



Compensation Committee | Stock Options

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Adding Performance Measures to Stock Option Incentives

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Making options more performance-based may be a viable strategy for companies wanting to continue granting options as an incentive for future performance. For our purposes here, we'll take a look at five different strategies that offer a variety of solutions, depending on a company's needs:

1. Basing the number of options granted on performance is a straightforward technique. The better the performance of the company or a particular division, the more options are granted to executives. The lower the performance, the fewer the options granted. If the performance fails to match a certain threshold, then no options are granted.
2. Accelerating vesting based on performance is another performance-based alternative. For example, a company grants a certain number of options that will vest at some time in the future, such as in seven years. If certain earnings or other financial targets are hit, however, the options will vest sooner, perhaps in three years.
3. Another alternative is to vest stock options only when performance targets are met. If none of the goals were achieved by a specific time, three years for example, none of the options would vest.
4. Accelerate the exercise price. This solves the problem of options providing a lucrative reward despite mediocre performance. These options only pay out if the stock performs better than some specified minimum growth rate.
5. Another alternative is to increase the exercise price at a rate equal to the company's cost of capital. If the stock appreciation does not outpace the cost of capital, the option is not in-the-money.

Utilizing indexed options requires the company to outperform the market or a group of peer companies. With indexed options the exercise price moves up and down with the stock market. The exercise price is tied to an index such as the Standard & Poor's 500, the Nasdaq Composite, or a basket of stocks representing a specific group of companies.

Donald Delves has over 20 years of consulting experience. Prior to founding The Delves Group, Mr. Delves started and managed the Chicago office of iQuantic. Prior to that, he was a Senior Consultant at Sibson and Company and an executive compensation consultant with Towers Perrin. He has also served as a manager in personal financial planning and taxation with Arthur Andersen & Co., and as a financial consultant to middle market companies for Harris Bank.

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