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MANAGING DIRECTOR

## Designing Performance Stock Unit (PSU) Programs in Volatile Times

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*An expert Q&A with Aalap Shah, Managing Director at Pearl Meyer, and Tristan Brown, an executive compensation partner at Simpson Thacher, regarding designing effective performance stock unit (PSU) programs in volatile times. In a conversation with Practical Law's Jessica Cherry, Aalap and Tristan address the prevalence of PSUs, traditional PSU design elements, new PSU program structures that are better insulated against macro volatility, primary tax and legal issues related to PSUs, the benefits of compensation consultants and executive compensation practitioners working together to design innovative PSU programs that best serve their clients, and more.*

Performance stock units (PSUs) have surged in popularity since the accounting rules changed in the early 2000s requiring companies to expense stock options. As shareholders and proxy advisors called for greater alignment between pay and performance, PSUs fit the bill. Companies could create customized metrics tied to their strategic goals, and the customary three-year performance period prioritizes long-term value creation over short-term results.

But PSUs are not without their challenges, especially in times of significant volatility. Consider the numerous unanticipated macro events that have occurred in recent years:

- The housing crisis (2007)
- The financial crisis (2007)
- The collapse of the automotive industry (2008)
- The COVID-19 pandemic (2020)

Companies that tried to forecast performance three years out wound up with ineffectual targets and no crystal ball to predict what would happen next. Today, when the likely impact of the Trump Administration's agenda on the market seems almost impossible to predict, many companies are either:

- Reconsidering whether PSUs remain an appropriate vehicle (and in some cases electing to instead grant additional restricted stock with an elongated vesting schedule).
  - Reimagining their PSU programs by, for example:
    - incorporating a balanced scorecard of financial, operational, and market metrics;
    - introducing a formulaic adjuster that modifies targets up or down when pre-determined macroeconomic conditions fall outside a certain range;
    - establishing a flat portion of the leverage curve where if performance is achieved within a target range, 100% payout is earned;
    - extending the leverage curve (for example, by allowing payouts to be earned at 25-35% of target); or
    - exploring whether it is appropriate to shift from absolute goals, which present
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forecasting challenges, to relative goals, which eliminate the forecasting challenges but create potential challenges related to selecting the appropriate comparator group.

Aalap Shah is managing director at Pearl Meyer and advises public and privately held companies on executive compensation issues, with a focus on pay governance, pay-for-performance alignment, and incentive plan design. Aalap works with companies to design innovative PSU structures that create long-term value and mitigate the effects of macro volatility.

Tristan Brown is a partner at Simpson Thacher & Bartlett LLP where, among other responsibilities, he assists companies in designing and implementing executive compensation programs that serve their business goals, are tax efficient, and comply with legal requirements.

Jessica Cherry of Practical Law asked Aalap and Tristan to address:

- The prevalence of PSUs at public and private companies
- Why PSUs are so popular and whether that trend is likely to continue
- How PSUs are typically structured
- Design strategies for enabling PSU programs to better weather macro volatility
- The primary tax and legal issues associated with PSUs
- Specific plan provisions that companies wrestle with when designing their plans
- Disclosure requirements for public companies granting PSUs
- How often companies should revisit the design and structure of their PSU programs
- How compensation consultants and executive compensation practitioners can collaborate to design innovative PSU programs that meet their clients' objectives

## What percentage of public companies grant PSUs as part of their executive compensation program?

**Aalap:** In general, when you take a wide cut of the industry, approximately 70% of public companies are using some form of PSU. But when you break that down by sector, there are wide fluctuations. In the technology and life sciences sectors, for example, the adoption rate is probably closer to 10-20%. These companies generally prefer to use restricted stock or stock options, or a combination of these two equity award types.

PSUs are more prevalent outside the tech and life sciences sectors, with their usage depending on:

- The company's ability to forecast
- How much volatility exists within their business

Consider that the typical performance period for a PSU program is three years. That means that the company must set goals three years in advance. For a technology company or a life sciences company, that can be very difficult to do given the rapid pace at which things change, whereas for companies in other sectors, it may be easier.

## For companies that grant PSUs, what portion of total compensation consists of PSUs?

**Aalap:** The percentage tends to tick up every year. Disregarding size, PSUs comprise approximately 40% of total compensation for CEOs. Breaking that down further, the compensation mix for CEOs tends to be 70-75% equity compensation, which means that approximately half of their equity compensation comes from PSUs. Looking at the rest of the C-suite, that number dips a bit. It tends to be approximately 30-40% of the total compensation package.

The precise numbers are size-dependent. For example, for companies with greater than \$10 billion in revenue, PSUs tend to be approximately 45% of total compensation, and for companies with less than \$1.5 billion in revenue, PSUs tend to be approximately 30% of total compensation.

Part of the reason that larger organizations tend to have a higher percentage of PSUs is that larger organizations generally make larger equity grants. And with larger grants comes a greater desire and expectation from shareholders that equity compensation awards will be closely aligned with performance. PSUs are, therefore, a logical choice.

## Why have PSUs become so popular?

**Aalap:** The trend toward PSUs started about 20 years ago when the accounting rules changed and companies were required to start expensing stock options.

At the same time, there was a growing interest in creating greater alignment between pay and performance. While stock options have performance alignment in the sense that there is no value to the option holder unless the fair market value of the underlying shares (and therefore the spread value of the option) increases, there was a movement among shareholders and proxy advisory firms to tighten that alignment further.

In addition to the less favorable accounting treatment for options, some viewed unfavorably that an option holder could receive significant value due to:

- Holding an option with a low exercise price
- The option value increasing due to macro conditions despite poor company performance

On the other side of the coin, the company could perform very well but external factors could depress the stock market and the company's stock price.

PSUs were an appealing alternative because they provide:

- A tighter pay-performance linkage
- The potential to focus on actual company results rather than the vagaries of the market

The ability to select a menu of metrics, such as financial results, stock price, and total shareholder return (TSR), which enables companies to create closer linkage and accountability, was viewed favorably, and PSUs caught on dramatically.

They went from having a very low adoption rate (approximately 30% twenty years ago) because of their complexity and forecasting concerns, to the majority of companies adopting them and touting their usage to stakeholders to demonstrate their compensation program's strong pay-for-performance linkage.

**Tristan:** Companies also want to get a good score on say-on-pay and protect directors from

negative voting recommendations. One of the key determinants in scoring appears to be having PSUs or performance shares. Certainly, when companies do poorly, one of the key criticisms they hear from institutional investors or key shareholders is often “you should have PSUs.”

## Is the PSU trend likely to continue?

**Aalap:** In the vein of everything going around in circles, in response to several macro events that have occurred in rapid succession, including the housing crisis, the financial crisis, and the COVID-19 pandemic, many companies are now revisiting whether PSUs are an appropriate vehicle. For boards of directors whose three-year PSU programs for the company’s executives have gotten blown up, in some cases multiple times, because something happened to make the goals set at the outset inappropriate, they have found themselves in the unenviable position of being stuck between:

- Management teams urging them to revisit the PSU program’s goals
- The negative stance of shareholders and proxy advisors on adjusting performance goals mid-stream

We have had several conversations recently with companies that are considering moving away from PSUs because of uncertainties related to tariffs and other items on the Trump Administration’s agenda. Many are now:

- Wondering whether they over-corrected by relying so heavily on PSUs
- Considering alternatives

## For companies that have been granting PSUs but are now considering alternative equity vehicles, what factors should inform their decision?

**Aalap:** When making this assessment, companies must revisit their equity compensation programs overall. The most common combination of equity vehicles for executives right now is either:

- PSUs (or performance shares) and restricted stock
- PSUs (or performance shares), restricted stock, and stock options

Either of these combinations creates a nice balance between time- and performance-vesting. Companies that are considering moving away from PSUs because of the goal-setting challenges are in many cases considering granting additional restricted stock, but they acknowledge that this decreases the level of performance alignment. They are therefore looking for something to trade in exchange for that reduction of alignment.

Some companies are considering extending the vesting period of the restricted stock from three years to five years, in which case they can make the argument that in exchange for the reduction in direct alignment, they are:

- Bolstering the likelihood that their executives stay at the company for an extended period
- Creating long-term value for shareholders

Other companies are considering addressing the uncertainty by swapping out their three-year program for a one-year program with an additional two-year vesting schedule, mirroring a standard PSU which vests at the end of three years. Companies tend to entertain a shorter performance period when forecasting over a multi-year period proves challenging due to volatility or cyclicalities or when there is a desire to “bank” a payout in the near term to build credibility in the PSU program over the long-term. Since one-year performance periods are not the norm, adopting a shorter period is:

- Likely appropriate only in specific situations
- May raise the ire of shareholders and proxy advisory firms if not designed appropriately

## Why do certain public companies choose not to grant PSUs?

**Tristan:** Public companies elect not to grant PSUs for one of two reasons. Either they:

- Do not have to
- Are not ready to

Regarding companies that do not have to, consider a controlled company or even a company with a majority shareholder. These companies are not particularly concerned about say-on-pay. It might be somewhat embarrassing reputationally if they fail, but they typically do not lose sleep over it.

Also consider an emerging growth company (EGC). They are not required to hold a say-on-pay vote, and they get to keep their EGC status for a few years. EGCs therefore often delay implementing PSUs until they are forced to reckon with say-on-pay.

With respect to companies that are not ready to, this refers to situations where there is a lot of volatility or it is challenging to predict earnings, and it is therefore difficult to set performance goals. Sometimes, depending on the industry and other factors, this becomes easier over time. But for some companies forecasting three years in advance will always be challenging.

**Aalap:** We are seeing the forecasting issue play out in what is left of the 2021 IPO class. They have had the benefit of a grace period during which they were not required to hold a say-on-pay vote. And now they are struggling to figure out how to execute multi-year forecasts.

I had one client say to me, “It is difficult for me to forecast nine months out. Why would we try to forecast out three years?” Also, initially there tends to be some concern about PSUs being a complex instrument, and the concern that people will not fully appreciate their value. But that concern eventually fades away.

If you consider the current IPO class, they have experienced significant volatility since they became public. While they are aware/strong pay-performance linkage, many:

- Have delayed adopting a PSU program
- Are willing to take the hit from shareholders and proxy advisors

Part of their reasoning is they recognize that once they adopt a PSU program, they have opened the barn door, and it becomes increasingly difficult to go back to a fully time-based vesting program. That would require a lot of explanation in their proxy statement, and they would still likely get a negative reaction.

Some companies have established successive one-year performance periods where the company sets a goal for the first year, and then when that year ends, they set a goal for the second year, and then again for the third year, but the payout is backloaded to the third year. The challenges with these one-year performance periods are:

- If not structured correctly, they can trigger variable accounting
- There is potential overlap with the company's bonus program, which can create the perception of a double dip

For example, if the company uses an EBITDA performance metric in its bonus program, and performance is measured over a one-year period, the company should not also use the same EBITDA performance metric in a one-year performance period in its PSU program. While measuring EBITDA over one year for purposes of the bonus program and three years for purposes of the PSU program is probably alright (ISS does not love it, but it is not automatically deemed problematic), where there is exact duplication, the company is asking for proxy advisor commentary.

Some companies that are being pressed to adopt a PSU program, or who think it is a really good idea to do so, will take the forecasting noise out of the situation by using relative TSR as their metric. That takes some of the anxiety of forecasting out of the equation because they are comparing against an index rather than setting an internal goal. But this approach is not without its problems. Like options, while executives should be generally accountable for the company's stock price, things do happen that impact stock price that are outside the executive's control.

## Do private companies grant PSUs?

**Tristan:** I work primarily with private equity-backed companies, and they tend to use appreciation-only instruments such as stock options, or profits interests if they are structured as a partnership or a limited liability company (LLC), as opposed to full value awards. Private equity-backed companies also do not tend to use the same types of performance goals that you see with public companies. Their goals are more often based on the private equity fund's return on investment in connection with an exit or liquidity event, so measures such as:

- Multiple on invested capital (MOIC)
- Money-on-money (MOM) return
- Internal rate of return (IRR) percentage

These exit-focused measures do not lend themselves to a three-year or other limited time horizon. You do occasionally see PSUs with EBITDA-based or earnings per share (EPS)-based vesting in the private company context. For example, I have seen mature retail companies use PSUs when they do not feel that there is sufficient upside in options.

But companies that go this route must deal with the added complication that recipients are taxed on the PSUs when they vest (and settle) when, in the private company context, there is no liquidity, that is, no market in which to sell the shares to pay the taxes.

Therefore, you often end up with a double-trigger structure, such as the one that Facebook (now Meta) pioneered, where full vesting is tied to a liquidity event (such as an IPO or a sale) occurring within a certain number of years.

The bottom line is that you end up with a very complicated instrument, with a time-vesting

component and a performance-vesting component (based on EBITDA or EPS, for example) and a double-trigger structure (where no value is realized unless a liquidity event occurs within a certain period of time). This is why you do not see them very often.

**Aalap:** I agree that private-equity backed companies typically prefer to design their own unique instruments.

In the case of mature private companies, you sometimes see a PSU program with the following features:

- A three-year vesting schedule
- 50% payout at the end of three years
- 25% payout at the end of each of the next two years

This structure allows companies to forecast for three years, and the 50% payout at the end of Year 3 takes care of the tax situation, with the company funding the payouts over that three-year period. The company must of course understand going in that even though there will not be a liquidity event, they will have this funding obligation at the end of Year 3. The trade-off is that they receive the additional retentive element created by the payout streams at the end of Years 4 and 5. They therefore have an instrument with a retentive element for five years as opposed to three years.

## How are PSUs typically structured?

**Tristan:** Individuals are granted a target number of PSUs, and there is also typically a threshold goal (below which nothing is earned) and a maximum goal (above which nothing additional is earned).

Performance is typically measured over a three-year period, where nothing is earned until the end of the three-year period, and subject to exceptions for certain terminations of employment, the executive must still be employed at the end of the performance period (or when performance is certified) to earn the award.

Typically, there are two performance goals, or in some cases three. One of the metrics has typically been TSR or relative TSR, and the other(s) might be EPS or EBITDA or an operational metric. Recently there has been a trend toward including multipliers, which some companies use to incorporate an environmental, social, and governance (ESG) component. For example, after the overall score is determined, it may be adjusted up (if the ESG target is exceeded) or down (if the ESG target is not achieved) by 15% or 20%.

Some programs are designed so that each of the goals is all-or-nothing, that is, the company either hits the goal or it does not, and where performance falls in between the threshold, target, and maximum set points is irrelevant. Under this design, if the maximum goal is 200% of target, a participant receives the maximum payout only if performance hits the full 200%. If performance lands at 199%, the participant only receives the target (100%) award.

An alternative design includes straight-line interpolation, where what is earned depends on precisely where along the line performance falls, which is more typical because it more closely aligns with performance.

**Aalap:** It is common for companies to structure their PSU program in a manner that resembles their bonus program, except that performance is measured over a longer time

horizon.

A standard design includes a series of metrics, typically two or three, with each metric assigned a weighting. The greater the number of metrics a company uses, the harder it is to forecast all of them three years out, which is why companies use a limited number of metrics.

To mitigate the forecasting issue, as Tristan mentioned, some companies have introduced a new element to their design structure—a modifier. In these cases, the program may include:

- A primary metric, which is the most important
- Secondary metrics that are still important, but less so; therefore, instead of being weighted, the secondary metrics operate as modifiers

For example, a company may have a program that is based on operating income growth, but at the end of the three-year performance period, the payout is modified based on the company's TSR. (While TSR has traditionally been a primary metric, we are increasingly seeing companies use it as a modifier instead.) This design still recognizes the importance of TSR but de-emphasizes it somewhat by making it a modifier. Shareholders have accepted this design and now recognize it as a common practice.

## What are the most important design principles related to PSUs?

**Aalap:** First and foremost, to ensure pay-for-performance alignment, companies must select metrics that have a demonstrated relationship to long-term value creation. A company should not select a metric that will not impact the enterprise value of the company at a later stage. When designing PSU programs, we do a lot of analysis around which metrics have the closest relationship to that value creation.

The second thing a company needs to focus on is goal-setting. Typically, as Tristan mentioned, there are threshold, target, and maximum goals. The vast majority of companies use straight-line interpolation instead of what I call the bucket approach, since interpolation yields payouts that are more closely aligned with actual performance. If an EPS goal is \$3, and the result is \$2.99, under the bucket approach the payout may drop to 50%, but by using interpolation, the payout is close to 100% and the company is acknowledging the significant progress the executive team made.

To address the forecasting issue, some companies have elongated the leverage curve and created a target range. For example, instead of creating a \$3 EPS goal, they may make the target anywhere between \$2.90 and \$3.10 or between \$2.80 and \$3.20. If performance falls anywhere in that range, the executives receive 100% payout.

It is essential that the goals sufficiently drive performance, and that they are not either overly difficult or too easy. We advise our clients that, as a general guideline, they should aim to see a bell curve, where there is:

- An 80-90% probability of the threshold goal being achieved
- A 50-60% probability of the target goal being achieved
- A 10-20% probability of the superior goal being achieved

It is important for companies to monitor both metrics and the goal-setting process.

Over the long-term, the average payout should hover around 100%. If a pattern emerges of PSUs not paying out, or consistently paying out at the maximum level, the company should



revisit either metrics, or the goal-setting process, or both.

Companies also must consider the incentives created by the goals they set. In March 2024, Chemours Company was faced with a federal securities class action lawsuit after Chemours executives engaged in efforts to delay payments to vendors and accelerate the collection of receivables in part to achieve free cash flow targets in their PSU plan. While this case involved extreme behavior, and the company launched an internal review and took considerable steps to resolve the matter, it should nonetheless serve as an important reminder to companies to assess their PSU program's leverage curve and determine if it encourages excessive risk-taking.

## Are PSU programs typically limited to executives? Are there any advantages to granting them further down within the organization?

**Aalap:** Most PSU programs are reserved for executives due to two issues:

- *Complexity:* It is difficult to explain the leverage framework to the broad employee population and why an employee could get a 2x payout and could get nothing.
- *Line of sight:* It can be challenging to demonstrate that an individual at a lower level within the organization can truly impact EPS, for example.

Some companies have experimented with granting PSUs further down in the organization because people like the leverage structure. The metrics may not be the same as those to which the executives are subject, although they should be related in some way, so there is linkage throughout the organization. Some companies have found broader PSU programs to be a very powerful tool in special circumstances, such as when:

- The company is launching a new product and there are milestones the company must achieve
- There is a need to create a more performance- oriented culture

While this experimentation is currently being undertaken by a very small group of companies, PSUs can be a very powerful tool for companies to use in these special situations.

## What are the primary tax and legal issues associated with PSUs?

**Tristan:** The taxation of PSUs is relatively straightforward. An executive receiving PSUs is not taxed at grant. Rather, the executive is subject to federal income tax at the end of the performance period (and any vesting period) when the PSUs are settled in shares of the company's common stock. At that time, the fair market value of the underlying shares is taxed as ordinary income. Employment taxes are due at the time of vesting on the fair market value of the shares at that time. For PSUs that settle shortly after vesting, the federal income tax and employment taxes are imposed at approximately the same time.

The company has a withholding obligation for both:

- The ordinary income tax
- Employment taxes (both the employer and employee portions)

When the executive later sells the shares, the executive will recognize a capital gain or loss which will be short-term or long-term, depending on how long the executive holds the shares.

Section 409A applies to PSUs, which means that they must be structured either to:

- Be exempt from Section 409A
- Comply with Section 409A's onerous requirements

As is often the case when Section 409A applies, the tax implications dictate program design. Typically, PSUs are designed to be exempt from Section 409A under the short-term deferral rule, which means that they must in all cases settle within 2 ½ months following the end of the year in which they vest (so for calendar year performance periods, settlement must generally occur by March 15 of the following year). Assuming that the program is intended to comply with the short-term deferral rule, then a key design consideration is whether the PSUs will be earned (vest):

- At the end of the performance period
- When the compensation committee certifies performance results and amounts are paid

Companies must ensure that the time between the end of the vesting year and the payment date may never exceed 2 ½ months. This means that if the performance period ends on December 31 and the compensation committee certifies results and pays out in April, there must be a continued service requirement through the certification date to comply with the short-term deferral rule. Alternatively, if certification and payment will always occur by March 15, then the continued service requirement can extend either through the end of the year or through the certification date, as both alternatives satisfy the short-term deferral rule.

For public companies, from a securities law perspective, the shares underlying the PSUs are generally:

- Coming out of the share reserve of a shareholder approved plan
- Registered on Form S-8

While it is always important for companies to monitor their share reserve, in the case of PSUs, where individuals can earn more than the target number of shares, this is even more crucial. To avoid any potential problems, when tracking the share reserve, we recommend that companies debit the maximum number of shares that could be earned under the PSU program, that is, if the plan provides that the maximum payout is 200% of target, then that is what should be debited for tracking purposes. A lot of companies do not follow this protocol. Rather, they debit the target number of shares, which can lead to problems if:

- They are not watching their share reserve carefully
- The plan contains an evergreen provision, but they are not paying close attention to the precise timing of the increase in shares under the evergreen provision.

If performance exceeds target, these companies can find themselves with a share deficit when the time comes to settle the PSUs. Often this means that the company has enough shares to cover the PSUs, but does not have enough shares to cover their annual award grants, putting them in the embarrassing situation of having to tell their executives that either:

- They will receive their annual equity grant at the scheduled time, but it will be subject to shareholder approval at the next annual meeting
- Since the company does not have enough shares left to make the annual grants, they will receive their award after the annual meeting, assuming they are able to get more

shares at that time

They are in real trouble if they do not even have enough shares to cover the issuance of the PSU shares.

**Aalap:** The issue of not having enough shares available under the Form S-8 at the time of settlement is the most common issue we see, especially for companies that are adopting PSUs for the first time.

I have even been in the situation where the company did not have enough shares to cover the PSUs. We had to do some fancy maneuvering in that case, converting the PSUs to a cash-settled instrument. It was not a great situation to be in. The lawyers were able to figure it out, but the company incurred a significant accounting charge. Sometimes companies are unaware that this can happen, and it really catches them off-guard. It is therefore a critical point to raise with clients up front.

## When drafting a PSU plan, what are the provisions that companies grapple with the most?

**Tristan:** There are two key provisions that companies grapple with:

- What happens if an executive's employment terminates during the performance period
- What happens if a change-in-control occurs during the performance period

With respect to termination, the general rule is that if the executive is not continuously employed through the end of the performance period, they forfeit the award. There are often exceptions to the general rule for terminations due to death, disability, retirement, or less often, terminations without cause or for good reason.

In these cases, the executive typically receives pro rata vesting based on actual performance through the portion of the performance period that the executive was employed. I have seen programs where companies pay out based on target performance (usually pro rata as well), but only in cases of death or disability. Also, because ISS does not like to see vesting periods of less than one year, oftentimes the pro rata payout only happens if the termination occurs after the first year of the performance period. Otherwise, the executive forfeits the award.

With respect to a change-in-control, the two most common designs are:

- The award is deemed earned at target as of the date of the change-in-control, often coupled with time-based vesting until the end of the performance period if the buyer assumes the award. Generally, the executive is required to be employed by the buyer at the end of the performance period, but often there are carve-outs for good leavers who are terminated after the change-in-control but before the end of the vesting period.
- The company cuts off the performance period on the date of the change-in-control and measures performance as of that date. By calculating the award based on actual performance, rather than target, this design better preserves pay-performance alignment. Some companies also include a time-based vesting component until the end of the performance period, thereby adding a post-change-in-control retention element.

**Aalap:** Companies should also consider what the rules of the road should be when special circumstances arise mid-flight, that is, in the middle of a performance period. For example, companies should give thought to establishing a formulaic mechanism that adjusts

performance goals if an acquisition, divestiture, or natural event occurs that significantly impacts results.

If there is no such mechanism in place, companies should not be afraid to use discretion, even though discretion has become a bit of a dirty word. While discretion is rarely used in the PSU context, in those situations where something happens that no one envisioned, exercising discretion is the appropriate thing to do.

## Are public companies required to disclose information about their PSU programs, including their performance goals, in their proxy statements?

**Tristan:** Yes. PSUs must be disclosed in the year of grant in three of the executive compensation tables:

- The Summary Compensation Table based on the grant date fair value at target, with a footnote disclosing the value if maximum performance is attained.
- The Grants of Plan-Based Awards Table, including what could be earned at threshold, target, and maximum levels of performance.
- The Outstanding Equity Awards at Fiscal Year-End Table, including the number of unvested PSUs and their payout value. The default rule requires the company to disclose the payout value based on achieving the threshold performance goal. However, if in the previous fiscal year, PSUs with the same performance goals exceeded the threshold goal, then the disclosure must be based on the next higher performance measure (target or maximum, as applicable). In practice, many companies disclose the target payout value in this table.

With respect to performance goals, if disclosing the target goals in the Compensation, Discussion, and Analysis (CD&A) section upfront would cause competitive harm, the company is not required to disclose them (and almost no one does). However, once the performance period is complete and performance against goals has been determined, the company must disclose in the CD&A a very clear description of what the goals were and how vesting occurred. But this disclosure is backward-looking as opposed to forward-looking.

**Aalap:** Despite not being required to disclose goals upfront, it might be in the best interest of the company to disclose the PSU metrics where there is a desire to signal to shareholders that the chosen metrics strengthen the alignment between the executives' interests and their own.

## Are there any design features that ISS and Glass Lewis feel strongly about or disfavor?

**Aalap:** ISS and Glass Lewis each have certain preferences regarding PSU program design. ISS strongly disfavors companies using the same metrics in both their short-term and long-term programs, even though the performance periods are different lengths. Glass Lewis also dislikes this practice.

With respect to three-year programs, ISS also dislikes catch-up features, where a company creates a series of one-year performance periods, and if the company fails to achieve its goals in the first year, but achieves them in the second year, the company pays out both the first

and second tranches. ISS prefers that if the company misses its targets in any year, there is no payout for that year, and no ability to catch up.

Glass Lewis strongly disfavors PSU plans with a single metric, and they have provided extensive commentary on this. They like to see at least two metrics in any PSU program.

**Tristan:** There are three other issues to be aware of:

- None of the proxy advisors likes to see discretion surrounding what happens on a change-in-control
- They all want to see a vesting period of at least one year
- They do not want dividends or dividend equivalents to be paid on awards before they are earned

## How often should companies revisit the design and structure of their PSU programs?

**Aalap:** Companies should revisit their PSU programs annually. This does not mean that they should do complete restructurings each year. But they should:

- Check in with market realities
- Ensure that performance measures continue to align with the company's business outlook and strategy
- Make sure that the plan's overall structure, including who is eligible to participate, remains appropriate
- Assess whether the goals for the prior year were sufficiently established and, if not, what changes should be made
- Track the evolving proxy adviser views on PSUs.

For instance, in late 2024 both ISS and Glass Lewis polled their respective client bases regarding the extent to which PSUs and time-based equity align with shareholder interests. The results revealed a growing interest in using longer vesting terms for time-based equity. This led to Glass Lewis softening its stance on the need for PSUs to be central to a long-term incentive compensation structure. (ISS has indicated that it will continue to monitor client sentiment and will reconsider the issue in 2026.)

Companies that are considering a potential overhaul of their PSU program should probably wait until the end of a three-year performance period, so they have a chance to see how the program plays out, before deciding to redesign the program completely.

We also advise our clients to seek feedback from their participating employee population by asking questions such as is the PSU program meaningful to you and do you think it is working well?

## How can compensation consultants and executive compensation practitioners collaborate to design and craft innovative PSU programs that meet their clients' objectives?

**Tristan:** As an executive compensation practitioner, it is very helpful to have access to the compensation consultant the company is working with. Sometimes executive compensation practitioners are provided with a high-level overview of a PSU program from which they are

supposed to draft a plan document. While they know there is a compensation consultant working in the background, the executive compensation practitioner is provided with no term sheet and nothing is fleshed out in the information provided. Providing an executive compensation practitioner with access to the compensation consultant enables better communication and promotes efficiency. The consultant can:

- Clarify and explain their rationale for various design features
- Direct the executive compensation practitioner to four or five precedents they can review or use as a starting point, rather than requiring the executive compensation practitioner to reinvent the wheel at the client's expense

**Aalap:** Collaboration is crucial with respect to creating both the right design and an effective communication strategy.

From a design perspective, especially if we are considering a design that is not plain vanilla, we always want to consult with counsel to ensure that everyone understands the full spectrum of legal and tax implications. Often group brainstorming sessions lead to refinements to the plan's design that serve both the company and its executives better.

From a communication strategy standpoint, whether the client is a public company drafting the executive compensation disclosure for their proxy statement or a private company drafting FAQs explaining the complexities of its first PSU program, it is always valuable to leverage the attorney's experience and get their perspective on what is most important to highlight to the applicable audience.

This candid communication opens the door to better collaboration, reduces the chance of unintended consequences, and ultimately benefits everyone.

## About the Author

Aalap Shah is a managing director at Pearl Meyer. With more than 20 years of experience, Aalap advises public and privately held companies on executive compensation issues, with focus on pay governance, pay-for-performance alignment, and incentive plan design. Of particular interest is the intersection between business strategy, people strategy, and compensation strategy, believing alignment of all three is required to design effective programs.

## 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.