Equity Incentive Plans: The Basics

Introduction to Equity Incentive Plans

Equity incentive plans, also referred to as equity compensation plans, are legal documents drafted to permit a company to grant one or more types of equity incentives to executives, directors and/or key employees. For public companies, their equity incentive plans are typically drafted as omnibus plans (i.e., they authorize many different types of long-term incentive (LTI) vehicles). This article provides an overview of equity incentive plans, how they work, their role in business, types of awards, implementation considerations, implications of a company's stage in its life cycle, design considerations and proxy advisor considerations when adopting or administering an equity incentive plan.

Definition and Purpose of Equity Incentive Plans

Equity incentive plans are plans which allow for the grant of LTI vehicles which either track the company's stock or can be paid out in company stock. They typically award company stock as it helps align executives and key employees with shareholders and generally has fixed accounting for the company.

The Role of Equity Incentive Plans in Modern Business

For most companies, total compensation consists of several elements including base salary, annual incentives/short-term incentives, and LTIs. For most companies, the LTI element represents the largest part of total compensation for their top executives. As such, it is used for many purposes including to attract and retain exceptional executives and key employees and to motivate them to achieve the company's long-term strategic and operational goals and objectives.

Types of Equity Awards in Equity Incentive Plans

Generally, most equity incentive plans allow for multiple types of equity awards to be granted. As a result, most equity incentive plans are regarded as "omnibus" plans as they allow for multiple types of equity awards. As these equity awards are typically used as incentives over a period longer than one-year, they are also sometimes referred to as long-term incentives. Most equity plans offer appreciation-type awards (an award that allows the recipient to benefit from the appreciation in the stock price after the date of grant, like a stock option), full-value type awards (an award that entitles the participant to receive a full share of Company stock if certain vesting requirements are satisfied, such as restricted stock or restricted stock units) and often permit performance measures to be attached to the vesting of both types of awards. Long-Term Incentive (LTI) Compensation: The Basics - Meridian Compensation Partners (meridiancp.com)

Stock Options

Stock Options provide employees the opportunity to purchase company stock at a fixed price at any time during a future exercise window of time. A stock option has no intrinsic value if stock price does not increase. However, it becomes more valuable as the company's stock price increases, aligning the interests of employees and shareholders. Stock options provide a future potential for financial gain based on company stock price performance.

There are two primary types of stock options: Incentive Stock Options (ISOs) and Non-Qualified Stock Options (NQSOs). ISOs meet the requirements of Section 423 of the Internal Revenue Code and have certain tax advantages for employees, provided certain rules are followed. While the majority of LTIPs provide for the ability to grant ISOs, very few companies actually grant ISOs given some of their disadvantages. As a result, the majority of stock options granted are NQSOs, stock options that do not qualify as ISOs.

Stock Appreciation Rights

A Stock Appreciation Right (SAR) entitles an employee to the appreciation in value of a specified number of shares of employer stock above an “exercise price” or “grant price” over a maximum specified period of time, though SARs typically can be exercised once vested. When exercised, the appreciation is typically paid out in the form of shares of company stock. SARs act very much like stock options except that an employee does not have to pay an exercise price in order to exercise the SAR as they would with a stock option.

Restricted Stock

Restricted stock is an award of employer stock that is subject to vesting requirements and transferability restrictions (generally at no cost to the employee). Typically, restricted stock is granted with voting and dividend rights. Since restricted stock is an award of shares of company stock, it provides employees with an ownership stake in the company, better aligning employees with shareholders.

Restricted Stock Units

Restricted Stock Units (RSUs) are commitments to grant a specific number of shares or the cash equivalent to employees at a future date. The value of RSUs directly correlates with the company’s stock price, providing a clear incentive for employees to contribute to the company’s success. Unlike base salary, RSUs create a longer-term retention and performance incentive, as they often vest over time and may also be tied to performance milestones.

Performance Shares, Performance Units, Performance Share Units

Performance Shares and Units (PSUs) are awards contingent on meeting specified performance objectives over a multi-year period. The payout can vary based on the degree of achievement of these objectives. PSUs provide a direct link between the rewards offered to employees and the company’s performance over a longer term (typically three years), emphasizing a focus on achieving strategic goals and objectives as opposed to the immediate rewards provided by a base salary.

LTIPs offer a structured approach to incentivize and retain key employees by aligning their financial interests with the long-term success of the company, distinguishing them significantly from base salaries and short-term bonuses, which do not typically foster a long-term outlook in employee performance and retention.

Other Stock-Based Awards

Many equity incentive plans also include a “catch-all” type of award, often referred to as an “Other Stock-Based Award.” This type of award typically is fairly flexible and can be used to grant any type of equity-based award to participants. This can be handy if a Company wants to grant a type of equity award that is not specifically identified in the equity incentive plan.

Design Considerations for Equity Incentive Plans

When designing equity incentive plans, there are several issues that must be considered, including the size of the share pool for the plan, how the plan administrator will be permitted to operate, which current best practices should be included and what types of LTI vehicles should be included. [Drafting a Modern Equity Incentive Plan - Meridian Compensation Partners (meridiancp.com)]

Determining the Size of the Share Pool

Determining the size of the equity incentive plan's share pool is both an art and a science. Typically, companies look to see what level of dilution would be acceptable to their shareholders and proxy advisors as well as the number of shares they are likely to need over the next several years. Sometimes, these numbers are the same, but often they are not. Often the number of shares that a company needs for the next several years is outside the bounds of what shareholders or proxy advisory firms would support. In such case, a company typically reduces the number of shares requested, recognizing that this will cause it to come back to shareholders sooner to ask for additional shares. Companies need to request at least an annual grant's worth of shares, which should get the company to the next annual meeting where it can again request more shares. Most equity incentive plans request shares that are sufficient to cover between one and four years' worth of annual grants.

Sometimes companies with a significant number of shareholders that follow one of the two major proxy advisors (ISS and Glass Lewis), will size their share pool so that it passes the tests of the appropriate proxy advisor(s).

Considerations for Plan Administrators' Discretionary Authority

Equity incentive plans generally should provide a significant amount of flexibility for companies to run and administer their equity plans as they see fit. When it comes to the plan administrator, that should also hold true. Plan administrators generally should be provided with the maximum amount of flexibility that does not contradict current best practices, technical requirements, or necessary proxy advisor policies. Doing so will ensure that the equity incentive plan can be administered in many more situations than those that are considered when a plan is drafted and approved by shareholders.

Current Equity Incentive Plan Best Practices

Best practices for equity incentive plans are constantly evolving. In early 2024, the best practices for equity incentive plans include:

- Having a minimum one-year vesting period for LTI vehicles grantable under the plan.
- Ensuring that dividends/dividend equivalents are only paid when the shares underlying the associated award are earned/vest.
- If directors are eligible to receive awards under the plan, including an annual limit on either awards or total compensation for directors.
- Including broad discretionary authority for the Company to accelerate vesting of awards.
- Not including an evergreen provision to replenish plan shares according to a formula.
- Not including reload stock options.
- Not including the ability to reprice underwater stock options or SARs without shareholder approval.

Types of LTI Vehicles to Include

As mentioned above, most plans' LTI vehicles include appreciation awards (such as stock options) and full value awards (such as RSUs). That said, most equity incentive plans are drafted to be fairly broad so as to provide maximum flexibility because if a company later decides to use an LTI vehicle that is not included in the plan, it could be forced to take an amendment to permit such LTI vehicle to shareholders for approval. Consequently, equity incentive plans generally include the following types of LTI vehicles: stock options (both ISOs and NQSOs), SARs, restricted stock, RSUs, performance shares, performance units, PSUs and other stock-based awards. For ISOs, the plan also needs to include a stated limit on the number of shares that can be granted as ISOs, which most plans include, even though most companies do not grant ISOs.

Implementation and Management of Equity Incentive Plans

Implementing a new equity incentive plan is a bit of an administrative undertaking. The plan itself needs to be drafted, approved by the Company's board of directors and then approved by the Company's shareholders. Once the plan is approved by shareholders, a Company then must register the shares grantable under the plan (often on a Form S-8), get the plan up and running and then maintain the plan going forward to ease the administrative burden.

Addressing the Challenges in Setting Up Equity Incentive Plans

Equity incentive plans need to be drafted to be as flexible as possible and generally we recommend that they include multiple types of LTI vehicles to increase the plan's flexibility. Having all possible LTI vehicles included in an equity incentive plan avoids having to go back to shareholders later to get approval to add any new LTI vehicles that might be desired.

Using a Stock Plan Administrator vs. Internal Tracking of Awards

Once the plan is approved by shareholders, a Company needs to figure out how it will administer the plan and the awards it grants thereunder. One option is to simply manage the equity awards internally, often using spreadsheets to record the grants, vestings and exercises of stock options. For companies with a small number of individuals receiving equity awards, this can be a cost-effective way to handle plan administration.

However, when the number of plan participants grows, administering a plan internally may no longer be as effective and desirable. In these cases, we often see companies contract with a third-party stock plan administrator to handle the details with respect to grants, vestings and exercises of equity awards. Third-party stock plan administrators generally have platforms that allow participants to check their awards and their potential value at any point in time and also see what awards will vest and/or become exercisable. While using a third-party administrator introduces additional costs to the company, it is generally more than made up for by the specialized systems that third-party plan administrators have and can deploy to help with the administration of a company's equity incentive plan. These systems can streamline the communication of awards to executives and employees and their acceptance and management of such awards. Additionally, third-party plan administrators' systems also have significant reporting capabilities to aid companies in managing their equity incentive plans.

Managing Equity Incentive Plans Internationally

If a company has plan participants located outside the United States, managing their equity awards under an equity incentive plan is more complicated. If there are only a few participants in any one country, it is likely that the administration will be done using the third-party administrator's platform used in the U.S., though it might not be available in the non-U.S. participant's country and may require manual input of certain information in order to facilitate plan administration. On the other hand, if a country has a high number of participants, then it is more likely that finding a local third-party plan administrator to run the plan administration locally will be worthwhile.

Equity Incentive Plans in Different Stages of a Company's Life Cycle

How an equity incentive plan is structured and utilized depends in part on the stage the company is in its life cycle. For example, the way start-ups and early-stage companies use equity incentive plans is a bit different than how mature companies use such plans. Additionally, the way private companies utilize equity incentive plans tends to differ from how public companies use such plans.

Application in Startups and Early-stage Companies

For start-ups and early-stage companies, equity incentive plans typically take the form of stock option plans. The plans may offer other types of LTI vehicles, but companies in such situations tend to grant stock options to their executives and key employees as they do the best job of sharing the growth in the company as a result of executives' and key employees' efforts.

Transitioning to Mature Companies

Once a company matures, it becomes less likely that its stock price will grow as significantly as in its early business stages. As a result, stock options no longer provide the same type of award they once did, so most companies switch their use of equity incentives to concentrate on a mix of full value awards, i.e., often a mix of time-vested RSUs and performance-vested performance shares.

Private vs. Public Companies

Both private and public companies utilize equity incentive plans. However, public companies have a ready market for their securities and are less constrained on how they can grant equity awards than private companies. As a result, it is common to see the values for LTI grants to public company employees be greater than those for private companies.

For private companies, there also are securities laws considerations that can limit the number of shareholders that they can have without having to register their securities and/or provide certain disclosures. These considerations tend to cause private companies to grant equity incentives to a smaller group of executives and key employees than similarly situated public companies. Additionally, private companies typically have fewer shares available for grants to executives and key employees, which tends to moderate both grant sizes and the number of participants.

Legal and Regulatory Considerations

As with many things, there are a number of legal and regulatory considerations that must be dealt with in order for equity incentive plans to operate effectively and without harmful effects for the Company or the participants.

Compliance with Exchange Rules

Public companies must comply with their listing exchange's rules with respect to equity compensation plans. Typically, this simply means that companies need to get shareholder approval for such plans and may only grant equity incentives in limited circumstances outside such shareholder-approved equity incentive plans.

Compliance with Securities Laws

The securities laws typically only require disclosure of grants made under equity incentive plans and a filing of a registration statement for company shares that can be issued under such plan. On an annual basis, the company must provide tabular disclosure for its shareholder-approved and non-shareholder-approved equity compensation plans (Item 201(d) of Regulation S-K, Equity Compensation Plan Information Table) and must also include a footnote in the company's financial statements detailing the company's actions (grants, exercises, vestings, payouts, etc.) with respect to its equity incentive plans. Finally, for certain executives (those that qualify as Section 16 officers) companies must file disclosure statements regarding their equity grants, vesting, and exercises (typically using a Form 4).

Tax Implications

Part of the requirements when asking shareholders to approve an equity incentive plan is to detail the tax implications of the various equity awards grantable under the plan to both participants and the Company. Generally speaking, equity awards are not taxed until they vest and are paid out. There are some exceptions to this general rule, particularly in the case of an award that vests upon retirement, so it is important to consult tax experts when developing your equity incentive plans and informing participants about the tax implications of their awards.

Navigating Clawback Provisions, Section 409A and Other Regulatory Hurdles

There are several other regulatory hurdles that companies must be mindful of as they draft their equity incentive plans. These hurdles include:

- The new requirements for a mandatory clawback policy in keeping with the Dodd-Frank Act requirements, as adopted by the listing exchanges that applies to incentive-based compensation. Early Learnings on Mandatory Clawback Policies - Meridian Compensation Partners (meridiancp.com)
- Section 409A that applies to deferred compensation, which is compensation that is earned in one year but paid out in a different year. Section 409A: Deferred Compensation Plans - Meridian Compensation Partners (meridiancp.com)
- Requirements of foreign countries where the plan is utilized.

These regulatory hurdles are not insurmountable and can be addressed within the plan document itself, the award agreements, or in company policies set up outside the plan. The important thing is to ensure that the Company has carefully considered all the possible regulatory hurdles and has taken steps to ensure compliance with them so that the operation of the plan will not lead to negative outcomes for the company or participants.

Equity Incentive Plans and Proxy Advisers

To the extent that a significant portion of a company's shareholders consider the proxy voting recommendations of proxy advisory firms with respect to equity incentive plans, it becomes important for the Company to consider the policies of such proxy advisors with respect to equity incentive plans to understand what their recommendation concerning the proposed equity incentive plan might be. [Relative TSR Practices & Proxy Advisors - Meridian Compensation Partners (meridiancp.com)]

ISS-Institutional Shareholder Services

Institutional Shareholder Services (ISS) is the largest proxy advisory firm in North America. As such, many of its policies with respect to compensation, including those with respect to equity compensation plans, carry some weight (though that weight varies based on the number of a company's shareholders that follow the ISS proxy vote recommendations). ISS evaluates equity incentive plans under its equity plan scorecard policy, which analyzes a proposed plan under three pillars: cost, grant practices and plan features:

- Cost is based on a company-specific algorithm that sets out a benchmark cost for the Company's equity incentive plans and then assigns points based on how close the calculated costs come to such benchmarks.
- Under the grant practices pillars, ISS looks at how equity has been granted and produces a score compared against what it views as benchmark points.
- Finally, under the plan features pillar, ISS looks at several features of the plan document and scores them against what ISS views as the best configuration of such features.

Once scores are calculated under all three pillars, a total score is produced which is compared to the applicable threshold. Thresholds depend on the index a company falls into as well as whether any special circumstances apply, such as emerging from bankruptcy or being newly public. If the score is at or above the threshold, then, unless there are certain overriding factors present, ISS will recommend 'for' the proposed equity incentive plan. If the total score is below the threshold, then ISS would recommend 'against' the proposed plan. ISS does offer companies the opportunity to model their proposed equity incentive plans and Meridian has helped scores of companies with running the ISS model to figure out the best design and share pool size for their proposed equity incentive plans.

Glass Lewis

Glass Lewis & Co. (Glass Lewis) is the second largest proxy advisory firm in North America. It has some influence with shareholders, though the influence is highly dependent upon whether a particular company's shareholders follow Glass Lewis' proxy voting recommendations. Glass Lewis also has numerous policies with respect to compensation and equity compensation plans. However, Glass Lewis' policies tend not to be as specific as those of ISS and with less shareholder influence, it is less likely that most companies will try and consider the Glass Lewis perspective on their equity compensation plan. Glass Lewis also offers companies the opportunity to model their proposed equity incentive plans.

Final Thoughts

Equity incentive plans are useful tools that enable companies to provide a competitive compensation package for their executives and key employees. Adopting and running equity incentive plans can be a bit complex, as there are a number of steps that must be followed to ensure technical and regulatory compliance, as well as terms that should be considered in order to ensure that the equity incentive plan is flexible enough that it can be used in a way that will best support a company's strategic goals and objectives.

Meridian Compensation Partners can help your company consider and adopt a state-of-the-art equity incentive plan incorporating current best practices that will be received well by both proxy advisory firms and, more importantly, shareholders, while ensuring the right amount of flexibility for the plan's operation.