Are Stock Options Ethical?
Introduction

When the technology bubble burst in March, 2002, managements practices came under a lot of scrutiny. These lead to a number of increased debates focusing on the ethical issues underlying management’s behaviour. Although certain issues were solved through reforms (ex. conflicts of interest issues in brokerage firms were resolved through the introduction of reforms that made it mandatory for stock analysts to disclose all the relationships their firms had with clients), others still remain unresolved. One of these issues deal with the use of stock options as a form of compensation for executives. Currently there are two separate viewpoints with regards to stock option compensation. One viewpoint, supported by ethicists, revolves around the unethical consequences that may result through using stock options for compensatory purposes. Another viewpoint, supported by management, centers on the effectiveness of using such a method of compensation. As this issue still attracts attention, this paper has been written to outline in detail the ethical issues arising as a result of awarding executives stock options.

To begin, I will discuss the reasons management continues providing support for this method. Following this discussion, I will focus on the ethical issues surrounding stock options. After this, I will present an analysis of whether stock options can be tied to corporate social responsibility, an issue though around for a while, has only recently been receiving an extensive amount of interest. Next, I will address whether stock options create incentives for fraud. Finally, based on my collective research, I will provide some suggestions relating to stock options.

Management’s Perspective
The use of stock options has drastically increased since the 1990s. Simply looking at the figures, the number of employees holding stock options in the U.S. increased from 1 million in 1991, to 10 million in 2001\(^1\). Though the recent trend has been to issue other forms of long term compensation (for instance, in 2003, Microsoft made a shift from issuing stock options to issuing restricted stock\(^2\)), stock options remain a primary form of compensation, with 90% of the largest U.S. companies currently using stock options\(^3\). Although they have been criticized as leading to unethical behaviour, management continues supporting their usage for a number of reasons. These reasons are outlined below.

**Attracting & Retaining Quality Employees**

One of the most commonly quoted reasons for implementing stock options is to attract and retain employees\(^4\). Furthermore, based on the economics concept of *information asymmetry\(^5\)*, management would have an incentive to award stock options in order to attract and retain the *best* available executive talent\(^5\). When management is in the process of hiring an executive, they may not have the necessary information to decide whether a certain executive will be a valuable asset to their company or not. In such circumstances, they may issue stock options in order to entice only those executives who are confident in their abilities to raise stock prices to apply. All those executives that do not believe in their abilities would avoid applying, thus providing management with the opportunity to select from the best and the brightest. As well, through the appreciation of

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\(^1\) *Information Asymmetry*: “Condition in which at least some relevant information is known to some but not all parties involved”.

In the case of management, the quality of the executive would be known by the executive but not by management.

stock prices, executives would further have a reason to stay with the company as their compensation would increase with the stock prices. Hence, for the pursuit of top-quality executives, management would be justified in awarding stock options.

**Aligning the Interests of the Executives & the Shareholders**

Another commonly cited reason for issuing stock options centres on the idea that by using such a method of compensation, the executive’s goals would align with those of the shareholders. Since maximizing shareholder wealth is the core objective of management, it would be in their best interests to direct the executive’s attention towards company stock prices. Utilizing stock options would cause executives to concentrate their efforts on trying to increase the stock price. In order to achieve this, executives would be forced to consider ways in which to increase company performance, so that a favourable earnings per share (a common measure of firm performance) would be reported. If the earnings per share (EPS) exceeds analyst’s expectations, then according to the markets, stock prices will rise, while a lower than expected EPS would decrease stock prices. Thus, awarding stock options can be seen as an incentive for executives to boost company performance.

**Lower Costs for the Employer**

With the advance of technology and globalization, the business environment experienced a large increase in the number of competitors. Due to this, management was driven to provide higher wages and increased bonuses (in cash and/or shares), in order to retain their employees and executives in a market where demand outweighed the supply of experienced and qualified professionals. Furthermore, as the wages increased, so did

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*Source: Paraphrased from Professor Alan Huang.*
all of the employer contributions⁸. However, through the introduction of stock options as a compensation method, management can effectively decrease a lot of these rising costs.

The first way costs decrease as a result of stock options is reduced employer contributions. As a trade-off to receiving stock options, executives are willing to accept lower wages and bonuses⁹. This effectively decreases employer contributions as the amount paid is relative to wages. Furthermore, the issuance of stock options does not create any additional employer contributions, as stock options do not represent wages being paid on the part of management¹⁰. Therefore, there are no rules requiring employers to calculate and pay any amounts in contributions relative to the value of the stock options.

Additionally, the issuance of stock options allows the firm to benefit from tax savings in the future. If a non-qualified stock option plan is used (which happens to be the predominant form of options¹¹), then the company is qualified to recognize tax savings equal to the amount of the income recognized when the options are exercised¹².

Along with paying less in contributions and incurring tax savings, awarding stock options could create the possibility of less cash outflows than expected. In the future, should stock prices fall lower than the exercise price, the options would not be exercised, resulting in the cash flows to remain unchanged¹³. Likewise, the cash outflows (to the company) resulting from exercising the options could be less than what was recognized in expense. In essence, this can be seen as lowering the “actual” costs for the employer as there would be less cash outflow, if at all. The following example will illustrate this concept:

<table>
<thead>
<tr>
<th>Company</th>
<th>Method of Compensation</th>
<th>Amount of Compensation</th>
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</thead>
<tbody>
<tr>
<td>A</td>
<td>Salary</td>
<td>$100,000</td>
</tr>
<tr>
<td>B</td>
<td>Stock Options (valued at $5 using the Black-Scholes model)*</td>
<td>20,000 options * $5 = $100,000</td>
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* The vesting period for the stock options are 1 year
** Assume both companies have a starting cash balance of $200,000, and for the next two years there are no cash inflows.

In the first year, both companies report a compensation expense of $100,000. However, company A incurs cash out-flows while company B remains unchanged. Company A should expect to incur cash out-flows once the options vest. If, however, after a year the price falls lower than the exercise price, executives would not exercise the options. Assuming there are no other cash outflows, this would mean company B’s cash flows would remain at $200,000, while company A’s cash flows would now be $100,000.

In addition, consider the scenario where the stock price is higher than exercise price (by $3). Assuming all options are exercised, net cash outflow would be $60,000. This results in company B holding cash flows of $140,000 (still higher than company A). Thus, this shows that a company awarding stock options could essentially lower their “actual” costs of compensation.

**Stock Options as a Better Vehicle for Performance over Restricted Stock**

According to recent surveysiii, companies are gradually phasing out the use of stock options and phasing in restricted stock as a method of compensation. However, currently there is a major argument that argues for the benefits of using stock options over restricted stock.

The argument supporting stock options is that they provide a larger incentive for executives to perform well. Since restricted stock can essentially be considered as an

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option with a zero strike, any transfer of compensation methods (to utilize restricted stock rather than stock options) would effectively transfer the burden of risk as well. When stock options are utilized, it is the executive’s responsibility to ensure prices rise above strike price in order for their options to be of any value. In this situation, it can be seen that the executives hold the burden of the risk as they would not want their options to become valueless. On the other hand, when using restricted stock, executives would have far lower incentives to boost stock prices as no matter what they do, their shares will have value. Since executives would then hold an equal stake in the company as other shareholders, the burden of risk can be seen as being transferred to the shareholders. Hence, with this dilution of risk, executives would not see the need to boost performance as they would have if they held stock options.

Stock Options as an Effective Tool for Start-Up & Risky Firms

Finally, stock options would be an optimal compensation tool to utilize for certain types of firms. First, firms in risky industries, such as biotechnology, would benefit far more from using stock options rather than other compensation methods. The reason is that risky firms face either periods of success or failure, and in order to be successful executives need to hold large incentives to push stock prices upwards (to offset failure). Second, start-up firms would be particularly inclined to use stock options as an effective compensation tool. As start-up firms are generally faced with liquidity concerns, they may not have the necessary cash to afford qualified executives (in terms of salary), who

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\(^{iv}\) Holders of restricted stock are entitled to owning the stock after vesting period. This means as long as the price is above $0, their stock will always have value (paraphrased from Professor Alan Huang). Options, on the other hand, entitle the owner to buy shares at the strike price and sell at the market price. This would mean their shares would only have value if the market price remains above strike price.

Source: Paraphrased from Professor Alan Huang

\(^{v}\) Source: Paraphrased from Professor Alan Huang
would add great value to their company. By issuing stock options, the firm can attract well-performing executives confident in their abilities (as mentioned above in the section “Attracting & Retaining Quality Employees”).

Ethics Standpoint on Stock Options

When the NASDAQ index began its downward spiral in 2002, a great deal of confidence had been lost in the marketplace by investors. Soon changes were demanded in order to restore some confidence back into the markets. Part of these demands dealt with stock options. A growing body of ethicists have since outlined several unethical practices that executives could partake in sometime in the future (if they had not already done so) in order to realize the maximum possible value on their stock options.

Critics have often used the economics-based framework of agency theory to explain executive compensation and incentives. According to the theory, it is assumed that all parties are motivated by their own self-interests (both principal and agent, who are the shareholders and executives, respectively)\(^20\). These self-interests are to maximize the total utility of their personal wealth. Henceforth, this theory shall be assumed as the motivating factor of executives when discussing the unethical practices.

Compensation for Risk

It has often been argued that executives are consistently over-compensated. The reasoning behind this can be related to the economics theory of utility. The following analysis can be better explained through the use of a modified total utility graph:
According to the total utility graph, at point A, shareholders benefit from greater utility over executives as their portfolios are diversified. As a result of holding stock options and shares in the company, executive’s personal portfolios become undiversified, thus subjecting them to higher compensation risks. To offset this risk, executives demand a higher expected value of compensation. This can result in executives taking questionable actions in order to raise their stock option values (discussed in more detail in the subsequent sections). To compensate for these increased risks, management may provide compensation in the form of “deadweight costs”, where a larger number of stock options are offered. This would increase the total utility for the executives holding an undiversified portfolio, to a more appropriate level (based on the graph, the quantity consumed, in this case stock options, would increase to point B, while utility increases from point D to point C). Thus, it can be seen how this could lead to unethical conduct as
management would use this explanation to justify the large payouts to executives (both in the form of stock options and other forms of compensation as well)\textsuperscript{23}.

**Horizon Matching**

In order to minimize risks (due to under-diversification), executives may engage in risk-averse behaviours such as under-investing\textsuperscript{24}. Their primary goals may be to appreciate stock prices as fast as possible, rather than taking a long-term perspective. This would allow them to exercise their vested options earlier, thus reducing their risk. Under-investing would ensure desirable stock prices in the short term as there would be no adverse effects on the EPS. The following example portrays this effect:

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<tbody>
<tr>
<td>A</td>
<td>5,000,000</td>
<td>5,000,000</td>
<td>3,500,000</td>
<td>3,500,000</td>
<td>0.60</td>
<td>0.60</td>
</tr>
<tr>
<td>B</td>
<td>5,000,000</td>
<td>5,000,000</td>
<td>3,500,000</td>
<td>4,000,000</td>
<td>0.60</td>
<td>0.40</td>
</tr>
</tbody>
</table>

* # of shares outstanding in 2005 & 2006: 2,500,000
** Assumptions: aside from an investment into R&D (for company B), all other figures are constant between years 2005 and 2006

Based on the table above, if company B invests into R&D in 2006, their earnings per share would decrease by $0.20 to $0.40. As stated earlier, EPS is a measure of company performance, and any decreases in EPS may cause an adverse reaction by the markets, causing stock prices to decrease. Company A, on the other hand, chooses to avoid R&D expenditures, and in the process manages to retain its EPS of $0.60.

However, this sort of behaviour by executives leads to major conflicts of interest with shareholders. Shareholders, being the owners of the firm, are interested in the long-term performance (assuming they are focusing on the long-term). Through under-investing, executives are not considering the long-term growth of the company\textsuperscript{25}.

Realizing the potential conflicts of interest resulting from the issuance of stock options, management has traditionally resorted to using calendar-vesting stock options\textsuperscript{26}.
However, even calendar-vesting stock options\textsuperscript{vi} fail to truly motivate executives to focus on the long-term growth of the company. Though initially they force executives to take risks (in the form of long-term expenditures), once the stock prices have risen substantially (so that the stock options have considerable value), executives may begin curbing their risky ventures\textsuperscript{27}. Using a theoretical example, if an executive has 75% of his options vested, with 10% more vesting within 3 years, and the remainder vesting within 6 years, based on a cost-benefit analysis, the executive would be inclined to avoid potential profitable risky ventures.

\textit{Corporate Dividend Policy}

One downfall of stock options centres on the fact that they do not provide any protection from cash dividend payments\textsuperscript{28}. If a cash dividend payment is made, it would invariably lower the value of the stock option as well (as cash dividend payments depress stock prices\textsuperscript{29}). This creates further conflicts of interest, while shareholders would prefer constant dividend payments, executives would opt for changing their dividend policy so as to lower dividend payments. Based on empirical evidence, it has been shown that those corporations using stock options as a compensation method have in fact, changed their dividend policy to lower payments. As Lambert, Lanen, & Larcker indicate in their paper, “The empirical results indicate a statistically significant decrease in the level of corporate dividends relative to the expected level of dividends indicated by the Marsh-Merton dividend model.”\textsuperscript{30} A more recent study by Fenn, & Liang, showed further

\textsuperscript{vi} Under calendar-vesting stock options, portions of the stock options awarded vest in fixed dates. For instance, 20% of the options may vest 3 years from now, while 20% more vest 5 years from now. This may create incentives for executives to consider the long-term effects of their actions as some of their options may not vest until several years from when they were awarded.

evidence that as a result of utilizing stock options, there is a shift in corporate practices from issuing dividends to engaging in stock repurchases. Hence, it can be seen that stock options cause executives to revise their dividend policy so as to favour stock option holders rather than stockholders.

Timing of Stock Options

Since the value of stock options fluctuates with changes in stock prices, it eventually became apparent that this could cause potential problems with relation to firm news announcements. According to the rules of finance, when a company releases good news, it is often followed by a rise in stock prices. Hence, this could be seen as a vehicle for potential unethical behaviours using stock options. Based on an empirical study performed by Yermack, it was proven that stock options were in fact, awarded prior to releases of good news. Furthermore, according to the paper, the only way companies disclose the granting of stock option awards is in annual proxy statements, which are filed 3 months after fiscal year-end. Drawing from the discussion of information asymmetry (in the section “Attracting & Retaining Quality Employees”), this would isolate shareholders from holding the knowledge that stock options were granted, prior to the release of the news. Should there have been a timely disclosure of the granting of stock options, then, grounded on the Efficient Market Hypothesis, markets would have anticipated positive news and stock prices would have adjusted accordingly.

The major ethical dilemma arising from this quandary would center on the true incentives of using stock options in the first place. As already discussed, stock options as compensatory tools are meant to create adequate incentives for executives to engage in beneficial behaviours for the firm. However, if management is manipulating the timing of
awarding stock options, then it tears at the very fundamental principles of issuing them in the first place. Instead, it can be seen that executives in fact, have no incentive to drive up stock prices\(^{37}\), but instead rides on good fortune.

**Earnings Management**

Since accounting numbers relying heavily on estimates and discretion, yet another door way for manipulation exists via earnings management. Empirical evidence provided by Bergstresser, & Philippon, suggest that executives manipulated reported earnings through the use of accruals\(^{38}\). The paper found evidence showing that companies with CEOs holding larger amounts of stock-based incentives (ex. stock options), also engage in greater amounts of earnings management (via accruals)\(^{39}\). Furthermore, the research was extended to analyse executive activity in periods of high accruals. Based on the data, Bergstresser, & Philippon, found that in periods of high accruals there was not only a significant amount of options exercised by CEOs, but a large amount of shares sold as well (not limiting to CEOs)\(^{40}\). Hence, through the abundant use of accruals, executives may manipulate earnings for their personal benefit. A specific example of a manipulation in an accrual will be looked at in detail in the next section.

**Options-Pricing Model Manipulation**

One final unethical practice that has recently come into existence focuses on companies changing their methods of estimating option costs. As recent accounting guidelines have made it mandatory for firms to expense stock options, management has begun taking steps to minimize the reported costs\(^{41}\). Specifically, companies are re-evaluating the volatility of their stocks. Since the volatility estimate is part of the Black-Scholes model, and has an impact on option values, companies are currently lowering
their estimates in order to report lower option values and related costs (higher volatility estimates produce higher option values as the option has a greater chance of moving deep in-the-money)\textsuperscript{42}. In terms of figures, in the year 2004 alone around 200 companies reduced their volatility estimates by an approximate average of 17%. This had an effect of lowering options expense by $1.5 billion (or 23\%)\textsuperscript{43}. Secondly, companies are also engaging in early vesting. They are purposefully speeding up their vesting periods so as to lower their option values and related option costs\textsuperscript{44}.

The first issue of re-evaluating volatility estimates generates the ethical question of whether such changes are grounded on genuine market changes, or whether they are just a method of manipulating earnings. Research into current Canadian accounting methods reveals that the extent to which management has to disclose their estimates is limited to only, “\textit{A description of the method and significant assumptions used during the year to estimate the fair values of options…}” (Section 59-186, paragraph 3870.68, Guide to Canadian Financial Reporting - GCFR)\textsuperscript{vii}. Furthermore, section 3870 states that a company, “…\textit{may provide any supplemental information that it believes will be useful to investors and creditors…}” (Section 59-187 – GCFR)\textsuperscript{viii}. Finally, paragraph 3870.A3 of the GCFR states that within a range of estimates, “\textit{If one amount within the range is a better estimate than any other amount, that amount is used}.” If none of the amounts are better, an estimate either at the lower end or higher end can be used (depending on the specific estimate)\textsuperscript{ix}. Based on the rules, a company only needs to disclose any significant assumptions made, and the estimates. There are no requirements for explanations

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\textsuperscript{viii} \textit{Ibid.}
\textsuperscript{ix} \textit{Ibid.}
justifying the assumptions made. Neither are there any requirements to adequately justify the estimates used. Without these justification requirements, it is entirely up to management’s discretion whether they wish to disclose further details (under section 3870) or not. Hence, without sufficient disclosure requirements, management may manipulate estimates with minimum justification (enough to create credibility), if at all.

The inherent ethical issue with the acceleration of the options vesting period has to do with the fact that all incentives to executives become irrelevant. By minimizing vesting periods, executive’s incentives to increase stock prices may diminish as they would only focus on maintaining stock prices for the short-term (assuming the options are in-the-money). If, in the situation the options are valueless (not in-the-money), executives may engage in any of the stated unethical activities (ex. earnings management) to boost firm performance and stock prices for the short-term.

**Stock Options and Corporate Social Reporting**

In light of recent renewed interests in corporate social reporting (CSR), experts have begun analysing the relationships between long-term incentives and CSR. Before delving into the analysis, a summary of the research is provided.

Firstly, based on research conducted on Canadian firms by Mahoney & Thorn “sic”, there were positive relationships found between stock options and total CSR, and stock options and CSR strengths. Total CSR was defined as a combination of CSR strengths (ex. strong community involvement, positive union relations, etc.) and CSR weaknesses (ex. human rights violations, fines, etc.) As well, another paper by Mahoney & Thorn “sic”, shows negative relationships between long-term incentives and total CSR weaknesses.
Additional research conducted by Frye, Nelling, & Webb found that CEOs in socially responsible (SR) firms do not engage in more risk-taking behaviour as a result of being awarded stock options (however, a link was established for non-SR firms). As well, the research indicates a larger probability of CEO turnover in SR firms rather than non-SR firms. This probability was shown as relating to firm performance\textsuperscript{48}.

Taken in its entirety, it can be seen that long-term incentives do have a positive impact on CSR. Mahoney & Thorn’s “sic”, papers show empirical support for the idea that by issuing long-term incentives, companies can better align executive’s goals with the broader goals of stakeholders\textsuperscript{49} (since stakeholders are more interested in the long-term social performance over a company rather than simply profits). In addition, the negative relationship in relation to CSR weaknesses suggests that firms avoid taking risks that could potentially lead to adverse effects on the firm\textsuperscript{50}. Frye, Nelling, & Webb’s empirical research (mentioned above) provides empirical evidence of the prior point.

However, the research performed does create some issues. First off, the research indicates that executives do not engage in risk taking behaviour in order to avoid adverse consequences. However, based on the discussions throughout the paper, it has been shown that the primary objective of issuing stock options is to compel executives into taking risks so as to boost firm performance. Furthermore, firms may increasingly hide their unethical conduct (of avoiding risky projects with potentially positive returns) through the new excuse that the project may hold adverse social consequences.

Additionally, I believe the implications of this research are far less beneficial than it seems. The existing research only tied the CSR performance of a firm to the amount of stock options granted (hence the positive relation between stock options and CSR)\textsuperscript{51}. If
one looks only at the numbers, then it can be argued how stock options produce better CSR performance. Management of SR firms may use these numbers to justify awarding more stock options. However, in closer inspection, it can be seen that the argument being used by the researchers is simply a slight modification to the existing argument that stock options can have the impact of better financial performance. The research fails to address a more critical question which is, do stock options influence CSR?

The following example will clarify my apprehension towards using this research to justify awarding stock options. Imagine an unethical executive had to choose whether to apply to a SR firm or non-SR firm. He would, in essence, find both options equally appealing (Assuming the SR firm provides a higher salary equal to the non-SR firm’s lower salary and bonuses. It has been shown empirically that SR firms pay higher salaries and lower bonuses while non-SR firms pay lower salaries and higher bonuses\textsuperscript{52}). If both firms are equal in terms of corporate governance (for this example, I assume the extreme case of having low corporate governance), and if both firms award equal levels of stock-options, then the CEO would have no additional incentives to make ethical over unethical decisions. Only when SR firms evaluate their CSR performance and notice it falling will they become aware of the executives unethical actions. However, by this time it may be too late as the executive may have already exercised the options and realized the gains.

Though I have made a major assumption in the prior example that corporate governance was low, I was merely attempting to express my concern over simply using data to analyze stock options and CSR. In reality, it is assumed that corporate governance in today’s time is far greater and executive actions more regulated. However, that is another issue not meant for this paper.
Do Stock Options Entice Fraud?

A major question that remains to be answered has to do with the question whether stock options produce incentives to commit fraud. Johnson, Ryan, & Tian, use empirical evidence to show that in fact, stock options (both vested and unvested) do not create incentives for fraud\textsuperscript{53}. Their paper further goes on to suggest that the chances of committing fraud are more influenced by slowdowns in earnings growth and/or during industry downturns\textsuperscript{54}.

Although many researchers have argued that unethical actions may result from using stock options, the above paper has managed to show that in actuality, it is not stock options that produce fraud, but rather the use of unrestricted stock (as compensation) or the economic condition\textsuperscript{55}. The paper raises the observation that with such a large negative emphasis in the press about stock options, the results obtained prove rather surprising\textsuperscript{56}.

Suggestions

Based on my collective research into stock options, I propose a number of suggestions that I believe will enhance the handling and reporting of stock options.

My first suggestion revolves around the issue of stock options and CSR. Specifically, I address the research showing that executives do not engage in as much risk taking behaviour in SR firms. In the paper by Frye, Nelling, & Webb, risk is measured by assessing the volatility of stock returns. The volatility is controlled for factors including total assets, leverage, and growth opportunities (by including them as independent variables)\textsuperscript{57}. However, I believe the paper neglects to take into consideration other key factors such as economic conditions. Additionally, I believe the particular type of risk involved is currently ignored. For instance, an executive investing into R & D for health
products would be considered a good risk, while another executive investing into R & D for cigarettes would be considered a bad risk. I strongly feel a distinction has to be made in future papers of this nature, and any future research should measure only bad risk. Though it may be very costly, I suggest a longitudinal study where a sample of firms (representing SR and non-SR firms equally) are followed overtime. Each firm’s ventures should be analyzed to judge whether they would be categorized as good risk or bad risk. The results can be based on the number of good risks & bad risks (if at all) SR firms engage in compared to the number of good risks & bad risks non-SR firms engage in.

My second suggestion would be to modify existing disclosure rules. As argued above, I believe current disclosure rules are too lenient in terms of what management is required to report. Particularly, I believe companies should be required to disclose the exact reasoning behind all significant assumptions. Furthermore, I believe all estimates should be backed by in-depth justification. Sometime in the future, if costs are not greater than benefits, I believe auditors should utilize actuaries and audit the justifications for the assumptions and estimates.

Finally, my most important suggestion uses knowledge attained from reading Neil Brisley’s paper. In his paper, he argues using a new model for stock options called “progressive performance vesting.” These options vest based on the price of the stock. Essentially, the number of options that vest is proportional to the appreciation of stock prices. Using a similar principle, I propose a new model for stock options. Instead of attempting to show that stock options have a positive relationship with CSR, I believe a new model should be created that makes stock options dependent on CSR. Titled “social performance vesting”, the model would allow vesting to occur in proportion to CSR.
measures. This would truly motivate executives to engage in socially responsible activities.

I have not come across any existing research suggesting tying CSR measurements to vesting periods of stock options. For this reason, I have made my proposition above. I believe this form of stock option has the capability of solving a large number of the problems outlined by several ethicists throughout the past. By tying stock options to CSR measurements, executives will not only have the incentive to engage in socially responsible ventures, but also have the incentive to boost firm performance (so that they may realize a gain on their options through rising stock prices).

**Conclusion**

This paper was designed to address the current debate around stock options. The paper started with an in-depth discussion of the reasons they are supported and used by management. It then progressed into a discussion of the unethical arguments brought forth by a number of ethicists. Once both sides of the argument were established, the paper delved into some new research focused around finding connections between CSR and long-term incentives (including stock options). Finally, bringing the paper to a close, a final topic of whether stock options had the ability of enticing fraud was discussed, followed by suggestions. To summarize, I believe stock options are inherent in all firms and should continue being employed. However, I believe a new model, effectively labelled “social performance vesting”, should be utilized for all stock options (especially for firms that pride themselves of being socially responsible). I believe even non-SR firms could use this model to encourage their executives from behaving ethically.
Note: All examples used in this paper were heavily simplified and ignored any tax effects.

End Notes

2 James, K., Graskamp, E. March 2006. “WHY Stock Options STILL Make Sense”. *Financial Executive*. Morristown. Vol. 22, Iss. 2; pg. 45; 3 pgs
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