

Despite Nacchio verdict, stock options attractive

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by Bob Mook

Joe Nacchio's conviction on 19 counts of insider trading might be a deterrent to others tempted to trade on inside information. But it most likely won't stop corporations from luring and retaining CEOs with lots of lucrative stock options.

If anything, observers say top executives will receive even more stock options to compensate for the "occupational hazards" associated with being a CEO, such as increased scrutiny from the regulators, investors and the public -- and even (in the case of the former CEO of Qwest Communications International Inc.) a possible prison sentence.

"Fewer people want to head up publicly traded firms," said Brian Hamilton, CEO and co-founder of Sageworks, a financial analysis firm based in Raleigh, N.C. "I have one friend who quit as the CEO of a large public company because he was spending 75 percent of his time on Sarbanes-Oxley (SOX)."

Enacted by Congress in 2002 in the aftermath of the Enron and WorldCom fraud scandals, SOX has become the bane of corporate executives everywhere because of its rigorous financial and accountability standards.

Yet, SOX and the fate of executives such as Nacchio appear to have done little to stop public companies from sweetening their contracts with stock options.

"I have not seen a significant change by CEOs and other top executives with regard to accepting big stock incentives in lieu of a big salary," said Richard Jacovitz, senior vice president of Liberum Research, a New York-based research firm that specializes in executive change at public companies. "You would think that would be the case, but I have not seen a trend of this kind."

Indeed, executive compensation packages appear to be on the rise.

According to The Corporate Library, a Portland, Maine-based research organization that focuses on corporate governance and CEO pay, compensation for the typical CEO rose by 9.3 percent from 2005 to 2006 -- outpacing wage gains of 3.8 percent for most workers.

A survey conducted by Equilar Inc. for The New York Times shows that pay for the average CEO increased 9.8 percent from 2005 to 2006 in companies that reported under the Security

and Exchange Commission's new disclosure rules. Companies that reported under the older, less stringent rules reported an average increase of 7 percent for CEOs during the same time frame.

Kevin O'Brien, a professor and lawyer who teaches ethics and securities law at the University of Denver's Daniels College of Business, said the new disclosure rules have had little effect other than make the SEC "feel better."

O'Brien said the movement to big stock options for executives started in 1992, when Congress changed the internal revenue code that imposed no limits on equity-flavored compensation.

"The reason corporations like it is if you pay [executives] a bigger salary, it affects the cash flow, but if you give 'em stock, you're merely diluting the market value," O'Brien said.

Nacchio's attorney, Herbert Stern, tried to argue during his client's trial that Nacchio asked Qwest's board for a bigger salary instead of more stock options, but the board declined.

During the trial, Stern called Nacchio's stock options "golden handcuffs" and told a federal jury the options were set to expire in an aggressive schedule. Because of the constraints, Stern implied the trades may have looked conspicuous when his client sold \$101 million in shares in the first five months of 2001.

On April 19, jurors convicted Nacchio on 19 of 42 charges of insider trading for stock sales he made between April 26 and May 29, 2001. Government prosecutors argued that Nacchio continued to sell and reaffirm Qwest's guidance when he knew the Denver-based telecom company wouldn't meet its financial targets for the year.

Nacchio's case raises interesting questions about corporate compensation, primarily, how does a top executive make large sales of stock without inside knowledge?

O'Brien cited SEC rules under the 10b5-1 trading plan that allow executives to exercise and sell stock on a pre-arranged schedule as an "affirmative defense" to trade regardless of inside information.

Larissa Herda, CEO of Time Warner Telecom Inc., exercised 20,000 shares of the Littleton-based telecommunications stock at \$3.46 apiece and sold them on April 13 for \$21.27 apiece the same day with no questions asked since the trades fell under the 10b5-1 plan.

Nacchio, who redeemed Qwest shares under the same rules, wasn't protected because he terminated his plan when Qwest shares fell under \$28.50 -- negating his affirmative defense, O'Brien said.

O'Brien said even when executives enter into a pre-arranged trading plan, whatever inside information they possessed when they made the deal may come back to haunt them later if

their company experiences a financial downturn, as did Qwest, that leaves CEOs flush and shareholders with little value.

The chief financial officer of Menu Foods Income Fund recently faced charges of insider trading when he sold nearly half his units with the Canadian-based company less than three weeks before a massive recall of tainted pet food. The CFO, Mark Weins, called the timing of the sale "a horrible coincidence."

Hamilton said there are no easy ways to avoid the appearance of insider trading, but increased board involvement may help. He added that congressional efforts to limit executive compensation packages will only further complicate the problem.

Jacovitz said stock options should be dependent on performance and should be on the balance sheet as potential expenses.

Rules adopted by the Financial Standards Board in late 2004 require public companies to deduct from earnings the cost of employee stock options at a predetermined price within a certain time frame. But critics say the rule puts startup companies at a competitive disadvantage since the cash-poor companies use stock options to woo talent.

Until regulators, legislators and businesses come up with a better solution, O'Brien may have a short-term answer to the predicament facing many CEOs.

"I take the position that if you want to avoid the appearance of insider trading, wait until you finish your employment," O'Brien said.