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Stock Options: The Backdating Issue

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Summary

Employee stock options are contracts giving employees the right to buy the company's common stock at a specified exercise price, at a specified time or during a specified period, and after a specified vesting period. The value of the option when granted lies in the prospect that the market price of the company's stock will increase by the time the option is exercised (used to purchase stock). At the grant date for the options, rather than selecting an exercise price based on the current market price for the stock, officials at some companies have selected a prior date with a lower market price; that is, they *backdated* stock options to an earlier grant date. If this backdating occurred *without public disclosure*, the recipient of the stock options received increased compensation in violation of Securities and Exchange Commission (SEC) regulations, generally accepted accounting rules, and tax laws. Some backdating is said to involve "sloppiness," not fraud. The backdating of stock options has imposed costs on shareholders, employees, bondholders, and taxpayers.

Approximately 200 companies are under federal investigation for backdating and/or have restated earnings. One study found that shareholders in 110 companies involved in the backdating scandal have lost at least $100 billion. A corporate official who has profited from undisclosed backdating of stock options may not be responsible or even knowledgeable of the backdating. "Nonqualified" stock options, which have no special tax criteria to meet, are the focus of the backdating controversy primarily because they can be granted in unlimited amounts.

The magnitude of stock option grants grew dramatically in the 1990s, subsequent to passage of the Omnibus Budget Reconciliation Act of 1993, a stock market boom, and revised accounting rules. Recent corporate disclosure changes have reduced the opportunities and rewards for backdating stock options. Empirical studies about backdating have been done by academics and investigative journalists.

Four recent regulatory actions may have reduced the backdating of stock options, but problems persist. On December 16, 2004, the Financial Accounting Standards Board issued new rules requiring companies to subtract the expense of options from their earnings. After August 29, 2002, the Sarbanes-Oxley Act required that companies notify the SEC within two business days after granting stock options. In 2003, the SEC required increased disclosure of stock option plans. The SEC issued enhanced option grant disclosure rules effective December 15, 2006. Corporate boards, corporate compensation committees, outside auditors, and the SEC are general protectors of investors' interests and are embodied in current backdating developments.

Policy options to further reduce backdating and other timing manipulation include changes in SEC regulations and a change in the tax law. Possible benefits of a policy option may be weighed against its administrative and compliance costs.

This report will be updated as issues develop, new legislation is introduced, or as otherwise warranted.

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Stock Options: The Backdating Issue

Introduction

Employee stock options are contracts giving employees (including officers), and sometimes directors and other service providers, the right to buy the company's common stock at a specified *exercise price* or *strike price* at a specified time or during a specified period after a specified vesting period. Options have most often been issued "at-the-money" (i.e., with an exercise price equal to the market price of the underlying stock at the date of grant) but may also be issued either "in-the-money" (i.e., with an exercise price below the market price of the underlying stock at the date of grant) or "out-of-the-money" (i.e., with an exercise price above the market price of the underlying stock at the date of grant). The intrinsic value of the option is the market value of the stock less the exercise price, which is only relevant if the stock option is issued in the money. The time value of the option when granted lies in the prospect that the market price of the company's stock will increase by the time the option is exercised (used to purchase stock); that is, its potential appreciation value. Setting a lower exercise price increases the value of the option.

At the grant date for the options, rather than selecting an exercise or strike price based on the current market price for the stock, officials at some companies have selected a prior date with a lower market price; that is, they *backdated* stock options to an earlier date. Thus, officials backdated the grant date of the option (e.g., on January 10 the company's officials decided to grant stock options as of January 5), which resulted in stock options being granted *in the money*.

If backdating occurred *without disclosure*, then the recipient of the stock options receives an increase in compensation at the expense of other shareholders when he exercises his options to purchase stock. Undisclosed backdating of stock options violates regulations of the Securities and Exchange Commission (SEC), accounting rules, and tax laws.

Failure to disclose backdating and recognize adverse tax and accounting consequences may result in 1) material errors in financial statements, fraud and other violations of securities law, including falsifying books and records; and misrepresenting financial filings to auditors — central concerns of the SEC (with respect to violations of civil law) and the Department of Justice (with respect to violations of criminal law); and 2) the loss of tax deductions and imposition of penalties and interest for failure to withhold and accurately report income and employment taxes — central concerns of the Internal Revenue Service (IRS).[1]

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[1] Eric Dash, "Dodging Taxes Is a New Stock Options Scheme," *New York Times*, Oct. 30, (continued...)

Backdating the grant date could be undertaken for innocent reasons (e.g., to provide equity for recently-hired employees when stock prices are volatile) that were undertaken in ignorance of the negative accounting and tax complications.[2] Backdating is not necessarily illegal. The SEC has resource constraints and thus is limited in the number of backdating cases that it can pursue. On January 12, 2007, Walter G. Ricciardi, a deputy director in the Enforcement Division of the SEC, stated that the SEC is currently investigating 130 stock-options cases and not all 130 cases will be prosecuted.[3] According to Stephen J. Crimmins, formerly of SEC's Enforcement Division and co-manager of its Trial Unit, as the SEC pursues the stock option cases,

> it will be particularly interesting to see how the government handles situations where individuals did not knowingly violate the law or deceptively cover up their activities, where individuals lacked an understanding of the accounting and tax rules involved in option grants, where they relied on in-house or outside professionals to alert them to potential compliance issues, and where problems stemmed from imprecision or outright sloppiness in tending to the formalities that drive the setting of grant dates.[4]

Approximately 200 companies are under federal investigation and/or have restated earnings.[5] According to a research firm, companies have taken charges totaling $5.3 billion against earnings for backdating, and at least 46 executives and directors have lost their positions.[6] An IRS official has stated that the Large and Mid-Sized Division was in the early stages of examining backdated stock option issues.[7] Two corporate officials have pleaded guilty in U.S. District Count to charges relating to backdating of stock options.[8] One academic study estimated that 29.2% of a sample of 7,774 companies (or 2,270 companies) manipulated the timing of

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[1] (...continued)
2006, p. 1.

[2] Although numerous empirical studies have found statistical support for the hypothesis that corporate executives and directors have benefitted from the undisclosed backdating of stock options, this does not prove that a particular corporate official was responsible or even knowledgeable of the backdating.

[3] Rachel McTague, "More Stock-Options Backdating Cases Expected in Near Future, SEC Official Says," *Daily Report for Executives*, no. 9, Jan. 16, 2007, p. A9.

[4] Stephen J. Crimmins, "Sorting Out the Cases Involving Backdating of Stock Option," Viewpoint in *Daily Tax Report*, no. 232, Dec. 4, 2006, p. J1.

[5] For a list and status of 138 of these companies (as of March 7, 2007), see the *Wall Street Journal* online site at [http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html]. This website also lists 58 officials of corporations with controversial past stock option grant practices. All of these officials were terminated or suspended; or decided to resign, retire, or step down.

[6] Dash, "Dodging Taxes Is a New Stock Options Scheme," p. 1.

[7] Joyce E. Cutler, "IRS Opens Preliminary Investigation into Stock Option Backdating Concerns," *Daily Tax Report*, no. 216, Nov. 8, 2006, p. G7.

[8] Paul Davies and Mark Maremont, "Sorin to Plead Guilty in Comverse Backdating Case," *Wall Street Journal*, vol. 248, no. 105, Nov. 2, 2006, p. A3.

option grants to top executives at some point between 1996 and 2005.[9] Another found that 460 firms out of 6,000 engaged in timing manipulation for 800 stock option grant events associated with 1,400 outside directors from 1996-2005.[10] Finally, an academic analysis found that the options backdating scandal reduced the value of the stock of 110 corporations by between $100 billion and $250 billion.[11]

While undisclosed backdating of stock options is the focus of this report and the most important type of timing manipulation, it should be noted that there are other forms of timing manipulation, which are discussed in **Appendix A**. In some cases when more than one form of timing manipulation occurs, it may be difficult to empirically separate the relative magnitude of the cost to the shareholders of these different forms of manipulation, including backdating.

In order to fully understand the backdating issue, this report covers the following topics: illustration of undisclosed backdating, types of stock options, growth of stock options in the 1990s, the extent of timing manipulation of options, the potential costs of backdating, key legislative and regulatory developments, gatekeepers, and potential policy options.

Illustration of Undisclosed Backdating

A hypothetical case of undisclosed backdating is shown in the following example, which demonstrates violations of laws and regulations. It should be emphasized that backdating can take a variety of forms, and in some cases an employee may not be aware that his stock options have been backdated.

Assume that ABC, Inc. is a publicly held corporation whose stock is selling for $50 a share on December 31, 1998. As a part of his compensation plan, ABC, Inc.'s chief executive officer (CEO) is granted options on that date to buy 10,000 shares of stock for $50 a share (at the money). But, without disclosure, the CEO knowingly selects a prior grant date of August 15, 1998, when the stock price was at its low for the year ($30). In other words, the grant date has been *backdated*, resulting in a reduced exercise price of $30. Because of backdating, in 1998, the CEO received an undisclosed gain on paper of $20 ($50 — $30) per share for a total of $200,000 ($20 X 10,000). This gain was not indicated in the financial statements of the corporation in 1998. Shareholders were unaware of the backdating, which occurred at their

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[9] Randall A. Heron and Erik Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?" Working Paper, College of Business, University of Iowa, p. 4. Available at [http://www.biz.uiowa.edu/faculty/elie/backdating.htm].

[10] Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer, "Lucky Directors," Working Paper, Harvard Law School, last revision: Dec. 2006, p. 31. Available at [http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/lucky_directors.pdf].

[11] Gennaro Bernile, Gregg Jarrell, and Howard Mulcahey, "The Effect of the Options Backdating Scandal on the Stock-Price Performance of 110 Accused Companies," Simon School Working Paper No. FR 06-10, Univ. of Rochester, Dec. 21, 2006, 18 p. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952524].

expense. This undisclosed gain is not consistent with the options agreement that the company filed with the SEC.

Assume that the vesting period is two years and any time over the next eight years he may exercise his options. On December 31, 2000, his options become vested; that is, he receives an unrestricted right to buy 10,000 shares of stock for $30 a share. Assume that on December 31, 2000, the stock price is $75. He decides to exercise his options. (He could have delayed exercising his options at any time until December 31, 2008). He pays ABC $300,000 ($30 X 10,000). He has an immediate gain of $450,000 ($45 X 10,000 shares) on paper. Assuming that these are nonqualified stock options,[12] in the year that the options are exercised (2000), the CEO owes taxes on the gain in value and ABC, Inc. deducts the $450,000 cost of these options. The CEO has the choice of selling some (or all) of his shares or delaying their sale with the hope that the price of the stock will rise further.

Types of Stock Options

The Internal Revenue Code (IRC) recognizes two fundamental types of options. One is "nonqualified" options, which have no special tax criteria to meet, but are taxed to the employee as wage income when their value can be unambiguously established (which IRS says is when they are no longer at risk of forfeiture and can be freely transferred).[13] They are deductible by the employer when the employee includes them in income (IRC Section 83). The other is called "statutory" or "qualified" options, which are accorded favorable tax treatment if they meet the IRC's strict qualifications (IRC Section 421-424). Qualified stock options are excluded from employment (payroll) taxes.

Nonqualified Stock Options

Nonqualified options may be granted in unlimited amounts; these are the options making the news as creating large fortunes for some officers and highly paid employees and are the focus of the backdating controversy. In addition to employees, these options may also be awarded to anyone "providing services" to the company, including members of the board of directors and even independent contractors. They are taxed when exercised and all restrictions on selling the stock have expired, based on the difference between the price paid for the stock and its market value at exercise. The company is allowed a deduction for the same amount in the year the employee includes it in income; that is, in the same year it is taxable to the recipient. They are subject to employment taxes also. Although taxes are postponed on nonqualified options until they are exercised, the deduction allowed the company is also postponed, so there is generally little if any tax advantage to these options. Since most of these options go to highly compensated individuals, whose marginal tax rates are approximately equal to the company's, the government probably suffers

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[12] Nonqualified options are defined in the next section of this report.

[13] Nonqualified options are not guaranteed; that is, they have no value if the company goes bankrupt.

little if any revenue loss. The justification for the postponement of taxes on the recipient and the deduction to the corporation is the uncertainty of their actual value; the tax rules follow the practical path of postponing tax until their value is realized, as is the case with capital gains.

Qualified Stock Options

Qualified (or "statutory") options include "incentive stock options," which are limited to $100,000 a year for any one employee, and "employee stock purchase plans," which are limited to $25,000 a year for any qualified employee. Employee stock purchase plans must be offered to all full-time employees with at least two years of service; incentive stock options may be confined to officers and highly paid employees. Qualified options are not taxed to the employee when granted or exercised (under the regular tax); tax is imposed only when the stock is sold. If the stock is held one year from purchase and two years from the granting of the option, the gain is taxed as long-term capital gain. The employer is not allowed a deduction for these options. However, if the stock is not held the required time, the employee is taxed at ordinary income tax rates and the employer is allowed a deduction. The value of incentive stock options is included in minimum taxable income in the year of exercise.[14]

Growth of Stock Options in the 1990s

The magnitude of stock option grants grew dramatically in the 1990s because of the passage of the Omnibus Budget Reconciliation Act of 1993, the stock market boom, and changes in accounting rules.

The Omnibus Budget Reconciliation Act of 1993

The Tax Reform Act of 1986 broadened the individual income tax base and lowered marginal tax rates. It can be argued that the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66) made two changes in the tax law that contributed to a substantial increase in the granting of stock options to corporate executives: higher marginal income tax rates and a deductibility cap of $1 million on applicable compensation.

Higher Marginal Individual Income Tax Rates. The Omnibus Budget Reconciliation Act of 1993 raised marginal individual income tax rates, which had a current maximum rate of 28%. The new maximum marginal tax rate was 39.6%. The stated reasons for raising marginal income tax rates were "to raise revenue to reduce the federal deficit, to improve tax equity, and to make the individual income tax system more progressive."[15] These higher marginal income tax rates gave an

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[14] A detailed description of qualified stock options is presented in **Appendix B**.

[15] U.S. Congress, House Committee on the Budget, *Omnibus Budget Reconciliation Act of 1993*, report to accompany H.R. 2264, 103rd Cong., 1st sess., H.Rept. 103-111, (Washington:
(continued...)

incentive to individuals to receive types of remuneration that would be taxed at a lower rate. Some returns on stock options are subject to the long-term capital gains rate. In addition, some individuals can defer redeeming stock options until their marginal tax rate declines. The importance of higher marginal tax rates was lessened, however, by the reductions in marginal rates during the Bush Administration — the highest marginal tax rate for 2006 is 35%.[16]

"Excessive Remuneration" — Section 162(m). The Omnibus Budget Reconciliation Act of 1993 established code section 162(m), titled "Certain Excessive Employee Remuneration," which applied to the CEO and the four highest compensated officers (other than the CEO) of a publicly held corporation. For each of these "covered employees," the publicly held corporation could only deduct, as an expense, the first $1 million of applicable remuneration. The reason for this change was that "the committee believes that excessive compensation will be reduced if the deduction for compensation ... paid to the top executives of publicly held corporations is limited to $1 million per year."[17] Exceptions to this $1 million in applicable remuneration include (1) "remuneration payable on commission basis" and (2) "other performance-based compensation." In order to qualify for this second exception, four conditions must be met:

- It is paid solely on account of the attainment of one or more performance goals.
- The performance goals are determined by a compensation committee of the board of directors of the taxpayer, which is comprised solely of two or more outside directors.
- The material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration.
- Before any payment of such remuneration, the compensation committee certifies that the performance goals and any other material terms were in fact satisfied.[18]

Undisclosed backdating of stock option grants in the money is not "disclosed to shareholders and approved by a majority of the vote in a separate shareholder vote before the payment of such remuneration"; hence, the third condition is not met.

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[15] (...continued)
GPO, 1993), p. 635.

[16] For historical data on individual income tax rates, see CRS Report RL30007, *Individual Income Tax Rates: 1989 through 2007*, by Gregg A. Esenwein.

[17] H.Rept. 103-111, p. 646.

[18] IRS Code Sec. 162(m), (4)(C).

Economic theory suggests that the $1 million cap on deductible compensation would increase the relative importance of performance-related compensation including stock options.[19] In retrospect, the provision appears to have made stock options relatively less expensive than base salaries, bonuses, or stock grants, which were subject to the cap.

With the backdating scandals as a catalyst, a number of policymakers have recently sought to examine some of the policy implications of the law. Charles Grassley, former Chairman of the Senate Finance Committee, has said

> companies have found it easy to get around the law. It has more holes than Swiss cheese. And it seems to have encouraged the options industry. These sophisticated folks are working with Swiss watch-like devices to game this Swiss cheese-like rule. I want to know what went wrong and consider whether it makes sense to make changes.[20]

SEC Chairman Christopher Cox testified that

> I well remember that the stated purpose [of the tax law] was to control the rate of growth in CEO pay. With complete hindsight, we can now all agree that this purpose was not achieved. Indeed, this tax law change deserves pride of place in the museum of unintended consequences.[21]

The Stock Market Boom of the 1990s

The substantial stock market advances of the 1990s provided a significant boost to the attraction of option awards. It could also be argued that because shareholders also benefitted from the market's gains, their inclination to criticize the growing size of executive option grants may have been reduced.[22]

Cost Accounting Rules for Certain Stock Options

Going into the 1990s, companies had the choice of recognizing the estimated value of stock options grants commonly awarded to executives and rank and file

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[19] A National Bureau of Economic Research (NBER) study found that section 162(m) had no significant effects on overall executive compensation because of the exemption from the cap of performance-based compensation, the ability to defer compensation, and the cap only applying to salaries of five executives. For these results, see Nancy L. Rose and Catherine Wolfram, "Regulating Executive Pay: Using the Tax Code to Influence CEO Compensation," NBER Working Paper 7842, Cambridge, Mass.: National Bureau of Economic Research, Aug. 2000, 47 p.

[20] "Grassley Takes Aim at Stock Options Backdating, Executive Pay," *Press Release from Senator Grassley's Office*, Sept. 6, 2006.

[21] "Testimony Concerning Options Backdating by Christopher Cox, Chairman, U.S. Securities and Exchange Commission Before the U.S. Senate Committee on Banking, Housing and Urban Affairs," Sept. 6, 2006.

[22] JoAnn S. Lublin and Scott Thurm, "Behind Soaring Executive Pay, Decades of Failed Restraints," *Wall Street Journal*, Oct. 12, 2006, p. A16.

workers as costs in their income statements or simply disclosing option grants in the footnotes to the financial statements, where they had no impact on reported earnings. Most opted to do so via the footnote disclosure. In 1991, the Financial Accounting Standards Board (FASB), the private sector entity that writes accounting rules, proposed that an estimated value of such stock options be a mandatory cost item in a firm's financial statements. But after vigorous corporate opposition, particularly from high tech industry firms, FASB opted not to adopt the proposal until 2004. Many have since argued that had the proposal been adopted earlier, firms might have been less generous in their executive option grant awards.[23]

The Extent of Timing Manipulation of Options

The literature on timing manipulation of stock option grants is extensive. Major empirical studies of timing manipulation other than backdating are summarized in **Appendix D**. These studies find strong statistical support for the hypothesis that some CEOs have arranged for their award of stock options to occur shortly before a positive public announcement by their company (springloading). Other studies have statistically verified the hypothesis that some executives controlled the flow of both positive and negative news around dates of scheduled grants of options. Another study found statistical support for the hypothesis that executives timed the repricing of stock options based on the release of corporate news.

This report focuses on the backdating of the grant date for stock options. The relevant literature, which is summarized in **Appendix C**, is divided between academic studies and empirical analyses in *The Wall Street Journal*. The first academic study was undertaken in 2004 by Professor Erik Lie, who found strong econometric evidence of extensive backdating. His subsequent work with Professor Randall A. Heron found that between January 1, 1996, and December 1, 2005, 29% of 7,774 companies engaged in timing manipulation (primarily backdating) in granting stock options to top executives. Other studies examined the role of outside directors and the effect of the options backdating scandal on stock-price performance of companies.

The Potential Costs of Backdating

Corporate executives appear to have profited handsomely from undisclosed backdating, although they may ultimately be faced with a number of costs related to

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[23] In 2004, FASB adopted a controversial accounting rule, FAS 123(R), which requires public companies to incorporate the estimated value of their option grants as a cost in their financial disclosures. For most firms, the requirement went into effect for fiscal years after June 15, 2005. One study found that after the accounting change, firms appear to have reduced their level of executive option grants, replacing them with other forms of compensation. Mary Carter, Luann Lynch, and A. Irem Tuna, "The Role of Accounting in the Design of CEO Equity Compensation," *The Accounting Review*, March 2007 (forthcoming).

such actions.[24] However, there is clear evidence of backdating's direct or indirect costs to specific entities, including shareholders, employees, bondholders, and taxpayers. This section describes such costs.

Costs to Shareholders

In general terms, the undisclosed backdating of stock options secretly transfers wealth from a company's shareholders to its option recipients, understating a company's expenses, and overstating net profits. When options are exercised, companies always receive less than what the shares are worth on the open market. Backdating increases this cost.

Costs from Earnings Hits. Firms where backdating is detected may have to adjust to the accounting shortfall by downward restatements of previous earnings disclosures. Public announcement that a restatement may be forthcoming usually has a strong negative effect on share prices. As mentioned in the introduction, an empirical study concluded that the options backdating scandal had reduced the value of the stock of 110 corporations by at least $100 billion.[25]

Costs of Reduced Executive Performance. By artificially lowering an option's exercise price, backdating can reduce some of a stock option's performance incentive effects on executives. Backdating the grant date of the options reduces the exercise price below the market price on the day of the award and gives an executive an immediate windfall. This means that over a certain share price range, there is no linkage between an executive's potential gain from an option award and the performance of the underlying stock.

Officials of firms involved in backdating probes may find that a significant amount of their time is diverted to probe-related matters, taking them away from more conventional corporate concerns. In more extreme circumstances, some corporate executives have been fired or forced to step down, introducing the prospect of corporate inefficiencies due to leadership discontinuities.

Costs from Delistings. Shareholders risk additional losses if the stock is delisted. Exchange bylaws call for the delisting of companies that fail to release required quarterly or annual financial disclosures on time. But due to internal option probes, it has been reported that nearly 50 firms with market capitalizations of $75 million or more had postponed their quarterly filings for the second quarter of 2006. By October of that year, it was reported that 54 firms had been told that they faced potential delistings for such delays. Three companies have had their stock delisted by Nasdaq for failing to publish audited financial reports on time due to problems

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[24] Corporate executives involved in undisclosed backdating of their stock options may lose their jobs, may have to pay substantial penalties for violating tax and securities laws, and also risk incarceration. In addition, these executives must bear high costs of litigation. The executives who have engaged in undisclosed backdating have violated SEC's disclosure rules, accounting rules, and tax laws.

[25] Bernile, Jarrell, and Mulcahey, "The Effect of the Options Backdating Scandal on the Stock-Price Performance of 110 Accused Companies," p. 11.

with backdating of options.[26] Delisting is usually followed by a sharp drop in associated share price, and delisted firms tend to face increased borrowing costs. If they migrate to another trading venue, it is generally a more marginal entity like the OTC Bulletin Board or the Pink Sheets, markets generally associated with low and volatile stock prices, and high trading costs.[27]

Costs from the Actions of Bondholders. Shareholders may experience financial losses due to bondholders demanding payments for breached indentures. Corporate bonds normally contain an indenture, a detailed contract between the issuer and the debt holders that requires the firm to file quarterly and annual reports with those holders at or around the same time it files with the SEC. This means that late filers, including many of the firms undergoing backdating probes, may be in technical default of their indentures. Historically, however, the convention has generally been that in such cases debt holders give the issuers adequate time to work things out. But there are reports that some bondholders, including hedge funds, have targeted a number of firms with delayed filings due to backdating concerns, and are either demanding immediate payment of the value of the debt or requiring the borrowers to pay substantial fees. For example, in the summer of 2006, Amkor Technology came close to missing the deadline for paying bondholders who had demanded repayment of more than $1.5 billion in debt. And during the same summer, the Sanmina-SCI Corporation asked its bondholders for an extension on the terms of its indenture, offering them financial concessions of $12.5 million.

Costs of Additional Taxes. Firms found to have been involved in abusive backdating may also incur additional tax expenses because the pay to their top five executives is not eligible for the same tax deductions that performance-based options are if the options they receive do not depend on a performance measure like an appreciation in the stock price after the option grant. Backdated options confer immediate paper profits and are not treated like performance-based options, making them ineligible for such deductions.

Costs of Probes, Fines, and Lawsuits. Firms that decide to conduct internal backdating probes can incur significant costs. In addition, the ongoing SEC, Department of Justice (DOJ), and IRS probes may result in certain firms facing significant fines.[28] A growing number of firms currently face backdating-based

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[26] Aaron Lucchetti and Pui-Wing Tam, "On the 'D' List: Big Stars Try to Avoid a Nasdaq Exit Amid Options Probes," *Wall Street Journal*, Oct. 17, 2006, p. C1.

[27] While New York Stock Exchange (NYSE) bylaws mandate a delisting when annual reports are not provided on time, the Nasdaq (where the vast majority of firms with backdating concerns are listed) can delist when there is a late quarterly report. A delisting also results in fiscal pain to the exchange since it is forced to forego the listing fees that the firms pay them. In 2006, companies listed on the Nasdaq paid an annual fee of $75,000 for the right, an amount that (pending regulatory approval) will rise to $95,000 in 2007.

[28] The general convention is that at the end of an internal probe, a firm is expected to provide its findings to federal prosecutors who use the information to determine whether to pursue the case further. Historically, providing such self-investigated findings has often resulted in federal agencies showing greater leniency in the punishment that they mete out

(continued...)

shareholder suits that allege either breach of fiduciary duty or violation of anti-fraud provisions of the U.S. Securities Exchange Act of 1934. The suits consume corporate resources in the form of legal expenses and may result in significant money judgments against the firms. Again, these are expended funds that cannot be reinvested in longer-term, potentially share-price- enhancing corporate growth or distributed as shareholder dividends.

Employees

Some employees may not be aware that their stock options have been backdated. Consequently, they may be liable "for unanticipated tax as well as interest and penalties."[29] Some companies distributed stock options to many levels of employees without disclosing to these employees (or the public) that their options had been backdated.[30] Some of these employees with gains on their incentive stock options (ISO) may have paid only capital gains taxes rather than regular income tax on the rise in value due to backdating. Now, these employees may owe the difference between the higher regular income tax and the capital gains tax, plus interest.[31] Furthermore, these employees may owe additional payroll taxes because backdating cancels an exemption from ISOs from payroll taxes. If an employee's stock options vested after December 2004, then-section 409A of the tax code applies, and tax is due when options vest rather than when they were exercised. Thus, these employees may also be liable for a 20% penalty and interest.[32]

Bondholders

A number of firms that have grappled with publicly disclosed backdating concerns have seen their debt trade at substantial discounts to par value, which can mean a loss in value for their debtholders. Bond raters may lower the debt ratings of firms that are confronting backdating problems. Lower rated debt raises the cost of corporate financing.

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[28] (...continued)
to offending firms. James Bandler and Kara Scannell, "Legal Aid: In Options Probes, Private Law Firms Play Crucial Role; As More than 130 Companies Come Under Scrutiny, Government Relies on Help; Questions about Fairness," *Wall Street Journal*, Oct. 28, 2006, p. A1.

[29] Anne Tergesen, " Those Options Could Cost You," *Business Week*, Oct. 2, 2006, p. 96.

[30] On Feb. 8, 2007, the IRS announced it will provide penalty and interest relief to workers who unwittingly exercised backdated and other mispriced stock options in 2006, but the compliance initiative does not extend to company executives or other insiders who benefitted most from the schemes. Internal Revenue Service, *IRS Offers Opportunity for Employers to Satisfy Tax Obligations of Rank-and-File Employees with 'Backdated' Stock Options*, IRS News Release, IR-2007-30, Feb. 8, 2007, p. 1.

[31] Tergesen, p. 96.

[32] Ibid.

Taxpayers

If recipients of backdated stock options underpay their taxes, then taxpayers in general lose. In order to raise a given amount of revenue, these other taxpayers must pay higher taxes. Some corporate executives have not reported the backdated basis price, and thus understated the realized gain on the sale of stock and underpaid their income tax. Some corporations involved in backdating have claimed deductions for executive remuneration above the $1 million limit that was not performance related. For qualified options, if some employees are able to illegally obtain additional compensation from backdating in the form of long-term capital gains, then tax revenue is lost because the marginal tax rate on long-term capital gains is below that on regular income. Also, taxpayers must cover the cost of litigation in prosecuting undisclosed backdating cases.

Key Legislative and Regulatory Developments

Several major legislative and regulatory developments may have reduced the use of options in the aggregate, and thus reduced options-related abuse, but they are not aimed at backdating per se.

American Jobs Creation Act of 2004 (Section 409A)

The American Jobs Creation Act of 2004 (P.L. 108-357) included new statutory requirements under Code Section 409A concerning deferred compensation, that is, the delay of the receipt of compensation and taxes on compensation to a future tax year. This section was included "in response to perceived abuses by executive employees in the recent wave of corporate scandals."[33] This section applies to amounts deferred in tax years that begin after December 31, 2004 and includes stock appreciation rights if the exercise price is less than the fair market value of the underlying stock on the date the stock appreciation rights are granted.[34] Section 409A generally provides that

> amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to substantial risk of forfeiture and not previously included in gross income, unless certain requirements are met.[35]

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[33] Joni L. Andrioff, "Deferred Compensation Revolution — Tough Transition to a Statutory System," *Taxes: The Tax Magazine,* vol. 83, no. 5, May 2005, p. 65.

[34] Ibid., p. 66.

[35] Internal Revenue Service, "Interim Guidance on the Application of Section 409A to Accelerated Payments to Satisfy Federal Conflict of Interest Requirements," *Internal Revenue Bulletin*, 2006-29, July 17, 2006, p. 1. Available at [http://www.irs.gov/irb/2006-29_IRB/ar11.html].

Thus, stock options, subject to 409 A, were included in income when they vested rather than when they were exercised. Consequently, Code Section 409A reduced the tax advantage of stock options, and presumably reduced the use of stock options.

FASB Rule for Expensing Stock Options

On December 16, 2004, the Financial Accounting Standards Board issued new rules [FAS 123(R)] requiring companies to subtract the expense of the estimated value of their option grants from their earnings as disclosed in their financial statements.[36] The requirement, which applies to the fiscal years beginning April 21, 2005, meant that firms can no longer choose between formally expensing the estimated value of their options grants or merely disclosing that value in footnotes. For many companies, especially the high tech firms that extensively issued options to their rank and file workers as well as their executives, the rule dramatically reduces their reported net earnings. In the rule's aftermath, grants of executive options are still quite substantial but the rule (in conjunction with other factors like the end of the 1990s stock market boom) has helped reduce the overall level of option awards.[37]

Sarbanes-Oxley Act: Stock Option Disclosure Reforms

Enacted in the wake of widespread accounting scandals at firms like Enron and WorldCom, the Sarbanes-Oxley Act of 2002 (SOX) contains a host of corporate governance and accounting regulatory reforms. Prior to SOX, firm insiders were required to disclose grants of stock options within 45 days of the end of a company's fiscal year. SOX requires that all insider transactions in a company's stock, including option grants, be disclosed within two business days. The requirement went into effect on August 29, 2002.

In a number of instances, this "fiscal year plus 45-day" reporting window may have given companies time to review their earlier stock price performance, identify the low point, and retroactively designate that date as the stock option grant date. After August 29, 2002, the Sarbanes-Oxley Act required that companies notify the SEC within two business days after granting stock options. This requirement reduced the frequency of backdating and the magnitude of the gains to executives from backdating. But many companies fail to file the required Form 4 within the two day period.[38]

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[36] Financial Accounting Standards Board, "FASB Issues Final Statement on Accounting for Share-Based Payment," *FASB News Release*, Dec. 16, 2004.

[37] Mary Ellen Carter, Luann Lynch, and A. Irem Tuna, "The Role of Accounting in the Design of CEO Equity Compensation," *The Accounting Review* (forthcoming).

[38] Erik Lie, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Sept. 6, 2006, p. 1.

SEC's 2003 Requirement of Approval of Compensation Plans

In 2003, the SEC approved changes to the listing standards of the New York Stock Exchange and the Nasdaq Stock Market that require shareholder approval of almost all equity-based compensation plans. Firms must disclose the material terms of their stock option plans, prior to obtaining shareholder approval for them. The required disclosures include the terms on which options will be granted, including whether the plan permits options to be granted with an exercise price that is below market value on the date of the grant.

SEC's 2006 Executive Compensation Disclosure Rules

While the aforementioned initiatives may have played a role in reducing the incidence of abusive backdating, a July 2006 SEC rule making, which went into effect in 2007, may have a salutary future effect in this area.[39] It consisted of a package of rules designed to enhance the transparency of proxy compensation disclosures for CEOs, chief financial officers (CFOs), the other three highest paid executive officers, and directors, the first such major reform since 1992. Passing no judgment on the practice's legality or illegality, the rules include provisions that require companies to disclose whether they are timing options grants to make them more lucrative to executives and other employees.[40]

The rules require companies to present, in tabular form, the stock price on the grant date, the grant date under accounting rules, the market price on the grant date if it is greater than the exercise price, and the date the compensation committee or full board granted the award if different than the grant date for accounting purposes. In a new section of the proxy, *Compensation Discussion and Analysis*, management must discuss material information such as the reasons a company selects particular grant dates for awards and the methods a company uses to set the terms of awards.

To provide investors with a better handle on firms' use of springloading (issuing options just before the release of good news, a practice which is not illegal per se), the rules also require management to answer questions such as:

- Does the company coordinate the timing of option grants to executives, including new executives, with the release of material nonpublic information?
- How does any such program fit in with granting options to employees more generally?
- What role did the compensation committee and executive officers play in such a plan? and

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[39] See CRS Report RS22583, *Executive Compensation: SEC Regulations and Congressional Proposals*, by Michael V. Seitzinger.

[40] These new rules are stated in 17 CFR Parts 228, 229, et al., pp. 53,158-53,166.

- Does a company plan to time, or has it timed, its release of material nonpublic information for the purpose of affecting the value of executive compensation?[41]

SEC officials have said that along with the aforementioned two-day option award reporting requirement ushered in by SOX, the new executive disclosure rules should inject more transparency into the option grant award process and should essentially eliminate "easy opportunities to get away with secretive options grants."[42] Agency officials and other observers have also indicated that largely due to the tightened option award window required by SOX, the opportunity for corporate officials to retroactively date option awards appears to have been all but eliminated.[43]

But several recent academic studies suggest that this sanguine view may be overstated and perhaps somewhat premature. The research found that although the incidence of backdating appears to have been greatly reduced, a relatively small but not insignificant level of option grant manipulation still persists, manipulation that likely includes backdating.[44]

Furthermore, critics argue that the new proxy tables do not include all stock options data because of two factors.[45] First , before FAS 123(R) took effect, over 900 companies accelerated the vesting of stock options to collectively erase about $8 billion of future stock option expenses from their books.[46] Second, in December 2006, the SEC changed a rule to allow corporations "to report the amount of stock options that vest per year rather than the total value of the options granted to an executive."[47]

Gatekeepers

A number of entities are commonly viewed as general protectors of investors' interests, a responsibility that arguably becomes more pronounced with the prospect

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[41] "SEC Votes to Adopt Changes to Disclosure Requirements Concerning Executive Compensation and Related Matters," SEC Press Release 2006-123, July 26, 2006.

[42] "Testimony Concerning Options Backdating by Christopher Cox, SEC Chairman, Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs," Sept. 6, 2006, p.1.

[43] For example, see "Options Backdating: The Enforcement Perspective," Speech by Linda Chatman Thomsen, Director, Division of Enforcement, SEC, Oct. 30, 2006.

[44] For example, see Lucien Bebchuk, Yaniv Grinstein, and Urs Peyer, "Lucky CEOs," Harvard Law School Working Paper, 2006. Available at [http://www.law.harvard.edu/faculty/bebchuk], and M.P. Narayanan, P. Seyhun, and Hasan Nejat, "The Dating Game: Do Managers Designate Option Grant Dates to Increase Their Compensation?" 2006. Available at [http://ssrn.com/abstract=896164].

[45] David Cho and Carrie Johnson, "Executive-Pay Summaries Conceal as They Reveal," *Washington Post*, Feb. 16, 2007, pp. D1, D2.

[46] Ibid., p. D2.

[47] Ibid.

of corporate misconduct such as abusive backdating. This section examines the roles of key "gatekeepers" — corporate boards, their compensation committees, outside auditors, and the SEC.

Corporate Boards and Compensation Committees

Among other things, corporate boards, particularly their non-managerial members known as outside directors, are responsible for upholding shareholders' interests vis-a-vis potentially self-serving executive behavior. This view is reflected in a number of statutory and regulatory rules, including requirements that only outside directors serve on board audit and compensation committees.

A corporate board generally possesses the ultimate authority for determining and overseeing the compensation of its key executives. A majority of the board may, however, broadly delegate that authority to board committees. Typically, such authority is delegated to the compensation committee which is responsible for (1) recommending compensation programs and pay levels for the CEO and other top executives; (2) approving employment agreements and other contracts with such executives; and (3) administering equity-based and other long-term incentive compensation plans, including option grants.

When a compensation committee recommends option-based compensation for company executives, the firm's board then adopts a stock option plan describing the basic terms of the plan. Option plans typically say that the options will have exercise prices close to the prevailing share price on either the day they are awarded or the preceding day.

In most cases, option plans are then submitted to the company's stockholders for approval as required by the exchange listing requirements discussed above. After approval of the plans, responsibility for overseeing the provision of option grant awards to specific individuals tends generally rests with compensation committees.

Corporate boards are thus integral to the option grant award process. And the centrality of this role — combined with the fact that historically CEOs have had significant influence in the selection of board members — has raised concerns over director complicity and oversight in the backdating scandals.[48]

To date, a number of directors have been sued in civil court. None has been indicted for actions related to backdating[49] but some of the directors of at least one

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[48] For example, SEC Commissioner Roel Campos has said that if the evidence was there, he would not be surprised to see a number of enforcement actions against non-managerial directors. "How to be an Effective Board Member," Speech before the HACR Program on Corporate Responsibility, Aug. 15, 2006.

[49] In 2006, news sources reported that a total of nine directors had lost their positions due to backdating-related concerns. See Chris Kraeuter, "More Execs Ousted As Options Scandal Widens, *Forbes online*, Oct. 12, 2006. Earlier on, some experts had observed that a number of the dismissals appeared to have at least in part been motivated by an attempt

(continued...)

company, Mercury Interactive, have reportedly received notices from the SEC informing them of potential civil actions against them.[50]

An examination of articles on various firms embroiled in options backdating reveals a wide spectrum of potential board involvement and non-involvement in improprieties involving backdating. For example, there have been reports of board members: 1) being duped by firm executives who manipulated the option grant dates; 2) giving executives blanket approval in the choice of their own option grant dates; and 3) being very much "out of the loop" with respect to the "nuts and bolts" responsibilities over options issuance (which could raise issues over the effectiveness of the board's oversight).

An exhaustive study of option grant awards to the outside directors of publicly traded firms between 1996 and 2005 found that a substantial number of directors have benefitted from suspiciously timed option grant awards, raising concerns over director involvement in backdating abuse. The study, by a group that included Lucien Bebchuk, director of the Harvard Law School Program on Corporate Governance, examined 29,000 option grants given to 1,400 outside directors and found that 9% (or approximately 800) were granted on the day of the lowest monthly share price. The likelihood of such a large percentage of grants occurring on monthly lows was so statistically improbable that the authors concluded that these "lucky grants" were evidence of deliberate and opportunistic timing.[51]

The authors' conclusion that the timing was generally deliberate in nature appears to have been buttressed by the finding that grant events were more likely to be "lucky" during months in which the difference between the median price and the lowest price was the greatest. The research also found that when the award dates for directors' grants coincided with those for the executives, especially the CEO, the director grants were more likely to be lucky. The study did not address key questions surrounding the backdating abuse such as who was responsible, who knew what, and the mindset of the parties involved.

Still, such findings raise fundamental concerns over the effectiveness of many outside directors as shareholder guardians vis-a-vis potentially self-dealing executives. The research also raises important corollary concerns about the adequacy of corporate governance structures and protocol. For example, the director grant

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[49] (...continued)
to send signals to the public that neither the board nor the compensation committee was complicit in the backdating and that corporate management was on top of the problem. Rochelle Garner and Andy Dunn, "McAfee Fires Executive; Sycamore Subpoenaed over Options," *The Seattle Times online,* May 31, 2006.

[50] Carolyn Said, "Being a Director Harder than it Used to Be: Tougher Laws, Longer Hours, Taking a Toll on Those who Serve on Corporate Boards," *San Francisco Chronicle online*, Sept. 17, 2006.

[51] Lucien Bebchuk, Yaniv Grinstein, and Urs Peyer, "Lucky Directors."

study also finds that firms lacking a majority of outside directors were more likely to award lucky grants to their board members.[52]

In another study, the same authors examined executive option grant awards issued by several thousand firms between 1996 and 2006 and found that lucky CEO grants were more apt to occur when a firm lacked a majority of outside directors. That research also determined that the longer a CEO's tenure, the greater the prospect of option manipulation, probably reflecting that executive influence over board composition and behavior may tend to grow over time.[53] Another study examined the firm characteristics that help influence the extent to which CEO's wield power and influence over their boards and compensation committees, and found evidence suggesting that weaker corporate governance tends to increase the likelihood that executive option grants will be backdated.[54]

Outside Auditors

To comply with U.S. securities laws, and to help ensure their financial accountability and to help identify weaknesses in their internal controls and systems, companies contract with independent accountants known as external auditors or outside accountants to conduct an audit of their financial statements, records, transactions, and operations. The most common kind of audit is a financial statement audit, which judges the reliability of the data in the financial report in light of generally accepted accounting principles.

As such, outside auditors are widely expected to serve a "watchdog" role over the integrity of a firm's internal accounting. Like the massive corporate financial reporting problems at firms like Enron and Worldcom that led to the Sarbanes-Oxley Act and major accounting regulatory reform, some of the abusive backdating appears to involve faulty financial disclosure.

To date, it appears that the preponderance of backdaters failed to make accurate disclosures, putting them in a position of potential non-compliance with GAAP.[55]

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[52] Ibid. (Since 2004, firms listed on the NYSE and NASDAQ have been required to have a majority of outside directors.)

[53] Lucien Bebchuk, Yaniv Grinstein, and Urs Peyer, "Lucky CEOs," Harvard Law School Working Paper, Nov. 2006. Available at [http://www.law.harvard.edu/faculty/bebchuk].

[54] Ibid.

[55] A related concern is that for some companies, abusive or inadvertent backdating could also be symptomatic of inadequate internal controls over accounting procedures. The controversial Section 404 of the Sarbanes Oxley Act of 2002 requires management to assess and publicly report on the effectiveness of a company's internal controls. The requirement has been particularly criticized by smaller publicly traded companies for its costs. See CRS Report RS22482, *Section 404 of the Sarbanes-Oxley Act of 2002 (Management Assessment of Internal Controls): Current Regulation and Congressional Concerns*, by Michael V. Seitzinger.

When such problems emerge, questions are invariably raised about the role played by the outside auditors.[56]

At this juncture, there is a wide range of speculation on the roles that outside auditors may have played in the corporate backdating misconduct. For example, one notion is that outside auditors should not have been expected to question the veracity of firm documents showing particular option grant dates. But a more critical perspective is that the auditors may have regarded options-based accounting reporting as a low-risk concern, approaching these concerns in a cursory and superficial way, at best, and taking companies' reporting at face value and expending little effort to confirm the documents' veracity, at worst.[57]

At this stage in the probes, no outside accountants have been implicated for their roles in corporate backdating. All the Big Four accounting firms, (KPMG LLP, PricewaterhouseCoopers LLP, Deloitte & Touche LLP, and Ernst & Young LLP) have corporate clients who have been implicated for backdating misconduct. But none of the auditors appears to have found any misconduct, although according to allegations of one firm that is suing Deloitte, the accounting firm gave its approval to a form of backdating.[58]

Research conducted by Eric Lie and Randall Heron found that among large and small accounting firms, PricewaterhouseCoopers and KPMG were associated with a lower percentage of stock option manipulation.[59] It also found little evidence that accounting firms actually promoted backdating to their audit clients, as some have alleged. The study also concluded that smaller auditors in contrast to larger ones were associated with a larger proportion of option grant award disclosures that were tardily filed, as well as unscheduled option grant awards,[60] which are more apt to lead to backdating.

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[56] Concerns that compromised outside accountant integrity may have contributed to the implosion of firms like WorldCom and Enron led to a number of provisions in the Sarbanes Oxley Act of 2002. Among other things, the provisions mandate that corporate audit committees: (1) be composed entirely of independent (non-management) directors, (2) receive information about accounting policies and problems directly from the outside auditor, (3) approve any consulting or non-audit services provided by the auditor to the corporation, and (4) include at least one director who qualifies as a "financial expert."

[57] Some observers claim that some accounting firms have admitted that historically, they have tended to take client firm options documents at "face value." See The Statement of Kurt Schacht Managing Director, Centre for Financial Market Integrity, Chartered Financial Analyst (CFA) Institute Committee on Senate Banking, Housing and Urban Affairs, Sept. 6, 2006.

[58] David Reilly, "Outside Audit Backdating Woes Beg the Question Of Auditors' Role," *Wall Street Journal*, June 23, 2006, p. C-1.

[59] Erik Lie, and Randy Heron, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?" Available at SSRN at [http://ssrn.com/abstract].

[60] Scheduled grant awards are awarded during the same time each year, in contrast to unscheduled awards.

The possibility that outside auditors may have been negligently complicit in the instances of abusive backdating has led to several actions. In the summer of 2006, the Public Company Accounting Oversight Board[61] (PCAOB) issued an unprecedented audit practice alert telling auditors that they must carefully scrutinize their clients' stock option practices. About the same time, the SEC accounting office asked accounting firms to identify errors by their public company clients that may have contributed to backdating, an initiative that would help the agency conduct its ongoing investigation of the matter.

One of the broad objectives of the Sarbanes-Oxley Act of 2002 was to help ensure that corporate audits are performed in an independent manner devoid of self-serving corporate bias. To date, the preponderance of the backdating being probed appears to have taken place before the enactment of the act. While many feel that the act's expedited option grant award reporting provision has virtually eliminated current backdating abuse, others are less convinced. And to the extent that this view proves credible, questions could be raised anew about the extent to which the act has led to greater auditing accountability in areas such as this.

Securities and Exchange Commission

As indicated earlier, along with the IRS and the DOJ, the SEC is currently involved in a number of backdating investigations. SEC officials have said that if Congress saw fit to provide it with additional resources for its work in this area, the funds would be put to good use.[62] The SEC faces the perennial challenge of marshaling adequate resources to deal with capital markets that continue to grow in both complexity and scope. Agency officials have said that they have sufficient resources to adequately pursue the backdating probes but acknowledge opportunity costs, meaning that other regulatory or enforcement endeavors will have to be sacrificed in order to shift resources to the backdating inquiries.[63]

The agency's investigators are reportedly combing corporate disclosures to identify patterns that suggest that executives consistently exercised their stock options at advantageous share prices, such as a monthly or quarterly low. When such cases trigger suspicions, the investigators may then request brokerage firm records and other documents from the firm to determine whether actual and reported exercise dates are consistent.[64]

At this early juncture in backdating probes, it is uncertain how widespread the abuse has been. Some predict that a relatively small number of firms will be sanctioned. But others are less sanguine about the pervasiveness of the abuse, citing

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[61] The PCAOB is a non-profit, private sector entity created by the Sarbanes-Oxley Act of 2002 to oversee the work of auditors.

[62] "U.S. Senator Richard Shelby Holds a Hearing on Stock Options Backdating, *The Political/Congressional Transcript Wire*, Sept. 8, 2006.

[63] Ibid.

[64] Eric Dash, "Dodging Taxes Is a New Wrinkle in the Stock Options Game," *New York Times*, Oct. 30, 2006, p. C-2.

the mounting number of firms that have discovered possible backdating irregularities, and Lie's finding that from 1996 and 2002, 29% of the sampled firms appear to have backdated or otherwise manipulated their option grants. And referencing what they perceive as problematic declines in SEC resources devoted to enforcement, they question the SEC's (and the DOJ's) ability to both adequately and comprehensively undertake the probes.[65]

Assuming that many firms are found to have engaged in backdating, some predict that the SEC and the DOJ may ultimately wind up pursuing a "manageable" number of deterrence-oriented enforcements — and ultimately institute what some call a "voluntary compliance protocol." For example, John Coffee, Jr., a law professor at Columbia University and director of its Center on Corporate Governance, speculates that

> after some deterrent prosecutions are brought ... I think you'll have to see the SEC and DOJ come up with voluntary compliance schemes under which companies can conduct an investigation, publish a report, make a confessional disclosure, install preventive controls and get immunity for doing that. Otherwise the DOJ will be doing these cases for a number of years."[66]

Late Filings. As indicated earlier, the longer option grant award disclosure deadlines that existed before SOX appear to have provided much greater opportunities for backdating. Along with other factors like the end of the bull market that began in the 1990s, SOX's tightened reporting requirements appear to have helped reduce backdating's incidence, giving some SEC officials a sense that the abuse is largely a thing of the past.

However, when grant award disclosures are filed late, greater opportunity exists for the retroactive falsification of grant dates. And in the post-SOX era, there is research that indicates the ongoing presence of a non-trivial level of late filings. For example, after examining several thousand filings, one study found that (despite an SEC website that should have simplified the filing process) 13% of the insider option grant award filings in 2005 were tardy.[67] This finding led the study's authors, who include Erik Lie, the author of the backdating study that helped alert the SEC to the

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[65] The agency has also been criticized for the fact that in FY2006 it brought 574 enforcement actions, which represents the lowest number since 2001and a nearly 9% decrease from FY2005. SEC officials largely attributed this to reversible short-term budgetary and human resource shortfalls. Some observers also note that the 128 agency enforcement actions involving financial disclosure and reporting declined by nearly 31% from FY2005 and are at their lowest point since 2001, which suggests that SOX has helped instill greater discipline in the way that firms evaluate their internal controls, resulting in fewer financial disclosure and reporting problems. Jack Ciesielski, "SEC Enforcement: Quality Or Quantity?" *The AAO Weblog Delivered by Newstex*, Nov. 6, 2006.

[66] Carolyn Said, "Backdating Issue Moves to Forefront," *San Francisco Chronicle*, July 22, 2006.

[67] Randall Heron and Erik Lie, "What Fraction of Stock Option Grants to Top Executives have Been Backdated or Manipulated?" *University of Iowa School of Business Working Paper*, July 2006. [http://www.biz.uiowa.edu/faculty/elie/Grants%207-14-2006.pdf.]

existence of the backdating abuse, to question whether the late filings reflect the existence of continued and widespread backdating.

Research by the proxy advisory firm Glass Lewis & Company, *The Backdating Scandal's Second Act?*, involved combing through hundreds of thousands of executive grant award disclosures between January 2004 to June 2006. In the end, the study found some 6,000 questionably timed stock-options grants to executives that had been tardily filed.[68]

Reflecting on the potential ramifications of their research, analysts at Glass Lewis observed that although they could not definitively ascertain the persistence of backdating from the study, they noted that "given the sheer number of delinquent filings, the supposed method of regulation that was going to close the door on backdating remains ajar...."[69] Additionally, the analysts said the study raised the prospect that "hundreds" of firms may have either knowingly or accidentally backdated awards after the 2002 changes.[70]

Since August 2002, the SEC has pursued enforcement actions against six delinquent filers, usually as part of larger investigations.[71] Noting that the lateness of the filings creates a greater opportunity for option grant abuse, Glass Lewis' researchers described the agency's enforcement as far too lax and thus lacking in significance as a meaningful deterrent to tardy submissions.[72]

In 2004, the SEC created a unit to pursue delinquent filers but, historically, enforcement against late filers appears to have been viewed as a low priority area with relatively little benefit relative to its costs. In response to the concerns raised by the Glass Lewis study, SEC officials spoke of their intent to continue to monitor whether backdating appears to be linked to delinquent Form 4 filings and to pursue enforcement actions where appropriate. Agency officials also emphasized that late Form 4 filings are most pronounced among smaller firms (with less stringent internal controls) compared to larger firms with market capitalizations of at least $750 million.[73]

The Question of the SEC's Alertness to Misconduct. As indicated earlier, the SEC's interest in the backdating misconduct appears to derive from the work of others, specifically research conducted by University of Iowa Professor Erik

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[68] As reported in: Therese Poletti, "Silicon Image Prompted to Review Stock Option Grants," *The San Jose Mercury News.com*, Oct. 31, 2006.

[69] Ibid.

[70] Emily Chasan, "Stock Option Backdating Scandal Could Grow," *Reuters*, Oct. 29, 2006.

[71] Emily Chasan, "US SEC Pursued Few Late Stock-Option Filing Issues," *Reuters*, Oct. 30, 2006.

[72] Tiffany Kary and Kaja Whitehouse, "Late Form 4s May Suggest Backdating Continued After SOX," *Dow Jones Newswires*, Oct. 31, 2006.

[73] Ibid, and Jessica Guynn, "Late Options Filings Proliferate Firm Says," *San Francisco Chronicle*, Oct. 31, 2006, p. D-1.

Lie. This would appear to be the third time in little more than a decade in which the agency relied on the "gumshoe" work of outsiders to learn of the existence of potentially widespread misconduct among entities that it regulates.

- A series of mid-1990s SEC enforcement actions and Nasdaq regulatory reforms stemmed from academic research that identified price rigging by some Nasdaq market makers.

- In 2003, New York Attorney General Spitzer announced that his office had discovered evidence that major mutual fund companies had been complicit in either illegal or unethical trading schemes, revelations that resulted in widespread probes, money settlements, and the SEC's adoption of a series of fund regulatory reforms.[74]

In the wake of the fund scandals, the SEC implemented a host of internal administrative reforms aimed at improving its alertness to misconduct. Still, when combined with current concerns over the possibility that the agency may face serious resource constraints this latest example of SEC reliance on investigations surfaced by others could be a potential area for oversight.

Potential Policy Options

Generally expressing their faith in the efficacy of existing regulations and laws (like SOX's two-day option grant reporting requirement) to curb abuse, various officials at federal agencies currently involved in the backdating probes, including the heads of the SEC and the IRS, question the need for additional measures at this point.[75] Yet, while it is almost universally agreed that backdating is no longer the kind of problem that it was several years ago, some research suggests it has been far from eliminated. Given these lingering concerns, this section describes a number of initiatives promoted as ways to help further stem backdating. Possible benefits of a policy option may be weighed against its administrative and compliance costs.

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[74] Prior to Sept. 2003, SEC staffers reportedly did not look for such fund trading abuses because agency officials tended to view other fund actions as higher risk concerns. Agency officials also reportedly believed that mutual funds had internal financial incentives to control frequent and potentially trading because it could lower their returns. But a 2005, Government Accountability Office (GAO) report concluded that SEC inspectors should have detected the market timing abuses before Sept. 2003, when regulators began an industry wide crackdown after New York Attorney General Eliot Spitzer exposed the violations. GAO Report-05313, *Mutual Fund Trading Abuses. Lessons Can be Learned From the SEC Not Having Detected Violations at an Earlier Stage*, April 2005.

[75] For example, see "The Testimony Concerning Options Backdating by Christopher Cox Chairman, SEC, Before the U.S. Senate Committee on Banking, Housing and Urban Affairs," Sept. 6, 2006.

Improve Enforcement of Timely Filing of Option Awards

Historically, the SEC has reportedly viewed enforcing tardily filed executive grant award disclosures as a low priority, low payoff exercise.[76] From 2001 to 2005, the agency reportedly brought 12 enforcement actions that included charges of late form 4 filings. Agency officials, however, say that it has a program that regularly reviews delinquent filers and brings actions where needed.[77] But late disclosures provide greater opportunities for backdating and critics argue that lax enforcement lowers deterrence, increasing the odds that firms may deliberately backdate.[78]

Require Same Day Filing of Option Grants

Claiming that backdating could be eliminated by requiring that stock options grants, including exercise prices, be filed electronically with the SEC on the day that they are granted, Professor Lie has argued for the agency to institute such reform.[79] While making the case for the change, he has emphasized that filing is already a simple process, that the forms can be filed online, and that some option grants are already filed on the same day.[80] In research that appears to lend some support to such reform, Professor Lie and co-researcher Randall Heron found that 7.0% of a large sample of grants filed within the two day requirement were backdated,[81] suggesting that the two day filing window has reduced but not totally eliminated the opportunity to backdate option grants.

Require Scheduling of Grants of Executive Stock Options

Compared to scheduled option grant awards, unscheduled grant awards give executives greater opportunity to take advantage of market vagaries, (or to time awards around the release of positive or negative corporate news). As a consequence, some observers propose that firms only be allowed to issue option grants on a regularly scheduled basis. One criticism of requiring only scheduled option grants is that it would unfairly tie the hands of firms who need to make unscheduled awards due to unexpected contingencies. From a jurisdictional standpoint, this kind of reform is the traditional province of corporate boards,

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[76] Emily Chasan, "US SEC Pursued Few Late Stock-Option Filing Issues."

[77] Tiffany Kary and Kaja Whitehouse, "Late Form 4s May Suggest Backdating Continued After SOX," Oct. 31, 2006, *Dow Jones Newswires online.*

[78] For example, see "Testimony of Erik Lie Associate Professor of Finance Henry B. Tippie College of Business University of Iowa Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs," Sept. 6, 2006.

[79] Erik Lie, Testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, Sept. 6, 2006, p. 6.

[80] Ibid.

[81] Heron and Lie, "What Fraction of Stock Option Grants to Top Executives have Been Backdated or Manipulated?" p. 3.

although some observers have suggested that the SEC might have authority to intervene in this area.[82]

Ban Equity-based Pay for Top Attorneys and Board Members

Some observers have proposed banning the use of equity-based compensation for corporate lawyers and directors. They argue that compared to conventional fixed compensation, equity-based pay is more apt to undermine the officials' roles as gatekeepers/protectors against executive misconduct like backdating. It would be unprecedented for a regulator like the SEC or an exchange in its capacity as an SRO to place limits on certain kinds of corporate pay. But employing similar arguments against compensating directors with equity-based pay, a number of firms are voluntarily deciding not to do so. For example, in October 2006, Campbell Soup announced that starting in 2007, it would stop issuing stock options as part of its directors' compensation. And in December 2006, IBM announced that beginning in 2007, as part of a companywide effort to reduce the reliance on the grants, it would stop granting stock options to its outside directors. Arguments against placing proscriptions on equity-based pay would, however, include the following: 1) there is little empirical evidence linking such the provision of such equity-based pay to improprieties on the part of corporate executives; and 2) there is research that has found a positive correlation between paying directors with stock options and certain measures of corporate financial performance.[83]

Increase Shareholder Roles in the Election of Board Members

In July 2003, the SEC proposed a rule that under certain conditions would have allowed public company shareholders with more than 5% of a company's voting securities to have their nominees for board membership included in a company's proxy materials.[84] This would enable large investors to formally nominate candidates for the board — a change from the current regime under which board members are almost always nominated by firm executives. A response to widespread concerns

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[82] For example, see John C. Coffee Jr., "The Dating Game," *The National Law Journal online*, Sept. 4, 2006.

[83] For example, see Eliezer M. Fich and Anil Shivdasani, "The Impact of Stock-Option Compensation for Outside Directors on Firm Value," *The Journal of Business*, vol. 78, 2005, pp. 2,229 — 2,254.

[84] "Proposed Rule: Security Holder Director Nominations, Release nos. 34-48626; IC-26206; FILE NO. S7-19-03, Securities and Exchange Commission," Oct. 17, 2003. [http://72.14.209.104/search?q=cache:S2ZazKrK5RIJ:www.sec.gov/rules/proposed/34-48626.htm+sec+and+security+holder+director+nominations&hl=en&ct=clnk&cd=2&gl=us]. At least one of two things would have had to have taken place in the previous year's board election to trigger the requirement: (1) 35% or more of shareholders voted to withhold support for at least one director at the company's annual meeting; or (2) a stockholder or a group of shareholders with at least 1% of the company's stock put a proposal on the proxy statement seeking the right to nominate a director, and the proposal was approved by a majority vote.

over the accountability of corporate directors after a number of corporate scandals, the proposal received the support of various observers, including some institutional investors who argued that the integrity of corporate boards would be enhanced by an expanded shareholder role in the director nomination process. Similarly, it could be argued that such a reform could result in boards being populated with a greater number of outside directors who are less beholden to management and better able to provide independent oversight and scrutiny of executive compensation practices and excesses, including backdating. It also could be argued that the research described earlier — that found that large numbers of outside large directors appear to have been the beneficiaries of options manipulation — provides additional support for such reform.

In August 2006, the United States Court of Appeals for the Second Circuit reached a decision in American Federation of State, County and Municipal Employees Pension Plan v. American International Group, Inc. This ruling was the appeal's courts response to an earlier petition by the American Federation of State, County and Municipal Employees (AFSCME) that the American International Group's (AIG) rejection of its effort to place a binding shareholder proposal in the company's proxy materials that would have changed its bylaws to facilitate shareholder nomination of directors be reversed. Historically, the SEC has allowed firms to exclude shareholder proposals from their proxies, as it did in this case. However, the Second Circuit found the SEC's policy in this area to be inconsistent and asked the agency to clarify it.

The SEC issued a press release saying that the commissioners would be responding to the court decision during an October 2006 meeting, which they did not do. Later, it issued a press release saying that the commissioners would be considering proposals for revisions to its earlier shareholder proxy access initiatives at a meeting on December 13, 2006, [85] which they also did not do.

Meanwhile, Representative Barney Frank, Chairman of the House Financial Services Committee, reportedly urged the SEC to promulgate a new policy that would be more accommodating to activist institutional investors like AFSMCE who are interested in gaining access to the proxy with respect to director nominations. Chairman Frank has suggested that Congress might need to intervene in this area if the SEC does not act.[86]

Eliminate the Cap on Deduction for Executive Pay

As previously indicated, in 1993, OBRA added Section 162(m) to the Internal Revenue Code, which limited a company's tax deduction on what it pays each of its top executives to $1 million, but exempted "performance-based" pay like stock options. In conjunction with other developments like the bull market of the 1990s and the pressure on firms to provide executive pay that better aligned executives' incentives with the interests of firm investors, OBRA is widely believed to have been

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[85] "Remarks Before the Willamette Securities Regulation Institute by SEC Commissioner Roel Campos," Oct. 19, 2006.

[86] Michael Brush, "The Coming Crackdown on CEOs," *MSNMoneyonline*, Dec. 30, 2006.

a factor in the rise in the use of stock options. Some have argued that rescinding OBRA, or limiting the kinds of exempt performance-based pay could help stem the use of stock options, thus limiting the supply of potentially backdatable stock options.[87] This kind of reform could, however, be criticized for being an exceptionally blunt approach that is only weakly connected to the basic machinery of backdating, raising questions about its ability to help stem the abuse. Moreover, a comprehensive look at OBRA's impact on CEO pay found that given the minimal impact that tax deductibility of executive compensation tends to have on firm profitability, the actual role that OBRA has played on the configuration of CEO pay "remains an open question."[88]

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[87] Senate Finance Chairman Max Baucus and ranking committee member Charles Grassley have both reportedly suggested that OBRA may have helped engender the current backdating problems, and have expressed their interest in possibly limiting it. Marie Leone, "Grassley Targets Backdating Advisors," *CFO.com*, Sept. 7, 2006.

[88] Nancy L. Rose, and Catherine Wolfram, "Has the 'Million-Dollar Cap' Affected CEO Pay?," *American Economic Review*, vol. 90, no. 2, May 2000, pp. 197-202.

Appendix A: Other Forms of Timing Manipulation

In addition to backdating, three other types of timing manipulation should be noted.[89] First, *spring-loading* and *bullet-dodging* concern the timing of option grants to coincide with public announcements by the issuing company.[90] *Spring-loading* occurs when stock options are issued in advance of a positive public announcement by the issuing company, which is expected to drive up the market value of the stock. Because the recipients of the stock options knew that the public announcement would be positive, but other investors did not, the recipients of the stock options received a "windfall" gain. *Bullet-dodging* is the reverse of spring-loading. Stock options are issued shortly after a negative public announcement by the company. Investors are surprised by the negative announcement, may overreact, and may temporarily reduce the market value of the stock, at which point the stock options are issued. Subsequently, if the price recovers, recipients of these stock options will have received a favorable exercise price. Spring-loading and bullet-dodging can also be applied to the timing of *option repricing*. When a company's stock price falls significantly below the exercise price of its stock options, some companies reprice the option's exercise price. The justification for repricing stock options is to restore their incentive effect.

Second, the *timing of corporate announcements* can be manipulated in relation to known dates for the granting of options. For example, a high tech firm could delay the announcement of a technological breakthrough until after the date of the granting of stock options.

Third, some executives have *changed the exercise date without disclosure* in order to reduce their tax liability.[91] By backdating the exercise date on their stock options to when the stock price was lower, executives can convert regular income into capital gains, which are taxed at a much lower marginal tax rate.[92]

In some cases more than one form of timing manipulation may occur, and it may be difficult to empirically separate the relative magnitude of these different forms of manipulation.

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[89] Whether or not the first two forms of timing manipulation are illegal has not been determined by the SEC or the federal courts.

[90] The SEC has not decided whether or not to pursue cases of spring-loading and bullet-dodging. Rachel McTague, "More Stock-Options Backdating Cases Expected in Near Future, SEC Officials Says," p. A9.

[91] Dash, "Dodging Taxes Is a New Stock Options Scheme," p. 1.

[92] Mark Maremont and Charles Forelle, "How Backdating Helped Executives Cut Their Taxes, *Wall Street Journal*, Dec. 12, 2006, pp. A1, A13.

Appendix B: Qualified Stock Options

Two types of stock options qualify for the special tax treatment provided in IRC Section 421: *incentive stock options* and *employee stock purchase plans*. Both types require that the recipient be an employee of the company (or its parent or subsidiary) from the time the option is granted until at least three months before the option is exercised. The option may cover stock in the company or its parent or subsidiary.

Both types of qualified stock options receive some tax benefit under current law. The employee recognizes no income (for regular tax purposes) when the options are granted or when they are exercised. Taxes (under the regular tax) are not imposed until the stock purchased by the employee is sold. If the stock is sold after it has been held for at least two years from the date the option was granted *and* one year from the date it was exercised, the difference between the market price of the stock when the option was exercised and the price for which it was sold is taxed at long-term capital gains rates. If the option price was less than 100% of the fair market value of the stock when it was granted, the difference between the exercise price and the market price (the discount) is taxed as ordinary income (when the stock is sold).

Companies generally receive no deduction for qualified stock options, so the tax advantage accrues to the employee, not the employer. Companies that would not be taxable anyway, such as start-up companies not yet profitable, would care little (if at all) about the tax deduction and would be expected to use this method of compensation. Many companies that are taxable grant qualified stock options, however, so these options must have some advantage that outweighs the tax cost. In some cases, the companies no doubt find that rewarding their employees with qualified stock options is worth the cost; in other cases, perhaps, the officers and employees who receive the options exercise special influence over the companies' compensation policies.

If the stock is not held for the required two years from the granting of the option and one year from its exercise, special rules apply. The employee is taxed at ordinary income tax rates instead of capital gains rates on the difference between the price paid for the stock and its market value either when the option was exercised or when the stock was sold, whichever is less. The company is then allowed a deduction just as if the employee's taxable gain were ordinary compensation paid in the year the stock is sold.

Imposing the alternative minimum tax on incentive stock options reduces their tax advantage; for persons paying the AMT, the tax treatment is similar to the regular tax treatment of nonqualified options.[93] In some cases, individuals have incurred a significant tax liability from exercising their incentive stock options but had not sold their stock before the price dramatically declined. The alternative minimum tax in combination with other rules could cause a large tax liability that could not be offset

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[93] For a description of the alternative minimum tax, see CRS Report RL30149, *The Alternative Minimum Tax for Individuals*, by Gregg A. Esenwein.

with an offsetting loss when the stock price fell.[94] On December 20, 2006, this "unfair" situation was solved by passage of the Tax Relief Act of 2006 (H.R. 6408), in Section 402.

Incentive Stock Options

Incentive stock options (IRC Section 422) must be granted in accordance with a written plan approved by the shareholders. The plan must designate the number of shares to be subject to the options and specify the classes of employees eligible to participate in the plan. The options must be exercised within 10 years from the grant date. The market value of the stock for any incentive stock options exercisable in any year is limited to $100,000 for any individual. This is the limit on the amount that receives favorable tax treatment, not on the amount that may be granted; options for stock exceeding $100,000 in market value are treated as nonqualifying options. There are additional restrictions for options granted to persons owning more than 10% of the outstanding stock. The value of incentive stock options is included in minimum taxable income in the year of exercise.

The tax code (IRC Section 422) states that "the option price is not less than the fair market value of the stock at the time such option is granted." But the code (IRC Section 422) also states the this requirement is met if there are "good faith efforts to value stock."

Employee Stock Purchase Plans

An employee stock purchase plan (IRC Section 423) must also be a written plan approved by the shareholders, but this type of plan must generally cover all full-time employees with at least two years of service (or all except highly compensated employees). It must exclude any employee who owns (or would own after exercising the options) 5% or more of the company's stock. The option price must be at least 85% of the fair market value of the stock either when the option is granted or when it is exercised, whichever is less. The options must be exercised within a limited time (no more than five years). The plan must not allow any employee to accrue rights to purchase more than $25,000 in stock in any year.

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[94] For a full explanation of this issue, see CRS Report RS20874, *Taxes and Incentive Stock Options*, by Jane G. Gravelle.

Appendix C: Literature about Backdating

Literature about backdating can be divided into academic studies and *Wall Street Journal* (*WSJ*) articles. The academic work provided the statistical verification of the hypothesis of backdating. Initially, the academic work did not specific any particular corporations involved in backdating. Articles in the *Wall Street Journal* named specific corporations that had backdated their stock options. Furthermore, these *WSJ* articles provided widespread publicity for the backdating issue to both the business community and the general public.

Academic Studies

Erik Lie. Professor Erik Lie, currently on the faculty of the University of Iowa, initially formulated the hypothesis that some companies, without disclosure, backdated dates for grants of options to times when prices of their stock were low.[95] Dr. Lie wrote an article titled "On the Timing of CEO Stock Options Awards," which included an empirical analysis supporting his backdating hypothesis, and sent a copy of this article to the SEC in 2004.[96] In May 2005, his article was published in *Management Science*. [97]

Dr. Lie indicates that "the board of directors of a company generally assigns the administration of the [stock option] grants of the stock option plan to the compensation committee."[98] Executives, however, may be able to influence the decisions of the committee because executives often propose parameters of stock option grants, executives often have close personal friendships with some committee members, and executives may influence the timing of compensation committee meetings.[99] Using a sample of almost 6,000 stock option grants to chief executive officers (CEOs) between 1981 and 1992, he conducted several statistical analyses and concluded "that the abnormal stock returns are negative before the award dates and positive afterward."[100] These findings were consistent with his hypothesis of backdating of stock options without disclosure. The publication of Dr. Lie's article led to SEC investigations of the timing of the granting of stock options by certain companies.

Heron and Lie (article). In their forthcoming article in the *Journal of Financial Economics* titled "Does Backdating Explain the Stock Price Patten Around Executive Stock Option Grants?," Professor Randall A. Heron and Professor Erik Lie examined the frequency of backdating of stock options since August 29, 2002, when

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[95] Steve Stecklow, "Options Study Becomes Required Reading," *Wall Street Journal*, May 30, 2006, p. B1.

[96] Ibid.

[97] Erik Lie, "On the Timing of CEO Stock Option Awards," *Management Science*, vol. 51, no. 5, May 2005, pp. 802-812.

[98] Ibid., p. 803.

[99] Ibid.

[100] Ibid., p. 810.

the Sarbanes-Oxley Act (P.L. 107-204)[101] mandated that the SEC change the reporting regulations for stock option grants.[102] Before the change, executives receiving stock options had up to 45 days after the end of the company's fiscal year to report them to the SEC.[103] After August 29, 2002, recipients of stock options must report them to the SEC within two business days of receiving the grant. One day after receiving this information, the SEC makes it public, and now firms with corporate websites are required to post this information on the day after they disclose it to the SEC. The authors stated that

> if backdating produced the abnormal return patterns around executive option grants, we hypothesize that the new reporting requirements should substantially dampen the abnormal return patterns that previously had been intensifying over time.[104]

Heron and Lie utilized a large sample of stock option grants to CEOs between August 29, 2002, and November 30, 2004, and compared this sample with a large sample from January 1, 2000, to August 28, 2002. The authors concluded that

> Overall, we find evidence suggesting that backdating is the major source of the abnormal stock return patterns around executive stock option grants. Our evidence further suggests that the new reporting requirements have greatly curbed backdating, but have not eliminated it. To eliminate backdating, it appears that the requirements need to be tightened further, such that grants have to be reported on the grant day or, at the latest, on the day thereafter. In addition, the SEC naturally has to enforce the requirements.[105]

Thus, the authors found that while the undisclosed backdating of stock options still occurs, it was far more prevalent before new reporting regulations took effect on August 29, 2002.

Heron and Lie (working paper). On July 14, 2006, Professor Randall A. Heron and Professor Erik Lie published a working paper based on a sample of 39,888 stock option grants of 7,774 companies to top executives, which were dated between January 1, 1996 and December 1, 2005.[106] (Top executives consisted of CEOs, Presidents, and Chairmen of the Board.) The authors estimated that before August 29, 2002, when the new two-day filing took effect, 23.0% of unscheduled, at the

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[101] The Sarbanes-Oxley Act was passed on July 30, 2002.

[102] Randall A. Heron and Erik Lie, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?," forthcoming in *Journal of Financial Economics*, pp. 2-3. This article is available at [http://www.issproxy.com/optionsbackdating/index.jsp].

[103] Ibid., p. 3.

[104] Ibid., p. 3.

[105] Ibid., p. 30.

[106] Heron and Lie, "What Fraction of Stock Option Grants to Top Executives Have Been Backdated or Manipulated?", Working Paper, College of Business, Univ. of Iowa, pp. 4-5.

money stock option grants were backdated.[107] But from August 29, 2002 through December 1, 2005, only an estimated 10.0% of this type of stock option grants were backdated.[108] The authors estimated that 29.2% of the 7,774 companies engaged in timing manipulation for stock option grants to top executives.[109]

Narayanan and Seyhun. In January 2005, Professors M.P. Narayanan and H. Nejat Seyhun published a University of Michigan working paper titled "Do Managers Influence Their Pay? Evidence from Stock Price Reversals around Executive Option Grants."[110] The authors tested their hypothesis that managers influence the grant date stock price for their stock options. They used a data base of 605,106 option grant filings by insiders between 1992 and 2002. The authors found that the abnormal stock return reversals on the grant date were consistent with the influence hypothesis. They found that "the market-adjusted return for the 90 days preceding the grant date is about — 3.6% and the return for the 90 days following the grant date is about 9.4%."[111] The authors concluded that the much smaller absolute value of the return before the grant date than after the grant date suggested that the firms were engaged in behavior that went beyond controlling the timing of the grants and the timing of corporate information disclosures.[112] The authors also advanced the hypothesis "that grant dates are set on a 'back-date' basis, that is in many cases, the lowest stock price during a window is picked as the grant date ex-post."[113] They found statistical evidence that was consistent with their backdating hypothesis.[114]

Narayanan, Schipani, and Seyhun. Professors M.P. Norayanan, Cindy A. Schipani, and H. Nejat Seyhun wrote an article titled "The Economic Impact of Backdating of Executive Stock Options," forthcoming in the *Michigan Law Review*.[115] They

> discuss four consequences of misdating that can adversely impact shareholder value: 1) Legal issues: There are legal consequences arising from backdating or forward-dating without complete disclosure. In addition, the ethical issues raised might have economic consequences as they undermine the investors' confidence in the top executives; 2) Tax issues: The tax treatment of in-the-money options with implications for both the company and its executives; 3) Corporate

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[107] Ibid., p. 13.

[108] Ibid.

[109] Ibid., p. 4.

[110] M.P. Narayanan and H. Nejat Seyhun, "Do Managers Influence Their Pay? Evidence from Stock Price Reversals around Executive Option Grants," Working Paper No. 927, Ross School of Business, University of Michigan, January 2005, 52 p.

[111] Ibid., p. 30.

[112] Ibid., p. 24.

[113] Ibid., p. 4.

[114] Ibid., pp. 25-27.

[115] M.P. Narayanan, Cindy A. Schipani, and H. Nejat Seyhun, "The Economic Impact of Backdating of Executive Stock Options, *Michigan Law Review*, forthcoming, available at SSRN: [http://ssrn.com/abstract=931889].

> disclosure issues: Disclosure of misdating practices can lead to restatement of earnings as the camouflaged pay is recognized as compensation expense. The reduced earnings can result in a downward reassessment of shareholder value; and 4) Incentive issues: Misdating amounts to stealth compensation. If this is done because executives have captured the compensation process, then the managers are being inefficiently compensated, resulting in incorrect incentives.[116]

The authors computed that the upper bound of the average benefit from potential backdating was $3 million for executives based on a sample of 39,864 option grants from 43 firms listed on a *Wall Street Journal* website.[117] In comparison, these firms experienced an average loss of $510 million in the value of their outstanding stock as a result of being implicated in backdating of stock options.[118]

Bebchuk, Grinstein, and Peyer (Lucky CEOs). Professors Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer, examined what they called "lucky" grants, which they defined at stock option grants given at the lowest price of the stock during the month.[119] They found that during the period 1996-2005, about 1,150 lucky grants to 850 CEOs (about 10% of all CEOs) and provided by about 720 firms (about 12% of all firms) involved opportunistic timing, primarily backdating.[120] The percentage of "lucky grants" declined from 15% before SOX to 8% after SOX.[121]

The authors identified links between the manipulation of the timing of granting stock options and business governance. The authors state that

> Lucky grants are more likely to occur when the firm lacks a majority of independent directors and when the CEO has longer tenure, both factors associated with greater CEO influence on the company's pay-setting and governance processes. Relatedly, we [the authors] find that CEOs receiving lucky grants also receive total compensation from other sources that is higher relative to peer firms, thus finding no evidence that extra gains from grant timing manipulation was used by firms as a substitute for other compensation forms.[122]

The authors also found links between the manipulation of the timing of stock options and the potential gains from this manipulation.

> Not only is manipulation more common in firms with higher stock price volatility, but it is also more likely to occur, for a given CEO and firm, in months in which the potential gain from it is higher relative to other times. Our analysis

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[116] Ibid., p. 4.

[117] Ibid., p. 40.

[118] Ibid., p. 48.

[119] Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer, "Lucky CEOs," Working Paper, Harvard Law School, Last revision: Nov. 16, 2006, 55 p. Available at [http://www.law.harvard.edu/faculty/bebchuk/].

[120] Ibid., p. 2.

[121] Ibid., p. 36.

[122] Ibid., p. 35.

> also highlights the existence of serial luck. Luck is persistent with CEOs more likely being lucky in their next grant when their prior grant was lucky.[123]

Finally, the authors concluded that "by providing estimates of the substantial incidence of lucky grants, firms, and CEOs in old economy firms, ... [their] analysis dispels the impression that grant manipulation is concentrated in new economy firms."[124]

Bebchuk, Grinstein, and Peyer (Lucky Directors). Professors Lucian Bebchuk, Yaniv Grinstein, and Urs Peyer analyzed whether or not outside directors received option grants involving opportunistic timing; that is, timing manipulation. Their sample consisted of "all grants given to directors of the about 6,000 public companies in the Thompson database during the decade of 1996-2005."[125] The authors found that 804 grant events during this period were due to opportunistic timing rather than mere luck, and 457 firms (7.1% of all firms) were involved.[126] The percentage of these lucky grant events was 35.7% before SOX and 25.4% after SOX.[127] An estimated 1,389 directors (or 4.6% of all directors) received one or more opportunistically timed grants.[128] Several statistical tests were consistent with the hypothesis that backdating played a significant role in opportunistic timing grants of options that benefitted directors.[129] The authors acknowledge that their methodology does not measure timing manipulation of stock options that occurred in "small look-back periods."[130] In contrast, some other studies measure all timing manipulation of options regardless of the time period. Furthermore, the authors state that their analysis "does not show what role, if any, outside directors played in the opportunistic timing of their own grants."[131]

Bernile, Jarrell, and Mulcahey. Professor Gennaro Bernile, Professor Gregg Jarrell, and Howard Mulcahey analyzed the effect of the options backdating scandal on the stock-price performance of 110 companies.[132] They examined the stock prices of 110 companies involved in the options backdating scandal that were named on a web page posted by *the Wall Street Journal.* The authors estimated that the cumulative abnormal return for these 110 companies over a period of 140 trading

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[123] Ibid, p. 36.

[124] Ibid., p. 36.

[125] Bebchuk, Grinstein, and Peyer, "Lucky Directors," p. 3.

[126] Ibid., pp. 15-16.

[127] Ibid., p. 15.

[128] Ibid., p. 16.

[129] Ibid., p. 19.

[130] Ibid., p. 7.

[131] Ibid., p. 8.

[132] Gennaro Bernile, Gregg Jarrell, and Howard Mulcahey, "The Effect of the Options Backdating Scandal on the Stock-Price Performance of 110 Accused Companies," Working Paper, Simon School at Univ. Of Rochester, Dec. 21, 2006, 18 p. Available at [http://papers.ssrn.com/sol3/papers.cfm?abstract_id=952524].

days was negative 25.86%, which equaled a loss in the value of stock of over $100 billion. These 140 trading days consisted of 60 days before and 80 days after the first company disclosure about option-backdating. For the period of May 16, 2005 through November 15, 2006 (100 trading days before and 380 trading days after Erik Lie's initial backdating article), the authors calculated a cumulative abnormal return for the companies of negative 54.14%, which equaled a loss in the value of stock of approximately $250 billion.

Wall Street Journal Articles

Dr. Lie's articles did not mention any company by name, but his hypothesis of backdating of stock options without disclosure was tested for five corporations by Charles Forelle and James Bandler in an article in *The Wall Street Journal* on March 18, 2006.[133] These authors examined the timing of stock option grants for five corporations. In each case, stock options were granted on dates when prices were extremely low. The authors concluded that the likelihood of this "happening by chance was extraordinarily remote."[134] For example, one CEO received six stock-option grants from 1995 to 2002, which occurred at dates when the stock price was unusually low.[135] The author found that the probability of these dates being selected by chance was around one in 300 billion.

On May 22, 2006, Charles Forelle and James Bankler wrote a second article in *The Wall Street Journal* concerning backdating of stock options without disclosure.[136] The authors identified five more companies "with highly improbable patterns of options grants."[137]

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[133] Charles Forelle and James Bandler, "The Perfect Payday; Some CEOs Reap Millions by Landing Stock Options When They Are Most Valuable; Luck — or Something Else?," *Wall Street Journal*, March 18, 2006, p. A1.

[134] Ibid.

[135] Ibid.

[136] Charles Forelle and James Bandler, "Matter of Timing: Five More Companies Show Questionable Options Pattern — Chip Industry's KLA-Tencor Among Firms with Grants before Stock-Price Jumps — A 20 Million-to-One Shot," May 22, 2006, p. A1.

[137] Ibid.

Appendix D: Literature about Other Types of Timing Manipulation

This appendix briefly summarizes several significant studies of other forms of the timing of stock options.

Yermack (Spring-Loading)

Professor David Yermack wrote the first article concerning the manipulation of the timing of stock options.[138] He formulated the hypothesis that some CEOs arranged for the award of the stock option to occur shortly before public announcements of positive information about their companies. This concept was later called spring-loading. In order to test his hypothesis, he used a sample of 620 stock option awards to CEOs of Fortune 500 companies between 1992 and 1994. At a 1% level of significance, he found that the average abnormal increase in option award value was $30,000 after 20 trading days and $48,900 after 50 trading days.[139]

Chauvin and Shenoy (Manipulation of Information Flow)

Professors Keith W. Chauvin and Catherine Shenoy analyzed abnormal stock price decreases prior to executive stock option grants.[140] They developed the hypothesis that executives cause bad news to be released prior to the time that options are granted in order to set the strike price of the options at a lower level. This negative information could be in the form of a formal public announcement, or else insiders "can put a more negative 'spin' on information than otherwise, speak 'off the record' to analysts, or strategically use rumor and innuendo to 'leak' information." The authors statistically analyzed a sample of 783 stock option grants from May 1991 to February 1994 issued to 209 CEOs and found "a significant stock price decrease prior to executive stock option grants."[141]

Aboody and Kasznik (Manipulation of Information Flow)

Professors David Aboody and Ron Kasznik investigated their hypothesis "that CEOs manage investors' expectations around fixed dates of scheduled awards for their stock options by delaying good news and rushing forward bad news.[142] The authors tested their hypothesis by using a sample of 2,039 stock option awards made

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[138] David Yermack, "Good Timing: CEO Stock Option Awards and Company News Announcements," *Journal of Finance*, vol. 52, no. 2, June 1997, pp. 449-476.

[139] Ibid., p. 458.

[140] Keith W. Chauvin and Catherine Shenoy, "Stock Price Decreases Prior to Executive Stock Option Grants," *Journal of Corporate Finance*, vol.7, no. 1, March 2001, pp. 53-76.

[141] Ibid., p. 74.

[142] David Aboody and Ron Kasznik, "CEO Stock Awards and the Timing of Corporate Voluntary Disclosures," *Journal of Accounting and Economics*, vol. 29, 2000, pp. 73-100.

between 1992 and 1996 to the CEOs of 572 firms."[143] The authors concluded that "overall, our findings provide evidence that CEOs of firms with scheduled awards make opportunistic voluntary disclosures that maximize their stock option compensation."[144]

Callaghan, Saly, and Subramaniam (Timing of Repricing)

Professors Sandra Renfro Callaghan, P. Jane Saly, and Chandra Subramaniam investigated the hypothesis that executive stock option repricings were systematically timed to coincide with favorable movements in the company's stock price.[145] If the exercise price of the stock options falls well below the market price of the stock, some executives maintain that the stock options should be repriced in order to "retain valued employees and to restore incentives."[146] The authors used a sample of 236 repricing of options for 166 companies from the period 1992 through 1997.[147] Their statistical analysis suggested that managers opportunistically timed repricings in conjunction with the release of corporate news.[148] Executives who anticipated favorable earnings reports repriced their option prior to the public announcement of the report. Conversely, executives who anticipated negative earnings reports repriced their options after the public release of earnings.

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[143] Ibid., pp. 73-74.

[144] Ibid., p. 98.

[145] Sandra Renfro Callaghan, P. Jane Saly, and Chandra Subramaniam, "The Timing of Option Repricing," *Journal of Finance*, vol. 59, no. 4, Aug. 2004, pp. 1,651-1,676.

[146] Ibid., p. 1,651.

[147] Ibid., p. 1,654.

[148] Ibid., p. 1,674.