

The Trouble with Stock Options

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Recent accounting scandals have revealed the potential for excessive risk taking by corporate executives as a result of the escalation in stock option grants and the excessive fixation on stock prices. The authors describe the different features of option grants and evaluate their merits and pitfalls. They also discuss other nonmonetary compensations granted to corporate executives.

Option grants to executives of S&P 500 Index companies increased from an average of \$22 million per company in 1992 to \$238 million in 2000. During the same period, the average pay of CEOs of those companies grew from \$3.5 million to \$14.7 million. Most of this increase stemmed from the rise in stock option grants. Furthermore, between 1993 and 2000, option grants in old economy companies increased 44 percent while grants in new economy companies increased 75 percent. The data, however, do not reveal the increased prevalence of broad-based option plans that cover all or most company employees. The increasing popularity of option grants can be attributed largely to their favorable tax and accounting treatments, especially tax laws enacted in 1994 that consider compensation in excess of \$1 million paid to proxy-named executives as unreasonable, thus making it nondeductible as a corporate compensation expense. The law does not impose limitations on performance-based compensation, including payments from exercising options.

Typically, options granted to executives can only be exercised over time, are generally nontradable, and are forfeited if the employee leaves the company before vesting. Most companies offer cashless exercise programs, in which employees simply receive the value of the spread between the market price and the exercise price in cash or shares of company stock. Under U.S. tax rules, options are qualified or nonqual-

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ified. For qualified options, employees pay nothing on exercise but pay capital gains taxes when the stock is sold. Companies, however, cannot deduct the employee gain on a qualified option as a compensation expense and require stock recipients to hold the stock for at least one year after exercise. For nonqualified options, the difference between the exercise price and the market price on exercise constitutes taxable personal income to employees and a tax-deductible compensation expense to companies. Most option grants are thus nonqualified.

In spite of their potential benefits and increasing popularity, stock options are troubling in five ways. First, compensation in the form of stock options is not entirely beneficial or efficient. Corporate executives are legally precluded from shorting their company stock, trading their options on “restricted stock,” or pledging those securities as collateral. Second, stock options may not necessarily help to attract high-quality employees. Third, a recent study of new economy companies shows that companies with greater cash flows use options more extensively. Additionally, well-known option-intensive companies, such as Microsoft, also pay high cash compensation. Thus, stock options do not appear to be a substitute for cash compensation or are not preferred by companies starved for cash. Fourth, the value of stock options tends to be lowest when a company’s stock is “underwater.” In bear markets, stock prices typically fall below the exercise prices and workers are likely to seek employment at competitor companies offering fresh compensation packages and more valuable option grants. And fifth, the number of shares tied to stock option grants is often a trivial fraction of the outstanding shares of the company. Even if employees increase the value of the company, their share of the gain through option holdings is small, thus creating a free-rider problem on top of the risk imposed on employees by stock-based pay.

Indexed stock options would greatly diminish many of the previously mentioned limitations of traditional stock options, but they are virtually nonexistent because (1) grants of indexed options need to be expensed, whereas traditional options do not, and (2) traditional options have a much higher probability of ending up in the money than indexed options. Because indexed options are less valuable to executives, they dominate traditional options only if their exercise prices are well below market prices at the time of grant.

Restricted stock offers several advantages over stock options. It provides relatively stable incentives, even when stock prices are lower, and overcomes the pressure for lowering exercise prices during stock market declines. Executives holding out-of-the-money options are more likely to engage in riskier investments than executives holding company stock. Additionally, executives owning restricted stock may pursue an appropriate dividend policy, whereas those holding stock options may prefer stock repurchases to cash dividend payments.

Next, the authors present data showing a strong positive association between option grants and stock market performance. Specifically, CEO cash compensation is weakly correlated with the DJIA, but CEO total compensation is strongly correlated with the stock market. Another interesting revelation is that the CEO of the average S&P 500 company earned 30 times the pay of the average production worker in 1970. By 2002, it was 90 times greater. Explanations include sharp increases in stock prices during the 1990s, renewed focus on shareholder value creation, and fixed-share policies, whereby the grant size remains constant over time in spite of stock price increases. According to one hypothesis, executives choose options over cash because options are less transparent to shareholders, politicians, and the media. Another explanation for the growth of option granting is that the perceived cost of options is less than the economic cost because the company receives a tax deduction for the spread between the stock price and the exercise price.

Proposals for expensing stock options have proliferated. Although this change would not affect future cash flows of companies, companies would be likely, as a result of better understanding of the true costs involved, to grant fewer options out of fear of a backlash in the market.

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