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Glass Lewis
Via email guidelinescomments@glasslewis.com

Date: 21 August 2024

# Glass Lewis 2024 Policy Survey - performance shares vs simpler, longer-term equity for CEO incentives in the US

Glass Lewis this summer announced its 2024 Investor Client Policy Survey as part of a review of its voting policy. Norges Bank Investment Management (NBIM) appreciates that Glass Lewis 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 auditor rotation, artificial intelligence and assurance of sustainability reporting, among others.

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.

Glass Lewis 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.

Glass Lewis has applied a preference for the majority of CEO equity grants to be subject to a second test after three years against a set of performance criteria. Glass Lewis has seen the usage of such 'performance share units', or PSUs, as a major mitigating factor in cases where the Glass Lewis retrospective 'pay for performance' screen give an unfavorable result. Companies not offering PSUs have faced a markedly higher risk of Glass Lewis 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, and similar policies by others in the proxy voting space, have 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.

Glass Lewis notes in its survey that some market participants advocate for granting non-performance-based awards subject to extended time-based vesting periods, but no performance conditions. We believe this is the case, and that the critique of performance shares has been increasing.

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Paradoxically, PSUs have at the same time grown in popularity among US listed firms, often in the belief that investors prefer this incentive design.

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.

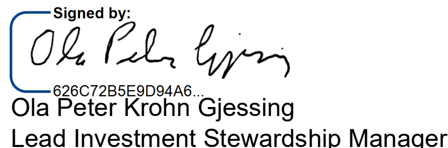
Despite the common classification of incentive equity grants as 'time-based' or 'performance based', we would argue that, over the long haul, all shares are performance shares. Stock return is not a perfect measure of management effectiveness, but over extended time periods we seldom see strong stock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

As such, we encourage Glass Lewis 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

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