Re-Thinking Long-Term Performance Plan Periods Within the Context of COVID-19

– BRIAN LANE, LINDA PAPPAS AND PETER RINGLEE

This Viewpoint is one in a series of ongoing articles Pay Governance will be publishing regarding the impact of COVID-19 on compensation programs. All of our Viewpoints can be found on our website at www.paygovernance.com.

Introduction

On March 23, Pay Governance released a Viewpoint article discussing COVID-19's impact on executive compensation programs. The article — "Everything Should Be On The Table" — outlined several high-level initial considerations that should be "on the table" as possible responses to the disruption caused by COVID-19.

It is still too early to understand the full impact, financial and otherwise, that the pandemic will have. Its effect on business and the appropriateness of potential responses will vary by industry and company. Our objective in presenting these considerations broadly is to arm compensation committees with a toolkit of possible adjustments and a general understanding of the benefits, drawbacks, and implications of any such actions.

This Viewpoint explores one consideration in detail: re-thinking long-term performance periods within performance stock unit (PSU) designs. We present potential alternative approaches to the traditional three-year cumulative measurement.

Prevailing practice — particularly for large companies — provides for PSUs to vest and be earned contingent upon actual company performance compared to an established goal measured cumulatively over a three-year period. Currently, variations to this design where performance is measured over shorter periods (e.g., three annual measurement periods) are less common. These variations can be useful in situations where setting long-term goals is difficult. However, they are often employed at the risk of negative scrutiny from proxy advisors and/or come with overarching three-year performance measures, such as a relative total shareholder return (TSR) modifier, to strengthen the focus on the long term.

Does the increase in uncertainty associated with COVID-19, which presents a fundamental challenge to setting reliable long-term goals, warrant consideration of shorter performance measurement periods on a temporary basis? Long-term plans can lose motivational and incentive value on both sides of the spectrum (i.e., if the goal is achieved too early or if the goal is perceived as unachievable). Both scenarios diminish one of the key objectives of long-term performance awards: encouraging and rewarding sustained long-term performance.

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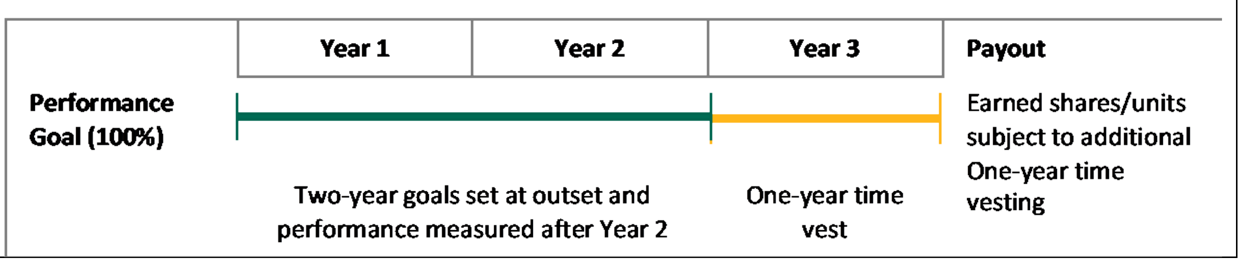
Our discussions with client compensation committees thus far have focused on an overarching theme: continue to motivate and incentivize management through performance-based pay that maintains alignment to the shareholder experience while acknowledging the disruption felt by many company stakeholders, including its community. The alternative approaches presented below seek to adhere to this theme while recognizing the challenges and uncertainty associated with the COVID-19 pandemic.

Alternative Approaches

Below, we present four alternatives to the traditional three-year cumulative performance cycle. Each comes with its own set of pros, cons, and broader implications, including external considerations which we discuss further below. The themes presented here are not meant to be exhaustive, and there are other design variations that may work just as well for a particular company's circumstances.

- ***Alternative 1*** — a two-year performance measurement period with one year of additional time vesting
- ***Alternative 2*** — three distinct annual performance measurement periods, with goals set annually (i.e., at the beginning of each year) within a three-year plan period
- ***Alternative 3*** — an extension of Alternative 2, where three annual performance measurements are combined with an overarching three-year relative performance goal (often relative TSR)
- ***Alternative 4*** — awards vest upon performance achievement (as opposed to a pre-determined date) with a minimum time vesting requirement

Alternative 1: Two-Year Performance Period with Additional Time Vesting		
Overview	• **Goal setting:** Two-year performance goals established at the outset of the plan cycle • **Performance measurement:** Actual performance measured against goals after completing the two-year period • **Vesting:** Earned amount subject to additional time vesting (e.g., one-year)	
Considerations	**Pros**	**Cons**
	• Longer-term orientation than designs utilizing one-year performance • Minimal departure from traditional three-year approach	• Setting reliable two-year goals may still prove challenging • Institutional investors and proxy advisors prefer three-year periods
Illustration		

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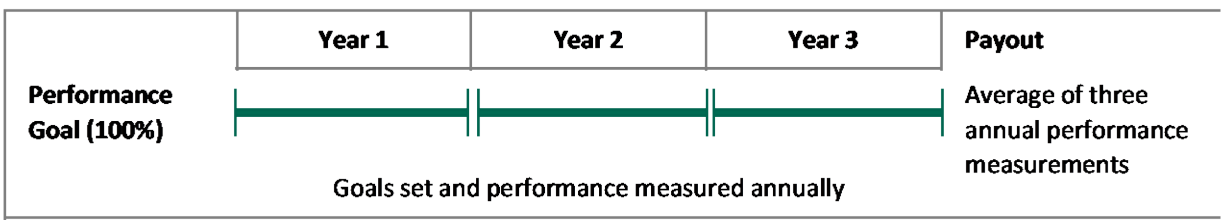
<table>
<tr><th colspan="3">Alternative 2: Three Annual Goals</th></tr>
<tr><td>Overview</td><td colspan="2">• Goal setting: Three annual goals set for each year of a three-year performance cycle, with goals set at the beginning of each year
• Performance measurement: Measured annually, final payout determined at the end of the third year via one of two approaches:
a. “Banking” Performance: final payout determined by applying the average of three annual performance measurements to the payout scale
b. “Banking” Payouts: final payout determined by the average of three annual payout measurements (i.e., performance for each year applied separately to the payout scale)
• Vesting: 100% of earned amounts vest upon completion of the three-year cycle</td></tr>
<tr><td rowspan="2">Considerations</td><td>Pros</td><td>Cons</td></tr>
<tr><td>• Ability to set goals annually
• Mitigates risk of losing motivational/incentive value</td><td>• Proxy advisor criticism for short-term nature of long-term incentive (LTI) goals
• Increased risk of criticism concerning overlapping metrics (e.g., if annual bonus and LTI metrics are the same)</td></tr>
<tr><td>Illustration</td><td colspan="2">
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<table>
<tr><th colspan="2">Alternative 3: Three Annual Goals Combined with Three-Year Relative Performance Modifier/Goal</th></tr>
<tr><td>Overview</td><td>• Goal setting: Same as Alternative 2 with an overarching three-year cumulative goal or modifier measuring relative performance
• Performance measurement: Same as Alternative 2 with a three-year cumulative relative goal (i.e., performance measured relative to peers or an index) established at the outset of the plan cycle
o Relative measurement (commonly relative TSR) can be incorporated with one of two approaches:
▪ Modifier: Payout calculation of three annual periods modified up or down (e.g., 0.8x – 1.2x) based on three-year relative performance
▪ Additive: Weighted goals (e.g., 75% on three annual goals and 25% on a three-year cumulative relative goal)
o If using relative TSR, “best-practice” designs incorporate a payout cap of 100% of target for negative TSR
• Vesting: 100% of earned amounts vest upon completion of the three-year cycle</td></tr>
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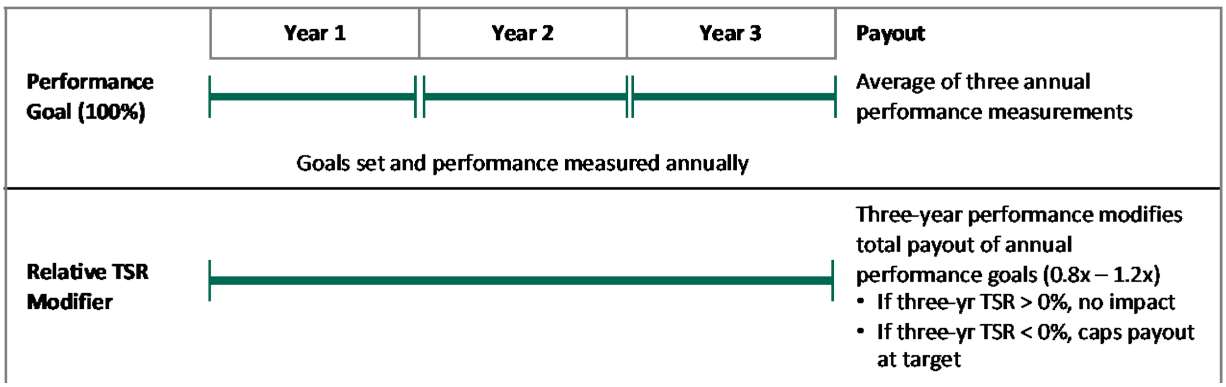
Alternative 3: Three Annual Goals Combined with Three-Year Relative Performance Modifier/Goal (continued)

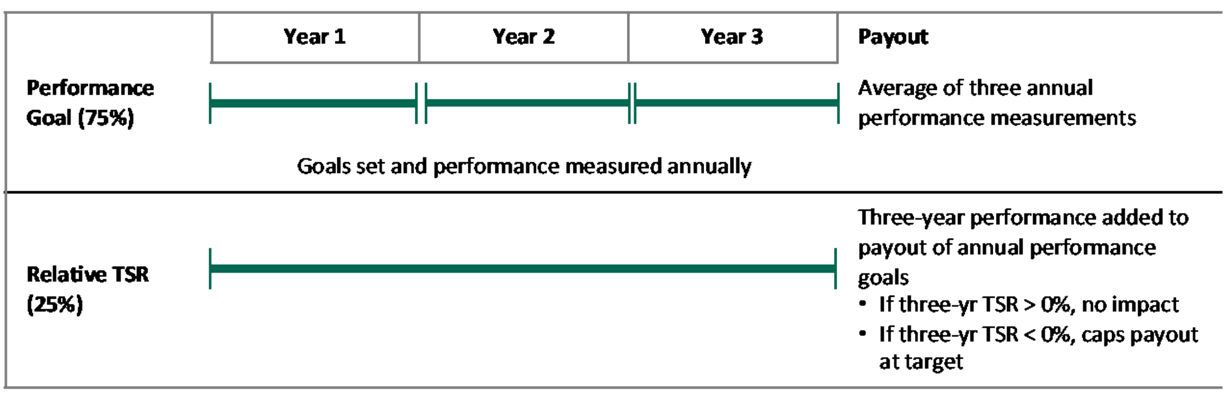
	Pros	Cons
Considerations	• Three-year focus without the the need to set long-term goals • Mitigates concern from proxy advisors and institutional investors over short-term goals • Balances operating performance with shareholder experience (if relative TSR)	• Challenges associated with relative metric (peer/index selection, appropriate level for target payout, etc.) • Less line of sight when compared to internal performance

Illustration

Modifier Approach:



Weighted Goal Approach:



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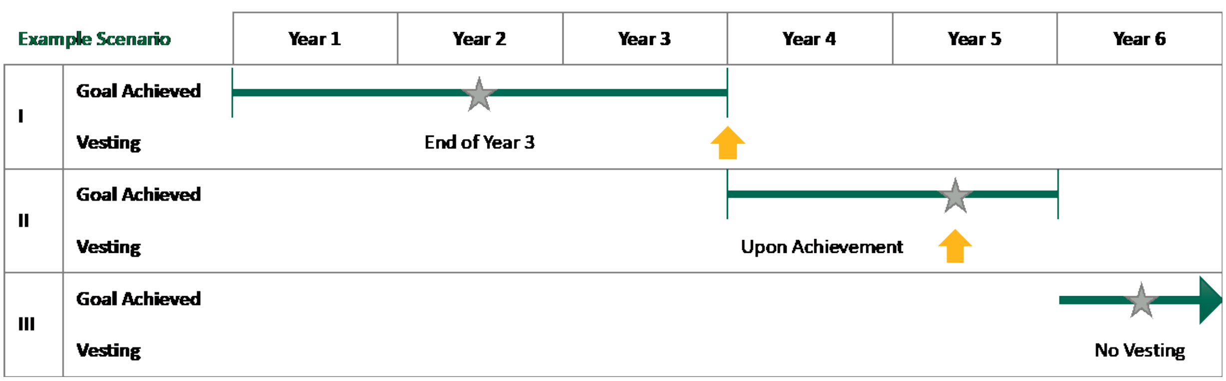
Alternative 4: Vesting Occurs Upon Performance Achievement with Minimum Time Vest		
Overview	• **Goal setting:** Long-term goal set at grant • **Performance measurement:** Actual performance tracked against goal, which must be achieved within the maximum plan term • **Vesting:** Upon performance achievement but not earlier than the minimum time vesting requirement • **Example:** PSUs vest with achievement of (i) 30-day average stock price representing 15% premium over pre-COVID levels within five years from grant and (ii) three years of continued employment o If performance is achieved before the end of year three, shares vest at the end of year three. Otherwise, shares vest upon performance achievement after three years, and there is no vesting if achievement does not occur until after year five • Such awards work well with singular financial/strategic milestone-type goals (e.g., break-even earnings, strategic milestones, absolute stock price/shareholder value creation goals)	
Considerations	**Pros** • Mitigates time constraints on performance achievement • Works well with singular financial or strategic performance milestones • Maintains time vesting component	**Cons** • Potential for prolonged "outstanding" period • Dramatic departure from current design for many companies • More difficult to return to traditional design in more stable times
Illustration	**Illustrated via various scenarios of timing of performance achievement** 	

External Considerations

Current voting policies among proxy advisors and several institutional investors favor either multi-year or three-year performance periods for LTI or PSU plans. While decisions should be made on the basis of what is appropriate for each individual company's circumstances, it is wise to fully understand the potential reactions from external parties.

Historically, proxy advisor criticisms of shorter PSU measurement periods have taken the form of a "red flag" or have potentially served as a contributing factor to an "against" Say on Pay vote recommendation (particularly where an overarching pay-for-performance disconnect has been identified). Heightened scrutiny may also result from the combination of PSUs which utilize a one-year metric that overlaps with the annual incentive program (i.e., “double dipping”).

Additionally, our review of proxy voting policies for the top 15 largest institutional investors (as defined by assets under management) suggests that about 20% of these firms, representing over $8 trillion in assets under management, prefer a three-year performance period.

If a company is contemplating a temporary shift from a traditional three-year performance period to an alternative design with a shorter measurement period, as with any significant change to an executive pay element, it may be prudent to provide strong disclosure of the rationale and outreach to the company’s largest shareholders to discuss the basis for these decisions.

It is yet to be seen whether the stance of proxy advisors and institutional investors on the length of long-term performance periods will shift in light of this unprecedented level of uncertainty. However, now more than ever, we anticipate these parties will expect companies to retain focus on the shareholder experience and the longer-term investor perspective.

Looking further ahead, as global markets stabilize and a sense of normalcy returns to day-to-day operations, companies may consider developing a road map to returning to multi-year goals in order to encourage longer-term alignment between executive pay programs and company performance.

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Pay Governance will return to these and other potential executive compensation strategies in subsequent Viewpoints, blog posts, and other communications. We will provide weekly updates on our website: paygovernance.com.