

## CEO stock ownership: Goals that make sense

*Is this happening at your company: Executives exercising their stock option, liquidating their position, and not holding the underlying stock? If so, here is some counsel on setting stock ownership guidelines.* **BY JAMES F. REDA**

**A**S WITH THE stock market itself through most of the 1990s, the fundamentals of executive compensation are significantly above historical or logical levels. The increasing levels of compensation over the past five years do not appear to have any basis in the marketplace. It appears that the high levels of executive compensation can be attributed to management's aversion to stock awards set by the Black-Scholes model, which places a higher value on stock at higher price levels. Of 100 top-performing companies we surveyed, about half awarded the same or more stock options from the year prior over the five-year period from 1994 to 1998, even though Standard & Poors' 500 Stock Index increased at the annual rate of approximately 20% over that five-year period.

Results of studies differ with respect to a link between ownership and corporate performance, but it is unproven that a long-term incentive grant with no real downside risk will compel management to work harder or make better decisions. Compensation committees, Wall Street analysts, and university professors agree that there is a competitive level of compensation needed to attract the right

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executive. Once the executive commits to a position, however, intrinsic qualities such as work ethic, curiosity, and the challenge of meeting goals are far more powerful than stock ownership.

The most startling trend in the past five years is the unusual behavior of boards and senior management in determining stock awards. The fixed share methodology, which works fairly well in a normal environment of 8-10% stock growth, fails miserably when the stock market growth accelerates to 20-25% per year, as it has over the past five years.

### Options versus real shares

It does not appear to matter to stock performance whether the executive's economic benefit is held in options or in real shares, except that, because stock option holdings provide greater leverage, they should give the executive more incentive to be concerned about stock price movement. A more efficient approach would be to prohibit exercise of stock option awards unless the executive holds more than the equivalent number of shares in the option spread (on an after-tax basis), thus encouraging executives to hold stock options which will be more volatile in response to stock price movements.

For example, if a CEO had an ownership guideline of five times salary, or \$5 million at a salary of \$1 million per year, he or she could only exercise options in excess of \$5 million, after paying tax on the spread. To illustrate, assume the executive holds 750,000 exercisable options with an average exercise price of \$25 per share. The current market price is \$50 and the individual income tax rate is 40%. The total option spread is \$18.75 million. The executive could only exercise up to \$10,416,667, or 416,667 stock options (equal to \$18,750,000 less the \$5 million divided by [1 - tax rate of 40%]). Why

transform the 750,000 stock options to 416,667 shares of stock where the executive would not be as highly leveraged should the stock price fall? In other words, it is in the best interest of shareholders for the executive to hold the more highly leveraged stock options.

Other ideas for encouraging executive stock ownership including the following:

- Require outright purchases as a condition to receiving each year's long-term incentive grant.
- Vest stock options quickly, but don't allow them to be exercised for several years (even if the executive leaves the company).
- Allow executives to purchase stock options with forgone cash compensation.

There is a contrast between real stock ownership and carried interest. Furthermore, even if there is a correlation between real CEO stock ownership and corporate performance, stock options — the main stock-related holdings of executives — are further removed from stock ownership, with a limited downside risk to executives. Most executives exercise the stock option and liquidate their position and so do not hold the underlying stock. The net result is that the executive seldom has a significant stock ownership position.

### Stock ownership guidelines

Executive stock ownership guidelines are not prev-

alent among our universe of 100 top-performing companies under review for the *Pay To Win* book: Only 25% of these companies have reported the use of stock ownership guidelines.

In general, executives (and compensation committees) should review the compounding potential of stock options before imposing stock ownership guidelines. A paradox exists in this regard, as the overwhelming majority of companies do not take into account unexercisable or even exercisable stock options in determining whether an executive has achieved his or her stock ownership guideline. Thus, the company encourages the executive to exercise the option award, pay the exercise price and taxes with option shares, and use the remaining full shares to meet these guidelines.

The efficiency of stock ownership guidelines is highly related to the chosen incentive vehicle. For purposes of this comparison, a review of the factors that influence stock ownership goals would be useful, including stock ownership guidelines.

The accompanying table reviews the effectiveness of various long-term incentive vehicles in achieving the benefits of imposed goals. Each long-term incentive vehicle (including stock ownership guidelines) is classified as high, medium, or low as an indication of its efficiency in achieving ownership guidelines from the perspective of the shareholder. ■

## Share Ownership Goals and Long-Term Incentive Vehicles

Long-Term Incentive Vehicle	Effectiveness in Creating Ownership Benefits	Shareholder Benefit/Cost Ratio	Comments
Stock ownership guidelines	Study/survey results as to the efficacy of stock ownership are mixed	High (unless used as excuse for higher grants)	Current designs seem more "for show"
Leveraged stock plans	High, if loan is at market interest rate and not easily forgiven. Otherwise, low	Depends on design (see effectiveness comment)	Often just an option and a performance plan together
Stock options	Creates high level of economic ownership	High (unless grant sizes are above market)	Need to communicate wealth creation power of stock options
Incentive payouts in stock	High, if paid in restricted stock. Otherwise, medium	Medium to high	Easy to do and easy to understand
Reload stock options	High (if executives really understand them)	Low to medium	Better for executives than shareholders
Restricted stock	High during vesting period. Otherwise, low	Low to medium	Difficult to justify to board and shareholders
Performance stock	Medium	Medium to high	More performance-oriented than ownership-oriented