**Aon**
Talent, Rewards & Performance

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# Equity Choice Programs: Making Your Incentives More Meaningful to Employees

*In an effort to provide more flexibility to employees and cater to different generational preferences, more companies are developing equity choice plans. Here's how they work.*

Business leaders who muse about how they'd like to get more bang for their buck from equity compensation programs (without actually having to spend more, of course) now have a new approach to consider. A growing number of companies are attempting to make their long-term incentive (LTI) plans more cost-effective, competitive and attractive by allowing eligible employees to pick and choose how equity is delivered. These so-called "equity choice" programs provide an added perceived benefit to employees at a relatively small cost to employers.

While the number of companies offering equity choice programs is small (a NASPP/ Deloitte study last year put the figure at 6%— up from 3% in 2013), in the highly competitive technology and life sciences job markets, we believe interest around equity choice programs is on the rise. The goal of an equity choice program is to maximize the perceived value of LTI through personalized customization based upon each individual's unique needs, life stage and risk profile.

Successfully executing an equity choice program isn't easy and takes considerable time, but the perceived benefit to your workforce can be considerable and result in higher engagement and retention. There are also important pros and cons to consider when adopting such a program— just as there are with any significant change to existing pay programs. In this article, we will discuss when a company should consider an equity choice program, different plan designs and how to successfully implement this approach.

## What Does Equity Choice Look Like?

The equity choice programs we are familiar with typically include a choice between stock options and time-based restricted stock— often at set percentages ranging from 100/0 to 75/25 to 50/50 to 25/75 and finally to 0/100. Some high-growth companies require a minimum level of options in the offering, particularly if they are transitioning from an options-only approach. An equity choice program is most often offered to all equity eligible employees with the exception of executive officers.

In Example 1 below, a fictionalized employer has historically granted options and now offers employees with three choices of equity mix (including the original options-only plan) between two different equity vehicles. An employee that is bullish on the company may wish to maximize their option holdings with Alternative 1, an employee looking to hedge their bets will move toward alternative 2, and a more risk-averse employee may choose Alternative 3 to emphasize the downside protection afforded by restricted stock.

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**Example 1**

| Alternative 1 (Company Default) | | Alternative 2 (New Choice) | | Alternative 3 (New Choice) | |
|---|---|---|---|---|---|
| **Higher Risk / Higher Reward** | | **Medium Risk / Medium Reward** | | **Lower Risk / Lower Reward** | |
| Options | Restricted Stock | Options | Restricted Stock | Options | Restricted Stock |
| 100% | 0% | 50% | 50% | 0% | 100% |

# Why Adopt an Equity Choice Program?

Most companies interested in adopting an equity choice program are motivated by several factors, including a desire to adopt a rewards program that emphasizes flexibility and customization to meet different employees where they are in their careers and life stages. Oftentimes, this program is but one component of a total rewards program that emphasizes choice in other areas, such as recognition programs that allow employees to choose from a menu of awards, a suite of health and retirement plans, flexible working arrangements and time off. Other companies may be prompted to overhaul their LTI plan following low engagement scores, high voluntary employee turnover, low employee tenure or other challenging workforce issues.

Interest in choice is also often driven by equity plan constraints on overhang and burn rate that impact the company's ability to maintain broad employee equity participation without making changes to vehicle mix or participation. Additionally, equity choice plans are often considered as a company transitions from an options-only approach to the use of restricted stock.

Companies that decide to adopt an LTI choice program should only do so after careful consideration. Many firms will survey their employees several times before rolling out the program and will pull the trigger only after laying the groundwork for implementation over one to two years.

# Design Considerations

Once your company has decided to implement an equity choice program, there are a number of overarching questions to ask when designing such a program, including:

## Employee Eligibility:

- What job levels are eligible for the program? Typically, you will want to include most, if not all, employees that are eligible for ongoing LTI grants with the possible exception of the C-suite. Executive officers, particularly NEOs, are excluded over the concern that their choice each year might signal to investors the executives' expectations for the performance of the company over the next year. Meanwhile, if a company grants small amounts of equity to lower-level employees it may not make sense to include them in a choice program where the target amount is too small to be significantly impacted by a choice.

- Should situations of death, disability or retirement be handled differently in an equity choice program? For example, should employees closer to retirement be allowed a different choice in equity vehicles or mix that has less inherent risk? Or should the implementation of a retirement provision be considered, allowing for continued vesting post retirement or extended exercisability to maximize the perceived value of the choice?

- Should choice be offered for new-hire grants or offered only on the annual grant? We have only observed the use of choice on the annual grant to-date, but it could be considered as a means to better customize the hew hire experience.

## Equity Vehicles:

- What equity vehicles will you offer in an equity choice program? While stock options and restricted stock are the most common, and often the only, choices offered, a very small percentage of companies include cash and/or performance shares in the mix. However, the rare inclusion of long-term cash or performance shares can be complicated to explain and execute.

- If the equity choice program marks the first time you are introducing restricted stock, you should think about the conversion rate from options to restricted stock and what level of dilution the company can afford based on projected conversion rates and future awards.

- What should be the default choice if an employee fails to make a selection? Typically companies will choose the default to be the same as the original program before choice was introduced or an equal mix of options and restricted stock.

- Should you keep a certain percentage of equity awards fixed? For example, you could design the program so that everyone maintains 50% options and chooses the other 50% to be either options or restricted stock. While this scenario isn't common, it would be a good approach for a company that wants to maintain a level of consistency across the organization and believes options provide an important element of pay-for-performance that time-based restricted stock doesn't deliver.

- Should you deliver awards based on number of shares or intended grant value? This decision partly depends on how you have presented your program to employees in the past. Smaller and mid-size companies tend to communicate number of shares while larger companies more often take a value-based approach.

## Timing:

- Do employees see the potential size of their award first or is it a blind election? Most companies go with a blind choice, which supports the idea of employees making their choices based on their risk-adversity profile rather than being influenced by the size of the award.

- Can an employee lock in their elections for multiple years or is the election period annual? Most companies go with a multi-year election period to reduce administrative burden.

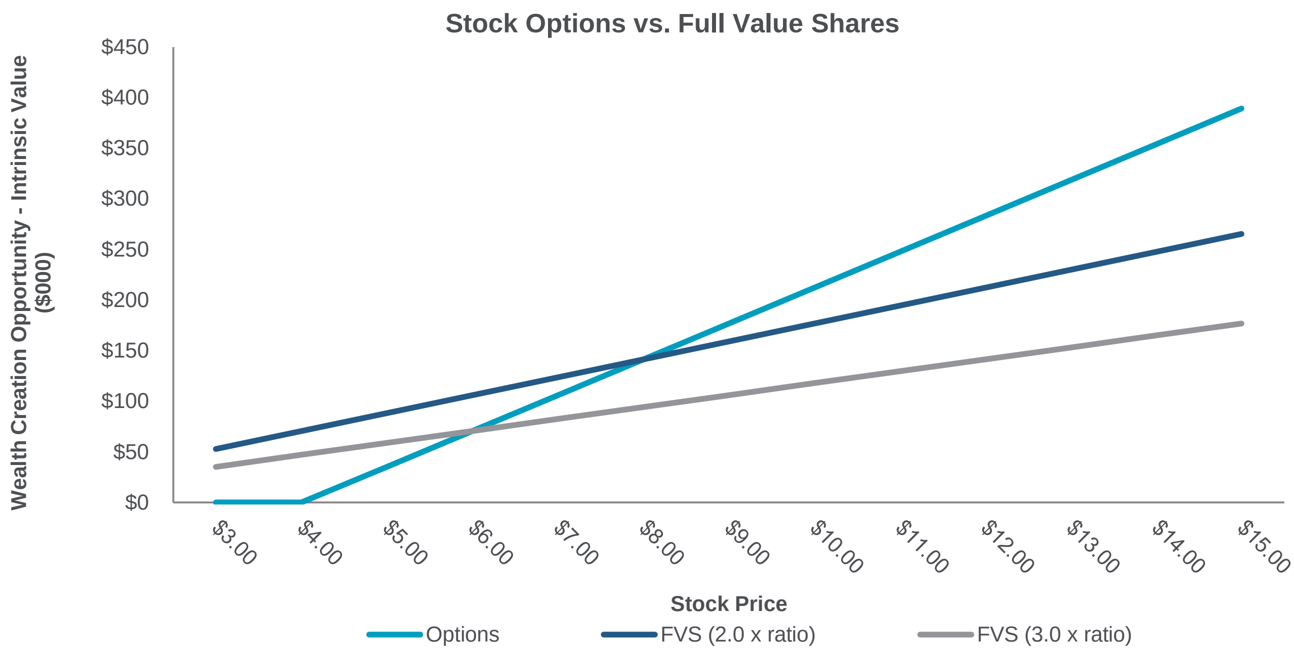
- Should you offer the ability to defer restricted stock? Some companies allow senior leaders (typically VPs or based on a minimum base salary threshold) to defer the vesting of restricted stock for a period of time.

# Education and Awareness

If you decide to initiate an equity choice program and have worked through the design details, the next step is to consider how you will communicate changes to employees. This is critical to the success of an equity choice program as employees are forced to become educated consumers with this program. Companies will provide detailed communication materials around this decision as illustrated in Example 2, which describes at what price point options are more valuable based upon the conversion ratio being used.

### Example 2

### How Conversion Ratios Influence the Value of Choosing Options vs. Restricted Stock




We recommend organizations that decide to adopt an equity choice policy use their HRIS system (some are less user-friendly with equity choice programs) or create an online portal or website that provides employees with all of the information related to the change, including why the new program is being adopted or amended, answers to frequently asked questions and contact information for further questions.

Education is a critical component to any rewards program change. While the change may seem like an obvious benefit to employees, not everyone may see it that way. Putting the right messages behind the program change will ensure HR and compensation leaders are effectively communicating the reasons and motivations behind the change and how it will impact employees' compensation.

# Key Takeaways

While many technology and life sciences companies still use stock options as a primary component in their LTI plans, the migration to restricted stock has accelerated in the past decade. Offering employees a choice empowers your workforce and provides employees more flexibility and ownership over their compensation.

Despite these benefits, the decision to adopt an equity choice program isn’t an easy one. Administering a program costs time, money and resources. If you don’t invest significantly in your employee outreach and education initiatives, the main benefits of the program could be negated. However, with proper planning and execution, the benefits of an equity choice program will often justify the cost of administering the program.

Even if you don’t anticipate adopting an equity choice program in the near-term, it is a good idea to become more familiar with them. As more companies explore and adopt equity choice, you could be hiring employees coming from organizations that offer this program, and they may be asking the question: “Why don’t you?”

For more information about offering a choice in LTI vehicles or for other equity-related questions, please write to consulting@radford.com.

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