



# **Stock & Option Solutions**



BNY MELLON  
SHAREOWNER SERVICES

## **Perfecting Performance Plans: Prominent Practices and Painful Pitfalls**

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# Agenda

Overview of Performance Grant Types

Goal Considerations

Structure of Grants

Other Design Features / Issues

Other Tips



# Survey / Market Research Data:

## Overview of BNY Mellon Shareowner Services Survey

- Survey conducted in January of 2008
- 65 Companies responded
- 50% of respondents had fewer than 1,000 participants
- 20% of respondents had more than 10,000 participants

## Additional Interviews

- Interviewed additional issuers across the country
- Best practices and tips and tricks on day-to-day administration

# Survey / Market Research Data:

## Overview of NASPP /Deloitte Survey

- Conducted October to December 2007
- Majority (93%) of respondents are public companies, traded primarily on either the Nasdaq or NYSE exchanges
- 78% have international employees
- For NASPP Members:  
[http://www.naspp.com/announcements/07\\_08\\_survey.htm](http://www.naspp.com/announcements/07_08_survey.htm)



# Performance Grant Trends

## BNY Mellon Shareowner Services Survey Data

- 76% of companies surveyed are granting or considering some form of Performance Grant

## NASPP Survey Data

- 64% have a performance plan (shares forfeited if criteria not met)



# Performance Grant Types:

## Performance Appreciation Rights (PARs)

- Not common in the US

## Performance Options (POps)

- Historically more common in Europe
- Shareowner Services survey:  
34% are currently granting performance-based options



NASPP Survey Data: 19% have options/SARs with performance criteria

# Performance Grant Types:

## Performance Stock Awards (PSAs)

- RSA with performance criteria

## Performance Stock Units (PSUs)

- Currently becoming more common in the US



# Performance Grant Types: Terminology

Many companies come up with “custom terms” for performance grants

- Shareowner Services Survey Data :
  - 58% consider the grants PSA or PSU
  - 42% consider the grants RSA or RSU
- Other terms:
  - PSUs called “Performance Awards” (PAs)
  - PSUs called “Performance-based Restricted Stock Units” (PBRsUs)
- Custom terms can make communication more challenging, especially as these grants become more common and participants move between companies



# Performance Grants & 162(m)

Performance goals ensure deductibility of compensation under 162(m)

- Plan must be shareholder-approved
- Goals pre-established by independent Comp Committee
- **New Rule:** Upon termination, payout cannot be made by disregarding achievement of performance targets
  - Acceleration for Change in Control OK
  - Termination w/o cause OR for “good reason” OR retirement is now a problem (Rev. Ruling 2008-13)
  - Transition period:
    - Performance period begins before 1/1/09
    - Compensation paid under contract in place before 2/21/08



# Performance Grant Types: PSAs

## Market Data

- Shareowner Services Survey: 15% granting PSAs

## Same Taxation as RSAs

- Subject to IRC Section 83 - Taxed at vest / lapsation
- 83(b) election possible
- Retirement eligibility: If vesting accelerated at retirement, taxes are due on retirement eligible date
- Exempt from 409A
- Excluded from 1 million limitation under 162(m) provided all conditions are met



# Performance Grant Types: PSUs

## Market Data

- Shareowner Services survey:  
69% granting PSUs



## Taxation

- Like RSUs: Sections 451 and 409A: taxed at delivery
- Retirement eligibility: If vesting is accelerated (or continued) at retirement...
  - Employment taxes are due on retirement eligible date (FICA)
  - May trigger 409A issues
- Excluded from 1 million limitation under 162(m) provided all conditions are met



# Performance Grant Types: PSUs

## Taxation: Deferrals

- Deferrals are possible...
- But... Subject to 409A if deferrals allowed
  - Deferral rules are 'easier' for PSU than RSU – 6 months before measurement
- Shareowner Services Survey participants: 12% allow deferrals on performance shares



# Performance Grant Practices: Broad-based or Executive? Bugatti or Civic?

Most companies limit to the top 5 to 20 Executives

- Setting goals for rank-and-file employees can be difficult
  - Hard to communicate
  - Corporate goals like EPS or Operating Income

Some companies go deeper, as far as senior directors

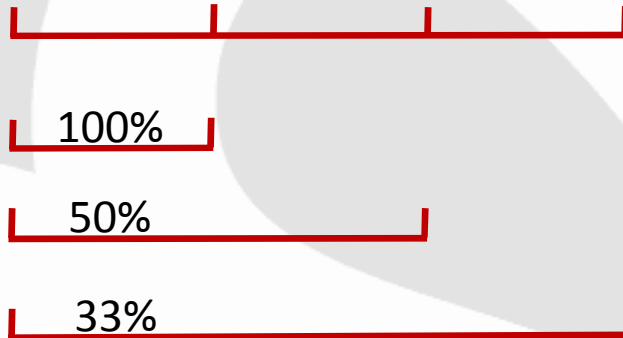
- One company issues to top 110, senior directors and above
- Another technology company, just issued performance grants to 18,000 participants...!



# Accounting Treatment: FIN 28

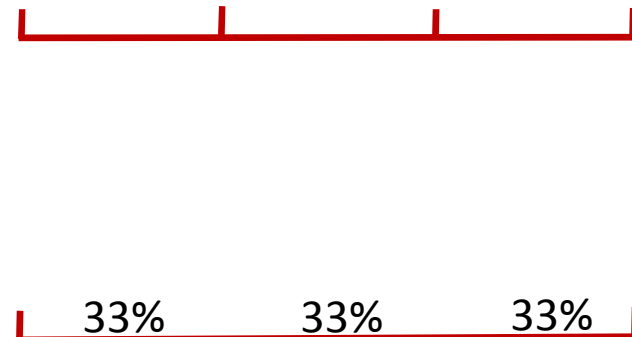
Most performance grants require FIN 28  
(accelerated) accrual

## FIN 28



61% of Total Expense accrued  
in the first year (\$183 of \$300)

## Straight-line



Expense accrued evenly over  
the service period

# Accounting Treatment

	Performance-based	Market-based
Accrual	Variable based on probable payout	Even accrual over service period
	Pitfalls: <ul style="list-style-type: none"> <li>➤ More work ongoing</li> <li>➤ Expense can be volatile</li> </ul>	Perks: <ul style="list-style-type: none"> <li>➤ No ongoing work</li> <li>➤ Expense fixed and known</li> </ul>
Reverse Expense if Forfeited?	Yes	No
	Perk: Recover expense if goals not met	Pitfall: No expense recovery if goals not met
Valuation Model	Stock price (RSA/RSU); Black-Scholes (options)	Monte Carlo
	Perk: Simpler model	Pitfall: More work up front
NASPP Survey: % Granting	75%	47%

# Pitfall: Variable Accrual: Unpredictable

## Facts:

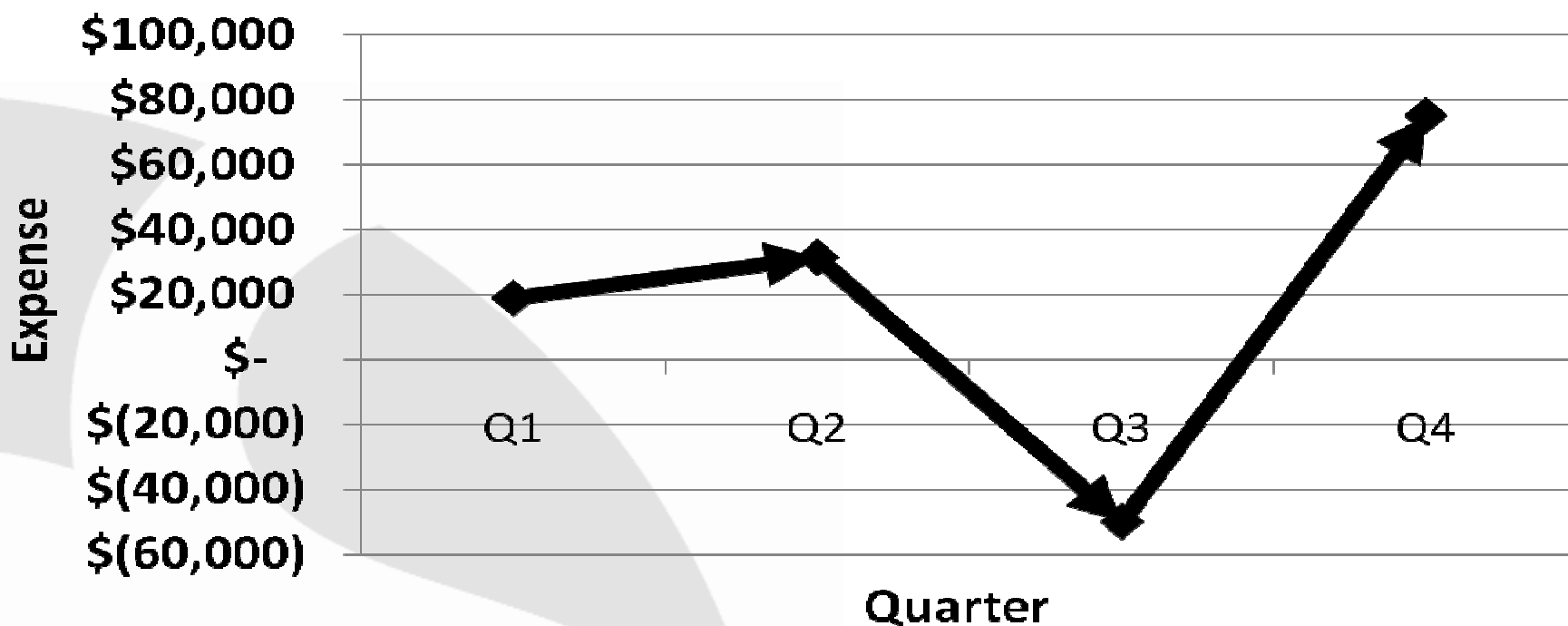
- PSU granted on 1/1/2009 for 10,000 shares, fair value \$5 per share
- Measured & vests on 1/1/2010
- Minimum Payout 0%, Maximum Payout 200%

## Accruals:

Qtr	% Service Period Completed	Estimated Payout	Calculation	Current Period Expense
1st	25%	150%	$(\$50,000 \text{ fair value} * .25 \text{ of service period} * 150\%)$	\$18,750
2nd	50%	200%	$(\$50,000 \text{ fair value} * .5 \text{ of service period} * 200\%) - \$18,750 \text{ prior expense}$	\$31,250
3rd	75%	0%	$(\$50,000 \text{ fair value} * .75 \text{ of service period} * 0\%) - \$31,250 \text{ prior expense}$	(\$50,000)
4th	100%	150% (pay out made)	$(\$50,000 \text{ fair value} * 1 \text{ of service period} * 0\%) - \$0 \text{ prior expense}$	\$ 75,000

# Pitfall: Variable Accrual: Unpredictable

## Variable Accrual of Performance Shares



# Prominent Practice: Second Chance Shares

## Second Chance Shares

- Multiple chances to earn prior tranches
  - Example:
    - Tranche 1 with Goal A over 1 year
    - Goal not achieved
    - Tranche 2 with Goal B over 2 years
    - If Goal B exceeded by 100%, can earn 50% of shares from tranche 1 in addition to tranche 2 shares!
- No industry-standard terminology for this yet...
  - Also “Catch-up Provision”
- Becoming more common
- Helps keep participants from “losing hope” after first goal not met



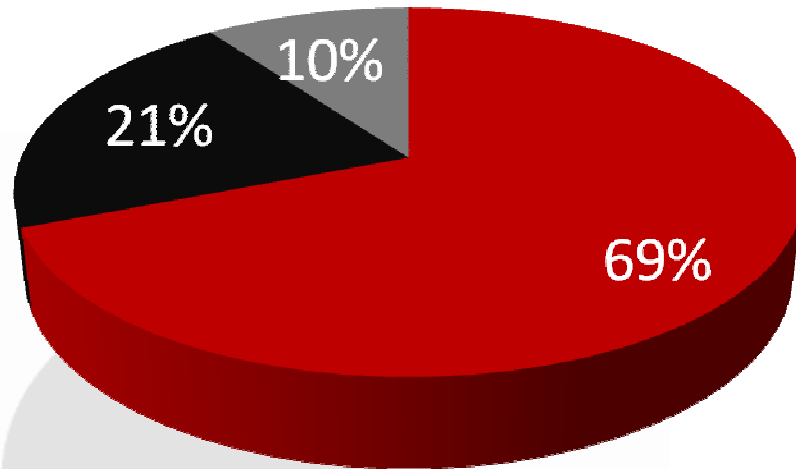
# As Time Goes By...

## Time Vesting in Addition to Performance Measurement

- Tranche 1 has goal X
  - Goal X is achieved on 12/31/09
  - Shares are “marked up” to 150%
- However, additional “service criteria” applies
  - Vesting is not complete until 12/31/10
  - If the participant terminates before then, shares are forfeited
- Rationales for design
  - Performance + Additional Retention benefit
  - Accrual is performed over a longer period



# Vesting Periods: NASPP Survey Data



- Overlapping
- Consecutive
- Cumulative

**Overlapping**: multiple performance periods can run at the same time independent of each other

**Consecutive**: a new performance period does not start until the previous period ends and periods are independent of each other, i.e., payout for one period is not impacted by whether or not targets in prior periods have been met

**Cumulative**: targets must be met in prior periods for subsequent periods to pay out (accrual is straight-line)

## Goal Design: Individual vs. Group Goals: One Size Fits All?

### Survey Results: BNY Mellon Shareowner Services

- Does your company assign same performance goal but allow different payouts by participant?
- Results
  - 21 % Yes
  - 65% No

80% of companies interviewed used the same goal for all participants

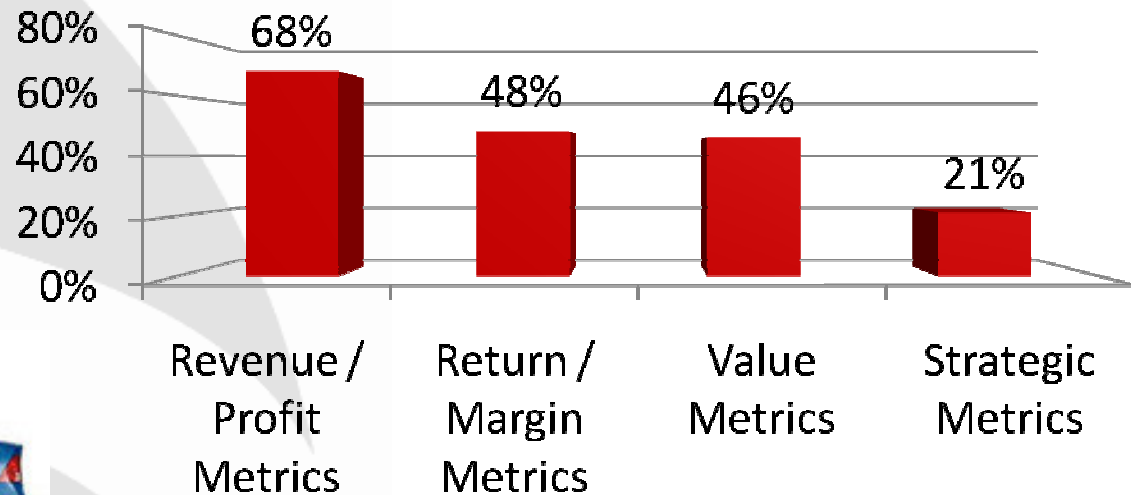


# Most Common Goals

## Interview Data

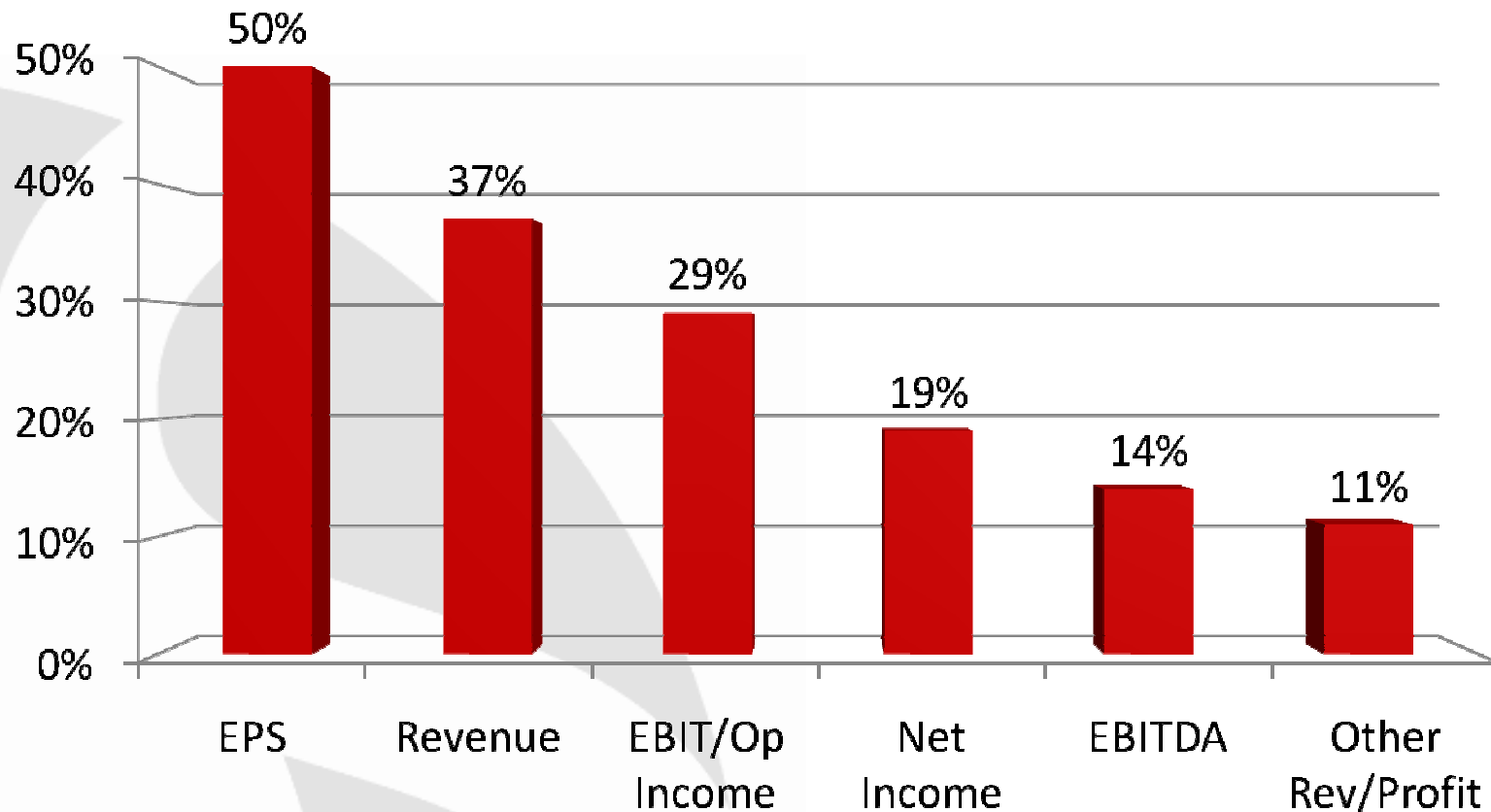
- 80% of companies interviewed used goals that were a combination of Revenue & Operating Income

## NASPP Survey Data



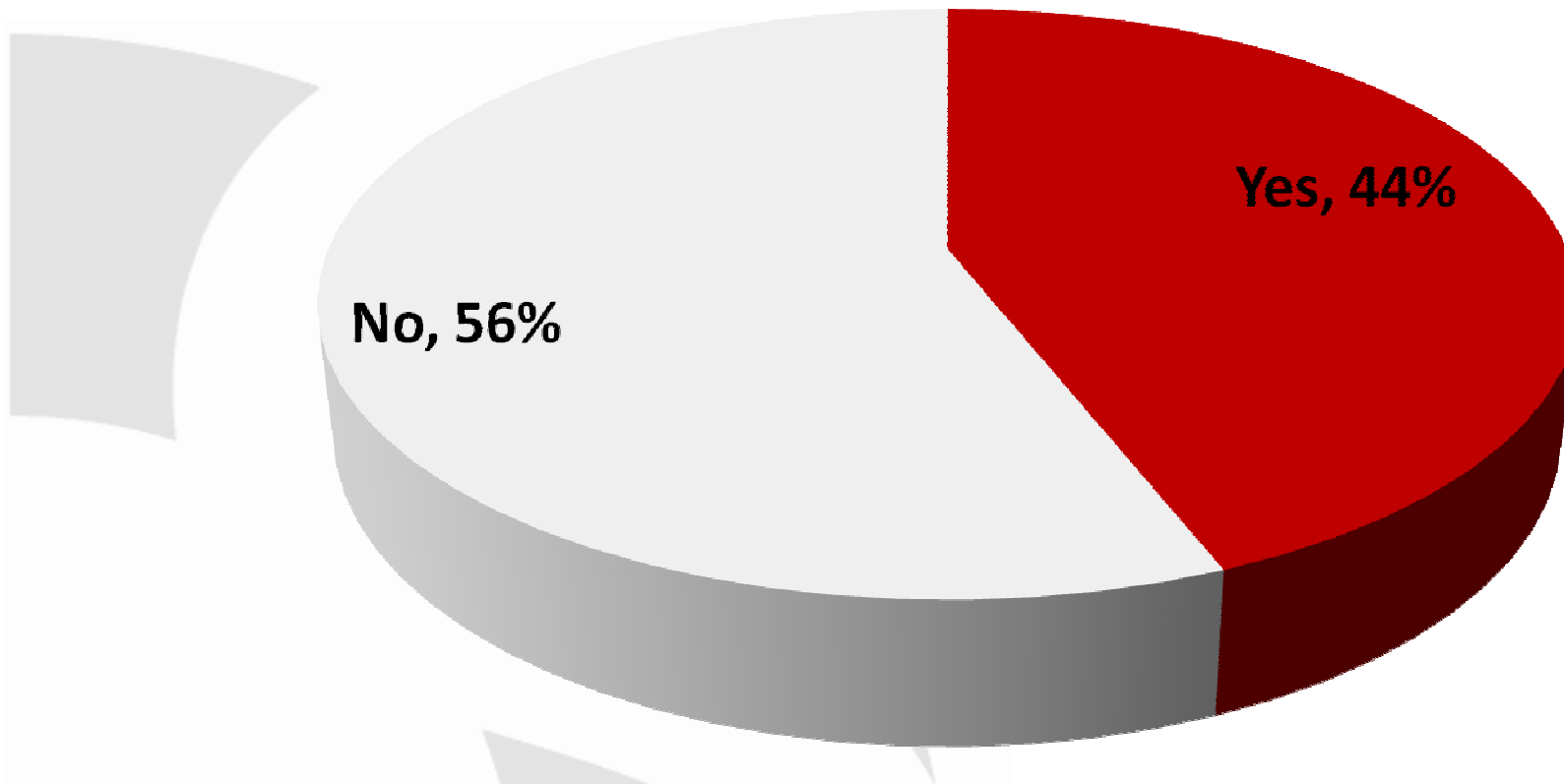
# Most Common Revenue/Profit Goals

## NASPP Survey Data



# Most Common Goals: NASPP Survey Data

Relative to Peers?



# Most Common Goals

## Perfect Practices

- Choose goals that are reported in the 10K
  - Auditable, Disclosable, Able to measure against peers, (if needed)
- Ensure that:
  - Definitions of how to measure are precise and clearly documented!
  - If financial goal (like revenue), finance should be involved in the definition



# Communicating Goals



Complicated goals are difficult to communicate

- If they don't understand the goals, how do they motivate behavior?
- One company's first performance grants did NOT change behavior, 2nd time, kept goals and communication simple

## Other Communication Considerations

- Shareowner Services Survey: Do you want goals on the participant web site?
  - 91% with performance grants wanted goal description
  - 76% wanted measurement date
  - 70% wanted minimum and maximum payout data
  - Only 15% wanted no goal information displayed



# Communicating Goals

## Perfect Practices

- Keep the language simple and understandable
  - Avoid participants lawsuits triggered by misunderstanding the goal
  - Have an “average” participant read it and tell you what they think it means
- One issuer included goal info in grant agreement which was available online
- Perfect Practice: if legal language necessarily complex,
  - Translate it into English and publish that as well (after your lawyers review it)



# Disclosure: How Much to Expose?

## Issuer 1:

- Goals were disclosed, not proprietary info

## Issuer 2:

- Provided a lot of information on what the goals were, overall, vest schedules, plans, etc.
- Filed on 8-K the agreement along with the examples in the exhibit
- Removed the actual numbers

## Perfect Practice

- If Goals are 10-K goals, fewer issues with disclosure



# Maximum Payouts

Avoid too high a maximum for performance-based awards

- Increases variability in accounting

How do you count shares against your plan?

- Most issuers seem to be counting maximum shares
- Prevents running out of shares and having to prorate payouts or ask shareholders for approval of more shares



# Perfect Practices for Tracking Goals

User-defined fields on the grant-level to track goals

- Allows multiple grants with different goals

Grant Number for Award Type

- RS - restricted stock awards, RU - restricted stock units, PA - performance awards (units)

Filter reports to exclude grants

- Plan balance reports
- Expensing reports
- Common equivalent reports (EPS)
- Most calculations must be done off-line



# Perfect Practices for Tracking Goals

## Don't Enter Grants Until Vested

- One issuer interviewed does not enter PSUs as RSUs until granted AND measured AND vested
- Tracked offline until then
- Uses database/vendor only for delivery of the shares

## Changing # of Shares on Measurement Date

- Can cause reconciliation issues
  - Track offline
  - Carefully document reasons for change
  - Keep in mind when running historical reports – rerun historic reports after changes to set “new baseline”

# Pitfall: Retirement Eligibility

## 162(m)

- Recent Rev. Ruling 2008-13 : Acceleration of payout by disregarding performance goals upon retirement prevents exclusion under 162(m)

## Crucial Tips

- Retirement accelerations create taxable events before retirement!
  - PSUs/RSUs – FICA due at Retirement Eligible Date
  - PSAs/RSAs – All taxes due at Retirement Eligible Date!
- Can also make an RSU without deferrals subject to 409A
  - “Vesting” does not occur at same time as Delivery = Deferral = Subject to 409A

# Dividends: The Spoiler



# Pitfall: Dividends: The Spoiler

## Not often paid on Performance Shares

### – Shareowner Services Survey:

- 19% of those with performance grants pay dividends on performance shares
- 67% of those that pay dividends on Performance grants pay cash on the payable date



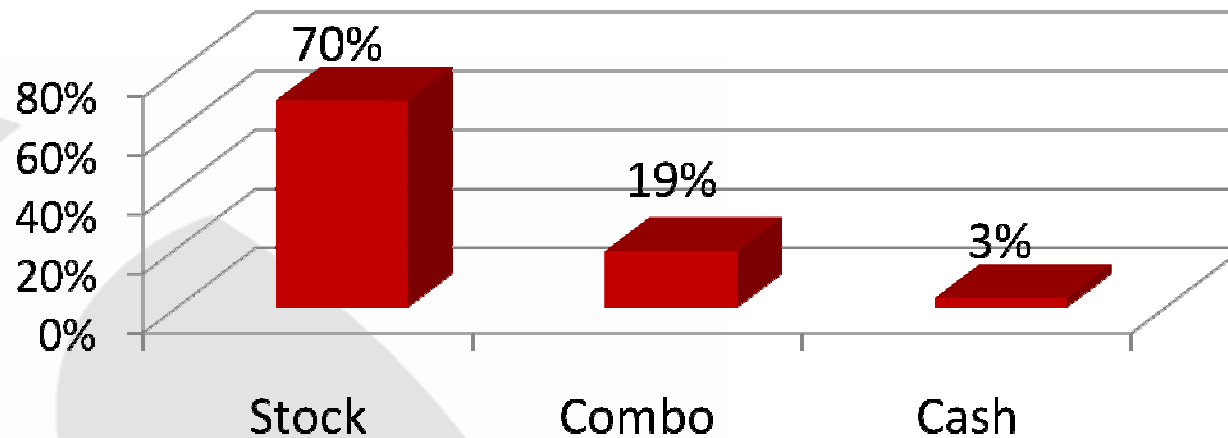
# Pitfall: Dividends: The Spoiler

## Perfecting Practice: Tips

- Reclassifying Expense for Shares not Earned
  - Cash divs paid, shares forfeited
  - Reclassification of expense required, often not done
- Beware of shareowner perception of dividends paid on forfeited shares
- Dividend Reinvestment can be problematic
  - What do you calculate dividends on? 100%?
  - What if you pay out less, or more?
    - Recalculate all prior dividends?
    - Problematic, especially for dividends on dividends

# Payout: Cash vs. Stock vs. Combination

## Shareowner Services Survey Data

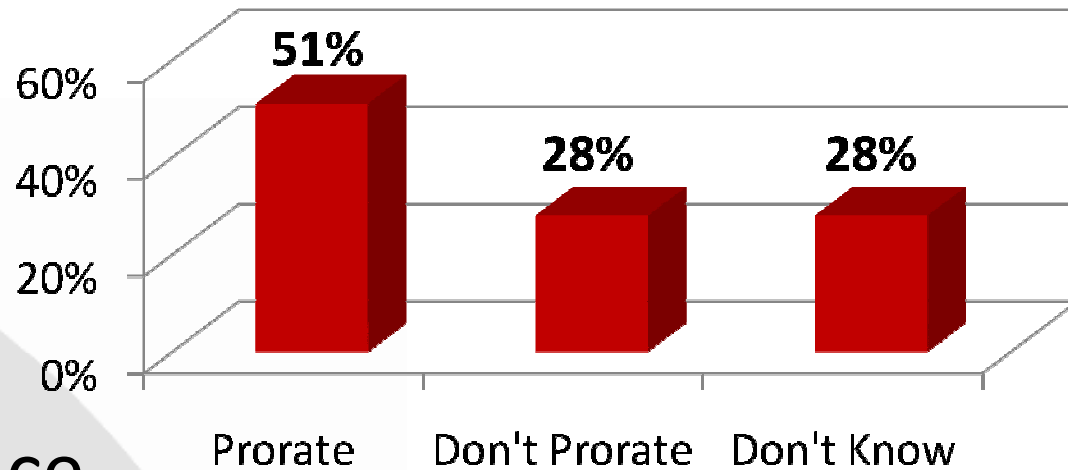


## Pitfall Designs

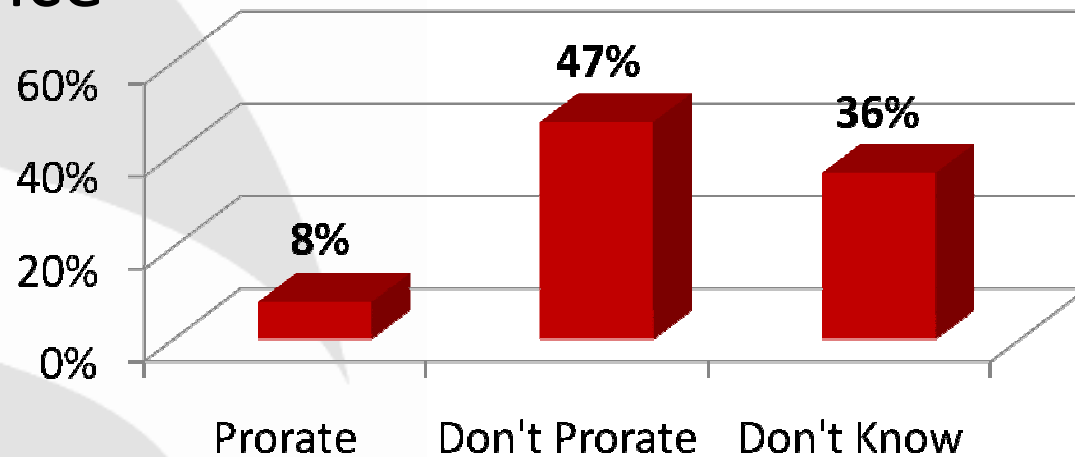
- Let the participant chose between cash or stock
  - If the participant (or the company) has a choice = liability accounting for all grants, even if they choose stock

# Prorating for Separation Practices: Shareowner Services Survey

## Termination



## Leave of Absence



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# Tax Payment Methods

## Perfect Practices

- Most interviewees do not allow participants to elect a tax payment method
- Share withholding is often mandated
  - Keep required cash outflow in mind, however
- Granted to insiders, “don’t want them making investment decisions”
- Removes issues around when they make elections
  - Making elections during a blackout period can be problematic, even if no sale involved

# Perfect Practices



## Keep it Simple

- Keep goals simple
- Keep structure of grants as straight-forward as possible

## Earn the Ear of the Designers

- Ask them to let you participate in design discussions
- Point out things they may not know about... 409A, etc.
- Propose solutions, not just problems, give them options

## Step-by-Step Process for Vesting/Measurement

- Make sure you have a step-by- step process flow for how approval/taxes/section 16 filing will work
- Often triggered by written comp committee approval – no questions about “when”
- Think it through and write it down!



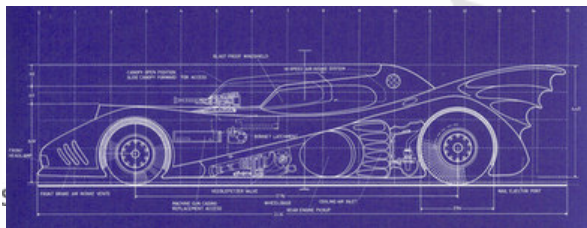
# Perfect Practices

Talk to your vendor about what they can support and HOW to best support it

- These plans are new and vary widely
- Systems cannot support it all,
- Document manual processes
- Propose slightly revised plan to compensation committee based on what you and your vendor can do

Continue Your Input to Vendor

- Regarding ongoing issues as they design new functionality
- Participate on an advisory board for performance grants
- Beta test, if possible!



# Questions?



# Contact Info

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