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Backdating Options and Why Executive Compensation is Not All About Norms

Geoffrey Manne* and **Joshua D. Wright****

In a recent post titled, “Backdating: Yes, Virginia, Execs Do Want Inflated Pay,”¹ on the blog site PrawfsBlawg,² Matt Bodie weighed in on the backdating “scandal.” We believe Brodie’s post is so misguided that it merits its own paragraph-by-paragraph rebuttal.

Matt begins by quoting us on why backdating is not the worrisome bother the *Wall Street Journal*, *New York Times* journalist Gretchen Morgenstern, and Bodie make it out to be. Then he takes us to task:

I think Geoff and Josh are putting together two notions here: (1) the value of the grants is published at some point down the road, and (2) even if the accounting was a little unusual, it doesn’t really matter because executives could and would have paid themselves the same amount in any event. Although I’m doubtful about (1), it’s really (2) that I’d like to take issue with here. Yes, I do believe that in the absence of backdating, executive compensation would have been lower.

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First, it is not our claim that “the value of the grants is published at some point down the road.” Our claim is that the value of the grants is known – as well as (or even better than) it can be for any options – the moment the grants are made (or, assuming minimal insider trading, the moment the grants are disclosed), just as it would be for non-backdated options. Not only is the value known, but it is incorporated into the share price (the effects of expected dilution when the options are exercised).

This is key. Most critics of backdating seem to act as if the options were in fact granted on the backdated date and not disclosed until later. In reality, disclosure is made in due course; only the strike price is set with reference to an earlier day’s stock price. There is not, in fact, delayed disclosure.

Brodie goes on:

As for (1), companies may have reported the value of the options down the road, and they may have reported the strike price. But as Jeff Lipshaw discussed,³ accounting rules required different reporting for options issued at a price lower than the current market price for the stock. So backdated options were clearly a lie: they said they were issued on a date when they were not actually issued. In addition, it may have been a violation of the company’s stock option plan to issue options at a price other than the market price of the date in question. Backdated options would thus also violate the requirements of such plans.

As Lipshaw notes in that very post, the economic effect of options is independent of their accounting treatment. The fetishization of accounting is something one of us have discussed elsewhere.⁴ But it bears repeating:

¹ Go to: <prawfsblawg.blogs.com>

² Go to: <prawfsblawg.blogs.com/prawfsblawg/2006/09/backdating_yes.html#more>

³ Go to: <http://prawfsblawg.blogs.com/prawfsblawg/2006/08/the_continuum_f.html>

⁴ Go to: <http://papers.ssrn.com/sol3.papers.cfm?abstract_id=676727>

Accounting is a convenient and imperfect means of quantifying behavior. It does not purport to – nor does it – represent true economic values. It's a short cut; it's a little like looking for your keys under the street light even though you lost them elsewhere. It certainly makes some calculations and some inter-firm comparisons easier. But accounting cannot do the impossible. There remain countless ways that, even under the same standards (hell, even under the same *rules*), accounting measures vary from firm to firm. If one firm expenses backdated options and another doesn't, aside from the possible technical rule violation, the effect on inter-firm comparison, share price, market valuation, etc. is unlikely to be significantly impaired.

The point is that, even if the accounting treatment of backdated options is different than the treatment of options that are not backdated but nevertheless are granted "in the money" on the date of grant, you would have to believe in a woefully imperfect and inefficient market to believe that the actual economic effect would pass unnoticed. And, as Ribstein has pointed out,⁵ even if it did, it takes a heroic and wholly-unsupported assumption to assert that the consequence of the oversight would be to line executives' pockets.

In short, there is no lie. On this point, one of us has previously noted that:⁶

I'm not sure why anyone thinks options backdating is a lie (technical violation of a rule, maybe, but lie, no). There's just no harm in the practice. It's not like the options cruise along for a period of time out of the money (and priced by the market accordingly) and then are miraculously turned into at the money or in the money options the moment they are exercised. Rather, the day the options are issued, they are issued with a strike price AS IF they had been issued on an earlier date when the market price was

⁵ Go to: <http://busmovie.typepad.com/ideoblog/2006/09/bodie_on_backda_html>

lower. But there's no lie here – it's just a convenient way of providing more compensation. ... The same could be done, I assume, by arbitrarily picking a strike price lower than the market price on the day of issuance. Either way, as I note in the comment liked above, the moment the at the money options are issued they pull down share price. They are not free, nor is their effect somehow hidden from investors. So why should there be any moral outrage or any serious consequences here at all?

Brodie notes:

But the sentiment in (2) is something I actually see a lot when it comes to issues of executive compensation. It's a form of "compensation nihilism": hey, there are no limits on executive compensation, so what does it matter how much executives pay themselves? Frankly, I think this logic is counterproductive: if you say it often enough, somebody is finally going to say: "O.K., fine, here are your limits!" But beyond that, I think it ignores the interaction of disclosure and norms when it comes to corporate pay.

No limits? What does Brodie think the market is, chopped liver? We do hold that there are no moral limits, no legal limits, no regulatory limits, no cosmological and no innate limits. But it is a gross mischaracterization of our position (and, we might add, a gross misdescription of the nature of markets in general) to say that we believe there are no limits on executive compensation. To take an obvious example, let's consider the competition to hire an executive. There is vigorous competition between firms at the time of contracting to hire executives, and this competition results in various contract terms and compensation packages (including options grants). Whether Brodie believes so or not, this competitive

⁶ Go to: <http://prawfsblawg.blogs.com/prawfsblawg/2006/08/thecontinuum_f.html>

dynamic between firms generates limits on compensation packages. This also bears repeating: Limits need not take the form of governmental fiat to be limiting!

Brodie goes on:

For accounting reasons, it became standard practice to issue stock options at the market price of the day of issuance. Sure, the option price could have been anything, but accounting rules punished lower prices, and executives didn't want higher prices. (As a side note, wouldn't higher option prices provide even more of an incentive?) Since options all had the same feature, it became possible to compare option grants and come up with some sense of what other executives were getting.

Accounting rules don't "punish" lower prices. That is ridiculous. If they did, we would sure like to know about it, because there would be lots of money to be made arbitraging this supposed "accounting effect."

Brodie continues:

Certainly, stock option valuations vary widely from company to company, depending on initial share price and the stock's volatility. But within a company, the quantity of the option grants offered some grounds for comparison between employees. And the size of option grants is roughly comparable even between firms. If the option grant happened to be at a low point for the stock – well, that executive got lucky. But changing the date to pick a low point is clearly gaming the system. It's outside the norms of what stock options represented.

OK. Try this thought experiment. Let's say you are a large shareholder in the Options-R-Us Corporation with a lot of extra time on your hands. You follow

closely the Corporation's disclosures. Hell, you even read the proxy materials. Yesterday you noticed that the Corporation granted its CEO 1000 shares of stock with a strike price equal to the market price of the stock on December 1, 2005. "That's odd," you think to yourself. "I can't imagine how I missed this grant in prior quarterly statements, since I read them all religiously. Let's see what the options are worth." So you log on to MSN Money and find out what the strike price is (if it isn't listed explicitly in the statement). You quickly calculate the value today. Voila. You even compare this value to grants received by other executives on other dates - whether backdated or not. Where is the complication? Where is the hidden information? Where is the problem (other than in valuing those pesky, non-backdated, out-of-the-money options)?

But this is really our favorite part:

Executive compensation is all about norms. Compensation committees pay experts to determine how much the average CEO in the industry is making, and then increase the amount to compensate their "exceptional" CEO. Stock options became part of the norm in the 1990s - staggeringly so. Backdating violated the norms of that process and may also have violated accounting and disclosure requirements.

"Executive compensation is all about norms." How can this possibly be true? It flies in the face of all common sense and basic economics since, say, 1776. Again, this view simply ignores the role of competition in determining executive pay packages and ignores the possibility that the prevalence of option backdating in compensation packages might well be evidence that these terms are an efficient component of executive compensation.

Further, we do not see how invoking "norms" here helps to explain anything. Really this is just odd - the idea that prices are set by norms. The market price for widgets is determined by economic forces (i.e. supply and demand). The

generation of the market price is not “all about norms.” Nor would “norms” analysis illuminate anything about what is really going on. The market price is the market price not because “norms” say so. There is a process by which that price is determined. It is better to understand the process than simply label it a “norm,” lest we concede that the term has no serious meaning at all.

We should hope that this point is obvious. Antitrust law, for example, does not prohibit cartels because they violate the norm of charging the market price. Rather, they prohibit cartels because the economic consequences of price-fixing decrease consumer welfare. Executive compensation is also determined by competitive forces.

There are real economic questions to be asked here, as one of us has recently discussed,⁷ about the economic forces generating the backdating. The assumption that “norms” can and should force firms to keep the number of options constant even when the value of each option increases might get the result that Bodie wants— less executive compensation but-for backdating— but it relies on an fundamentally misguided view of competition and an untenable view of firms.

And it is worth taking the time to dwell on this “untenable view of firms,” a view that is best evidenced by the opening line of Brodie’s post: “the stock options backdating scandal continues to unravel, showing yet more examples of corporate greed and misrepresentation.” Ah, yes, the ever-popular “corporate greed” explanation: Simultaneously both wholly uninformative and

immensely satisfying to the uninformed. It is also worth pointing out that it is puzzling to try to figure out what Brodie believes is causing backdating. On the one hand, he clearly believes it is a function of corporate greed and fraud. On the other hand, he believes that these greedy firms don’t understand the value of

⁷ Go to: <<http://www.truthonthemarket.com/2006/08/30/explaining-backdating-and-jenkins-channels-manne-again/>>

options — and by doing so, these greedy profit-maximizing firms leave dollars on the table. Perhaps the explanation of backdating is a combination of corporate greed, misrepresentation, and naivety. But we doubt it. Nevertheless any day now we fully expect a behavioral economic model of backdating hypothesizing that behavioral biases in the firm prevent them from understanding that options have value!

We have, since the beginning, maintained that the practice of backdating may well have violated accounting and disclosure requirements, at least in a narrow technical sense. The idea that it violates norms — or norms that matter, anyway — is a lot harder to swallow. What, exactly, are these “pay norms?”

According to one of us:

The focus on the backdating as fraud theory, in part, appears to be a product of the same sort of preoccupation. Preoccupation with a problem is not always bad. But merely repeating the mantra of fraud is not a substitute for rigorous analysis of backdated options, or the larger question of trends in executive compensation more generally (and especially, across countries). ... At the end of the day, and sadly, public perception about backdating may be more important than actually understanding the practice.⁸

Brodie concludes in his post:

So yes, I do think that if options had not been backdated, executive compensation would have been lower. Pay norms would have kept the option grants roughly the same in quantity. After all, not everyone was backdating — in fact, at least 75% of firms were not doing it. With the same number of options set at the actual date of

⁸ Ibid.

issue, pay would have been lower, and shareholders would have made more money. That's ultimately what this is all about.

Actually, no it's not. We cannot imagine what would make Brodie (or anybody else) comfortable with the assumption that "pay norms would have kept the option grants roughly in the same quantity." That just doesn't make any economic sense. It assumes, as we've pointed out, that firms do not understand that options have value and that firms do not compete for executive hiring and retention by offering compensation packages of increasing value. In other words, it assumes that executive compensation is simply a zero-sum game.

This follows, of course, from Brodie's belief that markets don't matter here, that compensation is just a skewed division of the corporate pie by the executives. But that assumption is ridiculous. The idea that "pay would have been lower" means necessarily that "shareholders would have made more money" is precisely the "naivety" explanation which was referred to above. As one of us has noted:

As far as economic explanations go for the trends in executive compensation generally, and the increasing prevalence of backdating specifically, I find naivety from the economic actors concerning option value to be a particular unsatisfying explanation for a trend this robust. Have compensation committees become increasingly naive about option values since the 1990s? It is difficult for me to believe that hundreds of companies do not understand that options are not "free." I do not find this explanation persuasive.

I suspect that one reason that economists and others are tempted to adopt naivety or fraud-based explanations of particular terms in executive compensation contracts is because we are puzzled by the growth of executive compensation in the US relative to other

countries (especially Europe). Without an efficiency explanation for these practices and trends generally, it is tempting to appeal to intuitive notions of “stealing” or assert that compensation committees “just don’t get it.”

“Norms,” “optimism bias,” and the “endowment effect” are in a heated competition to become the new “monopoly explanation,” for otherwise misunderstood business practices. We are not claiming that these concepts are entirely irrelevant in all contexts. Sometimes, they may be quite illuminating. But we hope it is not too late in the discussion of backdating to suggest that less mysterious economic forces have long been at work in firm hiring decisions, much like was the case with other one-time “pernicious” business practices that are now thought of as largely innocuous (e.g., resale price maintenance, exclusive dealing, vertical integration, tying contracts, exclusive territories, among many others).

At a minimum, we believe that deeper investigation of the economic forces at work with backdating is a more promising path than that offered by the alternative, and unsatisfying, theories derived from that strange combination of corporate malfeasance and corporate ignorance.