Rivkah Lewin, Editor

Illegal Stock Options Timing: It's Your Move, SEC

Shareholders and institutional investors have long bemoaned the bloated pay packages of many of the executives who run the companies they co-own. Whether the enterprises are successful or underperforming, shareholders are by and large still not permitted to have a say in the amount of rewards granted to the officers who lead them.

It's estimated that thousands of executives have turned a blind eye to the dissatisfaction and have continued to reward themselves at the expense of shareholders, employees, and the public. As revealed in recent years, scores of corporate heads have manipulated the timing of their own stock option grants by "backdating" them, engaging in theft to gain greater rewards than directors have approved for them. In many, but not all cases, backdating is illegal and unethical.

In a 2006 research paper, Erik Lie, University of Iowa finance professor, and Randall A. Heron, finance professor at Indiana University, unveiled their findings that individuals at more than 2,000 public companies, or 29% of U.S. companies that give stock options to executives, have backdated their options at some point. "We have not identified clearly those 2,000 firms," Lie notes. "But based on the evidence out there, that's what we estimate in terms of the number of firms that have engaged in this behavior."

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The corporate crooks who loot their firms by backdating haul in hefty amounts of plunder. According to a 2006 study by M.P. Narayanan and H. Nejat Seyhun, University of Michigan finance professors, if an executive who received a grant of one million shares of a typical company's stock reported the grant 30 days late, he might have boosted the value of his reward 8%, thereby stealing $1.2 million of illegal booty from shareholders and employees. Recipients of options are supposed to report to the Securities & Exchange Commission (SEC) within two business days after the grant.

Revelations of Backdating Hurt

No wonder shareholders have been complaining. When the plundering comes to light, they lose many times more than the actual value of the ill-gotten gains. A follow-up study by Narayanan, Cindy A. Schipani, and Seyhun found that "The revelation of backdating results in an average loss to shareholders of about 8%. This translates to about $600 million per firm."

To illustrate how rampant the practice of backdating has been, the California Public Employees' Retirement System (CalPERS) discovered that as many as 69 companies in its equity portfolio have practiced backdating and are being investigated by the SEC. The value of the stock option grants at 19 of those companies totaled about $2.8 billion. Twenty-nine executives have departed from the 69 companies.

It's the duty of compensation committees to oversee executive rewards. Why have so many of them failed to wipe the fog off their spectacles? "Compensation committees are supposed to be representing the interests of shareowners, and there's not supposed to be any conflict of interest or 'old boy's networks,'" says CalPERS spokesperson Clark McKinley.

"We're not against pay for executives. If they have shown that they deserve more than their peers because of performance, then clearly they should get some incentive for that, but backdating and spring-loading, both of those practices go beyond that." McKinley makes the point that shareholders are owners of the companies that practice backdating. "That's our money that's being spent, and it's a kind of theft. Why should this money go into the pockets of these people when it's not related to their performance in the market?"

"In some of the situations where we've seen options backdated, we see executives who have already made enormous amounts of money from their stock options and yet have still found it necessary to tweak the grant dates of their options in order to make another $100,000 or another $400,000 or $500,000 from an option profit," observes Paul Hodgson, senior research associate at The Corporate Library, Portland, Maine. "It seems extraordinary to me that so much time and effort should be spent—when enormous wealth is being delivered anyway—on making sure that even more wealth is being delivered to an executive. It is pure greed."

How Options Timing Schemes Work

Just how do executives carry out their timing plots? They state on the Form 4 that they file with the SEC that they received stock options from their board of directors on a date prior to the one on which the board actually approved the reward—that is, if the stock price was lower before the board's decision.

The executives could then potentially exercise the option and obtain the stock at a lower price. If so, it seems that the auditors or compensation committees could have kept watch by routinely comparing the dates on the Form 4s to the dates on which the boards approved the rewards.

Another options timing game executives play is dubbed "forward-dating." If the stock price was falling before the board approved the reward, backdating wouldn't be profitable since the price might end up even lower after the grant date. If the stock price continues to fall, executives may record a date in the future as the grant date.

Then there's "spring-loading." When executives know they are going to release good news that will buoy the stock price, they set the grant date after the positive news, hoping to enrich the share price—and their options profits.

Post-SOX, Executives Still Reported Late

The Sarbanes-Oxley Act of 2002 (SOX), which became effective in August 2002, requires that executives file Form 4 to report stock option grants within two business days after the grants. Post-SOX, the number of companies that backdated dropped substantially (see Table 1). Yet when Narayanan and Seyhun analyzed more than 638,000 option grants that were given from 2002 to 2004, they found that, despite legal sanctions, about 10% of executives still filed more than a month late. The reporting lag did improve, however, from nearly 18 days in 2002 to about eight days in 2004.

The Auditors' Role

How did such widespread corporate corruption come to pass, considering that companies are audited and that compensation committees charged with overseeing executive rewards are in place? In defense of auditors, Frank Edelblut, CEO of Control Solutions, a New York City-based provider of internal audit and internal control advisory services, believes that in the late 1990s to 2002, when illegal or unethical stock options timing was rampant, "The auditors were under a lot of pressure. Audits were basically commodity products that were driving the consulting practices. They were trying to spend as little time as possible on that audit to make any money at all."

Still, Edelblut believes that auditors shouldn't have overlooked the stock options timing information: "I just think it's unconscionable that [the auditors] didn't catch them." He recalls a statement from a partner of a large accounting firm saying that they should have caught the backdating, but it was included in the footnotes to the financial statements, not in the actual financial statements, so they didn't spend much time looking at them.

Though stock options grants were only mentioned in the footnotes, Edelblut believes that auditors should have checked into them. "The investors are looking at the footnotes, so shouldn't the auditors as well?" he asks. "The footnotes are an integral part of the financial state-

Table 1 Unscheduled,* At-the-Money** Grants Backdated Pre- and Post-SOX

	Pre-SOX Grants		Post-SOX Grants	
	Number of Companies Audited	Percentage of Companies that Backdated (estimate)	Number of Companies Audited	Percentage of Companies that Backdated (estimate)
PricewaterhouseCoopers	833	17.4	1,128	3.7
Ernst & Young	1,022	19.5	1,444	9.9
Deloitte & Touche	579	23.7	882	10.9
KPMG	681	17.5	954	8.6
Other Auditors	284	20.4	819	13.2

Table information courtesy of Professor Randall A. Heron, Indiana University, and Professor Erik Lie, University of Iowa.

*A grant is scheduled if it is either (1) dated within one day of the one-year anniversary of a prior grant or (2) followed by a grant that is dated within one day of the one-year anniversary of the grant in question; otherwise it is unscheduled.

**The exercise price equals the price on the grant date.

ments; that's the way the accountants describe it. So how can they be an integral part and yet not as important? You can't have it both ways. They're either integral or not."

The auditors "rendered an opinion that said that they performed an audit in accordance with generally accepted auditing standards, and in fact those auditing standards failed to adequately validate essential components of the financial statements. So it seems that the retribution is up to a judge and the shareholders," Edelblut adds.

Shareholders in a given company "should determine if there was a failure in the audit, and, if there was, then you have to hold those guys accountable for that failure," he advises. "Quite frankly, I don't think that anybody in the accounting profession would disagree with that. If they failed in their duty to the shareholders, the company, and the public, then they, too, believe that they should be responsible and accountable for their actions. That's what they're getting paid for."

The Role of Compensation Committees

Then there are the compensation committees that are responsible for awarding stock options and ratifying related decisions. In cases where there have been admissions of malpractice by companies, "The decision-making process has been to bypass the compensation committees completely," Paul Hodgson says. "In other words, they have simply been asked to rubber-stamp decisions that have already been made by management." Hodgson believes that in situations where compensation committees have been bypassed or have looked on and allowed manipulation of stock options timing, "They have failed their duty."

If compensation committees don't

fulfill their duties to the shareholders and the public, how can they be held accountable? It's commonly thought that independence of directors is the solution. In 2003, the New York Stock Exchange (NYSE) and NASDAQ put into place Corporate Governance Rules requiring that companies listed on the exchanges "must have a majority of independent directors." This should have improved the situation since the rules describe hiring requirements to ensure independence.

But, in reality, directors elected to the board are selected by a nominating committee, which may include the CEO or chairman of the company, as well as sitting directors. If these directors "already have a cozy relationship with management, they are not going to be first in line to elect a truly independent director who would be in a brave enough position to be able to stand up to management and say, 'No, you can't do this, you can't have that,'" Hodgson says.

Sham Nominations and Elections

If corporate nominating committees typically nominate directors who will kowtow to them, what's the remedy? Shareholders are allowed to nominate candidates for director positions, but by and large the nominating process required by companies is so onerous that it discourages even shareholders with the most serious intentions. Running a proxy contest to nominate directors incurs costly legal fees and other expenses and is time-consuming. Though corporations allow shareholders to nominate and vote for directors, the elections are a sham. Shareholders and the public need the help of the SEC to make true shareholder nominations and elections for directors a reality.

Shareholders have been calling for true elections where director candidates would be elected by the majority of voters rather than by the predominant "plurality" standard. "Shareholders are typically permitted to vote on the slate of board candidates that the management has offered; that's it," says Kurt Schacht, executive director of the CFA Centre for Financial Market Integrity, based in Charlottesville, Va. "There's seldom a contest, and, under the plurality standard, if a director gets one vote and a million and a half other votes are withheld against that director, it doesn't matter—that director is elected with one vote."

Shareholders and the public need the SEC's help to make true nominations and elections for directors a reality.

The Ball Is in the SEC's Court

If the SEC is serious about putting an end to illegal and unethical stock options timing, it will act on the so-called "proxy access" or "shareholder access" proposals that it has been considering to make it easier for shareholders to nominate directors. Qualified shareholders "would actually be able to nominate their own directors to appear on the company's proxy statement, so it would be an honest-to-goodness contest between the company's nominee and the shareholders' nominee for a particular slot," Schacht says.

With so-called "shareholder access," shareholders wouldn't have to incur great expense. They would simply have the right to have their candidate appear on the company's proxy so the candidates would be side by side in a typical election. "For director slot A, there would be two candidates. Shareholders would have nominated one of them, and the management typically would have nominated the other," Schacht adds.

The CFA Centre has sent a letter to SEC Chairman Christopher Cox, urging him to revisit this issue in the coming year and requesting "that this debate be reexamined and reopened up so that all of the issues associated with shareholder access be reconsidered. Because we think it's important for investors to have a meaningful vote in the process of electing directors, not just sort of a superficial, symbolic marking of the box, and no matter what happens, the director [nominated by management] is elected," Schacht explains.

In SEC Commissioner Annette L. Nazareth's December 1, 2006, "Remarks Before the ABA Committee On Federal Regulation Of Securities," she said, "As you undoubtedly know, the Commission will soon consider a proposal which would set the ground rules for shareholder access to corporate proxy ballots. The Commission last considered this issue in 2003, when it proposed rules that, once certain threshold requirements were met, would allow shareholders to use the issuer's proxy materials to place nominees on the ballot for the company's board of directors."

Will the SEC seize the opportunity to transform this aspect of the U.S. corporate environment from one that tolerates theft and corruption to one that is honorable and principled? They will certainly deserve kudos if they do. ■