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IS A THREE-YEAR PERFORMANCE PERIOD REALLY LONG-TERM?

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Over the last 10–15 years, we have observed a sea change in long-term incentive (LTI) award design. The role of stock options has dramatically declined, generally replaced by performance share or unit (PS/U) awards. Factors driving this change included the adoption of expensing for stock options under FAS 123R, increased shareholder focus on share burn rates and dilution, and growing external pressure from proxy advisors to increase the portion of long-term incentive awards that are considered "performance-based" (the fact that ISS does not view stock options as performance-based is a topic for another day!).

Based on analysis of public disclosures for 250 large publicly traded companies, in Meridian Compensation Partners' 2016 Corporate Governance & Incentive Design Survey*, 94% of companies use PS/U awards, most often to deliver more than 50% of LTI value to top executives (meanwhile, stock option use has declined to 58% of companies and deliver only about 20% of LTI value). These PS/U awards typically measure company performance based Total Shareholder Return (i.e., stock price appreciation plus dividends) relative to a peer group, or based on an absolute GAAP-type financial measure, with most all measuring performance over a three-year period.

Wait! Hold on! Since when is three years long-term? And how did that become the standard for "long-term" incentive awards? It appears that in trying to satisfy the proxy advisors, we've lost sight of the long-term!

First of all, three years is not long-term. Institutional shareholders may increase or decrease their holdings in a company multiple times during a three-year period, but it's unlikely these investors view three years as long-term. And while not all investors have the same preferred holding period as large pension funds, or certain private equity groups, even activist investors promote a long-term strategic focus.

So what's keeping us here? Several reasons come to mind. In general, conforming to "market norms" is a likely culprit. Many companies make design decisions within the context of competitive market practices. The decision to measure performance over three years is an easy sell when it is the prevalent practice. It would be more difficult to sell management or the Compensation Committee on a longer measurement period given that it's a small minority practice.

A more practical issue is the need to set fixed, three-year financial goals when using a PS/U. While most (85%) companies set multi-year goals, a vocal minority have succumbed to the challenges and uncertainty of setting goals three years into the future, by using an average of three one-year goals. Extending the performance period beyond three years would only serve to increase the challenge and uncertainty of this situation. Resorting to one-year goals set annually will usually result in the proxy advisory firms making adverse comments on this approach.

However, the goal-setting argument does not work when relative TSR is the performance measure (it's the most prevalent measure, used by 57% of companies), since no goal-setting is required; decisions instead focus on the shape of the award payout curve, which is generally defined by the company's percentile positioning or ranking versus peers. One could argue that for relative TSR plan designs, it should be easier to use a longer performance measurement period. Yet, only 2% of companies have performance periods longer than three years.

Also, shareholders may have concerns that extending performance periods would increase share dilution, as awards would be outstanding for a longer duration (this may be a concern for stock options, given their typical ten-year life). The strength of this argument is moderated by the fact that participation in PS/U awards is typically limited to senior executives.

Another external consideration is the impact a change in the performance period might have on the results of proxy advisor evaluations of the company's "say on pay" proposals. For example, ISS's "relative degree of alignment" ("RDA") test measures the alignment of CEO pay and TSR over a three-year period. Similarly, the new "financial performance" tests that ISS announced for 2017 will also measure three-year performance across a variety of financial metrics.

Finally, there is a perception that if the performance period is longer than three years, then the award recipients may assign a discount to the targeted value of the awards. We frequently hear companies express concern that the retention value or recruiting value of the awards is lessened if vesting (performance-based or service-based) is too long.

So, is a three-year performance period really long-term? Of course not, but that's where we find ourselves. As your company endeavors to balance multiple objectives through its LTI program, we think it makes sense to consider if performance should be measured over a period that more closely aligns with most investors' perspectives of what "long-term" means. Take steps to evaluate if program design changes should be made—e.g., engage shareholders, break free from market practices, consider the specific facts and circumstances of your company's situation. Most importantly, don't be deterred by the obstacles to implementing incentive plan design features that help meet your compensation and strategic business objectives.

*250 large publicly traded companies in the Meridian Compensation Partners' 2016 Corporate Governance & Incentive Design Survey; median revenues and market capitalization of $15.3 billion and $20.1 billion, respectively.

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