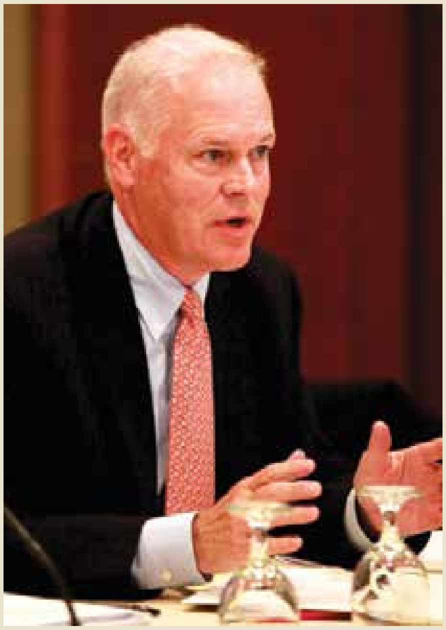
Are options dead?

Not yet . . . but sentiment is favoring a more balanced portfolio of compensation.

Ed. Note: On Oct. 25, 2013, the CHRO Board Academy convened several of the country's foremost experts on executive compensation to share their insights on long-term incentive programs and the use of stock options. The CHRO Board Academy — founded by Korn Ferry Vice Chairman Dennis Carey — is a select group of large-cap, U.S.-based chief human resources officers. The twice-yearly forum features intensely collaborative sessions designed to provide a free exchange of insights and intelligence among peers. The organization is co-chaired by three senior CHROs: Sandy Ogg of The Blackstone Group, Carole Watkins of Cardinal Health Inc., and Benito Cachinero-Sanchez of DuPont Co. The October panel included: Charles Tharp, co-CEO, Center on Executive Compensation and executive vice president of the HR Policy Association; John England, managing partner, Pay Governance LLC; Thomas Desmond, chair of the Corporate Practice Area and co-chair of the Executive Compensation Group of Vedder Price; and Daniel Ryterband, president of Frederic W. Cook & Co. Following are observations made at the roundtable on the future of stock options.



Thomas Desmond: If I were a compensation committee member, I would be in favor of options.

Daniel Ryterband

There are several key factors contributing to the declining use of options for long-term incentive programs:

• Cost efficiency: For the 250 largest U.S. publicly traded companies, the introduction of stock option expensing under FAS 123 was a large driver of the transition from a 99% prevalence of options in 2003 (before mandatory expensing) to 70% in 2013. Expensing led to a view that the cost of options is high versus the value employees perceive.

• Investor pressure: Some believe that the asymmetry of options (i.e., unlimited upside but downside capped at zero gain) might lead to excessive risk taking if options are underwater. Also, options aren't considered performance-based by the proxy advisory firms (ISS, Glass Lewis), who apply a penalty to compensation versus peers in a disproportionate manner when options are used.

• Opportunistic management: Given the perceived cost inefficiencies and the fact that share prices were sideways or declining for several years, many companies felt that options were delivering little value so they used it as an excuse to move from options to full-value rewards.

Nevertheless, options are not dead yet, for a variety of reasons:

• Cost inefficiencies have been mitigated due to a steady, multiyear trend of decreasing Black-Scholes ratios, which enables the granting of more option shares for a given level of targeted value.

Daniel Ryterband: Options aren't considered performance-based by the proxy advisory firms.

• Many institutional investors remain strongly in favor of options as performance-based, despite what ISS and Glass Lewis think.

• There is risk convergence between options and other incentives as a result of numerous factors. First, most investors view time-based restricted shares negatively, which creates pressure to reduce the amount of pay delivered in this form. Performance shares are viewed more favorably, but pressure to measure results over a multiple-year performance period requires a precision that companies don't have when setting performance goals, and if they set the bar too low they'll run afoul of say on pay.

• Opportunistic management now goes the other way, with many reasons to favor options again.

John England

Options are not dead, but they've been knee-capped, and probably justly. In the past,

John England: I rarely advise a company to abandon options altogether.

executive compensation used to be all about "how much?" so it was heavily skewed to options. But things changed:

• Shareholder advisory firms rose to prominence. They came to the table with a fairly socialist or redistributive bent, backed by pension and university money. And they embraced research that says that if 70-80% of a stock's movement is based on market or industry movement, then options are an imperfect vehicle because outside forces have more influence than performance.

• "Lead steers" in two key industries set a pattern for corporate America. Financial services, impacted by the regulators' disdain for options, dialed way back. And major tech firms like Google, Amazon, LinkedIn and Yahoo don't grant options.

I rarely advise a company to abandon options altogether. But I do encourage a well-balanced portfolio of compensation, typically with a relative TSR performance plan, restricted stock and performance options.

Thomas Desmond

Options are not dead. In fact, if I were a compensation committee member, I would be in favor of options. They are easy to implement, easy to explain, and they work. In particular, they work well when things are going well . . . but:

• The problem is that when things are bad, like in the financial crisis, options become worthless as incentives. However, they still have to be expensed and you cannot get rid of them.

• As discussed, regulators do not like options due to the asymmetry problem: they fear that when options are underwater, they create an incentive for management to double down on risk. Dodd-Frank introduced the concept of risk review and excessive risk into compensation decisions.

• Mixed compensation portfolios are here to stay, and it is unlikely that options will swing back to be a majority. This creates a bigger challenge for committees. Whereas options are easy to administer and perfectly aligned, performance share awards are harder, with many moving parts and more elements on which someone can challenge the board's judgment (metrics, peers, etc.).

You do not need to allow the shareholder advisors to lead the parade. If committees make well-reasoned decisions, you get good outcomes. If you have good reasons and explanations to shareholders in your CD&A, you should pass say on pay, regardless of what the advisory firms do.

More views on optimal compensation design

A quick poll of the CHRO Board Academy member companies attending the October 2013 roundtable discussion revealed a disparity of viewpoints on the issue of options. Several companies have eliminated options for everyone, moving to restricted stock and performance shares. However, members believe there's a place for options going forward, depending on the mix and how deep in the organization they go. One member company actually increased options from 25% to 50% of the mix — and still received a "for" recommendation from the shareholder advisors. Other discussion pointers:

• Remember that options are about alignment, not just incentive. They ask a recipient to co-invest in value creation, investing their human capital alongside the company's financial capital to create value.

• Recruiting packages are sometimes still skewed toward options, since options provide more leverage and can be helpful in "make whole" situations.

• Companies making supplemental compensation disclosures (such as realizable pay) usually have tougher pay for performance stories to tell — they need to explain why their compensation system is appropriate. Option-heavy systems often run afoul of ISS and Glass Lewis analyses, thus they can require supplemental disclosures.

• One member's view on optimal compensation design: 1) reasonable salary; 2) robust bonus plan tied to short-term performance, but paid out over the long-term; and 3) options, to drive a vested interest in value creation.

• Bear in mind the context in which a compensation committee operates. Board members are effectively "renting" their reputations, thus they are under intense personal pressure with increased transparency. Many board directors start by saying, "We're going to do what's right for the company, despite ISS," but then move to "How do I pass the vote and preserve my reputation?"