Don't Follow the Leader

The Present State of Executive Equity Compensation

By Seymour Burchman and Blair Jones, Sibson Consulting

Many forces are at play on the landscape of executive compensation these days. New regulatory requirements and activist shareholders are promoting significant change. The public outcry over executive pay continues, in spite of improving profits. The pressure is on to abandon once-popular equity vehicles, particularly stock options, which have taken the heat as a prime instigator of executive pay excess. As a result, market leaders are striking out in new directions with their executive pay programs — but new doesn't necessarily mean better.

In the midst of this turmoil, senior management teams, HR executives and compensation committees have an opportunity to rethink their executive pay programs. The current environment provides the chance for companies to step back from following the crowd in order to determine which philosophy, metrics, overall design and vehicles will work best for their executives and shareholders. The key is not to pursue the next new idea exalted by peers or in the business media, but instead to consider designs that will address a company's unique needs and circumstances.

QUICK LOOK

- The pressure is on to abandon once-popular equity vehicles, particularly stock options, which have taken the heat as a prime instigator of executive pay excess.
- A recent survey shows that approximately 80 percent of companies continue to use options or stock-settled stock appreciation rights as their primary long-term incentive vehicle (LTI).
- The right LTI design for a given company should be based on a careful consideration of the needs and characteristics of the company, its shareholders and its employees.

New Challenges

Many regulatory and reporting changes affecting executive pay have been introduced or are anticipated in response to the abuses of the 1990s. These changes primarily focus on three areas:

Increasing the transparency of executive pay. The most prominent change is the sweep-

Craig Fraizer

ing proposed modifications in the accounting for equity compensation to be implemented by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) in June 2005. These new rules will require companies to report — not just footnote — the expense for stock options in their quarterly and annual financial reports. Other parts of the rule will put performance-based restricted stock and options on more equal footing with their time-vested counterparts, with the end result being a more level playing field for comparison among all long-term incentive (LTI) vehicles.

Giving shareholders a more direct say over pay decisions. The New York Stock Exchange (NYSE) and NASDAQ now require shareholder approval of all stock plans. Shareholders must approve any repricing of underwater options, unless shareholder-approved plans already provided for such repricings.

Controlling specific abuses of the past.
The NYSE and NASDAQ also now require the independence of compensation committees.
In addition, the Sarbanes-Oxley Act of 2002 prohibits public companies from extending loans to executives.

This environment has several implications for executive pay programs. First, companies need to be more prudent and deliberate in their use of equity. More emphasis must be placed on rewarding the contributions and performance of the executive team, not just letting them benefit or be penalized based on market movements. As far as incentive vehicles, the leveled playing field no longer tilts toward options as the favorite in all cases. Stock ownership is clearly desired, but some of the past vehicles for achieving this end (i.e. loans to executives to buy stock or exercise options) are now precluded.

Company Responses

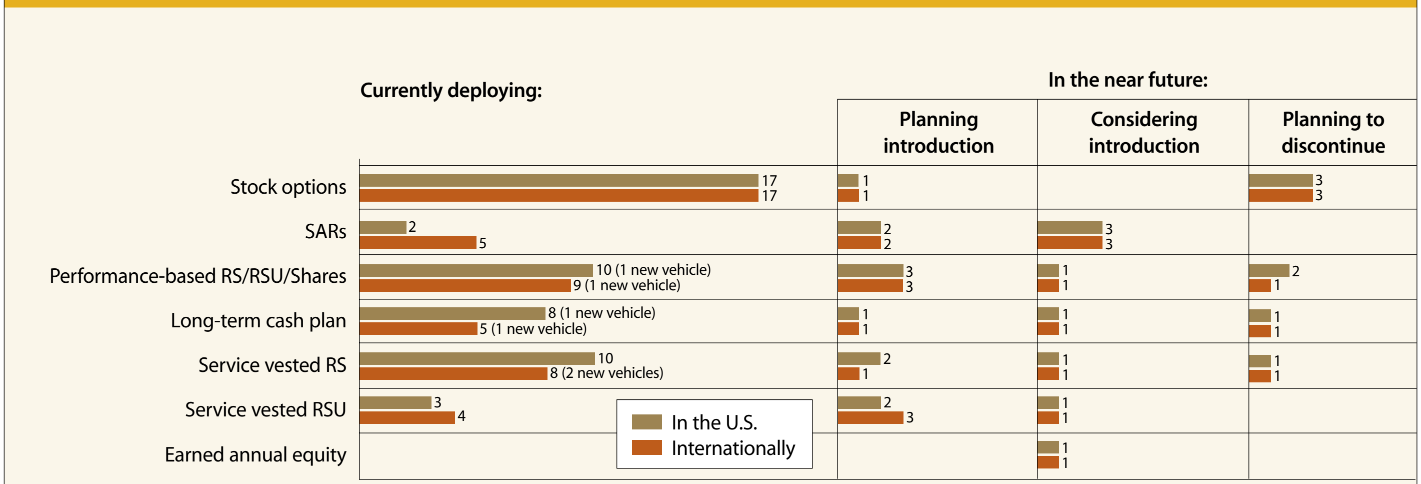
Many groups have offered guidance for fixing the ills of executive compensation, among them the Conference Board Commission on Public Enterprise and Public Trust, Richard Breeden (charged with creating a governance blueprint for MCI as it emerged from bankruptcy), the Business Roundtable and the National Association of Corporate Directors.

What's more interesting is the early view of how companies are responding. Some early movers decided to expense stock options in 2003 in advance of the FASB ruling and were among the first to modify their executive compensation plans. More plan changes were announced as 2004 proxy statements were published. A significant group, however, continues to delay any major changes until FASB modifies its accounting rules.

Early movers following the lead of companies such as Microsoft and Altria have leaned toward replacing standard options with restricted stock, mostly service-vested, or cash-based performance plans. There has also been a renewed interest in stock ownership guidelines with companies such as PepsiCo and Procter & Gamble implementing and/or increasing share ownership requirements, with some raising ownership levels as high as eight to 12 times salary for their CEOs (five times was previously the standard).

Further insights can be obtained from a recent Sibson survey of 23 leading consumer-packaged goods companies. The survey found that approximately 80 percent of companies continue to

FIGURE 1: **LTI VEHICLES DEPLOYED GLOBALLY**



[1] Includes four companies that use restricted stock for special circumstances
[2] One company uses a performance-accelerated vehicle. All others use performance-vested vehicles.
[3] Includes accumulated cash plans, performance unit plans and phantom stock plans. One company's plan intends to pay in shares. One company's plan pays in cash but participants must buy shares.
[4] Three companies currently use SARs in place of stock options in international grants. All companies currently deploy cash-based SARs. Two companies are planning to introduce stock-based SARs in the coming grant.

use options or stock-settled stock appreciation rights (SARs) as their primary LTI vehicle. (See Figure 1.) However, 61 percent now use stock options in combination with another vehicle, and another 12 companies plan to offer a combination of vehicles in the future, most by introducing either service-vested restricted stock, restricted stock units (RSUs) or their performance-based equivalents. The prospect of stock option expensing is the reason most cited for changing (or considering changing) their global equity programs.

Some aspects of these programs are to be applauded, while others cause consternation. In some cases, companies are repeating history, returning to many of the vehicles that did not work in the past. For example, most companies that substitute pure service-vested restricted stock for options are likely reducing shareholder alignment. Although these plans use fewer shares, service-vested restricted stock and cash plans with "slam dunk" performance goals look more like entitlements than performance-based pay.

So What Should Companies Do?

The right LTI design for a given company should be based on a careful consideration of the needs and characteristics of the company, its shareholders and its employees.

Company Perspective

The primary objective from a company perspective is *to achieve business and human capital objectives, while minimizing the economic cost and accounting impact of LTI grants.* To achieve this objective, three factors must be considered: business and market characteristics, talent requirements and the company's performance and rewards strategy.

Shareholder Perspective

The primary objective from a shareholder perspective is *to minimize dilution and economic costs to increase the net return to shareholders.* To achieve this objective, there are two primary concerns: dilution of ownership interests, be they voting rights or claims on future cash flows, and the economic cost of the programs, whether in cash and/or shares.

With current and anticipated changes in LTI design, shareholders will likely recalibrate the levels of dilution that are acceptable in the new environment. A strong business case is mandatory if dilution is beyond the norm, as dilution will continue to be a hot-button issue. It will also be important to help educate shareholders on the difference between economic and accounting costs. Accounting comparisons are not always indicative of what's best for the company from an economic standpoint.

Executive Perspective

The primary objective from an executive perspective is *to provide perceived value commensurate with the level of contribution and effort delivered by the executive.* There are again two primary concerns. The first is executive risk/reward profiles, which reflect the relative appetite for upside opportunity versus downside risk. A second consideration is the diversification needs and preferences of executives, particularly the amount of net worth and earnings potential they want tied to the company's stock. Companies may find that a well-designed and communicated executive compensation program can become an important source of competitive advantage.

Putting These Perspectives into Practice

Several examples from real company situations illustrate the application of these factors in selecting the appropriate executive compensation program.

Start-Up Company

A small start-up was strapped for cash. Gains to its shareholders came from stock price appreciation, not dividends. The company sought highly entrepreneurial talent who valued a highly leveraged risk-reward relationship in their pay package.

These characteristics suggested a pay program where a significant portion of the opportunity was delivered through an equity vehicle focused on stock price appreciation. The potential existed for significant shareholder wealth creation. The company was small enough so that executives had line of sight to stock price appreciation. The company couldn't afford the cash outlay required by a non-equity program. An at-the-money stock option with a 10-year term was the best solution. Despite all the recent criticism and reconsideration of stock options, plain vanilla stock options still have a place in certain company situations. If the compensation committee or management had any concerns that executives might be able to game the system in the short-term and create unsustainable stock price appreciation, they could adjust the vesting to guard against it (e.g., make vesting cliff vs. ratable and/or add a performance hurdle related to sustainability).

Mature Company

This mature company had steady, but not dramatic, stock price appreciation with a substantial portion of the shareholder return delivered through dividends. Its four large, autonomous business units needed to shift their focus to greater top-line and bottom-line growth after years of stagnation. Most talent needs could be met internally, with either current incumbents or promotions.

The facts suggested emphasizing business unit performance to reinforce the importance of business unit objectives and increase line of sight. Linking executives, particularly the most senior, to overall corporate performance was critical. It was also important to include dividends in the design given the company's strategy for delivering total return to shareholders.

The design for this company included performance-vested restricted stock as the primary vehicle, where the restricted stock was earned based on the achievement of return on investment and earnings growth goals for each of the business units. The earnings growth goals were given twice the weight to reinforce the emphasis on growth. The performance-vested restricted stock accumulated dividends, which were reinvested in additional shares and earned on the same basis as the performance-vested shares. Options were continued with the term reduced to seven years to lessen the associated expense and overhang exposure. A greater proportion of stock options were granted to top corporate executives, while opportunity within the business units was more highly weighted toward performance-vested restricted stock to drive appropriate accountability and line of sight.

Company in Turnaround

A company experiencing a major turnaround faced major changes in its senior leadership team and risked key future defections. Underlying growth potential was still strong, but only after the company refocused on its core business and divested several ill-advised business acquisitions.

The company introduced time-vested restricted stock for a short period to stabilize the leadership team. Awards were considerably differentiated, with the largest awards given to high performers in the most strategically important positions. After that, performance restricted stock was introduced, with goals based on achievement of key financial milestones associated with the turnaround effort. Stock options were also continued to allow participants to benefit from the turnaround once the business was repositioned.

No silver bullet exists for designing executive pay. As these examples illustrate, however, many appropriate choices are available. The times demand a thorough examination of company needs, shareholder needs and executive needs, all of which will ultimately influence a company's executive rewards philosophy and practices. Search for the approach that fits the unique circumstances of the organization and complements the company's competitive advantage. When companies begin to design pay packages that are right for their organization, business will have come a long way in restoring the integrity and credibility of executive pay. ws

ABOUT THE AUTHORS

Seymour Burchman is senior vice president at Sibson Consulting. He can be reached at sburchman@sibson.com or 609/520-2768. Blair Jones is practice leader and senior vice president at Sibson Consulting. She can be reached at bjones@sibson.com or 212/251-5303.

RESOURCES PLUS

For more information related to this article:

Go to www.worldatwork.org/advancedsearch and:

- Type in this key word string on the search line: **executive** AND **equity** OR **executive compensation** OR **long-term incentives**

Go to www.worldatwork.org/bookstore for:

- *The Complete Guide to Executive Compensation*
- *Responsible Executive Compensation for a New Era of Accountability*
- *Executive Compensation: The Professional's Guide to Current Issues and Practices*
- *Stock Options & The New Rules of Corporate Accountability: Measuring, Managing and Rewarding Executive Performance*

Go to www.worldatwork.org/certification for:

- T11: Fundamentals of Equity-based Rewards
- C6: Principles of Executive Rewards.