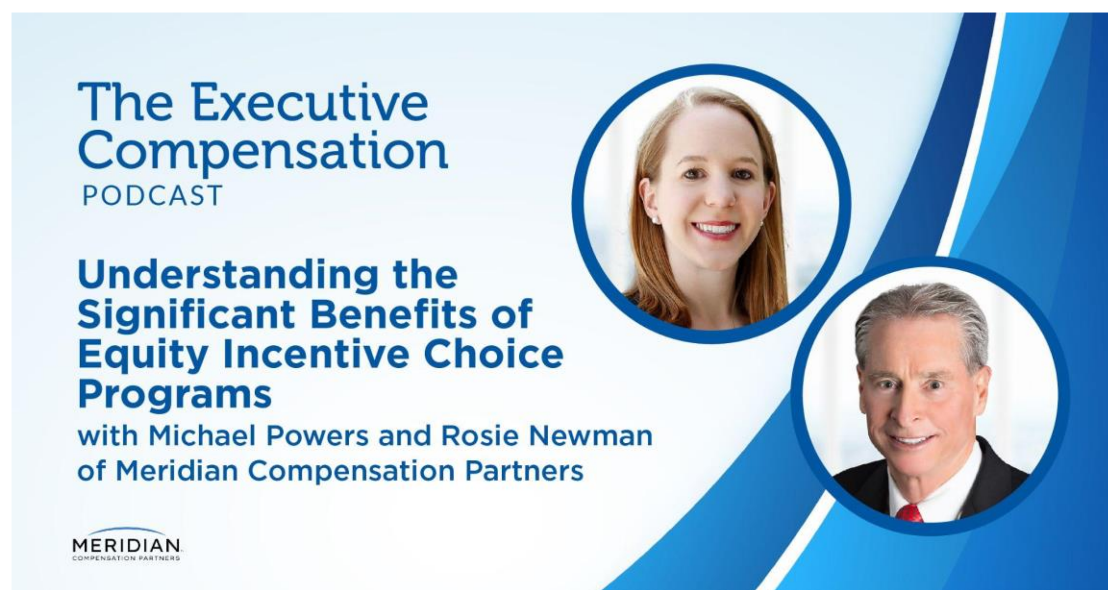
Understanding the Significant Benefits of Equity Incentive Choice Programs



What is equity choice?

Equity choice, fundamentally, is the elective right for a participant in a public company's long-term incentive program to choose which vehicles they prefer for their long-term incentives. In general, it involves a choice between stock options and restricted stock units (RSUs).

- **Stock Options** give participants the right to buy the company's stock for a fixed price, called the "exercise price," over a set term (generally 10 years).
- **RSUs** are an outright grant of company stock subject to vesting requirements, most often over a 3- to 4-year period.

Equity is often granted in terms of a dollar value, so the number of RSUs or stock options a participant receives depends on the price of the stock and other characteristics. For example, if an executive receives a $100,000 equity grant and opts for 100% RSUs, the grant value is divided by the stock price to calculate the number of RSUs issued. At a hypothetical $100/share, they would receive 1,000 RSUs. More complex valuation models like Black-Scholes determine what a stock option is worth on the date of grant, but the approach is generally the same—the grant value is divided by the option value to calculate the number of stock options issued. If the company had a 20% Black-Scholes value ($20 in our example) and the executive opted for 100% option mix, he or she would receive 5,000 options.

How do companies structure equity choice programs?

There are several key elements that factor into the design of an equity choice program. First is determining the pool of eligible participants. Broad-based participation with few restrictions is ideal—typically, all equity-eligible employees could be included. (Possible exceptions might be the exclusion of either the C-Suite, for reasons that are outlined in more detail below, or the long-term incentive program participants furthest down in the organization, who typically just receive RSUs.)

The second element is determining which investment vehicles will be included in the equity choice program. Typically, the choice only applies to options or RSUs. At Meridian, we recommend that performance shares be carved out separately and decided by the Compensation Committee. In one hypothetical scenario, a company may decide it wants the long-term incentive mix to consist of 50% performance shares, and the other 50% would be subject to equity choice. This ensures that the performance-based vehicles are weighted equally for all senior level participants.

Another important consideration is whether companies want to establish a set menu for how participants can combine options and RSUs within the equity choice portion. Are there limited alternatives (e.g., participants can only choose 100% of a single vehicle or a 50/50 split)? Or is there a standard conversion ratio (e.g., 3 options for 1 RSU or 5 options for 1 RSU) for substituting one vehicle for another that allows for splitting the equity portion into unequal parts?

	# Shares at Different Conversion Ratios		
Equity Choice	2 Options: 1 RSU	3 Options : 1 RSU	5 Options : 1 RSU
100% RSUs	1,000 RSUs	1,000 RSUs	1,000 RSUs
50% Options / 50% RSUs	500 RSUs, 1,000 Options	500 RSUs, 1,500 Options	500 RSUs, 2,500 Options
100% Options	2,000 Options	3,000 Options	5,000 Options

* Assumes $100,000 grant and $100 stock price at date of grant

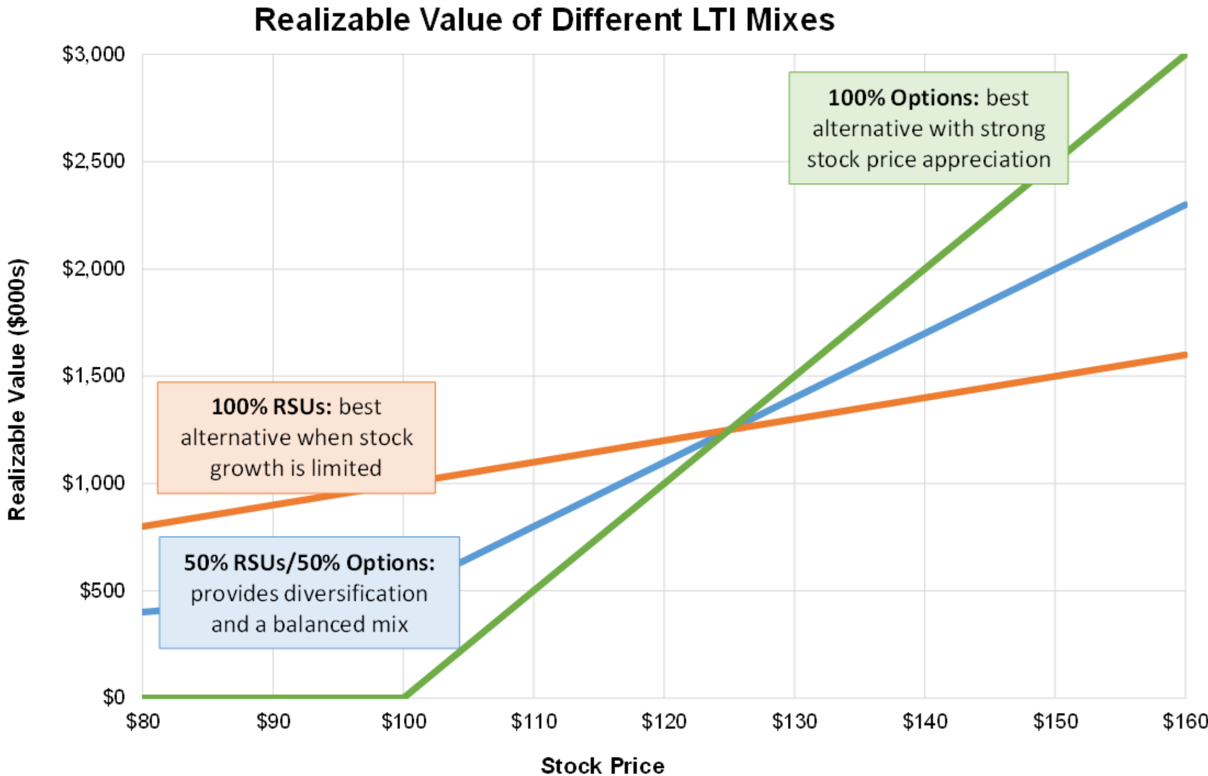
The right conversion ratio is not only critical for building an equity choice program that is both easy to administer and easy to explain, but will also have a significant impact on the number of shares granted to each executive.

Benefits of Equity Choice for Employees

Throughout a person's career, they progress through many life stages and have varying risk tolerances when it comes to investing for the future. Equity choice programs give individuals the opportunity to be compensated in a way that suits their current financial and lifestyle goals. For example, people might be more inclined to select RSUs if they are nearing retirement or preparing for a large expenditure like college tuition. RSUs deliver a known value at a known point in time, useful for those who would benefit from near-term cash flow.

On the other hand, stock options provide substantially more leverage. They offer a longer period, generally ten years, to benefit from growth in the company stock price. The long-term option typically provides ample opportunity for wealth accumulation. The other more subtle advantage is tax deferral. RSUs are taxed when they vest, typically in three years, whereas people might not pay taxes on their stock option gains for eight to ten years.

To get the most out of this benefit, companies must provide employees with education and resources so that they can make informed choices about their compensation. They need detailed descriptions and examples of the different equity choices to understand the tax implications and other considerations, including answers to frequently asked questions such as what happens if you do not make an election (e.g., is there a default selection?). Dynamic and tailored models can be invaluable tools for enabling employees to get an idea about possible future value based on the selections they make today. For example, communication materials might include an illustration or model similar to the following:



Note: Assumes $100,000 long-term incentive grant, $100 current stock price, and 20% Black-Scholes value. Performance shares are carved out separately.

Models should factor in current stock prices, conversion ratios, and different mixes of long-term incentive vehicles to illustrate potential future outcomes.

Benefits of Equity Choice for Employers

Equity choice programs are a significant competitive advantage for hiring and retaining executive and management talent. The employee experience matters at all levels of the organization. Since the pandemic, employees' expectations for flexibility and work-life balance have drastically increased. Equity choice programs show candidates that companies are being innovative about how they offer compensation, tailored to employee needs—an important element of employee-centric company culture.

What about the C-Suite?

If the C-Suite participates in the equity choice program, their selections are public. Proxy disclosure will break down whether they chose options, RSUs, or both. These disclosures can have a signaling impact for investors—does a named executive officer's choice imply that they are bullish or bearish on the stock? To avoid this potential risk, some companies exclude the C-Suite (or just the CEO) from the equity choice program entirely. In these scenarios, the Compensation Committee chooses the mix of investment vehicles for all C-level executives.

Like most disclosure requirements, however, the signaling risk is manageable and easily overcome with clear, succinct communication around the program design. Most institutional investors understand that individuals must diversify their investments over time and that one person's equity choices within this context are personal financial decisions. Executives often also have a significant amount of equity in other incentive vehicles as well, including performance share units.

Should your company consider equity choice?

Right now, equity choice programs are still a minority practice. According to Meridian's research, perhaps 10 to 20 large-cap organizations are using it successfully, but we expect that number to grow significantly over the next five to 10 years. The benefits to both employees and employers far outweigh the drawbacks, and more flexible compensation will soon be table stakes for employers seeking to gain a competitive edge in the market for top executive and managerial talent.