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Abstract

Every year executive remuneration grabs headlines in the press and for a short period there is an intense debate over it. The debate is largely about whether the level of remuneration is justified: whether it is a result of competitive pressure in the market for skilled managers, or a result of executives' greed and institutional shareholder apathy.

Keywords

executive remuneration, options, share options, equity compensation, executive share options, options-hedging, ASX principles of good governance practice

Disciplines

Law

SHARE OPTIONS AS A COMPONENT OF EXECUTIVE REMUNERATION: CURRENT ISSUES

Thomas Ritchie*

INTRODUCTION

Every year executive remuneration grabs headlines in the press and for a short period there is an intense debate over it. The debate is largely about whether the level of remuneration is justified: whether it is a result of competitive pressure in the market for skilled managers, or a result of executives' greed and institutional shareholder apathy.¹

While the level of executive remuneration is debated in the media, there is a deeper level of academic debate over issues concerning its *form*. Executive remuneration is typically provided as a combination of three forms: cash, equity compensation (ie shares or share options) and other miscellaneous compensation (including superannuation and 'fringe benefits' such as company vehicle).

The use of options as a component of executive remuneration in Australia generally paralleled their use in the US. The practice emerged in the 1970s, but it was not until the 1980s that they became truly widespread in both jurisdictions. The reasons behind their popularity differed: the Australian Fringe Benefits Tax of 1986 had the effect of encouraging companies to award executives in the form of cash bonuses and incentives according to job complexity and their performance, often in the form of options.²

In the US, options also became a popular form of compensation in the 1980s, as the stock market experienced a period of unparalleled growth. In 1993, US taxation laws changed with the effect of changing compensation practices to favour share options (and other types of performance-based non-cash compensation) even more.³ Over the last three decades the growth of options-based compensation has paralleled the growth in executive pay.⁴

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¹ Jeffrey Gordon, 'Executive Compensation: If There's a Problem, What's the Remedy? The case for "Compensation Discussion and Analysis', (2006), *The Journal of Corporation Law*, Available at SSRN: <http://ssrn.com/abstract=686464>.

² Jennifer Saiz, 'Expensing the cost of Executive Option Schemes: Case Studies in the Australian Healthcare System', (2003), 4 *Journal of Law and Financial Management*, Available at http://www.austlii.edu.au/au/journals/JLFM/2003/4.html#fn_15 accessed 13 August 2007.

³ John White, 'Testimony Concerning Tax and Accounting Issues Related to Employee Stock Option Compensation' (2007), *US Securities and Exchange Commission*, at <http://www.sec.gov/news/testimony/2007/ts060507jww.htm>, accessed 13 August 2007.

⁴ See generally, Michael Jensen, Kevin Murphy and Eric Wruck, 'Remuneration: Where We've Been, How We Got to Here, What are the Problems, and How to Fix Them' (July 12, 2004). Harvard

Today, options continue to be a valued remuneration tool for several reasons. They align the interests of executives and shareholders (exactly how they do this is explained below). For emerging growth companies, the use of options as compensation offered a way to conserve resources while attracting talent in highly competitive markets.⁵

HOW DO EXECUTIVE SHARE OPTIONS WORK?

A director can be issued options when they join the company and also as part of an annual remuneration package.

An option is a contract that gives the holder the right to buy shares at a defined price (the exercise price) during the option period. The exercise price is usually the same as the market price of the underlying shares on the issue date – so a change in the company's share price will affect the value of the options. If the share price increases so that the exercise price becomes lower than the market value of the underlying shares, the option-holder will make a gain when they exercise the option. If the share price falls below the exercise price, the option holder may choose not to exercise the options, because if they do they will make a loss.

Theoretically, if an executive holds options in their company, the quantum of their pay significantly depends upon the company's share price. In this way, options provide a strong incentive to executives to 'align their work-related efforts to the firm's wealth maximisation objectives.'⁶ That is to say, their interests become aligned with those of shareholders: they are both interested in increasing the company's share price.

This paper now turns to three current issues relevant to the use of share options as a component of executive remuneration. They are options-backdating, options-hedging, and accounting/taxation issues.

OPTIONS-BACKDATING

Options-backdating (or 'options fraud') is one of the simplest ways in which companies and executives can abuse executive options schemes to the detriment of shareholders.

The exercise price of options can be the market price at the date the options were granted.

NOM Working Paper No. 04-28; ECGI - Finance Working Paper No. 44/2004. Available at SSRN: <http://ssrn.com/abstract=561305> cited in Note 3.

⁵ See generally, Kevin Murphy, "Stock-Based Pay in New Economy Firms", (2003), 34(1) *Journal of Accounting & Economics* 29, cited in Note 3.

⁶ Colleen Fisher and Victoria Wise, 'Share-based payments: emerging issues', Working Paper. Victoria University, Melbourne, Australia. Available at <http://eprints.vu.edu.au/archive/00000559/>, accessed 13 August 2007.

To backdate these options, a company changes the date the options were granted, to make it appear that the options were granted at an earlier date (but more importantly at a lower price) than when the grant was actually made. By backdating the options, they can appear to have been granted at a lower market price. This allows the recipient to realise an even larger gain when the option was exercised.

The problem has been far more prevalent in the US than in Australia. In the US, backdating options has traditionally been relatively easy and risk-free, because until the Sarbanes-Oxley Act of 2002, executives were not required to disclose receipt of stock options until after the end of the financial year in which the transaction took place. The introduction of the Sarbanes-Oxley Act required disclosure of directors' option grants within 2 business days of the grant and exercise. This appears to have had some success in resolving the problem, however regulatory investigations continue into the practice.⁷ In fact as recently as 8 August 2007, a former executive was found guilty in the US of options backdating.⁸

A review of the literature indicates that Australia has not had the same problems as the US with options backdating. In Australia, provisions of the ASX Listing Rules operate to prevent the abuse in much the same way as Sarbanes-Oxley did in the US. Clause 3.19A of the Rules require disclosure of changes in directors' interests within 5 business days of the changes. The Rules define director's interests specifically to include those arising from options contracts.⁹

The resolution of this problem is a good example of how simply raising the bar for disclosure can make it practically impossible for companies to engage in wrongdoing, thus solving the problem.

OPTIONS-HEDGING

Another current, serious issue regarding options remuneration has been the incidence of executive options-hedging.

'Hedging' is a financial term meaning the practice of making an investment to reduce or cancel out a risk involved in another investment. In the context of options-hedging, the strategy is best explained by way of example. An executive holds options to purchase 100 ABC Limited shares for \$1.00. The executive believes the share price of ABC will fall to \$0.80. To hedge the options, the executive purchases 100 options to sell ABC Limited shares for \$0.90. If the share price does fall to \$0.80, the executive can exercise the options to sell ABC shares for \$0.90, thereby making a

⁷ Note 3.

⁸ David Stretfield and Michelle Quinn, 'Jail term for options fiddler sends tremor through Silicon Valley', *Sydney Morning Herald* (Online), 8 August 2007, at <http://www.smh.com.au/news/business/jail-term-for-options-fiddler-sends-tremor-through-silicon-valley/2007/08/08/1186530447887.html>, Accessed 19 August 2007.

⁹ See chapter 19 of the *ASX Listing Rules*, in particular definition of 'notifiable interest'.

gain of \$0.10 per option. This would cancel out the executive's loss from the first lot of options held.

Options-hedging allows a party to make money as a share price falls, minimising downward risk (but at a cost to the potential gains). If executives can hedge their options, then they render one of the key benefits of options-based remuneration – aligning their interests with those of shareholders – void.

This issue has not escaped the notice of the ASX, which has sought to remedy the problem by amending the *Principles of Good Corporate Governance Practice and Best Practice Recommendations* ('Principles'). The Principles currently recommend companies do the following:¹⁰

Require designated officers to provide notification to an appropriate senior member of the company, for example, in the case of directors, to the chair, of intended trading...

Following a lengthy public consultation process, the ASX has released an Exposure Draft showing a number of amendments that will be made to the Principles.¹¹ It indicates that the following words will be inserted into Box 3.2 (which is quoted above):

...including entering into transactions or arrangements which operate to limit the economic risk of their security holdings in the company.

The Exposure Draft also indicates that the Principles will be further amended so as to recommend companies to place on their websites in a clearly marked 'Corporate Governance' section 'a summary of the company's policy on prohibiting entering into transactions in associated products which limit the economic risk of participating in unvested entitlements under any equity-based remuneration schemes.'¹² The Explanatory Paper to the Exposure Draft states that these amendments are directed at hedging arrangements.¹³

The Principles are non-binding, however listed entities must make disclosure in their annual report of the extent to which they do or do not follow the Principles. The amended wording of Box 9.2 means that the ASX is recommending companies ban upon hedging unvested options.

Whether this attempt at regulating the practice will be enough remains to be seen. The amendments to the Principles were released on 2 August 2007. While the amendment to the Principles certainly represents a step in the right direction, the

¹⁰ *Principles of Good Corporate Governance Practice and Best Practice Recommendations*, Box 3.2.

¹¹ Available at

http://www.asx.com.au/supervision/governance/principles_good_corporate_governance.htm, visited 3 August 2007.

¹² Note 11.

¹³ Note 11.

issue may be of such fundamental significance that a legislative ban will be placed on executive options-hedging.¹⁴

In the US, executive options-hedging is regulated in a number of ways. Many companies include a prohibition on hedging in their option contracts with executives.

The United States Securities Exchange Commission ('SEC') Rules 16(b), (c), (c)(4) and 10(5) also regulate executive options trading. Rule 16(b) prevents short-swing trading of company shares – which means an executive may not buy or sell the company's shares within six months of each trade. Rule 16(c) prohibits the short sale of company stock by company officers, directors, and significant shareholders. Rule 16(c)(4) extends rule 16(c) to selling call options and buying put options on the company stock – effectively prohibiting options-hedging.

It is possible that the rule against hedging could be circumvented by hedging with a different but highly-correlated company's shares. If two companies' share prices are highly correlated, an executive can hedge against a fall in the value of his own company's shares by hedging against a fall in the value of the correlated company's shares. This raises an interesting question of whether this practice should be banned as well. On the one hand, the practice effectively skirts the prohibition on options-hedging. On the other hand, where the share price of two companies are highly correlated, the correlation is most likely due to market forces beyond the control of each company.

In any event, in Australia options-hedging with highly correlated shares is covered by the broad wording of the Principles: if a company allows this practice, it must be declared.

ACCOUNTING AND TAXATION ISSUES

The final issue this paper will examine is the difference in how accounting standards and taxation laws treat executive options remuneration.

The purpose of accounting standards is to allow outside viewers to gain an accurate understanding of an entity's financial standing. The purpose of taxation laws is to ensure an entity pays the correct amount of tax in a given financial year. Both seek to measure economic events and transactions that have occurred during the reporting period in order to achieve their objectives. However the value accorded to options can differ significantly when viewed through the prism of either accounting or taxation laws. This can have an effect on the accuracy of a company's financial statements.

¹⁴ See for example Parliamentary Joint Committee on Corporations and Financial Services 'Statutory Oversight of the Australian Securities and Investments Commission' at http://www.aph.gov.au/Senate/committee/corporations_ctte/asic/asic_07/index.htm, accessed 3 August 2007.

ACCOUNTING TREATMENT

Before 2004, issuing options gave companies extremely favourable accounting treatment as accounting standards meant that options issued below the market value of the company's shares were given a book value of zero.

Only in 2004 was an accounting standard introduced (generated by the International Accounting Standards Board ('IASB')) requiring options-based compensation to be recorded at 'fair value'. The standard became compulsory in 2006.

The fair value amount of an option must be measured using a market instrument or an option pricing model (such as Black-Scholes) and is recognized over the vesting period. The total amount of compensation expense recognised in the company's books is fixed at the grant date.

TAXATION TREATMENT

Tax benefits (in the form of deductions) for companies arise from options remuneration. When an employee exercises options, the difference between the exercise price and the fair market value of the company's stock on the date of exercise is treated as the employee's compensation, who is taxed on the gain. The company is entitled to an associated tax deduction on the gain realized by the employee.

Since the tax deduction is tied to an option's value at the *exercise date*, the deduction will likely be different than the compensation expense recognized in the company's financial statements, which is based on the option's fair value at the *grant date*. The company's tax deduction may be more or less than the expense recognized in the company's financial statement – it depends entirely on the market price of the underlying stock on the date of exercise.

If the market rises steeply and executives exercise their options making a large gain, then the company is entitled to a tax deduction that would grossly outweigh the 'fair value' of the options as recorded in the company's financial statements. On the other hand if the options expire (because the share price fell and the person did not exercise them) the company will not receive a tax deduction; however, the company will have recognized an amount of compensation expense in its financial statements.

Thus there can be a sizeable difference between the compensation cost of options that a company has expensed in its financial statements, and the tax deduction the company has taken in connection with the option-based compensation they have granted to employees.

While this is not a pressing problem that demands an immediate solution in the same way as options-hedging, it is an issue which can render a company's financial statements inaccurate, and for that reason alone it is worth resolving.

CONCLUSION

This paper has covered three current issues concerning the use of share options as a component of executive remuneration. The examination of options-backdating shows how disclosure can be a highly effective tool in combating an abuse by making it practically impossible to carry out.

While difference between accounting and taxation treatment of executive options is not as pernicious as options backdating or hedging, it can operate to render companies' financial statements inaccurate. It is important that a solution be sought for this reason.

Finally, options-hedging is a subtle but very serious way in which options-based remuneration can be abused. The amendments to the Principles which require companies to disclose their policies on this issue are likely to have a significant impact on the practice. Disclosure of the sort required by the Principles will allow shareholders to make more informed investment decisions, and will encourage companies to ban executive options-hedging. Some institutional shareholders¹⁵ have already expressed their concern over executive options-hedging. Once companies are forced to disclose their policies on this issue, shareholder pressure alone will no doubt be a significant encouragement to change. It is encouraging that a number of major listed entities (such as Coles, Stockland and Westfield) are already making disclosure of their options-hedging policies.

¹⁵ Such as the Australian Council of Superannuation Investors. See Leon Gettler, 'Corporate watchdog pounces on hedging schemes', *Sydney Morning Herald* (Online), 2 June 2006, <http://www.theage.com.au/news/business/corporate-watchdog-pounces-on-hedging-schemes/2006/06/01/1148956480776.html>.