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*The Crystal Report on Executive Compensation*



## **The Impact of Option Timing**

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People routinely assume that if an executive makes a goodly sum from exercising stock options, his company must, by definition, have performed well. To a large extent that's true. But there are two "contaminants" in the process.

The first is the date the executive chooses to exercise. His or her decision could be based on inside information as to the future of the company. Or it could be based simply on the fact that the executive needs more cash to send his children to college.

The second, which is the subject of this article, centers around when in a fiscal year the option grant is made. Obviously, an executive who receives an option carrying a strike price that, in the context of all the closing prices during the year, is ultra-low starts out the option race with a built-in advantage. And the reverse is true for the executive who gets an option with a strike price that is ultra-high.

To study the impact of grant timing, I examined 628 option grants made in 2008 to CEOs running companies with \$2 billion or more of market cap.

I compared each option to the average closing price during the fiscal year. Then using the standard deviation of all 252 closing prices, I calculated the percentile rank of the option's strike price. A percentile rank of 0 meant that the strike price approximated the lowest closing price during the year. A percentile rank of 100 meant that the strike price approximated the highest closing price during the year.

Looking at all 628 option grants, the median percentile positioning was 66, while the average percentile positioning was 58.

As a group, therefore, there was certainly no evidence that companies were playing games with option timing.

But there were wide divergences.

## Case Examples

Let's examine two extreme cases on each side of the distribution.

- Sanjay Jha, co-CEO of Motorola – On Aug. 4, 2008, Mr. Jha was granted options covering 16.6 million shares and carrying a strike price of \$9.82. The high price for the year occurred on the very first trading day of the year, when the stock closed at \$16.07. Thereafter, it was a mostly downhill run, with the stock bottoming out at \$3.15 on Nov. 20, 2008. The average price during the year was \$8.41. Mr. Jha's strike price came in at the 69<sup>th</sup> percentile of the distribution. Compared to having been granted his 16.6 million shares at the average price of \$8.41, Mr. Jha started out with a cumulative disadvantage of \$23.3 million. (16.6 million shares X (average price of \$8.41 – strike price of \$9.82).
- Kenneth Chenault, CEO of American Express. On Jan. 31, 2008, he was granted options covering 2 million shares and carrying a strike price of \$49.13 a share. American Express stock slowly dropped during the year until about the end of September, when it started hurtling over a cliff with the other financial stocks. Viewed in the context of all of Amex's closing prices for 2008, Mr. Chenault's grant positioned him at the 88<sup>th</sup> percentile, thereby starting him out with a \$22.2 million disadvantage compared to having received a grant carrying the average yearly closing price of \$37.99.
- Joseph Saunders, CEO of Visa. On March 15, 2008, he was granted options covering 719,715 shares and carrying a strike price of \$44. March 18, 2008 was the day Visa went public. For the remainder of the fiscal year ended Sept. 30, 2008, the stock described a sort of parabola, rising to a high of \$88.50 on May 7, 2008 and then finishing the year at \$61.39. The average closing price was \$74.08. Mr. Saunder's strike price of \$44, being the lowest price of the year, positioned him at the 0<sup>th</sup> percentile. Compared to having been granted his shares at the average price of \$74.08, Mr. Saunders ended up being better off by \$21.6 million.
- John Wren, CEO of Omnicom Group. He was granted options covering 1 million shares on Dec. 29, 2008 and carrying a strike price of \$25.48. The trajectory of Omnicom's closing prices in 2008 very much resembled that of American Express, i.e., higher prices at the beginning of the year and lower prices at the end of the year. The high occurred on May 15, 2008, when the stock closed at \$49.90, while the low occurred on Nov. 20, 2008, when the stock closed at \$22.23. Mr. Wren's price percentile rank was 2.4<sup>th</sup>. Compared to the average price of \$40.54, Mr. Wren came out ahead by \$15.1 million.

Was there some monkey business going on with these four transactions? Well, I think we can safely dismiss three of them:

- Motorola's Mr. Jha received his grant when he joined the company from Qualcomm.
- Amex's Mr. Chenault received his grant shortly after the end of the 2007 fiscal year in recognition of his performance during that year.
- Visa's Mr. Saunders received his grant at the IPO price.

That leaves Omnicom's Mr. Wren. Mr. Wren received no option grants at all during the six years 2002 through 2007. Instead, the company employed long-term performance grants.

So the questions here are: Why switch to options after having not granted options for quite a few years? And why make a large option grant two days before the end of the fiscal year, when final results were not officially known?

I have no answers here. One possibility, of course, is opportunistic grant timing, which is not illegal but in some circles is considered unethical. Mr. Wren's strike price was \$25.48. But the closing price as of this Dec. 18, was \$38.40, producing a handsome paper gain for him of nearly \$13 million. Not bad for a period of not quite one year.

It is also possible that Mr. Wren was just plain lucky.

To provide some further information, I first aggregated options for each CEO in the event that he had received more than a single grant during his company's fiscal year. I then averaged the CEO's percentile ranks and added together his net advantages or net disadvantages compared to having received his grants at the annual average closing price.

Herewith are two tables. The first lists the 50 CEOs who received the highest net advantages, expressed in dollars. The second lists the 50 CEOs who received the highest net disadvantages.

These tables show that the timing of an option grant, whether deliberate or simply fortuitous, can have a significant impact on the gains, if any, a CEO will ultimately receive from his option grants.

#### THE 50 CASES WITH THE LARGEST NET ADVANTAGE:

COMPANY	CEO	PERCENTILE RANK	NET ADVANTAGE (millions)
FOSTER WHEELER	MILCHOVICH, RAYMOND	5	\$29.0
ABERCROMBIE & FITCH	JEFFRIES, MICHAEL	10	\$22.9
VISA	SAUNDERS, JOSEPH	0	\$21.6

PROLOGIS	RAKOWICH, WALTER	3	\$18.6
SALESFORCE.COM	BENIOFF, MARC	6	\$15.4
OMNICOM GROUP	WREN, JOHN	2	\$15.1
ANADARKO PETR.	HACKETT, JAMES	6	\$12.6
VMWARE	MARITZ, PAUL	26	\$11.9
BROOKFIELD PROPERTIES	CLARK, RICHARD	2	\$10.4
BROOKFIELD ASSET MGMT.	FLATT, BRUCE	2	\$10.2
AFFILIATED MANAGERS GROUP	HEALEY, SEAN	9	\$10.1
BCE	COPE, GEORGE	1	\$10.0
VALERO ENERGY CORP	KLESSE, WILLIAM	6	\$9.9
TORONTO DOMINION BANK	CLARK, EDMUND	0	\$9.8
LIBERTY MEDIA	MAFFEI, GREGORY	30	\$9.2
WALT DISNEY	IGER, ROBERT	6	\$9.1
COCA COLA ENTER.	BROCK, JOHN	6	\$8.6
LIFE TECHNOLOGIES	LUCIER, GREGORY	2	\$7.9
DEVON ENERGY	NICHOLS, LARRY	5	\$7.1
QUALCOMM	JACOBS, PAUL	8	\$6.4
DAVITA	THIRY, KENT	1	\$6.3
ST JUDE MEDICAL	STARKE, DANIEL	2	\$6.1
BANK OF NOVA SCOTIA	WAUGH, RICHARD	0	\$5.8
CANADIAN NATL. RES.	LAUT, STEVE	9	\$5.5
HALLIBURTON	LESAR, DAVID	4	\$5.4
MGM MIRAGE	LANNI, TERENCE	16	\$5.4
EQUITY RESIDENTIAL	NEITHERCUT, DAVID	0	\$5.2
TERADATA	KOEHLER, MICHAEL	4	\$5.2
SOUTHERN UNION	LINDEMANN, GEORGE	2	\$5.2
FIDELITY NATIONAL	STINSON, ALAN	1	\$5.1
TRANSOCEAN	LONG, ROBERT	2	\$5.0
NEWMONT MINING	O'BRIEN, RICHARD	29	\$4.8
SMITH & NEPHEW	ILLINGWORTH, DAVID	0	\$4.8
CAMERON INTL.	MOORE, JACK	6	\$4.8
PUBLIC SVC. ENTER. GP.	IZZO, RALPH	9	\$4.5
FIDELITY NATL. INFO.SVCS.	KENNEDY, LEE	2	\$4.4
TELUS	ENTWISTLE, DARREN	3	\$4.2
CAMERON INTL	ERIKSON, SHELDON	6	\$4.1
TARGET	STEINHAFEL, GREGG	7	\$4.1
MGM MIRAGE	MURREN, JAMES	16	\$3.9
KOHL'S	MONTGOMERY, LAWRENCE	29	\$3.5
CANADIAN IMPER. BANK OF COMM.	MCCAUGHEY, G.T.	8	\$3.5
ECOLAB	BAKER, DOUGLAS	4	\$3.4
MONSANTO	GRANT, HUGH	8	\$3.3
BARRICK GOLD	WILKINS, GREGORY	10	\$2.7
SUNOCO	ELSENHANS, LYNN	19	\$2.7
GILEAD SCIENCES	MARTIN, JOHN	8	\$2.6
KEYCORP	MEYER, HENRY	22	\$2.5
DENTSPLY INTI	WISE, BRET	2	\$2.5
CORNING	WEEKS, WENDELL	51	\$2.4
	LOW	0	\$2.4
	MEDIAN	6	\$5.4
	AVERAGE	8	\$7.7
	HIGH	51	\$29.0

## THE 50 CASES WITH THE LARGEST NET DISADVANTAGE:

COMPANY	CEO	PERCENTILE RANK	NET ADVANTAGE (millions)
MOTOROLA INC	JHA, SANJAY	69	-\$23.3
AMERICAN EXPRESS	CHENAULT, KENNETH	88	-\$22.3
VORNADO REALTY TRUST	ROTH, STEVEN	94	-\$15.3
GOLDMAN SACHS GROUP	BLANKFEIN, LLOYD	85	-\$12.9
WILLIS GROUP HOLDINGS	PLUMERI, JOSEPH	90	-\$9.5
AMERIPRISE FINANCIAL	CRACCHIOLO, JAMES	84	-\$7.9
AUTODESK	BASS, CARL	83	-\$7.1
AETNA	WILLIAMS, RONALD	86	-\$7.1
MOTOROLA	BROWN, GREGORY	76	-\$6.7
HONEYWELL INTL.	COTE, DAVID	81	-\$6.6
CONSTELLATION ENERGY GP.	SHATTUCK, MAYO	83	-\$6.1
NORTHROP GRUMMAN	SUGAR, RONALD	86	-\$5.6
DISCOVERY COMMUNICATIONS	ZASLAV, DAVID	90	-\$5.5
JUNIPER NETWORKS	JOHNSON, KEVIN	79	-\$5.4
CITIGROUP	PANDIT, VIKRAM	81	-\$5.3
BURLINGTON NORTH. SANTA FE	ROSE, MATTHEW	94	-\$5.2
WELLPOINT	BRALY, ANGELA	90	-\$5.0
UNITED TECHNOLOGIES CORP	CHENEVERT, LOUIS	84	-\$4.9
ALLERGAN	PYOTT, DAVID	90	-\$4.9
TESORO CORP	SMITH, BRUCE	96	-\$4.9
AVON PRODUCTS	JUNG, ANDREA	68	-\$4.7
CISCO SYSTEMS	CHAMBERS, JOHN	93	-\$4.6
CARDINAL HEALTH	CLARK, KERRY	100	-\$4.5
SUNTRUST BANKS	WELLS. JAMES	94	-\$4.4
INVERNESS MEDICAL INNOVATIONS	ZWANZIGER, RON	100	-\$4.4
STATE STREET	LOGUE, RONALD	86	-\$4.4
BOEING	MCNERNEY, JAMES	87	-\$4.4
MERCK	CLARK, RICHARD	81	-\$4.4
WELLS FARGO	STUMPF, JOHN	75	-\$4.1
SUPERVALU	NODDLE, JEFFREY	93	-\$4.1
BANK OF AMERICA	LEWIS, KENNETH	91	-\$4.0
COCA COLA	ISDELL, NEVILLE	76	-\$3.8
FORD MOTOR	MULALLY, ALAN	71	-\$3.7
PRINCIPAL FINANCIAL GP.	GRISWELL, BARRY	86	-\$3.6
HUMANA	MCCALLISTER, MICHAEL	93	-\$3.5
MARRIOTT INTL.	MARRIOTT, WILLARD	88	-\$3.5
UNITED TECHNOLOGIES	DAVID, GEORGE	90	-\$3.4
DOW CHEMICAL	LIVERIS, ANDREW	77	-\$3.3
EATON VANCE	FAUST JR., THOMAS	97	-\$3.3
BANK OF NY MELLON	KELLY, ROBERT	73	-\$3.3
PRUDENTIAL FINANCIAL	STRANGFELD, JOHN	70	-\$3.2
XL CAPITAL	O'HARA, BRIAN	83	-\$3.2
LINCOLN NATIONAL	GLASS, DENNIS	75	-\$3.1
CVS CAREMARK	RYAN, THOMAS	82	-\$3.0

CIGNA	HANWAY, EDWARD	84	-\$2.9
THERMO FISHER SCIEN.	DEKKERS, MARIJN	63	-\$2.9
WYNDHAM WORLDWIDE	HOLMES, STEPHEN	80	-\$2.9
STARBUCKS	DONALD, JAMES	88	-\$2.9
STARBUCKS	SCHULTZ, HOWARD	88	-\$2.9
HERTZ GLOBAL HLDGS.	FRISSORA, MARK	82	-\$2.8
	LOW	63	-\$23.3
	MEDIAN	86	-\$4.4
	AVERAGE	84	-\$5.6
	HIGH	100	-\$2.8

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The compensation data used in this article were obtained from Equilar Inc., a leading provider of executive compensation information.

Graef Crystal's is now in his 51<sup>st</sup> year in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. (He still contributes occasional columns to Bloomberg News.) He has written six books and more than 1,600 articles on executive pay.