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Be careful what you wish for (P3 and F2) by the Examiner for P3 and John Dunn

An ancient Chinese proverb warns us to be careful what we wish for because it might just happen. The underlying sentiment is that we don't always know what is good for us and we may regret ever asking for it. That appears to be the case with executive share options, which have been blamed for almost every business scandal that has made the headlines in the past decade.

This short article is intended for anybody who is interested in the corporate governance issues associated with directors' remuneration. It is most directly relevant to students at the Strategic Level, particularly P3 Performance Strategy, but it might also be of some interest to those studying for F2.

What are ESOPs and why did we want them?

An ESOP (Executive Share Option Package) is part of a manager's remuneration package. The detailed workings of any given scheme are decided by the company itself, but the features generally involve the following:

- Each eligible manager is granted an allocation of options as part of his or her annual remuneration. The number of options will generally be decided by the remuneration committee, comprising non-executive directors.
- The options themselves will normally have a striking price that is equal to, or slightly higher than, the share price at the date the options are granted.
- There is invariably a vesting period of a few years that must pass before the options can be exercised. If the manager resigns or leaves the company during that period then the options will lapse.
- The options can normally be exercised on a specific date at the end of the vesting period.

In principle, these options have the same basic characteristics as any call options for the purchase of equity shares in quoted companies. The vesting period and the fact that the options must be exercised on a very specific date make them more difficult to value than the more typical traded options that can be bought and sold by third parties but they are fundamentally the same.

There are two main reasons why shareholders might be keen to reward their directors with options. The first is obvious. If the directors hold large numbers of options then they will have a financial incentive to maximise the share price. Provided the share price exceeds the exercise price at the relevant date the directors can exercise their options and buy shares for less than their market value. They will then either retain those shares as an investment (acquired at a bargain price, so providing an attractive return) or resell them at a guaranteed capital gain. If the share price does not rise during the vesting period then the directors will receive little or no value and so they will have a direct financial stake in delivering an increased share price.

The second reason for granting options is a little less obvious, but possibly even more important. By now you should be aware that diversification reduces risk. Any shareholder who wishes to achieve the best combination of risk and return should hold a diversified portfolio. One implication of that is that the shareholders are less concerned about the total risk associated with any given investment in their portfolio (if you have encountered portfolio theory by this stage of your studies then you will be aware that risk can be divided into systematic and unsystematic and that only systematic risks matter to the shareholders provided they are properly diversified).

The shareholders do not care about unsystematic risks because they can protect themselves, but the directors do not have that luxury. Each director has only one career and can only serve as an executive director for one company at a time so diversification is impossible. An investment opportunity that would be attractive to the shareholders because the potential returns are high relative to the systematic risks might be unacceptable to the directors because they will be exposed to the total risks of it going wrong. For example, a new product that fails might have a very limited impact on shareholders' total investment portfolios but could end the careers of the directors who were responsible for recommending that it should proceed.

Thus, if the shareholders really wish to align the directors' interests with their own they need to find some way to encourage the directors to accept the risks that they would choose to accept for themselves. Unfortunately, there is no way to ensure that that will always happen. The best that the shareholders can do is to find a way to encourage the directors to take sensible risks and ESOPs provide the answer.

The value of any share option is affected by a combination of intrinsic value and the volatility of the underlying security. Intrinsic value arises when the option is "in the money", that is when the exercise price is lower than the current market value. It is hardly surprising that an option to buy a share for $2.00 is worth something when the present share price is $3.00 and even more when the share price is $3.50 but why does volatility (which is effectively just another word for risk) push up the value of the option?

The nature of options means that the potential upside risk is, in theory, unlimited. As the share price rises above the exercise price every cent of increase adds a further cent to the intrinsic value of the option. There is, however, no corresponding downside risk. If the share price falls below the exercise price then the intrinsic value is zero and the option will lapse worthless if that remains the case when it expires. It does not make any difference whether the share price is one cent below the exercise price, several cents or several dollars.

If the directors hold large numbers of options then they will have an economic interest in accepting risky investment opportunities that they might otherwise be inclined to reject. If the investment succeeds and the share price rises then their options will be worth far more at the exercise date and they will not be exposed to any specific loss (at least on their options) if the investment fails and the share price plummets.

Thus, ESOPs give the shareholders the reassurance that the directors will wish to work hard to increase the share price and also accept realistic risks provided the potential return is high enough. As a secondary matter, the terms of the scheme will also encourage the directors to take a long-term view and to remain with the company rather than move elsewhere and lose their options.

So why are we afraid of ESOPs?

History suggests that directors should only be permitted to hold share options of any kind if they are honest and upright individuals. Clearly, many company directors are both but there will always be a few dishonest individuals in every walk of life.

Company directors were forbidden to hold share options in the aftermath of the 1929 Wall Street Crash. The Crash was the result of a bubble of excessive optimism, with constantly rising share prices. When the bubble burst there was such a slump in investor confidence that the global economy was thrown into depression. Some of the blame for the initial optimism was directed at company directors, who would purchase call options with their own money and then manipulate the share price, perhaps by distorting the financial statements so that the options could be exercised at a massive profit. It was felt that company directors had too much of an incentive to cheat and manipulate when they held options and so it became illegal for them to own them.

Time passed and the lessons of the Crash were forgotten. The late 1980s were marked by a period when company directors were being accused of taking excessive salaries and bonuses and steps were taken to reduce the amounts being paid. In the USA a law was passed to restrict remuneration to $1m per annum. Shareholders

were nervous that such a limit would give directors very little incentive to work hard and so ESOPs were used as a way round the restriction. The fact that it is extremely difficult to value the options granted under ESOPs meant that they were not accounted for in the total disclosed in the financial statements. The USA led and other countries such as the UK followed and soon it was common practice around the world to grant share options.

Sadly, the rest is history. Major scandals such as Worldcom in the 1990s and the recent Credit Crunch have been blamed on the pressures created by the possibility of directors earning huge amounts from any manipulation of the share price, timed to coincide with the exercise date of a tranche of ESOP options.

In conclusion

Understanding ESOPs involves understanding both basic finance and human nature. Finance theory dictates that ESOPs have many desirable qualities. Human nature suggests that ESOPs should be restricted to situations in which the directors are trustworthy individuals.

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