Pearl Meyer

ARTICLE | NOV 2024 |

Reconsidering the Role of Performance-Based Equity

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2024 could mark a pivotal moment for executive compensation practices. Both ISS and Glass Lewis—powerful proxy advisors and long-time believers that companies should deliver at least 50% of executive long-term incentives (LTI) in performance-based vehicles—are now seeking feedback on this standard. For the first time, through their annual policy survey, each asked for feedback from investors, issuers, and other advisors as to whether the standard ought to be relaxed in its current form. Depending on how this discussion takes place over the next several years, this could signal a major shift in executive compensation practices.

Drivers of the Debate

NBIM, Norway's Sovereign Wealth Fund and an active contributor to the dialogue surrounding executive compensation and corporate governance, has been a long-time supporter of simpler LTI structures and a skeptic of performance-based long-term incentive awards.

In a follow-up letter after the release of the ISS and Glass Lewis's respective voting policy surveys this fall, the NBIM observed that:

- Performance-based equity has been the primary source of growth in CEO pay;
- Funding of performance-based equity skews above target;
- Companies that grant performance-based equity underperform companies that do not; and
- Performance-based equity designs tend to be overly complex and lack transparency.

The NBIM advocates for a shift toward simple, time-based vesting of equity with longer vesting periods (e.g., five years or more, relative to current practices where equity vests over three to four years) and relaxing the dogma that 50% of long-term incentive pay should be delivered in performance-based equity. It argues that compensation costs can be better managed and executives' interests are better aligned with shareholders through this alternative approach.

Views from other Institutional Investors and Issuer Companies

ISS and Glass Lewis released the results from their policy survey in the last several weeks. Investor support was mixed on proxy advisors softening their standards on performance-based equity, with some investors favoring a relaxed view while others prefer leaving existing standards unchanged. Relative to the points argued by the NBIM, investors standards may be influenced by US practices and prevailing views on executive pay versus the European-centric practices endorsed by the NBIM.

Issuers and non-investors, on the other hand, were clearly supportive of changes in proxy advisor voting standards to soften voting policies on performance-based equity.

Changes in Proxy Advisor Voting Policies

Recently, Glass Lewis issued updates to their voting policy for 2025 while ISS issued proposed updates to their voting policy with an open comment period on the changes, with both proxy advisors signaling similar shifts in their current view of performance-based equity.

Updates to Glass Lewis's voting policy for 2025 indicate openness to the idea that delivering less than 50% of long-term incentives in performance-based equity may be acceptable. Specific changes to the Glass Lewis policy for 2025 indicate that 1) it now views additional post-vest holding periods as a "common feature of well-structured LTI plans," 2) decisions to grant less than half of LTI in performance-based vehicles will be viewed negatively but not necessarily lead to "Against" vote recommendations on compensation-related proposals, and 3) negative vote recommendations are more likely if a reduction in the portion of pay delivered in performance-based vehicles is not offset by modifications to "pay quantum and vesting periods, particularly in the absence of cogent rationale."

ISS on the other hand, does not expect to make formal policy changes for 2025. At the same time, ISS has indicated that for 2025 annual meetings, it will adjust its qualitative executive pay assessment methodology noting that design or disclosure concerns regarding performance-based equity will be more likely to drive negative vote recommendations on say-on-pay when there are pay and performance disconnects. This seems to indicate an informal change in ISS voting policy with a more formal adjustment to the voting policy occurring in 2026 (or later).

Pearl Meyer's View

Pearl Meyer's philosophy is that executive compensation is a tool for strategy execution. This manifests through incentive design strategies that provide a strong line of sight to the dimensions of performance that align with and support the business strategy. Long-term incentives are then delivered in equity to align the interests of executives with those of shareholders.

Investors and issuers agree with our philosophy, as nearly 90% of respondents from each group from the Glass Lewis policy survey believe that "performance-based equity is an important tool in setting clear goals and milestones to help direct executive efforts."

We are also opposed to one-size-fits-all standards. ISS and Glass Lewis solicit investor (and issuer) feedback which, based on the results of this year's policy survey at least, reflects a wide range of viewpoints and perspectives with respect to long-term incentives. They then use that feedback to create voting policies against which all companies are held to account, including a rigid standard that all companies should deliver at least 50% of long-term incentives in performance-based awards. We believe the focus ought to be on proximate alignment of executive pay and performance, along with greater deference to the judgment of shareholder-elected boards.

In practice, this may mean one company delivers 75% of their LTI in performance-based equity while another company delivers 30% of their LTI in performance-based equity and the remainder in time-based equity with extended vesting requirements. And we believe that both models can be aligned with shareholders' interests.

What's Next

As we look ahead to the next three to five years, it is clear that the landscape of executive compensation will continue to evolve. The ongoing discussions and potential shifts in policies may lead to significant changes in how performance-based equity is viewed and implemented.

Companies will need to stay agile and responsive to these changes, ensuring that their compensation strategies align with shareholder interests and link to business strategy. By embracing flexibility and focusing on long-term value creation, organizations can navigate these changes successfully and continue to drive growth and innovation.

About the Author

Brett Herand is a managing director at Pearl Meyer. Specializing in executive compensation, he works with boards and management on issues related to performance measurement and value creation, incentive plan design, and technical advisory work with respect to tax, accounting, and SEC regulatory issues. Brett works with public and private companies across many industries, including financial and diversified services, technology, and manufacturing. He has been quoted in various publications, including Workspan and Directorship magazines, Agenda, and Bloomberg.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.