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Stay Tuned... to Time Travelers Backdating Stock Options

By Hank Boerner

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Stay Tuned

. . . to Time Travelers: Backdating Stock Options

BY HANK BOERNER

TIME TRAVEL: WE'RE ALL FASCINATED WITH the fantasy of being able to travel through time. Imagine whisking back in time to correct mistakes or fast-forwarding to 2026 to watch events in your life. In the 1985 movie "Back to the Future," slacker teen Marty McFly (Michael J. Fox) is transported back to 1955 in a dilapidated DeLorean time machine by mad scientist Doc Brown. Of course, this is all fiction. Or is it?

According to prosecutors and corporate governance experts, more than 100 public company CEOs and boards may have figured out a form of time travel with huge financial windfalls for the lucky CEO travelers — and no fancy machines were needed. With the scratch of a pen, hundreds of millions of dollars were allegedly shifted around in time. This is fraud, says the Securities and Exchange Commission, if that information is improperly disclosed or accounted for — or not disclosed at all.

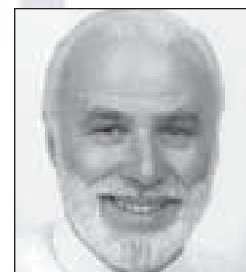
This is the practice of backdating lucrative executive stock options — the latest corporate scandal that began with a November 2005 *Wall Street Journal* story and has gathered momentum ever since. Here are the basic facts as reported by end of summer 2006:

◆ Professor Erik Lie, an academic at the University of Iowa's Tippie College of Business, published a journal paper in May 2005 in Management Science expressing the view that company boards were approving stock options for senior executives that were intended to be pay-for-performance but were more about deliberate manipulation of grants to maximize rewards for CEOs. In his summary, Professor Lie said: "This study documents [that] the abnormal stock returns are negative before unscheduled executive option awards and positive afterward. … Predicted returns are abnormally low before the awards and abnormally higher afterward. Unless executives possess an extraordinary ability to forecast the future … the results suggest [at least some of the awards] are timed retroactively. …"

By shifting grants to dates when the share price of the grant was most favorable (back to a lower-priced day), the executives enjoyed more profits. By not disclosing these facts, the companies (and individuals involved) may have subjected their companies and themselves to accounting, tax and criminal fraud consequences.

The Wall Street Journal picked up the professor's study and made it front-page news last March. The SEC also tuned in and began investigating a small number of companies (as a first step).

The logic of the Lie study — "On the Timing of CEO Stock Option Awards" — was simple: Looking at reams of data for 5,977 CEO stock options from 1992 through 2002, he determined that 1,688 were "unscheduled" and 1,426 "scheduled." "Abnormal" stock returns occurred around both types but were much more pronounced around the former, indicating manipulation of grants by boards and some CEOs.



Hank Boerner

The Wall Street Journal editors saw the results as proof of a contrived "perfect payday" for certain CEOs and has since kept up a drumbeat of coverage around the theme of "companies under scrutiny for options," including publishing online an "Options Scorecard" with details about specific companies. The SEC began immediate investigations into at least a half dozen companies. Federal prosecutors weighed in. Grand juries are investigating, and companies are disclosing they are under the microscope. Other media sniffed a scandal and began their own enterprising coverage.

The SOX Effect

With passage of the Sarbanes-Oxley in July 2002 came a wide range of corporate governance reforms, including new rules for more than 6,000 listed companies on the

NYSE and Nasdaq exchanges that required corporate disclosure of stock option grants within 48 hours of board action.

As the media coverage of the initial backdating issue broadened, Professor Lie and colleague Professor Randall Heron were completing another peer-reviewed study, to be published in the *Journal of Financial Economics*. In an unusual step, the professors first posted the study to a University of Iowa Web site ***(www.biz.uiowa.edu/faculty/elie/research.asp)***.

This second study, "Does backdating explain the stock price pattern around executive stock option grants?", looked at 48-hour filing data in the Thomson Financial Insiders Filings database — all public information in SEC forms 3, 4, 5 and 144, filed from Aug. 29, 2002, to Nov. 30, 2004 — and this is what it found:

◆ When option grants were required to be disclosed within 48 hours, there was no immediate increase in the value of the grant. Lie's original suspicions seemed to be verified. (The pair looked at 39,888 stock option grants at 7,774 companies.)

◆ Before Aug. 29, 2002, when the SEC approved the 48-hour disclosure rule, up to 30 percent of publicly traded companies were backdating unscheduled grants; after Aug. 29, the number declined to 10 percent.

Since then media coverage has intensified; so has regulator and prosecutor interest. As this goes to print, the SEC has brought criminal action against one company for backdating and is reportedly looking into the activities of 100 more, and "hundreds of companies," said *The Economist,* "are quietly conducting internal inquiries to see whether their option-granting processes were up to scratch." Some, such as Apple, Microsoft and Home Depot, are conducting internal investigations and proactively contacting the SEC if anything is amiss.

The SEC does not prosecute in criminal cases; they are turned over to the U.S. Department of Justice. In July the DOJ announced the formation of a "stock options backdating task force" that will investigate individuals and companies that may have deliberately backdated stock options with the intent to defraud.

The task force is under the direction of U.S. Attorney Kevin Ryan, who explained: "We will investigate whether individuals and companies may have deliberately backdated stock options with intent to defraud. We will evaluate the facts of each case and will bring criminal charges when appropriate." Media reports indicated more than 50, and perhaps as many as 100, companies may be under investigation by federal government agencies.

STAY TUNED … to the spreading stain of the options backdating "scandal." The actions to come will include high-profile criminal prosecutions, dramatic print headlines, biting comments from TV talking heads about more errant corporate

continued on page 17

STAY TUNED

continued from page 15

behavior, a run of pronouncements from regulators and prosecutors spotlighting individual companies, drafts of bills out of Congress, banks and lenders looking at the impact on loan covenants, delayed financial filings by a growing number of companies and stepped-up requirements for disclosure from the SEC. We could see an epidemic of corporate restatements of earlier results — what might the impact on the market be?

All these forces and more will continue to drive this issue toward major scandal status and will have varying effects on the companies involved. Already a number of senior executives have left companies, and plaintiff law firms are chatting up major shareholder lawsuits. Large public employee pension funds have begun filing lawsuits over stock option timing issues. D&O insurers are looking at "exclusions" for certain past actions if lawsuits are filed. Executives and companies are exposed to tax consequences, as well.

STAY TUNED ... to more experts weighing in. Analysts at Audit Integrity, a risk management consulting organization specializing in corporate accounting and governance fraud, using a database of 9,000 U.S public companies, said its most recent analysis of more than 50 public companies named in *The Wall Street Journal's* Options Scorecard showed these common characteristics: (1) persistently aggressive accounting behaviors; (2) frequent, unusually high levels of insider selling; (3) unusually high levels of options exercised; and (4) unusually high short-term compensation practices. Looking at these four "tests," 60 percent of companies in the *WSJ* Scorecard failed in three or more areas, and 82 percent failed two or more. (IROs: Where would your companies stand on these tests?)

Audit Integrity says its analytical tools now indicate more than 500 companies are likely to be cited for backdating options in the current investigations, based on predictive corporate behaviors. The company is circulating a list of specific firms to its clients, including investors and analysts, of "Companies at Increased Risk for Stock Option Backdating."

STAY TUNED ... to the SEC. In July, the commission issued guidelines to expand executive compensation disclosure. (Proxies filed after Dec. 14 will have to include "total" compensation for the five highest-paid top execs in one chart.) Annual reports issued in 2007 (covering the 2006 fiscal year) will be required to include a compensation discussion and analysis — similar in format to an MD&A. More stringent standards could be in the works if the scandal engulfs a large number of brand-name companies.

STAY TUNED ... to Professor Lie, who started all this. His research continues. In the paper posted to the University of Iowa Web site, he projects up to 30 percent of firms manipulated grants to top execs between 1996 and 2005. He concludes with this: "To eliminate backdating, it appears the requirements need to be tightened further, such that grants have to be reported on the grant day, or on the day after. And the SEC naturally has to enforce the requirements." Watch for these arguments to gather steam as the stain of the scandal spreads to involve more companies, resulting in more prosecutions, more media headlines and probably more action by SEC and/or Congress. IRU

Hank Boerner, a corporate governance columnist for IR Update, *is a crisis and issues consultant to senior managers and boards. He welcomes questions and comments at:* ***hank@hankboerner.com***.