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"FAIRNESS TO EMPLOYEES REQUIRES THAT SHAREHOLDERS ACCEPT MORE DILUTION FROM STOCK OPTIONS"

There is a significant gap between the returns to shareholders and returns to employees. Since 1981, the average total shareholder return for the S&P 500 has been 17% a year, while the average annual increase in employee pay and benefits has been 4% (see Chart). In 1995 alone, the return to shareholders was 37.5% while increases for employees amounted to 2.9%, a whopping gap of almost 35%.

Economic indicators bode well for continued double digit returns to shareholders, but not for substantive hikes in fixed pay and benefits for the average employee. Unlike earlier economic booms, employees are not directly participating in the results of productivity gains. The reason: Today, corporate managements are reluctant to increase fixed compensation costs in the face of global competition.

A continued significant gap between returns to shareholders and returns to employees creates the risk of social conflict, internal dissension, governmental intervention and burdensome costs that would be detrimental to shareholders and employees alike. What can be done to avoid these consequences?

One possible solution is to encourage programs that offer employees a portion of the total return to shareholders that they help create. Then, when modest fixed compensation increases are added to the returns employees receive as shareholders, the result will help close the gap between the two groups. This joint participation in corporate profits will, in the long run, make an important contribution to the social and economic fabric of the country as long as it can be accomplished without significant reduction in profits or lowering of total shareholder returns.

The Shareholder's Perspective

Over the 30 years that I have been a compensation consultant, the widely recognized standard of dilution resulting from employee stock option plans has been 5%. Boards of directors are comfortable in recommending, and shareholders are willing to approve, pools of shares for stock option grants to executives and key employees of up to 5% of the company's outstanding shares. This figure is generally expected to hold for five years. When added to previously granted and still outstanding options, the 5%/5-year standard results in a total potential dilution, at any given time, of 10% -- roughly 5% for outstanding options and 5% available for new grants.

Since the late 80s, a number of companies have extended stock option grants to lower levels of employees. This desirable trend, part of the pay-for-performance movement, responds to pressure from investors to align employee interests with those of shareholders. But it also results in greater dilution to shareholders. Total potential dilution from employee equity plans has been steadily increasing, and exceeded 10% in 1995 for the first time as reported by Pearl Meyer & Partners, executive compensation consultants. This increase in option dilution is running into resistance from shareholders who persist in applying the old 5%/10% dilution standard and vote against management's request to approve new stock option plans or to increase shares available under existing plans.

The percent of shares voted against new stock option plans has risen almost five-fold since 1988, reaching 17.3% last year, according to the Investor Responsibility Research Center (IRRC). The IRRC reports that most investors surveyed have drawn "a line in the sand" at 10% total potential dilution. They also found a definite correlation between higher dilution levels and negative votes:

Total Potential Dilution	% of Votes Against Plan
Over 20%	28.6%
10-20%	20.0%
Less than 10%	13.2%

These trends of increasing dilution from options for employees and increasing negative votes from shareholders are on a collision course. Managements and boards are well aware of these trends and, while willing to drive options to broader groups of employees, are reluctant to increase their stock option dilution requests for fear of receiving an embarrassingly low approval vote.

Shareholders: Using Old Standards for New Situations

What we have here is a situation where employees are receiving little or no increases in salaries or benefits, but are expected to maintain high morale and deliver gains in productivity. Management is not willing to increase fixed compensation expenses, but is willing to increase the number of stock options granted and drive them lower into the workforce. The problem is shareholders who apply old standards to new situations and increasingly vote against requests to approve new stock option plans or add shares to existing plans.

By being unwilling to share more than a limited portion (5%/10%) of their returns with employees who create those returns, investors are not only being selfish, but they are also risking the creation of conflict with employees that will hurt their returns in the long run.

Double Up and Spread Down

The solution is simple. Shareholders should double the old 5%/10% standard to one with a 10%/20% total potential dilution. And this adoption of a new standard should carry with it the understanding that most of the new shares would be pushed down to lower levels in the company, even, perhaps, to include all employees.

Can this be accomplished without significant reduction in profits or lowering of total shareholder return? I believe the answer is yes. First, there is no charge to earnings when stock options are granted or exercised. Second, there is no dilution to earnings per share unless the market value rises above the option price. Third, when options are exercised, the company's capital increases. This new capital can be either reinvested in growth initiatives or used to buy back shares on the open market, reducing any dilution.

In sum, broad-based stock options provide a win-win situation for shareholders and employees alike. They narrow the gap between returns to investors and returns to employees by increasing the returns to employees without raising fixed costs. All that is required is for shareholders to raise their standard of acceptable option dilution when new shares are used in a responsible way. Broad-based stock options are a solution to a growing problem that should be given serious consideration by managements and investors alike.

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