTALITY AND MARKET VOLATILITY** – A large proportion or companies subscribe to the notion that the accountants' estimate of the "value" of an equity award, as dictated by accounting rules, is a suitable basis for determining the pay value of that award. Common sense often prevails with respect to the Black-Scholes value of options when a Compensation Committee refuses to grant twice as many stock options because the stock price has fallen by 50%. But this is less clear with the complex valuation processes for performance awards, which may result in an accounting fair value far below the intended "target" value of the awards. This may be exacerbated by the same stock price effect, creating a larger number of units awarded due to the decline in stock price – which may realistically be the fault of the executives receiving the grants.

16. **TOTAL COST OF OPERATION –** ASC Topic 718 (nee FAS123R) and IFRS2 increased the operating cost of equity compensation plans due to more complex valuation, disclosure, auditing, and compliance requirements. These are heightened, however, with performance awards and few companies understand and track the total cost in terms of accounting, tax, legal, valuation, administration, communication, and disclosure – particularly when these awards are granted in multiple jurisdictions around the world. If the

complexity of the plans is reducing perceived value while increasing the cost to the company, the reduced return on investment (ROI) of performance awards presents a governance issue. Spending more to deliver less pay based on a questionable plan design is a core governance situation.

17. **PART OF THE "LTI PORTFOLIO" –** In the US, survey data continue to report a growing "prevalence" but survey data can be misleading – despite an increase in the number of companies making a performance award to executives and/or non-executive employees, a relatively small proportion of total long-term incentive value is being conferred through these""check the box" grants (by making these small grants a company can "check the box" on the shareholders' and/or proxy advisors' list of demands). While the survey data indicate increasing prevalence of performance awards, this trend is not offset by comparable declines in prevalence of options and RSUs. This is arithmetically possible due to the increase in the number of different types of equity award granted – sometimes called "portfolio LTI" in which stock options, RSUs, and performance awards are all granted in a single year; sometimes a fourth vehicle, a cash LTI is included as well. But portfolio LTI with one-of-everything ensures a payoff regardless. Stock price up with missed goals? Options pay. Stock price flat or down and missed goals? RSUs pay. Stock price flat or down but goals achieved? Performance equity pays, along with RSU value. Those encouraged by the surge in prevalence in the survey data must drill down to understand that the prevalence is not a pervasive one.

18. **UNNECESSARY COMPLEXITY –** It is disadvantageous to implement a program so complex that participants cannot understand it; the resulting costs, perceptions of diminished pay, and ineffectiveness of the plan are problematic. But more severe is the situation in which investors cannot understand it and, as they often do, vote against anything they don't understand – and against anyone associated with it. Recent research in "employee ignorance" regarding compensation and benefits programs indicates an already significant level of misunderstanding of stock options and RSUs. Multi-faceted performance programs are fueling this problem due to the behavioral economics notion of "bounded rationality" – people only have the time, energy, mental capacity, and inclination to absorb a certain amount of information as a basis for rational decisions.

19. **83(b) ELECTIONS –** It's hard to believe, but some companies allow 83(b) elections on performance share awards (performance stock awards, not performance share units). Still harder to believe is that a few individuals have made this election. In the US, an 83(b) election made by the award recipient results in ordinary income tax immediately on the contingent award. Someone doing this, of course, believes that they will vest in the award and they will benefit by realizing capital gains treatment on the future gain. Aside from numerous technical issues with this, it raises the question of how the individual is so confident of ultimately earning those shares that they are willing to pay tax on them at the present time. Speculation ensues that the performance goals are a "gimme" – a virtual certainty of being attained, or worse still that the individual has inside information that allows him or her to know in advance that such goals are certain of being attained. While either or both of those conditions may be true, allowing an individual to hedge their tax impact from such knowledge is yet another "under the radar" governance issue.

20. **ADMINISTRATION ON SPREADSHEETS –** Perhaps the great irony of performance awards is that the equity vehicle designed to address governance issues is frequently too complex to be administered in the company's equity administration system, requiring it to be managed separately in spreadsheets, working outside of internal controls established for stock options and RSUs. This creates the opportunity for error and fraud which the formal systems are designed and certified to avoid. The exclusion of equity compensation professionals from the plan design process – long an issue before the recent surge in performance plan adoption – results in a decision-making process that is ignorant of these administrative realities.

As outlined above, while there may be advantages and disadvantages to these design features in performance plans, holding them against the accepted and emerging standards of corporate governance highlights potential shortcomings from those perspectives. In the era of say-on-pay, companies can be significantly disadvantaged in investor relations by a share-based scheme that may trigger multiple governance red flags and call into question broader governance processes.

Design Solutions

How can a company deal with these issues given the complexity of the design process and the multi-faceted governance opinions in the marketplace? The solutions require considering broader and deeper processes than are now being employed in many companies.

- **FOCUS ON INTEGRATED DESIGN –** Much performance award design is driven from a single perspective without the necessary expertise included in the process. Often that program is then extended to a much broader population, or in some cases is limited to that group and then management is told "design something for the rest of the employees." It is not uncommon that a single feature in a program design can require the addition of a full-time employee to manage the plan. There is often little integrated thinking in this process – how does the performance award interact with other forms of equity, cash compensation, deferred compensation, and stock ownership guidelines? Many of the governance issues described have roots in the "aftermarket bolt-on" approach to design, like adding a cool-looking spoiler to a car that violates the engineers' design principles of the vehicle and actually diminishes performance.

- **USE AN INTEGRATED PROCESS –** Many performance plans are designed "at the top" – the Compensation Committee of the Board of Directors designing the program for a select number of senior executives with the assistance of an "independent" compensation consultant that has limited or no interaction with management to preserve such independence. This current is often detached from the realities of program implementation and communication, especially for a larger population. Companies must have a *process* for integrated design that transcends the current obsession with independence to the exclusion of integrating compensation design with business strategy, culture, and organizational needs.

- **PUT STRATEGY OVER MARKET DATA –** At a time when many companies are experimenting with equity program design and changing the program every year, it is not useful to base design decisions on survey data that tells "what other companies are doing." In fact, that data may be portraying what companies did last year, found to be unsuccessful, and are already changing for next year. More importantly, the great variation in performance plan design is not captured by any existing survey and the data can lead to erroneous conclusions about what is in fact happening in the market.

- **KEEP IT SIMPLE –** Elegant and complex plan design emanates from annual incentive design practices – plans that only last one year, and are paid in cash. Extending those ideas to multi-year equity-based programs may create a much longer "tail" that takes years to resolve. While stock options and RSUs may be criticized, what they have in their favor is simplicity. A program that is easy to understand by participants, investors, proxy advisors, and the media is, by definition, a positive corporate governance tactic as the misunderstanding and miscommunication of companies' pay programs is widespread and adding to the noise.

- **FOCUS ON THE REAL GOVERNANCE ISSUES –** In the say-on-pay environment, companies will need to choose their battles. It is technically impossible to meet the preferences of all investors and their various proxy advisors. Companies must understand what it is about their equity program that will and won't satisfy their key investor base, and move forward with those features. A focus on strategy with good communication to investors about that focus and that strategy will help avoid a reactive knee-jerk approach to plan design.

Conclusion: Risk for the Equity Compensation Idea

The large and growing list of governance issues presented by the use of performance awards creates the risk that they are viewed as another "workaround" for delivering pay regardless of the creation of value for shareholders – just another pay delivery scheme. Given that stock options and restricted stock units have already been labeled by some as inappropriate, the promoting of performance awards as a cure-all could backfire, leaving the alternative that *any* equity compensation is fraught with governance issues and thus unsuitable.

The opportunity to design these awards and programs to address these issues requires a thorough understanding of the many facets and complexities of these programs – often lacking at the Board of Directors level due to resource constraints. To the extent that a performance plan is sold to the Board as the solution and that plan later is criticized, Boards are assuming a greater risk by using them, to the disadvantage of all stakeholders.

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