

Long-Term Incentive Plans for Volatile Times: The Case for a 3x1 Approach

Introduction

In the mid-2000s, changes in stock option accounting rules and increased shareholder desire for pay and performance alignment led to the emergence of long-term performance-based vehicles (referred to herein as performance share units or “PSUs”). Despite their prevalence, traditional three-year PSU plans face challenges in practice, particularly in industries where business performance is hard to predict years in advance, such as life sciences or technology.

As seen in recent years, long-term plans can also be disrupted by macroeconomic events such as geopolitical tension, supply chain disruptions, or unforeseen catastrophes. In reaction, boards have had to choose between unpopular actions that invite shareholder scrutiny (supplemental awards, adjusting in-flight goals) or risk of losing critical talent (employees holding awards significantly below their intended value).

In addition to measuring company performance on a [relative basis](#), an emerging solution for addressing external noise in the market is the “3x1” PSU plan. This design balances rigor and flexibility while mitigating some of the forecasting noise by setting shorter-term goals.

Description of a 3x1 Plan

In a 3x1 plan, the company breaks the traditional multi-year performance period into three distinct one-year segments, with goals for each of the three years set prior to the beginning of the three-year period. For example:



A portion of the PSU award is earned based on the results of each year. No units are delivered to the executive until the end of the third year – the earned amounts from year one and year two are “banked” until the end of the period.

The 3x1 measurement carries several advantages in periods of high uncertainty:

- Allows for goal-setting with greater reliability
- Minimizes impact of any one year of outlier performance
- Encourages retention through a motivational reset each year

While this design may be an ideal solution for your company, it does come with its own risks, which should be carefully considered.

Risks to Consider

From a technical perspective, accounting for these types of designs can be complex and disclosure will be challenging. These designs require strategic planning to mitigate criticism from proxy advisory firms and institutional investors who prefer longer performance periods.

Institutional investors favor performance periods for PSUs of three years or more, so a long-term plan consisting of annual goals could trigger negative feedback absent transparency and thoughtful design. As such, it is

important to communicate that a 3x1 plan is not about lowering the bar or making pay outcomes easier. Any programmatic shift should be grounded in the company's strategic objectives, allowing for dynamic goal setting while retaining a long-term incentive.

A well-designed 3x1 can still demand strong performance each year and hold executives accountable for sustained results. In practice, companies often design the annual tranches such that the overall difficulty of earning a full payout is comparable to a normal 3-year plan – the difference is in how the path to get there is plotted.

What Can Meridian Do to Help?

For companies considering a shift to a 3x1, proper implementation is paramount. As a leading executive compensation advisor, Meridian can support compensation committees and management teams in several key areas to ensure the success of the plan:

- Calibrating goals and monitoring plan effectiveness through lookback analyses
- Assisting in drafting robust proxy disclosure to communicate the plan's merits
- Navigating technical accounting

While a 3x1 plan can be an effective solution to goal-setting in volatile times, it requires careful design, execution and communication.