THE MARKET RESPONSE TO EMPLOYEE STOCK OPTION REPRICINGS AND EXCHANGES

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1. Introduction

In order to give managers and employees an incentive to perform well, companies compensate them with call options. A call option is a contract that entitles its owner to acquire a share of stock in the future at a price specified when the contract is issued (the exercise or strike price). If the firm’s share price increases, the values of managers’ options do too, thereby giving managers an incentive to increase shareholder wealth. Conversely, if the stock price decreases, the value of the option falls as well. Should the firm’s stock price decrease by so much that the stock price is less than the option’s strike price, option holders will not exercise their options, as doing so will not be profitable. In this instance, the options are referred to as “out-of-the money” or “underwater”. For companies that rely on stock options as a form of compensation, there is great concern that underwater options are not good motivators or retention devices. Hence, companies that use options as compensation and whose stock price declines face a dilemma. Should they reprice the underwater options (effectively lowering the exercise price), or issue new ones in order to realign incentives? If they do so, will this repricing create perverse incentives by rewarding managers and employees for poor firm performance? Many boards have responded to falling stock prices by repricing managers’ options, but it is less clear whether such actions benefit shareholders. One way to investigate whether repricings are in the shareholder’s best interest is to analyze how the firm’s stock price reacts when companies announce repricings.
There are two primary methods by which companies may choose to reprice stock options. Until the proposal of Financial Accounting Standards Board (FASB) in 1998\textsuperscript{1} on accounting for employee stock option (ESO) repricings, the predominant way for repricing options was the direct lowering of an option’s strike price. When accounting rules changed and repriced options were recognized as expenses, firms began to switch to a more indirect method of repricing, namely a six-and-one (6&1) option exchange. Under this type of repricing, old out-of-the-money options are cancelled, and the firm waits at least six months (typically six months and one day) to issue new options. By employing this extended waiting period, a 6&1 repricing allows the firm to avoid recognizing the repricing as an expense for accounting purposes. Due to the substantial decrease of direct repricing programs, and the concomitant increase in the number of 6&1 programs in the recent years,\textsuperscript{2} this paper focuses on the latter type of option exchange programs.

Using a hand-collected sample of 398 firms that have undergone 6&1 option exchange programs, as well as other underwater option-related tender offers\textsuperscript{3} in the period 2000-2004, this paper analyzes the repricing firm’s stock price reaction to the announcements of these programs. Recent NYSE and NASDAQ rules began to require shareholder approval for most repricings\textsuperscript{4}. This ruling, effective June 30, 2003, corresponds to a sharp decline in repricing activity, a phenomena which will be analyzed in more detail.

\textsuperscript{1} See section 2.1.1 and 2.1.2 for the accounting details.
\textsuperscript{3} The sample also includes various other tender offers targeted at exchanging out-of-the-money employee stock options in order to realign incentives. Some examples include exchanges of options for restricted stock, or options for cash.
\textsuperscript{4} If a plan explicitly pre-authorizes the repricing, approval is not required. However, if a plan is silent on repricings, NYSE companies require approval while NASDAQ firms are silent on this issue. Here, repricings refer to both traditional repricings and 6&1 exchange programs.
This paper is closest in spirit to Kalpathy (2003) who examines the stock price response to repricings between January 1999 and May 2002. This paper uses a more recent dataset of companies undergoing six-and-one exchanges during the period January 2000 and December 2004. The sample used in Kalpathy (2003) is much smaller than the sample employed in this study and it spans a much more narrow date range. In any event study, the identification of the event date is critical for accuracy. This paper refines the approach of Kalpathy (2003) by employing an exceptionally thorough search method for announcement dates, which results in improved precision in the identification of the event date (Kalpathy’s method misses certain important announcements). Finally, the sample used in this paper extends Kalpathy (2003) by including various exchanges related to underwater options\(^5\) not included in that paper.

Section 2 describes the literature and accounting background of stock option repricing. Section 3 addresses data collection and description. Section 4 presents the empirical analysis and results. Section 5 concludes the paper.

### 2. Background

#### 2.1.1 Accounting for stock options and repricing programs

In 1972, the Accounting Principles Board (APB), a precursor to the FASB, issued Opinion No. 25: *Accounting for Stock Issued to Employees* which required companies to expense variable stock option grants to employees (i.e. grants with varying exercise prices and/or varying number of options) but not fixed stock option grants (i.e. grants with a fixed exercise price and number of options on the date of the grant). Although

\(^5\) Examples of such exchanges would include options for restricted and options for cash offers.
APB25 did not mention repricings, a FASB Emerging Issues Task Force (EITF Issue No. 87-33) clarified that repricings do not lead to variable accounting; they simply require a new issuance date (Ferri, 2003).

In 1995, FASB reconsidered the accounting for employee stock options and issued SFAS 123: Accounting for Stock-Based Compensation. This statement required the disclosure but not the recognition of an expense for fixed employee stock option grants. Furthermore, on December 4, 1998 FASB announced that it will issue an Exposure Draft related to accounting for ESO’s with fixed strike prices that have been repriced using the "variable method". Unlike the “fixed method” where companies were not required to record expenses related to stock options, FASB rules now require that if an option has been repriced and the stock price of the company’s stock goes above the strike price of the repriced option, the company is required to record an expense related to the difference between the stock price and the new exercise price of the option. FASB indicated that once the draft is approved, this method will be retroactively applied to all options issued after Dec. 15, 1998. The final rule was issued on March 31, 2000 as FASB Interpretation 44 (FIN 44) and was effective on July 1, 2000.

Following the issuance of FIN 44, companies adopted new methods of dealing with underwater ESO’s without directly resetting the strike price. A very common technique of avoiding the compensation expense associated with a direct repricing is the 6&1 exchange, where the underwater stock options are cancelled and new, usually at-the-money options are issued in at least six months and one day. Another commonly used method for avoiding the variable accounting treatment is the cancellation of the

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underwater options followed by their replacement with cash or restricted stock instead of new options.

2.1.2 Disclosure requirements for option repricings

As of October 21, 1992 the Securities and Exchange Commission (SEC) under Item 402(i) of Reg. S-K began to require companies to include a “Ten-Year Option Repricings Table”. Under this regulation, companies that have repriced options held by any of its executives\(^7\) in the previous fiscal year are required to report any repricings\(^8\) of its executives’ options that have occurred in the last ten years.

On March 21, 2001 the SEC began to require companies to treat option exchange offers as tender offers under Rule 13e-4 of the Securities and Exchange Act of 1934.\(^9\) In some instances, option exchange programs were treated as tender offers even prior to this date. For instance, Ferri (2003) documents the first exchange program filed as a tender offer in December 21, 2000 (Lante Corp), and the sample used in this paper has a December 12, 2000 option exchange program (ITC Deltacom Inc). By searching all SEC issuer tender offer filings (these filings will be referred to as the TO-I) for option exchange programs, I construct a comprehensive sample of all such programs occurring after March 21, 2001.

\(^7\) The term “executive” refers to the CEO and the four other most highly compensated executives of the firm. This may exclude various managers that are essential to the operations of the firm.

\(^8\) Under the rule, the term “repricing” refers to any direct or indirect amendment to the strike price. Hence a 6&1 exchange would usually be considered as a repricing under this terminology. These rules do not extend to small business issuers.

\(^9\) Ferri (2003) states that as early as February of 2001 the SEC began to require certain option exchange offers to be considered “tender offers” however there was no universal law.
2.2 Literature review

The practice of stock option repricing is controversial. Proponents of repricings assert that relieving managers and employees of their underwater stock options is simply a way to realign their incentives with the interests of the shareholders. Critics of repricings argue that such programs mainly reward managers for poor firm performance.

Employee stock option grants are issued in order to align the interests of the shareholders and the employees and to increase retention of employees. Alignment of interest is a result of the direct relationship between the employee’s compensation and the stock price of the company. Vesting schedules that govern stock option grants create retention. Instead of making all of the stock options exercisable on the date of the grant (which could lead to a “take the money and run” scenario), companies typically allocate ownership of the options to employees gradually over a period of a few years. Proponents of employee stock option repricings argue that such programs reestablish these fundamental characteristics of option grants as well as protect the managers and employees from industry-wide or market-wide factors that have a negative effect on a firm’s stock price but are out of the employees’ control. At the same time, critics of repricings state that these programs constitute a transfer of shareholder wealth to the employees and executives.

The argument for the restoration of incentives as a primary reason for option repricings has been examined in depth in the framework of traditional option repricings. Meulbroek and Jin (2001) show that a sharp decline in stock price often does not lead to misalignment in incentives for the managers due both to the long maturity of most executive options and to the increased volatility in the company’s stock price that
typically accompanies stock price declines. Focusing on two measures of stock option induced incentives, delta\textsuperscript{10} and vega,\textsuperscript{11} Coles et al. (2004) find that stock option repricings are primarily targeted at the reduction of vega (reduction of risk-taking incentives)\textsuperscript{12}. Rogers (2003) investigates a sample of US casino companies that have undergone stock option repricings and finds similar results. Carter and Lynch (2001) consider specifically the pay-to-performance effect of stock option grants and determine that firms are more likely to reprice options as they become more out-of-the-money\textsuperscript{13}. This result partially explains a firm’s desire to reinstate the delta incentive of ESO grants. Consistent with the previously discussed results, Kalpathy (2003) finds that traditional repricings and 6&1 exchanges are primarily targeted at reducing the risk-taking propensity of the managers and not at increasing the pay-to-performance sensitivity.

Another argument in support of stock option repricings is their use as a retention mechanism, but the evidence for this argument is mixed. Carter and Lynch (2004) determine that although repricing does not affect executive turnover, it does decrease overall employee turnover for a sample of firms that reprice in 1998.\textsuperscript{14} In contrast, Callaghan et al. (2003) find that repricing does improve executive turnover.\textsuperscript{15} Kalpathy (2003) distinguishes between 6&1 exchanges and traditional repricings and in both cases finds that the desire to decrease overall employee turnover is a significant factor in the

\textsuperscript{10} Delta is the sensitivity of an executive’s (or employee’s) pay to the firm’s stock price performance.
\textsuperscript{11} Vega is the sensitivity of an executive’s (or employee’s) pay to the firm’s stock price volatility.
\textsuperscript{12} Coles et al. (2004) use Execucomp to gather a sample of 122 firms that reprice the CEO’s stock options from 1992-2000. Execucomp indicates whether a firm repurchases stock options in a given year.
\textsuperscript{13} To determine this, Carter and Lynch (2001) compare a sample of firms that reprice underwater ESO’s with a control sample of companies where executives hold underwater options which are not repriced.
\textsuperscript{14} Carter and Lynch (2004) use the number of forfeited stock options as a proxy for overall employee turnover.
\textsuperscript{15} Callaghan et al. find that CEO retention is significantly greater for repricing firms relative to non-repricing firms for three years following the repricing date and for non-CEO executives retention is significantly greater for two years.
decision to reprice.\textsuperscript{16} In all of these instances repricing does prove to be a retention device for either the executives or the employees.

The critics’ claim that repricing merely constitutes a transfer of wealth from the shareholders to the poorly-performing managers has also been examined in academic literature. Kalpathy (2003) finds that for both 6&1 exchanges and repricing programs, the value gained by the managers from the repricing is not related to the decision to reprice.\textsuperscript{17} Grein et al. (2003) examine a sample of 57 Canadian firms that have repriced over the period November 1994 – July 2001. They find that the market does not react to the announcement of such programs as if managers are using them to extract rents from the shareholders.\textsuperscript{18} Contrary to the previously stated results, Carter and Lynch (2001) show that the repricing decision is explained by poor firm-specific performance rather than poor industry performance. This result is consistent with the argument made by the critics of repricing.

Other research has analyzed how company characteristics affect the repricing or 6&1 decision. Carter and Lynch (2003) identify a twelve-day window\textsuperscript{19} between the announcement and proposed effective dates of FIN 44, and find that there is a significant increase in repricing activity during and a decrease after this period. This is consistent with firms timing repricings to avoid the associated expense and the window allows the authors to identify the differences between the firms that choose to reprice during the

\textsuperscript{16} Kalpathy (2003) finds that prior year’s overall employee turnover is a significant determinant in the repricing decision using a logit regression with a sample of control firms.

\textsuperscript{17} Kalpathy (2003) determines the value gained as the difference in the value of the options after the repricing and before the repricing. There is sufficient information in the Proxy statement to determine these values for executives.

\textsuperscript{18} Grein et al. (2003) document a three-day positive mean abnormal announcement-date return of 6.6%.

\textsuperscript{19} On December 4, 1998 FASB announced that it will issue an Exposure Draft related to accounting for ESO's with fixed strike prices using the "variable method". FASB indicated that once the draft is approved, this method will be retroactively applied to all options issued after Dec. 15, 1998.
twelve-day period and those that choose to reprice after. Zamora (2005) determines that firms with greater financial reporting concerns and greater incentive realignment needs choose 6&1 exchanges while firms with greater financial reporting concerns and greater employee retention needs choose makeup grants over repricings.\textsuperscript{20} Zheng (2003) finds that 6&1 firms show greater growth potential, higher analyst following, and higher potential accounting charges.\textsuperscript{21}

Despite the abundance of academic articles on the topic of options repricings, few examine the stock price response to repricing announcements. One of the main reasons for this is the lack of timely disclosure requirements for traditional repricings. As discussed in more detail in Section 3 (below), the only disclosure requirement for traditional repricings is the mention of the program in the proxy or 10-K statement for the fiscal year in which the repricing took place. This disclosure date usually occurs much later than the event and is rarely accompanied by an earlier public announcement, making the identification of an event date problematic. Canadian firms, however, do require the disclosure of repricing. Grein et al. (2003) find a 6.6\% positive three-day cumulative abnormal return surrounding the announcement of the program for a sample of 57 Canadian firms.

In the United States, 6&1 exchange programs must file a TO-I statement, so this filing date can be used as an announcement date in an event study. For a sample of 144

\textsuperscript{20} In order to collect the sample, Zamora (2005) determines firms with a 50\% or greater stock price drop (lowest month-end stock price in the current year is less than 50\% of the highest month-end stock price over the past three years) during the period January 1999 to September 2002. Also searches Lexis/Nexis and Execucomp to determine additional firms that may have responded to underwater stock options and not included in the sample above. Proxy statements are reviewed to identify the type of response. The sample consists of 234 firms with 42 traditional repricings, 41 6&1 exchanges, and 151 makeup grants.

firms in the during January 1999 – May 2002 that have undergone 6&1 option exchange programs, Kalpathy (2003) finds significantly positive abnormal returns in various windows surrounding the event.

This paper contributes to the existing studies by employing a new dataset that captures all 6&1 exchanges in the period March 21, 2001 – December 31, 2004. In addition, an extremely thorough and extensive search of SEC filings and news announcements identifies nearly all announcement dates for the companies (see Section 3 for more details) creating an event study of exceptionally high accuracy. Kalpathy (2003) had just one announcement date for each event which is inaccurate due to the various levels of disclosure that can occur in the period between the first public announcement and the filing of the TO-I. For firms with announcements accompanying the issuer tender offer, the event study will be conducted using both the earliest announcement date and the date of TO-I filing as the event date.

3. Data methodology and description

3.1 Sample collection: traditional repricings and 6&1 exchanges

Identifying all repricing activity in the period 2000 to 2004, requires two types of searches. During this period FIN 44 caused a significant decrease in traditional repricings and an increase in 6&1 exchanges, however both methods of repricings were still used.

\(^{22}\) All 144 firms fall in the years 2001 and 2002 since companies were required to file TO-I’s in the case of 6&1 exchanges after March 21, 2001.

\(^{23}\) Finds [-1,-1] mean (median) abnormal return of 1.29% (0.98%) significant at 10% level; [-2,0] mean (median) abnormal return of 2.25% (1.61%) significant at 5% level; [-1,0] median abnormal return 1.85% significant at 5% level. Either the tender offer filing date or an earlier public announcement date is used as the event date.
Thus, two separate searches are conducted for the traditional repricings and the 6&1 exchanges.

Rule 13e-4 of the Securities and Exchange Act of 1934 requires all companies undergoing tender offers for options to file an issuer tender offer statement (TO-I). In particular, after March 21, 2001, this ruling treats six month and one day option exchanges as tender offers (see Section 2.1.2). To construct the sample, I searched all TO-I statements filed in the period between January 1, 2000 and December 31, 2004 for tender offers relating to underwater employee stock options and the realignment of incentives. This search resulted in 456 related tender offers. After eliminating four firms with missing CRSP information, twenty-three foreign firms, and eight more firms for reasons discussed in further detail in Table 1, 421 firms remained. Of these 421 firms twenty-three conducted multiple exchanges. I separate the multiple exchange firms in the analysis in order to account for the bias that may be induced by numerous programs related to underwater options. The final sample consists of 398 unique firms. Panel A of Table 1 summarizes the data selection process.

The annual proxy statements contain compensation information about the CEO and the other four most highly compensated employees of the company (who are paid more than $100,000). By means of Item 402(i) of Reg. S-K required by the SEC (see Section 2.1.2) all Executive Compensation subsections of the Proxy statements filed in the period June 1, 2000 through June 15, 2004 were searched for the “Ten Year Option

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24 Thomson Research was searched for all TO-I filings in the period January 1, 2000 through December 31, 2004. The search yielded 11,410 citations for 2,187 companies. Most of these citations included amendments to previously filed tender offer statements. Only the original filings (not the amendments) were searched for related tender offers, and the sample was not narrowed down.

25 A firm that conducted numerous exchanges may have a significantly different abnormal returns corresponding to an additional exchange because the market may react differently to such firms. Furthermore, these firms might be underperforming relative to the remainder of the sample.
Repricing Table\textsuperscript{26}. The start date of the search was chosen in order to capture all companies that may have repriced options in 2000 or later.\textsuperscript{27} The date of the repricing is recorded as the earliest date reported in the table or in the related section of the proxy statement on or after January 1, 2000. Hence only unique occurrences of repricing events were included in this sample; multiple repricers were not accounted for. The search resulted in 348 companies that have repriced their options between January 1, 2000 and February 23, 2004. I eliminate seventeen firms with missing CRSP data, eight foreign firms, five firms that are repeated in the sample because of a name change and one firm because it does not disclose the date of the repricing. In order to add uniformity to the combined sample of companies that have undergone related tender offers and companies that have done traditional repricings, I exclude those companies that have already appeared in the sample of tender offer firms. From an accounting perspective, a 6\&1 exchange is considered a repricing leading to the “Ten Year Option Repricings Table” requirement, which creates a significant overlap between the two samples\textsuperscript{28}. Of the 317 remaining firms, 140 are also included the tender offer sample, leading to a final sample of 177 unique firms in the repricing sample. Panel B of Table 1 summarizes the data selection process.

\textsuperscript{26} The “Free Edgar Text Search” capability of Thomson Research was used with the search string: “option! w/10 repric!” (Carter and Lynch, 2001). The search yielded 2153 citations.
\textsuperscript{27} There is a chance that this search missed the companies that have an unusual fiscal year end in the beginning of the year (Jan-Mar), which have repriced their options in exactly the same period. Carter and Lynch (2001) in their search for 1998 repricings search only the proxies filed in 1999 and limit their sample to companies that have a December fiscal year-end.
\textsuperscript{28} Numerous companies avoid the “Ten Year Option Repricings Table” requirement in the case of a 6\&1 exchange by having a subsection of the proxy devoted to the exchange program without having an actual table.
3.2: Event study data collection

Until the recently increased popularity of 6&1 exchange programs due to FIN 44, companies resorted to traditional repricings. There are no timely disclosure requirements regarding such repricings, creating a difficulty in running an event study on a sample of traditional repricings. In the absence of an accompanying announcement, the market would often not learn about an option repricings until the filing of the proxy statement, which could often be months after the actual program. In addition, proxy statements are filled with other information unrelated to the repricing that could also significantly affect the stock price. Grein et al. (2003) conducted the only available event study on traditional repricing firms with a sample consisting of 57 Canadian companies because Canadian firms face a timely disclosure of option repricings.

As of March 21, 2001 companies are required to treat option exchange offers as tender offers and are thus required to file issuer tender offer statements under Rule 13e-4 of the Exchange Act of 1934. This disclosure creates a foundation for an event study involving option exchange programs since in the absence of earlier announcements, the announcement date is the day of the TO-I filing. The analysis assumes that full disclosure of the announcement occurs on the day of the tender offer (and hence all information regarding the tender offer reaches the market by the time of this filing).²⁹ In order to search for public disclosures that may have occurred prior to or on the date of the issuer

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²⁹ This is not entirely accurate as companies undergoing the exchange offers are required to file amendments to the initial tender offer, which disclose changes to the program if appropriate and announce the results of the tender offer (i.e. how many options exchanged, how many new options will be granted).
tender offer filing two steps were performed. First, Dow Jones Factiva was searched for all announcements related to the option exchange offer going back two years before the TO-I filing. Of the 398 firms in the sample, only 142 (35.7%) are accompanied by a Factiva announcement. This is similar to Kalpathy (2003) who finds that 36% (52 out of 144 firms) of the events have an announcement related to the tender offer. This explains why Dow Jones Factiva alone should not be used to identify repricings, and SEC filings are needed for a complete sample. However, the search is not limited to the earliest announcement date since announcements on differing days may include different levels of information leading to varying stock price reactions. I find that a total of 29 (20.4%) companies have multiple announcements accompanying the event. Panel A of Table 2 summarizes this data.

Kalpathy (2003) fails to consider other SEC filings that may have foreshadowed the occurrence of a tender offer. The most common filing to precede the TO-I is the tender offer communication form (TO-C). This filing discloses any information pertinent to a potential tender offer such as e-mail communications to the employees or news announcements. Appendix A gives an example of a TO-C filing. To capture all announcement dates, I perform a search for all tender offer communication forms with

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30 Factiva does not track all earnings teleconference transcripts, which may have a slight effect on the announcement date, in the case that a potential exchange program is mentioned in the teleconference but not recorded in the accompanying press release.

31 The following search string was used: "company" and option* near10 (exchang* or repric* or re-pric* or cancel*). The word “company” represents a fragment of the firm’s name that is most likely to be present in a related article. The search dates for each filing were: [TO-filing date – 2 yrs, TO-filing date]

32 Since companies were not required to disclose 6&1 offers until March 2001, to identify any 6&1 exchanges between January, 2000 and March 2001 Factiva would have to be searched. There is a chance, however, that the search would result in an extremely low success rate.

33 The sample does not account for multiple announcements on the same day. A firm can only have more than one corresponding announcement if they are on different days.

34 SEC Edgar search for historical filings was used with the following string: “form-type=to-c company-name=(company)” for the following interval: [TO-filing date – 2 yrs, TO-filing date]
the results showing that for 89 (21.6%) TO-I forms there is a TO-C form filed on or before the date of the TO-I filing. This underlines the importance of considering these filings in the event study. Furthermore, all other SEC filings are searched for potential disclosure.35 There are 121 (30.4%) firms with other SEC filings accompanying the TO-I filings. Excluding the TO-C’s, the most frequent SEC filings that foreshadowed the exchange programs were the proxy statements.36 This is caused by an accounting regulation effective June 30, 2003 that under various circumstances37 requires companies to seek shareholder approval for stock option repricings (both traditional repricings and 6&1 exchanges). The effects that this regulation may have on the market response to repricing announcements are discussed in Section 4.2.4. Panel B of Table 2 summarizes SEC disclosure frequency data and Table 3 describes the types of filings that were encountered as a result of this search.

In order to justify a data collection process of this extent it is helpful to focus on the earliest date of any publicly available information regarding the tender offer. There are three sources from which this information may be derived: 1) Issuer tender offer, 2) any SEC filing excluding the TO-I (i.e. TO-C, 8-k, etc.) 3) Dow Jones Factiva announcement. Various permutations of these types of disclosures may occur on the earliest announcement date with the summary disclosed in Panel A of Table 4. The majority of the option exchange programs are not accompanied by any other form of

35 The “Free Edgar Text Search” capability of Thomson Research was used, however due to its limitations two accounts were used simultaneously with the following search strings: “option! w/10 (cancel! or exchang!)” and “option! w/10 repric!”. The search was performed for each company separately and the date range was: [TO-filing date – 2 yrs, TO-filing date]
36 This includes various forms of proxy statements (i.e. preliminary, amended, special, etc.).
37 If a plan explicitly authorizes the repricing, approval is not required. However, if a plan is silent on repricings, NYSE companies require approval while NASDAQ firms are silent on this issue. Here, repricings refer to both traditional repricings and 6&1 exchange programs.
announcement with the TO-I filing dates accounting for 205 (51.5%) of all earliest announcement dates. Furthermore, for 60 (15.1%) companies the issuer tender offer filing date is the earliest disclosure date, however it is also accompanied by a public announcement on the same day. At the same time, for 62 (15.6%) firms only an SEC filing other than the TO-I is the earliest announcement date. If SEC filings had not been searched for announcements, 15.6% of the announcement dates would have been incorrect. Thus only a thorough search of all SEC filings for disclosures related to the tender offers would capture the correct announcement dates and would establish the true information flow for these tender offers.

The time span between the initial rumor regarding a tender offer and the actual filing of the TO-I statement is variable. For a majority of companies (51.8%) there are no accompanying announcements, so the initial rumor is taken to be the TO-I filing date. For approximately half of the companies with announcements, this time span falls between zero and four days. This implies that for 23.9% of the entire sample the earliest mention of a potential exchange program occurs at least five days before the beginning of the offer. This includes 35 firms for which the earliest announcement comes at least fifty days before the tender offer filing. Panel B of Table 4 summarizes the time intervals between the earliest announcement and the TO-I filing.

3.3.1: Descriptive statistics: 6&1 exchanges and other related option exchange offers

Previous studies related to 6&1 exchange programs (Kalpathy, 2003; Coles et al. 2003; Zheng, 2003) despite undergoing the exhaustive search of issuer tender offer filings fail to document information on other forms of tender offers that are related to
underwater employee stock options. Specifically, Kalpathy (2003) focuses strictly on 6&1 exchanges without any mention of the other related tender offers. My search documents all tender offers related to underwater stock options as shown in Panels A and B of Table 5. Six-and-one option exchanges account for 294 (73.9%) of the tender offers, however various other forms of related programs are present in the sample. This includes 41 (10.3%) of the filed tender offers which relate to an exchange of options for restricted stock. Furthermore, 28 (7%) of the filings refer to option exchange programs where the new options are granted before six months, hence inducing an accounting expense through FIN 44. A comparison of these companies to those that choose a 6&1 exchange program may disclose the factors that influence a company’s decision whether to avoid the accounting treatment induced by FIN 44. Panel B discusses the tender offer types for companies that have had repeated programs over the time period. Similarly, a majority of the companies in this sample (18 (85.7%) companies) initiate 6&1 exchange programs.

Table 6 reports the industry distribution for the sample of the TO-I firms. Kalpathy (2003) finds that a majority (39%) of six-and-one firms belong to the “Business Services” industry, while Coles et al. (2003) show that 50% of their sample belongs to the “Business Services” segment. Consistent with these results, 142 (35.9%) unique

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38 Some examples include exchanges of options for restricted stock, options for cash, or options for new options granted before six months. All are targeted at dealing with the problem of out-of-the-money stock options.
39 Restricted stock refers to stock grants that are subject to various vesting schedules, i.e. grants that do not immediately are owned by the employee. This is another example of a retention and incentive alignment device.
40 Carter and Lynch (2003) attribute the following factors to a firm’s decision to avoid the expense: increasing earnings patterns, earnings close to zero, and a firm’s high growth nature.
41 The differing values may be explained by different time frames and the Kalpathy’s focus only on exchange programs with the eligibility of executives.
companies undergoing under-water ESO related tender offers are in the “Business Services” industry. The dominance of the “Business Services” industry in the sample may largely be attributed to the burst of the internet bubble. This sector primarily consists of firms in the computer programming services, prepackaged software, and computer integrated systems design sectors, which are all firms that were hurt significantly by the downturn of the market. As many of these firms may have relied on stock options as a dominant form of compensation, the drop in stock prices may have lead to the need for a realignment of incentives and the reestablishment of retention devices (Kalpathy, 2003). Furthermore, the “Electrical and Electronic Equipment” industry composes a second-highest 21% of the sample, which is consistent with a 12.8% second-highest value found by Kalpathy (2003) and a 14.1% second-highest value found by Coles et al. (2003).

Table 7 reports the index memberships of the tender offer companies. Consistent with the findings of Zheng (2003), who finds a majority of firms offering 6&1 option exchanges (89.5%) to belong to the NASDAQ Stock Market, 325 firms (82.3%) of my sample are NASDAQ members. Previous studies have not considered in great detail the futures of the firms that undergo either repricings or exchange programs. Table 8 shows that a significant portion of the tender offer firms (98 firms, 24.8%) are delisted within the time frame of the study. About half of these firms (44 companies) are delisted due to mergers and half (53 companies) are delisted due to various exchange related delistings (i.e. price fell below acceptable level, bankruptcy, etc.). This result is consistent with the poor stock performance of the firms that leads to repricings in the first place.

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42 Examples of companies in my sample from the “Business Services” industry would include: Palmsource Inc., Webmethods Inc., Novell Inc., Amazon.com Inc., and Ariba Inc.
43 I search for delisted companies in the period 2000-2004, which corresponds to the time frame of the sample.
3.3.2: Descriptive statistics: traditional repricings

The industry membership information for the traditional repricing companies is shown in Table 9. There is a strong correlation between the descriptive statistics of the option exchange firms and the traditional repricing firms. Previous studies on traditional repricings\textsuperscript{44} have found the “business services” sector to be the dominant industry in their samples. Similarly, the highest industry membership in my sample is “business services” with 32 (19.3%) firms. Similarly to the tender offer sample a majority of the repricing firms belong to the NASDAQ stock exchange (121 firms, 72.9%). For a sample of traditional repricing firms, Zheng (2003) finds that 88.6% belong to the NASDAQ. Table 10 discloses the exchange membership of the companies.

Consistent with the poor performance of firms that undergo traditional repricings, a large portion of these companies are delisted. A total of 65 (39.2%) of the firms are delisted during the window of the study.\textsuperscript{45} Unlike the delisting reasons for the tender offer sample, a majority of these firms (50 firms, 30.1%) are delisted due to exchange regulations such price falling below a specific level (17 firms) or not meeting the exchange’s financial guidelines for continued listing (15 firms). There are also 14 (8.4%) delistings related to mergers and one delisting due to liquidation. Relative to the sample of tender offer firms the repricing firms may bare less synergy opportunities explaining the large portion of companies simply delisted by the exchange without merging. The delisting information for traditional repricings is summarized in Table 11.

\textsuperscript{44} Kalpathy (2003) documents 17.9% of the sample do be in the “business services”; Coles at al. (2003) find 18.8%; Zheng (2003) finds 30.7%.

\textsuperscript{45} Delistings are searched for during the period 2000-2004.
3.3.3: Repricing frequency: combined sample

In order to analyze the frequency of the repricings and exchanges over the time period of the sample it is necessary to keep track of the time frames of each data search. Due to the accounting regulations, the TO-I statement is guaranteed to capture every related exchange offer in the period March 21, 2001 through December 31, 2004. Due to the disclosure requirements for traditional repricings, the sample search for traditional repricings will capture most of the repricing activity in the period January 1, 2000 and March 31, 2004 (see Section 2.1.2 for disclosure requirements and Section 3.1 for the search method). It cannot be guaranteed that this search will capture all repricing activity since there are numerous methods of disclosing the “Ten Year Option Repricings Table”. Thus the combined sample will capture most of the repricings and exchange activity over the period March 21, 2001 through December 31, 2004.

In discussing the time trends of repricings, I will focus specifically on traditional repricings and six-and-one exchanges since other forms of tender offers related to underwater options may not be consistent with the repricings. Carter and Lynch (2003) find that traditional repricings virtually disappeared after FIN 44 as 6&1 exchanges became the dominant method for the repricing of options. This trend is witnessed in my

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46 Companies were required to consider option exchange offers as tender offers and thus required to file a tender offer statement after March 21, 2001. Due to rumors circulating this requirement before the date, there was an increase in related tender offer filings throughout the first quarter of 2001.

47 This is assuming that the proxy statement becomes public three months after the occurrence of the exchange which is a relaxed assumption as this filing may take anywhere up to six months. With a six month assumption the examined period is January 1, 2000 through December 31, 2003.

48 I exclude tender offers that involve 6&1 exchange combined with another exchange (i.e. options for restricted stock or options for cash). This amounts to seven companies in the sample.

sample as the final traditional repricings sample is composed of 55 companies in 2000, 67 companies in 2001, 34 companies in 2002, and 21 companies in 2003. At the same time 6&1 exchanges greatly outnumber traditional repricings in the sample as they account for 128 (65.6%) companies in 2001, 103 (75.2%) companies in 2002, and 53 (71.6%) companies in 2003. Repricing frequency is summarized in Table 12.

Chart 1 provides a visual reference for the repricing activity by quarter over the examined period. There is a clear sharp decline in repricing activity following the 2nd quarter of 2003. This drop directly corresponds to the new NASDAQ and NYSE requirements which ask firms which to obtain shareholder approval for repricings (including 6&1 exchanges). This ruling was effective as of June 30, 2003 which corresponds to the beginning of the 3rd quarter. Hence the drop in repricing activity may be caused by the fact that firms do not believe that they may attract sufficient shareholder support for exchange programs so they decide not to waste time proposing an exchange program, which may send a negative message to the shareholders. After searching all of the SEC filings for the sample of tender offers I find the first incidence of shareholder approval for an option exchange program disclosed in a proxy statement on April 17, 2001 by Polycom Inc. A total of 32 firms asked for approval in the entire tender offer sample.\(^\text{50}\) There was one company in 2001, five companies in 2002, nineteen companies in 2003, and seven companies in 2004. After June 30, 2003 (as the NASDAQ and NYSE regulations became applicable), approximately 30% of the firms undergoing tender offers

\(^{50}\) This refers to the “first occurrence” sample, which excludes repeats of repricings (or related exchange offers) and foreign firms. In addition, there was one foreign firm which asked for approval (not included in the sample) and two firms which asked for approval for their second exchange program in the sample. These firms are included in a separate sample of multiple related tender offers filed during the period.
related to underwater stock options asked for shareholder approval.\textsuperscript{51} This suggests that a majority of the firms undergoing repricings during this period had compensation plans which either expressly authorized repricings (NYSE firms) or were silent on the issue (NASDAQ firms).

Section 4. Data Analysis and Results

4.1 Event study methodology

The event study methodology is employed to compute the stock price reactions related to the repricings announcements. At the basis of the event study approach is the fundamental assumption that markets are sufficiently efficient and rational to evaluate the impact of new information on the value of the firm (MacKinlay, 1997). The Center for Research in Security Prices (CRSP) database is used to gather stock price return data for each company and the entire market. The following model is used to calculate the abnormal return on the event date:

\[
R_{it} = \alpha_i + \beta_i R_{mt} + AR_i \gamma_{it}
\]

Here \(R_{it}\) is the holding period return (including distributions) of firm \(i\) on day \(t\), \(\alpha_i\) and \(\beta_i\) are the market model parameters estimated from the ordinary least squares (OLS) regression, \(R_{mt}\) is the value-weighted market return on day \(t\), \(\gamma_{it}\) is the dummy variable for firm \(i\) with a value of 1 on the announcement date and 0 elsewhere, and \(AR_i\) is the coefficient on the dummy variable which is a measure for the mean daily abnormal return for firm \(i\). In the case of an announcement window wider than one day, \(\gamma_{it}\) takes on a value

\textsuperscript{51} The sample has 45 firms the period July 1, 2003 – December 31, 2004. Thirteen of these asked for requested shareholder approval. Ten of these instances were not 6&1 exchanges.
of 1 for all days in the window and 0 elsewhere. For each company the return data is
gathered for the event window and the 150 trading preceding it. Market return data is
gathered for the same period. Once the ordinary least squares regression is executed, $AR_i$
is considered to be the mean daily abnormal return for company $i$ over the event window.
To calculate the cumulative abnormal return for firm $i$, the mean abnormal return is
multiplied by the number of days in the event window. The mean abnormal returns
(MAR) and the cumulative abnormal returns (CAR) for the entire sample are calculated
as follows:

$$MAR = \frac{1}{N} \sum_{i=1}^{N} AR_i$$

$$CAR = \sum_{i=1}^{N} AR_i$$

Here $N$ is the number of firms in the event study sample. At the heart of the event study
approach lays the assumption that in the absence of abnormal stock price performance,
the expected values of the mean abnormal return and cumulative abnormal return are
zero. Finally, in order to test the hypothesis that the mean abnormal returns and the
cumulative abnormal returns are statistically different from zero, the $z$-statistic is used.
This measure is preferred to the $t$-statistic because the $z$-statistic accounts for stock price
volatility.

In the following sections, the abnormal returns are analyzed for various event
windows: (1) the repricing announcement date [0], (2) one trading day before the
announcement through the announcement day [-1,0] (3) announcement day through one
trading day after the announcement [0,1] (4) one trading day before the announcement
through one trading day after the announcement [-1,1] (5) two trading days before the
announcement through the announcement [-2,0] (6) announcement day through two
trading days after the announcement [0,2], and (7) two trading days before the announcement through two trading days after the announcement [-2,2]. The various event windows are used in order to not overlook the effects of rumors prior to the announcements or delays in response following the announcements, as well as to account for announcements which became public after markets closed.

4.2.1 Abnormal returns surrounding the earliest announcement: entire sample

Although numerous announcement dates were gathered for each event in the sample of option exchange programs, the event study approach requires the earliest of all announcement dates to be considered as the announcement date. While for certain companies the earliest announcement may take place a significant amount of time before the filing of the TO-I\textsuperscript{52}, these announcements represent the first flow of information regarding the option exchange program. Thus the first event study was performed on the entire sample of option exchange programs with the event date considered to be the earliest of all announcement dates (both SEC filings and Dow Jones Factiva news releases). The entire sample of 398 firms could not be used for purposes of the event study due to the following limitations in the data: (1) all returns data available from CRSP is after the announcement date or event window (2) all returns data available from CRSP is strictly before the announcement date or event window (3) the returns data is not continuous\textsuperscript{53} (4) returns data is available for less than one hundred trading days prior to the event or the event window. The final event study sample is composed of 381 firms.

\textsuperscript{52} See Panel B of Table 4 for the number of days between the filing of the tender offer and the earliest announcement date.
\textsuperscript{53} This constraint was relaxed for 95 firms for which the event occurred around September 11, 2001 when all markets were closed.
Table 13 summarizes the determination of the final event study sample and Table 14 documents the sample by tender offer type.

Table 15 provides the results of the event study conducted for all tender offers using the earliest announcement dates. The mean abnormal return around the announcement date [0] for the sample of 381 firms is -0.10 %, and is not statistically significant on any conventional level. Similarly, the mean and cumulative abnormal returns are low and not statistically significant for all other considered event windows. These results point to the necessity for additional analysis through the consideration of subsamples of the 381 firms used in the event study.

The analyzed sample combined all types of option exchange programs which could lead to inaccurate results. Although the various types of tender offers are targeted at the same objective of alleviating the problems created by out-of-the-money stock options, they carry differing financial and economic costs to the firm leading to potentially different market responses. For instance, an offer to exchange options for cash may cause employees to collect the money and shortly leave the firm, which may be negatively interpreted by the market. At the same time, a 6&1 option exchange announcement may be positively interpreted by the market\textsuperscript{54} since an exchange of this type leads to improved retention and realignment of incentives. Such arguments justify the segmentation of the event study analysis by tender offer type.

Table 16 describes the regression results for the four major types of tender offers in the sample\textsuperscript{55}: (1) 6&1 option exchanges (282 firms) (2) options for restricted stock

\textsuperscript{54} Chidambaran and Prabhala (2004) argue that due to the six month period there is risk of turnover and the employees have the incentive to not increase, if not decrease the stock price.

\textsuperscript{55} These companies account for 95% of the 381 firm sample.
exchanges (39 firms) (3) options for new options (granted before six months) exchanges (28 firms) and (4) options for cash exchanges (13 firms). Panel A of Table 16 shows the abnormal return for seven windows of the 6&1 exchange sample. The mean abnormal return for the event date is -0.32% and is statistically insignificant. The abnormal returns for companies offering to exchange stock options for restricted stock are significant at the 10% level for the event date and the [-1,0] window. As shown in Panel B, the abnormal return for the event date is 2.09% and the mean daily abnormal return for [-1,0] window is 1.29%, with a cumulative abnormal return of 2.57%. The positive response is explained by certain favorable characteristics of restricted stock. Without loosing the retention effects\textsuperscript{56} of stock options, restricted stock is the most direct method of aligning the interests of executives and shareholders since the managers’ and the shareholders’ returns are similar.\textsuperscript{57} Despite the significantly higher accounting expenses associated with this form of compensation, the shareholders may believe that the benefits of the increased alignment of incentives combined with modified retention mechanisms (the vesting schedules of the restricted stock) outweigh the higher compensation expenses. In addition, even if stock prices plummet, restricted stock will always carry some realizable value whereas an out of the money stock option will not. Consistent with the findings of Chidambaran and Prabhala (2003), the market supports restricted stock as a superior form of compensation.

\textsuperscript{56} The “restriction” provision of restricted stock grants is similar to the vesting stock options. The employee is not entitled to the entire grant immediately; instead he gradually acquires ownership subject to the vesting schedule stated on the contract.

\textsuperscript{57} This does not take into account the lower “subjective” value of these grants due to the manager’s inability to diversify their holdings in the company’s stock.
To examine the relationship between firm size and the market response to the option exchange programs, the sample of firms that underwent 6&1 option exchange programs is separated into quartiles based on market capitalization on the date of the announcement as documented in Table 17. The event study was conducted for each quartile with the results disclosed in Table 18. Except for a 1.15% abnormal return (in the [0,2] window) for the first quartile of firms at the 10% significance level, the results for the first three quartiles are statistically insignificant. Considering the 4th quartile (73 firms), the mean abnormal returns are significant (10% and 5% levels) ranging between -0.65% and -0.96% with the CAR between -1.92% ([0,1]) and -2.48% ([0,2]). The negative reaction to these announcements can be explained by the lower stock volatility of larger companies. Companies with lower market capitalizations generally experience higher return volatility relative to the larger, more established, firms, which can lead to stock price drops and out-of-the-money options caused by factors outside of the managers’ control. At the same time, larger companies usually experience lower return volatility implying that drops in stock price which result in out-of-the-money options are caused by poor decision making on the behalf of the managers as opposed to a general volatile market environment. Thus the market believes that managers are being rewarded for poor firm-specific performance.

4.2.2 Information flow in the framework of an event study

A major issue in conducting an event study is determining whether an announcement contains sufficient information for the market to make a rational response. In the case of option exchange programs, there are numerous terms in the offer that
should affect the market’s reaction to the announcement. This includes factors such as the eligibility of executives, the vesting schedules of the new options, the exchange ratio of old options for new options, and the strike price of new options. Although under the event study approach, the first rumor should be considered as the event date, it’s probable that the earliest announcement does not contain sufficient information for the shareholders to respond adequately. At the same time, the terms of tender offer are guaranteed to become publicly disclosed with the filing of the TO-I statement. Thus for companies with disclosures prior to the TO-I filing date, there is a window between the initial announcement and the filing of the issuer tender offer statement during which the market acquires information about the exchange program. This is the main justification for the thorough collection of all announcement dates leading up to the tender offer filing. However, for companies that either do not have announcements accompanying the TO-I or only have public announcements on the date of the TO-I filing, all disclosures and all information pertinent to the offer becomes publicly available on the same day. Based on Table 4, this subsample would include any company for which the issuer tender offer statement is the earliest form of disclosure.\textsuperscript{58} For these firms it is expected that the market has sufficient information to respond rationally on the event date.

The sample of companies with the earliest announcement being the TO-I filing date is composed of 250 firms (65.6% of the entire event study sample) segmented by the four main tender offer types: (1) 6&1 option exchanges (197 firms) (2) options for restricted stock exchanges (27 firms) (3) options for new options (granted before six months) exchanges (17 firms) and (4) options for cash exchanges (9 firms). Table 19

\textsuperscript{58} The TO-I can be accompanied by either a Factiva announcement or another SEC filing made public on the same day.
shows the results of the event study for each type of tender offer. The results are statistically insignificant for each tender offer type suggesting the need for additional control variables. Consistent with Kalpathy (2003), the market may have a stronger reaction to TO-I filings accompanied by announcements due to additional disclosure.

Table 20 discloses the event study results for companies whose earliest announcement was the TO-I accompanied by a Dow Jones (Factiva) news report. Once again, the companies are separated by tender offer type, with strongly significant results for options for restricted stock exchange offers. The mean daily abnormal return for this subsample of six firms is significant at the 5% level with daily mean abnormal returns varying between 2.48% \([-2,2]\) and 6.11% \([0,1]\), while the cumulative abnormal returns are between 12.23% \([-1,1]\) and 13.84% \([0,2]\). These results are consistent with those obtained for the analysis of the market reaction to all options for restricted stock exchanges (see Table 16). The market’s positive perception of this tender offer type is magnified by the news releases accompanying the issuer tender offer statements.

4.2.3 The market response to the TO-I filing

A rumor of an option exchange program does not guarantee its eventual implementation. The sample was gathered in a manner that identified all option exchanges first and determined the announcement \textit{ex-post} the event. However, at the time of the rumor, the market may not have information sufficient to guarantee the eventual execution of the tender offer causing an insignificant market response. The greatest assurance of an eventual completion of an option exchange program is the filing of an issuer tender offer statement, however even this disclosure may not be sufficient to
guarantee the exchange.\textsuperscript{59} If the market does not trust early rumors regarding exchange offers it is likely that there will be no significant reaction until the commencement of the offer (which is typically the TO-I filing date). Thus the abnormal returns surrounding the TO-I filing date are calculated.

Table 21 summarizes the results of the event study separated by the four major types of tender offers: (1) 6&1 option exchanges (282 firms) (2) options for restricted stock exchanges (39 firms) (3) options for new options (granted before six months) exchanges (28 firms) and (4) options for cash exchanges (13 firms). The mean abnormal return for the 282 6&1 exchanges on the event date is -0.54% at the 10% significance level. The significance of this result relative to the abnormal return obtained for the event study using the earliest announcement date as the event date, suggests that the market is hesitant to react to a 6&1 exchange offer based on an initial rumor. Six-and-one exchange programs are seen as poor employee retention and incentive realignment methods, however the market responds in this manner only at the official commencement of the offer. The abnormal returns to options for restricted stock exchange announcements are highly significant and positive for a 39 company sample. The event day abnormal return is 2.02% at the 5% significance level, while the cumulative abnormal returns are 2.19\% (\([-1,0]\)) and 3.47\% (\([0,2]\)) significant at the 10\% level. Once again the market seems to value the restricted stock exchanges due to the increased alignment of shareholders’ and managers’ interests. Panel C shows that there is no significant response to option for option exchanges where new options are granted before six months. As shown in Panel D, the market exhibits a strong negative reaction to option for cash exchanges. The [0,1]

\textsuperscript{59} On December 16, 2002 Register.com Inc. filed a TO-I to conduct a 6&1 exchange, however terminated the program at a later date.
The mean abnormal return is -1.87% with a CAR of -3.75% significant at the 5% level. Since a direct cash pay-out does not lead to any of the beneficial effects of stock options or restricted stock (i.e. incentive alignment or employee retention), these exchanges are seen as a direct transfer of shareholder wealth to the managers.

The market does not react sharply to the earliest announcements of exchange offers, however it responds significantly to the TO-I statements, which are often filed at a much later date. This result is counterintuitive to the event study approach since it implies that the earliest rumors have little power to explain abnormal stock returns. However, it is possible that although there is no significant market response surrounding the day of the rumor, the increase in disclosure and publicity leads to a sharper market response at the time of the issuer tender offer filing. That is, the market waits to react until there is a significant chance of the execution of the exchange program. To test this hypothesis, all companies that have had announcements prior to the TO-I statement are considered, however the abnormal return is calculated surrounding the date of the filing of the TO-I (as opposed to the return surrounding the date of the earliest announcement). This creates a test for the importance of rumors to the abnormal return on the date of the issuer tender offer filing.

Table 22 displays the results of the event study for companies that have rumors preceding the filing of the TO-I, with the issuer tender offer filing date taken as the event date. As shown in Panel A, for eighty-five 6&1 exchanges for which there was a rumor prior to the filing of the TO-I, the abnormal return on the TO-I filing date is -0.89% at the 95% significance level. The increased negativity as well as the greater significance of this result suggests that the market shows a stronger response to events that are foreshadowed
through other SEC filings or Factiva announcements. The high anticipation of exchange programs leads to more negative abnormal returns. The early announcements create “negative publicity” for the 6&1 exchanges. Although there is already a negative market response to 6&1 exchanges on the day of the commencement of the offer, prior announcements only strengthen this result. The market responds to 6&1 exchanges as if they constitute a transfer of shareholder wealth to the management and other employees. Furthermore, the market response to the filing of twelve issuer tender offers for option for restricted stock exchanges in the presence of prior rumors is significantly positive and greater than the response for all TO-I filings of this type (with either the TO-I filing date or the earliest announcement date as the event date). According to Panel B, the event date return for twelve firms is 2.77% at a 5% significance level with cumulative abnormal returns ranging between 4.49%([-1,0]) and 7.86%([-2,0]) at the same level of significance. Abnormal returns for ten option for option (granted before six months) exchanges are once again insignificant. Panel D shows that the market response to five options for cash exchanges with prior rumors are significant and negative with a CAR of -5.81% for the [0,1] window significant at the 5% level. The market considers the option for cash exchanges to be inadequate methods of dealing with out-of-the-money stock options. The results stated above confirm the hypothesis that in the presence of prior rumors, the market exhibits an increased reaction to the TO-I filing.

4.2.4 Shareholder approval requirement for option repricings

As was mentioned earlier, after June 30, 2003 NASDAQ and NYSE firms began to require shareholder approval for stock option repricings (including 6&1 exchanges). In
the event study sample, 32 firms ask for the shareholders to approve the option exchange programs. Due to the small size of this sample the analysis will focus on 6&1 exchanges (27 firms). A majority of the announcement dates gathered for these events are the filing dates of Proxy statements, which announce the voting for the tender offer. These announcement dates occur on average 105 days before the beginning of the tender offer (TO-I filing date) with only nine of the announcements occurring within 50 days of the issuer tender offer filing. Because of the wide window between the first the announcement and the beginning of the program, there is a possibility that although a certain exchange program is voted upon, there is still uncertainty among the shareholders as to whether or not it will be implemented.

Panel A of Table 23 documents the event study results for the firms requiring approval for a 6&1 exchange program assuming that the event date is the earliest disclosure date (i.e. the date that is on average 105 days before the event). The results are insignificant, which was expected since an offer to vote for an exchange program does not guarantee the execution of the tender offer. There is still a large amount of uncertainty surrounding the 6&1 exchange offer leading to a lack of significance in the results. This supports the need for the analysis of the market’s reaction to the date of the TO-I filing (once the exchange program begins), with the results disclosed in Panel B. The daily mean abnormal return is -1.56% (5% level of significance) on the date of the event, -0.57% in the [-1,0] window (10% level of significance), and -0.78% in the [0,2] window (5% level of significance). The CAR ranges between -1.14% and -2.33%. These results are counter-intuitive since a program which is approved by the shareholders would be expected to be to the benefit of the shareholders, leading to increased shareholder
value. However, the market continues to react negatively to 6&1 exchange programs identifying these events as damaging to the shareholders’ interests. Despite the shareholders’ approval, the negative returns reemphasize the impact that prior announcements of a 6&1 exchange have on returns for the TO-I filing date.

Section 5. Conclusion

In order to identify the market’s perception of option exchange programs an event study on a sample of 398 firms was performed. Using the earliest announcement date as the event date, the analysis did not result in significant abnormal returns for any types of tender offers, except for option for restricted stock exchanges (the return was positive). The lack of significance in abnormal returns for the majority of the sample led to a modification of the approach. This included using the issuer tender offer filing date as the announcement date (since it signifies the beginning of the exchange program) as well as selecting subsamples of the 398 firms based on company size, levels of tender offer related disclosures, and shareholder approval of the exchange programs.

The evidence gathered for various subsamples is strongly inconsistent with the results obtained by Grein et al. (2003) and Kalpathy (2003), who find positive abnormal returns surrounding repricing announcements. The abnormal returns surrounding 6&1 exchange programs are negative for large firms and insignificant for smaller firms. Furthermore, the abnormal returns for all 6&1 firms relative to the date of the TO-I filing are negative and significant. For firms that have announcements prior to the 6&1 exchange program, the returns relative to the TO-I filing date are negative, statistically more significant and greater in magnitude than for firms without earlier announcements.
This evidence supports the critics of repricings who argue that option repricings and exchanges do not realign incentives or improve retention (Meulbroek and Jin, 2001; Chidambaran and Prabhala, 2004).

The recent requirement for shareholder approval of repricings for NYSE and NASDAQ firms does not result in positive reactions to the tender offer announcements. For a sample of firms that have asked for the shareholders to approve repricings, the TO-I filing date is used as the announcement date and the market reaction is estimated. The abnormal returns for the event dates are significantly negative and are greater in magnitude than for the various other subsamples of 6&1 exchange programs analyzed in the study. The results suggest that 6&1 option exchange programs do not accomplish the goals of realigning incentives of the employees and the shareholders as well as improving retention. Furthermore, the recent decline in repricing activity coincides with required shareholder approval suggesting that companies realize that repricing offers are inconsistent with the interests of the shareholders and will not gain sufficient support.

Announcements of options for restricted stock exchange programs result in highly positive and significant abnormal returns (using the TO-I filing date as the announcement date). This is consistent with Chidambaran and Prabhala (2003) who conclude that firms can reduce net repricing costs by replacing option grants with straight grants of restricted stock. With the imminent requirement of expensing employee stock options, shareholders may regard this type of an exchange as a method of avoiding the expenses that will become associated with the out-of-the-money stock options as well as realigning incentives and improving retention of the employees. Furthermore, abnormal returns in
options for cash tender offers are negative and significant suggesting that such exchanges are a transfer of wealth from the shareholders to the managers.

The study allows for various continuations. There is a considerable increase in abnormal returns surrounding the filing of the TO-I for companies that in some way foreshadow the tender offer relative to firms that do not have any prior announcements. The majority of significant results were gathered for event windows surrounding the TO-I filings, and not the earliest announcement date. Anticipation of the exchange program seems to result in greater stock price movements; however this is a very abstract justification. Further reasons for this phenomenon should be identified with rigorous analysis. Furthermore, various control factors relating to the terms of the tender offers (i.e. eligibility of executives) should be established in the event study to distinguish the various factors that may affect the abnormal returns.
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