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The Crystal Report on Executive Compensation

Many CEOs Got to Start the Race Before Their Peers

by Graef Crystal

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In normal times, you would expect that if, say, 500 CEOs received option grants at different dates in a fiscal year, the strike prices assigned to all 500 of them would, on average, be close to the average annual closing prices of their companies for all trading days in that year . There are, of course, always some winners and losers – those CEOs who are assigned a strike price that is lower than the annual average closing price of their company vs. other CEOs who are assigned a strike price that is higher.

But 2009 was a most amazing year. Between Dec. 31, 2008 and March 9, 2009, the decline in the Standard & Poor's 500 Index was 25.1 percent . But between March 9, 2009, when the S&P 500 hit its low for the year, and Dec. 31, 2009, the index climbed 64.8 percent . (For the entire year 2009, the S&P 500 Index rose 23.4%.)

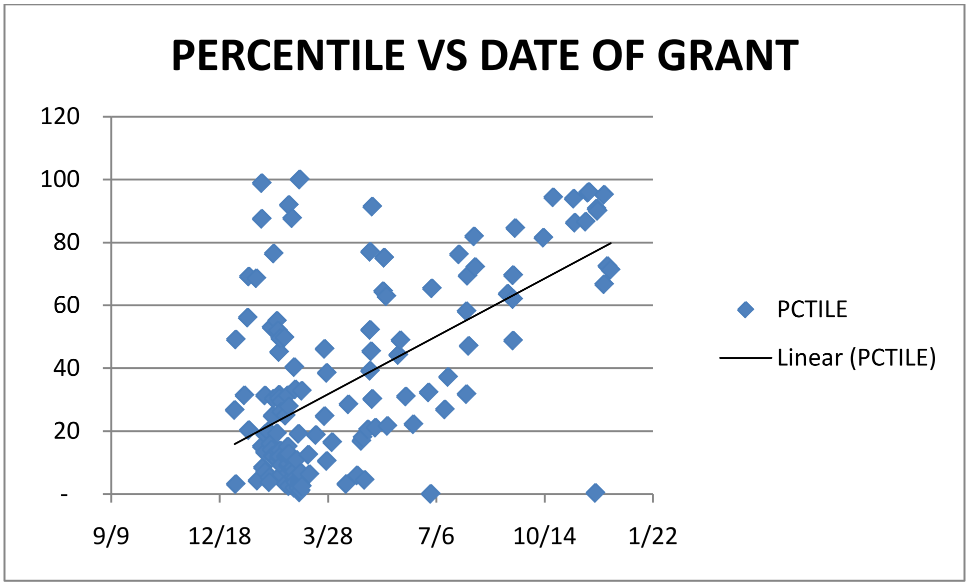
So, if you received a large option in the early part of 2009 – especially around the March 9 low, you were most likely given a real leg-up, in the form of an ultra-low strike price. And if you received a grant near the end of 2009, you were penalized with an ultra high-high strike price.

Methodology

To examine this pattern, I drew data from Equilar covering CEOs running companies with $17 billion or more of market cap and who received an option grant in 2009. There were 174 option grants in this category.

For each option grant, I determined the percentile positioning of the option's strike price in the array of daily closing prices for the company during 2009. A percentile of 0 means that the strike price was equal to the lowest price during the year. And a percentile of 100 means that the strike price was equal to the highest price during the year.

Here is a chart that plots the percentile positioning of each grant against the date of grant:



As can be seen, there is a pronounced advantage to having been given an option grant in the early months of 2009.

I then decided to concentrate on the 50 CEOs who received the very largest option grants, as measured by their Black-Scholes value at grant.

I went on to determine the advantage or disadvantage for each CEO by subtracting from the company's average daily closing price for every trading day in 2009 the particular CEO's strike price. This difference was then multiplied by the number of shares in the option grant.

The Big Winners

In the group of 50 cases, I found five CEOs who were given an advantage at grant of more than $10 million each.

The top-ranked CEO was Alan Mulally of Ford. On March 11, 2009 – just two days following the low of the market – he received an option covering 5 million shares and carrying a strike price of $1.96 a share. But the average daily closing price of Ford stock for the entire year was a much higher $5.75, giving Mr. Mulally an advantage of $3.79 a share, or $19 million for all 5 million shares. Arrayed against all the closing prices in 2009, his $1.96 strike price ranked at the 6th percentile, meaning that 94 percent of the prices during 2009 exceeded $1.96 a share.

Cynics are apt to respond: "Mulally somehow knew when the market was about to turn, and he convinced his board compensation committee to give him a huge grant at that point."

But there are two problems with this argument. First, I cannot think of any way Mr. Mulally could have serious knowledge of what the entire market was about to do. And second, his year-earlier grant in 2008 occurred on March 5, 2008, or at virtually the same time as his 2009 grant. (This grant's strike price of $6.14 ranked at the 71st percentile of all Ford closing prices during 2008.) So, based on the dates of the 2008 and 2009 grants, it would appear that Ford is following a consistent granting pattern, as opposed to trying to cherry-pick low points during a fiscal year.

As to the other four CEOs with advantages of $10 million or more:

- Richard Adkerson of Freeport McMoRan Copper & Gold received an advantage of $15.2 million. His grant date was Feb. 2, 2009. Here, the cynics might have an argument, because in 2008, Mr. Adkerson did not receive an option grant at all. His last grant was made on May 11, 2007. In the interim, he made do with performance share grants and another form of long-term incentive compensation. Even so, the cynics would still need to explain how Mr. Adkerson knew when the market was going to turn. The $24.59 strike price ranked at the 5th percentile of all the closing prices during 2009.

- Jay Johnson of General Dynamics. His grant date was March 4, 2009, just five days before the market hit its low. His advantage was $14.2 million. He did not become CEO until July 1, 2009. Mr. Johnson's $40.09 strike price ranked at the 2nd percentile of all the closing prices in 2009.

- Kenneth Chenault of American Express. His grant was made on Jan. 29, 2009 and conferred on him an advantage of $12.2 million. But he also received a grant on Jan. 31, 2008, which suggests that a pattern was being followed. Mr. Chenault's strike price of $16.71 ranked at the 13th percentile of the distribution of closing prices during 2009. (His 2008 grant's strike price of $49.13 ranked at the 88th percentile of closing prices during that year.)

- Andrew Gould of Schlumberger. His grant occurred on Jan. 22, 2009, conferring on him an advantage of $10.6 million. But his year-earlier grant was made on Jan. 17, 2008. The 2009 grant's strike price of $37.85 ranked at the 4th percentile of all closing prices during the year. (His 2008 grant's strike price of $84.93 ranked at the 55th percentile of all closing prices during that year.) Once again, there seems to be a pattern here.

You might ask how these five gents are doing with their option grants, as of the close on Oct. 8. The short answer is that all five are doing quite well, thank you very much.

- Ford's Mr. Mulally is sitting on a paper profit of $58.5 million. And that's just little more one-and-one-half years into his 10-year option term. Had his option's strike price equaled Ford's average closing price of $5.75 during 2009, his gain would be a smaller $39.5 million.

- Freeport's Mr. Adkerson has a $35.5 million paper profit, with 8.3 years to go before his option expires. Using FCX's average closing price of $55.00, his paper profit would be $20.3 million.

- General Dynamics' Mr. Johnson has a $19.8 million paper profit. In his case, though, his option expires after five years (thereby giving him 3.4 years before its expiration.) Had he received his option at the average closing price of $56.83, his paper profit would be $5.6 million.

- American Express' Mr. Chenault has a $25.5 million paper profit, with 8.3 years to go before his option expires. Using the average closing price of $26.93 as the strike price would reduce his paper profit to $13.2 million.

- Schlumberger's Mr. Gould's paper profit is $17.5 million. He, too, has a 10-year option term. Were his option to be granted at the average price of $53.42, his paper profit would be $6.9 million.

In summary, the five CEOs featured in this article received not only large option grants but option grants carrying relatively tiny strike prices. The median among the five received a grant that ranked at only the 5th percentile of the array of closing prices during the company's 2009 fiscal year. In contrast, the median CEO in my entire 174-CEO database received a grant that ranked at the 30th percentile. (The average strike price of all 171 CEOs equaled 93 percent of the average closing prices for the same companies. And the average advantage came out to $1.4 million.)

In the five cases featured in this article, considerable shareholder wealth has been added since these options were granted. But it surely helped these CEOs to have started the 100-yard dash 75 yards from the finish line. That does give you an advantage over your fellow runners.

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Option grant data were obtained from Equilar Inc., in my opinion, the leading provider of high-quality and timely executive compensation information.

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The Case of Larry Ellison

I find the notion of making an option grant shortly after the end of a fiscal year and sticking to that pattern year-over-year to be quite appealing. The compensation committee knows how the year turned out, and they can use this information wisely in deciding whether to give the CEO a large grant, a medium-sized grant or even no grant at all.

For some years, the compensation committee of Oracle has followed this approach with its CEO, Lawrence Ellison.

Oracle's fiscal year ends on May 31. And in early July, effectively right after the annual results for the preceding year are known and have been disclosed, Mr. Ellison is given an option grant.

For the fun of it, I measured the strike price of each of his last five grants against the daily closing prices for the preceding fiscal year. I extended the range in each case beyond the fiscal year to encompass the grant date itself.

Here are the results:

BEGINNING	GRANT DATE	PCTILE
5/31/2009	7/1/2010	22
5/31/2008	7/2/2009	82
5/31/2007	7/3/2008	49
5/31/2006	7/5/2007	96
5/31/2005	7/6/2006	97
	MEDIAN	82

Alternatively, if Mr. Ellison's strike prices were compared to the fiscal years that gave rise to his grants (e.g., May 31, 2009 to May 31, 2010, and excluding the period between the end of that fiscal year and the actual date of grant), his strike prices would still have been high in the distribution of closing prices – a median of 84.

So just because a CEO gets his grant early in a fiscal year does not guarantee he will always get some super-low strike prices. Mr. Ellison's comp committee is to be congratulated for sticking to the same pattern each year. And Mr. Ellison himself is to be given sympathy that, for the most part, his advantage at grant, compared to the average daily closing prices, has resulted in his starting out with a substantial penalty.

2010 marks Graef Crystal's 51ST 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.