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## **Opportunistically-Timed Options Are Alive and Well**

**by Graef Crystal**

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Option backdating may be out. But we still have with us the opportunistic timing of option grants.

With backdating, a company, employing the clear vision provided by hindsight, retroactively picks a delicious strike price for an option – never mind that the price chosen has nothing to do with the price on the date the option grant is actually made, except that it is a lot lower. That practice, which was always illegal, effectively ended with the passage of the Sarbanes-Oxley Act. Today, companies are required to report the grant by the end of the second business day following the day of grant.

A few senior executives are languishing in prison because of option backdating schemes. And many others have seen their careers wrecked.

But so far as I know, there has never been anything illegal about deciding that today's the day to make a huge option grant, so long as the strike price is set equal to today's price. That price may seem innocent enough until you learn a month or so later that the company has discovered the cure for cancer or, more likely, reports unexpectedly large earnings. Provided the option is not exercised for at least six months following the date of grant, no charges of insider trading are likely to be brought.

### **Some Companies Have Reformed**

Following the backdating scandal, some companies, in the manner of a temperance convert, took the pledge to eliminate opportunistic option grant timing. One was Oracle Corp. , which declared in a proxy filed on Aug. 23, 2006: "Our current policy with respect to annual stock option grants to key employees, including our executive officers (but excluding grants to newly hired employees) is that option grants occur during the ten business-day period following the end of the 'no trading' period (i.e., after the announcement of our earnings report) relating to our

fiscal fourth quarter.” (Prior to this declaration, Oracle’s option grant timing, not to put too fine a point on it, was more variable.)

As a further example, other companies decided they would make option grants in the January board meeting following the end of their Dec. 31 fiscal year or at some other fixed and unvarying time in the year.

### **A Pragmatic Examination**

To gain some sense whether companies like Oracle are in the majority, I turned to a database provided by Equilar Inc. that listed all the options granted in 2007 to the 508 CEOs running companies with market caps of \$3 billion or more at the time I drew the data. I narrowed my search to companies that had a Dec. 31 fiscal year and then looked for the very largest option grants, as measured by the product of the number of shares granted and the strike price per share (hereafter referred to as “aggregate strike price”).

I confined my search to 22 option grants, the smallest of which had an aggregate strike price of \$13.9 million and the largest of which had an aggregate strike price of \$207 million. (If a company made more than a single option grant to its CEO in 2007, I took the larger grant, or if there were more than two grants made during the year, the largest of the grants.)

The dates on which these large options were granted were all over the place. One was granted on Jan. 17, 2007, just days after the end of the 2006 fiscal year, while another was granted on Dec. 17, 2007, just days prior to the end of the 2007 fiscal year. Grants were also made in February, March, April, May, July, September, October and November 2007.

For purposes of further analysis, I will drop one of the 22 grants, not because it ruins my case but because it is in a special category I will discuss shortly.

Now, suppose you compared these 21 grants to the median closing prices of the various companies during 2007. You would expect that if the timing of the grants was essentially random, the median of the 21 strike prices, taken as a group, would be fairly close to the median of the 21 median closing prices – not perfectly aligned, given the small number -- but still close.

But that is not what I found.

For this further analysis, I compared each company’s strike price to the 251 closing prices for that company during 2007 and then calculated the strike price’s percentile rank. A percentile rank of 0 indicates that the strike price was equal to the lowest closing price during the year. A percentile rank of 100 indicates that the strike price was equal to the highest closing price during the year. And a percentile rank of 50 indicates that the strike price was equal to the median closing price during the year.

Here are the results, together with some summary statistics for the group as a whole.

Ticker	Company	Executive	Strike Price Percentile Rank	Aggregate Strike Price (millions)
SLB	SCHLUMBERGER LTD /NV/	GOULD, ANDREW	2	\$23.4
S	SPRINT NEXTEL CORP	HESSE, DANIEL R.	4	\$13.9
GILD	GILEAD SCIENCES INC	MARTIN, JOHN C.	6	\$19.7
COF	CAPITAL ONE FINANCIAL CORP	FAIRBANK, RICHARD D.	9	\$84.7
KO	COCA COLA CO	ISDELL, E. NEVILLE	10	\$42.9
MHS	MEDCO HEALTH SOLUTIONS INC	SNOW, JR., DAVID B.	14	\$22.0
MER	MERRILL LYNCH & CO INC	THAIN, JOHN A.	15	\$108.8
INTC	INTEL CORP	OTELLINI, PAUL S.	15	\$14.5
CBS	CBS CORP	MOONVES, LESLIE	17	\$143.5
NVS	NOVARTIS AG	VASELLA, M.D., DANIEL	18	\$68.9
ABT	ABBOTT LABORATORIES	WHITE, MILES D.	22	\$28.9
HON	HONEYWELL INTERNATIONAL INC	COTE, DAVID M.	23	\$33.2
Q	QWEST COMMUNICATIONS INTERNATIONAL INC	MUELLER, EDWARD A.	29	\$17.4
WFC	WELLS FARGO & CO/MN	KOVACEVICH, RICHARD M.	29	\$68.8
AGN	ALLERGAN INC	PYOTT, DAVID E. I.	30	\$22.6
AMP	AMERIPRISE FINANCIAL INC	CRACCHIOLO, JAMES M.	34	\$26.9
SLM	SLM CORP	LORD, ALBERT L.	40	\$207.0
AXP	AMERICAN EXPRESS CO	CHENAULT, KENNETH I.	49	\$81.1
DNA	GENENTECH INC	LEVINSON, PH.D., ARTHUR D.	63	\$31.8
SWY	SAFEWAY INC	BURD, STEVEN A.	74	\$35.4
SGP	SCHERING PLOUGH CORP	HASSAN, FRED	77	\$29.8
		Low	2	\$14
		Median	22	\$32
		Average	28	\$54
		High	77	\$207

As you can see, the 22<sup>nd</sup> percentile median strike price of these 21 grants is nowhere near the median closing prices of the companies involved.

When I first viewed these results, I thought that perhaps they had been distorted by a secular decline in stock prices during 2007. But there was no such decline during that period:

- The average of the Standard & Poors 500 Index for all of 2007 was 1,477.
- The average of the Standard & Poors 500 Index for the first half of 2007 was 1,461.
- The average of the Standard & Poors 500 Index for the second half of 2007 was 1,493.

To test the significance of this finding, I generated multiple series of random percentile ranks. Each series contained 21 values, with the values potentially ranging from 0 to 100. I ended up choosing for testing two series where the median of the 21 computer-generated random percentile ranks was within a hair of 50.

I then ran a statistical significance test between the actual percentile ranks of the 21 companies and each of the two random series. I learned that the likelihood that the 21 actual percentile ranks could have occurred by chance was, for one random sample, just four chances in 1000, and for the other, two chances in 1,000.

One case deserving special mention involves an option covering 4.5 million shares, which was granted on Nov. 26, 2007 to Albert Lord, the CEO of SLM Corp. With its \$207 million aggregate strike price, it turned out to be the largest option grant among the 21 I studied. As the table shows, the strike price was equal to the 40<sup>th</sup> percentile of all the SLM closing prices during 2007. But this particular option carried an out-of-the-money strike price. Had the option been assigned a strike price equal to the market price on the grant date, the percentile ranking would have declined to 7 from 40. Still, shareholders suffered no potential pain because, due to a subsequent restructuring of Mr. Lord's pay package, the entire grant was cancelled on March 3, 2008.

### **Be Careful in Interpreting Findings**

A word of caution here: I do not mean to indict any of these 21 companies individually. Perhaps there were good and valid reasons why the company made the grant when it did.

But you cannot escape the conclusion that, taken as a group, companies making extremely large option grants are taking advantage of insider information not available to ordinary shareholders. Their boards are, so to speak, putting their thumbs on the scales in favor of their CEOs.

That sort of behavior, of course, is not in the interests of shareholders, and it should be curbed. Although I am generally opposed to congressional action, I think it may be needed here to eliminate this nasty gamesplaying in which more than a few companies engage.

I say, “congressional action” because the latest proxy disclosure regulations promulgated by the U.S. Securities and Exchange Commission in 2006 do not, on the evidence, accomplish anything useful.

In its regulations, the SEC contents itself with asking companies that time option grants on the basis of “material non-public information” to state that they do just that, thereby putting the shareholders on notice. Although I have read through many “Compensation Disclosure and Analysis” sections of proxy statements, I cannot recall a company “fessing up” to such an odious practice.

### **The Alcoa Case**

I mentioned earlier that I had held back one of the 22 cases. That involves a grant made to Alain Belda, the chairman and former CEO of Alcoa Inc.

In his case, the day chosen for the grant came in at the 98<sup>th</sup> percentile of Alcoa’s 251 daily closing prices. That percentile rank seemed utterly unusual, until I discovered that Mr. Belda had on that day exercised a reload stock option grant. Under a reload stock option plan, most of which have now been discontinued, an executive who exercises receives a replacement grant. It was, of course, in Mr. Belda’s interest to exercise his original option when his company’s stock price was high. And that explains why the strike price of his replacement grant was also high.

Pay data for this article were obtained from Equilar, Inc., a leading provider of executive pay data ([www.equilar.com](http://www.equilar.com)).

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 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 has written six books and more than 1,600 articles on executive pay. In the Spring of 2009, he will be teaching a course in executive compensation at the University of California at Berkeley’s Boalt School of Law.