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In Compensation Philosophy

Four Reasons Why Stock Options Deserve Another Look

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Over the past 20 years, stock options have gone from being far and away the most popular equity vehicle to being viewed unfavorably by many. In the 1990's the grant date values of options constituted approximately 75 percent of the total value of long-term equity awards for large public companies, while now they represent about 25 percent[1]. Further, the prevalence of options/SARs among the top 250 companies in market cap has dropped from 71% to 59% over the last four years[2]. Many factors have contributed to the reining in of options, including FASB's decision to expense them (thus leveling the playing field with other vehicles), corporate scandals such as Enron where they were pointed to as one of the culprits, and some bad actors who were caught back-dating them. There were also some broad reservations against using options when not designed or implemented properly, including that:

- Options can potentially promote excessive risk-taking
- Option exercises are vulnerable to being timed to short-term market swings
- Options are subject to the vagaries of the market, regardless of company fundamentals (though shareholders benefit or lose alongside executives)
- Options provide only limited line of sight and accountability for executives
- Options can promote short-term actions to drive stock price near-term at the expense of sustained performance
- If unexercised for long periods, options can contribute to significant potential overhang which can limit flexibility for current equity awards.

[1] "What Has Happened to stock Options?" Harvard Law School Forum on Corporate Governance and Financial Regulation, J. Bachelder III, October 2, 2014.

[2] 2017 Top 250 Report, FW Cook

There are four good reasons why options deserve another look, especially in times when many believe: (i) companies should be investing for the longer term, (ii) companies should be encouraging more innovation with longer payback periods, and (iii) economic growth is increasing.

1 **Options can be a highly effective tool for the right business circumstances.** For example, good candidates for options are early stage businesses, companies in high growth situations, businesses with long-tailed returns, and enterprises that want to promote risk-taking and change. Companies that are in unpredictable markets over the short and medium-term may also be good places for options because they do not require goals to be set.

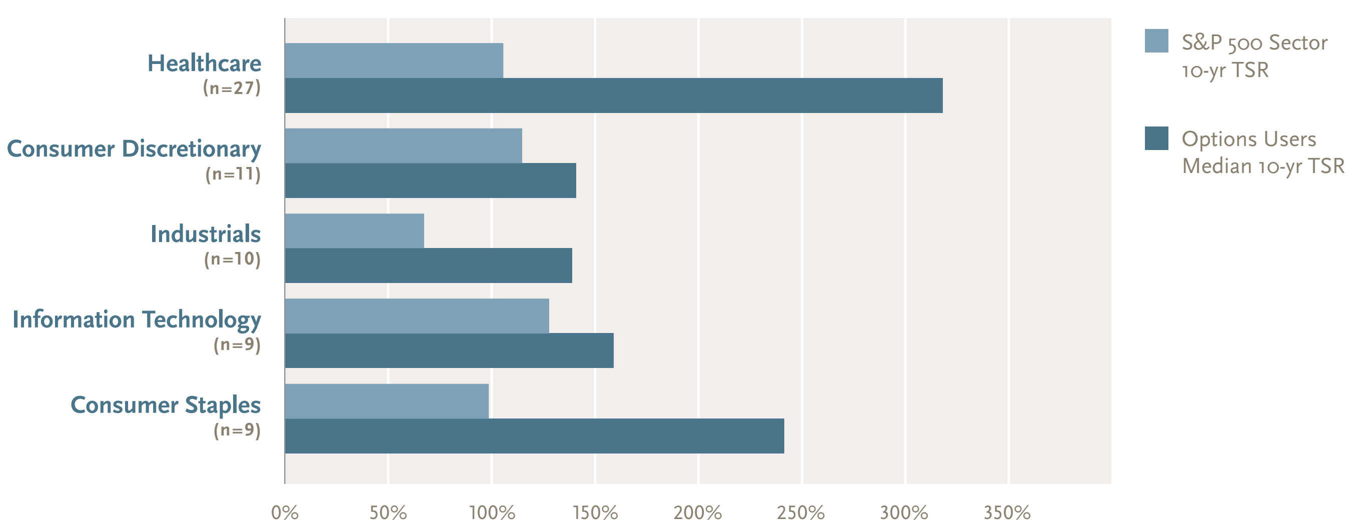
2 **Data suggests that companies that use options have outperformed their peers.** A Semler Brossy study showed that companies that granted greater than 40% of a CEO's total direct compensation in stock options in 2007 materially outperformed the market in TSR over the subsequent ten years—high option users posted a median +170 percent gain versus just +95 percent for the market overall. The outperformance was also evidenced for individual GICS sectors where we had at least 9 companies in our sample, as shown below.

Of course, this material difference does not necessarily indicate causality, i.e., we cannot determine whether option use causes the outperformance or the outperformance causes more companies to adopt them as the vehicle of choice.

3 **The governance and regulatory environment has changed considerably since 2000,** partially in response to the events causing criticism of options. Sarbanes-Oxley and Dodd-Frank legislation, the emergence of influential proxy advisors, stronger and more independent boards, more engaged institutional investors, and activist hedge funds all serve to better dissuade/and control for bad actors.

4 **The replacements for options have their own drawbacks.** Performance plans generally look out no more than 3 years (less than a presidential term), which is hardly long-term. Also, performance plans require long-term goals to be set, often resulting in slam dunk targets and end up being more like pay delivery vehicles than performance-based incentives. Conversely, in other cases, goals have so much stretch that they offer no incentive value at all. Time-based restricted stock plans, another alternative, have their own issues: they have significant embedded value and no real performance ties.

Companies that Use Options Outperformed Peers



Companies can address some of the downsides of options by being more creative in designing their option plans and the processes that support them. We envision the possibility of a new generation of options with features that address many of the flaws of earlier option designs. Holding requirements can prevent executives from taking excessive risks and exploiting market volatility. Fixed share grants, where a fixed number of shares are granted each cycle, rather than a fixed value, can help address some of problems with grant timing. Performance conditions can be added to provide more line-of-sight and accountability versus relying on market forces alone. If needed, option terms can be shortened from 10 to say 7 years to avoid high potential overhangs and minimize expense.

Given the right business circumstances, appropriately designed options may very well be the equity vehicle of choice. We believe that neither universal avoidance, nor universal adoption, is the solution. Rather, proxy advisors, governance groups, institutional investors, and companies looking to make changes should give options a second look when considering the unique needs of individual businesses.

We must add a cautionary note. In these times of extremely low market volatility, Black-Scholes values can be misleading and there is a danger of granting too many options. We suggest either being guided by longer-term Black-Scholes values that might be more representative of normal market volatilities (which has been true in the past after prolonged periods of low volatility) or focusing.

For more information, visit us at SEMLERBROSSY.COM, *or please contact:*

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