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The Committee for Effective Employee Ownership (CEEO)

In 2004, the National Center for Employee Ownership (NCEO); the Beyster Institute at the Rady School, UC San Diego; and the Global Equity Organization (GEO) created the Committee for Effective Employee Ownership (CEEO).

The CEEO's primary goal is to devise principles intended to help companies and investors make appropriate, economically sound choices about the distribution of equity among employees. In addition, the CEEO seeks to provide general guidelines on how companies can best use broad employee equity ownership plans to create more productive and rewarding workplaces.

The CEEO bases each of the principles in this document on objective research by scholars, advisors, and the National Center for Employee Ownership; the principles are not simply our opinion or philosophy.

The CEEO does not propose these principles as the basis for laws or regulations. Instead, it believes that market-proven benefits of responsible employee ownership can prove themselves without rhetoric.

In order to make this happen, business and investment leaders need a deeper understanding of how these various approaches to employee ownership operate. The findings of the CEEO are available at www.nceo.org/ceeo

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Employee Ownership Groups Set Guidelines for Responsible Equity Pay

Sharing equity broadly, not just with top executives, is the most important factor in what makes an equity plan effective. That's the main conclusion reached by a newly formed group, the Committee for Effective Employee Ownership (CEEO). The CEEO today is issuing a set of research-based guidelines for equity compensation.

"As proxy ballots hit shareholders' desks, it's critical for investors to know what to look for in an equity compensation plan. Too often, decisions on equity compensation plans are made based on intuitive or rule-of-thumb guidelines, on what other companies do, or on what top executives think they can persuade boards to accept," said Corey Rosen, executive director of the National Center for Employee Ownership, one of the three nonprofits that organized the committee. "The CEEO believes these decisions should be made on solid research about what works best to improve corporate performance. It turns out that research overwhelmingly points to sharing ownership broadly rather than focusing it just on top executives."

Recent reforms have helped reduce executive stock option grants in the past few years, but they've been replaced with other forms of pay. In 2003 alone, executive pay jumped 15%, according to The Corporate Library. So while executive options were down, everything else was up, including restricted stock and other deferred pay. Meanwhile, about 40% of companies with broad-based equity plans say they will cut back on them so that they can focus grants on "those who really matter most," an approach research does not support.

Now that the NYSE and NASDAQ have changed their proxy ballot rules to make changes to publicly traded companies' equity compensation plans a matter for shareholder approval, Rosen contends, "it's time for investor groups to pay attention to what the research shows more carefully: broad-based employee ownership is good for companies and their investors; large grants exclusively for executives have a negative correlation to corporate performance."

At least two giant pension funds have taken notice. Both CalPERS and CalSTRS already take broad-based ownership into account when they assess equity compensation plans.

The CEEO has provided a number of specific guidelines for equity compensation, outlined below. The committee is a project of the National Center for Employee Ownership, with help from the Beyster Institute at the Rady School—UC San Diego, and the Global Equity Organization. It consists of 15 leading national experts on all forms of equity compensation. Committee membership, its complete recommendations, and a comprehensive summary of the applicable research can be found at www.nceo.org/ceeo.

The CEEO's main conclusions are:

1. Effective equity compensation strategy is driven as much as possible by empirical data on what works rather than on theory, assumptions, and doing what other companies do.

2. Effective equity compensation allocates equity among executive, management, and non-management employees fairly and in a broad-based manner.

3. Broad-based equity plans should generally provide equity to a majority of full-time employees.

4. Executive ownership in public companies should be determined by an independent committee using rigorous established guidelines.

5. Companies should provide for diversified retirement opportunities as well as company equity ownership. *In some companies, this may simply mean having a 401(k) plan or adequate diversification within an employee ownership plan, but it always should be accompanied by information about retirement planning strategies.*

6. Public companies should provide adequate disclosure to investors and employees about equity plans. *Currently, it is impossible to know from public filings whether a company has a broad-based plan unless it voluntarily discloses it.*

7. Public companies' plans should be fair to shareholders as well as employees.

8. Governance and procedural practices should be established and clearly communicated.

9. Communications and education are essential and often underemphasized elements of an effective equity plan.

10. Creating and maintaining an ownership culture requires meaningful employee involvement in work-level issues. *This is a work in progress for most companies, and companies new to these plans cannot be expected to have ownership cultures bloom overnight, but each company should try to find a path that works for it.*

The CEEO's hope is that institutional investors will use these principles as guidelines to formulate investment policies that look beyond equity as simply an issue for a few top executives, and will use them as a way to help motivate companies to emulate the industry-leading innovators, companies like Whole Foods, Starbucks, Microsoft, Southwest Airlines and others that voluntarily adhere to many of the best practices set forth by the CEEO.

A detailed explanation of the rationale for each of the CEEO's principles and supporting research is available at www.nceo.org/ceeo.

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The Committee for Effective Employee Ownership (CEEO)

Over the last three decades, broad-based employee ownership has grown rapidly within American business. Research from the National Opinion Research Center and the National Center for Employee Ownership estimates that about 25 million Americans own stock, stock options, or some combination of the two in the stock of their employers. The research on employee ownership helps explain the phenomena:

- On a consistent basis, companies with broad-based plans perform significantly better than would have been expected without them.
- Growth, productivity, and returns on assets typically increase 2-4% per year over what would be expected based on these companies' previous performance relative to their respective industries.
- Simultaneously, these plans overall add a substantial amount of additional wealth to employees.
- By contrast, increasing concentrations of ownership in top executives actually leads to a decline in corporate performance.

Challenges to the Spread of Meaningful Employee Ownership

For all its well-documented ability and potential to enable employees, companies, and shareholders to maximize their productivity, the concept of employee ownership faces substantial challenges. Most important, relatively few public companies (and even fewer institutional investors) perceive the idea of broad-based employee ownership seriously. To be sure, many companies and investors publicly commend the virtues of broad-based employee ownership and inject some principles of the concept into their 401(k) plans, profit sharing plans, or, in some cases, employee stock ownership plans (ESOPs). Some others distribute stock options widely, while many have employee stock purchase plans (ESPPs). In reality, there are only a handful of major companies-Starbucks, Southwest Airlines, Whole Foods, Science Applications International, Publix Supermarkets, and Cisco, to name a few-that strive to share significant amounts widely among their employees and make the idea of employee ownership central to their corporate strategy and culture. It is more common, unfortunately, to see public companies that focus their version of employee ownership only on a handful of top executives, based on the argument that only top executives truly matter. And in the instances where public companies have actually shared ownership with employees, it has sometimes been engineered in a way that exposes employees' retirement plans to excessive and dangerous risk. The results are the stuff of outraged headlines: top executives receiving scandalous amounts of stock options and other rewards while regular employees are left with holdings that routinely amount to only symbolic amounts or, in the worst cases, nothing at all.

In closely held companies, the concept of employee ownership has enjoyed greater successes-when used effectively, of course. Most closely held companies, however, still know too little (or nothing) about what employee ownership is and how it works. The closely held companies that do have plans often seek benchmarks to measure their progress, a way to look forward and say: "This is the kind of culture we would like to achieve."

Recent Events Bring the Issue Into Focus

The issues surrounding the concept of employee ownership have been brought into sharp focus over the recent years. Highly publicized debacles at visible companies such as Enron, WorldCom, Lucent and others, where employees' 401(k) retirement assets were heavily invested in ill-fated employer stock, or the failure of the ESOP at United Airlines, have at times cast employee ownership in a negative light and certainly made it a more contentious public issue. Meanwhile, impending accounting rules from the Financial Accounting Standards Board (FASB) will require companies to expense stock options and other forms of equity compensation on their income statements. Part of the reason that FASB has been able to move forward on this change (it was blocked by Congress when it last tried in 1995), is outrage over excessive equity awards to CEOs and other top executives. Ironically, these same concerns have motivated both political parties and Congress to unanimously express their support for the concept of broad-based ownership. These supporters note that the general experience with employee ownership has been exceptionally positive. At the same time, one leading executive after another has lauded the importance of broad-based ownership, but many of these same executives say they might scrap the idea in favor of focusing ownership on a narrower employee population if these proposed accounting rules are implemented.

At the same time, the investment community has often focused its concerns too narrowly on mechanical definitions of how much employee equity is "too much" or on whether executive programs are performance based. These concerns certainly can be legitimate, but far too little emphasis has been placed on the actual allocation of equity within employee ownership plans. Is it all or mostly going to just a few people or is it more broadly distributed, as the research shows it should be?

Goals of the CEEO Project

The CEEO's goal in this pursuit is to devise principles intended to help companies and investors make appropriate, effective choices about the distribution of equity. The CEEO will base each of its principles on objective research by scholars, advisors, and the National Center for Employee Ownership; the principles are not simply our opinion or ideology. The CEEO does not propose these principles as the basis for laws or regulations. Instead, it believes that market-proven benefits of responsible employee ownership can prove themselves without rhetoric. In order to make this happen, business and investment leaders need a deeper understanding of how these various approaches to employee ownership operate.

For all these reasons, the NCEO has convened the Committee for Effective Employee Ownership (CEEO). We have been joined in this effort by two other organizations, the Beyster Institute for Entrepreneurial Employee Ownership and the Global Equity Organizations, both of which are U.S.-based nonprofits that espouse the virtues of employee ownership and do not engage in any form of lobbying activity.

The CEEO is composed of 15 highly accomplished senior experts on various elements of employee ownership, either in ESOPs or equity pay (and sometimes both), who have worked together to develop principles for what makes employee ownership effective. The principles will focus on a limited number of areas:

1. How should companies decide who gets how much equity in a company?
2. How should executive equity pay relate to equity pay for all employees?
3. Should there be performance standards for executive equity compensation?

4. What protections should employees have against excessive risk in employee ownership plans?
5. What makes equity compensation a more or less effective strategy?
6. What information and other rights should employees have in different kinds of equity plans?

Additionally, the CEEO will develop a number of "best practice" principles on corporate culture issues such as open-book management, employee involvement, and employee communications, education, and training. Hopefully, these principles will help companies committed to employee ownership gauge their effectiveness and progress.

The CEEO recognizes these principles are not absolutes, especially given the reality that most companies will be at different stages of employee ownership culture development; in other words, what works for one company will not necessarily work for another. The CEEO does find, however, that certain common practices seem to be generally effective and worth consideration. Now that the CEEO has completed its initial deliberations, it it seeking input from a variety of companies and institutional investors. If you are interested in commenting, you can do so directly on this site or you can send your comments to NCEO executive director Corey Rosen (crosen@nceo.org).

What We Hope to Accomplish

The most critical objective of the CEEO is to demonstrate to institutional investors, the press, and companies that responsible sharing of ownership in a broad-based manner is to the benefit of companies, shareholders, and employees. This is not a quixotic goal. Recently, CalPERS, the nation's largest pension fund, decided it would vote against equity-sharing plans in large companies where top executives received more than 5% of the total amount of shares allocated to all employees. The CEO of Charles Schwab recently wrote in the Wall Street Journal that this number should be limited to 10%. Both agree that sharing ownership broadly is a better approach. Many companies are reevaluating the role of company stock in 401(k) plans and Congress almost enacted legislation on the subject. We believe that the most effective change will be change that comes not through regulation or legislation, but from companies and investors realizing that well designed, broad-based employee ownership plans can create more wealth for companies, investors, and employees alike.

Questions or Comments?

Contact NCEO Executive Director Corey Rosen at crosen@nceo.org.

Committee for Effective Employee Ownership Principles

In 2004, the National Center for Employee Ownership (NCEO); the Beyster Institute at the Rady School, UC San Diego; and the Global Equity Organization (GEO) created the Committee for Effective Employee Ownership (CEEO). The CEEO's primary goal is to devise principles intended to help companies and investors make appropriate, economically sound choices about the distribution of equity among employees. In addition, the CEEO seeks to provide general guidelines on how companies can best use broad employee equity ownership plans to create more productive and rewarding workplaces. The CEEO bases each of the principles in this document on objective research by scholars, advisors, and the National Center for Employee Ownership; the principles are not simply our opinion or philosophy. The CEEO does not propose these principles as the basis for laws or regulations. Instead, it believes that market-proven benefits of responsible employee ownership can prove themselves without rhetoric. In order to make this happen, business and investment leaders need a deeper understanding of how these various approaches to employee ownership operate.

The CEEO is composed of 15 highly accomplished senior experts on various elements of employee ownership, either in employee stock ownership plans (ESOPs) or equity pay (and sometimes both). The principles on the allocation of equity focus on a limited number of questions:

1. How should companies decide who gets how much equity in a company?
2. How should executive equity pay relate to equity pay for all employees?
3. Should there be performance standards for executive equity compensation?
4. What protections should employees have against excessive risk in employee ownership plans?
5. What makes equity compensation a more or less effective strategy?
6. What information and other rights should employees have in different kinds of equity plans?

On the ownership culture side, the CEEO has developed a number of "best-practices" principles on issues such as open-book management; employee involvement; and employee communications, education, and training. We hope these principles will help companies committed to employee ownership gauge their effectiveness and progress.

We believe the primary audience for the equity allocation section of these principles should be public companies and the institutional investors who invest in them. Some of these principles are specifically only for public companies. However, we also believe that private companies, particularly larger ones, should consider the applicability of these principles as well. We believe that the ownership culture principles have applicability to all companies. For many companies, these principles will provide a set of goals to work toward; for others, they will be a way to measure their current performance.

A summary of the principles follows. That, in turn, is followed by a detailed development and explanation of each principle. We emphasize that these principles are based on and driven by the best available research. Our goal was to describe in this format the most essential findings on how equity allocation plans can work most effectively, not to set out a set of personal preferences or philosophical positions.

1. Effective equity compensation strategy is driven as much as possible by empirical data on what works rather than on theory, assumptions, and doing what other companies do.

Decisions about the allocation of equity should be based as much as possible on empirically sound research on cause and effect relationships between equity allocation and corporate performance rather than on theoretical or intuitive judgments. This analysis would include studies of what works best generally in terms of how broadly ownership should be distributed and look at corporate analyses of the economic impact of different approaches to equity sharing within companies.

2. Effective equity compensation allocates equity between executive, management, and non-management employees fairly and in a broad-based manner.

The allocation of available equity among executives, management, and non-management employees should be based less on issues of external comparability (whether top management is making what it might at comparable other companies) and more on whether top management's performance meets rigorous standards, as well as on issues of internal fairness (whether the ratios of rewards between groups or employees are justifiable based on the relative contributions each makes to the corporation).

3. Broad-based equity plans should generally provide equity to a majority of full-time employees.

With certain exceptions, at least a majority of full-time employees meeting minimum service requirements (of not more than two years of employment) should be eligible to participate in broad-based equity plans.

4. Executive ownership in public companies should be determined by an independent committee using rigorous established guidelines.

Executive equity compensation in public companies should be determined by an independent compensation committee with input from a compensation consultant with no other relationship to the firm or the executives. Equity plans for executives should be performance-based. In addition, public companies should consult the standards on these issued published by the National Association of Corporate Directors, the Conference Board, and the Executive Compensation Standards Conference, which propose more detailed procedural safeguards and processes that go beyond (and are more rigorous than) those described here.

5. Companies should provide for diversified retirement opportunities as well as company equity ownership.

A company's broad-based employee ownership plan should normally be accompanied by other more diversified retirement plan opportunities, either within the employee ownership plan or by having an additional plan in place. Diversified plans may be as simple as an employee funded 401(k) plan with multiple investment choices or as complex as a defined benefit plan.

6. Public companies should provide adequate disclosure to investors and employees about equity plans.

We strongly recommend that public companies disclose on their Web sites and in their SEC filings total employee equity (all ERISA plan, ESPP, options, etc.) broken down by kinds of equity granted and which employee groups currently receive it. In addition, when employees become owners by purchasing shares or exercising options, the company should provide adequate information on its financial situation and risks, on the tax consequences of employees' decisions, and offer general information on investment strategies.

7. In public companies, equity plans should also be fair to shareholders.

In public companies, equity plan design needs to consider not just fairness to employees, but to outside shareholders as well. Repricing of awards, whether immediate or delayed (such as on a six months-and-a-day basis), or otherwise changing conditions or terms so that they become more valuable or more easily obtained than previously intended should be limited to exceptional cases and be justified by an independent assessment, publicly available, of the economic costs and benefits to shareholders of doing so prior to submitting for shareholder approval.

8. Governance and procedural practices should be established and clearly communicated.

The committee recommends that companies establish a set of governance and procedural practices for the operations of their equity plans, covering who should oversee such plans, the provision of adequate and fair information to employees, rules for protecting the assertion of employee rights in connection with the plan, and how employees can file complaints concerning it.

9. Communications and education are essential and often underemphasized elements of an effective equity plan.

An ongoing communications program in companies with broad-based ownership plans using multiple communications and learning approaches should be in place to help employees understand how their equity plans work.

10. Creating and maintaining an ownership culture requires meaningful employee involvement in work-level issues.

Research has consistently shown that companies that use employee ownership to create "ownership cultures" for all their workers, rather than just make executives wealthier, perform substantially better. The techniques for doing this vary widely, but, at their core, share the common principles of open-book management and involving employees in day-to-day work decisions (often through teams) as much as possible.

Best-Practices Principles for Effective Employee Ownership

Context

Over the last several years, employee equity compensation has become a front-page issue. Who could have imagined a decade ago that changes in accounting rules for stock options or the shift by one company from options to restricted stock would be front-page news all over the country? The reasons for this attention are well known. Corporate scandals cost employees their retirement and many investors substantial wealth. Often egregious executive pay packages made up mostly of stock options outraged employees and stockholders. Accounting irregularities left investors wondering just what they were investing in and whether the way executives were being paid was leading to these and other imprudent, costly, and sometimes unethical decisions.

At the same time that executive equity packages were ballooning, broad-based employee ownership was accelerating. A rarity a generation ago, by 2002, the National Opinion

Research Center's General Social Survey estimated, about 40% of all U.S workers who worked for companies that issued stock had rights to acquire ownership in their employer in one way or another. Experience with the idea ranged from the fabulously successful (Starbucks, Microsoft, and Publix Supermarkets, for instance) to the disastrous (United Airlines, Enron, and WorldCom, for example). While plans covering most or all employees were becoming more popular, plans focusing primarily or solely on senior executives were often reaching staggering levels. Executive equity compensation, mostly in the form of company stock, was often measured in the tens of millions of dollars, and CEO compensation in the largest companies went up to 500 times that of an average employee. Many of these plans were structured, or restructured, so that executives could not lose, even if the company performed poorly. Because of all this, employee ownership, whether in the narrow sense of ownership by executives or the broad sense of ownership by all employees, became a major economic and social issue.

In response to these developments, investors and employee groups, accounting and securities regulators, and Congress have pressed for reform. New rules on corporate accountability, accounting procedures, and shareholder approval of equity plans are all either in place or coming. Laws to allow greater diversification of employer stock in 401(k) and similar plans are possible. Various institutional investors and corporate organizations have imposed or suggested guidelines and standards for executive ownership and/or total shareholder dilution from employee-ownership plans. Corporate governance groups have proposed much tougher standards for corporate boards and, particularly, compensation committees. Countless articles have been written about whether stock options should be replaced by some other form of equity, whether employees have too much stock in the 401(k) plans, how to tie executive equity to company performance, and what processes should be in place to decide all this.

These reforms and discussions, however, generally do not address what this committee believes is an essential issue: how equity should be allocated among employees in a company. To investors, the point of sharing equity with employees is to improve corporate performance. There are a lot of theories and assumptions about how this should be done, and many equity compensation programs are driven solely by these arguments. This committee, however, believes that, to the extent possible, these decisions should be driven by what the research has shown to be the best practices for sharing equity. We find that research on this issue consistently shows that broad-based employee ownership improves corporate performance, generating positive returns for both employee and non-employee shareholders, but that plans focused narrowly on senior executives have no effect or a negative effect. Yet in response to proposed changes in accounting procedures requiring companies to show options as a charge to compensation costs, as well as recent changes tightening shareholder approval requirements for equity plans, many companies are saying they plan to cut back not on executive equity, but instead on broad-based employee ownership. This response is economically irrational in the face of convincing research, but that research has been too often overlooked by companies and institutional investors alike. The latter group has largely ignored the issue of how equity should be allocated, focusing instead on measures such as total dilution or whether executive compensation, no matter how large, is linked to performance. While we agree that linking executive equity to performance makes sense, we believe this is only the beginning of an effective employee equity program.

While equity compensation has often not fulfilled its potential to improve business performance (due largely to a lack of understanding of how to use it effectively), it has spawned profound disparities in personal wealth in many companies between those at the top who have received massive equity grants and much of the remainder of the workforce who get little or nothing, even though these employees play key roles in the company's success. Economic issues of business productivity, then, are compounded by social, ethical, and fairness issues. This is not simply a point made by employee advocates. Such respected business names as BusinessWeek, the National Association of Corporate Directors, former Charles Schwab President David Pottruck, and Public Company Accounting Oversight Board chairman William McDonough, among others, have all made the same point. It seems important to us to address these issues not only from a standpoint of values, however. When employees see their workplace as essentially unfair, their companies suffer, especially when labour markets tighten.

While research and experience make clear that giving the entire workforce a stake in the success of the company through equity ownership is tied to improved financial results, it would be naïve to suggest that broad-based employee ownership is a guarantee of success. Research and experience make it very clear that some employee ownership practices are excessively risky, while others fail to maximize the potential that employee ownership can provide. Employees at dozens of large companies can personally attest to how equity ownership has been a burden, not a boon. And many more companies simply have failed to use the broad equity programs they do have to energize the workforce. Therefore, the committee has also outlined research-driven best practices to make employee ownership both responsible and effective.

The Committee's Charter

Our goal, then, is threefold:

1. To identify practical, achievable benchmarks for the allocation of equity in a corporation that can help optimise both corporate performance and employee rewards.
2. To provide a context for measuring fairness in equity plans to help restore workers' confidence in American corporations.
3. To propose a series of research-based suggested best practices that companies with employee ownership plans can use to assess their progress toward creating effective and fair ownership structures that: 1) provide adequate employee education and training about ownership plans and the company; 2) provide effective employee involvement in decisions affecting their own jobs; and 3) provide the right combination of financial ownership opportunities. This combination of education, communication, and involvement is what we call "ownership culture." This section of the recommendations recognizes that, for legitimate reasons, many companies may only be at a point where they are beginning to implement ownership culture practices, while others are well along that path. The recommendations here are meant to help those that aren't yet there to get there.

In sum, we believe that there are more and less effective ways to implement employee ownership. We cite the research and detail our experience in attachments to this document. The rationale for this exercise is not based only on corporate self-interest, however. We believe that effective employee ownership is a powerful way to build wealth for tens of millions of employees, creating more economic security and allowing broader participation in the market system. At the same time, poorly designed plans can have very negative results for employees. It is our purpose here to help define more positive and effective avenues to help employee ownership meet these twin goals of improving corporate performance and employee financial well-being.

It is not our intent here to propose these guidelines for legislative or regulatory purposes. Rather, we hope that investors and investor advisors will use the recommendations to help set their own policies about equity compensation, and that companies with employee ownership plans will use them to help benchmark their performance.

The guidelines described here are based on extensive research, summaries of which are appended to this document.

Ten Key Principles

1. Effective equity compensation strategy is driven as much as possible by empirical data on what works rather than on theory, assumptions, and doing what other companies do.

Decisions about the allocation of equity should be based as much as possible on empirically sound research on cause and effect relationships between equity allocation and corporate performance rather than theoretical or intuitive judgments. Boards should meet regularly and have a due diligence procedure to perform this evaluation. This analysis would include studies of what works best generally in terms of how broadly ownership should be distributed and with reference to corporate analyses of the economic impact of different approaches to equity sharing within a company.

Explanation

For most companies, the decision as to who gets how much equity is based on intuitive judgments, theoretical arguments, or comparisons with other companies (which are often using equally shaky standards), with an increasing focus on how to limit equity compensation below certain target dilution levels and/or to minimize accounting impacts. Very few companies assess the economic benefits ownership can have on turnover, productivity, and retention versus the costs in cash and shareholder dilution that awarding equity to various employee groups in varying amounts will have.

Companies can fund ownership plans in various ways, including issuing shares directly to employees or through trusts, allowing employees to buy stock, (usually at a discount), and providing individual equity awards, such as options, restricted stock, phantom stock, and stock appreciation rights, among others. Companies can pay for these shares by buying them from exiting owners or issuing new or treasury shares, thereby imposing a dilution cost on other owners. Regardless of how these plans are financed, however, if employees are receiving a benefit, there is either an ultimate cash cost to the company or a dilution cost to shareholders, or both. Yet companies take on these significant financial obligations without the same kind of careful economic analysis of costs and benefits they would for any other comparable expenditure. Some companies, such as closely held companies with employee stock ownership plans (ESOPs), must perform elements of such analyses as part of the fiduciary process, but most other employee ownership plans are not evaluated with nearly as much rigor. Plans would be more effectively targeted if companies were to assess the extent to which they improve performance, tenure, and other objectives.

Research is generally negative about the relationship between awards of equity compensation to top executives (as opposed to purchases of stock by executives) and corporate performance. A 2003 analysis of 229 prior studies showed no consistent relationship; a closer look at those studies shows that only a minority suggest that increasing executive ownership results in subsequent improvement in corporate performance relative to comparable companies, while most show either no relationship or a negative relationship. The most recent and most comprehensive analysis (see appendix) decisively shows that increases in executive compensation, including stock compensation, are negatively related to subsequent corporate performance. Increasing executive equity awards (as opposed to executives purchasing more stock) beyond industry norms is effective, then, only in exceptional circumstances justified by specific analyses of how executive decisions or actions have added value to the company greater than the value of the equity granted. Moreover, companies should predicate ongoing executive equity awards on meeting specific corporate performance measures rather than basing such awards on policies to compensate at or above the industry medians. This latter practice only replicates bad policy and endlessly ratchets up executive compensation.

By contrast, broad-based ownership (the actual ownership of stock or stock options, participation in a trust-based ownership plan, or other equity or equity-equivalent awards as opposed to the mere right to purchase shares or be theoretically eligible to receive options or other awards), has generally been shown to be positively related to improved corporate performance, with only a few studies showing no effect, and none showing a significant negative effect. We define broad-based ownership to mean that at least 50% of all full-time employees meeting minimal service requirements participate in an ownership plan, although there may be some exceptions to this in specific cases (such as a company that excludes foreign employees or employees in a particular subsidiary or union where the union has not bargained into the plan). Based on this evidence, then, the default position on ownership allocation should be that it is broadly based and that this is measured by the actual holding of ownership rights, rather than merely being eligible to receive an award or purchase stock.

2. Effective equity compensation allocates equity between executive, management, and non-management employees fairly and in a broad-based manner.

The allocation of available equity among executives, management, and non-management employees is currently largely based on issues of external comparability (whether top management is making what it might at comparable other companies) and, for executives, on whether performance meets performance standards. While we believe these factors must always be considered, we believe that issues of internal fairness (whether the ratios of rewards between groups or employees is justifiable based on the relative contributions each makes to the corporation) are equally, and perhaps more, important. In assessing corporate performance, the contributions of all employee groups should be assessed, rather than simply assuming that improvements in performance are primarily or solely the results of the actions of one or a few people.

A growing body of evidence suggests that, beyond certain levels, increasing equity awards to senior executives generates rapidly diminishing or negative returns in terms of retention and corporate performance. In the largest study, in major public companies, executive ownership of more than 23% of the total shares led to negative performance in subsequent years. Moreover, concentrating an excessive proportion of a company's equity compensation within the senior executive level undermines the development of a broad-based, companywide culture of employee ownership and commitment, a kind of culture that has been shown to lead to significant improvements in corporate performance and employee retention at all levels. Nonetheless, there is no definitive research on just how much of total equity awards should go to top executives in all kinds of public and private companies. We believe, however, that companies that want to create a productive equity culture should be aware of the evidence on this topic and should perform a cost-benefit analysis of how (or whether) equity compensation at all levels can improve performance by increasing tenure, motivation, or the contribution of new ideas and information by different employee groups. We also believe that, in general, companies have erred on the side of allocating considerably too high a percentage of total equity to top executives.

Many researchers, as well as institutional investors and industry leaders, have suggested specific limits, such as not more than 5% or 10% of total awarded equity (as opposed to founders' shares or shares bought at fair market value) in large public companies go to the top five executives, or somewhat larger amounts in any public company, being awarded to top executives as outright grants or the rights to acquire shares. We believe that these guidelines can be very helpful, but that each company needs to assess what will work best in terms of its own circumstances, then be prepared to defend that based on evidence of a careful assessment as described above.

Explanation

In recent years, executive equity compensation has been largely determined by comparisons with peer groups and a desire to pay at or above the median. This inevitably leads to a leapfrogging effect that ratchets up executive equity compensation at a much faster rate than other compensation. This approach has a number of risks and shortcomings. First, it does not equate the value being added by the extra pay to that produced by the particular executives. Second, it produces gaps between executive and other employee compensation that can create a serious sense of inequity and unfairness among employee groups. Thus, while executive pay has climbed very quickly in recent decades, driven largely by increases in equity compensation, the pay of other employees has generally barely kept up with inflation. Third, it is based on the (mistaken) assumption that almost any amount of compensation can be justified to retain and attract top executives because most or all the value added in a company derives from this group, while employees other than top executives add little or no value that could not easily be replaced with other employees. While companies routinely seek to pay top executives at better than the median, few companies have the same policy for non-executive, and especially non-management, employees. The assumption behind this model, however, is unsupported by research, as well as corporate rhetoric about how "people are our most important asset" (does this only mean the people in executive positions?). The largest analysis of marginal increases in executive compensation shows that they are negatively related to future marginal increases in corporate performance. That is, for every dollar increase in compensation, performance actually declines slightly.

The notion of limiting executive pay has found widespread support in recent months. For instance, William McDonough, chairman of the Public Company Accounting Board has said that executive pay is much too high and endangers public confidence. He said executive pay should have a "moral compass that treats employees as neighbours; 400 to 500 times the pay of a neighbour is not moral. The National Association of Corporate Directors argued that pay should be set with an eye toward fairness to other employees. CalPERS and CalSTRS, the twin California state pension funds, have adopted a rule that not more than 5% of total employee equity awards should go to the top five executives in large public companies.

3. Broad-based equity plans should generally provide equity to a majority of full-time employees.

At least a majority of full-time employees meeting minimum service requirements (of not more than two years employment) should be eligible to participate in broad-based equity plans. Employees covered by a collective bargaining agreement can be excluded subject to labour law requirements about negotiations over the plan. Exceptions to eligibility rules should also be made in cases where a company operates multinationally and sharing ownership is impractical in some locations. Reasonable vesting requirements consistent with industry practices and/or legal standards are appropriate. The amounts of ownership available should be financially significant (in terms of how much the awards contribute to an individual employee's overall compensation) rather than symbolic. While it is not possible to set a clear dividing line between what is symbolic and what is meaningful, research shows that typical broad-based ownership plans deliver equity value to non-management employees equivalent to at least one year's pay over 10 years of service. This provides a reasonable benchmark for equity pans that can be achieved in a variety of ways. Both broad-based stock option plans and ESOPs, for instance, on an annualised basis, have average company contributions equal to about 8% of pay. Given normal rates of return, this would provide an equity benefit worth more than one year's pay over 10 years. However companies seek to reach this goal, they should have a clear plan in mind about how their equity compensation plans can deliver enough value to make them meaningful to employees. (It is not possible to make these comparisons for ESPPs, which usually play an adjunct role to other employee ownership vehicles in a company). In making investment decisions in companies with broad-based plans, companies that fall significantly below these numbers are unlikely to realize the benefits from employee ownership, the research has demonstrated.

In addition to sharing equity, many companies have an added profit sharing or bonus plan. While there is no specific research on whether this combination results in improved performance, many experts argue that, where possible, it is a very effective part of an overall program to link employee rewards to behaviours.

Allocations of equity should be based either on formulas consistent with the requirements of defined contribution plans, on non-discriminatory opportunities to purchase stock at a discount or with pretax dollars, or on performance-based targets that either make ownership opportunities available to most employees or are combined with other more formula-based plans.

In addition to issues arising from employees buying stock, equity plans should generally be designed to allocate equity on a periodic, ongoing basis, rather than solely or primarily on a one-time major award. Such awards introduce excessive risk for the employee in that the value of the award is determined, in significant part, on the price of the shares or options when they were issued. Note that ESOPs and similar plans avoid this issue as a matter of standard design.

Explanation

Some companies claim to have broad-based plans when they make all employees eligible for awards, but in practice grant awards only to a minority of employees. While it is acceptable to give limited performance awards under one plan, it should be accompanied by a more broadly available plan. Examples include:

- An employee stock ownership plan (ESOP), a qualified profit sharing plan primarily invested in company stock, or a 401(k) plan in which most employees participate and receive a match partly or entirely in stock would meet the coverage guidelines (but not necessarily the guidelines for providing significant rewards) because the laws governing these plans require broad participation.
- An employee stock purchase plan (ESPP) would meet the coverage guidelines only if a majority of eligible employees participate, and the amount guidelines only if deferrals into the plan are more than symbolic, or the ESPP is an adjunct plan to another broad-based plan. ESPPs should, at the least, offer a 10% discount on purchase and/or a three-month or more look-back feature.
- An employee stock option, restricted stock, or similar plan would meet the guidelines if the amounts granted were more than symbolic and more than 50% of employees meeting minimal service requirements actually received grants rather than just being made eligible to receive a grant if their individual or group performance is adequate.

If one plan does not meet these criteria by itself, a company might still meet the guidelines through a combination of plans.

4. Executive ownership in public companies should be determined by an independent committee using rigorous established guidelines.

For public companies, we agree with numerous other bodies that have made the recommendations listed in this section. One of the most important of their recommendations is that executive equity compensation be determined by an independent compensation committee with input from a compensation consultant with no other relationship to the firm or the executives. Equity plans for executives should be performance-based. Performance measures should require performance above the median for the comparable firms in the industry but not be measured by short-term (one- to three-year) stock price movement, variation in which has consistently been shown to be too random to be clearly related to executive actions. Performance could also be based on individual or group measures. Guidelines for performance should not be adjusted after awards are granted to make targets easier to meet. Executives should be required to hold on to any shares for which they did not pay market value and that were not subject to performance contingencies (such as tenure-based awards) until after they leave office, with the exception of very limited and specified extraordinary financial needs.

In addition, public companies should consult the standards on these issues published by the National Association of Corporate Directors, the Conference Board, and the Compensation Standards Conference, which propose more detailed procedural safeguards and processes that go beyond (and are more rigorous than) those described here. Public companies should also establish rules for compensation committee consultants to issue a pay audit opinion similar to an auditors' opinion, stating that they have reviewed executive pay, including all long-term and short-term compensation, perquisites, and benefits. The report should indicate how executive compensation is related to general principles of pay-for performance.

Closely held companies should consider the guidelines described here. The committee recognizes, however, that some or even all of these guidelines may be impractical or inappropriate for some closely held companies. However, we recommend that these companies' boards seriously consider which of these guidelines may be applicable.

Explanation

The principal focus of these guidelines is not on setting executive pay; other proposals, such as those above, provide reasonable and detailed recommendations on this issue that we generally endorse. We believe the guidelines set here, however, provide minimally acceptable practices that help limit the potential costs and risks of excessive and/or poorly designed plans.

5. Companies should provide for diversified retirement opportunities as well as company equity ownership.

A company's broad-based employee ownership plan should normally be accompanied by other more diversified retirement plan opportunities, either within the employee ownership plan or by having an additional plan in place. An exception to this norm would be those cases when to do otherwise would directly affect employment, and employees are able to make a well-informed choice about the risks involved in concentrating retirement assets in a single plan or in ownership plans that can demonstrate highly realistic retirement security prospects without normal diversification. Cases involving potential job risk would primarily (but not exclusively) include employee purchases of companies that would otherwise close, start-up companies unable to pay competitive wages, stock-for-compensation/benefits concessions negotiated by a union, and the substitution of stock for compensation to prevent a major corporate layoff or closure. A second exception would be companies using employee ownership to effect a purchase of a substantial share of company assets and being unable, on a strictly temporary basis, to provide a diversified retirement plan as well. For companies seeking to rely primarily or exclusively on employer stock for retirement, without having a diversified retirement opportunity as well, the burden of proof should be on the company to demonstrate why its securities have an exceptionally low investment risk. Contributions of company stock to a 401(k) plan can be a very effective way to spread ownership, but companies need to provide adequate and objective information to employees about balancing the risks and rewards of investing their own deferrals in company stock in such plans.

Diversified plans may be as simple as an employee-funded 401(k) plan with multiple investment choices or as complex as a defined benefit plan.

Nothing in this section is meant to establish a simplistic measure of risk that looks solely at the percentage of total retirement assets or total wealth an employee has in an employee ownership plan relative to other retirement plans. An employee in a successful ESOP or stock option plan, for instance, may have a large amount of wealth in these plans, both absolutely and on a percentage basis and that, indeed, should be a goal of the plan. An employee with $100,000 in retirement assets, 75% of which are in employer stock, is 75% undiversified, but in better retirement shape than an employee with 100% diversification in a $25,000 account. Rather, the focus here is the provision of either an alternative diversified retirement plan, even if that is simply a 401(k) plan funded entirely by employee deferrals, or sufficient diversification within an employee ownership plan so that employees are not left unable to retire because of a failure of company stock. In addition, companies need to help employees understand the importance of having enough of their retirement savings invested in a diversified or, at least, secure portfolio to have enough at retirement to meet their minimum needs.

Explanation

The debacles at Enron, WorldCom, and other companies demonstrated the substantial risk of focusing most or all assets needed to meet minimal retirement needs in company stock. In general, employees should always have available an additional diversified retirement plan and/or have diversification opportunities within their employee ownership plan if it is the only retirement-oriented plan.

Employee risk is different in different kinds of plans. ESPPs have virtually no risk unless, after exercise, an employee voluntarily chooses to hold on to shares (just as any other investor has risk buying or holding shares). ESOPs are almost entirely funded by the company, usually in addition to other compensation, so their risk is different and less substantial than when employees invest their own money or give up wages for stock. Similarly, individual equity plans, such as stock options and restricted stock, usually provide the employee with the opportunity for gain but few, if any, risks for loss other than holding on to exercised shares, just as with ESPPs. Plans that are funded primarily by employee deferrals, such as 401(k) plans in which employees invest heavily in company stock, present a great deal more risk.

Broad-based employee ownership plans should also generally not require more risk taking than plans for executives. For instance, if executives get options, stock grants, warrants, or restricted stock grants all at no cost to them, and those awards are often adjusted or regranted if the original awards do not deliver their expected value, while other employees can become owners only by purchasing shares through an ESPP or a 401(k) plan, employees are clearly taking much more risk, even though they have less financial capability to do so.

A non-inclusive list of examples of responsible approaches follows:

- 401(k) plans and public company ESOPs that are funded in part by direct employee purchases of shares, other than through dividend reinvestments, or 401(k) plans having corporate stock as an investment choice should:

a. Allow for diversification of employee investment deferrals at the option of the employee within three years of their contribution.

b. In public companies, allow for diversification of corporate stock contributed by the employer after it has been in the plan for not more than three years (this requirement would be impractical in closely held companies).

c. Provide employees with information and advice on the importance of diversifying retirement assets.

- ESOP fiduciaries should generally not approve the funding of the plan by the movement of assets from diversified retirement plans except in unusual cases where:

a. This is the best method for saving a substantial percentage or all of the company's employment or is the most practical way for employees, on a voluntary basis, to assume ownership of a healthy company.

b. Employees are provided with detailed information about the change.

c. The reallocation of assets is either voluntarily directed by the employee or by an independent fiduciary.

d. The percentage of diversified assets reinvested is less than 30% of total retirement assets per employee if the decision is made by a fiduciary rather than by employee election. Amounts larger than this would require that employees be given individual choice about moving all or part of their retirement assets into an ownership plan.

6. Public companies should provide adequate disclosure to investors and employees about equity plans.

We strongly recommend that public companies disclose on their Web sites and in their SEC filings total employee equity (all ERISA, ESPP, options, etc.) broken down by kinds of equity granted and which employee groups currently receive them. Current rules provide for disclosure of total equity granted and equity held by only the top five executives. Some plans are not included, and it is very difficult to figure out just what percentage of a company is directly or indirectly owned by whom.

In addition, when employees become owners by purchasing shares or exercising options, the company should provide adequate information on the company's financial situation and risks, tax consequences of decisions, and general information on investment strategies, both before employees make the purchase and on an ongoing basis. Employees should be well informed about the particular tax, exercise, and distribution rules that apply to each kind of plan in which they participate. In closely held companies, employees should either receive statements indicating the independently appraised value of their shares (the preferred approach) or, if there is no independent appraisal, how the stock price is determined. If employees are purchasing shares, they should receive detailed disclosure on the risks and financial considerations involved in such purchases written in such a way that it is clear and understandable to non-sophisticated investors.

Explanation

As the experience at Enron and others demonstrated, employees do not always have a good understanding of the issues of risk and retirement investing. Company loyalty or, in some cases, pressure to buy stock can cause employees to buy more company stock than their financial situations would warrant. Companies should therefore make sure employees have unbiased, easy-to-understand, and regular communications about the pros and cons of purchasing employer stock, as well as information or access to information about how to plan for retirement.

7. Public companies' plans should be fair to shareholders as well as employees.

In public companies, equity plan design needs to consider not just fairness to employees, but to outside shareholders as well. Repricing of awards, whether immediate or delayed (such as on a six months-and-a-day basis), or otherwise changing conditions or terms so that they become more valuable or more easily obtained than previously intended should be limited to the most exceptional cases. Such changes should be justified by an independent assessment, publicly available, of the economic costs and benefits to shareholders of doing so prior to submitting for shareholder approval. Where awards are repriced or similarly modified, the new awards should be granted subject to a restart of vesting, should be granted at less than a ratio of 1:1 for exchanged shares, should be granted only if the cancelled awards were deeply out-of-the money, and could include other restrictive conditions that guarantee that the new awards will have less short-term value than the awards they replace. By contrast, it may be more appropriate and less costly to reprice broad-based equity awards in limited and appropriate circumstances, provided this is not done on an ongoing basis.

The dilution resulting from equity plans should be justified by an economic assessment of their costs and benefits. Instead of issuing guidelines for a maximum amount of allowable dilution, companies and shareholder groups should periodically agree to corporate goals that, if met, would trigger the release of an additional number of shares to be available for award. On an ongoing basis, the split between executive allocations and broad-based plans should stay at a consistent ratio within parameters established by the board. This guarantees that the allocation of stock will not be overweighed to executives.

While these guidelines are most applicable to public companies, the boards of closely held companies should also consider them in establishing best practices for executive compensation, understanding that some of the guidelines described here may be inappropriate or impractical.

Explanation

Few issues have stirred shareholder concern more than repricings of options or other equity awards for top executives. Even if companies do not literally reprice, they may achieve the same ends by issuing more options or other awards than initially intended or, if the awards are performance based, changing the targets mid-stream. Either way, the effect is to make contingent pay more like assured pay. Many of the committee members argued that repricings for top executives should never be allowed. Research on this subject is limited, but the one study that looked at the impact of repricing on retention rates found that it did not increase executive retention (but it did improve retention of non-management employees), so there appears to be little justification for its continuation for executives.

On dilution, the standard approach of many institutional investors has been to view dilution above some fixed level as per se bad. This is too limited a view. Shareholders should be willing to share the results of exceptional performance even if it increases dilution above guidelines. Conversely, if performance does not meet targets, shareholders have legitimate concerns about issuing additional equity. In this approach, then, employees have a contingent interest in corporate performance based not just on the growth in existing stock award values, but in the issuance of new awards as well. In terms of allocation of equity, plans should not be designed so that senior executives start off with a reasonable percentage of the total, but gain a larger percentage over time as performance targets are met. One approach to this would be to state that in any pool of awards made in a year, not more than a fixed percentage would go to senior executives; a second would be to set an upper bound on the total equity allocation going to the most-senior executives.

While these guidelines are focused on public companies, their principles would generally be applicable to closely held companies. For instance, an ESOP fiduciary might want to oppose the repricing of option awards to executives unless the ESOP received a compensatory contribution. The committee recognizes, however, that closely held companies present a variety of specific circumstances that may not, in all cases, make these guidelines appropriate.

8. Governance and procedural practices should be established and clearly communicated.

The committee recommends that companies establish a set of governance and procedural practices for the operations of their equity plans, covering who should oversee such plans, the provision of adequate and fair information to employees, rules for protecting the assertion of employee rights in connection with the plan, and how employees can file complaints concerning it. This would apply to any kind of ownership plan.

Specifically in trust-based plans, the fiduciary for a decision should not be one or more individuals with a financial interest in the outcome of that result. A seller to an ESOP, for instance, should not act as a trustee and/or fiduciary to determine if the buyer is paying a fair price for the seller's shares. A 401(k) plan trustee and/or fiduciary should not be a major shareholder when making a decision about whether to diversify out of company stock. In any case involving the sale or purchase of employer stock for employees, fiduciaries should be advised by independent, outside consultants specializing in this field.

In any stock plan, employees below the management level should not be pressured to buy, hold, or sell stock, nor should employees who raise concerns about the operation of a plan be subject to harassment or termination for this reason. Public companies should have clear procedures and training for meeting insider trading rules. Closely held companies should have consistent, justifiable standards for valuing shares so that sales to or purchases from one group of employees are not made in a manner that treats another group less favourably.

Explanation

Although ethical practices are difficult to establish as a matter of standards and structures, the issue of who should be a fiduciary for a plan decision is straightforward and backed by extensive case law, although not always statutory requirements. In many of the 401(k) plan lawsuits, for instance, executives and board members acted as fiduciaries for their plans, encouraging the purchase of shares and discouraging their sale at times when it was clearly in the interest of employees to act differently. Beyond fiduciary standards, however, ethical practice guidelines take on a more ambiguous colouring. Governance and procedural practices should therefore be enhanced by establishing an ethical guidelines policy for employee plans to make it easier for ethical people to retain their values and harder for less ethical people to impose theirs.

9. Communications and education are essential and often underemphasized elements of an effective equity plan.

Numerous studies show that many employees have little understanding of how their ownership plans work. This failure to communicate effectively undermines plan effectiveness and wastes shareholder assets. Companies with broad-based ownership plans can conduct ongoing communications programs that use multiple communications and learning approaches to help solve this problem. Where possible, non-management employees should be involved in the design and implementation of a communication program. Simply handing out summary plan descriptions, no matter how well-crafted, is not enough.

In addition to educating employees about how their plan or plans work, companies should provide education about how the company works. Companies will take many different paths on this, but for employees to work well as owners, it is vitally important that they understand just how what they do affects how the company performs.

Explanation:

It is extraordinary that companies spend as much money as they do on equity plans and as little as they do on making sure people understand them. Because employees learn differently, all but the smallest companies should use multiple learning approaches (meetings, printed material, Web sites, etc.) to help employees understand how the plans work. Resources should be available to answer questions and get more information. Companies should periodically assess how well employees understand the programs and how they can be improved.

10. Creating and maintaining an ownership culture requires meaningful employee involvement in work-level issues.

Research has consistently shown that companies that use employee ownership to create "ownership cultures" for all their workers, rather than just make executives wealthier, perform substantially better than their peers. The techniques for doing this vary widely, but, at their core, share the common principles of open-book management and involving employees in day-to-day work decisions (often through teams) as much as possible. The explanation below outlines the typical elements found in ownership cultures, although the mix of these elements varies considerably.

Explanation of best practices

Best practices for creating ownership cultures include the following:

a. Sharing financial information with all employees in a variety of ways, such as:
  - Sharing income statements and balance sheets, or summary versions of these designed to communicate the relevant numbers employees can actually affect.
  - Sharing other performance measurements that track corporate financial objectives and critical performance numbers.
  - Sharing performance measures for work groups, teams, or other operational units.
  - Sharing strategic goals.
  - Creating financial literacy vehicles that clearly link individual performance to value.

b. Providing employees with at least basic training to understand essential financial and performance measurements.

c. Providing employees with at least basic information and learning opportunities for how to plan for their own financial security.

d. Creating opportunities for employee involvement in work-level decisions, such as:
  - Establishing work-level teams, ad hoc committees, cross-functional teams, or other opportunities for employees to regularly interact with their colleagues to have input and/or make decisions about how their jobs are organized and performed.
  - Delegating authority for particular decisions so that they are based on expertise rather than formal position or strict hierarchical patterns.
  - Creating formal mechanisms for employees to make suggestions and receive prompt, specific feedback.
  - Evaluating which decisions should be made at which levels, with a bias toward having employees make any decisions for which they have the appropriate expertise.

e. Setting up an employee/management steering committee to help oversee participative management approaches.

f. Providing training programs to assist employees to gain additional skills to expand their job responsibilities and opportunities.

g. Allowing for periodic re-evaluations of ownership cultures, particularly through modeling after other successful ownership culture companies.

h. Using appropriate forms of sharing ownership. Research indicates that broad-based options and ESOPs can have a significant impact on performance, while ownership through 401(k) plans (particularly those driven primarily by employee investment) and ESPPs is generally less effective. The key here appears to be that ownership works best (if not exclusively) if it is in addition to other compensation. ESOPs and options tend to be set up this way. These plans also are more universal and more evenly allocated in their coverage as they do not depend on employee investment. This makes it easier to promote a "we are all in this together" culture. ESPPs and 401(k) plans can be effective, however, if they provide a substantial add-on benefit and have wide and significant participation.

Putting the best-practices ownership culture principles in context

These guidelines are intended to offer a set of criteria for companies to employ in pursuing the benefits of employee ownership through the establishment of "ownership cultures." Best practices in the employee ownership field are exemplified by companies that have created ownership cultures. The committee recognizes that companies setting up employee ownership plans may have only started along this path, and it would be inappropriate to judge them for not yet having reached all the objectives outlined here. The committee also recognizes that different companies will emphasize different elements of the best practices described here. There is no one road to the creation of an ownership culture. Effective companies have created dozens of different tools and techniques for making ownership real, and for getting employees to think and act like owners. What matters most are the guiding principles of sharing information, structuring meaningful employee input into decisions affecting their work, and providing appropriate training to make sure employees have the skills to be effective participants. If a particular practice seems to incorporate the appropriate principles, it can help build an effective ownership culture. For investors investing in employee ownership companies, these elements will be very powerful indicators of the likelihood of company success.

Questions or Comments?

Contact NCEO Executive Director Corey Rosen at crosen@nceo.org.

Members of the Committee for Effective Employee Ownership (CEEO)

Academic Members

John Logue, professor
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Dr. Logue is a professor of political science at Kent Sate University and the director and founder of the Ohio Employee Ownership Center. He was recently named one of the $50,000 award winners from Leadership for a Changing World, given by the Ford Foundation, which selects 17-20 outstanding leaders for their contributions to social change.

Joseph Blasi, professor
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Dr. Blasi is a professor at the Rutgers School of Industrial Management and Labor Relations. He is recognized as the leading scholar on employee ownership in the U.S. and the lead author of *Employee Ownership: Revolution or Ripoff?*, *The New Owners*, and *In the Company of Owners*.

ESOP Members

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Mr. Kaplan has worked on numerous ESOP transactions over the past decades, and is a highly respected professional in the field.

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Mr. Ludwig, now retired, was the leading legal practitioner in the field of employee stock ownership plans (ESOPs). He led the legal affairs committee of the ESOP Association, remains an editor of the *Journal of Employee Ownership Law and Finance*, and was widely viewed as the final authority on ESOP legal matters.

Christopher Mackin, principal
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Dr. Christopher Mackin is the founder and president of Ownership Associates of Cambridge, MA. Ownership Associates is a leading contributor in the fields of corporate training and assessment concerning the concept of ownership culture.

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Mr. Mathews, an NCEO board member, is considered the leading expert on plan administration and has been a consistent voice for the ethical design and operation of employee ownership plans.

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Mr. Burmeister is widely regarded as the leading legal expert on internal equity plans. He is also on the board of the National Association of Stock Plan Professionals and the Certified Equity Professional Institute at Santa Clara University.

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Ms. Schneider is with PricewaterhouseCoopers, as well as a co-founder of the Global Equity Organization and the National Association of Stock Plan Professionals. Before joining PricewaterhouseCoopers, she lead the global stock plan group at Watson Wyatt.

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Mr. Ward is senior vice-president at Aon Consulting, one of the largest compensation consulting companies in the world. Previously with WestWard Pay Strategies and Frederic W. Cook & Co., Mr. Ward is widely acknowledged as the leading authority on the use of equity compensation in the technology industry.

Visionary Members

Robert Beyster, founder, chairman of the board, and former CEO
Science Application International Corporation
Dr. Beyster deserves to lead this category. He is the founder, chairman of the board, and retired CEO of Science Application International Corporation (SAIC), an employee-owned company with 41,000 employees. Throughout the SAIC's history, employee ownership through options, ESOPs, and an internal stock market have been at the core of the company's culture.

Ray Smilor, president
Beyster Institute at the Rady School, UC San Diego
Dr. Smilor is President at the Beyster Institute at the Rady School, UC San Diego. Previously, he was vice president of the Kauffman Center for Entrepreneurial Leadership at the Ewing Marion Kauffman Foundation. In that capacity, he helped build one of the most prominent organizations promoting entrepreneurship in the United States. Before joining the Kauffman Center, Dr. Smilor was a tenured professor at the Graduate School of Business at the University of Texas at Austin. He also served as the executive director of the IC2 Institute at the University of Texas, which became an internationally recognized think tank for entrepreneurship and economic development. Ray has also been very involved in the writing and editing of several books and articles on entrepreneurship.

Ryan Weeden, consultant
Mr. Weeden was the executive director of the Global Equity Organization (GEO) until 2004. He has six years of experience in the equity compensation field, having worked previously at the National Center for Employee Ownership (NCEO) co-directing the center's stock option and international equity compensation activities. Mr. Weeden holds a master's degree from the University of Wisconsin at Madison and is a Certified Equity Professional (CEP). He is the

author and co-author of five books on employee ownership and equity compensation and is a frequent speaker nationally and internationally on the topic.

Lead Organizer

Corey Rosen, cofounder and executive director
National Center for Employee Ownership

Dr. Rosen is the executive director and cofounder of the NCEO. He received a Ph.D. in politics from Cornell University in 1973, taught politics at Ripon College, and worked as a professional staff member in the U.S. Senate, where he helped draft some of the legislation governing employee ownership. He has co-authored many books on employee ownership and written over 100 articles on the subject for business, professional, and trade publications. He has spoken at meetings all over the U.S., as well as in Europe, Asia, and South America.

Dr. Rosen, along with esteemed financial writer John Case, is set to publish a forthcoming book, *Equity*, through Harvard Business School Press in January 2005. This milestone book will address the fundamental nature of equity in today's economy: how it is distributed, and why it should be distributed. A long-time champion of employee ownership, Dr. Rosen has held close to the belief of Louis Kelso, an investment banker famous for developing the ESOP concept. Kelso believed that in order for capitalism to work, real workers need access to capital and/or capital-producing assets. Simply paying higher wages to mid- and low-income employees would, in essence, perpetuate the status quo of having a few select capitalists entirely benefit from this form of capitalism. With the NCEO and subsequent decades of work to promote the virtues of broad-based employee ownership and ownership culture, Dr. Rosen is a leader advocating the democratisation of capital.

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Committee for Effective Employee Ownership (CEEO)
Statement of Principles: Research Appendix

Employee Ownership and Corporate Performance: Does It Matter Who Gets Equity?

By the end of 2004, public companies in the U.S. and worldwide were facing increasing pressure to change their equity compensation programs. A requirement to expense options, both in the U.S. and, now, most industrial countries; tougher shareholder approval rules for companies whose stock trades on U.S. exchanges; and greater shareholder pressure to limit and/or change equity plans have made it necessary for many companies to think through who gets how much ownership more carefully. At the same time, more and more closely held companies are looking at sharing ownership broadly. Unlike public companies, where there are concerns about excessive concentration of ownership in the hands of executives who were not major investors in or principal entrepreneurial drivers of a company, in closely held companies the issue whether spreading ownership to other employees is economically or philosophically desirable. Ultimately, in all companies corporate boards and compensation committees need to ask which strategies work best for long-term corporate performance and shareholder returns. Fortunately, there is now considerable research on how the distribution of equity affects both these measures. Studies of broad-based equity plans and corporate performance indicate a consistently positive relationship; studies of equity compensation geared primarily for executives come to mixed and uncertain conclusions.

The most comprehensive summary of broad-based ownership's connection to corporate performance comes from Joseph Blasi, Douglas Kruse, and Aaron Bernstein in their book *In the Company of Owners* (Basic Books, 2003). Blasi and Kruse are at Rutgers University; Bernstein is at *BusinessWeek*. The authors analyzed research on what they call "partnership capitalism," namely sharing equity with most or all employees in one fashion or another, as well as on employee involvement and profit-sharing programs. Most of this research is on employee stock ownership plans (ESOPs), because this is the longest-established method for sharing ownership widely. There have been recent studies on options as well, however. It is worth quoting the authors' conclusions at length:

> "In the past twenty-five years, researchers have done more than seventy empirical studies of these forms of risk sharing [*ed.'s note:* by "these forms," they mean partnership capitalism]. Taken together, the studies provide compelling evidence for the net gain that the partnership approach can produce for a company's shareholders. …The results surprised even us, not because they were so positive, but because they were so extensive and so uniform. …The

> most striking conclusion: Every major study found that investors came out ahead if their company adopted key elements of partnership capitalism. …We added up all the conclusions and averaged them into a single finding for each of the four elements. Roughly speaking, we found that the partnership approach improves a company's productivity level by about 4 percentage points, compared to firms that don't adopt such practices. Total shareholder returns increase by some two percentage points relative to other firms. Profit levels—as measured by return on assets, return on equity, and profit margins—jump by about 14%…The gains in profits and returns came after the dilution borne by outside shareholders has been factored in."

As numerous as studies of broad-based ownership plans are, far more numerous are studies looking at executive pay, perhaps because funding is more readily available. One of the most thorough and recent analyses of these studies provides a useful summation. John Core, Wayne Guay, and David Larcker are all at the University of Pennsylvania's Wharton School. In their 2003 paper "Executive Equity Compensation and Incentives: A Survey" (*FRBNY Economic Policy Review*, April 2003), they state:

> "There is presently no theoretical or empirical consensus on how stock options and managerial equity ownership affect firm performance. …A limitation of this research is that the causal direction of the relation between equity incentives and performance in unclear. …Rather than higher equity incentives producing better future firm performance, it may be the case that firms expecting better future performance grant more equity."

Below, we break out the most important studies on this topic, looking primarily at those that show a before-and-after effect, rather than just a correlation. Correlational studies (studies that show that companies with certain ownership characteristics are better performers than those without them) are limited by the fact that it is not possible to know whether greater ownership is a cause or effect of better performance.

This is an important point that deserves some elaboration. Many studies, often from compensation consulting firms, show that executive ownership, largely through options and other grants, is correlated with corporate performance, usually measured by total shareholder returns. The best of these studies are clear in pointing out that no causal conclusions can be drawn from this, but others are less cautious. Consider the alternative explanations for this phenomenon:

1. *Executives were motivated by the possibility of greater equity and so worked harder to improve shareholder performance.* "Working harder" can be a slippery concept. Surely, if all it means if that CEOs are spending less time at work playing video games, the argument seems more parody than persuasion. More sophisticated analyses argue that working harder means paying more attention to shareholder returns as opposed to other things. But what would those other things be? Clearly, some could be purely personal—empire building, vanity enhancement (buying a sports team, perhaps), or even charity. Others things that could draw executives' attention, such as focusing on long-term corporate growth as opposed to near-term profits or maintaining a work force on the theory

that it will be worthwhile in the long run even if costly in the short run, are arguably good for shareholders, just not right away.

2. *Executives, having access to more information, pushed for more equity in anticipation of an increase in its value:* Even if direct ownership is measured, it could be that executives bought more shares because they had information, including decisions they would be making, leading them to believe it was a good time to invest. Alternatively, they may simply ask their boards for more equity.
3. *Given company success, boards rewarded executives with more ownership:* In this case, it was the increased performance that caused the higher grants of equity, not the other way around.
4. *Executives made decisions that pushed up short-term performance at the cost of long-term performance:* In the 1980s, the stock market almost inevitably rewarded companies for significant reductions in their work forces. CEOs of these companies were seen as tough-minded heroes. Subsequent analysis of these companies, however, showed the market was overly enthusiastic about the long-term impact of these efforts given that they often left companies unable to take advantage of future growth opportunities. Studies of the impact of executive equity grants, however, typically have a very short-term time horizon, rarely more than three years.
5. *In extreme cases, executives simply fudged the numbers:* While the total number of companies where this happened was a very small percentage of all companies, they included companies that, collectively, accounted for a much more significant part of the economy. Yet for some years, studies of the equity ownership in these companies would clearly show that concentrations of mega-grants of equity were a good thing.

This same critique, of course, could be leveled at some studies of broad-based equity programs. Early on, in fact, what studies there were of broad-based ownership were suspect precisely because it was unclear whether broad-based programs caused better corporate performance or resulted from it. More recent research has addressed that issue. We focus, therefore, primarily on studies that try to use what is called a "quasi-scientific" approach. The idea here is to take a group of companies using one equity approach or another and compare it to similar companies both before and after the plans were established. The idea is to index out industry effects and focus just on any incremental gains or losses caused by the program. So if ABC company was growing at 2% per year faster than its peers before its equity program, and grew 4% per year faster after, we could say that, absent some other identifiable factor introduced at the same time, the equity program appeared to have caused a 2% increment in growth. It's that 2% that matters.

In the material that follows, we summarize key research on these topics. Because our expertise is focused on broad-based plans, we present more detail on this research, relying primarily on summaries of executive ownership research by leading scholars in the field.

Broad-Based Ownership and Corporate Performance

Most of the research in this field applies to ESOP companies. As of yet, only a few major studies have been done on the impact of broad-based stock option plans on corporate performance. In ESOPs, the findings also apply primarily to closely held companies, although there are some data on public companies. By contrast, the options studies look primarily at public companies. There are currently no studies on the effects of ownership through 401(k) plans or ESPPs on corporate performance.

ESOPs and Private Companies

In the largest and most significant study to date of ESOPs in closely held companies, in 2000 Douglas Kruse and Joseph Blasi of Rutgers University found that ESOPs increase sales, employment, and sales/employee by about 2.3% to 2.4% per year over what would have been expected absent an ESOP (data provided for NCEO Web site, available at www.nceo.org/library/esop_perf.html; article currently in submission for publication). ESOP companies are also somewhat more likely than their competitors to still be in business several years later. This is despite (or perhaps because of) the fact that ESOP companies are substantially more likely than comparable companies to offer other retirement benefit plans along with their ESOPs.

Kruse and Blasi obtained files from Dun and Bradstreet on companies that had adopted ESOPs between 1988 and 1994. They matched these companies to non-ESOP companies that were comparable in size, industry, and region. Then looked for which of these companies had sales and employment data available for a period three years before the plan's start and three years after. The sales and employment growth data were then compared for each year for each paired company. They also checked the companies' filings with the Department of Labor to determine which of the companies had other retirement-oriented benefit plans. Finally, they looked to see what percentage of the companies remained in business in the 1995 through 1997 period.

The process yielded 343 ESOP companies and 343 pairs for the overall sample. However, missing data meant that employment data were available for only 254 ESOP companies and 234 pairs, sales data for 138 ESOP companies and 77 pairs, and sales/employee data for 115 ESOP companies and 65 pairs (some non-ESOP companies could be paired with more than one ESOP company).

The results showed that ESOP companies perform better in the post-ESOP period than their pre-ESOP performance would have predicted. The table below shows the difference in the pre-ESOP to post-ESOP period for ESOP companies’ sales growth, employment growth, and growth in sales per employee:

Difference in Post-ESOP to Pre-ESOP Performance, ESOP vs. Comparable Non-ESOP Companies

Annual sales growth +2.4%

Annual employment growth +2.3%

Annual growth in sales per employee +2.3%

It might be assumed that sales per employee would not go up by a full 2.3% per year since the sales and employment growth increases were about the same, but, the researchers explain, the differing compositions of the samples for the measures makes such a simple comparison misleading. The relative growth numbers might seem small at first glance, but projected out over 10 years, an ESOP company with these differentials would be a third larger than its paired non-ESOP match.

The first study to show a specific causal link between employee ownership and corporate performance was by Michael Quarrey and Corey Rosen of the NCEO ("Employee Ownership and Corporate Performance," *Harvard Business Review*, September/October 1987). The study looked at the performance of employee ownership companies for five years before and after they set up their ESOPs. It indexed out market effects by looking at how well employee ownership companies did relative to competitors in the pre- and post-ESOP periods, then subtracted the difference. For example, if a company were growing 3% per year faster than its competitors in the pre-ESOP period, and 6% per year faster in the post-ESOP period, a +3% difference would be attributable to the ESOP, other things being equal.

The study found that ESOP companies had sales growth rates 3.4% per year higher and employment growth rates 3.8% per year higher in the post-ESOP period than would have been expected based on pre-ESOP performance. When the companies were divided into three groups based on their levels of participative management they were, however, only the most participative companies showed gains. These companies grew 8% to 11% per year faster than they would have been expected to, while the middle group did about the same, and the bottom group showed a decline in performance.

Participation alone, however, is not enough to improve performance. A large number of studies show that the impact of participation absent ownership is short-lived or ambiguous. Ownership seems to provide the cultural glue to keep participation going.

These two studies remain the most significant analyses to date of the impact of ESOPs on corporate performance in closely held companies, but other studies, particularly by Gorm Winther of firms in New York and Washington (Gorm Winther, *Employee Ownership: A Comparative Analysis of Growth Performance,* Aalborg University Press, 1995), reached very similar conclusions. It is important to note that differences in compensation do not explain the improved performance of ESOP companies; again, research by Blasi and Kruse finds that ESOP companies are much *more* likely than comparable companies to offer other retirement plans (see citation for Blasi and Kruse above), and a comprehensive study in Washington state found that ESOP companies pay 5% to 12% higher wages (*Wealth and Income Consequences of Employee Ownership: A Comparative Study from Washington State,* NCEO, 1998).

Research on Public Companies and ESOPs

The data for public companies are much more ambiguous. A 1999 study by Hamid Mehran of Northwestern University for Hewitt Associates *(Unleashing the Ownership Dynamic—Creating Connections Through Employee Ownership—A Research Summary*, Hewitt Associates, 1999) found that ESOPs in 382 publicly traded companies increased their returns on assets (ROA) 2.7% over what would otherwise have been expected. The study looked at each company's financial returns for two years prior to the plan's implementation and four years after. Each company was compared to industry norm ROA figures for both periods. Mehran also found that for the 303 ESOP companies surviving the entire four-year post-ESOP study period, ROA was 14% higher than the comparison group scores, while for the 382 companies as a group, ROA was 6.9% higher for the four-year period. More than 60% of the companies experienced increases in their stock prices in the two-day period following public announcement of the ESOP, with the average increase for all companies at 1.6%. This suggests that the stock market now reacts positively to ESOPs, a change from the pattern in the 1980s when ESOP announcements were often seen as an indicator that a company was trying to prevent a hostile takeover.

In 1992, Douglas Kruse and Joseph Blasi of Rutgers University and Michael Conte of the University of Baltimore created the "Employee Ownership Index" (EOI), which tracked the average percentage increase in the stock prices of all publicly traded companies with public records of 10% or more employee ownership and more than $50 million in market value. The EOI was subsequently maintained by American Capital Strategies, before it was terminated in 1998. EOI returns were published quarterly in the NCEO's *Journal of Employee Ownership Law and Finance*. The EOI grew 193% from 1992 through 1997, while the Dow was up 145% and the S&P 500, 140%. The authors did not attribute any causal relationship between the ESOPs and these numbers, however.

Other studies look at before-and-after results, with mixed conclusions. Donald Collat, in a 1995 study (“Public Company ESOPs and Corporate Performance,” *Journal of Employee Ownership Law and Finance,* NCEO, 1995), found that public companies that did not set up their ESOPs in response to takeover threats saw their operating margins improve 2.1% per year compared with their pre-ESOP performance. The study looked at companies for three years before and after the ESOP, indexing for market effects. Takeover-threat ESOPs, however, saw a decline of 3.3%. In a 1996 study, Mary Ducy, Zahid Iqbal, and Aige Akhigbe (“Employee Stock Ownership Plans and Cash Flow Performance of Publicly Traded Firms,” *American Business Review* 15, no. 2, June 1997) found that ESOP companies showed a decline in operating cash flow of 0.2% to 2.1% in post-ESOP performance, also using a three years before, three years after measure, and again indexing for market effects. While these are the most thorough of several studies on public company ESOPs, others come to similarly mixed conclusions.

Finally, a 1996 study by Margaret Blair, Douglas Kruse, and Joseph Blasi (“Is Employee Ownership an Unstable Form or a Stabilizing Force?” reprinted in the NCEO’s *Employee Ownership and Corporate Performance*, 2002) found that companies that are publicly traded and at least 20% or more owned by an ESOP are more organizationally stable than comparable non-ESOP companies. Looking at companies between 1983 and 1996, the study found that 74.1% of the ESOP companies remained as independent operations while only 37.8% of the comparison companies did (these figures changed to 59.3% and 51.1% for the period 1983 through 1997, however). None of the ESOP companies went bankrupt, but 25% of the comparison companies did.

These mixed results are probably explained by three factors. First, a 1997 NCEO study found that public ESOP companies generally seem to view employee ownership solely as a benefit plan, not part of an explicit organizational culture, as many closely held companies do (“New Study Finds Public Employee Ownership Firms Not More Participative,” *The Employee Ownership Report*, January/February 1997). Second, ESOPs in public companies tend to own much smaller percentages of company stock than ESOPs in closely held companies. Some studies have indicated this is a factor in how effective ESOPs are. Finally, in many cases, public company ESOPs simply replaced existing 401(k) plans to which the company contributed its stock. Now the company used an ESOP to make this contribution instead. Hence, the "before" was really not much different from the "after," so not much could be expected to change as a result of setting up the ESOP.

Broadly Granted Stock Options and Stock Prices

In a 2003 study, Eric Hager of the University of British Columbia analyzed how shareholders reacted to announcements of broad-based options grants. Announcements were excluded if they did not indicate employees would receive stock options, but were included if employees only or employees in addition to managers, executives, directors, and/or consultants received options ("Do Employee Stock Option Grant Announcements Affect Shareholder Value?" NCEO *Journal of Employee Ownership Law and Finance*, Summer 2003).

Hager looked at companies in Canada and the U.S. For companies to be included in the study, trading data for the period from 120 days prior to the announcement to one day after had to be sufficiently available. Announcements had to involve actual grants, rather than just stock option plans. Hager points out that the announcement of a plan can be misleading, because a company may make a certain number of employees eligible for a plan but actually only make grants to a much smaller number. So Hager looked at actual grant practices. A total of 91 grant announcements were suitable for inclusion in the event study for Canada and 54 in the U.S. The U.S. grants were from 1993–2002 and Canada from 1995–2002. Hager used a standard event-study methodology to extract abnormal shareholder returns, that is, returns greater or less than what would have been predicted in the day following the announcement based on how a model accounting for other companies in the industry performed.

For Canadian companies, Hager found that returns were up 2.13% over what would have been expected for broad grants, and 2.33% greater when more than 1% of the equity was granted. The results were not affected by looking at grants only after September 1, 2000, when the markets began to fall sharply. For U.S. companies, Hager found that returns were up 1.78% over what would have been expected for broad grants when more than 1% of the equity was granted, but there was no significant relationship when less was granted. Again, the results were not significantly affected by looking at grants only after September 1, 2000. The findings for the broad-based grants were statistically significant (that is, not likely to be a result of random variation).

Broadly Granted Stock Options and Corporate Performance

The Rutgers Study, 2000

To date, there have been only three large-scale before-and-after assessments of the impact of broad-based stock option plans on corporate performance. The most important, and largest, was a 2000 study by Douglas Kruse, Joseph Blasi, and Jim Sesil of Rutgers University, and Maya Krumova of the New York Institute of Technology, using data provided by the NCEO. The study was published in *Stock Options, Corporate Performance, and Organizational Change* (NCEO, 2001). The data from that study also produced a number of subsequent studies on sub-samples of companies.

The study sample was drawn from the 1998 NCEO *Current Practices in Stock Option Plan Design* study. That study sent surveys to 1,360 companies that were identified as possibly having broad-based option plans, which we defined as plans in which more than 50% of full-time employees would actually receive options. We received 141 responses.

For the Rutgers study's purposes, 105 companies provided usable data. The authors used a before-and-after approach to the data to reduce or eliminate sampling bias issues.

Results were based primarily on the 91% of the sample companies that were publicly traded. Data were gathered on productivity, return on assets, Tobin's Q (a complex financial measure of return on assets that produced similar results to the return on assets measure and are not reported here), and total shareholder return. These were then compared to all non-broad-based stock option companies in their industries of similar size (the full sample group) and to paired comparisons of matched companies that did not have broad-based stock option plans (the paired sample).

Because few companies had discrete plan start dates early enough to perform a comprehensive before-and-after analysis, the researchers, as a substitute, analyzed companies in the periods 1985—87 and 1995–97, reasoning that few, if any, of the companies had option plans in the earlier period and most had them in the later period. Comparisons were made with non-stock-option companies for the two periods and the difference subtracted. In effect, the earlier period results provided a baseline to measure the performance in the later period. If a stock option company had productivity 3% greater than its peers in the earlier period and 6% greater in the later period, then it could be argued that the plan improved relative performance on this measure by 3%.

The study found that productivity rates did improve with the institution of a plan. The difference between productivity scores for the overall sample from the pre-plan period (1985–1987) to the post-plan period (1995–1997) was 14.8% when the comparison group was all non-option companies and 16.8% when looking just at paired comparisons. Sampling error can be strongly rejected as an explanation for these results.

Return on assets showed a similar pattern. Here the stock option companies showed an improvement of 2.5% on ROA relative to the full sample in the post-plan period compared with the pre-plan period. When just paired comparisons are used, the improvement was 2.05%. Again, sampling error is very unlikely to have caused these results.

Total shareholder return, however, showed no statistically significant difference during the two periods, meaning any measured change could simply reflect random sampling error. The researchers thus believe that the any value consequences of dilution caused by broad-based options seems counterbalanced by increased productivity.

Looking simply at how the companies did in the period 1992–1997, without trying to adjust for market effects, a similar pattern emerged. Productivity growth was 1% per year greater and return on assets 5.8% greater, but shareholder return was not statistically distinguishable.

The Wharton Study, 2001

In 2001, Wharton professors David Larcker, Christopher Ittner, and Richard Lambert looked at options and corporate performance, using data from 159 "new economy" companies providing detailed responses on their stock plans for an iQuantic/Buck Consulting (now simply Buck Consultants) survey. They found that the performance effects of option programs depended on how the options were distributed. The study, "The Structure and Performance Consequences of Equity Grants to Employees of New Economy Firms," (Ittner, Christopher D., Lambert, Richard and Larcker, David F., "The

Structure and Performance Consequences of Equity Grants to Employees of New Economy Firms" (January 2002). JAE Boston Conference June 2001).
The study found that broad-based equity grants were the norm in this sector. Companies with greater growth opportunities, larger market capitalization, better past stock market performance, and lower leverage all used options and other equity grants aggressively at all employment levels. The researchers then looked at whether stock returns subsequent to option grants improved or declined. To measure this, they developed a statistical model in which "return" equaled the "continuously compounded stock price return in the 12-month period following grant." They also created estimation models for burn rate (here defined as the rate at which new equity is issued to employees) and overhang (the percentage of total shares outstanding divided into the currently issued and unexercised equity awards plus shares that have been authorized for issuance for equity awards). The results were controlled by a variety of factors, including several industry indicators to factor out returns unrelated to the grants themselves. They also controlled for company size and book-to-market ratios (a measure of balance sheet versus stock market values), R&D expenditures, and advertising sales. The data looked at returns in 2000 relative to 1999.

The results showed that deviations from the norm for overhang and burn rate were unrelated to stock price performance, suggesting that variations in how much equity is granted do not affect abnormal stock price movements (movements away from what would otherwise have been expected). On the other hand, who gets equity does make a significant difference. Larger-than-usual grants to executives (CEOs, vice-presidents, and directors) did not significantly affect stock prices. Grants to managers, "individual contributors" (critical non-management employees), technical employees, and exempt non-technical employees, by contrast, resulted in significantly greater than expected stock price growth. The researchers explained that the model suggests that, for instance, "for a 20% increase in the ratio of equity to salary for similar new economy companies, there was a 5.1% increase in annual returns if the grant was to technical employees; for non-technical employees, the return was 2.7%."

Looking only at non-exempt employees (hourly employees not exempt from the Wages and Hours Act), the study found a small negative relationship between stock price and grants of more than the benchmark amounts to these lower-level employees. These companies had very, very few such employees, however (the iQuantic/Buck Web site indicated that only about 2% of the work force fell into this category), so these results are not very robust and cannot easily be compared to companies where non-exempt employees are a large percentage of the total work force. A Starbucks or Southwest Airlines, for instance, presents a very different picture of the importance of equity grants to non-management employees than does a small software company.

It should be kept in mind that this study looked only at changes in stock prices over the 12 months after equity grants. Stock price movements over any relatively short period, even when controlled for industry factors, can include considerable randomness and, in any event, are often not closely related to actual company performance. Concluding that any group of employees received equity awards in year one, causing them to behave differently enough so that company performance improved enough in year two to change market responses as measured by stock prices is obviously somewhat dangerous, as the authors, of course, understand. Nonetheless, this carefully done study does lend further support to the notion that the typical assumptions that equity awards to executives are what “really matter” does not appear to be correct, while broader grants to those who actually do the day-to-day work do matter.

The Sesil-Krumova Study, 2003

In “Broad-Based Stock Options Before and After the Market Meltdown,” James Sesil of Rutgers and Maya Krumova of the N.Y. Institute of Technology used NCEO lists of companies with broad-based options in 1998 and 2000 to evaluate the impact of these plans on productivity. The study was in submission for publication as this was written. The study looked at two questions: 1) would stock options be less effective in times of declining share prices than rising prices, and 2) does the effectiveness of broad-based stock options depend on the size of the company (specifically, do employees react more positively in smaller companies where their individual efforts have a more visible effect)?

To analyze this issue, Sesil and Krumova, using NCEO lists, studied companies providing broad-based stock options. Companies were included only if they provided stock options to 50% or more of their non-management employees and were in business from 1995 through 2002. From this, two datasets were created, one of 463 companies for 1995—1997, a period of rising stock prices, and one of 367 companies for 2000–2002, a period of falling prices. Companies were then classified as small (fewer than 500 employees), medium (500–5,000), or large (more than 5,000). Using data from Compustat, the researchers matched the broad options companies with comparable companies in their 2-digit SIC codes. Because the researchers could not know when the plans were established, they used a technique called a random effects estimator to correct for any bias these omitted data might introduce (this is a statistical technique used with panel data in a time series that allows corrections for certain missing data). Productivity was measured as a standard Cobb-Douglas function, a measure of productivity that, as used here, looks at how labor and capital combine to produce output. The researchers adjusted the formula to account for changes in employment and capital over time.

In the 1995–1997 period, they found that companies with broad-based options had productivity levels 20% to 33% higher than comparable firms. The smallest companies and largest companies registered at about a 20% differential; medium sized at 33%. In 2000–2002, medium and large companies retained these differentials; the small company differential declined by a little more than 1%.

The results indicate that the declining stock market did not undermine the impact of broad options. Moreover, contrary to popular perception that the incentive effects of options should be lower in larger companies (because individual employee efforts seem to matter less), company size does not seem to be consistently related to performance. These data thus do considerable damage to the so-called “freed rider” or “1/n” problem, both of which argue that if employees do not have a clear, direct line of sight between their own individual efforts and corporate performance, they will not be inclined to change their behaviors. If this is the case, then smaller companies should do better than large ones in terms of the incentive effects of options, but that is not the case. A major research project now being completed by Blasi, Kruse, and Richard Freeman at the National Bureau of

Economic Research will provide definitive evidence that the 1/n problem works much better in theory than practice. Workplace behavior turns out to be much more complex than a simplistic economic rationality model suggests.

Do Employees Actually Value Options or Ownership?

Classical economic theory would suggest that employees would not be motivated by options except in specific situations. First, their "line of sight" between their efforts and the reward must be clear, so that options should be less effective in larger companies. We have already seen that this does not bear out in the case of stock options. The same can be said of ESOPs. In the 1980s, the NCEO performed the largest survey to date of employee attitudes towards ESOPs, looking at dozens of variables (Corey Rosen, Katherine Klein, and Karen Young, *Employee Ownership in America,* Lexington Books, 1986). We studied 3,700 employees in 45 companies of all sizes. Company ssize was not a statistically significant predictor of employee attitudes towards the ESOP, whether the question was if being an owner made people work harder, or any other of 17 measures of work attitudes and behaviors. In subsequent research, we found it was also not a factor in whether companies with ESOPs performed better (Michael Quarrey and Corey Rosen, "Employee Ownership and Corporate Performance," *Harvard Business Review*, September/October 1987), and Blasi and Kruse, in their more recent study of ESOPs and corporate performance mentioned earlier, similarly found no relationship. In the NCEO data, we found that the more stock employees had added to their ESOP accounts each year, the less likely they were to leave, the harder they said they worked, the more they liked their jobs, and the more they cared about how the company performed.

Second, economic theory would indicate that employees would undervalue stock options relative to their value to the company. Indeed, studies consistently show just that. A 2003 Watson Wyatt study titled "How Do Employees Value Options: Results From a Special Survey" found that employees in S&P 1500 companies discounted their options by 30% to 50% off the Black-Scholes estimate of option value (although most analysts would argue that Black-Scholes overvalues options by perhaps 10% to 15% over more appropriate binomial models, thus reducing the employee discount somewhat). Employees with larger grants discount their options more (so discounting at the CEO "mega-grant" level would be very high), as do employees in companies that are not performing as well. Yet research on how employees actually behave with respect to options and work attitudes points in the opposite direction.

One of the largest and most intriguing analyses of this issue comes from Sibson Consulting and WorldatWork, a trade organization focusing on employee compensation and rewards. The 2003 study "The Rewards of Work: The Employment Deal in a Changing Economy" (Gerry Ledford and Matt Lucy, *Perspectives* [a Sibson online publication], Sept. 30, 2003), reports data from a large random sample of employees nationwide from both 2000 and 2003. Researchers asked employees the following question:

How different would a new job have to be in just one way to make you decide to take the new job? Additional reward required to induce 25%, 50%, and 75% of employees to take the new job:

	25% of Workers		50% of Workers		75% of Workers	
Employee would leave for:	Units	$ equivalent	Units	$ equivalent	Units	$ equivalent
Stock grant, face value	50 shares	$500	100 shares	$1,000	1,000 shares	$10,000
Vacation days*	7	$652	10	$1,400	15	$2,769
Bonus opportunity increase	$1,000	$1,000	$5,000	$5,000	$10,000	$10,000
Salary increase	10%	$3,750	20%	$7,500	35%	$15,000
Career opportunity: potential salary in 5 years	$6,000	$6,000	$15,000	$15,000	$35,000	$35,000
One-time retirement contribution	$5,000	$5,000	$20,000	$20,000	$50,000	$50,000

*Dollar equivalent using stated base salary

Respondents were told that the stock grant would have to be held for four years before it could be exercised. Half of the respondents said that just a $1,000 grant would induce them to leave, and 75% would leave for a $10,000 grant. Only vacation days come close to being as cost effective. It would take a salary increase 7.5 times as large to induce half the employees to leave. Conversely, when the researchers asked employees who already had stock awards what it would take for them to leave their jobs, it would take a $10,000 grant to induce half to leave, or 10 times as much as what it would take employees in general to induce turnover.

This clearly cannot be explained using traditional economic or organizational models; it's not economically rational. So what might be going on? Ownership is a very connotative reward. While it can be financially significant, workers may also see it as a marker that a company has a different attitude toward its employees, one that sees them as not just replaceable cogs but essential elements of corporate success. That kind of company, it could be argued, is more likely to treat employees better in other ways, including giving them more ability to make work-level decisions and more information about the company, both factors correlated with positive attitudes towards work. The Sibson data point in the same direction. Seventy-five percent of the 1,105 stock option holders interviewed said that options send a message that everyone is an owner, 38% say they work harder because of options, and 53% say they are more loyal. While it might seem that 38% is a small number, a large number of employees are either already working as hard as they can and not likely to be changed by material inducements to do a little more, while others are so disengaged that inducements don't matter. So 38% is an achievement. It is also notable that these attitudes did not change from 2000 to 2003, despite the dramatic fall in stock prices during that time.

Finally, on a related issue discussed in the CEEO document, we can look at whether repricing options affects employee behaviors. A 2003 study by Mary Ellen Carter at The

Wharton School and Luann Lynch at the Darden School of Business titled "The Effect of Stock Option Repricing on Employee Turnover" (*Journal of Accounting and Economics*, Vol. 37, No. 1, pp. 91-112) finds that repricing executive options has no impact on turnover, while repricing options for non-executives in broad-based plans reduces turnover about 9% from what would have been expected. The study was based on 1998 repricings in high-tech and non-high-tech companies.

Studies on Executive Equity Compensation and Corporate Performance

- The Wharton study mentioned above provides a good lead-in for this section on research on executive equity compensation and corporate performance. Studies on this topic are legion and support can be found for almost any position. As noted at the outset of this section on research, however, these studies typically suffer from some unavoidable methodological problems that make it exceedingly difficult to disentangle causes and effects.

In less well-designed research, studies simply look at whether executive equity pay is higher in companies with relatively stronger stock prices. This begs the question of whether executives caused the higher prices or, alternatively, stock was just a more readily available corporate currency. These studies, therefore, have value only if they show the converse. If there is no relationship, there is not much reason to argue that executive pay causes improved stock prices (nor is there reason to say it hurts them). More careful studies look at subsequent stock price movements, controlled by industry and other factors (as the Wharton study did), but there too the results are much more persuasive in arguing casualty where there is no relationship than when they find a positive or negative relationship.

With these limitations in mind, we can look at some of the major studies in this field. This is not a comprehensive list, but it is also not selective. We ran a Web search for recent articles, examined footnotes in those articles for articles we missed, and looked at the extensive references in *In the Company of Owners* and included any studies since 1998 that appeared methodologically rigorous. We looked particularly at studies of studies, as they provide useful summary information. We found that we ended up agreeing with what these summary studies all report: there is no consistent relationship between executive equity compensation and improved returns to shareholders or corporate performance. In fact, the weight of evidence makes it very difficult to argue that paying executives more than industry norms in equity pay improves performance, and that these norms themselves may be entirely unjustified.

What the Studies Find

Perhaps the most useful summary study is “Consequences of Executive Stock Options and Ownership” by Robert Grams (*WorldatWork Journal*, Q3, 2003). The article summarizes a longer paper by Grams titled “Behavioral and Performance Consequences of U.S. Executive Compensation and Ownership” (May 2003, unpublished as of that date). Grams is a research fellow at the Human Resources Research Institute at the Industrial Relations Center at the Carlson School of Management, University of Minnesota, as well as the principal consultant and owner of Compensation Strategies.

Grams notes that there are three main criticisms of current stock option grant design:

1) Executives are encouraged to assume excessive levels of risk because while stock options provide rewards for success, they do not offer a downside risk should an executive's approach cause failure.
2) A company's stock price is influenced by a number of factors; this weakens the connection between executive performance and their gains from equity-based pay.
3) Large stock holdings with short holding periods encourage focus on short-term stock price, rather than on long-term corporate health and wealth creation.

Grams surveyed the literature on the relationship between executive ownership and company performance, reviewing 229 studies. He found the correlations were too weak to draw substantial conclusions. A more complex view, he argues, would conclude that when insider ownership (including by directors) exceeds 20% to 30%, management entrenchment can occur, making change and adaptability less likely. Below 20% to 30%, increased management ownership may be effective, but above that there is either no relationship or a negative one.

Grams notes, however, that the research often suffers from serious flaws, including counting all vested stock options and those that are scheduled to vest within 60 days (the standard required for proxy reporting). Grams contends that when the data are looked at in terms of actual ownership versus contingent awards (equity awards yet to vest), a clearer relationship emerges. He cites a 2000 study by E. Ofek and D. Yermack, "Taking Stock: Equity-Based Compensation and the Evolution of Managerial Ownership," *Journal of Finance* 55 (June 2000), that looked at a sample of 1,646 companies, dividing executives into two groups: those who already owned a number of shares (through acquisitions other than options and through holding onto shares from exercised options) equal to or greater than their most recent stock option grants, and those who did not. When those in the group with higher ownership received additional options, they often reduced their ownership level in the year of grant, and their exercise of options was not associated with a net increase in ownership after exercise. For executives with lower ownership, option grants did not affect ownership at the time of grant and produced only a modest increase in ownership. The study thus showed that if a company wants more ownership, it should use tools other than stock options.

Grams says three main conclusions can be drawn from empirical research on publicly traded companies that provide stock options to those at relatively small or large compensation levels:

1) In large companies, giving an unusually large portion of all option grants to executives compared to other employees does not generate improved corporate performance.
2) Research on the causal relationship between option award sizes and company performance is mixed and can be inconsistent.
3) Although not definitive, research on CEO pay suggests that option grants might improve company performance at lower grant levels, but cause harm at above-average grant levels.

Grams argues that options have proven to be an inefficient way to reward executives and that more direct ownership should be encouraged instead, such as through stock purchase programs.

This argument is taken up by Jack Dolmat-Connell, a managing director of Clark Consulting's Pearl Meyer & Partners, in his article "Ownership, Not Options, Drives Performance: A Mandate to CEOs and Boards to Rethink and Restructure Executive Compensation" (*WorldatWork*, Q4, 2003).

Dolmat-Connell theorizes that the level of actual executive stock ownership drives company performance. The study looked at 106 of the largest companies in 10 diverse industries, as well as paired comparisons of 17 industry performance leaders and performance laggards (measured by stock price performance). It then analyzed whether there were significant differences in terms of beneficial ownership and stock options held.

The companies with the highest beneficial ownership by executives ranked, on average, in the 94th percentile in terms of the following year's stock price growth; companies in the 75th percentile of beneficial ownership ranked in the 63rd percentile in terms of stock growth. By contrast, companies ranked at the bottom or in the 25th percentile in terms of beneficial ownership averaged about the 23rd percentile in terms of the next year's stock price growth. When stock options holdings relative to actual ownership were compared, companies where the ratios of options to ownership were highest did the worst, and vice-versa. The same result held in paired comparisons of 17 industry leaders versus 17 industry laggards. In each case, the leaders had more beneficial ownership by executives.

These findings are statistically impressive, but Dolmat-Connell goes too far in arguing a causal relationship. Top executives have access to privileged information, and where they expect stock prices to go up in the short-term, they would be expected to hold on to shares and buy shares. By contrast, executives holding a lot of options would be reticent to exercise and hold them if they were skeptical about short-term stock price movements. Moreover, as Grams points out, studies that look at short-term stock price movements necessarily are subject to a lot of random variation because short-term (one- to three-year) stock prices fluctuate for reasons that are only poorly related to corporate performance. Presumably, though, if ownership matters, it matters because it motivates executives to improve performance, which improves stock prices. The considerable reliance of stock price movements in the following year on factors outside of the control of any CEO makes this argument hard to support with research. A more sinister explanation, of course, would be that executives who own more stock actually manipulate corporate earnings to jack up stock prices. While this clearly has happened in recent years, we would not argue that this is a widespread practice.

Another comprehensive and current analysis is "Executive Equity Compensation and Incentives: A Survey," by John Core, Wayne Guay, and David Larcker, all at Wharton, which has been a leading academic center for the study of equity compensation (*Economic Policy Review* 9, no. 1, April 2003). They note that "despite considerable prior research, the performance consequences of equity ownership remain open to question." They find some studies indicating options and other equity compensation seem related to better stock performance and some that do not, but indicate that none of these studies really can prove a causal connection. Much of the research they cite focuses on whether options are an efficient way to pay executives given that theory and empirical data indicate that executives value their options grants at less, and often considerably less, than their Black-Scholes values. What this means is that the estimated cost to the company of an equity award (Black-Scholes) is greater than the value the executive perceives, so the executive has to get more equity to arrive at an equivalent value to what would have been delivered by cash. Other research, however, suggests that equity compensation may be more efficient for some companies depending on their cash positions, their risk profiles, the executives' risk profiles, and other issues.

For further details on studies on this issue, go to Encycogov.com. Its table "Managerial Ownership and Performance—Empirical Studies" groups dozens of studies on the issue according to their principal hypotheses. Each study's findings and methodologies are briefly compared. The site identified 25 studies showing no relationship between management ownership and corporate performance, 15 arguing that managerial ownership is a function of improved corporate performance (that is, performance causes more ownership, not the other way around), 16 found a "non-monotonous" (irregular) relationship, 16 found a negative relationship, and 22 found a positive relationship. It is, of course, not sound methodology just to count the studies, but it is notable that significantly more find no relationship or a negative relationship than find a positive one.

One of the largest and perhaps the most rigorous of studies was performed in 2004. In "Corporate Governance, Executive Compensation, and Strategic Human Resource Management from 1992–2002" (in submission for publication), Joseph Blasi and Douglas Kruse of Rutgers University analyzed compensation for the top five executives and corporate performance in the 1,500 largest U.S. publicly traded companies. The study found that executive compensation, most of which has been in the form of options, increased in years when the stock prices of their companies went up. But when Blasi and Kruse examined whether increases in total compensation (again, primarily in options) were related to subsequent increases in stock prices or total shareholder return over the next three or five years, they found a slightly negative relationship (declines of less than 1% per year). They found the same result when they looked at the ultimate profit made from options exercises as opposed to the Black-Scholes value at grant. The study examined what are technically called "marginal" increases. In this context, that does not mean "small," but rather is a way percentage increases in compensation result in corresponding increases (or decreases) in company performance.

This study is one of the most comprehensive analyses of whether increases in executive compensation or options awards do what they are supposed to do—provide incentives for top management to improve returns to shareholders. Whether these increases in compensation actually motivate executives to behave any differently is unclear, but it is very clear that they do not result in the expected gains for shareholders.

Finally, a 2004 study by Watson Wyatt titled "How Do Employees Value Stock Options: Results from a Survey," found that employees undervalue stock options by 30% to 50% relative to the Black-Scholes value. The study was based on a survey of 650 high-income individuals. It found that employees who were better to able to identify their company's stock prices, worked for larger companies, and worked for companies with better stock price performance all place smaller discounts on options, while employees with higher incomes who get larger grants discount options more. In other words, for the top paid people with very large grants, the marginal value of additional grants is very small. Restricted stock is only discounted by a mean of 18%, by contrast.

It should be noted that the Black-Scholes formula is widely considered to overstate the value of options somewhat, although not by 30% to 50%. Also of interest is that higher income employees and those getting larger grants discount options more, meaning that very large grants to very high income employees (such as top executives) are the least likely to get a proportionate bang for their buck. So companies have to keep granting more and more options to higher income employees to provide an incentive, while grants to non-management employees can produce a much better return on investment.

Employee Ownership and Employee Financial Well-Being

In the wake of Enron, WorldCom, United Airlines, the dot-com implosion, and other employee ownership train wrecks, it seems legitimate to question whether employee ownership is actually good for employees or bad for them. There are three key questions here:

1. To what extent is employees' ownership a tradeoff for wages or other compensation?
2. Does employee ownership impose excessive risk on employees, particularly with respect to their retirement plans?
3. Aside from whether there are trade-offs or risks, how much wealth does employee ownership actually deliver to employees?

The conventional view of economic theory is that employee ownership has to be a tradeoff for wages or other compensation, but theory and practice don't always mesh. If employee ownership companies are, as suggested above, more productive, they may be better able to both to share ownership and pay as well as or better than comparable companies.

On the ESOP front, the most important study was a 1998 analysis by Peter Kardas and Jim Keogh of the Washington Department of Community, Trade, and Economic Development, and Adria Scharf of the University of Washington, *Wealth and Income Consequences of Employee Ownership* (NCEO, 1998), which shows that, in fact, employees are significantly better compensated in ESOP companies than are employees in comparable non-ESOP companies. Using 1995 employment and wage data from the Washington State Employment Security Department, and 1995 data on retirement benefits from a survey of companies and from federal income tax form 5500, the study matched up 102 Washington ESOP companies with 499 comparison companies in terms of industrial classification and employment size. In terms of wages, the median hourly wage in the ESOP firms was 5% to 12% higher than the median hourly wage in the comparison companies, depending on the wage level of those being compared. The study found the average value of all retirement benefits in ESOP companies was equal to $32,213, with an average value in the comparison companies of about $12,735. Looking only at retirement plan assets other than ESOPs, the ESOP companies had an average value of $7,952, compared to $12,735 for non-ESOP companies. Given that the typical ESOP is actually about 20% invested in diversified assets other than company stock, employees in ESOP companies would have had about as much in diversified assets as employees would have in all assets in non-ESOP companies. In ESOP companies, the average corporate contribution per employee per year was between 9.6% and 10.8% of pay per year, depending on how it is measured. In non-ESOP companies, it was between 2.8% and 3%.

On the issue of whether ESOPs are a trade-off for other retirement plans, Blasi and Kruse, as part of their comprehensive analysis of closely held ESOP companies, found that ESOPs were considerably more likely than comparable non-ESOP companies to offer diversified retirement plans. In other words, an employee working for an ESOP company is considerably *more* likely to have a diversified retirement plan than an employee working at a non-ESOP company, as the table below indicates. Note that this study was not based on a sample; it included all closely held ESOP companies during the study period for which data were available:

Percentage of Companies Having Other Retirement Plans

	ESOP	Non-ESOP
Plan type:		
Defined benefit	20.1%	4.9%
401(k)	33.3%	6.2%
Non-401(k) profit sharing	35.7%	8.0%
Other defined contribution	14.7%	2.3%

This same pattern, albeit less dramatically, prevails in public company ESOPs. According to testimony by Doug Kruse of Rutgers University before the House Subcommittee on Employer-Employee Relations of the Committee on Education and the Workforce (February 12, 2002):

> about 70-75% of participants in plans that are heavily invested in employer stock [ESOPs, 401(k) plans, and profit sharing plans] are in companies that also maintain diversified pension [or other retirement] plans, indicating that such plans tend to supplement rather than substitute for diversified plans. Among participants in large ESOPs (over 100 employees), 66.2% are in companies also sponsoring defined benefit plans, 34.7% are in companies also sponsoring diversified defined contribution plans, and 75% are in companies that sponsor either of these diversified plans. The numbers are similar for non-ESOP plans that invest more than 10% of assets in employer stock, with 70% of participants in companies also sponsoring either type of diversified plan. While exactly comparable numbers for the full work force are not comparable, employer survey data from the Bureau of Labor Statistics shows that 32% of all private-sector employees, and 50% of employees in medium and large establishments, participate in defined benefit pension plans. Therefore, it appears that participants in ESOPs and other plans heavily invested in employer stock are more likely than other employees to also be covered by defined benefit pension plans.

Data on broad-based stock options and employee wealth are much sparser. The NCEO's study *Current Practices in Stock Option Plan Design* (NCEO, 2000) indicated that a typical non-management employee received options on a periodic basis. If exercised periodically over a 10-year period in a market that increased at an average rate of 10%

per year, employees would average in the range of realized value about twice their annual pay. This average, however, masks considerable variation.

Whatever these numbers are, there is little reason to think that, as commonly believed, employees give up wages for options. In fact, in their study of companies with broad-based options referenced above, Blasi and Kruse found that employees were paid about 7% per year *more* than their peers in comparable non-broad-based option companies. The perception that options are a trade-off for wages and benefits appears to be true only for some (but by no means all) small start-up technology companies, and more at upper than lower levels, than for established companies. Yet the vast majority of employees receiving options work for these companies (well more than 95%).

Conclusion

It is important to view any study of the relationship between compensation strategies and corporate performance with some caution. People's behavior in organizations is highly overdetermined. Think of all the things that motivate you and your colleagues at work—pay, benefits, relationships, personal issues outside work, individual work ethics, the content of what you do, work organization, relationships with superiors, what you ate that day, and on and on. Identifying any set of factors across a company and saying that is what makes the difference is no easy task. But this just tells us what motivates people. Attempts to then link motivation to individual performance, and then to link individual to corporate performance, face a similarly daunting list of complications. For instance, does working harder really improve corporate performance much if work structures prevent people from sharing ideas and information on how to do things better?

Ideal studies look at large numbers of companies, identify measurable changes that have been instituted in discrete ways and at specific times (rather than creeping changes, such as gradual increases in benefits), index out industry effects, and compare before-and-after performance. This is practical in the case of employee ownership, because these plans usually have specific starting points. It is harder with executive compensation because it is rare to find executives who started off with no ownership, then received significant amounts into their tenure.

Nonetheless, the data are strikingly consistent. Broad-based ownership seems to improve corporate performance most of the time. Narrowly focused ownership has at best an uncertain impact and, in most analyses, a neutral or negative one. It is thus disheartening that many corporations now report that they will move away from what has been proven to work for shareholders toward something that appears not to work.

But in a free market, how can this be? If it is more rational for a company to share ownership more widely, won't the market make that happen? To a considerable extent, it has, as witnessed by the tremendous growth of broad-based ownership over the last 30 years. As the General Social Survey data detailed below indicate, it appears that about 40% of employees who work for companies that have stock actually own stock in their employers. That is an astonishing number. If the data reported earlier indicating about 40% of companies with broad-based option plans and about a third of companies with ESPPs will drop them are valid, this would still only reduce the percentage of employees holding stock in their employer by perhaps 5 percentage points, from about 40% to about 35%. We believe the actual behavior will be less dramatic.

Still, enormous amounts of seemingly irrational equity grants are going to top executives. While it may not be rational for the company they head to do this, it is entirely rational for them to want this to continue. Given the short tenure of many top executives, the fact that narrowly distributing ownership may not be good for stock prices in the long run is hardly their rational concern as individual wealth maximizers. As long as they and the boards who go along with them can control their compensation, there is not much reason to expect greed to morph into responsibility. That kind of change will depend on shareholders taking much more activist views on ownership distribution than they currently do. It is not enough for institutional investors to rage, as they now often do, about “too much dilution.” They need to rage too about who gets how much.

Extent of Employee Ownership in the U.S.

General Social Survey Data on Employee Ownership in the U.S.

The largest analysis of the extent of employee ownership comes from data collected in 2002 as part of the General Social Survey (GSS) of the National Opinion Research Center (NORC). The data indicate that 23.3% of all employees working for for-profit companies report owning stock in their companies, while 14.4% hold stock options. The two categories are exclusive of one another, but other data indicate that almost all employees holding options also own company stock in other ways. That would mean that approximately 25 million Americans own employer stock through ESOPs, options, stock purchase plans, 401(k) plans, and other plans; while 14.6 million hold stock options (and, usually, other stock). In 2002, 4.8% of employees received option grants, but because many programs are not annual, the number holding options is much larger. Looked at on the basis of companies, 37.8% of for-profit companies provide employee ownership plans for 50% or more of their employees, and 16.3% grant options to a similarly broad group. The individual data come from several questions included in the GSS, a 2002 random sampling of working adults performed by the NORC. The organizational data come from NORC's National Organizations Survey (NOS), performed in 2003. The individual data are based on 1,242 respondents; the organizational data on 315.

Previously, the NCEO had estimated that 25 million Americans own stock through one kind of employee ownership plan or another, essentially the same as the results here. We also estimated that about 10 million employees held stock options in 2002, less than the 14.6 million estimated in this survey. The survey may somewhat overstate the number of options holders, however, because some employees may have misinterpreted the question on options to include participation in an employee stock purchase plan (although a prior question made a distinction between stock options and direct purchases of stock). Because of the differing estimating techniques and inevitable ambiguities of data collection and interpretation in this area, however, variations in results are to be expected. These numbers, as well as any other estimates, should always be understood with the caveat that they cannot be precise.

Size of Holdings

In addition to these overall findings, the survey looked at how much employees actually own through their plans. Here, respondents were asked to indicate how much their ownership stakes would be worth, assuming they would be fully vested, if they sold them today. The results are below:

Size of Ownership Stake

Mean in dollars	$84,409
Median in dollars	$10,000
Mean as % of annual pay	99.6%
Median as % of annual pay	21.2%

The mean (average) and median (point at which half are above) differ so much because a small minority of employees hold very large stakes. Nonetheless, the median values are impressive, especially considering that many of these plans are fairly recent, and employees will build up considerable additional value over time. Those who argue that employee ownership usually provides only a trivial financial stake clearly are off the mark; these numbers are not too far from the median 401(k) holdings (the mean was about $57,000 in 2002; recent median data were not available, but were $11,300 in 1996 and would probably be about $17,000 today). Most participants in ESOPs, ESPPs, and stock option plans also are in 401(k) or other usually (but not always) diversified retirement plans.

Demographic Variations

Publicly traded companies are much more likely to offer employee stock programs than are closely held companies (16.4% compared to 4.2% of companies), partly because it is easier for them to do so and partly because many closely held companies are partnerships, LLCs, or sole proprietorships and do not have stock. Similarly, larger companies are more likely to have stock programs. There is a gradual increase in the prevalence of employer stock as company size increases in all closely held companies, with 46.8% of employees in companies with more than 2,000 workers holding stock. Public companies also show this pattern, but the numbers level out at around 21% of employees in plans for companies with more than 500 employees.

As expected, employees in the technology sector are the most likely to own stock, followed by finance/insurance. Surprisingly, union members are about as likely to hold stock as the overall employee population. Tenure does not seem much of a factor after two years, but, predictably, people making higher salaries are more likely to be included. The table on the following page provides more details.

Employee Ownership By Plan Type

Estimated Number of Plans and Employees; Value of Plan Assets

Type of Plan	# of Plans (as of 2003)	# of participants (as of 2003)	Value of plan assets (as of 2003)
ESOPs, stock bonus plans, & profit sharing plans primarily invested in employer stock	11,000	8.8 million	$400 billion
401(k) plans primarily invested in employer stock	2,200	11 million	$160 billion
Broad-based stock option plans	4,000	10-14 million	Not estimated
Stock purchase plans	4,000	15 million	Not estimated

The estimates are based on a variety of company surveys and, where available, government data. Because of the differing estimating techniques and inevitable ambiguities of data collection and interpretation in this area, however, variations in results are to be expected. These numbers, as well as any other estimates, should always be understood with the caveat that they cannot be precise. The data would likely be different if compiled in 2005 or later. A number of companies have said they will cut back on broad-based options, as well as employee stock purchase plans, in response to expected changes in accounting rules. We estimate that the number of employees holding company stock could drop by 3 to 4 million people as a result, but that competitive labor market pressures will likely make these short-term changes.

Another source of data on stock options comes from the 2004 Bureau of Labor Statistics survey, drawn from its National Compensation Survey for 2003 indicates that about 11% of all private sector employees (about 12 million people) participate in a stock option plan. That does not mean, however, that 12 million will actually get a grant. Some plans may make employees eligible for grants, but never make a grant to a particular employee while that person is employed for that company. It is not possible to know how to adjust this number to get just those currently holding options.

Growth of ESOPs and Equivalent Plans

Year	Plans	People
1975	1,600	248,000
1980	4,000	3,100,000
1990	8,000	5,000,000
1996	10,500	8,700,000
2003	11,000	8,500,000

The number of ESOPs is growing while the number of participants is shrinking because the average size of companies with ESOPs has been shrinking. This is happening largely because many large public companies that set up ESOPs years ago for purely financial and accounting reasons are terminating those plans as time goes on. There is anecdotal evidence, however, that ESOPs resumed strong growth in the early 2000s.

Growth of Stock Options

Unlike the case with ESOPs, it is not realistic to chart the growth of stock options year-by-year over this same period, because there is no hard data to go on. We can look back at 1990 and estimate roughly a million option holders and look at the present day and estimate roughly 7 to 10 million option holders, but it is impossible to accurately say how many employees held options in 1994, 1995, 1996, 1997, etc. Why? ESOPs are highly regulated retirement plans, and companies with ESOPs must tell the government every year how many employees are in the plan. The government regularly publishes summaries of this data. Although it is imperfect, it gives us something to go on. For stock options, on the other hand, nothing of the sort is available.

Variations in Stock Ownership By Industry and Demographics

	Have Company Stock*	Have Stock Options
Industry		
Computer services	58.3%	56.5%
Comm./utilities	55.3%	42.6%
Finance/insurance	39.8%	27.1%
Manufacturing	31.5%	20.0%
Others	16.8%	7.4%
Earnings		
<15,000	5.5%	4.0%
15,000-$30,000	18.0%	9.7%
$30,000-$50,000	28.4%	14.9%
$50,000-$75,000	36.6%	24.3%
$75,000+	50.7%	41.3%
Company Size		
<50 employees	12.0%	6.0%
50-499 employees	25.1%	18.0%
500+ employees	38.7%	23.4%

*Does not include stock options.
The complete results are available on the NCEO's Web site, www.nceo.org.