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Are Options Seducing Directors, Too?

TRYING to extricate company directors from their chief executives' pockets has been at the heart of many changes in corporate governance during these dizzying scandal years. Indeed, the most commonly cited cure-all for what ails corporate America is director independence.

But all the independent directors in the world cannot seem to fix perhaps the biggest problem facing shareholders: egregiously high and ever-rising executive pay. Even though members of companies' compensation committees now must be independent, executive pay just keeps on rocketing.

A new study by academics at Baruch College, part of the City University of New York, offers a possible explanation of why this may be. You may not be shocked to learn that - once again - it's about money.

Donal Byard and Ying Li, both assistant professors of accountancy at Baruch, analyzed stock option grants given to chief executives at United States companies from 1992 to 2002. The sample was large - almost 18,000 grants - and the study confirmed other academic research showing that options are very often granted to executives just before good news about the company is disclosed or directly after bad news. No companies were identified in the study.

The study also found that the practice of bestowing well-timed option grants - which the professors called "timing opportunism" - has become more prevalent in recent years. Puzzled by this, the professors said they decided to dig further. So they looked at how directors were paid and found that timing opportunism was more pronounced when directors on the compensation committee received a larger proportion of stock options in their pay package.

As a result, the professors said, a heavier reliance on stock options in the pay of independent directors more effectively aligns their interests not with the shareholders to whom they have a duty, but with top management.

"Since outside directors frequently receive options at the same time as C.E.O.s," the study noted, "these directors also benefit from any timing opportunism. We argue that when outside directors receive a lower proportion of their compensation from stock options, they are more likely to limit C.E.O.s' timing

opportunism."

The trouble, at least from a shareholder's perspective, is that stock options are growing as a percentage of the compensation that outside directors receive for serving on a board. During the first half of the study's 10 years, for example, the professors found that option grants averaged 16 percent of directors' pay. During the second half of the period, option grants averaged 46 percent of the pay to directors. In the technology sector, the percentages can be far higher. In some cases, stock options make up 100 percent of directors' pay.

FOR example, the most recent proxy filing from Siebel Systems, a company that makes software for managing customer relationships and for other purposes, noted that none of its outside directors received cash for their services beyond reimbursement for expenses they incur. Instead, they get options. New directors at Siebel, for example, receive options on 80,000 shares; each year thereafter they get 20,000 options for their board service.

"We believe that these option grant guidelines will motivate and reward our nonemployee directors for their service in a manner that is consistent with good corporate practice and the independence requirements of the Nasdaq National Market applicable to members of boards of directors and compensation committees," the filing said.

Options are also big at eBay, the online auction company. Outside directors receive options on 15,000 shares at each annual meeting; new directors who are not employees of eBay also receive $150,000 worth of what the company calls deferred stock units. One-quarter of these units vest on the first anniversary of the grant, while the rest vest monthly. Outside directors at eBay also receive $50,000 in cash plus $2,000 in fees for each meeting attended.

EBay's proxy filing from last June also noted that in 1998, before it became a public company, it had granted an option to a director to buy 1.8 million shares of its stock at an exercise price of $0.78 each. The company's shares closed Friday at $114.41.

To be sure, no one is saying that executives at Siebel or eBay are timing their option grants.

Henry Gomez, a spokesman for eBay, said, "We give grants when you are hired, if you get promoted, and in the first quarter of the new year. That way, it's consistent, and there can be no question about timing." The company also said the grants to eBay directors align their interests with those of shareholders.

The Securities and Exchange Commission has recently started investigating the timing of stock option grants, according to filings of companies that have received requests for information. None too soon, the Baruch professors said.

"You give these options to the C.E.O. and the directors to align their interests to shareholders," Mr.

Byard said. "But it's paradoxical in this situation; by giving directors these options, you are aligning them with the management against the stockholders."

One way to eliminate the conflicts facing directors who receive stock options as part or all of their pay is to spread out the grants to chief executives over the course of a year.

"Right now 80 percent of firms grant options in one lump sum," Ms. Li said. "If the S.E.C. were to state that options should be granted in 12 equal installments every month, that would curb a lot of this type of opportunism."

Ms. Li added: "If you leave this to the board to decide, it is not impartial in the decision at all."

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