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COMMENTARY

Are stock options still ideal for mining execs?

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In the smoking ruins of the global financial crisis, renewed attention has been focused on executive incentives and whether efforts to earn higher compensation promoted executive behaviour that created excessive, and in some cases, enterprise-jeopardizing risk.

This focus has led to new regulatory initiatives intended to limit risk and affecting executive compensation in a multitude of jurisdictions and industries. But what does this mean for the mining sector?

To answer that question, first we have to ask: what is risk?

In compensation terms, there has traditionally been far more concern with the downside perspective of risk — i.e., the failure of an executive to achieve corporate goals and the resulting impact on competitive compensation.

As is now glaringly apparent, little consideration was given to limiting the upside potential of variable compensation programs. In the financial services sector, overly leveraged pay programs led to institutions being destroyed or losing independence. The Economist Intelligence Unit found about 70% of financial companies surveyed viewed “risk management failures” as a leading cause of the world’s current economic problems.

Compensation systems without a limit on total potential earnings from variable pay encouraged executives to pursue strategies at the expense of shareholders. These strategies increased expectations or even hype about the future value of the company, leaving shareholders holding the bag when the lack of sustainable earnings became apparent.

The Enron and WorldCom accounting debacles resulted in the *Sarbanes-Oxley Act* in the U.S. and forced corporate boards to address weaknesses in financial controls.

The more recent Toxic Asset Relief Program controls in the U.S. and the Productivity Commissions’ proposals in Australia and punitive incentive tax in the U.K. attempted further expansion of controls on executive compensation.

Indeed, risk is now required to be addressed in the “compensation discussion and analysis” portion of proxy statements.

Stock options were initially widely favoured as there was no cost to the company in terms of funding, as there was no requirement to expense the cost, and the market funded any unlimited upside gain.

However, the expensing shortfall has now been addressed with companies required to capture the cost of granting stock options in annual financial statements.

When expensing rules were first introduced, the software industry lobbied against them on the basis that in start-up mode, there were no other affordable choices for them to both reward and retain creative designers working on a value proposition that would not emerge for some time.

> *Junior mining companies continue to depend heavily on stock options as a cash-effective way of incentivizing their senior teams for the long term.*

Risk that can damage an enterprise includes: exposure to criticism or damage of image with shareholders and customers; difficulty with proxy voting on proposals regarding executive compensation; board embarrassment; and risk of unintended payments.

The consequence of this controlling movement has been a fall from grace of stock options as an incentive for executives.

The mining industry was no different in this respect, but was and continues to be largely silent on the matter. Junior mining companies continue to depend heavily on stock options as a cash-effective way of incentivizing their senior teams for the long term.

Should we expect more executive-compensation regulation? Perhaps, but there will also be changes to customary

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best practice. Longer time horizons will impact the design of executive compensation programs and the use of longer holding periods for exercised or granted stock will focus on sustainable real long-term value rather than short-term folly.

Expect also more "bonus banks" or claw-backs to enable recovery of incentive pay if a longer time horizon shows performance results require a restatement.

Elements of compensation design today that are broadly considered to be high-risk in nature, and therefore suspect, include: low salaries relative to potential incentives; annual rather than multi-year performance incentives; uncapped upside incentives; and excessive use of stock options as a short-term incentive.

Wait a minute — this looks very much like the typical compensation plan at most junior and many mid-size miners. So how should companies respond?

Stock options are falling out of favour because they have no real downside. However, in companies where there is as yet no sustainable value, they continue to be the optimal choice to align executives and shareholders on the long run for junior and mid-size mining companies dependent upon a single or limited number of orebodies.

If combined with performance share units (PSUs) and/or restricted share units (RSUs), stock options remain an effective instrument that rewards both shareholders and executives consistent with the company's long-term goals.

Boards or their compensation committees will be under scrutiny for compliance with both best practice and commercial trends. Not just stock options but any compensation instrument should be accompanied with enhanced internal controls and insights into their use as a compensation instrument.

To ensure that total compensation is aligned with strategy, we need to consider the mix of short- and long-term compensation. Long-term is intended to retain and reward. Short-term annual incentives are usually cash awards for achievement of metrics that are milestones to strategic objectives. Cash is usually in short supply for junior and mid-tier companies and RSUs and PSUs with long-term vesting could be an additional or alternative incentive tool.

We need to use a balanced scorecard when assessing the performance of the top team with respect to attaining multiple objectives such as growth, managing the board, succession, coaching and mentoring.

Understanding all potential scenarios is also crucial. We can do this through greater use of business-modeling tools so that compensation committees can better see the potential impact of compensation decisions (e.g. "what if" scenarios and the anticipated result of the proverbial "home run," and the question of whether severance, change-in-control or incentives would motivate actions that trigger large payouts at the expense of shareholder value).

Generally, it's best to avoid compensation programs that reward executives as highly as successful entrepreneurs if they do not take board-approved entrepreneurial risks.

We also need to understand how pay-for-performance or "say-on-pay" initiatives may shape the junior and mid-tier company space, and how independent is the compensation consultant to the compensation committee if their compensation is reliant upon a favourable relationship with the CEO.

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