



SHARE-BASED INCENTIVE SCHEMES - GUIDELINE PRINCIPLES

Interpretation and Application in the Context of Currently Evolving Practice

Foreword

The ABI Guidelines have for many years provided an appropriate framework for share-based incentive schemes. Share incentive schemes have, however, evolved in recent years and many of these developments have been reflected in the subsequent papers issued by the Investment Committee on Senior Executive Remuneration and Emerging Good Practice for Long-term Incentive Schemes.

There has been a general move towards phased grants of awards which are a much more central part of the overall remuneration package and away from the traditional concept of subsisting options within a four times limit. In the light of developing practice, including the emergence of LTIPs, the increasing use of market-purchased shares to satisfy vesting of awards, and the conclusions of the Greenbury and Hampel reports and the provisions of the Combined Code, it is appropriate to reassess the practical application of the Guidelines and their underlying principles.

Introduction

Institutional shareholders support share incentive schemes which genuinely align the interests of participating directors and senior executives with the interests of long-term shareholders. The implementation of such schemes of necessity involves either the commitment of shareholder funds or the dilution of the shareholders' equity. It is important, therefore, that they be objectively costed, well-designed and form a coherent part of the overall package.

In evaluating incentive arrangements and determining their voting intention on the adoption of schemes, institutional shareholders have regard to a number of principles as outlined both in this paper and the shorter "Share Incentive Schemes – A Statement of Principles". These principles apply to all share-based incentive schemes, including arrangements whereby awards on vesting or exercise are made in the form of payment of the cash value, or transfer of shares to the value, of the imputed gain at vesting date.

It is hoped that remuneration committees and company boards will also have regard to these principles in developing and implementing share incentive schemes. While companies in some sectors of the national economy and some which are competing in the global market place may feel they have some difficulties in achieving full practical compliance, these principles are designed to be applicable to all companies.

It is important that schemes be regularly reviewed by remuneration committees to ensure their continued effectiveness. Shareholder authorisation should be secured to any substantive amendments to scheme rules and, in any case, after five years from date of adoption of the scheme. Companies are encouraged to maintain a constructive dialogue about issues relating to share incentive schemes with their major institutional shareholders.

Phasing of Awards

The concept of phasing of share-based incentive awards emerged during the deliberations of the Greenbury Study Group as did the recognition that awarding options in one block at the outset can produce “freak” results arising out of share price fluctuations.

There are, however, a number of other strong reasons encouraging the adoption of regular phasing. A policy of phased annual grants eliminates the perceived problem that a limit on subsisting options encourages early exercise. Phasing lessens the possibility of both the problem of “underwater” options, where the share price has fallen below the exercise price, and the difficulty in satisfying performance criteria where participation is awarded at a cyclical or structural peak. It also allows the adoption of a single performance measurement period at the end of which the proportion of the award vesting is determined. As the potential value of scheme participation rises it also becomes increasingly important to ensure that participation forms an integral part of the overall annual remuneration package.

For these various reasons, the preference of institutional shareholders would be for participation under share incentive plans to be phased, with awards being made on an annual or otherwise regular basis.

Performance Conditions

It is now widely recognised that alignment with the shareholder interest is best achieved through the vesting of awards under share incentive schemes being conditional on satisfaction of performance criteria which demonstrate the achievement of demanding and stretching financial performance through the incentivisation period. The greater the level of potential reward to individual participants the more stretching and demanding the performance conditions should be.

The key overarching principles regarding performance recognised by institutional shareholders are as follows:

- Challenging performance conditions should govern the vesting of awards or the exercise of options under any form of long-term share-based incentive scheme.
- The chosen criteria should demonstrate the achievement of a level of performance which is demanding in the context of the prospects for the company and the prevailing economic environment in which it operates.
- Performance conditions should be measured relative to an appropriate defined peer group or other relevant benchmark.
- The chosen performance conditions should be disclosed and the reasons for selecting these, together with the overall policy for granting conditional share or share option incentive awards, should be fully explained to shareholders.

The use of total shareholder return (TSR) as the primary criterion is generally acceptable where it is supported by a defined secondary financial criterion or a requirement for the remuneration committee to satisfy itself that the recorded TSR is consistent with the achievement commensurate with the underlying financial performance. Where consideration is given to devising unusual types of performance criteria, these will need to be fully explained, demonstrated to be robust and demanding, and linked clearly to the achievement of enhanced shareholder value.

It is important that there should be no automatic waiving of performance conditions in the event of a change of control or other capital reconstruction. As a minimum in such circumstances, remuneration committees should retain the discretion to withhold the vesting of all or part of the awards which have not achieved the stipulated performance hurdle.

There are two key concepts of performance which are recognised in ABI guidelines:

- 1) **Basic:** requires over the period of at least 3 years from date of grant performance reflecting no less than median/mean achieved by a target group, or where appropriate, an equivalent performance condition, for example, of earnings per share growth of $(rpi + X) \%$, which relates to reasonable expectation of company financial performance or growth.
- 2) **Superior:** the achievement of top quartile against a peer group over 5 years.

Under the traditional ABI guideline approach, these concepts have been represented through the award and vesting schedules of basic options and super-options respectively. However sliding scales between top quartile and median performance can be a useful way of ensuring that performance conditions are genuinely stretching, as well as demanding, and it is recognised that they provide a better motivator for improving corporate performance beyond the “single hurdle” that might otherwise apply.

These advantages have been recognised for many annual schemes introduced in recent years which have, in effect, integrated the basic and

superior performance concepts within a single scheme. The adoption of a 3-year performance measurement period for such schemes is acceptable although a longer measurement period may well be more effective in linking the vesting of awards to genuine and sustained financial performance.

Cost to Shareholders

The cost of share incentive schemes should be disclosed in order that shareholders can assess the likely benefits of the proposed scheme against the costs. In this regard, reference would generally be made to: -

- The potential value of awards due to individual scheme participants on full vesting.
- The expected value of the award at the outset, bearing in mind the probability of achieving the stipulated performance criteria.
- The maximum dilution which may arise through the issue of new shares to satisfy entitlements.

Institutional shareholders would expect sponsoring companies to adopt prudent and appropriate arrangements for any acquisition and financing of shares to meet contingent obligations to provide shares or pay deferred remuneration under a long-term incentive scheme in order to minimise financial risk to shareholders resulting from price movements in the company's shares.

The concept of **expected value** (EV) should be central to assessment of share incentive schemes, particularly so with participation in such schemes increasingly being seen as part of the overall remuneration package. However, calculation of the EV of share schemes is often complex and relies on a range of assumptions, and reliance on this concept by remuneration committees will require a sufficient measure of disclosure to enable shareholders to make informed judgments about such arrangements.

This complexity is particularly evident in the case of options. Institutional investors welcome efforts towards ensuring that accounting for share options awarded under incentive schemes fully reflects the true cost to shareholders.

The nature of performance hurdles governing exercise is also crucial to calculations of expected value. It must also be recognised that any facility for "retesting" will also increase the EV of the award. However, in moving towards phased grants, companies are strongly encouraged to move away from retesting and towards the use of a single pre-determined performance measurement period. Except in the case of options strictly within a four times limit, the stipulated performance criteria should never combine the use of a fixed rate of performance hurdle with measurement from a variable base date.

Where exercise prices are set at a premium to the share price at the outset, this will reduce the value of the EV of the instrument but the setting of a premium price is not a substitute for the adoption of a performance condition governing exercise.

Regard is likely to be had also to the potential value of the award assuming full vesting. This is likely to be expressed on the basis that a conditional award is made of shares, or options over shares, with a current value equal to a given percentage of base salary. However the potential value will also be a function of share price at the time of vesting and an additional measure of illustrative disclosure of potential outcomes may be helpful. Full vesting of awards of higher potential value should require the achievement of commensurately greater performance.

Although participation in more than one form of share incentive scheme is not prohibited, the Greenbury Report recognised that this is not desirable, and that any dual participation of this type must form part of a well-considered overall plan. Institutional shareholders will have regard to aggregate individual share incentive scheme participation levels within overall remuneration structure.

Comparative Valuation and Assessment of Share Schemes

The move towards phased grants of share options and restricted shares, and utilisation of both new and purchased shares to satisfy the vesting of awards, requires a comprehensive approach to valuation. Assessment should focus on expected value and will need to take account of the performance vesting schedule which is adopted as well as the existence of any “retesting” and “replacement option” facilities such as have been prevalent under traditional schemes.

This comparative valuation process should enable benchmarks to become apparent which are broadly comparable to existing Guideline limits and this is an area where further dialogue between companies and shareholders and their representative bodies could now be beneficial.

Co-Investment Awards

Where a portion of an annual performance bonus is payable in the form of shares, remuneration committees may consider the case for some form of matching share-based award, dependent on the initial shares being held for a period of three or more years. However, institutional shareholders are not supportive of arrangements whereby shares or options may, in effect, be granted at a discount. Remuneration committees will need to assess carefully what size and type of additional award is justifiable, bearing in mind what further performance criteria need to be satisfied for the matching award to vest.

Dilution Limits

Where the terms of any incentive scheme provide that entitlements may be satisfied through the issue of new shares then the rules of that scheme must provide that, when aggregated with awards under all of the company's other schemes, commitments to issue new shares must not exceed 10% of the

issued ordinary share capital of the company (adjusted for scrip/bonus and rights issues) in any rolling 10 year period. Remuneration committees should ensure that appropriate policies regarding flow-rates exist in order to spread the potential creation of new shares more evenly over the life of relevant schemes.

In addition, commitments to issue shares under discretionary or executive schemes, except to the extent that vesting will be dependent on the achievement of more stretching performance criteria, should not exceed 5% of the issued ordinary share capital of the company (adjusted for scrip/bonus and rights issues) in any rolling 10 year period.

Personal Shareholding Requirements

Institutional shareholders are generally supportive of companies which encourage their senior executives to build up meaningful shareholdings in the companies for which they work. The design of incentive schemes, especially where this facilitates the retention of a significant portion of shares to which participants become entitled, can be of considerable significance in achieving this objective.

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