Current Trend

- Fastest growing long-term incentive grant type since 2002
- Now accounts for $billions of annual grant value to executives that was formerly granted as options
- Multifaceted supporting rationale
  - High expected cost of options under FAS 123, and possible disconnect between option expense and pay delivery (i.e., underwater options still expensed)
  - Need for employment retention in uncertain and flat stock market
  - Multi-year goal setting too complicated to grant performance stock

Real Underlying Drivers

- Overreaction to criticism of options that was aimed at excessive use, not structure
- Attitude that late 1990s wealth creation should be guaranteed without corresponding shareholder value creation
- Conversion ratios favorable to executives (i.e., conversion of inflated option value to intrinsic value without adequate discount)
- Misinformation about what options will really cost under FAS 123, because more flexible valuation models will bring down expense
- Low risk of forfeiture with restricted stock units (IRS Section 451) versus actual restricted shares (IRS Section 83)

Defensible Design

- Trade-off from options based on equivalent economic value and cost under “refined” models
  - High volatility/no dividends (Technology): 1 restricted share for 3 or 4 option shares
  - Moderate volatility/moderate yield (Dow Industrials): 1 restricted share for 4 or 5 option shares
  - Low volatility/high yield (Utilities and REITs): 1 restricted share for 6 or 7 option shares
- Corollaries to long-term incentive structure with low-risk, guaranteed pay delivery
  - Conservative competitive positioning (i.e., median or lower if mostly restricted stock)
  - Higher ownership and share retention requirements