

New Watchwords in LTI Compensation:

efficiency, diversification and performance

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QUICK LOOK

- ➔ Three recent regulatory initiatives may forever change long-term incentive (LTI) compensation.
- ➔ To maintain LTI compensation as a competitive tool, companies have eliminated or replaced stock options or moved to 100-percent restricted stock or to a mixture of options, restricted stock and cash.
- ➔ In the area of retirement income accumulation, many companies are opting for performance-earned awards to a defined contribution supplemental executive retirement plan (SERP).

there are times in business when outside forces converge to create an unprecedented moment of opportunity. The decisions made during this time are pivotal. They can lead to a great business success—or to lost potential.

These forces can be summed up simply: SFAS 123(R), new Securities and Exchange Commission (SEC) disclosure rules about executive pay and Internal Revenue Code Section 409A. These three recent regulatory initiatives may forever change long-term incentive (LTI) compensation. Certainly, companies are motivated to rethink their philosophies about compensation, benefits and

retirement planning. Consider that SFAS 123(R) requires companies to expense the once-free value of stock option grants and causes companies to re-examine the efficiency of stock option awards.

Following are important points about the new SEC rules on disclosure:

- They apply to all forms of executive compensation
- They contain the greatest increase in disclosure of executive benefits plans
- Companies must justify why such plans are used and how they relate to other compensation forms.



It is time for companies to ask a simple question:

“Do we know how to make our LTI compensation plan as strategic, efficient and competitive as possible?”

Information about IRC Section 409A:

- More specifically defines rules for nonqualified deferred compensation (NQDC) plans
- Requires companies to restate and redocument all NQDC plans by the end of 2007
- May affect arrangements not typically regarded as NQDC plans, such as certain severance arrangements, provisions in employment contracts and more
- Creates the perfect opportunity to review how plans fit into current compensation philosophy.

Critical Question

It is time for companies to ask a simple question: “Do we know how to make our LTI compensation plan as strategic, efficient and competitive as possible?” By measuring the efficiency of various elements of LTI in terms of cost to company versus value to executive, much will be revealed. (See Figure 1.)

If the executive received a \$100,000 option grant/award, the company stock’s value would have to increase 40 percent for the executive to realize the same \$40,000 value the company expensed at grant. Were this to occur, the \$40,000 in restricted stock would be worth \$56,000.

Clearly, stock option plans are not as efficient as they once were due to SFAS 123(R) and its expensing requirement. As a result, many companies are backing away from full reliance on stock options as long-term awards.

Then, what can companies do to maintain LTI compensation as a strategic, efficient and competitive tool? In the author’s experience, a number of companies have either eliminated and replaced stock options, or moved to 100-percent restricted stock or a mixture of options, restricted stock and cash.

Company Contribution Awards

While the efficiency of restricted stock awards versus stock-option awards is clear, there is another element being introduced into LTI compensation packages—the use of company contribution awards to nonqualified deferred compensation plans (DCPs). DCPs are typically implemented because highly

compensated executives are limited in what they can save for retirement through 401(k) plans (a 2006 maximum pretax contribution of \$15,000 and a limit on company contributions up to \$220,000 of considered total compensation).

Existing DCPs can be amended to permit *discretionary* company contributions, generally with investment choices in the hands of the executive, and can thus be used to receive LTI awards. Assuming a \$1,000 award, if a company decides to go to “100-percent efficiency,” it would issue \$1,000 in restricted stock instead of stock options. An alternative approach with the same 100-percent efficiency would be to issue a portion of this LTI award in the form of a company contribution to the DCP, for example 20 percent, or \$200. In this case, 20 percent of the LTI would be deferred and invested in a diversified portfolio of investments directed by the executive, and the 80-percent balance would be in restricted stock.

While the line of thinking in Figure 2 on page 35 stresses efficiency, some companies may want to include a higher share of ownership for more performance incentive. In that case, a consulting firm may design the LTI plan with a smaller amount in options, a larger amount in restricted stock and a lesser amount in company contributions.

Diversify for Effectiveness

Ultimately, effectiveness is the key to successful LTI plans because it can lead a company to introduce the power of diversification. Quite simply, diversification

FIGURE 1: EFFICIENCY OF STOCK OPTIONS COMPARED WITH RESTRICTED STOCK

	Stock Options	Restricted Stock
Value of Grant/Award	\$100,000	\$40,000
Corporate Expense	\$40,000	\$40,000
Value to Executive at Grant/Award	\$-0-	\$40,000

Source: Assumes a 40 percent Black-Scholes valuation; actual valuation may be higher or lower.

FIGURE 2: EFFICIENCY OF STOCK OPTIONS COMPARED WITH RESTRICTED STOCK AND COMPANY CONTRIBUTIONS

	Stock Options	Restricted Stock	Company Contribution to DCP
Value of Grant/Award	\$100,000	\$40,000	\$40,000
Corporate Expense	\$40,000	\$40,000	\$40,000
Value to Executive at Grant/Award	\$-0-	\$40,000	\$40,000

increases the stability and, potentially, long-term effectiveness of the plan.

Typically, a single company's stock has far greater volatility than a diversified portfolio. Consequently, when a company introduces diversification into its LTI awards, to the extent that the executive has less volatility in his or her portfolio, the overall executive compensation program has greater stability.

Thus, the use of company contributions to a DCP with investment choices (just as efficient as restricted stock) adds effectiveness through diversification.

An Additional Direction

Soon each public company, as part of its "Compensation Discussion and Analysis" proxy disclosure, will have to explain its philosophy of executive compensation and executive benefits. Most companies have a well-developed philosophy of salary and short-term and long-term incentive pay. However, few have focused on a philosophy for the benefits side.

As they do so, many are articulating a goal of competitiveness. When applying such a goal to the area of retirement income accumulation (including nonqualified benefits), a sizeable percentage of companies is opting for performance-earned awards to a defined contribution supplemental executive retirement plan (SERP). The board sets performance criteria, which are often similar to the annual incentive plan; that is, high, medium and low achievement produces scaled awards.

Vesting varies, depending upon objectives (retention, attraction, reward).

Most companies are anxious to move confidently through the legislative storm, in this direction. This move can measurably improve the competitive standing of the overall benefits program. Several companies have already begun to implement performance-earned defined contribution SERP awards. In one instance, a company opted for a defined contribution SERP with a combination of a 50-percent award toward a goal of a competitive retirement benefit and 50-percent performance based. If the performance goals are met—on the average during an executive's career—the executive will end up with a competitive retirement benefit. In another example, a company moved totally to a 100-percent performance-based award, also targeting a competitive retirement benefit if performance goals are met. These bold actions are not surprising given that corporations operate today under the white-hot light of competition for talent.

IRC Sec. 409A

Where does this element fit in? Sec. 409A currently requires all nonqualified plans to be brought into documentary compliance by the end of 2007. Having to restate a plan gives the company an excellent opportunity to ask whether its current design fits with its newly articulated executive benefits philosophy. Companies using that opportunity for

a fresh look may well join the trend toward efficient, effective, diversified, performance-earned plans.

Time for a Change

All the legislative shifts and regulatory actions of recent years are causing companies to rethink their entire approach to executive benefits and retirement philosophy. Companies that are not already deep into reviewing their philosophy may want to move quickly.

It is essential that companies measure their plans against current and proposed requirements and then determine what actions are necessary to bring their plans into compliance, and up to best-practice standards.

To preserve the essence and intent behind NQDC plans, plan sponsors need expert interpretation and implementation of newly proposed SEC rules and Section 409A requirements. Companies should use this exceptional opportunity to revamp their plans and to bring the benefit of calm seas ahead for their company, directors and executives to achieve competitive and appropriate total retirement rewards. **WS**

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