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The Crystal Report on Executive Compensation



There's Still a Case To Be Made For Stock Options

by Graef Crystal

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Given the current economic crisis in which we find ourselves, have stock option grants become the dinosaurs of executive compensation?

I don't think so, but a well-informed and influential member of the Delaware bar does.

Here is what he wrote in an email to me arguing that stock options should not "represent any part of executive compensation any more". He went on to add: "In today's market, they have no correlation to performance. Why isn't this a golden opportunity to wipe them off the face of the planet as a form of executive comp? It would get rid of the short-termism they engender, would force corporations to develop real performance metrics, and in good times would eliminate the outsized reported compensation they can engender. It would also end all the valuation issues surrounding the subject. Let's get back to basics – salary, bonus and maybe some restricted stock. I do not think the Delaware courts will stand for another round of rescuing underwater options – the heads I win, tails you lose scenario."

Let me now discuss each one of the charges against stock options and present my own viewpoint.

Correlation To Performance

The writer says: "In today's market, they [i.e., options] have no correlation to performance". But if an option is not repriced and if it finishes out of the money, options do have a correlation to performance. No performance, no pay.

Repricing – the custom of turning in an option covering 1,000 shares with a strike price of \$50 a share when the current market price is \$25 a share and receiving 1,000 new shares with a strike price of \$25 a share – is no longer practiced, so far as I know. Or at least, it is no longer relatively common.

More common today is the practice of using the Black-Scholes model to determine the current worth of an underwater option and then to grant a new option carrying a strike price equal to the new, lower price but for that lesser number of shares that replicates the aggregate current present value of the underwater option.

For an illustration, let's go back to the example of the 1,000-share option carrying a strike price of \$50 a share. To this assumption, I will add assumptions for market price at grant (also \$50 a share); estimated future volatility (35 percent); estimated future dividend yield (1.7 percent); term (10 years); and risk-free rate (3.6 percent). On the basis of these assumptions, the present value per share is \$15.94, or \$15,940 for all 1,000 shares.

(As of Dec. 11, the median dividend yield on the stocks comprising the Standard & Poors 500 Index was 1.7 percent, a figure I used. But the median implied call volatilities for 12- 18- and 24-month periods were, respectively, 70 percent, 68 percent and 66 percent. Looking historically, I concluded that these figures have been artificially elevated due to the current financial crisis, so I opted to use a lower 35 percent volatility figure.)

Now suppose that three years into the grant, the market price plunges 50 percent, to \$25 a share. Assuming that the volatility and yield assumptions remain the same but that the term decreases to seven years and the risk-free rate drops to 3.02 percent, the new present value of this underwater option would be just \$2.94, or \$2,940 for all 1,000 shares.

Under the old, abusive repricings that found so much favor in Silicon Valley, the company would simply cancel the first option and offer the optionee a new option, again covering 1,000 shares but this time carrying a strike price of \$25 a share.

That practice, of course, would likely end up rewarding the optionee for his past failure. Were the stock to head back to \$50, he would receive compensation of \$25 a share that he would not have received absent the earlier decrease in his company's stock price.

But under more enlightened thinking, the company would first calculate the value per share of this new option. Assuming it carries a seven-year term (i.e., a term equal to the term remaining in the original grant) and the other assumptions just enumerated, the present value would be \$6.19 a share. Therefore, if the company wanted to offer the optionee a replacement grant worth \$2,940 in the aggregate, it would find that it could only offer a grant covering 475 shares, not 1,000 shares

I see this newer practice as being relatively benign. Option traders do the same thing every day, selling an out-of-the-money contract and using the proceeds to buy an at-the-market contract, albeit covering fewer shares.

Exchanging your option does not guarantee that you will be any better off. If, for example, the stock price falls further or never rises, you will end up with the same gain as you would have had from the original option, i.e., no gain at all.

And if the stock price rises a lot, you could end up with a lesser gain than had you kept the original, and larger, number of option shares.

A recent example of the just-mentioned phenomenon is Apple Inc.'s Steve Jobs, who in 2003 turned in 55 million underwater option shares for 10 million free shares. Given the terrific performance of the company since 2003 – even counting the recent stock price decline – Mr. Jobs would have been far better off -- \$3.7 billion better off -- keeping his 55 million underwater option shares. (For more on the subject of this option exchange, please see my article “Playing Option Valuation Games at Apple Computer”, published Nov. 10, 2008.)

I can make out an even more positive case for the type of option exchange just described. If the original, but now underwater, option is left in place, powerful pressure will be exerted to offer a consolation prize, viz., a new and larger option grant, the latter with a strike price equal to the new lower closing price. In that case, two grants would now be outstanding, And if the stock price were to rise enough in the future – to the point where the original grant went into-the-money -- the optionee would gain from both grants. Perhaps it is naïve thinking on my part, but when the original option is exchanged, then the pressure for the consolation prize would be lessened.

Winston Churchill once remarked that democracy was the worst form of government, except for all the others.

The “others” – when it comes to long-term incentives – include free shares of stock, which the email writer seems willing to tolerate. But free shares offer a payout when performance is terrible – indeed, if the stock price is slightly above zero. And the “others” include plans that not infrequently pay out based on the achievement of long-term targets that are set by the recipients of the pay and can be manipulated.

Short-Termism

The writer says that eliminating options “would get rid of the short-termism they engender”.

He makes an important point here, but it is a point that can be, and should be, corrected without throwing out the baby with the bathwater.

Most companies have vesting periods built into their options, whereby the option cannot be exercised from Day One of its term. But most companies do allow for some form of exercise after a minimum wait of one year.

How can they do that and, with a straight face, claim they are offering a long-term incentive?

How about revising the terms of the grant to say that none of the shares may be exercised for five years? Now that would be a real long-term incentive.

On top of the early vesting policies, most every company allows the executive to choose the timing of exercise. So if the option does not fully vest for four years and if the term of the option is 10 years, then the executive, any day in the ensuing six years, can raise his hand and claim his gain.

This flexibility opens the possibility of using insider knowledge to time option exercises. And even if that is not true in a particular case, it certainly can reward a person on the basis of sheer luck. (“Gee, Bill, I exercised my option a year ago when the price was \$50. Too bad that you waited.”)

This last point can be summarized as follows: Just because you can do something does not mean you should.

How about not only making the executive wait five years but then settling the transaction only on the fifth anniversary of the grant?

Indeed, how did we get a 10-year option term to begin with? The answer is simply that, years ago, the Federal government said we could have one.

I believe that a 10-year term represents a case of going too far. It is the rare CEO who makes decisions that take 10 years to come to fruition.

Besides, past option exercise history has shown that few optionees wait that long to exercise anyway.

Five years feels about right to me. (I suppose I should offer a nod here to V.I. Lenin, who promulgated the first five-year plan.)

As to flexibility of exercise, back in the 1970s, the rules concerning insider trading were much more strict than they are today. If an insider exercised an option and then within six months following the exercise sold his shares at a profit, that profit, using the intestinal metaphor favored by the U.S. Securities and Exchange Commission, had to be “disgorged” to the shareholders.

To get around this unpleasant aspect, some thoughtful compensation consultant or lawyer invented what was then called a “Stock Appreciation Right” or SAR.

The idea was that the executive, rather than exercising the option, could exercise the SAR and receive in cash the gain on the day of exercise, thereby neatly avoiding the six-month holding requirement.

For some time, the SEC refused to sanction the use of SARs. But it finally gave ground.

Still, back in those days, SARs, though now legal, also came with an accounting impediment. While an at-the-market option grant resulted in no charge to earnings, the exercise of an SAR triggered a charge to earnings equal to the amount paid out, which not only depressed profits but

created a sort of open-ended liability for the company. One CEO once told me that with five million SARs outstanding: “If our stock rises another 10 points, I’m going to kill myself!”

But in today’s accounting world, both options and SARs attract the very same accounting treatment. And there is no open-ended future liability.

So we could grant an option with a five-year term and require exercise only on the last day of the term. Or we could cut to the chase and simply do the entire transaction with a SAR.

Real Performance Metrics

The writer says that eliminating options “ would force corporations to develop real performance metrics.”

For my part, I see the long-term stock price as being about the only real performance metric. Please note that I said “long-term” stock price.

There are, of course, many other performance metrics a company might adopt, but almost all of them require the board to take on faith that the volume of performance being required to earn a payout is not, in the end, a case of playing tennis with the net down. To be sure, outside consultants can review management’s performance recommendations, but even outside consultants can be outfoxed by the superior, and inside, knowledge of the top management.

More recently, we have long-term incentive plans that predicate payouts on total return relative to a peer group or, more commonly, on the return of the Standard & Poors 500 Index. But plans like this can introduce strong elements of randomness in how participants fare from one performance cycle to the next. (Please see my article, “Relative Total Return Plans Pose Serious Problems”, published in August 2008.)

There’s a further advantage to tying truly long-term performance to a company’s stock price: shareholders will instinctively understand that the compensation plan is in their interests, and for that reason, they will more readily accept it.

Outsized Compensation

The writer says that the abandonment of option grants “would eliminate the outsized reported compensation they can engender” in good times.

If we transform options into a true long-term incentive by requiring no exercise for five years, that should remove most of the objections here.

It would be possible, of course, to cap the option gain so as to prevent a runaway payout. No one is thinking of such things today, of course, but we have seen Dutch tulip-like market surges in the quite recent past (think about the tech stocks in the late 1990s or real estate more recently).

Or, as an alternative to an outright cap, we could provide that if the stock price at the end of the five-year term is more than X, then any excess would be drained off into restricted shares that would be paid out three years later.

Valuation Issues

The writer says that forswearing options “would also end all the valuation issues surrounding the subject”.

He has a point, but valuation issues are always present in accounting. We have to make assumptions for useful lives of machinery and equipment, pensions contributions and, perhaps most difficult of all, the present value of health care procedures not yet invented.

But if my earlier suggestions of fixed, five-year terms, with no vesting until the last day are adopted, then the valuation becomes relatively easy. The nasty little games that companies play over when an option might be exercised would be ended. To be sure, there is some room to argue volatility, but I, for one, would be willing to live with that.

As the reader can see, I do not agree that options ought to be abandoned. But the person who emailed me made me think and identify the many things that are indeed wrong with options. I am most grateful to him.

2009 marks Graef Crystal's 50th 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.