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More On the SEC's Proxy Proposals

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In last week's article, I rejected the idea of mark-to-market reporting for stock options and stock awards. I now think I was wrong to do that.

My error lies in "either-or" reasoning. If it comes to a single choice – the current system using grant date fair values or mark-to-market reporting – I clearly favor the former.

But who says we have an "either-or" situation? How about a "both-and" situation?

There are many critics of grant date fair value for stock options. They make the following arguments:

- The value produced by the Black-Scholes is totally theoretical and may be considerably overstated, given that most option recipients are undiversified.
- It is also subject to assumption manipulation, especially in the areas of volatility and date of exercise.
- In the real world, the option may prove to be worthless. (Critics rarely admit that, in the real world, the option may prove to be worth a lot more than the Black-Scholes value would suggest.

But if you produce an alternative – dump the theoretical value and include the gains from exercising options in the particular year – other critics emerge. If a CEO makes more than $700 million from exercising options in a single year, as Larry Ellison of Oracle Corp. once did, they are quick to point out that you can't say that the entire $700 million was attributable to one year's work. It might have been attributable to much as 10 years work.

The Idea of Having Two Summary Compensation Tables

My revised thinking goes like this:

- Produce a Summary Compensation Table (SCT) as the SEC has now proposed. This approach provides a good picture of what the compensation committee intended to do from a pay policy standpoint.

- Then produce a second Summary Compensation Table to incorporate the "mark-to-market" approach.

For an illustration of how this second table would work, let's look at Time Warner Inc. and pretend that an option covering one million shares was granted on Dec. 31, 1997, when the close price was $12.54 a share. Let's also assume the option had a term of 10 years and was not exercised until Dec. 31, 2007. (I chose an end date of Dec. 31, 2007 to avoid the effects of the recent market crash.)

In preparing the "mark-to-market" SCT, the charge in each year to be shown for this option would be as follows:

		SCT	CUMULATIVE
	YEAREND	CHARGE	CHARGE
YEAR	PRICE	(millions)	(millions)
1997	$12.54		
1998	$85.95	$73	$73
1999	$168.16	$82	$156
2000	$77.13	-$91	$65
2001	$71.14	-$6	$59
2002	$29.03	-$42	$16
2003	$39.87	$11	$27
2004	$43.11	$3	$31
2005	$38.65	-$4	$26
2006	$48.27	$10	$36
2007	$36.59	-$12	$24
	TOTAL	$24	

Note that the charge for options shown in the SCT would:

- For any single year, represent the aggregate paper profits in the option between the date of grant and the end of the particular year, less the sum of all charges made in previous years. (If the option was underwater at the end of the particular year, then a negative sum would be recorded equal to all the charges made in previous years.)

- Incorporate the above reasoning for all options that were still outstanding as of the end of the current year

- Include any gains realized during the current year, without identifying the exercise proceeds as such. (If the option were exercised in any given year, the amount charged to the SCT that year would be predicated on the market price at exercise, rather than the yearend price.)

As a quid pro quo for this second table, the table showing option gains would be eliminated.

Note that, as with the option reported above for Time Warner, the figure shown in the SCT in a given year could be negative. Indeed, it could be so negative that the total pay figure in the SCT might also be negative.

Note also that the same reasoning would be applied to all outstanding free share awards.

Finally, note that in the Time Warner example shown above, the total gain at the end of Year 10 is $24.1 million. Yet the figure of $24.1 million would not show up in any of the 10 different SCT tables covering this option.

Although there would now be two SCT tables, instead of one, the aggregate number of tables in the proxy would remain unchanged, because the gains table would no longer be needed.

The two tables, in combination:

- Allow the reader to view the effects of the comp committee's policy decisions.

- Provide at the same time a real-life view of the way most CEOs think about compensation, when they think about compensation (which, for most CEOs is all the time!).

- Not penalize a CEO who exercised for a large gain in a given year, compared to a similarly-situated CEO at another company who decided not to exercise that particular year.

2009 marks Graef Crystal's 50^{th} anniversary in the executive compensation field. He has been a director of compensation for General Dynamics and Pfizer, worked as a consultant for Booz, Allen & Hamilton, served as worldwide practice director at Towers Perrin for 18 years, was a professor at the University of California at Berkeley's Haas School of Business for 10 years and a syndicated columnist for Bloomberg News for almost nine years. He has written six books and more than 1,600 articles on executive pay.