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The Crystal Report on Executive Compensation



Option Exchanges: OK or Immoral?

by Graef Crystal

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An increasing number of companies are considering handing their employees at-the-market options in exchange for currently-underwater options. Is that a good idea? Is it ethical? Is it moral?

Let's begin by going back in time. There were plenty of option exchanges in the 1980s (they called them "repricings" back then), especially in Silicon Valley. Advanced Micro Devices Inc. did six of them in six years. Apple Inc., if I recall correctly, did either eight or nine of them.

Back then, it was the custom to do a so-called share-for-share exchange. Thus, if the employee turned in 1,000 underwater option shares, he received back 1,000 at-the-market shares (i.e., where the new strike price was the same as the then market price), typically with no change in the expiration date.

These one-for-one exchanges were done at a time when your average comp person, if asked about the Black-Scholes, figured the question had something to do with the Exxon Valdez's despoliation of the Alaskan coastline.

But times have changed. Today, comp people know a lot more about the Black-Scholes model, and they are using the model to provide an economic rationale for an option exchange.

For the most part, though, such exchanges are not extended to the Top Five on a company's proxy statement. This practice, it could be argued, is vestigial.

Proxy Reform in 1992

Back in 1992, I was an informal advisor to Richard Breeden, then the chairman of the U.S. Securities and Exchange Commission. After being excoriated by a Senate committee for the

opacity of then proxy statements, he sought to reform the proxy disclosure system. (I was one of the witnesses testifying before that committee.)

He told me words to the effect: “I don’t want to do any bashing. I merely want a company to report fairly and honestly on whatever it does in the way of executive compensation.”

He mostly accomplished that goal. But there was one thing that caused his train to go off the track, and that was one-for-one option exchanges. He seemed to see these as being on a level with pederasty.

So he instituted an onerous requirement that forced a company doing an option exchange to put in its proxy a table showing details of every option exchange it had done in the past 10 years for any of the top five executive officers, whether or not they were still with the company. That would have exposed a lot of dirty laundry at the likes of AMD or Apple.

As a result, it quickly became the practice to bar the top five executives from participating in the option exchange.

Some saw this as progress and justice. But it can be argued that a company can do worse for its shareholders than exchanging options: Permit the optionee to keep his underwater options and then give him a large new, at-the-market grant. And that is precisely what many companies did for their top people. (One was Steve Jobs. Back in 2000, he was granted an option covering 40 million split-adjusted option shares. When the company’s market price subsequently sagged, his earlier-granted option was not exchanged. On the contrary, he was allowed to keep it, and then he was given a new option with a lower strike price. The second option covered 15 million shares.)

Interestingly, the new proxy disclosure system, inaugurated in 2006, no longer requires that 10-year repricing table. Yet many companies continue to act as if the table were still there.

An Example

How does an option exchange work? Let’s use Apple as an example:

- Apple stock closed at its all time high of \$199.83 on Dec. 28, 2007.
- Let’s assume that an Apple employee on that date was granted an option covering 1,000 shares and with a term of seven years (Apple’s current term for stock option grants).
- Now let’s fast forward to this June 2, when the stock closed at \$139.49, a drop of 30.2 percent since its high. (For comparison purposes, the Standards & Poor’s 500 Index dropped 36.1 percent during the same period.)
- We first need to value the underwater option. For this purpose, I have used a market price of \$139.49; a strike price of \$199.83; an expected volatility of 41 percent (the implied

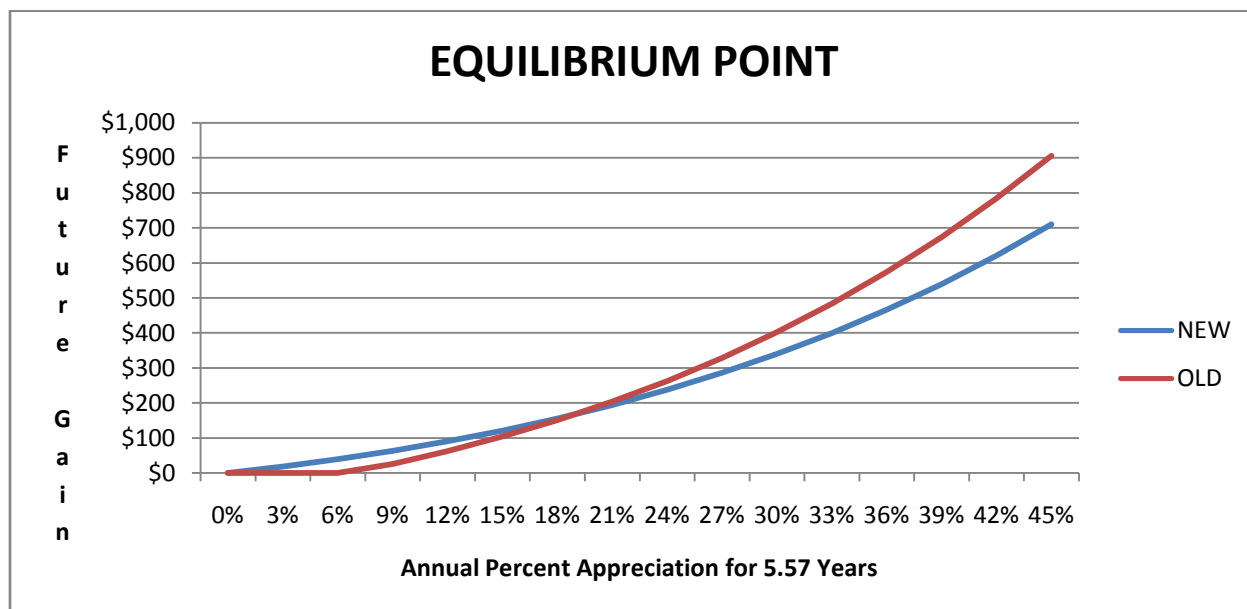
volatility on call contracts as of June 2); an expected yield of 0 percent (Apple has never paid a dividend); a term of 5.57 years (the amount of time left in the original seven-year term); and a risk-free rate of 2.94 percent (the interpolated Treasury strip rate on June 2 for a maturity of 5.57 years).

- On that basis, the value of the 1,000 underwater option shares is \$43,329.
- Now let's value an at-the-market option, with all the same assumptions, save only that the strike price has been lowered to \$139.49.
- Here, the value of a 1,000 share grant would be \$58,972, or 36 percent more than the underwater option.
- To equalize these two options, it would be necessary to reduce the number of shares in the at-the-market grant to 735, for a reduction of 27 percent. Doing that produces a value of \$43,344 vs. \$43,329 for the underwater grant.

Equilibrium Point

Critics will say here that such an exchange is unethical, even immoral, They see this as the equivalent of a high-jump contest where, after having knocked down the bar in an attempted jump, the contestant is invited to try again with the bar set lower.

They are right in a sense. But the exchange comes with a price, as can be seen in the following chart:



One line of this chart (labeled “old”) assumes that a holder of the underwater option refuses the exchange and waits to exercise until the last day of the term. The other line (labeled “new”) assumes that the holder takes the exchange and also waits until the last day of the term.

As can be seen, there are some trade-offs here. When future appreciation is low, the person who took the exchange benefits compared to the one who didn’t. But if future appreciation is high, then the person who continues to hold the out-of-the-money grant benefits.

The “indifference” or “equilibrium” point here is an appreciation rate of a rounded 19 percent per year for the 5.57 years remaining in the option’s term. At that point, both optionees come out the same.

Speaking for myself, I don’t see anything unethical or immoral about option exchanges, so long as they equalize grant date present values. That is because, as the chart suggests, while they can reward the optionee, they can also penalize him.

I long remember a Berkeley seminar I taught in the early 1990s, at which the then comp director of General Dynamics Corp. was present. GD’s stock had recently dropped considerably.

Following the seminar, the comp director sat down with his CEO, William Anders, and talked about an option exchange based on the Black-Scholes model. The CEO agreed, and he turned in a large number of underwater option shares for a smaller number of at-the-market shares.

Then the stock surged again. The CEO’s decision ended up costing him some \$2 million compared to what he would have reaped had he kept his larger number of then-underwater shares.

An even more dramatic example of an exchange occurred with Apple’s Steve Jobs several years ago. As already mentioned, Jobs had been given two option grants totaling a staggering 55 million shares. Both were underwater. Jobs finally threw in the towel and agreed to return the 55 million option shares in exchange for 10 million free shares.

Not long thereafter, Apple’s stock soared, with the result that Jobs would have been several billion dollars better off had he stuck with his 55 million option shares. They sure weren’t underwater any longer!

Still, option exchanges – whether immoral or not – may convey market intelligence. Doing an economic exchange where the Black-Scholes values are equalized suggests that the company may not be terribly bullish about its future stock price growth.

Net Dilution

One final point: Many companies try to justify an option exchange by saying that, when the smoke clears, there will be fewer option shares outstanding and hence less shareholder dilution.

Assuming the exchange is based on the Black-Scholes, that statement may be false.

The way I measure dilution involves the so-called “Treasury Method” of accounting. Here’s an example:

- A company grants an executive an option covering 1,000 shares and carrying both a market price and a strike price of \$50 a share.
- Several years later, the executive exercises the option when the market price has risen to \$90 a share.
- Upon exercise, the company receives \$50,000 from the executive.
- It also receives some tax relief from the government. Assuming a combined 40 percent rate for Federal and state income taxes, the company saves in this case 40 percent of the \$40,000 gain, or \$16,000.
- Hence, compared to the day before the exercise, the company has \$66,000 more cash.
- It takes that cash and buys back as many shares as it can from the open market. At a price of \$90 a share, the company buys back 733 shares.
- At that point, it has the same cash as the day before, and there are 267 more shares outstanding.
- Those 267 shares represent, to me, the true cost of the transaction. The company has in effect issued 267 shares for no monetary consideration.

At low future appreciation rates, the new at-the-market option will produce more net dilution, in shares, than the old underwater option.

At high appreciation rates, the old underwater option will produce more net dilution than the new at-the-market option.

But leaving net dilution aside, doing an option exchange will cause a decrease in the raw number of option shares outstanding. In turn, this may lessen the pressure on the company to ask shareholders for the authorization to issue more shares. Asking for such authorization at a time when the stock price has sagged is not, so I am told, a really effective PR strategy.

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.