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Companies reassess stock-option grants
New rules force changes in types of compensation

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Stock options ain't what they used to be.

Once touted as the lifeblood of tech companies, a way for them to attract, motivate and retain crucial talent, stock options have suffered a fall from grace.

First, the late 1990s cavalcade of accounting scandals -- Enron, WorldCom, et al -- led to stricter accounting rules, implemented last year, that force companies to deduct options as an expense, carving millions of dollars off their bottom lines. The more recent scandal of backdated stock options -- ones whose grant dates were manipulated to pump up their value -- has prompted even more disrepute.

The result is that compensation at many companies is swinging away from stock options and toward other forms of equity stakes. Most notable is restricted stock, which is an outright grant of shares that vest over time (hence the word "restricted").

In 2005, the Standard & Poor's 500 index companies granted 20 percent fewer stock options than in 2004 and their worth was 22 percent less, according to a report by Wall Street investment firm Bear Stearns. In the tech-heavy Nasdaq Stock Market, where options are a more intrinsic to corporate culture, the top 100 companies reduced the number of options they granted by 14 percent and the value of options by 16 percent, Bear Stearns said.

Many Silicon Valley companies still see stock options as a vital part of the entrepreneurial culture they seek to foster. Major companies, such as Intel Corp., Yahoo Inc., Oracle Corp., eBay Inc., Cisco Systems Inc.

and Hewlett-Packard Co., continue to confer them, taking big financial hits to do so.

Stock options give the recipient the right to buy company shares in the future at a set rate, called the strike price, usually the stock price on the date of issue. If the company's stock goes up, options holders reap a profit.

Options inspire strong words from both advocates and detractors.

"I think (expensing stock options, thereby reducing their use) will not only hurt (companies), it will hurt the United States economy," retired venture capitalist Kip Hagopian said. He recently wrote an article, co-signed by 30 prominent people from the worlds of accounting, economics and finance, saying that rules to expense options should be revoked because they're based on improper accounting.

"I believe stock options increase company productivity and therefore increase market value," Hagopian said. "As an investor for 25 years, I wouldn't invest in a company unless it had a significant block of stock reserved for all employees."

Sweetheart deals?

But Dan Pedrotty, counsel for the office of investment at the AFL-CIO, sees stock options as sweetheart deals for company insiders that hurt shareholders who buy stock on the open market. Union-sponsored pension funds hold about $400 billion in assets.

"The core problem is that they're not in the best interests of long-term shareholders," he said. "They give executives all the benefits of an increase in share price with none of the risks of a decline in share price. They reward executives for share price volatility. In some ways they give an incentive to manipulate the stock price, taking the focus away from long-term health and sustainability, trading off for short-term concerns."

There's no question that the new accounting rules have caused a decline in the use of options.

"Expensing has taken the sizzle out of stock options," said David Broman, chief executive officer of Syzygy Consulting Group, a Lafayette executive-compensation firm.

But that doesn't necessarily mean that executives have lost the chance to build an ownership stake in their companies.

Many companies simply changed to a different type of stock grant -- restricted stock. S&P 500 companies granted $15.3 billion in restricted stock in 2005, up 44 percent, according to Jack Ciesielski, author of the Analyst's Accounting Observer newsletter.

Stock options are supposed to motivate executives and employees to elevate the stock price, because the higher it rises, the more profit they'll realize when they sell their stock. If the stock falls below the strike price, the options have no value, known as being underwater.

The backdating scandal revolves around companies that allegedly

moved the grant dates back to when the stock was trading lower, giving options a lower strike price and increasing their potential value.

By contrast, restricted stock shares are outright grants of stock. Recipients don't have to pay a thing. Critics say that restricted stock is problematic because it allows executives to cash in even if they do an abysmal job and drive their companies' stock price into the ground. They deride restricted stock as "pay for pulse."

"Restricted stock (grants) are just options with a zero strike price," said Jesse Fried, a law professor at UC Berkeley. "If you think discounted options are not good, then you've got to think that restricted stock is really bad. It pays off even if the stock price of the company drops by 90 percent. There's a tremendous amount of pay-without-performance built in."

Meet goals, get stock

Pay for performance is the mantra of shareholder advocates, who take a skeptical view of the shift from options toward restricted stock. What they'd like to see is specific measurable goals being met before options or restricted stock are granted. Because the CEO and other senior executives receive the lion's share of options and stock -- and also have the most impact on a company's performance -- performance goals are most critical at the top.

"From a shareholder standpoint, we can go to companies and say, 'Why don't you award performance shares?' " Pedrotty said. For instance, the AFL-CIO filed a proposal at Cisco this year calling for grants of shares to be linked to performance.

Pedrotty commended Sun Microsystems for linking its CEO's equity awards to performance metrics.

Karen Rohde, Sun vice president of global talent management and rewards, said the company implemented performance-based restricted stock awards for the CEO and top-tier executives last year when the new accounting rules took effect. Goals are linked to operating income and revenue growth, but the specifics are not made public. Sun tries to balance aligning pay for performance with providing executive compensation in line with competitors, she said.

Scott McNealy, the company CEO until April, achieved about 29 percent of his target last year, she said.

"Overall for the year, we weren't meeting our objectives. As a result, (McNealy's) pay was very much under market," Rohde said.

Performance-based stock grants, such as those offered by Sun, are relatively rare.

Radford Surveys & Consulting, a San Jose company that studies compensation, found that only 14 percent of 393 technology companies it surveyed this year had implemented performance-based stock grants.

"It's not a broadly used tool at the moment," said Linda Amuso, senior vice president. "Part of the reason, we suspect, is that for many mid-

sized technology companies it's very challenging to figure out what the right metrics are to drive performance over two or three years. Particularly if you are in a volatile market, setting goals is challenging enough in an annual incentive plan."

Moreover, even when performance goals are set, the bar is often too low.

"Unfortunately, I've found that many (performance) metrics are not particularly challenging or not administered in a way that would make the award truly performance-related," said Paul Hodgson, senior research associate at the Corporate Library, a governance research firm.

Many companies design their plans with easily achieved goals, giving executives awards even when a company underperforms, he said.

Broman, the compensation consultant, said that management has yet to embrace performance stock awards.

"They haven't gained a lot of popularity in corporate management yet, primarily because of resistance to good, hard, fast performance goals," he said. "If (goals) are achieved and (management) gets compensation, great. If they're not achieved, management finds reasons to claim it's not reflective of their own performance -- market variations, outside events like terrorist attacks and wars."

Even before strict accounting rules spurred a shift toward restricted stock, some companies were making the change.

Restricted stock

Microsoft Corp. made headlines in 2003 when it switched from granting employees stock options to giving them restricted stock. As the company matured, its stock price was no longer rocketing upward. That created a two-tiered system: Long-term employees had seen their options dramatically appreciate, minting legions of "Microsoft millionaires." Newer employees felt they were second-class citizens, doomed to paltry returns. By giving restricted stock to everyone, Microsoft sought to provide equal compensation to its workers.

As shareholders advocates see it, restricted stock carries one plus over stock options. Generally, a single share of restricted stock is worth as much as three or four options. So companies grant far fewer shares of restricted stock to come up with the same monetary value. That means there is less dilution of the stock.

"Basically, they use less stock, which from a shareholder point of view is always a good thing," Hodgson said.

Types of stock compensation

Stock options: Gives the recipient the right to buy a certain number of shares in the future at a certain price. Stock options have value only if the stock price rises.

Restricted stock: Gives the recipient an outright grant of a certain

number of shares, which vest over time. Whether the stock rises or falls, the shares still have value.

Performance-based stock awards: Gives the recipient either restricted stock or stock options if the company meets performance goals, such as sales, profit, cash flow, etc. Generally limited to CEO and other top executives.

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