GEO GREATER CHINA CHAPTER MEETING

Essential Steps in the Design and Implementation of a New Stock Plan

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1. INTRODUCTION ABOUT GEO AND THE SPEAKER

- Importance of a professional organization fostering subject matter expertise in all aspects of stock plan design and administration

2. INTERDISCIPLINARY NATURE: TEAM EFFORT

- Business Strategy and Market Perspective
  - What is the purpose of the plan: to incentivise towards certain business goals (e.g. business performance goals, attraction and retention of key employees). Well-designed equity compensation plans can be an important vehicle for linking an executive's pay to company performance, and aligning the interest of executives with those of shareholders. Ensure that there is sufficient time for reflection on what performance should mean, and why the goals being used are appropriate.
  - Learn from the market: what are other companies in your industry doing, or at companies from which you recruit or to whom you may lose talent.
  - Companies are trying to be more creative with their plan design. Increased use of full value shares rather than stock appreciation based programs.
  - Start from this perspective, but you need to know something about all the other aspects mentioned below:
- Accounting: Expense measurement and recognition.
- Legal: Listing Rules; Securities and Company Law; Shareholder Approval Requirements; Drafting of Plan Rules, Award Agreements, Impact of Termination / Severance Provisions, and Change in Control; Disclosure Requirements and Filings.
- Taxation: Tax deductibility of equity compensation to the company; Income and Capital Gains (if any) taxable events for the employee.
- Human Resources & Compensation: Equity compensation is an entry point for HR to become more strategic and have a seat at the Board meetings, Talent attraction, retention, motivation; executive labour market dynamics; Collaborate with legal, Finance, Investor Relations, Communications, etc.

- Institutional / Substantial Shareholder Reactions and Engagement: What they may consider as poor equity pay practices (e.g. share option repricing, changing performance conditions, large one-off awards, high run rates, liberal share counting rules, and inappropriate risk-taking); their recommendations on Say-On-Pay votes.

3. CREATE ALIGNMENT AMONG THE VARIOUS STAKEHOLDERS

- CEO, CFO, CPO, CLO
- Board and Remuneration Committee (Chair and Members): A company's board and compensation committee are best suited to understand the Company's own business and setting the company's equity compensation program. They approve the incentive opportunities and the corporate goals, as well as the equity based incentive awards. They also assess performance and approve pay-outs of equity awards.
- Working with all the advisors.
- Spend considerable time to seek their input, keep them informed on progress, give yourself plenty of time.

4. STARTING POINTS

- Start with the business needs. This should drive the design. Should we implement an additional program, in addition to the share option scheme which reward purely for share price appreciation and which we may have used for many years? What type of program should it be: RSU (i.e. Restricted Share Unit (RSU) program, in which full value shares are awarded that can be earned subject to service conditions, or a Performance Share Unit (PSU) program, in which full value shares are awarded that may be earned subject to business performance and service conditions?
- Then look at market information, but not only from a quantitative perspective but also from a qualitative perspective. In the first instance, don't look so much at the 'how much', but at the 'what' and the 'why'. Why are other companies using a particular equity compensation or participation program; why are they using such and such performance conditions, with such and such weighting; what kind of mix do they have between the different programs. Do they only have share options, or also PSUs and RSUs, and what is the proportion between these type of programs, in value terms. How deep do the peer companies extend these equity programs into the organization?
- Realize the importance of peer groups, not only for pay level benchmarking, but also for qualitative market information on plan designs, and on measuring your relative business performance. Market trends should have an influence on your decisions on changes in plan designs.
- What programs do we use for purposes of buying out or making executive 'whole' when we recruit new executives? Do we have a policy on minimum shareholder requirements?
- Institutional investors like to see at least 50% in the form of PSUs, and they do not count share options as being performance based.

- Then you should look at how much is awarded to a CEO, CFO and other executives at your comparator companies, based on research from publicly available information or compensation surveys. This value is the ‘grant date fair value’ which is sometimes also called the ‘economic value’, it is not the face value.
- You should also look at how much do other companies typically give in total, per year, not only in terms of number of shares, but in terms of this economic value. This value should also be expressed as a percentage of revenues or EBTIDA or market capitalization (i.e. the total value of your company). By expressing the economic value of what you are granting as a percentage of market capitalization, you are effectively showing how much value you are transferring from your other shareholders to your employees (Shareholder Value Transfer [SVT]), and investors like to look at it in that way.
- You should have an Equity Status Report, that is updated at least once a year. You need to know how much has been granted over the prior years in total and how much the senior executives hold both in terms of vested and unvested shares, so that you can have a view on the retention power of outstanding awards and also on the type of gain having been realised.
- Create a set of alternatives with pros and cons, and highlight the risks and ways in which you sought to mitigate for this risk through various design features.
- Create an overall structure of equity compensation and participation for your workforce. For example, you may have your senior executives eligible for two programs, and the levels immediately below that on a single program, while the entire workforce may participate in an Employee Share Purchase Program (ESPP).
- If you are moving to equity compensation, it will generate quite a few new responsibilities. Equity compensation stands between HR/C&B and Finance. There will be some elusive and grey areas.

5. TYPICAL MISUNDERSTANDINGS

- When you make a grant, then that does not mean that the participant will actually receive those shares. Yes, you will have to disclose the award. But the award will have to be earned, either through continued service over the vesting and holding period, or through the performance conditions, such as share price appreciation or meeting business performance targets. So, the grant date fair value is not the same as the value that is ultimately realized. That is why, when you do a market benchmarking, there is one way to look only at the grant date fair value, but there is also the need to place this in the context of performance, and this is why a pay-for-performance analysis is so important, by comparing how you rank in terms of pay against various performance parameters. If you are in the third quartile, in terms of what has been granted, then how do you compare against your comparators in terms of total shareholder return, and whether you are also in the third quartile in terms of performance. Similarly, there are various pay versus performance tests that should be undertaken. Do changes in compensation track with your Company’s Total Shareholder Return and key performance indicators.

- Realized pay, or take home pay, is distorting because it depends on the date when you decide to exercise your options for example. Realizable pay is in the money intrinsic value at the end of the year, or the fair value of the options on that date.
- The ‘face value’ of an award is not the same as the grant date fair value (or, the accounting value), or that the compensation accounting cost to the company is the same as the benefit to the employee. These two do not typically go in tandem. Bear in mind that giving 100,000 share options is not the same as granting 100,000 RSUs or PSUs. 100,000 options with an exercise price of $10 may have a fair value of let’s say $300,000, but 100,000 RSUs would have a value of $1,000,000.

6. PAY FOR PERFORMANCE (INSTITUTIONAL SHAREHOLDER PERSPECTIVES)

- Two or more business performance conditions, that are industry specific and drive value.
- Ideally, one performance metric that relates to relative performance vis-à-vis a relevant peer group or index.
- Performance periods of at least three years
- Stretching metrics that incentivize executives to strive for outstanding performance while not encouraging excessive risk taking. What if you set target that are lower than the targets for the prior year, or lower than the actual for the current year? When goals are set lower, should the pay-out opportunities also be decreased? Compare your targets against the industry’s actual performance, e.g. to show that your target was actually above the industry growth rate.
- There is an increase in post vest holding restrictions: the shares are vested and no longer forfeitable, but they can’t be sold. In fact, if newly issued shares are used, they are not yet issued.
- Annual overlapping grants, and use of one-time or front loaded awards only when there is a convincing reason as to why annual awards do not provide for sufficient motivation.
- Use of Non-GAAP performance measures, and the need for reconciliation to the most directly comparable GAAP measure in the accounts. Many companies use it for incentive compensation. These measures have started to supplant financial measures rather than supplement (adjusted revenue, restructuring charges, FX impact, tax provisions). These adjustments should be identified at the beginning of the year. If there is a one-time item, then it should be truly one-time, such as when it relates to a disposition of an asset. There should be an overall assessment in a broader context as to whether the adjustments and the incentive compensation paid makes sense. In describing pay for performance, you need to explain the pre-determined performance criteria, how it was calculated, and what went into it.
- A word about Total Shareholder Return as a Performance measure:
  - Is the TSR peer group or index representative of the industry / companies that are impacted by similar macro economic events. Useful for companies with slow stock price growth and high dividend yield.

    - Criticisms of TSR relate to: primarily determined by the market, which is out of control of the executive; higher concern if it is the sole metric; more subject to manipulation for share repurchases.
    - But it is a widely applicable performance metric and shareholders are seeking increased stock returns.
    - Companies should consult shareholders as to whether they are open to other metrics, that also have a good rationale, and metrics that fit especially well with the strategy of the company.
    - Companies are also limiting pay-outs when TSR is negative.
    - Be careful with the precise definition of TSR, and how to deal with peer groups and special situations in your peer group (e.g. acquisitions, bankruptcies, spin-outs and delistings).
- But many companies in Hong Kong and China have RSUs rather than PSUs. Some shareholders are of the view that a substantial proportion of total annual remuneration should be provided as RSUs that are locked in for a considerable period of time. They consider the accuracy of finely calibrated performance targets to be illusory. The performance conditions in PSUs can be ineffective and may result in unbalanced outcomes. These investors consider that the Board should provide transparency, which provides legitimacy. These views tend to be expressed by some institutional investors. Others are of the view that equity remuneration should be tailored to the challenges of the business and encourage appropriate risk taking, and reward strategic initiatives by the CEO and the senior management team.

7. LEGAL CONSIDERATIONS

- Plan Document: Stock Option Plan, RSU Plan, Omnibus Plan:
    - Cost of the Plan including maximum dilution levels as per the listing rules. But in this regard it also has merit to be cognizant of ISS' (Institutional Shareholder Services) Proxy Voting Guidelines for Hong Kong which states that they will recommend a vote against the adoption of an equity compensation plan if:

      "The maximum dilution level for the scheme, together with all outstanding schemes, exceeds 5 percent of issued capital for a mature company and 10% for a growth company. However, ISS will support plans at mature companies with dilution levels for all outstanding schemes of up to 10 percent if each individual plan includes other positive features such as challenging performance criteria and meaningful vesting periods as these features partially offset dilution concerns by reducing the likelihood that options will become exercisable unless there is an improvement in shareholder value. In addition, ISS will support a plan's dilution limit that exceeds these thresholds if the annual grant limit under all plans is 0.5 percent or less for a mature company (1 percent or less for a mature company with clearly disclosed performance criteria) and 1 percent or less for a growth company." (ISS, Hong Kong, Proxy Voting Guidelines, 2018)

  - Claw-back definitions in event of a material misstatement due to fraud or misconduct, or materially inaccurate financial statements. Should it be applicable only to performance based awards, and not to time vesting awards. To whom does it apply, to all participants or only a limited number of executives.
  - Companies are reviewing the language in their plans in relation to the impact of termination events such as death, disability, retirement, voluntary and involuntary termination, and also in case of M&A and Change in Control.
- Award Agreements: Differentiation can be made between awards to different participants in these award agreements.
- Be careful about conflicting provisions among the governing documents: Plan Document, Award Agreement, Employment Contract, Annual Report / Proxy Disclosures, Severance Plans, Change in Control Severance Plans or Agreements.

8. ACCOUNTING CONSIDERATIONS

- Grant date fair value of an award
  - A share option with an exercise price of $10 can be said to have a 'face value' of $10, but the grant date fair value would likely be something like $3, depending on the valuation of the award. The grant date fair value is the expense of the option, and this expense is recognized over the vesting period. You cannot 'get rid' of the expense. So, if you give 100,000 share options, the grant date fair value is $300,000. That is the expense that is recognized over the vesting period, independent of the fact as to whether the options actually deliver a value of $300,000 or more or less than that figure or even when they expire unexercised.
  - Here you will have to understand something about the accounting treatment of share based compensation. The accounting cost is measured on the grant date, based on the fair value of the award on the grant date. The expense is recognized over the service vesting period.
  - For RSU awards the fair value is typically the share price on the grant date, and the expense is based on the shares that ultimately vest.
  - For PSU awards, a distinction has to be made between so-called market based conditions (i.e. performance conditions that are based on the share price, such as Total Shareholder Return, which is stock price appreciation and dividends reinvested) and non-market based conditions (e.g. growth in Earnings per Share (EPS), EBITDA (earnings before interest tax, depreciation & amortization), Net Income, etc.). Awards with market based conditions have to be measured on the grant date using a valuation technique, such as Monte Carlo Simulation), and the expense is fixed on the of grant, in the same way is the case for share options. So, if you award a PSU when the share price is $10, and you have a relative TSR performance condition in which you earn a target number of shares if R-TSR is at the 50th percentile against a comparator group of companies, and 50% of the target number of shares if r-TSR is at the 30th percentile, and 200% of the target number of

shares if the share price is at the 75th percentile, the fair value of one share may be somewhat smaller or larger than the $10. So, if you give a target number of 100,000 R-TSR based PSUs the value may be only $80,000 or $90,000 or $110,000. Again that is a fixed cost.

» But if you give PSUs with non-market based conditions, such a EBITDA targets, then the cost is the share price on the grant date, e.g. $10, times the shares that ultimately vest, e.g. 100,000 X$10 = $1M or 50,000 X $10 = $500K, or 200,000 X$10 = $2M, or 0 X $10 = $0, if the performance condition is not met.

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