

PERSPECTIVES

On the Use (and Abuse) of Stock Option Grants

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Executive compensation has long been a topic of significant debate. In recent years, the component of executive compensation packages generating the most controversy has been stock options. Companies use stock options to attract and retain executive talent while strengthening the relationship between executive compensation and performance of the company's stock price. In addition to providing incentives for grant recipients to increase shareholder value, stock options have also been used to reduce corporate taxes and to provide employees with compensation that does not require the company to make an immediate cash outflow.

Critics of stock options, however, argue that the true expense of option compensation has historically been concealed in financial reports and that the accounting treatment of stock options, coupled with tax advantages for stock options relative to cash-based compensation, has contributed to an excessive use of option-based compensation. The battle that has taken place throughout the past decade over how to account for the use of options for financial reporting purposes has recently been settled; companies are now required under Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), to expense stock options granted to employees by using option-pricing methodologies designed to capture the underlying economic, or "fair," value of the option grant.¹

A realistic (i.e., nonzero) estimate of the economic cost to the company of stock option grants must now be recorded as an expense in financial statements. Thus, one might expect that the controversy over the use of stock option grants would settle down. Opponents of stock option expensing

argue, however, that companies are now more likely to manipulate *other* inputs that determine the reported value of option grants.

In fact, as of 14 November 2006, at least 173 publicly traded companies have been identified as likely to have *backdated* stock option grants ("Digging Up Dinosaur Bones II" 2006). Backdating, described by some as the broadest corporate scandal in decades and the largest since the implosion of Enron Corporation, is the practice of selecting option grant dates on a retroactive basis to reflect a lower stock price than the stock price on the date the actual granting decision occurred. Because the number of options that may be granted to executives is often limited or fixed, backdating magnifies the financial gain to the grant recipient by lowering the strike price.² With the benefit of hindsight, one can see that companies that backdate options are effectively granting in-the-money options.

Some legal scholars contend that backdating option grants is simply a choice made by the compensation committee to grant in-the-money options. Although granting in-the-money options is not illegal, companies entangled in the scandal were typically not accounting for the backdated option grants as in-the-money options. As a result, compensation expense was underreported and net income was overreported for financial reporting purposes. Moreover, this practice of granting in-the-money options was usually concealed from shareholders. In addition, executive option plans approved by shareholders frequently specify that the exercise price of the options must not be lower than the fair market value of the stock on the date the grant occurred. The U.S. SEC and U.S. Department of Justice have taken the stance that the concealment of this practice from shareholders and the associated misrepresentation of financial statements constitute financial fraud.

Ironically, for tax purposes, the improper accounting often results in an increase in corporate tax deductions, at least for nonqualified option grants. For nonqualified options, the spread between the exercise price and the market price of

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the stock when the option is exercised is a tax-deductible expense for the corporation. If grants are backdated to create a lower exercise price, this spread (and thus the corporate tax deduction) widens beyond what it would be if the company established the exercise price based on the share price on the date when all grant terms were set (typically referred to as the “measurement date”). In addition, companies may backdate grants in such a way that they are actually in the money on the measurement date yet take tax deductions reserved for at-the-money or out-of-the-money grants under Section 162(m) of the Internal Revenue Code (see Heron and Lie 2007 for further discussion). As a result, some companies may face hefty tax bills and associated penalties in the near future to unwind improper tax benefits.³

Because the industry is in the early stages of learning about backdating practices, many questions remain unanswered. How many companies will ultimately be caught up in this scandal? What will the penalties be? How costly will it be to fix this mess? What factors contributed to the substantial increase in stock option grants during the 1990s and, perhaps indirectly, to the backdating practices recently uncovered? What is being done and what further should be done to prevent this practice in the future? Our aim in the remainder of this article is to provide some perspective on these questions.

We begin with a discussion of factors that we believe encouraged the liberal use of stock option compensation during the past decade and a half, and we present summary figures that illustrate how the structure of executive pay packages has changed.⁴ We then discuss the academic research that led to the discovery that executive option grants were being backdated and discuss how the backdating scandal surfaced in the media. We provide answers to as many of the questions in the preceding paragraph as possible based on our current knowledge. Finally, we discuss what additional measures are being taken and should be taken to prevent or limit option abuses like backdating in the future.

Be Careful What You Ask For

Several factors have contributed to the increased use of stock options in executive compensation packages since the early 1990s. Executive compensation became a hot political issue in those times as growing criticism by institutional shareholders and academic researchers highlighted the lack of pay for performance in executive compensation packages (see Jensen and Murphy 1990). Responding to the public outcry over the perception of excessive compensation, the SEC overhauled the compensa-

tion disclosure system by adopting enhanced disclosure rules for executive pay. For its part, the U.S. Congress passed Section 162(m) of the Internal Revenue Code, which limits the deductibility of non-performance-based compensation for top executives to \$1 million. In adopting Section 162(m), Congress effectively endorsed the increased use of performance-based compensation, including at-the-money and out-of-the-money option grants.⁵ If the goal of the regulatory change was to reduce overall levels of compensation, then as Perry and Zenner (2001) showed, it failed. Overall compensation levels continued to increase, and companies, especially those subject to 162(m), responded by altering the structure of CEO compensation toward more options.

Unfortunately, the accounting treatment for grants of executive stock options in place at the time typically allowed companies to avoid reporting the economic value of the options as compensation expense for financial reporting purposes. Prior to the adoption of SFAS 123R, which became mandatory beginning with the 2006 fiscal year, companies were able to use the “intrinsic value method” to expense options for financial reporting purposes.⁶ According to the intrinsic value method, as long as the exercise price is not lower than the stock’s market price on the measurement date of the grant, the option is not in the money and thus has an intrinsic value of zero. This intrinsic value is what showed up in a company’s public financial statements as the expense associated with a stock option grant. Given the incentive to report a lower compensation expense—together with the notion that options should provide rewards only if stock prices rise in the future—companies have typically issued options at the money. Thus, even though the exercise of nonqualified options creates a deductible expense for tax purposes, the company would not have to report any compensation expense related to the initial grant of the option. The combination of financial reporting and tax incentives associated with option grants encouraged a shift in compensation from a relatively transparent form of cash compensation toward a form that lacked transparency altogether—a condition that created the potential for abuse.

We show in **Table 1** the changing nature of CEO compensation over the 1994–2005 period. Table 1 reports the mean and median magnitudes (in thousands of dollars) of salaries, bonuses, option grants, and restricted stock grants for companies listed in the ExecuComp database.⁷ Although the values for salary, bonus, and restricted stock are reported directly by companies in the “Summary Compensation Table” of their

Table 1. Yearly Executive Compensation Components for CEOs, 1994–2005
(dollars in thousands)

Year	No. of Obs.	Salary		Bonus		Options		Restricted Stock	
		Mean	Median	Mean	Median	Mean	Median	Mean	Median
1994	1,549	\$514	\$454	\$ 436	\$250	\$ 872	\$ 245	\$1,127	0
1995	1,600	531	471	490	252	862	247	153	0
1996	1,651	548	500	595	300	1,475	369	209	0
1997	1,674	564	519	621	345	1,942	482	260	0
1998	1,731	580	525	605	319	2,258	621	676 ^a	0
1999	1,811	582	528	692	330	3,183	750	311	0
2000	1,792	607	550	736	331	4,455	801	424	0
2001	1,671	645	578	664	296	4,111	1,023	465	0
2002	1,671	663	602	714	361	2,579	909	539	0
2003	1,688	686	641	890	427	1,801	682	725	0
2004	1,685	711	651	1,059	570	2,064	769	877	0
2005	1,299	762	713	1,266	702	1,914	685	1,150	0
Growth 1994–2005		48%	57%	190%	181%	120%	179%	808%	

^aThe mean level for restricted stock reported for 1998 is skewed because of a single grant valued at more than \$650 million to Charles Wang of Computer Associates. Without that grant, the mean level of restricted stock for 1998 would be only \$300,000.

proxy statements, the disclosure rules during this time period required disclosure of only the number of options granted, not a separate estimate of value. The numbers we report are taken from ExecuComp, which uses a modified Black–Scholes valuation methodology to estimate option values for stock options granted in each fiscal year.

During this 11-year period, median salaries increased by 57 percent while the median value of option grants increased by 179 percent. Both the median and mean value of option grants have declined since 2001. Nevertheless, option grants represented the highest individual component of a CEO's total annual compensation in terms of mean values throughout the period. In terms of medians, option grants have represented the largest component of compensation in every year since 1998 except for 2005. **Figure 1** shows graphically the mean proportion of total compensation from salary, bonus, stock option grants, and restricted stock grants. Although stock options remain the highest-valued component of annual compensation, the trend since 2001 has been a reduction in stock options and an increase in restricted stock.

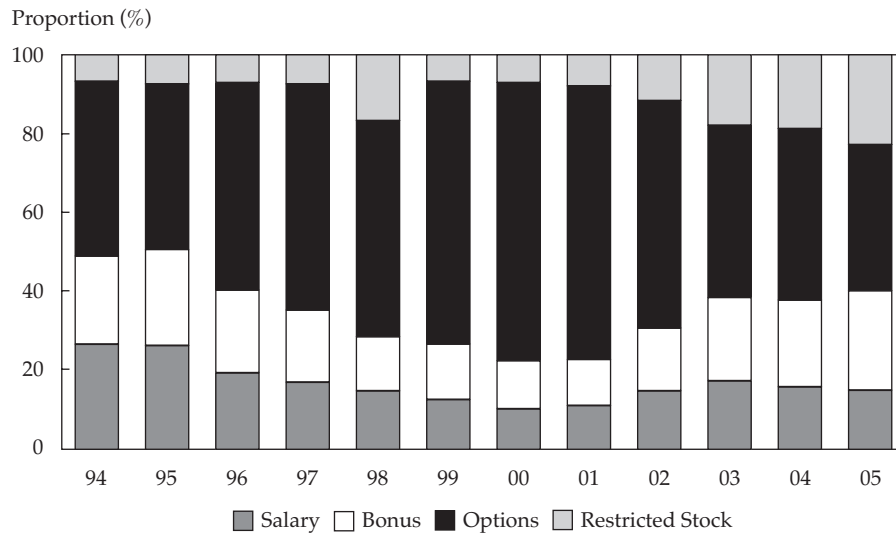
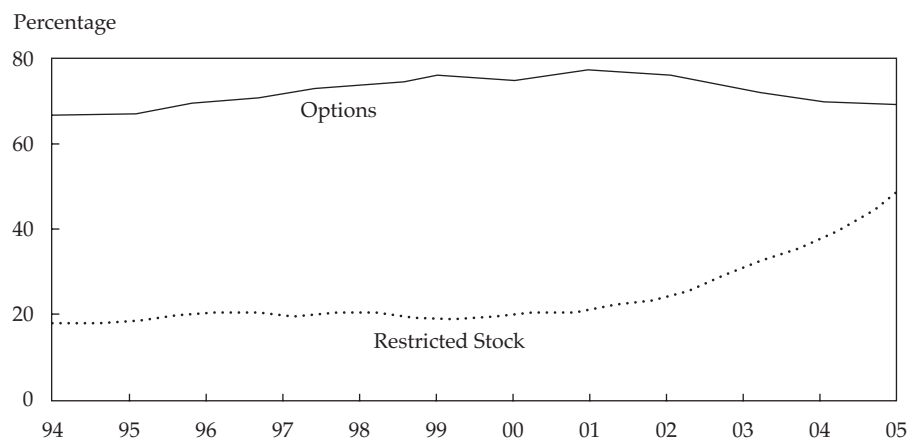
Figure 2 shows the percentage of companies that granted stock options or restricted stock in a given year. The portion of companies using restricted stock increased from 17 percent to 47 percent from 1994 to 2005. The percentage of companies granting options to the CEO in a given year

peaked in 2001 and appears to have leveled off at around 70 percent. A potential explanation for the shift from stock options to restricted stock is the recent accounting change requiring option grants to be expensed at their fair value rather than their intrinsic value. By requiring companies to record an expense that lowers reported earnings, this change has enabled shareholders and other interested parties to better ascertain the true economic costs associated with the option grants made by a company.

A Pattern Emerges

Yermack (1997) first documented return patterns around the time of option grants and suggested that managers are able to manipulate the timing of the option grants. He analyzed the returns around the time of grants to CEOs of Fortune 500 companies between 1992 and 1994 and found average abnormal returns in excess of 2 percent in the 50 trading days after the grant dates. Yermack concluded that grants are timed to occur before anticipated stock price increases. Chauvin and Shenoy (2001) arrived at a similar conclusion, whereas Aboody and Kasznik (2000) concluded that the information flow might also be manipulated around the time of scheduled grants.⁸

Lie (2005) found negative abnormal returns before and positive returns after CEO option grants made between 1992 and 2002. He also found that the magnitude of the favorable-return reversals

Figure 1. Proportions of Total CEO Compensation by Year, 1994–2005**Figure 2. Percentage of Companies Granting Options or Restricted Stock by Year, 1994–2005**

increased significantly over time. Perhaps more importantly, he documented that the portion of stock returns attributable to overall market movements exhibited a similar pattern as the abnormal stock returns. This finding led him to conclude that

unless executives have an informational advantage that allows them to develop superior forecasts regarding the future market movements that drive these predicted returns, the results suggest that the official grant date must have been set retroactively. (p. 811)

As a caveat, Lie (2005) pointed to such studies as Lakonishok and Lee (2001) suggesting that insiders can forecast at least long-term stock market movements. Similarly, Narayanan and Seyhun (2005) argued that in many situations, managers have proven a detectable ability to forecast stock market movements, even in the short term. On this

basis, they discounted Lie's conclusion that the favorable market movements following grants necessarily imply that option grants were backdated. Another limitation of Lie's study is that it did not address what portion of the abnormal return patterns around grant dates might be attributable to backdating rather than other explanations.

Regulatory Change to the Rescue

The Sarbanes–Oxley Act of 2002 (SOX), passed to strengthen auditing standards and to improve the disclosure and accuracy of financial reporting following the accounting scandals in the late 1990s, has been frequently criticized for the additional compliance costs associated with its implementation. One of its provisions, however, has turned out to be crucial in curtailing and, ultimately, exposing the practice of backdating option grants. That provision,

effective 29 August 2002, changed the reporting requirements for executive stock option grants. In particular, option grants to executive officers now have to be filed with the SEC on Form 4 filings within 2 business days of the transaction. Prior to the change, Form 4 filings had to be filed within 10 days of the month following the transaction (which varied from two weeks to six weeks after the transaction) and grant recipients often had the choice of reporting the grants on Form 5 filings, which were due 45 days after the end of the company's fiscal year. **Figure 3** illustrates the dramatic effect of the new reporting requirements on filing lags for a sample of roughly 40,000 grants to top executives from 1996 to 2005.

Lie (2005) wrote in a footnote that the change in reporting requirements mandated by SOX was likely to affect the ability to backdate stock option grants and, therefore, the surrounding stock returns. Lie's was the first suggestion of a link between backdating and reporting lags. Heron and Lie (2007) discussed this in further detail. Specifically, if companies comply with the new reporting requirement, backdating should be greatly curbed because the number of days a company can look back to find a closing stock price to use as the strike price is limited to two. Consequently, to the extent that backdating contributed to the growing pre-SOX stock price patterns around the time of option grants, the price pattern should have diminished since the new filing requirements were implemented.⁹

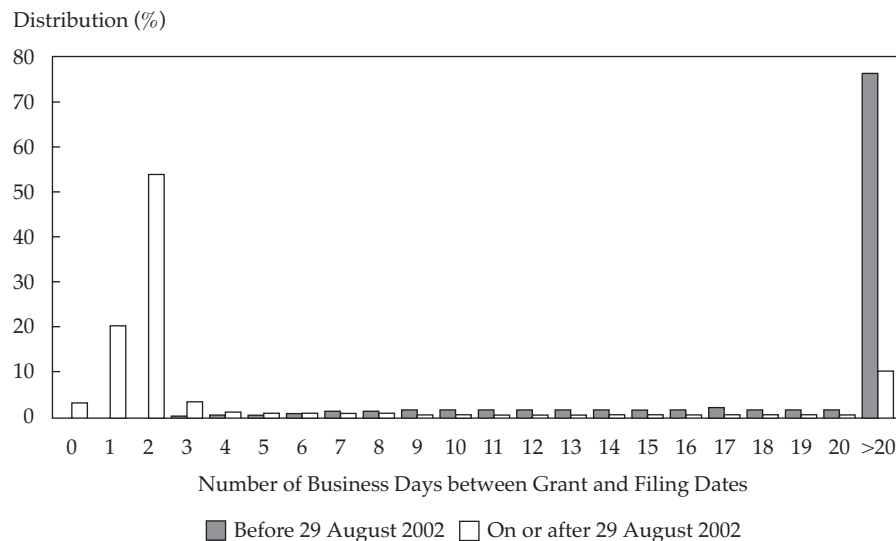
In their comparison of option grants before and after the change in reporting requirements, Heron

and Lie (2007) found that roughly 80 percent of the stock price pattern has disappeared since the new reporting requirements took effect. Any remaining pattern is concentrated in the two days between the reported grant date and the required filing date (when backdating still might work) and in longer periods for the minority of grants that are filed after the two-day reporting deadline.¹⁰

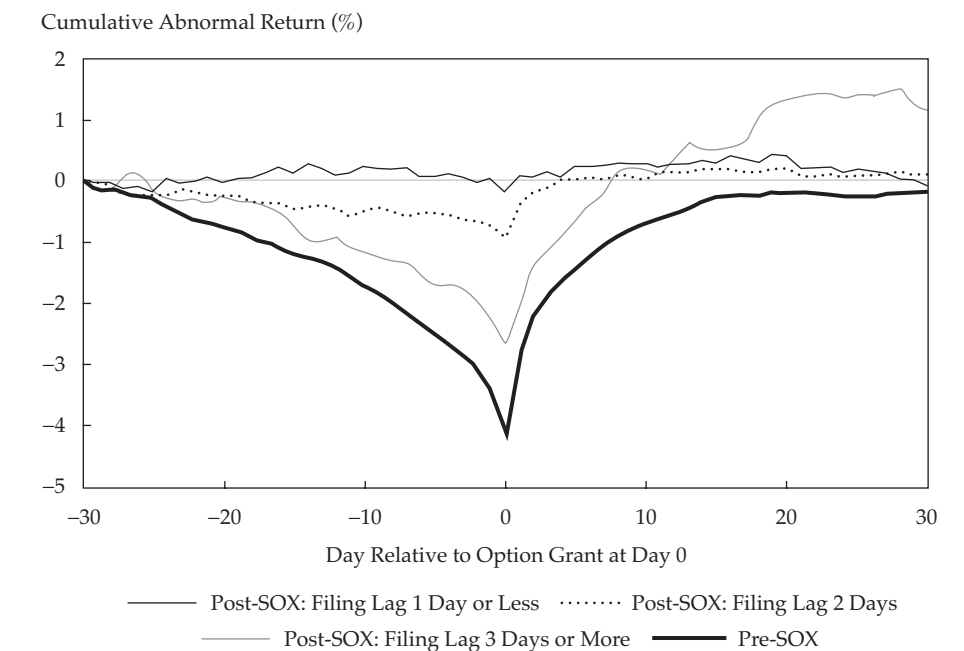
For illustration, we replicated these results in **Figure 4** by using a sample of approximately 40,000 grants to top executives during the period from 1996 to 2005. Heron and Lie (2007) interpreted such findings as strong evidence that backdating explains most of the price pattern around the time of option grants. Specifically, if other forms of potential grant-date manipulation, such as "spring loading" (timing grants to occur before the announcement of favorable news releases that management knows will produce an immediate increase in stock prices), were routinely occurring without the benefit of the hindsight from backdating, the favorable return patterns would not disappear (as they do in Heron and Lie's 2007 study) for the subset of grants that were reported immediately.¹¹

The magnitudes of the abnormal return patterns in the pre-SOX environment documented in Lie (2005) and Heron and Lie (2007) imply that a nontrivial proportion of option grants were backdated. For an illustration, we can consider different combinations of the fraction of backdated (or otherwise manipulated) grants multiplied by the average abnormal gain resulting from backdating to arrive at the roughly 4 percent abnormal decline

Figure 3. Distributions of the Reporting Lag, 1996–2005 Period



Note: The period before 29 August 2002 is the pre-SOX period; the period on or after 29 August 2002 is the post-SOX period.

Figure 4. Abnormal Stock Returns around the Time of Executive Stock Option Grants, 1996–2005 Period

Note: Pre-SOX is before 29 August 2002; post-SOX is on or after 29 August 2002.

in stock prices during the 30 days before option grants and 4 percent subsequent rebound during the 30 days following executive option grants during the pre-SOX period. For example, if we assume that only 5 percent of all executive stock option grants were backdated and none of the other grants were manipulated in any way, we find the average abnormal return reversal for these grants would have to be an astonishing 80 percent ($5 \text{ percent} \times 80 \text{ percent} = 4 \text{ percent}$). If we take a more skeptical view that only 1 percent of the grants were backdated, the average abnormal return reversal would have to be 400 percent ($1 \text{ percent} \times 400 \text{ percent} = 4 \text{ percent}$)! More realistic permutations include the possibility that 20 percent of option grants were backdated, which would produce average abnormal return reversals of 20 percent ($20 \text{ percent} \times 20 \text{ percent} = 4 \text{ percent}$). These simple examples show that the proportion of executive option grants that were manipulated is indeed nontrivial.

In their follow-up study, Heron and Lie (2006) sought to directly answer the question of what percentage of grants have been backdated or otherwise manipulated to inflate the value of executive options. Based on the logic that in the absence of grant-date manipulation the returns in the month before and after an option grant should be the same, they estimated that 23 percent of unscheduled at-

the-money grants to top executives between 1996 and August 2002, when SOX took effect, were backdated or otherwise manipulated. The new two-day reporting mandated by SOX reduced the proportion of manipulated grants since August 2002 by more than a half to 10 percent. Among the minority of grants that are filed late (i.e., more than two business days after the purported grant dates), the prevalence of backdating or manipulation, however, remains as high as 20 percent.

The proportion of grants to top executives that are filed late is steadily decreasing, but it was still as high as 13 percent in 2005. Although a nontrivial fraction of the grants that are filed on time (i.e., within two days) appear to have been backdated, the benefits of backdating have been greatly reduced in such cases because of the shortened window.

Heron and Lie (2006) also found that the prevalence of backdating differs according to company characteristics; backdating was more common among technology companies, small companies, and companies with high stock price volatility. Finally, the authors estimated that almost 30 percent of companies that granted options to top executives between 1996 and 2005 manipulated one or more of their grants in some fashion.

Based on anecdotal evidence, companies often backdated grants to the date in a certain calendar month with the lowest price (i.e., the “look-back

period"). If so, the price on the grant date should be the lowest for that given calendar month. **Figure 5** displays the distribution of the ranks of the grant-date closing prices relative to all other closing prices in the same month. (Because the new two-day filing requirement limits the look-back period to two days, grants dated after 29 August 2002 are excluded from this figure.) Clearly, an abnormally high percentage of grants occurred on dates that had the lowest prices for the month. In fact, we estimate the abnormal fraction of grants dated at the monthly price trough to be almost 9 percent. This information provides insight into the practice of backdating, even though it may overlook backdating in which (1) a date with a low, but not the lowest, price for the month was chosen as the official grant date or (2) the look-back period did not fully encapsulate the month of the grant.

The Scandal Surfaces

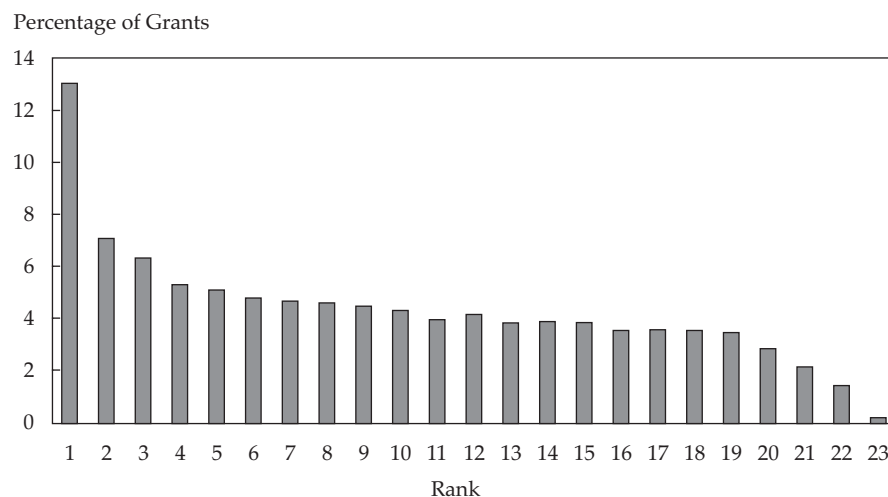
Heron and Lie (2007) documented a few early cases involving backdating or allegations of backdating, but not until the investigation of the high-tech company Mercury Interactive was revealed in November 2005 and reported in the *Wall Street Journal* did the matter start to receive extensive media scrutiny (Buckman, Maremont, and Richardson 2005). At that time, the press revealed that the SEC was investigating approximately a dozen companies, and most commentators seemed to believe that only a handful of companies were backdating option grants (Maremont 2005). The lack of media attention between November 2005 and March 2006

also suggests that most observers believed option backdating to be an infrequent practice.

Now, we know otherwise. Since 18 March 2006, when the *Wall Street Journal* started its series of "Perfect Payday" articles in which journal reporters publicly identified several companies with suspicious option-granting patterns (see Forelle and Bandler 2006), we have witnessed a continuous stream of announcements by public companies of investigations by the SEC or the Department of Justice or revealing internal investigations of "irregularities" in the accounting practices for option granting. Consistent with results reported in Heron and Lie (2006), we are also discovering that backdating option grants was more prevalent among technology companies with high stock price volatility and companies that relied heavily on option grants to compensate not only their top officers but also much of their employee base.

As we mentioned in the introduction, as of November 2006, more than 170 companies have been publicly identified as subject to investigation for alleged option-granting problems. Although many of these companies experienced significant declines in the value of their stock when identified as having potential option-backdating problems, this result has not always been the case. The puzzling manner in which the market has reacted to the public disclosure of this information probably reflects the significant divergence in opinions regarding the egregiousness of the practice and uncertainty about the number of companies that will ultimately fall under suspicion, the cost to investigate and fix the problems, and ultimately, the vigor

Figure 5. Distribution of Monthly Ranks of Grant-Date Closing Prices, 1996 to 28 August 2002



Note: The x-axis shows the rank of closing prices on the grant dates relative to other closing prices in the same calendar month; 1 is the lowest price of the month.

with which the U.S. IRS, the SEC, and the Department of Justice will take action against the individuals and companies involved.

Although the answers to these uncertainties may not be fully revealed for years, we have learned much in a relatively short time. The potential significance of the problems associated with backdated option grants apparently depends partly on the accounting practices of the companies. If a company backdated option grants but accounted for the grants correctly for financial reporting and tax purposes and also did not violate any provisions in the stock option plans approved by shareholders, the company is unlikely to have problems. At this point, however, how many companies will fall into this category remains unclear. In fact, given the large number of companies that have already announced the need to restate their financial statements, most companies apparently failed to account properly for the backdated grants. In other words, the accounting treatment for option grants by these companies concealed from shareholders that they were effectively in-the-money options at the time the grant decision was made (the measurement date). In addition, this treatment often inappropriately reduced the corporate tax bill for these companies. We also know that in some cases for which the investigations began with option-grant practices, investigators have found other material accounting problems and have alleged that documents were forged in an attempt to conceal the nature of the backdating practice. In these situations, the SEC and Department of Justice have filed both civil and criminal charges against individuals believed to have been involved. Moreover, a number of executives from suspected companies have been terminated by the boards of directors. One executive is currently considered a fugitive by the Department of Justice.

The results reported in Heron and Lie (2006) suggest that slightly less than 30 percent of public companies that used stock options for executive compensation manipulated at least one grant between 1996 and 2005. The business press has often mistakenly interpreted this number as an estimate of the number of *companies* that will become ensnared in the backdating scandal. For a variety of reasons (as the authors pointed out in that study's conclusion), the number of specific companies that will be identified as having backdated some of their option grants will be a much smaller figure.¹²

Nevertheless, the empirical evidence suggests that the number of companies having potential backdating problems (170+ as of November 2006) is likely to increase. Because of the large number of

option probes and limited resources, the SEC is relying on companies to self-report backdating discovered through the investigations of outside law firms. According to a recent *Wall Street Journal* article, the law firms are supposed to report their findings—and, in particular, especially egregious situations—to the SEC or federal prosecutors, who will then decide which cases to pursue further (Bandler and Scannell 2006). Because of the magnitude of the situation, the director of the SEC's enforcement division has indicated that the SEC will pursue enforcement only in those cases involving the worst conduct.¹³ We should also point out that, although we are convinced by the empirical evidence that the number of companies under suspicion for possible option backdating will continue to grow in the coming months, no one should immediately presume guilt just because a company is under investigation.

We also have some information on how costly it might be to investigate and fix problems arising from backdated grants. Mercury Interactive, which publicly disclosed its option-pricing problems in November 2005, recently revealed that it had spent more than \$70 million on legal fees and other related costs over the nine-month process of investigating and attempting to remedy its option-grant problems. In addition, as a consequence of its delisting for not being able to file financial statements on time, the company had to pay a \$7.1 million penalty to creditors together with granting an option to redeem the notes at a premium that would cost Mercury up to an additional \$40 million if exercised (Bandler and Forelle 2006). The expenses mentioned thus far exclude the costs of ongoing litigation and perhaps the largest and most difficult to quantify damages—namely, the injury to the company's reputation, the associated lack of confidence in management from the appearance of self-dealing, and the disruption in operations.

Although the expenses incurred by Mercury Interactive might be higher than expenses for the average company in the future, the costs of investigating and fixing backdating problems will clearly be material for many companies. In addition, these costs will be incurred at a time when the specter of significant governance and accounting problems will also make raising capital costly.

Fixing the Problem

Increased transparency combined with timely disclosure will certainly curtail the manipulation of option grant dates and restore investor confidence in the use of stock options as a form of compensation. The recent changes in reporting requirements

associated with SOX have substantially improved the transparency of executive compensation practices and removed some of the incentive and ability to manipulate option grant dates for personal gain. The research we have described shows that many individuals file late, however, and that companies can still backdate within the new two-day reporting window. Stronger enforcement by the SEC with regard to filing deadlines would probably reduce the opportunity for companies to backdate option grants for the benefit of executive officers. Furthermore, we have found that, although roughly half of the exercise prices equal the stock prices on the grant date, it is also common for the exercise prices to equal the stock prices on the prior day (and still be treated as at the money on the grant date) or to be linked in some other fashion to previous stock prices. Eliminating the use of stale prices for contracting purposes would make exploitation of recent price patterns impossible.

Two additional changes to the financial reporting and disclosure obligations for public companies will also affect the incentives or ability to backdate options. First, implementation of SFAS 123R, which requires the expensing of option grants at their fair values, is likely to influence the use of options as a means of compensation. Although the change will not alter the cash flows of a company, the accounting rules will no longer implicitly permit boards and compensation committees to disregard the value of options provided as compensation. As Hall and Murphy (2003) suggested, the historical failure to recognize the true "economic costs" of option grants for financial reporting purposes, when combined with the tax incentives created by Congress to shift compensation toward performance-based forms, has undoubtedly contributed to the widespread use and abuse of stock options. Ironically, many of the companies that successfully lobbied the Financial Accounting Standards Board and Congress for so long to prevent the immediate expensing of stock options according to fair value methods have now fallen under suspicion for backdating option grants (see "FASB Appears in a New Light on Stock Options" 2006).

Second, the SEC, in an attempt to improve transparency of executive compensation, has adopted significant changes to the executive compensation disclosure rules for the first time since 1992.¹⁴ While participants in the regulatory process were contemplating the changes, originally proposed in January 2006, the option-backdating scandal emerged and inspired the SEC to refine the disclosure obligations with regard to option grants. In addition to requiring companies to report the

SFAS 123R value of stock options for certain executive officers in the "Summary Compensation Table," the new rules, as adopted, also require a separate tabular disclosure of the company's option-granting practices. In that table, to be entitled "Grants of Plan-Based Awards Table," companies are required to disclose (1) the SFAS 123R grant date, (2) the closing market price on the grant date if greater than the option exercise price, (3) the date when the compensation committee or full board of directors took action to grant the option if that date is different from the grant date, and (4) a description of the methodology used to determine the exercise price if different from the closing market price per share on the date of the grant. The new rules also require a company to provide narrative discussion explaining its policies regarding the coordination of timing of option grants with the release of material nonpublic information. Without taking a position on the validity of such a plan or program and while acknowledging arguments on both sides of the issue, the SEC release expressly states that the information "would be material to shareholders and thus should be fully disclosed."

Ultimately, the responsibility to make sure that option grant practices are carried out in a manner that reflects the regulatory framework and shareholders' best interests resides with each company's board of directors. Boards need to demonstrate a better understanding than they have of the incentives provided by and the true costs associated with executive stock options and option-granting practices. The new SEC disclosure rules provide a board and/or compensation committee the opportunity to explain the company's policies for option grant timing and pricing to assure shareholders that options are not being abused in ways that either hide the true compensation or unfairly enrich executives at shareholders' expense. Companies that have either backdated option grants or coordinated the release of information to the benefit of option recipients have been effectively encouraged by the SEC to come clean and provide a rationale for this behavior.

For their part, shareholders play a significant role in their capacity as owners and external monitors. Investors need accurate and complete disclosure of compensation packages for executive officers in order to evaluate the effectiveness of the board of directors in representing shareholder interests. Shareholders can and should demand that the board negotiate on behalf of them, the owners, in setting the level and structure of compensation for executives through an arm's-length process. In the absence of such negotiation, investors should demand an explanation from the board of directors and consider measures to replace board

members—through the proxy voting process, where possible. Such efforts in the context of alleged option-backdating cases are already under way by the California Public Employees' Retirement System, Minnesota's Board of Investment, the AFL-CIO, the Council of Institutional Investors,

and others.¹⁵ The upcoming proxy season will allow all investors the opportunity to examine whether the stock price patterns around the time of option grants persist under the additional scrutiny.

This article qualifies for 0.5 PD credit.

Notes

1. Acceptable option-pricing methodologies include the Black-Scholes option-pricing model and a binomial pricing model.
2. The wording in the stock option plans of numerous companies can be found at <http://contracts.onecle.com/type/42.shtml>.
3. For more information, see the 6 September 2006 testimony of Linda Thomsen, director of the SEC's Division of Enforcement, before the U.S. Senate Committee on Finance (available at www.sec.gov/news/testimony/2006/ts090606lt.htm).
4. According to Hall and Murphy (2003), the observed structural changes in executive compensation began in the late 1980s.
5. Options granted to executives that were in the money were subject to the 162(m) limitation.
6. The intrinsic value method was put forth in 1972 in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*.
7. The ExecuComp database comprises companies that are currently in the S&P 1500 Composite Index or have been in the S&P 1500 at some time during the sample period.
8. Scheduled grants are grants that are "scheduled to occur" on a specific date. Because it is impossible to precisely identify scheduled grants in large-sample studies, most researchers have attempted to classify grants as being scheduled on the basis of whether they occurred at a similar time in previous years. Aboody and Kasznik (2000) defined grants as scheduled if the grants occurred within one week of the one-year anniversary of a prior grant date. Lie (2005) and Heron and Lie (2006, 2007) used a tighter window, one day, to classify grants as scheduled because of the evidence in Lie (2005) showing that favorable return patterns were not discernible when a one-day window was used to classify grants as scheduled.
9. The Heron and Lie (2007) study was accepted for publication in 2005. In a contemporaneous study, Narayanan and Seyhun (2005) used a similar logic but focused on the pre-SOX period when virtually all grants were filed with a long lag. The average reporting lag in their sample was 170 days. Because the cutoff for their subsample with the shortest lags was as much as 25 days, backdating could have occurred extensively even in this subsample. Thus, their analysis did not disentangle the effect of backdating on observed return patterns relative to other explanations.
10. Although the favorable return patterns reemerge in the sample of grants that were filed late in the post-SOX period, suggesting that many of the grants that were filed after the reporting deadline were backdated, one should not infer that all grants that were filed late or with a substantial lag (pre-SOX) were backdated. Clearly, many of the late filings were the unintentional results of simple administrative glitches or oversights.
11. Note that backdating a spring-loaded grant would ensure that the gains from a favorable news announcement were actually realized, rather than simply anticipated. As we pointed out earlier, the evidence suggests that the majority of spring-loaded grants were also backdated.
12. The reasons Heron and Lie (2006) pointed to include weak circumstantial evidence in many situations.
13. See the transcript of the 30 October 2006 speech by Thomsen, "Options Backdating: The Enforcement Perspective" (available at www.sec.gov).
14. See SEC Release Nos. 33-8732A and 34-54302A (29 August 2006): www.sec.gov.
15. See the Institutional Shareholder Services' publication titled "An Investor Guide to the Stock Option Timing Scandal" for more detail (available at www.issproxy.com/pdf/OptionTiming.pdf).

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