Institutional Shareholder Services (ISS)
Via email policy@issgovernance.com

Date: 21 August 2024

ISS Annual Global Benchmark Policy Survey - performance shares vs simpler, longer-term equity for CEO incentives in the US

ISS on 1 August this year announced its Annual Policy Survey as part of the recurring review of its voting policy. Norges Bank Investment Management (NBIM) appreciates that ISS has invited market participants to provide perspectives on the approach to US executive incentives. We also appreciate the focus on other relevant topics, such as Scope 3 emissions and workforce diversity.

NBIM is a division of the Norwegian Central Bank, which is mandated with the operational management of the Norwegian Government Pension Fund Global. The fund is globally diversified with assets valued at USD 1.6 trillion as of 30 June 2024. In the US, our USD 628 billion equity portfolio holds shares of 1803 companies, including most of the S&P 500, with an average ownership position of 1.1 percent.

NBIM applies its own voting guidelines. On CEO compensation, our voting, as well as our engagement with companies, are guided by a position paper which has been available on our web site since 2017.

ISS asks market participants for their views on performance shares as compared to simpler, longer-term equity incentives. The question is appropriate because proxy advisors' policies have substantially narrowed the freedom that compensation committees believe they have in the choice of incentive designs.

ISS has applied a clear preference for CEO equity grants to be subject to a second test after three years against a set of performance criteria. ISS has seen the usage of such 'performance share units', or PSUs, as a major mitigating factor in cases where the ISS retrospective 'pay for performance' screen give an unfavorable result. Companies not offering PSUs have faced a markedly higher risk of ISS recommending clients to vote against the 'say on pay' at the annual general meeting. We observe in our engagement with US companies that this policy has provided a strong impetus for compensation committees, and subsequently the boards of directors, to grant performance shares even if their preference was to incentivize the CEO on long-term stock performance more directly and transparently through simple, restricted shares.

ISS notes in its survey that a growing number of investors have become skeptical, or even critical, of performance equity practices in US executive pay. We believe this is an accurate statement. Paradoxically, PSUs have at the same time grown in popularity among US listed firms, often in the belief that investors prefer this incentive design.

Norges Bank Investment Management
is a part of Norges Bank – the Central Bank of Norway

Postal address
P.O. Box 0179 Sentrum,
NO-0I07 Oslo

Visiting address
Bankplassen 2,
Oslo

Tel: +47 24 07 30 00
Fax: +47 24 07 30 01
www.nbim.no

Registration of Business Enterprises
NO 937 884 117 MVA

Norges Bank Investment Management

NBIM's position paper suggests that companies incentivize CEOs on the long term by settling much of the compensation in stocks that are locked for 5-10 years. Such simple stock incentives would replace or reduce the more complex and shorter-term PSUs.

We argue that PSUs tend to be complex and non-transparent. In practice, they often expose the CEO to shifting and short-term milestones with a risk that management is distracted into making suboptimal decisions. The three-year metrics tend to disturb the exposure to the performance of the underlying shares. PSUs empirically vest more often above target than below, meaning the cost on average is higher than the total pay figure usually highlighted in contemporary analysis. When PSUs are headed towards no vesting, there is little or no incentive left to the CEO and pressure increases for retention awards or other one-time awards.

On the other hand, longer-term simple equity incentives align management better with shareholder interests. This approach shifts attention towards the wealth effect for the CEO of stock performance over a number of years, and away from the nearer-term management of results against a more or less fitting basket of metrics. As opposed to PSUs, unconditional shares provide more symmetric equity exposure, meaning the CEO is incentivized on long-term return even after initial disappointment. Simple, unconditioned stock grants provide complete transparency on incentives and quantum, letting the compensation committee better control the cost of compensating the chief executive.

Despite the common classification of incentive equity grants as 'time-based' or 'performance based', we would argue that, over the long haul, all shares are performance shares. Stock return is not a perfect measure of management effectiveness, but over extended time periods we seldom see strong stock performance without strong management.

As such, we encourage ISS to no longer view performance shares as favorable compared to simple equity incentives. Second, we suggest that equity grants with longer time horizons are viewed more favorable than those with shorter time horizons. Moves towards stretching the time horizon should be supported, whether it takes the form of post-employment stock-holding requirements, stretching out the vesting schedule for grants vesting in tranches, lengthening of the weighted average vesting period in each grant, moves to 'cliff vesting' from less-rigorous ratable vesting (i.e. all grants vest at the same time rather than gradually up until that time), etc. A policy or practice whereby the CEO demonstrably holds onto all or most of the allotted after-tax shares should also be viewed favorably.

Consistent with this view, we are more likely to support a pay report if the vesting schedule extends to at least five years, or if a long-term and meaningful equity exposure for the CEO is secured in comparable ways. In our discussions with compensation committees, we encourage the ways of lengthening of time horizons listed above.

We thank you for considering our perspective.

Yours sincerely

Signed by:	Signed by:
Carine Smith Ihenacho	Ola Peter Krohn Gjessing
C28B267008BE42F...	626C72B5E9D94A6...
Carine Smith Ihenacho	Ola Peter Krohn Gjessing
Chief Governance and Compliance Officer	Lead Investment Stewardship Manager

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