

*GraefCrystal.com*

*The Crystal Report on Executive Compensation*



## **Stock Options Are Not Inherently Evil**

**by Graef Crystal**

**March 30, 2009**

By its recent actions, the U.S. Congress has put stock options on the same moral plane as pederasty, implicitly blaming them for wrecking the U.S. economy and, as a result, banning them for use by companies receiving financial bailout money.

The Congressional argument rests on two premises. First, stock options are the most risky part of the executive pay package. You're not going to get any disagreement from me on this point.

Second, because stock options are so risky, they encourage the executive to swing wildly at every pitch, in the hopes of putting a ball over the centerfield fence. It is that wild swinging that caused all the problem with Wall Street firms and the major banks. Never mind that stock options have never been a large component of Wall Street pay. As for banks, options were used but not excessively so compared to non-financial firms.

### **Sandy Weill**

Except in two instances. The first is ancient history and applies when Sandy Weill was running Citigroup Inc. He persuaded his board to give him monster-sized option grants, all with so-called "reload" features, which automatically gave him new grants of lesser size whenever he exercised an earlier grant.

But you can't blame Mr. Weill for what has recently transpired at Citigroup. For proof, consider that on Sept. 30, 2003, the last day before Mr. Weill relinquished his CEOship, Citigroup's closing stock price was \$45.51. That compares to a closing price on this March 27th of \$2.62.

Even during the last stage of Mr. Weill's tenure, the argument that stock options lead to terrible outcomes made no sense. In the five years ended Sept 30, 2003, Citigroup's total return was 23 percent a year. That compared to a return of 1 percent a year for the Standard & Poors 500 Index.

## **Capital One's Richard Fairbank**

The second instance and the subject of this article is Richmond, Virginia-headquartered Capital One Financial Corp., and more specifically its CEO since July 1994, Richard Fairbank. Capital One had its IPO on Nov. 16, 1994, just months after Mr. Fairbank became CEO.

Mr. Fairbank is decidedly not your "usual" CEO. Far from keeping his distance from anything other than a sure thing, he has consistently embraced pay risk.

The proof of this observation occurred in 1995 when Mr. Fairbank received an extra-large option grant in return for forgoing his annual bonus.

Then in 1998, Mr. Fairbank gave up his salary, bonus and benefits for a further large option grant.

At this point, Mr. Fairbank had the most risky pay package of any CEO in the U.S. – consisting of all stock options, all the time.

And, with one exception, so it remained until the TARP regulations came into effect. (The exception was a performance share grant made in Dec. 2003).

In the early years, Capital One injected even more risk than normal into its stock option grants by requiring that the grant be forfeited unless the stock increased 73 percent or more during the first three years following the grant. That equated to 20 percent per year appreciation over the three-year period.

But changes in the way stock options were accounted for caused Capital One to modify this restriction and inject an "escape clause". The option still could not be exercised unless 20 percent a year appreciation occurred during the first three years, except that the option did become exercisable in the last year of its 10-year term, even if that 20 percent appreciation target had not been met earlier.

That escape clause was eventually dropped, but succeeding option grants at Capital One still are more risky than normal, in that there is no vesting until three years after grant, at which time the entire grant becomes exercisable for a further seven years.

Why would Mr. Fairbank take such a huge amount of pay risk? I'm not sure, but I assume that he had supreme self-confidence that he would win that bet.

And win it he did. Through Dec. 31, 2008, he garnered aggregate option gains of \$549 million.

But that is when he ran out of gas. As of this March 27, when the stock closed at \$14.23 a share, all of Mr. Fairbank's 8.3 million option shares outstanding as of Dec. 31, 2008 were underwater. The proxy covering 2008 shows that he had strike prices ranging from \$48.54 to \$87.28.

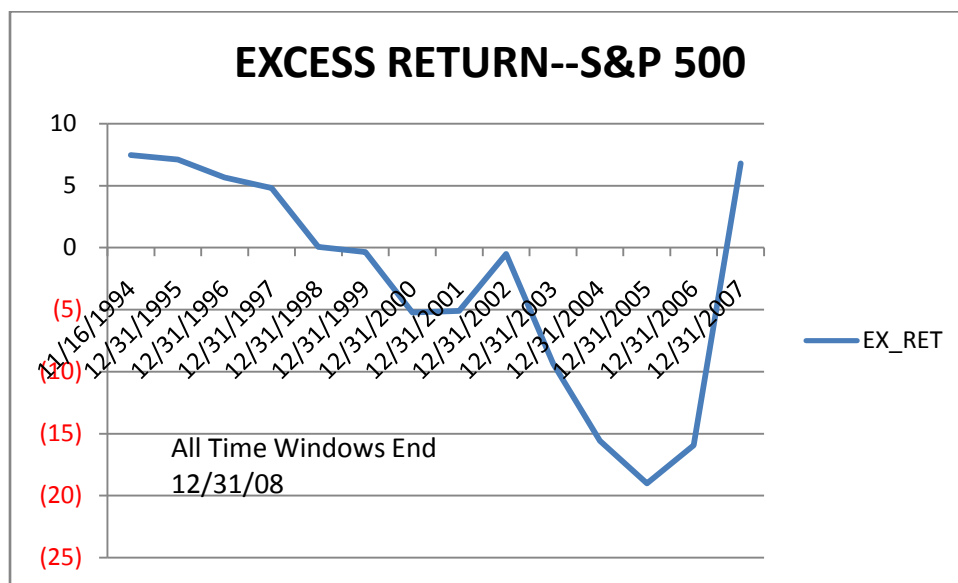
## Capital One's Performance

Granted that Mr. Fairbank did very well for himself with his all-stock-option diet, but how did his shareholders fare?

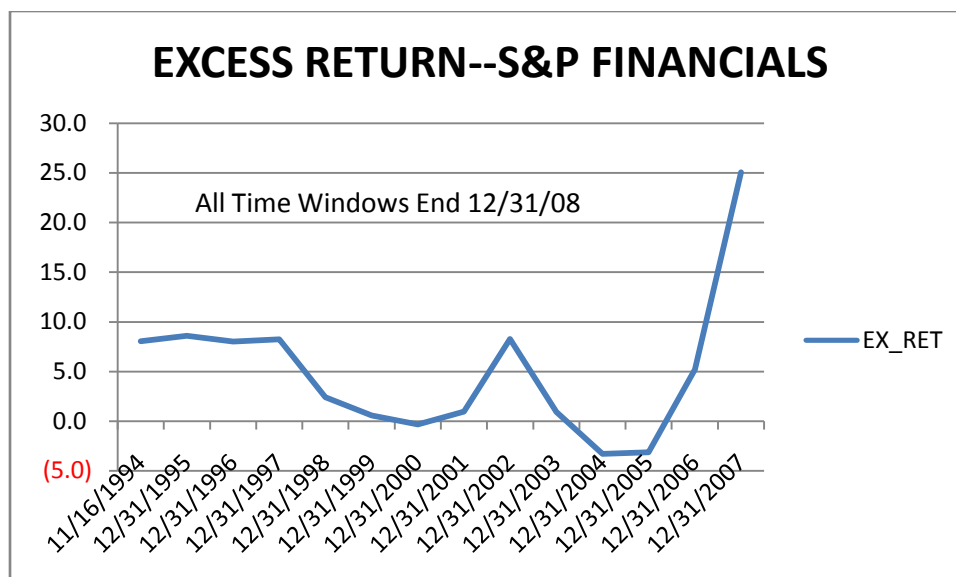
Between Nov. 16, 1994, the date Capital One went public and the close on this March 27, Capital One's total return was 7.9 percent a year, a level that outperformed the 5.8 percent a year return on the Standard & Poors 500 Index by two percentage points a year. It also outperformed the return on the S&P 500 Financials (an 81 member group) by four percentage points a year.

At this point, let's look at two charts. The first shows Capital One's so-called "excess return" in 14 different time windows. The first window begins on Nov. 16, 1994. The second begins on Dec. 31, 1995. Thereafter, the start of each further time window is incremented by one year, i.e., Dec. 31, 1996, Dec. 31, 1997 and so on. All time windows ended on Dec. 31, 2008. In this case, excess return is determined by deducting from Capital One's total return the total return on the S&P 500 Index.

You can see here that except for the one-year time window beginning Dec. 31, 2007, Capital One didn't do very well. But, hey, what financial company did?



The second chart is identical to the first chart, except that the point of reference for excess return is not the S&P 500 Index but rather the S&P 500 Financials Index.



Here, Capital One's star shined much more brightly. It outpaced the financials index in 11 of the 14 years, including a whopping average of 25 percentage points in the single year ended Dec. 31, 2008.

Being such an avid fan of numbers, I'd be the first to tell you that, to paraphrase, "Two swallows do not a summer make".

Sandy Weill and Richard Fairbank represent two data points in a sea of data points. But both of them put the pedal to the medal with stock option grants, and neither of them brought their companies to disaster.

Collectively, the entire U.S. Congress, with the exception of Senator Carl Levin (D-MI), knows less about executive compensation than a MBA who entered the compensation consulting field two years ago.

So it is not for me to justify that stock option grants do not represent "excessively risky compensation", as the current law says. It is for that august body in Washington to justify that stock option grants do represent "excessively risky compensation", in the process consigning the cases of Messrs. Weill and Fairbank to outlier status.

I understand that you have "to dance with the boy that brung you", that if Congress is going to bail out your company, it has a right to enact reasonable pay limitations. But the key word here is "reasonable".

As things now stand, TARP companies can pay virtually any salary they desire. But they cannot grant stock options, and they cannot grant bonuses of more than one-third of salary, and then the

bonus must be awarded in restricted stock the restrictions on which will not be lifted until the government gets its bail-out money back.

I think these regs are utterly dumb. First, why choose base salary as the one component of executive pay on which there is no cap? Second, and perhaps even more important, what's wrong with stock options? They may not be appropriate for everyone, but to say they are appropriate for no one is idiocy.

People tend to use their own pay as a frame of reference in judging other people's pay. Consider here that the U.S. Congress has been given a pay package with a single direct element, namely base salary. So what's wrong with that? Why not require that for everyone, while providing a concession for a small bit of restricted stock?

CEOs popularity with the public at large has plummeted of late, and that is quite understandable. Still, I have yet to see a poll that puts CEOs on par with that group of loud-mouthed, demagogues in Congress – the people who among other things reacted with their guts, not their heads, in voting to impose a 90 percent income tax rate on retention contracts at AIG that went into effect on Dec. 1, 2007, many months before anyone had ever heard of TARP.

### **Postscript**

Here's a bunch of past option grant dates for Mr. Fairbank:

Dec. 15, 2003  
Dec. 19, 2004  
Dec. 19, 2005  
Dec. 11, 2006  
Dec. 10, 2007

So taking that pattern into account, when would you think that Capital One would have made a grant to Mr. Fairbank in 2008?

If you answered "around mid-December", you would be logically right but factually wrong.

Actually, his grant for 2008 was not made until Jan. 29, 2009, at which point he was granted an option covering 970,403 shares and carrying a strike price of \$18.28 a share and a term of 10 years.

So why that delay of a month-and-a-half or so? According to Capital One spokeswoman, Tatiana Stead: "Moving the grant date to January for this cycle allowed the Board to gather additional information on market conditions and emerging practices relative to CEO compensation in the financial industry, which is evolving rapidly."

That certainly seems true. But it needs pointing out that both Capital One and Mr. Fairbank benefited by the delay:

- To avoid having the option grant show up in the proxy statement covering 2008. Because it didn't and because options constitute the entire pay package for Mr. Fairbank, except for a tiny amount of miscellaneous compensation, his total pay for 2008 was seemingly just \$68,344.
- To take advantage of a sharp drop in the market price of Capital One stock between Dec. 14, 2008 (the average grant date in December for the six grants made in 2002 through 2007) and Jan. 29, 2009. Dec. 14, 2008 being a Sunday, on Dec. 12, 2008 and Dec. 15, 2008, Capital One stock closed at, respectively \$28.12 and \$26.11. Mr. Fairbank's strike price for the option granted on Jan. 29, 2009 was just \$18.28.

On the same day Mr. Fairbank was awarded his option, he was also granted the opportunity to earn as many as 190,478 free shares of stock, to be earned based on Capital One's total return between Jan. 1, 2009 and December 31, 2011 compared to that for the S&P 500 Financials (but excluding companies in insurance and real estate). At the closing price on Jan. 20, 2009, those 190,478 shares were worth \$3.2 million.

According to Ms. Stead, Capital One was able to give Mr. Fairbank an outsized option and a large performance share award because the actions were taken before TARP was enacted.

In any event though, Mr. Fairbank will not be allowed to benefit from these grants until the government has been repaid.

Ms. Stead also noted that Mr. Fairbank's "compensation remains all equity, all at-risk, all deferred, as it has been for the past 11 years."

2009 marks GRAEF Crystal's 50<sup>th</sup> anniversary 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, 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 has written six books and more than 1,600 articles on executive pay.