

As We See It

Option Grants Shouldn't Be "All in the Timing"

Let's start with the obvious: the purpose of stock options is to align the equity interests of executives and shareholders on the basis of future stock performance. Whether through deliberate manipulation or administrative sloppiness, issuing stock option awards to senior management at artificially low exercise prices threatens to break that pay-for-performance link.

The SEC is now investigating widely-publicized allegations that some companies issued stock option grants that were backdated to share price lows or timed in advance of positive company news. Both scenarios would virtually guarantee that newly-granted options would be "in the money." In gamblers' parlance, pegging the grant date in advance of good financial news would be akin to fixing the race; backdating to a low share price would be placing the bet after the race is run.

Media attention has focused on the relatively few cases in which grant dates for multiple awards allegedly were cherry-picked to provide maximum financial advantage to the grantees. However, we believe many other companies may face possible exposure due to flawed grant practices that resulted in option grants being wrongly, but inadvertently, misdated or mis-priced. While the economic impact to executives in the latter circumstances may not have been significant, the current business environment demands scrupulous attention to the details of good governance. Looking forward, the question for Boards and consultants is: How do we protect the integrity of stock option awards?

As we see it, the questions surrounding option grant timing – like other recent pay "scandals" – do not require the imposition of more regulatory mandates at a time when companies already are struggling to comply with and pay for new governance-related regulations. Rather, Directors must take the necessary steps to put option grant procedures back on track, just as they recognized the need for closer attention to the nitty-gritty details of post-retirement benefits and deferred compensation programs in the wake of earlier controversies.

Here's how we view the option dating problem and how to address it.

Historically, Boards and compensation consultants have taken responsibility for determining and approving the size and vesting criteria of executive equity awards. The ensuing paperwork of actually making the grants, from writing participant agreements and complying with SEC filing requirements to pricing and dating the awards, has largely been left to management. Until relatively recently, companies were required to report stock option grants to the SEC on a quarterly basis, making it relatively difficult to verify that the grant dates and exercise prices were consistent with what the Board approved. The imposition of swifter reporting deadlines under Sarbanes-Oxley has reduced – but not eliminated – the potential for abuse or error.

Now, as more and more companies begin to scrutinize their option dating practices, we believe many will uncover administrative errors that call into question whether the grants were properly made. They must take quick and appropriate corrective action – regardless of reason or intent.

As with many governance problems, the devil is in the details. Before the SEC steps in, Boards and their consultants must take responsibility for ensuring that equity awards are properly administered. We believe that practically speaking, companies will find that the granting of broad-based option grants may still call for a degree of flexibility in pricing, in part to control costs. But grants related to senior level executives must be above reproach. More rigorous and standardized internal Board procedures will preclude the possibility of

strike prices for executive option awards being either inadvertently misstated or intentionally manipulated. This will protect the company, which otherwise will be vulnerable to shareholder litigation in regards to wrongly dated grants, as well as grantees, who could face potential civil and criminal exposure and the loss of previously paid compensation.

Some basic steps:

- Boards should establish a standardized policy regarding the date or dates of annual stock option grants to executives.
- The exercise price of option awards to executives should be the stock's fair market value on the day of Board approval.

- There should be a formal policy that no executive option award can be dated prior to actual Board approval.
- As with all governance matters, the Board should maintain detailed minutes of its intentions and actions.

As with any extension of their oversight, Directors will be challenged to avoid slipping into the role of micromanagers. But it is worth the risk to ensure that all stakeholders, whether investors or managers, are playing on a level equity field.