

## The Case for Longer Vesting and Simpler LTI Programs



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MANAGING DIRECTOR

Two separate circumstances are indicating the time may be right to re-evaluate long-term incentive (LTI) plans and consider restricted stock with longer vesting periods. First, the COVID-19 pandemic has highlighted potential weaknesses in what are considered market-prevalent plan designs, specifically around retention and continued engagement of plan participants. Many companies across industries have been negatively impacted and face some of the following challenges:

- Bonus awards and performance shares units (PSUs) that were otherwise on track to pay out, in some cases above target, are now tracking to pay below target or zero;
- It is difficult to keep plan participants motivated and engaged in performance priorities if participants won't see any value from their three-year PSU plan cycles; and
- There is uncertainty around setting new three-year PSU cycles and annual incentive plan goals for 2021 so long as there is potential for waves of illness by region and shutdowns to enforce social distancing.

Even positively impacted companies are uncertain about setting new annual and three-year performance goals for 2021. Restricted stock with longer-term vesting as an alternative (i.e., five years or longer) provides the retention needed to weather a once in a lifetime event (or, as companies in cyclical industries understand, business downturns) and avoids the need to establish performance goals that may quickly become obsolete. Stock options can then fill the role of the performance element as they provide direct alignment with shareholders. (However, we recognize that stock options may increase the burn rate and may be otherwise unaffordable.)

While periodic or one-time retention awards may seem like a good answer in this situation, proxy advisory firms have begun to criticize this approach. They have noted the need to make such grants as a potential failure of plan design. Creating more retention as part of the ongoing program could reduce the need for making ad hoc retention awards. And as an additional way to strengthen plan design in the eyes of external critics, requiring longer vesting, even into retirement (rather than accelerating vesting) requires executives to make decisions as future long-term shareholders and focus on long-range goals such as capital investment decisions or succession planning and transition, that may go far beyond three-year cycles.

The second trend we have observed is recent policy changes among investors to support longer vesting periods. In 2019 the Council of Institutional Investors overhauled their policy on executive compensation to support longer vesting and, specifically, to adopt simpler plans comprised of base salary and restricted stock that vests over five or more years.

Other institutional investors have also updated their proxy voting policies to support longer vesting. We identified six institutional investors that support longer vesting periods.

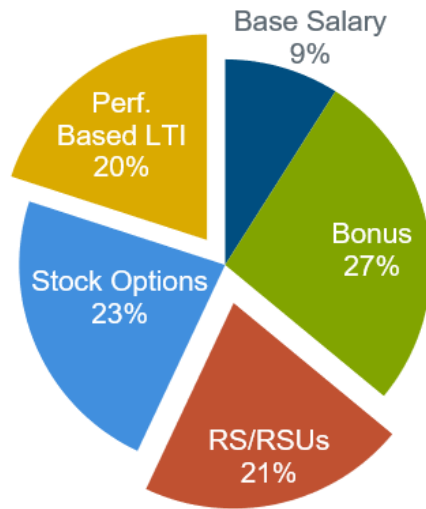
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Institution	Policy Excerpt
AEGON Investment Management	Shares granted to management board members without financial consideration shall be retained for a period of at least five years or until at least the end of the employment, if this period is shorter. The number of shares to be granted shall be dependent on the achievement of clearly quantifiable and challenging targets specified beforehand.
CalPERS	Companies should disclose any holding period requirements for executives after retirement or separation of service. We believe the equity compensation earned by executives should be held for a minimum of two years after they retire or separate from the company. Companies should disclose and clearly articulate the rationale for vesting periods and any mandatory holding periods on vested awards. The post-vesting holding requirements should ensure the executive's interests are properly aligned with those of long-term shareowners. To achieve this alignment, we believe equity compensation should be subject to a minimum vesting and/or holding period of five years from grant date, with the provision that no more than 20 percent of the equity can be sold annually starting in the sixth year from grant date.
Castlefield Investment Partners	Remuneration schemes should require executives to hold shares in the company for at least five years in order to align executives with the interests of all shareholders. If a remuneration report does not require this, it should be voted AGAINST. Castlefield expects executive directors to hold 200 percent of base salary in shares or their shareholding requirement in full, whichever is the lesser, for at least two years after leaving their post.
Fidelity (Canada) Asset Management	FCAM strongly encourages the long-term retention of shares. For shares awarded as part of a remuneration package FCAM will have particular regard for minimum required retention periods. Practice in this regard differs around the world but over time FCAM expect all companies to move towards a minimum guaranteed share retention period of at least five years from the date of grant.
Norges Bank Investment Management	A substantial proportion of annual remuneration should be provided as shares that are locked in for five to 10 years, regardless of resignation or retirement. Norges will not support a remuneration policy or report where the vesting or holding period fails to meet local-market best practice.
USS UK	USS expects a minimum five-year period before long-term incentives become available to executives (this includes the vesting and holding period).

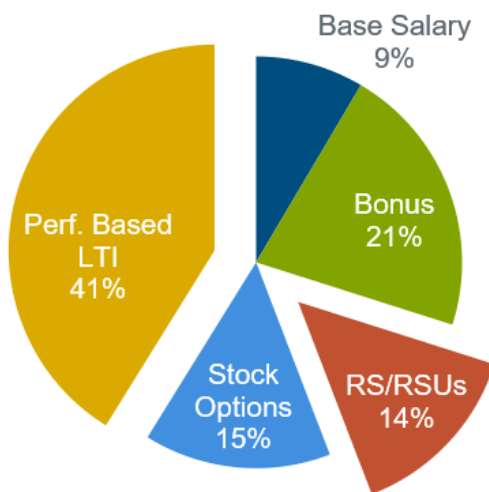
While this move toward longer vesting and simpler design promoted by the Council of Institutional Investors better aligns executives to longer-term strategies and is responsive to issues highlighted by the pandemic, it is different from prevalent market practices. Most large companies grant at least 50 percent or more of a senior executive's annual LTI award in PSUs and the remainder in restricted stock and/or stock options. This practice is largely a result of the advent of say-on-pay in 2006/07 and the increasing influence from proxy advisory firms, which is evident in the charts below comparing the CEO's total pay mix in 2007 and 2018 among the top 200 largest companies by revenues. Performance-based LTI increased from 20 percent to 41 percent, while stock options and restricted stock decreased from roughly 20 percent to 15 percent.

Top 200 Largest Companies by Revenue:

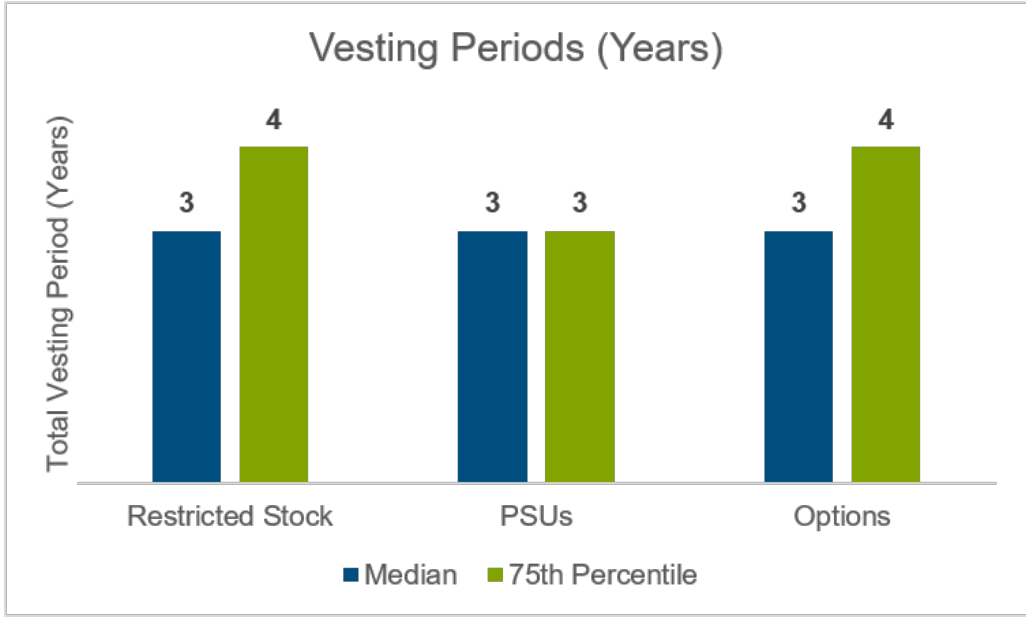
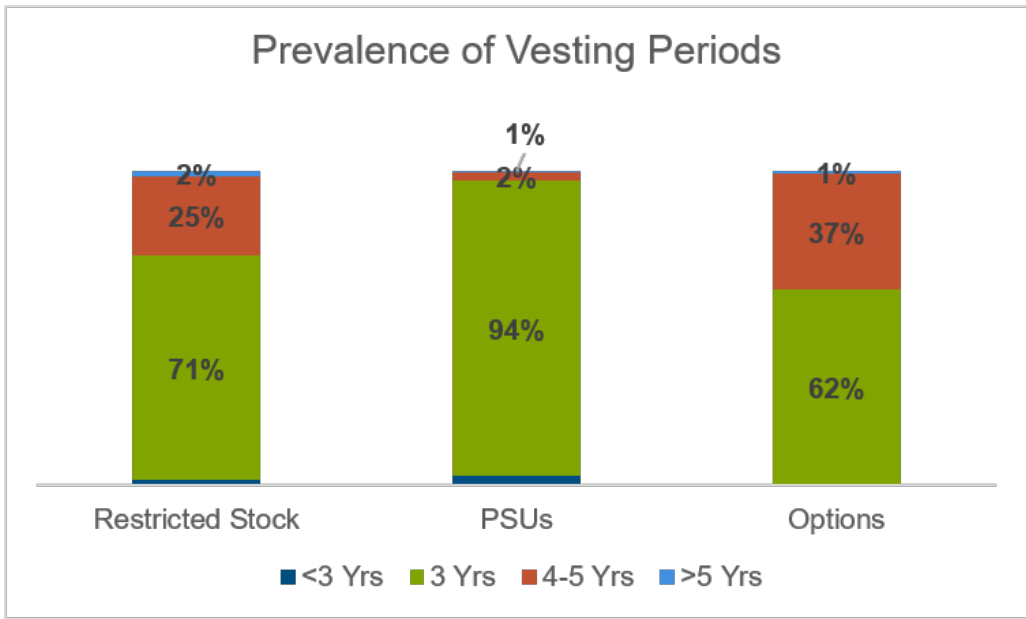
### 2007 Average CEO Compensation



### 2018 Average CEO Compensation



Three-year vesting for each of PSUs, restricted stock, and stock options is the most prevalent vesting schedule among these companies.



**Conclusion**

Because of the pandemic and related economic uncertainty, companies are in uncharted territory with respect to planning for 2020 payouts (and whether to use discretion to exclude the impact of the pandemic) and establishing the 2021 program and new performance targets. Traditional, market-prevalent compensation programs may not support retention objectives. Furthermore, there may not be enough visibility to establish new one- and three-year performance goals for the 2021 program.

A focus, at last temporarily, on retention may be the best course of action in 2021. Vesting longer than the market-prevalent three years would support retention objectives and may help to garner support from investors that are skeptical of time-based restricted stock.

Coincidentally, recent changes to selected institutional shareholder proxy voting policies and the Council of Institutional Investors' guidance suggest a potential early sea change in the

way in which investors think about executive compensation overall. It further suggests an open mind for 2021 plan design should companies choose to temporarily change their LTI plan design in response to the pandemic.

## About the Author

Jane Park is a managing director at Pearl Meyer. With nearly 20 years of experience, Jane advises public and privately-held clients on executive and non-employee director compensation issues. Her work is focused on pay governance, incentive plan design, pay-for-performance alignment, compensation benchmarking, proxy analysis, and special programs for IPO and M&A transactions.

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