GMD "THINKING"

Let's Go Back to:

The Good Old Days of Executive Options

GMD helps bring insight to today's most pressing organizational issues. In this article, we tackle the truth and perception around stock options.

As John Calhoun Baker's 1939 article "*Stock Options for Executives*"[1] shows, the concepts of executive remuneration we see today have been around for a long time though the essence of capitalistic executive compensation has changed little. Take for example, the compensation package of the Flintkote Company CEO in 1930:

1. Employment Contract – three to five years with provision for extension with a defined base salary
2. Option Contract – a definite number of shares at a definite price
3. The option to sell or hold stock was open to the Executive

This is easily recognizable as a modern compensation package with a term contract, base pay, and options.

However, unlike today, the purpose of options was for officers in the company to become shareholders and owners. They were obliged by practice, if not by contract, to keep the redeemed options in the form of company shares. Not so today when exercised options are usually cashed and booked over to the executive's bank account[i]. In the early 20th century, dividends made up a far greater percentage of shareholder returns than today; so the arrangement makes sense, as the 1930's executive could expect a handsome recurring income from his compensation as well as increasing his share of the company.

AGENT PROVOCATEUR

But, sadly, problems associated with options nearly 100 years ago are alive today. A key problem then was a dramatic drop in the price of the stock. When such an event mangles the profitability of granted options, the problem of *agency* comes more keenly into effect. Agency problems take place when the priorities and needs of the executive are not in line with those of the company. Back in Baker's day, contracts would be re-written to put the option at a lower price. In our modern world, we see the same thing in the many 'backdating' scandals of options.

Today, at least 250 NASDAQ-listed companies are under investigation by the U.S. Securities and Exchange Commission (SEC, 2008) for the backdating of options in order to salvage 'underwater' options or make 'in the money' options provide a more substantial payout. These are clearly not in the interest of shareholders and are simply backroom deals made under pretense of avoiding some larger problems like 'loss of talent'. As Baker said in his article, this kind of behavior "raises embarrassing

[1] Stock Options for Executives, John Calhoun Baker, Harvard Business Review, 1939. Also see: Incentive Compensation Plans for Executives, John C. Baker, Harvard Business Review, 1936 and How Should Executives Be Paid?, John Calhoun Baker, Harvard Business Review, 1938

questions as to [share options'] justification".

Another problem is the executive's heightened awareness of the share price on the open market, often followed by the unconscious drive to take more risks in order to increase it. The speculative nature of options encourages one to start to think of ways to mitigate the risk that the stock price might fall. This mitigation may or may not have any relation to running a successful business, and the problem of agency reappears.

SHOULD BE O.K.

To be sure, Baker is not all negative on options. They can be an attractive form of compensation when cash is tight or in a business where low-cost production or service is needed. It also gives a company the ability to attract top talent even when it may not be able to pay a 'top talent' base salary. Finally, it definitely makes the executive interested in the future of the company. He also mentions that options can be a way of retaining talent, but we must remember that options contracts then had a vesting period two to three times longer than those today and that executives were more likely to hold on to the shares rather than cash in the profit difference.

He points out, "It is doubtful that the virtual disappearance of bonus payments between 1931 and 1936 in any way affected the work or interest of executives." This supports the assertion of Steven Pinker's work on motivation and bonuses, i.e. that in high cognitive demand environments, it is probably Purpose, Mastery, and Autonomy that really get great performance, rather than big, fat pay plans[2]. Baker again: "Financial reward must be adequate to secure able people, hold them, and remove them from economic pressure, in both the present and the future, and permit them to maintain their group standards of living."

Options can be an excellent way of doing just this. ❖

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[i] There are interesting examples today of the opposite such as Enron and MCI WorldCom where any sale of shares by employees was brought to the attention of the CEO and the offending person received lower promotion possibilities and a stern email of warning against doing such things in the future.

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[2] On youtube.com: "RSA Animate - Drive: The surprising truth about what motivates us"