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CEO PAY BULLETIN

Longer-Term Restricted Share Plans As Replacements for Performance Share Plans

By Joseph E. Bachelder[†]

Today's Bulletin examines "longer-term" restricted share plans that, in some cases, have replaced performance share plans in executive pay programs. It focuses on such a replacement made by a U.K. company in 2018.

Restricted shares have been a form of long-term incentive award since the 1950s. They generally provide vesting over a period of several years. (Three years is typical but some restricted shares vest over longer periods, such as four or five years. Some awards provide for "cliff vesting"—meaning vesting, if it occurs, occurs at the end of the vesting period and not at intervals (such as pro rata) during that period.) Restricted share awards, as referred to in the Bulletin, represent the full value of the share (not just the growth in value). Acceleration of vesting may take place in certain circumstances such as a Change in Control or a "qualifying termination" (e.g., a termination by the employer without Cause or by the employee for Good Reason).

Performance shares, introduced in the early 1970s, basically are restricted shares with performance targets that must be met for the shares to vest. The performance period typically is three years but in some cases it is four or five years. Cliff vesting at the end of the performance period, provided targets are achieved, is typical. Acceleration of vesting may occur under circumstances noted in respect of restricted shares.

Both restricted shares and performance shares may include an additional holding period (such as two years) after vesting. Such additional holding periods have been a customary feature of long-term incentive awards in the U.K. but not in the U.S.

(The terms "shares" and "stock" are used interchangeably in today's Bulletin (reflecting interchangeable use of the terms by different commentators) and references to restricted shares and performance shares include restricted share units and performance share units, respectively (a "unit" representing a right to a share). Except for brief

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references, including in the chart below, the Bulletin does not discuss stock options, stock appreciation rights (SARs) or long-term performance cash awards.)

The following chart is based on a report by Frederic W. Cook & Co., Inc. It shows the prevalence, today, at the top 250 U.S. companies (by market cap), of three forms of long-term incentive awards: (i) performance awards, (ii) restricted stock and (iii) stock options/SARs.

Form of Long-Term Incentive Award	**Percent of the Top 250 U.S. Companies Using the Form of Award in Their Executive Pay Programs**		**Award Value as a Percentage of Total Long-Term Incentive Award Value for CEOs at the Top 250 U.S. Companies (Average)**	
	2017	**2018**	**2017**	**2018**
Performance Awards[(1)]	**95%**	**94%**	**56%**	**55%**
Restricted Stock[(2)]	**65%**	**69%**	**21%**	**24%**
Stock Options/SARs	**59%**	**57%**	**23%**	**21%**

Source: "2018 Top 250 Report," published by Frederic W. Cook & Co., Inc. (FWC) in November 2018.

(1) The FWC Report notes that performance awards consist of performance shares, performance share units and performance cash awards. It also notes that "[o]f those companies using performance awards, 88% denominate the awards in stock, 5% denominate the awards in cash units, and 7% use a combination of both. Compared to 2017, these levels show a slight but immaterial shift toward the use of cash (the 2017 split was 90% stock, 3% cash, and 7% both)."

(2) The FWC report notes that restricted stock includes restricted stock units.

Since their introduction in the 1970s, performance shares have grown to be the predominant form of long-term incentive for U.S. companies, as evidenced by the chart above. Most U.K. companies have used performance shares as the only form of long-term incentive in their executive pay programs (whereas U.S. companies typically have used more than one form of award). (See, for example, two reports published by Deloitte in October 2018: "Directors' remuneration in FTSE 100 companies" and "Directors' remuneration in FTSE 250 companies.")

Many commentators have emphasized the importance of long-term incentives being tied to achievement of targets, just as most annual bonuses are tied to achievement of targets. Instead of being paid for "simply coming to work" executives are paid based on achievement of long-term targets, motivating them to improve company performance

over the long term and, presumably, benefiting shareholders by an increase in the company's stock price.

"Longer-Term" Restricted Share Plan Replaces Performance Share Plan at The Weir Group

In 2018, The Weir Group plc, a publically owned Scottish engineering company (one of the FTSE 250 companies) replaced its performance share plan with a "longer-term" restricted share plan for its executives. Before The Weir Group change of plan, a number of U.K. companies had made similar replacements of a performance share plan with a "longer-term" restricted share plan. (For purposes of the discussion in today's Bulletin a "replacement" means a replacement, going forward, of performance shares by longer-term restricted shares as the form of award. It does not mean canceling existing performance share awards and substituting longer-term restricted share awards.)

The two largest proxy advisors, Institutional Shareholder Services and Glass Lewis, recommended a vote in favor of The Weir Group's new executive pay program that included the new restricted share plan. Ninety-two percent of the company's shareholders approved the new program.

In changing from a performance share plan to a restricted share plan The Weir Group did the following:

a) Reduced the size (face value) of the annual long-term incentive awards by 50%.

b) Replaced the three-year performance-based formula with a five-year time-vesting formula (subject to transitional rules, 50% after three years, 25% after four years and 25% after five years).

c) Continued the requirement that the shares be held for two years after vesting. Thus, the five-year combined vesting/holding period under the performance share plan was replaced by a combined vesting/holding period of five, six or seven years, depending on which tranche is involved, under the new restricted share plan. The reference in today's Bulletin to "longer-term restricted shares" is to restricted share awards with vesting periods or combined vesting/holding periods in the range of five to seven years.

d) Subjected the vesting of the restricted shares to future downward adjustment by the Committee. The Committee was given the discretion to reduce the number shares vesting if it concluded the reduced number would "better reflect the underlying performance of the Company over the [award] period." The plan also provides the Committee with discretion to reduce vesting if there is a failure to meet certain specific requirements. These

requirements include maintaining a specified dividend rate, satisfying (without special renegotiation) debt covenants, maintaining a specified "Return on Capital Employed" and avoiding material failures in corporate governance and certain illegal acts.

e) Continued forfeiture and clawback provisions (applicable, in the case of a clawback, for a period of three years following vesting) which "may be applied in the event of a material misstatement in the financial statements of the Group or a subsidiary/division, the discovery that information used to determine an award was materially incorrect, mistaken or misrepresented" or, in the case of an individual executive, "gross misconduct (leading to a termination for cause), or reputational damage causing significant damage to the Company and clearly attributable to the individual."

The company increased the shareholding guidelines for the CEO and the CFO, in each case doubling the level of shareholding required and extending the holding requirements for two years post-employment.

In its 2018 Annual Report The Weir Group explains the reasons for the change to the longer-term restricted share plan as follows:

> "The current LTIP suffers from 'all or nothing' characteristics…. Academic evidence has also indicated that simpler pay packages, with less reliance on short-term performance conditions and requiring large shareholdings, have a positive impact on investment, innovation, long-term decision making and long-term value creation."

(In 2016 Weir Group shareholders had voted down the company's then proposed executive pay program that included a "hybrid" approach of having a mix of performance share and restricted share awards.)

As noted above, a number of U.K. companies have shifted from performance share plans to restricted share plans similar to the new Weir Group restricted share plan. These include The Royal Bank of Scotland plc (in 2017).

At the time this Bulletin was written there did not yet appear to be a trend in the U.S. away from performance share plans to restricted share plans. In the U.S., longer-term restricted share plans have been used by major U.S. corporations for many years but not as part of any discernible trend to adopt longer-term restricted shares as replacements for performance shares.

A factor that may affect the use of performance shares in the U.S. is a modification of Internal Revenue Code Section 162(m) by the "Tax and Jobs Act of 2017" (Public Law No. 115-977). The amendment of Section 162(m) eliminated an

important exemption from the deduction limitation imposed by Section 162(m). That exemption had applied to certain performance-based awards (as well as to stock options). Section 162(m) limits a deduction of certain compensation paid by a publicly held corporation to a "covered employee" to the extent it exceeds $1 million in a taxable year. (For a further discussion of this, see my column entitled "Executive Pay at Public Corporations After Code §162(m) Changes," published in the New York Law Journal (March 23, 2018).) This puts performance shares (as well as stock options) on the same footing under Section 162(m) as restricted shares (i.e., no exemption from Section 162(m)) and may enhance interest in restricted shares (in the sense of "leveling the playing field" for tax purposes).

London Business School Professor Alex Edmans, formerly a professor at the Wharton School of the University of Pennsylvania, has criticized the complexity of performance targets in long-term incentive awards and encourages the use of restricted shares with time-vesting and post-vesting holding requirements. In his Written Evidence submission dated May 8, 2018 in connection with U.K.'s House of Commons Executive Pay Inquiry, Professor Edmans states:

> "Currently, the almost universal practice is to pay with Long-term Incentive Plans ("LTIPs"). [In referring to LTIPs, Professor Edmans is referring to performance-based long-term incentive plans in the U.K. As noted above, performance share plans have been the most dominant form of long-term incentive plan in the U.K.] Despite the name, LTIPs lead to short-term behavior. Instead, I advocate replacing them with restricted stock – stock that the CEO cannot sell for (say) 5-7 years. Giving executives restricted stock means that they are paid like owners. They will thus act and think like owners, rather than hired outsiders who aim to maximise their bonus." [Emphasis supplied in the Written Evidence.]

Conclusion

It is too early to conclude that restricted share awards with a longer vesting/holding period (in the range of five to seven years) will significantly replace performance share awards in executive pay programs, in the U.S. or the U.K. Both performance share awards and restricted share awards present issues. Performance share awards pose challenges in establishing and meeting effective targets (e.g., avoiding "gaming" at either end of the award period). Restricted share awards have been criticized for paying executives, as noted above, for "simply showing up for work" without regard to company performance. As also noted above, the new Weir Group restricted share plan addresses the "pay without performance" issue by providing the Remuneration Committee with discretion to make a downward adjustment in vesting of the award if, in its judgment, performance does not warrant the award amount.

Certainly the debate regarding performance shares versus restricted shares carries the message that "one size does not fit all." For a company needing a performance turnaround, performance shares may be the more appropriate of the two forms of award discussed in today's Bulletin. For a company seeking to sustain current growth in performance over an extended period of time, "longer-term" restricted shares may be more appropriate. In some cases (and notwithstanding the Weir Group 2016 shareholder vote) hybrids made up of both forms of long-term incentive award may be the most appropriate.