

A diver in silhouette is swimming underwater, surrounded by a large school of small fish. The water is a deep blue-green color, and sunlight filters through from the surface, creating a shimmering effect. The diver is positioned in the lower left quadrant, looking towards the upper right. The fish are scattered throughout the upper half of the frame, creating a sense of movement and depth.

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Share Options  
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talent on board*

Norman  
Broadbent

# Underwater Share Options

## *How to keep your talent on board*

by *Dr Mike Rugg Gunn,*

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### **What is the research about?**

This paper provides some advice to clients on how to retain their best executives who may be holding share options in their current employment that are perceived to be worthless. It synthesises:

- ◆ the outputs of research conducted by Dunford et al, from the Journal Personnel Psychology (2005) with :
- ◆ technical advice from experts in the area of executive remuneration.

### **What is an underwater share option?**

Share options are non-tradable rights to purchase a certain number of shares in one's company (or its parent) at a certain price known as the 'exercise price'. Share options are 'underwater' when the market price falls below the exercise price.

### **What did the research discover?**

Most of the results are entirely intuitive to the seasoned recruiter and search consultant; although they now have the benefit of being research driven.

The key outputs of the research are as follows:

- ◆ Executives who had share options entirely underwater engaged in more job search activity than those with options entirely above water or those with no share options.
- ◆ Those executives with share options 'in-the-money', engaged in less job search activity than those with no share options. Money share options may be a useful retention tool.
- ◆ There is a strong relationship between perception of financial inadequacy, the percentage of options underwater and job search. (Perception of financial inadequacy occurs because employees engage in social comparison when evaluating pay and other employment conditions. Satisfaction with pay is contingent on the pay levels of the employee's friends, colleagues or peers in other organisations).
- ◆ Company performance matters: Executives like to stay with winners and abandon losers. This is important because the percentage of underwater share options is likely to be related to the firm's overall performance. Those executives who have a larger percentage of their earnings in underwater share

options will show a greater willingness to job search.

- ◆ Perceived alternative employment opportunities moderated the relationship between underwater share options and job search. So, if the executive believes that he or she is in demand then underwater share options may reinforce the belief that they are losing out on the opportunity for significant wealth at other organisations.

### **Implications for our clients**

- ◆ Competition for talent remains tough: Effective employees with worthless options will pay closer attention to calls from head hunters.
- ◆ The problem of “underwater” options tends to be most acute in circumstances where an individual receives large irregular option grants, there is then the greatest chance that all or most of their option holding will be underwater. This happens most commonly where an individual has received all or most of their option awards in the form of a “big bang” grant, possibly at the time of recruitment.
- ◆ To reduce the risk of this type of problem, make annual (or half yearly) option grants. Institutional shareholders now regard this as “best practice” and are generally unsympathetic to any problems caused by heavily concentrated option grants that become underwater. Indeed, most newly introduced share option plans specify an annual limit on the grant of options rather than a limit over the lifetime of the plan (typically ten years).
- ◆ Take care when linking share option grants to individual executive performance. Organisations may be placing their top performers at greater risk when their options go underwater, assuming the share price declines for reasons beyond the executive’s control. In short, depreciating share prices may encourage the firm’s top performers to leave, although continuing option grants with lower exercise prices (that will typically also be over larger numbers of shares) can give a very considerable upside if there is a perceived likelihood of recovery.
- ◆ Consideration might be given to repricing underwater options. However, institutional shareholders are generally adamantly opposed to this and a preferable approach is likely to be to introduce new incentive arrangements that help mitigate the problem. For example, if a plan has a global grant limit that applies over the lifetime of the plan, it might be possible to introduce a new plan with an annual grant limit that will allow regular option grants without having regard to the overhang of underwater options from the previous plan.
- ◆ Consider replacing share option grants with awards that involve the acquisition of free shares. These might be:

- ◆ typical long-term incentive plan (LTIP) awards where the receipt of free shares after a period (typically three years) is dependant upon the achievement of corporate performance targets over that period. Grants would typically be expressed as a percentage of salary at the time of grant;

or

- ◆ rights to acquire shares under a deferred share bonus plan where the level of grant is determined by reference to performance over the financial year preceding the grant, but with the subsequent vesting of the award being subject only to remaining in employment.
- ◆ It should, however, be noted that even though LTIP award shares are free, the benefit can effectively become underwater due to it becoming apparent that there is little or no likelihood of the performance condition being achieved. On the other hand, the potential downside with deferred share bonus awards is that they typically represent all or part of a performance related annual bonus and if there is a sustained period during which such bonuses are not paid, it may be that no grants are made.
- ◆ An organisation should always aim to have at least some of its remuneration in a deferred form at risk of forfeiture, and with a reasonable proportion of that deferred benefit having some perceived value (so that there is a real perception of loss if the individual leaves). The perception of the possibility of such loss may discourage an individual from seeking alternative employment but, particularly in the case of the most senior employees, an organisation seeking to recruit them will often be prepared to provide compensation for the loss of long-term deferred benefits. Its own deferral period is, however, likely to apply and that may be longer than that for the lost awards (e.g. three years from the time of recruitment).

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## **References**

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