Chapter 11

THE STRUCTURE OF PERFORMANCE-VESTED STOCK OPTION GRANTS

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Abstract: U.S. executive compensation traditionally relies on stock options that vest over time. Recently, however, a growing number of institutional investors have called for the use of performance-vested options that link vesting to the achievement of performance targets. We examine the factors influencing the structure of performance-vested stock option grants to U.S. CEOs. We find that performance-vested options comprise a greater proportion of equity compensation in firms with lower stock return volatility and market-to-book ratios, and in those with new external CEO appointments, providing some support for theories on the options' incentive and sorting benefits. However, firms with larger holdings by pension funds are less likely to completely replace traditional options with performance-vested options, and make traditional options a greater percentage of option grants, suggesting that token performance-vested option grants may also be used to placate pension funds that are calling for their use. In addition, our exploratory examination of performance-vesting criteria finds similarities and differences to prior studies on the choice of performance measures in compensation contracts.

Key words: Compensation, stock options, performance measurement, incentives

1. INTRODUCTION

Two issues that have received considerable attention in the accounting and economics literatures are the use of stock option grants and choice of performance measures in executive compensation contracts. U.S. firms traditionally grant options with vesting conditional on elapsed time alone (e.g., 25% of the options vest in each of the four years after the grant).

However, an increasing number of institutional investors are calling for "traditional" options to be replaced by "performance-vested" options.[46] In contrast to traditional options, performance-vested options link vesting not only to elapsed time, but also to improvements in stock market, accounting, or other performance measures. According to proponents, these options only reward executives when they achieve superior economic performance and not when performance merely mirrors competitors or follows market trends, thereby providing stronger incentives to maximize shareholder value. Yet, despite these claims and extensive international use of performance-vested options, theoretical and empirical research on performance-vested options is extremely limited.

The objective of this study is to provide a rich description of the structure of performance-vested option grants made by U.S. firms, and to offer exploratory evidence on some of the factors influencing variations in the magnitude of these grants, the mix between traditional and performance-vested options, and the performance measures used for vesting purposes. In doing so, we hope to foster additional research on a compensation component that many expect to see widely adopted by U.S. firms (e.g., Tully, 1998; Frieswick, 2003), as it already has been by many of their international counterparts.

We explore these issues using a sample of 128 U.S. firms that initially granted performance-vested options to their CEOs between 1993 and 2002. Two of the strongest determinants of performance-vested option grant design are the firm's stock return volatility and market-to-book ratio, with lower volatility and market-to-book ratios associated with greater use. New CEO appointments also appear to have some influence on the mix of options and the choice of performance objectives for vesting. Moreover, we find that firms with larger holdings by pension funds are less likely to completely replace traditional options with performance-vested options, and make traditional options a greater percentage of option grants. We conclude our exploratory analysis with suggestions for future research.

[46] Among the U.S. institutional investors or investment advisors calling for the use of performance-vested or other performance-based options (e.g., premium or indexed) are the AFL-CIO (2003), CalPERS (2003), and Institutional Shareholder Services (2004). In the U.K., institutional pressure from organizations such as the Association of British Insurers and the National Association of Pension Funds have led the vast majority of British firms to include performance-vesting criteria in their option grants. Similarly, a survey by Towers Perrin finds significant use of performance-vested options in other countries (http://www.towers.com/towers/locations/germany/pdfs/(20.pdf)), which they attribute to differences in tax and legal systems and in the role of institutional investors.