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Stock Option Grant Guidelines: Allocation Method

Introduction

Many companies use option-pricing models (e.g., Black-Scholes, binomial) to determine benchmark option grant values in developing their company's executive grant guidelines. In recent years, stock price volatility has risen to historically high levels, which may result in aberrant stock option values. A high current option valuation for the company versus a comparator group could result in granting too few shares, while a low valuation could result in granting too many shares. This issue creates skepticism about the competitiveness of the resulting stock option awards.

In order to mitigate the impact of stock price fluctuations, an alternative method of determining grant guidelines is available. This method is based on (1) share usage as a percent of total shares outstanding and (2) stock options allocated to named executive officers ("NEOs") expressed as a percentage of total options granted to all employees. This "allocation method" avoids the effects of stock price fluctuations and the reliance on option-pricing models. It can also bring consistency to option granting practice, and allow companies to manage dilution. To better understand the foundation of this methodology, a study of options allocated to the five highest-paid executives ("Top 5") of the largest U.S. companies was conducted.

Description of Study

The primary purpose of the study was to determine the percentage of total stock options allocated to the Top 5 during the latest two years (fiscal years 1999 and 2000 typically). Two general industry groups were examined:

- *Business Week's* 250 largest companies as reported in the special Spring 2001 edition ("Top 250")
- Nasdaq-100 Index companies as of July 9, 2001 ("Nasdaq-100")

For these groups, data was collected to determine the following:

- Total stock options allocated to the Top 5
- Stock options allocated to the CEO only
- Total stock options allocated to the second to fifth highest-paid NEOs ("2-5 HP")

A secondary purpose of the study was to identify year-to-year changes in stock option allocation practices. All data was obtained from the option grants table found in the company proxy statements.

Summary of Findings

The following tables summarize the percent of total option grants that were allocated to the CEO, 2-5 HP and Top 5 during 2000 and 1999, and the year-to-year changes for each group.

Top 250	2000			1999			Year-to-Year Change (+/-)		
	CEO	2-5 HP	Top 5	CEO	2-5 HP	Top 5	CEO	2-5 HP	Top 5
75th Percentile	8.09%	9.57%	17.66%	8.59%	9.62%	18.20%	- 0.49%	- 0.05%	- 0.54%
Average	5.67%	7.58%	13.25%	7.41%	7.40%	14.81%	- 1.74%	+ 0.18%	- 1.57%
Median	**3.89%**	**5.90%**	**9.79%**	**3.81%**	**5.51%**	**9.31%**	**+ 0.09%**	**+ 0.40%**	**+ 0.48%**
25th Percentile	1.59%	2.92%	4.50%	1.70%	2.89%	4.59%	- 0.11%	+ 0.03%	- 0.08%

Nasdaq-100	2000			1999			Year-to-Year Change (+/-)		
	CEO	2-5 HP	Top 5	CEO	2-5 HP	Top 5	CEO	2-5 HP	Top 5
75th Percentile	9.23%	10.40%	19.63%	7.92%	14.48%	22.40%	+ 1.32%	- 4.09%	- 2.77%
Average	6.45%	8.07%	14.52%	6.36%	11.53%	17.89%	+ 0.08%	- 3.46%	- 3.37%
Median	**4.15%**	**5.74%**	**9.89%**	**2.79%**	**7.60%**	**10.39%**	**+ 1.36%**	**- 1.86%**	**- 0.50%**
25th Percentile	1.31%	2.63%	3.94%	0.87%	3.90%	4.77%	+ 0.44%	- 1.27%	- 0.83%

The median data for the Top 250 and Nasdaq-100 shows that approximately 10% of total option grants have been allocated to the Top 5 during 1999 and 2000. The year-to-year change in allocation to the Top 5 was 0.5% or less for both groups, indicating a high level of consistency.

Median data for the Top 250 shows that during 1999 and 2000 approximately 4% and 6% of grants were allocated to the CEO and 2-5 HP, respectively. Year-to-year change in allocation practice was less than 0.5% for the CEO and 2-5 HP.

Median data for the Nasdaq-100 shows that during 1999 and 2000 approximately 3%-4% of total options granted were allocated to the CEO and approximately 6%-7% were allocated to the 2-5 HP. This group did not have the same level of year-to-year consistency in allocation practice as the Top 250. The median allocation to the CEO of Nasdaq-100 companies *increased* by 1.36 percentage points from 1999 to 2000, while the allocation to the 2-5 HP *decreased* by 1.86 percentage points.

The additional table below summarizes the 2-year average allocations for the two groups.

2-Year Average	Top 250			Nasdaq-100		
	CEO	2-5 HP	Top 5	CEO	2-5 HP	Top 5
75th Percentile	8.34%	9.59%	17.93%	8.57%	12.44%	21.01%
Average	6.54%	7.49%	14.03%	6.41%	9.80%	16.20%
Median	**3.85%**	**5.70%**	**9.55%**	**3.47%**	**6.67%**	**10.14%**
25th Percentile	1.64%	2.90%	4.54%	1.09%	3.27%	4.35%

The following tables indicate the percent of companies that fall within certain allocation ranges for the two sample groups.

Top 250	**2000**		**1999**		**2-Year Average**	
	CEO	**2-5 HP**	**CEO**	**2-5 HP**	**CEO**	**2-5 HP**
< 5%	59%	46%	58%	45%	58%	45%
5% - 10%	23%	32%	21%	32%	22%	32%
10% - 20%	14%	14%	13%	18%	14%	16%
> 20%	4%	7%	8%	6%	6%	7%

Nasdaq-100	**2000**		**1999**		**2-Year Average**	
	CEO	**2-5 HP**	**CEO**	**2-5 HP**	**CEO**	**2-5 HP**
< 5%	57%	46%	61%	34%	59%	40%
5% - 10%	21%	28%	18%	30%	19%	29%
10% - 20%	18%	17%	16%	19%	17%	18%
> 20%	4%	9%	5%	18%	5%	13%

The data indicates that for both the Top 250 and the Nasdaq-100 the largest percentage of companies allocated less than 5% of their total option grants to the CEO or 2-5 HP. A clear majority allocated less than 10% to the CEO or 2-5 HP.

<u>Approaches to the Stock Option Allocation Method</u>

There are two approaches to the allocation method. The first approach uses the allocation method to double-check grant guidelines determined using existing methodologies. The allocation data from the study above can be used to verify the reasonableness of the determined guidelines. To illustrate, assume the following:

- A large-cap general industry company with 500 million total shares outstanding
- A share usage analysis indicates that a competitive usage rate for the year is 2% of total shares outstanding, which results in an option pool of 10 million shares (500 million x 2%)
- Option-pricing model valuations determine that a total of 950,000 options should be granted to the Top 5 (350,000 and 600,000 to the CEO and 2-5 HP, respectively)

Based on these assumptions, the Top 5 would be allocated 9.5% of the total options granted, of which 3.5% and 6.0% go to the CEO and 2-5 HP, respectively. According to the median data from the 2-year average table, an appropriate allocation to the Top 5 is approximately 10%, of which 4% and 6% are allocated to the CEO and 2-5 HP, respectively. This data suggests that the determined grants in this example are reasonable. If the determined grant(s) to the CEO, 2-5 HP or Top 5 result in an allocation substantially greater (or less) than the study data, then this would indicate that the respective grant guideline may be too high (or low) and needs to be reviewed further for reasonableness.

The second approach uses the allocation method as the primary method to develop grant guidelines (i.e., no use of option-pricing models). To illustrate, assume the following:

- A large-cap general industry company with 500 million total shares outstanding
- A share usage analysis indicates that a competitive usage rate for the year is 2% of total shares outstanding, which results in an option pool of 10 million shares (500 million x 2%)

Based on the median data from the 2-year average table, appropriate allocations to the CEO and 2-5 HP are approximately 400,000 (10 million x 4%) and 600,000 (10 million x 6%) options, respectively. This leaves a pool of 9 million shares for other option eligible employees (10 million – 400,000 – 600,000). In addition to determining reasonably sized option grants, this approach would ensure that aggregate share usage stays within a reasonable range of competitive practice, irrespective of changes in stock price or option-pricing model value.

Conclusions

The data provided by the study is suitable for large general industry companies (Top 250) or large high-growth companies (Nasdaq-100). For companies that do not compare well with the groups in this study, specific peer group analyses of 15-20 companies should be conducted. Some companies may find that this method of determining grant guidelines is more appropriate for their needs than existing methods. These companies may include start-ups, private companies, recent IPOs and companies that have recently experienced drastic stock price changes.

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For further information, please contact David Yang or James Kim in our Chicago office at (312) 332-0910. Copies of this letter and other published material are available on our website at www.fwcook.com.