EQUITY COMPENSATION IN AN ERA OF SCARCITY
Understanding the past and preparing for the future
Between the period October 9, 2002 (when the Dow Jones Industrial Average touched its last bear market low of 7,286) and exactly five years later on October 9, 2007 when it peaked at 14,165, the DJIA realized an impressive, although in hindsight clearly unsustainable, growth of 94%. Then suddenly the party ended, and in the ensuing 16 months (through February 19, 2009), the DJIA has given back all but 180 points of that nearly 6,900 point gain. The performance of the S&P 500 has mirrored that of the DJIA almost to the day. Meanwhile, the U.S. unemployment rate, which reached a cyclical low of 4.4% in early 2007, has been charging upwards, reaching 7.6% (11.6 million unemployed) in January 2009, and it shows no signs of turning around soon, notwithstanding the $787 billion economic stimulus plan, passed by both the U.S. House and Senate, and signed into law on February 17.

Unsurprisingly, in the context of this unending drumbeat of dire news, shareholders have become, depending on the day, scared, disillusioned or angry. In this environment companies’ management and directors must confront the issues of employee remuneration broadly and the use of equity compensation as one component of it. Executive compensation generally and equity compensation specifically have become tainted by recent well publicized practices, particularly by the management at some of the now defunct investment banking houses. This system of paying for any performance has not resonated well on Main Street or, for that matter, in Congress, which is understandably sympathetic to the widespread pain being felt throughout the economy.

Economists are still debating whether the root causes of the speculative excess are principally the U.S. residential real estate market bubble, the opacity and complexity of credit derivatives, laxity of underwriting standards in an era of asset securitization, the lack of U.S. personal savings or the extensive leveraging by individuals, corporations and governments alike, but all are likely primary and collective culprits. In addition to the real estate bubble, the increase in the wealth effect through stock market holdings had contributed to our sense of well being. Shareholders who had just recently been burned during the tech run up and meltdown (prior to the recent bull market, the Nasdaq had increased from 1,419 in October 1998 to 5,049 on March 10, 2000 before falling to a new low of 1,119 on October 7, 2002) were in a generous mood, ready to share the wealth and richly reward the executive teams who made such returns possible. Never mind the rising tide and the ships which became the wreckage of 2007-2009.

A BRIEF HISTORY OF EMPLOYEE STOCK OPTIONS

Although it isn’t known exactly when the first option contract traded, it is believed that the Romans and Phoenicians used option-like contracts in shipping. It is also recorded that during the Holland tulip mania of the early 1600s, tulip dealers (buyers) used ‘call options’ to make sure they could secure a reasonable price to meet the escalating demand. The tulip growers, on the other hand, used ‘put options’ to lock in a profit. Before long, speculators began trading tulip options for profit. When the tulip market crashed, many speculators were unable to honor their contracts and unsurprisingly this ‘market’ failure, lacking any form of regulation, tainted the view most people had of options.
In the 19th Century U.S. there was no exchange on which to trade ‘call and put contracts’ and because the terms differed by contract, there was no organized secondary market. Sellers and buyers typically offered terms for specific ‘calls and puts’ in newspaper ads.

Options in the U.S., because of their leverage effect, came under scrutiny as one of the many contributory causes to the Great Depression. While the Investment Act of 1934 ultimately sanctioned options, it also regulated the trading of options under the newly formed Securities and Exchange Commission (SEC).

From the 1940’s to the late 1960’s trading in options was still novel, as they lacked an organized trading exchange and therefore remained administratively burdensome and largely illiquid. Even as late as 1968, annual volume was less than 300,000 contracts. However, after extensive study and planning, the Chicago Board of Trade established the Chicago Board Options Exchange (CBOE) and began trading listed call options on 16 stocks on April 26, 1973.

With the rise of technology stocks in the mid-1980’s and the explosion of the Internet in the mid-1990’s, employee stock options became a preferred compensation vehicle for aligning shareholder and employee interests. A benefit for cash constrained technology companies was the ability to trade off cash compensation today for the promise of riches through stock option exercises tomorrow, and there are myriad stories of Microsoft millionaires. In fact, Microsoft, “used to balk at paying high wages . . . but started giving annual bonuses, and then stock options, beginning in 1982,” wrote Michael Cusumano and Richard Selby in their 1995 book Microsoft Secrets. And in early 2000, according to the Giga Group, there were as many as 7,500 Microsoft employee millionaires, later updated to 9,000 in the July 21, 2003 Newsweek article, “Running Out Of Options: During the boom, they were hailed as the key to infinite wealth. But now Microsoft is giving up on them, signaling a broader shift in pay packages.” by Allan Sloan. This was the article addressing the seminal event of Microsoft abandoning stock options for new restricted stock awards and thus signaling the end of its “go-go” era. It was noteworthy that gains from exercised options in 2000 among Microsoft employees amounted to a staggering $12 billion, or $600,000 before taxes per assumed employee exercising, according to the same article.

In 1995, the Financial Accounting Standards Board (FASB) first addressed the issue of employee stock options not being a free good (on the premise that stock options awarded at the then stock price of a company had no intrinsic value at the time of grant). Statement of Financial Account Standards (SFAS) 123 required the recognition of the compensation expense associated with stock options awarded to employees. This expense was to be calculated using acceptable stock option valuation methodologies which practically speaking meant the Black Scholes value of the options. Not surprisingly, early on few companies adopted the voluntary compensation expense disclosure under SFAS 123, preferring instead to include a footnote disclosure which drew less scrutiny.
According to Benjamin Templin in a January 2005 article entitled, “Expensing Isn’t the Only Option: Alternatives to the FASB’s Stock Option Expensing Proposal,” in the Journal of Corporation Law, as financial scandals came to light in 2001, culminating with the Enron bankruptcy in December, many companies voluntarily elected to expense options. And by February 2004, companies comprising 41% of the market capitalization of S&P 500 index had elected fair-value accounting instead of intrinsic value. Likely playing a factor as well was the stunning statistic, cited in the same article, that the average ratio of CEO pay (with the gains from stock option exercises accounting for a significant share of that compensation) to the pay of a company’s average production worker had increased from 42 times in 1982 to 411 times by 2001.

In the wake of the accounting scandals, many firms wanted to signal to the market that they were forthcoming and transparent and instill confidence in their governance processes as a result. Presumably, this transparency would translate into more favorable analyst and shareholder impressions and rising share prices—a virtuous circle.

By early 2004, Silicon Valley had mustered its final arguments against expensing and lined up Congressional support where possible. However, the debate had run its course, and in December 2004, nine months after issuance of its Exposure Draft 1102-100, Share-Based Payment, which generated over 4,800 comment letters in the ensuing three months, the FASB issued SFAS 123 (Revised), Share-Based Payment, requiring the fair value expensing of employee stock options within the income statement.

Now, with the latest financial meltdown and associated stories of executive excesses (not long after the publicity on options backdating appeared to have run its course), the debate over the benefit of employee equity compensation (which also includes other instruments such as restricted stock, performance shares and stock appreciation rights) is raging anew.

THE UNCERTAIN ROAD AHEAD FOR EQUITY COMPENSATION

As far back as 1990 Fortune magazine was warning of the lack of effectiveness of stock options. In an article, “THE TROUBLE WITH STOCK OPTIONS They’re more popular and lucrative than ever. But they don’t do what they’re supposed to do, and the cost might shock stockholders -- if they knew it.” Thomas Stewart writes as follows.

“Consider a study by James H. Carbone, a management consultant in Novato, California. He examined a sample of 180 companies that were regulars on the FORTUNE 500, checking ten measures of corporate performance, such as return on stockholders’ equity, net sales growth rates, and earnings per share, over 25 years. He found no statistically significant correlation between performance and stock option compensation. Companies without option plans did as well as companies with them. Companies that updated their plans to take advantage of tax law changes did no better than those that let their plans fall behind the times.”
Common sense reinforces what Carbone’s study suggests: Options don’t really make managers walk in the owners’ moccasins. Only after executives exercise options do they truly become owners. Until then they have no capital at risk, and if the stock sags, they can expect a new grant the next year at a lower price. Some companies even cancel ‘underwater’ options and replace them with new ones. Many did so after the October 1987 market crash.

Further evidence of a gap between optionees and regular shareholders comes from compensation expert Graef S. Crystal, of Berkeley’s business school, who studied the option gains of 130 CEOs from 1986 to 1988. Crystal tracked the CEOs’ option profits against the appreciation of their companies’ stock, reasoning that the two ought to move together. Instead, his regression analysis yielded an extremely weak correlation: Only about one-seventh of the CEOs’ profits could be explained by the stock’s movement. Most came from bigger grants, and some from other factors, such as the timing of the exercise and replacement of underwater options. In short, CEOs’ option compensation is far out of proportion to any gains ordinary shareholders get from rising stock prices. Option holders must become regular shareholders eventually, when they exercise their options -- but most apparently get right off that bus by selling the shares and pocketing the spread in cash.”

Further, a study by Stanford Graduate School of Business Professor Paul Oyer, as published in the August 8, 2001 issue of Business Wire, indicated that while stock options worked as an employment inducement, they were not especially effective as a performance incentive at larger companies. Essentially, stock options can serve as salary buffers to keep workers from leaving their firms when salaries or other benefits start to rise in the labor market around them.

Oyer posited that stock options and other remuneration based on firm performance help large companies, over wide fluctuations in market wages, design compensation packages that retain workers when the costs of employee turnover and renegotiating pay packages are high. “My argument has nothing to say about startups,” says Oyer. “Their stock options are very strong incentives.” Oyer found that stock options are effective [as a competitive remuneration tool] in industries where individuals’ market wages vary widely, in tight labor markets where worker replacement costs are high, and when the specific sector of a particular industry experiences greater common shocks, such as a sudden downturn in product demand. Rather than constantly making counteroffers to retain their workers, companies gave them an incentive to stay by offering stock options that increased in value at a rate commensurate with the outside offers.

As the economy slowed, those same companies have benefited in the down market. “When the market was hot, companies did not make the high market wages a permanent fixture of their employee wages by promising them x dollars in cash year in and year out, and then have to go in and reverse that,” says Oyer. “Now there’s a nice natural process. When the demand for workers went down, firms did not have to take anything back from them. Their salary stayed about the same, but the value of their options has floated down and we’re back in a new equilibrium.”

This works in principle, except when it doesn’t. In a perceived tight labor market, company management and directors often feel pressured to make good on the so-called option promise of a “guaranteed” gain, notwithstanding the real loss realized by the company’s shareholders. This was manifested prior to SFAS 123(r) in the form of 6-month and 1-day option repricings and more recently in the form of option exchanges. (See Solium white paper “Underwater Option Dilemma—The 2008 Market Meltdown”, published in December 2008.)
Unlike the period of 2001-2003, things really are different this time, if for no other reason than the breadth of stocks which have experienced a significant price decline. According to Alix Stuart and David McCann in the January 1, 2009 CFO Magazine article, “No Lifeline for Underwater Options: Repricing proposals for underwater options likely will receive a chilly response from shareholders,” while in the period 2001-2003, after the bursting of the Internet bubble, approximately 400 publicly held U.S. companies offered to reprice or exchange underwater options, most observers expect a much lower number this time despite the number of companies affected. According to Watson Wyatt, approximately 60 companies had proposed option exchange programs in 2008, mostly in the fourth quarter.

Further, four features of exchanges which make them more shareholder-palatable, especially in combination, have gained a fair amount of traction. These are:

- Excluding Board members and executive officers named in the company’s proxy statement
- Excluding options originally priced under the company’s 52-week stock price high from eligibility
- Using a value neutral exchange rate, i.e. fewer new options than old options or in the case of restricted stock or RSUs received for old options, a greatly diminished ratio
- Resetting the vesting schedule to extend the performance period for earning the award

All of these are more stringent and less appealing to the option holders than was the case six years ago. Arguably, the most severe is the value neutral exchange where an option holder might expect to receive only 10% or fewer replacement options (or 5% or less restricted shares or units). These criteria and the expense (both in terms of dollars spent and lost shareholder good will) may prompt a number of companies to forgo this approach this time around.

Shareholder frustration with executive compensation is manifesting itself in other ways. In an article in the February 13 Wall Street Journal, “Shareholders Renew Push to Regulate Executive Pay,” say on pay proposals have been submitted in the case of 40 financial firms, most of which are TARP money recipients. This is up from slightly over half that number last year, according to RiskMetrics Group. Further, RiskMetrics’ Proxy Season Watchlist, as of February 1, 2009, showed 82 proposals pending for a shareholder advisory vote on executive compensation and a further 14 proposals submitted for a mandated retention period for stock obtained as a result of restricted stock lapsing or option exercises. In certain cases, these holding periods would extend beyond the executive’s retirement. In a late addition to the massive U.S. economic stimulus bill,
signed into law on February 17, 2009, executives (yet to be defined but potentially covering as many as 25 people) at companies receiving TARP funds since its inception would be subject to a limitation on bonuses of no more than 50% of base compensation. (Technically, the legislation states that bonuses can be no more than one-third of total compensation.) There is an exemption for those who are contractually entitled to a formula-based annual bonus. Unclear, at this point, and potentially subject to Treasury interpretation is the treatment (and valuation) of stock awards in “bonus” and “total compensation”. There are even more onerous limits for those receiving “extraordinary assistance” under TARP, although no companies are in this category today.

A further dialogue now taking shape is whether equity-based awards and especially time-based stock option awards (because of their leverage feature) incent executives to take on outsized risks in an effort to boost returns and thereby the share price. Under the Capital Asset Pricing Model, there are potentially premium returns to be captured by boosting a company’s market risk or Beta. The difficulty here is this is also correlated with greater volatility of returns and stock price and hence a greater likelihood of company failure. There is some sentiment that publicly held investment banks, and to a lesser extent commercial banks, moved out on the return-risk line, to the detriment of shareholders. Whether stock options promoted that behavior and whether shareholders supported that move will be the subject of future studies by academicians.

What is clear is general shareholder resistance in this era of austerity to allowing a ‘do-over’ of equity awards to executives, board members and others, because shareholders are not necessarily convinced these individuals were acting in the shareholders’ best interests.

So, we find ourselves in the midst of a perfect storm.

a) Management is dealing with depressed market capitalizations—we need to go back to June 1997 to find the point that the DJIA was first crossing present levels on the way up.

b) General shareholder dissatisfaction is very high—there is already talk of the U.S.’s ‘Lost Decade’.

c) Prevalent public frustration with executive management—bonuses proposed or paid in 2008 on top of government “bailouts” only add fuel to the fire.

d) Employee concerns about prospects for retirement following decimation of IRAs and 401(k) holdings.
The single factor that works in the interests of companies relative to compensation today (and hopefully will prove temporary) is the high and rising rate of unemployment in nearly every sector and geography. This has already translated into reduced raises and, in some cases, general pay reductions.

Companies are still left with the challenge of attracting, retaining and motivating top talent to succeed in an increasingly competitive environment. Where are equity awards likely to fit in this equation?

- First, to the extent that it existed in the past, the one-size-fits-all approach will be considerably less appealing. Companies will need to treat equity awards as the scarce commodity that they are and ration them accordingly. This will require a hard look at the company’s underlying compensation philosophy and the specific behaviors that compensation mix is designed to incent.

- Second, and related to the above, there is presently less value to be conveyed to recipients of stock based awards. With stock prices in many cases at multi-year lows, using past dilution guidelines means lower aggregate award value. This suggests either smaller average awards, a smaller recipient population or perhaps both.

- Third, below the executive ranks there has often been a disconnect between the perceived value of awards (lower and sometimes significantly so) and the calculated cost of those awards to the company. This will require a combination of shifting how those individuals are appropriately remunerated, and for those who continue to receive stock-based awards companies will need to do much better in communicating these awards to the recipients so that they can be appropriately valued.

- Fourth, awards tied to service conditions can be expected to become less common. This begs the issue of what performance metric(s) is (are) appropriate, the performance timeframe and whether those differ by recipient position and from year to year. For those not in a position to influence overall company performance and whose influence on share price is therefore much less direct, non-share price based performance measures (with relevant timeframes) and rewards may well be in order.

- Fifth, either companies (or academics) will need to be able to support a correlation between equity awards and superior company (and therefore share price) performance. Recall the Carbone study cited in the 1990 Fortune article above suggesting little, if any, correlation between performance and stock option compensation.

- Sixth, given the stories about executives realizing multi-million dollar equity payouts just shortly before collapse of the stock, there is likely to be increased pressure for longer holding periods. Already, there is emerging sentiment for holding periods extending beyond retirement.

So, for the Finance or Human Resources professional in this era of scarcity, it is back to drawing board to reformulate and hopefully recharge equity awards to position their companies for a long term, sustainable competitive advantage through attracting, retaining and appropriately motivating and incenting top talent in a backdrop of unprecedented market upheaval.
Your roadmap to simple and effective equity compensation plans

ABOUT SOLIUM CAPITAL

Solium Capital Inc. (TSX:SUM) is a leading global provider of web-based stock plan administration technology and services. Solium’s integrated solutions help corporations automate and manage their stock option and stock purchase plans, including comprehensive regulatory and financial reporting. Founded in 1999, Solium Capital has offices in Canada and the United States.

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