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BOARD ADVISORY LLC

Reconsidering Executive Equity

For at least the past three decades, CEOs and compensation committees have allocated stock options and restricted stock, and numerous other equity-based incentive arrangements based upon the annual competitive practice of peer companies. During this same era executives have been reminded that their "total compensation" consists of salary, bonus and an annual equity award. In an effort to provide comparability between options, stock and cash, companies have gone to great lengths to calculate each form of reward on a present value basis – even when an instrument like an option does not lend itself to a present valuation. Unfortunately, by treating executive equity as a form of annual compensation, companies have created a number of unintended consequences, including rewarding management for poor performance and penalizing good performance. (The taxation and reporting of executive equity compounds these problems and will be the subject of future issues.)

We believe boards can benefit viewing executive compensation from the eyes of the investor. Consider the common practice within private equity buyout situations, where executive compensation is largely dictated by individuals with substantial personal capital at risk (i.e., the private equity funds). In these cases, awards are thought of in terms of adequate incentive and total dilution – not expense and peer behavior. To contrast, the current process for managing executive equity in public companies has three significant disconnects between investor and executive interests.

First, when boards adopt a policy of providing competitive annual equity grants based upon the present value of the equity, they create the perverse phenomenon where stock price decreases (investor losses) result in granting more shares (higher dilution) to management to maintain "competitive pay." When stock price appreciates, the opposite result is found, where fewer shares are necessary to create the competitive annual award level. This issue was particularly evident in 2009, where due to depressed equity values executives were granted 60%-70% more shares just to maintain comparable equity "values" to 2008 .

Second, most compensation policies strive to provide competitive equity awards in terms of annual equity grants, but not in terms of aggregate equity ownership. Thus, a new CEO and a very senior CEO, all other things being equal, would be provided comparable equity awards. As a result, we find ourselves in the somewhat irrational position of waiting 5-7 years before the executive realizes the sizeable equity incentive. Keep in mind the median tenure of a CEO today is 5.5 years .

Lastly, executive stock vesting provisions typically allow the executive to sell their shares, to the extent the executives' holdings exceed a nominal ownership requirement, allowing the executive to convert the incentive into current income. This reduces the executive's wealth ratio (the ratio between a change in company value and the change in the executive's total wealth), diminishing the overall strength of the incentive and diminishing the alignment with investors.

One solution for resolving these disconnects is found by changing our basic view of long-term incentives. Rather than treating equity as part of a competitive annual reward package, remove equity from annual pay discussions and make it part of the terms of employment for key executive positions. Specifically:

- Establish a competitive ownership percentage for each key executive officer position based upon total holdings of fully tenured peer executives at similar companies, and reflecting incentives appropriate to the role and the situation. Define ownership percentage in terms of percent of total shares outstanding rather than specific present value.
- Create a substantial equity position for executive officers early in their tenure through aggressive grants, but establish actual vesting based upon performance outcomes. Suspend or limit awards once the competitive ownership/incentive level is achieved.
- Treat long-term equity as a career investment, no longer subject to liquidation in order to buy the vacation home. Require all equity awards be held until separation from employment. For example, limit the transferability of all equity granted (after vesting) until two years following retirement, requiring the executive to also have "skin in the game" for the near-term success of the succession program.

Bifurcating the compensation process between annual and career rewards will require that compensation committees continue to discuss and manage executive compensation, and to remain abreast of dynamics within peer companies. In addition, should the committee wish to accelerate the grant of equity, terms of vesting will take on increased importance in balancing executive gain with returns to investors. For executives, this approach will mean changing the view towards equity and cash flow.

The principal value of this approach to executive pay is that it eliminates the current misalignment of actual equity grant practices with investor outcomes. It also substantially increases the wealth opportunity for executives by more clearly and quickly aligning their interests with investors – and aligning their career wealth with that of long-term investors. Lastly, by eliminating the concept of an annual "competitive" equity award, we will take an important step in changing the public perception that executive pay is a "heads we win, tails you lose" proposition.

- Jeff McCutcheon

Jeff McCutcheon works with a number of Board Advisory clients within the banking and related financial services arena on executive pay alignment, performance measurement, and executive performance issues. Mr. McCutcheon's bio is available at http://www.board-advisory.com/team.php. If you have any question or comments on this article, or want to speak with Jeff about any executive rewards, performance, or succession issue, he can be reached at jmccutcheon@board-advisory.com, or at (904) 306-0907.