A Board Link to Option Timing

Independent directors reduce odds that CEOs get 'lucky' with stock grants, a study finds

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Backdating of stock options was more likely to occur at companies that did not have independent board directors in the majority, according to a study being released today.

The study, conducted by professors from Harvard and Cornell universities and the University of Chicago, examined stock option grant dates at 5,800 companies over the last decade.

Of the companies examined, as many as 720 appear to have backdated the grant dates to coincide with a low point in the stock price, thereby boosting the gains to executives who received the options, according to a draft copy of the study obtained by the Los Angeles Times.

Options are the right to buy stock at a set price within a certain time period. As stock prices rise, options become more valuable.

The study's authors rated an option grant as "lucky" if it was issued at the lowest price of the month. The study rated grants "super lucky" when they were issued at the lowest price during the quarter.

An independent board — one on which the majority of members were not insiders nor had other business dealings with the company — reduced by 33% the chance that a company would provide lucky grants to its chief executives, said Lucian Bebchuk, a Harvard professor and a coauthor of the report.

The longer a CEO had been employed by the company and the more stock he held, the more likely he was to get lucky and stay lucky, according to the study. And a CEO who received one lucky grant increased his chances of getting another lucky grant by 82%.

Corporate watchdogs said the research largely confirmed the importance of a strong and independent board. Directors are supposed to represent the interests of shareholders, but too often they've got such cozy relationships with top managers that they fail to provide sufficient oversight.

On the bright side, the continuing focus on the options scandal may improve behavior, experts said.

"I think the scandal has demonstrated that many boards have a lack of control or understanding of the detail of option plans," said Amy Borrus, deputy director of the Council of Institutional Investors. "One thing that's coming of this is that boards are seizing control from management. You will see boards announcing static grants — options being granted at the same time each year — and paying much more attention."

Erik Lie, an economist at the University of Iowa whose study on backdating ignited the scandal this year, said his research indicated that 2,200 companies manipulated stock grants. But the two studies used different methods to identify cases of suspected backdating.

Bebchuk said his study was focused less on the number of companies that backdated options and more on the factors that might have allowed the practice to happen.

The new study found that backdated options were most often given to the highest-paid CEOs when the company's stock price was making big moves up or down — times when backdating could make a big difference in option values.

Overall, the instances of suspected manipulation boosted the value of option grants by an average of 20% and hiked total pay by 10% above the amount companies reported, the study found.

The study also concluded that "old-economy" firms were actually more likely to backdate than technology firms. Of the 1,150 grants that Bebchuk estimates were manipulated, about 950 involved old-economy firms.

What linked firms willing to manipulate were weak boards and strong CEOs, he said.