Managing Directors Simon Patterson, who is based in London, and David Bixby discuss restricted stock units as a component of executive pay.

Q. A few companies in the UK have recently made a switch from primarily using performance shares in executive incentive pay programs to using smaller grants of restricted stock that have longer vesting periods. The changes have been made in light of recent criticism of high executive compensation. Do you see this becoming a trend in the UK?

Simon Patterson: Yes. The momentum behind this was the result of an analysis of executive pay by a working group set up by the Investment Association. One of their recommendations was for investors to reduce the “stigma” attached to restricted stock, because—in their view—if executives had more certainty about outcomes, they would demand less up front in terms of equity compensation. This was an initiative to reduce complexity and reduce headline pay numbers. I see this as an important trend.

Q. The central bank of Norway has argued that long-term incentive (LTI) plans are too complicated and the goals and metrics may be encouraging unintended behavior. Would you agree with them?

David Bixby: I am sympathetic to the concern about overly complicated programs. I am less convinced that performance-based LTI programs are a major driver of unintended behaviors, although the devil is in the details. A poorly designed program is always a threat to drive unintended behavior—including unintended departures and retention concerns.

I do agree that many companies and award recipients seem to find performance-based long-term incentives either confusing or largely beyond their control to influence, particularly in the case of relative Total Shareholder Return (TSR) programs.

Results from our recent 2018 compensation planning survey seem to support the claim that most companies are not extremely satisfied with their plans. Neither are they terribly disappointed, but when you spend as much on long-term incentive compensation as many companies do, you would hope to see a greater level of satisfaction:

- Less than 20 percent of companies were very satisfied with their long-term incentive program;
- Less than 30 percent felt that there was a significant impact on executive behavior and focus due to the long-term incentive program; and
- Less than half felt that plans were effectively communicated to participants.
Better communication may improve the level of satisfaction and the confidence that awards are driving behavior, but I consistently hear that performance-based LTI award recipients either do not understand or do not fully appreciate the value of said awards.

I haven’t seen much concern about long-term performance-based awards driving unintended (read: harmful) behaviors. Typically, long-term incentives, however designed, are viewed as a way to keep executives focused on the best interests of the entire enterprise over the long term and to discourage short-term thinking. Also, many large companies use multiple award types so that participants have some combination of time-vested shares, some options, and some performance units to help balance retention and performance leverage.

The annual incentive plan design is typically where I see more concern about metrics driving unintended behaviors which may benefit individuals in the short run but harm the company in the long run.

Simon Patterson: We do not have specific analysis of “complexity,” but we have strong anecdotal evidence to support the idea that long-term incentives sometimes end up with performance metrics that are unnecessary in quantity (TSR, EPS, plus one other, for example) and also unnecessary in design. The basic rule for incentive compensation design is to account for the trade-offs between growth and returns. It is very difficult to achieve high growth and high returns simultaneously, yet many LTI plans build in an expectation that managers can achieve the impossible. The highest performing companies often have the simplest long-term plans. In terms of behavior, what we are looking for is managers’ focus on achieving results in the short term that are sustainable over the long term...a challenging requirement. It is particularly challenging, if one takes the view that three years (the average length of an LTI cycle) is “long term.” Five years or more is a better definition of “long term.”

Q. Do you think that boards could shift executives’ focus toward longer-term strategy by changing their pay mix to include a greater proportion of restricted stock than they currently do on average?

David Bixby: Potentially.

First of all, I think there is an argument that companies could spend less on compensation if they shifted a greater portion of LTI value into restricted shares, because the certainty of value (as compared to options) and reduced complexity (as compared to performance shares) could very well cause many executives to accept a lower face value of pay in return for a less risky compensation portfolio.

A less risky LTI portfolio in turn could reduce whatever incentive there had been to focus on producing specific financial or stock price results over the near term or mid term.

If you then lengthen the vesting period for the restricted shares you grant, you could further cement the long-term focus for the executive. For example, one energy company grants shares that vest 50 percent at five years and 50 percent at the later of 10 years or retirement. Vesting through retirement and beyond may be particularly
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helpful in ensuring that executives do not have an incentive to make rash business decisions, subsequently depart and cash out, and leave their mess to someone else.

Of course, all of this is a tricky proposition—a balancing act. If you lengthen the vesting period too far, you could lose some talented people who start to devalue their grants. Competitively you will continue to bump up against peers who are willing to grant shares that vest in full over a three-year period—so the value proposition (size of the grant and faith in the future of the company, for example) will need to be weighed against the time executives have to wait for some realization.

You also need to be careful, if you are going to reduce risk or leverage in the incentive program, that you don’t simply set up a program that “pays for pulse,” which is the problem that many investors and advisory firms have with programs heavily weighted toward restricted stock. A robust performance-management system that identifies and rewards high performers with larger grants, for example, could help mitigate against this outcome.

Simon Patterson: Yes.

Q. Do you see US companies adopting this method of incentive pay or do you know of any US companies that already do?

David Bixby: I do not see many US public companies moving in this direction, although there are some proposed changes to the tax code that could encourage some movement.

Since 2008, I have seen a significant increase in the number of companies using restricted stock, primarily due to retention concerns. However, the use of restricted stock exclusively is not common, due in large part to pressure from external parties like institutional investors and proxy advisory firms, as well as concerns by many directors about “paying for pulse.”

Historically public companies in the US have also been concerned about deductibility of incentive pay for named executive officers (NEOs) under 162(m). Under 162(m), any compensation to an NEO (excluding the CFO) that is (a) above $1 million and (b) not incentive-based, is not a deductible compensation expense. Under 162(m), restricted stock does not qualify as incentive pay but stock options and performance shares do.

However, both the House and Senate versions of the new tax bill would remove the “performance-based” exemption under 162(m) entirely—meaning that all compensation to an NEO that is above $1 million would no longer be deductible, even if it is incentive-based. If that exemption is removed, restricted stock could suddenly become more attractive to large public companies who would otherwise be concerned about 162(m).

While the tax impact of changes to 162(m) may be offset by a reduction in the corporate tax rate, the removal of 162(m) could potentially encourage some companies to offer executives an LTI award of 100% restricted stock but at a lower face value than their previously diversified portfolio—reducing compensation.
expense and increasing or maintaining a consistent perceived value from the standpoint of the executive.

Based on data from Main Data Group,¹ I have a few brief observations:

1. Nearly four percent of companies (166) in the database of over 4,000 granted only time-based restricted stock to their named executive officers (NEOs) during FY2016.
2. About seven percent of companies over $20B in revenue (12) averaged 100 percent restricted stock to NEOs over the past three years (in years where no stock was granted, that counts as an “NA”).
3. About 15 percent of $20B+ companies made no performance-based grants to NEOs over the past three years (i.e., they used only restricted stock and stock options).

Among the large companies granting only restricted stock over the past three years are a few names you might recognize: Alphabet, Altria Group (formerly Phillip Morris), Amazon, AstraZeneca, ExxonMobil, Facebook, and Sears.

Q. If a board wanted to shift the CEO’s incentive pay mix away from performance shares and toward restricted stock, how do you think institutional investors would react and do you think it would be easy or difficult to generate buy-in?

David Bixby: Again, I think most institutional shareholders like to see a significant performance-based element to CEO compensation, whether in the form of performance units (as the proxy advisory firms would prefer) or in the form of stock options.

A portfolio of entirely restricted shares would be hard to sell, on its face. The keys, in my opinion, to selling the program would be:

• An established history of strong performance (or, in the absence of this, some level of trust and regular communication with key shareholders);
• A reduction in the total value of LTI to account for the low-risk award structure, no matter the design of the pay package (in the end much of the concern with executive pay for those who are concerned comes down to the magnitude of the number); and
• An extended vesting period relative to typical market practice (e.g., five-year cliff or vesting through retirement instead of three-year ratable vesting).

Simon Patterson: In the UK, increasingly, they would look at such a design with favor.

¹ Data Source: Main Data Group
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About David Bixby

David Bixby is a managing director in Pearl Meyer’s Houston office with more than 15 years’ experience advising compensation committees and management teams on compensation program design and governance. Mr. Bixby consults extensively with compensation committees and senior management teams on the assessment and design of executive and director pay programs, compensation strategy and philosophy development, annual and long-term incentive plan design, employment and severance agreements, pay and performance alignment, competitive pay analyses, and corporate governance.

About Simon Patterson

Simon Patterson is a managing director and head of the firm’s London office. He is actively engaged as advisor to the remuneration committees of several FTSE 100 companies and consults widely on executive compensation, incentive compensation design, and performance measurement.

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