



A L E R T

C O U N C I L R E S E A R C H S E R V I C E

Volume 11

No. 24

June 23, 2006

SPECIAL EDITION FOCUSING ON OPTION BACKDATING:

Recent revelations about companies backdating stock options have dominated the headlines and raised the ire of shareowners. This issue of the Alert focuses on this timely topic. Beth Young, consultant to the Council, wrote the memorandum contained in this Alert, which takes a comprehensive look at the issue of stock option backdating and addresses its potential consequences for companies, as well as what shareowners can and should do to respond.

Also attached to this issue is a Council comment letter to the SEC supplementing the previous comment letter submitted on the commission's proposed Executive Compensation and Related Party Disclosure rule. The June 21 letter asks that any new disclosure rules provide detailed information about the timing of stock option awards and urges the commission to step up enforcement in instances where it finds evidence of manipulation.

A shorter more general sample letter for members to send to the SEC to weigh in on the topic also is attached to this issue.

Stock Option Backdating—What Investors Need to Know

Beth M. Young
June 14, 2006

Over the past several months, investors have watched with dismay as dozens of companies—*The Wall Street Journal* pegs the total at 46 as of June 14, and many observers expect that number to grow—have come under civil and criminal investigation for backdating executive stock options or have begun internal reviews of the issue. Although academic studies had long noted suspiciously favorable patterns related to option granting, it was not until a 2005 study by Erik Lie and follow-up analysis by *The Wall Street Journal* earlier this year that regulators and investors began to entertain the notion that companies or executives might be choosing option grant dates on which the stock's price was lowest in order to maximize the options' value to the executives.

This unfolding scandal already has spurred action from investors and regulators. It has prompted Council members to seek additional information from portfolio companies, demand independent reviews of option granting practices, ask companies to reform their policies and, in a few instances, begin litigation. SEC Chairman Christopher Cox recently indicated that the Commission was considering changes to its proposed executive compensation disclosure reforms to ensure that investors have complete information about grant practices and any backdating.

This memorandum addresses three questions:

1. What is backdating and how did it happen?
2. What are the consequences of backdating for affected companies?
3. What steps can investors take to address backdating issues at portfolio companies?

WHAT IS BACKDATING AND HOW DID IT HAPPEN?

The term “backdating” is being used to describe a range of behavior related to the granting of stock options. The most culpable conduct encompassed within the term involves intentionally changing the date used to set an option’s exercise price to one on which the stock’s price was at a low. Because the backdating investigations are still ongoing, it is not clear how often such intentional misconduct took place. A few companies have already discovered evidence of intentional wrongdoing: **McAfee** fired its general counsel last month after finding irregularities relating to one of his option grants; **Vitesse Semiconductor** terminated its CEO, CFO and an executive vice president after suspending them on concerns over the “integrity of documents”; and a special board committee at **Mercury Interactive** found that the company’s former CEO “should be treated as having been terminated for cause” as a result of stock-option-related matters.

Although frauds involving insiders can be difficult to detect under any legal or disclosure regime, the staleness of insider transaction reporting until August 2002 clearly abetted intentional backdating. Before that time, when new SEC rules mandated by the Sarbanes-Oxley Act took effect, stock option grants were not reportable on Form 4 filings, which disclose transactions in an issuer’s securities by insiders. The first that investors learned of an option grant was in a Form 5 filing, a summary of all changes during the fiscal year, which was not due until 45 days after the fiscal year end. A grant in January of one year was thus not reportable until February of the following year, assuming a December 31 fiscal year-end. Compounding the delay was the fact that Form 5s were not filed electronically, so investors had to order a hard copy from a document retrieval service or inspect filings at the SEC’s offices in Washington, D.C.

This long delay before public disclosure of a grant meant that insiders had more time to watch stock price trends, identify the date on which the price was lowest and take the necessary steps to ensure that this date was used to establish the exercise price for the stock option, all before the terms of the grant (including the exercise price) were disclosed outside the company. Backdaters would have to worry about covering their trail internally, but not about the possibility that someone outside the company would notice the discrepancy between the exercise price disclosed in a filing and a lower price that appeared on the filing reporting the eventual exercise of the backdated option.

In addition to intentional backdating of the kind described above, backdating is also being used to refer to company actions and policies that had the effect of causing an option to be granted with an exercise price that was lower than it should have been under applicable rules. Press accounts and company filings indicate that sloppy documentation, delays involving the grant approval process and other undesirable practices may have caused the granting of options with exercise prices that were lower than the market price on the grant date.

Disclosures to date suggest that a major cause of inadvertent backdating was the misapplication of the accounting standard, APB 25, which governed stock options until 2005 when companies began having to expense all employee stock options. APB 25’s intrinsic value method, which was used by nearly all public companies, required companies to recognize compensation expense for stock options only if the exercise price of the option was less than the market price of the stock on the measurement date. Many investors have assumed that the measurement date was always the same as the grant date, but under the intrinsic value method that was not necessarily true. Instead, the measurement

date, which could not be earlier than the grant date, was the date on which the number of shares and exercise price were fixed. If a company incorrectly recorded the measurement date for an option grant, the exercise price could be lower than appropriate even absent any intentional wrongdoing.

An example, based on practices described by *Michaels Stores* and *Affiliated Computer Services*,¹ illustrates one way this could happen. Board committees sometimes use a written consent process, in which a document describing an action is circulated serially to committee members for their signatures, to take certain kinds of routine actions such as granting stock options. Under state law, the action is not deemed approved until the last director signs the consent.

If a written consent purports to approve an option grant and sets the exercise price at \$10, which is the market price on the date the consent is sent to the first director, but the last director does not sign the consent until later when the stock price is \$15, the price on the measurement date is \$15. As a result, the \$5 difference between the exercise price and the stock price on the measurement date constitutes compensation expense and the options are considered in-the-money. In the pre-expensing accounting regime, companies had a strong incentive to avoid recognizing this \$5 because it would reduce reported earnings. It remains to be seen whether companies and their auditors made honest mistakes applying accounting standards or if companies aggressively interpreted the standards in an effort to avoid recognizing compensation expense.

Administrative glitches, such as reallocation of grants made to a number of different employees from an authorized pool, are another possible cause of inadvertent backdating because they could delay the fixing of option terms and cause the measurement date to differ from the grant date. Misspecification of the measurement date could also occur in the new-hire context. Under APB 25, neither the grant date nor the measurement date could fall before the date on which someone becomes an employee of a company.² Specifying some earlier date, such as the date on which the executive accepts an offer of employment, as the grant and measurement date, could cause option exercise prices to be lower than they should be.

Finally, some discussions of backdating have also included the practice of timing option grants to take advantage of stock price moves expected as a result of not-yet-public company developments. For example, earlier this month a securities analyst accused *Cyberonics* of granting executive stock options during an evening board meeting the same day in 2004 that an FDA panel recommended approval of a medical device made by the company. The next day, *Cyberonics*' stock price rose by 78 percent. The SEC has begun an informal investigation. Although such timing—like backdating—gives executives windfalls and can undermine the effectiveness of options as a motivator of future performance, it has different legal and corporate governance implications for companies and is not addressed in this memorandum.

WHAT ARE THE CONSEQUENCES OF BACKDATING FOR AFFECTED COMPANIES?

Although granting in-the-money options does not itself violate any law—it may, however, violate the terms of a company's equity compensation plan—a finding that stock option backdating occurred at a company may trigger a raft of potentially serious accounting, legal and reputational problems. Regardless of whether backdating was intentional or inadvertent, financial statements must be adjusted to reflect compensation expense resulting from the difference between the stock price on the measurement date and the option's exercise date. If the impact of a misstatement is material—and the SEC has cautioned that misstatements that increase management compensation may be material even though they involve a “quantitatively small misstatement”³—the company will be required to restate

¹ See 10-Q filed by *Michaels Stores* on June 13, 2006; Form 12b-25 Notification of Late Filing filed by *Affiliated Computer Services, Inc.* on May 10, 2006.

² Pat McConnell et al., “Digging up Dinosaur Bones: 20 Frequently Asked Questions on Stock Option Backdating,” *Bear Stearns Equity Research & Tax Policy report* (May 25, 2006).

³ Staff Accounting Bulletin No. 99—Materiality (Aug. 12, 1999).

its financial statements. The process of sifting through data and restating financial statements can take so long that a company may be unable to make annual or quarterly filings on time; in extreme situations like the one Mercury Interactive faced, a company's shares can be delisted from the exchange on which they trade.

The most important tax consequence for companies of finding that options have been backdated relates to section 162(m) of the Internal Revenue Code, which permits companies to deduct compensation in excess of \$1,000,000 only if it is performance-based. At-the-money options—but not in-the-money options—are considered to be performance-based compensation. Reclassification of options from at the money to in the money could result in the loss of the tax deduction and liability for additional taxes, interest and possibly penalties.

Companies found to have engaged in option backdating could face several different kinds of legal liability. Companies and certain insiders may be liable for violations of the federal securities laws on the grounds that the companies' SEC filings contained material misrepresentations regarding option grants. Individual officers and directors—especially option grantees and compensation committee members—may be sued by shareowners derivatively on behalf of the corporation, asserting claims for breach of fiduciary duty and other claims arising under state law. Current compensation could even be affected by these cases: One group of litigants against **United Health Group** has asked the court to enjoin certain United Health executives from exercising outstanding stock options while the case is pending.

Finally, companies may suffer reputational harm if backdating is found to have occurred. Although intentional backdating attracts the most media attention and will likely create greater legal liability than inadvertent forms of backdating, backdating caused by inadequate internal controls will also raise red flags.

WHAT STEPS CAN INVESTORS TAKE TO ADDRESS BACKDATING ISSUES AT PORTFOLIO COMPANIES?

Investors may want to discuss option backdating with portfolio companies to reassure themselves that the companies are taking appropriate steps to address the issue and to understand better the companies' practices around stock option grants. Bear, Stearns has identified characteristics of companies that may present a higher risk of option backdating and thus should move to the top of the list for investor engagement. These traits include: allowing executives to choose their option grant dates, granting options many times each year, having a non-standard pattern of option grants from year to year, having internal controls weaknesses (though Bear, Stearns noted that many of the companies already targeted by regulators received unqualified Sarbanes-Oxley section 404 internal controls opinions), small size, short history as a public company, being a high-growth or highly-acquisitive company and having weak corporate governance.⁴

High on many investors' lists of concerns is whether backdating is still occurring. The most recent study by Professor Lie and Randall Heron, which focuses on company and overall stock price movements both before and after option grant dates, found a return pattern consistent with substantially reduced backdating after the SEC adopted the new Form 4 filing requirements in August 2002. Those grants that were not reported within the required two-day period, however, continued to be associated with return patterns more suggestive of backdating, and the magnitude of the return pattern was greater the longer the delay in reporting. Lie and Heron found that one-fifth of the grants during the study period from August 29, 2002, through November 30, 2004, were not reported within the two-day timeframe.⁵

⁴ Bear, Stearns report, *supra* note 2, at 12.

⁵ Erik Lie, "Backdating of Executive Stock Options (ESOs)," undated (available at www.biz.uiowa.edu/faculty/elie/backdating.htm); Erik Lie & Randall Heron, "Does Backdating Explain the Stock Price Pattern Around Executive Stock Option Grants?" (available at www.ssrn.com).

It may therefore be useful for investors to focus their engagement efforts on companies that disclose in their proxy statements that one or more Form 4s were not filed on time. Investors can ask these companies:

- Whether they have performed an analysis of past grants to determine if there is a pattern suggesting backdating;
- Whether options are granted on a fixed schedule and when that schedule was adopted;
- If there is no fixed schedule, how the frequency and dates of grants are determined, including the extent to which management participates in the decisions;
- Whether policies have been adopted to ensure future compliance with insider transaction reporting requirements; and
- What procedures are in place to ensure adequate documentation of actions related to stock option grants.

COUNCIL OF INSTITUTIONAL INVESTORS

Suite 500 • 888 17th Street, N.W. • Washington, D.C. 20006 • (202) 822-0800 • Fax (202) 822-0801 • www.cii.org

June 21, 2006

Nancy M. Morris
Secretary,
Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-9303

RE: File Number S7-03-06
Executive Compensation and Related Party Disclosure

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of more than 140 corporate, union, and public pension plans with more than \$3 trillion in assets. The Council requests that the Commission accept this letter as additional comment in response to the Commission's proposed Executive Compensation and Related Party Disclosure rule.

Recent reports regarding stock-option granting practices at some companies have raised significant concern for investors. Concerns center on two major topics: 1) the potential that some stock option grants have been backdated; and 2) the potential that companies may be purposely timing equity grants to take advantage of significant events or news releases that are likely to affect the market value of their stock. We believe the Commission should consider potential amendments to the proposed disclosure rule as well as other disclosures and actions in response to these issues.

The Council recognizes that backdating and grant-timing may not in all circumstances be illegal. However, we strongly believe these practices are inconsistent with the long-term interests of shareholders and obviously can have very significant potential legal ramifications. In each case, we believe these practices are akin to insider trading and very specific disclosures should be required to assist investors in monitoring the behavior of companies in this regard.

Accordingly, we request the Commission consider the following actions:

- 1) Amend the Executive Compensation and Related Party Disclosure rule proposal to provide the following:
 - a) A requirement that companies disclose whether they have adopted a comprehensive policy regarding equity grants. The required disclosure should include specific components of the policy, including grant-date timing, methodologies for establishing strike prices, the roles of responsible parties related to key steps in establishing and administering equity grants, and the basic procedures the company will use to ensure the equity grants are administered in compliance with the policy. The

Council believes this policy should address all equity grants to any employees, not just Section 16 officers, but any differences in the treatment of varying classes of employees should be clearly delineated.

- b) The date(s) in the preceding year in which the committee approved each equity grant, and the date the grant became effective. Any discrepancy between these dates should be fully explained. The Council continues to support the Commission's proposed disclosure of the grant date for stock or option awards in the Supplemental Annual Compensation Tables.
 - c) For each equity grant, a requirement that companies provide a brief explanation for the purpose of the award and the grant date of the award. We believe the Commission should require adequate disclosure such that investors will be able to clearly identify situations in which equity grants are made, even if only partially, for the purpose of timing specific events or news, whether specific to the company or otherwise.
- 2) Review current requirements and enforcement of disclosures related to equity grants made to Section 16 officers. The Council believes the provisions in the Sarbanes-Oxley Act that strengthened the reporting requirements under Section 16(a) of the Exchange Act have likely been an impediment to backdating practices since their implementation in August 2002. Under the new rules, reporting changes in beneficial ownership through a Form 4 filing, including receipt of a grant of stock options, must be done within two business days of receipt of the grant.

However, it appears that in some instances the Form 4 filings are not being made in a timely manner. According to a recent study,⁶ roughly one fifth of a sample of approximately 3,700 option grants between August 2002 and November 2004 violated the two-business-day reporting requirement. Moreover, the study indicated that those grants that were not reported in time were associated with return patterns suggestive of backdating, and the magnitude of the return pattern was greater the longer the delay in reporting. Thus, it appears that, if the two-day reporting requirement is not complied with, the beneficial impact of the requirement as it relates to inhibiting backdating is diminished.

The Council requests the Commission consider the following actions related to Form 4:

- a) Increased enforcement action and penalties for non-compliance with the current two-business-day filing requirement for Form 4.
- b) For each instance in which the filing requirement for Form 4 is violated, require disclosure in the company's proxy statement of the reason for the violation and the status of any action resulting from the violation.

In addition to improved disclosure related to equity granting policies and procedures noted above, the Council believes SEC enforcement action is a critical element of an appropriate response to the backdating scandal. The Council strongly supports the SEC's regulatory actions to date. We believe it is imperative that the Commission investigate fully all instances where there is evidence of backdating and take strong action against all participating parties, including board directors and legal counsel, in those circumstances where improper behavior is discovered. In cases where it is determined fraudulent or misrepresentative disclosures and financial statements occurred, we believe it is appropriate for

⁶ Does backdating explain the stock price pattern around executive stock option grants? Randall A. Heron, Kelley School of Business, Indiana University, and Erik Lie, Henry B. Tippie College of Business, University of Iowa. Paper is forthcoming in the Journal of Financial Economics. JEL classification: J33; M52 Keywords: Executive stock option grants; Backdating.

the Commission to seek to nullify the related grants or seek restitution of the gains associated with the grants.

Finally, the Council believes that the backdating controversy illustrates that the financial accounting and reporting for employee stock option grants is an area in which there is a high risk of intentional misapplication of the accounting requirements. The Council notes that those companies involved in the backdating controversy appear to have failed to comply with the rules-based exception contained in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25").

The Opinion 25 exception permitted companies for over 30 years to structure their option grants to understate compensation cost and inflate reporting earnings. Financial Accounting Standards Board Statement No. 123R, *Share-Based Payments* ("FAS 123R"), which became effective for most companies on January 1, 2006, replaced the Opinion 25 rules-based exception with a principles-based standard.

FAS 123R improves financial accounting and reporting of stock option grants by requiring that, consistent with the Council's corporate governance policies, all employee stock option grants be accounted for as compensation costs reducing reported earnings. The Council, however, is concerned that some preliminary evidence surrounding the adoption of Statement 123R appears to indicate that some companies may be intentionally understating certain inputs required by the standard in an effort to continue the Opinion 25 practice of understating compensation costs and inflating reported earnings.⁷ The Council believes that the benefits of Statement 123R will not be fully realized by investors unless and until the SEC closely monitors and rigorously enforces a high quality implementation of the standard's requirements.

The Council looks forward to continuing to work with the Commission to improve the quality of information investors receive about executive compensation.

Sincerely,



Ann Yerger
Executive Director

CC: The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban Affairs
The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs
The Honorable Michael G. Oxley, Chairman, Committee on Financial Services
The Honorable Barney Frank, Ranking Member, Committee on Financial Services

⁷ Jack T. Ciesielski, *The Accounting Analyst's Observer* (May 2, 2006), page 16 (indicating that 81% of companies examined had reduced their volatility input for measuring the cost of employee stock options in 2005).

DATE

Ms. Nancy M. Morris
Secretary
Securities & Exchange Commission
100 F Street, NE
Washington DC 20549-9303

Re: Executive Compensation and Related Party Disclosure, File Number S7-03-06

Dear Ms. Morris:

I am writing on behalf of COMPANY NAME to comment on the Securities & Exchange Commission's proposed executive compensation and related party disclosure rule in light of disturbing reports about stock options-granting practices at some companies.

Investors are concerned that some options grants have been backdated and that companies may have deliberately timed equity grants to take advantage of events or news releases that are likely to affect the market value of their stock. While not always illegal, these practices are akin to insider trading and are unfair to shareholders.

We urge the commission to enhance its proposed rulemaking on executive compensation to require companies to reveal whether they have a comprehensive policy regarding equity grants, including grant-date timing, and any role that executives have in the grant process. Companies should disclose whether stock options are granted on a predetermined schedule or on an ad-hoc basis. They also should disclose the date(s) in the preceding year on which the compensation committee approved each equity grant, and the date the grant became effective. Any discrepancy between these dates should be fully explained

It also is critical that the commission investigate diligently all instances where there is evidence of backdating, and take strong enforcement action against companies (and individuals) that have acted improperly. When disclosures and financial statements have been found to be fraudulent or misrepresentative, the commission should seek to nullify the grants or seek restitution of the compensation associated with the grants..

Sincerely,