Ethics of Stock Option Backdating

Charles Geam, Matthew Rider, Marin Rutherford, Leah Semann

Introduction

Executives backdating stock option grants led to a loss of approximately $500 million per firm in returns to investors from 1995 to 2002. With over a 100 companies being investigated for backdating, an ethical dilemma arises concerning the practice itself. The ethics of backdating are examined using a contract-based ethical framework, and the breakdown of ethics by the overwhelming number of participants is examined using moral disengagement. Through this analysis, the backdating of options is shown to be unethical, leading to the question of what should be done about it. Recommendations are presented addressing the major weaknesses in backdating prevention. Through an acceptance of the unethical nature of backdating, and implementation of the forthcoming recommendations, investor confidence can be regained to rebuild the efficiency of the current investor environment.

Background on stock option grants and the advent of backdating

Stock option grants, and other forms of performance-based compensation, are a means of avoiding agency problems by tying executive compensation to company performance. Agency problems are defined as managers not acting in the best interest of shareholders. As a manager of any firm, the most important goal is to maximize returns to shareholders through growth and profit producing activities. Stock option grants are meant to align the incentives of executives with those of the shareholders. If a large portion of an executive's compensation is in the form of stock options, there is a greater incentive to increase share price through value-adding activities. A raise in stock price increases both the value of the stock options as well as shareholder returns.

This form of performance-based compensation became increasingly favored over conventional salary compensation during the 1990's. One reason was the boom of the technology industry, which used stock options to lure talented managers to their start-up

firms. Lacking the on-hand capital to pay large salaries to executives, stock options were offered instead. This method of compensation was incredibly attractive in the tech industry as booming growth dramatically raised stock prices, equating to huge gains for executives who exercised their options at the peak of industry performance. Another factor contributing to the popularity of stock option grants was the passing of Section 162(m) of the federal tax laws in 1993, which placed a $1 million cap on compensation that could be tax deductible on corporate tax returns (SEC, 2006). However, this change in tax law only placed a cap on executive salary and not on performance-based forms of compensation.

Stock option grants come in the form of call options, which allows the owner of the option to buy the firm's stock at some given time in the future for a set price. Stock options are granted "*at the money*," meaning that the exercise price is set at the current market price, otherwise known as the "*strike price,*" of the stock at the time the option is granted. However, in some cases the option might be granted "*in the money*," being set at a price lower than the current market price, and thus creating instant paper gains. Normally, stock option grants come with a vesting period, in which the recipient cannot exercise the options. At the end of the vesting period, when the options are exercised, an executive compensated in this manner stands to make a huge sum of money if the stock price has indeed appreciated since the date of issuance. A failure to increase the firm's value essentially makes the options worthless.

The Backdating Scandal

The recently publicized backdating scandal sheds light on managers retroactively changing the date an option was granted. Changing the grant date to a period when the stock price was lower than the original exercise price creates instant paper gains. While backdating stock options is not illegal, the improper disclosure of information in financial statements is. The way a stock option grant is reported has tax liability implications, and when a backdated stock option is improperly reported as having been granted "*at the money*" the corporation illegally avoids these tax liabilities. Options granted "*in the money*" are not classified as performance-based compensation, and do not qualify for the tax benefits of Section 162(m). Misleading disclosure reduces corporate transparency and

could possibly violate shareholder-approval requirements set by the New York Stock Exchange and NASDAQ (ISS, 2006). Before the creation of the Sarbanes-Oxley Act of 2002, a company did not have to report stock option grants until 45 days after the end of the fiscal year they were granted (ISS, 2006). This lengthy window of opportunity allowed many executives to reset their grant dates to coincide with days where the stock was trading at its lowest. The Sarbanes-Oxley Act attempts to rectify this problem and minimize the opportunity to backdate by requiring companies to report an option grant within two business days.

In a March 18, 2006 Wall Street Journal article, Erik Lie, an associate professor of finance at the University of Iowa, examined the stock option grants of several companies during the period from 1995 to mid-2002. The research showed that many executives were granted options immediately before large gains on the stock price. Mr. Lie made the observation that the sharp increase in stock price after option grant dates was indicative of option backdating. To eliminate the possibility of coincidence, a single executive's grant dates were analyzed. Affiliated Computer Services Inc.'s then president, Jeffery Rich, was the focus of the analysis, taking a look at his option grants in 1998. ACS stock price rose 60.2% during the 20-day period immediately following his stock option grant. This huge gain was the best 20-trading-day period all year for ACS (WSJ, 2006). This sort of "perfectly-timed" grant date was not isolated to ASC and Jeffery Rich, but to many senior executives at numerous firms. A look at probabilities would show that any stock option grant should be followed by mixed performance, with some stock prices going up and some going down. In some instances the options were "spring-loaded," being granted immediately before the release of good news that was expected to increase stock price.

The Ethics of Backdating

The ethical issue of stock option backdating has to do with the deception of shareholders by firm managers. Since managers are charged with increasing shareholder value, an ethical dilemma arises when executives alter stock option grant dates to increase their own compensation, effectively reducing returns to shareholders. Ethics also come into consideration when managers provide misleading information to the

shareholders, by way of financial statements, as to the amount of compensation they are receiving for the services they render. Reducing corporate transparency leads to a loss of shareholder confidence, and violates the social and legal contract executives entered into with the shareholders when they accepted a position at the company. Misleading and deceptive information is unethical when there is a contractual obligation to provide honest and accurate information.

Backdating violates the ethics of the manager/shareholder contract-based framework. An implicit agreement is said to exist between individuals and the groups they belong to. This agreement dictates the rights and responsibilities of the individuals within the group. This framework applies to executives, in that they work at a firm on a voluntary basis, and this choice is what obligates them to act ethically. In the case of most executives, the agreement is more than an implicit one, since they are explicitly defined by actual, legal contracts of employment as well as by the laws and regulations of the society in which they operate. Some might argue that the social contract theory does not hold in the case of government regulation, in this case taxation, because the agreement is not entered voluntarily but rather through government force. However, the unethical behavior is not reliant on the tax evasion property of backdating, but on the detriment caused to the shareholders that the executives work for. Backdating directly reduces returns that the shareholders would have otherwise realized. According to a contract-based ethical framework, the act of backdating and misrepresentation of compensation practices is unethical.

Moral Disengagement

It can be argued that only a few managers at a few firms might take advantage of loopholes to increase their compensation. This counterargument is the basis for the belief that backdating was not a product of a widespread breakdown of ethics, but in actuality the wrongdoings of a few individuals with each situation being detached from the rest. However, a recent joint investigation by the Securities and Exchange Commission and Justice Department has found potentially fraudulent behavior with executive stock option grants at more than 120 companies. The question is then, how did so many executives, all at different companies, come to take part in this unethical act? The answer is moral

disengagement. Moral disengagement occurs when an unethical behavior is justified or euphemistically labeled. In this case, executives referring to the act of theft as "backdating an option" make the act much more palatable. In a survey conducted by a corporate governance research firm, The Corporate Library, 51 of the 120 companies being investigated for backdating had directors that sat on multiple boards within the group of companies being probed (CNNMoney.com, 2006). As an increasing number of managers took part in backdating options, a diffusion of responsibility occurred. The idea that, "Everyone else is benefiting from this, why shouldn't I?" takes hold and allows the manager to minimize, ignore, or misconstrue the consequences of their unethical behavior. Dehumanizing the victim also facilitates moral disengagement, by viewing the shareholders as a large faceless entity the unethical behavior is allowed to continue without recourse.

Recommendations

There are ways to reduce the occurrence of backdating while still providing the benefits of a performance-based form of compensation. Recommendations have been made by many organizations that deal with corporate governance. To address the existing problems in the option granting process, a number of possible remedies have been researched and are presented here.

Access to Non-Public, Potentially Market-Moving Information

Rules already exist for stock purchases and sales by insiders because the information they possess is not available to the public. The existence of potentially market-moving information reduces investor confidence, which negatively effects the operation of an efficient market. If investors believe that the market is not fair, with certain individuals having an advantage over the rest, they will become unwilling to participate. Lack of investor participation will cause the free flow of capital from lenders to borrowers to cease and cause detrimental effects to the economy. This is, of course, a worst-case scenario, but it is the underlying reasoning behind the regulations already in place. To remedy the problem of "spring-loaded" options, regulations can be enacted that would create a blackout period for executives privy to market-moving information. The

blackout period would prevent executives from timing their options to be granted just prior to the release of the information.

Enforcement of Existing Reporting Regulations

The Sarbanes-Oxley Act of 2002 amended portions of the Securities Exchange Act, requiring the reporting of a stock option within two business days of the grant. Stock option grants, as well as option exercises, require the filing of a Form 4 within two business days of the transaction. However, there is a clause in the rule that exempts the two-business-day reporting period if it is deemed that it would not be "feasible" to report the grant within the timeframe. Many companies continue to report option grants beyond the two-day required time period. This loophole can be remedied through stricter enforcement of the Sarbanes-Oxley Act by regulating bodies such as the SEC. If large monetary penalties were levied or transactions were negated the occurrence of backdating could be reduced.

The Timeframe and Frequency of Stock Option Grants

Normally, most companies grant stock options once a year. However, there is no regulation guiding when, or how frequently, a stock option can be issued. By allowing the stock option to be granted on any day of the fiscal year, it allows executives to research stock prices and backdate their options to the most desirable date. To minimize this problem a fixed grant date schedule could be adopted. Stock options would be granted on a periodic basis (monthly, quarterly, or annually), along with rules that would govern option exercise prices on grant dates. Requiring a disclosure of the rationale for grants on a certain date would also help to prevent his problem. An explanation of why the compensation committee chose a certain date, over other possible dates, would mitigate the problem of fraudulent backdating. These requirements would inhibit executives from picking specific low-stock price days to maximize compensation.

The recent exposure of the backdating scandal in the United States has left many investors wary of executive compensation practices. Regardless of the legality of backdating, its inherent untruthfulness and the financial detriment to the shareholders make it unethical. A contractual-based ethical framework dictates that the voluntary

nature of an executive's employment inherently obligates them to act in an ethical manner conducive to the group he belongs to. The vast number of executives and corporations involved in the current scandal implies a level of moral disengagement, brought upon by the social networking of many of the directors involved. Tighter regulations regarding the use of market-moving information and the timing of option grants, as well as enforcement of existing regulation are recommendations for the eradication of backdating. Unethical practices in the business environment have begun to diminish the confidence people have in corporations, and a lack of trust will lead to larger economic problems.

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