LOADED FOR BEAR, OR BULL: ASSESSING THE PRACTICE OF GRANTING SPRING-LOADED OPTIONS IN EXECUTIVE COMPENSATION

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Over the past decade, the international business community has witnessed a considerable growth in the size and complexity of executive compensation packages. This growth has been lauded by some and lamented by others. Those who recognize the importance of attracting the best corporate talent to their company might consider today's soaring compensation rates to be well worth the expense. Those who believe in an unbridled free-market economy would argue that the wealth bestowed by a corporation upon its executives reflects the true value of the services executives provide. On the other side of the debate, there are those who would advocate a more egalitarian distribution of wealth within society, or who would consider today's compensation rates to be unfair to shareholders or to the company itself.

Performance-based compensation has been introduced as a supposed check on run-away executive compensation. In theory, the issuance of stock options should fall into the category of performance-based compensation. This note addresses an emerging compensation practice that has blunted the performance-based motivating effect of some stock option grants: the issuance of spring-loaded options. Spring-loaded options allow a compensation committee to offer near-guaranteed and near-instantaneous wealth to corporate executives. This note will examine the practice, legality, and advisability of granting spring-loaded options in executive compensation packages. This note also addresses the question, "Should this practice be regulated?"

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I. INTRODUCTION: A LOOK AT THE TRENDS IN EXECUTIVE COMPENSATION

Compensation packages for corporate executives have come a long way. That is, they have grown remarkably in measures of (1) size and (2) creative complexity.

A look across time at the average compensation packages for corporate executives illustrates the first point. Joann Lublin and Scott Thurm of *The Wall Street Journal* indicate that "[t]he average [pay for chief executives of large companies in 2005] was $10.5 million, a figure that includes salary, bonus and the value of stock and stock-option grants."[1] This figure represents a rapid increase in pay since the mid 1990s.[2] To illustrate just how much of an increase this figure represents, consider that in a 1991 survey of compensation packages for CEOs of the country's biggest companies "[t]he median total CEO compensation [in 1990], including salaries, bonuses, and long-term compensation was $1.4 million."[3] Although this is a look at mean versus median compensation rates, the figures remain indicative of rapid growth.

To give further perspective to the rapid rise of executive compensation since 1990, a look further back in time is illuminating. In 1936, big companies offered their top executives an average of "about $95,000, according to MIT's Professor Frydman, equivalent to $1.4 million in today's [2006] dollars."[4] Note that the relative value of these 1936 corporate compensation packages matches the value listed above for the median total CEO compensation packages in the country's biggest companies in the 1990s. In other words, executive compensation did not change much in measures of size from 1936 to 1990. In the 1930s, these payouts were thought to be generous and were considered symptomatic of the perceived greed of American corporations at the time.[5] Lublin's October 12 article in *The Wall Street Journal* suggests that despite the growing prosperity of the post-war decades, these figures changed very little "reflecting . . . more egalitarian societal values."[6]

Lublin states that in the late 1970s, corporations began to pursue new and creative forms of executive compensation "[a]fter a decade-long bear market soured executives on stock and stock options."[7] Some of the

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[1] Joann S. Lublin & Scott Thurm, *Behind Soaring Executive Pay, Decades of Failed Restraints*, WALL ST. J., Oct. 12, 2006, at A1.
[2] *Id.* at A16.
[3] Amanda Bennett, *Executive Pay (A Special Report) – Hard Times Trim CEO Pay Raises: But Stock Options Set the Stage For Big Future Gains,* WALL ST. J., Apr. 17, 1991, at R1.
[4] Lublin, *supra* note 1, at A16.
[5] *Id.*
[6] *Id.*
[7] *Id.*

compensation packages offered to corporate executives created, in theory, incentives for high performance on the part of the executives. Iman Anabtawi, in the *North Carolina Law Review* explains, "[c]ompensation is the principal means by which companies in the United States seek to motivate managers to act in the best interests of shareholders."[8] For example, traditional stock options, with their intrinsic motivational qualities, continued to be widely offered.[9] "By giving executives options, supporters of the practice say, top managers have a strong incentive to raise the value of the company's shares."[10]

A further example of motivational compensation components is provided by golden parachutes. A golden parachute is "a termination severance payment agreement which shelters executives from the effects of a change in corporate control."[11] These generous payments are guaranteed to executives in the event that their company is taken over and aim to prevent executives from blocking deals that might be in the best interest of the company.

On the other hand, some of the compensation packages offered to executives do not appear to be strictly performance oriented. Signing bonuses, guaranteed bonuses, and enhanced pension packages all fall into this category because executives do not have to undertake any extra care or duty in order to obtain them. Though these might, strictly speaking, not be performance oriented, some will argue that any form of an attractive compensation package is useful for drawing the most successful, powerful executives into the company.

More recently, stock options have also entered the domain of compensation not strictly oriented to performance. This is due to opportunistic practices related to timing. In the 1990s, the practice of backdating stock options erupted onto the scene, capturing the attention of America with a series of high-profile corporate corruption cases highlighted by the national and international media.[12] Backdating further enhanced the

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[8] Iman Anabtawi, *Secret Compensation*, 82 N.C. L. REV. 835, 835 (2004).

[9] Stock options are contracts offered by companies, in this case, to their executives. The options allow the executive (or any holder of the options) to buy shares of the company in the future at the price of those shares at a specified date. Stock options offer the holder an opportunity to win on the markets without the usual corresponding risk of loss. If the stock gains value after the date on which they were granted, the holder may exercise the option to buy and gain the difference in value. If the stock fails to gain value or in fact loses value after the options have been granted, the holder may simply choose not to exercise their option to buy the stock, thereby avoiding any loss. *See id.* at 840.

[10] Jonathan Peterson, *SEC Broadens Stock Option Investigation*, L.A. TIMES, June 20, 2006, at C1.

[11] Jay Zitter, Annotation, *"Golden Parachute" Defense to Hostile Corporate Takeover*, 66 A.L.R. 4th 138 § I(2)(a) (1988).

[12] Backdating of stock options "means retroactively picking an option grant date earlier than the date on which the board, compensation committee, or other corporate official

attraction of stock options by, in effect, creating instantaneous wealth when the options were exercised. While the Securities and Exchange Commission ("SEC") and the general media have long had backdating in their sights, a new timing-related options practice has more recently come to the SEC's attention: the lesser-known practice of issuing spring-loaded options.

In response to growing federal concern with corporate ethics, including the contentious issue of the increasing quantity and complexity of executive compensation, Congress passed the Sarbanes-Oxley Act in 2002.[13] SEC Commissioner Paul S. Atkins, speaking at the International Corporate Governance Network's 11th Annual Conference, pointed out that as a result of this legislation "companies have been subject to tougher internal control requirements, and have filled compensation committees with independent directors. More importantly, the SEC requirement for disclosure of stock option grants to executives and directors has been greatly accelerated to two days from the previous one-year requirement."[14] This aspect of the Sarbanes-Oxley legislation directly affected the practice of backdating options in executive compensation. Jonathan Peterson of the *Los Angeles Times* points out that "[b]efore the Sarbanes-Oxley corporate reform law, companies could have several weeks or even months in which to report their options grants. But the 2002 law cut those deadlines to two business days, greatly reducing wiggle room on the dates."[15]

Presently, federal concern and a federal willingness to intervene in executive compensation have been demonstrated. The elections of November 2006 saw a turnover of parties in Congress. With this turnover, new committee chairmen are setting new goals and agendas. Senator Max Baucus (D) of Montana, Chairman of the Senate Finance Committee, is advocating "higher taxes on executive compensation."[16] In the other house of Congress, Representative Barney Frank (D) of Massachusetts, Chairman of the House Financial Services Committee, is advocating "more

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actually approved the grant in order to use a lower stock price in effect on the earlier date as the option exercise price." Brian E. Pastuszenski, Stephen D. Poss & Marian A. Tse, *The Current Regulatory Focus on Options Dating Practices,* MONDAQ, July 20, 2006, *available at* http://www.mondaq.com/article.asp?articleid=41400&searchresults=1. The timing of an options grant can have a significant impact on the value of the grant. Iman Anabtawi's article points out that "most options are granted as of the date the award decision is made with an exercise price that is equal to the market price of the company's stock on that date (that is, 'at the money')." Anabtawi, *supra* note 8, at 843.

[13] Sarbanes-Oxley Act, Pub. L. No. 107-204, § 116 Stat. 745 (2002).

[14] Paul S. Atkins, Commissioner, SEC, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), http://www.sec.gov/news/speech/2006/spch070606psa.htm.

[15] Peterson, *supra* note 10, at C1.

[16] Sarah Lueck, *Executive Pay Looks to Take Hit, Democratic Congress Gets Tough on Compensation Packages,* WALL ST J., Jan. 30, 2007, at A4.

shareholder power over executive pay."[17] On Thursday, February 1, 2007, the Senate voted to pass its version of a new minimum-wage increase bill.[18] According to Jim Kuhnhenn of the Associated Press, this bill differed from the House version in that it would forbid executive contributions into tax-deferred compensation plans beyond $1 million per year, or beyond "100 percent of the average annual salary over a five-year period."[19] This bill faced the challenge of being reconciled with House Democrats who insisted "they [wanted] a minimum wage bill with no strings attached."[20] Ultimately, facing the combined opposition of business lobbies and a House reluctance to tie the bill to executive compensation, this component of the Senate's version of the minimum-wage increase bill was dropped.[21]

The Democratic Party's "increasingly populist appeal" can certainly be cited as an important factor in the federal government's current willingness to intervene in executive compensation.[22] The need for a politically acceptable target in raising budget revenues would also appear to be a driving force. Sarah Lueck of *The Wall Street Journal* reports that "[d]emocrats[23] have pledged to live within pay-as-you-go budget constraints that require new spending or tax breaks to be offset by budget cuts or revenue increases. Under those rules, executive pay makes a more tempting target than, perhaps, raising middle-class taxes, or cutting popular spending programs."[24]

Against this backdrop of exponential growth in the volume and complexity of executive compensation, this Note will explore the more recent practice of granting spring-loaded options as a part of executive compensation packages. This note will consider the legality of issuing such options, along with the benefits and detriments inherent to the practice. Finally, this note will address the question, should the issuance of such

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[17] *Id.* These examples not withstanding, the Democratic Party is not unanimous in its interventionist approach to executive compensation. Representative Charles Rangel (D., N.Y.), Chairman of the House Ways and Means Committee stated, "I don't want to get involved in people's salaries." *Id.*

[18] Kate Zernike, *Senate Passes Wage Bill, but Obstacles Await*, N.Y. TIMES, Feb. 2, 2007, at A15.

[19] Jim Khunhenn, *Senate Backs Wage Boost with Pro-business Provisions*, DAILY BREEZE, Feb. 2, 2007, at A8.

[20] *Id.*

[21] Lori Montgomery, *Minimum-Wage Accord Produces Protests*, WASH. POST, Apr. 24, 2007, at D1. Ironically, though this component of the Senate's bill met its demise, the House's wish for a "clean" minimum-wage hiking bill without strings attached has potentially been thwarted by further modifications. A subsequent attempt to pass minimum-wage legislation involved attaching the proposed wage hike to an Iraq spending bill. *Id.*

[22] Lueck, *supra* note 16.

[23] The author of this note does not intend, through the inclusion of this excerpt, to indicate that the use of such factors in deciding tax policy is confined to any one political party.

[24] Lueck, *supra* note 16.

options be regulated? While the need for SEC regulation of increasingly opaque compensation packages may be apparent to many, doubts haunt the issue. In light of how the U.S. corporate environment is perceived internationally to be restrictively over-regulated, is further regulation of executive compensation a good idea?

II. WHAT ARE SPRING-LOADED OPTIONS?

Spring-loading refers to two related practices: (1) granting stock options shortly before a public release of positive information or (2) granting stock options shortly after a public release of negative information.

On the one hand, stock options might be granted shortly before a public release of positive information about the company that is likely to increase the value of the company's stock. Simply put, this is "timing grants to come ahead of good news."[25] The public release of positive information is presumably followed by a rise in the company's stock price. This creates opportunity for the same instant wealth that occurs in the practice of backdating stock options. The stock options are fixed to the pre-release price for the options holders, and this fixed price is effectively guaranteed to be below the new post-release value of the stock. When the holders (in this case corporate executives) exercise the option to purchase the stock, the value of the stock obtained is in excess of the price they spent in the purchase.

On the other hand, stock options might be granted shortly after a public release of negative information that is likely to decrease the value of the company's stock. This is "offering [grants] after bad news."[26] This form of spring-loading has also been called "bullet dodging."[27] A drop in the company's stock price presumably follows the public release of negative information. Stock options are then granted to the executive, and they are exercised while the stock value is lower than usual. As time passes, the value of the stock presumably rises once again, benefiting the holder of the options.

Both of these practices involve choosing an advantageous date on which to grant the options to the corporate executive. Both approaches "aim to capture presumed lows in stock prices for the options' strike prices."[28] Both also aim to increase the value of the options for the recipient.[29] Either of these practices involves a grant of options "at the money," or "with an exercise price that is equal to the market price of the

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[25] Alix Nyberg Stuart, *The Spring-loaded Options Trap*, CFO MAGAZINE (2006), *available at* http://www.cfo.com/article.cfm/7851837/c_7873404?f=magazine_alsoinside.

[26] *Id.*

[27] *Id.*

[28] *Id.*

[29] Peterson, *supra* note 10, at C1.

company's stock on that date."[30] This is significant because at-the-money options are afforded advantageous accounting treatment.[31] This classification might be seen as a point of contention. For example, a carefully timed spring-loaded option will presumably quickly turn into an option "in the money" (meaning the option's strike price is below the market price) when the pending good news is released to the public.

A related tactic that produces much the same effect as spring-loading is for a company to maintain a set schedule for the granting of stock options to executives. The company may then take advantage of this set schedule by manipulating the dates of the release of positive or negative company information to the public. This practice attempts to avoid the impression of stock options manipulation, but it is effectively a manipulation of the back-half of the equation – the timing of the release of value-affecting information to the public.[32]

III. ARE SPRING-LOADED OPTIONS LEGAL?

A. *What is the SEC's Stance on Spring-Loaded Options?*

With a dubious eye on the manipulative nature of granting spring-loaded options, many critics have questioned the legality of such grants. In fact, until very recently the legal status of the practice remained gray and murky.[33] In an era promoting compliance with the spirit of the law, some have considered the risk of such a practice to outweigh the benefit. To illustrate how serious these considerations are, "[a] Justice Department official recently testified that fraud in options grants could bring lengthy prison terms and fines in the millions of dollars."[34] Further, Alix Nyberg Stuart reports in *CFO Magazine* that in November of 2005, "Analog Devices spent $3 million to settle spring-loading charges with the SEC."[35] Against this backdrop of criminal and civil liability, are spring-loaded options legal? The short answer to this question is yes.

On August 29, 2006, the SEC released its new rules affecting executive and director compensation and related disclosures in Release Number 33-8732A.[36] National interest in the changes to executive compensation rules has been overwhelming. According to SEC Chairman

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[30] Anabtawi, *supra* note 8, at 835.
[31] *See id.*
[32] *Id.*; Peterson, *supra* note 10, at C1.
[33] Stuart, *supra* note 25.
[34] Peterson, *supra* note 10, at C1.
[35] Stuart, *supra* note 25.
[36] Executive Compensation and Related Personal Disclosure, 17 C.F.R. §§ 228, 229, 232, 240, 245, 249, 274 (2007). This release is available on the SEC's website at http://www.sec.gov/rules/final/finalarchive/finalarchive2006.shtml (last visited May 12, 2007).

Christopher Cox, in a speech addressing a SEC open meeting on July 7, 2006, "[w]ith more than 20,000 comments, and counting, it is now official that no issue in the 72 years of the Commission's history has generated such interest."[37] It would appear that corporate America had long awaited this SEC release.

Under the new rules, "Form 8-K[38] requirements significantly increased the number of filings related to executive compensation."[39] Item 5.02 of Form 8-K now requires "companies to include additional information regarding material employment compensation arrangements involving named executive officers . . . ."[40] In addition, a new disclosure requirement includes the "'Compensation Discussion and Analysis' (CD&A) section, which replaces the traditional compensation committee report and will be in addition to a new and different compensation committee report."[41] These new rules took effect on November 7, 2006, and the compliance date was set for mid December of 2006.

These rules, for the first time, required disclosure of executives' entire compensation packages, including:

- the objectives of the company's compensation program;
- what the compensation program is designed to reward;
- each element of compensation;
- why the company chooses to pay each element;
- how the company determines the amount (and, where applicable, the formula) for each element of compensation; and
- how each compensation element and the company's decisions regarding that element fit into the company's overall compensation objectives and affect decisions regarding other elements.[42]

This disclosure requirement, according to Chairman Christopher Cox of the SEC, "will give investors a much clearer picture of exactly how

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[37] Christopher Cox, Chairman, SEC, *Chairman Cox Addresses SEC Open Meeting*, US FED. NEWS, July 26, 2006.

[38] The SEC's webpage explains that "[f]orm 8-K is the 'current report' companies must file with the SEC to announce major events that shareholders should know about." SEC, *Form 8-K*, http://www.sec.gov/answers/form8k.htm (last visited Feb. 13, 2007).

[39] *SEC Amends Related Person Transaction, Corporate Governance and Form 8-K Disclosure Requirements*, Procter Client Alert at p. 5 (Sept. 11, 2006), *available at* http://www.goodwinprocter.com/getfile.aspx?filepath=/Files/Publications/CA_GovernanceRules_9_11_06.pdf.

[40] *Id.*

[41] Laura G. Thatcher, *SEC Releases Final Rules on Disclosure of Executive and Director Compensation*, 61 EMPLOYEE BENEFIT PLAN REV., Issue 4, Oct. 2006, at 13.

[42] *Id.*

much they're paying the executives who work for them."[43] Addressing an open meeting of the SEC in July of 2006, Chairman Cox explained that these new rules "will give companies an opportunity to explain their compensation policies, and to share with investors how they arrived at the particular levels and forms of compensation for their highest paid executives."[44] Cox elaborated, "Shareholders and their representatives need intelligible disclosure that can be understood by a lay reader without benefit of specialized expertise, and without an advanced degree."[45]

Chairman Cox stated that these rules are premised on the idea that the SEC considers the practice of granting options in executive compensation to be a legitimate method of compensation, "and there is nothing inherently wrong with choosing any particular date or using any particular methodology for determining an option's strike price – as long as it is fully and fairly disclosed to shareholders and properly accounted for."[46] In the face of these comprehensive new requirements, "the Commission has made it clear that it is not in the practice of judging the propriety of a company's executive compensation program."[47]

The new requirements also include:

- Disclosure of the full grant date fair value of an option at the time the award was actually made;
- A comparison of the exercise price to the grant date market price, whenever the exercise price is lower than the market price;
- Disclosure of the date when the compensation committee took action on an option grant if that date differs from the grant date; and
- A plain English description of how the company determined the timing of option awards to executives.[48]

This requirement of "plain English" descriptions should have the effect of helping shareholders, compensation committee members, and

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[43] Cox, *supra* note 37. The new rules also require that as of 2006, companies must list an expense for the stock options granted. This new stipulation was faced with its own challenge: how do you value the options grant? In a January 25, 2007 letter, SEC Chief Accountant Conrad Hewitt concurred with the view of the vice president of Zions Bancorporation of Salt Lake City, that an auction system designed by that company could be used "as a market-based approach to valuing employee share-based payment awards" in employee stock options. Letter from Conrad Hewitt, Chief Accountant, SEC, to James G. Livingston, Vice President, Zions Bancorporation (Jan. 25, 2007) (on file with author), *available at* http://www.sec.gov/info/accountants/staffletters/zions012507.pdf. *See also* David Reilly & Serena Ng, *SEC Clears Market-Based Way To Value Staff Stock Options*, WALL ST. J., Jan. 30, 2007, at C5.

[44] Cox, *supra* note 37.

[45] *Id.*

[46] *Id.*

[47] Thatcher, *supra* note 41.

[48] Cox, *supra* note 37.

board members to understand exactly what is included in the compensation package, and why it is included, even if those individuals do not have a specialized knowledge of finance. It is significant that disclosure makes this information available to board members and shareholders, rather than simply to compensation committees. "Due to the complexity of executive compensation matters, compensation committees typically rely on professional compensation consultants for advice. . . . Frequently, consultants are hired to evaluate the compensation of the CEO who hired them."[49] Full disclosure helps to counter potential conflicts of interest that might easily arise in such arrangements.

Chairman Cox elaborated, "Among the most important features of these new rules is that there will now be one bottom-line number, including all options, for an executive's total compensation. And that number will be comparable from company to company."[50] This bottom-line number should ease the process of comparing the compensation packages offered. This should ease comparisons of executive to executive, and comparisons of company to company.

Along with the backdating of options, spring-loading is "not technically illegal, provided the company's compensation committee was not deceived in any way"[51] according to Stuart's article in *CFO Magazine*. SEC Commissioner Paul Atkins, in his speech at the 11th Annual Conference of the International Corporate Governance Network (ICGN), put it this way: "Specifically, we need to ask ourselves whether there has been a securities law violation even if a nexus can be identified between the grant and the news event."[52] His statement makes it clear that the mere presence of a nexus between the options grant and the release of information does not *per se* make the grant illegal. Under the new SEC regulations, spring-loaded options are permitted as long as corporate governance guidelines are adhered to, including full disclosure to the board and to the shareholders.[53]

Chairman Cox's and Commissioner Atkins' remarks indicate that spring-loading is legal. Does that sit well? If so, why have there been so many critics?

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[49] Anabtawi, *supra* note 8, at 850.
[50] Cox, *supra* note 37.
[51] Stuart, *supra* note 25.
[52] Paul S. Atkins, Commissioner, SEC, Remarks Before the International Corporate Governance Network 11th Annual Conference (July 6, 2006), *available at* http://www.sec.gov/news/speech/2006/spch070606psa.htm.
[53] Cox, *supra* note 37.

B. *What About the Question of Insider Trading?*

The SEC has spoken. What then, is the cause for concern? Critics of the practice might be quick to state that spring-loaded options stink of insider trading.

On this topic, remarks from the SEC appear to be less clear. Concerning the practice, Cox has stated that the SEC is "concerned with misbehavior in using inside information to time the granting of options."[54] On the other hand, SEC Commissioner Paul Atkins, has stated that spring-loading is not insider trading, "because no one is harmed."[55] How do these statements mesh? Atkins further clarified that while exercising their business judgment, "[b]oards . . . should use all the information that they have at hand to make option-grant decisions . . . . An insider-trading theory falls flat in this context, where there is no counterparty who could be harmed by an options grant. The counterparty here is the corporation – and thus the shareholders."[56]

Further bolstering this statement, "Peter Romeo, former chief counsel of the SEC, was quoted as stating that he did not believe the insider trading rules would apply to the grants because actual share trading was not involved."[57]

Professor Dale Oesterle,[58] of The Ohio State University's Moritz College of Law, has explained the current state of the law on this subject in his Business Law Prof Blog:

> Is this or should this be illegal? . . . The answer is complex. The practice is illegal if the company delays news that it should disclose so as to grant the options but is not illegal otherwise as long as the option grants and the news are disclosed within SEC mandated deadlines. It is similar to making stock grants to executives before good news is announced. It is not "insider trading," it is a form of compensation that is an alternative to a cash grant. Whether the executives deserve the value depends, first, on whether they are performing well in their positions and, second, on proper procedure (whether an independent

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[54] Peterson, *supra* note 10.

[55] Vineeta Anand, *'Spring-loading' not Insider Trading / SEC Official Says 'Well-timed Options' Benefit Investors*, HOUS. CHRON., July 7, 2006, at Business 4.

[56] Kara Scannell et al., *Can Companies Issue Options, Then Good News? SEC is Divided on Practice Known as 'Spring Loading;' Critics See 'Insider Trading'*, WALL ST. J., July 8, 2006, at A1. For a developed argument that spring-loaded options grants to executives are good for shareholders, *see infra* Section IV(A).

[57] Anabtawi, *supra* note 8, at 838 n.8 (quoting Timothy D. Schellhardt, *Options Granted During Takeover Talks Are Boon for Executives at Fore Systems*, WALL ST. J., May 14, 1999, at C1).

[58] Professor Dale A. Oesterle: Gilbert J. Reese Chair, Moritz College of Law, The Ohio State University, Columbus Ohio, 2003 to present.

> board of directors has made the decision). The only argument is with the timing of the disclosure -- the SEC could force companies to disclose the practice before the grant of options or stock rather than a few days after (current practice).[59]

Taking these statements together, the SEC will be concerned with a misuse of inside information – specifically in the form of the issuance of spring-loaded options without the required disclosure of the practice, and disclosure of the rationale to the shareholders. The SEC may deem a failure to disclose to be misleading to the shareholders.

IV. *SHOULD* SPRING-LOADED OPTIONS BE ALLOWED, OR NOT?

Opinions differ sharply when the question is considered: Does the practice of issuing spring-loaded options provide a benefit or a detriment to the markets? SEC Commissioner Atkins has stated that it does not harm shareholders. Critics would argue the point. Various arguments have surfaced to defend either side of the issue.

A. *Arguments For The Use of Spring-Loaded Options*

One of the most public proponents of the use of stock options in general, including spring-loaded options, is Commissioner Paul Atkins of the SEC. In his speech noted above, Atkins indicated that spring-loading benefits shareholders by enabling fewer but more valuable options to be granted to executives.[60] This, in turn, enables the issuance of lower salaries.[61] Atkins stated, "It is cheaper to pay a person with well-timed options than with cash."[62] Atkins pointed out that issuing spring-loaded options allows a compensation committee to obtain "the biggest bang for the buck."[63] By that, Atkins means that the practice of spring-loading allows a company to issue fewer options, because the options that are granted are more valuable. Atkins elaborated, "Fewer option grants would mean that existing shareholders would face less dilution from additional shares in the marketplace."[64]

These decisions (how much compensation to offer an executive, and in what format to offer it) involve factors that will be most familiar to the business judgment of a corporate board and its compensation

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[59] "Spring Loaded" Compensatory Stock Options, http://lawprofessors.typepad.com/business_law/2006/07/spring_loaded_c.html (July 10, 2006).
[60] Anand, *supra* note 55.
[61] *Id.*
[62] *Id.*
[63] *Id.*
[64] Tom Petruno, *When Manipulation Might Equal Fraud*, L.A. TIMES, July 9, 2006, at C2.

committee. Speaking to this issue, Commissioner Atkins states, "Boards, in the exercise of their business judgment, should use all the information that they have at hand to make option-grant decisions."[65] Atkins elaborates, "Who are we to second-guess that decision? Why isn't that decision in the best interests of shareholders?"[66] If granting fewer options, which have attractive potential for growth in value, is cheaper for the corporation, perhaps the use of spring-loading can be in the best interests of the shareholders, and the corporation itself. More than compensation is at stake: voting rights and power on the board are directly implicated.

Regardless of the shadowy history of spring-loaded options, the present and future use of this practice would appear benign under the present regulations. Even as an attempt to manipulate the value of a component of an executive's compensation package, "executives can argue, truthfully, that there is no way to know for certain how the market will react to impending news."[67] Much of the concern that moved the SEC to act stemmed from the mysteriously opaque nature of the compensation packages that were being granted. Not only were shareholders and board members unaware of the makeup of the packages that were being granted, it is also safe to say that many were not even aware of what spring-loading was, or whether it was legal. The SEC has acted to remove the mystery surrounding the legality and presence of spring-loaded options in corporate executive compensation packages.

B. *Arguments Against The Use of Spring-Loaded Options*

While the SEC has decided to allow the regulated practice of spring-loading, some critics continue to denounce its use.[68] The issue has been considered a gray or murky one.

Before the August SEC ruling, the practice was seen by many to be simply another way around the compensation regulations already in place with overtones of insider trading. Companies have had to spend large sums to try to avoid prosecution. Kevin Cameron, president of shareholder advisory firm Glass, Lewis & Co., has stated that "[r]ight now boards all over the country are hiring outside counsel and forensic accounting experts

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[65] Pasteszenski et al., *supra* note 12.

[66] Anand, *supra* note 55.

[67] Helen Shaw, *Is Spring-loading Wrong?*, CFO MAG. FOR SENIOR FIN. EXECUTIVES 5, Sept. 6, 2006, *available at* http://www.cfo.com/printable/article.cfm/78801157/c_2984338?f=options.

[68] Arguing against the notion that the issuance of spring-loaded options would result in increased retention of benefits by shareholders, Damon Silvers (Associate General Counsel for the American Federation of Labor and Congress of Industrial organizations) says "It's also true that if you let your employees steal from the cash register, you don't have to pay them that much . . . ." Anand, *supra* note 54. *See also* Miller, *infra* note 71.

to look at their option practices."[69] Now that the SEC has moved to regulate the practice, a question remains as to how effective this regulation will be in producing transparent disclosure. Lynn Turner, formerly Chief Accountant at the SEC, denounced the practice of spring-loading. He states that, of the companies accused of spring-loading, "the disclosures of stock option grants 'have been grossly misleading and false . . . . Investors were misled and executives failed to tell the truth, which is a violation of securities law.'"[70]

Critics of the practice of spring-loading argue that the practice undermines the intended performance incentive of stock-option grants. As discussed above, stock option grants to corporate executives are, in their pure form, beneficial to the shareholders at large. An executive who has been granted options will have personal motivation to do everything possible to raise the value of the company's stock. When the stock has accrued value, he may then exercise his options and reap the benefit of the difference between his options' set price and their actual value. The use of well-managed spring-loaded options, on the other hand, might do more to guarantee quick wealth for the executive, and reduce the long-term efforts otherwise required of an executive to raise the value of the stock.[71]

Apart from the criticisms that spring-loading "rigs" the options grants for easy profits, it is also said that the practice raises the specter of deceptive business practices. One of the effects of spring-loading is to provide a means for the manipulation of public information in the expense report. It is argued that "[i]t would take an extreme optimist, nay, a totally naïve person, to believe that the directors would spring-load the options without noticing that doing so minimizes the reported expense."[72] While an executive may be awarded an eventual $100 million in value through the use of spring-loaded options in his compensation package, the corporation may report a significantly smaller figure in its expense reports.[73] Executives might be interested in hiding part of their pay package because, at a certain point, "even directors who are inclined to favor management in the compensation process will refuse to approve a compensation package, or shareholders might seek to impose limits on executive compensation."[74]

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[69] Petruno, *supra* note 64.

[70] Shaw, *supra* note 67.

[71] In response to the argument that the practice of spring-loading allows fewer options to be granted to the executive, thus saving the company money, critics might point out that the wealth of the shareholder is still being transferred to the employee. If $100 million is the compensation required to secure the services of an executive, that money will ultimately be awarded to the executive, regardless of how many options are involved in the package.

[72] Paul B.W. Miller & Paul R. Bahnson, *Spring-loading: SEC's Atkins Misses the Point,* WEB CPA, Sept. 4, 2006, http://www.webcpa.com/article.cfm?articleid=21737&pg=acctoday&print=yes.

[73] *Id.*

[74] Anabtawi, *supra* note 8, at 852.

Investors may view this practice as a subterfuge or a distortion of facts, and lose trust.[75]

V. SHOULD THIS PRACTICE BE REGULATED?

Regardless of the arguments for or against the use of spring-loaded options in executive compensation packages, the SEC has decided to allow the practice to occur in a regulated form. Should this practice be regulated? Past attempts at regulation of executive compensation may provide insight into whether regulation of spring-loading will be effective.

A. *Rule Changes In Executive Compensation: Historic Reactions to New Regulations*

In 1993, federal securities regulators acted to address the perceived run-away compensation packages offered to corporate executives. According to Joan Lublin of *The Wall Street Journal*, the regulators took the step of forcing companies "to reveal details about pay and perks for top officials, in some cases for the first time."[76] The intent of this regulation was to increase the transparency of executive compensation, and to promote informed decisions when compensation plans were being approved. Lublin reports that "[s]ince then, the average pay for chief executives of large companies has quadrupled, according to Kevin Murphy, a professor at the University of Southern California's Marshall School of Business."[77] In 2005, the average large company chief executive compensation was $10.5 million.[78] This market reaction took regulators by surprise.

Several factors can undermine the effects intended by rules regulating compensation. An executive compensation race-to-the-top may be encouraged by the transparency that results from disclosure rules. As corporate compensation figures are disclosed, executives gain insight into what their peers earn in competing companies.[79] Executives who wish to push for richer compensation packages are given readily available chips with which to negotiate. Companies that wish to gain or maintain the services of an effective executive have been forced to compete with other companies to offer a competitive compensation package.

Another factor that can undermine regulations of executive compensation has been likened to Jell-O. Kayla Gillan, appointed by the SEC as a founding member of the Public Company Accounting Oversight Board, and previously the general counsel to the California Public Employees Retirement System (CalPERS), states that efforts to regulate

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[75] *See* Miller, *supra* note 72.
[76] Lublin, *supra* note 1.
[77] *Id.*
[78] *Id.*
[79] *Id.*

executive compensation are "like moving Jell-O . . . [when compensation is squeezed in one place] . . . it squirts out in another."[80] For example, in 1984 Congress passed a tax on golden parachutes. This bill "taxed awards valued at more than three times an executive's average compensation over the previous five years."[81] The effect of this new tax regulation was to increase executive pay. The tax effectively "blessed the existence" of golden parachutes and brought that form of executive compensation to the attention of companies, and into increased use. Further, the passage of this law inspired creativity in compensation packages. "Gross up" tax compensations[82] began to be offered to cover the cost of the new taxes.[83] If the intent of this regulation was to rein in run-away corporate compensation packages, the effect was certainly the opposite.

Lublin states that one of the stipulations of the 1993 regulation was that "companies could no longer take tax deductions on executive compensation of more than $1 million, unless it was related to performance."[84] Here, the intention of the law was undermined by a new executive perception that this cap represented a "minimum wage for CEOs."[85] The regulation also sparked a creative growth of "'less transparent forms' of pay, such as pensions and deferred compensation."[86]

In 2004, reports Lublin, "accounting rulemakers finally required stock-option grants to be treated as an expense."[87] True to pattern, compensation packages adapted in response. While fewer stock options were granted, more restricted stock was granted. Here, the intention to regulate executive compensation was undermined by another potentially detrimental side effect: the potential loss of performance-based compensation. "[U]nlike options, restricted stock retains [some of] its value even if share prices decline."[88] Yet this effect is not universal – some companies have become more interested in performance-based pay.

This brings us to the present. In August of 2006 the SEC once again has modified its rules to further regulate corporate executive compensation.[89] History would seem to indicate that the market will find a way around compensation regulations. Are these new disclosure regulations a good idea?

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[80] *Id.*
[81] *Id.* at A16.
[82] Gross up tax compensations mean that the company will cover what would have been the executive's liability under the tax, leaving the executive with the pre-tax value of the compensation package. *See Id.*
[83] *Id.*
[84] Lublin, *supra* note 1.
[85] *Id.*
[86] *Id.*
[87] *Id.*
[88] *Id.*
[89] Executive Compensation and Related Personal Disclosure, *supra* note 36.

B. *Is Regulation Really a Good Thing?*

Jennifer Hill, in her *Wake Forest Law Review* article, points out that "[a] management's disclosure obligations and its fiduciary duties to maximize corporate and shareholder welfare coexist uneasily in the law."[90] There is a tension that can exist between full disclosures on the one hand and a desire to withhold sensitive information from competitors or parties with adverse interests on the other hand. A basic manifestation of this tension may be seen in the "occasional desire of management to delay some disclosure until a big deal is closed."[91]

The far-reaching impacts of the Enron and WorldCom accounting scandals would seem to make it clear that, despite some degree of burden placed on businesses, some degree of regulatory oversight is needed to protect shareholders. Do these new SEC regulations protect the delicate balance between the interests of the corporation and the interests of the shareholders?

C. *Did The SEC Get it Right This Time?*

In August of 2006 the SEC released further rules to regulate executive compensation packages.[92] Spring-loaded options are allowed under these rules, but their use is contingent upon the full disclosure to the board and shareholders of the practice, the accounting behind the practice, and the rationale behind the practice. Has the SEC discovered a workable balance this time by not declaring a practice to be illegal, yet requiring transparency? Or is this going to be yet another well-intended regulation of corporate America which will produce unintended side-effects?

While the history of new regulations of executive compensation would indicate cause for concern regarding unintended side-effects, the present regulation may prove to be an exception to the trend. The SEC through its ruling did not condemn or outlaw spring-loaded options. Its mandate of full disclosure might just find the right balance – the best of both worlds. Full disclosure might just protect corporate boards and shareholders from unconscionable executive packages, while keeping the corporation free to offer packages to potential executives in the format that the board finds most beneficial to the corporation. If this proves to be the case, the SEC's decision will prove to be a very good thing.

It can be argued that a full, true disclosure of executive compensation details will not, in the long run, harm the interests of a corporation. With similar disclosure taking place among all the companies

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[90] Jennifer Hill, *Timing Corporate Disclosures To Maximize Performance-Based Remuneration: A Case Of Misaligned Incentives?*, 35 WAKE FOREST L. REV. 83, 109 (2000).

[91] *Id.*

[92] Executive Compensation and Related Personal Disclosure, *supra* note 36.

in the United States, such disclosure may help to ensure fair and competitive executive compensation while protecting shareholders against undue drains on the wealth of the corporation. Yet, with the expansion of international enterprise, and international competition, the question remains: Is more regulation really a good thing?

Another consideration has been forced upon federal regulators in the aftermath of the Sarbanes-Oxley Act. "American-style regulation" has recently come under intense attack. Such intense regulation is regarded by many as a primary culprit when domestic corporations move off-shore, and when foreign corporations look elsewhere. According to *The Wall Street Journal*, in 2005, "24 of the 25 biggest non-U.S. floats listed in London and other offshore markets rather than in New York."[93] It would appear that American-style liability, the offspring of American-style regulation, is something most executives and directors would prefer to avoid if at all possible.

While this line of reasoning might be a popular perception of America's new business climate, it does not represent the complete picture. Keith Attoe, a Director of the China-based Migao Corporation, provides another perspective of America's current regulatory climate. Mr. Attoe, via telephone interview, stated that the direct effect of the new SEC regulations was that it became more difficult for companies to be listed on the New York Stock Exchange ("NYSE").[94] The indirect effect was that a NYSE listing became more prestigious.[95] The implication is that if a company is able to obtain the NYSE-listed status, it is perceived as a better company. Referencing the different regulatory climates of the NYSE and the London Stock Exchange ("LSE"), Mr. Attoe stated that in China, for a company "to be established on the NYSE . . . it is seen to be more prestigious than being established on the LSE."[96] Pointing out that there are benefits to be weighed when listing in either New York or London, Mr. Attoe further explained that part of the move of IPOs from New York to London is simply a matter of businesses going where they can raise money.[97] Presently, a significant portion of Asian wealth (along with European wealth) is situated in London.

VI. CONCLUSION

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[93] Corey Boles, *London Remains an IPO Draw, U.S. Changes Notwithstanding*, WALL ST. J., Aug. 8, 2006, at C4.

[94] Telephone Interview with Keith Attoe, President of Cognitive Finance Inc., Chairman of the Attoe Foundation, and a Director of the Board of Migao Corporation (Apr. 27, 2007). Cognitive Finance is a proprietary derivative trading and director services company.

[95] *Id.*

[96] *Id.*

[97] *Id.*

Regulated spring-loaded options, as a component in executive compensation packages, would appear to be here to stay for the indefinite future. It is entirely possible that the SEC has found a workable balance between the positions of advocates and critics of the practice: to allow companies the full freedom to issue spring-loaded options, but to require full disclosure of their presence and the rationale for their presence as part of a compensation package.

While it is true that the IPO market has, to some extent, moved offshore in the current atmosphere of American market regulation, the presence or absence of this new regulation of spring-loaded options is not likely to be much of a factor in any conceived attempt to woo this business back. It seems that an avoidance of "American-style regulation" is only one factor that has shifted corporate interest from New York to London. Other important factors include the availability of funds for IPO's and the ideal qualities of London itself. London is an historic center of commerce and banking, it is within the rapidly expanding European Union, and it sits strategically in Greenwich Mean Time. (This last aspect is significant, because companies in London can do business with Asia in the morning, with Europe during the day, and with America in the evening, in the same working day.)

In its effort to find the delicate balance between under-regulation (with a resultant atmosphere of unprotected shareholders) on the one hand, and over-regulation (with further alienation of large business interests within the American theatre) on the other hand, it is just possible that the SEC may have protected both flanks this time. Time, and free enterprise, will tell.