Abundant Options in Alternative Compensation

The Motley Fool

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While nearly every investor has heard of stock options, few are likely aware of their close cousins, restricted shares and stock appreciation rights. Even if investors have heard of them, fewer still probably understand how they work.

Stock options

You know stock options: They give the holder the right to buy a stock at some point in the future, hopefully when it's trading a much higher price than that set when the options are granted. Options gained popularity as a form of non-salary compensation in the early 1990's, when a $1 million cap on executive pay was imposed. Just last year, SEC Chairman Christopher Cox said the salary cap "deserves pride of place in the Museum of Unintended Consequences."

Abuse of stock options has seemingly become rampant. Investigations have uncovered nearly 200 companies that engaged in backdating - retroactively setting the price of an option at an earlier date and a much lower price. Backdating gives executives additional unearned profits, at shareholder expense. Not surprisingly, options are not nearly as popular a form of compensation as they once were.

Restricted stock

A close but less-observed cousin of stock options, regularly used to compensate management, is restricted stock. The restriction is usually the amount of time that must elapse before the recipient gets the shares. An employee awarded restricted shares must do nothing more to receive them than remain employed for a set number of years. **Microsoft** (Nasdaq: MSFT) created quite a stir when it announced a few years back that it would switch from options to restricted shares.

Restricted stock is considered a better form of compensation than stock options. With a stock option, the holder can choose to exercise the option once it vests, depending upon the price. A restricted share, on the other hand, is given to the holder on the vesting date, regardless of the price. Restricted stock encourages holders to take a vested interest in the well-being of the company, while options simply encourage holders to increase the stock price. **American Eagle Outfitters** (Nasdaq: AEOS) took the restricted-stock approach last year, requiring executives to guide the company to certain goals in order to get compensated.

Both, however, are subject to abuse. In addition to backdating, stock options are subject to other tricks, including "repricing," which arbitrarily resets the price of the option to a lower cost. That usually happens when options are "underwater," or below the price at which they were initially granted. Repricing defeats the option's original purpose and rewards failure. Similarly, restricted shares can simply be cancelled if they are below the award price.

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Investment banking firm **First Albany** (Nasdaq: FACT) actually did both recently, announcing that it would cancel the restricted shares it issued employees, issuing stock appreciation rights in their place. At the same time, it would reprice previously issued stock options. The chairman and president of First Albany collectively hold more than 31,000 shares of restricted stock, and more than 550,000 options, both of which were well below their grant prices at the time of the announcement. Think that might have influenced the decision-making process?

Stock appreciation rights

Stock appreciation rights are similar to options in some respects: They're granted at a set price, and once they vest, employees can exercise them at any time prior to their expiration. But employees don't have to pay a price to exercise them, as they would with options. They just get the difference between the grant price and the exercise price, which can be paid in cash, stock, or a combination of the two.

Though **Apple** (Nasdaq: AAPL) CEO Steve Jobs famously receives just a $1 annual salary, few people mention the large amount of stock appreciation rights he also receives. You can probably expect more and more companies to opt for stock appreciation rights as a way to compensate and reward employees.

Foolish final thoughts

While stock options are not nearly as popular as they once were, don't expect them to disappear. In a raging bull market like we had a few years ago, options were very popular because of the chance to gain huge sums of money. In down or sideways markets, options are less of an incentive. That's why we're likely to see companies issue greater numbers of restricted shares and stock appreciation rights - until the next bull market.

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