A compelling alternative to stock options

Compensation committees might consider a Combination Price-Vested Equity vehicle. Here is how a CPVE works.

BY STEPHEN CHARLEBOIS AND MARGARET HYLAS

Today, compensation committees seem to have fewer tools in their arsenal to directly incentivize a company's stock price growth. Increasingly since 2007, stock options have been replaced by various performance-based vehicles. As a result, long-term incentive plans (LTIPs) may be paying for achievement of operational or financial performance goals while shareholders fail to benefit from a similar growth in share value.

Many companies have attempted to solve this issue by incorporating relative total shareholder return (rTSR) with operational performance metrics. However, rTSR does not necessarily work well for many companies, and rTSR does not directly incentivize the management team to grow share price in a sustainable way.

An alternative to this approach is something called a "Combination Price-Vested Equity" (CPVE) vehicle. This vehicle is a full-value share that acts like a stock option; however, it also directly incorporates operational goals by requiring a minimum threshold level of financial performance (e.g., return on capital, operating margin, earnings per share) to gain access to the share price accelerators. CPVEs enable compensation committees to appropriately balance three key factors in today's executive compensation environment: i) performance orientation, ii) executive retention, and iii) sustainability, all within a single vehicle.

CPVEs are a grant of performance-based restricted stock which incorporate two performance requirements over a period of four years. The primary metric is a financial measure that requires the organization to meet a minimum level of performance over a four-year period. If the primary financial requirement is not met, then no shares are earned. However, once the hurdle is achieved, executives have the opportunity to benefit from share price appreciation.

Attaining various pre-established share price hurdles will result in increasingly higher equity payouts (like a traditional performance share plan). The hurdles mimic the value creation that would be achieved with an option grant. To the degree the financial performance requirement is met but the share price does not meet the minimum hurdle, the overall grant may be reduced by 25% to 50%. This design helps to preserve some of the retentive value, but still provides significant leverage and potential payout to the executive if they meet operational targets and grow the share price over time.

As such, the plan essentially mirrors an option but within a specified range of prices. The distinction between a CPVE vehicle and options is twofold: risk exposure and controlled goal setting. An option exposes executives to a significant downside risk if the stock price falls below the exercise price. Underwater options do not contain any type of natural correction mechanism to preserve their retentive value. CPVEs limit that downside (as long as the operational financial goals have been met), thereby preserving some of the retentive value in the grant, even in the face of poor stock price performance. On the flip side, CPVE grants have a more limited payout potential than options at higher share price growth rates given there is less leverage from a lower number of shares delivered at grant through the full-value vehicle.

We recently worked with a compensation committee to develop a CPVE plan for a company that competes within a historically volatile industry. The company's stock price had seen significant growth and then descent. Just as important, the executive team was new to the organization and their roles, making retention a key concern of the committee. Additionally, the company had a much more diversified portfolio relative to its direct peers, making any rTSR comparisons very difficult.

The committee wanted to ensure retention of the newly appoint executive team, link incentive payouts to the achievement of goals aligned with their long-term financial model, and directly reward the team for achieving aspirational growth in shareholder value. Our CPVE design seemed like a particularly viable vehicle and design given these goals and circumstances.

We believe a CPVE design is best suited for companies that still have significant growth potential (or those mature companies that have stagnated share prices and are looking to unlock additional growth), but are not comfortable with the potential dilution or downside risk of an option program. This plan design should also be considered by those organizations that do not have strong comparator groups in which to measure rTSR.

Companies exploring CPVE should be alert to the higher demands of its goal-setting challenges. Setting multiyear absolute share price goals requires a particularly attentive compensation committee with an appetite for taking a more nuanced and ongoing look at company performance. Committees must revisit the hurdles every year and take into account year-over-year changes in the company's valuation and its impact on setting price hurdles.

Assuming there is a reasonable aggressiveness to the financial performance threshold and the price hurdles, we believe this plan design would be well embraced by shareholders and proxy advisory firms alike. To further reinforce this point, a singular vehicle such as the CPVE would be 100% performance based, and would directly seek to bridge the gap between operational performance and share price that can occur.

Overall, CPVE can be a solution for companies wishing to balance the relationship between risk and rewards in one single vehicle. The combination of operational performance goals and stock price hurdles offers low risk and high but controlled rewards — maximizing the plan's risk-reward profile and acting as a stabilizing mechanism for driving sustainable shareholder value.

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The 2016 audit committee agenda

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and accounting processes. Companies should use the additional transition time to finalize implementation plans, identify areas that require close attention, and implement the necessary changes to processes, systems, and controls. (The FASB plans to issue additional guidance on the revenue standard early in 2016.)

The obligation to report country-by-country tax information to all jurisdictions is also on the immediate horizon. The impact on multinationals will be profound, with significant implications for tax compliance and reporting functions, transfer pricing policies, tax audits and controversies, and reputational risk. In October, the Organisation for Economic Co-operation and Development (OECD) released its final report — a 15-point action plan — focused on addressing the perceived profit-shifting behaviors of multinational enterprises that contribute to erosion of the tax bases of countries.

Under the OECD's Base Erosion and Profit Shifting (BEPS) project, multinationals with more than 750 million euros in revenue will be required to provide, in a single country-by-country (C-by-C) report, detailed information about every jurisdiction in which they operate. The first C-by-C reports will relate to fiscal years beginning on or after January 1, 2016, with the report due one year later. (For multinationals with fiscal years ending December 31, 2016, the report would be due by December 31, 2017.) Many countries, including the U.S., have signaled their intent to adopt the OECD recommendations — including the C-by-C reporting requirements — immediately. Audit committees of multinationals will want to assess their company's readiness. What systems and process changes will be required to comply with the new documentation requirements? Have we assessed our transfer pricing strategies and identified those that are likely to be challenged? Do we have an effective communications plan to explain and interpret the C-by-C data and appropriately defend our transfer pricing strategies?

Reinforce audit quality and set clear expectations for the external auditor.

Audit quality is enhanced by a fully engaged audit committee. Set the tone and clear expectations for the external auditor, and monitor auditor performance through frequent, quality communications and a robust performance assessment. (See the Center for Audit Quality's External Auditor Assessment Tool.) Pay close attention to the PCAOB's initiative to identify audit quality indicators (AQIs) that may provide insights into audit quality. Have the audit committee, management, and the external auditor identified AQIs that will enhance understanding of the audit and how to maintain or improve audit quality? Does the audit committee's evaluation of the external auditor take those AQIs into account?

Be sure to have discussions with the external auditor regarding the firm's internal quality control system — including results of PCAOB and internal inspections and efforts to address any deficiencies. (See the PCAOB's Audit Committee Dialogue, released in 2015, for a summary of the PCAOB inspection process and insights into its findings.)

Remember that audit quality is a team effort, requiring the commitment and engagement of everyone in the process — the auditor, the audit committee, and management.

Consider how the company's disclosures can better tell the company's story — and the audit committee's.

Think about going beyond what's required to provide a fuller picture not only of the company's recent performance, but also where it's headed and the key risks it faces. In addition to traditional financial metrics, can the company provide investors with greater insight into the drivers of long-term growth, such as customer satisfaction, talent, or innovation? Does GE's recently revamped form 10-K — as well as disclosure initiatives undertaken by regulators — signal the beginning of a new generation of leaner and cleaner financial disclosures?

Also, consider ways to enhance the audit committee's disclosures (in the audit committee report and elsewhere in the proxy) to provide greater insight into how the audit committee carries out its oversight responsibilities. In response to the SEC's Concept Release on Audit Committee Reporting Requirements, the majority of comments supported a voluntary framework to enhance disclosures — a growing trend that's highlighted in the CAQ's 2015 Audit Committee Transparency Barometer.

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