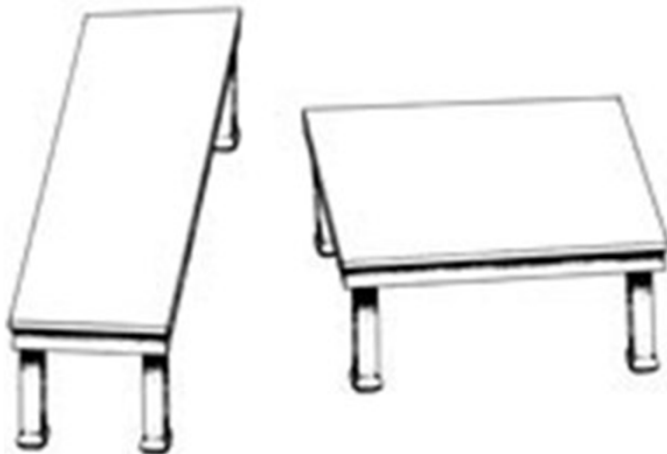


Behavioral Economics and Equity Compensation Part II

Fred Whittlesey

Compensation Venture Group (US)

26-October-2011



Thank you for joining today's webinar

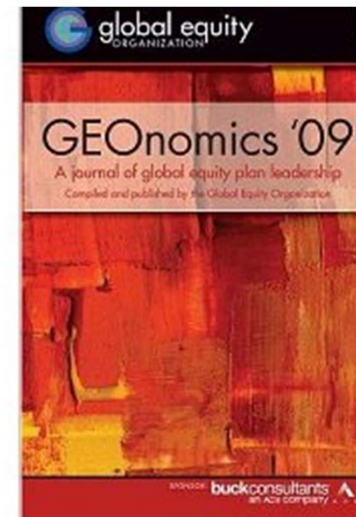
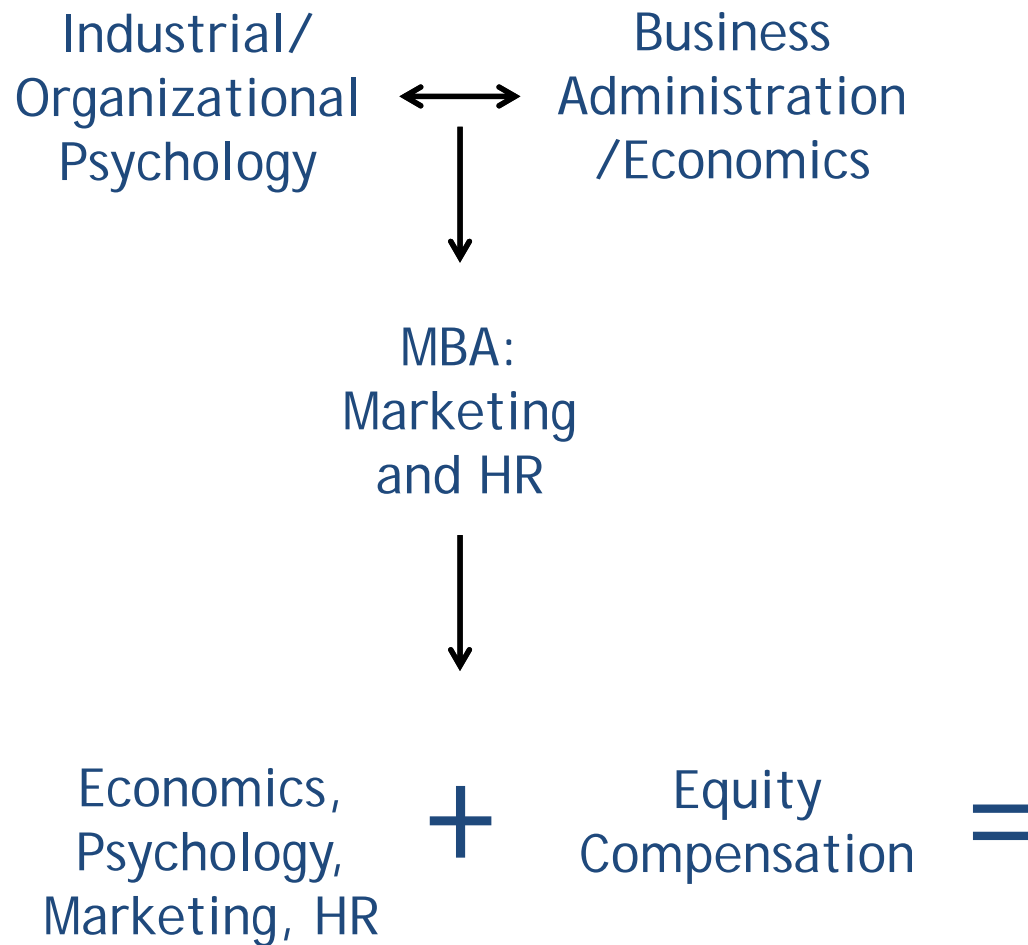
We will begin in just a few minutes

**If you haven't done so already, please dial-in
to the teleconference portion of the meeting:**

**US and Canada dial in: 1 866 740-1260
Outside US and Canada dial in: +1 303 248-0285
Access code: 7927913 (followed by the # key)**



Background



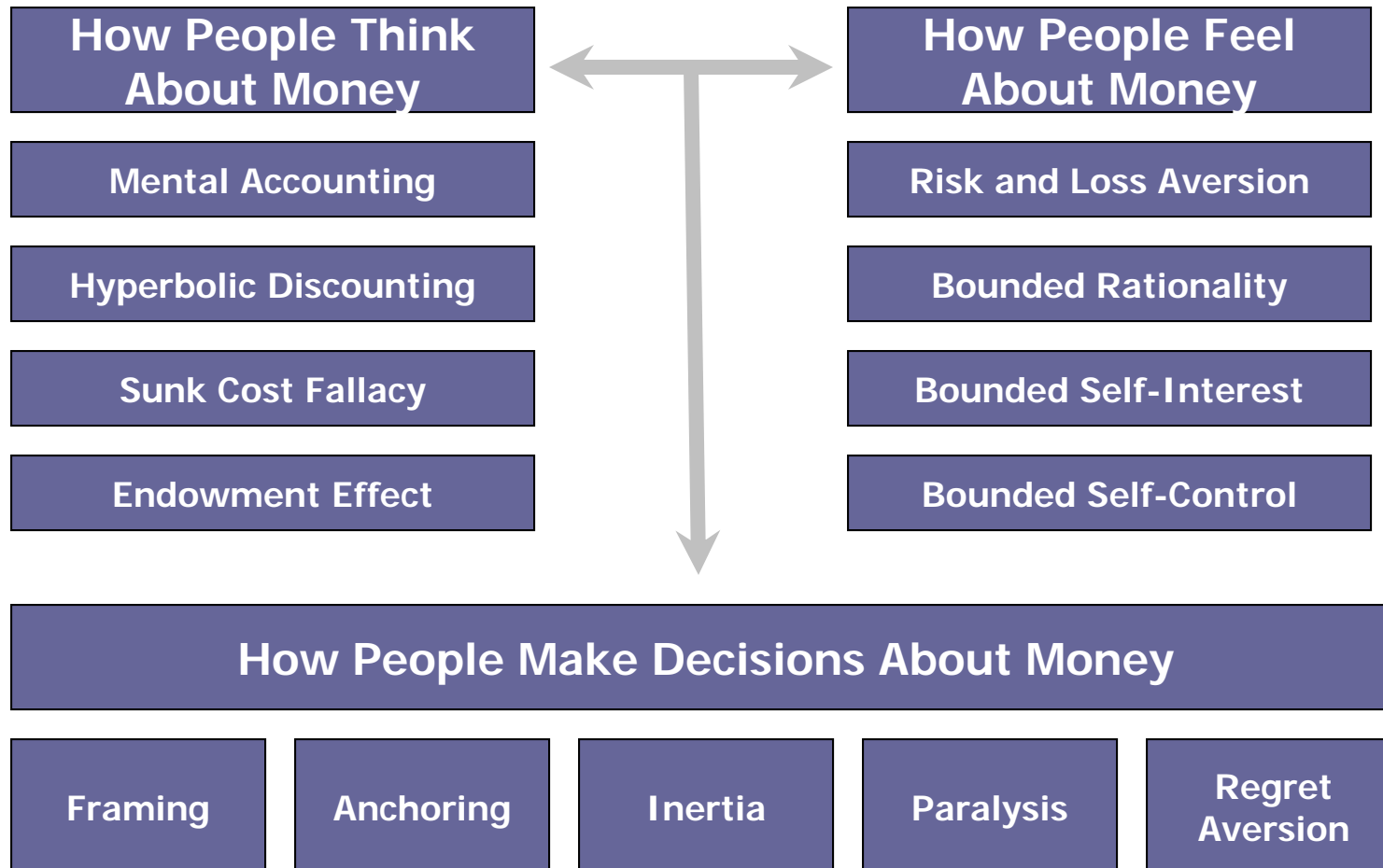


Questions Addressed in Part I

- Why are we discussing this?
- What goes wrong with equity compensation?
- What is behavioral economics?
- How does this apply to equity compensation?
- Nice theory – has anyone really done this?
- What behavioral challenges in equity compensation?
- Where we can go from here?



Tenets of Behavioral Economics





Applications to Equity Compensation

How People Think About Money

Concept	Meaning	Equity Compensation Example
Mental accounting	Tendency to value some dollars differently from others based on source	“This is not part of my compensation”
Hyperbolic discounting	Tendency to put more value on more immediate payoffs but asymmetrical effects when timeframe is extended	“That’s too long – I’ll take it now” but “That’s even longer, I’ll wait”
Sunk cost fallacy	Decisions about future financial outcomes based on irrecoverable previous costs	“I’m already vested in these underwater options”
Endowment effect	People value what they own more than what they do not own	“Why should contribute to ESPP – I give up cash now for a risky stock”



Applications to Equity Compensation

How People Feel About Money

Concept	Meaning	Equity Compensation Example
Risk Aversion	Preference for a more certain though likely lower payoff	Preference for RSUs over stock options
Loss Aversion	People prefer avoiding losses to acquiring gains; people overweight losses	Early exercise of stock options (“suboptimal exercise”); sell-all exercise
Bounded Rationality	Some decisions are just too complex for perfect rationality	Option exchange program nonparticipation
Bounded Self-Interest	People will not always maximize; may help others after a certain gain	Institutional shareholders/ advisers vs. employee ownership advocates
Bounded Self-Control	Procrastination	Failure to make decision re: ESPP enrollment



Applications to Equity Compensation

How People Make Decisions About Money

Concept	Meaning	Equity Compensation Example
Framing	People draw conclusions based on how information is presented	“Forfeit shares” or “thanks to vesting!”
Anchoring	First impressions are lasting	“That’s fewer shares than I got last year”
Status quo bias (inertia)	People prefer things as they are; take no action	“The stock will come back, I’ll just hold on to these underwater options”
Decision paralysis	Tendency to “do nothing” when the decision is complex	“What if I make the wrong decision?”
Regret aversion	No decision is better than a bad decision	“What if I make the wrong choice?”



Equity situations for application of principles

How might equity plan design and operation have room for improvement based on these concepts?

- New hire grant and annual grant
- Vesting schedules
- Combination of stock options and RSUs (and PSUs)
- Opportunity for ESPP participation
- Company stock as a 401(k) investment alternative
- Cashless exercise
- Option exchange program
- Choice program (options or RSUs)
- Dollar-denominated equity awards based on fair value



Some Important Assumptions

The plan design ideas are rooted in several assumptions, all of which are current controversies about equity compensation

Regarding equity compensation:

- Employers need, and want, to improve the ROI of their equity compensation costs (dilution, expense, operating cost)
- Employee ownership can help improve company performance – dilution from stock grants is not a static event
- Equity compensation for executives (if done correctly) aligns interests with shareholders and incents performance, not just fraud (see “The Dark Side of Equity”)
- Increased holdings of employer equity does not create an undesirable level of wealth concentration



Some Important Assumptions

The plan design ideas are rooted in several assumptions, all of which are current controversies about equity compensation

Regarding employer and employee behavior:

- Employees make decisions about equity compensation awards not in their best interest and explained by behavioral economics
- The *inherent* complexity of equity compensation is a contributing factor to this, made worse by *program* complexity
- Employers should engage in some degree of “libertarian paternalism” to guide employees toward better financial decisions
- Plan design changes are essential, coupled with communication and education initiatives
- Each form of compensation should try to do just one thing well (not attract and retain and motivate)



Some Important Considerations

Regarding the application of behavioral economics ideas to equity compensation problems:

- Each individual idea will not necessarily be effective if implemented alone
- Some ideas may require legislative or regulatory change to allow adoption
- Increasing opposition to employee equity and ownership is rooted in beliefs contrary to these ideas
 - European Commission comment on EO regarding risk exposure for employee equity
 - HBR author: No equity for executives
 - Academic studies: No relationship to performance
 - Financial planners: Too much concentration of wealth



Some Important Considerations

But...

- Many of the concepts could be applied to cash-based plans
- Cash plans can simulate employee ownership dynamics
- Equity and cash are not an either/or choice
- Equity plan design needs to consider outcomes and behavioral dynamics of other compensation and benefits programs
 - Salary increase
 - Annual incentive and bonus
 - Signing bonuses paid in cash
 - 401(k)
 - Profit sharing
 - Nonqualified deferred compensation



Plan Design Solutions Derived From Theory

New Hire Grants and Annual Grants: Rebalance

- Issues
 - Large new hire grant, then smaller annual grants
 - Reliance on single date price for largest grant “value”
 - Inability to adjust later based on performance
 - Paying up front for accumulation at previous employer
 - Largest grant ever is not performance-based
 - High run rate and expense for companies in growth mode
- Theoretical support:
 - Anchoring
 - Mental accounting
 - Framing
 - Sunk cost fallacy (by employer) influences future grants



Plan Design Solutions Derived From Theory

New Hire Grants and Annual Grants: Rebalance (*continued*)

- Potential solutions
 - Staggered grants
 - Performance-based first-year grants
 - Earn-in grants
- Result
 - Increased perceived value of accumulating equity
 - Deferred expense
 - Smoother run rates
 - Established as performance-based, not entitlement, from the beginning

Just one example of rethinking equity practices based on behavioral economics...there are more



Plan Design Solutions Derived From Theory

Liquidation at exercise/vesting: Opt-out

- Sell-to-cover as default at exercise (options) or vesting (full-value awards)
- Theoretical support:
 - Inertia
 - Risk aversion and hyperbolic discounting
 - Bounded rationality
- Existing examples
 - 401(k) enrollment
 - Automatic insurance renewal of last year's choices
 - Default organ donation in Europe
- Issues addressed: Suboptimal exercise, cash-out
- Result: Higher employee gains per dollar of expense



Plan Design Solutions Derived From Theory

ESPP Participation: Simplified Form and Process Design

- Yes Box design
- “Channel factors” – minor situational details
 - Turn intention into action
- Theoretical support:
 - Bounded rationality
 - Risk aversion
 - Decision paralysis
- Existing examples
 - College student tetanus shots
 - 1040EZ tax return



Plan Design Solutions Derived From Theory

ESPP Participation and Suboptimal exercise/sale:
Timing grant and vesting dates with other compensation events

- ESPP enrollment timing after pay increase or bonus announcement – and before it is paid
- Vesting dates away from major spending seasons (vacation, holidays, credit card bills from those)
- Theoretical support:
 - Framing
 - Mental accounting
 - Hyperbolic discounting



Plan Design Solutions Derived From Theory

ESPP Contributions: Buy More Tomorrow

- ESPP contributions increase with pay raises
- Sell-to-cover as default
- Theoretical support:
 - Inertia
 - Bounded rationality
 - Endowment effect
- Existing examples
 - Save More Tomorrow TM
 - Electronic deposit of government checks to encourage banking among economically disadvantaged



Plan Design Solutions Derived From Theory

Perception of Low Value of Equity: Vesting Dates

- Shorter vesting dates for compensation and motivation
- Average investor holding period in US has declined from 3 years to 2.5 months over the past 5 years: alignment
- Theoretical support:
 - Endowment effect
 - Hyperbolic discounting
- Existing examples
 - Immediate vesting of options for new hire grant
 - Monthly vesting for low cash/high equity companies



Plan Design Solutions Derived From Theory

Suboptimal exercise/sale: Vesting Dates

- Longer vesting schedules for ownership and retention
- Shares only, not options
- Grant additional shares in return for longer vesting
- Theoretical support:
 - Inertia
 - Endowment effect
 - Hyperbolic discounting
- Existing examples
 - 401(k) and pension cliff vesting
 - Career Shares



Plan Design Solutions Derived From Theory

Move from “communication” and “education” to “consultation”

- Individual meetings with employees
- “Outcomes tool” models of past behavior and potential gains – Christmas past, not just Christmas future
- Wealth accumulation modeling
- Theoretical support:
 - Framing
 - Bounded rationality
- Existing examples
 - Executive financial planning perk
 - Executive “dynamic tally sheets”



Selling Economics to Accounting, Finance, Legal, HR

Implementation of these ideas will require cross-functional participation to eliminate roadblocks

- Ensure that any myths have been countered with data
- Support behavioral claims with participant data
- Create financial model showing incremental ROI with potential changes in participant behavior
 - Employee pay outcomes
 - Dilution
 - Expense
 - Company cash flow
- Shift from “grant date valuation” approach to equity to “realized/realizable wealth” approach



Questions?



Contact Information

Fred Whittlesey

Principal Consultant

Compensation Venture Group, Inc.



fred@compensationventuregroup.com

206-388-9068 mobile

206-780-5547 office

Blog <http://payandperformance.blogspot.com>