

Stock Option Backdating Webinar



Porter, Wright, Morris & Arthur LLP

Thomas O. Gorman

Robert J. Tannous

www.SECActions.com

SEPTEMBER 2006

Backdating: What It Is

- Stock Option Backdating – What is it?

- A stock option gives executives the right to buy future shares at a current price
- Stock option backdating occurs when the grant date of the stock option is earlier than the date on which the grant is actually made
- Types:
 - ***“In the Money”*** – when exercising an option would generate a profit
 - ***“Springloading”*** – grant prior to disclosure of good news
 - ***“Bullet Dodging”*** – grant after announcement of bad news

Impact

- Can result in violations of securities laws, accounting standards, and other laws
- Backdating is NOT necessarily illegal
 - As SEC Commissioner Paul Atkins commented in a July 6, 2006 speech: “[b]ackdating of options sounds bad, but the mere fact that options were backdated does not mean that the securities laws were violated.”

Impact

- Backdating is not illegal if:
 - Documented properly
 - Communicated to shareholders
 - Accounted for properly: income
 - Accounted for properly: taxes

Investigations

- Widespread coast to coast
- Current investigations (as of 8/29/06):
 - SEC: 76 publicly disclosed
 - DOJ: 47 publicly disclosed
 - Internal investigations: 102 publicly disclosed
 - 37 companies have disclosed restatements

Government Oversight

- Congress involved:
- Holding two separate hearings on stock option timing
 - On September 6, 2006, the Senate Finance Committee held a hearing – Committee's Chair, Senator Grassley (R-Iowa), argued for Congress to change the tax laws to tackle backdating
 - The Senate Banking Committee also plans to hold a hearing on option timing issues in the near future

Origins

- First noted by David Yermack of NYU and Erik Lie of University of Iowa
 - Lie studied 5,977 option grants between 1992 and 2002
 - Believes that at least 10% of all US corporate stock options were backdated
- Height of the dot-com boom
- SOX
- Mercury Interactive Corp. announced in July 2005 an internal investigation in concert with SEC informal probe
- WSJ - Authorities Probe Improper Backdating of Options – Practice Allows Executives To Bolster Their Stock Gains; A Highly Beneficial Pattern, by Mark Maremont (Nov. 11, 2005)

Potential Issues

- Disclosure / Reporting Issues
 - Enforcement actions
 - Criminal and civil liability
 - Class action and derivative litigation
- Accounting Issues
 - Restatement of financial statements
 - SOX Internal Controls Compliance
 - Concealing information from auditors

Potential Issues

- SOX Certification Issues
 - Personal liability
- Tax Law Issues
 - Company → loss of deduction, penalties and interest
 - Individual → acceleration of tax obligation, 409A excise tax, penalties and interest

Potential Issues

- **D&O Insurance Issues**
 - Loss of coverage
 - Higher premiums or inability to renew
- **Investor Relations Issues**
 - Negative publicity
 - Loss of name and/or brand
 - Loss of value

Who is at Risk?

- The Company:
 - *SEC – Civil Enforcement Actions*
 - *DOJ – Criminal Enforcement Actions*
 - *FBI – Investigations*
 - *IRS – Civil and Criminal Enforcement Investigations*
 - *Class Actions (8 as of June 2006)*
 - *Derivative Actions*

Who is at Risk?

- Individuals:
 - Corporate Capacity
 - Directors
 - SEC Commissioner Roel Campos: "If the facts permit, and I want to emphasize that all our enforcement cases are very fact-specific, it wouldn't surprise me to see charges brought against outside directors."
 - Executives, "Gate Keepers"
 - Attorneys
 - Accountants
 - Restatement affects: remit bonuses, false certifications, etc.
 - Individual Capacity
 - Persons who received backdated options

Enforcement Actions

- Brocade Communications Systems, Inc
 - July 20, 2006, the SEC and U.S. Attorney N.D.Cal. filed civil and criminal charges:
 - Against the former CEO, President and Chairman
 - Former VP of Human Resources
 - Alleging several instances of:
 - Backdating options
 - Falsification of books and records to conceal their actions from auditors, shareholders and the public

Enforcement Actions (cont.)

- Comverse Technology, Inc.:
 - On August 9, 2006, the SEC and DOJ filed civil and criminal charges against:
 - Former Chairman and EIC; Former General Counsel; and Former CFO
 - Board's Compensation Committee approved most of the grants; backdated and "in the money"
 - Phantom employees
 - Cover up and falsification of books and records
 - Restatement

Enforcement Actions (cont.)

- Mercury Interactive
 - On July 3, 2006, Mercury announced that the SEC informed Mercury that it may recommend civil enforcement proceedings against three Mercury directors
 - Alleging the directors knew or should have known about the manipulation of option grant dates
- Others on the way

What Companies Should Do

- Do not backdate grants
- Adopt “Best Practices”
 - Have a clearly defined approval process for all grants
 - Have a clearly defined approval process for extraordinary grants
 - Minimize extraordinary grants

What Companies Should Do

- Adopt “Best Practices” (cont.)
 - Approve all grants in writing
 - Avoid making grants pursuant to unanimous consent actions
 - Reconcile records with written approvals of grants
 - Avoid delegation of authority to make grants

What Companies Should Do

- Adopt “Best Practices” (cont.)
 - If unavoidable, have clearly defined grant authority for executives
 - Establish set schedules for approving grants
 - Provide Section 16 Reporting Persons with advance notice of grants
 - Avoid modifying outstanding grants

What Companies Should Do

- Adopt “Best Practices” (cont.)
 - Complete grant documentation in a timely manner
 - Periodically audit grant guidelines and procedures
- Examine grant history and practices with counsel

What Companies Should Do

- Consider modifying subcertifications to CEO and CFO certifications
- Prepare to disclose
 - Impact of new SEC Executive Compensation Rules
- Be diligent and proactive

Conclusion

- Expanding scandal
 - Continues to grow daily
 - WSJ: Options Scorecard daily update
- Today's hot topic
 - No end in sight
- Prudent action
 - Carefully review option grants



Questions?