



CEO opportunism?: Option grants and stock trades around stock splits[☆]



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ABSTRACT

Decades of research confirm that, on average, stock split announcements generate positive abnormal returns. In our sample, 80% of CEO stock option grants are timed to occur on or before the split announcement date. With the average market-adjusted announcement return of 3.1%, awarding the grant before the split announcement results in an average gain per CEO-grant of \$451,748. We find additional evidence consistent with timing of CEO stock trading around the split announcement. In the case of CEO stock sales, about two-thirds occur after the split announcement, resulting in an average gain of \$345,613.

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1. Introduction

A number of studies document the apparent timing of various corporate events relative to the granting of executive stock and option plans. For example, [Aboody and Kasznik \(2000\)](#) analyze stock prices around earnings forecasts and present evidence consistent with the hypothesis that CEOs opportunistically time voluntary corporate disclosures relative to grants of compensation plans, in an attempt to maximize their personal wealth. Our study contributes to this literature by examining the timing of option grants to CEOs around the announcement of a stock split. Our approach allows us to more directly link the actions of the CEO and Board of Directors (BOD) to a major corporate event (the announcement of a stock split) and the timing of CEO option grants. Further, we are able to provide accurate estimates of opportunistic gains to the average CEO and show that these gains are economically significant. We provide corroborating evidence of apparent opportunism by examining CEO trading activity around the split announcement. Understanding patterns consistent with

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opportunistic behavior is important, as these behaviors may reflect inadequate governance or governance breakdowns (e.g., Bebhuk et al., 2010; Collins et al., 2009; Morgenson, 2004).

The effect of stock split announcements on share prices has been studied for over 40 years, and one of the consistent results of this scrutiny is the significantly positive abnormal stock return found around the announcement of the stock split.¹ This result is perplexing because, economically speaking, stock splits are cosmetic – they merely adjust the price of the minimum unit of trade. There are however, non-trivial costs related to splits, and yet their use has remained over a long period of time as firms persist in splitting their shares. Split announcement returns are not just positive on average, they are positive for approximately three-quarters of all splits. For the typical firm, a stock split announcement results in a fairly certain share price increase without changing the underlying characteristics of the firm or altering the timing or content of other corporate disclosures.

In this paper, we examine whether the granting of stock options to CEOs appears to be timed in relation to the split announcement. Further, we test whether there is any apparent opportunistic timing of the CEO's personal sales or purchases of the firm's stock around split announcements, so as to maximize personal wealth. Our empirical evidence is consistent with the idea that CEOs behave in an opportunistic fashion around stock split announcements.

For stock splits that also have option grants within a 21-day window centered on the split announcement, we find that 80% of these grants occur prior to or on the announcement day. This is statistically different from the 20% of CEO stock options granted after the split announcement. The announcement of a stock split is a discretionary event, so it is not surprising that the result holds for scheduled, unscheduled, and unclassified option grants (as it is possible to time a split to follow an option grant, regardless of whether that grant is scheduled or unscheduled). We estimate that such timing results in an average increase in the value of the options awarded by a splitting firm to the CEO, of \$451,748 (with a median of \$39,234).

Insider trading data provides further evidence consistent with the notion that CEOs behave opportunistically around split announcements. We find significantly higher levels of selling immediately after compared to before the split announcement. In addition we find the opposite effect for stock buying activity by CEOs. The overall amount of trading around splits is four times greater than the trading in the prior year for the same calendar time period. As a result of this trading behavior, on average CEOs are \$345,613 (with a median of \$48,188) better off from selling after the split rather than before. Together with the granting behavior; we interpret this evidence as consistent with our hypothesis that, on average, CEOs behave opportunistically around the announcement of stock splits.

Although we have made every effort to carefully analyze the data, some qualifications remain. First, while we can observe the benefits of timing option grants around the split announcement, we cannot say definitively that the CEO's gains are directly at the expense of shareholders. Typically, only highly successful firms engage in stock splits. Therefore, the apparent opportunistic timing of option grants could simply be another way in which the BOD rewards and retains a high performing CEO. We investigate this possibility by examining the total compensation as well as the amount of options granted in the prior year. In general, total compensation and the number of option grants are significantly higher in the year of the split, relative to the prior year. Second, we do not address whether the ability to time options relative to splits results in more splits occurring – in other words we assume that the decision to split is exogenous. Examining whether option-based compensation leads to abnormal splitting behavior is an interesting question for future research. A third caveat relates to the economic gain of the CEO. The economic gain from timing option grants is a “paper” gain only and we only estimate this for the current option grant. Any prior option grants would also gain in value and may even be vested at the time of the split announcement (a portion of this gain may be observed in the insider trading analysis), however given the available data, we are unable to obtain more definitive estimates of economic gain. Finally, while our evidence is consistent with opportunistic behavior by CEOs, it is not possible to directly test CEO intent.

The rest of the paper proceeds as follows: Section 2 provides a brief literature review while in Section 3 we develop our hypotheses. Section 4 presents a description of the data, whereas Section 5 presents our results. Section 6 discusses the economic significance of our findings, and Section 7 concludes the paper.

2. Literature review and institutional detail

Our paper is related to two distinct areas of the literature. First, the area of opportunistic managerial behavior and insider trading that examines managerial actions around corporate events. Second, the literature on stock splits that documents the mechanics of a stock split and the associated stock price effects of stock splits.

2.1. Opportunistic managerial behavior and insider trading

A growing body of literature finds evidence consistent with opportunistic timing of option awards. Using a sample of Fortune 500 firms, Yermack (1997) finds strong evidence that CEO stock option awards are timed to occur immediately before the release of positive corporate news. He argues that this timing is not the result of insider trading, leakage of the award announcement, or manipulation of the news release. He reports that the mean (median) abnormal increase in the

¹ See Fama et al. (1969).

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