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All You Wanted To Know About Back Dating Of Options But Were Afraid To Ask

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The Story Is Just Starting To Unfold

It seems as though every time you pick up the *Wall Street Journal* or *New York Times* another company is being investigated by the Securities and Exchange Commission (SEC) or is commencing its own internal investigation regarding the back dating of stock options. The most recent tally indicated that over 60 public companies are now being investigated for backdating or otherwise manipulating stock option grant dates. The number will likely rise, considering that this controversy is just in its early stages. The technology sector, where stock options have always been one of the coins of choice for hiring and retaining employees, has been particularly hard hit.

What Is Back Dating?

In order for options to qualify as "incentive stock options," they must be issued with a strike price equal to the fair market value of the underlying shares as of the date of issuance. A company is therefore at the mercy of the market when it issues options. Nothing can be more frustrating than issuing options to an employee with the intent of rewarding the employee only to have the price of the shares drop after the issuance, rendering the options of little value. The company could reissue or reprice the options, but there is a price for doing this, including reporting costs and a potentially negative impact on the issuer's financial statements.

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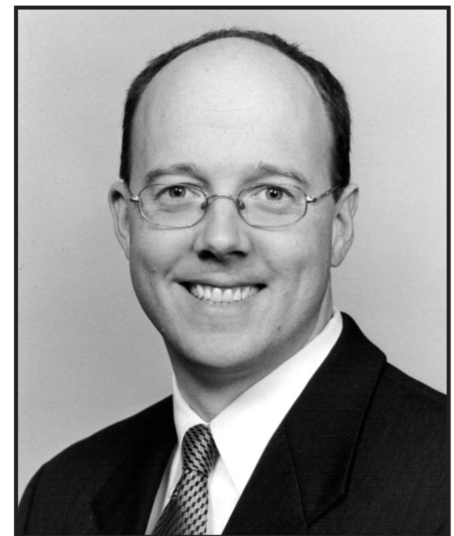

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Back dating options is a questionable effort to avoid this problem, by granting options to employees at a price below the fair market value of the underlying stock at the time the options are granted. In its most basic form, a company would issue options on one date, but the options would be dated as of a prior date and would have the lower strike price that was in effect on the prior date. This could be accomplished by changing the date of the agreement, or the date of the board meeting or compensation committee meeting at which the options were awarded. For new hires, some companies may have listed an employee's start date as earlier than the actual start date in order to take advantage of a low stock price.

The forward looking parallel to back dating is called "spring loading." In this scenario, rather than looking backwards at past stock prices, the company tries to match the timing of the option grants with the release of information in the future. For example, the company may issue a large number of options right before it releases positive information that will likely increase the stock price. The options are issued, the information is disclosed, the price goes up and the options are immediately "in the money." Some

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companies have also engaged in what is referred to as "bullet-dodging," by delaying planned grants until after the release of bad news, on the expectation that the stock price will drop and the employee will get the options with a lower strike price.

Much of the present enforcement action has been initiated based upon recent studies conducted by analysts, reporters and researchers that show an uncanny correlation between stock option grant dates and the stock prices of companies. Significantly more options are issued when the stock prices are low than when the price is high. The SEC and other regulatory agencies are betting that this is no mere coincidence.

Is This Illegal?

It is possible that some companies did not break the law. In certain circumstances, the back dating of stock options may not be illegal (in our view, however, it is still a questionable practice). It appears that in most if not all of the current cases, however, the back dating was neither approved by issuer's board of directors nor properly disclosed in regulatory filings (the difference between the current strike price and the back dated strike price should be properly recorded as a compensation expense). The SEC has said that it will look at each of these matters on a case by case basis. To date, no criminal charges have been filed, but the SEC has indicated that they will be pursuing civil charges very soon and already several top executives from several different companies have been fired or resigned. SEC Chairman Christopher Cox has recently asserted that criminal charges may be warranted in some cases, and reportedly stated that forging documents and lying to corporate directors and shareholders about option grants "can form the basis of criminal as well as civil charges."

Who Is Hurt?

Those investors that paid "market price" for the shares of a public company can be hurt by the practice of back dating. Their investment may be unduly diluted by the issuance of shares to option holders at an artificially low price. If the back dating practice is reserved only for a certain class of employees (such as upper management), then the employees that received options that were not back dated will also be diluted. Further, all shareholders are harmed when these improper practices come to light. Management's loss of focus on the business while dealing with the investigation, the costs and expenses associated with resolving the issues, the public's loss of confidence in the company and its management, and the inevitable bad publicity that accompany the untimely disclosure of these matters all work to impair market value.

In addition, if an option is truly issued at a price below its fair market value, those options would have immediate value to the employee and could be viewed as compensation to the employee. The employee would have to take this into income, and it would be taxable. The flip side is that the company may have to treat this as a compensation expense, and would be required to record a compensation deduction. This could and has led companies to restate their compensation expense, income tax deductions and retained earnings for prior years in which back dated options were issued.

What Is The SEC Doing To Stop It?

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) implemented significant changes in the rules relating to stock transaction reporting by insiders. Under rules adopted by the SEC pursuant to Sarbanes-Oxley, all insiders of a company (directors, officers and 10 percent shareholders) are required to file transaction reports (on Form 4) by the end of the second business day following the date of a stock transaction. Under the old rules, these reports were due by the 10th day of the month following the month in which the transaction took place. The new rules adopted pursuant to Sarbanes-Oxley extend the two day reporting requirement to stock option transactions, including option grants, exercises, cancellations and repricings. Under the old rules, many of these transactions were subject to substantially deferred reporting requirements. The two day reporting period closes a significant window of opportunity for potential stock option grant manipulation. Many of the option grants that are currently under investigation relate back to options granted prior to August of 2002, when Sarbanes-Oxley came into effect.

In addition to shortening the reporting period, Sarbanes-Oxley touches on a number of other issues relating to stock option grants. Recently enacted rules require shareholder approval for the adoption of certain equity compensation plans, including stock option plans (as well as shareholder approval of material revisions of existing plans). Further, Section 406 of Sarbanes-Oxley and the implementing regulations adopted thereunder, require companies to disclose whether they have adopted a code of ethics for their senior financial officers, including the principal financial officer, principal accounting officer and the principal executive officer. Sarbanes-Oxley defines a code of ethics as "including standards that are reasonably necessary to promote… full, fair, timely and understandable disclosure in the periodic reports required to be filed by the issuer." The NASD and the NYSE have also adopted their own rules relating to codes of conduct. The NASD rule states that issuers "shall adopt a code of conduct applicable to all officers, directors and employees, which shall be publicly available." The NYSE regulations state that listed companies must adopt a code of conduct. All of these rules and regulations stress that the overall goal in requiring the adoption of such codes is to foster ethical behavior, and encourage prompt disclosure to the appropriate corporate office of conduct that violates these codes. It is likely that the practice of back dating stock options without proper disclosure violates these codes of conduct, especially given the emphasis on the goal of "full and fair reporting" to the public. The adoption of these codes of conduct should help to stem the practice of back dating options.

The SEC is currently preparing materials addressing disclosure of executive compensation issues. It is likely that these materials will also include guidance on stock option reporting.

What Can A Company Do To Limit Its Exposure?

The most important action a company can take in avoiding the option back dating quagmire is to foster an atmosphere of ethical behavior. The board of directors and upper management must set the tone for compliance by refusing to engage in these practices. It is important that management stay current with newly enacted legislation, both under Sarbanes-Oxley and otherwise. Companies may also want to consider adopting a timed option grant plan where all options are issued at the same time every month or every quarter to avoid the potential lure of trying to time the options.