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2010 Compensation Plans

A Year in Flux

By Warren Rosenstein
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Mandatory deferral plans were never particularly interesting. Firms were preoccupied with being “competitive with the street”. There wasn’t a great deal of variety and innovation. Employees griped about having some portion of their bonuses deferred, and then often sat back and watched the value of their awards escalate. Of course, that hasn’t always been the case in the last couple of years.

A combination of political pressure, unpredictable business results, a burgeoning regulatory environment, and some pretty creative thinking has set the stage for what is turning out to be the most interesting year in compensation plan design in a long time. Certainly one of the big drivers of this creative thinking has been the change in focus from employee retention to aligning delivered compensation with firm / divisional performance.

This article will review the nuts and bolts of the plans that are out there, and also take a look at some not so typical wrinkles that are starting to emerge.

While technically outside the scope of this analysis, it is interesting to consider whether firms are trying to fix a problem that is occurring further upstream (bonus pools funded without appropriate risk-weighing) by adding on large deferrals further downstream. As suggested previously, it may be more effective to hold back some portion of a business’ bonus pool based on an assessment of the business’ risk, and deliver that money in subsequent years, when it is clear that performance is truly what it appeared to be.

This paper will examine what is changing in long-term plan design with regards to:

1. Eligibility Criteria
2. Deferral Percentages
3. Vesting Schedules
4. Award Vehicles
5. Clawback Provisions

ELIGIBILITY CRITERIA

EARLY READ

For relatively high paying firms, there isn’t any significant movement to push deferrals down to more junior / lower paid staff. This is a different story once you get outside the high payers / bulge bracket firms. A limited number of firms under regulation or wanting to get a jump on potential regulation in 2011 are including a broader population in their deferral plans. On a broad basis, we do not expect to

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see firms with existing deferral plans making big changes to who is included in these plans.

REASONABILITY ASSESSMENT

The bulge bracket firms are acting sensibly. They know that it is expensive and time-consuming to administer relatively small deferral awards, junior staff need their cash flow, and that employees receiving small bonuses have little oversight for the risk profile of the firm.

2010 WRINKLE

A significant number of firms that historically have paid bonuses in cash are now considering implementing deferral plans. In some cases the motivation is to get ahead of the regulators, in some cases to put more risk back on senior staff, and in many cases, simply because they can, in this environment. For firms that decide to implement deferral plans, aligning deferral percentages to bulge bracket firms may be short-sighted—particularly if they do not have the same business / risk profile.

It is advantageous for firms to defer pay—they can often push the charge into a subsequent year, when an employee resigns the forfeited award flows back into the company, and it does encourage retention, though this is often overstated. The big decision point is this: do firms that have been "all cash shops" lose more in recruitment than they gain in laying off some risk?

DEFERRAL PERCENTAGES

EARLY READ

Quite simply, these are going up, particularly for highly compensated individuals. Deferral percentages (60% and up) that were typically reserved for operating committee members and senior MDs are now seeing broad use, at firms of all sizes. Most firms will have increases at the margin of at least 5%-15%, with the exception of firms that already had "max cash" provisions last year.

REASONABILITY ASSESSMENT

Last year, firms increased deferral percentages due to a scarcity of cash. This year, firms are trying to solve for the question of, "how do you pay annually on a business whose results are best measured over multiple years"? They are also trying to adhere to, or get ahead of regulatory guidelines. While the motivations for pushing more money into deferrals may be mixed, it is hard not to think that this is a sensible answer, at least until the industry learns to better measure risk.

2010 WRINKLE

While there has been some bounceback in share prices, many firms still have relatively low share prices based on historic levels. These very large deferrals may make some people who are complaining loudly now, very happy in a few years, if business performs well.

Separately, there are reports of resourcefulness, both by firms and employees, to ensure cash flow for staff with outsized deferrals, including the widely reported salary increases, and in isolated cases, the use of bridge loans, until deferrals vest. While most deferral plans include language prohibiting pledging, hedging or transferring ownership of deferred awards, there has been some talk of employees trying to structure derivative transactions where they can use their deferrals to obtain cash at a discount.

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VESTING SCHEDULES

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Vesting schedules have been largely static, though a few firms have added a fourth year to their pro-rata schedules. Some firms with multiple plans are vesting one plan very quickly, perhaps to provide more cash flow. In some instances firms are implementing broader holding provisions (these provisions were typically reserved for executive management), requiring employees to keep their equity awards after they have been vested.

REASONABILITY ASSESSMENT

This is probably the area of plans where the least innovation has taken place. Why is three year pro-rata the most common vesting cycle? I don't know if anyone can answer this.

OUTSIDE THE BOX

Why not have different vesting schedules for employees based on the category of risk they take on (i.e., HR staff have awards that vest quickly, employees trading cash products on behalf of clients vest moderately, and proprietary traders dealing in products with limited liquidity vest slowly).

AWARD VEHICLES

EARLY READ

The big news in this regard is that some number of firms have implemented deferral programs that feature performance-based awards for a broad population. These are not just awards that have performance-based vesting (holdback provisions), but awards that fluctuate in value, or even multiply and become more units based on performance.

While these have not become the industry standard, the increase in these awards, along with continued use of deferred cash, makes RSUs a less prevalent vehicle.

REASONABILITY ASSESSMENT

In some cases, employees will be triply exposed to the performance of their firm: their bonus size, subsequent share price, and ROE, or other performance metric. The best of these plans expose employees to the performance of their specific divisions—there is something inherently sensible, particularly from a risk perspective, in subjecting an employee to divisional performance, rather than letting a big loss get buried in a global share that is less prone to fluctuation.

2010 WRINKLE

It is a little surprising that the option is seeing relatively limited use. The substantial uncertainty that exists around where profit levels are heading seems to be an environment that is well-suited for options or SARS. Let employees' pay return to historic levels if share prices appreciate significantly, if not, options and SARs can expire without value. This seems like a very reasonable proposition in this environment, in spite of the accounting treatment.

CLAWBACK PROVISIONS

EARLY READ

The term "clawback" has become ubiquitous, though as it gets used more broadly, it is beginning to take on secondary meaning. "Clawback" specifically means taking back an award that has already been delivered. Firms are now also using this term to indicate cancellation or forfeiture of an undelivered award as well. In any event, almost all firms are implementing or considering this in their

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plans, mostly because it is the most non-controversial thing a firm can do. It is impossible to imagine someone objecting to a clause that penalizes someone for misrepresenting financials or exceeding trading limits.

REASONABILITY ASSESSMENT

While there is little harm in implementing clawback provisions, it would be interesting to review what has transpired in the last two years, and ask the question: "At firms that failed, or suffered significant losses, how many actions took place that would have actually triggered a clawback?" And then ask: "How much money would have successfully been retrieved"?

OUTSIDE THE BOX

In almost every instance, a holdback is more sensible than a clawback (retrieving delivered money is almost always challenging, and potentially expensive in terms of legal fees). In fact, thoughtfully structured holdback provisions really seem to trump purely time-based vesting, in almost all cases.

Grant an award—performance vest it (fast or slow depending on employee role) based on firm performance, multiply it up or down based on division / group performance, throw in some options so there is both leveraged upside and zero-return risk for the employee, and now you have an employee that is really engaged.

CONCLUSION

There is a lot of creative thinking going on, a number of regulations / guidelines being issued, and a workforce that has a little less opportunity to move around than they did in the past if they are not happy with their deferral plan. Overall, this is a pretty fertile environment for change and new plans. It will be exciting to see what comes of it. ■

Warren Rosenstein is Head of Client Business Analysis at McLagan. Mr. Rosenstein works with clients to develop customized analysis strategy across compensation, staffing and productivity. He has provided solutions for a variety of client needs, including compensation plan design, organization structure and salary strategies.

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